

# BALANCING THE RELATIONSHIP BETWEEN THE UNION AND MEMBER STATES THROUGH THE MARKET PROCESS

NUNO ALBUQUERQUE MATOS\*

*There are mainly two paths to fiscal discipline within a federation or within a monetary union: either through markets or through hierarchy. By establishing the no-bailout clause, the Stability and Growth Pact and the Excessive Deficit Procedure, it was thought that the Maastricht Treaty had chosen market mechanisms to achieve that objective. However, the financial crisis showed the severe shortcomings of the model, marking a shift towards surveillance. This article argues that such failure was not due to the market mechanism but by flawed institutional choices. By establishing a procedure for fiscal adjustment, Member States cast doubt on the credibility of the no-bail out clause and took matters into the political realm. As a result, the political process was at the forefront since inception. There are several ways to deliver a certain social goal. Accordingly, goal choice and institutional choice are inextricably linked because it is the institutional choice which connects goals with their legal or public policy results. Importantly, to choose the best avenue comparative institutional analysis needs to be conducted. After briefly considering the political process, this article purports that other processes should be fully explored. When addressing the financial crisis in multi-level governance, some alternatives have already been employed: state default and supranational bailout. Within the EMU, no State has defaulted on its debt obligations prior to receiving a bailout. However, there is room to explore an option that would be based on market mechanisms with judicial elements while reducing dependence on the political process in the long-term: allowing Member States to orderly default on their debts. The article discusses its main problems, constitutional admissibility and democratic necessity.*

## 1 INTRODUCTION

One very important question loomed while setting up the Economic and Monetary union (EMU) in the European Union (EU or Union): whether and how different Member States, with very diverse economic structures, would adjust, endure and thrive under a common currency.

To achieve a positive outcome, the Maastricht consensus was based on the principle of market pressure. In essence, it conveys the idea that Member States without monetary policy autonomy should rely solely on fiscal policy for public debt management.<sup>1</sup> Crucially, members of a monetary union issue government debt in a currency they do not control and, as a consequence, cannot always guarantee repayment to bondholders. On the contrary, countries not participating in a monetary union can provide a higher degree of trust because they have their own central banks. This contrast creates a situation where a liquidity crisis can occur within a monetary union and, because such a crisis leads to significant increases in the interest rate on public debt, it may result in default. Given this framework, countries

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\* PhD candidate, Católica Research Centre for the Future of Law, Universidade Católica Portuguesa, Lisbon.

<sup>1</sup> Fabian Amtenbrink, 'Economic and Monetary Union' in Pieter Jan Kuijper et al (eds), *The Law of the European Union* (5th edn, Wolters Kluwer 2019) 883, 906.

should be provided with an incentive to maintain their debt at manageable levels, since otherwise markets would signal this by raising interest rates on bonds.

Hence, market pressure was translated into a no-bail out clause and the adoption of several public finance instruments, such as the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP). Observance of these instruments would be entrusted to the European Commission (Commission) and, ultimately, sanctions would be decided by the Council of the European Union (Council).

Nevertheless, the intensity of macroeconomic instability and asset overvaluation in years of economic prosperity as well as excessive austerity in years of economic recession has brought about scepticism regarding the role of the market.<sup>2</sup> While before the crisis markets did not flag risk potentially emanating from peripheral countries' sovereign debt, after the crisis they exaggerated risks dramatically, which is referred to as a failure of the market.<sup>3</sup>

While there is support for the understanding that market failure is a major cause of instability in European economic integration, the view purported here is that, on the contrary, it is a symptom of flawed institutional choices. At the outset, the existence of a procedure to require Member States to perform fiscal adjustments in the event of the excessive debts or deficits, in fact, casts doubt on the credibility of the no-bail out clause, as excessive debt accumulation is only a problem if there is a reason to expect that ensuing difficulties will be resolved through a bailout.<sup>4</sup>

Moreover, when the SGP was not enforced after its initial breach, neither by Member States<sup>5</sup> nor by the Court,<sup>6</sup> it sent a dual signal to both the market and the individual Member States. On the one hand, that fiscal discipline was not as highly valued a feature as previously assumed and, implicitly, a perception of bailout began to develop. On the other hand, the largest Member States had the political power to circumvent the rules, while smaller countries engaged in creative accounting without facing punishment. These actions inadvertently undermined market discipline. How could a bailout be ruled out if it was politically

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<sup>2</sup> Paul de Grauwe and Yuemei Ji, 'Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone' (2012) 50 *Journal of Common Market Studies* 866, 877.

<sup>3</sup> *ibid.* See also Olli Rehn, 'Economic Governance in a Changing Union: Fiscal Rules and Market Discipline in the Euro Area' in Koen Lenaerts et al (eds), *An Ever-Changing Union? Perspectives on the Future of EU Law in Honour of Allan Rosas* (2020) 83, 86-89, where the author indicates his view that markets have been trusted too much to deliver discipline on their own.

<sup>4</sup> Barry Eichengreen and Jürgen Von Hagen, 'Fiscal Restrictions and Monetary Union: Rationales, Repercussions, Reforms' (1996) 23 *Empirica* 3, 15.

<sup>5</sup> The first breach took place in 2003 by France and Germany. However, strict implementation of the SGP was blocked by some Member States, which led to the first revision of the Pact. On this see Antonio Estella, *Legal Foundations of EU Economic Governance* (Cambridge University Press 2018) 134. But this was not the first breach of the Pact, as it also occurred at least in 2014 and 2016. In this vein see Roger Kelemen, 'Commitment for Cowards: Why Judicialization of Austerity Is Bad Policy and Even Worse Politics' in Tom Ginsburg, Mark D Rosen, and Georg Vanberg (eds), *Constitutions in Times of Financial Crisis* (Cambridge University Press 2019) 157. Criticising the Court as a promoter of the ensuing fiscal indiscipline, see Gavin Barrett, 'The Role of Courts in the Eurozone' in Martin Belov (ed), *Judicial Dialogue* (Eleven International Publishing 2019) 127, 129. However, the author also states that budget discipline is often an area of high political salience and controversy, which can seldom be resolved with legal decisions.

<sup>6</sup> Case C-27/04 *Commission of the European Communities v Council of the European Union* EU:C:2004:436.

impossible to enforce the rules put in place to prevent it? Hence, institutional failure occurred.<sup>7</sup>

In turn, the development of this understanding of the market process led to institutional failure resulting in failure of institutional choice. Indeed, the evolution of the economic governance framework towards a surveillance paradigm, including the adoption of the six-pack, two-pack or the Treaty on Stability, Coordination and Governance has imposed extensively detailed constraints. Arguably, these constraints evolved into a dysfunctional process.<sup>8</sup>

Crucially, the fact that Member States have their overall budgets reviewed by the Commission and their fellow Member States in the Council exacerbates the problem. In fact, if Member States experience economic and financial hardship, they may be tempted to shift the blame to EU institutions. These institutions, in turn, will be seen as co-responsible for economic instability and potential collapse, thus increasing the likelihood of a bailout. In short, this reinforces the supranational political process as the prominent one in delivering fiscal and financial stability, indicating a certain level of co-responsibility.

Hence, this article will focus on how to achieve balance between the Union and the Member States through the market process, specifically by creating a legal framework for sovereign debt restructuring. Although this pillar would not act in isolation, it is nevertheless an essential component in the *iure condendo* process that could be designated as the horizontalisation of EU integration, considering the increased participation of different institutional actors and the detachment of the political process it would foster.

The present article is structured as follows: in section 2, a brief comparative institutional analysis will be performed and the importance of the market process, particularly regarding sovereign debt restructuring in general, will be highlighted. Section 3 will address the main challenges, usually associated with a debt restructuring framework, specifically concerning collective action, Member States' autonomy, moral hazard, and financial issues. Section 4 will reflect on the admissibility of such a procedure from a constitutional perspective, namely the EU Treaties and, lastly, section 5 on the democratic necessity.

## 2 BRIEF COMPARATIVE INSTITUTIONAL ANALYSIS AND IMPORTANCE OF SOVEREIGN DEBT RESTRUCTURING

The 2008 financial crisis marked a significant shift in the EU from a market-based into a surveillance paradigm. In essence, this shift implies that economic intermediation is no longer primarily based on market mechanisms but instead is concentrated in the political process.

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<sup>7</sup> Jonathan Rodden, 'Market Discipline and U.S. Federalism' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 130. The author points out that the Brazilian and Argentine federal systems also had elaborated procedures for monitoring and regulating the debts of states and provinces. Unfortunately, however, these regulations and procedures were undermined by the politics of federalism. In Brazil, for instance, the Senate was responsible for approving and regulating the borrowing of states, and representatives of insolvent states found that approval for unsustainable borrowing was relatively easy to obtain as part of the game of legislative horse trading. Similar to the Eurozone, if officials found it politically impossible to sanction São Paulo for its dubious loans from state-owned banks, how could they possibly gather political support to allow it to default?

<sup>8</sup> Christian Joerges, 'Pereat Iustitia, Fiat Mundus: What Is Left of the European Economic Constitution after the Gauweiler Litigation?' (2016) 23 Maastricht Journal of European and Comparative Law 99, 113.

In economic policy matters, this shift has brought about changes in the relationship dynamic between supranational and national authorities. The dependency from the former has grown steadily since the surveillance framework was set up as a response to the financial crisis. This dependence is evident in several ways: direct provision of financial assistance to Member States, indirect support for maintaining affordable interest rates in the bond market and the growing reliance of EU regional policy in public investment in various countries. These developments have been accompanied by legal changes that impose stricter restrictions and monitoring of public finances. However, there has been only modest progress in reducing debt as some Member States have exceeded the maximum allowed debt-to-GDP threshold by more than double.

At the same time, the judiciary has a limited role in enforcing public finance restrictions.<sup>9</sup> In fact, the opposite often holds true, as courts rarely have the required expertise or the necessary tools to comprehensively evaluate all the implications that decisions regarding debt and deficits involve: both the market and the political processes are better equipped to handle this task, given their access to experts who support the decision-making process.

