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LEGAL ASPECTS OF THE EUROPEAN SOVEREIGN DEBT CRISIS

CHRISTOPH HERRMANN*

I. *Introduction*

The European sovereign debt crisis, often referred to as the "Euro crisis" (despite not really being a currency crisis), constitutes one of the most dangerous economic threats of our times, not only to the EU itself, but to the global financial system and the world economy as a whole. This is particularly interesting as the overall debt burden of the euro area member countries is lower than the debt burden of the United States and much lower than that of Japan.[1] The reason for the crisis — in all likelihood — can partly be found in the particular legal framework of the euro area, which is made up of the provisions on Economic and Monetary Union (EMU) in the Treaty on European Union (TEU)[2] and the Treaty on the Functioning of the European Union (TFEU)[3] as well as the constitutions of the Member States of the EU and the euro area in particular. Law — its normative force as well as its failures — has played a key role in the development of the crisis and it plays a key role in all efforts to solve it: law matters! Most of the measures that were taken by the EU, the euro area or its Member States have given rise to cases before national constitutional courts or the Court of Justice of the European Union, with some of them still pending. In most cases, it is being argued that the measures were "illegal" under European Union law or national constitutional law (or both).[4]

The present contribution aims at giving an overview over the most pertinent legal questions that have been and that are being discussed in the euro area over the last three years. Given the complexity of the matter as well as the extensive discussions and intricate legal problems, we will only be able to touch upon a number (i.e. the so-called "no bailout clause" (Art. 125 (1) TFEU) and the prohibition on monetary financing (Art. 123 TFEU)) but not all of

* The author holds the Chair of Constitutional and Administrative Law, European Law, European and International Economic Law at the University of Passau, Germany. He was legal expert for the German Bundestag on the ESM-Treaty and the Fiscal Pact and has regularly advised financial market participants on the matters presented in this paper. He is author of numerous works on European Law, in particular in the field of Economic and Monetary Union.

[1] See Jeanne, *Fiscal Challenges to Monetary Dominance in the Euro Area: A Theoretical Perspective*, February 2012, p. 12, available at http: //www.econ2.jhu.edu/People/Jeanne/OJeanne_FSRpaper.pdf (last visited 2 November 2012); cf. also the sources quoted in fn. 5 below.

[2] OJ 2012 L 326/13 (consolidated version).

[3] OJ 2012 L 326/47 (consolidated version).

[4] For an overview of the different positions and argument see Adamski, *National Power Games and Structural Failures in the European Macroeconomic Governance*, CMLRev. 2012, pp. 1219-1364; Athanassiou, *Of Past Measures and Future Plans for Europe's Exit from the Sovereign Debt Crisis: What is Legally Possible (and What is Not)*, ELRev. 2011, pp. 558-575); Ruffert, *The European Debt Crisis and European Union Law*, CMLRev. 2011, pp. 1777-1806; Tomuschat, *The Euro — A Fortress Threatened from Within*, in: Ligustro/Sacerdoti (eds.), Problemi e Tendenze del Diritto Internationzale Dell'Economia, Liber amicorum in onore di Paolo Picone, 2011, pp. 275-297.

them.

II. *The European Sovereign Debt Crisis — An Overview*

The European sovereign debt crisis started with the announcement by the newly elected Greek Government in the autumn of 2009 that the budget deficit was rather around 12.5 percent of GDP than around 6.0 percent of GDP (as previously notified). The reasons for the deficit are manifold: Greece had manipulated its budgetary figures upon accession to the euro area in 2001 already, but the global financial and economic crisis after the burst of the US subprime mortgage bubble contributed significantly to the precarious budgetary positions. In all European countries tax income plunged dramatically after 2007. At the same time, governments had to spend more on social security benefits for unemployed as well as on bank bailouts, refinancing and stimulus packages for the "real" economy. As a result, the average overall debt burden in the euro area rose from 66% to 88% (2007-2011).[5] Additionally, the need for deleveraging and a reassessment of risks of investments by financial market participants (partially triggered by changes in the regulatory framework) brought the question of sustainability of public debt into the focus of financial markets, whereas previously Government bonds were largely considered as practically risk free (and were treated accordingly in regulatory frameworks). This external shock brought to light the underlying economic imbalances that had built up over the first decade of EMU, consisting of enormous balance-of-payments deficits in some peripheral countries, which were financed by financial markets until the crisis hit.

In spring 2010, it became obvious that Greece would sooner or later loose access to market financing as the interest rates for its bonds soared to unsustainable levels. Over March and April 2010, the euro area Member States repeatedly stated their willingness and preparedness to "*take determined and coordinated action to safeguard financial stability in the euro area as a whole*".[6] In May 2010, they had to act. First, a "rescue package" for Greece, consisting of 110 billion euro of bilateral loans by the euro area Member States (80 bn.) and the IMF (30 bn.) was set up. Over the same weekend, a larger "rescue umbrella" with a volume of 750 bn. Euro, available for all euro area Member States in need was enacted at European level, consisting of the European Financial Stabilization Mechanism (EFSM), the temporary European Financial Stability Facility (EFSF) and additional IMF commitments. Furthermore, the European Central Bank (ECB) made provision to buy Government bonds on the secondary markets in order to ensure the liquidity of these markets and the transmission of its monetary policy.

