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Abstract (from the introduction)

The eurozone sovereign debt crisis, despite all the pain and suffering that has caused to the peoples of the affected countries of the European periphery, has the potential to serve the purpose of European integration, if the right signals are transmitted to the political establishment of Europe. Clearly, the crisis has challenged the basic premise that underpinned the creation of the Economic and Monetary Union (EMU), namely that coordination of economic policies would be enough to safeguard the consensus over the common currency. During the last year the leaders of eurozone Member States have taken unprecedented action to make up for the failures of economic policy coordination by devoting significant funds to rescue Greece, Ireland and Portugal from a default. It appears that for now the consensus was retained, and the euro survived, but at the expense of the initial commitment of the European political establishment that financial transfers from one Member State to another should not to be allowed.

If, however, economic policy coordination has failed and a fiscal union remains, in principle, outside of the current European accord, then how can the euro survive the next crisis or any unexpected turns of the present one? It is the position of this paper that European Union (EU) leaders should seek to reestablish the EMU on the basis of a different kind of consensus. Essential
to this approach would be the notion of European Federalism, whereby coordination of economic policies is made possible by financial transfers from the centre to the periphery.

It should not be forgotten, though, that such a task goes way beyond the current institutional arrangement of the EU, and most importantly, requires broader transformations towards the creation of a legitimizing basis for the establishment of representative European political institutions. This paper will not venture to explore in a detailed manner how this could be realized, but rather to demonstrate the limitations and fallacies of the solutions that have been given until now, and furthermore, to stress the need to reinitiate the -currently absent- discourse about political integration in Europe.

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A. INTRODUCTION
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At the first part of the paper I discuss the legal provisions underpinning the EMU contained in the founding treaties and secondary law. The analysis of the relevant provisions and the experience
of their application reveals that coordination of economic policies has been hindered by the soft law character of “positive integration” and the loose implementation of the more concrete obligations imposed by the Stability and Growth Pact (SGP). In light of the proposed amendments to the SGP, it is argued that the new rules will not restore the damaged credibility of the Pact, given that Member States will still be called to sanction themselves in case of violations. However, a substantial shift towards a different approach requires an amendment of the Treaty on the Functioning of the European Union (TFEU).

The second part of the paper examines in more detail the sovereign debt crisis and the responses provided by eurozone leaders so far. The establishment of the bailout facilities signaled a departure from the basic premise of the EMU, that the common currency will not be supported by direct financial transfers among Member States. Furthermore, it stressed the strong commitment of politicians towards the survival of the euro, even if overly broad interpretations of the TFEU were to be employed. Notwithstanding, however, the historical significance of the measures that have been adopted, the arrangements for Greece, Ireland and Portugal do not address the pressing problem of debt reduction that is essential for every exit strategy from the crisis in these countries. Accordingly, allowing a debt restructuring, instead of providing liquidity assistance at the level of Member States, could address both the concerns of the distressed countries as well as the domestic challenges within the main contributors to the bailout facilities. Indeed, the elements of a transfer union can be more effective and less politically controversial if they are channeled in a more regular way, as opposed to being part of emergency crisis containment mechanisms.

The measures of economic governance which comprise the “Euro Plus Pact” are discussed at the third part of the paper. It is argued that the policies of the Pact, apart from their build-in enforceability problems and the tensions that are creating between the Euro-in and Euro-out countries, will also be ineffective in increasing the competitiveness of the countries of the periphery. For that to happen, significant resources should be attributed by the other Member States. This Federal model for the EU, however, cannot be applied, unless legitimate political
institutions that would be mandated to implement distributive policies at the European level, are established. Given that the Federalization of the EU will be a long and uncertain process, the survival of the common currency rests upon the commitment of politicians to safeguard it, often at the expense of the democratic guarantees of national Constitutions.

B. LEGAL FOUNDATIONS OF THE EUROPEAN ECONOMIC AND MONETARY UNION.

I.

Title VIII of the TFEU sets out the primary law provisions underpinning the EMU. However, under the title “Economic and Monetary Policies”, the TFEU encompasses policies that aspire to different degrees of integration with respect to the economic pillar, on the one hand, and the monetary on the other.

Thus, while Article 3 of the TFEU gives the Union exclusive authority over the monetary policy of Member States that have adopted the common currency, the coordination of economic policies is treated separately in Article 5 of the TFEU. According to Article 4§1 TFEU, “The Union shall share competence with the Member States where the Treaties confer on it a competence which does not relate to the areas referred to in Articles 3 and 6”. Consequently, economic policy coordination is systematically classified as a competence that is shared between the Union and the Member States. The fact, however, that Member States retain the primary responsibility over economic policies, with the EU having only coordination authority, has led to the assumption that economic policy coordination is essentially a complementary competence, of the type described in Article 6 of the Treaty.  

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1 According to Article 3 TFEU, “The Union shall have exclusive competence in...monetary policy for the Member States whose currency is the euro”
2 Article 5 TFEU states that “The Member States shall coordinate their economic policies within the Union. To this end, the Council shall adopt measures, in particular broad guidelines for these policies. Specific provisions shall apply to those Member States whose currency is the euro.”
3 According to Article 6 TFEU, the EU exercises complementary competences when its actions are merely of a supportive, coordinating or supplementary character to the policies of Member States. “The Lisbon Treaty. A Legal and Political Analysis”. Jean-Claude Piris. 77.
Accordingly, the framework laid down by the Treaty is in effect bifurcated: eurozone Member States have delegated to the EU the exclusive authority to formulate and implement monetary policy for the euro, thereby having consented to abandon crucial aspects of their monetary sovereignty. On the other hand, economic and fiscal policies are drafted at the national level, being subject solely to a loose supranational coordination, mainly in the form of constraints rather than positive obligations. It is thus apparent that while the monetary union has been fully realized for the members of the eurozone, the term “economic union” is, for the time being, a misnomer, used to describe an aspirational goal, the realization of which is contingent on the will of Member States.  

This misalignment between monetary and economic integration has rendered eurozone Member States more interconnected than they have ever been in the course of the history of European institutions. Indeed, expansionary fiscal policies in a small number of eurozone members have the potential to create broader inflationary pressures and lead the European Central Bank (ECB) to raise interest rates, with a corresponding decrease in private investment, causing this way adverse effects for the whole eurozone.

Furthermore, the realization of the internal market and the advent of the monetary union have increased the economic costs of financial crises. As financial services have been liberalized, the effects of financial institutions’ failures cannot be ring fenced within the jurisdiction of a Member State that has served as the home country of a systematically important financial institution. Accordingly, contagion to other Member States where the activities of the failed institution have been expanded is much more probable, given that in many cases host country authorities are obliged to recognize the determinations of the regulators of the country of incorporation with respect to the safety and soundness of financial institutions.

In addition, the consequences of recession that usually follows financial crises have been exacerbated by the monetary union, due to the fact that eurozone members cannot effectively combat them on their own capacity, as they have delegated the monetary policy tool to the EU.

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4 “Legal Foundations of International Monetary Stability”. Rosa M. Lastra. 274.
5 Id, at 251-2.
Accordingly, they should expect from an institution of the Union, the ECB, to adjust its policies to the economic realities they face in order to bring about internal recovery.  

In light of the links of interdependence and the policy limitations created by the monetary union, the consensus over its long-term survival depends on the achievement of some degree of coordination over economic and fiscal policies. Indeed, this proposition is verified by study evidence suggesting that high differentiations in inflation rates among monetary union members make the dissolution of the union a much more probable event.

Thus, in order to safeguard the common currency, the founders of the Maastricht Treaty included primary law provisions that sought to coordinate domestic economic policies so as to avoid adverse spillovers within the eurozone, whereas a set of secondary law regulations was introduced overtime, to supplement the basic treaty provisions. In the following lines I survey this legal framework, comprised by the primary law provisions, now inserted in the TFEU, and the pertinent secondary law.

A closer look to the relevant provisions reveals that the rules in place fall short from constituting a reliable framework that could guarantee the effective coordination of fiscal and economic policies, and thus offers limited protection to the common currency. That is because, as it will be explained in the following chapter, the relevant provisions are either not legally binding, or where concrete obligations exist, compliance has not been achieved.

