Institutions and the Crisis

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PREFACE

The Florence School of Banking and Finance at the European University Institute's Robert Schuman Centre of Advanced Studies and the Brevan Howard Centre at Imperial College London, in cooperation with BAFFI CAREFIN at Bocconi University and with the kind support of the European Investment Bank Institute, organised on 26 April 2018 a conference entitled 'Institutions and the Crisis'.

This event follows the tradition, established in 2011, to gather yearly in Florence the leading economists, lawyers, political scientists and policy makers to discuss Europe's economic and financial governance, in the light of the most pressing policy priorities, challenges and future prospects. In particular, this year's conference was convened to critically analyse, review and debate the most salient elements and gaps of Europe's post-crisis institutional architecture.

The event was opened by the first panel, which looked back at the way the EU Institutions managed the financial crisis and drew analytical and practical insights from both a research and public policy perspective. Discussions in the panel evaluated the European crisis management, going beyond the established view that Europe did 'too little too late'. The panellists reflected on the capacity of EU institutions and instruments to manage interdependencies stemming from a common currency.

The second panel discussed the role of the various European courts in tackling the recent financial crisis, particularly assessing how they discussed, challenged and legitimized the EU's key crisis response mechanisms and decisions. Speakers discussed whether courts are likely to be effective enforcement mechanisms for the new fiscal rules and assessed how judicial control interfered with crisis decisions by other public authorities.

The discussion in the final panel was focused on the Eurozone's future institutional prospects, looking at the crucial reform steps necessary to make the EMU and the euro sustainable and ‘future-proof’, discussing the existence of possible alternatives for ensuring the stability of the Euro, as well as addressing the difficult balance between risk-reduction and risk-sharing measures that Europe must find in the current populist context, to stay on course in EMU reform.

The event follows a 2017 conference entitled ‘The Changing Geography of Finance and Regulation in Europe’, a 2016 conference entitled ‘Filling the Gaps in Governance: The Case of Europe,’ a 2015 conference entitled ‘The New Financial Architecture in the Eurozone,’ a 2014 conference entitled ‘Bearing the Losses from Bank and Sovereign Default in the Eurozone’, a 2013 conference ‘Political, Fiscal and Banking Union in the Eurozone,’ a 2012 conference, ‘Governance for the Eurozone: Integration or Disintegration, and that of 2011, ‘Life in the Eurozone With or Without Sovereign Default.’

As with all the previous conferences, the debate after each panel and was lively and thoughtful. We prefer not to take a stance here on any of the issues but simply provide in this book the contributions by individual speakers and let the reader draw his or her own conclusions.

KEYNOTE SPEECH
Euro area reform: reflections on an initiative[1]

Jean Pisani-Ferry[2]

The euro is nearly 20 years old: 10 quiet years followed by 10 tumultuous ones. The end of the first decade was marked by glowing, oddly uncritical reviews.[3] Ten years later, however, complacency has largely vanished from assessments of the state of the euro area, and disagreements over its future remain unsolved. Six years ago already, the heads of the European institutions issued a blueprint for the future, the "Four presidents' report" of June 2012 (Van Rompuy et al., 2012), and the heads of state and government of the euro area agreed on "breaking the vicious circle between banks and sovereigns" by establishing a banking union (Euro-area leaders, 2012). Much has been done for sure, but the agenda set by the leaders has not been completed and the roadmap for the future remains a matter for fierce controversy. At their June 2018 summit,

1 Updated version of remarks prepared for the conference *Institutions and the crisis* held in Florence in April 2018. This paper is also published in Franklin Allen, Elena Carletti and Mitu Gulati (eds), *Institutions and the Crisis* (RSCAS, Florence School of Banking and Finance, European University Institute, Florence; Brevan Howard Centre at Imperial College, London; Baffi Carefin, Bocconi University, Milan, forthcoming 2018.
I am grateful to Agnès Bénassy-Quéré and Isabel Schnabel for comments on an earlier draft and I am especially indebted to Jeromin Zettelmeyer, with whom I extensively discussed the relevance and implications of the contributions to the Voxeu debate platform that we moderated jointly between April and July 2018.

2 Tommaso Padoa-Schioppa chair at the European University Institute, Florence and Mercator Senior Fellow at Bruegel, Brussels. Professor at Sciences Po, Paris and the Hertie School of Governance, Berlin.

3 I must admit that I (modestly) contributed to this literature.

despite the prior Franco-German rapprochement and the joint Meseberg declaration by President Macron and Chancellor Merkel (French and German governments, 2018), the heads of state and government of the euro area could only agree to call for further work on a series of still-divisive issues.

The nature of disagreements

Why is it so difficult to agree? Why is it so difficult, for countries that jointly decided almost thirty years ago to embark on what they knew was an extremely ambitious endeavour, to find agreement on directions for reform? The architects of the euro were fully aware of the incomplete character of the contract written down in the Maastricht treaty. They knew, or at least they suspected, that the launch of the European currency would mark the start of a journey and that further decisions on economic integration, financial policy, the creation of a fiscal capacity and the coordination of national policies would be needed down the road. But they assumed that participation in the euro would create a momentum and help to tackle future issues. It is therefore striking that discussions have proved so difficult and that since the crisis erupted in the open in 2010, so many decisions were only taken on the edge of the precipice.

There are essentially two possible theories for this enduring state of controversy: the "Battle of interests" and the "Battle of ideas". The first posits that problems are fundamentally distributional: decisions are controversial because they pit creditors vs. debtors, high-debt vs. low-debt states, stable vs. crisis-prone countries or global banks vs. local banks. The second emphasises cognitive issues. According to this reading, a major factor behind disagreements is that actors do not share the same representation of reality but rather work with different implicit or explicit models of it.

As with any zero-sum game, divergent interests may be hard to reconcile, but they are analytically simple to deal with, because the settling of a dispute is regarded by both sides as a purely transactional matter. Divergent representations may be less divisive, because the protagonists may ultimately all gain from cooperating, but agreement may be harder to reach. Worse, because they reason with different models, participants may agree on a solution that leaves them actually all worse off.[4] As

4 This is a classic result from the theory of international coordination. See for example Frankel and Rockett (1986).

emphasised by Baldwin and Giavazzi (2015) it is essential, to settle on lasting and effective responses, to start from an intellectual consensus on the causes of the crisis.

Richard Cooper's study of XIXth century international cooperation in public health provides a telling example of a battle of ideas (Cooper, 1989). Public health is an interesting case to study because there cannot be any doubt that all countries share a common interest in containing the propagation of diseases. Distributional dimensions can therefore be assumed minimal. It took however no less than five decades and seven international conferences to reach an effective international agreement on the prevention of cholera, because participants in the negotiation adhered to opposite models of disease transmission. The contagionist school assumed that it essentially took place through contact and advocated long quarantines, whereas the miasmatic school emphasised poor sanitary conditions and advocated local sanitation. On several occasions, fierce negotiations resulted in compromising on a short quarantine. This was an ineffective solution in both models, and for this reason it was not implemented. It is only when the intellectual dispute was resolved (essentially by acknowledging that the miasmatic school was right) that a lasting solution could be found.

In the euro context, the "Battle of interests" view offers an appropriate lens for analysing controversies over legacy issues: debts, NPLs, real exchange rate misalignments and imbalances – and in general all what the jargon categorises as risk reduction issues. But as analysed by Brunnermeier, James and Landau (2016) or Mahfouz and Pisani-Ferry (2016), there are other, long-standing controversies over the rules of the policy game and the role of policy institutions that cannot be understood until their genuinely cognitive dimension is taken into account.

This type of reading is particularly suited to the analysis of Franco-German debates. True, official views on banking union are on both sides coloured by interests: France is the home base of several of the largest European banks, whereas the German banking system is characterised by a much lower degree of concentration and the mostly regional reach of the vast majority of banking institutions. Discussions on supervision and deposit insurance, for example, are therefore best read within the framework of the "Battle of interests", even more so because of the closeness between national banking lobbies and national ministries of Finance. But other disputes, especially on the resolution of the euro crisis and the reforms needed to avoid further crises, cannot be understood within this perspective. Although the two economies have grown dissimilar, particularly over the recent decades, it is hard to pin down French and German stances over stabilisation, moral hazard or the role of discretionary policies as the naked expression of interests.[5] France and Germany have genuinely different perceptions of risks and their propagation.

The 7 + 7 initiative

This difference is one of the reasons why a group of 14 French and German economists (hereafter the 7 + 7 Group) joined forces in September 2017 to endeavour to forge ambitious proposals for euro-area reforms. Their fear, as expressed in an initial op-ed (French and German economists, 2017), was that the two countries would settle on a "small bargain" that "would not make the euro area more stable", that "would not address the fundamental causes of why fiscal rules have not worked well" and that might "induce a false sense of security, hindering needed reforms both at the national and European levels": In other words, a sort of short quarantine. Four months later they issued a joint report (French and German economists, 2018) that started from the recognition that "both the French and the German position have a point" and stated that making progress without ending up with a collection of half-baked compromises required "a shift to reconcile fiscal prudence with demand policies and rules with policy discretion". Claiming that "market discipline and risk sharing should be viewed as complementary pillars of the euro area financial architecture, rather than as substitutes", the 7 + 7 Group put forward a series of proposals for the financial, the fiscal and the institutional architecture of the euro area.

5 Michael Burda (2015) claims that German economists do not differ from their European colleagues because they rely on a different analytical framework but because they stand for a different national interest. His demonstration however fails to convince.

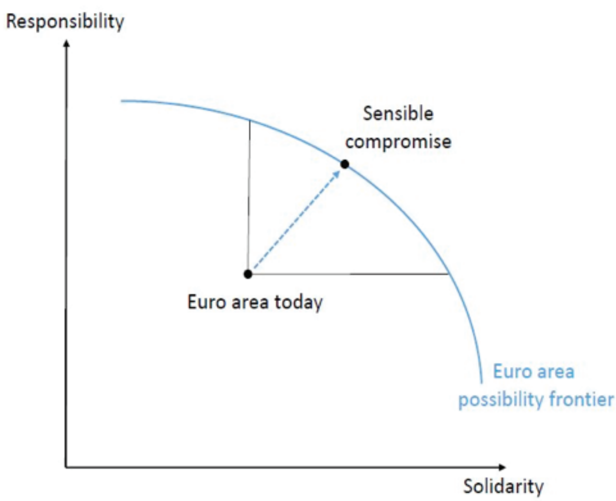
Box1: Key proposals of the 7 + 7 report

1. Reform of fiscal rules, including of the enforcement device
    - Introduce debt-corrected expenditure rule (acyclical discretionary spending)
    - Ditch EU sanctions, assign more individual responsibility to countries
2. More and better risk sharing
    - Reduce home bias in bank sovereign portfolios through concentration charges
    - Introduce common deposit insurance with national compartments
    - Promote "safe asset" based on diversified sovereign debt portfolio (e.g. ESBies)
    - Create low-conditionality access to ESM liquidity for pre-qualified countries
    - Create unemployment/employment reinsurance fund
3. A targeted role for market discipline
    - Enforce the fiscal rule via mandating the issuance of subordinated (junior) bonds for the financing of excess spending
    - Make sovereign debt restructuring a credible last resort when debt is clearly unsustainable
4. Clarify role of institutions
    - Separate "prosecutor" (watchdog) and "judge" (political)
    - Upgrade ESM to IMF-like institution, introduce political accountability
    - Strengthen national fiscal councils

Throughout their joint work, 7 + 7 never actually bargained over different interests. Their common aim was to overcome intellectual disagreements stemming from different appreciations of risk or different implicit models. As standard among economists, they started from the desirable properties of the target regime, rather than from the current situation. Legacy issues such as the high public debt ratio of some euro countries or the strong home bias exhibited by bank balance sheets were taken on board at a later stage, when addressing transition from one equilibrium to another.

The 7 + 7 furthermore shared the conviction that negotiation on the basis of national "objectives" and "red lines", as traditionally practiced, was bound to constrain the outcome to inferior solutions. As illustrated in Figure 1[6], they saw for example the discussion over trade-offs between German-inspired responsibility and French-inspired solidarity as essentially pointless as long as the solution set under discussion remained situated inside the efficiency frontier. There was in their view room for simultaneous improvement on *both* accounts.

Figure 1: Trade-offs vs. efficiency: A stylised representation



In the 7 + 7's view, a reason why such improvement on both axes was regarded as possible was a strong, but generally neglected complementarity between risk-sharing and fiscal discipline. Far from being antagonistic, they thought that both aims could go hand in hand for the following reasons:

- A common deposit insurance protects banks from runs and helps to break the 'doom loop'. Hence, debt restructuring becomes a more feasible option;
- A common safe asset helps banks to diversify away from domestic sovereign bonds. Hence, it contributes to delinking sovereigns

6 This representation was first proposed by Jakob von Weizsäcker in a comment on the 7 + 7 report.

from 'their' banks and to strengthening market discipline;
- Precautionary liquidity lines for pre-qualified countries help to cushion shocks but also incentivize fiscal responsibility;
- Temporary stabilizing transfers to cushion severe economic disturbances alleviate the burden on national fiscal policies, therefore contributing to fiscal sustainability;
- Overall, risk-sharing arrangements make the no bail-out rule easier to enforce and therefore more credible.

The debate about the report

Although it was discussed at various stages with senior officials from both sides, and although some of the ideas therein made their way to the French-German roadmap issued by the ministers of Finance issued a few days before the Meseberg meeting (French and German ministers of Finance, 2018), it is fair to say that the gist of the report was not endorsed by the French and German authorities. France was circumspect on the concentration charges and uncomfortable with the acknowledgement that debt restructuring had to feature as a last-resort option, because it feared being dragged into accepting some form of automaticity. It was sympathetic to deposit insurance but unwilling to spend much political capital for it. Germany was politically unhappy with the emphasis on a European deposit insurance scheme and had reservations about the proposal for a stabilisation fund, whose functioning would involve fiscal transfers. Both governments were doubtful of the junior bonds and the common safe asset (and they actually closed the door to Sovereign Bond-Backed Securities – SBBSs – in their joint June 2018 roadmap). And none of them was keen on questioning the effectiveness of the Stability and Growth Pact in the way the report did.

The report was however influential in that it helped to structure discussions on euro area reform. Presentations have been made at the European Parliament, the European Commission, the Economic and Financial Committee (EFC), the European Stability Mechanism (ESM), the ECB, the IMF as well as to Treasuries and central banks in Belgium, France, Germany, Ireland, Italy and Spain. It was discussed in a series of seminars, elicited significant interest in the community of economists and triggered a series of discussions within the profession. In April

2018, a debate page[7] was opened on www.voxeu.org.[8] By end-July it had attracted 25 contributions.

The contributions to this debate provide an interesting collection of views and are indicative of the discussions triggered by the proposals of the 7 + 7 report. The sample is admittedly biased: very few contributions emanated from the Northern European conservative school whose strong reservations towards the very principle of a new stabilisation instrument were forcefully expressed in the paper by eight Finance Ministers prepared at the initiative of the Netherlands (Eight-ministers position paper, 2018). Although well-represented at national level in several countries – and despite invitations to contribute – this school of thought largely abstained from entering the European debate on EMU reform.

On the contrary, several of the contributors criticised the report for not going far enough, especially on fiscal stabilisation and liquidity provision. One, by Peter Bofinger (2018 expressed the view that the balance between stabilisation and discipline was so tilted towards the latter that implementing the report's proposals would make the euro area worse off. The opinion that in a steady state, it would be "a game-changer in the wrong direction" was however not shared by the other contributors.

In what follows I take up some of the important criticisms or comments made and aim at clarifying the corresponding debate.

Legacy vs. system design

As already indicated, the 7 + 7 did not emphasise proposals to address problems inherited from the past (what economists call legacy problems) but rather ideas for a better permanent regime. This does not mean that they started from a clean slate and overlooked the legacy issues. Rather, the features of the proposed permanent regime and the transition leading to it were conceived in a way that was meant to allow countries with high public debts or weak banking sectors to take part in it.

Because of its public finances and recent banking sector troubles, Italy is an especially testing case. Bini-Smaghi (2018) and Micossi (2018) implicitly or explicitly wonder if the proposed regime would increase its vulnerability. Tabellini (2018) goes one step further and argues that it would be dangerously destabilising for high-debt countries and the euro area as a whole. But the proposed solution has also attacked from the

7 https://voxeu.org/debates/euro-area-reform

8 I moderated it jointly with Jeromin Zettelmeyer.

opposite angle: as explained in his contribution (Feld, 2018), Lars Feld, who was initially part of the 7 + 7 group, did not endorse the final report because he thought it involved the risk of a distributional bias in favour of high-debt countries. His reasoning is that lack of fiscal space at national level would inevitably lead them to draw disproportionately on common fiscal facilities. As his contribution makes clear, he is not convinced that the devices introduced to limit this risk – prequalification, co-payment, thresholds, etc..) would be sufficient to control it.

An alternative strategy could have been to start by addressing the legacy issues head on through some sort of stock operation (a debt work-out and the cleaning up the bank balance sheets) even at the cost of accepting some degree of mutualisation. This was the logic behind the debt redemption pact of the German Council of Economic Experts (2012), co-authored by Lars Feld, Beatrice Weder di Mauro (one of the 7 + 7, at that time a member of the GCEE) and others: get rid of the shadow of the past, so that the steady state system could remain based on sound principles. In this particular case, Feld means restoring the fiscal space at national level and upholding the Maastricht assignment that made individual member states responsible for stabilisation. Better, in a way, pay now than commit to open-ended solidarity.

An objection to Feld's approach is that the 7 + 7 proposals did not simply, not even primarily intended to find a way around the lack of fiscal space. They aimed at addressing systemic weaknesses in the design of the Maastricht system that were revealed by the crisis and would persist even if all public debt were magically reduced to 60% of GDP and if all bank NPLs were suddenly eliminated.

Another objection is that its political feasibility is questionable. The proposal for a debt redemption pact was first formulated seven years ago and in policy circles, it was at best considered with polite interest. Even in the case of Greece, for which debt unsustainability is manifest, no agreement has been found to proceed to a genuine stock operation. To put it simply, the states' revealed preference is to avoid to pay now.

Monetary dimensions

Redenomination risk

The 7 + 7 report has been criticised for not addressing the redenomination risk (Bini Smaghi 2018, Cohen-Setton and Vallée 2018, De Grauwe and Ji 2018, Domenech et al. 2018, Watt 2018). It is true that in the report, the risk that markets would price an exit from the euro area – as opposed to merely the solvency risk – is mentioned only once and that the corresponding response, the ECB's Outright Monetary Transactions (OMT) instrument, is not mentioned at all. But as explained by Farhi and Martin (2018), one of the authors' important aims was in fact to address and diminish the redenomination risk.

Although this aim should have been spelled out more explicitly, there is in fact little substantial ambiguity on this point. The report adamantly advocated resolving sovereign debt crises through restructuring inside the euro area rather than through exit from it. Indeed, the reduction of the cost of restructuring it called for would logically diminish the threat of exit. Furthermore, proposals to break the "doom loop" for good (through concentration charges on bank balance sheets, a common deposit insurance and the introduction of a safe asset) would help contain the risk of self-fulfilling exit expectations.

The role of the ECB

A related criticism is that the 7 + 7 report did not discuss the role of the ECB and did not mention the Outright Monetary Transactions scheme (Cohen-Setton and Vallée 2018, Wolff 2018). Again, this is factually true as the report's focus was on the agenda for intergovernmental Franco-German discussions, which were (fortunately) not expected to cover issues related to the way an independent ECB fulfils its mandate. But whereas the 7 + 7 deliberately abstained from discussing central bank policy, they worked under the assumption that the ECB would continue tackling the risk of self-fulfilling crises, including through activating the OMT if necessary (Farhi and Martin 2018). So there is in fact no neglect of central bank policy matters.

A number of issues however do deserve further discussion. Cohen-Setton and Vallée (2018) especially argue that the ECB should be made able to backstop the sovereign bond market of a solvent country even in the absence of a conditional assistance programme. It is true that the 7 + 7 acknowledge the possibility for a solvent country to be granted access to a liquidity window without being required to change its policy, while the official ECB doctrine remains that the OMT can only be activated in complement to national reform efforts (Cœuré, 2013). If access to ESM liquidity if granted to a prequalified country without ex-post conditionality, this should logically apply to the OMT as well. The point relates more broadly to the need for an alternative liquidity support scheme advocated in the report.

Liquidity support

The 7 + 7 report proposed creating at the ESM a liquidity support line for pre-qualified countries. The new facility would provide low-cost lending to countries with continued market access satisfying pre-set criteria. The safety provided by this additional buffer would help to avoid precipitous fiscal retrenchment in times of rising risk aversion and it would thereby contribute to overall stabilisation.[9] However the report did not specify the amounts involved and it did not specify how this facility would be financed.

Vihriälä (2018) strongly endorses the need for reforming the current regime for liquidity support. He argues that the €500bn ESM capacity ceiling could quickly be exhausted, that it is not appropriate to endow the ECB with the responsibility of deciding whether or not to provide support to sovereigns, and that to condition liquidity support on an adjustment programme is likely to delay its activation excessively. However, he finds that the 7 + 7 report fails to define how precautionary lending would be financed.

Vihriälä's solution would be to give to the ESM access to ECB funding for the financing of precautionary lending (and not for standard conditional assistance, which would continue being financed on the basis of the resources provided by the member states), so that it could provide liquidity in adequate amount. Technically, the ESM would borrow from the ECB, using its capital as collateral. There would be no pre-set size limit to overall liquidity support, but eligibility conditions would be strict. There should also be a clear separation between the ECB decision that market conditions warrant the activation of liquidity support and the ESM decision to grant it to a particular sovereign.

9 A similar proposal features in the Franco-German roadmap of June 2018.

Fiscal architecture

Quasi-automatic restructuring

The 7 + 7 report has been criticised by officials and observers for having advocated quasi-automatic sovereign debt restructuring and for having taken the risk of corresponding financial trouble lightly. In fact, it emphatically rejected both numerical thresholds and procedural automaticity (such as the automatic roll-over of standard bonds coming to redemption during an ESM programme). As far as debt sustainability is concerned, the 7 + 7 report made two proposals:

- That debt restructuring be considered as a last-resort option for insolvent sovereigns. The no bail-out rule – that is, the principle that the ESM does not lend to an insolvent state would be upheld – but exactly in the way the same principle is implemented by the IMF: lending would be decided on the basis of a debt sustainability analysis and would be conditional on a high enough probability of sustainability;
- That debt restructuring be made less disruptive financially and economically through the introduction of single-limb collective action clauses (that would make it possible to let creditors pass a single vote on a restructuring proposal, instead of voting separately on the treatment of each issuance, which makes it possible for hold-outs to retain a blocking minority).

These two proposals were endorsed in the Franco-German Meseberg declaration and can now be regarded as being part of the two countries' policy consensus. Several contributors (De Grauwe and Ji, 2018, Tabellini, 2018, and Wolff, 2018) however argue that the very existence of a sovereign restructuring procedure may trigger panic. De Grauwe and Ji furthermore dispute the possibility of deciding if a government is actually insolvent and recall that in the early 2010s, Ireland, Spain and Portugal were regarded by some as insolvent, whereas they were in fact suffering from liquidity shortage – a point already alluded to by Micossi (2018).

This is a fundamental debate. The no bail-out rule, one of the core principles of the EMU, requires avoiding official lending or indirect central bank support to an insolvent state. To renege on this principle because insolvency is hard to diagnose in real time would amount to endorsing fiscal dominance. In the eyes of the German constitutional court, such an acknowledgment would in turn amount to an infringement to the core EMU contract. So there is in fact no choice but to operationalise the principle that as a last resort, an insolvent sovereign must undergo debt restructuring. When and how it should be enforced is a matter of judgement. For this reason, this decision should be bestowed to a technically apt and politically legitimate institution. What institution it should be, what would guarantee that it decides even-handedly and consistently, and what methodology should guide its assessment are admittedly matters for further work. But the principle should not be regarded as a matter for discussion. Indeed, in his counterfactual account of the Greek crisis, Papaconstantinou (2018) points out that the lack of an agreed framework for debt restructuring contributed to unhelpful gambles for redemption.

Fiscal rule

Had the 7 + 7 criticism of the Stability and Growth Pact (SGP) been formulated a few years ago, it would certainly have elicited strong rebuttal, especially from official circles. The fact that few commentators disputed it is indicative of the evolution of the debate. Only Bini-Smaghi (2018) regards its negative assessment as unjustified, whereas Beetsma and Larch (2018) speak of an “excessively complex system of rules that few understand”, and Wieser (2018) bluntly claims that the present rules-based SGP has become “nearly unmanageable”. Wieser is even harsher than the 7 + 7: he argues that the present system has produced short-termism, fine tuning of the rule book and political loss of legitimacy.

Beetsma and Larch point out a “surprising convergence of views” on how to overhaul the SGP. They regard the essential tenet of the 7 + 7 proposal – an expenditure rule based on potential GDP growth but adjusted to address situations of excessive public debt – as a potentially consensual solution that would provide a basis to streamline the current system and help to limit the recourse to escape clauses.

The proposed rule was criticised by some for remaining dependent on unobservable variables. It is true that potential output growth is not directly observed, so that controversy on the proper assessment of it would remain. But an expenditure ceiling based on potential output would create much less noise than the current approach based on the current and projected output gaps.

Two further controversial points in the 7 + 7 proposal are, first, the possibility left to governments to depart from the agreed rule provided they finance additional expenditures through the issuance of junior bonds and, second, the reform of the institutional set-up.

Junior bonds

In coherence with the view taken on the SGP and the need to make governments more responsible for their own mistakes, the 7 + 7 report advocated the introduction of fixed-duration junior bonds for the financing of expenditures over and above the ceiling given by the national spending rule. These bonds – and only them – would undergo an automatic maturity extension in case of an ESM programme. But as they would presumably be issued in small quantity to finance departures from the agreed expenditure rule, the bulk of the public debt stock would remain unaffected.

The idea stems from political considerations: at a time when the policy consensus of the 1990s has eroded, the EU should avoid being held responsible for imposing a fiscal straightjacket that would offer an easy target to populist grievances. Rather, governments should be free to make their own choices and try to convince markets that their policies might actually work. But they would be legally compelled to finance additional expenditures or tax cuts through standardised 5-year bonds that would be subject to automatic maturity extension in case of ESM programme and would be first to suffer a haircut in case of restructuring.

Echoing concerns often heard in official circles, Buti et al. (2018) fear that junior bonds, though clearly distinct from standard bonds, would provide a conduit for transmitting destabilising market reactions. Increased probability of an ESM programme, the reasoning goes, would lead to a freeze of the secondary junior bond market that could spill over onto the market for standard bonds. Although not subject to maturity extension, the latter would suffer from the deteriorating reputation of the issuer. Ultimately, the entire bond market could freeze prematurely.

There is indeed no experience of issuance of such bonds by sovereigns and even private-sector experience is limited in this regard. The proposal in the 7 + 7 report is that junior bonds would be (i) optional, so that a country could commit not to resort to such instruments, (ii) standardised, so that they would be clearly distinguishable from regular bonds, and (iii) subject to a specific regulatory treatment. These provisions should limit the risk of spill-over onto the regular bond market.

Other objections are that the market for junior bonds would be thin, that financial markets are subject to wide gyrations in their assessments, and that it would be hard to establish and enforce a legal obligation to finance excessive deficits by junior bonds. These are real concerns, but the proposal by Beetsma and Larch to suspend the disbursement of EU funds to a country in infringement of the rules would not be easy to implement either. Ultimately what must be found is a balance between two imperfect institutional arrangements: one that relies on peer pressure underpinned by legal obligations and one that relies on market pressure. Neither is failure-proof.

Purple bonds

A dual sovereign bond market structure is also advocated by Bini-Smaghi and Marcussen (2018), but in a different way. Drawing on the Blue Bonds-Red Bonds proposal of Delpla and Weizsäcker (2010), they propose to introduce "purple bonds" that would benefit from a non-restructuring guarantee under an ESM programme. In a permanent regime, to be reached at a 20-years horizon, each sovereign would be allowed to issue such bonds up to 60% of its GDP. Additional bonds (dubbed red) could be issued, but as they would not benefit from the same guarantee, the risk of restructuring would be priced in and as in the case of junior bonds, they would serve as a channel for market discipline.

To avoid destabilisation, Bini-Smaghi and Marcussen envisage granting the purple bond status to the entire stock of public debt outstanding. Gradually however, new issuances would be guaranteed only for an amount corresponding to compliance with the Fiscal Compact. The rest, if any, would have to be issued in the form of red bonds. To be concrete, a country that starts from a 100% debt-to-GDP ratio would need to reduce it by two percentage points per year to bring it to 60% within 20 years. The stock of purple debt would therefore be gradually reduced over this 20-year transition period.

The purple bonds proposal would in a way achieve the stock operation mentioned earlier. Apart from the fact that objections to the junior bonds proposal would also apply to the red bonds, the question is raises is whether the ESM can extend a no-restructuring guarantee to all existing public debt. This would commit it ex ante to the type of concessionary lending currently granted to Greece, to the benefit of any country whose present level of public debt would prove unsustainable. As discussed already, political appetite for an ex ante transfer, even a contingent one, seems limited.

Institutional set-up

The 7 + 7 report claimed that the institutional architecture of fiscal surveillance should be reformed, first by assigning more fiscal responsibility to national fiscal councils and, second, by better separating the role of 'prosecutor' and 'judge'. The latter would be done either by assigning different tasks to the Commission and the chair of the Eurogroup or, if the role of chairing the Eurogroup were assigned to the ECFIN Commissioner, by separating functions within the Commission. The discussion about these issues is bound to gain in importance as there seems to be wide agreement that the role of the ESM should be strengthened. It is also easy to be sceptical, as Weiser (2018), about the actual degree of independence of national fiscal watchdogs. Further debate is likely on how to avoid duplication and rivalry between European institutions, and how to ensure that fiscal responsibility is better rooted in credible domestic institutions.

Fiscal stabilisation and fiscal capacity

The Maastricht policy assignment was remarkably clear and simple: reflecting the consensus of the time, monetary policy was regarded a strong enough instrument for addressing area-wide shocks whereas, provided governments played by the rules, national fiscal policies were supposed to enjoy sufficient margins of manoeuvre within the constraints of the SGP to tackle country-specific shocks.

These hypotheses have been seriously questioned by the economic developments of the last decade. Contrary to the view of the early 2000s (Taylor, 2000), fiscal policy is increasingly regarded as a necessary complement to monetary policy, especially in situations when the latter is constrained by the zero lower bound (Furman, 2016); and market reactions, or the fear of them, can prevent national fiscal policy from playing its stabilisation role when a country is hit by a large shock. Hence the need to reconsider the role of fiscal policy in EMU.

The 7 + 7 report aimed to provide a response to the second problem – how to help individual countries deal with large shocks – by proposing a fiscal stabilisation scheme based on the evolution of employment or unemployment indicators. The idea was also endorsed by the IMF (Arnold et al., 2018). The proposed system would take the form of a fund, financed by national contributions, that would provide one-off transfers to countries experiencing a sudden and large change in the employment or unemployment rate. Contributions would be set in such a way that it would not give rise to one-way recurring transfers. A similar idea was outlined in the French-German roadmap, however without transfers. In the ministers' proposal of June 2018, large shocks would merely elicit loans. Loans, however, may not provide effective stabilisation in a situation where countries fear being cut off from access to liquidity;[10] and they could furthermore result in lasting disputes between creditors and debtors.

As to the first problem, the report fell short of proposing a euro area budget or a central fiscal capacity able to cover aggregate shocks. It recognised that aggregate fiscal support might be desirable but argued that a euro budget could only be the result of decisions regarding common public goods and the institutional underpinnings of their financing.

Apart from Peter Bofinger, commentators generally regard the stabilisation proposals of the 7 + 7 report as positive, though insufficient (Dullien 2018, Domenech et al. 2018, Watt 2018, Wolff 2018). Dullien for example points out that had the proposed scheme been in operation prior to the crisis, Spain would have received in total a transfer amounting to 1.3% of its GDP and Ireland less than 1%). Though some in Northern Europe would regard this number as high, it is certainly not commensurate to the stabilisation provided by the US federal budget. Several would have wished the report propose either a proper budget, or a central fiscal authority capable of monitoring and steering the aggregate fiscal stance. The challenge here, however, is not to demonstrate that the euro area would be macroeconomically better off with a significant common budget. It is to overcome either one of two major obstacles: the fact that coordination is toothless whenever it comes to telling a surplus country that it should relax its stance; and the fact that a proper budget requires agreeing on the common public goods, revenue, and accountability procedures.

10 Research has evidenced significant multiplier non-linearities in conditions of market concerns over a country's fiscal sustainability.

Financial architecture

As far as banking union is concerned, the 7 + 7 report advocated precise steps aiming to break the "doom loop" for good. It proposed introducing (i) concentration charges so that banks exhibiting (home) bias in the composition of their sovereign bonds portfolio would be required to post more capital (but no risk-weighting of individual assets, which implies that all sovereign bonds would continue to be treated in the same way); and (ii) a common deposit insurance scheme that would guarantee all bank deposits equally but for which banks would continue paying different fees depending not only on bank-specific risk, but also on the safety of the national banking systems.

Concentration charges would make it costly for national banks to continue to disproportionately hold bonds issued by their sovereign. For this reason, their introduction would primarily affect countries, such as Italy, where banks have behaved as the residual buyer of domestic government securities. In order to avoid destabilising sovereign bond markets, the 7 + 7 report advocated for concentration charges to be phased in gradually, possibly after having granted grandfathering to all existing holdings. Here especially, the aim was to define the target of the long-term regime and to work out the transition very carefully.

Deposit insurance

As detailed in Schnabel and Véron (2018a, 2018b), the scheme for deposit insurance was also designed in order to combine the guarantee that all deposits are equally safe – a strong deterrent to bank runs – and a financing system avoiding full mutualisation for as long as national authorities can influence bank solvency through a variety of policy provisions such as company and household bankruptcy procedures. The 7 + 7 scheme therefore combined a fully integrated setting with differentiated contributions (based on structural indicators of creditor rights) and a two-tier waterfall financing structure with national compartments and a common compartment that would start to pay out once the national compartment has been depleted, and that would be reimbursed over time so that the operation of the system would not involve any permanent transfer.

The scheme was essentially criticised for being unnecessarily complex and potentially inadequate. Building on simulations, economists at the

ECB have claimed that a single fee structure could be designed that would ensure a high degree of safety and avoid any cross-subsidisation (Carmassi et al., 2018). They even claim that reinsurance-type structure could have undesirable distributional consequences – but their assumed structure differs from that proposed in the 7 + 7 report (because it assumes fixed target levels for the national compartments). Schoenmaker (2018) also criticises the proposed system on the ground that the replenishment of national compartments could be procyclical. So even if an agreement could be reached on the principle of a common deposit insurance, its design would remain a matter for economic debate.

Safe asset

The 7 + 7 report proposed common synthetic safe securities be introduced in parallel to the concentration charges so that banks would be incentivised to treat them as diversification assets. The safe asset issue has been part of the euro discussion at least since Delpla and Weizsäcker (2010) formulated their Blue bonds–Red bonds proposal. Over time several variants were put forward, discussed, and (generally) discarded but as observed by Buti et al. (2018), versions of the idea that involve pooling and tranching but no mutualisation have not been fully explored yet.

The version endorsed in the 7 + 7 report did not involve any mutualisation. Instead, it advocated introducing privately issued but regulated Sovereign Bond-Backed Securities (SBBSs) based on a diversified portfolio of euro-area sovereign bonds. The senior tranche of the synthetic asset – what Brunnermeier et al. (2017) called ESBies – would constitute a euro-area safe asset. It would be introduced in parallel to the phasing-in of bank concentration charges, from which it would be exempt, and would therefore constitute an investment vehicle for banks aiming at reducing their home bias. The creation of euro-area safe assets would therefore neither be left to private-sector initiative (because of the creation of a specific regulatory framework) nor be taken charge of by an official institution (as in some proposals that envisaged them to be issued by the ESM).

Claeys (2018) rightly observes that despite having been endorsed by the European Commission and the European Systemic Risk Board, SBBSs remain controversial and that they are especially unpopular with debt management agencies. As pointed out by Zettelmeyer and Leandro (2018), there are three main reasons for this distrust: first, the fear that the senior tranche would lose safety in a crisis; second, the fear that in adverse market conditions, the issuance of synthetic securities could be blocked by the lack of buyers for the junior and mezzanine tranches; third, the potential spill-overs from the synthetic asset on the demand for national bonds and the liquidity of the corresponding markets.

Simulations by Zettelmeyer and Leandro (2018) suggest that these fears are not without rationale – indeed, the SBBS's junior tranche could lose market access and the senior tranche could be hit by extreme tail risks – but that they are largely exaggerated. Distrust remains however. A demonstration of it was given by the Franco-German roadmap of June 2018, which discarded SBBSs out of hand.

Other dimensions

Northern bias

As Frieden (2018) points out, any reform programme for the euro area must address the concerns of both core and periphery countries. Though they intended to help unlock the French-German discussion, the 7 + 7 aimed at proposing solutions that would suit all euro area members. Several contributors however implicitly regarded their report as unbalanced and biased towards the perspective of Northern member states. The critique was most explicitly formulated by Tabellini (2018), who claims that the 7 + 7 report "reflects the nationality of its authors, namely two countries that belong to the core of the Eurozone and are not exposed to a considerable risk of a sudden stop on their sovereign debt". He argues that the compromise found by the 7 + 7 is not suitable to a country exposed to the risk of a debt run and that its proposals would in fact increase the vulnerabilities of countries with high legacy debt.

Tabellini's critiques of the knock-on effect of the acceptance of sovereign restructuring as a last-resort option and of the junior debt instrument echo those formulated by other commentators and officials. He furthermore adds that the ESM would not be the right institution to carry out a debt sustainability analysis, because it represents the interests of the stronger member states, who are also creditors. But he falls short of saying how situations of insolvency should be dealt with.

His more important and original point is however that breaking the doom loop is a bad idea in the first place. He claims that through acting as residual buyers of domestic sovereign bonds in situations of stress, national banks play a stabilising role that should not be hampered by concentration charges or other provisions aiming at the same goal. This is in fact a fundamental critique of the direction taken by EMU reforms since 2012, when the heads and state and government decided to opt for banking union. If domestic banks are to remain the safety valve of the sovereign bond market, it is fully rational for the markets' assessment of their solvency to be correlated to that of the sovereign. This in turn creates a major conduit for overreaction in times of economic stress and elevated risk aversion. If Italy and countries in similar high-debt situations reject the very idea of a bank balance sheet diversification, the logical implication will be for regulators in financially stronger countries to perpetuate or even intensify ring-fencing in order to protect their financial systems from the fallout of financial disorder across borders. That is exactly what policy architects in the EU have been trying to avoid since the crisis erupted in 2010.

Structural convergence and structural reforms

Finally, some commentators (especially Domenech et al., 2018, Dullien, 2018, and Wolff, 2018) have criticised the 7 + 7 report for what it does not address: boom-bust cycles, macroeconomic imbalances prior to the crisis, and the divergence in economic performance that resulted from it.

The authors of the report are certainly the last to deny that these are major issues for the sustainability of the euro area. But concerns about them should not prevent serious discussions about the policy system. Convergence is important, but by itself it cannot address flaws in the rules of the game or inherent vulnerabilities of the policy system. Both must be tackled.

Conclusion

The authors of the 7 + 7 report were aiming at breaking the deadlock in Franco-German discussions and at changing the broader policy conversation on euro area reform. It is fair to say that they had limited success on the first point. Some of their proposals certainly found their way to the Meseberg declaration. Their plea for an ambitious agreement that exploits the hidden complementarities between the 'French' and the 'German' agendas was at least heard. But the overall architecture of the official French-German compromise is quite different from the one proposed in their report. The logic put forward by the 7 + 7 was intellectually coherent but probably not palatable enough politically for officials from France and Germany to endorse it and build on it. As illustrated by some of the contributions prompted by the report, it also elicited several guarded or even negative reactions from other countries, especially Italy.

