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Can a European Monetary Fund address the weaknesses of the Eurozone?

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INTRODUCTION

Fiscal laxity, disregard for the budgetary discipline rules of the Stability and Growth Pact (SGP) and banking sector immoderation have pushed some of the Euro area Member States into insolvency in the sovereign debt stage of the financial crisis.[1] The crisis that engulfed Europe in 2009 was no exception to the empirical rule that "severe financial disruptions tend to be followed by public debt explosions, which are apt to develop into sovereign debt crisis."[2]

Given the enormous disruptions generated by the contradiction between the centralization of monetary policy for the Euro area Member States and the descentralization of fiscal policy, left in the hands of national authorities and to the vagaries of the domestic political process in each of the Member States,[3] greater fiscal harmonization led by appropriate political will is essential to the future of the European Union.

For this reason, this paper examines two measures in response to the European sovereign debt crisis aimed at achieving closer fiscal union. The first is the European Financial Stability Facility (EFSF), which provides financial assistance to Euro area Member States beset by budgetary difficulties. The second, not yet acted upon, contemplates the establishment of a

[1] Athanassiou, Phoebus "Of past measures and future plans for Europe´s exit from the sovereign debt crisis: what is leaglly possible (and what is not)" European Law Review 2011. Many of the arguments in this documents are drawn from this insightful article.
[2] Reinhart, C.M. & K.S. Rogoff "This time is Different: Eight Centuries of Financial Folly" Princeton 2009, Princeton University Press.
[3] Athanassiou, *supra* n.1.

European Monetary Fund (EMF) as a permanent Euro area support fund to be based on the EFSF.

The purpose of this paper is to analyze the suitability of the establishment of a European Monetary Fund as a measure to avoid future crises. Special attention will be paid to the legal basis and feasibility of the measures in question, since a "liberal approach toward rules (whether those of budgetary discipline, risk management, prudential supervision or common sense)"[4] has contributed, to a great extent, to the present crisis.

The paper is divided into three parts. The first part addresses the measures taken and proposals made in response to the sovereign default stage of the financial crisis in the Euro area. The second examines features and legal aspects of the European Financial Stability Facility, and the third analyzes the different aspects involved in the establishment of a European Monetary Fund (EMF) as a policy to prevent similar crises. Finally, a brief conclusion is offered.

REFORMS TO ADDRESS THE WEAKNESSES OF THE EUROZONE

Given the unsustainable level of debt present in some of the periphery countries, reforms related to macroeconomic, structural and institutional policies must be considered.[5] These should deal with main four areas:

1. Addressing the problems with the banks and establishing the true scale of its fiscal problem

To begin with, as far as banking problems are concerned, the periphery economies are divided into two groups. In the first, constituted by Greece and Portugal, the public sector is overleveraged, but the banking sector is comparatively low, whereas in the second - Ireland

[4] Ibid.
[5] Llewellyn, Preston & Jon Peace "Policy challenges: the crisis and longer term" " in Nomura Global Economics *Europa will work* (March 2011). A great deal of the information in this section has been drawn from this paper.

and Spain -, public sector debt is comparatively low, but the banking system is perceived by investors to be insolvent.

In the case of Ireland, “the huge liabilities of Irish banks relative to GDP illustrate why the economy sought external support from the EFSF. Even after forcing equity and junior debt holders to take write-downs, Ireland’s authorities were unwilling or unable to bankrupt the banks and force senior debt holders to share the burden. Hence the amount of capital that is needed to be injected into the Irish banks to write down bad assets and to recapitalize the banking system to maintain it as a going concern is more than the country can raise.”[6]

As for Spanish banks, they constitute the main concern of the markets at present. “Following the housing market boom and bust, and with economic growth weak and unemployment high, the market is concerned that credit losses may overwhelm the thin capital bases of the country’s numerous savings banks, which account for around half of the system’s assets. The Bank of Spain has already taken several steps to improve the health of the banking sector, including mandating increased provisioning, forcing the merger of several savings banks, and establishing a fund, the Fund for Orderly Bank Restructuring (FROB), which has injected several billion euros of capital into the smaller banks. Recapitalization is required… to reopen access to the private sector funding markets. Without this, the liabilities could fall to the state (which, like Ireland, might not be credibly able to extend the guarantee) or to private sector debt holders, which could cause a chain of defaults on a scale not seen since the fall of Lehman Brothers. The cost of recapitalizing the bank system in Spain is manageable at up to €80bn, or under 8% of GDP. The issue is whether Spain might in the short term need to avail itself of the “increased flexibility” promised for the EFSF to effect this capital injection because the FROB is currently unfunded.”[7]

[6] Ibid.
[7] Ibid.

The bank stress tests[8] conducted in March 2011 by the European Banking Authority (EBA) on 91 banks from across Europe found that the majority of European banks were adequately capitalized. Only nine banks failed those tests with a core tier one capital ratio – a key measure of financial strength – of less than 5 per cent. However, since an all-out default of Greek sovereign debt is not factored into the tests, the market reaction has not been as expected.[9]

On the other hand, it has been pointed out that the real merit of the tests is the data disclosed alongside the results. Banks were forced to publish details of their holdings on sovereign bonds and credit exposures country by country. Investors, concerned about the macroeconomic, "top-down" approach, "remain skeptical that banks can withstand the losses of a default by a European government, and whether they would be able to cope with the accompanying disruption in the short-term funding market."[10]

Moreover, bankers and analysts identified liquidity and banks' ability to fund themselves in sharply deteriorating markets as the main concern. Recently, the head of the IMF pointed out that "the common problem facing the developed world is an excessive overhang of claims on debt that financed worthless investments. These claims will have to be liquidated, and the quicker the better".[11] She also suggested some form of mandatory recapitalization, potentially using the EFSF to make direct capital injections into the region's weakest banks.[12] Another alternative to consider is the recapitalization of banks through "mandatory debt to equity swaps that put unsecured bondholders where they belong – behind both taxpayers and

[8] The stress test objective is "to provide policymakers with information to assess the robustness of the EU banking system against adverse economic developments and the ability of individual EU banks to absorb potential shocks to the balance sheets, including sovereign debt risk. Source: Alexander, Kern "Sovereign Debt Restructuring in the EU: lessons from the Recent Crisis" in Delimatisis, P & Herger, Nils *Financial Regulation at the Roads. Implications for Supervision, Institutional Design and Trade* (Kluwer 2011).
[9] Jenkins, Patrick "Europe stress test undermined by indecision" *Financial Times* (London, 18 July 2011).
[10] Ibid.
[11] Financial Times "Lagarde´s ugly truth on debt" (London, 28 August 2011).
[12] Murphy; Spiegel & Atkins "Lagarde call surprises regulators" *Financial Times* (London, 28 August 2011).

depositors", in order to avoid taxpayers acting "as unpaid lifeguards for the financial system."[13]

As European Union law was designed to deal only with imbalances in the public sector but not with the excesses in the banking sector, "eurozone banks became among the world's most over-leveraged, and they remain in need of protection from counterparty risks. The first step was taken by authorizing the European financial stability facility to rescue banks. Now banks' equity capital levels need to be greatly increased. If an agency is to guarantee banks' solvency, it must oversee them too. A powerful European banking agency could end the incestuous relationship between banks and regulators, while interfering much less with nations' sovereignty than dictating their fiscal policies."[14]