However, the discussion about the deficiencies of economic policy coordination does not suggest that a significant improvement in the rules will insulate the EMU from the danger of dissolution, as if an important number of Member States were to abandon the euro, due to failure to comply with the fiscal rules, then the monetary union would become increasingly irrelevant and

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6 In fact, given its focus on the overall eurozone outlook and its strong anti-inflationary mandate, it is not always easy for the ECB to adopt monetary policies that satisfy the particular economic realities that eurozone Member States face. While, starting from October 2008 and during the course of the financial crisis, the ECB adopted unprecedented measures, in what has been generally conceived as an appropriate response to the dangers that the whole eurozone was facing, its recent decision to raise its key interest rates has been criticized for failing to take into account the concerns of the highly indebted countries of the periphery, which will see their debt servicing costs to rise. See ‘ECB criticized ahead of its expected rate rise’, citing Nouriel Roubini’s statement that “tightening by the ECB is going to exacerbate the growth, fiscal and financial stresses of the periphery”. Financial Times, April 4, 2011, 6.

7 “International Finance, Transactions, Policy, and Regulation”. Hal S. Scott. 346.
ultimately fade away. Accordingly, more effective coordination over economic and fiscal policies should be pursued in tandem with the elaboration of strategies that seek to mitigate the internal imbalances of the eurozone, thereby making the rules of economic governance realistic from an economic and political perspective (this point is discussed at the third part of the paper).

II.

The core elements of economic policy coordination remain largely unchanged by the provisions of the Lisbon Treaty. Consequently, coordination will continue to be implemented through broad economic policy guidelines, multilateral surveillance and the excessive deficit procedure. The process of economic policy coordination can be doctrinally categorized to elements of “positive” and “negative” integration, with the former referring to the approximation of laws and regulations, and the latter to the abolition of domestic measures and abstention from certain actions (i.e, excessive deficits). It has been accurately noticed that while “positive integration” resembles soft law, in the sense that it relies on self-commitment, peer review and benchmarking by the Member States, “negative integration” has the characteristics of hard law, as it provides for binding rules and severe sanctions. Accordingly, Member States assume merely political commitments to implement at the national level the broad economic policy guidelines that are decided at the Council, subject solely to non binding recommendations by the Council in case of non compliance. On the other hand, failure to meet the quantitative budgetary goals with respect to the deficit and debt to Gross Domestic Product (GDP) ratios entails, inter alia, the imposition of fines.

Article 121 of the TFEU sets out the two principle mechanisms of “positive integration”, that is broad economic policy guidelines (121§2) and multilateral surveillance (121§3). According to the first paragraph of Article 121, “Member States shall regard their economic policies as a

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8 If for instance, following a voluntary withdrawal of southern countries, the euro was only used by a number of countries of the European core, an incentive towards return to national currencies would exist, as southern countries would be able to resort to competitive undervaluations of their currencies, gaining this way market share at the expense of core countries.
9 Supra note 3, at 301.
10 Supra note 4, at 247.
11 Id, at 248.
12 Id.
matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120”. While this provision has an overly broad content (what does “common concern” really mean?), and consequently a mainly aspirational character, Member States are subject to more concrete obligations with respect to the prohibition of policies that are inconsistent with the notion of internal market.13

According to article 121§2, broad economic policy guidelines adopted by the Council, following a recommendation from the European Commission, and after consulting with the European Council, take the form of recommendations. These recommendations resemble the reports and economic surveys of the IMF or the OECD, as they merely serve as a code of “good economic conduct”, without any binding force.

Multilateral surveillance is a task, performed by the Council with the assistance of the European Commission, seeking to “ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States”, as well as to safeguard the consistency of domestic economic policies with the broad guidelines of paragraph 2.14

According to paragraph 4 of article 121, the Council can issue recommendations to Member States that fail to comply with the economic policies guidelines of paragraph 2, acting pursuant to a recommendation from the Commission. It should be mentioned that the Council can amend the recommendations of the Commission by a qualified majority vote, as article 293§1 TFEU, according to which the Council can modify Commission proposals solely with a unanimous vote, does not apply to recommendations.15 In effect, the potential to circumvent the Commission with a qualified majority vote in the Council makes the already “toothless” framework of broad economic policy guidelines and multilateral surveillance contingent on political approval and thus extremely dysfunctional.

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13 This assumption is based on the combined interpretation of Articles 121§1, 120 and 119 of the TFEU: Article 121§1 refers to the provisions of Article 120, which in turn refers to Article 119, according to which economic policies adopted by Member States should be based on “…the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition”.
14 TFEU, Article 121§3.
15 Supra note 3, at 306-307.
The treaty provisions regarding coordination of economic policies and multilateral surveillance have been supplemented by Regulation 1055/2005, which constitutes the “preventive pillar” of the SGP. The main obligation for Member States deriving from Regulation 1055/2005 is that of providing to the Commission and to the Council Stability and Convergence Programs, which are assessed in order to preemptively identify potential problems.\(^{16}\) Compliance with Stability and Adjustment Programs is evaluated by the Council, pursuant to the procedure of Article 121§4, described above.

Articles 123-126 TFEU constitute the main elements of “negative integration” in the area of economic policies. Articles 123 (prohibition of monetization of government debt) and 125 (prohibition of bailouts of governments) are discussed at the second part of the paper in the context of the sovereign debt crisis.

The central “negative integration” treaty provision is Article 126 TFEU which prohibits excessive government deficits (126§1). The administration of article 126 is a shared responsibility assumed by the Council and the European Commission. Thus, it is for the Commission to monitor budget discipline and for the Council to decide whether a Member State has violated its obligations (by identifying the existence of an excessive deficit), and furthermore to compel it to observe them.\(^{17}\) By and large, article 126 is procedural, as it sets out the stages of the Excessive Deficit Procedure. Its substantive provisions are mainly those of paragraphs 2, 3 and 11. In particular, paragraphs 2(a) and (b) provide that budgetary discipline will be measured against specific reference values relating to the ratio of actual government deficit and government debt to GDP.

Ratios exceeding these benchmarks will not entail a violation of the rules in case that the ratio of actual government deficit to GDP “has declined substantially and continuously and reached a level that comes close to the reference value or, alternatively, the excess over the reference value is

\(^{16}\) Supra note 4, at 263. In essence, Stability and Adjustment Programs submitted by Member States contain a country-specific medium term objective for their budgetary positions. While Stability and Adjustment Programs shall provide for a “safety margin” with respect to the 3 per cent of GDP government deficit ratio, Member States decide the exact budgetary position. After assessing the programs, the Council can call Member States to adjust them, if it considers it necessary.

\(^{17}\) Id, at 254.
only exceptional and temporary and the ratio remains close to the reference value”, or the ratio of
government debt to GDP “is sufficiently diminishing and approaching the reference value at a
satisfactory pace”.\textsuperscript{18} The reference values are specified in the Protocol on the Excessive Deficit
Procedure, annexed to the TFEU, according to which actual government deficits should not exceed
3 per cent of GDP, and government debts 60 per cent of GDP.

However, these reference values are not the only factors to be taken into consideration in
assessing budgetary discipline. Thus, according to Article 126§3 TFEU, the Commission should
also “take into account whether the government deficit exceeds government investment expenditure
and take into account all other relevant factors, including the medium-term economic and budgetary
position of the Member State” when drafting its reports. Furthermore, the Commission can prepare
an excessive deficit report even when the reference values of paragraph 2 have been met, in case
that it deems that a “risk of an excessive deficit exists in a Member State”.\textsuperscript{19}

The excessive deficit procedure is described in detail in paragraphs 3-13 of Article 126 TFEU.
The procedure is characterized by the existence of subsequent stages of recommendations, and
sanctions are imposed only in cases where Member States have consistently ignored the
recommendations of the Council to correct their budgetary policies. Compliance with the
recommendations is also achieved through the possibility of making them public, triggering a
confidence shock in international capital markets.

According to Article 126§11 TFEU, in case that a Member State fails to implement the deficit
reduction measures that have been decided pursuant to paragraph 9, the Council may apply one of
the following measures: (1) require the Member State concerned to publish additional information,
to be specified by the Council, before issuing bonds and securities, (2) invite the European
Investment Bank to reconsider its lending policy towards the Member State concerned, (3) require
the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the

\textsuperscript{18} TFEU, Article 126§2 a,b.
\textsuperscript{19} TFEU, Article 126§3.
Union until the excessive deficit has, in the view of the Council, been corrected, (4) impose fines of an appropriate size.\textsuperscript{20}

III.

Regulation 1056/2005 constitutes the cornerstone of the SGP. The regulation specifies and strengthens the Treaty provisions regarding the excessive deficit procedure, while Regulation 1055/2005 is the so-called “preventive pillar” of the SGP (see above, page 9).

