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How to strengthen the European Monetary Union

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European League for Economic Cooperation, a.i.s.b.l.

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Foreword

The European Economic and Monetary Union is in turmoil. The financial crisis that broke out in 2008, turned from a banking crisis into a sovereign debt crisis. It shook the foundations upon which the euro was build. Rapidly it became clear that you can not have a monetary union if at the same time the participating countries are not tightly linked by an economic union – or even a political union.

You can not unscramble an omelette. The EMU was designed as irreversible and there is no way back. But even more important, the euro has brought tremendous economic benefits to the participants, such as exchange rate stability and the total disappearance of the cost of exchange risks. It was a tremendous step into the direction of a single market in Europe.

For the European League for Economic Cooperation (ELEC), there is no doubt that the euro is here to stay. All our efforts should be directed to find ways to strengthen the Monetary Union. In our continuing efforts to participate constructively in that debate, ELEC has devoted several meetings of its commissions to the question of how to strengthen the euro. We also devote this issue of our "Cahier Boël" to the subject, after we already published a Cahier on "the creation of a common European bond market" at the end of 2010.

This Cahier is the result of a very lively discussion of our Monetary Commission that convened in Utrecht on March 21st 2011. Several papers by external experts and by our own members were presented that sought solutions on how to strengthen the Monetary Union.

All interventions stressed the need for more fiscal discipline, greater attention to competitiveness and structural reforms to harmonize economic policy between the 17 euro countries. A lot of attention went to the creation of a permanent rescue mechanism, the revision of the Maastricht Treaty, the possibility/desirability of debt restructuring, the risk of contagion and the pro's and con's of issuing Eurobonds.

What is essential of course is political will to implement the various blueprints that have been launched. Let us not forget that one of the elements that contributed to the present crisis, was that the existing Stability and Growth Pact was not respected. Hopefully this time, the lesson will be learned.

Bernard Snoy
President

Jerry van Waterschoot
Secretary General

Breaking up is hard to do

Mark CLIFFE
Chief Economist, ING

The departure of even one member of European Monetary Union (EMU) would wreak enormous economic damage. Sadly, the current thrust of economic policy is failing to suppress the doubts about EMU's sustainability aroused by the Eurozone's debt crisis. Policy-makers are focusing on fiscal austerity as the remedy to the crisis. Yet the crisis turns not just on fiscal discipline. At the heart of the crisis is the failure of EMU to deliver the real economic convergence that its architects hoped for. Indeed, it will be hard to dispel the risk that EMU will break-up without convincing signs that its weaker members will be able to generate stronger growth in the longer term.

The Eurozone's economy has been developing on the presumption that monetary union is irreversible. Indeed, the financial markets were treating it as such until early last year. Ironically, excessive confidence in EMU may have contributed to the current crisis. Confidence that membership would be permanent led to a dramatic convergence in interest rates from the end of the 1990s. This prompted sharp falls in funding costs in the peripheral economies such as Greece, Ireland, Portugal and Spain. In turn, this led to credit-fuelled booms which have now turned to bust. The markets have recoiled at the build-up of debt exposed by the crisis.

It is vital to understand precisely how the policy-makers' challenge of restoring confidence in public finances is connected to that of restoring confidence in EMU itself. In the first instance, it might be said that the two issues are not directly connected: After all, the Maastricht Treaty's 'no bail-out' clause does leave open the possibility that EMU member states could default on their public debt without having to leave the Eurozone. Moreover, were a heavily indebted member to leave EMU, it might find that the immediate impact would be to severely worsen its fiscal solvency. This because its new currency might depreciate strongly, pushing up the burden of repaying its existing euro-denominated debt. Even if it successfully negotiated the tricky challenge of redenominating its existing debts into its new currency, this would merely keep its public debt to GDP ratio unchanged.

So how might leaving EMU help a country to restore its fiscal solvency? If we leave aside the option of defaulting on, or restructuring, its public debt, then there are essentially three ways for solvency to be restored. One is fiscal restraint: governments need to aim to reduce their borrowing. This is the current preoccupation of Eurozone policy-makers. Second is to lower the interest rate on the debt. Convincing the bond markets of their commitment to fiscal restraint is one way for governments to achieve this, but the credibility of monetary policy in restraining inflation is also important too. But there is a third route to solvency, which is to boost economic growth. In other words, policy should aim to lift denominator of the debt-to-GDP ratio, rather than simply reduce the numerator. This is where departure from EMU could play a role. By restoring control over its currency, a country could seek stronger growth through an effective real depreciation in its exchange rate.

Box: The Mechanics of Sovereign Debt Sustainability

The Eurozone's sovereign debt crisis has sensitised the financial markets to the ability of all governments to put their finances on a sustainable footing. Countries with outstanding public debts in excess of annual GDP have come in for particular scrutiny. In the long term, markets want to see the public debt to GDP ratios stabilise and then fall from the elevated levels sparked by the financial crisis.

The key drivers of the change in Public Debt (as %GDP) over time can be derived from the following equation:
Change in Debt = Primary Budget Deficit + [(Interest rate – GDP growth) x Debt]
Note: public debt and deficits expressed as %GDP, primary budget deficit excludes debt interest

Accordingly, the growth in public debt can be reduced in the following ways:

1. Improved primary budget balance = either lower expenditure or higher taxes
2. Lower interest rates = either loose monetary policy or bullish bond market sentiment
3. Faster nominal GDP growth = either faster real growth or higher inflation
4. Reduce existing debt = either sell-off assets or restructure/default on existing debt

For the peripheral Eurozone economies that are struggling with their government debts, departure from EMU is not a straightforward solution. Indeed, in the short term, it would make matters worse. The immediate depreciation in the new domestic currency would increase the cost of servicing their euro-denominated debts. Even if, as we believe most likely, they chose to address this by re-denominating these debts into their new currency, their solvency would be challenged initially by higher interest rates and higher primary deficits. The calculation is that currency depreciation would in the longer term fuel stronger nominal growth and, as result, lower primary deficits. This combination would allow them to reduce their debt to GDP ratios.

Source: ING

Indeed, IMF research shows that heavily indebted countries that have successfully avoided default have typically done so because they have enjoyed strong real economic growth combined with unanticipated inflation and/or an effective real exchange rate depreciation. In the absence of their own currency and monetary policy, struggling members of the Eurozone are left with trying to secure the latter through competitiveness gains achieved via real wage restraint and/or faster productivity growth. Since productivity miracles are not easy to conjure up, this points to a tough regime of wage restraint. In fact, since the European Central Bank shows no sign of abandoning its price stability mandate, this means that the struggling peripheral economies are looking at outright wage cuts in order to restore their price competitiveness. Coming on top of years of fiscal restraint, this hardly an enticing prospect.

As the Eurozone's periphery faces up to the prospect of years of economic pain, it hardly surprising that commentators continue to debate whether they will succumb to the temptation of leaving EMU and letting their newly recreated currencies fall in order to promote faster economic growth. But for all the debate about the ***probability*** of exits from, or even a complete break-up of EMU, remarkably little attention has been paid to what ***impact*** this would have. This is all the more remarkable given that the consequences ought surely to have a bearing on decisions on whether or not countries choose, or are perhaps forced, to leave EMU.

The reality is that there is no definitive way of putting probabilities on EMU exits or break-up. Wider bond spreads are a clue, but these may reflect the risk of default or restructuring of sovereign debt risk rather than the potential currency losses that might be incurred if countries were to leave EMU. Recent surveys of market players provide another indication. They suggest substantial minorities expect exits in the next few years. But ultimately, this amounts to a question of political will. Are societies ready to accept the economic sacrifices needed to sustain EMU?

This brings us back to the question of what the impact of countries leaving EMU would be. Unless we have some idea of the answer to this, it is impossible to make a rounded assessment of the economic sacrifices that member states might need to make to stay part of the club. Last year, ING's economists undertook a study to attempt to do just this [1].

Evaluating the impact even of one member leaving, let alone a complete break-up of the monetary union, is a daunting challenge. The history of break-ups of other monetary unions is of only limited guidance, given the unprecedented scale and ambition of EMU. Indeed, it might be said that assessing a break-up of EMU this is trying to "quantify the unquantifiable". Nevertheless, faced with this risk, policy-makers and investors need to take a view.

The ING study evaluates two boundary cases: a Greek exit and a complete break-up. Although there are many permutations in between, the results give some indication of their potential impact as well. In short, damage to output in the first two years would be huge. This damage would flow through a variety of channels. First, there would be the enormous logistical and legal problems of reintroducing national currencies. Secondly, plunging asset prices combined

[1] '**EMU Break-up** – Quantifying the Unthinkable', ING Financial Markets Research, 6th July 2010

with a chaotic capital flight would cause extreme exchange rate volatility, in turn disrupting of trade and investment. Thirdly, this would associated with a new dimension of financial system distress as plunging asset prices and widespread asset and liability mismatches triggered waves of defaults.
Fourthly, consumer and business confidence would plummet. Fifthly, this blow to confidence would be compounded by the pressure markets would place on governments to deliver yet more fiscal restraint. Finally, collapsing euro-bloc economies and currencies would spread the pain outside the Eurozone.

As to the calibration of the effects of EMU departure, this would clearly depend on the precise scenario. But even at the milder end of the spectrum, that of a Greek exit, while the initial economic damage is naturally focused on Greece itself, the effects elsewhere are non-trivial. While Greek output falls by 7½% relative to the base case scenario in the first year after exit, the remaining Eurozone economies could see their output fall by as much as 1%. Losses on Greek assets spread the pain across Europe and beyond.

By comparison, the impact of complete break-up would be dramatic and traumatic. In the first year, output falls by between 5% and 9% across the various former member states, and asset prices plummet. With their new currencies falling by 50% or more, the peripheral economies such as Spain and Portugal see their inflation rates soar towards double-digits. Meanwhile, Germany and other core countries suffer a deflationary shock. Indeed, with the US dollar surging on safe haven flows, the US also suffers a bout of deflation. As a result, the break-up scenario leads to massive divergence in both interest rates and bond yields. Ten year bond yields in Germany fall below 1% while those in the peripheral markets might soar even well beyond their current elevated levels.

Some argue that the current sovereign debt crisis has exposed EMU as not being what economists would call an optimal currency area. Indeed, that could be used to argue that there would be long run economic benefits from partly or wholly dismantling EMU. However, the initial trauma that would more certainly ensue is sufficiently grave to give pause for thought to those who blithely propose EMU exit as policy option.

In any case, this is to ignore the essential political dimension of EMU. While even German Chancellor Angela Merkel has said that departure from EMU cannot be ruled out as an ultimate policy option, she has been at pains to stress that "*if the euro fails, then Europe fails*".

So how can departures from EMU be avoided? As we have already seen, fiscal austerity alone is unlikely to be enough. Indeed, the attendant short run damage to economic growth and hence popular support to incumbent governments means it could even be counterproductive. One policy option would be for the European Central Bank (ECB) to keep its monetary stance sufficiently loose to allow economic growth to accelerate. However, the buoyancy of the German and other core economies is such that the ECB is now more concerned about meeting its price stability mandate. Indeed, it is already signalling that it is planning to raise interest rates.

The ECB's apparent determination to tighten monetary policy in turn makes it less likely that Eurozone growth will receive a fillip from a weaker euro, at least against the US dollar. On the other side of the Atlantic, the Federal Reserve is in no hurry to raise interest rates, given that neither inflation nor unemployment give it grounds to do so. Peripheral Eurozone economies are therefore unlikely to enjoy a boost to their international competitiveness and hence growth from a generalised decline in the euro.

With monetary policy unlikely to be of much help, the next option to lift growth is structural reform. This is of course a long-standing policy objective not just of the Eurozone, but of the EU itself. While the debt crisis has given this debate a new urgency, proposals for a competitiveness-enhancing package of reforms in the 'Pact for the Euro' are unlikely to provide a quick fix, even in the event that they are agreed or, more importantly, implemented. In any case, there must be major doubts about implementation. Despite German pressure to the contrary, targets for reforms are non-binding, and responsibility will remain in the hands of national governments.

In the absence of a sudden and unexpected boost to growth from outside the Eurozone, there are essentially two remaining ways in which EMU might survive intact. First, and most likely in the short run, is that Eurozone governments will have to concede defeat on their efforts to avoid restructuring of the sovereign debts of one or more of the peripheral economies. While this would certainly be both politically and economically damaging, at least the financial markets are already some way towards pricing-in this possibility. This means that some of the adverse effect on the creditors (many of them residing in the core countries) has already been taken on board. Nevertheless, restructuring, or even outright default, would undoubtedly force more action to recapitalise banks across the Eurozone.

The second way in which EMU might survive intact is one that would have appealed to many of its original architects: namely a substantial increase in fiscal transfers. If a combination of fiscal restraint, structural reform and even restructuring fail to restore the fortunes of the Eurozone's struggling periphery, then this is all that will remain. EMU's survival may in the end rest on the willingness of the Eurozone's core creditors to pay for the poorer periphery. For now this is politically unpalatable. But one way or another, the core will pick up the bill.

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Eurobonds – Concepts and implications

Document written on the request of the European Parliament's Committee on Economic and Monetary Affairs.

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1 - Introduction [1]

After last year's sovereign crisis, the euro area is still far from sailing in safe waters. Severe reforms have to be undertaken to guarantee the future of the Economic and Monetary Union (EMU). This has to start with the enlargement of the temporary stability fund to at least EUR 700 billion. Fortunately, this is currently a major point on the EMU political agenda. However, we simultaneously need a strengthening of the fiscal rules in the Stability and Growth Pact (SGP), especially when it comes to enforcement [2]. This should be a prerequisite for moving to the last reform, namely a permanent defense mechanism for the Eurozone. This would be a move towards making EMU a more integrated fiscal union. In December 2010, the European heads of state and government and the economics and finance ministers decided to introduce a permanent European Stability Mechanism (ESM) from 2013 on to replace the European Financial Stability Facility (EFSF). Recently, though, other ideas to guarantee the stability of the euro area have been put forward. In what follows, I am focusing on 'Eurobonds', to be defined as 'pooled' sovereign debt instruments of the Member States of the euro area. These have been the object of intense political debate lately. Proposals span from the possibly most cited Blue-Red Bond proposal by Bruegel to political manifests such as the one in December 2010 by Tremonti and Juncker. However, there is a need to understand the features and the policy implications of the different proposals, including their differences, more fully. To this end, let us first establish what a Eurobond solution should offer. Boonstra [3] has summarised this in five points. The introduction of Eurobonds could contribute to the better functioning of EMU in different ways:

1) Market discipline: the markets should be able to correctly discipline governments for good and bad behavior, instead of acting very erratically as they did last year. However, some authors doubt whether or not the markets are able to correctly discipline governments.
2) Fiscal discipline: these bonds will have to contribute to strengthening the enforcement of budgetary rules, i.e. those from the SGP. Some authors believe that Eurobonds could also weaken fiscal discipline.
3) Speculation deterrence: by guaranteeing stability of the Euro, the bonds should help to shelter from speculation in financial markets. However,

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[1] The author gratefully acknowledges the very helpful comments of Professor Hans Blommestein and Dr. Wim Boonstra and the excellent research assistance of Mr. Rob Nijskens, M.Sc.
[2] Eijffinger, 2010.
[3] Boonstra 2010.