2. Overcoming the private-public debt dynamics within a number of the periphery economies

In order to overcome the dynamics of debt once the scale of the public debt is known, it is necessary:

a) To move and maintain a primary surplus. Increases in taxation and reductions in government are required to move and maintain a primary surplus. Not only the size, but also the form, of the fiscal retrenchment must be considered. "Fiscal consolidation that cut expenditure, rather than raise taxes, produce, in general, a better growth outcome over the long term."[15]

b) To lower the starting burden of debt.[16] In this regard, a soft restructuring of the bail-out countries´ debt has been implemented. The greater flexibility given to the EFSF

[13] See footnote 13.
[14] Soros, George "Three steps to resolving the eurozone crisis" *Financial Times* (London, 14 August 2011).
[15] Lewellyn & Peace, *supra* n.5
[16] The scale of cross-border dependencies has determined that eurozone governments have not required holders of government debt to suffer any loss. "For example, at the end of 2009 French banks were heavily exposed to the sovereign debt of Greece, holding €11.6bn (6% of their Tier 1 capital).97 German banks were also heavily exposed, holding €18.7bn (12% of their Tier 1 capital) of Greek public debt, €12.9bn (8% of Tier 1 capital) of

has involved maturities being extended - from 7.5. years to at least 15 - and interest rates being lowered to about 3.5 per cent.

c) To reach the lowest possible cost of borrowing. This will depend on the credibility of the policy package. Such credibility requires "a technically feasible fiscal plan, usually accompanied by a long-term program of structural reform and visibly solid political commitment."[17]

Another issue to consider is the role played by rating agencies. Since the cost of borrowing is highly determined by rating agencies, "the clear statement that public authorities should place less reliance on private rating agencies – the European Central Bank (ECB) should not delegate responsibility to judging what is and is not acceptable as collateral – was long overdue, especially given the rating agencies' terrible record in making judgments and the continued flaws in governance (often being paid by those that they are asked to rate)." [18]

"If the ECB is concerned that a credit event will lead to turmoil in financial markets, it should take a more active stance to address the underlying problems: eliminating the non-transparent over-the-counter derivatives, ensuring that banks are adequately capitalized and preventing banks from being excessively interconnected."[19]

Moreover, the Governing Council of the ECB has established through a decision[20], a securities markets program (SMP) for the "conduct of outright purchases, by national central banks (NCBs) and the ECB, of eligible market debt instruments." The stated objective of the SMP was to ease "severe tensions in certain market segments" as well

Irish public debt, €10.9bn (7% of Tier 1 capital) of Portuguese public debt and, most strikingly, €31.9bn (21% of Tier 1 capital) of Spanish public debt". Source: Lewellyn & Peace, *supra* n.5.

[17] Lewellyn & Peace, *supra* n.5

[18] Stiglitz, Joseph "Europe finally admits its debt problem to save the euro" *Financial Times* (London, 22 July 2011).

[19] Ibid.

[20] Decision of the European Central Bank of May 14, 2010 establishing a securities markets program [2010] OJ L124/8.

as to "address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism" necessary for the effective conduct of the single monetary policy.[21] The scope of the market interventions conducted under the SMP covered the purchase on the secondary market of eligible marketable debt instruments issued by the central governments or public entities of Euro area Member States and, on the primary and secondary markets, of eligible marketable debt instruments issued by private entities incorporated in the Euro area."[22]

The Eurosystem's competence to establish and implement the SMP was challenged before the German Federal Constitutional Court, as part of a "wider constitutional challenge of Germany's participation in the European rescue packages for Greece and the Euro area. This was premised on the contention that, in agreeing to the extension of financial assistance, Germany and the Eurogroup members violated the claimants' fundamental rights arising from some of the basic principles of the German Constitution (including the principle of representation of the German people and the Constitution's respect of the fundamental right to property) as well as the no-bail out clause."[23]

d) To achieve the fastest economic growth. This is essential to reaching long-run sustainability of debt positions. To that end, it is required: "[to lower] the primary deficit – by closing the output gap, and thereby eliminating the cyclical component of the primary deficit; [to diminish] the snowball – by creating a more favorable interest rate/growth rate differential; and [to minimize] stock-flow adjustments – by helping to

[21] ECB Decision [2010] OJ L124/8 Recitals 2 and 3.
[22] ECB Decision [2010] OJ L124/8 arts 1 and 2.
[23] While the Court's ruling was still pending at the time of writing, an application for interim measures was rejected by the Court (BVerG, May *Page12*7, 2010, 2 BvR 987/10; BVerG, June 9, 2010, 2 BvR 1099/10). For an account of the challenges pending before the German Constitutional Court, and an assessment of the likelihood of their success, see Deutsche Bank Research, "Constitutional complaints -- German rejection ofrescue packs unlikely", Research Briefing (March 17, 2011), at *http://www.dbresearch.com/PROD/DBR…EN…/PROD0000000000271154.pdf* [Accessed July 7, 2011]. Source: Athanassiou, *supra* n.1.

avoid a wave of new losses in the banking sector that could be transmitted all across the euro area."[24]

European leaders called for a comprehensive strategy for growth and investment in Greece in the European summit held on 21 July. A task force will be appointed to establish the details of how European Union structural funds could be used to that end. "If unused EU structural funds are used to leverage further loans from the EIB, there may be some €16bn available over the next two to three years. It should be reallocated to an Economic Revival Fund and used to boost growth and competitiveness, by improving the quality of higher education; helping to lower labor costs; and supporting enterprise and innovation. Only intervention will trigger the necessary shift of resources as long as the price system delivers the wrong signals."[25]

Even more important is the commitment to investments that will stimulate the economy, create jobs and increase tax revenues. "Growth cannot be restored unless lending, especially for small and medium-sized enterprises, increases. The increased flexibility given to the EFSF may help, but I suspect more needs to be done, for instance through creating a small business revolving fund."[26]

3. Improving the conditions for economic performance over the long term

This involves raising:

a) the quantity of the economy's fundamental inputs (such as labor and capital, whose supply ultimately curbs the level of output);
b) the quality of these inputs, which can increase the "raw" labor and capital;
c) the ease with which the economy adjusts to continual change (new technologies, new competitors, new patterns of demand); and

[24] Lewellyn & Peace, *supra* n.5.
[25] Pisani-Ferry, Jean "Europe must intervene to get Greece growing" *Financial Times* (London, 27 July 2011).
[26] Stiglitz, *supra* n. 18.

d) the economy’s resilience to shocks (for instance, changes in the price of oil or in the volume of exports) that affect some regions more than others.

4. Putting in place policies to avoid future crises of the scale seen recently

This category may be divided into two groups: microprudential policy[27] and macroprudential policy[28].

a) Within microprudential regulation, capital requirements and cross-borders issues have been addressed by the new Basel 3 regime and the establishment of the European Supervisory Authorities (ESAs) respectively.