The 7 + 7 had more success with their second aim. As this survey illustrates – and despite uneven willingness to engage in the debate on the part of the various schools of thought – the tone of the discussion has changed in comparison to what it was a year ago when Emmanuel Macron's ideas started being discussed. Within the group of economists who participated in the endeavour, there is not a German position and a French position anymore. All the 7 + 7 stand by what they have proposed. Nobody can claim anymore that French and German economists behave as the prisoners of their respective national crisis narratives. This is not a minor achievement.

Furthermore, the report has served as a reference point for a much-broadened discussion among policymakers and academics. Through its questioning of the relevance of well-established quarrels – such as the dispute between the advocates or risk-reduction and the proponents of risk-sharing – and because it has put forward new options, it has helped to break the status quo bias that is so pervasive in European policy discussions and to clarify which ideas command wide consensus and which remain a matter for controversy. Some feel that the 7 + 7 proposals are insufficient, some that they have gone too far, some that they have taken the wrong direction. But such controversies are definitely useful.

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DINNER SPEECH
Europe and financial crises in the future

Natacha Valla[1]

At a time when the global environment is surrounded by renewed uncertainties, and as initiatives to construct a more robust architecture and governance for the European Monetary Union have stalled, it is useful to pause and take stock of the progress made to better understand "what is really missing" for Europe to become a safer place when the next financial crisis bursts.

My remarks will be divided into three parts, starting with a short historical benchmarking of the European crisis. Having done so, the paper will turn to the prospects of European Monetary Union moving forward, arguing that the achievements so far have been substantial for a still juvenile currency. Finally, the paper will close with thoughts about what it would take to make Europe a safe and resilient environment.

1. Financial crises: five lessons from history and four questions for Europe

Taking some distance from the mere facts that describe the economic and financial history of Europe over the past decade, let me zoom out and select five facts from history, which can be seen as relevant for the European context today. Narrowing down the lessons from history to a mere set of "five" is by definition a very subjective exercise. But that selection will point to the specific questions we, in Europe, need to ask ourselves at

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the current juncture.

A first fact that economic history has taught us is that sovereign default has been a fairly banal phenomenon for a long time. In previous centuries, it was not rare for a large number of countries to be in simultaneous default. In several occasions, 40% of sovereigns happened to be in default – 1840, 1889 and 1940 are examples at hand, which Carmen Reinhart and Rogoff describe in their works. Many of the countries that now qualify as "advanced economies" – France, Austria and the likes – and benefit from a favourable assessment of the state of their public finances by markets used to be serial defaulters and have "graduated" from default after a long learning process. This pervasiveness of sovereign defaults should help us put in perspective the notions of "safe assets", or "benchmark" for risk free debt instruments, about which parties tend to become very passionate when it comes to assessing Europe's financial situation.

A second lesson from history is that we have become better – or faster - at handling default. Again relying on the work of Carmen Reinhart, looking at the average length of sovereign crises, experience shows that over the period 1800 to 1945, there have been over about 120 countries in default and it took on average six years to sort the situation out. Over 1945 – 2006, the number of countries in default rose to close to 170, but the average length of a default episode falls to three years. Collectively, somehow, we have therefore become faster at handling (more) sovereign default.

All good. But there are mitigating factors that should be taken into account. A third lesson from history is that while the global economy learnt its way through managing default, the structure of financial interactions has changed in the meantime. Relative to the already quite dense network of financial interactions that developed over centuries, capital mobility has intensified substantially over many decades. And despite the – now well documented[2] – abrupt sudden stop in international capital flows that materialised in 2008, the gross international investment positions are today very large, as will be commented below.

Fourth historical observation: the understanding of financial crises by the economics profession has improved. Our understanding of the mechanisms by which sovereign currency or banking crises unfold are now clearer than in the past. But our ability to predict, ex ante, the timing of a crisis or its amplitude, remains limited. In their seminal work, Schularik and Taylor show that one can go a long way in detecting

2 See Bussière et al. (2018)

imbalances by looking at a parsimonious set of simple macroeconomic variables such as loan growth, loan to GDP ratios, and house prices. The dynamics of those variables turn out to be fairly solid predictors of crises. But turning points or bursting times remain to a large extent cryptic to forecasters.

Final lesson from history: short term costs of crises have often turned out to be very sizable. This explains why successful policy reactions to financial crises have been massive, and rightly so. It has not been rare to see a hit of 10 to 100% of GDP after a financial event. Likewise, the fiscal burden related to bank recapitalization by the public sector can amount to 40- 45% of GDP. Public debt levels also tend to surge as a result of crisis management measures – by so much as 15 to 80% of GDP. Finally, ratios of non-performing loans have at times climbed to up to 60% of GDP. Taken altogether, those short-term costs are still in collective minds today.

Those stylised facts raise very specific questions for Europe and its position within the international monetary system today:

- On sovereign debt: what do we collectively want to achieve? Do we want to reduce the probability of sovereign default episodes to occur in the future? Or to improve our ability to handle them once they occur? Or a little bit of both?
- On capital mobility: are we ready and willing to be more "hands on" when it comes to handle investment flows across borders? Is there a consensus view, today, about what would be an efficient cross-border allocation of savings within Europe? This question is important because it has implications on the way public policies react to the arithmetic of the balance of payments. For a very long time, trades dynamics was seen as the main driver of global imbalances, while developments "below the line" of the balance of payments, those that have to do with capital flows, were merely seen as a mirror image of their "above the line" current account counterparts. Today, however, our understanding of the network effects of financial flows is continuously improving as more data becomes available,[3] and policymakers have understood that the dynamics of economic integration across countries is as much a financial matter as a mere "trade" one.
- On loan and asset price dynamics: this is a candid question, but if the link between the behaviour of bank lending and asset prices,

3 See for example the work by Battiston or by Heipertz et al.

> and the occurrence of crises is as strong as the literature suggests, why does there seem to be a tendency nowadays to look through their (too?) strong growth rates in some jurisdictions? Recent studies by the OECD or the IMF vindicate this view.

To sum-up, the short-term cost of crises is very high and might have become politically unacceptable; countries may learn their way away from sovereign default over time, but this process is secular and current outstanding debt levels need to be kept in mind ; and the dynamics of those asset prices that happen to be informative about forthcoming financial disruptions are, in some places, preoccupying. So should it be concluded that everything should be made so as to avoid the next crisis, for example via a further, and more granular, tightening of financial regulation?

2. Stressing crisis prevention over crisis mitigation

The question as to whether priority should be given to crisis *prevention* over crisis *curation* is everything but rhetorical for Europe. Yet, the literature – for example the works of Rancière and Tornell - has shown that there might be a trade-off between risky and safe output growth so that the answer is not univocal. Comparing the growth of real per capita GDP in countries that have consistently displayed different approaches with regards to financial liberalisation, they find that countries that let their financial systems grow and develop in an unconstrained way fared on average better – looking at real GDP - than those that have imposed limits to financial and credit developments. India and Thailand are cases in point.

Another argument usually put forward in favour of financial liberalisation is that it tends to be accompanied by structural improvements in the legal system of a country, a deepening of its contractual environment, and in particular an improved enforceability of contracts. Seen that way, one may ask whether Europe should consider adopting a softer approach when it comes to sovereign debt, asset price and loan growth dynamics, and pressures on its banking sector.

Unfortunately there is something special about current historical circumstances in Europe that reduce the validity of this argument. First, it would very likely rule-out a repeat of the massive policy measures taken between 2008 and 2015. Today's initial conditions are not favourable: first, a generalised bail-out would not be politically supported. Second, the "reform return" usually stemming from the policy support proposed to crisis-hit countries in exchange for structural reform agendas to their economies had probably become quite low. A reform fatigue has spread across many countries in Europe. And third, the macroeconomic volatility associated with financial disruptions is detrimental to many, in particular as our democracies had failed to reassure their citizens that they would share the benefits of stronger but riskier growth and be protected by appropriate safety nets if needs be. So overall, the structural "returns to" financial crises are likely to be currently very thin. In fact their potential political implications are currently unambiguously dissuasive.

3. A stocktaking of progress, and a wishlist for, EMU

Let me turn to what could be a wishlist for the European Monetary Union moving forward. It has become a sad leitmotiv to restate the need for more economic policy coordination as long as economic convergence among EMU member states remains insufficient and given the absence of fiscal transfers that would prevail if EMU was also a political union.

But achievements should not be understated. Europe has just about recovered from the most severe financial and economic crisis over the past hundred years. Democracies still prevail, even if they are subject to preoccupying populistic movements. The euro is turning twenty: this is certainly a milestone worth celebrating. But in the scale of time needed to establish a new currency, twenty years are in fact very short: this calls for patience and clemency.

Banking Union and Capital Markets Union

Within a few years, European countries came up with very ambitious plans: they established a fairly advanced Banking Union, laid the ground for the Capital Markets Union, and the European Central Bank adapted its monetary policy framework and stance to very extreme economic and financial circumstances.

As always when progress is made, it can be done better, or faster. The Banking Union still lacks a solid backstop for its Single Resolution Fund. On this front, advances in the spring of 2018 have been encouraging. It also lacks an insurance scheme for retail deposits that would bar bank runs for good. On that front, political hurdles are higher. But does this mean that the current context is worse than before? A last, topical example relates to debt sustainability issues and the role of debt sustainability analysis in the European debate about risk sharing and risk reduction. It would be helpful to focus more on criteria rather than processes in that debate.

Regarding the Capital Markets Union, policymakers might have understood that its purpose lies way beyond technical and institutional set-ups: its stakes are in fact very deep and far reaching. By focusing on the fundamental aims of financial deepening, on the development of deep and liquid markets and on the prevalence of smooth and continuous supply and demand for asset classes that are indispensable for long term investors to allocate savings efficiently across geographies and intertemporally (this is the case for safe assets, green assets, and the financial instruments needed to securitise nonmarketable assets in general), CMU caters for the promotion of the euro as an international currency.

Achieving a capital markets union in Europe would lay down the necessary conditions for the euro to become and remain a leading international currency. The trajectory of the US dollar at the time it became a dominant currency globally offers interesting parallels. In their work, Eichengreen and Flandreau have looked at the development of the US dollar in the 1920s. Back then, the US currency followed a path very similar to the CMU agenda today, including initiatives to deepen markets, strengthen institutions and integrate infrastructure.

The European financial structure

Another dimension of integration very specific to Europe is the evolution of its financial structure. Very often, the differences between the relative strengths and weaknesses of financial ecosystems based predominantly on bank or on markets have been underlined. The mutation and expansion, even if mild and uneven, of market finance in Europe is a fact. The jury is still out, but there is evidence that the diversification of financing channels can become a factor of resilience in an environment where banks would become smaller but healthier.

Another manifestation of this structural shift in financial structures in Europe, and between Europe and the rest of the world, is the new anatomy of international capital flows. With the "sudden stop" in 2008, banks from Western Europe virtually disappeared from the map of cross-border investment flows, as suggested in the recent work of Bussière et al.

Non-bank financial institutions do matter more than before in the way Europe is financially intergrated with the rest of the world. Insurance companies, pension funds have gained space. They account for increasing shares of gross international investment positions, thereby being also more exposed to valuation effects. At the global level, investment volumes affected by those institutions are still relatively small, but make up for about 10% of total global financial investment. Another category of financial intermediaries, so called "other financial intermediaries", grow the fastest and currently represent investments of around USD100 trillion.

Where does this evolution leave Europe on the international financial scene? It certainly creates new potential risks that need to be monitored. Such entities do engage in maturity and liquidity transformation. Their leverage is sometimes significant. At the same time, a lot will depend on whether non-banks behave in a way that can compensate, and not amplify, the cyclical behaviour of bank funding and bank risk taking.

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PART I

A Look Back: Evaluating European Institutions' Crisis Management

OFFICIAL LENDING IN THE EURO AREA: A LOOK BACK[1]

Aitor Erce

Introduction

Until it was dragged into the resolution of the euro area sovereign debt crisis, the International Monetary Fund targeted solvent but illiquid sovereigns facing temporary international liquidity shortages. The Fund did this through three- to ten-year loans provided against a pre-agreed path of policy adjustment focused on fiscal, monetary and exchange rate measures.[2]

This lending approach, in place when Greece requested support in 2010, was the result of a process of adaptation driven by various waves of crises after trade and financial liberalization. As described in Schandler (2013), during the 1990s the IMF started to face crises characterized by sudden swings in capital flows. As a result, larger and more front-loaded loans were needed to stave off the crises than during earlier trade-related crises. This led the IMF to develop the exceptional access policy (EAP) and various front-loaded and precautionary instruments. As the EAP increased the Fund's risk exposure, more stringent conditions on

1 This chapter heavily draws on joint work with Giancarlo Corsetti and Timothy Uy. I thank Jose Bustamante, Gong Cheng, Antonio Fernandes, Mitu Gulati, Efstathios Sofos, Rolf Strauch, Vilem Valenta, Mark Walker and seminar participants at 2018 Banca d'Italia Fiscal Workshop and "Institutions and the Crisis" Conference (European University Institute) for useful comments. These are the author's views and not those of The European Stability Mechanism.

2 The work-horse IMF instruments for crisis resolution are the Stand-By Arrangement (SBA), and the Extended Fund Facility (EFF). The SBA aims to help countries addressing *short-term* balance of payments problems, while the EFF aims to help overcome *longer-term* problems. EFF implies up to four years of programme engagement (instead of three under the SBA) and long maturities (up to ten years compared to five years under the SBA).

the country's ability to repay were put in place (IMF, 2016a). Only if the IMF's debt sustainability analysis (DSA) showed that debt was sustainable with high probability could a country access the EAP. Otherwise, a debt restructuring was required. The Fund's involvement in the euro area -a monetary union of heavily financialized and interlinked economies, some of which had accumulated large imbalances- put this approach to the test. In the face of contagion fears if official support was not provided to Greece the Fund annexed a new clause (*systemic exemption*) to its exceptional access policy. While previously only countries passing the IMF's DSA could access it, with the new exemption the IMF could lend to sovereigns whose solvency was uncertain if their default could have systemic effects (IMF, 2016a).

In parallel, the euro area authorities took an incremental approach to fighting the crisis leading to the development of a permanent crisis resolution mechanism (Corsetti et al., 2017). The fact that different assistance vehicles were used in Cyprus, Spain, Ireland, Portugal and Greece shows the extent to which the approach evolved. While initial euro area official loans followed the IMF blueprint as the crises deepened lending vehicles and their terms were adjusted. As summarised in Table 1, this adjustment to the terms of support led to a significant departure from IMF standards.

This chapter describes the development of the euro area crisis resolution framework and uses its divergence from the IMF approach to gain insight into the effect of official loans on market access and debt sustainability. Armed with those insights the chapter discusses issues relevant for the design and implementation of sovereign bailouts.

The Development of the Euro Area Sovereign Safety Net

While there was prior experience of International Monetary Fund-European Union cooperation in funding sovereign bailouts through the medium-term financial assistance (Hungary, Latvia and Romania) such a route was not available for euro area countries.[3] Thus, when the Greek government first approached its euro area partners arguing about its difficult position the reaction was to impose on Greece a significant fiscal adjustment.

As this failed and the situation spun out of control, in March 2010,

3 Article 143 excluded euro area members from this facility and Article 125 prevented cross-country fiscal support (no- bail-out clause).

euro area governments agreed to provide, together with the IMF, a financial assistance program composed of IMF credit and bilateral loans by euro area countries (Greek Loan Facility, GLF) for a total of 110 billion euros.[4] The GLF, which contributed with 80 billion euros, included the following conditions. The maturity of the loan was 5 years with a 3-year grace period. The pricing of the loan followed IMF practice. For the first 3 years, the interest rate was set at 6-month euribor with a 300 basis points (bps) surcharge (100 bps above IMF surcharges). Thereafter, the cost increased by 100 bps. According to Pisani-Ferry et al. (2013), the higher interest rates (even if below market rates) were aimed at limiting moral hazard. From its side, the IMF contributed with a 30 billion euro *Stand-by-Agreement*, with a five-year maturity and the standard (at the time) 200 bps for credit 300% above the quota plus additional 100 bps for credit outstanding after 3 years.

Given the availability of resources at the European level, why was the participation of the IMF necessary? Pisani-Ferry et al. (2013) argues that recourse to the Fund was needed given the lack of expertise at the EU level. According to Jost and Seitz (2012) another motivation was the lack of confidence of some governments on the capacity of the European Commission (EC) to deal with the crisis without bending to political pressures. Taking part in the Greek program did not come free of charge for the IMF. In order for the Fund to provide the amount of resources requested by Greece it needed to resort to the exceptional access policy. But that required that Greek public debt was sustainable with a high probability. As discussed in IMF (2014), this was not the case. According to Schadler (2013), in the face of political pressures and the need to act swiftly to avoid an even bigger meltdown the IMF created an exemption (*systemic exemption*) allowing access to the EAP, even if debt was not sustainable with high likelihood, if the default could have systemic implications.

Unfortunately, despite the signing of the Greek program, Ireland and Portugal started to suffer market pressures. Faced with the need to provide additional official support the authorities reacted by creating jointly managed institutions. In May 2010, the European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF) were created. The EFSM was designed as an emergency funding program

4 The disbursement of the bilateral loans was decided by unanimity and subject to strict conditionality assessed by the European Commission and the European Central Bank, together with the IMF and the corresponding country authorities.

reliant upon funds raised on the financial markets by the European Commission using the budget of the European Union as collateral.[5] In turn, the EFSF was created as a temporary rescue mechanism for euro area countries.[6] The creation of these institutions changed the program's funding structure from direct bilateral loans to public guarantees on market financing. Beyond this difference, the Greek template was the one to be applied in EFSM/EFSF programs.

In December 2010, overburdened by the housing bubble burst and subsequent bailout of its banking system, Ireland became the first client of the new institutions. The Irish program provided a financing package of 85 billion euros. It included contributions by the EFSM (22.5 billion euros) and EFSF (17.7 billion euros, and bilateral loans from the UK, Sweden and Denmark (3.8 billion, 0.6 billion and 0.4 billion euros, respectively).[7] The maturity of the loan was set at 7.5 years and the spread at 294 bps. Additionally, Ireland signed an Extended Fund Facility (EFF) agreement with the IMF for 22.5 billion euros. A few months later, in April 2011, it was the turn of Portugal to request support. In this case the financing of the 78 billion euro program fell on equal parts on the EFSM, EFSF and IMF. The maturity was set to 7.5 years and the spread slightly above 200 bps (see Table 1). In turn, Portugal signed an EFF program with the IMF.

Confronted with a still worsening situation, in June 2011, the authorities agreed to set up a permanent institution to deal with crises within the euro area, the European Stability Mechanism (ESM), which would become operative by 2014.[8] It was also agreed to enable both the EFSF and ESM to provide loans for bank recapitalization, and to intervene directly in primary and secondary sovereign bond markets. The bank recapitalization facility, created to assist in the management of bank crises, focuses its conditionality on the financial sector. This

5 The EFSM can borrow up to €60 billion and on-lend the proceeds to the beneficiary country.

6 In order to build a sufficiently large firewall, euro area governments provided the EFSF with guarantees able to support a 440 billion euro lending capacity. Overcollateralization (165%) gave the EFSF a high rating, enabling cheap funding (a few bps over German bund).

7 The program also included an Irish contribution of 17.5 billion euros.

8 Within the ESM framework, country assessment and conditionality design is done by the EC, who acts, in liaison with the ECB, as an agent of the ESM. Also program negotiation remains an EC task that, whenever possible, should involve the IMF. To achieve this new policy regime, the Lisbon treaty was reformed to strengthen fiscal coordination and surveillance. One of these changes was the inclusion of collective action clauses in all new euro area sovereign bonds.

remarkable change in program design opened the door to official lending without IMF participation.

By then, despite the fact that the first program reviews spoke of "an impressive start", the situation in Greece took a turn for the worse.[9] The reaction was to provide additional support by lowering the interest on the loan and increasing maturities (June 2011). Despite these additional measures, it soon became clear that Greece would not manage without a contribution from its private-sector creditor base. In March 2012, Greece signed a second program with the EFSF and the IMF, which envisioned additional funding for 130 billion euros to be added to 34.5 billion euros of undisbursed funds from the GLF.[10] From the 130 billion euros, 19.8 billion came from a new EFF program with the IMF. The rest was provided by the EFSF with a 20-year maturity and 150 bps spread. Simultaneously, the GLF borrowing costs and maturities were changed to match those of the EFSF. The terms were softened again in December 2012.

Something similar happened with the Portuguese and Irish programs. While both programs remained on track, the actual performance fell short of expectations. According to Pisani-Ferry et al. (2013), the Irish under-performance was due to the effect on public debt of the bail-out of the banks' junior creditors. In Portugal, the program relied on the implementation of structural reforms which did not materialize.[11] In July 2011, both loans underwent significant reductions in interest and increases in maturities. The aim of these changes was to provide fiscal space and enhance the ownership of both programs. The euro area loans to Ireland and Portugal experienced a last 7-year maturity extension in late 2013.

As the fire spread to Spain and Italy, the authorities accelerated the inauguration of the ESM to October 2012, with 500 billion euro lending capacity supported by 700 billion euros in capital. Since its inauguration, it has delivered loans to Spain (July 2012), Cyprus (June 2013) and Greece (2015).[12] While the euro area framework could deviate substantially

9 According to Pisani-Ferry et al. (2013) the reasons for the set-back were: excessively optimistic economic projections, initial official indecision, weak program implementation and excessive stringency of initial funding conditions.

10 The new MoU asked for a debt restructuring and recognised the failure of the previous program to lift competitiveness.

11 The initial design failed to see the problems with implementing structural reforms, in a monetary union, during a crisis. In fact, the IMF's DSA showed that only structural reforms could stabilize Portugal's debt dynamics (Pisani-Ferry et al., 2013).

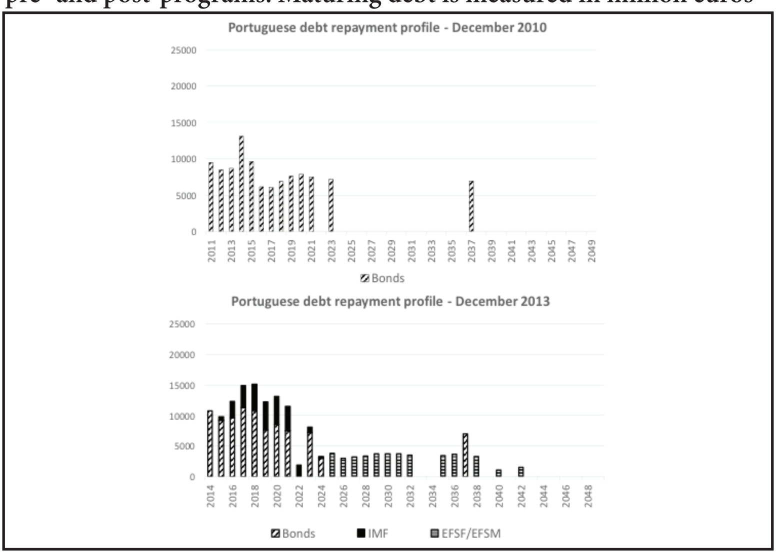
12 On June 2012, euro area governments agreed to provide financial assistance for Spain´s banking system through the EFSF until the ESM became available. Eventually, by the time an agreement was reached the ESM was operational.

from the IMF´s blueprint, the Cypriot template replicated previous programs, with ESM and IMF contributing with 9 billion and 1 billion euros, respectively. Still, as summarized in Table 1, the average maturity of the euro area loan to Cyprus was 15 years, with the final payments in 2030. Instead, the Spanish program was markedly different. By granting up to 100 billion euros for bank recapitalization in exchange for financial sector reform, the euro area proceeded with a bail-out without the IMF's financial involvement.[13]

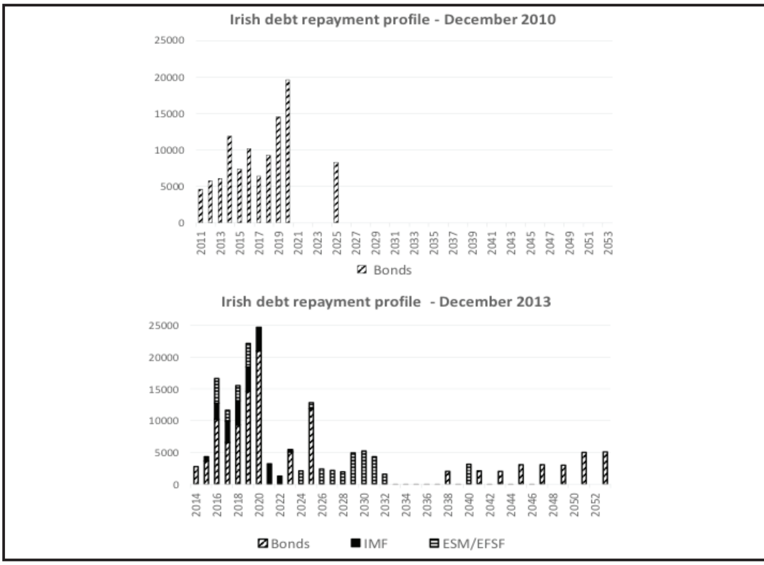
Shift in Paradigm: Key Differences in IMF-style and ESM-style Lending

As just described, a major difference between IMF and euro area official lending is the longer maturities applied by the latter. This approach significantly reduces roll-over needs of countries under support. Figure 1 exemplifies this effect using Irish and Portuguese debt repayment profiles both prior to the programs and once they had been implemented. The importance of euro area loans in smoothing debt redemptions, as debt stocks increased, is evident.

Figure 1. Managing Debt Repayment Flows: Redemption Profiles pre- and post-programs. Maturing debt is measured in million euros



13 Both loans featured small margins over borrowing costs (10 bps to Cyprus and 30 bps to Spain).



Sources: Corsetti, Erce & Uy (2017).

In addition to this divergence in lending terms, there were (at least) three other relevant departures from the IMF blueprint. First, motivated by the fear of spillovers the official sector moved beyond catalytic finance to lend into uncertain solvency in what Tirole (2015) defines as "self-interested solidarity". Second, traditional IMF conditionality includes adjustments to the exchange rate, managed through interest rates and foreign reserves. This framework was not applicable in the euro area where interest and exchange rates are out of the control of national central banks. As a result, conditionality focused on fiscal and structural measures. Finally, euro area bailouts can address bank crises, subject to conditionality focused on financial sector reform. The Spanish program exemplified how this change could put the euro area official lenders on a path of action out of reach for the IMF. As the program was designed to tackle structural problems in the banking system and conditionality focused on financial sector issues, the IMF could not co-finance the program.

The Effect of Repayment-Flow Management on Market Access

As the aim of the euro area approach is to manage repayment flows in order to minimize roll-over risks and reduce the likelihood of a disorderly default, in Corsetti et al. (2017) we call it *"repayment-flow management to smooth market access"*.

This approach has been criticised in the Greek case on the grounds that it failed to provide a final solution to the debt overhang (Eichengreen et al. 2018) and, by discouraging investment, further depressed growth (Marsh et al., 2016). Against this background, this section uses the July 2011 Eurogroup decision to extend the maturities of the EFSF/EFSM loans to Ireland by 7 years as a large-scale "experiment" and presents evidence that the terms of official loans can be effectively used to affect market access conditions.[14]

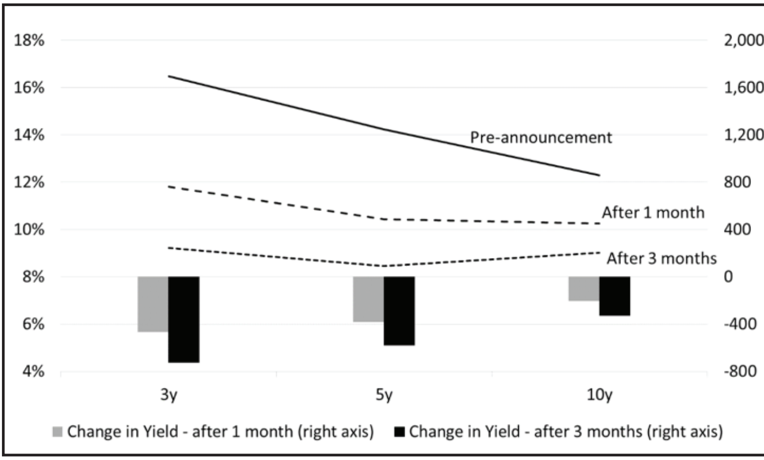
As the extension aimed to reduce refinancing risks in a window of seven years, one would expect default risk to recede more within that window. To assess whether repayment-flow management had a heterogeneous effect across maturities, I use data on sovereign yields (coming from Bloomberg) for three maturities: three, five and ten years.[15] To facilitate the description of the dynamics following the maturity extension, Figure 2 contains three snap-shots of the yield curve: one week before the extension, one month after, and three months after. In turn, Figure 3 show changes to market liquidity, as measured by bid-ask spreads (also from Bloomberg) three months after the event.

Before the July 2011 extension Ireland was facing substantial stress, the yield curve inverted and 3-year yields averaging 16.5%. Figure 2 shows that the announcement had a strong and long-lasting positive effect. Already after one month all yields had fallen. After three months all yields were further down and the yield curve had flattened out significantly.

14 The event analysis presented in this section is one of four that Corsetti et al (2017) contains. In Corsetti et al (2018) we do a related exercise using a quantitative model and the Portuguese experience.

15 An important caveat to our approach is that we do not control for other explanatory factors, especially monetary policy, which could also explain the dynamics. Comfortingly, no major ECB operation coincided with this window.

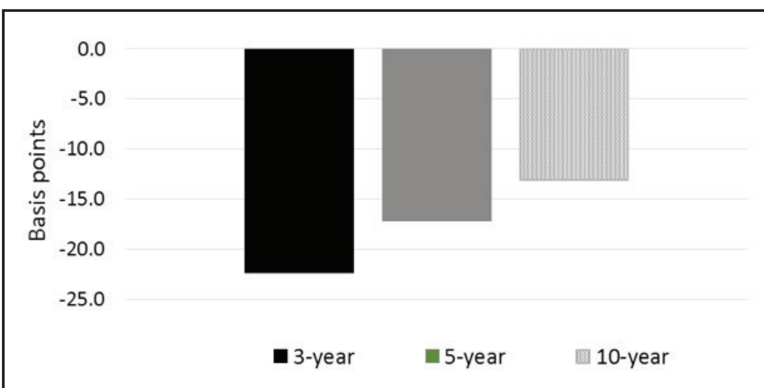
Figure 2. Yield Curve after Maturity Extension



Source: Bloomberg and European Stability Mechanism.

Market liquidity also improved. Figure 3 shows that bid-ask spreads narrowed for all maturities. Similar to the yields, the largest drops in bid-ask spreads occurred in the 3-year maturity, followed by the five and the ten-year ones.

Figure 3. Market Liquidity after Maturity Extension



Source: Bloomberg and European Stability Mechanism.

The maturities benefiting most from the extension were those below seven years, indicating that the measure provided the desired benefits. Remarkably, the effect extended beyond the seven-year window. As argued in Corsetti et al. (2017, 2018), this reduction in risk across-the-curve (and beyond the extension window) implies that default expectations and market access conditions are endogenous to the lending terms imposed by the official sector.

This important linkage between official lending and market access supports the argument that in giving its bailout funds flexibility to set the terms of official support the euro area equipped itself with additional room for manoeuvre, which adequately used can enhance program effectiveness.

Implications

This section discusses potential implications of the feedback from the terms of official lending into market access and default expectations just described on a number of aspects relevant to the design of official bail-outs.

Moral Hazard

Moral hazard is probably the major drawback invoked against the use of official support. As an insurance scheme it creates incentives not to undertake costly policies that can reduce default.[16] That concern explains why official lending is delivered against conditionality (IMF, 2014).

What about more concessional loan terms provided by the euro area? Do they worsen moral hazard? While repayment-flow management can be designed to affect investors' risk perception and smooth the transition back to market financing, Abraham et al. (2018) argues that more concessional lending reduces reform efforts. According to Marsh et al. (2016) this deters further investment. Relatedly, Corsetti et al. (2018) shows it can increase the risk of fundamental default, a form of moral hazard independent of adverse effects on effort. Instead, Mueller et al. (2016) argues that official sector flexibility increases ownership of the reforms.

This last argument may be most relevant to the euro area, where a

16 See Conesa and Kehoe (2016) or Abraham et al. (2018).

long boom fuelled by capital inflows and low rates led to the build-up of significant imbalances (Gourinchas and Rey, 2017). Whether the deep structural reforms carried out by program countries, such as Greece or Ireland, were discouraged or made easier by repayment-flow management is unclear. Most likely the answer is case-specific. This calls for further work on understanding the link between incentives to reform and the terms of official support.

Measurement of Debt Sustainability

For the IMF to provide large loans, public debt needs to be sustainable with high probability. This policy design puts the concept of sustainability at the core of the crisis resolution approach.

Following the failure of the first and second Greek programs, voices of discomfort emerged that debt sustainability was too focused on debt stocks and should also consider flow-related debt metrics.[17] The resulting debate triggered a change to the official debt sustainability analysis (IMF, 2013b). To limit rollover risk official debt sustainability analysis (DSA) now incorporates a threshold based on the so-called gross financing needs (GFN). If this threshold value is exceeded debt is not sustainable (Hagan et al 2017). GFN adds interest payments, maturing debt and primary deficits and is designed to capture the forthcoming financing needs of a country (Gabriele et al., 2017). Given the critical role of official lending in shaping refinancing needs, it is straightforward that debt sustainability needs to be assessed simultaneously with the availability and modalities of potential official loans.

One major drawback of repayment-flow management is that longer-horizon loans require forecasting macroeconomic dynamics even further in the future, increasing uncertainty and making it even harder to assess whether a debt stock is sustainable. Instead, the maturity of IMF lending operations requires focusing on sustainability up to one decade after the start of a programme, the time it usually takes countries to repay the IMF loan.

17 For example, according to the 2012 Eurogroup framework, reaching a debt-to-GDP ratio of 124% in 2020 and remaining below 110 percent of GDP in 2022 would ensure Greece's debt sustainability. See also Bassaneti et al. (2016).

Debt Restructuring

There is broad agreement that the international financial architecture places too much burden-sharing on the taxpayer (IMF, 2013c). A number of recent proposals try to correct this through changes to the framework that limit the extent of private-sector bail out via official loans and facilitate a smooth restructuring of privately-held sovereign debt.[18]

The feedback between market access conditions and the terms of official lending presented in this chapter informs the design of these proposals. One clear implication of this feedback is that proposals envisioning automatic restructuring, without considering whether official lending could make debt sustainable, may be sub-optimal and move the framework from "too little, too late" into "too much, too early".[19] An adequate framework embedding official lending and debt restructuring in market economies needs to recognize (and benefit from) the feedback from the terms of official support into market access conditions.

Solvency and Spillovers: A New Rationale for Official Lending?

As described in Hagan et al. (2017), IMF lending should be catalytic and only made available to solvent economies. The prospects of systemic fallout following a Greek default challenged this rationale. In the euro area, IMF lending was also used to prevent cross-border spillovers.

This was done through a "systemic exemption" clause added to the exceptional access policy. The ensuing debate crystallised in an internal evaluation in the use of this policy in the first Greek program (IMF 2013c). The negative evaluation of the experience led the IMF to eliminate the exemption in 2016. The exemption was replaced by a clause stipulating that IMF involvement in the financing of countries with an unsustainable debt burden (according to the Fund's DSA) could still be justified provided other official creditors commit to cover any funding gaps (IMF, 2016a).

Should the euro area follow suit and only lend against solvency? Or should systemic considerations remain a factor determining official lending? According to the rationale in Tirole (2015), for as long as

18 See Corsetti et al. (2015), Andritzky et al. (2016) or Benassy et al. (2018)

19 According to IMF (2014), calling a debt restructuring unnecessarily may have larger costs that solving the crisis through the usual combination of domestic adjustment and official support. Instead, according to Andritzky and Schumacher (forthcoming), the damage from mild restructuring operations can be very small.

strong financial linkages across euro area economies remain there will be incentives to use official lending to avoid the potentials spillovers from sovereign defaults ("self-interested solidarity").

Seniority

A contentious issue during the crisis was related to the payment ranking of creditors. Under the current set-up the IMF is senior to anyone else (Schlegl et al., 2015). The IMF's rationale for claiming seniority relates to debtor-in-possession (Diaz-Cassou and Erce, 2011). According to this logic, the financing provided by the IMF will increase debtors' ability to repay, benefiting all pre-existing creditors. In exchange for this, the Fund claims seniority. Still, as discussed in Schadler (2014), it is not infrequent that if an IMF program fails new funding is made available to refinance the official loans.[20] Similar reasoning applies to the ESM, next in the creditors' pecking order.[21] Remarkably, the ESM waived its seniority on the Spanish program. One driver of this decision was the fear of an adverse market reaction. According to Gros (2010) and Ghezzi (2012), the euro area experience proved that private sector subordination can have perverse effects when markets are not certain about the success of the program. As the proportion of liabilities held by the official sector increases, a lack of program success effectively dilutes private creditors and may undermine market access.

One implication of the feedback between the terms of official lending and market expectations discussed in this chapter is that official creditors willingness to backload the repayment of their loans -effectively counteracting the debt dilution effect of official seniority- may result in an increase in the perceived likelihood of repayment (see also Hatchondo et al., 2016).

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20 Such "inherited-program" problem can impair the IMF's catalytic role and limit its impartial role (Simpson, 2006).

21 The EFSF, EFSM, private creditors and bondholders all share seniority status. In the context of the OMT, the ECB said it would be pari-passu. Still, during the Greek debt restructuring ECB holdings were spared from the restructuring exercise (Gulati et al. 2013).

Coordination within the Global Safety Net

The international monetary system is composed of a plethora of regional and multilateral organisations tasked with guaranteeing financial stability.[22] Globalisation has increased the need for coordination across the various layers of the official safety net and global and regional lenders need to adjust to it.[23] According to IMF (2016b), regional lenders may bring in-depth regional knowledge, better tailored instruments, enhance legitimacy and have stronger incentives to avoid spillovers. In turn, the IMF and other multilaterals may be better equipped for systemic crises and, through their broader representation, suffer less political pressure.

The insights regarding the effect of the terms of official lending on market access conditions presented before imply that multilateral and regional official lenders could reconsider their co-operation models. When the loan structure is rigidly front-loaded, repayments may kick in exactly when a country is trying to re-enter the market -see the experience of Greece during the summer of 2016 when bond repayments became due in tandem with IMF loan repayments. In order to avoid such episodes, official lenders need to work out efficient ways to coordinate repayment-flow structures while considering the goals and degrees of seniority of each lender.

Conclusions

The virulence of the euro area crisis forced the authorities to design new policies and institutions without much time for reflection. The need to re-adjust policy frameworks is well illustrated by the development of tools and mechanisms for the provision of official lending. In this corner of the policy toolkit, the euro area started the crisis in an institutional void, with no tool or procedures beyond pre-existing IMF loans. As the crisis grew worse, the authorities moved from bilateral loans to the creation of a permanent crisis management institution.

This chapter has read the evolution of the lending vehicles used to provide official support as an experiment and extracted lessons regarding the relation between the terms of official lending and market access. The extent to which official programmes are successful in restoring growth and market access depend critically on the terms of the support. The

22 See Cheng (2017) for an overview.

23 See G-20 (2016) or ESM (2017).

evidence points to potential efficiency gains for the official sector from better understanding how the management of repayment-flows impacts market access, incentives for structural reforms and stabilisation policies and, therefore, affects debt sustainability.

In addition, the euro area experience has redefined the goals of official lending. While the traditional approach builds on the idea of catalytic finance, the recent experience -where large amounts of lending have been provided to countries which did not pass the debt sustainability analysis but were considered systemic- suggests additional grounds to motivate official lending. Preventing cross-border spillovers from default in one country motivates forms of self-interested solidarity, which work more effectively through policy coordination.