After a short period of time, it turned out that the crisis could not be solved by the measures taken until summer 2010. The correction of macro-economic imbalances takes time, but financial markets were not willing to provide further financing for this — unforeseeable

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[5] See ECB, *Analysing Government Debt Sustainability in the Euro Area*, Monthly Bulletin, April 2012, p. 55 (56). For more details see Lojsch/Rodriguez-Vives/Slavik, *The Size and Composition of Government Debt in the Euro Area*, ECB Occasional Paper Series No. 132, October 2011.

[6] See Statement by the Heads of State or Government of the European Union, Brussels, 11 February 2010; Statement by the Heads of State or Government of the Euro Area, Brussels, 25 March 2010.

period — at least not at sustainable interest rates; they are still hard to convince that the structural reforms that have been initiated will suffice and succeed.

The situation in which the euro area or at least some of its members found themselves resembles a "death spiral", consisting of burst financial or real estate bubbles, a recession, capital flight, rising refinancing costs, decreasing tax income and the need to refinance financial institutions in order to prevent a credit crunch that further propels the crisis. Countries having a currency of their own would usually devalue their currency, introduce capital controls and print money in order to prevent a sovereign default at least in their own currency. However, the euro area Member Countries have none of these options and operate in fact under similar conditions as a Country having a foreign currency as legal tender.[7] EU law, hence, makes a default of a Member State in its own legal tender not only legally possible, but even more likely. On the other hand, exiting the euro area in order to restore monetary sovereignty is not foreseen in the Treaties, would hence be legally extremely troublesome[8] and most likely meet severe resistance from economic actors fearing the ensuing devaluation (and inflation).

The solution chosen so far combines different elements of strategy: (1) prevent a disorderly sovereign default because of the likely contagious effects for the European financial system and the danger of domino effects hitting other endangered countries by providing funds to euro area members in distress (the "rescue packages"); (2) subjugate these members to economic austerity and structural reform programs by making the loans conditional; (3) reform the institutional framework of EMU to ensure fiscal soundness and economic convergence in the future (a "Fiscal Union" and "European economic governance"); (4) reconstruct European financial market regulation including prudential supervision and mutual deposit guarantee schemes (a "Banking Union").

From a purely legal point of view, this strategy meets certain difficulties under EU law: (1) under the principle of limited attribution of powers (Art. 5 (1) TEU), the EU as a whole may not be able to enact secondary legislation desperately needed to counter the crisis; (2) an amendment to the Treaties requires unanimity by the Member States and ratification or similar constitutional processes in all Member States which may be hindered by political opposition or constitutional requirements for referenda; (3) the legal bases in the Treaties explicitly designed for asymmetrical integration, i.e. integration measures that are not supported by all Member States (Art. 136 TFEU for EMU in particular; Art. 20 TEU, Art. 326-334 TFEU on enhanced cooperation in general) are insufficient to address the situation as measures taken thereunder must comply with the Treaties in general (or — in the case of Art. 136 (1) TFEU — with the specific procedures of Art. 121 and 126 TFEU) and are therefore not apt for meaningful overhauls of the insufficient elements of the legal framework of EMU. Because of these particular problems, the Member States repeatedly resorted to (semi-) extra EU measures: bilateral loans to Greece, a special purpose vehicle under Luxemburg law (EFSF), a gentlemen agreement without binding legal force (the "Euro-Plus-Pact") or agreements under public international law (the ESM Treaty and the Treaty on Stability, Coordination and Governance

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7 See Pisani-Ferry, *The Euro Crisis and the New Impossible Trinity*, Bruegel Policy Contribution 2012/1.

8 See Athanassiou, *Withdrawal and Expulsion from the EU and EMU — Some Reflections*, ECB Legal Working Paper Series No. 10 December 2009; Herrmann, *Griechische Tragödie — der währungsverfassungsrechtliche Rahmen für die Rettung, den Austritt oder den Ausschluss von überschuldeten Staaten aus der Eurozone*, EuZW 2010, p. 413 (416 et seq.).

(TSCG or "Fiscal Pact")[9]. However, even once a Treaty amendment, a separate Treaty under public international law (or a secondary measure) has been agreed upon, it may still be subject to constitutional challenge in the Member States, as e.g. in Estonia, Germany and Ireland in the case of the ESM Treaty.

Despite all the aforementioned problems (and enormous political opposition by citizens), the EU has managed to prevent a disorderly sovereign default so far (the debt restructuring for Greece in the spring of 2012 was on voluntary terms, even though there has been significant pressure by the euro area on private creditors to take a bit or get nothing at all). A breakdown of the financial system has also been avoided, as well as the exit of a Member State from the euro area, which would presumably be extremely costly in economic and political terms alike. What is even more important, though, is the significant progress which the EU and its Members have made with regard to restoring fiscal solidity and structural reforms.

Nevertheless, these successes are overshadowed by costs that have already materialized and risks that are born: (1) In almost all European countries that held general elections over the last three years, the respective government was voted out of office. The austerity programs imposed on countries in distress bring about tremendous social problems; at the same time, taxpayers in the solid countries fear that their taxes are being used to pamper the peripheral countries or that inflation will let their financial wealth melt away. (2) Within the payments system operated by the Eurosystem (TARGET2), huge balance positions have built up and are being criticized as being a central bank transfer and loan system for the countries in distress which is not democratically legitimized and might cause hundreds of billions of euros in losses (for Germany in particular) in case the euro area broke up. (3) Lastly, the creditor countries are exposed to the risk of a default of a debtor country under the several rescue mechanisms and the consequences for their own fiscal income and debt burden.[10]

III. *The General Legal Framework of Economic and Monetary Union*

According to Art. 3 (4) TEU, the European Union establishes an economic and monetary union whose currency is the euro. However, not all but only 17 EU Member States participate already in EMU. Whereas the United Kingdom and Denmark have an explicit exception from the principal obligation to participate, eight Member States have a "derogation" that means that they have not yet adopted the euro as their legal tender, but they may do so once they fulfill the necessary conditions and their derogation is being lifted by the Council of Ministers unanimously (ECOFIN) (Art. 139 et seq. TFEU).

