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List of Acronyms

CAC – Collective Action Clause

ESM – European Stability Mechanism

EU – European Union

GDP – Gross National Product

IMF – International Monetary Fund

UK – United Kingdom of Great Britain and Northern Ireland

UN – United Nations

US – United States of America

Exploring Sovereign Bankruptcy Regime

Abstract

In this study I provide theoretical overview of the concept of sovereign bankruptcy. The problem of unsustainable sovereign debt is becoming extremely important with modern sovereign bond market liberalization. Theoretical possibility of applying certain norms of corporate law to the sovereign state is broadly discussed in the literature. In this study I try to provide a comprehensive approach to creating a new sovereign bankruptcy regime. Combining investigation of the problem of sovereign debt sustainability and the reasons for economic unbalances with an extensive overview of the solutions proposed in the literature, I have develop a system of building blocks for three different levels of sovereign bankruptcy workout.

Key Words: Debt, Bankruptcy, Insolvency

Kurzfassung

In dieser Studie gebe ich einen theoretischen Überblick über das Konzept eines Staatsbankrotts. Das Problem von nicht nachhaltigen Staatsschulden wird bedeutender im Zusammenhang mit der Liberalisierung des Staatsanleihenmarktes. Die theoretische Möglichkeit bestimmte Normen der Unternehmensgesetze auf souveräne Staaten anzuwenden, wird in der Literatur eingehend diskutiert. In dieser Studie versuche ich einen umfassenden Ansatz zu bieten um ein neues System für Staatskonkurse zu schaffen. Aus dem Problem der Nachhaltigkeit von Staatsschulden und Gründe für ökonomische Unausgeglichenheit, kombiniert mit einem umfangreichen Überblick von der Literatur vorgeschlagenen Lösungen, entwickle ich ein System der Bausteinen für drei verschiedene Ebenen von Verfahren des Staatsbankrotts.

Schlagwörter: Schuld, Bankrott, Insolvenz

1.1 Introduction

Modern sovereign debt mode seems to have been imperfect for many years now. It has also been proven vulnerable to shocks of different nature and magnitude. Recent financial crisis appears to be one of many examples of international community not being capable of dealing with sovereign debt crisis. The most obvious of those is the lack of comprehensive tools to manage such a situation. Moreover, there is virtually no common framework to encompass the scenarios of sovereign insolvency. Furthermore, there are no clear ex-ante game rules for different stake holders of the sovereign debt workout. As a result, the process which follows state insolvency lacks predictability and is in many ways harmful for world economy in general and regional economic stability in particular.

In this situation there is a great need in developing a system of regulations for state insolvency procedure. The presence of clear rules is of utmost importance for all stakeholders. It goes without saying that if the road map is defined ex-ante, there are much less unpredictable surprises. There is also less need to do a onetime exclusive adjustments ex-post. Good example of this type of actions, are the Troika initiatives we could observe during the last crisis. As these exclusive measures cannot be systematized, they seem to be harmful for the system by creating legal precedents.

Over the past years there has been a significant increase of interest to the topic of international sovereign debt regulations. A great amount of researchers were trying to develop a model which could solve the above stated issues. Unsustainable sovereign debt has been a challenging problem for the firms, governments and international financial institutions. In my master thesis I will provide a critical assessment of this issue. I will also suggest some building blocks for the model which can help dealing with, or even help avoiding sovereign debt crisis.

The rest of the study is organized as follows. In the first section I will provide the introduction into the topic of bankruptcy of the sovereign government. I will then show the importance of the topic and briefly describe the motivation for this research. In the second section I will discuss the current sovereign insolvency issue, as well as a default problem and its consequences. Next, I will provide an overview of latest literature on the topic. In this part the existing theories, views and opinions will be structured. In section three I will try to bring together all the information gathered during the research. The analyses of the possibility of introducing the new sovereign bankruptcy regime, as well as the cost-benefit analysis of the stakeholders will be provided; some of the possible mechanisms that can contribute to the solution be discussed. The summary of the research and concluding remarks will be given in the fourth section.

1.2 Definitions

In this subsection I present contextual definitions of the key terms used throughout the current study for the reason of importance of clear understanding of the aspects of selective term used in the literature on sovereign bankruptcy regime. The significant terms and their interpretation follow in alphabetical order. Some of the terms are used in their specific meaning in the context of the sovereign debt topic.

Bankruptcy of the sovereign government is the state of the economy, when the government cannot pay the interest on the debt or repay the body of the debt. It may occur as consequence of budget deficit of government expenditure versus tax revenues or import –export imbalances. Sovereign bankruptcy is a theoretical concept of applying some features of the corporate bankruptcy law to the sovereign debt crisis workout in order to lower the cost of the orderly debt restructuring practice by the governments, which face unsustainable debt levels.

Collective action clause is a specific term of the sovereign debt contract. It has been introduced to the bond contract on a wide scale in the early 2000. Collective action clause gives the majority of the bondholders the right to amend the terms for the whole bond series. Its main purpose is to provide the mechanism for effective debtors’ coordination and potential weapon against the holdout minority of the creditors, who may disrupt the debt restructuring process.

Debt dischargeability a set of conditions, under which the debt contract can be invalidated. In present, due to the absence of the sovereign bankruptcy procedure or alike, the sovereign debt is theoretically not dischargeable. Therefore, even if the country is in the state of default, it doesn't really have a fresh start.

Debt restructuring is a process of renegotiation of the debt contract in the time of distress. Debt restructuring typically presume a significant debt relief, namely lowering the face value of the bonds and the coupons. Debt restructuring offer can also include rescheduling of the debt repayment. Often governments also offer an exchange of the financial instrument, mostly, for a more liquid one, in order to reach higher creditor participation in the debt restructuring.

Exit consent is a term of the debt contract, by which an issuer can redeem the financial instrument. It is sometimes used in the debt renegotiations by the governments to redeem its bonds at a discounted price in order to reach a desired debt relief.

Foreign immunity is a norm or international law, which grants sovereign government immunity to any legal prosecution. According to the theory, a sovereign government is free in its actions, and cannot commit a legal wrong. It also applies to countries' assets and installations abroad. In most sovereign debt contracts governments waive its sovereign immunity.

Holdout creditors is a holder of debt contract which rejects a restructuring offer by the issuer. A holdout tactic by the creditor often includes lawsuits and long litigations for the total repayment of the debt. This practice is used by special fund, which buys the discounted bonds of the governments facing a crisis. Then they litigate for the total repayment of the original contract value.

Insolvency of the state (bankruptcy) is a state of the country's finance, when the country cannot meet its debt obligations. There are three ways out of this situation. The first: the country can accumulate more new debt to repay the old, together with introducing austerity policies in order to lower the deficit. The second: the government can try to renegotiate the debt contracts with the creditors in order to receive a debt relief or a delay of repayment. The third: the government may default on its obligations.