   The Basel 3 regime raises “the minimum common-equity capital requirements for banks from effectively 2% to at least 7% of risk-weighted assets (RWA), with “systemically important” banks expected to maintain even higher capital levels (Switzerland has demanded at least 10% for its large banks). Basel 3 also introduces new liquidity requirements for banks (sufficient liquid assets need to be held against a potential bank run, and long-term assets must be financed by long-term liabilities), and Basel 3 introduces for the first time in some countries a cap on overall gross leverage.”[29]

   The European Supervisory Authorities (ESAs) were approved by the European Parliament in September 2010 and came into operation at the beginning of 2011. It includes a European Systemic Risk Board (ESRB) – made up of EU central bank governors and chaired by the President of the ECB - and three pan-EU watchdogs given power to intervene in financial markets and settle disputes among national regulators: the European Banking Authority (based in London), the European

[27] Microprudential policies are aimed at increasing the resilience of individual banks to shocks.
[28] Macroprudential policies are aimed at “preventing the build-up of unsustainable deficit/debt positions, whether in the public or the private sectors”. Source: N4.
[29] Lewellyn & Peace, *supra* n.5.

Securities and Markets Authority (based in Hamburg), and the European Insurance and Occupational Pension Authority (based in Frankfurt).

b) Macroprudential policies are required in order to protect the financial system since a domino run deposit is always a possibility. Given the fact that banks borrow short and lend long, they are "always intrinsically vulnerable to a run on deposits. Typically a run begins with the bank or banks that are in the weakest position: and then, if they fail, it moves on to the next-most vulnerable bank or banks. The failure of successive US investment banks, which culminated in the collapse of Lehman Brothers, is an ever-present reminder of the risk of domino failure."[30]

If private sector ill-discipline reaches systemic scale, it becomes a public debt problem. To avoid this possibility, it would be necessary to create one or more instruments to control private sector credit in the aggregate. These are to be carefully constructed and sensitively administered to not constrain economic growth unnecessarily.

As for the banking sector, according to the new Basel 3 regime, "a countercyclical common-equity capital buffer of up to 2.5% of GDP is proposed when a country's private sector credit/GDP exceeds trend. This would apply both to domestic banks and, pro rata, to foreign banks operating in the overheating economy. The purpose is to slow bank lending through higher capital requirements and thereby slow the formation of excess leverage".[31]

[30] Ibid.
[31] Ibid.

Nonetheless, a study[32] recently published by the Committee on the Global Financial System (CGFS) states that "elements of Basel III, such as the liquidity coverage ratio and the risk-weighted part of the capital buffers, by encouraging banks to hold more sovereign debt could contribute to the next crisis, rather than prevent it." The paper identifies a "vicious circle between the conditions of public finances and those of banks. As banks' funding costs worsen, so does the creditworthiness of the sovereign, which in turn heightens funding costs. If such a vicious circle does indeed exist, then incentivizing banks to hold more sovereign debt in order to fulfill regulatory requirements would only compound the problem".

In this case, the CGFS advises as follows. "If governments do not return rapidly to sustainable fiscal trajectories, and the risks on their sovereign debt remain elevated, authorities should closely monitor the interaction of sovereign risk with regulatory policies which provide banks with strong incentives to hold large amounts of government debts. In this new environment, the preferential treatment of government debt (particularly that which is lower-rated) relative to private debt may be less justified."[33]

In the end, the integrity of an economy´s financial system can be guaranteed only by the state. This requires the state to have "sufficient 'head room' or 'fiscal space'… to assume responsibility for any likely level of private sector debt without degrading the capacity of the state to service the resulting public debt. This requires long-term fiscal discipline to limit the size of the public debt.

[32] Committee on the Global Financial System "The impact of sovereign credit risk on bank funding conditions" CGFS Papers N° 43 (July 2011).
[33] Ibid.

With respect to fiscal ill-discipline,[34] there have been some European moves towards enforcing greater fiscal discipline and centralized monitoring, control and enforcement over the public finances of Member states. Some of them are as follows:

a) Strengthening the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP).[35] The Commission has proposed that " (1) a numerical benchmark be used to assess the extent to which a participating Member State's government debt ratio declines at a satisfactory pace; (2) national budgetary frameworks be measured against a set of minimum requirements regarding, among others, statistics, numerical rules and forecasting systems; and (3) that compliance with fiscal rules and/or recommendations be reinforced through financial, peer review and political measures, applied earlier and in a more gradual manner compared with those provided for under the existing framework (which can only be adopted by majority voting on conclusion of the EDP)."

b) Deepening and broadening coordination. Coordination has been mainly enhanced through the European Semester - implemented in January 2011 -: the reference is to the "six-month annual period during which Member States´ budgetary and structural policies will be reviewed to detect any inconsistencies and

[34] In aggregate, the euro area's current public-debt problems are slightly less severe than those of the US. "In 2010, and on a common (Maastricht) basis, the general government131 consolidated gross debt of the euro area 16 averaged just over 84% of GDP, while the equivalent US figure was 6 percentage points higher, at just over 92%. In 2012, the euro area figure is projected by the European Commission, on present policies, to increase by around 4 percentage points, to 88%, while the US is projected to rise by almost 10 percentage points, to just over 102%." Source: Lewellyn & Peace, *supra* n.5.

[35] On September 29, 2010, the Commission proposed a comprehensive package of legislative Measures, "the adoption of which would signal a far-reaching review of EU economic governance arrangements, with an emphasis on the SGP and the EDP. The legislative package (see COM(2010) 522, COM(2010) 526 final, COM(2010)527 final, COM(2010) 523, COM(2010) 524 final, COM(2010) 525 final) consists of six pieces of draft legislation: four proposals dealing with fiscal issues, including a reform of the SGP, and two new regulations aiming at detecting and addressing emerging macroeconomic imbalances within the EU and EMU." Source: Athanassiou, *supra* n.1.

imbalances."[36] The objective of this monitoring mechanism is to reinforce coordination while budgetary decisions are still under preparation.

c) Fostering stronger institutions. To this end, national public institutions have been established to provide independent analysis and forecasts on domestic fiscal policy matters.

d) Establishing a mechanism for macro-prudential surveillance. This involves a two-stage process. The first includes an annual assessment of the macroeconomic imbalances and vulnerabilities of the eurozone. "This assessment would be based on a number of macroeconomic and financial indicators, each assigned lower/upper limits to denote risk thresholds. The variables to be monitored could include: current account balances, net foreign assets, measures of competitiveness, credit growth, and changes in house prices". The second part of the process involves "continued monitoring of the variables, and strict enforcement of the thresholds."[37]

At the same time, there is a need to provide for an "orderly unwinding of excessive debt positions" and a permanent crisis resolution mechanism.

The need for a permanent crisis resolution mechanism has been addressed by the European Stabilisation Mechanism (ESM) which will be a permanent replacement of the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM).

On March 25, 2011, the European Council adopted a decision based on the newly introduced "simplified revision procedure" of art.48(6) TEU. The decision -which inserts a new para.3 into art.136 TFEU, allowing for the establishment of the ESM-[38] is to enter into force on

[36] Ibid.

[37] Lewellyn & Peace, *supra* n. 5.