A further economic goal of the EU stated in Art. 3 (3) (1) TEU is economic growth and price stability. The latter is repeatedly described as the primary goal of the monetary and exchange-rate policy of the EU, to be determined and implemented by the Eurosystem, consisting of the European Central Bank (ECB) and the national central banks of the euro area member states (Art. 119 (2), 127 (1), 282 (2) (2) TFEU), which must be independent from

[9] On the fiscal pact see Craig, *The Stability, Coordination and Governance Treaty, Principle, Politics and Pragmatism*, ELRev. 2012, pp. 231-248.

[10] On the TARGET-"problem" see Sinn, *Die Target-Falle*, 2012; for a more nuanced discussion of the problem see German Council of Economic Experts, Annual Report 2011-2, pp. 82-85.

other EU institutions as well as Member States' governments (Art. 130, 282 (3) (3) TFEU).

The economic policy of the EU generally rests on the ideal of an open market economy with free competition (Art. 119 (1), 120 TFEU), soundness of fiscal policy and budgetary autonomy of the individual Member States. To that end, the TFEU contains a number of specific intricate provisions: the prohibition of "excessive deficits" (Art. 126 TFEU), supplemented by the Stability and Growth Pact (SGP),[11] the prohibition on monetary financing (Art. 123 TFEU) and privileged access to financial institutions (Art. 124 TFEU) as well as the now notorious so-called "no bailout clause" (Art. 125 (1) TFEU). The precise meaning of these provisions, in particular of Art. 123 and Art. 125 TFEU, has become highly debated during the crisis, and we will turn back to that question shortly. What is often overlooked when dealing with the interpretation is that the notions used in these provisions are subject to clarifying definitions by secondary Union law on the basis of Art. 125 (2) TFEU. It is one of the interesting and unanswered political questions of the crisis and the way to deal with it why no effort has been made to make use of this option, at least so far.

However, the elaborate legal framework was not sufficient to prevent the current crisis. The prohibition on excessive deficits was not taken sufficiently serious and the SGP, which was breached on several occasions anyway, was watered down in 2005 after France and Germany had been (unsuccessfully) subjected to its disciplines by the EU Commission.[12] Furthermore, economic policies of the Member States were not effectively coordinated in the Council as foreseen in Art. 5 (1), 121 TFEU) and accompanying secondary legislation (the preventive arm of the SGP). Many of the imbalances that emerged during the crisis, in particular the loss in competitiveness and the ensuing current account deficits of some peripheral countries, but also the real estate bubble in Spain and the vulnerability of the Irish banking sector, were willingly neglected for a decade. When the crisis finally hit, the legal framework did not provide any useful answers to it: neither is a way foreseen to ensure the solvency of euro area Member States (contrary to EU Member States with a derogation which can receive so-called medium term assistance for balance-of-payments difficulties),[13] nor does the Treaties provide a procedure for a sovereign default or an exit from the euro area. The only legally available (though not entirely undisputed)[14] possibility existing at that time was the use of the regular IMF credit facilities.

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[11] The Stability and Growth Pact consists of a number of legal documents. For a detailed analysis of this dimension of the problem see Adamski, fn. 4, pp. 1336-1348.

[12] See ECJ, Case C-27/04, Commission./.Council, ECR [2004] I-6649.

[13] Cf. Art. 143 and 144 TFEU and Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, OJ 2002 L OJ L 53/83.

[14] The usual IMF operations consist of currency purchase-repurchase agreements with members facing balance-of-payments crises, i.e. an IMF Member receives international currencies against its own domestic currency for the time of the "lending". It has been questioned during the crisis, whether IMF lending can also take place in situations where an IMF member needs funds in its own currency; cf. Gaitanides, *Intervention des IWF in der Eurozone — mandatswidrig?*, NVwZ 2012, pp. 848-852. However, more convincing is the assumption that the IMF members may engage in a subsequent practice which is not clearly forbidden by the IMF Articles of Agreement and responds to the situation of IMF members participating in a currency union.

IV. *Measures Taken in Response to the Crisis*

1. Bilateral Loans to Greece

Given the absence of rules on what to do when a Member State faces a possible default, the euro area Member States in May 2010 decided to make a loan package of 110 bn. Euro available to Greece, 80 bn. of which were provided by the euro area Member States in shares derived from their respective capital subscription to the ECB and 30 bn. provided by the IMF. Both were made subject to strict conditionality and divided into several installments which were only to be paid out if the policy conditions were being complied with by Greece. The surveillance of the program (as the negotiation of the specific conditions) is executed by the so-called troika, consisting of officials of the EU Commission, the ECB, and the IMF. As the difficulties of Greece turned out to be more severe and the recession caused by the crisis and the austerity program worsened, the conditions for the loans were adapted (i.e. the interest was reduced and the maturity prolonged) in 2011. However, even these changes were ill-suited to restore the sustainability of the Greek debt position. Hence, another loan package (this time by the EFSF and the IMF, see below) was drawn up and a "voluntary" restructuring of the Greek debt towards private creditors was negotiated until early 2012.