The SGP has received severe criticism over the years for a number of reasons.\textsuperscript{21} In particular, it has been argued that its rules are more about stability than growth, as fiscal consolidation may conflict with the promotion of economic growth in the short-term.\textsuperscript{22} Indeed, the quantitative standards (that is, the deficit and debt to GDP ratios) imposed by the Pact do not leave much space for expansionary fiscal policies that can be beneficial for an economy in downturn. Furthermore, the provisions introducing some degree of flexibility with respect to the deviation from the quantitative standards have been criticized for being inefficient in addressing the need of Member States to deal effectively with domestic economic realities.

These defects contributed to the abrogation of the SGP’s rules by the two most important players within the EU, Germany and France, without the imposition of any sanctions. Consequently, the SGP lost its credibility and more countries felt free to disregard their commitments. This, in turn, triggered new controversies as the excessive deficit procedure, that had been effectively watered down by the Council in the cases of Germany and France\textsuperscript{23}, was later initiated against smaller countries like Ireland, Greece and Portugal. However, sanctions were never imposed for none of them as well. The damaged credibility of the Pact is evidenced by the

\textsuperscript{20} Paragraphs 9 and 11 of article 126 are not applicable to non-eurozone Member States.
\textsuperscript{21} It is telling that in 2002 Romano Prodi, then the President of the European Commission, described the Pact as “stupid, like all rigid decisions”.
\textsuperscript{22} Supra note 4, at 261.
\textsuperscript{23} In 2003 the Council of Ministers of the EU voted for the suspension of the imposition of sanctions to France and Germany that have failed to comply with earlier recommendations of the Council to control their deficit to GDP ratios. Following the decision of the Council, the European Commission brought an action for annulment to the ECJ, which ruled that although the Council decision was illegal, it could not impose any sanctions, as only the Council had the authority to do so under the EC Treaty. Following the ruling of the ECJ, the Council did not alter its decision. The Court’s decision stressed that judicial check over the administration of the excessive deficit procedure will be of limited significance. See Supra note 7, at 347-48.
fact that twenty four countries are currently under the excessive deficit procedure, which means that
only three are meeting their obligations pursuant to it.\textsuperscript{24}

In light of the manifest failure of the SGP -especially of its preventive functions- to avert the
sovereign debt crisis, the European Commission came up with six legislative proposals last
September with a view to boost economic governance in the EU through a reform of the Pact. The
conclusions of the Heads of State or government of the eurozone of March 11, 2011 and of the
European Council of March 24-25, 2011, call EU Member States to work on these proposals, which
will complement the policy framework of the “Euro Plus Pact”.

The main changes that the Commission has proposed with respect to the SGP are the
following: First, the concept of “prudent fiscal policy-making” is introduced in order to push for
convergence towards the Medium Term Objective (that is, budgets close to balance or in surplus),
with the possibility for a Commission warning and the imposition of a non interest-bearing deposit
in case of significant deviations.\textsuperscript{25} Second, deviations from the 60 per cent to GDP threshold in
government debt will be posed at an “equal footing” with those regarding the 3 per cent to GDP
limit in government deficit.\textsuperscript{26} Accordingly, countries with a public debt exceeding 60 per cent of
their GDP, should move to reduce their debt ratios to the 1/20th of the difference with the 60 per
cent to GDP threshold over the last three years.\textsuperscript{27} Third, the decision of Article 126§6 TFEU about
the existence of an excessive deficit will be accompanied by the imposition of an interest-bearing
deposit equal to 0.2 per cent of the GDP of the country; this would be converted into a fine if the
country does not comply with the recommendation that is issued pursuant to the decision of Article
126§6.\textsuperscript{28} Furthermore, the decisions for the imposition of these sanctions will be made by a
“reverse voting mechanism”.\textsuperscript{29} This means that the proposition of the Commission to the Council

\textsuperscript{24} See http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm
\textsuperscript{26} Id.
\textsuperscript{27} Id.
\textsuperscript{28} Id.
\textsuperscript{29} Id.
for the imposition of sanctions will be deemed adopted, unless it is overruled by a qualified majority vote by the Council.

Clearly, the propositions of the Commission are a call for more belt tightening in the countries of southern Europe, whose fiscal profligacy has been seen as the main reason for the current crisis. Interestingly, though, the propositions are a clear retreat from the last major reform of the SGP in 2005, when in the aftermath of the German and French abrogation of the Pact, Regulations 1055/2005 and 1056/2005 were introduced in order to make the Pact less automatic and more flexible. True, these reforms did not increase the credibility of the SGP as a number of countries never truly achieved to comply with the rules and, following the German and French paradigm, no sanctions were ever imposed. Having said that, though, it is rather unlikely that an increase in the available sanctions will improve the compliance record of the SGP. Indeed, nothing in the propositions changes in a material way the balance between the Commission and the Council in the administration of the excessive deficit procedure, and particularly during the crucial stage of sanctions imposition. Furthermore, such fundamental changes in the policy direction of the Pact give the impression that its reforms are predominantly the outcome of political conjunctures rather than long term planning.

In any event, while the question of whether the credibility of the SGP could be better served by the adoption of more stringent rules of fiscal discipline or by a more flexible approach that could give more leeway to Member States to accommodate domestic priorities, is open to different analyses, what is certain is that the present enforcement mechanism has been proved ineffective and that the proposed reforms fall short from addressing this reality. This is due to the fact that observance of the fiscal rules of the SGP can be only achieved through the political procedures that lead to a Council decision to impose sanctions, and Member States are reluctant to set precedents.

\footnote{For that purpose, it has been proposed that the Commission’s role at the sanctions imposition stage could be fortified by requiring the Council to decide on the basis of a Commission proposal, rather than recommendation. Furthermore, the Commission could be entrusted with the, essentially technical, decision of whether an excessive deficit exists (currently, according to Article 126 TFEU, the authority rests with the Council). \textit{See “How can the Stability and Growth Pact be improved to achieve stronger discipline and higher flexibility”. European Parliament Briefing Paper, November 2002. 7-8.}
that could turn against them in the future. However, any departure from this approach necessitates an amendment of the excessive deficit procedure that is described in article 126 of the TFEU, and consequently, a substantial improvement of the SGP’s credibility should not be expected in the near future.

What is more, the whole framework of economic policy coordination will be completely ineffective in promoting fiscal discipline as long as the competent authorities of the Union do not have a clear and realistic view of the existing deficits of Member States. The fact that Member States misreport the figures of their budgets in their communications with the EU authorities was highlighted by the Greek accounting scandal that preceded the debt crisis and led the Eurostat (the EU’s statistical agency) to revise the Greek deficit in 2003. It appears that Greece was not the only country that was engaged in these practices, and thus a broader need to exercise more control over national authorities from the part of Eurostat clearly exists, if fiscal rules are to have any significance whatsoever.

C. THE SOVEREIGN DEBT CRISIS AS A CATALYST OF EUROPEAN ECONOMIC GOVERNANCE.

I.

The decision of 17 December, 2010 of the European Council to create a permanent European Stability Mechanism (ESM), starting from 2013, to deal with the sovereign debt crisis in the eurozone, constitutes the most radical move that the leaders of the monetary union have taken so far in the course of the crisis. The period that led to the Council decision was characterized by an almost sadistic sequence of idle reassurances, conflicting statements and retreats, which challenged the capacity of European policymakers and institutions to safeguard the economic stability of the

31 Eurostat discovered that Greece was underreporting military expenses and overreporting social security surpluses. Other types of “creative accounting” that have been used by EU Member States in the past include, inter alia, off-balance sheet borrowing by guaranteeing obligations of state-owned enterprises, interest rate swaps that reduce current borrowing costs by transferring the additional burden to the future or hiring private banks to construct deficit-hiding devices. See Supra note 7 at 350.

32 For an illustration of the practices that Member States have undertaken in order to avoid the disciplinary control of the SGP see Tilman Brück and Andreas Stephan “Do Eurozone Countries Cheat with their Budget Deficit Forecasts?” Available at www.econstor.eu/bitstream/10419/18359/1/dp508.pdf.
countries of the European periphery, and thereby of the common currency. To be sure, given the tenacity that the eurozone leaders displayed in remaining behind the curve of developments during the last year, the historian of the future will probably be very reluctant in classifying agility among European virtues.