Furthermore, budgetary decisions hold an inherent political nature. They often reflect the views of a majority at a particular point in time. Therefore, it is exceedingly challenging for the judiciary to incorporate this diversity to legal proceedings, at least not without significantly increasing the costs of the procedure, either by requiring more witnesses, hiring of experts to provide advice or by extending the time needed to reach a decision. These factors may explain why courts tend to defer to political institutions.<sup>10</sup> They do so because they may struggle to produce high-quality results, especially in complex situations such as evaluating public budgets and economic contexts.

When addressing the financial crisis in the context of multi-level governance, some alternatives have been employed: state default and supranational bailout. However, within the EMU, no State has defaulted on its debt obligations prior to receiving a bail-out.

Nevertheless, these are not the only alternatives to consider. There is room to explore another option, which would blend market and judicial elements while reducing dependence on the political process in the long-term: allowing Member States to orderly default on their debts. Such an option would yield three essential outcomes. Firstly, since a significant portion of the current EU economic governance framework would become obsolete, States would regain autonomy in defining their own economic and fiscal policies, thereby restoring democratic legitimacy. Secondly, fiscal responsibility would be integrated into the market process, increasing participation from actors beyond Member State governments and reducing inter-State politicisation of internal issues. Thirdly, as a result of these two mentioned outcomes, the fiscal choices and consequences of States would become an internal matter and largely cease to be a topic of an EU-wide discussion. Importantly, the

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<sup>9</sup> In this vein see David Skeel, 'Institutional Choice in an Economic Crisis' (2013) 2 *Wisconsin Law Review* 629, 638. More generally see Neil Komesar, *Imperfect Alternatives: Choosing Institutions in Law, Economics and Public Policy* (The University of Chicago Press 1997) 53, arguing courts' capacity is limited and that the costs of participation in the judicial process are high.

<sup>10</sup> Carlos Aymerich, 'Challenging Austerity before European Courts' in Anusheh Farahat and Xabier Arzo (eds), *Contesting Austerity: A Socio-Legal Inquiry* (Hart Publishing 2021) 99; Cesare Pinelli, 'Are Courts Engaged in a "Dialogue" on Financial Matters?' in Martin Belov (ed), *Judicial Dialogue* (Eleven International Publishing 2019) 111.

establishment of a proper legal framework for fiscal responsibility would help rebuild inter-State trust.

Bankruptcy procedures are typically designed for companies, although they have also been applied to local and municipal governments.<sup>11</sup> Currently, there are no bankruptcy procedure in place for sovereign entities, whether unitary or federal states (including at sub-national level). Sovereign debtors are both uniquely vulnerable to, and uniquely shielded against, creditors' legal remedies. Unlike corporate bankruptcy procedures, there are no laws that would protect an overindebted sovereign borrower from legal actions by creditors in the event of non-compliance with payment obligations. Simultaneously, there is no orderly, court-supervised procedure in place to reorganize a sovereign entity's financial affairs. As a result, when it comes to debt instruments, especially those governed by foreign law, there are two alternatives:<sup>12</sup> either pay the debt according to its contractual terms or face enforcement action.

Nonetheless, the strength of creditors is also their weakness. Sovereigns can be held accountable when engaging in commercial activities outside their borders, either by adhering to the restrictive theory of sovereign immunity or by including a waiver of sovereign immunity in bond contracts. This waiver secures the sovereign's consent to foreign jurisdiction and judgment enforcement proceedings. However, sovereigns often have limited assets abroad,<sup>13</sup> with a significant portion held by central banks, which are typically considered as separate legal entities and are usually inaccessible for satisfying creditor's claims.<sup>14</sup> From an international law perspective, general bankruptcy principles and outcomes, such as the 'no creditor worse off principle', cannot be applied because states are not subject to liquidation.<sup>15</sup> Additionally, sovereigns enjoy protection from governance constraints that could be imposed during a bankruptcy procedure, as there can be no insolvency court or

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<sup>11</sup> For instance, in the US, the first federal municipal bankruptcy statute was passed in 1933, whereby municipalities were permitted to negotiate settlements of their debts with their creditors. Once a settlement was approved by a certain percentage of the creditors (seventy-five percent) it could be imposed on the minority. As for the courts, they did not have jurisdiction or control over the municipalities governing powers. However, they were required to determine the plan's fairness and equitability. Currently, it is regulated under chapter 9 of the US bankruptcy law. No such legal framework exists at EU-level.

In Portugal, the law on the finances of local municipality and inter-municipality (Law No 73/2013) establishes a mechanism for municipal financial prevention and recovery, every time the legally establish debt level is overcome. Financial recovery procedures may be mandatory or voluntary, depending of the level of financial imbalance. As a general rule, the State cannot assume responsibility for the obligations of municipalities, nor can it assume the commitments arising from them. Although the procedure does not allow for debt restructuring, it does hinder access to budgetary funds which would otherwise be spent by municipalities. In any case, there is certainty that financing will occur from the national government and, as such, shields them from market forces' deterrent effect.

<sup>12</sup> In the case of domestic-law governed bonds, there is a possibility of imposing a particular solution, for instance by legislative fiat. This was the case in Greece which, in 2012, in the midst of its debt restructuring, passed a law imposing collective action clauses in all local law bonds, with retroactive effects. See Jeromin Zettelmeyer, Christoph Trebesch, and G Mitu Gulati, 'Managing Holdouts: The Case of the 2012 Greek Exchange' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 25.

<sup>13</sup> Rosa Maria Lastra, 'How to Fill the International Law Lacunae in Sovereign Insolvency in European Union Law?' *ESCB Legal Conference 2016* (European Central Bank 2017) 56, 57.

<sup>14</sup> Lee Buchheit and Elena Daly, 'Minimizing Holdout Creditors: Carrots' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 3; See also Robert Kolb, 'Sovereign Debt: Theory, Defaults, and Sanctions' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 3.

<sup>15</sup> Steven Schwarcz, 'A Minimalist Approach to State "Bankruptcy"' (2011) 59 *UCLA Law Review* 324, 335.

other bodies determining policy choices. However, it is worth noting that this notion has somewhat evolved, especially during the eurozone crisis.<sup>16</sup>

Despite these advantages, this solution is often met with scepticism. In fact, critics typically highlight several challenges. In the following section, some of the most significant challenges in the context of the EMU's current institutional framework will be addressed.

### 3 MAIN CHALLENGES

#### 3.1 ISSUES RELATED TO COLLECTIVE ACTION

While most sovereign entities adhere to their debt obligations, there are instances when they find themselves unable to service their bonds. In such cases they typically engage with their creditors to negotiate an agreement. Ideally, financial terms of the settlements will be favourable to the debtor, often in the form of debt relief. Conversely, this increases the likelihood of compliance, improving the creditor's prospects for repayment when the obligations are due.

However, what if one or a few creditors disagree with the terms agreed upon by the majority of creditors, and refuse to give their consent to bond exchange? This issue is generally referred as the 'holdout problem'. These creditors can create two sets of issues. First, in the absence of provisions (of contractual or legislative nature) stating otherwise, a deadlock situation can emerge, whereby any modification to the bond can only be successful if consent is granted by every bondholder. Veto power is, therefore, granted to all of them, thereby creating the conditions for minoritarian bias, that is, a minority (or only one, for that matter) may prevent a situation generally favourable and agreed to by the (large) majority.

Secondly, it may foster a 'rush to the exit', which means that some creditors may resort to enforcement action sooner rather than later, in an effort to recover the full value of their bonds instead of being faced with a settlement subsequently negotiated by the majority of creditors. And, by doing so, the other bondholders may find themselves with fewer options.<sup>17</sup>

In essence, there are two main avenues to devise State restructuring: the institutional and the contractual way.

##### *3.1[a] Procedure-based State restructuring*

The institutional approach involves establishing a well-defined legal procedure.<sup>18</sup> Notably, Adam Smith recognised the necessity for such a method. In his words, '[w]hen it becomes necessary for a State to declare itself bankrupt, in the same manner as when it becomes

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<sup>16</sup> For an overview, see Menelaos Markakis, *Accountability in the Economic and Monetary Union: Foundations, Policy and Governance* (Oxford University Press 2020).

<sup>17</sup> David Billington, 'European Collective Action Clauses' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 399, 400.

<sup>18</sup> This procedure has been labelled as 'statutory' or 'restructuring mechanism', which entails a supranational administrative body (either the IMF or some other) to manage the process. However, as the term procedure-based is preferred here, in order to capture the idea of a structured, open and transparent process, regardless of the managerial body and its legal nature.

necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least harmful for the creditor'.<sup>19</sup>

While a procedure-based approach has not yet been fully implemented, several proposals have emerged with many drawn inspirations from US bankruptcy laws, specifically chapter 9 (pertaining to municipalities) or chapter 11 (concerning corporations). These proposals often aim to achieve a few key objectives: allowing for a temporary halt on creditor claims, resolve holdout issues by bolstering creditor coordination and establishing a mechanism, which permits new funding during the restructuring process and after it.

The earliest attempt to create a formal mechanism goes back to 1979, when a group of developing countries proposed the formation of an international debt commission, which was responsible for addressing various emerging crises. Despite never coming to fruition, due to opposition from creditor countries and lack of authority to enforce binding decisions, some of its objectives remain relevant. These include debt reorganisation, party coordination, appointment of a neutral arbiter or mediator as well the facilitation of raising new financing.<sup>20</sup>

Following the debt crises of the 1980s, there was a growing interest in extending some type of bankruptcy protection to sovereign States. In this context, in 1981, Christopher Oechsli proposed a procedure analogous to chapter 11 of US bankruptcy code. Oechsli argued that many of the procedures outlined in chapter 11 could be applied to renegotiation of debt in less developed countries. These procedures included the establishment of a creditor committee, an independent examiner, a monitoring party, which does not take control of the debtor's business, and a formal initiation procedure. Oechsli emphasized that the IMF could be entrusted with monitoring but stressed the importance of including debtors in the formulation of a restructuring plan. Regarding the initiation procedure, it should be triggered by both creditors or debtors, although creditors and the IMF may not necessarily accept the debtor petition.<sup>21</sup>

Debevoise adds to Oechsli's proposal by suggesting that Article VIII (2) (b) of the IMF's Articles of Agreement grants the authority to order a stay on collection of debt.<sup>22</sup> This interpretation would indeed enable the IMF to issue a payment standstill decision with broad implications.