2. The May 2010 "Rescue Umbrella"

During the European Council meeting of 8/9 May 2010, besides finalizing the Greek loan package, the EU and the euro area took additional measures to safeguard financial stability in the EU as a whole. Financial markets had become hyper-nervous over the development of the crisis and some markets for government bonds of peripheral countries dried up. In response to the fear that more euro area Member States might lose access to financial markets and therefore default, the so-called "rescue umbrella" was set up. It consists of three key instruments: the European Financial Stabilization Mechanism (EFSM), the European Financial Stability Facility (EFSF), and the continued involvement of the IMF. This package was designed to make an overall volume of 750 bn. euro available in case further euro area Member States would have refinancing difficulties on the markets. Additionally, the ECB announced the Securities Markets Program (SMP) to tackle the specific liquidity problems of parts of the financial markets in the EU.

a. The European Financial Stabilisation Mechanism (EFSM)

The EFSM is a mechanism set up by means of an EU regulation that was passed by the Council on proposal of the Commission on the basis of Art. 122 (2) TFEU. This proviso reads as follows:

> "*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.*"

On the basis of the regulation, the Commission is empowered to raise funds of up to 60 bn. euro on the financial markets and make them available as loan or credit line to the Member State which is experiencing or threatened with severe economic or financial disturbance caused by exceptional occurrences beyond its control (see Art. 1, 2 of Regulation No. 407/2010). The regulation provides also for the procedure to be followed in the application and disbursement of the financial assistance as well as for the Memorandum of Understanding laying down the economic policy conditions.

b. The European Financial Stability Facility (EFSF)

The more important part of the rescue umbrella constitutes the EFSF, a special purpose vehicle established by the euro area Member States under Luxemburg private law and tasked with providing loans to Member States in distress, which are financed through the issuance of marketable instruments on the financial markets, the latter being guaranteed by the euro area Member States on a pro rata basis (again in line with the respective capital share of the ECB and a super-guarantee).[15] In order to ensure an effective lending capacity of 440 bn. euro and a triple-A rating, the guarantees had to be raised once (to now almost 780 bn. euro) and other financial instruments than loans to Member States were added to the tool box of the EFSF. Whereas the Greek case was solved on the basis of bilateral loans only, the EFSF has now different instruments at hand, including precautionary credit lines, loans for the recapitalization of financial institutions and bond purchases on primary and secondary markets.

The legal framework for the EFSF is complicated. It consists of the Articles of Incorporation, and the more important Framework Agreement between the Member States as shareholders and guarantors of the EFSF. In addition, the different financial instruments other than loans are governed by guidelines issued by the board of directors of the EFSF. The board is generally the body taking decisions of the EFSF and all euro area members as shareholders are being represented therein. In the different Member States, the participation in the EFSF may be subject to specific constitutional or other legal constraints. In the case of Germany, an act of parliament was necessary to enable the Minister of Finance to take on the guarantees.[16] Following a decision by the German Constitutional Court,[17] the participation of the German Minister of Finance in the board of directors of the EFSF is subject to prior parliamentary approval, which is either given in plenary session or in the budget committee. Only in specific cases where confidentiality must be ensured, the decision may be taken by a special, very small sub-committee of the budget committee.[18]

The EFSF was constructed as a temporary institution, i.e. its statutory activity will end on 30 June 2013 (Art. 2 (11) Framework Agreement). However, it will not cease to exist immediately, as it will have to administer the repayment of the debt instruments by the EFSF as well as the financial assistance agreed upon prior to this date (but partially disbursed thereafter). All rights and obligations may, however, be transferred to the permanent European

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[15] See www.efsf.europa.eu for detailed information on the EFSF and its legal framework. See also Seyad, *A legal analysis of the European Financial Stability Mechanism*, Journal of International Banking Law and Regulation 2011, pp. 421-433.

[16] Gesetz zur Übernahme von Gewährleistungen im Rahmen eines europäischen Stabilisierungsmechanismus (Stabilisierungsmechanismusgesetz — StabMechG), BGBl. 2010 I p. 627, amended BGBl. 2012 I p. 1166.

[17] BVerfG, Judgment of 7 September 2011, 2 BvR 987/10 etc., BVerfGE 129, p. 124.

[18] BVerfG, Judgment of 28. February 2012, 2 BvE 8/11.

Stability Mechanism that was legally established on 8 October 2012 (ESM; see below) (Art. 13 (10) Framework Agreement).

c. Involvement of the IMF

The IMF has traditionally been the lender to countries facing balance-of-payments problems and has gained significant experience — positive and negative — in the management of such credit relations and in the imposition of structural reform programs ("IMF conditionality").[19] EU institutions, at least at the beginning of the crisis, lacked this professional experience. The involvement of the IMF was therefore helpful, despite the partial loss in control over the financial assistance programs to Washington bureaucrats and non-EU-IMF members. For this reason, it took some time before the euro area decided to seek substantial IMF participation, financial as well as political. The reason may also be found in the complicated legal relationship between the largest and most important currency union in the world and the key international organization in the field of monetary relations.[20] The IMF articles of agreements do — differing in particular from the World Trade Organization (WTO) — not provide for other members than States (see Art. 1 Sec. 2 IMF Articles of Agreement). As the EU (or euro area) is undoubtedly not a state (yet), it cannot become a formal member of the organization. Even though most of the competencies relevant to matters falling in the realm of the IMF have been transferred to the EU (with effect for the euro area), the representation of the euro area in the IMF bodies is still not solved satisfactorily.