In any event, the decisions that have been taken by eurozone leaders during the last months, signaled a dramatic shift in the concept of economic governance within the Union. Indeed, the reinforcement of the EMU by a crisis resolution mechanism for distressed Member States was either neglected or deemed inappropriate at the time the Treaty of Maastricht was negotiated, and was still renounced when the sovereign debt crisis first struck the eurozone. Nevertheless, in the sight of a possible contagion of the crisis, EU leaders moved to adopt what they had previously recanted.

Greece was the first eurozone country that faced a severe confidence shock in international debt markets. In April 2010, the spread\(^33\) of the 10-year Greek bond breached the 450 basis points limit, a threshold margin which, according to market experts, renders debt servicing non sustainable.\(^34\) Practically excluded from international markets, Greece would have been unable to meet its outstanding debt obligations in the absence of external financial assistance. Thus, on May 2, 2010 Greece agreed with the European Commission, the ECB and the International Monetary Fund (IMF) on a three-year program of economic and financial policies, accompanied by a €110 bn rescue package, in the form of bilateral loans from eurozone Member States and the IMF. Disbursement of the loan tranches is subject to strict policy conditionality, and thus installments are released only after the issuance of a review confirming that Greece has undertaken the necessary policies to meet the specific performance criteria that it agreed with its creditors.

The fact that the loan has been granted from eurozone members -collectively represented by the European Commission- without the existence of a specific basis on EU law, raises a number of interesting legal issues. In this respect, it should be noticed that the absence of a specific legal basis

\(^{33}\) The so-called spread represents the extra cost a country has to pay in yields over Germany in the bond market. In essence, it is the difference between the yield of a country’s bond and that of the German bond.

\(^{34}\) See http://www.bloomberg.com/apps/quote?ticker=.GRK:IND
does not prohibit Member States from engaging in various forms of cooperation on a voluntary basis. Thus, as long as the agreement has a voluntary character, it can only be challenged on the grounds of a violation of an express prohibitive provision of the TFEU.

The TFEU contains at least two provisions which forbid EU institutions or Member States from providing financial assistance to other Member States: Article 123§1 bars the ECB and the national central banks from providing any type of credit facilities to Member States or directly purchasing their debt instruments; Article 125§1 -the so called no-bailout provision- makes it illegal for EU institutions and Member States to assume in any way obligations of other Member States.\(^{35}\)

Given that the loan to Greece has been given directly from eurozone members, without the intervention of their respective central banks or of the ECB, it does not constitute a prohibited credit facility of the type described in Article 123§1 TFEU.\(^{36}\) With respect to the no-bailout provision of article 125§1 TFEU, it should be noted that the prohibition refers to the assumption of liabilities or commitments of Member States from the Union or other Member States, and not to financial assistance in the form of loans.\(^{37}\) While the loan to Greece does not fall into the scope of the no-bailout clause, this provision may come into play in case of restructuring strategies that could be employed in order to deal with the Greek debt.

What is more significant than the legal aspects of the bailout is its political repercussions. Indeed, the decision to bailout Greece corroborated the commitment of eurozone leaders not to permit, at least at the first stages of the crisis, a default of a eurozone member. This decision was taken in light of at least two considerations:

First, the possibility of a contagion of the crisis to other vulnerable members of the eurozone, like Ireland, Portugal, and most importantly, Spain, Belgium or Italy. If such a domino effect had taken place, the survival of the euro would be threatened. Second, the fact that the main foreign holders of Greek debt are European banks made a Greek default a potential trigger for a European-

\(^{36}\) Id.  
\(^{37}\) Id.
wide banking crisis, at a time when the European banking system still faces important vulnerabilities.\textsuperscript{38}

II.

The financial stability package currently in place to deal with the European sovereign debt crisis encompasses three pillars: The European Financial Stabilization Mechanism (EFSM), the European Financial Stability Facility (EFSF) and the financial contribution from the IMF.

In essence, the scheme constitutes the formalization of the loan agreement that was introduced to deal with the Greek crisis. Accordingly, the funds of the three contributors are available after a formal request from a Member State has been made and are subject to strict conditionality. Until these lines were being written, Ireland had resorted to the mechanism in order to receive a €85 bn bailout, while Portugal was in negotiations with the European Commission, the ECB and the IMF for a €80 bn bailout agreement.\textsuperscript{39}

For the time being, the nominal financial capacity of the packet is €750 bn, with the EFSM contributing €60 bn, the EFSF €440 bn and the IMF €250 bn. The funds of the EFSM and the EFSF are raised through the issuance of bonds that are backed by the EU budget and eurozone members respectively.\textsuperscript{40} Consequently, the funds of the EFSM are available to all EU Member States, whereas EFSF funds are available only to eurozone members. Importantly, the funds that have been endowed to the EFSF in the form of guarantees do not equal the amount of the loans that it can provide. That is because of the use of “credit enhancements” that have been put in place in order to guarantee the triple-A rating of the debt instruments issued by the EFSF. Accordingly, the EFSF has to retain a buffer to reassure investors that the states which back the debt issuances will honor their obligations.

The creation of the EFSM and EFSF provoked intense debates about the consistency of the two devices with the TFEU. What is more, their creation gave rise to litigation in Germany, whose

\textsuperscript{38} According to figures of the Bank for International Settlements, as of June 30 2009, French banks had an exposure greater than $79 billion to Greek debt, whereas German banks’ exposure was $43 billion. See Supra note 7. 336.

\textsuperscript{39} See “Portugal goes on holidays as bail-out talks begin overtime”. Financial Times, April 23-24, 2011. 4.

\textsuperscript{40} Non eurozone members can contribute to the funds of the EFSF on a voluntary basis.
The political establishment has been traditionally opposed to any form of financial transfers from the European core to the periphery.

The EFSM was created pursuant to Regulation 407/2010, the legal basis of which is article 122§2 TFEU. According to this article, the Council may grant EU financial assistance to a Member State where “a Member State is in difficulties or is seriously threatened with severe difficulties caused by … exceptional occurrences beyond its control”.

However, it is at least doubtful whether the creation of a bailout mechanism had been originally envisaged as one of the purposes of the provision. Even if the financial crisis could be considered as an “exceptional occurrence” beyond the control of Member States, it is hard to judge with some degree of certainty whether the difficulties that they face are the result of the crisis or of their domestic policies.

What is even more problematic is that if Article 122§2 TFEU constitutes a proper legal basis for the establishment of an EU-wide bailout mechanism, then what is the need for the amendment of the TFEU in order to create the permanent ESM? The contradiction is rather obvious, and it could be well perceived as an implicit acknowledgement that article 122§2 TFEU is not a proper legal basis for the establishment of bailout vehicles.

Conversely, the creation of the EFSF was made possible through an intergovernmental agreement among eurozone members, following the precedent of the ad hoc Greek mechanism. Given the significantly larger size of the EFSF, any other solution would run the risk of being struck down in domestic courts. Still, the EFSF was challenged at least one instance, on the basis of article 125 TFEU and the prohibition that the treaty imposes on the Union and Member States to assume the liabilities of other Member States, even in the form of guarantees. As already mentioned, Member States have guaranteed the funds that the EFSF raises from third parties through the issuance of bonds (thereby, providing guarantees against a default of the facility), and

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42 Supra note 35.
43 Supra note 41.
44 Supra note 35.
not the funds that distressed Member States receive from the EFSF.\textsuperscript{45} Although, as a practical matter, the default of a Member State that has received funds from the EFSF would threaten the facility, causing this way its guarantors to step in to safeguard that the EFSF will honor its obligations vis-à-vis the holders of its debt, this is not the equivalent of a guarantee against the default of a Member State.\textsuperscript{46}

Against the background of increasing concerns about the sustainability of the austerity programs implemented in Greece and Ireland, and the possible need for new bailouts within the eurozone, reforming the EFSF was deemed necessary in order to deal with these developments. At the same time, however, increasing the firepower and the scope of the bailout facility triggered new worries within the eurozone that, by committing new funds for profligate Member States, a transfer union was coming closer to realization. In order to reconcile these considerations, eurozone leaders - under strong Franco-German guidance- agreed on 17 December, 2010 that any future transformation of the EFSF, as well as the creation of the permanent ESM in 2013, will be conditioned on the establishment of stringent rules of economic coordination, as a safeguard against future crises.