In 1995, Jeffrey Sachs made an influential contribution, which would shape many subsequent proposals, arguing the IMF transitioning from being primarily an international lender of last resort to more of a bankruptcy court. Sachs contended that due to the nature of the IMF lending 'taxpayer dollars', it was exceedingly cautious about providing funds in risky circumstances. However, he pointed out that extreme crises involve risks.

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<sup>19</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (The Electronic Classics Series 2005) 770.

<sup>20</sup> Kenneth Rogoff and Jeromin Zettelmeyer, 'Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001' (2002) IMF Staff Papers 49(3), 472 <<https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Bankruptcy-Procedures-for-Sovereigns-A-History-of-Ideas-1976-2001-15993>> accessed 10 December 2023

<sup>21</sup> Christopher Oechsli, 'Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act' (1981) 21 Virginia Journal of International Law 305.

<sup>22</sup> Whitney Debevoise, 'Exchange Controls and External Indebtedness: A Modest Proposal for a Deferral Mechanism Employing the Bretton Woods Concepts' (1984) 7 Houston Journal of International Law 157.

Consequently, IMF loans tended to be insufficient and often arrived late. By the time these loans were disbursed, the government might have already lost control of the situation.<sup>23</sup>

This led to the well-known Sovereign Debt Restructuring Mechanism (SDRM) proposal by Anne Krueger, who was acting as first deputy managing director of the IMF, in 2001.<sup>24</sup> The author presented this tool as a ‘catalyst’ to encourage debtors and creditors to negotiate unsustainable debt restructuring in a timely and efficient manner, as long as these negotiations were conducted in good faith and led to policies capable of preventing similar problems from arising in the future. In return, the debtor country would be granted legal protection from creditors opposing restructuring. In Krueger’s view,

[t]he mere knowledge that such a framework was in place should encourage debtors and creditors to reach agreement of their own accord. Our model is one of a domestic bankruptcy court, but for a number of reasons it could not operate exactly like that. It is better to think of it as an international workout mechanism.<sup>25</sup>

According to Rogoff and Zettelmeyer, this proposal is welcome on two fronts: motivation and good behaviour incentives.<sup>26</sup> Concerning motivation, the IMF’s unilateral standstill procedure is a suitable mechanism to address liquidity crises, debt crises and emphasize bailout implications on moral hazard. Regarding behaviour incentives, it explicitly references debtor good faith as a critical issue, in line with the US Bankruptcy Code, Chapter 11 (Section 1123), which links it to the principle of necessity, meaning that the debtor shall not seek debt reduction beyond what is necessary to establish medium-term debt sustainability.

In 2016, Guzman and Stiglitz proposed a Soft Law Mechanism for Sovereign Debt Restructuring.<sup>27</sup> This mechanism was based on nine UN principles on Sovereign Debt Restructuring processes, which were approved by the UN General Assembly in September 2015.<sup>28</sup> The proposed mechanism recognised that the sovereign states must have the right to determine their policies, in alignment with their objectives, including the right to

<sup>23</sup> Jeffrey Sachs, ‘Do We Need an International Lender of Last Resort’ (1995) *Frank D. Graham Lecture at Princeton University*, 14 <<https://www.jeffsachs.org/newspaper-articles/rnscc4pw7ep45shcf835rm8652tftpt>> accessed 10 December 2023.

<sup>24</sup> Anne Krueger, ‘A New Approach to Sovereign Debt Restructuring - Address by Anne Krueger, First Deputy Managing Director, IMF’ (26 November 2001) <<https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp112601>> accessed 10 December 2023; Anne Krueger, ‘A New Approach To Sovereign Debt Restructuring’ (2002) <<https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf>> accessed 10 December 2023. For a detailed analysis of SDRM, see Rodrigo Olivares-Caminal, ‘Statutory Sovereign Debt Resolution Mechanisms’ in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 333.

<sup>25</sup> Krueger, ‘A New Approach to Sovereign Debt Restructuring - Address by Anne Krueger’ (n 24).

<sup>26</sup> Rogoff and Zettelmeyer (n 20) 490.

<sup>27</sup> Martin Guzman and Joseph Stiglitz, ‘A Soft Law Mechanism for Sovereign Debt Restructuring: Based on UN Principles’ (2016 Friedrich Ebert Stiftung) <<https://library.fes.de/pdf-files/iez/12873.pdf>> accessed 10 December 2023. Similar features have been proposed by Kathrin Berensmann and Angélique Herzberg, ‘An Insolvency Procedure for Sovereign States: A Viable Instrument for Preventing and Resolving Debt Crises?’ in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 379. For an analysis, see Giuseppe Bianco, *Restructuring Sovereign Debt: Private Creditors and International Law* (University of Oslo: Faculty of Law 2018).

<sup>28</sup> United Nations, ‘Resolution Adopted by the General Assembly on 10 September 2015’ (2015) <<https://digitallibrary.un.org/record/804641>> accessed 10 December 2023. This was preceded by United Nations, ‘Resolution Adopted by the General Assembly on 9 September 2014’ (2014) <<https://documents-dds-ny.un.org/doc/UNDOC/GEN/N14/530/05/PDF/N1453005.pdf?OpenElement>> accessed 10 December 2023.



decide whether to restructure their debt (sovereignty principle). However, a duty to negotiate in good faith would apply to both debtor and creditors when the sovereign's debt position becomes unsustainable (good faith principle), with the goal of restoring sustainability (sustainability principle). This duty also includes the obligation to disclose potential conflicts of interest, which could undermine the outcome of a restructuring process, such as holding credit default swaps (transparency principle). Creditors should be treated impartially, independently (impartiality principle) and in a non-discriminatory manner (equitable treatment principle), while debtors should be protected under the principle of international law, which states that no country can renounce its immunity (sovereign immunity principle). Importantly, all aspects of the restructuring procedure, including its institutions and operations, should adhere to requirements of inclusiveness and the rule of law (legitimacy principle). Lastly, sovereign debt restructuring agreements, which are approved by a qualified majority of creditors should not be affected by a minority of creditors, who must respect the decisions adopted by the majority. To achieve this, the UN encourages states to include Collective Action Clauses (CAC) in their sovereign debt issuances (majority restructuring principle).

Plans for an EU mechanism have also been proposed. The creation of a European Sovereign Debt Mechanism, similar to Anne Kruger's proposal, has been suggested.<sup>29</sup> Other proposals, based on the ESM, have also been developed by the Committee on International Economics and Policy Reform<sup>30</sup> and the German Council of Economic Experts.<sup>31</sup> The former proposes amending the ESMT to (i) condition ESM lending on certain debt thresholds and (ii) prevent holdouts in ESM-sanctioned debt restructurings from enforcing their claims through European courts. At the same time, 'both the restructuring country and "innocent bystanders" would need to have access to ESM lending to deal with the fallout of a restructuring'.<sup>32</sup> The latter is based on maturity extensions to address liquidity crises and, if necessary, significant debt restructuring when solvency issues are involved. Significantly, it assigns the ESM the task of assessing and imposing the terms of a sovereign debt restructuring.

### 3.1[b] *Collective actions clauses*

A CAC is a contractual provision in the multi-creditor debt instrument, which allows the majority of bondholders to agree to the modification of the contract, including payment

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<sup>29</sup> Bettina Nunner-Krautgasser, 'The Importance of Being Prepared: A Call for a European Sovereign Debt Restructuring Mechanism' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (C.H. Beck 2014) 241; Daniella Strik, 'Investment Protection of Sovereign Debt and Its Implications on the Future of Investment Law in the EU' (2012) 29 *Journal of International Arbitration* 183.

<sup>30</sup> Lee Buchheit et al, 'Revisiting Sovereign Bankruptcy: Committee on International Economic Policy and Reform' (October 2013) <[https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5904&context=faculty\\_scholarship](https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5904&context=faculty_scholarship)> accessed 10 December 2023.

<sup>31</sup> Jochen Andritzky et al, 'A Mechanism to Regulate Sovereign Debt Restructuring in the Euro Area' (2016) Working Paper 04/2016 <[https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier\\_04\\_2016.pdf](https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_04_2016.pdf)> accessed 10 December 2023.

<sup>32</sup> Buchheit et al (n 30) 35.

terms, provided that a certain threshold is met.<sup>33</sup> The most significant consequence of this provision is that the decision becomes binding on the dissenting minority.<sup>34</sup> In this regard, CACs serve a dual purpose: firstly, they facilitate sovereign debt restructuring and, secondly, they require investors to share the costs of borrowers' financial distress to thus reducing the burden on taxpayers.

Collective actions clauses have been promoted since 1995 by academics and public officials.<sup>35</sup> However, due to resistance from both creditors and borrowers, it was not until 2003 that they began to be widely adopted.<sup>36</sup> The shift occurred with the US Treasury initiative to include CACs in bonds issued under New York Law and EU Member States to incorporate these clauses into international debt issuances.<sup>37</sup>

There has been an increasing pressure to strengthen the contractual framework to more effectively address the collective action problem, particularly in light of the experience with the Argentine (2005) and Greek (2012) debt restructurings.<sup>38</sup> Pursuant to Article 12 (3) ESMT, in January 2013 the Eurozone initiated the inclusion of standardised 'double-limb' aggregation CACs in all new Euro area government bonds with maturities exceeding one year irrespective of whether the bonds were governed by domestic or foreign law. These CACs require that a minimum level of support must be achieved both across all series of securities being restructured and within each series. In the case of the Eurozone, the former requires a 75% threshold, while the latter requires a 66.67% mark.<sup>39</sup>

Subsequently, in 2014 the International Capital Market Association (ICMA) proposed enhancing CACs,<sup>40</sup> by advocating the use of single-limb clauses. These types of clauses enable the restructuring of bonds through a single vote, encompassing all instruments or a

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<sup>33</sup> A 75% majority of votes required is the typical form of CACs. However, according to Bradley and Gulati, voting threshold to change the terms may vary from 18.75% to 85% of the outstanding bondholders, the former being applied in case an initial quorum requirement is not satisfied. See Michael Bradley and Mitu Gulati, 'Collective Action Clauses for the Eurozone' (2014) 18 *Review of Finance* 2045.