3. The Permanent European Stability Mechanism (ESM)

Over the year 2010 and 2011 it became increasingly clear that the measures taken in May 2010 and the announced reform of the economic governance framework of the EU and the euro area would not succeed in reestablishing market confidence in the sustainability of government debt rapidly. Hence, a permanent crisis resolution mechanism for the euro area was negotiated. An agreement was (after a previous version of the ESM treaty was redrafted) finally concluded on 2 February 2012 and the ESM — after a partially troublesome ratification process, in particular in Germany — was legally established on 8 October 2012.[21]

In principle, the ESM follows the design of the EFSF (in particular with regard to its financial instruments and their financing by raising funds on the financial markets), but there are also important differences. Whereas the EFSF was set up as a legal person under Luxemburg private company law, the ESM is an international organization with legal personality under public international law. Furthermore, the EFSF bonds are being guaranteed by the euro area member governments, whereas the ESM is equipped with a capital of 700 bn. Euro, 80 bn. thereof paid-in capital, the rest being callable capital. The capital is divided among the euro area Member States following the capital subscription key of the ECB with the Federal Republic of Germany being the largest shareholder at 27,1464% (and having an ensuing veto

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[19] On IMF conditionality see Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 412 et seq.

[20] Cf. Herrmann, *Monetary Sovereignty over the Euro and External Relations of the Euro Area: Competences, Procedures and Practice*, EFARev 2002, pp. 1-24; Horng, *The ECB's Membership in the IMF: Legal Approaches to Constitutional Challenges*, ELJ 2005, pp. 802-822.

[21] General information about the ESM can be found at www.esm.europa.eu. For a detailed analysis see Ohler, *The European Stability Mechanism: the long road to financial stability in the euro area*, GYIL (2012), forthcoming.

power for all decisions requiring 80% of the votes cast).

Against the backdrop of the discussions about the legality of in particular the EFSF under Art. 125 (1) TFEU (see V.1. below), the Member States agreed to a limited amendment to Art. 136 TFEU, adding a new paragraph 3, designed to bring an end to these discussions and clarify that a permanent stability mechanism may legally be established, provided certain conditions are met. The proviso — agreed in the simplified amendment procedure of Art. 48 (7) TEU[22] — reads as follows:

> "*The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.*"[23]

At the time of writing of this contribution, the amendment had not entered into force yet, as three Member States had still to complete their ratification procedures (even though rather formal steps of it).[24] This triggered the question — in November 2012 decided by the ECJ[25] — whether the amendment was a necessary precondition for the ESM (which has already entered into force) to be in conformity with EU law (in particular Art. 125 (1) TFEU)[26] or whether it is a purely declaratory clarification (see V.1. below).

4. The ECB's Measures: SMP, Outright Monetary Transactions (OMT) and TARGET2

The only institution having unlimited financial resources at its disposal is the Eurosystem, consisting of the ECB and the national central banks of the Member States that have already adopted the euro as single currency. As early as in May 2010, the ECB decided to not only neglect the rating for Greek government bonds in relation to their taking as collateral in its lending operations[27], but it also enacted the Securities Markets Program (SMP),[28] a legal act under which the Eurosystem bought euro area government bonds from market participants, i.e. on the so-called secondary markets. The program started off only with Greek bonds being bought but the ECB later moved to also buying Irish, Portuguese, Spanish and Italian bonds

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22 Whether or not the use of this simplified procedure was permissible was the question in a case before the European Court of Justice, cf. Case C-370/12, Reference for a preliminary ruling from Supreme Court (Ireland) made on 3 August 2012 — Thomas Pringle v Government of Ireland, Ireland and the Attorney General.

23 See European Council Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, OJ 2011 L 91/1.

24 See European Parliament, Article 136 TFEU, ESM, Fiscal Stability Treaty — Ratification requirements and present situation in the Member States, October 2012 (Note).

25 See C-370/12, Judgment of 27 November 2012 (fn. 22 above).

26 Furthermore, it is sometimes argued that the Member States must not set up a stability mechanism because of the exclusive competence of the EU for monetary policy (Art. 3 (1) c) TFEU). This is obviously nonsense as a stability mechanism has no direct relation to the monetary policy provisions of the Treaty (namely Art. 127 through 133 TFEU), but only with the provisions on economic policy coordination (Art. 119 through 126 TFEU), which is not even a true competence of the Union (see Art. 5 (1) TFEU).

27 Decision of the ECB of 6 May 2010 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Greek Government (ECB/2010/3), OJ 2010 L 117/102.

28 Decision of the ECB of 14 May 2010 establishing a securities markets programme (ECB/2010/5), OJ 2010 L 124/8.

(there are not details given on the precise respective amounts) and spent around 210 bn. euro until early 2012, when the program was suspended. The ECB always communicated that the primary reason for the program was to ensure the smooth transition of monetary policy impulses and that it was needed to counter the imperfect working of specific parts of financial markets in the euro area. The effect is of course also that interest rates for the Member States whose bonds are being bought are lowered, even though the lower interest rates on secondary markets may not translate necessarily into lower interest rates on the primary markets where Governments issue bonds.