Sovereign bonds is financial security issued by the country's government. It typically has a maturity of 10-15 years. Bonds also entitle the holders to the regular coupon (interest) payments. Often countries with unstable currencies issue bonds denominated in the one of the "hard" currencies.

Sovereign guaranties is the guarantee of the government that the obligation is certain to be fulfilled if the primer obligor defaults.

1.3 Sovereign debt

As a very fist step of the analysis it is necessary to clear the picture and set the scene. The clear understanding of all the elements is the primary issue in all the complex systems. Therefore, I believe it is necessary first to define the subject, that is, to understand what the foundations of sovereign bonds market are. Because there are numerous distinguished differences between the corporate debt and sovereign debt, the crucial one is that under provisions of the international law sovereign state enjoys foreign immunity. In the view of the debt contract it means several aspects. First, most of the assets of the debtor are located within the jurisdiction of the sovereign state. This means that, a creditor cannot cease virtually any of the debtors assets in case of former's default. Second, under the foreign immunity "sovereigns cannot be sued in foreign courts without their consent" (Panizza 2009).

It is difficult to imagine domestic court ruling against its own government. In view of the above stated, it has been a puzzle to the economic research why sovereign debt ever got replayed, or why foreign financial institutions are willing to invest into government bonds; and also, why it has been for many years one of the safest investment options on the market. To answer these questions we need to turn back to the economic literature on the topic at hand developed since 1980's. Extensive overview of those findings will be provided in section two of this study. At this point it is important to understand the basic cost benefit analysis of the agents. Most of the authors suggest that there are a number of economic incentives for the governments to repay their debt.

First of all, it is the reputation concern of the country, which makes governments stick to their debt agreements. From the political point of view, it is very important for the government to keep its face. However, some of the scholars believe that the reputation is not enough to provide incentive for repayment of the sovereign debt.

The second reason, which is the one of the practical implications of the first one, for the government to repay its debt is the considerations of the market access. In most cases when the government defaults on its debt obligation, it loses access to the foreign financial market. Man scholars agree that it is the most important reason why governments try not to default. Losing access to the foreign assets market mean that government loses one of the biggest sources of financing the budget deficit, as well as any development projects. However, it also cannot entirely explain economically why countries repay their debt. Because exclusion from sovereign debt market is not permanent. Following their economic interests, investors start crediting sovereign governments after a certain period of time after the latter's default. For example, countries defaulting in the 1980's regain access to international capital markets after four to five years, on average. "And eventually almost all the countries that defaulted in the 1980's regained market entry in the 1990's" (Panizza, Sturzenegger and Zettelmeyer 2009).

Third, in case of the default the cost of borrowing rises for sovereign debtor. This also harms the national economy of the debtor country, and can be a catalyst of further financial difficulties of the sovereign state. On average, the spreads of the bonds of defaulting countries are 400 basis points higher in the first year after default (Panizza, Sturzenegger and Zettelmeyer 2009). But as well as the former, this effect of the default is not permanent. Further statistical studies show that this effect diminishes after the second year. This makes it a rather strong but short term effect.

Among others, it is also important to mention relative trade reductions and domestic costs of default that government of the debtor country faces. The former has proven to be present in part of the cases of sovereign debt default. There are empirical evidence of presence of positive correlation of bilateral trade and bilateral lending. But there is only weak evidence that trade flows suffer from the state of default.

As for the domestic costs, they may provide a strong incentive for the governments to hold their end of the debt obligations. The domestic costs that the government faces in the case of default are closely tied to the political future of the political parties and personalities that are in power. The effect of internal costs of default is twofold. On one hand, it provides a solid incentive for the government to run a sound and prudent policies in order to be able to service its debt obligations. But on the other hand, it creates a moral hazard. The reason for this is that the sovereign debt contract is definitely the one which features the asymmetric information. Asymmetry occurs in the knowledge of the true state of economy. As a result, the governments are obviously in the position to better assess its ability to meet the debt obligation. Moreover, the debtor government may be tempted to hide the true state of the economy, to earn political credit, and shift the cost to the successors. This presents a serious moral hazard, and raises an issue of monitoring and accountability.

1.4 Motivation

Free flow of international capital has numerous upsides for economic agents, but it may also lead to severe financial crises. There are two ways how the international community can offset or soften this effect. There are crises prevention and crisis management policies. The presence of the orderly sovereign debt restructuring procedure or sovereign bankruptcy procedure can contribute to both.

Since the last sovereign debt crisis there have been a lot of political will accumulated to make changes to the current system of sovereign debt accumulation and management.

As the research on the subject developed, there still hasn't been any consensus on the actual steps that have to be taken toward more stable international financial system. It is still unclear which type of crisis management is most suitable in the situation of sovereign debt crisis. There are a lot of special cases which should be dealt with separately. Nevertheless, it is of utmost importance to design a system which can encompass most of the possible scenarios of states insolvency.

After the recent crises there has been a call for establishment of the sovereign bankruptcy regime. The need of orderly restructure procedure was felt most strongly during the Greece crisis. The crisis threatened the stability of the whole Eurozone. The case of Greece, as a member of currency union and the European Union, makes it of particular interest. The reason for it is that the already existing EU institutions make the introduction of the sovereign bankruptcy procedure in the EU more plausible than in the rest of the world.

It is worth mentioning that the idea of applying the principles of bankruptcy procedures to sovereign government is not new. It goes back to the foundation of the theory of modern economy.

2.1 Historical overview

It is generally accepted that state insolvency is not just a feature of last years of advanced international securities markets. In different periods, national economies faced imbalances of government expenditure and tax revenues and/or trade deficit. As it was outlined in the definitions section, the latter may lead to the insolvency of the sovereign government, in other words, when the government cannot meet its debt obligations. The history of sovereign government bankruptcy is one that stretches over several centuries. Since the early 16th century, the countries have used foreign loans to finance their budget deficits. Furthermore, the default was very common. Between 1500 and 1800 France defaulted on its Sovereign debt eight times, while Spain defaulted thirteen times during the same period (De Paoli, Hoggarth and Saporta 2006).

There were a number of cases of sovereign bankruptcy in the 19th century and after the World War I. In the 1930's after the Great Depression, French and British governments defaulted. The emerging countries defaulted in the 1980's. Besides this, Russia defaulted on its legal obligations to the domestic and foreign creditors. The new millennium began with Ecuador and Argentina insolvency.