Closely connected, the "co-operation despite divergence" by the euro area lenders and the International Monetary Fund holds lessons for official operations in a world where the interaction between regional and global safety nets is set to increase. The insights from the euro area crisis imply that multilateral and regional official lenders could design efficient ways to coordinate the loans' repayment flow structures, while considering their mandates and degrees of seniority.

Table 1. Official Support in the Euro Area

		European Official Support			
		Vehicle	**Program Duration**	**Size**	**Loan Maturity**
Greece	May-10	GLF	3 years	80 bill	5 years (+3 grace period
	June-2011	GLF			10 years
	March-2012	GLF			20 years
	March-2012	EFSF	3.5 years	144.7 bill	20 years
	December-2012	EFSF			30 years (+10 grace perio
	December-2012	GLF			30 years (+10 grace perio
Ireland	December-2010	EFSM	3 years	22.5 bill	7.5 years
	December-2010	EFSF	3 years	17.7 bill	7.5 years
	July-2011	EFSF/EFSM			15 years
	June-2013	EFSF/EFSM			22 years
Portugal	May-2011	EFSM	3 year	26 bill	7.5 years
	May-2011	EFSF	3 year	26 bill	7.5 years
	July-2011	EFSF/EFSM			15 years
	June-2013	EFSF/EFSM			22 years
Spain	Nov-12	ESM	2 years	100 bill**	12.5 years
Cyprus	May-13	ESM	3 years	9 bill	15 years

Sources: International Monetary Fund, European Commission, European Financial Stability Facility (EFSF) and European Stability Mechan the EFSM loans the reference rate is the EU funding costs, for the EFSF the EFSF's cost of funding and for the GLF the 6 month Euribor. ** commitment fee and deferred interest payments for 10 years.

		International Monetary Fund Support				
	Spread over reference rate[1]	Program Type	Program duration	Size	Loan Maturity	Spread over 3-month SDR
)	300-400 bps	SBA*	3 years	30 bill	3 years	200-300 bps
	200-300 bps					
	150 bps					
	150 bps	EFF	4 years	28 bill	8 years	200-300 bps
d)	0 bps					
d)	50 bps					
	250 bps					
	250 bps	EFF	4 years	22.5 bill	8 years	200-300 bps
	0 bps					
	215 bps					
	210 bps	EFF	4years	26 bill	5 years	200-300 bps
	0 bps					
	30 bps	-	-	-	-	-
	10 bps	EFF	4 years	1 bill	4 years	200-300 bps

ism (ESM). EFSM stands for the European Financial Stability Mechanism. * The SBA program was replaced by the susequent EFF. [1] For
' Only 41.3 billion were actually disbursed. *** On December 2021, the EFSF waived Greece the payment of the guarantee

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REGULATORY INTEGRATION AND POLITICAL SUBORDINATION[1]

Tuomas Saarenheimo

The euro crisis changed European economic policy landscape. Within a span of only a couple of years, there was a flurry of new legislation, with the aim of "strengthening" the European economic governance framework. The reforms touched nearly all areas of economic policy. The European Semester was born, and the six-pack and two-pack legislative packages together with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the Fiscal Compact) provided it with substantive content. In parallel, the Banking Union centralised the responsibility for supervising and regulating significant banks.

With a few years of experience of operating the new framework, one can now make two observations. First, it is fair to say that, as is often the case when matters are fixed in a great hurry, the implementation of the reforms has not been without difficulties. While some parts of the new framework have worked more or less as planned, in others enforcement seems to be falling chronically short of expectations. But second, and more fundamentally, as I will argue below, these changes have taken the direction and content of EU integration into a new and qualitatively different territory, with novel challenges that the Union has found difficult to navigate. I will argue that there is a link between these two observations. What worked and what did not was largely predictable and depended on the type of responsibilities that the EU institutions were tasked with. To make EMU integration sustainable, it is important to learn from these experiences.

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1 This presentation draws on the following two articles: Leino P. and Saarenheimo T. (2017), "Sovereignty and Subordination: On the Limits of EU Economic Policy Co-ordination", European Law Review, issue 2, 2017; Leino P. and Saarenheimo T. (2018), "Fiscal Union for EMU – Managing Incompleteness", European Law Review, forthcoming.

The EU regulatory state

Let us start from the reforms that worked. Most observers would probably agree that, by and large, the Banking Union has got to a good start. It is true that the Europe-wide Comprehensive Assessment of bank balance sheets in 2014 may not have become the hoped-for watershed moment in the transition from the old, fragile national banking systems to a new, well-capitalised European one. Likewise, some recent cases of dealing with failing banks may have taught us more about the remaining gaps and loopholes in the European regulatory architecture than about the architecture itself. But dealing with the mountain of legacy problems in European banking was always going to be difficult and involve unpleasant trade-offs. In the end, legislation has been followed and, even when executive choices have provoked debate, they have fallen within a reasonable scope of administrative discretion. While work remains to be done, what we have now is a European banking sector that, by any standard, is much stronger and more consistently supervised than the old one. Likewise, the European System of Financial Supervision, and particularly its three microprudential supervisory agencies (EBA, ESMA, EIOPA), have contributed to a much more coherent and uniform supervisory rulebook across Europe.

What needs to be pointed out here is this: these developments are essentially a continuation of Europe's traditional integrationist project, building on a "regulatory state", as Giandomenico Majone called it in the 1990s.[2] By this term, Majone referred to the process of replacing public ownership, planning and dirigiste policies by privatization of economic activity and delegation of its regulation to non-elected expert bodies. In the glory days of EU integration, from around the Single European Act to early 2000s, this is where the focus of action was. It is in those years that the Commission's DG Competition became the competition authority, and the European agency apparatus, including Environment, Medicine, Food Safety and, a little later, Chemical agencies, were established. Even the single monetary policy can be considered belonging in this category.

These were all tasks for which there are good reasons to treat them as regulatory and suitable for delegation to executive agencies (in the case of monetary policy, an independent central bank). By and large, before assigned to EU agencies, these tasks were already delegated to

2 Majone G. (2007) The rise of the regulatory state in Europe, West European Politics, 17:3, 77-101, DOI: 10.1080/01402389408425031

technocrats at the Member-State level. In countries outside of the EU, they still are. Within the Single Market, it made a great deal of sense to bring those tasks to the European level. There was no qualitative difference: technocrats continued in charge, only now acting in EU level bodies. The obvious benefit was that, instead of performing their tasks in a nationally fragmented manner, they operated consistently throughout the Union, ensuring level playing field, better competition and substantial benefits to the European economy. So far so good.

Crossing the boundary to the political

Many other measures the EU took in response to the crisis were of a different nature. Pressed on by the impeding risk of a euro breakdown, the need to impress markets by a decisive response, and by the widespread perception that the crisis was rooted in failures of national economic policies, the EU essentially took upon itself the task of preventing national economic policy mistakes.[3] The regulatory, technocratic approach as such did not change, but its subject matter did. While continuing to centralise regulatory functions, the EU regulatory state also entered the space of the Member States' national decision-making in areas that fall under the competence of their democratic institutions.

In this way, the EU extended the regulatory mode of integration into areas that were far beyond the traditional boundaries of administrative tasks delegated to technocratic experts. The EU's regulatory presence started to expand deeper into political issues, with the Commission as the technocratic agency, with the aim of guiding Member States towards better economic policies. It is not clear how many of those involved realised at that time that a fundamental boundary was being crossed, with substantial implications. Some did, including Majone,[4] but many probably did not. There is little evidence that this viewpoint was widely debated or even recognised in the discussions leading to the adoption of the relevant legislation.

Many tasks allocated to the Commission under the new Economic governance framework adopted from 2011 onwards fall into this category. On the fiscal policy side, the Stability and Growth Pact had already existed since the 1990s, but the six-pack made it much wider and denser. On

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3 This issue has been examined in more depth in Leino and Saarenheimo, 2017.

4 Majone, G. (2014), From regulatory state to a democratic default. J Common Mark Stud, 52: 1216-1223. doi:10.1111/jcms.12190

the side of macroeconomic policies, the loose obligation to co-ordinate macroeconomic policies was sharpened into the Macroeconomic Imbalances Procedure and Country-Specific Recommendations, with few limits to their scope of application. The European semester was born and new types of sanctions were introduced, either through direct fines or through links to EU funds. This process seems destined to continue. The Five Presidents' Report foresees a process of "binding structural convergence", which would expand EU intervention to a wide range of matters falling under national competence such as labour market regulation and social policies.[5]

The first thing to note is that, unlike in enforcing fiscal discipline, where the Treaties give the EU clearly circumscribed powers to address excessive deficits, the EU has little legal competence in matters of economic policies. The Treaties leave fiscal stabilisation as well as macroeconomic and structural policies squarely to the Member States. The EU has the power to coordinate and to issue recommendations, which, under Article 288 TFEU, are non-binding. While legally speaking these are weak powers, the fact is that today these powers are exercised with the threat of substantial financial sanctions attached. This demonstrates how the Union has already managed to stretch its powers remarkably far. But even more importantly, the type of regulatory control exercised through the SGP, the MIP and the CSRs is very different from the traditional regulatory integration model. It is not about transferring executive powers from national agencies to European ones. It is about bringing deeply political national decisions under centralised control by the EU institutions.

Before proceeding, it needs to be recognised that the distinction between the 'technical' and the 'political' is not always clear. The line between those public powers that are fundamentally political and belong to elected officials and those that can be de-politicised and delegated to technocratic agencies is subject to debate and can change over time. The broad trend seems to be towards de-politicisation; many policy fields where political decision-making used to be the norm are today commonly delegated. Monetary policy provides the perfect example of this. In the early part of the 20th century, monetary policy used to be, to varying degrees and with some notable exceptions, under political control. During the latter half of century, central banks gradually gained

5 https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf

greater independence, a process accelerated by the 1970s stagflation and, during the 1980s, a growing body of academic literature demonstrating the benefits of independent monetary policy guided by a mandate centred on price stability. By the end of the 1980s, the de-politicisation of monetary policy was largely complete throughout the Western world. This was an important precondition for the creation of the common monetary policy in the EU. It is difficult to imagine that an agreement on EMU would have been possible as long as monetary policy was still under party political control at the national level.

To be suitable for technocratic delegation, a public function needs to be such that it can be confined within a reasonably well-defined legislated mandate.[6] Executive agencies can and regularly do deal with trade-offs, but those should be technical in nature – such as the one between economic or therapeutic value and safety considerations in health, medical or chemical regulation – and not involve significant value judgments. Another relevant viewpoint to drawing the line between the regulatory and the political is electoral salience. Issues that tend to mobilise people politically and feature prominently in political parties' electoral programs are, almost by definition, political, and poorly suited for delegation. In contrast, issues that are suitable for being treated as regulatory, are less likely to reach public consciousness and become politically divisive.

Against these metrics, fiscal, labour market and social policies are clearly located at the highly political end of the spectrum. They contain trade-offs that necessitate fundamental value judgments, and they feature high on political agendas. They are essentially what electoral platforms are made of, the very heart of political contestation and democratic choice. In any society that we would call democratic, they are for elected officials with a political mandate to decide.

Technocratic steering for political decisions

The above arguments have hopefully established that, with its economic governance framework, the Union has entered into an endeavour that is qualitatively different from its traditional model of regulatory integration. But to appreciate the full implications of this endeavour, it is important

6 See, for example, Leino, P. (2017): "Accountability dilemmas of regulating financial markets through the European supervisory agencies." In C. Harlow, G. Della Cananea and P. Leino (eds), Research handbook on EU administrative law, Chelteham ; Northampton : Edward Elgar, 2017, Research handbooks in European law series, pp. 209-240.

to understand that there are two distinct dimensions to the process. The first dimension is geographic; the centralisation of certain public powers from the national level to the Union. The second dimension is technocratisation; the attempt to correct the perceived failings of (national) political decision-making by subjecting it to technocratic controls.

The european economic governance framework is, indeed, a deeply technocratic exercise, run by career civil servants. Application of the complex rules of the Stability and Growth Pact, the In-Depth Surveys underlying the MIP assessments, and the Country-Specific Recommendations are all prepared primarily by mid-level Commission staff, aided by technocratic committees of Member State experts. Under the Reverse Qualified Majority voting rules, established as part of the six pack, Commission proposals, once cleared by the Commission College, are eventually sent to the Council to be rubber stamped, for example the Fisheries Council as an A-item, without any substantive discussion. This is executive decision making and therefore European Parliament is not involved, apart from the highly theoretical prospect of calling the Commission as a whole into account.

In a sense, the most political stage of the process may actually be the one that takes place within the College of Commissioners, which adopts each Commission proposal. Whether it is right to call the Commission political is an interesting point of debate. On the one hand, by proclamation of its President, the self-identity of the present Commission is clearly political.[7] On the other hand, the traditional ethos of the Commission is one of a technocratic, non-political "guardian of the Treaties". What is clear is that a mere proclamation by its President to be political does not create the checks and balances and accountability structures that constitute an integral part of proper political decision-making.[8] The institutional reforms introduced by the Lisbon Treaty and intended to tighten the ties

7 "The Commission is political. And I want it to be more political. Indeed, it will be highly political." J.-C. Juncker, "A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change Political Guidelines for the next European Commission", Opening Statement in the European Parliament Plenary Session Candidate for President of the European Commission (Strasbourg, 15 July 2014), p.16.

8 Leino, P. and Saarenheimo, T. (2018), Discretion, Economic Governance and the (New) Political Commission. In J. Mendes (ed), Executive Discretion and the Limits of Law. Oxford University Press, forthcoming.

between the Parliament and the Commission help little in this respect.[9] A further question is the extent to which the European Parliament is the appropriate accountability forum for decision-making that is directed at the Member States on matters that fall under their national competence.

Regardless of the nature of the Commission College, the reality is that the EU economic governance framework is largely run by technocrats, and there really is no other way to do it. The task is just too complex, its dimensionality far too large for democratic bodies to handle. At the level of a nation state, the government and the parliament only deal with policy questions of a single country, their own. Even at the level of a single country, economic policy assessments tend to be complicated, with multiple interconnections and feedback loops, and there are limits to the level of sophistication which the ministers and members of the parliament can be expected to develop on them. But generally, the national political institutions can be relied on to acquire a sufficient level of understanding on key economic issues in their own country. This enables them to debate the issues, consult with stakeholders, decide, and communicate the issues to the media. The media can generally be relied to report the issues to the public, and the voters, if they are so minded, have the means to keep track of the decisions and hold their elected officials accountable. They frequently do so, since this is the stuff that national elections are made of.

When moving from the national policy sphere to the EU economic governance framework, one needs to multiply the dimensionality by 28 (soon 27). The identified sources of macroeconomic imbalances or the content of the Country-Specific Recommendations are indeed country specific - they differ from country to country. Forming an informed view on the merits of each recommendation requires a comprehensive, systemic understanding of and interconnections between the economic structures in that country. For 28 countries, the dimensionality of the task would surely overwhelm the capabilities of any elected body. There simply is no conceivable way for an elected body to scrutinise and debate each separate set of country-specific instructions in an informed manner. In reality, it does not matter whether those instructions are sent for approval to the Ecofin Council of the Agricultural Council; the Finance Ministers are no more likely to rise to the challenge than the Agricultural Ministers.

9 For the close linkages between the Commission and the Parliament, see Article 17(7) and 17(8) TEU, and their interinstitutional framework agreement (IIA, 2010) and the 'special partnership' it aims to develop [2010] OJ L304/47.

But even if an elected body could be created with the superhuman abilities to match the task, the outcome would still not be proper democratic accountability at the European level, because many other prerequisites would still be missing. There still would be no true European political party organisations to formulate consistent political platforms throughout the Union for the voters. There would still be very little in terms of European civil society organisations. There would still be no real European media to communicate decisions to the voters. And, with the present convoluted EU decision-making mechanisms, there would be no feasible way for the voters to figure out who exactly was responsible for the decisions and factor it in their voting behaviour in the European elections. In sum, if these tasks are indeed increasingly transferred to the EU level, the country-specific, tailored approach incorporated in the European economic governance framework, coupled with the shortcomings of European political integration, means that the framework can only be operated by technocratic bodies, outside of proper democratic accountability.

So, in contrast to the traditional regulatory integration, where power was transferred from national technocrats to European technocrats, the Economic Governance framework represents a different kind of transfer of public power: from national democratic, political institutions to European technocratic bodies. The political space in which national elections operate shrinks without a counterbalancing increase in political space at the European level. The result is a net reduction of democratic choice.

Enforcement blues

To be more precise, the result would be a net reduction of democratic choice, if the framework were to be enforced. In practice, this has not been the case. Instead, EU institutions have found it difficult to make effective use of their increased powers to regulate Member States' fiscal and economic policies. Almost everyone – academic observers,[10] the

10 Bofinger P., "The Way Forward: Coping with the Insolvency Risk of Member States and Giving Teeth to the European Semester" in How to Fix Europe's Monetary Union (2016); C. Claeys, Z. Darwas and Á. Leandro: "A proposal to revive the European fiscal framework", Bruegel Policy Contribution 2016/07 (2016).

ECB,[11] the European Court of Auditors[12] – agrees that the fiscal rules have been enforced unevenly, at best. The sanctions related to the Excessive Imbalances Procedure have never been used. And the macroeconomic conditionality in the EU budget has proved to be largely a dead letter. I would argue that these difficulties were foreseeable.

Trying to limit political choices of sovereign nations, for example to get a Member State to correct its fiscal deficit or to implement an important structural reform, is not a simple matter. The reason why Member States find fiscal consolidation or structural reforms difficult in the first place is that they tend to be unpopular among the electorate. Even if the government managed to muster the political will to push through the unpopular reforms, the price is often lost elections and reversal of the reforms by the next government. Jean-Claude Juncker phrased it ten years ago: "We all know what to do, but we don't know how to get re-elected once we have done it."[13]

In such politically loaded matters, any interference by the EU tends to be highly visible in the Member State, and anything that looks heavy-handedness usually gets bad press. Almost invariably, there are political forces standing ready to capitalise on the situation. Anti-EU narratives will be ready to present the EU as the perpetrator, captive to neoliberal interests or a religion of austerity, the sitting government as a gutless collaborator, unwilling to stand up for its sovereign rights, and the Member State citizens as victims. The risk is an electoral response of the kind that Brussels considers unhelpful.

As the EU institutions do not wish to make themselves the champions of eurosceptic platforms, they have adapted. Instead of blind enforcement of rules, the economic governance framework has evolved into what it is today: a discursive, context-sensitive process, which tries to coach countries towards sensible policies, all the while taking good care not to overdo it, not to damage the good guys or help the bad guys.[14] This was the case when Italy, heading for elections, received lenient treatment under the SGP in late 2017. It was also the case in 2016 with Spain and Portugal, two seriously austerity-fatigued countries, when the EU

11 See speech by Mario Draghi, Frankfurt am Main (16 March 2015), http://www.ecb.europa.eu/press/key/date/2015/html/sp150316.en.html.

12 European Court of Auditors (2016), "Further improvements needed to ensure effective implementation of the excessive deficit procedure", Special Report No.010/2016.

13 The Economist (2007), "The Quest for Prosperity", March 15th

14 In his 2016 State of the Union speech, President Juncker assured that the Commission "… will continue to apply the pact not in a dogmatic manner, but with common sense and with the flexibility that we wisely built into the rules." http://europa.eu/rapid/attachment/SPEECH-16-3043/en/SOTEU%20brochure%20EN.pdf

decided to cancel their fines under the SGP. And it was definitely the case with France in 2015, when it was allowed, once again, to miss its deadline for correcting its excessive deficit, "because it is France", as explained by President Juncker.[15]

This is not to say that the process is without value. On the contrary, in many cases the discourse can be a helpful input to domestic political debate. Further, the signals emanating from Brussels carry authority and can be an important focal point for bond market participants. This, in turn, strengthens Member States' incentives to do what they can to receive a clean bill of health from the EU. From the broad perspective of nurturing a political environment that supports responsible fiscal and economic policies, the reasons for flexibility were, in each of the cases mentioned above, logical. Still, it is decidedly not the rules-based, mechanistically-enforced system that some had in mind. One could also argue that there is something disturbing in the thought that the EU administers its economic governance framework, at least in part, to promote certain outcomes in national elections.

What is the alternative?

I would argue that the biggest risk to EMU long-term stability is not economic or financial, but political. The risk is we end up creating an economic governance system that, even if benevolent in its intentions, ends up removing ownership of policies from the Member States and deprives their citizens a meaningful voice in them. When key building blocks of political platforms are removed from the national political space and outsourced to Brussels, there can be all kinds of undesirable consequences. Apart from voter apathy, there is a high risk of discontent and an anti-EU backlash.

A better choice, I think, would be to build the EU *and* the Euro Area on the basis of the principles of subsidiarity and conferral. The EU can advise and assist Member States in formulating their economic policies, but ultimately it needs to respect their sovereignty in policy areas that belong to their legal competence. It should be understood and accepted that the EU has neither the legal powers nor the legitimacy to prevent Member States from making policy mistakes.

15 "EU gives budget leeway to France 'because it is France'—Juncker" Reuters, 31 May 2016, http://uk.reuters.com/article/uk-eu-deficit-france-idUKKCN0YM1N0 [Accessed 14 February 2017].

Once one abandons the goal of preventing Member States' policy mistakes, it follows that one needs to concentrate on reducing the cross-country externalities from those mistakes. Private risk sharing, through the Banking Union and the Capital Markets Union, will need to work much better. This is technically demanding, but there is nothing fundamentally impossible there. It is essentially continuation of the regulatory integration model that has been thoroughly tested and found to work.

If there are some policy fields that are just too risky to leave to the Member States, then the EU should not try to centralise them through the backdoor of coordination. Instead, it should centralise them openly, by changing the Treaties and shifting legal competences to the EU, as it did with the Common Agricultural Policy. Instead of the EU tailoring reform programs for each Member State - which bear some resemblance with IMF programs – the EU would be legislating unified policies for the EU (or the Euro area) as a whole and for all its citizens. In other words, it would follow the traditional federal route. The European Parliament would play a central role in the substantive content of policies, instead of just co-legislating the bureaucratic procedures for technocratic decision-making, as is the case with the coordination-based approach. This would provide EU citizens at least some chance to keep decision-makers democratically accountable.

It is perfectly understood that recreating at the EU level the mechanisms of democratic accountability that we take for granted at the national level will be, for reasons described above, slow and difficult. It can only be a process of evolutionary nature, rather than a one-off reform, and any results will come far too late to be a solution to the immediate concerns of the Eurozone. Yet, the federalist model is far better suited to support the development of proper mechanisms of democratic accountability than an economic governance framework based on coordination and supported by financial sticks and carrots. It presents a clear division of responsibilities, raises the visibility and stakes of European elections, and thereby nurtures gradual politicisation of European decision-making. Even then, the realistic time frame is likely to be very long.

I am aware that calling for a Treaty change and federalist solutions will be seen by some as so long-term as to be obstructive. But it is not my intention to be obstructive. These are big issues, and they touch the very core of our democratic systems. I do not think we should use shortcuts in dealing them. Some things are simply too important to be rushed.

THE EUROPEAN COURT OF AUDITORS AND THE EU'S DEVELOPING ECONOMIC AND FINANCIAL ARCHITECTURE

Baudilio Tomé Muguruza

The ECA: responding to the financial crisis

Since the global financial crisis and the ensuing sovereign debt crisis, the EU has devoted considerable time and resources into reacting to the immediate effects and building a new framework to stave off future problems. The challenge for the European Court of Auditors (ECA) has been to keep pace with the myriad responses and developments. Considering the amounts that have already been committed and the changes to the EU's financial architecture, it is vital that we carefully assess the measures taken to date, and devise new ways in which to carry out our duty as the guardians of the EU's finances to help Europe be better prepared the next time problems occur in the financial sector.

The financial crisis "swept across EU Member States in waves, first affecting the non-euro area countries in 2008-2009 and later spreading to the euro area itself".[1] The first wave, affecting non-euro area countries led to Hungary, Latvia and Romania seeking assistance from the EU's balance of payments mechanism and the IMF. The second caused sovereign bond ratings to decrease and interest to increase, meaning Greece applied for financial assistance in 2010, followed later by Ireland, Portugal and others.

1 ECA (2015) "Financial assistance provided to countries in difficulties", *ECA Special Report no.18/2015*, p7

European policymakers had to react to resolve the crisis with both urgent and extraordinary measures, and reforms for longer-term restructuring of Europe's financial and economic governance frameworks. The EU's response can be grouped into four clusters: the new supervisory and regulatory authorities; the monitoring role of the Commission; the financial and technical assistance provided to countries in difficulty; and the establishment of the Banking Union.

The ECA, acting as the external auditor of the EU, did not ignore these developments. This meant new challenges for public audit. To begin with, the Court addressed the myriad developments in the field by producing a position paper on the topic in 2011. The paper highlighted an important link between the unfolding EU-level response to the financial crisis and the important implications for the use of public funds in the EU. Meanwhile a wider debate was taking place, and a resolution by the Contact Committee of Supreme Audit Institutions (SAIs) of the EU outlined concerns and informed all EU SAIs of their respective roles.

At the same time, the Court was also reviewing its own strategic outlook. In order to better understand the changing audit environment and how to adapt to it, the ECA published a paper[2] in 2014 seeking to reflect on the developments and highlight the issue of accountability. Alongside setting out six elements for a strong accountability and audit chain[3], the ECA also identified a number of challenges to accountability at the EU level. These included the EU's then rapidly changing institutional set-up, which contained different audit arrangements for different institutions and bodies. An example of this is the European Central Bank (ECB). Since the financial crisis, the ECB has been afforded more responsibilities due to its special position and expertise. However, while the ECA has a mandate to audit the ECB's operational efficiency, not all of these functions have been subject to external audit. This led to the ECA's suggestion that, "differences in accounting, audit and discharge arrangements may lead to disproportionate levels of scrutiny, gaps and

2 ECA (2014) "Gaps, overlaps and challenges: a landscape review of EU accountability and public audit arrangements"

3 Six elements for a strong accountability and audit chain: a clear definition of roles and responsibilities; management assurance about the achievement of policy objectives; full democratic oversight; existence of feedback loops to allow for improvements; strong mandate for independent external audit; and the implementation of audit recommendations and follow-up (ECA (2014) "Gaps, overlaps and challenges" p6).

overlaps".[4]

It was thus decided in 2013 to establish a specialised project team to build the ECA's capacity in this area, so we could adequately cover the new developments in the field of EU financial and economic governance. The team, made up of 20 auditors from across the Court, as well external experts, received specialised training programmes. These adaptations were necessary for the Court to be fully able to address the new European finance architecture.

The new supervisory and regulatory authorities

In its response to the crisis, and to help prevent future crises of this nature, the EU created three new supervisory and regulatory authorities. Together, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) are part of the European System of Financial Supervision (ESFS) umbrella.[5] At the time of writing, the ECA has completed work on the first two of these authorities, which are outlined in the rest of this section. A third special report, on EIOPA, is due for publication in 2018.

European Banking Authority (EBA)[6]

EBA was set up in 2011 out of the Committee of European Banking Supervisors (CEBS) to strengthen the regulatory framework and the supervision of banks. Integration of the markets for financial services and their deregulation in the EU has been fast, but supervision of banks' activities had until then been restricted to national borders. As a response, EBA now has stronger legal powers of supervision and within the legislative process of the EU. The authority[7] is tasked with developing the 'Single Rulebook' and monitoring and assessing the market. However, EBA does not carry out day-to-day supervision of financial institutions;

4 ECA (2014) "Gaps, overlaps and challenges", p7

5 Under the umbrella are the European Banking Authority (EBA); European Securities and Markets Authority (ESMA); European Systemic Risk Board (ESRB); and European Insurance and Occupational Pensions Authority (EIOPA).

6 ECA (2014) "European Banking supervision taking shape – EBA and its changing context", *ECA Special Report no.5/2014*

7 The organisation itself is financed 60% from national supervisory authorities and 40% from the EU budget.

that responsibility lies with the European Central Bank and the Single Supervisory Mechanism (SSM). Instead, the system relies on cooperation, "with information exchanged via the supervisory colleges in order to have a consolidated overview of a bank's risk exposure".[8]

For its audit, the Court looked to assess whether the Commission and EBA had "satisfactorily carried out their responsibilities in setting up the new arrangements for the regulation and supervision system of the banking sector and to examine how successfully those new arrangements were functioning".[9] The report found that EBA laid the foundations for a new regulatory and supervisory system in the European banking sector, which is an "important first step" in the response to the causes of the crisis.[9]

However, there were shortcomings that need to be addressed, namely related to EBA's mandate. In the future it will be important for EBA to have a clear and wide-ranging mandate and experienced staff to ensure the reliability and credibility of stress tests. Clarification of the roles and responsibilities of EBA (and the SSM) is also necessary for a successful Banking Union and effective banking supervision; these tasks are already enough of a challenge with a clear division of responsibility, let alone with contradictions and conflicts.

European Securities and Markets Authority (ESMA)[10]

The experience of the financial crisis prompted the realisation that reform of credit rating agencies (CRAs) was needed. Before 2007 regulators everywhere relied on credit ratings agencies, and CRAs were only lightly regulated in combination with self-regulation, focusing on a few specific areas such as insider trading and market manipulation.[11] The harsh realities of the 2008 financial crisis changed all that. As a result, the European Securities and Markets Authority (ESMA) was established in 2011 as well to "protect public interest by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets".[12] Within six months of its establishment, it was also given

8 ECA (2014) "EBA and its changing context", p15

9 Ibid., p8

10 ECA (2015) "EU supervision of credit rating agencies – well established but not yet fully effective", *ECA Special Report no.22/2015*

11 According to a Communication from the Commission on Credit Rating Agencies (OJ C 59, 11.3.2006, p.2).

12 ECA (2015) "EU supervision of credit rating agencies", p9

exclusive supervisory powers over EU and non-EU CRAs[13], to add to existing responsibilities concerning: market intelligence and research for risk assessments; investigations into non-compliance; and disclosure of CRA methodologies and key assumptions. In addition, in May 2013 another amendment was approved with the aim of reducing reliance on credit ratings and improving EU Member States' sovereign debt ratings.

For its audit, the ECA specifically analysed whether registrations had been done correctly, whether risk assessment had been implemented soundly, whether the supervisory framework really addressed the problems with CRAs, and whether enough information was published by ESMA and CRAs.

The report found that overall ESMA represented another good foundation and that its methodology for ratings was rigorous. Nowadays for instance, it is easier and faster or credit rating agencies to register. However, ESMA's supervision is too broad, meaning consistency is lacking, and it would thus benefit from a definition of its exact supervisory tasks. Additionally, despite shortening the two-part process, regulatory requirements for agency registration are cumbersome at 227 days in length on average.[14] In addition, ESMA's risk-based approach was not always evenly applied leaving some high-risk areas under-supervised. The ECA also found weaknesses with regards to transparency, such as a lack of public scrutiny on the disclosures. Lastly, CRAs often force users to create accounts and surrender their data to third parties in order to access the disclosed information.

Monitoring by the Commission

Macroeconomic Imbalance Procedure (MIP)[15]

The MIP operates on an annual cycle, beginning with the publication of an economic and financial assessment, and then an in-depth review where required, before the Commission offers country-specific recommendations to correct the imbalances. If a country's imbalances are found to be 'excessive', the Commission should propose that the Council activate the 'excessive imbalance procedure', which includes the

13 This amendment to the CRA regulation is also referred to as CRA II.

14 ECA (2015) "EU supervision of credit rating agencies", p15

15 ECA (2018) "Audit of the Macroeconomic Imbalance Procedure (MIP)", *ECA Special Report no.3/2018*

possibility of sanctions on euro area Member States. It exists to prevent the build-up of imbalances across the euro area, which was an issue before the 2008 financial crisis.

The ECA audited the design and the implementation of the MIP between 2012 and 2017. We found that the procedure is well designed, but that the Commission is not implementing it in such a way to ensure effective prevention and correction of imbalances. When the Commission offers country-specific recommendations (CSRs), it is the responsibility of the Member State concerned to implement those recommendations. However, without the systematic linking of the MIP-country-specific recommendations to specific macroeconomic imbalances by the Commission, it is difficult for Member States to take appropriate remedial action. The ECA also noted that there is some inconsistency between CSRs offered for the national level and those offered at the euro area level.

It is also notable that the Commission has not recommended activation of the excessive imbalance procedure since the establishment of the MIP in 2012, despite several Member States having been identified as having excessive imbalances, with some on no less than 16 occasions.[16] The Commission could not provide sufficient audit evidence to justify the systematic non-activation of the excessive imbalance procedure, leading the ECA to conclude that the politicisation of the later stages of the process have "reduced the credibility and effectiveness of the MIP".[17]

Excessive Deficit Procedure (EDP)[18]

The Excessive Deficit Procedure is designed to help prevent EU Member States amassing excessive government deficits. This is done by checking the data from each Member State to assess whether thresholds have been breached. The Commission then provides a series of recommendations and a deadline to any Member State placed under the EDP, and continues to monitor the implementation of the corrective measures.

The ECA examined the Commission's implementation of the procedure in six Member States between 2008 and 2015. We found positive signs in the Commission's efforts to adapt, simplify and rationalise the procedure. According to the ECA's 2016 special report, the

16 Ibid., p33

17 Ibid., p34

18 ECA (2016) "Further improvements needed to ensure effective implementation of the excessive deficit procedure", *ECA Special Report no.10/2016*

Commission acknowledged that further improvements could be made in the usefulness of the tool by increasing transparency to "maximise the effectiveness of extensive rules and guidelines".[19]

The ECA also found that the effectiveness of the Commission's enhanced surveillance under the new reporting requirements of the 'Six-pack' and 'Two-pack' measures was dependent on the cooperation of the Member States, and that there is no legislative provision or sanction to ensure compliance. Therefore, it is even more important that the Commission makes full use of the tools it does have at its disposal in other areas. However, as with the Macroeconomic Imbalance Procedure, the ECA's auditors found that the Commission does not make full use of its powers, in this case to ensure progress towards the resolution of 'action points' concerning methodology and data completeness, even if their resolution within the deadline is also not mandatory.

In addition, transparency – always regarded by the ECA as vitally important – was found to be lacking, despite improvements, with a lot of information on data assumptions and parameters unavailable.

The ECA is also in the process of preparing two reports on the European Semester, which are due to be published in 2018.

Assistance to countries in difficulty

A number of financial instruments were used to help countries experiencing difficulties. For instance, a balance-of-payments mechanism was available to both euro area and non-euro area countries through loans conditional on the implementation of policies designed to address underlying economic problems, often in cooperation with the International Monetary Fund.[20] In addition, during the crisis, bilateral loans from euro area countries (the so-called Greek Loan Facility) were also provided in 2010 as the first financial support programme for Greece. The European Financial Stabilisation Mechanism was created to provide conditional financial assistance to euro area countries in difficulty and was used in Ireland and Portugal, as well as to provide short-term bridging loans to Greece. Though it still exists for specific tasks left over from the crisis, the principal provider of financial assistance to EU countries is

19 Ibid., p75

20 European Commission (2018) "Balance of payments (BoP) assistance", https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/loan-programmes/balance-payments-bop-assistance_en

now the European Stability Mechanism (ESM), which has been used in Greece, Spain and Cyprus. The ESM is the successor to the temporary European Financial Stability Facility (EFSF). The EFSF and now the ESM act as a €700 billion backstop for euro area countries who can no longer access the markets.[21]

Financial assistance to countries in difficulty[22]

For its audit investigation into the financial assistance provided to countries in difficulty – Hungary, Portugal, Ireland, Latvia and Romania – the ECA found that after initially being unprepared, the Commission oversaw programmes that were successful in prompting reforms. Until the crisis, the Commission had estimated those countries' public budgets to be stronger than they actually turned out to be, thus exposing weaknesses in its methodology for estimating fiscal balances and surveillance of large foreign financial inflows. This meant that the Commission was unprepared when countries started requesting assistance. That said, even with warning signs missed, given the enormous time constraints, the Commission managed to take on new management duties and gather the necessary expertise.

The ECA found that in the Commission's processes there was limited quality control, weak monitoring and shortcomings in documentation. Furthermore, there were differences in the way some countries were treated in comparable situations. This stemmed from the fact that the Commission managed the conditions for each financial assistance programme differently. In some cases, frequent changes to conditions made progress hard to track, while in others reforms became gradually diluted, making them less stringent and therefore easier to comply with. The structural reforms required were not always in proportion to the problems faced, or they pursued widely different paths. In some countries deficit targets were relaxed more than the economic situation would appear to justify.

21 ESM (2018) "History", https://www.esm.europa.eu/about-us/history

22 ECA (2015) "Financial assistance provided to countries in difficulties", *ECA Special Report no.18/2015*

Despite these weaknesses in process, some of which did improve over time, the assistance programmes were successful in prompting reforms.[23] Overall, the assistance was soundly based and countries continued with the reforms initiated by the programmes, with deficit targets mostly met.

Financial and technical assistance to Greece[24 25]

When Greece requested external assistance in 2010, the European Commission responded with both technical and financial assistance. The technical assistance involved the creation of a Task Force, which was focused on helping Greece undertake reforms of its public administration, improve the tax system, and also helping foster growth. The financial assistance took the form of three economic adjustment programmes – the last of which is due to finish in August 2018 – which aimed to cover the country's immediate financing needs, as well as prompting structural reforms in the Greek economy.

The two ECA special reports on both types of assistance to Greece sought to assess whether the EU's interventions made a positive impact in helping bring about reform. It should be noted that we did not audit the actions of the International Monetary Fund, European Stability Mechanism or Greek authorities, nor did we examine the counterfactual scenario of no financial assistance.

The ECA found, as was the case for the other countries in difficulty, that after initially being unprepared, the Commission did well to establish new functions quickly in a field where it had little prior experience. In all the assistance provided to Greece, also as with the financial assistance to other countries, we found a need to better formalise inter-institutional cooperation with other programme partners, namely to improve transparency.

The EU's financial assistance has had varying degrees of success in bringing about reform in four key areas: taxation, public administration, the labour market, and the financial sector.

23 One of the areas that improved markedly during the period audited was the programme documents, which provide the basis for the decisions taken by the Council or Commission. In time, the Commission allocated staff more effectively and was better prepared (ECA (2015) "Financial assistance to countries in difficulties" p9).

24 ECA (2015) "More attention needed to improve the delivery of technical assistance to Greece", *ECA Special Report no.19/2015*

25 ECA (2017) "The Commission's intervention in the Greek financial crisis", *ECA Special Report no.17/2017*

We found that the conditions in the economic adjustment programmes were not embedded in a broader, Greek-led, long-term strategy for the country. The Commission also did not adapt their scope and timing appropriately. There were also weaknesses in the assessment of implementation of structural reforms. The assessments should be more systematic and accurately documented, and the Commission should undertake an interim evaluation for successive programmes.

Overall, reforms did bring fiscal savings, but the specific objectives of the adjustment programmes were only met to a limited extent, partly because of the political instability the country experienced in this period. That said, most importantly, these programmes helped avoid default by Greece, by promoting reform and bringing fiscal consolidation. However, the country's ability to finance itself fully on the financial markets remains a challenge as of early 2018.

As far as the technical assistance is concerned, a Task Force mobilised expertise from Member States, international organisations, and other specialist bodies, and coordinated technical assistance requested by the Greek authorities as they worked to implement structural reform commitments under the Economic Adjustment Programmes for Greece. We found that the Task Force was flexible and effectively delivered assistance that was innovative but did not always prove effective in some areas, such as in the design of long-term projects.[26]

A key player in the EU's financial assistance, and increasingly in other areas such as the Banking Union, is the European Central Bank (ECB). The European Court of Auditors is mandated to audit the operational efficiency of the management of the ECB, thus we attempted to assess its involvement in the Greek programmes. However, this line of inquiry has emerged as an audit gap in recent years, as the Bank has questioned this mandate and refused to provide sufficient evidence for audit conclusions to be drawn. As the following section will highlight, this poses a risk to accountability, both at present and in future.