The ECB also repeatedly announced that it "sterilizes" the effects which the bond purchases have on the monetary basis by lending central bank money from commercial banks. It could theoretically expand the sterilization, e.g. by increasing the minimum reserve requirements.

In September 2012, ECB president *Mario Draghi* announced that the ECB would — under a new program labeled "Outright Monetary Transactions" (OMT) — stand prepared to buy — without any limit — bonds of Governments which have arranged for a loan program of either the EFSF or the ESM, in order to ensure the functioning of monetary policy throughout the euro area. At the time of writing, no legal act for the OMT was officially published yet, but the main features of the program had been explained by the ECB in other publications.[29] Under the new program, bond purchases will only take place if a Government has secured a memorandum of understanding with the EFSF or ESM, only if necessary for monetary policy reasons, only on secondary markets and always with full sterilization of the central bank money used. Furthermore, the SMP will be repealed by the OMT.

Lastly, the ECB is operating the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2), an electronic payment system. This is fully in line with the task of the ECB to promote the smooth operation of payment systems in the European Union (cf. Art. 127 (3) fourth indent TFEU). However, the balance positions of the participating national central banks resemble very much traditional balances of payments and reflect financial flows within the currency area. Until the beginning of the financial crisis in 2007, hardly any imbalances appeared in the system, since the current account deficits (and surpluses) of the different euro area Member States were balanced by cross-border private sector lending. This balancing dried out during the financial crisis and the imbalances were aggravated by capital flight from the peripheral countries.[30] The causes and meaning of the TARGET2-situation are intensely debated among economists, in particular with a view to the risks associated with them (which, however, would only become relevant in the case of a break-up of the euro area). Yet, there is hardly a legal argument being made, at least under EU law, that the ECB was transgressing any legal boundaries erected under the treaties by permitting these imbalances to develop.

V. *Legality of the Different Measures under European Union Law*

With regard to practically all measures that have been taken in order to cope with the

[29] ECB, Monthly Bulletin 2012/9, p. 7.

[30] See German Council of Economic Experts (fn. 9), p. 84.

crisis, concerns are being voiced that they infringe European Union law, national constitutional law or both. Consequentially, a number of cases have been brought before European courts, among them the Court of Justice of the European Union, the German Constitutional Court and the Irish and Estonian Supreme Courts. We will not be able to discuss all the aspects raised in these cases, but focus on the two most pertinent legal challenges: (1) according to a widely held belief, the voluntary granting of loans to euro area members in distress infringes the so-called "no bailout clause" of Art. 125 (1) TFEU; (2) whether the ECB in buying government bonds transgresses the limits of its competences to define and implement the monetary policy of the euro area or infringes the aforementioned prohibition on monetary financing (Art. 123 (1) TFEU). We will address these two questions in order.

1. The "No Bailout Clause" and Financial Assistance

The so-called "no bailout clause" (there is no official title of provisions in the TFEU) is enshrined in Article 125 (1) TFEU, which stipulates:

> "*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.*"

The relevant phrase here is "*[a] Member State shall not be liable for or assume the commitments of central governments, [...] of another Member State*". Firstly and undisputed, it means that no EU Member State may be held liable by the creditors of another Member State. This is a mere clarification as there is no general principle of law — not even in truly federal systems — that being part of an international organization or a federation of States automatically brings about mutual liability for government debt. Furthermore, the provision prohibits assuming the commitments of other Member States. Given the careful and neat wording of the different provisions (Art. 123 through 125 TFEU), there is no need to include the voluntary creation of a new creditor-debtor relationship between Member States as being prohibited under the prohibition "to assume" the commitments of other Member States.[31]

The opponents of such a verbatim interpretation of Art. 125 (1) TFEU point to its *telos*, which is to ensure the financial self-responsibility of the Member States and their individual rating by creditors as well as to prevent moral hazard. However, this goal can also be fulfilled if Art. 125 (1) TFEU only prevents automatisms, as there is then still no guarantee that a Member State will receive financial means by the others if need may be. This is supported by the fact that Slovakia abstained from the Greek "bailout" and the discussions (at the time of writing) whether Greece would receive the next tranche under the different packages at all. Still, a default of Greece is not entirely precluded and it is for the Member States (in accordance with their respective national legislation) to decide whether they continue to lend to

[31] On this discussion see Athanassiou (fn. 4), p. 558 (561 et seq.) and Ruffert (fn. 4), p. 1777 (1785 et. seq.); See also ECJ, C-370/12, Judgment of 27 November 2012 (fn. 22 above).

Greece (and the other Member States in distress) or not. Strikingly, the spread between the bond yields of peripheral countries and Germany, which had remained extremely low until 2007/2008 started to rise significantly at the very moment where the euro area governments began to "bailout" Greece, i.e. the goal of the proviso started to be achieved only after it had allegedly been breached. As regards the mentioned moral hazard, one can see that the conditionality attached to all financial instruments rather had the effect to let Member States hesitate to make use of them than to induce them to financial leniency.

Furthermore, a comparison with the legal situation applying to non-euro-area EU Member States and with third countries deserves attention. EU Member States "with a derogation" (cf. Art. 139 (1) TFEU) may receive "medium-term financial assistance" by the EU when faced with balance-of-payments difficulties (cf. Art. 143, 144 TFEU).[32] Third countries may receive funds from the IMF which are partially financed by the euro area Member States or precisely by euro area national central banks benefitting from an exception from the monetary financing prohibition.[33] It would be rather surprising, if euro area Member States could lend to third Countries and non-euro EU Member States, but not to their closest fellows, where their own self-interest to prevent a default would naturally be the greatest. Furthermore, it would not be convincing to support a reading of the TFEU which would in effect leave euro area Member States helpless in a situation where the existence of their currency is at risk.