On March 11, 2011, the terms of the bargain were outlined in the conclusions of the Heads of State or government of the eurozone. As far as the EFSF is concerned, the main changes were the increase of the real financing capacity of the facility to €440 bn\textsuperscript{47}, and the grant of additional powers to it, so as to be able to buy sovereign bonds in the primary market.\textsuperscript{48} However, a final deal was not reached at the March 24-25 conclusions of the European Council, and the reforms that have been agreed in principle were deferred for the summit of the forthcoming June.\textsuperscript{49}

Clearly, the reform of the EFSF -as it now stands- falls short from addressing the concerns of the states that have received a bailout. That is because the direct purchase of bonds by the EFSF

\textsuperscript{45} Id.
\textsuperscript{46} Id.
\textsuperscript{47} During the transition period until the creation of the ESM, the financing capacity of the EFSF will not exceed €500 bn.
\textsuperscript{48} Purchases of the bonds of a Member State will be allowed only after the implementation of austerity measures, similar to those imposed on bailout states, and exclusively in the primary market.
\textsuperscript{49} See Financial Times. March 26-27.
offers too little to these countries, as it will only prolong their dependence from official emergency borrowing facilities, at a time when their immediate concern is to be able to return to debt markets on their own capacity. That could be only achieved by lowering their borrowing costs at the secondary market through the intervention of the EFSF which would guarantee liquidity for their bonds, and at the same time would alleviate the ECB, which has concentrated around €77 bn on bonds from the countries of the eurozone periphery.50

Furthermore, and most importantly, the limited reforms that were decided with respect to the EFSF reflect the uneasiness of euro area leaders to deal with a restructure of the debt of the peripheral countries, at least until 2013. While the ESM provides for a mechanism of mandatory debt restructuring, its initiation may come too late for Greece and Ireland, whose borrowing needs will probably exceed the bailout funds in late 2012.51 Portugal is under less pressure, but it will also see its debt to breach 100 per cent of GDP during the fiscal year 2011-12, with an upward tension that will lead to a debt to GDP ratio of 115 per cent by 2015.52 Similar to Greece and Ireland, the assumption for Portugal is that its debt is not sustainable on the medium to long term.53 Moreover, if Greece or Ireland restructure, Portugal will be tempted to follow.54

Accordingly, propositions have been made so that the EFSF could lend the necessary funds to the indebted countries, in order to enable them to buy back their bonds (the transaction would have a voluntary character) at their current reduced market price and thus to effectively restructure their debt.55 Other strategies set out even more drastic solutions, such as a swap between the outstanding bonds and new issuances with a deferred maturity date, a discount of the face value, or a reduced

50See http://blogs.wsj.com/brussels/2011/03/12/2570/
51See http://country.eiu.com/Greece
53Id.
54Id.
55However, this solution has high political cost and uncertain effectiveness. That is because the holders of Greek and Irish debt will probably value the fact that the EFSF will lend to their debtors the necessary funds in order to buyback their debt, and thus they will raise the prices of the bonds they are holding. Consequently, there will be no significant debt relief, as the EFSF will have to lend an amount which approximates the current debt levels of Greece and Ireland. Nevertheless, such a strategy could suppress the interest rates on Greek and Irish bonds. See at http://country.eiu.com/Greece. Another interesting point, which also indicates the political sensitivity of this solution, is that Germany has recently passed non binding legislation urging the German government not to permit the ESM to be engaged in a debt buyback. There is no such recommendation however as far as the EFSF is concerned. See http://www.reuters.com/article/2011/02/23/eurozone-germany-buyback-idUSLDE71M1TC20110223?pageNumber=2
interest rate.\textsuperscript{56} In the past such solutions were made possible on -at least typically- a volunteer basis because a third party (in the case of Brady Bonds, the US) was able to guarantee the new bonds, offsetting this way the losses of creditors with the surety of repayment.\textsuperscript{57} In the context of the European sovereign debt crisis, the EFSF could have a similar role. Although outright guarantees are prohibited by article 125 TFEU, the EFSF could lend additional money to the indebted countries that could serve as collateral for the restructuring bonds.

Allowing the EFSF to be engaged in restructuring strategies would offer important guarantees to the creditors of the peripheral countries, and thus the unwarranted postponement of the restructure of their debt until 2013 could be avoided.

III.

As it has been mentioned above, the ESM will be the successor of the EFSF when the latter terminates its activities in 2013 (or at any later date that no claims will exist vis a vis the states that used EFSF’s resources). In order to establish the ESM, a mini amendment to the TFEU will be introduced, due to the fears that the loan arrangements of the EFSF run the risk of being struck down by the GCC.\textsuperscript{58} Indeed, the inclusion of a special provision in the TFEU will make it impossible for the GCC to invoke article 125 TFEU to challenge any loan that will be agreed by the ESM.

Given that the ESM will “inherit” all the functions of the EFSF, as these would have been developed until 2013, the analysis of the current and potential functions of the EFSF made above applies to the ESM as well. However, there are a number of important differences between the two schemes. From a legal perspective, the ESM will be an intergovernmental organization, established

\textsuperscript{56} A similar proposition was recently backed by the German government, which, presumably, has now changed its original position of opposing to debt restructuring, at least as far as Greece is concerned. See “Germany plans for Greek debt shake up”. Financial Times, April 16, 2011 2.

\textsuperscript{57} See http://www.cato.org/pubs/journal/cj16n2-4.html

\textsuperscript{58} Accordingly, Article 136 TFEU will be amended to include a paragraph stating that “The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.”
by international treaty, with a legal personality under public international law. On the other hand, the EFSF is a subject of private law, incorporated under the laws of Luxembourg. Most notably, the ESM will condition its assistance to states that are willing and capable to restructure their debt pursuant to an agreement with their creditors.

Accordingly, a debt sustainability analysis will be conducted by the European Commission, the IMF and the ECB in order to determine whether the country that has asked for financial assistance faces a solvency or liquidity problem. In case that a solvency problem has been detected, financial assistance will be contingent on the negotiation of a debt restructuring plan between the Member State and its private creditors which would be capable to restore debt sustainability. In order to facilitate debt restructuring, Collective Action Clauses (CACs) will be inserted in all eurozone government bonds, starting from June 2013. Moreover, ESM loans will enjoy preferred status vis-à-vis private creditors and will be junior only to IMF lending.

Hence, it appears that the ESM has been designated to constitute the ultimate resolution mechanism for Greece, Ireland and perhaps Portugal. Indeed, as the debt servicing costs of, at least, Greece and Ireland will exceed the bail out funds in late 2012, the two countries will be assisted by the ESM in restructuring their debt, perhaps after having received another bailout from the EFSF.

It should be noted, though, that this solution is extremely damaging for the reasonable interests of both countries, which by 2013 will see their debt burden to increase significantly, along with the corresponding economic losses and adverse social consequences of austerity.

Furthermore, decisions in the ESM will be taken on the basis of qualified majority voting (which is defined as requiring 80 per cent of the votes). Votes will be weighted so as to reflect the financial contribution of each country to the capital of the ESM (which in turn will reflect the contribution of Member States to the capital of the ECB).


Furthermore, the ESM will have a total lending capacity of €500 bn, while contributions of euro area Member States will not be limited to guarantees, as there will be also paid in and callable capital. See Financial Times, March 26-27.


CACs are contractual terms inserted in debt instruments which permit amendments to the repayment terms of the instrument pursuant to a majority decision from the bondholders. The introduction of such clauses in sovereign bonds has caused significant controversies, as it has been argued that private creditors will respond by increasing borrowing costs.

See http://country.eiu.com/Greece

The debt burden of Greece will exceed 160 per cent of its GDP in 2013, while, by the same time, the Irish debt will approximate 125 per cent of the country’s GDP. See http://country.eiu.com/Greece and
D. MAKING ECONOMIC GOVERNANCE WORKABLE.

I.

The initial form of the “Euro Plus Pact” came under the title “Pact for Competitiveness” and included, inter alia, highly controversial measures such as scrapping indexation of wages to prices, a common corporate tax base, reforms of pension systems to reflect demographic developments and inclusion in national Constitutions of debt alert mechanisms. The “Pact for Competitiveness” was renamed to “Pact for the Euro” after the March 11, 2011 meeting of the Heads of State or government of the euro area, and further renamed to “Euro Plus Pact” following the March 24-25 meeting of the European Council. The final version of the Pact is significantly less ambitious from what the initial propositions suggested. That is because commitments for the adoption of specific measures (mainly, scrapping wage indexation and adopting Constitutional debt brakes) were replaced by language calling for discretionary assessment of policies by the Member States.