<sup>34</sup> Lee Buchheit and Elena Daly, 'Minimizing Holdout Creditors: Sticks' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 15, 21.

<sup>35</sup> In the context of the G-10 meeting, whereby a Working Group was formed to propose policies for an orderly sovereign liquidity crisis of such a magnitude that rescue packages would not become a source of moral hazard. A report was delivered in 2012. See Group of 10, 'Report of the G-10 Working Group on Contractual Clauses' (2012) <<https://www.bis.org/publ/gten08.htm>> accessed 10 December 2023.

<sup>36</sup> Sönke Häsel, 'Collective Action Clauses in Sovereign Bonds' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 235.

<sup>37</sup> Economic and Financial Committee, 'Implementation of the EU Commitment on Collective Action Clauses in Documentation of International Debt Issuance' ECFIN/CEFCPE (2004) REP/50483 Final <[https://europa.eu/efc/sites/default/files/docs/pages/cacs\\_en.pdf](https://europa.eu/efc/sites/default/files/docs/pages/cacs_en.pdf)> accessed 10 December 2023.

<sup>38</sup> Kay Chung and Michael G Papaioannou, 'Do Enhanced Collective Action Clauses Affect Sovereign Borrowing Costs?' (2020) IMF Working Paper WP/20/162, 9. <<https://www.imf.org/en/Publications/WP/Issues/2020/08/07/Do-Enhanced-Collective-Action-Clauses-Affect-Sovereign-Borrowing-Costs-48960>> accessed 10 December 2023. See also Christian Hofmann, 'A Legal Analysis of the Eurozone Crisis' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (Verlag C.H. Beck 2014) 43, 63.

<sup>39</sup> See 'Euro Area Model CAC 2012, Common Terms of Reference' (2012) <[https://europa.eu/efc/sites/default/files/docs/pages/cac\\_text\\_model\\_cac.pdf](https://europa.eu/efc/sites/default/files/docs/pages/cac_text_model_cac.pdf)> accessed 10 December 2023. See also European Council, 'European Council Meeting (24/25 March 2011) – Conclusions, EUCO 10/1/11' (2011) <<https://data.consilium.europa.eu/doc/document/ST-10-2011-REV-1/en/pdf>> accessed 30 May 2022.

<sup>40</sup> International Capital Markets Association, 'Standard Aggregated Collective Action Clauses ("CACs") for the Terms and Conditions of Sovereign Notes' <[https://www.icmagroup.org/assets/documents/Resources/ICMA\\_Model\\_Standard\\_CACs\\_August\\_2014.pdf](https://www.icmagroup.org/assets/documents/Resources/ICMA_Model_Standard_CACs_August_2014.pdf)> accessed 10 December 2023.

subset of instruments, thereby preventing a creditor or group of creditors from holding in a particular series.<sup>41</sup> These single limb clauses were also endorsed by the IMF in the same year<sup>42</sup> and have gained widespread adoption worldwide.<sup>43</sup>

This development was followed by the Eurozone in December 2018, whereby the Eurogroup announced support among finance ministers to amend the ESMT. This amendment would require the gradual introduction of single-limb CACs in all Euro area issuances as from 2022, later confirmed by the Heads of State and Governments of the Euro area.<sup>44</sup>

### 3.1[c] *Are collective action clauses sufficient and suitable?*

Procedure-based sovereign debt restructuring is often considered unnecessary and inappropriate. It is unnecessary because the contractual approach has evolved and has proven to be an effective way to address the issue. In the EU context, some academics argue these clauses could serve as proxy for a bankruptcy procedure,<sup>45</sup> especially considering that most debt contracts already include single or double-limb clauses.<sup>46</sup> They are also deemed unsuitable because CACs strike a fair balance between creditors and debtors, avoiding ‘regulatory overkill’.<sup>47</sup>

Others argue that CACs are an insufficient legal figure to effectively address the issue given the numerous existing gaps.<sup>48</sup> There are three main issues with CACs: insufficient comprehensiveness of debt restructuring, inadequate levels of debt reduction and the

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<sup>41</sup> Chung and Papaioannou (n 38) 10.

<sup>42</sup> International Monetary Fund, ‘Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring’ (October 2014) <<https://www.imf.org/external/np/pp/eng/2014/090214.pdf>> accessed 10 December 2023.

<sup>43</sup> European Central Bank, ‘The IMF’s Role in Sovereign Debt Restructurings’ (September 2021) Occasional Paper Series 262 <<https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op262~f0e9e1e77e.en.pdf>> accessed 10 December 2023.

<sup>44</sup> Euro Summit, ‘Euro Summit Meeting (14 December 2018) - Statement, EURO 503/18’ (2018) <<https://www.consilium.europa.eu/media/37563/20181214-euro-summit-statement.pdf>> accessed 10 December 2023. See also EFC Sub-Committee on EU Sovereign Debt Markets, ‘2022 Collective Action Clause: Explanatory Note’ (2022) <[https://europa.eu/efc/system/files/2021-04/EA\\_Model\\_CAC\\_-\\_Draft\\_Explanatory\\_Note.pdf](https://europa.eu/efc/system/files/2021-04/EA_Model_CAC_-_Draft_Explanatory_Note.pdf)> accessed 10 December 2023.

<sup>45</sup> In this sense see Yves Mersch, ‘Reflections on the Feasibility of a Sovereign Debt Restructuring Mechanism in the Euro Area’, *ESCB Legal Conference 2016* (European Central Bank 2017) 6. See also Ludger Schuknecht, ‘The German Perspective: The Structure of the European Stability Mechanism’ in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (C.H. Beck 2014) 185.

<sup>46</sup> Chung and Papaioannou (n 38) 10, signal that, as of March 2020, an estimated 1.3 trillion dollars of foreign law-governed bonds was outstanding. Approximately 51 % of the outstanding debt stock includes the single-limb CACs, while 45% has double-limb CACs. Only 4% did not include any CACs.

<sup>47</sup> Udaibir S Das, Michael G Papaioannou, and Christoph Trebesch, ‘Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts’ (2012) IMF Working Paper 12/203 <<https://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf>> accessed 10 December 2023. See also Nouriel Roubini and Brad Setser, ‘The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions, and the Argentine Episode’ (2004) 1 *Journal of Restructuring Finance* 173.

<sup>48</sup> Rosa Maria Lastra, ‘How to Fill the International Law Lacunae’ (n 13) 56 The author indicates issues regarding applicable law, litigation, collateral, human rights and protection of democracy. See also Christoph Paulus, ‘How Could the General Principles of National Insolvency Law Contribute to the Development of a State Insolvency Regime?’, *ESCB Legal Conference 2016* (European Central Bank 2017) 64, and Otto Heinz, ‘Issues and Possible Reforms in the Context of a Euro Area/EU Sovereign Insolvency Framework’, *ESCB Legal Conference 2016* (European Central Bank 2017) 93, 102.

challenge of securing new financing.<sup>49</sup> The first limitation is connected to the complexity of the debt profile. According to Bolton and Skeel, restructuring with CACs has predominantly been employed by smaller countries, displaying fewer complex profiles (for instance with fewer different bonds). Therefore, the diversity in bond legal terms, namely maturities and payout conditions, diminishes the effectiveness of the restructuring process. Furthermore, the extent of creditor losses is also strongly correlated with the holdout rate, as observed in cases, such as Ukraine in 1999 and Greece in 2012, which suggests that CACs alone do not assure full participation.<sup>50</sup>

Nevertheless, single-limb clauses represent an improvement. In fact, this form of CAC is the only one that minimizes the holdout problem. Empirical evidence demonstrates that single limb clauses help reduce holdout rates, especially when they entail substantial losses for creditors. On the contrary, CACs with bond-by-bond voting or two-limb structures are insufficient to achieve high participation rates.<sup>51</sup>

In this context, the Greek debt restructuring stands out, not only because it was the largest debt restructuring in the history of sovereign defaults, but also because it is the only Eurozone country to have undergone such a process to date. This restructuring was carried out through private sector involvement. Greece achieved a total participation of €199.2 billion, or 96.9% of eligible principal. As a result of this exchange, Greece's debt was reduced by approximately €107 billion, constituting 52% of the eligible debt. This implies that the creditors have accepted significant losses. The success of this operation was significantly aided by the introduction of single-limb CACs, which retroactively applied to all domestic bonds issued under Greek law.<sup>52</sup>

A closely related limitation is insufficient debt reduction. Private creditor in particular will carefully weigh the benefits and costs of reduced debt repayment. Therefore, a debt restructuring that is overly favourable to creditors may result in less significant improvement in the debt profile. In addition, it is important to note that CACs do not address a country's non-bond debt, such as bank loans.

Participation of public creditors is constrained for additional reasons. Article 125(1) TFEU, as interpreted by the CJEU in its case-law, allows for the provision of assistance under certain conditions. The question arises as to whether assistance can be construed in terms of granting access to credit or reducing the principal amount of debt. Ioannidis argues that the latter option could be acceptable if the perspective of protecting the interests of the public creditor is adopted.<sup>53</sup> Indeed, if there is a risk that, without restructuring, the public creditor would face even greater losses due to the debtor's inability to repay, then the purpose of their involvement would be to safeguard the creditor's investment, rather than providing the debtor with an alternative source of funding. According to the author, only the latter

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<sup>49</sup> Patrick Bolton and David Skeel, 'Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?' (2004) 53 *Emory Law Journal* 763, 772.

<sup>50</sup> Chuck Fang, Julian Schumacher, and Christoph Trebesch, 'Restructuring Sovereign Bonds: Holdouts, Haircuts and the Effectiveness of CACs' (2021) 69 *IMF Economic Review* 155.

<sup>51</sup> *ibid.*

<sup>52</sup> Hofmann (n 38) 66; Lee Buchheit, 'Use of the Local Law Advantage in the Restructuring of European Sovereign Bonds' in Franklin Allen, Elena Carletti, and Mitu Gulati (eds), *Institutions and the Crisis* (European University Institute 2018) 95.

<sup>53</sup> Michael Ioannidis, 'Debt Restructuring in the Light of *Pringle* and *Gauweiler* - Flexibility and Conditionality', *ESCB Legal Conference 2016* (European Central Bank 2017) 81.

situation was intended to be covered and, thus, prohibited by the drafters of Article 125 TFEU.