Blommestein [4] concludes that there is no solid empirical evidence against speculation ('short-selling') and that it should be banned.

4) Market stability: the market for government bonds will be larger and more stable, sheltering from large swings in market sentiment.
5) Benefits for both strong *and* weak Member States: this is very important politically, as a large participation rate is vital for the Eurobond proposals to succeed.

All proposals discussed in this paper satisfy these demands, at least to some degree. In the next section, the most important proposals will be analysed and discussed with their advantages and disadvantages respectively.

2- Overview of the various proposals for introducing Eurobonds

Favero and Missale [5] have summarised the most recent proposals for Eurobonds. They conclude that the proposed Eurobonds can improve on liquidity and default risk over sovereign debt, while these bonds also ensure continued market access for all Member States. Moreover, they are able to protect against speculative attacks and improve the position of the Euro as an international reserve currency. Concerning economic governance, the bonds can lead to improved budget discipline, reduce the probability of a bailout and, ultimately, lower costs for the taxpayer. However, the realisation of these benefits hinges on credible cooperation and commitment, a high enough participation rate and the credibility of fiscal discipline and the no-bailout clause. Additionally, flexibility in debt management is reduced and set-up costs may be very high.

Let us now consider the various Eurobond proposals, and describe their basic concepts and differentiating features (summarised in Table 1). The first proposal for the introduction of Eurobonds has been made by Boonstra.[6] It is also one of the most detailed and analysed proposals. He proposes to move from national to central financing for all public debt, thereby abolishing the possibility for countries to separately raise debt on financial markets. A newly to be established independent 'EMU fund' will issue Eurobonds, and lend the funds raised to the participating EMU countries at a premium over the Eurobond rate. This premium will be based on deficit and debt deviations from the average levels of Germany and France. Only countries performing worse than Germany and France will pay a premium. The formula for this premium looks as follows:

$$R(i) = a[O(i) - O(m)] + b[S(i) - S(m)],$$

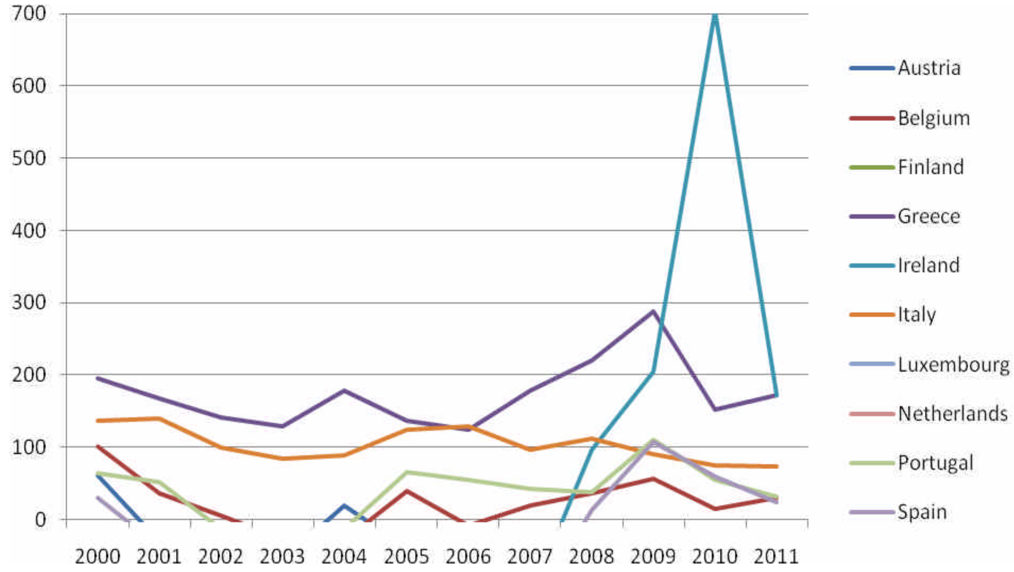
where
R(i) is the margin payable by country i over the funding costs of the EMU fund,
O(i) is the government deficit ratio of country i,
S(i) is the government debt ratio of country i,

4 Blommestein 2010.
5 Favero and Missale (2010).
6 Boonstra 2005, 2010.

the variables O(m) and S(m) represent the average for French and German government deficit and government debt, and
the parameters *a* and *b* are coefficients, used to determine the weight of the relative performance. These coefficients have to be determined ex ante; see also below.

Figure 1 illustrates the hypothetical case where the EMU fund is introduced in 2000 and *a* and *b* are set to 0.25 and 0.02, respectively. The total premium over the EMU fund rate is for Belgium, Italy, Portugal and Spain since the start of the financial crisis in 2008 around 100 basis points or less. For the countries that were bailed out by the EFSF – Greece and Ireland – the total premium spiked to respectively 300 and 700 basis points in 2009 and 2010 to decline to less than 200 basis points at the beginning of 2011.
It should be noticed that the total premium over the EMU fund rate is very much depending on the setting of the parameters *a* and *b.*

Figure 1: Total premium (basic points) over the EMU fund rate



Source: Author's calculations, based on data from OECD Economic Outlook No. 88.

This proposal is very straightforward, and has several advantages: average borrowing costs will decrease, fiscal policy quality is reflected in interest rates, and countries face a more gradual discipline from the EMU fund instead of that of erratic financial markets. However, the proposal also has some strong requirements. First, participating countries have to agree not to engage in monetary financing or directly approach financial markets for funding. This behaviour, like defaulting on the debt to the EMU fund, will be punishable by sanctions imposed by the fund. Second, participation is voluntary. However, Boonstra argues that the large liquidity and stability benefits of participating will ultimately convince all countries to participate. When countries have decided voluntarily to participate, then they are fully committed to the costs and benefits of the EMU fund. Additionally, not joining this program will be a bad signal to financial markets, thereby increasing borrowing costs. Finally, credibility of the EMU fund has to be very high, so as not to break with the no-bailout clause introduced by the Maastricht Treaty. This is also essential to generate enough fiscal discipline. Some other issues with this proposal may be the setting of the parameters and the base rate, and the practical and political implementation; mainly the transition from the current regime to the new one. Fortunately, many studies have looked into the first issue and as such we can draw from this literature to set the values for the parameters [7].

The practical implementation will have to be dealt with in the political arena, in particular the setting of the parameters. Notice that these parameters are also depending on the enforcement of the revised SGP (automatic sanctions).

The proposal by De Grauwe and Moessen [8] is formulated in a simpler and more modest way. They propose a scheme in which an EU institution, i.e. the European Investment Bank (EIB), issues Eurobonds. The share of Member States in this scheme will be based on the EIB equity share, and the coupon rate on these bonds is a weighted (by the same shares) average of the yields in the national government bond market. Then, the proceeds from this issue will be allocated to Member States in the same way. Finally, the participating countries will pay the same rate as they pay on their own government bonds, thereby eliminating free-riding possibilities. This proposal will guarantee funding for all Member States, and safety for investors in these bonds, while there can be no free-riding by weaker countries. However, it may also raise issues such as the sharing of collective responsibilities, the possible existence of implicit guarantees by stronger countries participating in the scheme (they will not want to let it break down) and the determination of the yield to be paid, as national bond markets may be distorted when Eurobonds are introduced.

Furthermore, Delpla and von Weizsäcker [9] propose another variant of the Eurobond, in a scheme that is lies between the abovementioned two proposals. Their proposal states that EU countries should pool their debt to a maximum of 60% of GDP (the Maastricht limit), in so-called 'blue bonds'. Beyond the 60% level, countries will have to go to the capital market on their own, which will lead to higher borrowing costs. This part of the debt is called the 'red debt'. This leads to a tranching of debt: the blue bonds will be senior, more liquid (as they are pooled) and subject to lower default risk, while the red bonds will be junior, illiquid and subject to the same default risk as before. As the red debt carries higher costs, countries will have an incentive to consolidate their budget as to bring their debt to below 60% of GDP.

Several institutional details will have to be arranged for. First, the distribution of gains and costs will have to be stipulated, preferably on the basis of fiscal positions. This can for instance be achieved by linking the blue bond quota to fiscal discipline, with a minimum of zero and a maximum of 60% of GDP. Second, an agreement to not borrow 'on the side' has to be signed, to guarantee the credibility of the scheme's discipline. Third, an orderly and

[7] see i.a. Mayordomo et al, 2009.

[8] De Grauwe and Moessen 2009.

[9] Delpla and Von Weizsäcker 2010.

stable process for allocation of blue bonds has to be set up, preferable in an independent body that can decide on the credibility the participating countries' fiscal policies. This also pertains to the no-bailout guarantees that have to be built into this scheme: an orderly bankruptcy procedure has to be arranged for countries defaulting on their red debt, so as to prevent another sovereign crisis. Finally, the transition from the current situation to the blue/red bond system has to be arranged. Delpla and von Weizsäcker propose a phasing out of national debt, by letting blue and red bond issues replace national bonds. They state that a debt restructuring is also possible if the scheme has to be implemented faster. As a final point, the authors argue that countries have several incentives to participate. First, the liquidity of a large part of their debt improves, leading to lower borrowing costs. Second, countries with weak fiscal policies can use the scheme as a commitment device for improving their budget.

Finally, they state that strong countries do not have to worry about having to pay for a bail-out anymore. However, this advantage completely depends on the credibility of the set-up.

A last proposal has come from the political arena, and is a very practical approach to Eurobonds. Juncker and Tremont i[10] propose that an independent European Debt Agency (EDA), a successor to the current stability fund, issues Eurobonds. It should finance up to 50% of EMU member issues, to guarantee a deep and liquid market. Furthermore, the EDA should offer a transition from national bonds to Eurobonds. This transition should take place at a discount on national bonds (higher for countries with weak budgets), to make the Eurobonds attractive for investors. This will immediately force countries to improve deficits. The proposal again leads to lower borrowing costs, shelter from market shocks and speculation, and reduction of moral hazard through automatic fiscal discipline. Moreover, the authors argue that taxpayers will not have to foot the bill, as the EDA will realise a profit from converting national bonds at a discount. However, the proposal is quite ad hoc: the set-up of an EDA is not discussed in detail, and no estimates of the discount or the EDA's interest rate are given. More in-depth analysis is necessary to assess the merits of this proposal.

Table 1: Comparison of the various proposals for introducing Eurobonds

<table>
<tr><td colspan="2"><u>Boonstra (2005, 2010)</u>
• Central financing through EMU fund, replacing sovereign bonds
• Spread based on deficit and debt deviations from target or average
• Clear sanctions when rules are breached, i.e. in case of non-payment
• Voluntary participation, but strong signalling effects from participation
• Benefits for weak and strong countries</td></tr>
<tr><td>Advantages
+ Increase in liquidity, lower costs
+ More gradual market discipline</td><td>Disadvantages
- How to set the parameters?
- What should be the base rate?</td></tr>
</table>

10 Juncker and Tremonti 2010.

+ Shelter against speculation & shocks + Objective implementation + Early warning for budget problems	- Practical/political implementation - Possible tension with no-bailout
De Grauwe and Moesen (2009) • EU institution issues Eurobonds with average yield of participating countries • Governments pay the same rate as before on their national debt • Everything is based on equity share in European Investment Bank • Benefits will realize for weak countries mainly	
Advantages + Increase in liquidity (only for the weak euro area countries) + No free-riding in borrowing rates + Shelter against speculation & shocks + Objective implementation + Guaranteed funding	*Disadvantages* - How to share responsibilities? - Implicit guarantees by stronger states - National markets may be distorted - No far-going integration - Cutting up of the European market for public debt
Delpla and von Weizsäcker (2010) • Blue (senior) bonds up to 60% of GDP, and red (junior) bonds beyond the threshold • Beyond this margin, fiscal discipline will be needed to reduce debt to below 60% of GDP • Independent administration by a newly to be established stability council • Orderly bankruptcy procedure for red debt to minimise disruptive defaults • Benefits for all countries participating	
Advantages + Simple proposal + Increase in liquidity, lower costs up to 60% of GDP blue bond ceiling + Automatic, explicit fiscal discipline + Less disruptive defaults for red debt + Limited joint guarantees and liability	*Disadvantages* - Full participation necessary - Credible commitment necessary - Administration must be independent - Transition may be messy - Limit to 'side financing' needed - Cutting up of the European market for public debt
Juncker and Tremonti (2010) • European Debt Agency, successor to stability funds, issues Eurobonds • Transition from national to Eurobonds at a discount • Creates a liquid global market for Eurobonds	
Advantages + Simple proposal + Transition is accounted for + Lower rates exercise discipline	*Disadvantages* - Ad hoc proposal - No institutional details given - Independence necessary

To summarise this section, we can list the differentiating features of the abovementioned proposals. The dimensions on which we can distinguish the proposals are the degree or amount of funding obtained, the institutional set-up of the bond issuer, the way in which participation is organised and the calculation of the borrowing costs. They are summarised in Table 2 below. Since the proposal by Juncker and Tremonti is not very detailed and very similar to the other proposals, this is left out. We can see that most proposals aim at complete centralised funding in the long run, they all require some form of independent issuer, participation is voluntary (but very much encouraged) and that borrowing costs depend on fiscal discipline, in one way or the other.

Table 2: Differentiating features of the various proposals for Eurobonds

	Boonstra (2005, 2010)	**De Grauwe and Moessen (2009)**	**Delpla and von Weizsäcker (2010)**
Funding degree	Complete replacement of national markets	Eurobonds are complements to national bonds	Eurobonds are complements, but national debt is made very unattractive
Institutional set-up	Independent institution issues bonds centrally. No individual issuance by members	EU institution issues bonds, making use of existing set-up	Independent institution allocates issuance quota, countries issue themselves
Participation	Voluntary, but staying out is a bad signal (no opting out)	Voluntary, but limits on debt	Voluntary, but limits on debt and opting out is a bad signal
Calculation of rates	Based on deviation from fiscal thresholds	Based on EIB equity share	Based on market rates, different for blue and red bonds

3 - Implications for financial markets and economic governance

As mentioned in the overview above, the different proposals have important implications for borrowing cost, the liquidity of European bond markets and market discipline in general. We can safely state that borrowing costs in all proposals will decrease for all countries with weak fiscal policies. However, depending on the institutional set-up countries with a strong fiscal discipline will not gain (Boonstra) or only little (De Grauwe and Moesen). This implies redistribution from strong countries to weak countries, especially considering the possible tensions with the no-bailout clause that are implicit in all proposals (see also below). The liquidity of European bond markets, however, will improve almost certainly. Although this depends on the degree of participation in the different schemes, a unified bond market for Europe will send a strong signal to financial markets. Finally, market discipline may decline or increase; this differs for every proposal. While Boonstra's proposal replaces market discipline by EMU fund discipline, Delpla and von Weizsäcker argue that market discipline will become stronger, especially at the margin between blue and red debt.