The declared goals of the Pact are to foster competitiveness and employment, and to increase sustainability of public finances, as well as, to reinforce financial stability. The main policy instruments of the Pact include: Monitoring and adjusting Unit Labour Costs (ULCs), while “each country will be responsible for the specific policy actions it chooses to foster competitiveness”; tax reforms, such as lowering taxes on labour; aligning the pension system to the national demographic situation; putting in place national legislation for banking resolution; enacting appropriate legislation in order to “translate” at the national level the fiscal obligations of the SGP, and the development of a common corporate tax base. Clearly, the Pact covers areas (mainly in the fields

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67 See http://eulaw.wordpress.com/2011/03/13/the-pact-for-the-euro-a-summa
of economic and employment policies) which primarily fall under national competence, and its provisions will be mainly implemented through non binding policy guidelines.\(^{68}\)

Consequently, the elements of economic governance included in the “Euro Plus Pact” will probably face the same implementation problems that their predecessors did. To be sure, most of the policy framework of the Pact is a reformulation of some of the goals of the “Lisbon Agenda” and the “Europe 2020 Strategy” which were launched in 2000 and 2010 respectively as the economic policy blueprints of the EU.\(^{69}\) The admitted failure of the “Lisbon Agenda”\(^{70}\) has been attributed, inter alia, to the adoption of the so-called “Open Method of Coordination”, according to which compliance was sought through peer-pressure as opposed to the imposition of sanctions.\(^{71}\) Although the language that was used in the communications of last March is nuanced enough to be open to different interpretations, it seems that a similar approach will be prevalent in the “Euro Plus Pact” as well.\(^{72}\)

Besides, it should be noted that the TFEU poses significant constraints to the achievement of the goals of the Pact, especially because harmonization of national rules by the adoption of legislative acts by the Union is prohibited with respect to key areas such as direct taxation, employment and pension policies.\(^{73}\) Accordingly, progress will be conditioned on the political agreement of Member States to implement measures at the national level, something not very

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\(^{68}\) Article 5 TFEU §1,2 states that “The Member States shall coordinate their economic policies within the Union. To this end, the Council shall adopt measures, in particular broad guidelines for these policies”, “The Union shall take measures to ensure coordination of the employment policies of the Member States, in particular by defining guidelines for these policies”.

\(^{69}\) The “Lisbon Agenda” had the ambitious goal of of making Europe “the most competitive, knowledge-based economy in the world.” Following the failure of its predecessor, the “Europe 2020 Strategy” set the more modest target of aiming at “smart, sustainable, inclusive growth” with greater coordination of national and European policy. See http://ec.europa.eu/news/economy/100303_en.htm.

\(^{70}\) See http://www.euractiv.com/en/priorities/sweden-admits-lisbon-agenda-failure/article-182797

\(^{71}\) See http://www.chinadaily.com.cn/thinktank/2011-02/16/content_12028313.htm

\(^{72}\) Some of the guiding principles underlining the Pact will be that “the effort for stronger economic policy coordination for competitiveness and convergence...will be in line with and strengthen the existing economic governance in the EU”. Furthermore, “in the chosen policy areas common objectives will be agreed upon at the Heads of State or Government level. Participating Member States will pursue these objectives with their own policy-mix, taking into account their specific challenges.” Finally, “the implementation of the commitments and progress towards the common policy objectives will be monitored politically by the Heads of State or Government of the Euro area and participating countries on a yearly basis, on the basis of a report by the Commission”. CONCLUSIONS OF THE HEADS OF STATE OR GOVERNMENT OF THE EURO AREA OF 11 MARCH 2011 and CONCLUSIONS OF THE EUROPEAN COUNCIL OF MARCH 24-25.

\(^{73}\) With respect to employment policies, Member States are only subject to policy guidelines and recommendations. See Article 148 §§ 2,4 TFEU.
promising for any significant steps ahead, given their stated differences in a number of important issues.\textsuperscript{74}

Another concern about the measures that have been put forward by the Pact is their relation with the provisions of the TFEU regarding Enhanced Cooperation (Articles 326-334 TFEU). Enhanced Cooperation is a procedure that seeks to advance the growth of EU law, by allowing a number of Member States that are willing to be engaged in closer integration to do so, without being stopped by the dissenters.\textsuperscript{75} However, Enhanced Cooperation is subject to a number of conditions, most notably, Article 326 TFEU, according to which an Enhanced Cooperation “shall not undermine the internal market or economic, social and territorial cohesion” and “It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them.”

These conditions, however, could be violated by some of the policies undertaken pursuant to the Pact. Indeed, a contradiction could easily occur between the objectives of a Union that is based on the notions of freedom of movement and undistorted competition, and those of a subgroup, which moves towards increased integration by coordinating more closely economic and social policies.\textsuperscript{76}

It seems, though, that the “Euro Plus Pact” will not be implemented through Enhanced Cooperation, as no mention to the procedure was made in the two communications of last March. Instead, Article 136 TFEU, which allows the Council to take specific measures for the Eurozone, could be used.\textsuperscript{77} Furthermore, according to the March 24-25 Conclusions, Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania (which do not use the euro) opted-in to the Pact, while the Pact remains open for any EU country that wishes to join on a volunteer basis.

\textsuperscript{74} Indicatively, notwithstanding their agreement on the “Euro Plus Pact”, France will probably not raise its retirement age to 67 in the near future, Belgium will continue to be opposed to the abrogation of wage indexation and Ireland to deny to raise its corporate tax rate.

\textsuperscript{75} See http://www.bnegroup.org/blog/2011/02/

\textsuperscript{76} Id. In particular, the members of the “Euro Plus Pact” may be able to gain competitive advantages within the internal market vis a vis the other Member States. For instance, if labor costs were to decline in the countries participating to Pact, investment decisions could be distorted as these countries would be a more favorable destination for potential investors.

\textsuperscript{77} Id.
In any event, however, a strengthened framework of economic governance among a number of EU Member States on the basis of policies targeted on increased competitiveness has the potential to undermine the internal market, notwithstanding the fact that Enhanced Cooperation will not be formally employed. Accordingly, the limitations that Article 326 TFEU poses cannot be avoided by circumventing Enhanced Cooperation. Indeed, this fact was recognized by eurozone leaders by explicitly stating that any effort towards a more comprehensive economic governance in the euro area will not undermine the internal market and the integrity of the Union.

Consequently, it appears that, given the existing primary law limitations, implementing the policy framework of the Pact will be proved a rather challenging task, and thus its overall outcome is at least uncertain. Previous experiences suggest that EU Member States have been extremely reluctant in allowing the institutions of the Union to trump their sovereignty in areas such as economic, fiscal and employment policies. Considering that in the past Member States have in effect voided the explicit legal commitments of the SGP, it is hard to believe that the results of the essentially political procedure that is outlined in the Pact would bring about a stronger framework of economic governance in the eurozone. Another kind of question is whether, if such stronger economic governance was made effective, the rest of EU Member States would feel that the benefits of the internal market would be eroded for them. The balance that Article 326 TFEU seeks to achieve is a delicate one, and could pose significant obstacles to the further integration of the eurozone.

Thus, if euro area leaders indeed intend to be engaged in stronger economic governance, amending the TFEU would be the only way forward, both in terms of effectiveness and legality. Of

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78 Id.
79 The exact language used by the Heads of State and Government was that “Euro area Member States are fully committed to the completion of the Single Market which is key to enhancing the competitiveness in the EU and the Euro area. This process will be fully in line with the treaty. The Pact will fully respect the integrity of the Single Market.” CONCLUSIONS OF THE HEADS OF STATE OR GOVERNMENT OF THE EURO AREA OF 11 MARCH 2011 and CONCLUSIONS OF THE EUROPEAN COUNCIL OF MARCH 24-25.
course, this would be time consuming and risky, but it would give “teeth” to their commitments, while safeguarding the consistency of EU law.\textsuperscript{80}

Beyond the formidable legal constraints mentioned above, the “Euro Plus Pact” is also problematic from a policy perspective. While the need to increase the competitiveness of the economies of the European periphery is essential for the achievement of the quantitative targets set out in the annexed protocol on the Excessive Deficit Procedure, the road that the Pact proposes is questionable. That is because it imposes a “one size fits all” German model for adjustment that will certainly have significant economic cost for the less competitive countries of the eurozone, with an at least uncertain outcome.