This reasoning would also be in line with State aid law. When dealing with debtor enterprises, the CJEU has established a long-standing case law in assessing the requirement of economic advantage, as stipulated in Article 107(1) TFEU: the State should act as if it were a private creditor,<sup>54</sup> guided by profit maximisation and loss limitation, depending on the context.

Be that as it may, it is difficult to determine whether the motivation for restructuring is based on such considerations or is aimed at offering further assistance, as Ioannidis also notes.<sup>55</sup> In addition, it would make sovereign restructuring more contentious and, consequently, lengthier and adding more uncertainty as to the outcome.

In the current state of affairs, it seems more plausible that the teleology of Article 125 TFEU is more in line with the view that directly assuming the liabilities of a Member State or offering loans to provide payment for old liabilities and, subsequently, waiving these loans (as is the case with a restructuring of debt held by the public sector), should be seen as interchangeable measures<sup>56</sup> and, therefore, not be permitted. In the same vein, the ESMT in recital 12 only refers to private sector involvement, and even this option only applies in exceptional circumstances.

The ECB is also a relevant creditor in potential debt restructurings, given its ability to purchase significant quantities of sovereign bonds on secondary bond markets. In *Gauweiler*, the Court did not directly address the issue. Notwithstanding, it did state the ECB's lack of privileged creditor status meant that it would be exposed to the risk of a debt cut decided by other creditors. Significantly, it also stated that this risk should be understood as inherent to the purchase of bonds on the secondary markets, an operation authorised by the treaties without being conditional upon the ECB holding privileged creditor status.<sup>57</sup> However, it would be difficult to reconcile the statement in this paragraph with the objective of Article 123 TFEU which, paradoxically, the Court made reference to in this case, by emphasizing the need to avoid moral hazard and foster fiscal discipline. Given the foregoing, although the issue is not settled in the case-law, it is likely that a restructuring involving the ECB would breach the treaties and, therefore, prevented its participation.<sup>58</sup>

These limitations inherent to EU law are crucial, especially because the ESM is intended to be an institution, which provides loans (or other types of assistance) to ensure liquidity, ensuring Member States' ability to roll-over their debt obligation. In practice, there

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<sup>54</sup> Case C-342/96 *Kingdom of Spain v Commission of the European Communities* EU:C:1999:210; Samuel Cornella, 'The "Market Economy Investor Principle" to Evaluate State Aid: Latest Developments and New Perspectives' (2015) 22 *Maastricht Journal of European and Comparative Law* 553.

<sup>55</sup> Ioannidis (n 53) 81.

<sup>56</sup> Christian Hofmann, 'Greek Debt Relief' (2017) 37 *Oxford Journal of Legal Studies* 1, 24.

<sup>57</sup> Case C-62/14 *Peter Gauweiler and Others v Deutscher Bundestag* EU:C:2015:400 para 126. However, Advocate-General Cruz Villalón states, in his opinion, that the ECB would not actively contribute to bringing about a restructuring but would, instead, seek to recover in full the claim securitised on the bond – Opinion of AG Cruz Villalón in Case C-62/14 *Peter Gauweiler and Others v Deutscher Bundestag* EU:C:2015:7 para 235.

<sup>58</sup> Funds held by central banks usually enjoy immunity from satisfaction of creditors' claims in the context of their country's default, which was the case of Banco Central de la República Argentina, as described by Thomas Baxter and David Gross, 'Special Immunities: Central Bank Immunity' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 117. However, such cases are different from central banks directly participating in principal payment reduction of purchased bonds.

is a gradual shift in debt ownership, from the private sector to the public sector. Problematically, if the assistance programmes provide a significant amount of funding, it means that the ESM will progressively become a more important creditor. This could make meeting the CACs modification thresholds more challenging.

Importantly, the problem with ESM influence is that not only are funds controlled by Heads of State or Governments, potentially creating tensions between sovereigns,<sup>59</sup> but power is also skewed towards a few countries.<sup>60</sup>

Lastly, the issue of new financing arises. An essential feature of restructuring law in the US's Chapter 11 but also in the EU's Directive 2019/1023<sup>61</sup> is the possibility of obtaining debtor-in-possession (DIP) financing, in order to preserve company's value. DIP financing may be even more critical for sovereign debtors due to their vulnerability to capital flight as has already been alluded to. Arguably, the ESM could serve a similar function but, similarly to the IMF, it does not link its lending to a negotiation of a restructuring agreement between Member States and their creditors. Consequently, investors have an incentive to wait until a bailout becomes unavoidable and new financing is provided by public sector institutions.<sup>62</sup>

### 3.2 RESTRICTION OF MEMBER STATE AUTONOMY

One of the reasons why the IMF procedure was rejected was the fear of many countries losing national autonomy<sup>63</sup> and this fear is understandable, given the diversity within an institution composed of 190 members.<sup>64</sup>

This question is important because, unlike municipalities, states (both in the EU and in the US) are considered sovereign entities and, thus, any restriction on their autonomy should be anchored in the treaties or the respective Constitutions. This issue has received particular attention in the case law of the US Supreme Court. For instance, in 1936 *Ashton* case,<sup>65</sup> Justice Cardozo argued:

There is room at least for argument that within the meaning of the Constitution the bankruptcy concept does not embrace the states themselves. In the public law of the United States a state is a sovereign or at least a quasi sovereign. Not so a local governmental unit, though the state may have invested it with governmental power. Such a governmental unit may be brought into court against its will without violating the Eleventh Amendment. It may be subjected to mandamus or to equitable remedies. Neither public corporations nor political subdivisions are

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<sup>59</sup> In this vein see Paulus (n 48) 76.

<sup>60</sup> See Federico Fabbrini, *Economic Governance in Europe: Comparative Paradoxes and Constitutional Challenges* (Oxford University Press 2016).

<sup>61</sup> Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L172/18.

<sup>62</sup> Bolton and Skeel (n 49) 775.

<sup>63</sup> Christoph Ohler, 'Der Staatsbankrott' (2005) 60 *JuristenZeitung* 590, 598.

<sup>64</sup> See International Monetary Fund, 'List of Members' (last updated: August 30, 2023) <<https://www.imf.org/external/np/sec/memdir/memdate.htm>> accessed 10 December 2023.

<sup>65</sup> *Ashton v Cameron County Water Improvement District No 1* [1936] 298 US 513, 542.

clothed with that immunity from suit which belongs to the state alone by virtue of its sovereignty.

The application of the municipal bankruptcy act to the national level could, therefore, be unconstitutional if one embraces Justice Cardozo's view. However, from a financial perspective, a high burden of debt effectively limits autonomy,<sup>66</sup> since the fiscal position is used to assess credit risk. The higher the risk, the higher the cost of borrowing, resulting in a decrease in autonomy when defining national economic and fiscal policies.

A similar perspective was adopted by the US Supreme Court in the *Bekins* case,<sup>67</sup> when assessing the 1937 revised municipal bankruptcy law enacted by Congress. Given its voluntary nature and the passive role of the bankruptcy court, limited to approving or disapproving a presented plan, the US Supreme Court determined that the Federal Bankruptcy law should be understood as granting cities and States the power to impair contracts in case of dire financial situation, a prerogative that was previously reserved for the federal government. In this way, '[t]he bankruptcy power is competent to give relief to debtors in such a plight'. By removing such reserved power '[t]he State acts in aid, and not in derogation, of its sovereign powers' as '[i]t invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue'. In conclusion, the US Supreme Court argues that it sees 'no ground for the conclusion that the Federal Constitution, in the interest of state sovereignty, has reduced both sovereigns to helplessness in such a case',<sup>68</sup> especially considering that the statute was designed to respect the sovereignty of the State, for instance retaining control of its fiscal affairs.

However, the situation might not be as simple as the US Supreme Court presented and evaluated it regarding fiscal sovereignty of States. In McConnell's view, courts must determine eligibility to the bankruptcy process, which involves a judicial assessment of the applicant's solvency. This analytical exercise indirectly compels courts to evaluate whether a State has exhausted its capacity to generate revenue and reduce spending. Moreover, while courts lack the authority to create bankruptcy plans, they can refuse to accept a plan or condition their approval on the fulfilment of specific requirements. Both actions can significantly impact the sovereignty of Member States, as taxation lies at the core of their sovereign powers. In this sense, McConnell concludes that bankruptcy would, in practice, transfer control of fiscal affairs to the court.<sup>69</sup> This would be the case regardless of the body chosen to administer the process.

In the EU context, the situation is different. Member States have been committed to building an ever-closer Union since 1957. In the initial decades, integration predominantly deepened on the regulatory and technical fronts. Crucially, as this process continued, all countries became increasingly interdependent, leading to a growing necessity to accommodate the spillover effects of national measures. Consequently, this gradual interdependence has resulted in a reduction of Member States' autonomy.

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<sup>66</sup> In this vein see, in the doctrine, Nunner-Krautgasser (n 29) 243.

<sup>67</sup> *United States v Bekins* [1938] 304 US 27.

<sup>68</sup> *ibid*, 54.

<sup>69</sup> Michael McConnell, 'Extending Bankruptcy Law to States' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 229, 233.

More recently, the establishment of EMU has necessitated greater coordination on politically-sensitive topics, including national economic policies. As mentioned earlier, the European economic governance framework, implemented in response to the financial crisis, represents a fundamental shift in the relationship between the Union and its Member States. Under this framework Member States have ceded a significant portion of their sovereignty when it comes to freely designing their national economic policies. Instead, they must adhere to a strict procedure conducted by the Commission, which ultimately results in the approval or disapproval of national budgets at the supranational level.

Considering this context, a bankruptcy procedure would be less intrusive in comparison with other regions of the world,<sup>70</sup> particularly when viewed alongside the proposals presented elsewhere.<sup>71</sup>

### 3.3 MORAL HAZARD

In the debate on a sovereign bankruptcy framework, moral hazard is typically one of the main concerns.<sup>72</sup> In the EU, for instance, the concept of moral hazard has been at the forefront since the Treaty of Maastricht. This concern finds expression in Article 125(1) TFEU, which prohibits both the EU and Member States from assuming the financial commitments of another Member State. Article 123(1) TFEU also prohibited the ECB from engaging in monetary financing.