[38] Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the Euro [2010] OJ L91/1. The amendment reads as

January 1, 2013, subject to all Member States notifying the Secretary General of the Council of the completion of the procedures for its approval "in accordance with their respective constitutional requirements".[39]

The ESM would be activated, whenever necessary, "to safeguard the economic and financial stability of the Euro area, with temporary financial assistance being granted subject to strict policy conditionality.[40] The ESM itself is to be established by virtue of a treaty among the Euro area Member States, signed on July 11, 2011 as an intergovernmental organisation of public international law, located in Luxembourg."[41]

THE EUROPEAN FINANCIAL STABILITY FACILITY: FEATURES AND LEGAL ASPECTS

On May 8, 2010, "the ECOFIN[42] Council and the Eurogroup reached an agreement on a financial support package for Greece, conditional upon the adoption by the Greek Government of a range of economic and fiscal measures.[43] The support package comprised EU80 billion, in the form of centrally pooled bilateral loans from Greece's Euro area partners, and EU30 billion, in the form of an IMF-sponsored loan. The European component of the support package was activated on May 9, 2010, with the signature of a Loan Facility Agreement.[44] In May 2010, that package was inter alia backed by (1) a Council Regulation

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follows: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

[39] Article 2 of Decision amending art.136 of the Treaty.

[40] "Conditionality refers to the honoring, by the beneficiaries of financial assistance, of any budgetary austerity, privatization and structural reform commitments they may have undertaken vis-à-vis their EU partners, the IMF and the ECB, as a condition precedent for their access to the ESM."

[41] Athanassiou, *supra* note 1.

[42] Economic and Financial Affairs Council.

[43] These conditions have been stipulated in "Decision 2010/320 addressed to Greece with a view to reinforcing and deepening fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit [2010] OJ L145/6."

[44] The Loan Facility Agreement between the 14 Euro area Member States and KfW, on the one hand, and the Hellenic Republic and the Bank of Greece, on the other, is available at *http://www.hellenicparliament.gr* [Accessed July 5, 2011].

establishing a European Financial Stabilisation Mechanism (EFSM),[45] to extend financial assistance to EU Member States in difficulty, in the form of interest-bearing loans or credit lines,[46] and (2) an inter-governmental agreement among the Euro area Member States, complementing the EFSM with a European Financial Stability Facility (EFSF), in the form of a special purpose vehicle,[47] to provide a further EU440 billion in financial assistance." [48]

The EFSF issues bonds on the market, "using pro rata basis guarantees by all Euro area Member States who commit up front to their share of EU440 billion, providing loans at interest rates determined on the basis of a pricing formula consistent with the IMF lending rates. Issues can be made via syndications but, also, auctions, private placements, new lines and tap issues. In the case of an issue by auction, the German Debt Management Office (Finanzagentur) is to act as issuance agent and be responsible for the placement, with the EFSF as the issuer."[49]

To access the EFSF, Member States first need to agree on a "macroeconomic adjustment program with the Commission and the Eurogroup, in liaison with the ECB and, depending on the circumstances, also the IMF. The Eurogroup retains its decision-making responsibility, in particular with regard to the evaluation of conditionality and the authorization of disbursements. The EFSF was activated on January 25, 2011 with a landmark five-year bond auction worth EU5 billion to raise funds for Ireland and was expected to provide an estimated EU78 billion worth of aid to Portugal."

[45] Regulation 407/2010 Establishing a European financial stabilisation mechanism [2010] OJ L 118/1. The legal basis for that Regulation was art. 122(2) TFEU.

[46] "It is the Council, acting by qualified majority on a proposal from the Commission and after hearing the views of the ECB, which decides upon the activation of the EFSM, the funds of which, in the order of EU60 billion, are guaranteed by the EU budget and secured by borrowing on the capital markets or from financial institutions. Close to the time of the finalization of this article, the Commission had issued, on behalf of the European Union, a EU4.75 billion bond with a 10-year maturity to fund disbursements of the assistance packages to Ireland and Portugal. Ireland was to receive EU3 billion and Portugal EU1.75 billion from the disbursements."

[47] "The SPV was established by the EFSF Framework Agreement of June 7, 2010 (available at http://www.efsf.europa.eu [Accessed July 5, 2011], as a Luxembourg law public limited liability company, for a period of three years."

[48] Athanassiou, *supra* note 1.

[49] Ibid.

As for the legality of the above mentioned rescue package, and bearing in mind that financial support measures lie outside the scope of the exclusive competences of the EU, it is due to examine (1) the interpretation of Art.125 TFEU (the no-bail out clause), and (2) an understanding of the relationship between the no-bail out clause and Art. 122(2) TFEU (the financial solidarity clause), which was the legal basis for the adoption of the Council Regulation.

Article 125(1)TFEU provides that: "The Union shall not be liable for or assume the commitments of central governments of … any Member State … [a] Member State shall not be liable for or assume the commitments of central governments… of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project ….". Its objective is "to reinforce the Member States' fiscal discipline by avoiding the moral hazards to which mutual assistance expectations could expose them."[50]

On a literal interpretation of the no-bail out clause, "the mere financing by the Union of a Member State's liabilities, through bilateral loans (or credit lines), lies outside its ambit, provided that such loans or credit lines are genuine, in the sense of being discretionary, interest or fee-bearing (hence, non-concessionary) and temporary in nature, as in the case of those provided by the Member States in 2010 and envisaged by the Council Regulation. To lend is not to assume any obligations, as loans are "assets" (unlike obligations, which are "liabilities").[51]

It follows that the no-bail out clause prohibits the "substitution of one Member State debtor by another (or, a fortiori, by the Union as a whole), whether at the instance of the original

[50] M. Kerber, *Währungsunion mit Finanzausgleich? Eine Klarstellung zur Legalität von Finanzhilfen für Finanznotstandsstaaten der Eurozone*, Europolis, Occasional Paper 1/2010, p.7, at *http://www.europolis-online.org* [Accessed July 5, 2011].
[51] Athhanassiou, *supra* n.1.

Member State debtor or at that of any third party wishing to hold the Union or any of its Member States liable (in law) for the debts of another."[52]

A teleological reading of the no-bail out clause confirms that "its prohibition is unlikely to have been intended as a blanket one. For, while it is true that Art.125 TFEU is "a crucial element of [the] stability within the Union" and "an essential part of the 'budgetary code' of the Union", its ban would not necessarily apply in a situation where an "unprecedented global financial crisis and economic downturn" have provoked such "a strong deterioration in the deficit and debt positions of the Member States" that "this situation, if not addressed as a matter of urgency, could represent a serious threat to the financial stability of the European Union as a whole."[53]

"Invoking, as some have[54], the no-bail out clause indiscriminately to declare illegal any manner of temporary financial assistance to a Member State in difficulty would be tantamount, first, to disregarding the common interest in the maintenance of price stability (explicitly recognized, in its own right, as a Treaty objective, by Art.3(3) TEU as well as Art.127(1) (ex Art.105(1) EC) TFEU and Art.2 of the Statute of the ESCB and the ECB); secondly, to taking risks with Union-wide economic and financial stability; and thirdly, to ignoring the principle of solidarity, enshrined in Art.3(3) TEU as one of the guiding principles for Union action. Ultimately, if temporary financial assistance, with conditionality, can help Member States return to fiscal discipline (rather than default), the fiscal discipline objective of Art.125 TFEU is well served."[55]

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[52] Ibid.
[53] Ibid.
[54] Kerber, "*Währungsunion mit Finanzausgleich?* ", Europolis, 2010, pp.7--8, at *http://www.europolis-online.org* [Accessed July 5, 2011]; T. Jeck, " *Euro-Rettungsschirm bricht EU-Recht und Deutsches Verfassungsrecht* ", cepStudie (July 5, 2010), p.4, at *http://www.cep.eu* [Accessed July 5, 2011]; M. Seidel, *Der Euro-Schutzschild oder Falle*, ZEI Working Paper, B 01 2010, pp.8--9, at *http://www.zei.de* [Accessed July 5, 2011]; H. Kube and E. Reimer, " *Grenzen des Europäischen Stabilisierungsmechanismus* " [2010] NJW 1911, 1912--1913; " *Europäische Verträge verbieten eine Rettung* ", FAZ.com (February 11, 2010), at *http://www.faz.net* [Accessed July 5, 2011].
[55] Athanassiou, *supra* n.1.