This brings us immediately to the question what the issuance of bonds with joint guarantees implies for economic governance in the euro area and the legislative proposals currently under discussion. Of course, this completely depends on the credibility of the institutional set-up of the scheme. Especially France and Germany are concerned about moral hazard issues, which can ensue when market discipline is not replaced by fiscal discipline through a proper independent institution. This danger is present in the proposal by De Grauwe and Moesen, but less so in the other three. Especially the proposal by Boonstra, if political agreement on this can be reached, will provide strong fiscal discipline as the EMU fund can set independently the importance of deficit and debt consolidation. It follows that Eurobonds can only succeed with a strong underlying economic governance structure that has to be independent, credible and effective in setting sanctions. Otherwise, they will simply lead to a redistribution of costs from weak to strong states and a strong violation of the no-bailout clause. However, the structure has to be agreed upon before setting up any Eurobond issuance scheme. This means that the political discussion has to lead to follow-up of the stability fund, namely a revision of the SGP as I have argued before [11]. This reform has to give the SGP more teeth, so as to be able to enforce the fiscal rules better. When this has been done, one can start thinking about a Eurobond issuance scheme.

4 - Arguments against the introduction of Eurobonds and alternatives

As mentioned in the section above, there is much (political) opposition against these proposals, mainly from the stronger Northern euro countries. The arguments against focus particularly on the redistribution of costs, the explicit and implicit guarantees from strong to weak countries and the practical hurdles to be taken. Issing [12], for instance, is very worried that the introduction of a Eurobond would lead to moral hazard issues in fiscally weak countries, at least in the short run, and to higher costs for countries with sound fiscal policies. This means that it is politically very hard to 'sell' the proposal to taxpayers in these countries. The only solution viable in the long run is a credible commitment by all EMU members to reform and fiscal discipline. Kösters [13] agrees with this standpoint, and notes that Eurobonds with joint guarantees by all EMU members will violate the no-bailout clause introduced by the Maastricht Treaty. He argued then that bail-outs have to be ruled out at all costs. Of course, the bail-outs have already taken place.

Becker [14] argues the same point, adding that Eurobonds make very explicit the burden sharing among Member States in case of an impending default. He notes that this implies a risk of increasing euro-scepticism in Member States with AAA-rated debt. To resolve this, he suggests several alternatives. A possibility to improve liquidity in the market for sovereign debt is an alliance of countries with the same rating. However, this option is not very likely as these

[11] Eijffinger, 2010.
[12] Issing 2009.
[13] Kösters 2009.
[14] Becker 2010.

countries cannot gain much from pooling their debt. Another alternative is for small and medium-sized countries to pool their bond issues, akin to the German federal system. This however, hinges again on the imposition of fiscal discipline in these countries. A third option is to have EMU countries qualify for participation in a Eurobond scheme by consolidating in boom times. This may succeed, although it does not discipline Germany or France and requires a reform of the SGP. A last alternative proposal is the creation of a liquid short-term debt instrument by Germany and France, thus competing with US T-bills. This would greatly increase European bond market liquidity, but does not address any fiscal discipline issues nor strengthen the international position of the Euro.

The discussion above leads me to conclude that a thorough reform of the fiscal rules is a firm prerequisite for any Eurobond scheme to succeed. Without a strong fiscal basis, any proposal for joint bond issuance will be built on quicksand.

5- Conclusion

The main advantages of Eurobonds are increased liquidity of European bond markets (conditional on participation), protection from large market shocks and erratic market discipline, guaranteed funding for all EMU countries and an improvement in the international position of the euro. The main disadvantages are possible free-riding problems, tensions with the no-bailout clause, credibility and political viability. By presenting the various proposals for introducing Eurobonds with their advantages and disadvantages, we hope to have clarified the messy discussion on Eurobonds in a more structured way.

Especially the political viability may prove to be a large hurdle to be taken before starting any Eurobond scheme. As I have argued before, [15] the Member States of EMU will first have to build a strong enforcement mechanism of fiscal discipline into the SGP. That implies strengthening the preventive arm of the SGP by, amongst others, the introduction of a European Semester, as well as strengthening the corrective arm of the SGP by the enforcement of (semi-) automatic sanctions. In spite of all the possible benefits of Eurobonds, proper fiscal coordination and discipline will have to be agreed upon before embarking on a journey towards further European bond market integration, including the introduction of a Eurobond scheme.

[15] Eijffinger, 2010.

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The unexpected revision of the Lisbon Treaty and the establishment of a European Stability Mechanism

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In the first semester of 2010, rescue mechanisms were conceived in order to help peripheral euro-area member states with considerable problems in their public finances. The assistance took various forms. As the crisis became first manifest in Greece [1], euro-area member states engaged in a scheme of bilateral agreements (for €80 billions) of the euro-area member states except Slovakia, with a complement contributed by the IMF (€30 billions) under strict conditionality supervised by the Commission, the ECB and the IMF. The reports of the trio successively presented allow for the allocation by tranches of the €110 billions.

Due to the existence of serious problems in some other countries (Portugal, Spain, Italy and, later on, Ireland) and the risk of contagion, a more ambitious scheme was adopted, under article 122.2 TFEU (formerly, article 100.2 ECT) [2], in May-June 2010, including a *European Financial Stability Mechanism* (EFSM), managed by the Commission and which assistance was potentially open to all EU member states (60 billions euros) (the Commission would borrow on the markets and lend to the country with problems under the guarantee of the EU budget) and a *European Financial Stability Facility* (EFSF) to which the states in difficulty would have access. The Facility, a special purpose mechanism under Luxembourg law, would borrow on the markets under the guarantee of the euro-area member states (plus, as the case may be, other willing EU member states) for on-lending to the country in need of assistance up to an amount of 440 billions euro (which, for technical reasons and, in particular, the objective of a AAA quotation for the loans of the Facility, gives to it an effective borrowing capacity of 250 billions euros) to which one has to add 250 billions euros in credits from the IMF.[3]

These structures were meant to be temporary in order to remedy to the crisis. Their compatibility with the Treaty is contested before the German Constitutional Court by Eurosceptic economists and politicians who, for some,

[1] On Greece and the EMU, see Kevin Featherstone, "Greece: A Suitable Accommodation", in Kenneth Dyson (ed.), *The Euro at 10. Europeanization, Power and Convergence*, OUP, 2008, p. 165-181.

[2] "2. 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 President of the Council shall inform the European Parliament of the decision taken."

[3] Jean-Victor Louis, "Guest Editorial: The No-Bailout Clause and Rescue Packages", *Common Market Law Review* 47: 971-986, 2010. Annamaria Viterbo e Roberto Cisotta, "La crisi della Grecia, l'attaco speculativo all'euro e le risposte dell'Unione Europea", *Il Diritto dell'Unione Europea,* 2011

had also applied, in the past, against the Maastricht Treaty and against the Lisbon Treaty, alleging the contrariety of the participation of Germany to these treaties with the German Constitution. Now they object in particular that the rescue packages are contrary to the stability of the currency based on the no-bailout clause of article 125 of the TFEU (formerly article 103 ECT) [4] and recognized as fundamental by the Constitutional Court. Actions are still pending and the German Government thought that it was imperative to insert in the Treaty a provision allowing for the creation of a mechanism, which will be referred to as the (permanent) European Stability Mechanism (ESM), requiring strong conditionality for its intervention.

The idea of a small revision of the TFEU came to light during the work of the Task Force on Economic Governance, created by the European Council, at its meeting of 25-26 March 2010, at the request of the Heads of State or Government of the euro-area. The Task Force, chaired by Herman Van Rompuy, the president of the European Council, dealt with an ambitious reform of the economic governance; it focused on the strengthening of the Stability and Growth Pact, by effectively covering the stock of debt, neglected until then, as well as deficits, by introducing earlier and progressive sanctions and a reverse majority in the Council to adopt them, allowing for a quasi automatism. It proposed the setting up of a preventive and corrective procedure against excessive macroeconomic imbalances (EIP), with sanctions, in parallel with the Excessive Deficit Procedure (EDP). It provided also for the reform of the budgetary framework of the Member States in order to allow in particular for the organisation of the so-called European semester dedicated to a joint examination of national budget proposals, convergence and stability programmes and national objectives in the field of the EU 2020 strategy that succeeds to the failed Lisbon Strategy of 2000.

At the meeting of the European Council of 4 February 2011, Germany and France proposed a Pact on Competitiveness. For Germany, the adoption of this Pact which concerned, a.o the link between wage development and productivity, the suppression of an automatic link between wages and inflation, the necessity of aligning the pension system to the national demographic situation, the corporate tax base harmonisation, etc., was a condition for this country to accept an increase of the means of the EFSF and the future ESM. Received with a lot of negative reactions, it was substantially watered down after the conciliatory work of the president of the European Council and the president of the Commission. After been called for a while "Pact on the euro", it was adopted by the European Council, at its meeting of 24-25 March under the more neutral denomination of "Euro Plus Pact", because it was open to non euro-area member states. It aims at "stringer economic policy coordination for competitiveness and convergence". Its implementation will be "monitored politically" by the Heads of State or Government, at a yearly meeting attended only by the states having subscribed to the Pact. On March 24/25, six non

[4] "1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."

euro-area members had join the seventeen euro-area member states. Only Hungary, the Czech republik, Sweden and the UK remain outside.[5]

If there is no explicit link between the acceptation of the Pact and the future ESM, some mention an implicit link. It seems clear that a country with no special status towards the euro (like the UK and Denmark) would normally subscribe to the Pact in order to demonstrate its good will and facilitate a positive appreciation on the meeting of the criteria when it will ask for adopting the euro. Nevertheless, neither the acceptance of the Pact can replace the necessity of an in-depth examination of the existence of a "sustainable convergence" for adopting the single currency, nor the opting out of the Pact could per se bar a member state from the monetary union.

On 29 September 2010, the Commission transmitted to the Council a bundle of proposals on economic governance, which developed the content of earlier communications and concerned all the subjects at the agenda of the Task Force. Its report took on board most but not all of the substance of the proposals, and for some of them, not without change. The European Council endorsed the report of the Task Force at its meeting of 28-29 October 2010. The objective was "for the Council and the European Parliament to reach agreement by summer 2011 on the Commission's legislative proposals, noting that the Task Force report does not cover all the issues addressed in the proposals and vice-versa." There were indeed more than nuances between the six proposals submitted by the Commission on economic governance and the final report of the Task Force.

The necessity of a "limited treaty change" was evoked by Germany. In a meeting in Deauville, on 18 October 2010, President Sarkozy and Chancellor Merkel agreed on a compromise [6] concerning a number of points of the Task Force report where there was still no agreement. One of these points related to the necessity of a limited revision of the Treaty in order to establish a permanent and robust mechanism for the ordered treatment of crises.

The European Council of 28-29 October agreed "on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole" and invited "the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect, not modifying article 125 TFEU ("no bail-out clause")" The European Council mentions among the general features of a future new mechanism three important elements: "the role of the private sector, the role of the IMF and the very strong conditionality under which such programmes should operate."

The European Council decided to revert to this matter at its December meeting where it would decide on the outline of a crisis mechanism and on a limited treaty amendment with the objective of its ratification "at the latest by mid-

[5] See euractiv.com 25 March 2011: "Le 'pacte euro plus' divise les pays hors de la zone euro". See also http://euobserver.com/9/32086?print=1 29 March 2011: "Annual euro-pact summits will see refuseniks asked to leave the room". We have get no confirmation of this "exclusion" of the refuseniks.

[6] http://www.elysee.fr/president/les-actualites/declarations/2010.

2013."[7] And indeed at its session of 16-17 December, the European Council agreed on a draft amendment presented by the Belgian Government, the first stage in the simplified revision procedure of Article 48, paragraph 6 of the TEU and it endorsed the Eurogroup statement of 28 November on the "General Features" of the future permanent European Stability Mechanism (ESM), which, as it was learned afterwards, would be incorporated, after completion, in a separate treaty.

On 21 March 2011, an extraordinary meeting of the Finance Ministers, chaired by Jean-Claude Juncker, president of the Eurogroup, adopted key structural features of the ESM.[8] The document provides for the establishment of the ESM by a treaty as an international organisation. The European Council, which endorsed these features [9] at its meeting of 24-25 March, decided that:
"The preparation of the ESM treaty and the amendments to the EFSF agreement, to ensure its EUR 440 billion effective lending capacity, will be finalised so as to allow signature of both agreements at the same time before the end of June 2011."[10]

Two developments are now to be clearly distinguished: on the one hand, the amendment of the TFEU in order to provide, on a permanent basis, for financial assistance to euro-area member states and, on the other hand, the establishment by a treaty among these member states, of the ESM as an intergovernmental organisation under public international law.

We will first analyse the draft amendment, after having said a few words about the procedure and then we will describe, as they are presently known [11], the "key structural features of the ESM".

Section I. The amendment of the TFUE

A. The procedure for the adoption of the amendment

The procedure under Article 48, paragraph 6 TFEU is called the "simplified procedure" of revision because it allows the European Council to modify the treaty, on the initiative of a government, the European Parliament or the Commission, without the convocation of a Convention and of an intergovernmental conference, as it would be requested in the ordinary

7 The date of the entry into force of the amendment was later on fixed on 1 January 2013 in order to enable the ESM to become operational on 1 July 2013.

8 See **Term Sheet on the ESM**, 21 March 2011, http://www.gouvernement.lu/salle_presse/actualite/2011/03-mars/21-mes/esm.pdf?SID=92bb4eed014d947404d14348821a8cd1

9 After having adopted a modification bearing on the rescheduling of the payment of the paid-in capital, see infra.

10 A number of Finn political parties are opposed to the increase of the guarantees offered by the EFSF and for this reason, the government whished to postpone negotiations on the way to increase the guarantees till after the legislative elections in Finland on April, see Reuters: "L'UE se donne trois mois de plus pour éteindre la crise", KePoint.fr 25 March 2011. Finland's debt has an AAA rating.

11 Needless to remark that changes are always possible in the course of the negotiation of the treaty and, as we will see, some clarifications will be needed on some delicate points (like the "preferred creditor status"). In principle, one should not expect important modifications to the content of the Term Sheet but more useful precisions.

revision procedure under Article 48, paragraphs 2 to 5. Nevertheless, an amendment will need the unanimity within the European Council and the approval of all the member states in accordance with their respective constitutional requirements. The decision also needs the previous consultation of the European Parliament and of the Commission. The European Central Bank has to be consulted in case of institutional modifications in the monetary field.

The simplified procedure is submitted to limitations. It can only be applied to the modification of provisions of the third part of the TFEU, related to internal policies and actions of the Union. The decision of the European Council can bear on all or portion of the third part of the treaty. It cannot increase the competences of the Union under the Treaties.