Throughout the history there were different resolution procedures for state insolvency. Before signing the United Nations charter, Article 2 of which prohibits countries to use force, creditor countries were not reluctant to threaten debtor counties or even wage wars to secure the repayment of the debt. Countries used force to ensure repayment of the debt of both public and private investors. In the time of the Gold Standard in the late 19th and early 20th century countries used force to enforce their creditor's rights. There were two major types of this practice. First, using military forces the creditor country attacked the debtor country to insure repayment of the debt. Second, creditor state overtook the political administration of the debtor country.

The most prominent example of the first method was the attack of Venezuela by first the United States in the mid-1890s and then by Great Britain and Germany. In 1902 military fleets of two countries kept on attacking the coast of Venezuela until the latter repaid the debt (Buchheit 2005). This precedent became known in the history as a "gunboat diplomacy".

There are also other examples of the so called "gunboat diplomacy". For example, United States used military force to ensure the debt repayment of Panama, Nicaragua, Haiti, Cuba, Honduras and Dominican Republic. But as sovereigns became less immune to legal actions in twentieth century, this practice also became less used. At the same time, many changes to the national and international legislation made it difficult for a country to justify military action with protection of private investments or collection of the public debt.

The other form of "super-sanctions", which deserves attention, was foreign administration of the debtor country. The so called "house arrest" included the control of the social and fiscal policy of the debtor country, as well as trade tariffs and monetary policy. This can be illustrated by the examples of the British invasion of Egypt in 1882, British and French administration of Turkey and Greece in the early 20th century. Other distinctive example of the "house arrest" was the United States initiative of "controlled loans". Under the provision of such loans the debtor country voluntarily let the United States control its economic policy, in case the debtor country fails to service the loan. This direct and indirect control of the debtor country's government by the United States is also known as "dollar diplomacy".

It is, however, worth mentioning that the effect of the "house arrest" of the government on the debtor countries economy is twofold. On the one hand, in most cases, foreign administration stayed in place for a considerable period of time. For example, government of Egypt was deprived of its economic freedom for 32 years. The Turkish government was under the "house arrest" for 31 years. On the other hand, foreign administration often brought significant improvement to the country financial and political systems, and in some cases even to the country's infrastructure. This happened because it was much easier for foreign administration to introduce unpopular policy, which created benefits for the host country in the long run. For example, during the Turkey's "house arrest" foreign administration negotiated investments in the railroads. This significantly improved countries infrastructure and transportation system. Foreign fiscal commission increased the borrowing power of the Greek government by introducing very important fiscal reforms. In Egypt British administration, among other, introduced new fiscal policy and tax collection system. Although "house arrest" did have its benefits for the debtor countries, it came at a very high price. In total during the Gold Standard "super-sanctions" were used 43 times, which account for 28% of all sovereign defaults of the same period.

The historical examples of the "gunboat diplomacy" and "house arrest" show that sovereign immunity was never enforceable enough, without the effective implementation of the separation of powers. The international community was not able or willing to ensure that the sovereign state has exclusive right to control its own affairs. Although now the practice to enforce debt repayment with military force is no longer in play, sovereign governments still face a broad variety of political and economic pressure in case of the default.

2.2 Theoretical literature overview

It is widely agreed that the idea of introducing a sovereign bankruptcy procedure is not new. It has been long discussed in the economic and political economy literature. The origins of the concept of the sovereign bankruptcy regime dates back to the late 18^{th} century to the father of modern economy, Adam Smith (1776):

> "When it becomes necessary for a State to declare itself bankrupt, in the same manner as when it becomes 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 hurtful to the creditor" (Smith 1776).

In the modern research publications the oldest reference to the sovereign government bankruptcy suggestion is Ohlin (1976) who provides the argument for the orderly insolvency procedure. According to Ohlin "development finance needs something like the institution of 'honorable bankruptcy'", which the author believed would "enable the credit system to work without too much risk aversion and to recover quickly from failures. The option of bankruptcy would prevent the machinery from getting clogged up by a lot of dead debt" (Ohlin 1976). In his work Ohlin advocates the importance of the swift and structural procedure for dealing with sovereign debt crisis. Ohlin outlined that it is harmful for the international economic relations to have the situation of difficult and unpredictable debt discharge or restructure process. Similar arguments were raised during Peru sovereign debt restructuring process by the Stallings (1979) and Cline (1981).

The first author who suggested the procedure for restructuring sovereign debt similar to Chapter 11 of the US Bankruptcy Code was Oechsli (1981). Oechsli proposed to apply the number of procedures of Chapter 11 to sovereign debt restructuring. The author outlined three most important procedures. According to Oechsli (1981) there should be formal initiation procedure, the presence of the creditors committee and the independent examiner, which does not disrupt the debtor's activities. The author believed that the IMF can play the role of the intermediary, but emphasized that the sovereign debtor should be involved into design of the restructuring offer. The initiation procedure could be triggered by both debtor and creditors. But creditors and the examiner, the IMF, are not obliged to accept the debtor submission. Oechsli recognized the problems of current sovereign default procedures. Among others, he outlined the too long negotiations and unpredictable outcomes. Author also believed that the significant contributions to the problem are information asymmetry and creditor coordination problem. In view of that Oechsli concluded that, although, the institutional solution to the problem is desirable, it is not the only one possible.

> "Alternatively creditors could specify binding arbitration procedure in their contracts… Neither, however, is necessary for Chapter 11 procedures to be applied successfully in the renegotiation context. Establishment of a renegotiation plan could be by the agreement and consensus of the parties, and not by imposition from some international institution, accounting losses upheld" (Oechsli 1981).

In his time, Oechsli's proposals did not find much support, despite being very farsighted. His debt restructuring idea as a three-party negations process between the stakeholders and the independent arbitrage institution were later formalized by Bulow and Rogoff (1988). In their work the authors used Oechsli's framework to analyze the ex-ante problem of creditor moral hazard and ex-post sovereign debt restructuring efficiency.

The next important milestone in the research on sovereign insolvency was Sachs (1984). In his study, Sachs focused on the collective action problem in the view of rescheduling or restructuring of the sovereign debt. He emphasizes the presence of the free rider problem in the current sovereign debt workout. Sachs argues that the free rider and the holdout problem of the single creditor are harmful both to the debtor country and to other creditors. "Even in bank syndicates significant free rider problem remains" (Sachs 1984). In his later work Sachs also refer to the Chapter 11 procedures. He argued that the internationalization of the provision of the Chapter 11 of the US Bankruptcy Code may contribute to the solution of the holdout problem and prevent the self-fulfilling crises.

> "Individually, these creditors have an incentive to call in their claims against the overextended debtor countries, even if doing so injures the economic performance of the debtor so much that the creditors suffer collectively. Preventing such a destructive race to liquidate assets is one of the major purposes of the bankruptcy code, which restricts the ability of the individual creditors to act against the group interest. Unfortunately, countries cannot file for Chapter 11 protection" (Sachs 1984).