A contextual/systematic interpretation of the no-bail out clause corroborates the conclusion that "the prescribed ban was not intended as an absolute one. Referring to the interplay between the no-bail out clause, on the one hand, and Art.126 TFEU and the Excessive Deficit Procedure (EDP),[56]on the other, one commentator has aptly observed that "the authors of the Treaty realized that it is not wise to be exaggeratedly confident of the reactions of the markets in order to maintain financial stability", which is why "it was … thought necessary to supplement the [no-bail out clause] with …specific rules addressed to the budgetary policy of the Member States."[57]

In regard to the interaction between the no-bail out clause and Art. 122(2) TFEU, the latter provides that "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned."

The consensus among legal scholars is that Art. 122(2) TFEU establishes "an exception (or a "counterweight") to the no-bail out clause, the very existence of which contradicts the assertion that no form of Union financial assistance is possible to a Euro area Member State."[58] After all, both provisions form part of the same chapter of the TFEU "(suggesting that both have a bearing on economic policy)[59] and lie in close proximity to one another

[56] See "Stability and Growth Pact, supplemented by Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1997] OJ L209/1; Regulation 1467/97 of on speeding up and clarifying the implementation of the excessive deficit procedure [1997] OJ L209/6; and Regulation 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community (Codified version) [2009] OJ L145/1."

[57] Louis, "The no-bail out clause and rescue packages" (2010) 47 C.M.L. Rev. 971, 978.

[58] Louis, "The no-bail out clause and rescue packages" (2010) 47 C.M.L. Rev. 971, 981--982; P. Vigneron, " *Réflexions sur le soutien financier à la Grèce -- Pour une lecture moins politique du Traité* " (2010) 541 Revue du Marché commun et de l'Union européenne 489, 490--491.

[59] See, for instance, J. Heß, "*Finanzielle Unterstützung von EU-Mitgliedstaaten in einer Finanz-und Wirtschaftskrise und die Vereinbarkeit mit EU-Recht* " (2010) 4 Zeitschrift für das Juristische Studium 473, 475.

(pointing to the conclusion that they need to be read *in conjunction with* rather than *in isolation from* one another).”[60]

The idea that the no-bail out clause must always prevail over Art. 122(2) TFEU[61] should be dismissed for two reasons: “first, because these two clauses are normatively equal to one another (hence the issue of deciding which of the two is hierarchically superior does not arise in the first place, absent any indication to the effect that either of them can be regarded as *lex specialis*)[62]; secondly, because, if the above were to hold true, Art.122(2) TFEU would lose its meaning.”

As a conclusion, “in deciding whether or not to exercise its discretion under Art. 122(2) TFEU, the Union has to have regard to Art.125 TFEU, satisfying itself that the conditions of the financial solidarity clause are fulfilled in each individual case before this can be activated. In this way, it is argued that “while an excessive deficit would not per se qualify as an “exceptional occurrence” within the meaning of Art.122(2) TFEU, its transformation into a threat to sovereign solvency would fit the primary law description, since the choice for the Member State concerned would no longer be between an immediate return to budgetary rectitude or continued market lending at higher (punitive) risk premia but, rather, between borrowing at sustainable conditions and outright default.”[63]

Thus, for the reasons explained above, Art.125 TFEU is compatible with the extension of emergency financial assistance to a Euro area Member State, “which is experiencing, or is

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[60] Athanassiou, *supra* note. 1.

[61] “This assertion is based inter alia on a Declaration on the Treaty of Nice, dated February 26, 2001, concerning art.100 EC (now art.122 TFEU), which recalls that decisions regarding financial assistance, such as are provided for in art.100 EC, must be “compatible with the no-bailout rule laid down in Article 103 TEC (now, art. 125 TFEU)”.

[62] See Heß, “*Finanzielle Unterstützung von EU-Mitgliedstaaten in einer Finanz-und Wirtschaftskrise und die Vereinbarkeit mit EU-Recht* ” (2010) 4 Zeitschrift für das Juristische Studium 473, 476. „If anything, it is the opposite conclusion that one may draw, on the basis of the well-established *lex specialis derogat lex generalis* principle of statutory interpretation.”

[63] Ibid.

seriously threatened with, a severe economic or financial disturbance caused by exceptional occurrences beyond its control", whether by its partners or by the Union itself.[64]

Finally, on 21 July 2011, the Council increased the flexibility given to the EFSF and ESM to allowing them to:

- act on the basis of a precautionary program;
- finance recapitalization of financial institutions through loans to governments including in non program countries ;
- intervene in the secondary markets on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability and on the basis of a decision by mutual agreement of the EFSF/ESM Member States, to avoid contagion.

Thus, the new powers given to the EFSF constitute the next step towards the establishment of a European Monetary Fund.[65]

A EUROPEAN MONETARY FUND AS A POLICY TO AVOID FUTURE CRISES

Among the ideas for addressing the European debt problem since the beginning of the financial crisis, one has been largely endorsed:[66] the establishment of a European Monetary Fund (EMF), proposed by Gros and Mayer,[67] as an independent institution to tackle the

[64] Regulation 407/2010 art.1.

[65] "The European Council of 21 July 2011, effectively decided to transform the European Financial Stability Facility (EFSF) into a European Monetary Fund by allowing it to engage in precautionary programmes and even to acquire debt at a discount on the secondary market. French President Nicolas Sarkozy declared proudly that euro area leaders "have agreed to create the beginnings of a European Monetary Fund". Source: Gros & Giovannini "The EFSF as a EMF: Does it have enough resources? CEPS Policy Brief No. 408, Centre for European Policy Studies, Brussels (July 2011).

[66] German Chancellor Merkel and German Finance Minister Wolfgang Shäuble have supported the idea, although recognising that, without amendments to the Treaty, establishing an EMF would not be possible.

[67] D. Gros and T. Mayer, "How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund", CEPS Policy Brief No. 202, Centre for European Policy Studies, Brussels (February 2010); D. Gros and T. Mayer, "How to Deal with the Threat of Sovereign Default in Europe: Towards a Euro(pean) Monetary Fund" (2010) 2 *Intereconomics* 64.

solvency problems of EMU Member States in difficulty, through the provision of emergency loans or guarantees for the issuance of public debt.