Nobody contested the legality of the use of the simplified procedure in this case [12] and no national referendum seemed to be necessary for its approval.[13] This doesn't mean that the national procedures will necessarily progress smoothly. The example of the Lisbon treaty is there to demonstrate that surprises are not excluded when 27 ratifications are required.[14]
The European Council expected the required opinions for the end of March.

The Commission gave its opinion on 15 February.[15] The European Parliament on 23 March, the day before the meeting of the European Council. Although there was in this case no formal obligation, the European Council also asked for the opinion of the ECB, which gave it on 17 March.[16]

We will come back on some elements of these opinions in further paragraphs.

B. The analysis of the new provision

The revision will add a third paragraph to Article 136, in a chapter of the TFEU, which includes "Provisions specific to Member States whose currency is the euro." It will read as follows:

> "3. *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*."

a. <u>An intergovernmental mechanism</u>

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12 See Opinion of the Commission, 15 February 2011, COM(2011, 70/3, point 9 and foll.

13 If the EU Bill presently discussed by the British Parliament is adopted, a referendum will not be needed in the UK because the amendment will only apply to euro-area members.

14 There are voices in Germany to request a two-thirds majority vote in the Bundestag for the approbation of the amendment. See "German plaintiff fears 'self-surrender' of Bundestag", http://www/euractiv.com 17 February 2011.

15 Commission Opinion on the draft European Council Decision amending Article 136 of the TFEU with regard to a stability mechanism for Member States whose currency is the euro, COM(2011)70/3, 15 February 2010; and Speech of president Barroso at the European Parliament, Speech/11/105.

16 See this Opinion (CON/2011/24) on the web site of the ECB.

The intergovernmental feature of the future mechanism is the first point that strikes at reading the new provision and, it is no surprise, there were criticisms in the European Parliament of this bias which for some was only acceptable as a transition to a Union's mechanism. The Commission would also have preferred a solution more anchored in the system of the Union, as told by President Barroso to the European Parliament. Both the ECB and the European Parliament in their respective Opinion made a reflection of the same nature. The EFSF was also "intergovernmental" but the big difference is that far from being a special vehicle under the form of a company governed by Luxembourg law, the ESM will be "an intergovernmental organisation under public international law", as we will mention further on. It is interesting to compare with the first suggestion of the ECB, in its contribution to the Task Force, which thought to the "establishment of a euro area crisis management institution (sic) on the basis of the EFSF."[17] The ECB was also of the opinion at the time that "Financing this mechanism through contributions from euro-area countries would maintain a transparent link for each country involved between providing financial resources and the exercises of effective mutual surveillance." For some member states and in particular for Germany, the activation of the Mechanism had to remain a bundle of individual decisions, a "mutual agreement of the euro-area Member States"[18] This would preserve a veto right for Germany that could, in its view, avoid the transformation of the Union in a "Transfer Union".[19]

An important difference with the existing assistance package is that the EFSM, proposed by the Commission, decided by the Council [20] and based on Article 122, paragraph 2 TFEU will disappear with the establishment of the ESM. The necessity of a unanimous decision to mobilise the permanent mechanism, which requires a decision of national parliaments for its activation is for many the best instrument one can imagine against the profligacy of some member states.

Is a Union decision based on Article 122, paragraph 2 excluded in the future? The Preamble of the draft decision includes in recital No 8 the following words:
"At its meeting of 16 December 2010, the European Council agreed that, as this mechanism is designed to safeguard the financial stability of the euro area as whole, Article 122(2) of the TFEU will no longer be needed for such purposes. The Heads of State or Government therefore agreed that it should not be used for such purposes."

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[17] See "ECB. Reinforcing Economic Governance in the Euro Area", 10 June 2010, p. 2 and 12. This means in particular that each euro area Member State will have to contribute in proportion of its key in the capital of the ECB, i.e. ½ following the GDP and ½ following the population. Slovakia has proposed the adoption of a key taking into account the strength of the economies (including GDP, public debt, and the development of the financial sector). This proposal was backed by Slovenia and Estonia. This key would be, according to Slovakia, fairer and more beneficial to the euro area's poorest members. See *CE Weekly*, issue 8 (105), 3 March 2011, p.5. A special treatment was temporarily decided for these countries, see infra.

[18] As observed in the "Term Sheet on the ESM" (page 1, note1), "a decision taken by mutual agreement is a decision taken by a unanimity of the Member States participating to the vote, i.e. abstentions do not prevent the decision from being adopted." We will come back on the voting rules in Section II.

[19] See Wolfgang Proissl, "Why Germany fell out of love with Europe", *Bruegel Essay and Lecture Series*, Brussels, 2010, p.31.

[20] See Council regulation (EU) 407/2010 establishing a European stabilisation mechanism, O.J. 2010, L118/1

One could not interpret this recital as meaning that the member states have, by a kind of executive agreement, the possibility to exclude the application of a Treaty provision. Article 122, paragraph 2 will continue to open the possibility for granting financial assistance, under certain conditions, to a member state in difficulties or seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control. The Commission makes this clear in its opinion.[21]

The president of the Commission, the Eurogroup Statement of 28 November 2010 and the European Parliament, in its dialogue with the institutions on the project, insist on the role of the EU institutions and the complementary character of the ESM with the programme on economic governance, focusing on prevention, which is included in the proposals in discussion. We will come back on this point in section II.

b. <u>A mechanism for the benefit of the euro-area member states</u>

The choice of adopting an amendment to Article 136 TFEU underlines that the ESM will be established for the exclusive benefit of euro-area member states, as the present EFSF. But in point 4 of the Conclusions of its meeting of 16-17 December, the European Council states that:
"Member States whose currency is not the euro ... may decide to participate in operations conducted by the mechanism on an ad hoc basis."
It is well known that the UK, Sweden and Denmark participate to the assistance decided for Ireland, under the present mechanism. EU Member States whose currency was not the euro were also able to participate to the design of the new Mechanism.

c. <u>A mechanism intended as a last resort, in the interest of the stability of the euro-area as a whole</u>

In their first declaration on Greece of 11 February 2010, the heads of State and Government of the euro-area who recognized "their shared responsibility for the economic and financial stability in the area", already affirmed that action would be taken "for the safeguard of the financial stability in the euro-area as a whole". It is primarily to the member state in need to cope with the situation in taking the required measure for reestablishing balanced public finances in conformity with the Stability and Growth Pact. The reference to the stability of the whole euro area aims at reassuring the German Constitutional Court that so much insisted in its Maastricht decision [22] on the respect of the stability of both the currency and the public finances and on the instrument to achieve this goal: the "no bail-out clause" of Article 125 TFEU. The assistance

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[21] After having remarked that the draft decision didn’t create a new legal base which would allow the Union to take action that was not possible before this Treaty amendment, the Commission continues:
"Nor does the draft decision reduce the competences conferred on the Union. In particular, it does not affect either the specific solidarity mechanisms provided for in Articles 122 and 143 of the TFEU in the event that a Member State is in difficulties or is seriously threatened with difficulties or the Union’s competences in terms of coordination and surveillance of the economic and financial policies of the Member States..." In his speech to the European Parliament on 15 February 2011, president Barroso affirmed: "Contrary to the opinion of some, Article 122 is not modified." Speeech/11/15.

[22] See Constitutional Court, Case Nos 2 BvR 2134, 12 October 1993, in Andrew Oppenheimer (ed.), *The Relationship between European Community Law and National Law: The Cases*, Cambridge U. P., 1994, p.527-575, ad p. 568-569.

is presented, far from being in conflict with the clause, to be a last resort instrument for guaranteeing the stability which is the objective of Article 125 TFEU.

In the conclusions of its meeting of 28-29 October 2010, the European Council referring to the limited treaty change mentioned that this revision would not modify article 125 TFEU ("no bail-out clause"). As was the case for interventions through the EFSM, under Article 122, paragraph 2, and through the EFSF, the setting up of the intergovernmental ESM appears as a counterweight in time of crisis to the rigour of the spirit behind the no bail-out clause. It is also applicable in exceptional circumstances for safeguarding the stability of the euro-area as a whole.

The concept of last resort was interpreted by the heads of State or Government of the euro- area in their statement of 25 March 2010. It was hold as meaning "in particular that the financing by the market was *insufficient*." When at last, the intervention in favour of Greece was decided, the market was not only insufficient but also practically inexistent for Greek bonds. In its contribution to the Task Force chaired by Herman Van Rompuy, the ECB expressed the opinion that "The mechanism should only be activated in very exceptional cases, *when market access for the country concerned is no longer possible*" [23] The ECB interestingly added, "Mechanisms could also be established for the Eurogroup to be able to elicit the activation of the support mechanism by a country which – due to a loss of market confidence – could otherwise endanger the financial stability of the Union as a whole." Unfortunately, there is no more explanation on this in the ECB document.

d. The strict conditionality (and the question of the interest rate)

There is also nothing new in the requirement of "strict conditionality", which was already included in the assistance to Greece. This implies, as recorded in the "General features" already mentioned, "stringent programmes of economic and fiscal policy adjustments to be implemented by the affected Member State and ensuring debt sustainability". The same idea is present in the Term Sheet. It is justified by the necessity to avoid moral hazard.

In the same spirit, Germany asked, in the elaboration of the rescue packages during the spring 2010, for non-concessional rates (5.8 % for Ireland in November 2010) for loans to member states in difficulty. This was also supposed to strengthen the compatibility with Article 125 TFEU on the prohibition of bail-out. In its contribution to the Task Force, the ECB advocated a more radical feature for the loans: the support should be "at penalty terms, preferably under pledge of collateral and preferred creditor status". This is not included in the new paragraph of Article 136. A high interest rate introduces an element that would make more difficult the restoration of a balanced budget and an ever-decreasing level of debt.[24] We will see that the heads of State or

[23] Italics are ours. See "ECB. Reinforcing Economic Governance in the Euro Area", 10 June 2010, p. 11.
[24] The Irish authorities ask the renegotiation of the interest rate on the EU part of the loan for obtaining a better deal. The IMF rate is not negotiable. It is low and the same for all IMF members. See Donald Donovan, "EU-IMF open to proposals they consider realistic",

Government of the euro-area recognised this at their meeting of 11 March but without drawing all the consequences from this observation.

The IMF was associated to the rescue packages as they were organised in 2010. The European Council does not refer to the IMF in its conclusions of 16-17 December although in the conclusions of its meeting of 28-29 October, the role of the IMF was mentioned as an essential feature of the future new mechanism, with the role of the private sector and the "very strong conditionality". The IMF will remain a decisive part of the picture.[25] In the Eurogroup Statement of 28 November, "Eurogroup ministers agree that this ESM will be based on the EFSF [26] capable of providing financial assistance packages to euro-area member states under strict conditionality functioning under the rules of the current EFSF." They specify: "Assistance provided to a euro-area Member State will be based on a stringent programme of economic and fiscal adjustment and on a rigorous debt sustainability analysis conducted by the European Commission and the IMF, in liaison with the ECB." Analogous formulas are to be found in the Term Sheet. Each Statement refers to the IMF involvement in the definition of the adjustment programme and in the monitoring of its implementation, as we will see in further developments. The adjustment programme will be detailed in a MoU, as specified by the Term Sheet in conformity with the practice so far.

For the ECB, "Non-compliance with conditionality should be met with sanctions" going as far as the possibility of the "establishment of an enforcement Officer appointed by the Eurogroup with loss of fiscal sovereignty."[27] This seems uselessly aggressive. Anyway, the submission to an adjustment programme includes per se a limitation of sovereignty.

e. The flexibility of the permanent ESM

The mechanism will stand by "for any financial assistance". These words open the possibility of a variety of interventions, as it is the case under Article 122, paragraph 2. It could, as the EFSF, borrow on the markets for lending to Member States in difficulty, under the guarantee of euro-area member states, but the new provision of the Treaty will not necessarily limit the instruments of the mechanism to this kind of intervention.

f. The silences of the new Treaty provision

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http://www.irishtimes.com/newspaper/opinion/2011/0210/12. The author thinks nevertheless "although much rhetoric is being expended on this issue, the amounts potentially involved should be kept in perspective." Anyway, any concession to Ireland would call for a compensation.

25 The intervention of the IMF was a subject of controversy in the first discussions about a rescue mechanism; The ECB, the Commission and France were reluctant. They were of the opinion that it could appear as a weakness of the EU but Germany, and especially, Chancellor Merkel were strongly in favour. The *Kanzlerin* believed that it would strengthen the credibility of conditionality, contribute to gain the nihil obstat of the Constitutional Court and let the EU benefit of the experience of the IMF. Judgments on the influence of the intervention of the IMF on the acceptability by the public opinion of the State concerned were and still are divided. One should take into account that the IMF being a global institution cannot treat some of its members in a different way than the others.

26 This formula is rather curious as point 1 of the conclusions of the European Council of 16-17 December 2010 provides that the ESM "will replace the EFSF and the EFSM." Further developments have indeed clarified the question.

27 Quoted document, June 2010, p. 13.

It is remarkable that the new paragraph 3 of Article 136 makes no allusion to what is called in a diplomatic way "private sector participation". We have seen that this element is mentioned as one of the three most important features of the permanent mechanism in the conclusions of the European Council of October 2010. This was a point on which Germany insisted in order to protect taxpayers' money and it was part of the Deauville agreement with France. The "General Features" as the Eurogroup elaborated them – and which were confirmed later on - devote important paragraphs to the hypothesis of default and "debt restructuring". The international treaty establishing the ESM will integrate these elements that are included with important nuances in the Term Sheet. This means that if restructuring will have no base in EU primary law, it will be provided by an international treaty, as advised by the authors of the Bruegel (a Brussels think tank) study on the matter.[28] We will come back on this in Section II.

Section II. Key features of the ESM

As mentioned by the Term Sheet of 21 March 2011, the ESM will be established, by a treaty concluded among the euro-area member states, as an international organisation under public international law and will be located in Luxembourg, as is the EFSF. It has been alleged [29] that this threaty would substantially change the conditions for joining EMU because the future adherent to it would have to subscribe to obligations included in a new treaty of which it was not a party. This is true but this treaty constitutes the implementation of the amendment of the TFEU, to be approved by all 27 EU member states and is legitimated by it, either we like it or not.
The statutes will be set out in an annex of the treaty.

The Term Sheet qualifies itself as a document setting out "the key structural features of the ESM", as we have noted. Some additions would be welcome. A complete analysis will only be possible on the basis of the definitive text of the treaty. On the other hand, we are used in EU negotiations to last minutes changes to a seemingly agreed text. It is with these reservations in mind that the following elements should be read.
We have decided to only comment on the most important points included in the Term Sheet.

A. The governance of the ESM

There are important indications on the governance. The basic structure is copied exactly on the one of the IMF: Board of Governors, Board of directors and managing Director but the big difference is the role of the "mutual agreement" for the main operations.

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[28] "A European mechanism for sovereign debt crisis resolution: a proposal" by François Gianviti, Anne O. Krueger, Jean Pisani-Ferry, André Sapir and Jürgen von Hagen, *Bruegel Blueprint N° 10*, Brussels, 2010.