More concretely, it is argued that Germany has achieved to increase its market share in the eurozone by squeezing wage increases\textsuperscript{81} and thus effectively imposing a real exchange rate depreciation that has rendered its exports extremely competitive within the monetary union.\textsuperscript{82} On the other hand, the countries of the periphery have seen their aggregate ULCs\textsuperscript{83} to increase much more drastically compared to those of Germany, with a corresponding loss in their competitiveness and market share.\textsuperscript{84} Accordingly, the argument endorsed by the propositions included in the Pact is that the countries of southern Europe (Greece, Italy, Portugal and Spain), plus Ireland, should follow a similar, though much more drastic, recipe. Thus, they should regain their “lost

\textsuperscript{80} See http://eulaw.wordpress.com/2011/02/07/looking-for-the-philosopher’s-stone-of-economic-governance-coordination/

\textsuperscript{81} For the period 1980-2007 the average annual growth rate of nominal labor compensation in Germany was 2.66 per cent. Indeed, this is the lowest rate in the eurozone. See Jesus Felipe and Utsav Kumar “Unit Labor Costs in the Eurozone: The Competitiveness Debate Again” 8. Working Paper No. 651. Levy Economics Institute. Available at www.levyinstitute.org/pubs/wp_651.pdf.

\textsuperscript{82} The notion of exchange rate devaluation may seem paradoxical within a monetary union, however, this is only valid with respect to the nominal exchange rate. The real exchange rate can still fluctuate, due to the differences in the rates of inflation in the countries that use the Euro. Accordingly, the lesser the inflation rate is in a given country the more its real exchange rate is undervalued vis a vis countries with higher inflation rates. See http://www.economist.com.hk/research/articlesBySubject/PrinterFriendly.cfm?story_id=3666544. During the period 1994-2009, Germany has experienced a depreciation of its real exchange rate by approximately 20 per cent compared with the EU’s 27 countries. See http://www.voxeu.org/index.php?q=node/5212.

\textsuperscript{83} ULCs are a measurement of economic competitiveness and are defined as the ratio of a worker’s overall compensation to labor productivity. At the company level, a relative increase in labor compensation compared to labor productivity entails a corresponding competitiveness loss. However, this may not be the case with respect to aggregate ULCs, which are used to measure competitiveness at the level of the whole economy See Supra note 80 at 2.

\textsuperscript{84} During the period 1980-2007, aggregate ULCs increased with an average annual growth rate of 8.45 per cent in Portugal, 5.31 per cent in Spain, 5.07 per cent in Italy and 3.64 per cent in Ireland. Greece experienced even higher growth rates than the other countries of the periphery. On the other hand, Germany had the lowest average annual growth rate (1.21 per cent). Id at 7.
competitiveness” by imposing an internal devaluation, that is by cutting wages in order to reduce their aggregate ULCs. 85

This course of action, however, may not necessarily lead to the desired increase in the competitiveness of the peripheral countries. As Felipe and Kumar have argued, the discussion about decreasing aggregate ULCs in the periphery ignores the absence of well-defined empirical evidence of an inverse relation between the growth in aggregate ULCs and growth output. 86 Indeed, it has been found that during the postwar period the countries which experienced the biggest increase in their aggregate ULCs had also achieved the biggest increase in market share. 87 Accordingly, lowering wages in the periphery is by no means panacea that would guarantee exit from the crisis.

Another point in the analysis of Felipe and Kumar is that, apart from ULCs that measure competitiveness from the “workers’ side”, Unit Capital Costs (UKCs) are also a reliable measure of competitiveness, this time from the “capital side”. 88 As UKCs in the periphery (with the exception of Greece) have increased faster than aggregate ULCs, it should be asked why the burden of adjustment should be assumed exclusively by the workers through a reduction in aggregate ULCs. 89

Finally, as Felipe and Kumar note, there is an inherent flaw in comparing the German economy with those of peripheral countries. 90 That is because Germany and most of the peripheral countries

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85 One could argue that the proposals of the Pact make little difference for Greece and Ireland given that these countries have already implemented (and Portugal will follow shortly) much more fierce austerity measures as a condition to their bailouts. However, it is one thing to horizontally cut salaries as an emergency measure of temporary character and quite another to make austerity the policy blueprint of the eurozone.

86 As the authors note, this lack of empirical evidence is known in the literature as the “Kaldor’s Paradox”, by the name of the economist who first documented it. According to Felipe and Kumar, the “Kaldor’s Paradox” may be explained by the fact that aggregate ULCs (the standard method that is used to calculate ULCs) are not an appropriate yardstick of an economy’s competitiveness, given that they are not an weighted average of the firms’ ULCs and thus an increase in aggregate ULCs can be well attributed to other factors, apart from a relative increase in labor compensation vis-à-vis labor productivity. Indeed, Felipe and Kumar suggest that, with the exception of Greece, the increase in aggregate ULCs in the periphery should be attributed to the increase of the price deflator that is used to calculate labor productivity at the economy level. See supra note 80 at 3.

87 Id.

88 UKCs are defined as the ratio of nominal profit rate to capital productivity. Id, at 14.

89 Id, at 15.

90 The comparison with Germany with respect to the policies that are included in the “Euro Plus Pact” is implicit in the language that was used in the conclusions of the Heads of State or government of the euro area of March 11, according to which, “Each year, concrete national commitments will be undertaken by each Head of State or Government. In doing so, Member States will take into account best practices and benchmark against the best performers, within Europe and vis-à-vis other strategic partners.”
export different categories of products.\textsuperscript{91} In particular, Germany is one of the main exporters of the ten most complex products, whereas -perhaps with the exception of Ireland- peripheral countries are far below in that list.\textsuperscript{92} Accordingly, Germany does not compete directly with Greece, Portugal, Spain or Italy.\textsuperscript{93} This means that comparing ULCs in Germany and in peripheral countries in order to draw conclusions about what measures these countries should take in order to improve their competitiveness is misleading.\textsuperscript{94} That is stressed by the fact that the export profile of countries such as Greece or Portugal is more similar to that of China, and accordingly if peripheral countries should increase their competitiveness by reducing their ULCs the correct benchmark should be China.\textsuperscript{95} Of course, a policy recommendation towards this direction could not be acceptable within the institutional framework of the EU.

Consequently, the lack of competitiveness vis a vis Germany should not be attributed to increased labor costs or reduced productivity, but rather to the obsolete production model of a number of peripheral countries that has not followed the technology advances that the German economy has achieved.\textsuperscript{96} It follows that the correct policy propositions would call for an alteration of the production model of peripheral countries, instead of a drastic reduction of their aggregate ULCs.

II.

If a broader reorientation of the economic model in the periphery is needed in order to restore the region’s competitiveness, this could be only achieved if the governments of these countries were able to commit significant resources in investment programs so as to promote innovative sectors of their economies that emphasize knowledge and technology, putting this way the less developed countries of the eurozone on an equal footing with the highly advanced economies of central and

\textsuperscript{91} Supra note 80 at 10.
\textsuperscript{92} Id.
\textsuperscript{93} Id.
\textsuperscript{94} Id.
\textsuperscript{95} Id.
\textsuperscript{96} Id.
\textsuperscript{97} Id at 11.
\textsuperscript{98} Id.
northern Europe.\footnote{Felipe and Kumar imply that a similar approach is perhaps the only solution (apart from leaving the eurozone) that could lead the uncompetitive peripheral countries out of the crisis. \textit{See} Id at 28. Of course, within the present environment of the sovereign debt crisis calls for increased public spending are completely unrealistic. Accordingly, these propositions have a long-term horizon of realization.} It should be acknowledged, though, that increased public spending can lead to upward inflationary pressures that could challenge the consensus over the euro (see above, pages 5-6). Thus, moving towards a fiscal union appears as the only alternative. This entails further centralization of fiscal policies, along with the authority to raise taxes, borrow and spend in order to mitigate the development imbalances among the different regions of the Union.