The analogy with the IMF, nonetheless, should not be stretched too far, because of "both the unique features of the European Union, against the background of which the proposed EMF would operate, and the sui generis financing mechanism suggested for it - a direct penalty payment for countries with an excessive debt or deficit ratio."[68]

The features of the proposal to establish a EMF are as follows:

1. Principle of solidarity and enhanced cooperation

The creation of the EMF would be a concrete expression of the principle of solidarity enshrined in the Lisbon Treaty, emphasizing in this case the particular responsibility of euro area Member States to avoid creating difficulties for their partners.[69]

Moreover, according to the proponents, the EMF could be implemented within the framework of enhanced cooperation as laid down in Art. 20 TEU and in Art. 326 TFEU. "Should the Council establish that the implementation of the Union's objectives will not be attained within a reasonable period of time by the Union as a whole, as a last resort it can authorize enhanced cooperation in this area by a group of at least nine Member States, enabling those Member States to proceed more quickly. Nevertheless, participation must be open to every other State which complies with any conditions laid down by the authorizing decision."[70]

The sixteen States of the eurozone can be considered as such a group, but participation in enhanced cooperation is optional and, what is more, "EMU is, in and of itself, a special form of differentiated integration and may not, for that reason, be amenable to enhanced cooperation within the meaning of the Treaty."[71]

[68] Athanassiou, *supra* n 1.
[69] Gros & Mayer, *supra* note 67.
[70] Häde, Ulrich "Legal Evaluation of a European Monetary Fund" *Intereconomics-Forum 2* (2010): 69-72.
[71] Athanassiou, *supra* n.1.

"The closer "coordination and surveillance" among the Euro area Member States contemplated in the newly introduced Art.136 TFEU would appear to provide, subject to certain adjustments, the only acceptable legal basis for establishing a Euro area support fund, and for laying down the conditions subject to which its support could be granted to Member States in need". This despite the fact that a "fund providing assistance to Member States in need can only indirectly be said to be "strengthening the coordination and surveillance of their budgetary discipline", as per Art.136 (1)(a) TFEU." Given its permanent nature and Euro area scope, Art.122(2) TFEU -the legal basis for the emergency-motivated EFSM- could not provide an appropriate foundation for setting up a permanent EFM."[72]

Another consideration to take into account is that "as part of the regular budgetary procedure at national level, state guarantees are subject to parliamentary assent. Should those guarantees have to be drawn upon in the future, whether by the ESM or by the EFSF, those Member States whose Constitutions contain balanced budget provisions (so called "debt brakes") could run the risk of transcending them, especially if the drawings on those guarantees were to be substantial. Should such a situation materialize, delicate questions could arise of relevance to the relationship between constitutional, Union and public international law, and their normative hierarchy."[73]

Indeed, similar questions have arisen before in the jurisprudence of the Germany's Federal Constitutional Court (Bundesverfassungsgericht), "which is of significant relevance in this regard as, within the European Union, debt brakes were, at the time of writing, a feature of German Constitutional law only.[74] "The Solange jurisprudence of the Federal Constitutional

[72] Ibid.
[73] Ibid.
[74] "The reference is to art.115(2) of the German Constitution, which stipulates that, as of 2016, the Federal Government's structural deficit cannot exceed 0.35% of Germany's GDP. Similar provisions already apply in Switzerland (art.126 of the Swiss Federal Constitution) and the United States (s.4 of the 14th Amendment of the US Constitution). Close to the time of writing, the Austrian Parliament was set to vote in similar, constitutional budgetary restrictions, while France's lower house approved a Bill to enshrine budget restraint rules in the French Constitution. If approved by the French Senate, the proposed change would need to be approved by referendum or by a three-fifths majority across both houses." Source: Ibid.

Court[75] and, in particular, its Solange III or "Maastricht judgment"[76] suggests that the Bundesverfassungsgericht has "put itself in the position of supervising any further European integration",[77] and that there is still room for "a nationally assertive position",[78] with all the uncertainties that this is bound to entail at so crucial a juncture.[79] This is without prejudice to the amendment of the German Constitution to conform to the principles enunciated by the Federal Constitutional Court in its Maastricht judgment."[80]

Since then, Union law can only be subjected to constitutional review by the Bundesverfassungsgericht "where it is asserted that its evolution has fallen below the requisite standards of fundamental rights protection and democracy guaranteed by the German Constitution or is out of tune with the principles of subsidiarity and proportionality or the conferred powers doctrine. The Federal Constitutional Court has more recently applied much the same reasoning to the assessment of the compatibility of the Act Approving the Treaty of Lisbon with the German Constitution." [81]

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[75] "Order of May 29, 1974 (Solange I) 37 *BVerfGE* 271; and Order of October 22, 1986 (Solange II), 73 *BVerfGE* 339". Source: Atanasious

[76] "Order of October 12, 1993 (Maastricht) 89 *BVerfGE* 155."

[77] K.D. Makowski, "Solange III: The German Federal Constitutional Court's Decision on Accession to the Maastricht Treaty on European Union" (1995) 16 *University of Pennsylvania Journal of International Business Law* 155, 176.

[78] K.M. Meessen, "Hedging European Integration: The Maastricht Judgment of the Federal Constitutional Court of Germany" (1993) 17*Fordham International Law Journal* 511, 512.

[79] It is worth recalling that, according to the judgment of the *Bundesverfassungsgericht* in *Solange III*, "The concept of the currency union as a 'community based on stability' (*Stabilitätsgemeinschaft*) is the basis and subject matter of the German Act of Accession. If the monetary union should fail to deliver on a continuing basis the stability present at the beginning of the third stage of EMU within the meaning of the agreed mandate for stabilisation, it would be abandoning the Treaty conception and thereby fall outside the authority conferred in the Act of Accession" (at [90]). Moreover, "Under the EU Treaty, monetary union is no more apt to give rise,automatically, to a political union than to an economic union. That would require an amendment of the Treaty, which could not happen without a decision of the national State institutions, including the *Bundestag* " (at [93]).

[80] "Article 23(1) of the German Constitution, providing for the participation of Germany in the development of an EU that is committed to democratic, social, and federal principles, to the rule of law, and to the principle of subsidiarity, and that guarantees a level of protection of basic rights essentially comparable to that afforded by this Basic Law."

[81] "Order of June 30, 2009 (Lisbon), 123 *BVerfGE* 267. Interestingly, however, the Federal Constitutional Court found that the accompanying Act Extending and Strengthening the Rights of the *Bundestag* and the *Bundesrat* in European Union Matters infringed arts 38.1 and 23.1 of the Basic Law, insofar as the *Bundestag* and the *Bundesrat* have not been accorded sufficient rights of participation in European lawmaking procedures and Treaty amendment procedures".