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26 ECA (2015) "'Technical assistance to Greece", p8

Banking Union

Single Supervisory Mechanism (SSM)[27] and its crisis management[28]

The financial crisis also encouraged euro area Member States towards establishing the Banking Union. The first pillar of this is the Single Supervisory Mechanism (SSM). It is designed to guarantee the consistent application of prudential rules – to improve financial condition of credit institutions – across the euro area. This move towards Banking Union gave the ECB, through the SSM, the power to supervise the banking sector in close cooperation with the national authorities. If the ECB finds that one of the 120 most important banking groups that it supervises is failing, or is about to fail, it notifies the Single Resolution Board, and then the Board adopts a scheme placing the bank concerned into resolution.

The ECA audited the operational efficiency of the SSM, as well as its crisis management mechanisms. In general, it found that the ECB succeeded in establishing a complex supervisory structure and system of supervision in a relatively short time, but this complexity means it is reliant on on strong coordination. In practice this means that it is too heavily reliant on national competent authorities rather than its own inspectors to ensure 'full and effective supervision', as required by EU law. For instance, when carrying out inspections, teams were 92% staffed by the national authorities, as opposed to ECB officials. This means that while resources are shared, there is considerable scope for overlap and possible conflicts of interest, as very few ECB staff are involved in both on-site and off-site supervision.

Also there is a lack of separation between monetary policy and supervision functions. The ECB's structure means that supervision is overseen by the SSM Supervisory Board, but this does not have control over the supervisory budget, which raised concerns at the Court about the independence of the two areas of the ECB's work. Moreover, there is a sharing of services between departments, where some provide services to both functions, but without clear rules to minimise potential conflicts of objectives.[29]

27 ECA (2016) "Single Supervisory Mechanism – Good start but further improvements needed", *ECA Special Report no.29/2016*

28 ECA (2018) "The operational efficiency of the ECB's crisis management for banks [SSM II]", *ECA Special Report no.02/2018*

29 ECA (2016) "Single Supervisory Mechanism", p10

On the ECB's crisis management for banks, the ECA found that overall the framework for crisis management procedures was substantial and the ECB's process for assessing banks' recovery plans is positive. However, the same problems occur in this area with regards to allocation of staff when urgent situations arise. Furthermore, there are flaws related to guidance in the operational framework for crisis management. In particular, there is a "lack of objective criteria or indicators for determining that a bank has entered a crisis situation" and "there is no guidance on the best use of the ECB's powers or the most appropriate measures to be considered in specific scenarios".[30]

Single Resolution Board (SRB)[31]

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM), which has responsibility for dealing with failing banks in the euro area, with decisions taken by the Single Resolution Board (SRB). The SRB's work, as part of a broader system of supervision, is guided by the Single Rulebook, which is a harmonisation of legislation and guidelines on the resolution and supervision of banks. The SRB, with the assistance of national resolution authorities, is responsible for contingency planning for the resolution of banks within its remit, and for managing bank resolution procedures as necessary and appropriate. Its remit extends to all significant banks and cross-border less significant banks in the euro area.

For its audit, the ECA assessed whether the SRB is equipped to undertake bank resolutions effectively. As with all the newly created components in the EU's financial architecture, setting up in a short time frame proved a challenge. Resolution planning, it was found, requires continued efforts to improve the resolution plans, as well as a system of rules and guidance for resolution planning. Staffing issues also affect the SRB. In this case though, the Board's activities are being held back by a basic lack of personnel.

The SRB's future work and impact is also dependent on an improvement in external cooperation and coordination with the ECB, and between these bodies and national level. Specifically, the division of responsibilities between the national authorities and the SRB is still

30 ECA (2018) "The operational efficiency of the ECB's crisis management for banks", p11

31 ECA (2017) "Single Resolution Board: Work on a challenging Banking Union task started, but still a long way to go", *ECA Special Report no.23/2017*

unclear. These issues have the potential to delay and restrict information-sharing – particularly the flow of information with the ECB – and detract from the efficiency of coordination.[32]

However, as with its investigations into the financial assistance provided to Greece, the Court had trouble fully carrying out its audit investigations. For the three reports into both pillars of the Banking Union, access to many documents from the ECB – which were necessary for completing the audits – was withheld. While the ECA was still able to make several observations, it was prevented from drawing full conclusions on its findings, despite having an audit mandate. These incidences highlight a growing trend towards the emergence of potential audit gaps, and the serious knock-on effects this has for public accountability, particularly in light of the potential for future developments in the EU's financial architecture.

Future developments

The experiences of the last decade have been a considerable test for the EU, its institutions, and its Member States. Overall, the ECA has found that in the white heat of the financial and sovereign debt crises, the European Commission has generally laid positive foundations towards resolving the weaknesses that left it so exposed to the last crisis. Nevertheless, there are inevitably improvements to be made throughout all four clusters discussed in this chapter.

In the moment of writing, in early 2018, we are presented with a great opportunity to make those improvements to the construction and governance of the euro area, and complete the Banking Union. It is vital that we capitalise while the euro area is returning to health.

Proposals outlining how the EU's economic and monetary union might develop over the coming years have been made, and it is now up to Europe's policymakers, to decide what shape the future will take.

However, it is equally important that accountability plays a central role in that future. The financial crisis has prompted the EU and its Member States to improve the EU's financial governance architecture, but this has meant the EU's institutional framework has become more complex. As the ECA highlighted in 2014 and has discovered since, some institutions and bodies have gained responsibilities quickly, but are not subject to comprehensive external audit. This means, for example, that the ECA is

32 ECA (2018) "The operational efficiency of the ECB's crisis management for banks", p10

limited in what and how it can audit the activities of the ECB. Meanwhile, the ESM is an international financial institution that currently lies outside the TFEU, and therefore also outside the remit of public auditors.

Without proper and consistent public audit arrangements, there remains the strong possibility for gaps in accountability in the EU's financial governance architecture. Reform requires policymakers to pay attention to not only the core aims of the initiatives being undertaken, but to proper accountability to the European and National Parliaments, as well as clearly defined audit and access rights for external auditors, such as the European Court of Auditors, to properly fulfil its mandate as the guardians of the EU's finances in the future.

WHY HAS EURO CRISIS MANAGEMENT BEEN SO HARD?

Jeromin Zettelmeyer[1]

The euro crisis began in 2010 as a fiscal crisis in Greece and a banking crisis in Ireland, two small countries which together made up about 4 percent of euro area GDP. IMF-EU programs backed by the ECB were meant to quickly address the underlying fiscal and financial problems and prevent contagion. Instead, the crisis spun out of control. By early 2011, it had reached Portugal; by the third quarter of 2011, Italy and Spain. By 2012, the entire euro area was in recession. Even after it began to recover, in 2014, aftershocks of the crisis continued to haunt the euro area. After a government opposing EU- and IMF- sponsored adjustment came to power, Greece almost exited the euro in 2015. Most recently, a government coalition crystalizing anti-EU sentiment in Italy poses a serious, perhaps existential, challenge to the euro and the EU. With similarly polarized views in other countries, it looks like the euro crisis may be perpetuating itself indefinitely (or until the euro collapses).

Why was it so difficult to bring the euro crisis under control, and why do we continue to suffer from its legacies today, after more than eight years? Part of the answer surely has to do with the extent of private and public debt problems accumulated in the boom years – in some countries, on top of high pre-existing levels – and the magnitude of the external financial shock that hit the euro area in 2008-09, triggering a deep recession. But the United States and other advanced countries were similarly affected by the 2008-09 financial crisis and recovered much more quickly. Among 37 countries listed as "advanced" by the IMF, 32 suffered negative growth in 2009, but only 11 – nine members of the euro area,

1 Peterson Institute for International Economics, CEPR and CESifo.
I am grateful to Olivier Blanchard, Mitu Gulati and Jean Pisani-Ferry for insightful comments on an earlier draft.

plus neighboring Sweden and the Czech Republic – suffered a double dip recession, with negative growth in 2012. Hence, the full answer must surely include the struggle of euro area institutions – defined broadly to include the European Commission, the ECB, political institutions such as the Eurogroup of finance ministers, and national authorities – to develop a coherent and effective crisis response.

This essay explores three reasons why European institutions found it so difficult to manage the crisis, all of which are specific to the euro area setting.[2] First, managing a center-periphery crisis in a currency union setting poses specific challenges. It took European institutions time to understand and address them. The second reason was a collective action problem caused by creditor-debtor conflict of interests. The third reason, finally, reflects an intellectual and political failure, namely, the transposition of creditor-debtor conflicts to a setting – the debate about euro area reform – where these conflicts could and should have been avoided.

Learning to manage an international financial crisis inside a currency union

Compared to systems of pegged exchange rates, which European countries had experimented with in the 1980s and 1990s, currency unions are much more resilient because the payments system linking member central banks (called "Target" in the euro area) can accommodate unlimited capital flows between members. A currency union is equivalent to a fixed exchange rate regime combined with permanent and unlimited central bank swap lines, at pre-determined rates, between the members of the regime. Official balance of payments support of the kind that the IMF has traditionally provided is hence unnecessary: unlimited access to such support is an automatic privilege of membership. Perhaps reflecting this reasoning, the EU's Balance of Payments Facility, created in 1988 to allow EU members to adjust to balance of payments disequilibria, excluded Euro area members from 2002 onwards.

However, the consequences of capital flow reversals go beyond the

2 These reasons are not meant to be exhaustive. For example, a frequent criticism is that euro area authorities were slow to force banks to recognize losses and raise capital, delaying the recovery (see the April 2013 and April 2014 issues of the IMF's *Global Financial Stability* report). This criticism is directed primarily at national authorities managing their own economies, and it is not clear that membership in the currency union had much to do with this particular set of policy choices (a similar criticism, although to a lesser extent, was directed at the UK).

balance of payments. "Sudden stops" in capital flows can prick credit bubbles, expose underlying private debt problems, and precipitate a collapse of credit and investment through financial sector channels. In severe cases, they can trigger banking crises. They can also lead to sovereign debt crises: via tighter financing conditions, spillovers from banking crises, and through the impact of a recession on government finances.

As it turned out, these implications of capital flow reversals not only continued to be possible in the euro area, they also became harder to manage. As Europe discovered after the collapse of Dexia in late 2008, pre-crisis financial integration, partly induced by currency union, can make the resolution of banking crises more difficult. The same is true for the management of fiscal crises: currency union sovereigns are exposed to self-fulfilling debt runs, since they lack national central banks that would normally be able to backstop their liquidity (De Grauwe 2011). With Italy and Spain on the brink of losing market access in 2011 and 2012, a construct needed to be found that allowed the ECB to assume this role within the legal constraints posed by its prohibition of monetary financing of governments.

European institutions responded to these challenges – incrementally, and punctuated by mistakes and setbacks, but they eventually got it right.[3] The first step was the creation of temporary facilities – the European Financial Stability Facility (EFSF) and the ECB's Secondary Market Programme (SMP) – to lend to crisis-hit sovereigns and stabilize government bond markets, respectively. This was followed by a blueprint for creating the ESM, designed specifically to deal with sovereign debt crises inside the euro area. Mistakes and setbacks included the design of the SMP, a limited-volume program subordinating private bondholders; the design of the first Greek program; the Deauville announcement linking the creation of the ESM to "private sector involvement" (PSI); and the initial decision to "haircut" depositor in Cyprus. Most of these mistakes were later reversed or at least contained, albeit at considerable cost; but some, like the catastrophic Greek program, caused permanent damage.

The backdrop for some of these mistakes was a conflict of interests – in particular, the desire to minimize any redistribution benefiting the crisis countries, a topic taken up below. Others simply reflected a lack of

3 For accounts of the crisis response, from different perspectives, see Pisani-Ferry (2014) and Bastasin (2015).

experience in managing financial crises. The Deauville announcement is a case in point. The principle that unsustainable debt ought to trigger a debt restructuring "involving" private creditors is commonsensical (even tautological), and the idea that the euro area should have a procedure for doing so was sound. But the communication was terrible. Markets interpreted the PSI announced at Deauville not as a rarely-to-be-used feature of the European financial architecture that would be erected after the crisis (as it was presumably intended), but as a signal that the official sector would insist on debt restructuring in the crisis that was just beginning to unfold.

The crisis was contained only after the ECBs announced the "Outright Monetary Transactions" (OMT) program, plugging the most threatening hole in the crisis resolution architecture of the euro area – the inability to stop a self-fulfilling run on the debts of a member state. The period of experimentation and ad hoc institution-building was over, but it took two and a half years – from April 2010 until September of 2012.

A "chicken game": crisis resolution in the presence of distributional conflict

The resolution of debt crises involves a trade-off between fiscal adjustment, official financing, and debt restructuring. How this trade-off is resolved has significant distributional implications. Fiscal adjustment goes at the expense of the debtor country. Official financing puts the resources of official creditors and their shareholders – referred to as the creditor countries – at risk. Debt restructuring goes at the expense of private creditors, and so reduces the direct drain on public resources. But it also creates financial stability risks in both debtor and creditor countries, as private creditors may be systemically – and politically – important.

As a result, while creditor and debtor countries have a shared interest in resolving the crisis quickly, their interests conflict on *how* to resolve it. In the euro crisis, debtor countries wanted moderate fiscal adjustment, ample official financing and – in the case of Ireland – a bail-in of senior bank bondholders. In contrast, creditor countries wanted as much fiscal adjustment and as little official financing as possible (preferably on penalty terms, one of the several mistakes of the initial Greek program). They were also opposed to restructuring bondholders, in Ireland and initially in Greece, both because the ECB feared that this would set an adverse precedent and lead to contagion and because some of the banks holding bonds had tight connections to their respective governments.

This resulted in an incentives structure prone to gambles for redemption – postponing debt restructuring to see if it could be avoided altogether. Incentives faced by debtor and creditor countries also shared some of the features of the "game of chicken", in which accommodation by at least one side is necessary to avoid catastrophe, but each side prefers the other to do the accommodation.[4] In the case of the euro area crisis, as in the game of chicken, outright catastrophe – in the sense of disorderly default and euro area exit – was avoided. Instead, one of the two equilibria predicted by the game of chicken prevailed – namely, deep fiscal adjustment, and too little debt restructuring. Debtor countries agreed to crisis resolution strategies that accommodated the preferences of the creditor countries.

Apart from being inefficient, this equilibrium created problems that went beyond what is captured in the (static) chicken game. First, even where fiscal adjustment worked in the sense of eventually engineering a return to capital markets, it contributed to a sense of unfair treatment in the debtor countries. Europe helped them avoid catastrophe, but on harsh and seemingly self-serving terms. Second, in one case – Greece – excessive fiscal adjustment and the failure to undertake meaningful reform exacerbated the economic collapse, led to a debt restructuring that was too little and too late, and created a political backlash that generated a new crisis in 2015.

Neither debtor nor creditor countries can be blamed for trying to resolve the crisis on their terms. There was a genuine conflict of interest. This said, the creditor countries and the institutions advising them and setting the terms of the adjustment – the European Commission and the IMF – should have realized that pushing the debtor countries too far risked undermining the crisis resolution strategy in both economic and political terms. More than eight years after the agreement on the first program, in Greece, Europe is still suffering the consequences.

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4 The game of chicken has its name from a game played by two trucks on a collision course, in which the first driver to "chicken out" (i.e. to accommodate by swerving to avoid collision) loses the game. There are no equilibria in which both sides accommodate, or both fail to accommodate. Failure to accommodate by both sides would lead to collision, which any of the two sides would prefer to avoid by swerving. Accommodation by both sides is not an equilibrium either, since each side would prefer to win by not accommodating. Hence the two equilibria of the game involve one side accommodating but not the other. In the context of the euro crisis, accommodation by a debtor country can be interpreted to mean to accept ambitious fiscal adjustment, while accommodation by the creditors would have meant a larger financing envelope or an early acceptance of debt restructuring.

Euro area reform through the prism of redistribution

The third reason why the euro crisis dragged on and crisis-related political fault lines became increasingly cemented was that the distributional conflict created by the crisis infected attempts to reform the long-term financial architecture of EMU. This created costs by shackling institutional design – for example, defining the ESM as an "ultima ratio" institution that can be activated only in the face of a threat to the euro area as a whole, rather than pre-emptively and proportionally. It also stopped more ambitious reforms, such as the completion of banking union. And it contributed to a continuing anti-euro backlash in both creditor and debtor countries.

In the public opinion of creditor countries, plans for more risk sharing across EMU members – proposed by the European Commission and countries such as France, Italy and Spain – are now widely viewed as attempts to create a regime in which virtuous, better performing countries would pay for the sins of past and future crisis countries. In the debtor countries, lack of progress on euro area reform has been widely interpreted as a sign that the creditors were unwilling to show solidarity, instead forcing the "south" to engage in austerity policies and other forms of self-harm. Both narratives lead to the same conclusion: that the euro is a threat to democracy, either because it forces countries to take actions against the will of their electorates (a familiar argument in Italy) or because it creates contingent fiscal commitments, through a growing number of institutions that mutualize risk, forcing elected representatives to surrender fiscal control (a frequent line of argument in Germany). The creation or rise of populist parties such as Syriza, the AfD, the Lega, or Five Star is directly linked to these narratives.

However, the premise on which these arguments are built – that more risk sharing in the euro area boils down to more north-to-south transfers – is incorrect. Unlike crisis resolution, successful institutional reform in the euro area does not entail an inherent distributional conflict. Depending on how risk-sharing institutions are designed, the alleged trade-off between risk sharing and good incentives may not exist. This is clear from the fact that insurance arrangements are commercially viable, which could not be the case if they were to lead to systematic transfers from the insurer to the insured. Although insurance can give rise to moral hazard, this can be contained through the design of the insurance contract, which ensures that insurance is beneficial for all contracting parties. By transposing features of insurance contracts such as deductibles or experience-rated contributions to euro area risk sharing arrangements such as euro area deposit insurance or unemployment insurance, it would be possible to significantly lower risk in the euro area without creating a "transfer union" (see, among others, Gros 2013, Gros 2018, Bénassy-Quéré et al. 2018, and Véron and Schnabel 2018).[5]

Two recent papers, by Bénassy-Quéré et al. (2018) and Berger et al (2018), take this argument a step further. They argue that, far from leading to "transfer union" and undermining incentives, well-designed risk sharing arrangements are in fact needed to rule out transfer union, because without them, the no-bailout-rule is not credible. When debt restructuring leads to significant domestic euro area disruptions, even creditor countries will be in favor of bailouts. Hence, debt restructuring is unlikely to happen even when it is efficient ex ante, and when the chances that bailouts will succeed are low.[6]

Unfortunately, governments across the euro area – particularly creditor country governments – have failed to distance themselves from the idea that risk sharing in the euro area necessarily entails (systematic) redistribution. Some governments, notably in Germany, are in fact guilty of actively promoting the idea. The German government has traditionally rejected both European deposit insurance and fiscal risk sharing, claiming that this would lead to moral hazard. Even reinsurance was viewed as an unacceptable "further mutualization of risks".[7] Little wonder, then, that many German voters have bought into the idea that any form of additional euro area risk sharing runs counter to the German interest. By promoting the idea that more risk sharing will likely lead to north-to-south redistribution, the German government has given intellectual respectability to the arguments of Eurosceptics and done a disservice to German and European interests.[8]

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5 See Gros (2013), Gros (2018), Bénassy-Quéré et al. (2018) and Véron and Schnabel (2018).

6 This argument is not new: Gros and Meyer (2010) advocated the creation of a "European Monetary Fund" on the grounds that "Market discipline can only be established if default is possible because its cost can be contained."

7 German non-paper on banking union, 8. September 2015, http://blogs.ft.com/brusselsblog/files/2015/09/Nonpaperfinal_20150910091345.pdf

8 Very recently, there are signs that the German position may be shifting. Germany's new finance minister, Olaf Scholz, has recently endorsed the idea of a European unemployment reinsurance mechanism, albeit one based on loans rather than transfers. See http://www.spiegel.de/international/germany/interview-with-finance-minister-olaf-scholz-a-1211942.html

More surprisingly, the proposition that meaningful euro area risk sharing is possible without systematic transfers has also been under attack from the opposite end of the political spectrum. Commentators such as Münchau (2018a) and academics such as de Grauwe and Ji (2018) have taken the view that only full risk mutualization will make the euro area safe, in the form of a jointly and severally guaranteed "Eurobond." Proposals to create euro area safe assets that avoid mutualization (see Brunnermeier et al, 2017 and Leandro and Zettelmeyer 2018 a,b for a survey) are derided as a euro area version of the "CDO scam of the subprime years", and the Bénassy-Quéré et al. (2018) proposals to reconcile risk sharing with good incentives as "astonishing for its lack of ambition" (Münchau 2018a,b). These commentators agree with the intellectual premise of the Eurosceptics, namely, that risk sharing inevitably implies redistribution at the expense of countries with track records of fiscal prudence. The only difference is that they view redistribution of this type as an acceptable price to pay for a successful euro area, whereas northern Eurosceptics do not.

Conclusion

The euro crisis was difficult to bring under control in part because managing a debt crisis inside a currency union posed new challenges that took time to understand and address, and in part because debt crises create conflicts of interests that turned out to be particularly pernicious in the euro area context. These conflicts delayed or prevented effective crisis resolution and created a legacy of resentment and distrust between debtor and creditor countries. They also contributed to the view that meaningful euro area risk sharing necessarily has redistributive consequences, at the expense of countries with track records of fiscal prudence.

Although wrong, this view is hard to dispel, in part because it has attracted support both from opponents of any risk sharing at the level of the euro area and from proponents of full risk mutualization. Reform of the euro area financial architecture that seeks to avoid permanent redistribution is rejected by one side because it is viewed as a ploy that will ultimately lead to mutualization through the back door, and by the other because it lacks mutualization through the front door. It is hard to see how meaningful reform – with or without redistribution – can succeed in such circumstances.

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PART II

Disentangling The Crisis And The Courts

USE OF THE LOCAL LAW ADVANTAGE IN THE RESTRUCTURING OF EUROPEAN SOVEREIGN BONDS

Lee C. Buchheit[1]

Abstract

Emerging market sovereigns issue bonds in the international capital markets governed by a foreign legal regime such as the law of England or New York State. European sovereigns, however, have been able to issue bonds governed by the issuer's own law. In the event of a future financial crisis, this gives European sovereign issuers the ability to pass local legislation that will facilitate an eventual restructuring of their bonds — the "local law advantage." Greece did this in 2012 as part of a restructuring of €206 billion of Greek Government bonds.

The validity of the revisions to Greek law enacted in 2012 by the Greek Parliament has been upheld in multiple judicial challenges (in Greece, Germany, Austria and before the European Court of Human Rights), as well in a major ICSID arbitration. This raises the question of whether other European sovereigns enjoying the local law advantage over their bonds can, in an emergency, rely on the power of their own legislatures to amend local law in order to facilitate a future restructuring of those instruments.

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The Local Law Advantage

When emerging market sovereigns issue bonds in the international capital markets, those bonds are governed by a foreign law, normally the law of England or the State of New York. The reason is simple. Allowing a sovereign bond to be governed by the sovereign's *own* law places the investor at the mercy of the local legislature. If the local law changes in a manner that impairs the performance of a local law bond or facilitates its restructuring, even judges in New York and England must respect that change.[2] I shall refer to this as the "local law advantage" that a sovereign enjoys over a bond governed by its own law. In contrast, a sovereign bond governed by a foreign law will be beyond the mischievous reach of the country's legislature. Sovereigns can (and occasionally do) attempt to pass laws — normally in the nature of capital controls — that purport to interfere with the performance of foreign currency-denominated bonds, but these enactments rarely provide the issuer with a legal defense to the performance of the instrument in a foreign court.[3]

Unlike their emerging market counterparts, European sovereigns have generally been able to issue bonds governed by their own law. Investors seem to have more confidence that a developed country will not attempt to change its law in a manner that may injure holders of the sovereign's debt instruments. To do so, the argument goes, would be suicidal for a country that must regularly refinance its debt from the capital markets with the support of foreign investors.

Greece 2012

When the Greek sovereign debt crisis erupted in the spring of 2010, the official sector (the EU and the IMF) elected to lend Greece all the money needed to repay maturing Greek Government Bonds ("GGBs") in full and on time. A similar policy was later followed in the bailouts for Ireland, Portugal and Cyprus. The problem was that Greece's debt stock was obviously unsustainable. On the night/early morning of October 26-27, 2011, the official sector actors therefore careened from their prior position of forbidding Greece from restructuring *any* of its debt to a new

2 See New York City Bar, *Governing Law in Sovereign Debt-Lessons from the Greek Crisis and Argentina Dispute of 2012*, Committee on Foreign & Comparative Law, Feb. 2013, at page 7, summary point 3. http://www2.nycbar.org/pdf/report/uploads/20072390-GoverningLawinSovereignDebt.pdf.

3 Lee C. Buchheit & Elena S. Daly, *Contracts in a Time of Capital Controls*, J. INT'L BANKING AND FIN. LAW (Sept. 2015).

position *commanding* Greece to restructure *all* of the GGBs left in the hands of private sector investors with at least a 50% principal haircut. Having decreed the result, however, the official sector did not confide the method by which that result was to be achieved. Greece was given five months to complete the debt restructuring or face default and a possible exit from the Eurozone.

For the prior two years, GGB holders saw Greece's official sector sponsors lend Greece the money needed to repay maturing GGBs. Senior public officials such as the President of the European Central Bank and his deputies issued regular assurances to the effect that there never would be a sovereign debt restructuring in the Eurozone (which the market understandably heard as an assurance that all Eurozone sovereign bonds would be paid in full).[4] The market could thus literally smell the official sector's fear of bringing a messy Argentina-style debt crisis to the belly of Europe. In the face of this, a significant number of GGB holders would probably have called the official sector's bluff by declining to restructure their GGBs. After the tens of billions of euros already sunk in bailing out Greece, Ireland and Portugal, would the official sector really risk a collapse by allowing Greece to default on holdout GGBs? The question of the hour was therefore how to minimize the anticipated holdout creditor population in a savage restructuring of GGBs.

Greece enjoyed a significant local law advantage with respect to its bond indebtedness. Approximately 93% of GGBs were governed by Greek law. To facilitate the debt restructuring, the Greek Parliament passed a law on February 23, 2012 that effectively homogenized the holders of Greek-law governed GGBs into a single class for purposes of voting on a debt restructuring. If holders of at least 50% in aggregate principal amount of the Greek law-governed GGBs voted either in favor or against the proposed amendment, and at least two-thirds of the principal amount voted accepted the terms of a debt restructuring, their decision would bind all other holders of those instruments. The law thus embodied the notion of supermajority creditor control of the process, very much along the lines of the class voting mechanism prescribed in domestic insolvency regimes for corporate debtors.

In choosing to retrofit a class voting mechanism on the holders of Greek law-governed GGBs, the Greek Parliament made a restrained use of its local law advantage. Parliament could, for example, have attempted to impose directly the financial terms of the restructuring by legislative

4 For a description, see Paul Blustein, Laid Low: Inside the Crisis that Overwhelmed Europe and the IMF (2016).

fiat, rather than allow the affected creditors to vote on the measure. But such a thermonuclear use of the local law advantage would not have been supported by Greece's official sector sponsors. Moreover, the members of the Euro-area had already endorsed the use of a creditor class voting mechanism as a method for dealing with future sovereign debt crises in Europe.[5]

It worked. The necessary supermajority of creditors approved the restructuring in March 2012 and accordingly there were no holdouts among the universe of Greek law-governed GGBs. Thirty-six series of GGBs were governed by English law, each with its own collective action clause. The required supermajority bondholder consent to join the restructuring was obtained for 17 of these series of English law GGBs. Holdout creditors had acquired blocking positions in the other series. Approximately 97% of the eligible debt stock was covered by the restructuring.

Parliament's action was subsequently challenged in Greek, German and Austrian courts, as well as in a major arbitration commenced under one of Greece's bilateral investment treaties.[6] The action was also challenged in proceedings before the European Court of Human Rights.[7]

5 On November 28, 2010, the finance ministers of the larger European countries released a document bearing the caption 'Statement by the Eurogroup'. It contained the following paragraph: In order to facilitate this process [the restructuring of the private sector indebtedness of an insolvent euro area Member State], standardized and identical collective action clauses (CACs) will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro-area government bonds starting in June 2013. 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 negotiations. This would enable the creditors to pass a qualified majority decision agreeing to a legally binding change to 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. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf. This statement was repeated verbatim in the 'Conclusions of the Heads of State or Government of the Euro Area of 11 March 2011' http://www.consilium.europa.eu/media/21423/20110311-conclusions-of-the-heads-of-state-or-government-of-the-euro-area-of-11-march-2011-en.pdf.

6 For a discussion and thorough analysis of these legal challenges see, Sebastian Grund, *Enforcing Sovereign Debt in Court -- A Comparative Analysis of Litigation and Arbitration Following the Greek Debt Restructuring of 2012*, 1 U. Vienna L. Rev. 34 (2017).

7 *Mamatas and Others v. Greece* (application nos. 63066/14, 64297/14 and 66106/14). *See* European Court of Human Rights press release of 21 July 2016, ECHR 256 (2016).

None of these legal challenges prospered.[8]

Ex post facto laws and sovereign debt workouts

The retroactive implementation of a class voting mechanism on the holders of Greek law-governed GGBs was not undertaken lightly. It represented perhaps the mildest possible use of Greece's local law advantage over the Greek law-governed debt stock consistent with the need to ensure that a transaction — if broadly supported by a supermajority of similarly-situated creditors — could not be undermined by a holdout minority. The Greek authorities and their official sector partners were acutely aware that passing any law with retroactive effect, often referred to as an *ex post facto* law, is generally undesirable.

The Greek Parliament's decision was subsequently validated as a matter of Greek and European law. Which raises the question, why cannot other European sovereigns — whose debt is wholly or principally governed by the sovereign's own law — follow the Greek precedent should circumstances ever require a restructuring of their bonds? Is anything more needed, over and above the local law advantage enjoyed by most Euro-area sovereigns, to facilitate an orderly restructuring of sovereign debt in Europe? In effect, does the Greek precedent obviate the need for any other measures to facilitate future sovereign debt restructurings in Europe?

My view is that any use of the local law advantage by a European sovereign should only be considered as a last resort and, even then, only if a crisis erupts before an orderly debt restructuring mechanism can be put in place. My reasons are:

(i) *Ex post facto* laws are disfavored in all legal regimes for the obvious reason that they erode the fundamental premise that contracts will be enforced as written.

(ii) Any public suggestion that members of the Euro-area expect to rely on *ex post facto* laws as the principal tool to facilitate future sovereign debt restructurings could restrict European sovereigns from borrowing under their own laws. Investors should logically

8 *See* Sebastian Grund, *Restructuring Sovereign Debt Under Local Law: The Greek case and Implications for Investor Protection in Europe*, 12 Cap. Mkts L. J. 253, 273 (2017) ("Five years after Greece implemented the biggest sovereign debt restructuring in history, European courts and international tribunals have finally vindicated its legal decision.")

begin insisting on the use of a foreign law for European sovereign bonds[9] or they might begin charging a basis point penalty for the continued use of local law. [10]

(iii) It is true that Greece survived the legal challenges to its 2012 legislative retrofit of a class voting mechanism on the local law debt stock. But rippling through those decisions is a sense that Greece acted with considerable restraint and under absolute necessity. That same latitude may not be shown if the member state concerned had the opportunity to put in place a forward-looking mechanism to ensure an orderly debt restructuring but simply neglected to do so.[11]

(iv) Each member country will have its own constitutional constraints on the ability of the government to interfere with private property. The Greek Constitution, for example, provides that no one shall be deprived of property "except for public benefit" (Article 17), subject to the power of the State "to consolidate social peace and protect the general interest" (Article 106). Not every constitution may offer similar flexibility.

(v) Since 2013, all European sovereign bonds have incorporated an aggregated collective action clause (that is, a contractual provision that mimics, with certain exceptions, the class voting mechanism of corporate insolvency regimes). If a crisis were to occur during the next decade or so, however, only a portion of the bonds of the afflicted sovereign will contain such clauses. In such a situation, what would be the relationship between bonds *with* CACs and those with*out* CACs? Two options. The local legislature could pass a law:

- retrofitting a new class voting mechanism over the entire debt stock (effectively ignoring the presence of CACs in some of the

9 Following the action of the Greek Parliament in February 2012, for example, the Hellenic Republic has been forced to designate English law as the governing law of its international bond issues.

10 For empirical illustrations of this dynamic, see Marcus Chamon et al., *Foreign Law Bonds: Can They Reduce Sovereign Borrowing Costs* (2014 draft), https://editorial-express.com/cgi-bin/conference/download.cgi?db_name=RES2015&paper_id=901; Michael Bradley *et al.*, *Pricing Sovereign Debt: Foreign versus Local Parameters*, European Fin. Mgt. J. (forthcoming 2018), https://onlinelibrary.wiley.com/doi/full/10.1111/eufm.12161

11 For a prior discussion of this question, see Lee C. Buchheit & Mitu Gulati, *Sovereign Debt Restructuring in Europe*, Global Pol'y (forthcoming 2018), https://onlinelibrary.wiley.com/doi/abs/10.1111/1758-5899.12531

bonds), or

- imposing a class voting regime only on the bonds that do *not* contain CACs (relying on the CACs in the bonds containing the clauses to facilitate the restructuring of those series).

In either case, were the retrofit voting mechanism to be more liberal (in terms, for example, of the voting thresholds required to approve a debt restructuring) than the corresponding features of the contractual CACs, this might forfeit judicial sympathy in a future legal challenge by an aggrieved bondholder.

JUDICIALIZATION OF THE EURO CRISIS? A CRITICAL EVALUATION

Bruno De Witte

In the literature dealing with the euro crisis and euro crisis reforms, the view is often taken that we have seen a process of judicialization of key decisions in this field. We understand the concept of judicialization in the loose meaning of the 'transfer to courts of contentious issues of an outright political nature and significance' (Saurugger and Fontan 2017, 5). There is certainly an appearance of judicialization because we have seen, over the past eight years, numerous court judgments (some at the European level, but mostly at the national level) dealing with aspects of the euro-crisis reforms. But it is not so obvious that these many court rulings also denote a true transfer of powers from the political institutions to the judiciary, as claimed for example by Federico Fabbrini: 'the Euro crisis and the legal and institutional responses to it have dramatically increased the powers of the judiciary vis-a-vis the political branches, making economic and monetary affairs in Europe more judicialized than even in a hyper-judicialized system like the US.' (Fabbrini 2016, 63). In this contribution, I submit that no 'dramatic increase of powers' for the judiciary has happened. Even though courts were often called to intervene in relation to crisis measures, they have, most of the time, adopted a cautious position backing up the measures taken by the political actors.

The fairly large number of court cases dealing with the crisis measures can be explained by the legal nature of some of those measures. A first category of cases originated from the fact that the European Stability Mechanism and the Fiscal Compact took the form of separate international treaties, rather than EU law proper. This triggered the use of domestic procedures allowing supreme or constitutional courts to review the constitutionality of new international treaties (which is a normal task for courts in many national legal systems[1]). A second category of cases originated from challenges brought by individuals against austerity measures and haircuts in programme countries (mainly in Greece, Portugal and Cyprus, but also in Romania, Latvia, Hungary and Ireland). Those challenges were brought before national courts, but also spilled over occasionally to the Court of Justice of the EU and to the European Court of Human Rights. In particular, these challenges could be seen as test cases for the justiciability of fundamental rights, in particular two sets of rights: the right to property (in relation, for instance, to the 'haircuts' imposed on debt holders or bank customers), and fundamental social rights (such as the right to social security, the right to collective action, the right to housing, etc.).

I will start by examining the first group of court cases: in a number of euro area countries, constitutional and supreme courts were indeed called to conduct, in 2012 and 2013, an ex ante or ex post review of the legality of the ESM Treaty and the Treaty on Stability, Cooperation and Governance in the Economic and Monetary Union (better known as Fiscal Compact, after the title of its most important chapter). Those countries include Slovenia, Estonia, Ireland, Germany, Austria, Hungary, France and Belgium. The two international treaties raised several procedural and substantive constitutional issues (Bardutzky and Fahey 2014). The courts were clearly under considerable pressure to approve those treaties, due to the economic interests at stake and the volatility of financial markets, and all of them did, in fact, approve them. The fact that the courts were under political pressure to give the 'right answer' does not mean that their reasoning was unconvincing, on the contrary (Reestman 2017, 269). They all found their own way of performing a credible constitutional analysis, dismantling the potentially explosive constitutional implications of some treaty provisions, and taking the edge off arguments that the ESM or Fiscal Compact undermined national parliamentary democracy. Their judgments have helped to legitimize the ratification of those treaties, and have thus contributed to a major shift in the functioning of EMU.

In one country did the constitutional challenge spill over to the European level. In the *Pringle* case, the Irish Supreme Court was faced with a challenge by a member of the Irish parliament, Mr Pringle, against

1 For an earlier discussion of the legal-constitutional reasons explaining the recourse to separate international treaties rather than to EU law proper in dealing with the euro crisis, see De Witte 2012.

the ratification of the ESM Treaty by Ireland. Mr Pringle argued that ratification by the Irish parliament without a prior referendum would be unconstitutional, but that argument was rejected by the court. He also argued that the conclusion of the ESM Treaty breached various provisions of EU law, and this challenge was referred by the Irish Supreme Court to the Court of Justice of the EU. The latter court reacted very quickly (it was pressed by time, as the preliminary reference was lodged in 2012, during the hottest period of the euro crisis) and gave a ruling in which it held that the ESM treaty was perfectly compatible with EU law. In particular, the Court of Justice rejected what was, perhaps, the strongest objection, namely that the creation of the ESM was incompatible with the no-bail-out clause of Article 125 of the Treaty on the Functioning of the European Union because it created a financial rescue mechanism for Eurozone states facing major sovereign debt problems. The Court of Justice adopted a literal reading of Article 125, pointing out that the ESM grants loans to countries, rather than directly assuming the debts of those countries, and it buttressed that literal (but controversial) reading of the no-bail-out clause by pointing out that ESM loans would be accompanied by strict conditionality and would contribute to the overall stability of the euro area, which, after all, was the original rationale for incorporating the no-bail-out clause in the Maastricht treaty (De Witte and Beukers 2013; Hinarejos 2015, 123-129).

As regards the second set of court cases, those dealing with austerity measures and their impact on the fundamental rights of individuals, the overall picture is one of either judicial avoidance (that is, courts refusing to engage with the substantive issues by raising procedural hurdles) or of judicial deference to political choices. This is most obviously the case for the haircuts affecting private property interests. The *Mamatas* judgment of the European Court of Human Rights is a clear case of judicial deference.[2] The applicant, after having unsuccessfully appealed before Greek courts against the 'haircut' imposed on private holders of Greek public debt, brought the case before the European Court of Human Rights in Strasbourg. The European Court readily agreed that the imposition of the collective action clause against the will of private owners of Greek bonds, such as Mr Mamatas, reduced the value of their bonds and constituted therefore an interference with the right of property which is protected by the European Convention. But the Court went on

2 European Court of Human Rights, judgment of 21 July 2016, *Mamatas v Greece*, Application o. 63066/14.

to hold that this interference was justified by the public interest, namely the need to deal with the grave sovereign debt crisis affecting Greece, and that the interference was not disproportional: the burden imposed on the applicant (and the other victims of the haircut) was commensurate to the need of achieving a substantial reduction of the overall volume of Greek debt. When making this proportionality assessment, the Court insisted that, in economic and financial matters such as these, states had a particularly large margin of appreciation with which the European Court would interfere only for cases of manifest violation of Convention rights.

The legal challenges brought against the haircuts of bank accounts in Cyprus 2013 show a similar picture of judicial deference in the other European court, the Court of Justice of the European Union. In the case *Ledra Advertising and others*, a claim was made by a number of Cypriot account holders that the European Commission, by acting as part of the troika preparing the Memorandum of Understanding with Cyprus, had helped causing their loss of possessions. The Court of Justice of the EU, in its judgment of 20 September 2016, found the case admissible, i.e. it agreed that the action of the Commission had been conducive to an interference with the right of property of the Cypriot citizens. That interference was, however, justified according to the Court of Justice because it served 'the objective of general interest pursued by the European Union, namely the objective of ensuring the stability of the banking system of the euro area as a whole.'[3] The Court added that the measures taken were not disproportionate, without applying the detailed proportionality test that it otherwise employs when assessing restrictions of fundamental rights. Again, like in the *Mamatas* judgment of the European Court of Human Rights, we see that the European judges are reluctant to interfere with what they perceive as highly discretionary political choices.