Perhaps the most prominent proposition towards the development of a fiscal union is the adoption of a eurobond (E-bond), the creation of which has been discussed for many years within European circles, and has come again at the political forefront by a proposition from Jean-Claude Junker and Giulio Tremonti.\footnote{\textit{See} http://www.ft.com/cms/s/0/540d41c2-009f-11e0-aa29-00144feab49a.html#axzz1HYuPbSw7} According to this proposition, a common E-bond would be issued by a European Debt Agency (Junker and Tremonti envisaged this agency as the successor of the EFSF) that could cover up to 50 per cent of the borrowing needs of EU Member States, while in cases of Member States that can only access the financial markets at a very high cost, it could cover their full financing needs.\footnote{Id.} Another important element of the Junker-Tremonti proposition - and perhaps its main vulnerability - was that the value of the issued paper per country could not exceed 40 per cent of its GDP, while the overall value at a European level could not exceed 40 per cent of the EU GDP.\footnote{Id.} Furthermore, the EDA would have the capacity to switch E-bonds with national bonds at their face value or at a discount, in case that the value of the sovereign bonds is under market pressure.\footnote{Id.}

The E-bond constitutes an extremely valuable tool of economic governance, as it has the potential to act both as a crisis resolution mechanism (by offering switches of sovereign bonds with E-bonds), as well as a growth stimulus, by creating a European bond market roughly of equivalent size to this for US Treasuries.\footnote{Id.} Furthermore, the EDA could issue special E-bonds in order to
finance particular development projects that could boost growth, thereby reducing the regional imbalances throughout the EU.

In addition, an increase of the EU budget is essential for the promotion of regional development programs that could stimulate growth in the poorer areas of the Union, and ultimately decrease the gap between the European centre and the periphery. It should be noted that under the current rules the resources that are available for the EU budget (the so-called “own resources”) cannot exceed 1.24 per cent of the Gross National Income (GNI) of EU Member States. What is more, the percentage of GNI that is devoted to the EU budget is consistently in decline, despite the Union’s enlargement between 2004-2007 with twelve Member States, the majority of which have lower incomes than the other fifteen, and the increase in EU’s competences.

Thus, all things considered, eurozone leaders cannot escape from the fact that the formidable task of increasing the competitiveness of the countries of the periphery should include some degree of burden sharing from the EU, acting as a fiscal and political union.

The counterargument here is that the countries of central and northern Europe do not have the incentives to be engaged in such an arrangement. According to this view, it seems contradictory to ask from the strongest economies to assume a part of the adjustment burden in order to assist peripheral countries to improve their competitiveness so as to be capable to comply with the budgetary rules of the Union, given that the very inclusion of these rules in the TFEU sought to avoid financial transfers to profligate Member States, by preempting the possibility of sovereign defaults.

However, this may not be the case. It has been already argued that the main rationale behind economic and fiscal policy coordination is to achieve price stability and avoid the adverse consequences of interest rate risings for the most fiscally prudent members of the eurozone. The

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103 Supra note 3, at 290.
104 Id.
105 For a good illustration of the growing public resentment in central and northern Europe about the bailouts of the peripheral countries See Peter Spiegel “Disillusionment spurs fringes to host Europe’s own Tea Party”. Financial Times, April 12, 2011 2.
106 See above, pages 5-6.
pivotal importance of price stability for the eurozone is further stressed by the creation of an independent central bank, with a strong anti-inflationary mandate.

What is more, by establishing the bailout mechanisms during the present crisis, eurozone countries have proved that in practice are willing to assume significant economic burdens if the survival of the euro is at stake. There is no reason to believe that this cost-benefit analysis will alter if financial transfers take a more regular, less dramatic, and hence, less politically costly form.

In sum, the central problem with the establishment of a closer fiscal union is not the lack of incentives from the part of Member States towards its creation, but, as it will be explained in the remainder of the paper, the institutional limitations of the EU.

Accordingly, the core hindrance behind the idea of a fiscal union is that the EU is not a federal state, but merely an association of sovereign nation states, in process of economic and political unification. The broad misuse of the term “Constitution” (or its derivatives) in the past to describe the character of the founding treaties of the Union cannot hide the fact that the TEU and the TFEU do not create a Constitutional order that can serve as the legitimate basis for a federation. Hence, financial transfers -a sine qua non element of a fiscal union- among states lack the necessary democratic legitimacy. This situation stresses the limitations of the core premise that has underpinned the process of European unification from 1950 until today, namely, that economic integration will inevitably lead to political unification.

While this principle has generally served the European project well by achieving a historically unprecedented degree of mergence among sovereign states, it does not offer any guidance for going forward when economic integration is paralyzed exactly due to the lack of legitimate and effective political administration. As the GCC has put it, if European integration should ever go to far, the inherited democratic deficit of the EU would become unacceptable under the domestic

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107. Indeed, the structure that has been created by the founding treaties of the Union falls short from corresponding to the traditional characteristics of a Constitutional order, given the limitations to responsible government, the absence of a bill of rights tradition and the blurred separation of powers. Consequently, the “Constitutionalization” of the treaties has been mainly based to the jurisprudence of the ECJ, however, this cannot serve an adequate ground for establishing a European Constitutional order. See Stefano Bartolini “Taking ‘Constitutionalism’ and ‘Legitimacy’ Seriously” in “EU Federalism and Constitutionalism, the Legacy of Altiero Spinelli” 18.

108. See http://www.cer.org.uk/articles/n_2_4.html
Constitutional order. Accordingly, the GCC noted that, as long as the EU restrains itself to the role of a creation of sovereign states under public international law, it does not need to establish a democratic order similar to this of its Member States, and indeed it does not have one. However, movements towards a fiscal union clearly go far beyond the scope of traditional forms of international cooperation, resembling the functions of a federal state. It is difficult to see how such a transformation of the EU could be compatible with the core principle of democratic governance that is enshrined in the national Constitutions of EU Member States.

Thus, it seems inevitable that in the absence of strong European political institutions that would be mandated to complement the EU with the elements of a transfer union, and furthermore to handle the resulting tensions among Member States, the EMU will continue to be vulnerable to its internal imbalances. To what extent these imbalances will even threaten the existence of the EMU is difficult to predict. Clearly, the capacity of politicians to circumvent domestic pressures when there is need to intervene in the name of the common currency will play a crucial role in this respect. As the recent crisis has stressed, “economic self-interest” and “political will” can be indeed proved strong elements of cohesion within the EMU. However, this may come at the cost of trumping some of the most important guarantees of democratic governance that, for the time being, can be only protected at the level of national Constitutions.

E. CONCLUSION

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109 In this respect, at its judgement of 30 June 2009, the GCC has noted: “The Lisbon Treaty contains contradictions because with the Treaty, the Member States follow the construction pattern of a federal State, without being able to create the democratic basis for this under the Treaties in the form of the equal election of a representative body of the people and of a parliamentary European government that is based on the legitimizing power of a people of the Union alone.” According to the GCC, the main reason of the EU’s failure to establish a “democratic basis for a federal State” is that the Union does not respect the “one man one vote” principle. That is because the weight of the votes of citizens for the elections of the European Parliament differs by a factor from one to twelve, resulting this way to overrepresentation of the citizens of smaller states. See Supra note 3, at 142-3.

110 Supra note 3, at 343.

111 Supra note 107.

112 “The ‘grand bargain’ is just a start”. Martin Wolf, Financial Times, March 29, 2011. Available at http://www.ft.com/cms/s/0/0364f530-5a4a-11e0-8367-00144feab49a,dwp_uuid=79cadde4-5c1b-11df-95f9-00144feab49a.html#axzz1IQxAqxnV
The sovereign debt crisis accelerated the historic time of the development of the EU and forced its Member States to move towards more mature stages of economic governance. The establishment of the EFSF, the EFSM, and the forthcoming amendment of the TFEU so as to create a permanent ESM, have created a crisis resolution framework that had either been neglected or deemed inappropriate when the Treaty of Maastricht established the EMU. Moreover, the “Euro Plus Pact” constitutes a policy blueprint that aspires to avert future crises in the EU, and particular within the eurozone.

This paper has argued, however, that the measures that have been put in place in order to deal with the sovereign debt crisis in Greece, Ireland and Portugal fail to address the main problem that these countries face, namely their inability to service their debt at its current levels, and that the policy mix proposed by the “Euro Plus Pact” is misguided and will not be successful in boosting the competitiveness of the countries of the periphery.

While the resolution of the crisis in Greece, Ireland and Portugal could be solved through debt restructuring without insurmountable institutional problems, the task of increasing the capacity of these, and other, countries to compete with eurozone’s best performers presents formidable constrains that go to the heart of the political and democratic deficits of the EU.

In this light, the absence of a discourse about the political and democratic underpinnings -or their lack- of the Union, although explainable by the yet recent backlash of the rejection of the Constitutional treaty, is quite disturbing. Even if economic self-interest and political will can be proved enough to keep the euro in place, the corresponding political activism that will be exercised by the EU while trying to rescue the common currency poses a threat to the guarantees of democratic governance that are enshrined in national Constitutions. This arrangement cannot qualify as an economic governance on the benefit of the governed.