2. Financing mechanism

The financing mechanism of the EMF will be made through contributions, in terms of penalties, from those Member States that do not comply with the budgetary discipline established in Union law. This would have the double virtue of creating additional incentive to comply with the budgetary discipline as laid down in Union law and generating resources that could be used to solve a crisis, should such a situation reappear.[82]

One of the problems pointed out as far as the financing mechanism is concerned is that the proposal "puts the entire onus of the crisis resolution on delinquent countries, with no mutual assistance from other EU (or euro area) countries. Furthermore, to make only delinquent countries pay for assistance would be politically untenable. Sooner or later the payers would claim possession of the fund and deny any right in deciding how to use it to those who had not contributed to it. The two aims of strengthening the hand of the virtuous countries and of making the non-virtuous pay for assistance are mutually incompatible."[83]

Another argument[84] against the EMF funding mechanism is the possibility of the EMF turning into a threat for European integration. "Fiscally sound northern European countries – particularly Germany – would fear being indirectly forced (and to some extent blackmailed, because of the contagious effects of a default) to bail out fiscally profligate EMU countries. At first glance, this fear seems to be mitigated by the fact that the EMF should be partly financed by countries with excess debts and deficits. But northern European countries would have to participate in the initial funding and would eventually be liable for the loans which the EMF most likely would have to take out in large amounts in order to obtain sufficient resources for crisis resolutions. Thus, because northern European countries would feel

[82] Gros & Mayer, supra note 67.
[83] Pisani-Ferry & Sapir "Crisis Resolution in the Euro Area: An Alternative to the European Monetary Fund" *Intereconomics*- Forum 2 (2010): 72-75.
[84] Matthes, Jürgen "The EMF is Better Suited than a EMF to Deal with Potential Sovereign Defaults in the Eurozone" *Intereconomics Forum* 2 (2010): 75-81.

exploited, voters in these parts of the eurozone might turn against EMU. In the end, it is imaginable that northern European countries could even leave the eurozone – in order to form a new currency union."[85]

From a legal perspective, the EMF shall be financed through payments from those Member States that do not meet the reference values for government debt (60% in relation to GDP) and for the budgetary deficit (3% in relation to GDP) as stated in Art. 126 TFEU in conjunction with the Protocol (N° 12) on the EDP. According to Art 126 (11) TFEU, Member States failing to comply with this budgetary discipline may be subject to sanctions- enumerated in an exhaustive way- which, in the worst case, would be high fines. These sanctions are not limited to the mere exceeding of the reference values, but to the formal decision proclaiming the existence of an excessive deficit. As a result, Art.126 TFEU does not allow payment obligations in terms of contributions to the EMF.[86]

3. Borrowing money from the markets

This aspect, according to the proponents, could manage the issuance of a common euro government bond in the future. In fact, the issuance of Eurobonds as a means of putting an end to the sovereign debt crisis[87] has been one of the most prominent ideas advanced since the onset of the financial crisis. The proponents of the idea of Eurobonds[88] conceived them "as primary market, European (that is, common to all Member States) sovereign bonds, issued by

[85] Ibid.
[86] Häde, *supra* note 69.
[87] "J.-C. Juncker and G. Tremonti, "E-bonds would end the crisis", *Financial Times,* December 5, 2010. The idea of issuing some sort of "Eurobonds" had earlier been considered by scholars, some of whom were against it. For instance, in favour, see P. De Grauwe and W. Moesen, "Gains for all: A Proposal for a Common Euro Bond" (2009) 3 *Intereconomics* 132 (Eurobonds to be issued through the EIB, based on a guarantee proportional to the Member States' participation in the EIB's capital, with the proceeds also allocated proportionately to their participation in the EIB's capital); J. Delpla and J. von Weizsäcker, "The Blue Bond Proposal", Bruegel Policy Brief 2010/03 (May 2010) (separation of the Member States' debt in blue and red tranches--the former covering debt below 60 per cent of GDP and the latter all debt in excess thereof--and pooling together of the blue tranches, to create a deep government bond market and reduced borrowing costs on the blue tranche, creating incentives for Member States to keep their debt to 60% of their GDP or below). Contra, see W. Kösters, "Common Euro Bonds -- No Appropriate Instrument" (2009) 3 *Intereconomics* 135."
[88] The Italian Finance Minister and the President of the Eurogroup called for the issuance of Eurobonds in December 2010.

a “European Debt Agency” (EDA)[89] as a successor to the EFSF. The EDA would finance up to 50 per cent (in exceptional cases 100 per cent) of new debt issues by its members, but never beyond 40 per cent of their GDP (so as not to breach the Maastricht limits).”[90]

The EDA could also “stabilize the secondary market for national debt by offering Member States in difficulty the possibility to swap outstanding national bonds for Eurobonds at a discount, the size of which would depend on market conditions. Eurobonds would enjoy a higher priority than national debt and would qualify as eligible collateral for Eurosystem credit operations. As Eurobond interest rates would be lower than their national rates, at least in the case of Member States suffering from fiscal imbalances, the refinancing through Eurobonds of a large portion of their existing debt would improve both their solvency and their liquidity position.”[91]

The principle of borrowing money from financial markets on behalf of the Member States of the European Union has a precedent. This principle had been previously applied to offer financial support to some Member States of the European Union but that lie outside the eurozone to help them out of their critical balance of payments crisis (Art 143 TFEU).[92]

Thus, in 2008 and 2009, the European Union agreed to lend EU6.5 billion to Hungary, EU3.1 billion to Latvia and around EU6 billion to Romania. “These Member States received emergency loans from the IMF and European Union when their budgets were hit hard by the global economic downturn. The Commission is empowered to contract borrowings on the capital markets or with financial institutions, using the creditworthiness of the Union to guarantee troubled countries' debts.”[93]

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[89] The idea of creating an EDA had been floated in March 2010 by the Belgian Prime Minister, Yves Leterme.
[90] Athanassiou, *supra* note 1.
[91] Ibid.
[92] Seyad, Sideek “A legal analysis of the European Financial Stability Mechanism” Journal of International Banking Law and Regulation (2011).
[93] Council Regulation 332/2002 establishing a facility providing medium-term financial assistance for Member States balances of payments [2002] OJ L53/1.

4. Call on the guarantees

In the event that Member State faces financial difficulties, it could, upon submission of an adjustment program, call in the guarantees of the Fund in an amount equivalent to its previously deposited contributions. Additional drawings would depend on the agreement of further conditions and financial budgetary disciplinary restraint.[94]

A factor that could complicate the development of this facility would be the political process of negotiating a stabilization program as well as the political independence of the EMF staff in charge of such a task.[95] The council has so far delegated the unpopular role of imposing technocratic solutions against the will of democratic governments to an outside agency- the IMF.

Potential problems with time-inconsistency and with the lack of credibility of the conditions to be imposed by the EMF have been also pointed out. “The threat of continuously enforcing strict fiscal discipline no longer appears credible in times of large-scale protests directed against EMU institutions or other EMU countries. The same applies to the SGP and the no-bail out clause. The SGP´s threat to impose sanctions is counterproductive and also not credible if a county is in a deep fiscal crisis”.[96]

5. Orderly sovereign default

Provided that the financial support provided by the EMF does not suffice, a mechanism capable of managing an orderly default and debt restructuring of public and private debt is

[94] Häde, *supra* note 69.
[95] Mabbet, D & Schelkle, W. “Beyond the Crisis- The Greek Conundrum and EMU Reform” Intereconomics Forum 2 (2010): 81-85.
[96] Matthes, *supra* note 84.

also included. This would eliminate the risk of disorderly default, which is the main threat that Member States in a fiscal crisis pose to the systemic financial stability of the eurozone.[97]

So far, such a procedure does not exist. As a result, the insolvency of one Member State would have incalculable consequences for other Member states, giving it a certain power for extortion.