[29] See Paul N. Goldschmidt, "Le Sommet européen: le Conseil européen a dégoupillé la grenade qui pourrait faire éclater l'Union monétaire et…l'Union tout court", http://www.paulngoldschmidt.eu/Economic%20Web/Sommet%Europeee%20mars%202011.htm.

In the *Board of Governors*, the ministers of Finance of the euro-area member states will seat with the European Commissioner for economic and monetary affairs and the president of the ECB as observers. The Board will elect a chairman among its voting members.

The Board of Governors "will take the following major decisions by mutual agreement:
- the granting of financial assistance
- the terms and conditions of financial assistance
- the lending capacity of the ESM
- changes to the menu of instruments."

The Board will take other decisions by qualified majority (i.e. 80% of the votes; the voting weight being proportional to the subscriptions to the capital), unless stated otherwise.

The Board of Governors will decide on any dispute arising between a euro-area member state and the ESM in connection with the interpretation and application of the treaty establishing the EMS. If the member state contests this decision, the case could be submitted to the Court in accordance with Article 273 TFEU.

The *Board of Directors* will carry out specific tasks as delegated by the Board of Governors. Each euro-area member state will appoint one director and one alternate. The Commission and the ECB will each nominate an observer and an alternate. The Board will take all decisions by qualified majority, unles otherwise stated.

The *managing director*, appointed by the Board of Governors, will be responsible for the day-to-day management and chair the Board of Directors.

B. The capital structure

The objective of the ESM will be "to obtain and maintain the highest credit rating from the major credit rating agencies". It is a preoccupation that was not fully taken into account when the first decisions about the EFSF were adopted.

The total subscribed capital will be €700 billion with an aimed effective lending capacity of €500 billions, in comparison with respectively €440 billions and €250 billion for the EFSF.[30] Of the amount of €700 billion, €80 billion will be in the form of paid-up capital provided by the euro-area member states, in five annual payments of €16 billion [31]. The Term Sheet indicates: "In addition, the

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[30] The European Council decided at its meeting of 24 March 2011 that the "temporary facility" will get a lending capacity of € 440 billion that would be in place in June.

[31] This funding structure was adopted at the request of Germany on the margin of the meeting of the European Council of 24 March after a last minute experts' meeting. The agreement reached on 21 March provided for a first upfront payment of €40 billion and the remaining €40 billion would be split into three further annual payments. This would have supposed a payment of €11billion for Germany in 2013, a federal elections year. This provoked reactions of the Bundestag and the formula agreed three days before was changed at the insistent request of Bundeskanzlerin Angela Merkel. See "Accord sur le filet de sauvetage permanent", http://www.euractiv.com 25 March 2011. See also "Der Mythos der

ESM will also dispose of a combination of committed callable capital and of guarantees from euro-area member states to a total amount of €620 billion."

The contribution key will be based, as for the EFSF, on the paid-in capital key of the ECB.[32] By the ratification of the treaty, member states will be committed to provide their contribution to the total subscribed capital.

It will be for the Board of Governors to decide by mutual agreement on the adaptation of the subscribed capital or when calling capital except in specific cases duly mentioned: it will be for the Board of directors to decide by simple majority, when calling in capital is needed in order to absorb losses or to respond to an on-demand guarantee procedure. One should hope that the markets would judge this kind of guarantee sufficient.

C. The instruments of the ESM

"The ESM will provide assistance subject to strict conditionality under a macro-economic adjustment programme, commensurate with the severity of the imbalances of the member state." In these words, the Term Sheet sums up important elements of the philosophy of the intervention of the ESM.

We have seen that the amendment to the TFEU does not list the forms that the financing can take. The Commission gave in a document for the Eurogroup Working Group a list of other possible actions.[33] It mentioned the purchase of sovereign bonds on the secondary market (so-called buy-backs to alleviate the task of the ECB), the purchase of sovereign bonds on the primary market (an operation not allowed to the ECB due to the prohibition of monetary financing), sovereign bonds exchanges (buying bonds on the secondary markets and swap it against new bonds issued by the beneficiary State) and the provision of credit lines.[34] The Commission was of the opinion to submit the four first operations to a specific macro-economic adjustment programme and the credit lines to the full (and durable) respect of the Stability and Growth Pact. The ECB supported the idea of the purchase of government securities on the market by the crisis management institution.[35] The Bundesbank was hostile to this idea. So was the German Government but it could seem a position of

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kostenlosen Euro-Rettung ist zu Ende", welt.de 25 March 2011. The *Financial Times*, 26 March 2011, notes at this subject under the title "EU agrees 'grand bargain' package": "But leaders, recognising the smaller cash infusions might leave the fund short of firepower if a large economy such as Italy needed rescuing, could not agree how to speed up payments to meet a shortfall in an emergency."

32 Member states with a GDP per capita of less than 75% of the EU average will benefit from a temporary correction for a period of 12 years after their entry in the euro area. This responds to a request made by Slovakia and backed by Slovenia and Esthonia. See CE WEEKLY, Centre for Eastern Studies, Warsaw, issue 8(105), 3 March 2011.

33 See "EU eyes greater powers for rescue fund", *Financial Times*, 14 January 2011.

34 Most of these formula's are considered by Axel Weber, the outgoing president of the Deutsche Bundesbank, as leading to "*untransparenten zwischenstaatlichen Transfers*" or sacrifying the "*strenge Konditionalität der Hilfen*". He seems to forget that the State that would be the "beneficiary" of these interventions would have been submitted for the main loan to a strict conditionality. The political groups of the German governing coalition were open to the views of Prof. Weber on this point, see "Koalition gegen Anleihekaüfe des Rettungsfonds ESM", FAZ, 23 Febr. 2011. A resolution was to be put to vote on 17 March at the Bundestag. Since its written contribution to the Task Force (op. cit.), the ECB has supported the idea that financial assistance could come not only in the form of loans but also "and/or purchases of government debt securities issued by a Member State in distress". For the ECB, these purchases would take place in the open market.

35 See ECB document, quoted, p. 12.

negotiation. The ECB was concerned by the increase of the amount of bonds it bought on the secondary market since June 2010, a practice, at the fringe of the legal powers of the ECB, which raised a lot of criticism in Germany and also within the ranks of the Governing Council and that is not without risk for the balance sheet of the Eurosystem, especially in case of a possible restructuring including an hair-cut.

The euro-area heads of State and Government took position at their meeting of 11 March on the instruments available to the ESF and EFSF and this position was confirmed at the meeting of the Finance Ministers of 21 March. For the Term Sheet, assistance "will be provided through loans". This intervention will be called "ESM stability support (ESS)". The ESM may also "intervene, as an exception, in debt primary markets on the basis of a macro-economic adjustment programme with strict conditionality and if agreed by the Board of Governors by mutual agreement." This intervention will be known as a "Primary market support facility".

In line with the flexibility of article 136 §3 TFEU, "the Board of Governors may review the instruments at the ESM's disposal and may decide to make changes to the menu of instruments".

D. The activation of financial assistance and related questions

The Term Sheet recalls the fundamental principle, already applied to the intervention of the temporary mechanisms: "the financial assistance will in all cases be activated on a request from a member state to the other members states of the euro-area". In case of such a request, the Board of Governors will ask the Commission "to assess, in liaison with the ECB, the existence of a risk for the euro-area as whole and to undertake a rigorous analysis of the sustainability of the public debt of the member state concerned, together with the IMF and in liaison with the ECB."

Following stages are to be respected:

1. The assessment of the actual financial needs and the nature of the required private sector involvement, by the Commission, together with the IMF and in liaison with the ECB
2. The mandate by the Board of Governors to the Commission, together with the IMF and in liaison with the ECB for negotiating a macro-economic adjustment programme with the member state concerned, detailed in a MoU
3. The proposal by the Commission to the Council of a decision endorsing the macro-economic adjustment. For its part, the Board of Governors will decide on the granting of the assistance and its terms and conditions [36]. The Commission will sign the MoU after the adoption of the programme by the Council and subject to prior mutual agreement by the Board of

[36] The preceding general features provided that it was the task of the Eurogroup ministers to decide on the assistance. The Term Sheet draws the consequences of the establishment of the ESM as an international organisation based on international law.

Governors. The Board of directors will then adopt technical aspects of the assistance.

4. The monitoring compliance with the policy conditionality by the Commission, together with the IMF and in liaison with the ECB, and the reporting to the Council and the Board of directors. The Board of directors will decide by mutual agreement on the disbursement of the new tranches of the loan.
5. The possible decision by the Council, after discussion in the Board of Governors, on a proposal by the Commission, "to implement post-programme surveillance, which can be maintained for as long as a specified amount of financial assistance has not been repaid."

One can observe a great involvement of the Commission at the different stages of the intervention of the ESM. The European Parliament particularly wished the involvement of the Commission. The intervention of this institution will need the approval of the EU member states as observed in the Term Sheet. The text also expresses the preoccupation to maintain the consistency of the decisions autonomously decided by the Board of governors with the EU surveillance framework and the guarantee of the respect of EU procedures, which implies a role for the Council.[37] The document acts the intention of the Commission "to propose a regulation clarifying the necessary procedural steps under article 136 of the Treaty in order to enshrine the policy conditionality in Council decisions and ensure consistency with the multilateral surveillance framework." The European Parliament received with satisfaction these "positive" signals and it acknowledged also the commitment of both the Council and the Commission to inform it on a regular basis.

E. Pricing

At their meeting of 11 March 2011, the heads of state and government of the euro-area had decided that: "Pricing of the EFSF should be lowered to better take into account debt sustainability of the recipient countries, while remaining above the funding costs of the facility, with an adequate mark up for risk, and in line with the IMF pricing principles. The same principle will apply to the ESM."[38]

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[37] It has been objected that this implication of the institutions would risk blocking the mechanism in a context where rapid decisions are needed. See Paul N. Goldschmidt, op. cit., note (27). This remark seems to neglect that in any case both at the Council (where all the EU members are represented) and at the Board of governors of the ESM, only the euro area member states will have the right to vote, as provided by article 136 TFEU. We take this opportunity to mention that non-euro-area members participating in an operation would be represented at the relevant meetings of the ESM boards that will decide on the granting and the monitoring of the assistance.

[38] At the same meeting, the heads of state and government decided on the principle of "soft restructuring" measures for the loans made by the member states to Greece under the May 2010 programme. The interest rate on the loans to Greece will be adjusted by 100 basis points (i.e. from a medium of 5.2 to 4.2%; it seems that Greece had asked for a reduction of 200 basis points). The maturity for all the programme loans to Greece will be increased to 7.5 years (from the original 4.5 years), "in line with the IMF". These concessions took into account the realisations and the commitments of Greece. Ireland got nothing similar because it took no commitment on corporate tax base harmonisation.

The Term Sheet takes over these principles and states the pricing structure applicable to ESM loans. It also provides that "the pricing policy of the ESM will be reviewed periodically".[39]

F. Private sector involvement

As we have already mentioned, the main element of the general features is the so-called participation of the private sector or private sector involvement. The Eurogroup statement of 28 November 2010 already provided that, "Rules will be adapted to provide for a case by case participation of private sector creditors, fully consistent with IMF policies". This involvement will depend "on the outcome of the debt sustainability analysis, in line with IMF practice."[40] This "case by case approach" was asked by France and accepted by Germany at the Deauville summit. Germany was initially in favour of systematically restructuring.

The Term Sheet makes a distinction between two situations, on the basis of the debt sustainability analysis.

a) "If, on the basis of a sustainability analysis, it is concluded that a macro-economic adjustment programme can realistically restore the public debt to a sustainable path, the beneficiary Member State will take initiatives aimed at encouraging the main private investors to maintain their exposures (e.g. a "Vienna Initiative" approach [41]). The Commission, the IMF, the ECB and the EBA will be closely involved in monitoring the implementation of such initiatives."

b) "If, on the basis of a sustainability analysis, it is concluded that a macro-economic programme cannot realistically restore the public debt to a sustainable path, the beneficiary Member State will be required to engage in active negotiations in good faith with its creditors to secure their direct involvement in restoring debt sustainability. The granting of the financial assistance will be contingent on the Member State having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decision on disbursements".

Terms are very different in the "Term Sheet" as compared with the previous "General Features" of 28 November. The controversial concept of "insolvency" has disappeared. The obligations of the state are made clearer: they will have "to engage in active negotiations in good faith" and they need to have a

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39 Paul De Grauwe ("Welke steun van het Europese steunfonds?", *De Morgen*, 26 March 2011) criticizes the extra interest rate provided fort he loans of the ESM. They are indeed not in line with the necessity to take into account "debt sustainability".

40 The Term Sheet defines (note 6, p. 29 of the Conclusions of the European Council of 24-25 March 2011) the meaning of this reference:"In line with the IMF, debt is considered sustainable when a borrower is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure. This judgment determines the availability and the appropriate scale of financing."

41 On the so-called "Vienna initiative", see Camilla Andersen, "Agreement with Banks Limits Crisis in Emerging Europe", IMF Survey Magazine, October 28, 2009.

credible plan and demonstrate sufficient commitment to ensure participation of the private creditors which is to be adequate and proportionate. Four principles are to be respected in the negotiation: proportionality, transparency, fairness and cross-border coordination. We will particularly underline, under the key word: "fairness", the obligation to consult creditors "on the design of any rescheduling or restructuring of public debt with a view to reaching negotiated solutions". Haircuts are to be considered only if other solutions do not permit to reach the "expected results". Cross-border coordination is needed in order to avoid the risk of contagion and potential spill over effects on other member states and third countries. The text recalls the need of preserving the stability of the euro-area as a whole.

Although the reference to the IMF practice, which was present in the earlier "General Features", has disappeared, it is interesting to allude to this practice. Indeed, if we look at the way "lending [by the IMF to a member] into arrears [towards private creditors]" occurs as described in the Fund's documents, one observes that if this member has to make "good faith efforts" (a reference which is present in the new formulation) to conclude an agreement with the private creditors in order to be entitled to receive a loan from the IMF, it doesn't seem to be required that negotiations would have successfully been concluded. What is important for the Fund since 1999 is to retain "its capacity to lend into arrears if this were judged to be essential for the success of the member's adjustment program."[42]

Indeed, under the practice of the Fund, "two conditions are imposed to the availability of financial support to a country that has defaulted on some or all of its obligations to private creditors:

- provision of Fund support must be considered essential to the success of the defaulting country's adjustment programme; and
- the defaulting country must be pursuing appropriate policies and making a 'good faith effort' to reach a collaborative agreement with its creditors."[43]

The formula in the Term Sheet differs with the stringent formulation found in the Bruegel document that proposes "A European Mechanism for Sovereign Debt Crisis Resolution": "Should a euro-area country be found insolvent, the provision of financial aid should be conditional on the achievement of an agreement between the creditors reestablishing solvency".[44]

The Collective Action Clauses

As the previous "General Features", the "Term Sheet" provides the necessity to insert in the new bonds starting from July 2013 Collective Action Clauses

[42] See IMF, Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion, July 30, 2002, points 14-15. Rosa M. Lastra, *Legal Foundations of International Monetary Stability*, OUP, 2006, p. 489-491.