In conclusion, the better arguments — confirmed now also by the ECJ — support a reading of the TFEU which considers voluntary lending as not being covered (and therefore not prohibited) by Art. 125 (1) TFEU. The treaty makers possibly assumed that the preventive elements of the Treaty (Art. 123 through 126 TFEU) would ensure that a situation as we experience since 2009 would never arise. Given the importance of the euro as an integration instrument (and objective of the EU), they would certainly not have wanted the single currency to break up as result of a restrictive interpretation of the treaties which is not even explicitly written into them.

2. The Prohibition on "Monetary Financing"

Less extensively but not a bit less intensively has been the criticism for the ECB's bond purchase programs, the SMP and now the OMT. Fervently the argument is being put forward (in particular in the political realm) that these purchases (or even their announcement for the future) is a breach of the mandate of the ECB/Eurosystem, since they constituted not monetary policy but fiscal policy; that the safeguarding of the stability of the financial system of the euro area was a goal not to be pursued by the Eurosystem; that the purchase breaches the prohibition on monetary financing (Art. 123 (1) TFEU) and — last but not least — that the bond purchases endanger price stability, which to ensure is the primary objective of the Eurosystem.

However, the critique of the measures is unjustified. The basic tasks of the Eurosystem

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[32] See fn. 12 above.

[33] See Art. Article 7 of Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty, OJ 1993 L 332/1:
"The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty."

include to "*define and implement the monetary policy of the Union*" (Art. 127 (2) first indent TFEU). As there is no legal definition of monetary policy given in the Treaty, one will have to assume that it covers the use of monetary policy tools with the goal of influencing monetary targets. The most important monetary policy tools are (non-conclusively) listed in Art. 18.1 of the Statute of the ESCB and the ECB and include to

- "*operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in euro or other currencies, as well as precious metals;*
- *conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.*"

Furthermore, the ECB may impose minimum reserve requirements (Art. 19 of the Statute) or use other instruments of monetary control. What is common to all these (traditional) monetary instruments is the effect they may have on the monetary basis or the money supply of the financial system and the interest rates in financial markets.

With regard to the SMP and the OMT, the ECB has consistently argued that these programs respond to specific stress in particular segments of financial markets within the euro area, which may also be due to fears of investors that individual countries might be coerced to leave the euro area.[34] Given the overall objective of the EU to "establish an economic and monetary union whose currency is the euro" (Art. 3 (4) TEU), which is also binding on the ECB as an institution of the Union (Art. 13 TEU), it is legitimate for the ECB to try to erase irrational exuberances in markets or to extinguish risk premiums based on unjustified (but self-energizing) anxieties of a break-up of the euro area in order to ensure the smooth transition of monetary policy signals into all markets of the euro area. Given that the Eurosystem is called upon also to "define" the monetary policy of the EU and enjoys independence from other political bodies, it seems most likely that the European Court of Justice will grant the ECB/Eurosystem a wide margin of discretion in assessing the monetary policy needs, strategies and appropriate instruments. This includes considering the impacts of monetary policy instruments on market stability as a necessary precondition of monetary policy. Furthermore, the explicit mentioning of "buying outright [. .] marketable instruments" also includes the buying of government bonds on the secondary markets, as these bonds are unquestionable "marketable instruments".[35] Whether or not they are actually traded is of no legal relevance in that regard.[36]

Whether or not the transactions under the SMP or under the OMT indeed lead to inflation (which would then be contrary to the primary goal of the Eurosystem to ensure price stability) is an open question. As long as the ECB successfully sterilizes the impact of its purchases on the monetary basis, no inflationary effects will result from the transactions anyway. Even if they were not fully sterilized, it would still need an expansion of credit by commercial banks to

[34] See fn. 28 above.

[35] Guideline of the ECB of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem (recast) (ECB/2011/14), OJ 2011 L 331/1, Chapter 6, para. 6.2.1.5.

[36] But see Seidel, *Der Ankauf nicht markt- und börsengängiger Staatsanleihen, namentlich Griechenlands, durch die Europäische Zentralbank und durch nationale Zentralbanken — rechtlich nur fragwürdig oder Rechtsverstoß?*, EuZW 2010, p. 521.

private households or undertakings to induce inflationary demand-pull effects. However, the development of the monetary aggregate of M3 — most relevant from the perspective of inflation — in recent times has been rather slow and much weaker than prior to the crisis. In sum, there seems to be quite some leeway for the ECB to purchase bonds without necessarily causing inflation.