Apart from policy proposals, which required significant change to the national and international legislation, there were also some distinctive ideas, which relied on the existing legal framework. One of the most interesting once was the proposal of Debevoise (1984). Debevoisse suggested a keen interpretation of the Article VIII, Section 2[1] of the IMF Articles

[1] "a) Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payment and transfers for current international transactions.

of Agreement in order to use it to protect sovereign debtor suspending its debt servicing unilaterally during the debt restructuring process.

The idea of Debevoise was for the IMF to introduce interpretation of the Article VIII in order to recognize debt contracts as type of “exchange contracts” mentioned in the Article. However, Debevoise proposal didn’t have any practical implications.

The next wave of proposals focused again on the establishment of new institutions or changing the existing ones. After the Mexican crisis in the 1994, there were a number of articles, which contributed to the modern discussion about the design of the sovereign bankruptcy procedure. Among others, the most distinctive studies were conducted by Barnett, Galvis, Gouraige (1984), Kaeser (1990) and Raffer (1990). Most of these studies continued in spirit of the ideas previously expressed by Oechsli and Sachs. Barnett, Galvis, Gouraige, for instance, suggested that it is important to create a new international court-like institution for sovereign debt crisis resolution. This institution, according to the authors, should be completely independent from the IMF. Barnett, Galvis, Gouraige, unlike the authors of previous contributions like Oechsli, argued that the IMF is not the best candidate for the job. The reason for this is that, the conflict of interests that the IMF may face when presented with the case of a sovereign state, which at the same time is the debtor of the IMF. In view of this, Barnett, Galvis, Gourage advocated the creation of the additional supranational body, which should be entitled to the following actions. It should be in power to host and arbitrage the negotiation between debtor country and the creditors, order the debt renegotiation procedure, protect debtor from any litigation of the creditors, decide the fair conditions of the restructuring deal, and preempt the parties from undertaking different restructuring procedures then agreed under the provision of this institution (Barnett, Galvis and Gouraige 1984). Among others, one of the most important aspects that should be addressed with this initiative is the collective action problem of the creditors. In their work Barnet, Galvis, Gourage, as much as earlier Sachs, emphasizes the problem of the holdout

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b) Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.”

creditors which can free-ride on the resolution plan and by doing so render it ineffective. Despite stating the benefits of proposed international institution authors also recognize the presence of significant political obstacles for this initiative. However, they believe that the international community can benefit even from the creation of a more modest institution.

Continuing this line of argumentation another distinguished contribution was made by Raffer (1990). He also advocated the creation of supranational bankruptcy court. Moreover, in his work Raffer proposed to internationalize Chapter 9 of the US Bankruptcy Code. According to the author Chapter 9 is much more suited to be used for sovereign bankruptcy procedure than Chapter 11. The reason for it is that Chapter 9 applies the bankruptcy procedures for the US municipalities. First of all, Chapter 11 is not possible to apply to the sovereign states in full because of the liquidation procedure, which is clearly impossible for a country. On the contrary Chapter 9 suggests limited court interference with municipality policies. Furthermore, in his later publications and presentations Raffer argued that Chapter 9 of the US Bankruptcy Code is ready to transplant to the European Union, almost “as if”, with the same provisions.

It can be argued that, the particular importance of Raffer’s contribution to the topic of sovereign debt managing mechanism is in one more aspect. In his studies, Raffer emphasized the moral side of any ordered restructuring of renegotiations of the sovereign debt. This consideration is mostly related to the least developed and overindebted countries. In the case of a court-like bankruptcy regime, these countries can be led in the direction of the violation of the human rights. By implementing unpopular austerity policies, the government can substantially lower the quality of life of its citizens. Raffer claims that such cases cannot be allowed. Therefore, there should be additional possibilities to control restructuring plan and debt relief in the case of sovereign bankruptcy procedure.

One more important, but less frequently discussed contribution to new institutional wave of proposals was by Kaeser (1990). He developed the idea of a supranational control further. The author suggested the new features of these procedure which reappeared during the modern discussions. Kaeser suggested designing the mechanism of the sovereign bankruptcy workout, which should be tied mostly to overindebted countries. The author proposes to establish a permanent monitoring of countries sovereign debt level. Based on the available statistical data Kaeser suggests establishing a threshold of countries debt at 25% of total trade revenues. Moreover, the country that reaches this line, should file for bankruptcy with the supranational institution. The latter, in turn, will order the restructure procedure and reform, in order for countries to get back to the safe levels of debt. Kaeser argues that this type of the mechanism would serve two purposes at the same time. First, it will provide the clear and predictable procedure for debt renegotiations and restructuring. Second, this mechanism will also make borrowing cheaper for the solvent countries, which are below the margin. Kaeser believed that such framework would significantly revitalize sovereign bond market and normalize the debt levels.

There is a number of studies which develop the topic further. They provide interesting suggestions and emphasize on the important aspects of the sovereign debt managing problem. But in terms of identifying the problems and suggesting the key tools of the solution mechanism they mostly rely on the above mentioned ideas. It is, however, of utmost importance to mention the most influential contributions which brought the topic further. Among others, I want to focus on the influential lecture by Sachs (1995) and the speech that triggered the modern discussion of the sovereign bankruptcy regime by Krueger (2001).

As mentioned before, in his speech Sachs did not bring any new issue to the table. But he offered a broad view of the sovereign bankruptcy regime benefits. Sachs emphasized that the presence of the sovereign bankruptcy regime will not only help solving the solvency crisis, but also preempts the appearance of the latter. More than that, he argues that the stand still feature of the bankruptcy court procedures can preempt the self-fulfilling debt crisis, caused by investors' debt runs. According to Sachs, the insurance that the money will not flee the country will provide disincentive to such actions, which under current conditions, cause disastrous consequences. He did not precisely spell out the moral hazard in case of official crisis lending. Rather, in his broader picture, Sachs provided an argument that under the predictability of the rules and the presence of seniority of the new debt, the private sector can effectively play the role of the provider of new money. Apart from generalizing the topic and discussing the crucial insights, the importance of the Sachs speech is in the popularizing the topic.

The credit for bringing the issue of sovereign bankruptcy regime to light in the new millennium belongs to Krueger (2001). In her speech, Krueger stressed the challenges that the international community is facing. She underlined the inability of the current financial system to deal with unsustainable sovereign debt. Krueger suggested that the orderly workout of the sovereign debt crisis would only benefit all the parties involved. In her speech, Krueger implicitly proposed the establishment of the sovereign bankruptcy procedure under the provision of the International Monetary Fund. The Sovereign Debt Restructuring Mechanism should have encompassed all the aspects mentioned in the literature. According to Krueger, the SDRM should have had four distinctive features:

> "First, it would need to prevent creditors from disrupting negotiations on a restructuring by demanding repayment through national courts. Second, it would have to ensure that the debtor behaved itself during the period of the stay, treating creditors properly and adopting appropriate policies. Third, private lenders would need to be encouraged to provide new money with some assurance that they would be repaid ahead of existing creditors. And fourth, the mechanism would have to bind minority creditors into accepting a restructuring once it was agreed to by a large enough majority." (Krueger 2001).