Sovereign debt loan assistance came with conditions that states had to meet. Those conditions prioritised rapid fiscal consolidation and structural reform, leading to major changes to employment and welfare rights and entitlements in bailout states. There have been cuts to health, education, social security and social assistance, public sector salaries, pensions as well as an extensive deregulation of collective bargaining structures and workplace protections. Judicial challenges to those austerity measures were mostly unsuccessful (Kilpatrick, 2017). A

3 Court of Justice of the European Union, Joined Cases C-8/15P to C-10/15P, *Ledra Advertising et al., v European Commission and European Central Bank*, judgment of 20 September 2016, paragraph 71 of the judgment. See the comment on this case by Dermine, 2017.

characteristic example of judicial deference to political decision-making is formed by the interconnected decisions of the Greek Council of State (February 2012) and of the European Court of Human Rights (May 2013) in the *Koufaki* case.[4] Both courts reasoned that the severe cuts in wages and pensions for Greek civil servants were in the general interest of Greece, and also of the euro area as a whole. Whereas Ms Koufaki's pay cut was defined by the European Court of Human Rights as restricting her right to property, that restriction was held to be justified by the budgetary emergency faced by the Greek state.

Not all European courts were equally deferential, though. Unlike the Greek Council of State, the Portuguese Constitutional Court found that the extremely serious financial situation of the country could not justify all the austerity measures implemented by the government and parliament. The Portuguese Court struck down some of the austerity measures on the ground of violations of the principle of equality, because some categories of people (in particular civil servants) had been treated worse than others (Canotilho, Violante and Lanceiro 2015). It was however careful to treat those cases as purely domestic ones, without tracing back the Portuguese austerity measures to their origin in the Memorandum of Understanding prepared by the troika, and thereby avoiding to challenge the legality of EU action.

At the end of the day, we see that neither the European Court of Justice nor the European Court of Human Rights have struck down a single euro-crisis related measure, and that national constitutional and supreme courts have, for the most part, been quite deferential to the political choices made by their governments and parliaments.

The one, partial, exception to this landscape of judicial restraint is the German Constitutional Court. In a series of judgments in 2011 and 2012, it did approve the participation of Germany in the early euro rescue programmes, in the ESM and in the Fiscal Compact, but those judgments were accompanied by warnings as to the limits of financial solidarity in the euro area, and by instructions to reinforce the control powers of the German parliament in fiscal policy matters. Later on, the Constitutional Court expressed skepticism about the legality of the euro-crisis policy of the ECB, in the *OMT* case (also known as the *Gauweiler* case, after one of the applicants in this case). The Court in Karlsruhe took the view that the ECB might have overstepped the limits of the

4 European Court of Human Rights, judgment of 7 May 2013, *Koufaki and ADEDY v Greece*, Application no. 57665/12 and 57657/12.

powers conferred on it by the Treaty on the Functioning of the European Union, but accepted to refer that question for final determination to the Court of Justice of the EU. The Court of Justice, as it had done in *Pringle* some years before, deployed its interpretative resources to save an essential element of the euro crisis response. In its *Gauweiler* judgment, it held that the ECB had remained within the limits of its constitutional powers; it defined the announcement of the OMT buying programme as a measure of monetary rather than economic policy, which therefore falls squarely within the scope of the ECB's powers as defined by the European Treaties. It furthermore held that buying sovereign debt on the secondary markets, if done by the ECB in a restrained manner, did not constitute a form of monetary financing prohibited by Article 123 of the Treaty on the Functioning of the European Union. The European Court's judgment thus entirely upheld the sovereign debt policy announced by the ECB and reinforced the latter's institutional position (Zilioli 2016). At the same time, the Court's judgment was sufficiently subtle and nuanced as to convince the German Constitutional Court – when that court had to decide the case after the preliminary ruling - not to pursue its threatened rejection of the ECB's measure. In this way, the widely feared open confrontation between CJEU and German Constitutional Court was finally averted (Steinbach, 2018), and the judicialization of the euro crisis reforms took, once again, a rather benign turn.

We can conclude this contribution by qualifying the thesis of the judicialization of the euro crisis. Whereas it is undeniable that many courts have been called to judge the legality of crisis measures, the overall attitude of those courts has been to respect the choices made either by the political institutions (national governments or Eurogroup) or by the European Central Bank. This attitude of judicial deference is certainly convincing when it relates to the adoption of general policy measures such as the creation of the European Stability Mechanism or the launch of a bond buying programme by the ECB. Judicial deference is more problematic when individuals complain about direct interference by euro crisis measures with their property or livelihood; in such cases, courts are called to exercise their natural role of protecting citizens against legislative or administrative measures that affect their fundamental rights. However, also in those 'austerity' cases affecting individual persons, the courts have mostly (with some exceptions) been rather timid in reviewing the choices made by the political actors. There is thus no evidence of the kind of strong judicialization that would consist in a massive transfer of powers from the political to the judicial branches.

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PAPER TIGERS (OR HOW MUCH WILL COURTS PROTECT RIGHTS IN A FINANCIAL CRISIS?)

Mitu Gulati & Georg Vanberg

Abstract[1]

Constitutions often contain rules that are meant to constrain the behavior of future governments during crises. Anti-discrimination rules and protections against expropriation of private property are classic examples. But when crisis hits, politicians are typically tempted by their short-run interests to try to bypass these rules. Enforcement of such constitutional constraints is therefore often placed in the hands of courts. But can courts serve as effective enforcement mechanisms in crisis times? We argue that courts, deciding in the middle of a crisis, will often be tempted to convert what are supposed to be hard rules into softer standards, effectively negating the constraining effect of these provisions on policymakers. While existing literature has argued that weak courts are particularly likely to engage in such behavior when confronted by strong executives, we argue that similar dynamics can also develop between strong courts and weak executives. Using examples from the recent sovereign debt crisis in the Euro area, we illustrate both logics.

1 For comments, thanks to Lee Buchheit, Sebastian Grund, Bruno de Witte, Jeromin Zettelmeyer, and Chiara Zilioli, and participants at the Institutions and Crisis conference and the Managing and Understanding Sovereign Risks course at the European University Institute in April 2018.

Introduction

The financial crisis of 2008-2013 had sweeping economic and political consequences around the world. In an effort to stabilize economies threatening to spiral out of control, and to prevent further disaster, governments around the globe took unprecedented actions, ranging from infusion of public capital to specific banks and enterprises, to "bail outs" of national governments, to deep cuts in social services and government spending. As the immediate crisis receded, and the economic turmoil abated, commentators and policymakers began to consider "lessons learned" in an effort to minimize the risk of a repeat of such events, and a number of institutional reform efforts commended. An important element of these reforms focused on strengthening budgetary rules, financial regulations, and oversight. In Europe, the most salient of these was the adoption of the "Fiscal Compact," a treaty that requires EU member states to adopt a number of budgetary procedures in order to be eligible for future EU aid under the European Stability Mechanism (ESM).[2]

These reforms were motivated in part by the conviction that previous rules had not been backed by sufficiently strong enforcement mechanisms, and that new procedures should include provisions that would make them "stick." In order to achieve this, policymakers placed increasing weight on courts as potential enforcers. Thus, the Fiscal Compact required member states to incorporate the new fiscal rules into domestic law ("preferably constitutional," as the treaty stated) in order to make them enforceable by national courts (which governments could supposedly ignore only with great difficulty). The treaty also provided that members states could face challenges before the European Court of Justice for failing to comply with these requirements (see Keleman 2018 for a detailed treatment).

In this paper, we are concerned with an aspect that has received only limited attention in these debates, but that is critical given such reliance on judicial enforcement: are courts likely to be effective enforcement mechanisms for the new fiscal rules? The fact that this question has received little scrutiny is surprising. An answer is central to understanding whether the newly-adopted measures are likely to work. Moreover, there is material one can draw on in trying to think about

2 The formal title of the Fiscal Compact is the "Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union." It was adopted by EU member states in 2012, and came into force in 2013. For a discussion on the adoption of the fiscal rules by individual countries during the crisis, see Asatryan et al. (2016).

the role that courts might play in enforcing fiscal rules, particularly in times of crisis: courts were intimately involved in various aspects of the crisis response. Austerity measures (including public sector wage and pension cuts) were subjected to judicial review in various countries (Contiades & Fotiadou 2018, Violante & Andre 2018). Similarly, attempts to restructure sovereign debt as well as the decision by the European Union (through the European Central Bank's OMT policy) to provide access to low interest credit for governments threatened by fiscal collapse (most notably, Greece) were the subject of legal cases before national and supranational courts (Vanberg & Gulati 2018).

The argument we develop in this chapter is that courts are likely to face significant limitations in their ability and willingness to enforce constitutional rules in times of (financial) crisis. These limitations are a result of the peculiar institutional features of courts. In consequence, we argue, courts are not well-suited to provide "teeth" for rules – including fiscal rules – that EU members states (or, more generally, constitution writers anywhere) may want to impose in order to constrain policymakers in times of crisis. We illustrate our argument with two case studies from the recent fiscal crisis – the decisions by the German Federal Constitutional Court and European Court of Justice on the European Central Bank's Outright Monetary Transactions ("OMT") policy, and the European Court of Human Rights' decision on the Greek government's restructuring of its sovereign debt in 2012. The conclusion that emerges from our argument is that – in light of the limited efficacy of judicial enforcement of fiscal rules and rules affecting sovereign debt – consideration of how to provide such rules with teeth without relying on courts is an important area of future research.

The Argument

By definition, crisis places stresses on a political system. The fact that "business as usual" is inadequate implies that policymakers will often feel the need, or pressure, to take extraordinary measures in an effort to confront a crisis – including measures that may be in tension with underlying constitutional commitments. Recognizing that extra-constitutional action may sometimes be required in such circumstances, many constitutions provide for emergency powers that allow for the suspension of specific constitutional provisions.

At the same time, crisis does not provide a blank check for dispensing with all constitutional restrictions, for two reasons. First, some constitutional constraints are imposed *precisely* because constitution writers want to restrict the ability of governments to engage in particular actions during crisis times. For example, the restriction on issuing "paper money" in the US Constitution was adopted in order to prevent state governments from responding to pressure to provide debt relief through the printing press (Appleby 1987).

Perhaps more interestingly, the intended effects of some constitutional provisions in *ordinary times* require that individuals expect these rules will have teeth in *extraordinary circumstances*. Consider two examples. A long literature in political economy has stressed the importance of secure property rights and constitutional restrictions on arbitrary takings as a key ingredient for economic growth (North & Weingast 1989, Olson 1993). But of course the beneficial effects of constitutional protections of property rights on the willingness of individuals to invest will be undermined if individuals do not expect these restrictions to be binding when governments are tempted to engage in expropriation in times of crisis. The second example is of more immediate relevance to current paper. Consider the "no bail out" provision of the Maastricht Treaty (Article 125). This provision restricts the ability of the European Union to "bail out" member states who are unable to meet their fiscal obligations. The intent behind the restriction is clear: in creating the common currency Eurozone, member states were concerned to ensure that governments would engage in responsible spending. By shutting off the possibility that the consequences of excessive deficit spending might be forestalled by a bail-out, Article 125 was intended to provide incentives for fiscal discipline. Crucially, however, note that this provision can only have this effect *if* governments expect that the provision will be enforced in times of crisis. Put differently, the entire logic of these kinds of provisions is predicated on the assumption that they will be enforced in extraordinary times.[3]

But what are the prospects for enforcement of such provisions in times of crisis – particularly by courts? We argue that judicial enforcement faces two potential obstacles. The first emerges from a feature that has

3 One potential objection to this example is that the "no bail-outs" clause never meant to be a strict rule, but rather intended as a malleable standard that would allow for financial assistance to debt-burdened countries. We are skeptical of this claim, but recognize that the issue is the subject of considerable disagreement and debate (e.g., Gerner-Beurle 2015). Importantly, however, this is not material to the thrust of our theoretical argument. Our concern is not whether Article 125 is a rule or a standard. Rather, it is the more general point that if the drafters of constitutions (or founding treaties) want to adopt rules that will bind the hands of future governments, judicial enforcement cannot always be counted on.

received considerable scholarly attention: the relative institutional weakness of the judiciary. Courts are typically dependent on executive or legislative cooperation for the enforcement of their decisions. In ordinary circumstances, these branches are under pressure to comply with judicial orders. But when a crisis raises the (perceived) urgency of particular measures for these actors – even if these measures are in tension with constitutional norms – the risk of non-compliance looms. In such circumstances, courts may be ineffective because their decisions are ignored. More likely, courts may be ineffective because judges anticipate their precarious situation, and choose to sanction a contested policy rather than expose their institutional weakness (Vanberg 2005). Examples of such "strategic retreat" are not difficult to find, including the US Supreme Court's decision to uphold FDR's abrogation of the gold clauses in federal government bonds (Glick 2009), or the Russian constitutional courts increasing deference to presidential authority following a confrontation with President Yeltsin in 1993 (Epstein, Knight & Shvetsova 2001).

While the fact that the relative weakness of courts can undermine the effective enforcement of constitutional rules is well understood (Staton 2010, Vanberg 2005), scholars have paid less attention to the fact that – ironically – judicial *strength* can also limit enforcement of constitutional rules in times of crisis. Suppose that a court does not face a compliance problem: its decisions, including a decision to enforce a constitutional rule that restricts government action in times of crisis, will be followed by relevant actors. Such a scenario is plausible, including in many EU member states, when governments may face a significant public backlash for brazen defiance of judicial decisions (Vanberg 2005). Courts typically enjoy higher public support than other branches (Gibson, Caldeira & Baird 1998). This support provides a significant resource, since resisting decisions becomes risky for executives and legislative majorities – especially if the decisions themselves are popular. To take a concrete example, consider the German constitutional court's decision on German participation in the ECB's OMT policy, designed to provide fiscal crutches to Greece and other distressed EU member state governments. A decision of the constitutional court to veto German participation would have been popular in Germany, and given the court's standing, resisting such a decision would have been difficult for the German government. (We return to this decision in more detail below.)

In times of crisis, a court that is powerful in the sense that its decisions are likely to be respected faces a different challenge than a weak court. For judges on such courts, the question is no longer whether the court *can* enforce a particular constitutional rule, but whether it is *willing* to do so. As we argue at length elsewhere (Vanberg & Gulati 2018), there are strong reasons to suspect that judges may be reluctant to do so. Perhaps the most important reason is crisis itself: although ostensibly charged with enforcing the law, judges are also aware of the practical implications of their decisions. Few believe in the maxim "let justice be done, though the heavens may fall." In crisis situations, these practical consequences of judicial decisions – particularly a decision to veto a governmental response to a crisis – are likely to weigh heavily, since the potential consequences of prolonging or deepening the crisis are salient.

Judicial sensitivity to the potential consequences of vetoing a governmental response during crisis is further exacerbated by the particular institutional structure and position of the judiciary. One aspect is the judiciary's place in the policy process. As a veto player – and one who is perceived to act "at the end" of the policy process – judges face skewed accountability incentives. A decision to veto a governmental policy exposes the court to blame if the crisis appears to lengthen or deepen as a result. But a decision to uphold a policy, even if it is ultimately unsuccessful in resolving the crisis, is likely to saddle blame for the failure on the government that formulated it. Second, the fact that courts are not directly accountable to citizens, and do not have access to the immediate claim of a popular mandate, may make judges especially reluctant to take on this risk of vetoing a government's actions in times of crisis. A final aspect concerns the fact that judges typically lack economic expertise and have less access to independent expert advice – particularly on highly complex issues, such as restructuring of sovereign debt, or the fiscal and economic implications of budgetary decisions. In short, the perception that they are dealing with complex issues in which they are not expert, that a decision to veto a governmental response may – given crisis conditions – have significant detrimental consequences, and that the court potentially exposes itself to being blamed – and thus damaging its standing – for hamstringing a government's crisis response through such a veto, is likely to make judges particularly careful in engaging in rigorous enforcement of certain constitutional restrictions.

In short, our expectation is that crisis conditions generate two challenges for courts that make these institutions less capable of reliably enforcing constitutional restrictions than one might believe at first. Given the perceived high stakes of crisis response actions, weak courts may not be *able* to reliably enforce restrictions, even if they were willing to do so, because governments would fail to comply. And strong courts – because they *are* able to enforce these rules – may not be *willing* to do so, given the perceived high stakes of the situation. In either case, courts may prove to be less efficacious than is commonly assumed in the reforms that have been adopted in response to the financial crisis.[4] We now turn to two case studies to illustrate the argument.

Our first case study considers challenges to the Greek debt restructuring of 2012, during which the Greek legislature retroactively changed the terms of its government debt contracts, so as to be able to force a restructuring on its creditors. Unsurprisingly, creditors sued in the European Court of Human Rights (ECHR), claiming that they had been expropriated in violation of basic property rights protections the Greek state owed them. As we argue in more detail below, the ECHR found itself in a weak position vis-à-vis the Greek government. The second study examines challenges to the European Central Bank's OMT policy (announced in August 2012) before the German Constitutional Court. We argue that in contrast to the ECHR, the German court was in a strong position, and could have – had it chosen to do so – forced a German withdrawal from OMT. And yet, in both cases, when push came to shove, the courts elected not to try to enforce restrictions on governmental behavior that had plausibly been violated.

The Greek Retrofit of 2012

Our first case study centers around the multiple legal challenges brought against the Greek sovereign debt restructuring during the recent financial crisis. After making its way through local tribunals, the most important of these challenges arrived at the European Court of Human Rights (ECHR) in 2016. The issue at stake originated in 2012. At the time, Greece (and thanks to it, the entire Euro area) had been mired in financial crisis for almost two years. Temporary funding from the IMF and the Euro area had failed to resuscitate the market's confidence in Greece's ability to repay its outstanding debt (roughly Euro 400 billion in 2010).[5] Worse, the Greek crisis had diminished market confidence regarding a number of other Euro area countries. Borrowing costs had risen sharply for the weaker Euro area economies (Spain, Portugal, Ireland, Italy, Cyprus,

4 This is an argument about general tendencies – undoubtedly, there is variation among judges to rule against crisis actions even in the face of crisis.

5 For details on the crisis, see, e.g., Zettelmeyer et al. (2013); Blustein (2016).

among others), and IMF rescue plans had been put in place for both Portugal and Ireland.

By mid 2012, many observers had concluded that something drastic had to be done to rescue Greece from its debts, and to prevent financial contagion from spreading to the rest of the Euro area. One potential answer was for the European Central Bank (ECB) and the richer Euro area nations to guarantee all Greek, Italian, Irish, and Spanish government bonds. But that option seemed to be closed off. Legally, such a guarantee would appear to violate Article 125 of the Lisbon Treaty, the "no bailout" clause that states that the Union is not responsible for, and will not assume, liabilities of members. Politically, Greece, along with a number of other southern European nations, was viewed by many citizens in northern EU member states as having borrowed irresponsibly for years. There was little appetite in these countries for providing funds to bail out what appeared to many as irresponsible southerners and their equally irresponsible creditors.

Caught in this bind, the Greek government turned to a retroactive modification of the terms of its debt as a solution. It was able to pursue this avenue because the vast majority of Greek debt (over 90%) was governed by local Greek law. This, in turn, implied that the Greek parliament could affect the value of the debt through legislation. For example, it might pass a law to mandate that all debt claims under Greek law go through a six-month process of court-supervised mediation before being brought before a judge – a move that would be legally valid and also reduce the value of the debt claims.

The specific strategy the Greek government settled on was to impose a provision that would allow for a change in the payment terms of its bonds with the agreement of a supermajority of the creditors (66.67%) and the debtor. Importantly, a large fraction of Greek debt was held by regulated institutions (banks, mutual funds, pension funds, etc.) who were likely to be amenable to governmental suasion on the part of European authorities. Presumably, the Greek government and its advisers had calculated that the required approval could be obtained at 66.67% before settling on this threshold. As a result, rather than requiring the approval of every single bondholder for a restructuring (something that would be impossible to accomplish), it would be possible for a supermajority of bondholders to force a restructuring on dissenting bondholders (highly plausible). The Greek parliament passed the required legislation, and one of the largest sovereign debt restructurings in history went through, imposing an NPV haircut of upwards of roughly 65% on bondholders (Zettelmeyer et al. 2013, provide details). With the help of some additional policy moves (described in the next case study), the crisis gradually abated.

The Greek government's actions provoked multiple legal challenges (Grund 2017a & b, Buchheit 2018). Several of these focused on the fact that the European Convention on Human Rights Law guarantees all European Union citizens the protection of their property rights. Specifically, Article 1 of Protocol No. 1 protects the right to the "peaceful enjoyment of possessions" (Buchheit & Gulati 2010; Wautelet 2013).[6] This right may be restricted only in the public interest, and only through measures that do not impose an individual and excessive burden on a private party. While Article 15 opens the door to measures that are "inconsistent" with the convention in times of "public emergency," there were significant doubts whether the current circumstances, and the Greek government's actions, warranted such an exception. Because these legal challenges had to wind their way through local avenues first, the case, *Mamatas and Others v. Greece*, did not reach the ECHR -- which has ultimate authority on the question of whether Article 1 was violated -- until 2016. Significantly, by this point, the borrowing costs of governments across the Euro area had gone back down to their pre-crisis levels; it appeared that the combination of public policies that had been pursued had effectively quelled the crisis.

In confronting this case, the ECHR found itself in a tough position. On the one hand, the Greek government had engaged in a fairly blatant taking of property. It had retroactively inserted new contract terms into its bonds with the precise goal of dramatically reducing the amounts it owed creditors – a move that would seem to be precisely the kind of action that Article 1 is supposed to guard against. At the same time, even if the judges did not want to sanction the ability of European governments to rewrite their contracts to expropriate value from investors, as a policy matter, the restructuring appeared to have worked. By 2016, the sovereign debt crisis of 2010-2013 that nearly destroyed the European Monetary System appeared to have been brought under control.

Moreover, the court found itself in a weak position. As an international court, staffed by foreign judges, the ECHR enjoyed little public support in Greece. It is unlikely that a decision by the Greek government not to comply with an adverse judicial decision would have imposed domestic

6 The Greek constitution itself also has protection for property rights, in stating that no one shall be deprived of private property except for the "public benefit" (Article 17) (Buchheit 2018).

political costs on the government. Moreover, a decision to declare the Greek restructuring illegal would have been near impossible for the Greek government to comply with even if it had wanted to. Greece was still mired in a deep debt crisis (Zettelmeyer et al. 2017). But unlike during the 2010-12 period, there was no longer any appetite on the part of official sector institutions to provide Greece with the bailout funds that would have been needed to pay creditors. In the other words, the ECHR found itself in the position of a relatively weak court that could anticipate that an attempt at vigorous enforcement of property protections would likely be met with noncompliance by the government. *Even if the judges believed that the government had blatantly violated the rule of law, they could not expect that a decision to declare the restructuring invalid would be honored.* The Court reacted in the manner our argument suggests: rather than risk non-compliance, which would have weakened the court's legitimacy, the Court choose to uphold the Greek government's actions.

Importantly, in engaging what can arguably viewed as a strategic retreat, the court attempted to minimize the future implications of its ruling. Three moves are especially relevant. First, the Court rejected the argument that the modification of the bond contract terms was not an interference with property rights, but rather part of the government's prerogative as a sovereign lawmaker. Put differently, the judges rejected the argument that sovereign immunity protected the government from judicial review, an argument that had worked in some domestic courts (Grund 2017). Instead, the court took the position that the Greek action was clearly a significant interference with the right of enjoyment of possessions. However, the judges cautioned, this did not necessarily imply that the action was invalid. The second key element of the court's decision was to argue that the Greek action could not be sanctioned just because Greece was in dire emergency (as per Article 15). Arguably, this move served to narrow the loophole for future governments that might attempt to expropriate value from their creditors. Had the Court relied on Article 15 alone to uphold the Greek action, in the future, it would almost surely have to defer to the judgments of local governments regarding whether a crisis is deep enough to justify extraordinary actions – a judgement that would likely be initially reviewed in a local court (which would surely be sympathetic to the local government) before being appealed to the ECHR.

In short, to constrain future governments (and future courts) from allowing similar behavior, the judges would have to add more conditions to their decision – conditions that would be difficult to satisfy in the future. This is what the third element of the decision – which focused on investor expectations – did. The Court explained that investors had had fair warning that a restructuring of the debt was likely ever since late 2010. Surely, the judges explained, investors could not have expected that their bonds were immune, given that the government was in crisis, and unable to pay back its creditors in full. Further, the court held, the Greek retrofit had put in place a restructuring mechanism (one requiring an affirmative vote of 66.67% of all the creditors in favor of the restructuring plan) that was similar to the standard mechanism in the sovereign bonds governed by foreign laws. As a result, the judges concluded, investors were being treated as well as they could have expected.

Legally, the "investor expectations" argument made by the Court was flimsy (Violi 2016). Investors indeed knew in March 2012 that a restructuring attempt was likely because the Greek government was in deep crisis. But that does not mean that they expected that the government would use its legislative power to retroactively rewrite their contracts in a fashion that would allow the government to impose severe haircuts on creditors.[7] Senior European policy makers like Lorenzo Bini Smaghi and Jean-Claude Trichet had, after all, made multiple statements in the context of the Greek crisis to the effect that no Euro area sovereign debt would be restructured (Blustein 2016).[8]

It is difficult to know how successful the court's strategy of relying on the "investor expectations" (in a crisis) argument will be in

7 As for the argument that it was fair to put in place restructuring clauses in the bonds because such clauses were standard in bonds on the international market, that is ever weaker. The fact that other bonds have provisions that make them easier to restructure says nothing about whether investors who had bonds that did <u>not</u> have these provisions were expecting such provisions to be legislatively imposed on them. If anything, the fact that these investors had purchased bonds lacking the option to restructure suggests that investors did not expect to be restructured. Worse, the provisions that Greece retrofit onto its local law bonds were nothing at all like the ones in international bonds. International bonds require a 75% vote of the creditors (in amount) on a <u>bond by bond basis</u>. In the Greek retrofit, the vote requirement was not only lower (66.67%), it was an aggregated requirement for all of Greece's local law bonds (Zettelmeyer et al. 2013). In other words, much easier to satisfy than what would have been required in a standard international bond.

8 Bini Smaghi memorably (and, in hindsight, hilariously) told the Financial Times, in May 2011: "A debt restructuring... would be like the death penalty – which we have abolished in the European Union." (Atkins 2011). Similarly, European monetary affairs commissioner, Joaquim Almunia, said in an interview with Bloomberg in 2010: "No Greece will not default. In the Euro area, default does not exist." (Monaghan 2010).

circumscribing the conditions under which a sovereign in the Euro area can impose bond restructuring in the future. Certainly, the court was trying to constrain future courts and governments from going down the Greek retrofit path. That said, given the vagueness and manipulability of the concepts at hand, we are skeptical that this standard will impose an effective constraint. Time will tell. As Robert Scott and Jody Kraus observe in their classic Contract Law text, judges – when faced with tough decisions that will produce high short term costs – often choose to convert bright line rules into fuzzy standards in order to avoid these costs (Scott & Kraus 2013). But, as Scott and Kraus explain, this strategy opens Pandora's box in terms of long term costs.

"Whatever it Takes"

While the ECHR's decision in *Mamatas* arguably illustrates strategic retreat by a weak court in the face of likely defiance, our second case study is designed to showcase the other end of the spectrum: judicial "self-censoring" by a strong court concerned about the potential consequences of limiting a government's ability to respond to crisis. This case study revolves around two opinions issued by the German Federal Constitutional Court (FCC) in a dispute surrounding the European Central Bank's (ECB) response to the economic crisis enveloping Europe in 2012. By the summer of that year, it appeared that threats to the viability of the common currency were becoming real for the countries of the Eurozone: borrowing costs were skyrocketing for a number of European countries, putting them in an increasingly dire financial situation.

In the face of this threat, ECB governor Mario Draghi promised in August 2012 to do "whatever it takes" to calm financial markets, and to protect the financial stability of Euro zone governments (Gerner-Beuerle, Küçük & Schuster 2014: 282, Khan 2016).[9] The policy he announced in order to accomplish this was the Outright Monetary Transactions Policy (OMT). Under the OMT program, the ECB promised to buy the short-term bonds of Euro area member countries in unlimited amounts should circumstances call for it (lending credence to the promise to do "whatever it takes"). Moreover, the ECB promised that should a restructuring of a Euro member nation's bonds occur, the ECB would not claim priority status (as it had some months prior with Greece) (Coeure 2013).

The hope of the ECB, shared by other European policymakers,

9 Draghi's specific words were: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

was that the OMT program would lower the cost of financing for distressed countries. Knowing that the ECB was standing ready to buy bonds in the secondary market in "unlimited" amounts, purchasers in the primary market for bonds would feel safer, leading to a lowering of interest rates. The ultimate goal of the policy was thus to avert the risk of "redenomination" – that is, the need for a member nation to exit the Euro. Greece, of course, was the primary candidate for such a development. By all appearances, the combination of Draghi's statement and the announcement of the OMT program worked to calm the markets (Jones 2015: 63). Interest rates fell dramatically, including for the bonds of countries in distress.

Despite its apparent success, the ECB's OMT policy was not met with applause in all corners of the Eurozone, particularly in Germany. In Germany, European Union efforts to "prop up" Southern European countries, including through OMT, were unpopular. At its core, the ECB is a collection of central banks. Thus, the guarantee to do "whatever it takes" was, in effect, a guarantee by the stronger central banks to purchase bonds issued by financially distressed governments. The strongest of these central banks was the Bundesbank – and the potential that German taxpayers might be liable for what would amount to significant transfer payments to Southern European countries raised significant, and politically salient, concerns in Germany.

Moreover, to many German observers, OMT represented a violation of the terms under which Germany had entered the Euro, and submitted to the authority of the ECB.[10] Under the Maastricht Treaty, the ECB has a circumscribed mandate to engage in monetary policy to keep prices stable, but not to engage in monetary financing of individual Euro area countries (Article 123 TFEU). A promise to buy unlimited quantities of a member country's debt in order to prop it up when it did not enjoy the confidence of the markets seemed inconsistent with the ECB's mandate (Mody 2014, Art 2015).[11] It also appeared in tension with the so-called "no bail-out clause" of the Lisbon Treaty (Article 125), which prohibits the European Union from "bailing out" member state governments in financial distress. From the perspective of the critics in Germany, OMT

10 The title of a Bloomberg article reporting on the case is telling: "ECB Bond Program Dubbed 'Financial Dictatorship' in German Court" (Matussek & Speciale 2016).

11 The fact that the ECB seemed to have announced a willingness to take haircuts on the same terms as ordinary investors made things worse: It further increased the risk that countries like Germany faced in the event that another member nation of the Euro area acted irresponsibly in accumulating too much debt.

constituted not only a violation of European law, but also a violation of German law (Wilkinson 2015: 1050). Significantly, these concerns were shared by the Bundesbank itself: Jens Weidemann, the head of the Bundesbank, was staunchly opposed to OMT (Wagstyl 2016). Led by a German legislator, Peter Gauweiler, a number of prominent politicians and academics lodged constitutional complaints in front of the German Constitutional Court to challenge the legality of the ECB's OMT program, arguing that the policy violated both European law, and the budgetary autonomy of the German parliament.

Potentially, these challenges posed a significant threat to the OMT policy (Sinn 2013). There were two reasons. One was the authority of the constitutional court. The FCC enjoys tremendous confidence among German citizens – exceeding trust in other political institutions, including parliament and the federal government by significant margins (see Vanberg 2005; Vorlaender & Brodocz 2006). Opposing a negative ruling on OMT by the court – especially given the general public skepticism towards German financial obligations towards Southern European countries – would likely incur significant political costs on the part of the German government. Second, the German institution most directly involved in the OMT program – and therefore most immediately affected by a potential FCC veto – was the Bundesbank. And the Bundesbank had already taken the position that participating in the OMT was improper, including in materials submitted to the FCC.[12] Put differently, given that implementation of an order from the FCC finding the OMT to be *ultra vires* would have been in the hands of the Bundesbank (in its role as Germany's representative at the ECB), compliance with a veto of OMT seemed assured. Moreover, even though the German government led by Mrs. Merkel had indicated its support of Mr. Draghi's program (Mody 2014), it gave no indication of being willing to cross the combination of two of the most respected institutions in Germany should the FCC rule against OMT. And without German participation, the credibility of the OMT's program would have been severely compromised, arguably jettisoning the policy.

The judges of the FCC likely knew that they were in a position – via a veto – to undercut the ECB's crisis response, and to cripple the OMT policy. When the court issued its final decision in June 2016, it refused to veto OMT, and largely upheld the ECB's policy. To make a case that

12 For a report on the amicus brief filed by the Bundesbank, see Jan Hildebrand, "Weidmann rechnet mit der EZB ab," *Handelsblatt,* April 4, 2013.

this decision can be interpreted as an instance of "strategic retreat" by a powerful court concerned to avoid the consequences of a veto, we need to show that it is plausible that:

1. The judges of the FCC believed that OMT constituted a violation of German and/or European law, and
2. That they chose to uphold OMT because they were concerned about the consequences of hamstringing the ECB's crisis response.

Of course, it is not possible to establish the views of the judges conclusively. However, strong evidence regarding the judges' sincere views of the legality of OMT emerge out of the sequential nature of the two opinions issued by the court in this case. The FCC's decision in June 2016 was the second opinion it had issued on the constitutional complaints. The court had issued an earlier, initial decision in January 2014 – a decision in which the court announced its view of the OMT program, but referred the case to the European Court of Justice (ECJ) for a ruling on the compatibility of the program with EU law.[13] This initial opinion left little doubt that the six member majority (two judges dissented) viewed the OMT program as inconsistent with European law. Moreover, the court explicitly laid out the narrow conditions under which, in the opinion of the judges, the OMT policy would be legal. Specifically, the FCC posited that there could not be a commitment to buying bonds in unlimited quantities, and that a meaningful time gap between the issuance of debt by a distressed sovereign and its purchase by the ECB would be required. Moreover, the FCC insisted that the purpose of the ECB's actions must be price stability (not economic resuscitation), and that the ECB's bonds would not face the risk of being restructured. In effect, the conditions laid out by the German court in its initial decision would gut the OMT (Mayer 2014). "Whatever it takes" would no longer be the policy promise.

However – despite clearly articulating its view that the program was illegal – the court refrained from striking it down. Instead, the judges forwarded the case to the European Court of Justice (ECJ) under the preliminary reference procedure – the first time the Second Senate of the FCC had done so. The decision to do so was widely seen as unusual and historic (see Wendel 2014: 263-64; Gerner-Beuerle, Küçük & Schuster 2014: 282), in part because the judges had the option of ruling on the case as a matter of domestic German law by focusing on the question

13 Bundesverfassungsgericht (BVerfG) [Federal Constitutional Court], Jan. 14, 2014, Case No. 2 BvR 2728/13.

whether the OMT program was in violation of Germany's accession to the monetary union – a position that had been taken by the petitioners. One interpretation of this move fits well within the framework of our model: by sending the case to the ECJ, the judges of the FCC – knowing that a decision to strike down the OMT would place tremendous pressure to comply on the German government, putting the risk of a return to economic upheaval on the table – stepped back from a line they were reluctant to cross. As an editorial in one of the major German newspapers put it at the time, "First, the judges ruled that the conduct of the ECB was illegal. Afraid of their own courage, they then turned to the ECJ for help."[14]

Given its forceful language, and the explicit conditions demanded, the initial German opinion seemed to indicate that if the ECJ failed to impose the specified restrictions on the OMT program, the FCC might strike down the program in its final decision. Of course, should the ECJ follow the FCC's demands and rule OMT illegal (or subject to conditions that would make it unworkable), there loomed the risk of returning the Euro area to crisis. In the end, the judges of the ECJ – generally much more favorable to the program of European integration – called the FCC's bluff. The ECJ ruled OMT legal as a matter of European law, without the need to respect the conditions that the FCC had demanded (Wilkinson 2015). The case now returned to the FCC for final decision.

The situation confronting the judges of the FCC at this juncture was both similar, and significantly different than it had been in 2014. It was similar in the sense that given the authority of the FCC, the support the Court enjoyed from the Bundesbank, and the significant public opposition in Germany to continued German financial support for distressed Euro area governments, supporting OMT in the face of a negative FCC decision would have been difficult if not impossible for the German government.[15] A negative decision would almost certainly undermine the OMT policy in a significant way. The situation was different in the sense that, unlike in 2013, the court no longer had the option of "passing the buck," at least for a time, to the ECJ. By 2016, the judges of the FCC understood that they would now have to make a decision, and that that decision would be implemented by the relevant

14 See Holger Steltzner "Die Angst der Verfassungsrichter" ("The fear of the constitutional court judges"), *Frankfurter Allgemeine Zeitung*, 2/7/2014.

15 Case C-62/14, Peter Gauweiler and Others v. Deutscher Bundestag (June 16, 2015), http://curia.europa.eu/.

German institutions. Moreover, the apparent effectiveness of the OMT program was clear: Four years had passed since the crisis. A decision to rule the OMT program illegal raised the specter of a return to chaos and the most significant crisis the EU had faced in its existence. The blame for such an outcome would fall on the FCC.

Despite the forceful argument in its original decision that OMT could not pass muster without significant limitations, in June 2016, the FCC caved: in its second decision, the court accepted the ECJ's judgment, and upheld the OMT program despite the fact that the ECJ had not imposed any of the conditions demanded by the FCC (Evans-Pritchard 2016; Jones 2016).[16] Importantly, *all* of the six judges who had comprised the majority in the 2014 decision, remained on the court: the switch in the court's position cannot be explained as the result of turnover on the bench. In our view, a plausible interpretation of the court's "about face" is as an instance of strategic retreat by a strong court: knowing that a veto carried the real risk of plunging the Eurozone back into financial crisis, the judges of the FCC chose to uphold the ECB's policy despite their legal reservations.[17] Thus, this episode illustrates that – as suggested by our argument, and contrary to the traditional view of courts – judicial self-censoring may not only result from judicial weakness, but also from judicial strength.

Conclusion

History tells us that governments around the world frequently react to financial crises by enacting legislation constraining their future selves from over indulging in debt. The hope is that by enshrining constraints on fiscal policy in law, governments can pre-commit themselves to responsible behavior (Ginsburg 2018). But history also tells us that the political flesh is weak, and that when new crises arise, politicians will be tempted to push the boundaries of these constraints, and even overstep them. The question we ask in this paper is whether courts can – as is often expected of them – act as effective enforcement mechanisms in these kinds of situations. We argue that there are strong reasons to be skeptical.

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16 Perhaps to save face, the FCC noted that it reserved the right to revisit the matter if OMT were to be used to assist countries without "market access." But this was an empty threat given that the ECB's promises were going to ensure market access in the first place.

17 A second, and not inconsistent, aspect of this episode is that a veto of OMT following the ECJ's decision would have created a direct confrontation between the ECJ and the FCC.

If courts are weak relative to governments, and expect their decisions to be ignored, courts will be tempted to capitulate. Conversely, if courts are strong and expect that their decisions will be respected, then courts risk being blamed for having exacerbated the crisis – something judges will not want, if they value public support. The result is the same in both cases: courts, and particularly local courts, are not likely to be effective at enforcing long-term commitments to rules in times of financial crisis, even if these rules are intended to be enforced.