Lastly, the question must be answered whether bond purchases on the secondary markets may amount to a prohibited "monetary financing". The relevant Article 123 TFEU reads as follows:

> "*Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.*"

The relevant phrase here is *"the purchase directly from [Member States bodies] by the European Central Bank or national central banks of debt instruments"*. There can be no doubt that the indirect purchase of government bonds from investors does not fall into the prohibition of direct purchases. Yet, the argument is being made that the prohibition must not be circumvented by indirect purchases and this argument is being supported by preamble language of a secondary law instrument defining the definitions contained in Art. 123 TFEU.[37] The German Constitutional Court, in its September 2012 preliminary decision on the ESM and Fiscal Pact — against the backdrop of the ECB's announcement of the OMT a week earlier — has voiced explicit concerns about such a circumvention and has tried to define the content of a possible prohibition of circumvention. According to the German Constitutional Court, pointing to the mentioned preamble,

> "*an acquisition of government bonds on the secondary market by the European Central Bank aiming at financing the Members' budgets independently of the capital markets is prohibited as well, as it would circumvent the prohibition of monetary financing.*"[38]

This interpretation is remarkable, as it neglects the sole and ultimate responsibility of the European Court of Justice to interpret Union law (cf. Art. 267 TFEU). Furthermore, it is doubtful whether an interpretation focusing on the intent of the behavior of the ECB is really useful, as it might be difficult to prove. Lastly, the phrase *"financing the Member's budgets independently of the capital markets"* raises numerous further interpretative questions, e.g. whether the influencing of interest rates alone would already suffice for an infringement or whether it would be necessary to prove that buyers on primary markets act no more on the basis of a genuine investment interest but only as intermediaries of the Eurosystem and pass on the bonds directly after purchase.

Whatever may be the correct interpretation of the legal framework applicable to the ECB's bond purchases, it will not have to be given by the German Constitutional Court, but by the

[37] Recital 7 of Council Regulation (EC) No 3603/93 (fn. 32).

[38] BVerfG, Judgment of 12 September 2012, 2 BvR 1390/12 etc., para. 247 (available in English at http://www.bundesverfassungsgericht.de/entscheidungen/rs20120912_2bvr139012en.html).

ECJ. Should the German Constitutional Court consider an interpretation of Art. 123 (1) TFEU necessary to render a judgment in the main proceedings on the ESM Treaty, it will have to refer the question to the ECJ for a preliminary ruling first.

VI. *Legality of the Measures under German Constitutional Law*

Generally speaking, EU law and the actions of institutions of the EU are not subject to legal review on the basis of any Member State legal order. This follows from the principle of supremacy of EU law over any national law including the Member States' constitutions, accepted by the constitutional courts across the EU as a consequence of the transfer of sovereign rights to the EU level (for Germany see Art. 23 Basic Law). However, the general acceptance of the supremacy of EU law has not been limitless and the German Constitutional Court has been the frontrunner in developing reservations to it. These reservations include a sufficient protection of basic rights on the EU level, respect for the competences vested in the EU and a prohibition on encroaching upon competencies forming the core identity of German Statehood.[39]

The principle of democracy is considered to constitute a part of the latter and the German Constitutional Court has derived certain limitations from it which do also apply in relation to measures that have been taken to solve the euro crisis, namely the principle of budgetary responsibility and autonomy of the German Bundestag. This principle resembles the more general principle of "integration responsibility", developed in the Lisbon judgment of the Constitutional Court, and it requires that all decisions that may have a significant impact on the German federal budget are to be taken in the Bundestag[40] — in principle in plenary session[41] — which must also be informed properly of all political initiatives under Art. 23 (2) Basic Law, even if they take place outside the formal treaty framework of the EU as in the case of the ESM and the Fiscal Pact.[42]

Even if it is for the Bundestag to decide whether euro area Member States should receive financial aid or not and the Bundestag enjoys a wide margin of discretion to what extent liabilities taken on by the Federal Republic are still sustainable, it must not establish a mechanism which would be

> "*tantamount to accepting liability for decisions by free will of other states, above all if they entail consequences which are hard to calculate"*.[43]

Consequentially, it is constitutionally permitted to help out other EU governments as long as no liability automatism outside the control of the Bundestag is established. Regarding a possible absolute limitation to the acceptable amount of liabilities, the German Constitutional Court has emphasized the large discretion vested in the Bundestag.[44]

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[39] See most recently BVerfG, Judgment of 30 June 2009, 2 BvE 2/08 etc. (Lisbon Judgment), available at http://www.bundesverfassungsgericht.de/entscheidungen/es20090630_2bve000208en.html

[40] See fn. 16.

[41] See fn. 17.

[42] See BVerfG, Judgment of 19 June 2012, 2 BvE 4/11.

[43] See BVerfG, fn. 37, para. 198.

[44] Ibid., para. 201.

In its (preliminary) decision of 12 September 2012 on the constitutionality of the ESM and Fiscal Pact ratification measures, the German Constitutional Court did not raise fundamental objections against them, but reaffirmed the need for their parliamentary control. It demanded a clarification of the ESM Treaty with regard to the maximum amount of callable capital and to the provisions on professional secrecy and their subordinance to the right of the German Bundestag to be informed about the use of the financial means provided.

VII. *Concluding Remarks and Outlook*

The European sovereign debt crisis poses challenges for politicians, economists and lawyers alike. So far, the worst case scenarios have been avoided, including a break-up of the euro area, the exit or a disorderly default of individual Member States. Of course, all the "rescue umbrellas" and interventions by the ECB cannot solve the fundamental causes of the crisis, which can be found in the lack of competitiveness and in economic imbalances within the euro area as well as in unsustainable budgetary policies of at least a number of euro area Member States. In order to counter these fundamental problems, the EU has also set on track a major reform of economic governance in the EU and the euro area, including a strengthening of the stability and growth pack, the introduction of an economic imbalance procedure and the Fiscal Pact. However, it will take time until the reforms produce visible and credible results. Until this point, the "bailing-out" will have to go on. The monetary legal framework of the EU does not hinder it.