She argued that despite the obvious political difficulties of arriving to this solution, the SDRM is vitally important to the health of the modern financial system. Krueger's proposal has triggered a big discussion of the topic of sovereign bankruptcy regime and was considered by the IMF. However, it was never realized.

3.1 The issues of design of the sovereign bankruptcy regime

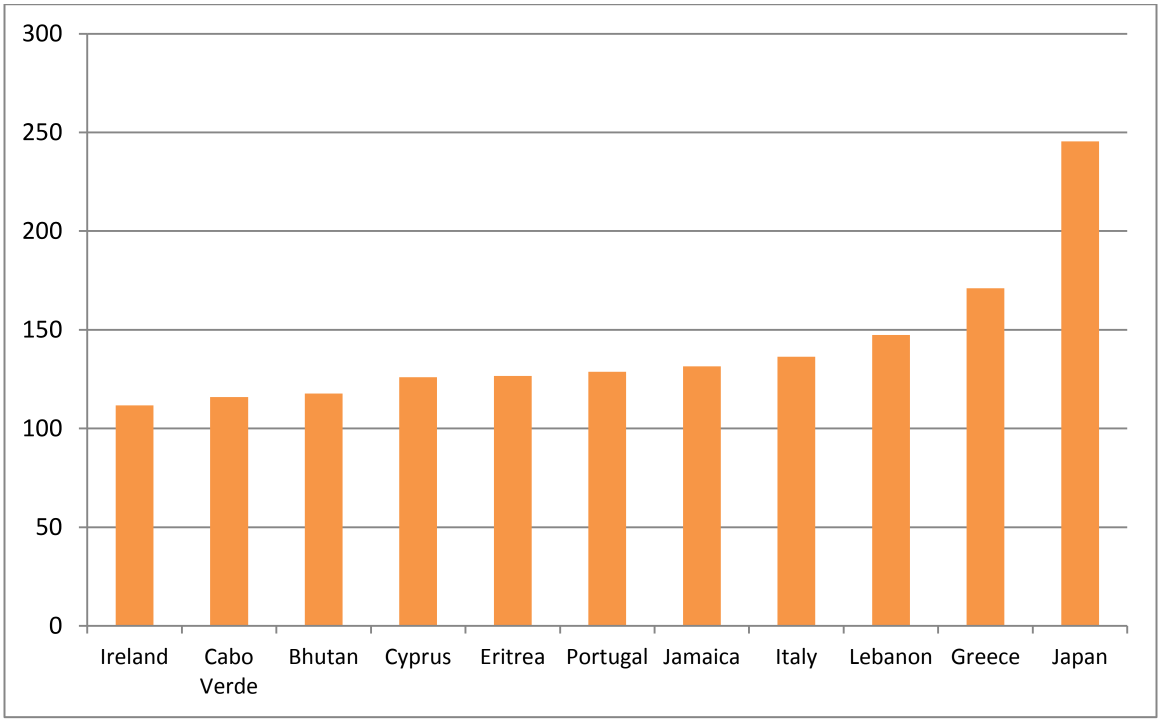
As it is important to develop a comprehensive system of the sovereign debt crisis workout, it is crucial to first identify the problems that have to be solved. The sovereign bankruptcy regime should be effective in two ways. First, it should have enough deterrent incentives for countries to avoid overborrowing ex ante. Second, it should provide extensive roadmap for the orderly debt restructuring procedure ex post. For these reasons it is important to clearly define all the aspects it has to encompass. For the sake of simplicity I will structure the issues that have to be concerned into two broad categories. Namely, pre-crisis ex ante problems, and ex post inefficiencies and dangers.

3.2 Ex ante issues

Since the sovereign debt crisis rarely appears from nowhere, it is the very first task of the analysis to study the causes that leads to the crisis situation. Although most of the sovereign defaults are the consequence of a combination of issues and it is very difficult to disentangle the pre-crisis environment. There are some stochastic events, as well as imprudent policies that most often lead to the sovereign debt crisis. Among others, scholars define the next most common causes of the sovereign debt crisis.

First, it is the shock to the fundaments. An external or internal shock to the fundamental economic components is often among the triggers of the debt crisis. A dramatic change of commodity prices on the international market, for instance, could serve a potential cause of the country's financial difficulties. However, the shock to the fundamentals is seldom a sole cause of the debt crisis. Although it can be a starting point of the countries budget imbalances. This, in turn, in combination with other factors, such as, imbalance of imports and exports, can bring country to an edge of the default necessity.

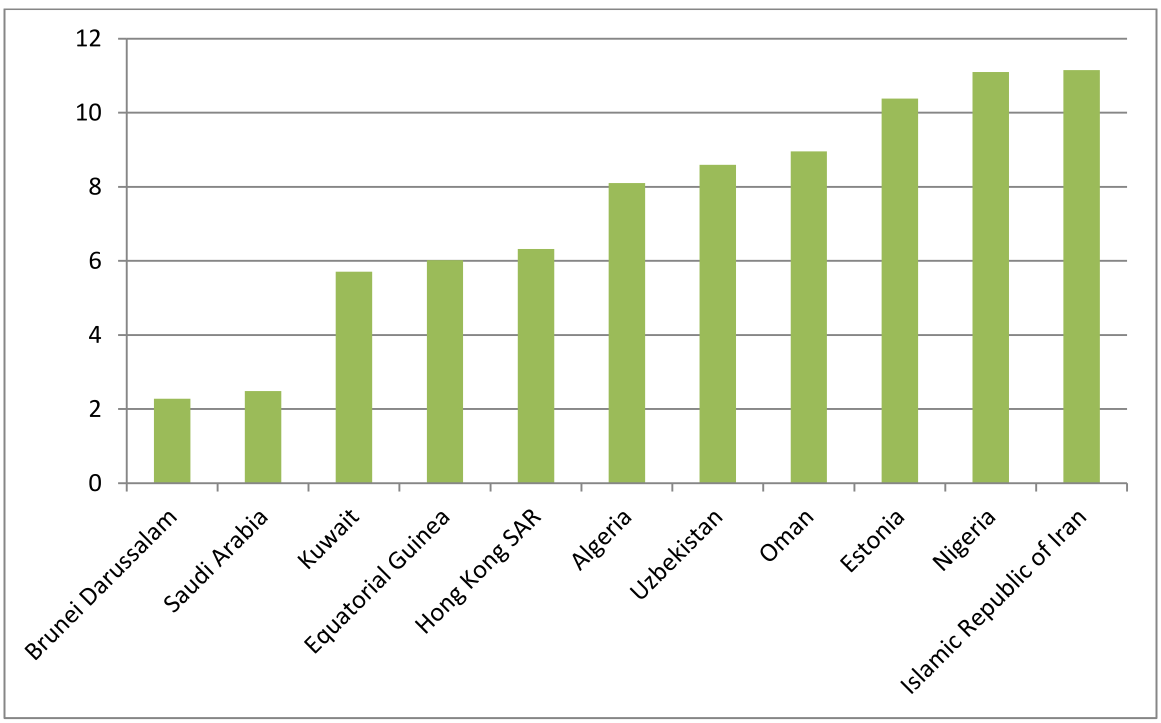
Figure 1 Countries with highest debt to GDP ratios in 2014