The prospect of a future debt relief may indeed exacerbate the problem of debt discontinuity,<sup>73</sup> which highlights the risks associated with the disconnect between the moment of issuance, the moment of payment, and corresponding accountability.

Moral hazard risk can be identified in several instances. First, it could empower States with a potent tool they could use to exert pressure on bondholders to accept the proposed new payment terms, in order to avoid a legal proceeding, or to seek a bailout from a supranational government.

Second, when a country faces financial distress, self-fulfilling runs on the country's debt may occur, creating multiple equilibria. As Panizza points out,

in a good equilibrium, a solvent borrower has continuous access to finance and remains solvent. In the bad equilibrium, the sudden withdrawal of financial resources caused by panicked lenders can push an otherwise solvent borrower towards insolvency.<sup>74</sup>

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<sup>70</sup> David Skeel, 'Rules-Based Restructuring and the Eurozone Crisis' in Franklin Allen, Elena Carletti, and Giancarlo Corsetti (eds), *Life in the Eurozone With or Without Sovereign Default?* (FIC Press 2011) 97, 101. See also Jeannette Abel, *The Resolution of Sovereign Debt Crises: Instruments, Inefficiencies and Options for the Way Forward* (Nomos/Routledge 2017) 403.

<sup>71</sup> Nuno Albuquerque Matos, Next Generation EU and the Balancing of Economic Union Through Horizontalisation (2023) REBUILD Centre Working Paper No. 8/2023 <<https://ssrn.com/abstract=4367092>> accessed 10 December 2023.

<sup>72</sup> Ugo Panizza, 'Do We Need a Mechanism for Solving Sovereign Debt Crises? A Rule-Based Discussion' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (C.H. Beck 2014) 223, 227.

<sup>73</sup> Stewart Sterk, 'The Continuity of Legislatures: Of Contracts and the Contracts Clause' (1988) 88 Columbia Law Review 647.

<sup>74</sup> Panizza (n 72).



In the latter situation, during bankruptcy proceedings, countries typically turn to the IMF as an effective international lender of last resort to provide bridge financing. In the EU, the IMF provided funding to certain countries during the sovereign debt crisis, alongside the EFSF and the ESM.<sup>75</sup>

However, while resorting to these lenders may contribute to managing financial instability, it may also be a source of moral hazard and overborrowing. In fact, as previously explained, if creditors know, or believe they can rely on a supranational institution to provide funding when sovereign defaults occur, they may become more careless in their lending practices than they would otherwise be. As Dooley argues, ‘private creditors watch what the [International Monetary] Fund does very carefully, not for wisdom about the credit worthiness of countries, but for clues about the terms on which official creditors will lend to debtor governments’. Consequently, ‘the “threat of crisis” is the only effective incentive for repayment by sovereign debtors’.<sup>76</sup>

Lastly, at the end of the bankruptcy procedure, moral hazard manifests itself in the form of debt pressure relief. As there is a means to discharge debt, incentives for complying with EU and national public finance obligations could diminish. In a way, bankruptcy could have the same effect as supranational bailouts.

Although these concerns are legitimate, this perspective undervalues the fact that reality is dynamic, not static. Relying on a bankruptcy procedure would prompt investor adjustment in the future by imposing a range of sanctions,<sup>77</sup> which could serve as a deterrent effect.

Moreover, it is premised on the assumption that decision-makers would be tempted by the bankruptcy option rather than viewing it as a last resort measure. Apart from the fact that States’ governments can threaten to default on their debt even in the absence of a framework, Skeel convincingly argues that ‘one of the most attractive features of state bankruptcy is the extent to which its benefits would arise even if no state ever filed for bankruptcy’,<sup>78</sup> not least because of the presence of a neutral party ensuring the

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<sup>75</sup> For a thorough analysis of the institutional participation in the EU sovereign debt crisis see Nicolas Véron, ‘The IMF’s Role in the Euro-Area Crisis: Financial Sector Aspects’ (2016) Bruegel Policy Contribution 13/2016 <<https://www.bruegel.org/2016/08/the-imfs-role-in-the-euro-area-crisis-financial-sector-aspects/>> accessed 10 December 2023.

<sup>76</sup> Michael Dooley, ‘Can Output Losses Following International Financial Crises Be Avoided?’ (2000) National Bureau of Economic Research Working Paper 7531 <[https://www.nber.org/system/files/working\\_papers/w7531/w7531.pdf](https://www.nber.org/system/files/working_papers/w7531/w7531.pdf)> accessed 10 December 2023.

<sup>77</sup> For instance economic sanctions, by increasing the cost of loans or hinder market access both to the public and private sectors, as well as decline in national output, as argued by Kolb (n 14) 7, and Odette Lienau, ‘The Longer-Term Consequences of Sovereign Debt Restructuring’ in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 85. But also political sanctions, as shown by Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press 2010) and Daniel Waldenström, ‘How Important Are the Political Costs of Domestic Defaults?’ in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 287. In the EU, the share of domestic debt (debt held by resident in a given Member State) is not negligible, granting voters relevant accountability power. In this vein see Daniel Gros, ‘Restructuring in a Monetary Union: Economic Aspects’ in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 195.

<sup>78</sup> David Skeel, ‘State Bankruptcy from the Ground Up’ in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 191, 195. With an opposing view, Edmund McMahon, ‘State Bankruptcy Is a Bad Idea’ (*Wall Street Journal*, 24 January 2011) <<https://www.wsj.com/articles/SB10001424052748704881304576094091992370356>> accessed 10 December 2023.

existence of due process.<sup>79</sup>

### 3.4 FINANCIAL PROBLEMS

#### 3.4[a] *Reputation and market access*

One of the most important factors influencing debt payment is a country's reputation. As states aim to ensure access to future market financing, they prioritise debt repayments which, in turn, instils confidence in lenders to continue extending funding. This consequence was already recognised as the primary cost of default in US States in the 1840s,<sup>80</sup> even though it may not always be a primary concern.<sup>81</sup>

The fear for reputational sanctions also plays a significant role, potentially affecting relationships that rely on trust to some extent. For example, following a debt default, other governmental suppliers may begin to request advance payments before delivering goods or providing services. Similarly, the resident population may reduce their level of trust in government.<sup>82</sup> All these spillover events contribute to increase the overall cost of default.

This reasoning can be traced back to game theory, notably in repeated games. As Benoit and Krishna explain,

[i]n a repeated setting, players can condition their behavior at any stage of the game on the observed past behavior of other players. As a result, a player may behave in a way that is not in his or her short run interests because any attempt to realize short run gains may lead to future losses if other players retaliate.<sup>83</sup>

Therefore, while it may seem advantageous for sovereigns to avoid complying with payment obligations in the short-term, the need for continued engagement with financial markets provides the necessary incentive to behave differently.<sup>84</sup>

In this context, it is argued that reputation costs can be effectively addressed by establishing a sovereign restructuring procedure. The idea is that institutionalisation would reduce costs by making it more socially acceptable and transparent: a country that undergoes such a procedure would be better positioned to gain trustworthiness, while a country that

<sup>79</sup> Abel (n 70) 413; Patrick Bolton, 'Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice around the World' (2003) 50 IMF Staff Papers 41, 62.

<sup>80</sup> William English, 'Understanding the Costs of Sovereign Default: American State Debts in the 1840's' (1996) 86 *The American Economic Review* 259, 268. Market access disturbance also took place in Finland, during the years of depression in the 1990s. Finnish bond yields rose quickly and widened very much compared to German equivalents. As Rehn explains, this mechanism, or its mere threat, could enforce the long-run budget constraint on an economy and prevent it from over-borrowing. See Rehn (n 3) 84.

<sup>81</sup> Smaller countries meet their debt-related obligations not so much to keep their reputation, because frequently it is not possible for them to display one, as argued by Jeremy Bulow and Kenneth Rogoff, 'Sovereign Debt: Is to Forgive to Forget?' (1989) 79 *The American Economic Review* 43. However, the authors mostly focus on Third-World debt management problems. In contrast, EU Member States are considered as being relatively rich countries and do have a reputation to cherish.

<sup>82</sup> Kolb (n 14) 8. The author exemplifies with defaults of the Spanish Empire in the XVI<sup>th</sup> century (inability to pay to the army); Peru in 1826 (fearing Europe, as main financiers and export destination, would seize exports as compensation); or Russia in 1993 (court litigation and seizures).

<sup>83</sup> Jean-Pierre Benoit and Vijay Krishna, 'Finitely Repeated Games' (1985) 53 *Econometrica* 905.

<sup>84</sup> In this vein, see Jonathan Eaton, Mark Gersovitz, and Joseph Stiglitz, 'The Pure Theory of Country Risk' (1986) National Bureau of Economic Research Working Paper No 1894 <[https://www.nber.org/system/files/working\\_papers/w1894/w1894.pdf](https://www.nber.org/system/files/working_papers/w1894/w1894.pdf)> accessed 10 December 2023.

relies on financial assistance will be perceived as a risk factor, potentially hindering new investment.<sup>85</sup> Moreover, the assumption that all creditors will cease lending if there is a default against one of them is empirically incorrect, as is the assumption that such exclusion will be permanent.<sup>86</sup>

### 3.4[b] *Bond market disruption and contagion*

Another objection raised is that a bankruptcy procedure could disrupt bond markets and increase states' borrowing costs, even those with stronger fiscal indicators due to contagion.<sup>87</sup>

In the EU, the argument was invoked by the ECB during the sovereign debt crisis.<sup>88</sup> In the US, similar arguments emerged in 1934, during the discussion preceding the enactment of Chapter 9 of the Bankruptcy Act by the US Congress, and in 2011 during the debate on exploring the possibility of States' bankruptcy bill, which was not adopted. Regarding the debate on Chapter 9, opponents of the bill contended that opening the doors of the bankruptcy court to municipal corporations represented a radical departure from long-established practices that would adversely affect municipal bond markets. They were particularly concerned about solvent cities being impacted by spillover effects from insolvent ones. Furthermore, opponents also argued that only a small percentage of municipalities would likely use such an instrument and, therefore, costs would outweigh benefits.<sup>89</sup>

Regarding the US States' potential bankruptcy bill, the main issue under discussion was the fear expressed by congressman Mike Quigley that bankruptcy filing by a few States would trigger a contagion effect affecting all States, regardless of their fiscal merit. It was stated that 'bankruptcy for States would cripple the bond markets and [p]ermitting States to break their promises to bondholders would decrease investor confidence and damage States' ability to invest in much-needed infrastructure'.<sup>90</sup> The problem, once again, lay in the fact that fiscal issues were confined to only few States:

The municipal bond market is now responding to legitimate concerns about the long-term structural imbalances in these six to eight States. But I believe we would be correct to distinguish these bad apples from the other 40-some States that have been relatively well managed and only have temporary deficits. That is why a one size-fits-all approach like bankruptcy for States could do more harm than good.<sup>91</sup>

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<sup>85</sup> Abel (n 70) 413. In this vein, see Erik Jones, 'The Politics of NGEU', *REBUILD Launch Conference* (24 February 2022), which stated that ESM reliance was beginning to become 'toxic'.