[43] Paul Bedford and Gregor Irwin, "Reforming the IMF's lending - into – arrears framework", *Financial Stability Paper* No 4, Bank of England, p.4.

[44] François Gianviti, Anne O. Krueger, Jean Pisani-Ferry, André Sapir, Jürgen von Hagen, Brussels, Bruegel, 9 November 2010, p. 2.

(CACs) but the Term Sheet includes some more developments on this question.

The text agreed by the Eurogroup only mentioned "In order to facilitate this process, standardized and identical collective action clauses (CACs) will be included, in such a way as to preserve market liquidity, in terms and conditions of all new euro area government bonds starting from June 2013."[45] The Eurogroup text added: "Those CACs would be consistent with those common under UK and US law after the G10 report on CACs, including aggregation clauses allowing all debt securities issued by a Member State to be considered together in the negotiations. This would enable the creditors to pass a qualified majority decision agreeing a legally binding change of the terms of payment (standstill, extension of the maturity, interest-rate cut and/or haircut) in the event that the debtor is unable to pay."

The Term Sheet underlines that "the objective of such CACs will be to facilitate agreement between the sovereign and its private-sector creditors in the context of private sector involvement." It includes the same references to "identical and standardised clauses" and to "New York and English law" (in lieu of "UK and US law"). It adds details on the "*aggregation clause*" to be included in the CACs. This clause would enable "a super majority of bondholders across multiple bond issues subject to such a clause and subject to the law of a single jurisdiction to include a majority clause where the needed majority of creditors for restructuring would not be attained within a single bond issue." It also mentions the necessity of appropriate representation and of larger majorities for so-called "reserve matters (e.g. key payment terms, conversion or exchange of bonds)" as well as appropriate quorum requirements. It states the important principle that "changes agreed by the relevant majorities are binding on all bondholders." It also stresses that "an appropriate disenfranchisement clause" will apply [46] and that "appropriate clauses to prevent disruptive legal action will be considered."

Despite these additions to the previous text, an important work is still to be done on CACs. The Term Sheet provides that "detailed legal arrangements" will be decided on the basis of work to be undertaken by the EFC Subcommittee on EU Sovereign Debt Markets, following appropriate consultation with market participants and other shareholders, and be finalised by the end of 2011."
The context of restructuring and CACs evokes important documents and relevant practice at global level.

There are two G10 reports, relevant for our subject: the classical report, called the Rey report (from its chair, Jean-Jacques Rey of the National Bank of Belgium), [47] and especially its annex IV [48], and another Report of the G10

[45] In the absence of such CAC, one could have imagined what two authors have called a "Mopping-Up law" of the Debtor State which could "operate in the manner of a contractual collective action clause in a syndicated debt instrument". See Lee C. Buchheit and G. Mitu Gulati, "How to Restructure Greek Debt", 7 May 2010, http://ssrn.com/abstract=1603304. This solution could be applied in the absence of CACs but offers less legal certainty for the debtor.

[46] This clause has the purpose of introducing legal certainty in determining which bondholders have the right to vote and those who lost it.

[47] See Lastra, op.cit., p. 481, "The Resolution of Sovereign Liquidity Crises" http://www.bis.org/publ/gten03.htm

Working Group on Contractual Clauses of 26 September 2002.[49] The first report includes a comparative law analysis of the question of representation of bondholders; the second provides in the Annex "Model New York Law Collective Action Clauses" for illustrative purposes, "for use to sovereign bonds governed by the laws of a U.S. jurisdiction and [which] can be used as the basis for development of clauses in specific issuances in the U.S. and in other jurisdictions in accordance of the laws of those jurisdictions." Their authors have intended to take into account market practice ("particularly with respect to sovereign bonds issued under English law"). They favour the election, by a majority of 66, 2/3% of the outstanding principal amount, of a special bondholder representative, empowered to engage in restructuring discussions with the debtor without delay.[50] The Bruegel report evokes in a scheme closer to the IMF's SDRM proposal of 2001-2003, a representative creditors committee, perhaps a more sensible idea than one person for this task.[51]

It is interesting to refer to the three key objectives that the 2002 G10 Working Group inscribed at the beginning of its report:
"(i) to foster early dialogue, coordination, and communication among creditors and a sovereign caught up in a sovereign debt problem;
(ii) to ensure that there are effective means for creditors and debtors to re-contract, without a minority of debt-holders obstructing the process; and
(iii) to ensure that disruptive legal action by individual creditors does not hamper a workout that is underway, while protecting the interests of the creditor group."

The "Term Sheet", as the previous "General features", deals with a useful ingredient that will be inserted in CACs of future bonds' contracts concluded by Euro area Member States: the "aggregation clauses". The inclusion of all creditors ("aggregation") in the settlement that would avoid needing an agreement for any individual bond issue is rightly presented by the Bruegel report as the main advantage of their proposal in comparison with CACs. Nevertheless, the insertion of an aggregation mechanism appears also to be possible in the collective clauses. Prof. Lastra refers, basing herself on a article by two eminent practitioners, Lee Buchholt and Jeremiah Pam, [52] to the experience of Uruguay's debt re-profiling 2003. To make a long story short, this mechanism allows for "a proposed amendment to the payment terms of two or more series of bonds [to be] incorporated through aggregated voting to other series of bonds simultaneously by the approval of a double majority (of eighty per cent of the aggregate principal amount of all affected series and by 66, 2/3% of each specific series)". [53] Lastra notes that "the aggregation voting mechanism *à la Uruguayenne* facilitates a more comprehensive approach to sovereign debt workouts than a single series CAC" and so "bridges the gap between the SDRM proposals (dealing with the whole existing stock of debt,

48 Annex IV.Report on Existing Forms of Collective Representation Applicable to Debt Instruments, p. 64-65
49 http://www.bis.org/publ/gten08.htm
50 Op. cit., p. 3. The representative, similar to a trustee, is the speaker for the bondholders. The fiscal agent, as he is known in civil law countries is more an intermediary for the lender.
51 Bruegel report, p. 12.
52 See Lastra, op. cit., p. 482-483 and Lee Buchholt and Jeremiah Pam, "Uruguay's Innovations", (2004) 19 Journal of International Banking Law and Regulation 28.
53 Lastra, op.cit., p. 483; Buchholt and Pam, op. cit., p. 30.

thus including different classes of creditors) and the single series of CAC."[54] But, of course, it needs a cooperative approach on the part of the creditors.

Preferred Creditor Status of the ESM

The Term Sheet, in more sober words than the earlier "General features", provides for a "preferred creditor status of the ESM." While the "General Features" stated "In all cases, in order to protect taxpayers' money, and to send a clear signal to private creditors that their claims are subordinated to those of the official sector, an ESM loan will enjoy preferred creditor status, junior only to the IMF loan," the Term Sheet only mentions that "heads of State or Government have stated that the ESM will enjoy preferred creditor status in a similar fashion to the IMF, while accepting preferred status of IMF over ESM." The text adds: "This shall b effective as of 1 July 2013 without prejudice to the terms and conditions of any other agreement provided under the RFSF and the Greek facility."

The subordination of private claims to official ones is not provided for the outstanding loans. The new rule constitutes a warning for private creditors and give more weight to the insustainability risk of the debt of their sovereign debtor, something they were, only some years ago, not used to envisage. It will surely make more problematic the financing of states with difficulties. The same reflection could be made about the insertion of CACs. The Term Sheet tries to reassure the private creditors in this respect: "The inclusion of CACs in a bond will not imply a higher probability of default or of debt restructuring relating to that bond."
It has been rightly observed that the allocation of a preferred creditor status to the ESM needs at least a further reflection in the negotiation of the treaty.[55]

Section III. Some comments on restructuring

The German chancellor and the Minister of Finance underlined in various occasions the importance of debt restructuring as a way to reestablish market discipline. It was in particular the case in the famous Sorbonne speech of Mr. Schäuble, on 2 November 2010. He said among other arguments:
"*A central element of the mechanism must be the involvement of the private sector. Holders of sovereign bonds receive a risk prime but they must also have to effectively support this risk in case of crisis. Through this the taxpayer would be dispensed to contribute. Private investors and markets should no longer count on a bail out by the European taxpayer, because this strengthens the tendency of engaging in irresponsible debts and investments*."

Mr. Schäuble continued in a more radical language:

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54 Lastra, ibid.
55 See the critics and questions of Paul N. Goldschmidt, op.cit., note (27) who evokes a number of questions like the rank of the preferred status in relation with the privilege of the EIB, the creditor status of the EU member states which contribute in parallel to an intervention of the ESM, the policy of eligibility of bonds as collaterals by the ECB, etc. Let us mention that the Term Sheet provides that the euro-area member states will support equivalent status of the ESM and that of other member states lending bilaterally alongside the ESM.

"*To those who (still) would have a problem with this kind of crisis settlement, I would like to recall that the monetary union was not conceived as a model for the enrichment of financial speculators.*" [56]

Existing bonds are not concerned, as we have repeatedly observed. It is the message that Germany and its partners have made known since October 2010: restructuring is for the future, and now the precise date is known: for the bonds issued from July 2013. However, this communication – made for reassuring the markets - was received with incredulity. Holders of bonds of peripheral states (Greece, Ireland, Portugal, in particular) expressed fears for a possible restructuring of bonds they detained and proceeded to sell them. The euro went down. Ministers of Finance present with the heads of government at the 11-12 November 2010 G20 Seoul meeting had to publish a denial but it didn't help. This bad communication is said to have been if not the cause at least a motive of acceleration of the Irish disaster which required an urgent intervention from the Union.

There are many voices calling, in an insistent manner, for restructuring the Greek debt without too much delay.[57] Typical of this attitude is a recent paper of Bruegel, titled "A Comprehensive Approach to the Euro-Area Debt Crisis".[58] They plead for "revising EU assistance facilities and restructuring debt where needed". They conclude from a sustainability assessment that "Greece has become insolvent" and that "a wait-and-see approach is a dubious strategy". They suggest, "either a restructuring of official loans, or a significantly higher eventual haircut on private claims." "Soft options" like a lowering of the interest rate, an extension of maturity of all official loans (something which was decided afterwards), or the purchase by the EFSF of government bonds held by the ECB, would "not be enough to return Greece to solvency". [59]

And they add interestingly "the current stance of 'no default now, but possible default on bonds issued from 2013' is inconsistent and not credible." This has been for a long time the standpoint of other economists who consider that restructuring the debts is a requirement of justice, equity and also of economic efficiency.[60]

A manifesto adopted by 189 members of the VWL (association of German professors in economy) on the Debt crisis [61] advocate from the German Government to take preventive measures for the case of failure of the European rescue packages and immediately to elaborate, in collaboration with

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56 http://www.bundesfinanzministerium.de/nn_88146/DE/Presse/Reden-und-Interviews/20101102-Sorbonne.html. The translation from German is mine.

57 See the views of Thomas Mayer and Daniel Gros "Zweifel am neuen Euro-Rettungsschirm", *Financial Times Deutschland*, 28 March 2011, p. 15.

58 Authored by Zsolt Darvas, Jean Pisani-Ferry and André Sapir, bruegelpolicybrief, issue 2011/02, February 2011.

59 We have mention that measures of this kind ("soft options") have been adopted by the heads of state of government of the euro area on 11 March 2011 but for the loans made by the Member States to Greece under the May 2010 programme.

60 As, among others, Daniel Gros, "Il est urgent de restructurer les dettes en Europe", *Le Monde*, 23 Nov. 2010. or Nouriel Roubini, "Une restructuration de la dette est inévitable", *La Tribune*, 4 April, 2011.

61 http://www.faz.net/s/Rub3ADB8A210E754E748F42960CC7349BDF/Doc~EE66342E82CC048C7B6E77231B642759C~ATpl~Ecommon~Scontent~Afor~Eprint.html 24 Febr. 2011. There were 6 votes against and 10 abstentions. See also Monika Merz and Bernd Lucke, "Ohne Insolvenzregeln geht es nicht", *Financial Times Deutschland*, 7 March 2011.

the European partners, a detailed insolvency plan for euro area over indebted Member States. For these economists, permanent rescue mechanisms that exclude State insolvency and debt restructuring, would lead to an unjust transfer from the taxpayers of the solvent countries to the creditors of the Debtor States.

Against this attitude, one should recall the official position as stated in the "General Features" endorsed by the European Council at its meeting of 16-17 December 2010: "We restate that any private sector involvement based on these terms and conditions would not be effective before mid-2013". Similar sentence is not to be found in the Term Sheet but the date is repeatedly mentioned (for the inclusion of CAC's in new securities and for the preferred creditor status of the ESM).

Debt restructuring is not universally promoted, also for the period starting in July 2013. A number of economists have expressed serious doubts about the idea of a sovereign debt default mechanism.[62] The first criticism came on from the IMF staff in a paper which title included the dramatic words: "Unnecessary, Undesirable and Unlikely".[63] Their thesis was that, contrary to the situation of emerging countries in the past, the developed states don't have a problem of service of the debt - for the euro area member states, contracted mostly in euro, their currency – but structural problems of public (or private) finance that lead to imbalances: deficits and debt. A default could not really help in such a situation. Lorenzo Bini-Smaghi, an ECB Executive Board member, denounced, in various speeches and articles [64] the idea of preconceived restructuring. He opposed, in particular the views of Finance Minister Schäuble we have quoted earlier. For him, Schäuble's ideas were a recipe for disaster. Let us quote Bini-Smaghi: "There is no such thing as an orderly debt restructuring mechanism." A restructuring mechanism, "if made too simple, could lead to moral hazard. Furthermore, the very nature of the markets would mean contagion spreading immediately to the other countries, as participants would start guessing which other country might need to undergo restructuring." On 1 November, he came back on this theme arguing, "There should be no automatic mechanism linking financial support to debt restructuring, because it would attract speculative pressure and precipitate a crisis, even for countries that are solvent."[65] Bini-Smaghi affirms his reluctance to give to the markets the responsibility to evaluate the solvability of the

[62] Paul De Grauwe, "Duits 'moralisme' bedreigt muntunie. De autodestruction of the eurozone", *De Morgen*, 25 Nov. 2010; Daniel Cohen, "Crise de la dette: l'Europe n'est pas l'Amérique latine", *Le Monde*, 25 novembre 2010. We borrow some passages of this section to a speech we have made at Humboldt University in Berlin, on 15 December 2010 on the subject: "Managing Public Finance Crisis. Lessons and Perspectives for the EU and the Euro Area".

[63] Cotarelli, Forni, Gottschalk and Mauro, "Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely", IMF Staff Position Note 10/12, 1 September 2010. The Press observed an ongoing reluctance of the IMF staff to restructuring the debt of a euro-area country.