Source (IMF, World Economic Outlook Database, October 2014)

Therefore, the second, and seemingly the most important one is the overborrowing by sovereign governments. Overborrowing is a very common practice in the modern world of advanced financial instruments. Theoretically, however, countries should be in the situation of the “underborrowing”. This is clearly implied by constraint, which sovereign governments face, namely the potential costs of the default. These costs were briefly discussed in the previous section. However, despite the fact that classical economic theory predicts “underborrowing” most of the countries are, indeed, accumulating more sovereign debt that they should from the social perspective. According to the theory, in the perfect world, governments should borrow to the point where cost of one additional unit of debt equals the social benefit of additional unit of debt. However, looking at the sovereign debt statistics, one could argue that most of the advanced economies are well above this level. Therefore, in the real world it is safer to assume that the debt levels are defined by the policy choices, and not by social optimum. In most cases, overborrowing triggers debt crisis through its pro-cyclicality. In a typical case investors tend to lend too much to the countries during the good times driven by overoptimistic herding behavior, and. after a global shock, liquidate the investments causing self-fulfilling crisis. The main case for this type of creditors' behavior is the presence of international lender of last resort. In view of this, part of the creditors may disregard the risk levels and lend too much to the countries with weak economies. One other reason for governments to overborrow, is, clearly, the myopic or dishonest policymakers. In some cases self-interested government officials may raise the debt levels above the sustainable levels to earn fast political credit, disregarding the future consequences.

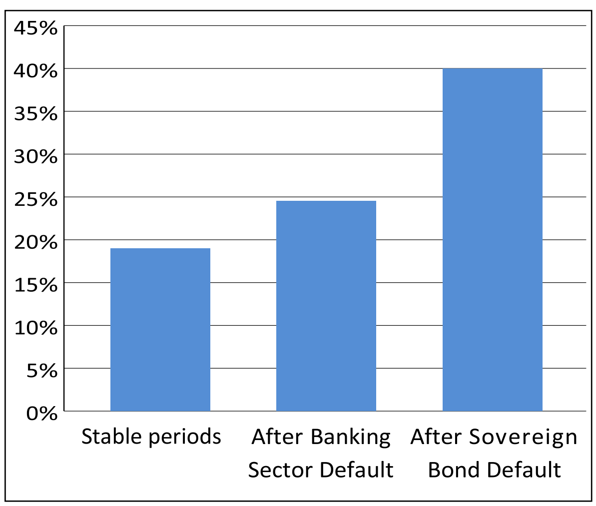
Figure 2 Countries with lowest debt to GDP ratios in 2014



Source (IMF, World Economic Outlook Database, October 2014)

Third, pre crisis issue, which can, in worst cases, lead to a sovereign default is bad debt management. The most important in this domain is the delaying of a needed debt restructuring by the policymakers. Self-interested policy makers may delay the restructuring or renegotiation of the debt in view of personal costs. According to recent study (Borensztein and Panizza 2009), there is a high probability of staff change in case of the sovereign debt default (Figure 3). The other reason for delaying the needed restructuring, that government officials overstate the real cost of the restructuring, as there is no clear debt restructuring roadmap. These procrastination policies are extremely dangerous. Moreover, they may substantially contribute to the debt of the future crisis. The reason being, that procrastination on the part of the government extend pre-crisis state of uncertainty among investors. Therefore, may further decrease the country's ability to repay the debt.

Figure 3 The probability of replacing the minister of finance



Source (Borensztein and Panizza 2009)

3.3 Ex-post inefficiencies

The current practice of debt restructuring is surrounded by inefficiencies. This happens for the reason of sovereign debt existing virtually in the legal vacuum. With no automatic or quasi-automatic triggers and no clear mechanism, the sovereign debt restructuring process is inefficient both ex-ante and ex-post. The success of the sovereign debt renegotiation and restructuring process in current conditions depends on a number of circumstances. Among others, this process depends on barging power and skills of the parties, commitment, external factor and “luck”. Luck omits the restructuring episodes where the holdout creditors arise. In the past, however, the holdout creditors haven’t disrupted the restructuring process. One of the most important exceptions is the case of Argentina restructuring its sovereign debt obligations in early 2000’s. The case of Argentina is both worrying and illustrative, as it can provide the potential litigators, specialized in the distressed debt funds, new revenue generating tool. The Argentina case in a nutshell is as follows. In the early 2000 Argentina defaulted on more than $80 billion of its debt in foreign bonds. Argentina offered a debt restructuring conditions of 70% haircut to its creditors and reached 93% creditor participation. However, NML Capital, Ltd., affiliate of the Elliot Associates, was among the creditors who rejected the proposed restructuring offer and decided to start a legal dispute in order to get full repayment. Argentina, in turn, decided not to settle with NML Capital and moved its foreign assets beyond reach. In 2012 the New York federal court ruled that Argentina has violated its bond contracts, namely, the pari passu clause in the debt contracts. Pari passu means that all the bond holders have equal rights of payment. According to the court by paying the coupons on the restructured bonds, and not paying the holdout on their original bonds, Argentina violated the right of equal payments. Since pari passu is one of the clauses that Argentina voluntarily committed to, federal court and the court for second circuit both rejected the Argentina’s appeals. In view, of the alleged violation of the equal right of payment clause, the court prohibited Argentina to service the restructured debt unless the holdouts were paid in full simultaneously. The court also threatened third parties, such as clearing houses and payment systems, with sanctions if they provide Argentina with a possibility to channel its payments. Argentina with its president Kirchner, however, didn't seem to back off its positions. Argentina filed a law suit to the International Court of Justice against the United States, that it has infringed Argentina's sovereign immunity. Argentina also announced to offer its creditors a swap of New York bonds for domestically issued bond, which would effective shield it from further attachments from the holdouts. Although, Argentina with its present foreign policy is not easily persuaded, the legal precedent itself may be contagious per se.