<sup>86</sup> Kolb (n 14) 6.

<sup>87</sup> David Skeel, 'States of Bankruptcy' (2012) 79 *The University of Chicago Law Review* 677; Abel (n 70) 408.

<sup>88</sup> Peter Spiegel, 'Trichet Warns on Bail-out System Dangers' (*Financial Times*, 29 October 2010) <<https://www.ft.com/content/cba1de4a-e37c-11df-8ad3-00144feabdc0>> accessed 10 December 2023.

<sup>89</sup> Jonathan Henes and Stephen Hessler, 'Deja Vu, All Over Again' (*New York Law Journal*, 27 June 2011) <[https://www.kirkland.com/-/media/publications/article/2011/06/deja-vu-all-over-again/newyorklawjournal\\_june-2011.pdf](https://www.kirkland.com/-/media/publications/article/2011/06/deja-vu-all-over-again/newyorklawjournal_june-2011.pdf)> accessed 10 December 2023.

<sup>90</sup> Hearing of the Courts, Commercial and Administrative Subcommittee of the House Judiciary Committee 'Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter' (14 February 2011) <<https://www.govinfo.gov/content/pkg/CHRG-112hhrg64585/html/CHRG-112hhrg64585.htm>> accessed 10 December 2023.

<sup>91</sup> Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the Committee on Oversight and Government Reform, 'State and Municipal Debt: The Coming Crisis?' (9 February 2011)

This argument relies on misguided assumptions: firstly, that the market does not differentiate between financially sound Member States and those at risk of default and, secondly, that the negative effects will be significant and enduring.<sup>92</sup>

From a theoretical perspective, the impact on costs could go either way. Sovereign debt contracts are challenging to enforce and willingness to pay is closely linked to default costs. Thus, improving a system to reduce such costs might not only diminish incentives for contractual compliance but also increase investment risk, subsequently raising borrowing costs. Conversely, excessive accumulation of debt and delayed default could result in loss of value and overborrowing, further deteriorating sovereign risk profile and bond yields. Addressing these concerns could potentially lead to lower costs.<sup>93</sup>

However, from an empirical viewpoint, the hypothesis lacks a solid foundation. Concerning the market's ability to differentiate, evidence from the US municipal bond market demonstrates that markets function to a significant degree with proper differentiation.<sup>94</sup> Contagion and inadequate differentiation is frequently exemplified with the Orange County filing for municipal bankruptcy in 1994 after defaulting on debt,<sup>95</sup> which triggered a market-wide decrease in the value of bonds without direct exposure to it. Nevertheless, it is important to note that the bankruptcy option has been available since the 1930s, making it more likely that the reaction was due to the default itself, rather than the mere existence of the bankruptcy option. Additionally, this effect only lasted for one day,<sup>96</sup> making it more difficult to suggest a causal relationship for justifying the avoidance of a particular public policy.

A proper restructuring procedure would also contribute to enhance risk assessment and country differentiation in the EU, thus enhancing markets' ability to distinguish between high(er) and low(er) borrower quality and adjust premiums accordingly. As Paulus argues,

in the beginning there is likely to be a mess when and if the new set of rules were introduced here and now. However, it would be wrong to assume that this messy situation would last forever.<sup>97</sup>

On the contrary, a transparent and predictable process mitigates chaotic market reactions and fosters market discipline on Member States, since all participants know which rules to follow. In this way, it can significantly contribute to the stability of the EU as a whole and promote price stability as long as the ECB refrains from intervening in the secondary bond market, effectively monetising national public debts and deficits.

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<<https://www.govinfo.gov/content/pkg/CHRG-112hhrg68362/pdf/CHRG-112hhrg68362.pdf>> accessed 10 December 2023.

<sup>92</sup> Skeel, 'States of Bankruptcy' (n 87) 718.

<sup>93</sup> Panizza (n 72) 229.

<sup>94</sup> See Municipal Bonds Screener (*MunicipalBonds.com*) <[https://www.municipalbonds.com/screener/#sort\\_by=yield&sort\\_direction=asc&page=3](https://www.municipalbonds.com/screener/#sort_by=yield&sort_direction=asc&page=3)> accessed 10 December 2023.

<sup>95</sup> John Halstead, Shantaram Hedge, and Linda Klein, 'Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets' (2004) 39 *The Financial Review* 293, 313.

<sup>96</sup> Skeel, 'States of Bankruptcy' (n 87) 720.

<sup>97</sup> Christoph Paulus, 'A Resolvency Proceeding for Defaulting Sovereigns' in Patrick S Kenadjan, Klaus-Albert Bauer and Andreas Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (De Gruyter 2013) 181, 189.

Regarding other implemented solutions resembling limited restructuring mechanisms, such as CACs, there is a significant amount of evidence that these clauses did not result in additional borrowing costs when compared to non-CAC bonds,<sup>98</sup> suggesting that restructuring options do not cause contagion.

Regarding significance and durability of costs, sovereign defaults generally have no substantial negative impact on subsequent growth, as they often mark the final stage of a crisis and the beginning of economic recovery.<sup>99</sup> In fact, there is a growing body of evidence indicating that the costs associated with sovereign debt restructuring are neither very severe<sup>100</sup> nor long-lasting.<sup>101</sup>

#### 4 CONSTITUTIONAL ADMISSIBILITY

A debt restructuring mechanism is essentially a process designed to restore financial viability to its subject, through various measures such as reducing the overall amount of principal, decreasing interest rates, setting a new deadline for payments, among other types of measures. In any case, the debtor will emerge with improved and more advantageous financial circumstances.

The features of this framework pose challenges under EU law, primarily due to the existence of the prohibition of monetary financing in Article 123 TFEU and the no-bail out clause in Article 125 TFEU. The common aim of these provisions is to ensure that the correct incentives are in place for Member States to pursue sound budgetary policies.<sup>102</sup> In foreseeing the ECB should refrain from purchasing debt in primary markets and that neither the EU nor the Member States shall be liable for or assume each other's commitments, the question arises as to whether a scenario of financial relief, with their institutional involvement, would be a possible outcome. From this perspective, relief from the original conditions of the purchase on the (secondary) market might be interpreted as monetary financing of Member State(s), since it would alleviate budgetary pressures.

Similarly, the teleology of Article 125 TFEU is to promote sound budgetary policies. In this regard, Maduro argues that this objective would be endangered only if the EU or Member States become legally responsible for the debt of other Member States, in which case the practice would be in violation of the Treaty. This would not be the case if financial assistance was provided voluntarily to a Member State, which is no longer capable of fulfilling its commitments. In this scenario, neither the EU nor the Member States are ex ante assuming any liability or committing to the obligations of that Member State towards others. In fact, it would create a bilateral relationship with the creditor, who would independently decide on the debt relief.<sup>103</sup>

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<sup>98</sup> Abel (n 70) 411; Fang, Schumacher, and Trebesch (n 50) 120.

<sup>99</sup> Eduardo Yeyati and Ugo Panizza, 'The Elusive Costs of Sovereign Defaults' (2011) 94 *Journal of Development Economic* 95.

<sup>100</sup> Kevin Kordana, 'Tax Increases in Municipal Bankruptcies' (1997) 83 *Virginia Law Review* 1035, 1074; Richard Schragger, 'Democracy and Debt' (2012) 121 *The Yale Law Journal* 860, 874.

<sup>101</sup> Ugo Panizza, Federico Sturzenegger, and Jeromin Zettelmeyer, 'The Economics and Law of Sovereign Debt and Default' (2009) 47 *Journal of Economic Literature* 651, 664.

<sup>102</sup> See Jörn Axel Kämmerer, 'Article 123 (Ex Article 101 TEC) [Prohibition of Credit Facilities]' in Helmut Siekmann (ed), *The European Monetary Union* (Hart Publishing 2022) 155.

<sup>103</sup> Miguel Poiarés Maduro, 'EU Law and Sovereign Debt Relief' in Koen Lenaerts et al (eds), *An Ever-Changing Union? Perspectives on the Future of EU Law in Honour of Allan Rosas* (Hart Publishing 2020) 75, 77-78. In contrast,

Moreover, the CJEU has ruled that the ESM is not incompatible with Article 125 TFEU. This decision was based on the necessity of financial assistance to ensure the financial stability of the Eurozone as a whole and because of the attached conditionality.

Importantly, there are two sides, or different moments in the legal relationship between a creditor and a debtor. Granting financial assistance marks the initial moment, where the relationship begins and legal obligations are defined for both parties. This was the side the Court focused on in *Pringle* to ensure that, from the outset, the objective of maintaining sound budgetary policies in Member States through market pressure was preserved.

However, there is another side to the creditor-debtor relationship, which involves the fulfilment of obligations by the debtor, most notably the repayment of funds. The CJEU did not analyse the relationship from this perspective. Nevertheless, there is a risk of non-performing loans, situations where debtors may not be able to meet their repayment obligations. The question arises whether, at the outset, debtors are aware, or can reasonably assume, that their debts will be written off at some point. However, this matter relates to maintaining pressure over Member States' budgetary policy, not to debt relief. Viewed from this perspective, debt relief by EU institutions or Member States may or may not be contrary to the treaties, depending on whether the debtor is aware of the creditors' intentions before entering into such debt. If there is no such prior knowledge, debt relief should be permitted under EU law. In fact, in the *Gauweiler* case, the Court argued that potential ECB exposure to losses would not, in itself, reduce market discipline.