[64] Zeit Online, 10 November 2010; Intervention before the ECON Committee on "Improving the economic governance and stability framework of the Union, in particular in the euro area", 15 September 2010, p.4; "The Challenges Facing the Euro Area", speech, Abu Dhabi, 1 November 2010. Lorenzo Bini-Smaghi clearly expressed the standpoint of the ECB Governing Council. See J.C. Trichet, speech at ECON, 27 September 2010, p.2. See also the detailed answer given by the president of the ECB and reproduced in the transcript of the questions asked and the answers given by Jean-Claude Trichet, president of the ECB, and Vitor Costâncio, vice-president of the ECB, 4 November 2010, http://www.ecb.int/pressconf/2010/htlm/is101104.en.htm

[65] On this point, one will observe that the orientation taken by the Eurogroup on 28 November and endorsed by the European Council on 16/17 December doesn't provide for such automatism.

States concerned, the same markets that one wants to avoid speculating.[66] In a way, the ECB also reminded the States to their responsibility for their central banks.

Paul De Grauwe takes similar arguments to fight what he called no less than "A mechanism of self-destruction of the eurozone".[67] He compares the situation that would be created by the perspective of restructuring to the one observed in the functioning of the ERM 1, before the euro, when speculators were selling currencies hoping for the devaluation of the weak currency in the system.

It is far from sure that restructuring will lessen the burden of indebted states. This clearly appears from the fact that the threat of restructuring is seen as a means for increasing the discipline of the "sinners".

In front of the extraordinary task required from countries like Greece in order to come back to "healthy and stable financial conditions" (article 119 TFEU), there is the jump in the unknown that obviously frightens. Nobody can predict what would be the consequences of a declaration of "debt insustainability" of a member state of the euro area.

Conclusion

One has argued that if the Stability and Growth Pact, the Excessive deficit procedure (EDP) and the new Excessive imbalances procedure (EIP) and all the other obligations deriving from the preventive and corrective procedures were observed by the member states, there would be no need for a ESM.[68] To those asking the same question, Herman Van Rompuy answered in advance "even if all the right budgetary and economic measures are taken by everybody, one may never exclude surprises. Politics is not a zero-risk business."[69] In a more colored way, Paul De Grauwe referred to the image of a fire-code without a fire brigade: "This is like saying that if people follow the fire code regulations scrupulously there is no need for a fire brigade."[70] A group of authors observed: "Even the most sophisticated and most effectively enforced set of fiscal rules will not eliminate the possibility of future debt crises in the euro area."[71]

We may regret that the EFSF is made permanent under intergovernmental clothes. The Eurogroup paper of 28 November 2010 provided for an evaluation

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66 Zeit Online, 10 November 2010. In the plan now discussed, it would be for the IMF and the Commission to judge on the insolvability.
67 CEPS Commentary, 9 November 2010.
68 Jürgen Stark, "Wirtschaftspolitische Herausforderungen im Eurogebiet", speech, München, 27 October 2010, p.7.
69 Press remarks, 29 October 2010, PCE 249/10.
70 Paul De Grauwe, "Fighting the wrong enemy", VOX, 19 May 2010 www.voxeu.org/index.php?=node/5062
71 Authors quoted in note (28).

of the framework in 2016 by the Commission, in liaison with the ECB. This sentence has disappeared from the Term Sheet. We hope that this element was just forgotten and that it will reappear in the treaty. Some have regretted that the ESM would not be created as an independent organisation.[72] This was probably politically unthinkable. We have observed that the structure of the ESM is identical in its basic elements to the one of the IMF. We think that it is more than symbolic. It is an embryo of regional sui generis EMF that will be born.

It would have been preferable in our view to establish the ESM in the form of a union organ, included in the EU legal order and accountable. Such a development is not excluded. This would need a revision of the Treaty through the ordinary procedure. It would have been the same for a true "Debt Agency" benefiting of the joint and several liability of the member states, which is a perspective that for clear motives, Germany and other AAA countries refuse.[73] Various plans [74] for the issuance of Eurobonds on the model of US T-bills in order to secure more liquidity to the euro area have been proposed. They usually include provisions in order to avoid the so-called moral hazard that would result from the possibility to escape to the common disciplines. Unfortunately, its has not been possible to demonstrate up to now that such bonds would not raise the cost of Germany and other AAA countries financing, which seems the main reason for the negative attitude of Germany, the Netherlands, Finland...

It is to be hoped that the reform of the economic governance, the adoption of the Euro plus Pact and the finalisation of the agreement on the ESM will not lead our authorities to forget the need to continue the reform of banking regulation and supervision. The Larosière reform is an important step but we still need a mechanism for crisis resolution and a truly *European* system of financial supervision.

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[72] See Thomas Mayer in diepresse.com 24 March 2011.

[73] See Paul N. Goldschmidt, "Propositions concernant l'établissement d'un Mécanisme Européen permanent de Gestion de Crise et l'Émission d'Eurobonds", 6 January 2011, www.paulngoldschmidt.eu.

[74] Jakob von Weizsacker and Jacques Depla, "The Blue Bond Proposal", Bruegel Policy Brief, May 2010 http://www.bruegel.org/pdf-download/?pdf=uploads/tx_btbbreugel/1005-PB-Blue_Bonds.pdf. See also the recent proposal Tremonti/Juncker that could not be debated by the heads of government of the Eurogroup. See the presentation and the comparison of a number of proposals in Sylvester C.W. Eijffinger, Eurobonds – Concepts and Implications, Briefing Note, European Parliament, IP/A/ECON/NT/2011-1, PE 457.357, March 2011.

Permanent crisis management mechanism

Proposals concerning the establishment of a permanent European crisis management mechanism and the issuance of 'Euro Bonds'
Two distinct but complementary issues

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A. Introduction

The financial crisis, leading to a "Sovereign Debt" crisis affecting members of the European Monetary Union, has given birth to a plethora of proposals emanating from political, economic and financial circles. While they are all well meaning, most suffer from a lack of detail rendering their evaluation difficult, or, alternatively, demonstrate a lack of understanding of market mechanisms which make them largely inapplicable.
The purpose of the analysis hereunder is to bring some clarity to the debate. It suggests some exploratory avenues which attempt to reconcile considerations of a "political" nature which should not be overlooked with the objective constraints imposed by the workings of financial markets.

Let us analyse first the question of establishing a **permanent mechanism** aimed at providing assistance to EMU members facing financial difficulties.

The need for such a mechanism surfaced when it became clear, in the light of the Irish crisis, that the measures decided in the spring of 2010 – in particular the creation of the European Financial Stability Fund ("EFSF") – were proving insufficient to alleviate the fears of investors. Followed the initiation of a vicious circle in which questions relating to the solvency of some peripheral EMU members and/or their respective banking sectors raised the spectre of the implosion of EMU which, for the first time, became a realistic concern. This development raised, in turn, the question of the survival of the single currency and implicitly that of the ultimate survival of the EU itself.

However, there can be no doubt that the economic and financial foundations of the Euro as a "currency", as well as those concerning EMU area as a whole, are strong particularly when compared to those of the United States, the United Kingdom or Japan, three major economies which remain in full control of their "monetary" sovereignty. Even if in terms of budgetary deficits or public indebtedness the EMU "aggregates" should not worry excessively financial markets, too little attention has been given to the fact that by pooling their monetary sovereignty, EMU countries have created a situation in which the economic as well as legal position of their respective "national debt" in relation to their "national sovereignty" has been profoundly altered. Markets have been prompt to distinguish between countries who retain control over their respective monetary policies and their own national currencies and EMU members which, having abandoned their monetary sovereignty, have also lost the political and financial control over the "foreign" currency (the Euro) that they have decided to use in common.

B. A permanent European Crisis Management Mechanism

A first question concerns the need for such a mechanism. It is clearly the fundamental role played by the local "currency" in any market economy that commands that this essential "transmission mechanism" be soundly and prudently managed in the interests of each and every of its users; as far as the Euro is concerned, it is a matter of the "pari passu" interests of the 330 million citizens of EMU's 17 member States.

While the ECB has successfully preserved the "value" of the Euro in terms of "purchasing power" by controlling "price stability" within the Eurozone in conformity with its mandate, it is, however, totally outside of its remit and ability to influence a series of other parameters (such as levels of indebtedness, budget deficits or competitivity) whose disequilibria, either internal or cross border, can weigh heavily on the solvency individual EMU member States.

It follows that, in the absence of a credible mechanism, capable of restoring confidence in the public debt securities of EMU participants (so as to make them comparable to the trust benefitting other public issuers), financial markets will be prone to penalise the weaker issuers compromising their ability to access markets and thus their solvency.

Default by an EMU Government does not necessarily lead to the implosion of EMU and the disappearance of the Euro but such a development can only be avoided to the extent that the prevention of "contagion" remains **firmly under control**. However, sharing the same currency and belonging to the EU "single market" has created an extremely dense interdependent network linking EMU members to their respective banking sectors (that are closely tied through their reciprocal financing needs) as well as within the entire EMU banking sector itself, as was demonstrated in the Irish crisis. A "sovereign" default increases dramatically the "**systemic**" risk of contagion which should render the mere consideration of such a scenario totally unacceptable for all EMU members. Furthermore a "programmed" exit from EMU - be it by its strongest or weaker members - would create systemic risks of a similar nature which forbid its implementation.

Proof of the absolute need for setting up a permanent intervention mechanism is therefore unquestionable. Let us now turn to examine the characteristics that need to be embedded in such a system.

There are three separate aspects that must be distinguished concerning the **credibility** of the mechanism:

- **The financial credibility of the "Borrower", responsible for the primary funding, which ensures the interface with investors (the market).** Its solvency must be beyond question which implies that it is totally independent from the final Beneficiary which – by definition – is in a precarious situation. In addition, its securities must *necessarily* benefit from the highest rating, so that, in the eyes of the market, the Borrower's securities will integrate the highest standards of acceptability, benefit from a liquid secondary market and be acceptable as collateral by the ECB.

- **The credibility of the structure framing the on-lending by the Borrower to the final Beneficiary**. This concerns the "conditionality" appended to the loans and the accompanying surveillance mechanism as well as the specific financial conditions pertaining to each drawdown. Its main purpose is to reassure the (direct/indirect) guarantors of the loans who would be called upon in the event of default of the Beneficiary.

- **The credibility of the arrangements by which the Borrower can fund itself in the event of default of the financial Beneficiary.** This entails a "political" negotiation which establishes in which form the solidarity between EMU members is organised in the event one of them defaults.

Let us outline how it is possible to conceive of a system which would articulate in a coherent manner the requirements described here above.

1. As far as the financial credibility of the Borrower is concerned, the most elegant and ideal solution is to transform the existent EFSF into a fully fledged EU debt "Agency" benefitting of its unconditional "Budgetary Guarantee".

Such a structure would meet all the requirements outlined here above from the standpoint of market acceptability of the Borrower's securities as it provides - "by construction" - the **joint and several guarantee** of all EU member States. This solution offers the advantages of simplicity and transparency and, in addition, avoids any need for a Treaty change. It implies however amending the "financial perspectives" which will have to provide for an adequate and revisable debt ceiling.

The proposal does, however, create an important "political" problem insofar as it transgresses two taboos that have been partially responsible for the unsatisfactory structures currently in place. The first of these taboos concerns the transformation of the *several* guarantees provided to the ESFS by EMU members into *joint and several* guarantees, move that has been always strongly resisted by Germany. The second would be to enlist the guarantee of all EU Members for a mechanism which, at least initially, is meant for the benefit of EMU members only and which should, on that count alone, provoke considerable opposition, in particular from the United Kingdom.

Without underestimating these difficulties, it should be possible to significantly reduce their impact through the appropriate structuring of the two complementary aspects, referred to above, which ensure the credibility of the mechanism as a whole.

2. As far as the credibility of the structure of the "on-lending" by the Borrower to the Beneficiary, the "conditionality", based on the usual

criteria imposed by both the EU and the IMF, should be complemented, on each drawdown, by the issuance by the Beneficiary for the benefit of the Borrower of "serial covered bonds" corresponding to the debt service of the loan.

The basic idea is that the additional security provided by the "covered bond" structure, derived from the pledging of specific resources of the Borrower to ensure the punctual servicing of the debt, would constitute an important assurance for the guarantors and reduce commensurately their risk of being called under the guarantee. In exchange, the financial conditions of each drawdown would be identical to those obtained in the market by the Borrower (with the possibility of adding a de minimus 0.05% servicing fee) reducing considerably the financing costs of the Beneficiary compared with the current conditions of EFSF funded loans.

3. As far as the mechanism through which the Borrower funds itself in the event of a default by the Beneficiary, it is suggested that the ECB be authorised to "purchase" at face value the covered bonds held by the Borrower on the eve of their respective maturities. This would allow the Borrower to meet, whatever the circumstances, its obligations towards its own bondholders.

Within such a mechanism, the guarantee of EMU members would be for the exclusive benefit of the ECB, separately from their implicit *joint* guarantee given to the EU budget. It would be perfectly possible to maintain at this level a structure of "*several*" guarantees limiting, for each EMU member, his commitment to his quota (without the need for a 20% enhancement) as this would in no way affect the perception by investors (or rating agencies) of the soundness of the securities issued by the Borrower.

If this structure was implemented, it could be complemented by an agreement covering the interventions of the ECB in public debt markets of its shareholders which has been recently at the centre of intense discussions: for instance, the ECB could refrain from any intervention in the market of its member's debt securities in the event that the member had recourse to the Stabilisation mechanism. Indeed, because the ECB would be contractually committed to acquire the "covered bonds" pledged to the Borrower, it would be prudent to limit the Central Bank's balance sheet exposure to these issuers.

A further requirement (to be compulsorily included in the loan conditionality) would be that, in exchange for the ECB's contractual obligation to acquire the covered bonds, the National Central Bank of the Beneficiary (a member of the European System of Central Banks) would be charged with the supervision of the security attached to the issuance of the covered bonds, providing additional assurance to the ECB of the punctual servicing of the related debt.

C. The issuance of "Euro Bonds"

The scheme described here above meets largely the criteria deemed necessary to ensure the long term credibility of the mechanism in the eyes of the market; it would also contribute to the creation of a more stable environment for EMU and the Euro.

Viewed in this light, it is possible to envisage broadening the scope of the mechanism in order to provide answers to two additional important objectives: the first aims at providing a suitable justification for the participation in the scheme of non EMU members; the second aims at creating a broad market for EU securities (Euro Bonds), providing all EU Members with access to a competitive financial instrument comparable to the US Treasury Securities market.

1. Justification for the participation of non EMU members

In exchange for their joint budget guarantee, stemming directly from the Treaty itself, one could envisage that all EU Member States would be given access to funding of their respective national debt through the European Agency for Debt Issuance on an equal footing with EMU members. If a country availed itself of this privilege, it would assume its corresponding share of the guarantee mechanism benefitting the ECB; its National Central Bank would be responsible for the supervision of the collateral securing the "covered bonds" pledged to the Borrower within the framework of the loan conditionality.

2. Establishment of a broad market for EU public debt securities

Several of the recent proposals addressing the question of establishing a permanent European Crisis Management Mechanism call for the simultaneous creation of a deep and liquid market for securities representative of the EU's largely underused borrowing capacity.