The New York court ruling in the Argentina vs. NML Capital case, is very important is several respects. First, it may have created the new litigation technique, with which holdouts can enforce repayments imposing sanctions on the third parties, and, by doing so disrupting the sovereign debt restructuring process. Second, New York court ruling may have a disincentive effect on creditors' participation in the restructuring negotiations. A creditor would be less likely to accept a haircut, when there is a possibility to have even this reduced payments interrupted.

One potential solution to the holdout problem may be the introduction of the collective action clause into the sovereign bond contracts. The collective action clause means that under certain conditions the majority of the bondholders may impose the restructuring conditions on the minority. The collective action clause also helps to solve the creditor coordination problem. Using this feature of the bond contracts, creditors can commit to symmetric actions, which makes the debt renegotiation process easier. Since the early 2000s sovereign governments started to introduce collective action clause in their bonds. However, it will take some time until the majority of the sovereign bonds will contain this collective action clause. Also it is important to mention, that most of the collection action clauses presume changing of the debt servicing conditions only for the given bond series. This means that, in order to arrive to the consensus, creditors would have to vote series by series every bond issue. In this framework, in the case of the sovereign debt crisis, the "professional" holdouts may still target the small bond issue, purchase majority of the bonds at a discounted price and demand a full repayment. One other consideration regarding the effectiveness of the collective action clause is illustrated by the Irish Bank Resolution Corporation case. The Irish Bank tried to misuse the collective action clause. In its restructuring offer to the bondholder, the Irish Bank asked them to vote for the decreasing of the face value of the non-participating bonds by 99,99%. After this the bank was sued. In its ruling the UK court decided that this was oppressive and ordered the Irish Bank to pay the nonparticipating bondholders and participating bondholders equally. With this ruling the UK court effectively reduced the future value-added of the collection action clauses. If the nonparticipants and participants restructuring both receive the same, then the incentives to participate are weaker.

3.4 The model building blocks proposal

As it is shown in the previous sections, there are issues that have to be addressed by a comprehensive and effective system that is called to solve the sovereign debt crisis problem. Unfortunately, by this time there seems to be no solution present in the current financial system. It is also hard to encompass all the issue under one framework without endangering a spill over to the other important mechanisms of the modern sovereign bond market.

In this section I will present different approaches to solving the problem of sovereign debt crisis work out. Then I will combine them into a simple high-level proposal. In this exercise I am assuming that there is enough “political capital” accounted to implement the changes needed for the new orderly sovereign bankruptcy regime to be effective.

First of all, the objectives of the sovereign bankruptcy regime design will be summarized. From the debtor side, the government need a protection of ex-ante borrowing capabilities. The sovereign bankruptcy regime should ensure that the possibility of the default does not drive the prices of debt up. The government should also have a transparent view of the default risk costs. It is of utmost importance that the politicians have conscience understanding of the cost associated with the default risk. The sovereign bankruptcy regime should also fill in the legal vacuum of absence of an orderly sovereign debt restructuring procedure. From a creditor's perspective, the sovereign bankruptcy regime should provide a clear understanding of default risk costs. In this way the presence of an orderly sovereign debt workout should prevent the moral hazard of lending to high risk debtors. The new regime should also address the issue of the seniority of new debt accumulated during the freeze of the original obligations. In this way it would be possible to attract new money to the overindebted country, and help revive the economy more quickly with public lending. Never the less the new sovereign bankruptcy regime should remove the unpredictability of the sovereign debt workout by providing the clear road map and setting expectation of all parties involved.

In order to create a comprehensive sovereign bankruptcy procedure I concluded that it is important to address several issues simultaneously. For this procedure to be effective it has to be implemented in several streams at the same time. The effective sovereign bankruptcy procedure should first of all be able to lower the cost of default. As discussed in the previous sections, the presence of the commonly known reliable an enforceable procedure will by only it's presence inevitably lower the cost of default and allow the government with unsustainable debt level to set for a fresh start. It would also foster the inflow of the fresh money to decrease the economic recovery period and revive the national financial system.

At the same time this procedure should not make the debtor country borrowing cost higher, for example, be forced to offer higher interest rates. In the presence of an easy default option the debtor would have to compensate for the higher risk by charging higher risk premium. Consequently, the cost of borrowing would be higher for the debtor country with all conditions being equal. To avoid latter negative externality of the presence of sovereign bankruptcy procedure the transparent screening by the third party should be allowed before filing for the sovereign bankruptcy procedure. The third party should confirm the country need in sovereign bankruptcy workout only in the case of the unsustainable debt level present. It should not be allowed for the debtor countries to use the sovereign bankruptcy procedure to execute a strategic default at the time convenient for the debtor country's government.

As the basis of a new healthy sovereign borrowing system the new system should unquestionably create the legal basis for conducting an orderly sovereign bankruptcy procedure. It means that the contractual base of the debtor – creditor relations should be changed. As the bond contract design alongside with the institutional framework is one of the stepping stones for making an orderly sovereign bankruptcy regime possible. The debt contracts have to change in, at least, two distinguished ways. First of all, it should include the collective action clause, in order to protect the sovereign debt workout from the holdout problem. Under the provision of the added collective action clause the majority of the bond holders should be able to impose the achieved, during the sovereign bankruptcy negotiations, conditions on the minority. However, as the evidence of the past suggests simple collective action clause may fail in protecting the sovereign bankruptcy procedure from the professional litigators, as the latter may target the small series of the bonds and still holdout. In order to avoid this type of holdout problem the collective action clause has to be of an aggregated level. Under this type of collective action clause the bond holders, disregarding of the series of the bond, may agree to the restructuring plan on the aggregated level and force the minority of the holders to accept the terms. Only this type of the collective action clause may by design be a sufficient deterrent for the holdouts seeking profit in holding the distressed sovereign bonds

Last but not least, the new sovereign bankruptcy regime should provide a clear road map for the default procedure. The presence of such transparent roadmap ex-ante would enormously contribute to the issues of predictability of the debt workout so far. By setting expectations of all the stakeholders the sovereign bankruptcy procedure would change the sovereign default from complicated and highly intransparent bargaining process into a legitimate institutionalized and orderly procedure.

3.5 The model setup

In my proposal for the new sovereign bankruptcy procedure I distinguish several levels of solution. Depending on the amount of effort and commitment of the international community, there are several improvements that can be made to the sovereign debt workout. Starting from the least difficult and cumbersome adjustment and concluding with the full comprehensive sovereign bankruptcy regime.