The lack of awareness of original creditors' intentions may not be as straightforward as it may seem. Crucially, the ECB's asset purchase programs were designed to operate as unpredictably as possible. Nevertheless, the intervention of the ECB was not a matter of *if* but a matter of *when*, given that preventing the break-up of the Eurozone became one of the ECB's *de facto* objectives. Concomitantly, if one of the main objectives in granting financial assistance is to preserve financial stability within the Euro area, a similar logic may underlie it.

In this context, Maduro argues that the form and extent of debt relief are not irrelevant. In fact, the more substantial the debt relief, the harder it becomes to demonstrate that conditionality-based financial aid represents a functional equivalent. Debt relief, particularly a haircut, reduces the incentive to consolidate budget policies and can heighten moral hazard. Hence, to preserve market discipline, differentiated credit risk needs to be maintained. In addition, conditionality must be in place to offset the fact that market funding will not be needed during the assistance period.<sup>104</sup>

However, the relevance of the form and extent of debt relief must be assessed not so much by focusing on these two features, but by considering the type of procedure set up for debt restructuring. In essence, moral hazard is a cognitive process by which the subjects anticipate that present actions will be replicated in the future. The form and extent of debt relief provide limited information about creditors' future decisions. What truly informs us

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see Christoph Ohler, 'Article 125 (Ex Article 103 TEC) [Prohibition to Assume Liabilities]' in Helmut Sickmann (ed), *The European Monetary Union* (Hart Publishing 2022) 181, 188, which argues that for the 'assumption' definition to be covered it is irrelevant whether the support is given unilaterally on a voluntary basis by one Member State or due to an agreement between Member States. However, Article 125 does not cover loans but also the purchasing of bonds on the primary market by other Member States if they are conducted under market conditions.

<sup>104</sup> Maduro, 'EU Law and Sovereign Debt Relief' (n 103) 81.

about the likelihood of decision-replication is how such decisions are carried out. At this point, it could be applied what was discussed above: the current process of verticalisation within the EU has increasingly shed light on what those future decisions might resemble, such as the dominance demonstrated by the ECB in Member States' debt markets, as well as the overly prescriptive approach of the EU economic governance framework, which reduces national ownership of economic policy and encourages supranational assistance.

Conversely, a process based on a debt restructuring framework would offer enhanced legal certainty for both creditors and debtors, creating a legal relationship with market actors, which discourages future fiscal recklessness. Crucially, national fiscal policies would come under closer scrutiny by the market. Their willingness to provide more or less funding would, thus, be proportional to the degree of success or failure each Member State demonstrates in conducting their economic policies. Similarly, the readiness to undertake restructuring would reduce the likelihood of future funding being granted which, in turn, would reduce moral hazard. Ultimately, the anticipation of a debt restructuring process would enhance fiscal responsibility and diminish the threat of restructuring.

In light of the above, debt relief would be acceptable within the framework of the case-law and would be compatible with current Treaty provisions, especially Articles 123 and 125 TFEU.

## 5 DEMOCRATIC NECESSITY

The previous section discussed the costs associated with sovereign debt default and restructuring, highlighting the challenges they pose while emphasizing that they are not insurmountable.<sup>105</sup> However, in a world of imperfect alternatives, these costs should only be considered excessive if there are less burdensome options available.<sup>106</sup> As seen above, bailouts are one option, which takes place outside the market realm, but they bring about significant costs on financial, economic, social and political levels in the short-to-long-term. At the same time, there is a substantial risk that bailouts leave the underlying issues of fiscal responsibility and debt overhang unresolved.

In the context of the EU, there are other reasons that might favour the implementation of a bankruptcy procedure and shed light on how the Union can achieve a better balance from a democratic and accountability perspective.

There is a well-established body of literature, which argues for a democratic deficit in the EU, primarily stemming from deficient (or complete absence of) national internalisation of interdependency costs.<sup>107</sup> Functionalistic and instrumental approaches have the critical

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<sup>105</sup> A good overview on sovereign default costs is given by Bianca De Paoli, Glenn Hoggarth, and Victoria Saporta, 'Output Costs of Sovereign Default' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 23. See also Adam Feibelman, 'American States and Sovereign Debt Restructuring' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 146, 172.

<sup>106</sup> Clayton P Gillette, 'What States Can Learn From Municipal Insolvency' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 108.

<sup>107</sup> Miguel Poyares Maduro, 'A New Governance for the European Union and the Euro: Democracy and Justice' (2012) Robert Schuman Centre for Advanced Studies Policy Paper 2012/11 <[https://cadmus.eui.eu/bitstream/handle/1814/24295/RSCAS\\_PP\\_2012\\_11rev.pdf?sequence=1&isAllowed=y](https://cadmus.eui.eu/bitstream/handle/1814/24295/RSCAS_PP_2012_11rev.pdf?sequence=1&isAllowed=y)> accessed 10 December 2023; Fritz W Scharpf, 'Democratic Legitimacy under Conditions of Regulatory

shortcoming of presenting solutions for EU integration as inevitable to the maintenance of a flawed political project, notably the Euro. The functionalistic approach, as developed by EU institutions, is one of the reasons why Member States later opted for a more intergovernmental method within the European Council regarding economic policy, rather than furthering supranational economic policies, for instance by restructuring the EU budget.

With Lindseth's perspective in mind, EU integration should not be purely technocratic. Instead, it should be viewed as a democratic process, where the supranational solution is seen as suitable substitute, in a democratic sense, for reducing national politics.<sup>108</sup> In a way, it seems that the 'legacy costs' of an originally flawed EMU have been primarily shouldered by the so-called debtor countries, which is not consistent with the shared democratic responsibility each Member State embodies in such an endeavour.<sup>109</sup>

Even if the democratic identity in the EU has slowly been emerging, allowing for the existence of an emergency government (or governance) in the absence of a sovereign state,<sup>110</sup> this relationship needs to work both ways and be effectively owned by each Member State. Merely signing an international treaty, which obliges states to pass a national law or constitutional amendments to introduce balanced budget rules is insufficient, as this process will always be seen as externally-driven and, to some extent, imposed during times of financial hardship. This context is hardly conducive to facilitating a national debate on whether a 'golden rule' should be introduced. From this perspective, it may be untenable to continue pursuing supranational economic coordination whose output is to impose and ensure compliance with budgetary restrictions, as is the case with the EU economic governance framework and financial assistance programmes. This paradigm places a heavier burden on the so-called 'debtor countries', as they are the ones more likely to face financial constraints and need to introduce restrictions.

Another challenging hurdle to overcome in EU economic integration is the fear of becoming a 'transfer union', meaning the establishment of a system of permanent and continuous financial transfers from more developed to less developed Member States. From the perspective of 'creditor countries', this not only generates moral hazard, but essentially creates a system with little accountability and responsibility leading to financially dependent states in the long term.

Hence, beyond providing financial grants to Member States in need, there are concerns about consolidating a transfer-dependency system. This is yet another reason to consider a market-based process within a new EU federal consensus. If triggered, sovereign debt restructuring would be conducted through a legally binding process, providing legal certainty. While certain Member States and EU institutions would have to bear some losses, these

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Competition: Why Europe Differs from the United States' in Kalypso Nicolaidis and Robert Howse (eds), *The Federal Vision: Legitimacy and Levels of Governance in the United States and the European Union* (Oxford University Press 2001); Simon Hix and Bjørn Høyland, *The Political System of the European Union* (3rd edn, Bloomsbury Publishing 2011).

<sup>108</sup> Peter Lindseth, 'Thoughts on the Maduro Report: Saving the Euro Through European Democratization?' (*EUTopialaw*, 13 November 2012) <<https://eutopialaw.wordpress.com/2012/11/13/1608/>> accessed 10 December 2023.

<sup>109</sup> Peter Lindseth, 'Power and Legitimacy in the Eurozone: Can Integration and Democracy Be Reconciled?' in Maurice Adams, Federico Fabbrini, and Pierre Larouche (eds), *The Constitutionalization of European Budgetary Constraints* (Bloomsbury Publishing 2014) 379.

<sup>110</sup> Signe Rehling Larsen, *The Constitutional Theory of the Federation and the European Union* (Oxford University Press 2021) 149.



would be internalised in both creditor and debtor countries' political processes. The major difference lies in the certainty that transfer dependency was severed, the no-bail out clause reassured, individual responsibility bolstered, and market confidence restored. This confidence is not only in the sense that Member States whose debt is being restructured would be in better financial conditions, but also because each market participant would have the incentive to scrutinise national economic policy sustainability and make actual risk differentiation.<sup>111</sup>

## 6 CONCLUSION

At the beginning of EMU integration, fiscal compliance was expected to be delivered through market forces. However, with the financial crisis, the focus has shifted towards developing economic governance through the political process, as evident from the increased economic surveillance in the fiscal and economic domains.

According to the perspective of the writer, this change in approach stemmed from an inadequate assessment of the causes of market failure. The mispricing of Member States' sovereign debt was more a symptom of a flawed design than a mistake in choosing the market process. This article, therefore, has reevaluated this approach, by examining the feasibility of a debt restructuring framework.

By addressing some of the main challenges often associated with this option, the conclusion is that, in a world of imperfect alternatives, the benefits outweigh the associated risks. Most importantly, a debt restructuring framework would increase the participation, as scrutiny of economic and fiscal policies would become distributed throughout market participants rather than being confined to the political process.

While this increase in participation might raise the complexity, it is argued that it would yield better results in terms of Member States' financial autonomy and sustainability, and addressing democratic concerns. Importantly, this approach aligns with the principle of subsidiarity, which calls for action to be placed at the most effective level of governance.

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<sup>111</sup> In the same vein see Jeromin Zettelmeyer, 'Ist Der Euro Noch Zu Retten? - Vorschläge Für Eine Neue Europäische Wirtschaftspolitik' (*politik für europa*, 2017) 11 <<https://library.fes.de/pdf-files/id/ipa/12819.pdf>> accessed 10 December 2023.

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