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FROM FORM TO SUBSTANCE: JUDICIAL CONTROL ON CRISIS DECISIONS OF THE EU INSTITUTIONS (WITH A FOCUS ON THE COURT OF JUSTICE OF THE EUROPEAN UNION)

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With few exceptions[2] the courts, by definition, intervene only "ex post facto". One could say that their function is to check what has happened,

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2 The Court of Justice can also be requested by a Member State, the European Parliament, the Council or the Commission for an *ex ante* Opinion as to whether the content of an envisaged agreement to be signed by the EU is compatible with the Treaties (Article 218(11) TFEU), in order to forestall complications which would result from legal disputes (Opinion 1/09 of 8 March 2011, para. 47), or to assess the competence of the Union or its institutions to enter into that agreement (Article 196(2) of the Rules of Procedure of the Court of Justice. See also Opinion 1/03 of 7 February 2006). A decision of the Court of Justice stating an incompatibility after the conclusion of a binding international agreement could in fact provoke "not only in the internal EU context but also in that of international relations, serious difficulties and might give rise to adverse consequences for all interested parties, including third countries" (Opinion 2/13 of 18 December 2014 on the draft agreement providing for the accession of the European Union to the European Convention for the Protection of Human Rights and Fundamental Freedoms, para. 146). Once issued, the Opinion is binding for the institutions of the Union and therefore, once the incompatibility of the draft agreement with the Treaties is established, it can be concluded only after having modified such draft agreement or the Treaties.

and eventually redress it, in the light of the principles and rights[3] recognised as fundamental in the specific legal order. Courts are expected to apply these principles and rights and balance them against each other; since none of them is absolute, each needs to coexist with the others.

In a society based on the rule of law, a judge has the delicate task of ensuring the respect of fundamental rights and, when two conflicting principles and rights are at stake, of balancing them for the common good. The common good entails protecting individual rights against abuse which, in turn, maintains the citizens' trust in the rule of law, but at the same time allowing these rights to be limited. (We should also remember here that we are talking of fundamental economic rights, for which the question of compensation in the event of their infringement is perhaps more unambiguous than for other fundamental personal rights.) During the financial crisis, the pressure to take decisions quickly to protect the public good of financial stability, overruling sometimes the private rights at stake, has provoked discussion on whether, in a crisis, fundamental rights deserve the same level of protection and whether the dichotomy between Union law, where fundamental rights are protected by the Charter[4], and other legal frameworks (for example, under the Treaty establishing the European Stability Mechanism), where they are not but in which the EU institutions have been assigned certain tasks, is sustainable. Several decisions taken during the crisis, made under the pressure of emergency, were indeed very "different" from usual business and normal procedures. This is probably why after the crisis we have experienced an increase in the recourse to the courts to check their legality.

The focus of the panel to which my paper contributes is to examine the role that the courts have played, both during and after the crisis, in balancing the rights of all the affected parties and in challenging the practices, procedures and sometimes legislation established in the crisis time.

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3 In the EU legal system, and especially in the Charter of Fundamental rights of the European Union, fundamental rights and general principles are considered differently, even if the distinction is not quite clear, and the Explanations relating to the Charter (OJ C 303 of 14 December 2007, at p. 35) do not really help.
On the difference between these two concepts in Union law, see T. Tridimas, *Fundamental Rights, General Principles of EU Law, and the Charter,* in *Cambridge Yearbook of European Legal Studies*, Vol. 16, 2014, p. 361 et seq.; S. Peers et al., *The EU Charter of fundamental rights: a Commentary*, Oxford, 2014; S. Walkila, *Horizontal Effect of Fundamental Rights in EU Law*, Groningen/Amsterdam, 2016, especially p. 181 et seq. See also the Opinion of AG Cruz Villalón of 18 July 2013 in Case C-176/12, *AMS*.

4 Charter of Fundamental rights of the European Union.

(I was fortunate to speak last, so I could relate my comments to the ones of the previous speakers.) Georg Vanberg has analysed whether courts are unduly soft and compromising when having to take decisions and applying fundamental principles to political decisions. He described his ideal judge as one that is strong enough to apply an absolute right in an absolute way, with no concessions, no balancing and no proportionality. My frank opinion is that the judge that society needs is *not* this – a machine that will apply absolute principles in a rigid manner, no matter what other (absolute) right or public interest is affected. This is why I do not feel critical of the many judgments that have been adopted on the political and legislative decisions taken during the crisis, rather I consider that they have been as a rule very constructive. I would tend to agree with Bruno de Witte that the courts have broadly been coherent with their previous stance on the issue of judicial restraint and, where two interpretations were legitimately possible, have chosen the interpretation more consistent with the existing constitutional and institutional order (perhaps with the exception of the *Bundesverfassungsgericht* – German Federal Constitutional Court).

In this paper I analyse the jurisprudence of the Court of Justice of the European Union and of national constitutional courts, looking in particular at three questions.

First, whether the more frequent recourse to the courts and the prominence of their decisions have increased the weight of the courts in the constitutional balance of powers.

Second, whether the scope of judicial control has changed, becoming broader, and if so, in what way and in what respects.

Third, whether the intensity of judicial control has deepened, bringing the courts beyond the traditional judicial restraint.

My conclusion is that the control exercised by the courts in the post-crisis period has played an important role in reassuring citizens that the fundamental principles stand and must be respected even when decisions need to be taken under pressure; and that the courts, beyond formal barriers, do not hesitate to analyse measures that have an impact on citizens, while exercising judicial restraint and remaining coherent with the fundamental principles of our legal framework and within the constitutional balance of powers.

1. Has the more frequent recourse to the courts and the prominence of their decisions increased the weight of the courts in the constitutional balance of powers?

In my opinion, the constitutional balance of powers has not been unsettled by the courts in their rulings after the crisis. Indeed, it is precisely the role of the constitutional courts to intervene and judge on the respective competences of the public authorities, as a guarantor of the distribution of powers established in the national constitution or in the Treaties. Of course, this can have an impact on the other powers of the State – when a red light is shown, the objective is to re-establish the proper interinstitutional balance.

In this context, some national constitutional courts, such as the *Bundesverfassungsgericht* (BVerfG) have adopted decisions which, in the end, might be seen as influencing policymaking, either by aiming to limit the scope of discretion of EU institutions and specifically that of the ECB (first listing proposed conditions under which the ECB can exercise its discretion; then referring to the limits of the German law authorising the ratification of the Maastricht Treaty as the limit that every German institution has the duty to comply with and be vigilant on[5]), or by reinforcing the legislative process through introducing new

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5 *Bundesverfassungsgericht*, judgment of 21 June 2016, 2 BvR 2728/13, para. 174: "… the constitutional complaints and the application in the *Organstreit* proceedings – to the extent that they are admissible – are unfounded. If the conditions listed below are met, the inaction on the part of the Federal Government and of the Bundestag with regard to the policy decision of the European Central Bank of 6 September 2012 does not violate the complainants' rights under Art. 38 sec. 1 sentence 1, Art. 20 secs. 1 and 2 in conjunction with Art. 79 sec. 3 GG, nor are the *Bundestag*'s rights and obligations with regard to European integration – including its overall budgetary responsibility – impaired. As long as the conditions formulated by the Court of Justice of the European Union in its Judgment of 16 June 2015 are met, the policy decision of the Governing Council of the European Central Bank of 6 September 2012 and its possible implementation neither constitute a qualified exceeding of the competences attributed to the European Central Bank by Art. 119 and Arts. 127 et seq. TFEU, Arts. 17 et seq. ESCB Statute (1.), nor violate the prohibition of monetary financing enshrined in Art. 123 TFEU (2.). The German *Bundesbank* may participate in the implementation of the OMT decision only within the framework laid down by the Court of Justice of the European Union. If it does not do so, the Federal Government and the *Bundestag* would be required to intervene (3.). As long as the conditions formulated by the Court of Justice of the European Union are met, no threat to the *Bundestag*'s overall budgetary responsibility that would require the Federal Government and the *Bundestag* to take steps against the OMT Programme in order to protect the constitutional identity is apparent (4.). However, should the OMT Programme be implemented, these organs would be obliged to constantly monitor the fulfilment of these conditions in order to counter threats to compliance with the European integration agenda or to the overall budgetary responsibility of the German *Bundestag* early on (5.)".

procedures. On the latter, all the crisis-relevant judgments of the BVerfG strengthen the position of the *Deutscher Bundestag* (the German Federal Parliament), the expression of the sovereign will of the electoral body, underlining the need to respect the form of parliamentary government and the democratic principle which also binds the Federal Executive to its decisions and approvals.[6]

This jurisprudence is also reflected *inter alia* in a form of positive law which gives extensive powers to the German legislature.[7]

Another way in which the BVerfG can be seen as influencing policymaking is through judicial cooperation: in a recent case, it managed to broaden the pool of information provided to the Court of Justice with a view to its giving judgment.

In the *Gauweiler* case, the *Deutsche Bundesbank* was not invited to the preliminary ruling proceedings in front of the Court of Justice as its participation in the main proceedings before the BVerfG had been as expert witness and so the Bundesbank was not a party thereof. In the *Weiss* case, however, the BVerfG informed the Court of Justice that the

6 Already the first crisis-related judgement of the Court (Bundesverfassungsgericht, Judgment of 7 September 2011, 2 BvR 987/10, 2 BvR 1485/10 and 2 BvR 1099/10, para. 128 et seq., on aid for Greece, European Financial Stability Facility (EFSF)), despite ultimately rejecting the applicant's claims, set procedural minimum standards that aimed at ensuring the involvement of the German legislature in decisions with important budgetary implications. (See also *Bundesverfassungsgericht*: Judgment of 28 February 2012, 2 BvE 8/11 and Judgment of 12 September 2012, 2 BvR 1390/12. See M. Steinbeis, *Das ESM-Urteil des Bundesverfassungsgerichts: ein fiebersenkendes Mittel*, in *Verfassungsblog*, 12 September 2012; D. Jaros, *German Constitutional Court on the Ratification of the ESM Treaty and of the Fiscal Compact*, available at http://europeanlawblog.eu, 10 October 2012; M. Bonini, *Il BVerfG, giudice costituzionale o «signore dei trattati»? Fondo «salva-stati», democrazia parlamentare e rinvio pregiudiziale nella sentenza del 12 settembre 2012*, in *Rivista telematica giuridica dell'Associazione italiana dei costituzionalisti*, 6 November 2012. Finally, see also *Bundesverfassungsgericht*, Judgment of 18 March 2014, 2 BvR 1390/12.) In general, the *Bundesverfassungsgericht* enhances the value of parliamentary law institutions which, by expressing the form of government accepted by the German Basic Law (*Grundgesetz)*, ask for a strict application by the legislature and a strict respect by the executive.

7 The ESM Financing Act (*ESM-Finanzierungsgesetz, ESMFinG*) of 13 September 2012 (Federal Law Gazette I, p. 1918), amended by Article 1 of the Act of 29 November 2014 (Federal Law Gazette I, pp. 1821 and 2193). Section 5 – Participation of the Budget Committee of the German Bundestag: "In all other matters concerning the European Stability Mechanism affecting the budgetary responsibility of the German Bundestag where a decision by the plenary is not provided for pursuant to section 4, the Budget Committee of the German Bundestag shall be involved. The Budget Committee shall monitor the preparation and implementation of agreements on stability support" (para. 1). The second paragraph contains a detailed list of cases in which the prior approval of the Budget Committee is required.

Bundesbank was formally an expert but, in substance and according to German law, a party in the main proceedings which were the subject of the reference. The Court therefore gave the *Bundesbank* the opportunity to submit written observations in the case, in its capacity as party to the main proceedings.[8]

Yet the BVerfG had not made this point in *Gauweiler*.

One cannot but think that this new interpretation from the BVerfG is linked to the concern aired by it in paragraph 182 of the final BVerfG decision in *Gauweiler*,[9] in which the BVerfG complains that the Court of Justice has not analysed properly any other evidence than the opinion of the ECB. By requesting in *Weiss* that the *Bundesbank* submit observations, the Court will be obliged to consider its opinion, despite its well-known reluctance to hear expert witnesses.

Other examples are even more obvious. Some constitutional courts have unilaterally annulled parts of memoranda of understanding (MoUs) agreed by the executive on the grounds of infringement of fundamental

8 Article 23(2) of the Statute of the Court of Justice of the European Union and Article 96.1 of the Court's Rules of Procedure state that shall be entitled to submit statements of case or written observations to the Court: the parties in the main case, Member States, the European Commission and, where appropriate, the institution, body, office or agency which adopted the act the validity or interpretation of which is in dispute. Article 97.1 of the Rules of Procedure states that "the parties to the main proceedings are those who are determined as such by the referring court or tribunal in accordance with national rules of procedure".

9 *Bundesverfassungsgericht*, Judgment of 21 June 2016 - 2 BvR 2728/13, para 182: "… the Court of Justice accepts the assertion that the OMT Programme pursues a monetary policy objective – an assertion that has been contested in a substantiated manner in the present proceedings – without questioning or at least discussing and individually reviewing the soundness of the underlying factual assumptions, and without testing these assumptions against indications that evidently argue against a character of monetary policy – particularly the selectivity of the purchases (BVerfGE 134, 366 <406 and 407 para. 73>; cf. […]) and the parallelism of those purchases to the EFSF and ESM aid programmes (BVerfGE 134, 366 <407 and 498 paras. 74 et seq.>; cf. […]). The Court of Justice does not address the consideration that limiting the OMT Programme to monetary policy goals aiming at restoring the transmission mechanism could be hindered by the fact that according to the policy decision purchases of government bonds are generally not permissible – irrespective of the effects on the transmission mechanism – if the state in question does not have access to the bonds market or if it does not abide by the rules of current macroeconomic adjustment programmes; it also does not address the fact that the quantifiability of the share of the interest rates that is not dependent on macroeconomics has been disputed – e.g. by the Bundesbank – although quantifiability would be a precondition for the determination of the volume that could by justified under monetary policy considerations if the programme were implemented".

principles[10]. I refer to the decisions of the constitutional courts in Portugal and Greece especially, which compelled the Member State to find another way of achieving the agreed total amount of budgetary consolidation. By way of example, the Portuguese Constitutional Court rejected the legality of some of the austerity measures (in particular those related to equal treatment of pensioners, both public and private[11]) that had been agreed between the Portuguese Government and the Troika as conditions for the release of the loan package granted by the Economic Adjustment Programme, which established a plan for budgetary deficit reduction.

2. Has the scope of judicial control changed? Has it broadened, and if so, in what way and in what respects?

Looking at the jurisprudence of the Court of Justice, I would answer in the positive and I would underline three issues.

First, the Court of Justice has started to analyse also non-binding acts (and not limiting itself to declaring the action inadmissible), arguing that such acts are actually creating changes and producing consequences, even though they do not in themselves directly affect citizens. I refer, for instance, to the ECB's press release of 6 September 2012[12] stating that,

10 See the Memorandum of Understanding on Specific Economic Policy Conditionality, 17 May 2011, agreed between the Portuguese Government and the Troika, i.e. the European Commission, European Central Bank and the International Monetary Fund.

11 Portuguese Constitutional Court (*Tribunal Constitucional*), Acórdão No. 353/2012. A group of members of Parliament requested the Court to declare unconstitutional some of the rules of the 2012 State budget Law (Law No. 64-B/2011 of 13th December), after the rejection (at a majority of nine judges against three) of the same request with reference to the 2011 State budget Law (Acórdão No. 396/11). See also Acórdão No. 187/2013 (against some norms of the 2013 State budget Law), No. 602/2013, and Acórdão No. 14/2014 (against the Law No. 83-C/2013, of 31 December 2013, which approved the State budget for 2014) in which the Court declared the unconstitutionality of the public sector wage cuts; of the cuts in survivors' pensions and of the contribution on unemployment and sickness benefits. See M. Nogueira de Brito, *Putting Social Rights in Brackets? The Portuguese Experience with Welfare Challenges in Times of Crisis,* in C. Kilpatrick, B. De Witte (eds.), *Social Rights in Times of Crisis in the Eurozone: The Role of Fundamental Rights' Challenges*, EUI Working Paper LAW 2014/05, p. 67 et seq.; J. Gomes, *Social Rights in Crisis in the Eurozone. Work Rights in Portugal, ibidem*, p. 78 et seq.; R. Cisotta, D. Gallo, *The Portuguese Constitutional Court Case Law on Austerity Measures: A Reappraisal,* in *ibidem*, p. 85 et seq.; M.L. Pires, *Private Versus Public or State Versus Europe? A Portuguese Constitutional Tale,* in *Michigan Journal of International Law*, Emerging Scholarship Project, 2013, p. 101 et seq.

12 https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

as announced at the earlier press conference, decisions had been taken concerning the programme for purchasing government bonds issued by Member States of the euro area, which were to be known as "Outright Monetary Transactions (OMTs)". Although this programme has never been translated into reality and the implementing legislation is missing, the announcement was in itself sufficient to have the (expected) effect on the financial markets and generate questions on its compatibility with Article 123 of the Treaty on the Functioning of the European Union (TFEU)[13].

Also the Eurosystem Oversight Policy Framework, published on 5 July 2011 on the ECB's website, a non-binding policy paper describing the Eurosystem's role in the oversight of payment, clearing and settlement systems, has been the subject of an action before the Court of Justice[14].

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13 See Judgment of the Court (Grand Chamber) of 16 June 2015, Case C-62/14, *Peter Gauweiler and Others* v *Deutscher Bundestag* (ECLI:EU:C:2015:400). The Court of Justice, instead of accepting the objections of inadmissibility coming from Italy, Ireland, the Netherlands, Spain, France, Greece, Portugal and Finland as well as the Parliament, the ECB and the Commission, according to which in the absence of implementing acts the OMT programme would have been a mere communication tool and not a binding act, choose to provide the ECB with an interpretation. The Court therefore replied to those exceptions that: "as regards the argument that the dispute in the main proceedings is contrived and artificial and that the questions referred are hypothetical, it should be observed that, as is apparent from paragraph 15 of this judgment, it is solely for the national court before which the dispute has been brought, and which must assume responsibility for the subsequent judicial decision, to determine in the light of the particular circumstances of the case, both the need for a preliminary ruling in order to enable it to deliver judgment and the relevance of the questions which it submits to the Court. Consequently, where the questions submitted concern the interpretation or the validity of a rule of EU law, the Court is in principle bound to give a ruling (see, to that effect, judgment in *Melloni*, C399/11, paragraph 28 and the case-law cited)" (para. 24) and that the fact "that the programme for purchasing government bonds announced in the press release has not been implemented and that its implementation will be possible only after further legal acts have been adopted, it does not — as the referring court states — render the actions in the main proceedings devoid of purpose since under German law preventive legal protection may be granted in such a situation if certain conditions are met" (para. 27).

14 Judgment of the General Court (Fourth Chamber), 4 March 2015, Case T-496/11, *United Kingdom v European Central Bank* (ECLI:EU:T:2015:133). According to the Court, a requirement for central counterparties (CCPs) involved in the clearing of securities to be located within the euro area exceeds the ECB's competences under Article 127 TFEU and in Article 22 of the Statute.

The same can be said of some MoUs on EU financial assistance[15].

Finally an ECB (non-binding) opinion has originated a direct action for damages before the General Court. The Court is requested to decide whether ECB opinions, i.e. opinions adopted by the ECB in the context of compulsory consultation by other Union institutions and Member States on draft legislation in the ECB's fields of competence, could be capable of incurring the liability of the ECB owing to a lack of consideration of fundamental rights issues[16].

Second, the relevance given to the respect of fundamental rights, even for decisions taken during the crisis and even when institutions exercise competences conferred on them outside the Treaties, is higher than before. It is well known that Article 6(1) of the Treaty on European Union (TEU) recognises the Charter of Fundamental rights of the European Union and gives it "the same legal value as the Treaties". In moments of crisis, fundamental rights and general principles are confirmed as an inalienable parameter, in the assessment of the Court of Justice, against

15 Judgment of the Court (Grand Chamber) of 13 June 2017, Case C-258/14, *Eugenia Florescu and Others* v *Casa Judeţeană de Pensii Sibiu and Others* – reference for a preliminary ruling (ECLI:EU:C:2017:448). The *Florescu* judgment clarifies that MoUs fall within the jurisdiction of the Court and are part of Union law. According to the Court, the Romanian MoU "gives concrete form to an agreement between the EU and a Member State on an economic programme, negotiated by those parties, whereby that Member State undertakes to comply with predefined economic objectives in order to be able, subject to fulfilling that agreement, to benefit from financial assistance from the EU" (para. 34). Among the conditions attached to the financial assistance, set out in the MoU, is the reduction of the public sector wage bill, while the fourth subparagraph of point 5(b) states that the pension system needs to be reformed (para. 46). The purpose of the national measure at issue in the main proceedings, which introduces wage cuts and pension reforms, is to implement the undertakings given by Romania in the MoU, which is part of Union law (para. 47).

16 See Application of 6 February 2017, Case T-107/17, *Steinhoff and Others* v *ECB*, http://curia.europa.eu/juris/document/document.jsf?text=&docid=190130&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=211251
in which the applicant argued that the ECB, in its opinion of 17 February 2012 (CON/2012/12), failed to point at the illegality of the Hellenic Republic's intended debt restructuring "by means of a compulsory exchange". The ECB opinion related to the draft law "retrofitting" collective action clauses into Greek law-governed sovereign bonds. In the applicants' view the ECB produced an incomplete and thus fundamentally erroneous document, not pointing out in the opinion the unlawfulness of the forced debt restructuring in view of the principle of *pacta sunt servanda*; they underlined the contrast with Article 17 of the Charter on Fundamental rights of the European Union (protecting the right to property), and the breach of Article 63 TFEU on the free movement of capital and of Article 124 TFEU on privileged access to financial institutions.

disproportionate or inadequate decisions[17]. It is not possible to analyse in-depth in this paper the scope of the Charter; the extent and limits of its application; the recognition of horizontal direct effects of some of its articles and the related question concerning the distinction between rights and principles[18]; and the limitations imposed upon rights[19]. Suffice it to remember that the judgment in the *Ledra*[20] case clarifies the scope of the Charter: " … the Charter is addressed to the EU institutions, including … when they act outside the EU legal framework". According to the Court, the Commission is bound to ensure that every MoU is consistent with the fundamental rights guaranteed by the Charter and should thus refrain from signing a MoU whose consistency with Union law it doubts[21]. More generally, the role of the Court of Justice as a constitutional court is enshrined not only in its exclusive competence to check that secondary legislation complies with the Treaties (e.g. action for annulment, preliminary ruling on validity, exception of inapplicability), or in the

17 Judgment of the Court (Grand Chamber) of 20 September 2016, Joined Cases C-8/15 P to C-10/15 P, *Ledra Advertising Ltd and Others* v *European Commission and European Central Bank (ECB)*, para. 70.; C. Kilpatrick, B. De Witte, *A Comparative Framing of Fundamental Rights Challenges to Social Crisis Measures in the Eurozone*, in Swedish Institute for European Policy Studies, 2014, available at http://www.sieps.se/en/publications/2014/a-comparative-framing-of-fundamental-rights-challenges-to-social-crisis-measures-in-the-eurozone-20147epa/.

18 See the judgment of 17 April 2018, Case C-414/16, *Egenberger* (ECLI:EU:C:2018:257).

19 J. Fraczyk, *EU fundamental rights and the financial crisis*, in S. Douglas-Scott, N. Hatzis (eds.), *Research Handbook on EU Law and Human Rights*, 2017, p. 468 et seq.

20 Judgment *Ledra Advertising,* op. cit., para. 67.

21 See paragraph 59. For an opposite position, see C. Barnard, *The Charter, the Courts and the Crisis*, in University of Cambridge, Faculty of Law, Research Paper No 19/2013, according to whom in crisis human rights are not respected in the same way. It should be noted however that the article was written before the *Ledra* judgment. For an analysis of that issue, see C. Zilioli, *Justiciability of central banks' decisions and the imperative to respect fundamental rights,* in *ECB legal conference 2017, Shaping a new legal order for Europe: a tale of crisis and opportunities*, Frankfurt am Main, 2017, p. 91 et seq.; D. Sarmiento, *Who's afraid of the Charter? The Court of Justice, national Courts and the new framework of fundamental rights protection in Europe,* in *Common Market Law Review*, Vol. 50, issue 5, 2013, p. 1267 et seq. Cf. also D. Sarmiento, *The Price of Borrowing EU Institutions, and the Price of Being Borrowed – A short comment on Ledra Advertising*, in *Despite our Difference*, 21 September 2016, available at https://despiteourdifferencesblog.wordpress.com/2016/09/21/the-price-of-borrowing-eu-institutions-and-the-price-of-being-borrowed-a-short-comment-on-ledra-advertising/; A. Hinarejos, *Bailouts, Borrowed Institutions, and Judicial Review: Ledra Advertising*, in EU Law Analysis, 25 September 2016, available at http://eulawanalysis.blogspot.com/2016/09/bailouts-borrowed-institutions-and.html; and P. Dermine, "The end of impunity? The legal duties of "borrowed" EU institutions under the European Stability Mechanism Framework", in European Constitutional Law Review, 2017, p. 369 et seq.

interpretative function of Union law (including the indirect checking of compliance of national law with Union law, shared with national courts and with the European Court of Human Rights), but also, more specifically, in ensuring that the EU institutions balance different general principles, values and fundamental rights. These must be guaranteed and protected by Union law in the actions of the EU institutions, even where they enjoy exclusive competence: striking a balance between the need to preserve the discretionary powers of the institution and the need to ensure respect of fundamental rights, as indicated in the Treaties and in the Charter and interpreted by the Court[22] in the actions of the institutions.

Third, there is an attempt by many plaintiffs, some of which are still ongoing, to bring the Court of Justice to extend the causality link, thus facilitating the attribution of acts to the institutions and imposing liability for a *de facto* "influencing" of decisions that are formally taken at the national level. The question is whether the causality link can be extended to beyond what is normal, reaching out to factors influencing the choice. (The argument that a government had no choice is very difficult to sustain. That said, if an obligation to follow instructions could be demonstrated, it might be possible to impute liability to the instructing party).

It should also be noted that in *Ledra* the plaintiffs were heard in appeal, despite their case having been declared non-admissible by the General Court: the Court of Justice wants to look at the substance of the case, not at the form, and nevertheless gave the plaintiffs the opportunity to be heard, despite the inadmissibility of their case as declared by the General Court.

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22 See F.G. Jacobs, *Is the Court of Justice of the European Communities a Constitutional Court?,* in D.M. Curtin and D. O'Keeffe (eds.), *Constitutional Adjudication in European Community and National Law*, Dublin, Butterworth, 1992, p. 25 et seq.; B. Vesterdorf, A Constitutional Court for the EU?, in International Journal of Constitutional Law, Vol. 4, issue 4, 2006, p. 607 et seq.; A. Tizzano, *Il nuovo ruolo delle Corti supreme nell'ordinamento politico e istituzionale: la Corte di giustizia dell'Ue,* in *Il diritto dell'Unione europea*, 2012, p. 811 et seq.; G. Itzcovich, *The European Court of Justice as a Constitutional Court. Legal Reasoning in a Comparative Perspective*, in *Sant'Anna Legal Studies*, 2014, available at http://stals.sssup.it/files/itzcovich%204%202014.pdf; C. Zilioli, *La Corte, giudice costituzionale delle competenze attribuite alle istituzioni dell'Unione: il caso della Banca Centrale europea,* in Lenaerts, K., *Un parcours européen: de la Cour de justice des Communautés européennes à la Cour de justice de l'Union européenne,* Liber Amicorum in honour of Antonio Tizzano, Giappichelli, 2018, and the literature cited therein.

3. Has the intensity of judicial control deepened, bringing the courts beyond the traditional judicial restraint?

My third question mirrors the one that Bruno de Witte already mentioned, whether the intensity of judicial control has intensified.

It is true that, with *Gauweiler*, for the first time in history a monetary policy decision has been challenged in front of a court of law[23], but the scrutiny of the Court of Justice was limited owing to the exclusive competence of the ECB to take decisions in this field and the Court's recognition of the ECB's wide discretion in this very technical matter[24].

I would argue that the general approach of courts (with the exception of the BVerfG) has remained one of judicial restraint: thereby acknowledging the need to respect the provisions of the Treaties establishing the respective – and sometimes exclusive – competences of the various institutions and the power to make policy choices within those competences. The Court of Justice only verifies the legality of the actions of other EU institutions, without entering into the merits of their policy decisions, which are part of the discretion the drafters of the Treaties decided to grant to them[25]. This judicial restraint is best shown by two examples.

First, in the important cases on monetary policy decisions, and in the discussion on the room for discretion that EU institutions have in taking complex economic decisions, judicial restraint has prevailed. Two cases were referred by the BVerfG to the Court of Justice on this issue. In the first, *Gauweiler*, the Court confirmed its jurisprudence on judicial restraint in cases in which the institution is conferred powers and needs to decide in cases that require a complex economic analysis, despite the concerns of the BVerfG: "Generously accepting as fact asserted aims while at the same time granting wide margins of assessment to bodies of the European Union and considerably decreasing the intensity of

23 Case C-62/14, *Gauweiler*, op. cit. and C. Zilioli, 2017, op. cit, p. 94-95.

24 On the contrary, concerning matters in which the scope for discretion is more limited, the Court's review can be more intensive, going to the appraisal of the facts, as in individual decisions involving staff, or to an unlimited jurisdiction, in decisions imposing sanctions (Article 5 of Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the European Central Bank to impose sanctions (OJ L 318, 27.11.1998, p. 4)). Also concerning the supervisory field, the intensity of the judicial scrutiny depends on the scope of the discretion granted by the EU legislator and on the degree of complexity of the subject matter. For a deeper analysis of these aspects, see C. Zilioli, 2017, op. cit.

25 C. Zilioli, 2017, op. cit., at p. 98.

judicial review is well-suited to enable institutions, bodies, offices, and agencies of the European Union to autonomously decide upon the scope of the competences that the Member States have attributed to them (cf. BVerfGE 123, 267; 349 et seq.). Such an understanding of competences does not sufficiently take into account the constitutional dimension of the principle of conferral"[26]. The Court recognised that "questions of monetary policy are usually of a controversial nature and in view of the ESCB's broad discretion, nothing more can be required from the ESCB apart from that it use its economic expertise and the necessary technical means at its disposal to carry out that analysis with all care and accuracy"[27], only requiring a careful and impartial analysis of all relevant elements of the situation in question and an adequate statement of the reasons for its decision[28].

The second case, *Weiss*[29], is still pending (the hearing will be on 10 July 2018) and the same questions have been asked again, although applied to a situation involving the implementation of the ECB's public sector purchase programme (PSPP). It is now to be assessed whether, given the PSPP's magnitude and the impact on the market, the Court's approach should remain the same. In *Gauweiler* the Court said that the fact that a monetary policy measure has an impact on economic policy does not make it an economic measure. Now the question being asked is whether or not, if the impact on the economy is so big, it is still possible

26 Decision of 18 July 2017 - 2 BvR 859/15, 2 BvR 2728/13, para. 184.

27 Case *Gauweiler*, op cit., para. 75.

28 Ibidem, para. 69. For an analysis, see C. Zilioli, *The ECB's powers and institutional role in the financial crisis. A Confirmation from the Court of Justice of the European Union*, in *Maastricht Journal of European and Comparative Law*, February 2016, p. 171 et seq.

29 Request for a preliminary ruling from the Bundesverfassungsgericht lodged on 15 August 2017, Case C-493/17, *Heinrich Weiss and Others*.

to talk about monetary policy measures[30].

Second, even in *Ledra*, where the Court went in-depth into the application and applicability of fundamental rights considerations, the Court has not assessed the substance of an institution's balancing[31] of the two conflicting interests of property vs. financial stability: "… the Commission cannot be considered, by dint of having permitted the adoption of the disputed paragraphs, to have contributed to a breach of the appellants' right to property guaranteed by Article 17(1) of the Charter. It follows that the first condition for establishing non-contractual liability of the European Union is not satisfied in this instance, so that the appellants' claims for compensation must be dismissed"[32].

I think such judicial restraint is good. Our democratic society is based on the separation of powers. As Justice Lübbe-Wolff highlighted in her dissenting Opinion (in the referral of BVerfG in *Gauweiler*), the will of the drafters of the Constitution and the Treaties was to assign certain tasks to a certain power. It is not for the judges to substitute their decision for the one of the technical experts, to take over another power of the

30 In this regard, see Bundesverfassungsgericht, Decision of 18 July 2017 - 2 BvR 859/15, para 114: "(…) there is strong evidence that the PSPP decision is not covered by the ECB's mandate due to its size and more than two years of implementation. From the point of view of the Senate, based on an overall view of the relevant demarcation criteria, it could no longer be regarded as monetary policy but as a predominantly economic policy measure. Although the PSPP has an explicit monetary policy objective, it uses monetary policy to pursue that objective (aa); however, due to the volume of the PSPP and the related predictability of the purchase of government bonds, the economic impact is already directly inherent in the program itself (bb). Thus, the PSPP may prove disproportionate to its underlying monetary policy objective (cc). In addition, the decisions forming the basis of the program lack a reasonable justification which would allow the continuity of the program to be kept under review during the multi-annual implementation of the decisions (dd)".

31 Cf. de Vries, Balancing Fundamental Rights with Economic Freedoms According to the European Court of Justice, in Utrecht Law Review, 2015, in which the author specifically discusses the "balancing of conflicting interests", available at https://www.utrechtlawreview.org/articles/10.18352/ulr.220/galley/217/download/.

32 *Ledra Advertising*, op. cit., para. 75.

tate[33]. Such restraint, however, should find its limits in the compliance with the constitutional guarantees envisaged by the Treaties and in the acknowledgement of the role of the Court of Justice as a constitutional judge regulating not only vertical and but also horizontal conflicts of competences[34].

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33 Dissenting Opinion of Justice Lübbe-Wolff on the Order of the Second Senate of 14 January 2013, para. 3 et seq.: "At any rate, what the plaintiffs, insofar as they turn against federal inaction with respect to the OMT decision, petition the Federal Constitutional Court to order goes, in my view, beyond the limits of judicial competence under the principles of democracy and separation of powers. The demarcation of these limits is open to debate. There may also be good reasons for controversy over the question which of the various techniques to avoid overstraining judicial power (political question doctrines, other criteria of admissibility, recognition of margins of appreciation or application of other restrained standards of review) is applicable in a given case. Under German law, which has so far been interpreted as not containing a political question doctrine, such controversy will concern the choice between admissibility criteria and reduced intensity of review as instruments of judicial restraint. A judge considering the limits of justiciability transgressed will therefore typically not be able to invoke clear standards in support of that claim. I must admit that this is so in the present case, but I do think that some guidelines can be derived from the principles of democracy, separation of powers and the rule of law. To mention only those which have a bearing on the case at hand:

1. The limits of reasonable governance by rules must be respected, because under the principles of democracy and separation of powers, decisions by judges at whom the citizens cannot, either directly or indirectly, come back by exercising their right to vote are justifiable only as decisions according to legal rules.
2. The need for determinative legal standards, even if they be just judge-made standards from earlier case-law, grows with the importance of the decision to be made. The judicial branch of government will not work without a creative element. But the more far-reaching, the more weighty, the more irreversible – legally and factually – the possible consequences of a judicial decision, the more judicial restraint is appropriate where, due to vagueness, the legitimating force of existing legal rules appears feeble.
3. In determining the reach of judicial competence, the reach of judicial power to implement should be considered. This is not just a pragmatic maxim serving to avoid losses of authority that might endanger the proper functioning of a court, but also a legal imperative, since from the means of power vested or not vested in a court or in the courts in general by constitutional and other statutory rules, inferences can be drawn as to intended competences.
4. The more judicial restraint is required, the more preferable is it to exercise such restraint by way of refusal to go into the merits (political question doctrine, criteria of admissibility) rather than by way of applying restrained standards of review (recognition of margins of appreciation, substantive obviousness criteria and the like). That is because the former path is the path of greater restraint. Dealing with the substance of the case is altogether avoided here, while the mere application of restrained standards of review will typically result in some kind of benediction, although reduced in scope, of the object of judicial review.
5. It should be kept in mind that the limits of justiciability are not necessarily the same for national and transnational courts, but may diverge – in varying directions, depending on the nature of the case – because national and transnational courts differ in the sources of legitimacy of their operation, notably in the legal bases of their competence and implementing power".

34 C. Zilioli, 2018, op. cit.

PART III

The Way Forward: The Eurozone's Institutional Prospects

MACRO RATES VIEWS: IS EMU 'BREAK-UP' RISK OUT FOR GOOD?

Francesco U. Garzarelli

The risk of redenomination into national currencies priced in Euro area financial assets was a distinctive feature of the 2009-12 European sovereign and banking crisis, and one that intensified the economic downturn. The fear of EMU ''break-up' was not just an expression of investors' collective uncertainty. Indeed, in the negotiations surrounding Greece's third round of financial assistance, the prospect of the country leaving the single currency was fielded as one of the options. Operational procedures were also put in place for such a contingency, tainting the notion of an 'irreversible' currency agreement.

On most measures, redenomination risk reflected in EMU government bonds and other Euro area financial assets is now back to pre-crisis levels. This is due to a combination of the ECB's large-scale QE (and investors' expectations that, in the extreme, the central bank will intervene as 'lender of last resort'), the improvement in the business climate and a series of upgrades to the Euro area's institutional architecture – probably in that order. Looking ahead, we argue that greater *ex ante* 'risk-sharing' among member states is needed to keep EMU 'break-up' risk more structurally in check. Progress in this area is proving slow, however. Down the line, it may also result in dislocations and, possibly, subordination of existing EMU government bonds.

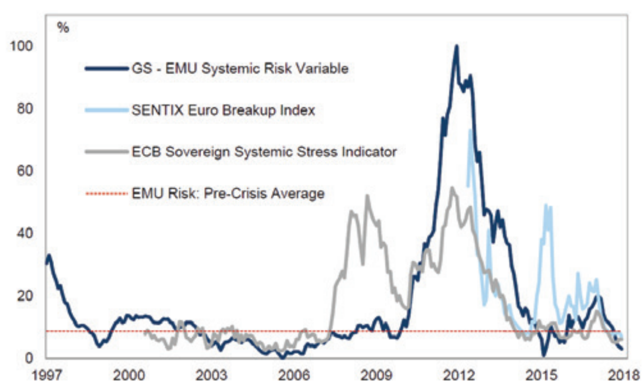
1. EMU 'Break-Up' Risk Is Down...

There are several ways of quantifying the time-varying amount of EMU-wide systemic stress perceived by market participants. The most direct one is to run a periodic survey of investors and analysts, such as the one collated by SENTIX[1]. Another avenue involves aggregating prices on financial assets subject to credit risk, as the ECB's Composite Indicator of Systemic Stress[2] (CISS) does.

Our preferred measure of systemic risk is based on the behaviour of intermediate maturity sovereign bond benchmark yields issued by EMU member states.[3] Specifically, we compute the second principal component (PC2) of the level of 10-year government bond yields in the major EMU markets. Since the first principal component (PC1) of yields captures their co-movement related to a common duration factor, PC2 isolates the cross-sectional variance of EMU yields that is uncorrelated to market-directional shifts. Our systemic risk measure is plotted in **Exhibit 1**, on a scale ranging from 0 (minimum in-sample systemic risk) to 100 (maximum in-sample risk).