As discussed in the previous section, the most basic improvement to the current sovereign bankruptcy procedure would be a contractual enchantment. The improvement to the existing sovereign bond contracts by introducing collective action clause that is enforceable on the aggregated level across all the bond issues. This change alongside with standardisation of the bond contracts in major jurisdictions would provide a possibility for the debtor countries to renegotiate or restructure the sovereign debt with much lower risk of encountering the holdout problem. Removing holdout problem which has disrupted the restructuring attempts of a number of overindebted countries, the contractual approach would provide common ground for the debt renegotiating in the future.

The next level of the sovereign debt workout procedure is the partial institutional solution. In the framework of this solution a supranational body should be created. Such an institution would have the power to check the sovereign debt sustainability on the country level. Playing the role of the referee this institution would provide a resolution mechanism of examining the country's insolvency claims. It would necessarily be a basic feature of such an institution to have the enforcement power and the jurisdictional legitimacy. As it is extremely difficult from the political and socio-economical perspective to create a new supranational body, it would be a logical approach to use the existing institutional landscape for this purpose. The obvious candidate would be the International Monetary Fund. There are a number of reason for creating the new sovereign bankruptcy procedure under the IMF jurisdiction. First of all, the IMF already is an established economic forum which includes the majority of the countries. One other important feature of the IMF is its function as the lender of the last resort. The latter is the addition to the mechanism of an orderly sovereign debt restructuring.

In the design of the partial institutional solution the role of the IMF would be twofold. On the one hand, it will assume the role of the referee. The IMF would have the power to decide whether the debt is unsustainable or not. In the case of the country's sovereign debt level being unsustainable, the country would be eligible for the special sovereign bankruptcy procedure under the IMF protection against individual creditors' litigations. At the same time the country filing for the bankruptcy procedure would be blocked from the receiving other type of financial support from the International Monetary Fund. This aspect of the design would reduce the moral hazard from the presence of the international lender of last resort. If the IMF, having examined the bankruptcy claim, decides that the sovereign debt level is still sustainable without any need of the debt relief, the debtor country would not be allowed to proceed with bankruptcy workout and would be offered a standard IMF credit package.

The partial institutional solution is suitable for application on the international level and does not require the creation of the new institutions or signing new treaties. It can be achieved only by signing an amendment to the International Monetary Fund Articles of Agreement, with consequent ratification by the member states. However, partial institutional solution still lacks some important feature of the sovereign bankruptcy regime. Namely, the continuous monitoring of the member states debt levels, debt to GDP ratios, fiscal and financial prudency of the governments. Moreover, it lacks the automatic trigger of the bankruptcy procedure for the countries which reach the certain threshold level. However, the latter features are extremely difficult to implement on the broad international level. For this reason, in my opinion, the current solution is the maximum that international community should aim at this level of the international relations.

The complete institutional sovereign bankruptcy procedure would include all the above stated terms and would be most effective and comprehensive framework for solving the problem of the sovereign debt workout. It would also remove the roots present in the majority of the sovereign debt crises. However, taking into account the current legal and jurisdictional diversity of the modern global financial system, such a solution could only be implemented in highly integrated part of the international community. The best example of the fertile grounds for such an initiative would, without doubt, be the European Union. Sharing the same currency and negotiating the creation of the banking union, the EU countries would be ready for setting the sovereign bankruptcy procedure as a part of the existing EU level supranational institutions. The proposed agreement can fit the existing framework of the European Stability Mechanism. The competence of the agency may be updated with the following additional attributes. The ESM would play the role of the referee for the bankruptcy procedure on the European level. Moreover, under the provision of the sovereign bankruptcy procedure in the legal scope of the ESM agreement, the debtor country may be politically forced to start the bankruptcy procedure when reaching a threshold level of sovereign debt. The latter may be set to a level of 65% debt to GDP ratio. Although, one may argue that this number is arbitrary, however, it achieves the most important goal of being a commonly known transparent figure. By setting clear boundaries of debt levels that are allowed for the countries, the sovereign bankruptcy procedure would establish a new level of transparency on the international sovereign bonds market. In this way one of the goals set in the previous sections is achieved, namely, to keep the sovereign debt cost at the acceptable level. Prior knowledge of the probability of the country entering into the bankruptcy procedure would set clear expectations for the creditors, and, therefore, stabilize the cost of debt. On the other hand, the obligatory nature of the bankruptcy procedure at the time when the country exceeds the threshold, decrease the probability of the country reaching this level, and, subsequently, lower the cost of default risk. The important detail in this situation is that there should be a short time period during which the country may return to the safe debt to GDP ratio level without having to file for bankruptcy procedure. Having this safety corridor would allow countries to accommodate higher levels of debt during recessions or economic crisis periods. However, so that this safety corridor should not be misused, the transparent monitoring of the countries economical KPI's is mandatory. This brings us back to the main building block of this proposal, namely, creating the supranational body or reusing the currently present one. This institution, as argued above, should necessarily have the mandate to screen the country's economic performance, and to be able to evaluate the debt structure and sustainability.

The complete institutional solution, as discussed at the beginning of this subsection, is the most effective sovereign bankruptcy procedure proposed and theoretically possibly in the current international legal landscape. However, the possibility of achievement of such level of convergence of interests of different members of the international community is highly unrealistic, therefore, the solution is presented only as a desirable theoretical concept.

4.1 Implications and Conclusions

The steps presented in the previous section suggested improvement of the current sovereign debt workout have a number of serious consequences and presume some political implications. First of all, it is obvious that such serious changes to the financial system, that one may argue, relatively limits the country's sovereignty in its financial affairs, are difficult to implement. In order to reach the needed level of consensus the sovereign bankruptcy regime has to be seen by major countries as a necessity and a logical addition to the liberal sovereign bond market, as well as, be of the lenders' interest. I believe the recent crisis has provided the feeling of necessity for an orderly sovereign bankruptcy procedure, at least in Europe. If such a procedure is implemented, it would require channelling of the accumulated political will into negotiating the implementation of sovereign bankruptcy regime with the other countries. It would also require a great deal of political pressure on the bystanders, as there will definitely be governments which will be reluctant to hand over some of their sovereign rights to a supranational body. This means that there is a necessity of a common understanding of the introduction of a new stable system for lowering ex-post costs of default. But keeping incentives for ex-ante prudency inevitably comes with a price. However, the international community needs to understand that it might be the only way to avoid sovereign debt crisis with all the external spill overs that comes with it in the future.

To conclude, I want to emphasise that the ways presented in this study are ranging from simple contractual changes to complex treaty amendments. However, all of the theoretical steps presented require time, consideration and a lot of political will, which has not been able to reach the needed magnitude yet. But the improvements to the international financial system are enormous and, without doubt, worth the effort. Unfortunately, any unstructured process makes it possible for one party to benefit.

Therefore, the introduction of sovereign bankruptcy procedure would encounter possible resistance from myopic politicians and rent seeking professional litigation companies. However, post-crisis environment always provides the window of opportunity for changing the system.

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