These securities, referred to in general and somewhat ambiguous terms as "Euro Bonds or Eurobonds" have been the subject of various schemes, some of which went into considerable detail. However, because of extensive doubts concerning their practical feasibility, they have not been able to galvanise sufficient "political" support in order to justify a detailed preliminary assessment, a necessary precondition to implementation, as was the case with the Single Currency.

Starting from the outline described here above within the framework of assisting EMU countries facing difficulties, one could conceive of extending the mandate of the Agency (the Borrower) to allow for the funding of Member States within the "*ordinary*" task of managing their national public debt. While the "*stabilisation*" mandate of the Agency would be exercised as outlined in section **B**, it mandate as an "*ordinary*" Borrower would be subject to significantly greater flexibility as described hereunder.

Let us revisit the three aspects that ensure the credibility of the mechanism in the light of this new objective.

1. There are no changes required concerning the structure of the Borrower which must retain the benefit – for all its operations –of an EU Budget Guarantee.

This is necessary in order to ensure that its securities are fungible, provide investors with adequate liquidity and benefit from the broadest market acceptance.

2. Regarding the structure of the on-lending from the Borrower to the Beneficiary, conditionality would be a function of respecting a series or criteria derived from the Commission proposals updating the Stability and Growth Pact (SGP) and implementing the "European Semester".

It could relate to a series of objective "indicators" concerning the budget deficit, the level of indebtedness, other economic imbalances (competitivity) whose appropriate articulation would provide "mechanically" an "EU Rating" graduated from 1 to 3. This rating would apply to the Beneficiary's **entire extant debt** and would be updated on a regular basis, at least annually, during the European Semester exercise.

A "**1**" **Rating** would require meeting more stringent conditions than the pure and simple compliance with the SGP and would allow the Beneficiary to dispense with any specific loan conditionality. It would nevertheless be subject to the obligation of pledging debt securities whose value at maturity corresponds to its debt servicing obligations. This pledge would become subject to "enhancement" in the form of providing "cover" in case of a downgrade of the rating. In such a case, the Beneficiary would have the option to prepay his loan (subject only to a penalty covering possible reinvestment losses by the Borrower).

A "**2**" **Rating** would be assigned to a Beneficiary meeting all the conditions of the revised SGP. The only conditionality attached to the loan would be the pledge of serial covered bonds to the Borrower in order to guarantee the punctual servicing of the debt.

A "**3**" **Rating** would apply to the outstanding debt of a Beneficiary that would be the subject of recommendations, procedures or sanctions envisaged within the framework of the European Semester. The entire procedure described here above for execution of the Agency's "*stabilisation*" mandate would apply, including conditionality required by the EU and IMF.

Such a Rating system, if applied objectively (the applied methodology should be made public) and without any political interference, could serve as a way to reduce significantly the market impact of rating changes by private Agencies.

Recourse to the Agency's "*ordinary*" funding program by a Member State would remain purely voluntary. It should be expected that countries who retain direct access to markets at more favourable conditions would abstain, as is the case currently for Germany France and several other issuers when compared with conditions obtained by the European Financial Stabilisation Mechanism or those anticipated by the EFSF. One can however expect, with the progressive development of a deep and broad market for "Euro Bonds", that issuing conditions obtainable through the Agency will prove advantageous for an ever growing number of Member States.

3. As regards the mechanism ensuring the financing of the Borrower's debt servicing obligations, the specific roles assigned to the ECB and the participating National Central Banks would be applicable.

This covers in particular the "*several*" guarantee benefiting the ECB issued by EMU members securing the Beneficiary's debt service obligations, which would automatically be extended to any EU Member State participating in the scheme.

D. Conclusion

If implemented, the necessary conditions leading to the creation of a deep and liquid market for EU debt securities would have been assembled, capable of mobilising, within a secure and transparent framework, the Union's still largely underutilised borrowing capacity.

The mechanism encompasses a fair "political compromise" which should prove acceptable to all Member States. They will, indeed, both collectively and individually, benefit from the Union's more stable financial footing. The Euro's credibility will also be considerably enhanced by dissociating the questions relating to the solvency of individual Member States from those concerning the survival of the single currency.

It will also enhance significantly the EU's bargaining power at international level and strengthen its independence vis à vis other major actors (China in particular) who, in the current environment, could exert undue influence if their creditor status was brought to bear to the detriment of individual Member States.

Armed with such a mechanism, the Union could also aspire to exercise greater influence within the G20 and weigh more effectively on the reform of the international monetary system and the governance of globalised financial markets.

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Comments on the paper of P. Goldschmidt

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There is no euro currency crisis

There is much talk about the euro crisis. The fact is that there is no currency crisis. The euro is in a good shape as far as both the internal and the external value of the currency is concerned.

The ECB has had a good track record in terms of *price stability and financial crisis management* so far. However, there are increasing risks for price stability stemming from the steep global rise of food and commodity prices. Therefore, the ECB must remain vigilant and ready to raise key rates if necessary in order to avoid rising inflationary expectations and second round effects in wage agreements.

The *exchange rate* of the euro has been fluctuating between 1.20 USD/EUR and 1.40 USD/EUR in recent years with the exception of the peak of 1.60 USD/EUR in summer 2008. Measured by PPP-standards, the euro is even overvalued against the dollar. A temporary fall of the euro exchange rate to the lower end of the fluctuation band cannot be interpreted as a signal of a currency crisis.

De facto, the so-called euro crisis is a crisis in government debt in several euro area countries (14 out of 17 countries are subject of an excessive deficit procedure) and in the banking system of a few member states.

A permanent rescue mechanism is not necessary

Basically, a single currency of a monetary union does need solidity, not solidarity. In EMU this is reflected in the principle of (national) fiscal discipline and the non-bail-out clause. In case of emergency, i.e. in the point of culmination of the public debt crisis in the euro area in May 2010, a temporary action of solidarity became necessary and was justified.

I disagree, however, with the statement that it is necessary to establish a *permanent mechanism* aimed at providing assistance to EMU members facing financial difficulties. The rescue operations in 2010 and the creation of a permanent rescue facility are quite different stories.

As a result of the rescue actions in 2010 two major pillars of monetary union have been severely damaged, namely fiscal discipline and the non-bail-out-clause. The key problem of the euro zone is not a lack of public debt or a lack of new joint government loan facilities such as the proposed issuance of common government bonds. The very fact that neither the giant rescue packages of May 2010 nor the announcement of the planned creation of permanent rescue facility in December 2010 have restore market confidence is a clear signal that rescue packages alone do not work. The key problem is a severe lack of fiscal discipline as well as weak competitiveness in several EMU member countries.

Monetary union could be compared with a multi-family house. If one or even more supporting pillars of the house are dismantled, the structural analysis will lose stability and the house will become untenable in the end. If the supporting pillars of the euro are not repaired the euro might suffer the same fate as the abovementioned house.

In this context I do not share the view that a permanent rescue facility is necessary as ‘a "sovereign" default increases dramatically the "systemic" risk of contagion’. Financial market participants understand very well whether a problem country can rely on the support of other euro area member states or not. If the EMU governments’ message is that solidarity is limited then investor will be more cautious and demand higher risk premiums and yields thus providing an incentive for a solid fiscal policy. However, if the message is conveyed that there will be a bail-out in any case in order to protect banks in other EMU countries holding substantial volumes of government bonds of problem countries, then markets are, of course, tempted or even invited to play the "contagion game" and the test the other EMU countries’ "ability to support". Again, in case of an emergency an ad hoc tailor-made rescue package might be needed in order to prevent a systemic risk. But there should be no permanent rescue mechanism giving the certainty of support, as there are moral hazard problems on the part of the beneficiary countries as well as on the part of investors in government bonds.

For a *country* a permanent rescue facility is very likely to trigger the syndrome of "après moi le déluge". This is even true, if support for a problem country is associated with a strict austerity programme under the aegis of the IMF. Which government in the euro area would implement an unpopular tight fiscal policy risking losing power, if the alternative approach is to maintain power as long as possible by pursuing a lax fiscal policy? In case of severe fiscal problems it would be the task of the next government to put through the necessary consolidation package. Against this background, it seems to be an illusion to believe in permanent rescue facility as ‘a credible mechanism, capable of restoring confidence in the public debt securities of EMU participants’.

There is also a moral-hazard problem on the part of *investors.* If investors can expect that a euro area country is bailed-out in any event, they will have a clear incentive to incur higher risks. The message of the European Council in October 2010 to demand a risk participation of investors in future will create a dilemma. Either investors will continue to invest in government bonds of weak EMU countries provided they get a substantially higher yield or they will refrain from investing in such bonds. In the latter case a part of the budget financing in problem countries is transferred to the taxpayers in strong EMU countries, be it in form of guarantees for bond issues, a deterioration of the rating of the strong EMU countries (and higher bond yields there), bilateral loans or direct transfers. The important aim of restoring investors' confidence also requires providing clarity about future risk participation of investors.

At present the guarantee schemes for Greece and Ireland do not absorb taxpayers' money from other euro area countries. Given the abovementioned moral hazard problems a permanent rescue facility is, however, very likely to increase the risk that a transfer of tax payers' money from the strong euro area countries to the weaker member states will become a regular feature in the future. In this case the euro area could move in the direction of a transfer union and finally in the direction of a political union with a European government, a larger EU budget and a fully-fledged European Parliament. This would go far beyond the current EU being a construction "sui generis", which all member states of the euro area have preferred so far.

Financial markets focus on economic facts not on gimmicks

Financial markets expect an improvement of the economic and fiscal fundamentals but definitely not stopgap measures aiming at increasing or redistributing the reliability for public debt in the euro area. There are numerous proposals under debate inter alia increasing the volume of the existing rescue facilities, buying of government bonds by the European financial stabilisation facility in the market or from the ECB, providing guarantees in favour of existing bonds and new bonds of weak member states as well as issuing joint European government bonds which is broadly discussed in the abovementioned paper. However, all these proposals including the creation of a permanent rescue facility have two big disadvantages.

First, they do not cure the problem, but only try to treat the symptoms. The euro area definitely needs less public debt, not more debt or new debt schemes to increase or redistribute the liability for public debt among EMU member states. Therefore, these proposals are not apt to calm financial markets.

Second, all these proposals do not boost fiscal discipline which is, however, essential to restore the sustainability of public debt positions in the euro area.

Four lines of action to strengthen EMU

Against this background the following four lines of action seem to be advisable in order to "*strengthen the Monetary Union*".

First, a return to *solid fiscal policies* is the most important element. A second reform of the *stability and growth pact* (after 2005) seems to be necessary but the experience with pact so far is not encouraging that things will turn for the better in the future. The best rules are unhelpful if the political will is missing. Therefore, governments of euro area countries with excessive budget deficits should convey the message to the markets that they will pursue a convincing consolidation path over several years. This will imply weak growth in the adjustment phase. In this context, it is very helpful if Germany will continue to be the growth engine for the euro area for quite some time.

Structural reforms are the second important element given the lack of competitiveness and the massive current account deficits of four problem countries in the euro area. Reforms concern in particular the tax and social security systems as well as the labour market. They are essential in order to foster structural change and growth. A closely connected aim is to strengthen competitiveness in order to reduce the huge current account deficits of the four problem countries. A coordination of structural reforms by close cooperation under the umbrella of a fiercely debated "pact to increase competitiveness" might be helpful, but is not compulsory. Governments must define what they mean if they talk about more close cooperation in economic and fiscal policy and the creation of a "gouvernement économique". What counts from a market point of view is the political will of individual governments to carry out reforms.

Large current account deficits of individual EMU member countries do not cause monetary problems for the euro as the current account of entire euro area has been roughly in balance so far. However, current account deficits of individual member countries matter in real terms as they are associated with increasing external debt, which has to be serviced in the future. Therefore, structural reforms should also strengthen the debt servicing capacity of a deficit country both in terms of servicing public and private sector debt.

Third, an *orderly debt restructuring procedure* should be agreed on for emergency cases in order to firmly strengthen fiscal discipline on the national side. The threat of an orderly debt rescheduling is necessary, because it seems to be very likely that the stability and growth pact will continue to be a toothless tiger. An orderly debt restructuring procedure should be based on existing structures, i.e. the Paris Club (for public creditors) and the London Club (for private sector creditors). Furthermore, a new arrangement for the organization of private bond holder, which play a key role in public debt in the euro area, is recommendable (perhaps a "Berlin Club").

The close economic ties within the euro area and the possibly inherent systemic risks are often used as killer arguments against the option of a rescheduling the government debt of a euro area country. However, the possible systemic risk caused by those banks, which are heavily invested in bonds of euro area problem countries, should not be overestimated, as the "haircut" concerning the holding of government bonds of problem countries would probably be limited or is already "priced in" the secondary markets. It would, in any case, be better to rescue, once again after 2008, some systemically relevant banks by taxpayers' money than to bail out all member countries with unsound fiscal policies. The latter could easily prove to be a bottomless pit.

Fourth, the *ECB* should be able to focus on its prime goal of price stability. This also implies that the political authorities in Europe must do everything to promote the robustness of the European banking system in order to secure a smooth transmission mechanism from the ECB to the real sector in case of a restrictive monetary policy. One key measure will be the implementation of Basel III to strengthen the quality and quantity of banks' equity capital and therefore their capacity to shoulder risks. The test of a restrictive monetary policy is still to come.

In light of the public debt crisis in the euro area the ECB has put its exit strategy on ice since 2010. Moreover, the ECB started the purchase of government bonds of the four EMU problem countries in May 2010 in order to stabilise the markets. This has triggered inflationary fears, in particular in Germany. However, such concerns should not be overestimated. Direct open market operations belong to the ECB's tool box but are, of course, not the ECB's "core business". The purchase of government bonds should be abandoned as soon as possible in order to lull the impression that monetary policy is taken hostage by fiscal policy.

Five good arguments for fiscal discipline

Finally, it should not be overlooked that there are five good reasons in favour of fiscal discipline: (1) restoring market confidence in the sustainability of public finance in order to secure a smooth financing of government debt in the future, (2) creating scope for fiscal stimuli in a future recession, (3) meeting the rising demographic costs, (4) creating room for tax reductions, i.e. growth-friendly tax policies in the future and (5) supporting the monetary policy of the ECB.

Armed with fiscal solidity (and not with a permanent rescue mechanism) the euro area and the EU as a whole 'could also aspire to exercise greater influence within the G20 and weigh more effectively on the reform of the international monetary system and the governance of globalised financial markets'.

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What is ELEC?

Created in 1946, the European League for Economic Co-operation (ELEC) is a non-governmental and non-party organisation that aims to promote the economic integration and socio-cultural identity of Europe, and to enhance its role in the world.

ELEC consists of a network of national sections, whose members mainly come from the economic and financial world, but also include senior national and European officials as well as politicians and academics.

Its field of action materializes within international working commissions which meet regularly, and leads to various types of publications (working documents, resolutions, series "Cahier Comte Boël", etc.).

More information on **http://www.elec-lece.eu**

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