The advantages of this methodology are twofold. First, PC2 provides a clear market-based taxonomy of 'core' and 'peripheral' EMU constituents, allowing it to evolve over time. Before and after the crisis, Germany is, in the eyes of the market, the ultimate 'core' country. Greece and Portugal are at the periphery, geographically and financially, while Belgium sets the boundary between the two groups. Second, our statistical

Exhibit 1: EMU 'Break-Up' Risk Has Returned to Pre-Crisis Levels
Selected measures of EMU systemic risk: GS, SENTIX and ECB



Source: Bloomberg, Goldman Sachs Global Investment Research

1 https://www.sentix.de/index.php/en/sentix-Euro-Break-up-Index-News/

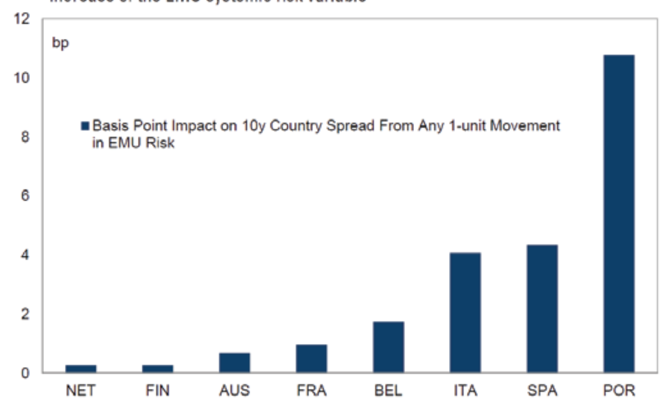
2 https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1426.pdf

3 See: 'EMU Sovereign Spreads: the Macro, the Policy and the Politics', *Macro Rates Views*, 21 April 2017. https://research.gs.com/content/research/en/reports/2017/04/21/8e54745c-80a8-4e24-aa8f-b0fd1f99161c.html

measure allows us to gauge the sensitivity of different sovereign issuers funding costs to swings in systemic risk – and therefore to better capture movements in sovereign bond differentials that are related to country-specific macroeconomic fundamentals. On our estimates, the sensitivity of Italian and Spanish sovereign yields versus their German counterparts to swings in EMU risk sentiment is four times greater than France's. Portugal's is even higher (**Exhibit 2**).

Exhibit 2: Peripheral Country Spreads Are More Responsive to Swings in EMU-wide Systemic Risk

SURE estimated coefficient - response of country spread to a 1% increase of the EMU systemic risk variable

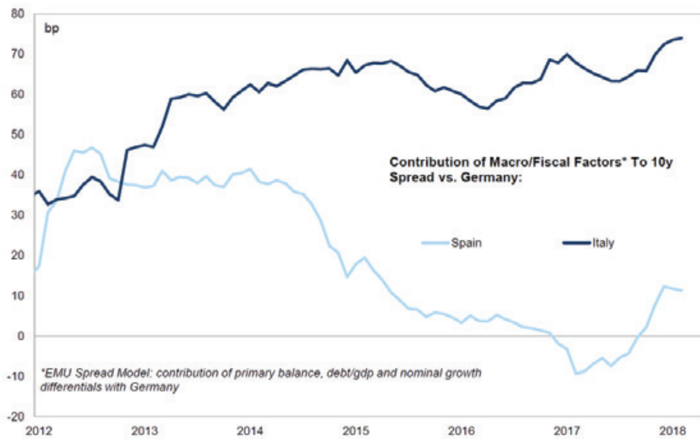


Source: Bloomberg, Goldman Sachs Global Investment Research

As can be seen from Exhibit 1 above, investor perception of EMU-wide systemic risk appears to have now returned to pre-crisis levels. With the exception of a brief period ahead of the French Presidential election in the spring of 2017, systemic risk has been resilient to political tensions across numerous EMU Member States – most recently, those surrounding the formation of a government in Italy.

Even within the restored more benign systemic risk environment, investors continue to discriminate between sovereign issuers based on their creditworthiness. The underperformance of Italian government bonds versus their Spanish counterparts over the past year is a good example. Our modelling work suggest that around 40-50 basis points of the yield differential between Italy and Spain (currently at around 65 basis points) reflects the fact that the prospects for nominal GDP growth in the latter are stronger, in turn supporting a relatively faster improvement in public finances. **Exhibit 3** plots the contribution of these macro factors to 10-year benchmark yields in the two countries.

Exhibit 3: The Macroeconomic Underpinnings for Italian Sovereign Bonds Are Weaker Than Those for Spain
Contribution of macro/fiscal factors to GS model estimates of 10-yr BTP-Bund spread and 10-yr Bonos-Bund spread, in basis points



Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research

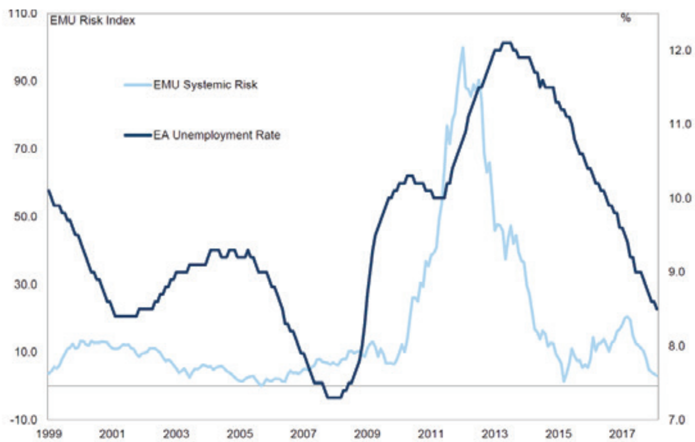
2. ...But Is It Out for Good?

The degree to which one can be confident that EMU 'break-up' risk is out for good is a more contentious matter than measuring its level and variance over time. One way to approach this involves trying to identify which factors may have contributed to bringing it down, and whether they have permanent effects.

A first factor is economic growth and the improvement in the jobs market. As **Exhibit 4** shows, the decline in EMU systemic risk has been reinforced by a pick-up in Euro area GDP growth and a resulting decline in the rate of unemployment across most member states. The improved economic performance also contributed to stabilising public finances[4], and allowed banks to raise private capital.

4 See: 'European Views: Healthier composition of public finances', *European Views*, 2 May 2018 (https://research.gs.com/content/research/en/reports/2018/05/02/3e-fa9bf3-b01f-479b-b170-c04b22af3402.html) and 'Euro area government deficits fall further', *European Views*, 25 April 2018 (https://research.gs.com/content/research/en/reports/2018/04/25/9055b10c-471e-4798-897d-519b243e6427.html)

Exhibit 4: The Decline in EMU Systemic Risk Has Been Reinforced by a Pick-Up in Euro Area GDP Growth and a Fall in Unemployment
GS EMU systemic risk indicator and EA unemployment rate



Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research

A second factor is the progressively heavier dose of monetary stimulus provided by the ECB: conventional rate cuts, long-term refinancing operations, negative rates. This sequence culminated with the launch of QE at the start of 2015. On our estimates, QE has shaved 50-80bp off 10-year German Bunds through a 'stock effect' of cumulative purchases, and boosted the 'forward guidance' of the ECB on policy rates[5]. Combined, these measures have also provided EMU sovereigns more room to manoeuvre fiscal policy by lowering the interest bill on public debt.

A third factor consists of EMU's institutional upgrade. The central structures in the new landscape, largely built between 2012 and 2016, include (i) an inter-governmental entity – the European Stability Mechanism, or ESM – with committed capital and senior creditor status. The ESM can extend loans to EMU member states and intervene in primary and secondary markets for sovereign debt (albeit subject to conditionality). And (ii) the establishment of a banking union

5 See: 'ECB QE Withdrawal Syndrome?', *Global Market Analyst*, 17 April 2018 (https://research.gs.com/content/research/en/reports/2018/04/17/39c49738-b4ba-4bfc-8b3c-3116767a86bc.html)

comprising a single banking supervisor – the Single Supervisory Mechanism, or SSM – alongside a Single Resolution Mechanism, or SRM, and an accompanying Single Resolution Fund, or SRF. Banking union has brought more transparency, and hence market discipline, into the banking industry and mitigated the risk of losses spreading from banks to the sovereign balance sheet of their country of domicile.

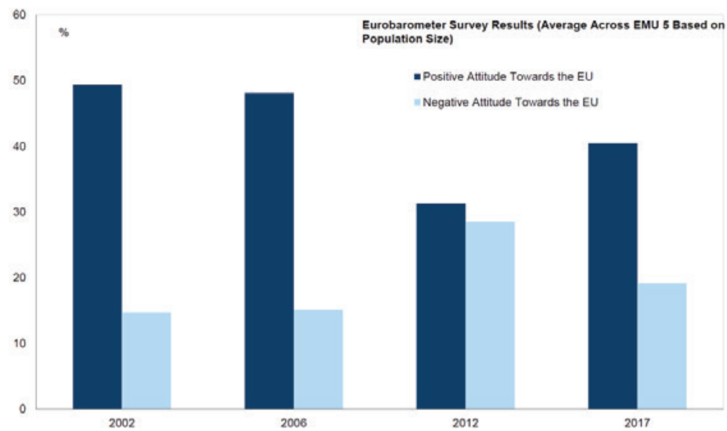
3. More 'Risk-Sharing' is Needed...

Which of the three factors identified above has been most important for the reduction in EMU 'break-up' risk is a point of contention, particularly since they overlapped. In our opinion, the ECB's QE has played a crucial role through the large scale exchange of public debt of all EMU sovereign borrowers (bar Greece) with single fiat-money currency. That said, none of these factors seems to us of permanent nature, at least yet. This is for a number of reasons.

A material slowdown in economic growth, let alone a recession, seems a long way off. But should it occur sooner, the ensuing rise in unemployment could accentuate a rise in anti-mainstream and European institution sentiment that was fuelled in the crisis years. The Eurobarometer, a public opinion survey regularly conducted by the European Commission, indicates that confidence towards the European Union still has some way to go in order to return to pre-crisis levels, as can be seen in **Exhibit 5**. Similarly, 'anti-establishment' political formations remain in the ascendancy in many member states (although this appears also closely connected with concerns over immigration), and could gain more traction if the economy worsens. With public indebtedness at post-war highs in several EMU countries,[6] negative rates and QE already in place, the space for counter-cyclical policies at the political, fiscal and monetary level appears lower now than during the sovereign and banking crisis.

6 On this point, see the latest IMF Fiscal Monitor, April 2018 (https://www.imf.org/en/Publications/FM/Issues/2018/04/06/fiscal-monitor-april-2018)

Exhibit 5: Positive Attitudes Towards the EU Still Remain Below Pre-Crisis Levels
EU citizens' attitudes towards the EU - Eurobarometer Survey (population weighted average of EMU-5)



Source: European Commission, Goldman Sachs Global Investment Research

The QE effects on EMU sovereign bond yields should remain largely 'in the price' for as long as national central banks continue rolling over the stock of public debt (around a quarter of the total) they have accumulated over the four-year period to the end of 2018.

But the days of large scale net secondary market purchases, where the Eurosystem bought the equivalent of close to 100% of gross bond issuance of the large member states, look to be behind us. The ECB has restricted itself to not own more than a third of public bonds to avoid becoming a dominant creditor of Euro area governments, with all its potential legal ramifications. Eventually, policy rates should normalise. All this will put upward pressure on the cost of funding, particularly for EMU peripheral sovereigns.

Open market operations in sovereign debt by the ECB will still be available under the Outright Monetary Transactions framework (which ECB Board member Coeuré once described as an 'an insurance policy against redenomination risk'[7]). But these operations in secondary markets will be subject to conditions, and possibly debt restructuring, agreed with member states. How such conditionality will interplay with domestic activity and the political process in the country under financial duress,

7 https://www.ecb.europa.eu/press/key/date/2013/html/sp130902.en.html

and whether it will amplify calls to leave the euro, is anyone's guess.

The 'home bias' in the ownership of public debt in peripheral countries is higher than it was before the crisis. This has mixed implications. On the positive side, the risk of a 'sudden stop' in the roll-over of public debt is lower since domestic investors have a higher propensity to invest in their own sovereign paper (and can be more easily be subjected to 'financial repression'). Moreover, thanks to portfolio re-investments, national central banks will remain involved in secondary government bond markets (for a country the size of Italy, we estimate that the central bank will roll-over roughly the equivalent of the annual deficit). On the negative side, the amount of sovereign credit risk shared amongst private non-domestic bondholders is lower. A fall in value of sovereign bonds resulting from fiscal problems would thus fall more squarely on domestic investors.

Finally, the institutional evolution of the Euro area over recent years has been notable, lending further support to French diplomat Jean Monnet's maxim that "Europe will be forged in crises". There appears to be agreement among most member states that more is required to lower the odds of systemic events occurring, and addressing them without incurring economic costs as high as in the last crisis. The policy debate, however, appears to have reached a stalemate such that further 'risk sharing' will require decisive steps towards 'risk mitigation'. The notion that a deeper integration can bring benefits to all EMU participants is hindered by unequal starting positions (public debt, NPLs, etc.), an inadequate incentive structure, and near-term political pressures.

Such dialectics are evident in the policy work surrounding the completion of the banking union. This envisages the phasing in of a common European Deposit Insurance Scheme, or EDIS, and the creation of a common 'fiscal backstop' for the Single Resolution Fund, both of which presume greater pooling of risks among EMU member states. Given a large 'home bias' in banks' holdings of sovereign bonds (which carry a zero risk weight for regulatory capital purposes), countries with stronger public finances fear that granting greater common insurance to financial institutions domiciled in higher-debt countries will result in a relaxation of fiscal discipline. 'Risk mitigation' in this context entails higher bank capital buffers (negotiations on the minimum requirement for banks' own funds and eligible liabilities, or MREL,[8] are ongoing), a reduction in domestic sovereign exposures, and more ambitious plans to reduce non-performing loans. While all these initiatives have merit,

8 https://srb.europa.eu/en/content/mrel

pushing them through too forcefully may perversely set off the risk that they were intended to reduce.

4. ...And a Euro area 'Safe Asset'

The policy debate around these issues is germane to the one surrounding a Euro area 'safe asset'. What public debt instrument should a financial institution located anywhere in the Euro area consider 'risk free' from an economic and regulatory standpoint?

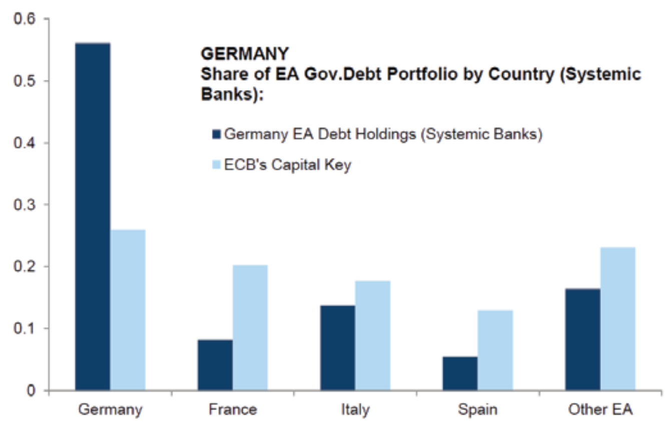
German Bunds – which would fit the bill from a pricing behaviour standpoint – are in too small supply to satisfy everyone's needs. A genuine Eurobond involving mutual guarantees and/or a central taxation capability in Member States has little political support. Against this backdrop, the policy choice for 'safe assets' has converged on a GDP-weighted portfolio of sovereign issuers – very similar in composition to the 'capital key' based allocation that the ECB uses in the conduct of QE. This choice carries implications for the pricing of its sovereign constituents, however.

Consider for example a situation where banks are taxed for holding too many government bonds of one sovereign, or in proportion to their departure from the capital-key benchmark.[9] This would address one dimension of risk mitigation, possibly allowing for greater risk sharing within the banking union. **Exhibit 6** and **Exhibit 7** illustrate that, for example, the larger banks (those under common supervision and subject to the EBA stress tests) in both Italy and Germany would potentially need to rebalance their government bond holdings towards the portfolio benchmark. More prominent effects would stem from the response of the myriad of smaller banks, where the sovereign 'home bias' is most acute.

9 See: 'Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures', Nicolas Veron, November 2017 (http://bruegel.org/wp-content/uploads/2017/11/IPOL_STU2017602111_EN.pdf)

Exhibit 6: German SIFIs Underexposed Mostly to France and Spain vs Capital-Key Benchmark

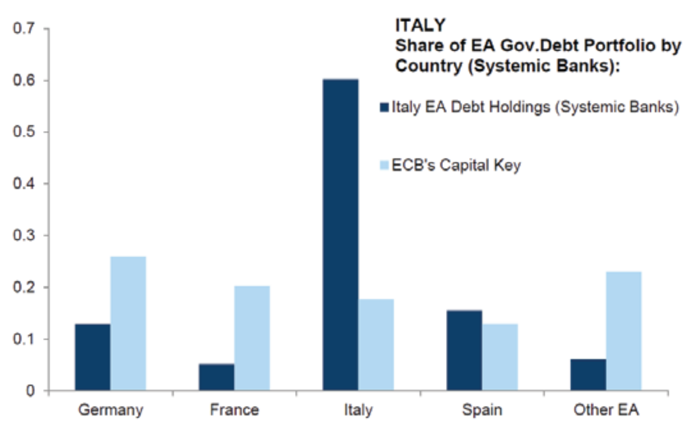
German banks' EA debt holdings and same holdings weighted by capital key



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 7: Italian Banks Would Need to Reallocate Towards 'Core' Sovereigns

Italian banks' EA debt holdings and same holdings weighted by capital key



Source: Haver Analytics, Goldman Sachs Global Investment Research

Estimating what could be the impact on government bond yields of the phasing in of such capital surcharges for concentrated sovereign exposures is not straightforward. Consider that sovereign debt is already subject to the EBA's stress test (in the adverse scenario, for instance, the test assumes a 10% markdown on 10-year Italian BTPs), so systemic banks are already sensitive to being too-heavily exposed to their own sovereign. And if this new regulation unlocks EDIS, the overall benefits to economic growth brought about by a greater 'fungibility' of bank deposits across the Euro area would need to be taken into account. Still, in high-debt countries banks' scope to earn 'positive carry' would decline and sovereign bonds would need to find a new home outside the aggregate financial sector, potentially leading to displacements.

More elaborate forms of 'safe assets' under discussion in European policy circles build on the capital-key portfolio concept. The ESM raises funds in capital markets against the name of all EMU member states in order to provide financial assistance to Euro area countries and banks. Since joined issuance entails that the rating of ESM bonds would correspond to the rating of its weakest backer, the institution has, since inception, secured committed and paid-in capital from the member states. The ESM also enjoys senior creditor status, i.e., in the event of default, EMS bondholders would get paid ahead of investors in national government securities.

Making the ESM bigger in order to cope with fiscal issues of the scale of the larger EMU countries, or assigning it more functions, can go some way in fostering the stability of the Euro area as a whole, thus lowering 'break-up' risk. But the larger the ESM becomes in size and scope, the greater the potential of eating into the demand for national public debt – of both core and peripheral countries.

Finally, there is a proposal to launch European Safe Bonds,[10] or ESBies, which has been captained by the European Financial Stability Board (EFSB), and could soon receive a formal endorsement by the European Commission.[11] The idea is to use securitisation techniques to 'tranche' a capital-key-weighted portfolio of EMU government bonds into a senior slice, which would receive preferential treatment in the case

10 https://www.esrb.europa.eu/pub/task_force_safe_assets/html/index.en.html

11 See: "Making EMU more resilient - Assessing the 'safe bonds' proposal", European Economic Analyst, 14 March 2018 (https://research.gs.com/content/research/en/reports/2018/03/14/e3846f38-34dd-439a-9f86-a6c485475207.html)

of default, and one or two junior ones. Holders of both the senior and junior tranches of such sovereign CDOs would be exposed to the same credit risk as holding the capital key portfolio. Proponents argue that Euro area banks should receive preferred capital treatment for holding the senior tranche of the securitisation – which would therefore become the 'safe asset' – but not the loss-absorbing junior tranche.

Financial intermediaries would have little difficulty in pricing and making a market for ESBies. In principle, their creation of a sovereign securitisation could also be fast-tracked by using the ECB's large government bond portfolio built through QE. Given the deep economic and financial inter-linkages among EMU member states, whether the senior tranche of the CDO is really all that 'safe' should one of its larger constituents default, and who would be interested in owning the junior tranche in bad times are topics still for debate. Equally importantly, the launch of ESBies would mark a clear segmentation of the existing EMU sovereign bond market, with an unclear status of existing national bonds which are not part of the securitisation.

All told, the decline in EMU 'break-up' risk in recent years has been remarkable, providing investors with outsized returns. But, in our opinion, it has been driven by factors which are not permanent. In our opinion, greater *ex-ante* 'risk-sharing' among member states is needed to achieve a more lasting reduction in area-wide systemic risk.

Progress in this area will also involve identifying a 'safe asset' for the Euro area. Since joint and several common issuance is not politically feasible, several policy proposals have emerged which build on a GDP-weighted portfolio of EMU government bonds, either securitised or collateralised. If these 'safe asset' proxies gain prominence, they could lead to dislocations of the existing national bonds and, potentially, their outright subordination. This should be seen as the cost to keep redenomination risk more structurally at bay.

INSTITUTIONS AND THE CRISIS

Wolfgang Münchau

The main point I made during the conference is that the Eurozone requires deeper reforms for its sustainability than those currently under discussion in Brussels. In this essay I will address the following connected issues:

- Why it is the best course of action for the Eurozone not to undertake half-hearted reforms right now.
- Why the priority of Eurozone politics should be to challenge the dollar as the leading global currency.
- Why the biggest threat to the Eurozone's sustainability right now is not Italy, but a German fiscal policy geared towards the eradication of all national debt.
- How Eurozone crisis resolution gave rise to populism and why the centrist establishment underestimate the scale and the nature of the threat.
- Time to pull the plug on Eurozone reforms.

It was only a few months ago when Angela Merkel and Martin Schulz agreed that Germany would enter into a meaningful dialogue with Emmanuel Macron on reform of the Eurozone. As it turned out, the Eurozone agenda was a personal project of Mr Schulz', not of the SPD. When Mr Schulz was ousted as party chairman in February, the SPD lost interest. The grand coalition is once again in power, but now without the one and only interesting project that would have justified its existence.

Olaf Scholz, the SPD finance minister and the party's new strongman, is notably cool on the whole idea. His previous political experience has been in national politics - first as the party's general secretary in the last decade and later as mayor of Hamburg. On the important issue of a European deposit insurance scheme, he is seen as even more skeptical than Wolfgang Schäuble.

The usual opposition to Eurozone reform from inside Ms Merkel's party, the CDU, and its Bavarian sister party, CSU, is as strong as ever. The CDU/CSU Bundestag group rejects all but one of the items on Mr Macron's reform agenda. They do not want an enlarged European stability mechanism, the rescue umbrella. They do not want a single Eurozone budget. And like Mr Scholz they do not want a European deposit insurance scheme until the Italian banks have managed to get rid of most of the bad loans on their balance sheet. This is not going to happen anytime soon. They oppose debt relief for Greece too. The only reform project for which there is some lukewarm support is the idea of a fiscal backstop to the bank resolution fund, but on a very limited scale - beyond of what an economist considers a fiscal backstop. Under discussion is an extended credit line.

The message is clear: Germany is saying no to Mr Macron on Eurozone reform. There may still be some token deal, perhaps a tiny Eurozone budget with no macroeconomic significance. France is now in the position Marine Le Pen has warned about: in a monetary union in which the voice of France counts for little and a geopolitical situation in which the UK is the more reliable partner.

Mr Macron's enthusiastic support for European integration contrasts with the unchanged political reality that France and Germany are no longer the natural allies of yesteryear. Unlike in France, the pro-European parties in Germany are in retreat. Ms Merkel's party lost one million votes to the FDP and the AfD, both of which advocate policies that would lead to the destruction of the Eurozone. We should recall that 60 CDU/CSU MPs voted against the Greek support programme in 2015. If faced with a rebellion of the same magnitude today, the grand coalition would no longer have a majority. The lack of parliamentary majority is the real constraint of German politics right now.

Does this make Eurozone reform impossible for all times? Of course not. The June deadline for Eurozone reforms was chosen because Mr Macron needs to something concrete to show for before the European elections in May 2019.

As a long-standing advocate of Eurozone reform myself, I am finding myself in the unusual position of favouring a tactical retreat. It would be better to wait for a better moment to push the two issues that really matter, neither of which is on the agenda right now: the creation of a mutualised safe asset, a Eurobond in other words; and the legal and political separation of national governments and their banks. Reformers should use the fact that the large and persistent current account surpluses of the northern Eurozone countries make them vulnerable to a sudden disruption of trade flows. Only an existential crisis that threatens the very survival of the Eurozone has the potential to concentrate minds in the northern Eurozone. There is no guarantee that the north would come to the conclusion that it needs to accept the reality of a political union. Northern European states may conclude the opposite. But as the evolving dialogue between France and Germany shows, the arguments on positions on governance have hardly changed over the last 30 years.

The alternative would be to waste scarce political capital on the wrong type of reforms, like a securitised and not mutualised safe asset, a forever incomplete banking union, and semi-automatic debt restructuring as demanded by Germany.

If the alternative is a big leap in the wrong direction, standing still constitutes relative progress.

1. The original sin: a euro without geopolitical ambitions

Many of the problems faced by those who are trying to find a solution to the Eurozone's governance problems date back to the 1990s, when the euro's architecture was drawn up. One particularly fateful decision, not often discussed, has been the voluntary renunciation by Eurozone members of a broader geopolitical role of the euro. At a time when the EU is threatened by the secondary effects of US sanctions, against Iran and Russia, and by trade tariffs on various categories of products, the omission is critical. The Eurozone would be in a much stronger position if the euro had been designed as a political currency from the ground up. It would still have had a crisis, but it would have had a mutualised debt instrument to deal with it. And it would have been in a much stronger position to defend itself against an increasingly erratic EU policy. The dollar, by contrast, has been an integral part of US foreign policy for many years. Its role as the global anchor currency allows the US to cut off an entire country from access to international commerce and finance as in the case of Iran. Or a group of individuals as in the case of Russia.

The euro was not designed as a geopolitical instrument. I recall the debate in Germany in the 1990s. The Bundesbank deliberately did not want a strong international role for the euro, fearing it might conflict with the price stability objective. I also recall the debates among international economists whether the euro could challenge the dollar as a global reserve currency. The opportunity was there. Serious academic papers were written. The fact that it did not happen was the result of a conscious political choice.

That choice is in part responsible of EU's difficulty in responding effectively to Trump today. The biggest problem with the US President's decision to pull out of the Iran nuclear deal is the extra-territorial effect. Defiant European companies would be cut off from US financial and product markets. So would the banks that fund those companies. Multinational companies or banks cannot afford that. Mr Trump can do this because the US is ultimately in control of all dollar-based financial flows, including those that originate outside the US. The EU cannot impose extraterritorial sanctions on US companies that defy European policy. The euro is not as critical to them as the dollar is to Europeans. After the euro was introduced in 1999, it quickly became the world's second most important currency but still lags behind the dollar on most metrics. Its share of foreign exchange reserves[1] was under 20 per cent at the end of 2016 against 64 per cent for the dollar. The gap was of similar magnitude in the categories of international debt and loans. The dollar leads the euro in foreign exchange turnover by a factor of three to one. The only category where the euro has almost caught up is that of a global payment currency. In the last decade the gap began to narrow but it widened again since the financial crisis.

In response to Mr Trump's decision on the Iranian deal, the European Commission only managed to dig up the old blocking statute,[2] a ban on Europeans to comply with the sanctions. The problem is that the EU has no financial instruments to protect European companies. How, for example, would you compensate a European bank for no longer being able to transact in dollars?

The failure to develop the euro into a rival to the dollar also makes the EU more vulnerable to trade tariffs. This is mostly due to the trade surplus. This, in turn, is the result of how the Eurozone tackle the debt crisis: by forcing crisis countries to run positive current account balances. One consequence of the policy is a populist political backlash of the kind we see in Italy right now. US protectionism is another.

Before the financial crisis the Eurozone ran a small current account

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1 https://www.ecb.europa.eu/pub/pdf/other/ecb.euro-international-role–201707.pdf

2 http://europa.eu/rapid/press-release_IP–18–3861_en.htm

surplus. By last year, it reached 3.5 per cent of economic output.[3] The larger the surpluses became, the more dependent the Eurozone had become on the rest of the world.

Instead of hyperventilating about Mr Trump, Europeans might want to reflect on what got them into this mess. They would be more resilient today if they did not handle the Eurozone crisis the way they did, and if they had made the euro more robust from the outset.

Technically, it would still be possible for the EU to fix the problem, but that would require a degree of political union that goes far beyond of what Emmanuel Macron proposed. It requires at its core a mutualised debt instrument, a euro bond, as a financial instrument to underpin a large sovereign debt market. It would also require a broader mandate for the European Central Bank.

This brings us back to the theme in part one. A weak deal is not going to solve the problem, and it may make it harder to resolve the problem when it is needed.

2. Why German fiscal policy constitutes a long-term threat to the Eurozone sustainability

Another issue that is not on the official agenda of Eurozone policy makers, but should be, is divergent fiscal policy. Italy is currently set on a course that puts it in conflict with the observance of both the fiscal compact and the associated fiscal rules, and possibly even the EU's overall 3% ceiling for the deficit-to-GDP ratio. Germany, by contrast, not only fulfils all of the EU fiscal rules, it has also unilaterally set itself a tougher target.

The 2019 German budget is one of those. Olaf Scholz, Germany's new social democratic finance minister, has proposed a budget with the following four characteristics: a nominal cut in investment; a reduced ratio of defense spending to gross domestic product; a freezing of funds for development aid at 0.5 per cent of GDP; and a lower contribution to the next EU budget than what he himself had previously suggested.

The budget fulfils two narrow goals instead: it will ensure that the government will run a fiscal surplus through the 2019–2022 budget period. And Germany's debt as a percentage of gross domestic product will fall below the artificial 60 per cent threshold set out in the Maastricht Treaty in 2019. As the journalists André Kühnlenz and Philipp Stachelsky

3 https://www.ecb.europa.eu/press/pr/stats/bop/2018/html/ecb.bq180406.en.html

have remarked,[4] Mr Scholz's ambition is to become the "Red Hawk" with a goal to push the budget into a surplus of 1 per cent of GDP or higher. Such a surplus would, over time, eradicate all public debt.

Beyond the negative consequences for Germany itself, this budget will invariably exacerbate the Eurozone's already strong imbalances. Germany has been running current account surpluses of around 8 per cent for the last couple of years. According to a news report by Spiegel, the German news magazine, the country's air force has become dysfunctional as a result of chronic under-investment. Only 10 out of 128 Eurofighter aircraft are fit for combat. Angela Merkel, who supports the budget, has been less than honest with her repeated commitment to NATO defense spending target of 2 per cent of GDP.

There is a rather simple solution to all of these problems: run a moderate fiscal deficit, of say 2 per cent of GDP, invest in the restructuring of the country decrepit military capacity, replenish the depreciated stock of public sector infrastructure, and actively encourage high-tech projects. This would help the German chancellor counter accusations that Germany is not pulling its weight in NATO. It would make Germany and the EU less of a target for US trade tariffs by reducing Germany's and the Eurozone's external savings surplus. And it would strengthen Germany's long-term potential growth. It is not often that one could achieve so many objectives with a single policy tool.

I know, of course, that this is legally not possible because of a constitutional "debt break" - a fiscal rule that forces Germany to a run a nearly balanced budget over the economic cycle. But this rule is self-inflicted. It is the work of a previous grand coalition. It is not an external constraint, but an internal choice.

And besides, Mr Scholz is not just following rules here. He is doing more than he needs to. The SPD is returning to its pre-Keynesian roots.

I care less about the fast progressing self-destruction of the SPD than about the externalities. The Germans made a choice. They will get what they voted for. But the policy will affect millions of people who did not have a vote because the budget will set the path for the rest of the Eurozone. In particular, it will constrain the degree of fiscal flexibility the European Union would grant to countries during an economic downturn. Italy, for example, desperately needs more public investment in addition to economic reforms as a way out of a twenty-year period of economic stagnation. The voters have been turning away from the established

4 https://makronom.de/wir-brauchen-eine-positive-investitionsquote–26332

parties of the centre, a trend likely to continue unless there is a sustained economic recovery. France is in a better position but not strong enough to follow Germany either. We may marvel at Macron's rise to the French presidency a year ago, but he only got 24 per cent of the votes in the first round of the presidential elections. The far-right National Front remains a clear and present danger both to him and the Eurozone.

There will never be a solution to the Eurozone's existential uncertainty unless the other Eurozone countries speak truth to power. They should deem Germany to be in breach of the single most important policy rule set out in the Maastricht Treaty: that member states treat economic policy as a matter of common concern. The German budget is as un-European as Greece's excessive fiscal deficits almost a decade ago.

I only have a single rational explanation for such a policy choice. Getting rid of your own debt is a way to end the whole debate about risk sharing in the Eurozone.

3. On the destructive role of complacent narratives

We have so far looked at two policy instruments that could go a long way to solving the Eurozone's multiple problems, which are becoming political in nature. A geopolitical euro and a co-ordinate fiscal policy among member states. The failures of the past have led to a rise of popular parties in different Eurozone member states that make such policies even harder to implement than would otherwise be the case. In this section I will argue that the rise of populism is to a large extent a self-inflicted wound of a liberal establishment that has been far too complacent about the Eurozone.

It is, of course, pointless to compare today's populists and nationalists to the Nazis and fascists eighty or ninety years ago. But I see much clearer parallels between the fall of the Weimar Republic and the vulnerability of Europe's liberal elites. Some of today's defenders of the liberal order are making the same mistake as, for example, the German Centre party of the early 1930s, by underestimating the scale of the threat.

Harold James, the Princeton historian, has given us ten reasons on why our political systems today share some of the self-destructive characteristics of the Weimar Republic.[5] One is the strength of the economic shock. Another is an excessive optimism about the power of

5 https://www.project-syndicate.org/commentary/weimar-republic-lessons-for-today-by-harold-james–2018–05

constitutions to protect the system.

I would like to offer some additional thoughts on the role of complacent narratives, the stories we tell each other that make us feel better. As a commentator of Eurozone affairs, for example, I keep on hearing that a euro exit cannot happen because it is not allowed. The Italian constitution, for example, makes it impossible for a government to rescind international treaties by referendum. This argument not only overestimates the power of constitutional law to protect from us from illegal acts by governments, as Professor James pointed out. It also ignores the circumstances under which a country would leave the Eurozone. All its government would need to do is engineer a financial crisis, declare force majeure and introduce a parallel currency over a long bank holiday weekend. There is nothing in the Italian constitution to prevent a financial crisis or to stop a government from giving people the means to buy food.

This is also why it does not matter why the Italian coalition agreement no longer contains a formal euro exit clause, as it did in an earlier draft. We know that Matteo Salvini, leader of the Lega, wants to create conditions for a euro exit. We also know that some, though not all, members of the Five Star Movement want that too. That is all we need to know.

Another argument is that the financial markets would frustrate a rebellion. This shares some similarities with the first. Those who make it commit the error of attaching the mindset of a centrist politician to that of the new leaders. Centrists, in Europe at least, have an emotional need to be considered fiscally-conservative. Centrists look at bond spreads the way deer stare at headlights. To someone like Mr Salvini, a financial crisis is not a threat but a promise, one that allows him to pull the plug on euro membership.

A third argument is the super-human ability by the Italian president to prevent disaster. The Italian constitution has wisely given the president strong powers. The president has the right to appoint ministers and refuse to sign legislation deemed incompatible with the constitution. But presidential mandates are finite, and even a strong president like Sergio Mattarella cannot tell MPs and Senators to pass a Eurozone-compliant budget.

A fourth argument is that the centre will always be able to stitch things up. Really? I recall the attempt by the Partito Democratico and Silvio Berlusconi's Forza Italia last year to change the electoral system in their favour. The miscalculated the sheer scale of support of the populists. You cannot save liberal through gerrymandering.

Fifth, I hear if all else fails, there is always the European Central Bank. Mario Draghi saved the Eurozone in 2012, can he save liberal democracy? His main anti-crisis tool, a programme known as Outright Monetary Transactions, is irrelevant in this case. OMT was designed for rule-compliant governments that find themselves under a speculative attack by investors. Not the case here. Quantitative easing did help, but the programme will eventually end. It was justified by the fall in inflation rates. I cannot be revived as a tool to fight a future debt crisis.

And finally, there is the hope that the economic recovery will benefit the centrist parties. I think the opposite is the case. The Five Star Movement and Lega will generate a recovery through a large fiscal stimulus, and will gain the credit for it. They are in power precisely because the centrists failed to deliver on the economy.

The truth is that there is no such thing as a technical backstop for liberal democracy.

And herein lies the main lesson of the Weimar Republic. If liberal democracy fails to deliver economic prosperity for a sufficient large portion of the population over long periods, it ends - along with the financial and economic institutions it has created.

Conclusion

The Eurozone and the EU are facing these future existential challenges:

- A trade war that is in part the result of its persistent structural current account surplus, which is itself the result of its approach to Eurozone crisis management.
- A rise of populism in Italy, that challenges especially all aspects of the EU policy consensus: on fiscal policy, on monetary policy and the sanctity of a single currency, and on external relations, in particular with Russia.
- The effect of secondary US sanctions in relation to Iran and Russia.
- Widening imbalances due to a permanent divergence of national fiscal policies.

The reforms currently under discussion are not going to address the first three problems. The only plausible answer to these problems is the launch of a mutualised debt instrument and a genuine capital markets union.

The fourth problem - opposite fiscal policies by Germany and Italy in particular - needs to be addressed directly. Fiscal policy needs to converge in the absence of a full fiscal union.

I see the temptation by officials to jump for quick fixes like sovereign bond-backed securities. I am not sure that it would even solve the narrow objective of reducing banks' exposure to the sovereign debt of their home states. They would certain not address the more urgent issues of strengtheing the Eurozone's tactical position in a trade war, stopping the effects of secondary sanctions, or reducing the internal imbalances in the Eurozone.

The Eurozone is facing a whole number of existential challenges. They can be met by acceptance of mutualised debt and a fiscal union. The direction of the current policy debate suggests to me that none of the challenges is adequately addressed, if addressed at all.

I therefore see the disintegration of the Eurozone, and possibly the EU, as the most probable result of these events.

DEEPENING OF EMU: SOME TOPICAL CONSIDERATIONS

Thomas Wieser

In this paper, I set out some considerations for completing the set up of the Euro. They are framed against the present topical political debates, and how I assess the feasibility of a set of solutions. The politically desirable outcome should largely complete the Banking Union and have a few further reform steps, that will only partially satisfy the ambitions of some Member States whilst going beyond what others see as desirable or necessary at this stage.

I start off by discussing the changes and reforms that have been introduced over the last six to eight years. They form the background to the discussion of priorities in the completion of EMU. Whilst there is little disagreement on the need for a complete Banking Union, the issue of fiscal deepening was and remains divisive. However, even on the issue of Banking Union, short term political problems may outweigh the considerable intellectual agreement on how beneficial a completely homogenous or transnational banking and financial sector would be for the Euro Area.

Incrementalism or Grand Design?

At the time of the negotiations for the Maastricht Treaty, it was clear to participants that the text was not the final configuration of Economic and Monetary Union (EMU). Two strands of discussion at the time are worth recalling:

- The sequencing debate: prominent especially in Germany, where the “crowning theory” (Krönungstheorie) was central to the debate. Its main theorem was that Political Union had to precede a fully loaded EMU.

- Progress through crisis: in analogy to Schuman ("not built all at once …. (and) will be forged through crisis").

Historical developments have shown that progress through smaller steps has indeed been the politically plausible and achievable mode of deepening European integration.

Living with imperfection, or incompleteness, has some advantages and some drawbacks. Experimentation in small steps avoids large mistakes that can not be rectified. Each step of integration can be assimilated into the political culture of Member States for longer periods before the next step commences.

Conversely, the incomplete architecture of the European project increases risks of instability, and even fears of reversal in troubled times.

The project of completing EMU has stress tested the economic and political resilience of Member States over the last ten years. Whilst the different stages of the crisis post-2008 were not necessarily causally related to EMU, they brought out the faultlines of design and practice. Judged by the uneven progress of the last 2 decades, Schuman appears vindicated for now: it took the Great Financial Crisis and the subsequent Euro crisis to see any progress in deepening Europe's Economic and Monetary Union.

If there is a strong consensus on anything in Europe, it is on the fact that Treaty changes (apart from technical changes) are politically not feasible. This belief rests on experiences with referenda over the last decades and populist attitudes towards Europe, indeed towards all political mainstream parties and institutions.

This has resulted in a number of the reforms of recent years being based on intergovernmental agreements. The implications for the role of European institutions, and the relative shifts in influence among larger and smaller Member States deserve a wider discussion than they get.

In any case the result has been a succession of reform steps that were not necessarily addressing the most important institutional and economic deficits in the most appropriate manner.