According to the proposal, the EMF shall guarantee an amount equivalent to 60% of the GDP of a Member State, which would make sovereign default a manageable risk.[98] In order to limit the losses to financial institutions, the payments to the creditors of the insolvent Member State could be based on some form of Brady-bonds.[99] This could save most European banks from sliding into another crisis.[100] Derivatives and other transactions not previously registered with a special arm of the EMF dealing with the verification of public debt figures would not be exchanged. The transparency of public finances would be thus enhanced.

At the same time, the moral hazard on the side of the creditors would be reduced as they would be prevented from pocketing high interest payments on Greek treasuries without facing a real default risk because they expected a generous financial rescue package by eurozone Member States.[101]

However, the funding of the EMF – assuming that it would be based on the EFSF – would have to be much larger if Member States like Spain or Italy were to be rescued. “The problem of the eurozone is not Greece but the rise in market interest rates of Italy and Spain, two large countries in the eurozone’s core. The most important priority is the size and flexibility of the EFSF. At present, the overall size of the EFSF is €450bn. With a second Greek credit agreed

97 Pisani-Ferry & Sapir, *supra* note 83.
98 Häde, *supra* note 69.
99 Brady bonds are “US-dollar denominated bonds backed by the US Treasury, issued by developing countries, mainly in Latin America, as part of a restructuring of their debt to foreign bank creditors, mainly US banks. The bonds are named after Nicholas Brady, the US Treasury secretary at the time the scheme was launched in 1989.
100 Matthes, *supra* note 84.
101 Ibid.

and second program for Ireland and Portugal very likely, the ceiling will not be big enough to bring in Spain, let alone Italy. To do that the ceiling would have to be doubled, or trebled. Without this increase, it is inconceivable that the eurozone can get through this crisis intact."[102]

For this reason, some argue that a better alternative is to introduce such a mechanism – an orderly default procedure- in the International Monetary Fund (IMF). One of the arguments behind this proposal is the fact that using the threat of an IMF intervention could eventually strengthen the eurozone´s institutional framework to discipline decentralized decision-making in fiscal policy. Besides, establishing an EMF would entail strongly interfering in the national sovereignty of eurozone Member States.[103]

6. Amendments of the Treaties

For the reasons explained above, certain aspects of the proposal could not be implemented under current Union law:

- The financing mechanism through payments from those Member States that do not meet the reference values for government debt and for the budgetary deficit would be incompatible with Art.126 TFEU;
- Guarantees for public debts and payments to the creditors of the insolvent State within the orderly insolvency proceedings would be incompatible with Art 125 (1) TFEU;
- Any other deviation from the procedures established in the TFEU (participation of the ECB, voting rights limitations that are not provided for) or even expulsion from the Monetary Union.

Therefore, it would be required to amend the Union Treaties.

[102] Münchau, Wolfgang „Some useful steps but not much of a strategy" *Financial Times* (London, 21 July 2011).
[103] Matthes, *supra* note 84.

The EU treaty provides for three different procedures to amend the Treaties:[104]

- the ordinary revision procedure[105] which may, inter alia, serve either to increase or reduce the competences of the Union on a proposal from a government, Parliament or the Commission to the Council which submits it to the European Council and notifies the national parliaments. After consulting Parliament and the Commission, the European Council decides by a simple majority in favor of examining the proposed amendments;
- the simplified revision procedure[106]: this revision procedure concerns only provisions of Part III[107] of the TFEU relating to the internal policies and action of the Union. The European Council, after consulting Parliament and the Commission, adopts an amending decision, which must be approved by the Member States. The decision may not extend the competences of the Union;
- the so-called bridging amendment [108]: where the TFEU or Title V of the EU council may authorize the council to act by qualified majority, except in the area of defence. Similarly, where adoption by the Council is provided via a special legislative procedure[109], the European Council may authorize adoption via the ordinary legislative procedure[110]. These initiatives must act by unanimity after obtaining the consent of Parliament given by a majority of its components members.

[104] Mathijsen P.S.R.F., *A Guide to European Union Law as amended by the Treaty of Lisbon* (10th edn Sweet & Maxwell, London 2010).
[105] Art 48 (2) to (5) EU.
[106] Art. 48 (6) EU.
[107] Part III "Union Policies and Internal Action" inludes practically all the activities of the Union, except any external action.
[108] Art 48 (7) EU.
[109] Art 289 (2) TFEU.
[110] Art 294 TFEU.

In this case, a key question is whether the conferral of additional policy areas from the Member States to the Union for the establishment of an EMF increases Union competences or not.

Art. 48 (6) TEU - the simplified revision procedure- would apply provided there is no increase in the competences conferred to the Union. The ordinary revision procedure – Art. 48 (3) TEU- would have to be applied given an increase in the Union competences. As a result, “a convention composed of representatives of the national Parliaments, of the Heads of State or Government of the Member States, of the European Parliament and of the Commission would have to be convened. However, the European Council could, after obtaining the consent of the European Parliament, decide to avoid a convention due to the limited extent of the proposed amendments and instead convene a conference of representatives of the governments of the Member States. The results of the convention or of the intergovernmental conference would then need to be ratified by all Member States before they could enter into force.”[111]

CONCLUSION

The European sovereign debt crisis, characterized by fiscal laxity, disregard for the budgetary discipline rules of the Stability and Growth Pact, and banking sector immoderation, has drawn attention to the conflict between centralization of monetary policy and descentralization of fiscal policy, emphasizing the need for policies to avoid future crises in the European Monetary Union.

Among the measures taken and proposals contemplated in response to the sovereign default stage of the financial crisis in the Euro area, this paper has examined features and legal aspects of the European Financial Stability Facility, as a temporary emergency tool, and the

[111] Häde, *supra* note 69.

different issues involved in the establishment of a European Monetary Fund, as a permanent institution.

The European Financial Stability Facility, whose legal feasibility sparked great controversy, finds an adequate legal basis in Art. 122(2) TFEU in terms of extension of emergency Union financial assistance to Member States in difficulties, and is compatible, subject to conditions, with the prohibition of transfer liabilities enshrined in Art. 125 TFEU.

The popular proposal to establish a European Monetary Fund – as a means to tackle the solvency problems of EMU Member States in difficulty through the provision of emergency loans or guarantees for the issuance of public debt – could be implemented under the newly introduced Art. 136 (3) TFEU which allows “closer coordination and surveillance” among the Euro area Members States. However, some aspects of the proposal – the financing mechanism or guarantees for public debts - could not be implemented under current Union law, and an amendment of the Treaties would be required, which, if leading to an increase in Union competences, would imply a long and hazardous process.

The advantages of establishing a European Monetary Fund – an orderly sovereign default mechanism, incentives for fiscal discipline, transparency of public finances and reduction of the moral hazard problem – are thus constrained by the need to amend the Treaties and the condition to provide the fund with an adequate lending capacity able to support large economies. These two requirements involve decisive political will and leadership.

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