"Firewalls"

The absence of instruments for addressing balance of payments crisis in the Maastricht Treaty rested:

- on the assumption that within a monetary union there could per definition no longer be such a crisis, and

- on the no bail out provisions of the Treaty (which merely specify, inter alia, that "a Member State shall not be liable for or assume the commitments …. of another member State …").

The absence of such instruments was one of the reasons why it took Europe so much longer to resolutely address the effects of the financial crisis. The Euro Area now has the European Stability Mechanism (ESM) with a paid in capital of 80 billion Euro, which can provide adjustment loans against conditionality of up to 500 bn Euro. The ESM had to be set up as a body outside the Treaty, as an intergovernmental institution ruled by a Board of Governors, i.e. the Finance Ministers of the Eurogroup. The Commission is not a party to the Treaty setting up the ESM.

The founding of the ESM in turn led to what was presumably the game changer in our crisis approach. It enabled the ECB to announce OMT and thus transcend the monetary financing prohibition.

There is an ongoing discussion of turning the ESM into a European Monetary Fund. There are few specific thoughts and suggestions on what precisely this should encompass and achieve. An important aspect in this debate is what effect this would have on the future role of the IMF in Europe, and the future wider relationship between Europe and the IMF.

Changes in the role of the Commission could have wider ramifications and need to be carefully addressed. The debate on changing the set up of the ESM has had two interconnected sources. First, the Commission has clearly set out its ambitions to bring the ESM into the perimeter of institutions under the Treaty, which would be possible as an Agency. This has so far been rejected by a clear majority of Member States.

The second strand of debates is more complex. The adjustment programs, first under the EFSF and subsequently the ESM, led to new institutional relationships between the Member States of the Euro Area, the Commission and the other institutions, i.e. the ESM, the ECB and the IMF.

At the beginning of the crisis, it was not yet clear whether the IMF should actually be part of the institutional crisis architecture of the Euro Area. Even in countries such as Germany there was no strong *a priori* at the outset. The final decision, as set down in the ESM Treaty, was clear: the IMF should be part of the adjustment programs. Partially this was due to the strong push from IMF management at the time, and largely this was due to the wish of a number of Member States to have an outside, quasi neutral, participant on board.

As it turned out, differences of approach between the four institutions increasingly led to frictions in program design and execution. Especially the difference between the IMF and the Commission proved difficult to overcome. The contrast could hardly have been greater: on the one hand a technical institution that had been set up decades ago to deal with financial and financing crisis, far removed from day to day control and supervision by national parliaments. On the other hand the Commission, that increasingly understood itself to be a political actor, and which by ways of our constitutional set up has to interact with Member States in a multitude of areas. This leads to internal contradictions and conflicting targets and trade offs.

These trade offs make the Commission see program design and implementation with other eyes than the IMF. As seen by a fairly large group of Member States this has made the Commission susceptible to (in their eyes) unacceptable compromises on program conditionality, requiring other institutions to be present as a corrective. Thus the IMF, and thus the debate on shifting important program responsibilities from the Commission to the ESM. The possibilities for such shifts are more limited, due to clear Treaty provisions, than some Member States would wish for.

Banking Union

Progress has been significant: we have made large steps towards Banking Union, especially since 2012.

There is a single supervisor (SSM) for banks under the umbrella of the ECB in Frankfurt. It has ensured that the playing field is becoming more level than it was. We have a single Resolution Authority which is funded by the European banking system. Regulatory reforms have made the banking system more robust and resilient.

The next steps should be a political agreement on Deposit Insurance (EDIS) which hopefully should come about this year. The debate of the last years has shown that this will only happen in conjunction with a number of so-called risk reduction measures. More correctly, one should be talking about necessary risk control measures.

The principle underlying this negotiating package is the following: risk will be shared across Member States if, and only if, there is trust in how contingent liabilities come about, and how they are dealt with. This requires trust in the institutions that govern these markets and how effective surveillance is. If risks are to be shared among Member States (or economic actors) then the factors that lead to such shared (contingent) liabilities need to be controlled, either jointly (intergovernmental approach) or through a joint institution (Community method).

Importantly, there is a good chance that such measures will include exposure limits for sovereign bonds in bank balance sheets, and a convergence process for national insolvency frameworks and practices. Quantified target values for national NPL ratios and their reduction are likely. Whether sovereign debt restructuring principles should be included or not is being hotly debated.

Such an agreement, if reached, can not be implemented in one step. The most realistic agreement would involve a process of moving from one step to the next step of integration of deposit insurance schemes, each step dependent on progress in fulfilling the quantifiable parameters as described above. One should therefore expect fairly lengthy transition periods.

Unfortunately, knee jerk reactions on both sides of the debate abound. In a small number of Member States, a powerful lobby of politically well connected banks has made the move towards joint deposit insurance domestically very difficult, even though the economic rationale is quite clear: all Member States would be winners.

In other Member States, sovereign exposure limits are seen with equal trepidation, even though some kind of limit to such large exposures is a *sine qua non* in a Banking Union. Sovereign Debt Restructuring has faced equal opposition, even though the underlying principle would not differ vastly from what we already have today.

Our ultimate aim should be clear: achieving a truly integrated market for banking services, where nationality and place of incorporation of the institutions are irrelevant. Only then would risk be truly shared and diversified, and sovereign risk would significantly be lower. A unified banking sector is obviously the most efficient way of channeling surplus savings from one part of the monetary union to another. With this, the banking crisis in Ireland and Spain, to name but two, would not have morphed into the sovereign crisis as they actually did. This requires, as above, trust in the institutions that are relevant for banks: the supervisor, national tax administrations, national courts and insolvency procedures, to name a few. Clearly, we have an important convergence process ahead of us, but a convergence process well worth pursuing as one of the top policy priorities of the Euro Area.

In the longer run even further change might be desirable: I consider a Treaty based separation of monetary policy and banking supervision in the best interest of both. This requires a Treaty change and, therefore, is not for the immediate future.

Fiscal Union, Fiscal Rules

A fiscal union can be described as one that combines joint resources with joint disciplines, and has the appropriate democratic legitimacy. Few dispute the fact that a monetary union needs a fiscal framework in order to ensure that negative spillovers are containable, and so that joint policies yield the appropriate benefits.

Moving towards a fiscal union can come in many forms. Attitudes towards these political choices are usually informed by approaches towards the political legitimation of such policies. A useful categorization is whether fiscal policies are:

- regulated through institutions
- by common rules
- or through market discipline.

Again, we see the choice between political union (joint institutions that are democratically legitimized) and a common approach that rests on a mix of national sovereignty and mutually agreed rules that are surveilled by a central institution (the Commission) or regulated through market discipline. The latter has not worked that well in practice.

Providing the Euro Area not only with rules but with a common budget, or fiscal capacity, has been widely debated over many decades. Suggestions range from a small investment budget, to a small budget that should stimulate economic reforms, right up to large joint budgets that are capable of macroeconomically significant countercyclical policies.

An argument often made in favor of a joint fiscal capacity is that macroeconomic stabilization at the Euro level would improve the effectiveness of monetary policy. This would then exclude the need for fiscal mechanisms that are not correlated to the business cycle, such as structural support capacities.

A useful question in this debate is which problem one is trying to fix: issues of regional cohesion, lack of public investment, problems of asymmetric shocks, or making sure that "others" (i.e. everybody else) have the "correct" fiscal stance.

The feasibility of such joint fiscal capacities differs according to the extent to which the fiscal sovereignty of national Parliaments is affected.

Budgets analogous to the EU Budget, i.e. financed by transfers of national governments that are calculated according to an agreed set of rules, avoid constitutionally difficult questions. The main issue is who decides on spending algorithms.

More difficult are those joint budgets that are financed by joint policies. Suggestions abound, ranging from joint financing of unemployment insurance schemes to financing through joint tax policies.

The present situation is characterized by the following parameters:

- an EU budget that in form and substance has nothing to do with the Euro Area
- fiscal rules that are incomprehensible to most
- their application in practice has led to mistrust and discord among Member States and between Member States and the Commission, and
- increasingly divergent levels of debt among Member States.

In this situation, large changes to the present set up of the Euro Area are unlikely. A plausible outcome of this year's political negotiations would be an agreement on a small fiscal capacity that is financed by transfers, and focuses on common public goods.

A simplification of the Stability and Growth Pact (SGP) would be highly desirable. An intelligent step in the right direction could be to focus on larger fiscal errors, and not on the values behind the comma.

Using cyclically adjusted values for budgetary purposes as we do is economically intelligent, but challenging in practice. Forecasting potential output based on current values is not a useful basis for practical short run fiscal decisions. A promising approach would be to focus on an expenditure rule, giving the debt rule a more prominent role, and focus on the medium term budgetary approach of governments instead of adjusting (in extreme cases) requirements several times a year.

Using nominal values, as was done up to 2005, is economically not optimal. This would only work if one gives an institution, obviously the Commission, a fair degree of discretion to evaluate the cyclical component of budgetary developments and to make recommendations accordingly. This takes away some of the quasi-automaticity of the present framework, and requires increased trust in the judgment and recommendations of the Commission, higher than some Member States have at present.

The Commission, at the center of the system of fiscal rules, has been put into an unenviable position. One of the reforms during the crisis shifted responsibilities for fiscal surveillance even further towards the Commission. Shifting voting rules to reverse requirements for qualified majorities meant that Member States could, in practice, not overturn Commission decisions. The thinking at the time was that this would empower the Commission to take unpopular decisions, and see them through. In reality, the burden of decision taking has become heavier, as the Commission is seen as the one and only relevant actor in this game. The lethargy in the Council in discussing fiscal issues may partially be explained by this shift in roles and responsibilities.

As the Commission attempts to steer a course that is described as political, sticking to the rules often would imply unpopular decisions. Not sticking to the rules is not possible in a system that is so clearly rule-based. The only way out is creating new rules when difficult decisions loom, so that unpopular decisions need not be taken, and rules are upheld. This, however, creates in turn conflicts with other Member States that lament the resulting lack of fiscal discipline.

A possible solution would be to simplify the rules, which makes them less "academic", and trust the Commission to take the necessary decisions that incorporate good economic reasoning. For this, a fairly high degree of discretion would be necessary. This requires trust of the Council in the Commission.

I am skeptical if governments will have the strategic foresight to agree to the necessary changes in the short run. They are more necessary and pressing than they realize. Whilst there has been some progress in fiscal consolidation, the balance between stabilization policies and sustainability concerns has not been a great success. Some Member States with elevated debt levels have increased debt levels even further. Credibility in the system has been undermined through continuous fine tuning of rules with only partial compliance. Mistrust in this areas spills over into other areas.

Economic Union

The Euro was not conceived as an isolated monetary experiment, but as the monetary complement to a fully functioning Internal Market of the European Union. This is not the occasion to treat in depth the question of how well the Internal Market functions, or which further integration steps are required. Suffice to say that there are still significant obstacles to reaping the full benefits of European integration in this area. Examples are markets for energy and other utilities, services and even some professions. The better such markets function, the better the benefits of the Euro can be realized, and vice versa.

Developments in the first ten years of EMU brought about wide divergences in real unit labour costs, mostly in countries that had not had a long history of shadowing the Deutsch Mark through hard currency policies. Strong institutions and processes help in aligning wage, price and productivity developments, thus limit negative spillovers and external disequilibria within the Euro Area. This is of course a symmetric issue of adjustment requirements within the area.

Democratic Accountability

The question of democratic accountability is often raised, usually in the sense of some perceived democratic deficit. Accountability and legitimacy need to rest where the constitution positions them.

In the context of the policies of the EMU there are reporting requirements of the ECB to the Council and the European Parliament, as well as hearings in front of the EP.

There have been repeated complaints about the lack of democratic accountability of decisions taken in the Eurogroup, such as on country adjustment programmes. Such decisions are taken on an intergovernmental basis, based on the constitutional domestic requirements of the Member States represented there. As such there can be no deficit.

An issue in the context of political transparency and involvement seems to me that the economic policies of the Euro Area are discussed in the Euro Group in Brussels. And that is often where they stay. A considerably deeper involvement and information of national policy actors would seem to be necessary in order to improve the understanding and acceptance and legitimacy of the policies that are joint policies. This could largely be the task of the President of the Eurogroup. Given that this is a job that is exercised in parallel to that of national Finance Minister, this will not happen. Making the job a full time and Brussels-based one would make this possible. His or her interactions would need to include regular and intensive consultations with national Parliaments.

Summary and Outlook

Progress in deepening EMU has been significant over the last years. Banking Union and other measures have led to a significant strengthening of the Euro Area. For 2018, I would expect political decisions on completing Banking Union, quite possibly decisions on a small budget for the Euro Area, and hopefully some progress on making the fiscal framework more practical and politically legitimate. Whilst not representing a "completed and final Monetary Union" these steps are important ones towards this goal.

Steps that require major Treaty changes will not be taken, also because they would lead to a rebalancing of core constitutional powers between national Parliaments and the central institutions of EMU.

PUTTING THE CART BEFORE THE HORSE? A CRITICAL APPRAISAL OF THE EUROPEAN FINANCE MINISTER IDEA[1]

Maria Patrin and Pierre Schlosser

1. The argument

The idea of establishing a European Finance Minister has been in the offing for some time now. However, with a few exceptions (Enderlein and Haas, 2015; Wolff, 2017; Xanthoulis, 2018), the significant bearing and implications of such a proposal on Europe's Economic and Monetary Union (EMU) – and on the European polity in general – have been insufficiently studied by scholars. This contribution intends to fill part of this gap.

The key argument of the paper is that the *ex nihilo* creation of a state-like figure such as a European Finance Minister in a political system as post-modern as the European Union is a worrisome choice; especially in the form proposed by the European Commission in its recent package on completing EMU (EC, 2017b). We claim that the establishment of such a new institutional position would indeed go against both letter and spirit of the Maastricht Treaty as it would constitute a radical change of economic policy cooperation paradigm in EMU. Setting up a Finance Minister position would precipitate and formalize the departure from a rules-based, fragmented and thin fiscal union – which we refer to as a coordination model – towards a thick fiscal union relying on centralized and concentrated discretionary power – i.e. a model based on a central

1 This paper elaborates on earlier contributions by Patrin (The European Finance Minister, *EUI ADEMU Working Paper*, 2018) and Schlosser (*Europe's New Fiscal Union*, forthcoming)

economic policy authority which we refer to as fiscal federalism. The empowerment of a Finance Minister would therefore undo the Maastricht logic of fiscal policy coordination and would set EMU on the trajectory of fiscal federalism (Hinarejos, 2013), a path which was however unambiguously discarded by Maastricht Treaty designers.

We therefore argue that the creation of a Finance Minister would be path-breaking. Moreover, entrusting executive powers to a European Finance Minister would significantly tilt the current inter-institutional balance of the EU polity and would also fundamentally undermine the inner Commission working principle of collegiality. It is our belief that the Treaties, as the primary legal source of EU law and as the anchor of power distribution among EU institutions, deserve more consideration. In this spirit, the paper raises strong doubts as to whether a European Finance Minister can be at all created in the absence of Treaty revision. It does so in terms of both the political consequences of such a step and the legal implications that would underpin the changes. We argue that the current Commission's proposal of creating a European Finance Minister – as valid an end point for Europe's future Fiscal Union it may be – is an ill-advised idea. It would not only amount to 'putting the cart before the horse': it would represent a constitutional change. We do not however intend to imply that the Maastricht Treaty is a perfect working arrangement, it is by all means far from it.

In its section 2 the paper first embeds the finance minister idea into a deeper debate on fiscal centralization in an asymmetric EMU. Section 3 then recalls the Maastricht logic of fiscal policy coordination within EMU and sketches out why the Maastricht spirit has started to tumble. Section 4 deciphers in further details the proposal of a Finance Minister as a new way out of the EMU institutional conundrum. Section 5 assesses the implications of such a new position from both a legal and inter-institutional perspective. Section 6 provides a normative view on the proposal and concludes.

2. Maastricht's Negative Choice: No Centralized Economic Policy Authority

EMU's institutional design has been incomplete from its beginning. Its asymmetrical setup, 'with the almost complete transfer of sovereignty in monetary policy making to the European level, but with very limited transfer of sovereignty in economic policy making' (Verdun, 1996:

65) was perceived as 'a post-modern construction defying the laws of gravity' (Tsoukalis, 2003: 150). When creating EMU, Treaty designers deliberately decided that it should not be accompanied by a political union. The imbalanced architecture of Europe's Economic and Monetary Union should hence, first and foremost be seen as a conscious choice *not* to create a classic fiscal union supported by a political union. This negative choice had two main consequences.

First, it meant that EMU would see at its centre the absence of a political counterpart to the ECB: no European institution was 'introduced to flank the ECB' (Verdun, 1999: 107). EMU thus currently features a strong, very independent and institutionally isolated central bank that has no central political counterpart. The Maastricht Treaty therefore did not create any new economic policy authority and hence did not lead to the constitution of a fiscal body or institutional capacity (Cameron, 1997: 476-477). As a consequence, 'it is unclear which political authority will be held responsible if EMU leads to an uneven distribution of costs and benefits across the euro zone' (Verdun, 1999: 107).

The absence of a central fiscal and politically legitimized institution alongside the ECB, i.e. of an authority which could delineate the field of action of a European economic policy (Cameron, 1997: 477) had deep implications which were anticipated by a few. Verdun (1996), Strauss-Kahn (1997), Goodhart (1998) Padoa-Schioppa (2004) and De Grauwe (2006) – all in their own way – stressed a specific danger of having a common currency deprived of a fiscal and political underpinning. Namely, the 'risk of the Eurosystem being seen as the only macroeconomic policy-maker in the euro area, and hence to be held responsible for any adverse development in the European economy, not only inflation but also unemployment and slow growth' (Padoa-Schioppa, 2004: 57; Pisani-Ferry, 2006: 834). As predicted by Verdun, 'one can wonder what political body can be held accountable for any imperfections once EMU is fully operational' (Verdun, 1999: 110).

The second consequence of the Treaty designer's choice *not* to create a fiscal institution alongside EMU's monetary institution, is that a second best to political unification had to be found to avoid too divergent economic policies and the resulting internal imbalances that divergent paths would have led to. The road of fiscal policy coordination was hence explored as an immediate alternative and as a substitute to a fiscal and political union: 'the project of achieving fiscal union through coordination remained alive' (Pisani-Ferry, 2006: 825).

When looking at fiscal policy coordination arrangements it is important to distinguish between the fiscal policy coordination 'technology', i.e. rules, technocratic discretion or a common economic policy institution, and the fiscal policy coordination 'actor', i.e. multiple or single actors. In line with the Maastricht spirit of a minimalistic approach to fiscal powers centralization, the type of coordination adopted in Europe was a rules-based coordination system. Both in Maastricht and thereafter, rules have been preferred as a coordination device to bind Member State commitments and to hold fiscal policy spill-overs in check. With the exception of monetary policy, sovereign states retained large discretion in designing and implementing their domestic economic policies. However, their behaviour was made subject to a series of EU level rules – the no bail-out clause and the Stability and Growth Pact – aimed at 'ensuring that negative spillovers are contained' (Wieser, 2018: 4).

Another distinctive trait of EMU was its fiscal policy coordination 'actor' choice. Following the Maastricht decision not to create any economic policy institution, the key economic policy functions were kept at the Member State level while some coordination tasks were attributed to the Commission, the ECOFIN and, in a second step, to the Eurogroup. The few existing economic policy coordination tasks were thus fragmented among a plurality of actors. They were deliberately not concentrated in the hands of a single institution. The ECOFIN Council was expected to act both as a forum for the coordination of economic policies and as the formal legislator on economic and financial affairs for the European Union. The European Commission was tasked with the mandate of monitoring economic developments and was entrusted with the proposal of sanctions to be adopted by the ECOFIN while the ECB was empowered with the conduct of EMU's monetary policy. Crisis management instruments did by and large not exist (Sapir and Schoenmaker, 2017). When those instruments and mechanisms were finally created during the euro crisis, the 'centrifugal' (Dehousse, 1997) delegation pattern was confirmed and institutional fragmentation was accentuated.

To sum up, the Maastricht fiscal policy coordination approach was made up on the one hand of central rules which ensured that negative spill-overs among member states sharing a currency would be held in check. On the other hand, EMU's thin central coordination powers were fragmented among several economic policy actors. Given the magnitude of the sovereignty transfers that the simultaneous creation of a monetary centre and of a fully-fledged fiscal centre would have implied, such a Monet-like, incremental (see also Wieser in this edition), craftsman-style approach seemed rather reasonable. With hindsight, such a second best solution proved however ineffective and short-sighted.

3. EMU's fiscal policy coordination model is tumbling

Over the last 25 years, Europe has been the laboratory of a distinctive fiscal policy coordination model. This large-scale experiment by and large failed, both in terms of the choice of 'technology' and in terms of the choice of 'actor'.

Although it appeared as much less intrusive a solution for Treaty designers, the Maastricht rules-based surveillance technology has proven to entail dangerous features too (Hinarejos, 2013). The original model as well as the more recent reforms pushed regulatory integration to its most extreme retrenchment: 'new and more detailed provisions were added with the aim of limiting national fiscal policy discretion' (Larch and Braendle, 2018: 268). Fiscal policy coordination has been strengthened and expanded with the adoption of the Six Pack and the 2 Pack (Laffan and Schlosser, 2016). With the creation of the European Semester and of the Macroeconomic Imbalance Procedure, rules-based surveillance has even spilled-over to economic policy coordination more broadly. Overall, rules have been made more complete and more specific in the hopes, at the time, that these reforms would enhance rule enforcement. However, this approach disempowered national economic policy actors and ensured that they now feel increasingly 'baby-sitted' (Pisani-Ferry, 2018) by Brussels. Put differently, 'the EU essentially took upon itself the task of preventing national economic policy mistakes' (Saarenheimo, 2018: 2; Leino and Saarenheimo, 2017).

Another corollary of the above reforms was that fiscal rules have become so complex that, as of today, they can only be operationalized through the expert interpretation[2] of the European Commission. In other words, a complete contract approach to rules-based coordination has led to the advent of central technocratic discretion and an unenforced system: 'the SGP has become fairly complex and enforcement ultimately clashes

2 Jean Pisani Ferry recently argued that 'the 224-page vademecum on implementing fiscal discipline in the EU is hopelessly complex, to such a degree that no finance minister, let alone parliamentarian, fully understands what his or her country must abide by' (JPF, 2018b)

with the sovereignty of the Member States' (Larch and Braendle, 2018: 280). The unintended consequence of the Maastricht fiscal coordination choice was thus that fiscal powers have been 'centralized through the backdoor of coordination' (Saarenheimo, 2018).

The existence of a plurality of actors in charge of fiscal policy coordination in EMU has equally led to some tension. A second unintended consequence of Maastricht was indeed a 'centrifugal' (Dehousse, 1997) institutional dynamic at play in EMU. Looking at one example of fiscal powers, crisis management, Enderlein and Haas (2015: 8) explain that 'there are too many actors involved in crisis management negotiations' (Enderlein and Haas, 2015: 8) while 'no one seems to be fully in charge' (Enderlein and Haas, 2015: 8). Similarly, the 4 Presidents report on the EMU and the 5 Presidents Report on Completing Future of EMU have highlighted that considerations over EMU's design lie close to the heart of many European institutions but also that EMU misses a clear executive voice. This situation echoes the debate in the early EMU days about who Mr. (or Ms) Euro is. Is it the President of the European Central Bank? The President of the Eurogroup? Or the European Commissioner in charge of EMU? Moreover, further fragmentation has been provided by the recent Commission Juncker reform which ushered in the creation of a Vice-President in charge of EMU while preserving a Commissioner in charge of economic and financial affairs.

While attempts are being made within the Commission and within the Euro Working Group to put the genie back into the bottle (e.g. by simplifying the Stability and Growth Pact rules), there is no mistaking the reality that only a radical choice can restore a clear division of fiscal powers between the centre and the periphery. One should thus confront the reality that the model of fiscal policy coordination chosen in Maastricht has ran its course. Only a Treaty revision can undo the Maastricht logic and provide a more symmetric EMU as well as a genuinely alternative fiscal integration model. Yet, the package on deepening EMU brought forward by the Commission in December 2017 is explicitly based on the premises that Treaty reform is not an option at this stage (EC, 2017 a). As such, it aims at fixing Maastricht's unintended consequences – and the even messier consequences of the crisis – by resorting to secondary law instruments and *ad hoc* political arrangements. But is this feasible or desirable?

4. The idea of a European Finance Minister: a path-breaking institutional innovation – The political issue

On 6 December 2017 the European Commission presented its package on Deepening the Economic and Monetary Union (EC, 2017 a). It entails a number of measures deemed necessary to completing EMU and strengthening its democratic accountability. Measures proposed include:

- The creation of a European Monetary Fund as a successor to the European Stability Mechanism
- Integrating the Treaty on Stability, Coordination and Governance (the so called Fiscal Compact) into the Union legal framework,
- New budgetary instruments with a stabilisation function that can be used by Member States under certain conditions, the possibility to mobilise EU funds in support of national reforms and a strengthening of the Structural Reform Support Programme; (ROADMAP) and finally
- The creation of a European Finance Minister

It is interesting to note that the most prominent proposals of the package such as the design of a fiscal backstop and the evolutionary transformation of the ESM into an EMF appear as largely path-dependent solutions aiming to consolidate the reforms undertaken during the euro crisis. By contrast, the idea of constituting a European finance minister is path-breaking as it would move away both from the past Maastricht-style fiscal surveillance model and from the reforms adopted during the euro crisis. This step would probably fall under what Saarenheimo terms in this issue, the 'new and qualitatively different territory' (Saarenheimo, 2018: 1) and would thus amount to a constitutional change. Whereas it can be argued that the other proposals are necessary to integrate and streamline the sets of measures adopted during the crisis, there is no intrinsic necessity in the *ex nihilo* creation of a European Finance Minister. This is the reason why this contribution focuses on this new, path-breaking institutional arrangement, assessing it from both a political and a legal perspective.

In the words of the Commission, the proposal to create a Finance Minister aims at increasing the coherence, effectiveness and transparency of EU economic policy-making (EC, 2017b: 1)[3]. The Finance Minister

3 It has to be noted that the proposed creation of a European Finance Minister is no legislative proposal, as it takes the form of a Communication, a non-legislative instrument (EC, 2017b).

would combine existing functions at the EU level, simplifying the EMU governance and streamlining decision-making procedures. To do so she would be at the same time a member (possibly a Vice-President) of the Commission and a permanent Chair of the Eurogroup. In reality, the Finance Minister would altogether cumulate three different 'hats' as she would also be the Chair of the ESM's (or indeed the EMF's) Board of Governors. The responsibilities of the Finance Minister would include strengthened policy coordination and oversight of economic, fiscal and financial rules, centralised management of euro-area budgetary instruments (e.g. support for structural reform) and oversight of the work of the European Monetary Fund (once established).

In many respects the proposal addresses Maastricht's unintended consequences, by centralising the functions, powers and responsibility for fiscal governance in the hands of a single person, thereby creating a political counterpart to the monetary power of the ECB. Interestingly, the Commission justifies the creation of such a position with arguments that very strongly echo the concerns presented earlier in this paper about the plurality of actors and the complexity of EMU institutional arrangements: 'compared to monetary policy, which is unified for euro area Member States and easily identified by citizens, fiscal policy is essentially managed by individual Member States and coordination efforts at EU and euro area level are conducted by many actors' (EC, 2017b: 1). The Commission goes on in stressing that such institutional patchwork 'has led to complex decision-making processes, which have often been criticized for not being sufficiently understandable and efficient' (EC, 2017b: 1).

However the idea proposed by the Commission is halfway between a political and a technocratic response to EMU's shortcomings. Per definition, the position of Minister is of a political nature. Undoubtedly there is a political ambition behind the Commission's initiative, which intends to strengthen the democratic basis of EMU, especially against the background of deep disaffection and dissatisfaction of EU citizens for the Brussels-centric management of the Eurozone. Entrusting EMU affairs to a centralised figure that can be held responsible and accountable in front of the European Parliament and the Council would possibly increase the public acceptance of EU action in this field. Yet, the tasks and functions attributed to the new Minister are by and large of a technocratic nature. They answer to the need of centralising the management of EMU affairs – fiscal surveillance above all – in the hands of technocratic experts. At the end of the day the Finance Minister would still be a Commission's member and would as such perform his duties in full independence and neutrality. It is hard to see in how far the political mandate of the new Minister would be any different from that of other Commissioners. Assigning different hats to a Finance Minister will reduce the number of presidents chairing institutions and agencies currently executing fiscal tasks. However, it will not lead to a reduction of the high number of these institutions and agencies. It is fallacious to believe that by creating a new, permanent position the deficiencies of the current fiscal regime would magically dissolve.

To sum up, the Commission's attempt to step away from technocratic governance runs the risk to end up being a renewed technocratic solution with a semblance of democratic and political legitimacy, as the political mandate is missing, or at least highly controversial. Such a path-breaking innovation does not find any basis in the EMU architecture agreed in Maastricht and would therefore require a revision of the Treaties in order to be fully legitimate. In the absence of a thorough rethinking of the legal and democratic foundation of EMU, the Minister position risks being an empty shell for what looks like a new technocratic arrangement through the backdoor.

In the next section, we argue that also from a legal perspective such a reform would require Treaty change.

5. Institutional Implications of the proposal: compatibility with the Treaties – The legal issue

In the introduction to the Communication on the European Finance Minister, the Commission states that the Finance Minister shall be created within the current EU legal framework: 'in particular, the Communication describes the added value of an ultimate merger of the function of Commission Vice-President in charge of the Economic and Monetary Union with that of President of the Eurogroup, and it highlights that this could already be achieved under the existing Union Treaties' (EC, 2017b: 2). Undoubtedly the Commission is well aware of the difficulty – almost impossibility – to agree on a Treaty reform in the short run and is keen on advancing institutional reform that can remain within the Treaty boundaries. It inserts the Finance Minister in the continuity of the reform of the Commission's college implemented by Commission President Juncker at the beginning of his mandate, which strengthened among others the role of the Vice President in charge of EMU policy coordination. In this respect the increasing powers attributed to Vice-Presidents under the Juncker Commission and the growing importance of EMU related matters would represent first steps in the direction of creating a dedicated post (EC, 2014). Yet, the changes contained in the Commission's proposal are far-reaching and bear significant consequences for the EU institutional architecture. As such, they should take more seriously into account the constitutional constraints of the Treaties.

In our opinion, the arguments put forward by the proposal in order to avoid Treaty changes are not entirely convincing.[4] According to the Commission, the merging of the positions of Commission member and Eurogroup chair does not require Treaty revision because the rules for electing the President of the Eurogroup are not in principle incompatible with the position being taken up by a member of the Commission. Protocol n° 14 on the Eurogroup, annexed to the Treaties, only states that "The Ministers of the Member States whose currency is the euro shall elect a President for two and a half years, by a majority of those Member States"[5]. Thus, as the Commission points out, Eurogroup Ministers would only have to change their Working Methods, which currently foresee that the President shall be a national Finance Minister. No other impediment seems to exist: "The Minister would not create a new supranational bureaucratic layer, nor would the Minister impinge on national competences" (EC, 2017b: 5).

This might well be true in relation to the role and governance of the Eurogroup. But what about the Commission? In a rather enigmatic formulation, the proposal comments on the compatibility between Commission's and Eurogroup's tasks, declaring that: 'the Commission participates in the work of the Eurogroup, as is foreseen in Protocol n° 14 to the Treaties. Art. 17(1) TEU lays down the mission of the Commission to promote the common interest of the Union, which it does in all its activities. It is thus Union primary law that makes it clear that there is no incompatibility between the tasks of a Member of the Commission and involvement in the work of the Eurogroup' (EC, 2017b: 7). Arguably, however, there is a sizeable difference between "being involved" in

4 On a similar note, Enderlein and Haas (2015) support the idea of creating a 'double-hatted' European Finance Minister yet they admit that such a change "would require a change of the European Treaties".

5 *Treaty on European Union* - Protocol (No 14) on the Euro Group, Official Journal 115, 09/05/2008 P. 0283 – 0283

the work of the Eurogroup and presiding over it. Whereas the former is unproblematic from a primary law perspective, it may well be the case that taking up the Chairmanship of the Eurogroup might require further adjustments. It is no coincidence that institutional changes of this kind and magnitude have in the past been agreed during Treaty negotiations. The obvious precedent for this institutional reform, the creation of the position of the High Representative for Foreign Policy, who is Vice-President of the Commission and permanent Chair of the Foreign Affairs Council, was notoriously agreed by Treaty revision and its role and functions are now clearly spelled out in the Treaties. It is curious that no mention to the High Representative is to be found in the Commission's communication on the Finance Minister. Is the omission a simple oversight or a deliberate and strategic choice?

Be that as it may, we believe that the proposed creation of the European Finance Minister would have significant consequences on the internal balance of the college and would run counter to the principle of collegiality, which informs the whole Commission's decision-making. Art. 17.6 TEU states that the Commission should act efficiently, consistently and collegially under the guide of its President. The introduction of an EMU Vice-President who would also be the Eurogroup President will likely greatly affect the power balance within the college. Contrary to foreign policy, which remains solidly in the hands of the Member States, we are dealing here with core Union competences in which the Commission's powers have been continuously growing in importance. Especially when it comes to budgetary supervision, the Commission is already performing very sensitive tasks and enjoys a great deal of autonomy in managing these tasks. The transformation brought about by the merging of both Commission's and Eurogroup's functions will distort the internal collegial decision-making of the Commission. Internal decisions of the college on issues pertaining to key EU competences will need to be shared with another, external institution. The leverage of the college, and possibly of the Commission's President himself, on the new super Minister will arguably be limited. [6]

6 For further consequences of the creation of the Finance Minister position for the EU inter-institutional balance see Patrin, 2018.

6. Interpretation and Conclusion

The Commission proposal to create a European Finance Minister, because of its potentially enormous ramifications on the EU polity, constitutes a path-breaking idea that deserves the full attention of policy-makers and expert observers alike. The full implications, as we argued, can only be understood when put into the context of a path-breaking shift from a Maastricht-like fiscal policy coordination model to a fiscal federalist model that relies on the creation of a central economic policy authority of some form.

Some have argued that 'no deal is better than a bad deal' when it comes to euro area reform (Bofinger, 2018). Yet, at times, no agreement is better than second best agreements when those dramatically affect the relationship between the members of a community and risk altering the very nature of the community. The fact that 'second best theory that half-way progress sometime leads to inferior outcomes' (Pisani-Ferry, 2006: 835) should caution sceptics against other second best options to the design of EMU. Münchau, for one, strongly argues in this edition, that 'it is the best course of action for the Eurozone not to undertake half-hearted reforms right now' (Münchau, 2018: 1).

In our opinion, a sound and sustainable EMU can only be achieved via an ambitious institutional reform that would consist in the constitutional creation of a formal fiscal institution.[7] The neo-functional logic that characterized the single market integration when applied to EMU seems to be failing and should, in our view, not be applied to core state powers. The creation of a Finance Minister, instead of offering a clear-cut solution to fiscal policy coordination in EMU, amounts to continuing the inconclusive middle way of a combination between rules and technocratic discretion. This doesn't bode well at all for the future stability of EMU and for the sustainability of Europe's domestic democracies.

In this respect, the Commission's Communication raises a fundamental constitutional issue. The insistence on the fact that the position does not require Treaty change points to a deep mistrust towards the constitutional foundations of the Union. Treaties are viewed as a constraint. However,

7 In his paper N. Xanthoulis argues that "For a Union finance Minister to have more than a *de minimis* impact on economic policy formulation and implementation, its title must be accompanied with the transfer of substantial powers to the EU level. […] the Minister's position must be coupled with the real centralisation of fiscal policy and an effective accountability regime that would provide the required democratic legitimacy", Xanthoulis (2018) 24.

the constitutional value of the Treaties lies in their authority to distribute power and to attribute functions to the Union's institutions. Admittedly, the Commission's proposal for a European Minister of Finance precisely aims to change the inter-institutional distribution of powers and functions, without any constitutional mandate and in the name of "further strengthening democratic accountability" (EC, 2017b: 1). However, by bypassing the key democratic tool of the Union, the Treaties, the proposal risks undermining the EU democratic foundations rather than strengthening it. It does so by reverting to technocratic arrangements and structures to provide a political response to the many shortcomings that we inherited from the post-Maastricht era. This is why we believe that, should EU leaders ultimately decide to implement the Commission proposal, it should be conducted via Treaty change, not through the back-door of covert and technocratic institutional change. In sum, the proposed creation of a European Finance Minister corresponds exactly to the type of institutional capacity-building measure that would tilt the balance of the current – admittedly ineffective and flawed – fiscal policy coordination model towards fiscal federalism. It would constitute a central fiscal authority. Yet, it is quintessential when designing a new political authority that the process through which this authority originates is legitimate. The institutional engineering of the euro crisis period makes one worry about a technocratic temptation.

In this light, we therefore strongly argue in favour of democratic fiscal federalism solutions and strongly against technocratic fiscal federalism, especially when this happens as a hidden result of the alleged attempt to strengthen democratic legitimacy and accountability. Only by his name, the position of a Finance Minister echoes strong political mandate and democratic basis (Xanthoulis 2018). His main EU function, however, would consist in centralising the technocratic management of EMU affairs. This sounds like a dangerous solution, especially against the background of current political contestation at the national level and growing populism threatening the mere existence of the European Union. If EMU is to be made symmetric and complete, there is no way around Treaty change to create a European fiscal institution.

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CONFERENCE PROGRAMME

Conference

Institutions and the Crisis

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26 April 2018

Introduction

The crisis has turned Europe's economic and financial governance into a patchwork of bodies, instruments and rules that are hard to disentangle. Against this background, the purpose of this conference is to critically analyse, review and debate the most salient elements and gaps of Europe's post-crisis institutional architecture.

More specifically, the conference aims: (1) to draw analytical and practical lessons from the crisis management solutions provided by European Union institutions, (2) to interrogate how courts discussed, challenged and legitimized the EU's key crisis-led decisions and (3) to look ahead and boldly ask and discuss what should be the Economic and Monetary Union's optimal institutional set-up – also in light of a renewed and conceivably more dynamic French-German cooperation moment.

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Programme

09.15 - 10.15	Registration and Welcome Coffee
10.15 - 10.20	Welcome by **Elena Carletti |** Bocconi University, BAFFI CAREFIN and Florence School of Banking and Finance
10.20 - 12.00	**Session 1: A Look Back: Evaluating European Institutions' Crisis Management** *Chair and moderator:* **Franklin Allen |** Brevan Howard Centre, Imperial College Speakers: ▪ **Aitor Erce |** European Stability Mechanism ▪ **Tuomas Saarenheimo |** Finnish Ministry of Finance ▪ **Baudilio Tomé Muguruza |** European Court of Auditors ▪ **Jeromin Zettelmeyer |** Peterson Institute for International Economics
12.00 - 13.00	Chair: **Elena Carletti |** Bocconi University, BAFFI CAREFIN and European University Institute Keynote Lecture: **Jean Pisani-Ferry |** European University Institute
13.00 - 14.30	*Lunch*
14.30 - 16.00	**Session 2: Disentangling the Crisis and the Courts** *Chair and moderator:* **Mitu Gulati |** Duke University Speakers: ▪ **Lee C. Buchheit |** Cleary Gottlieb Steen & Hamilton LLP ▪ **Bruno De Witte |** European University Institute ▪ **Georg Vanberg |** Duke University ▪ **Chiara Zilioli |** European Central Bank
16.00 - 16.30	*Coffee break*
16.30 - 18:00	**Session 3: The Way Forward – The Eurozone's Institutional Prospects** *Chair and moderator*: **Brigid Laffan |** European University Institute Speakers: ▪ **Francesco Garzarelli |** Goldman Sachs ▪ **José Leandro |** European Commission

- **Wolfgang Münchau |** Financial Times
- **Thomas Wieser |** Bruegel

18.00 - 18.15 Closing remarks

18.15 - 21.30 Reception and Dinner

- **Natacha Valla |** European Investment Bank

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