Universiteit Leiden
The Netherlands

The transformation of the euro: law, contract, solidarity

Borger, V.

Citation
Borger, V. (2018, January 31). *The transformation of the euro: law, contract, solidarity*. *Meijers-reeks*. E.M. Meijers Instituut voor Rechtswetenschappelijk onderzoek van de Faculteit Rechtsgeleerdheid van de Universiteit Leiden, Leiden. Retrieved from https://hdl.handle.net/1887/60262

Version:	Not Applicable (or Unknown)
License:	Licence agreement concerning inclusion of doctoral thesis in the Institutional Repository of the University of Leiden
Downloaded from:	https://hdl.handle.net/1887/60262

Note: To cite this publication please use the final published version (if applicable).

Cover Page

Universiteit Leiden

Leiden University Repository

The handle http://hdl.handle.net/1887/60262 holds various files of this Leiden University dissertation

Author: Borger, Vestert
Title: The transformation of the euro : law, contract, solidarity
Date: 2018-01-31

4 Law and economic wisdom

1 Introduction

When the member states signed and ratified the Treaty of Maastricht they stamped their future currency union with the strongest stability imprint one can imagine. Price stability was not just turned into the unassailable goal of the European Central Bank, it determined the monetary union to the bone. Besides its consolidation in the Treaties, this stability set-up also became entrenched in national constitutional law, especially in Germany. In October 1993 its constitutional court, the *Bundesverfassungsgericht*, assessed the permissibility of the Treaty in its *Maastricht Urteil*.[1] The judges in Karlsruhe approved of Germany's participation in the currency union, but only because its legal set-up ensured it would be a '*Stabilitätsgemeinschaft*', a 'community based on stability'.[2] This stability conception of the single currency was 'the basis and subject matter' of Germany's act of accession.[3] If at some point this conception were abandoned, the constitutional court argued, this could ultimately lead to Germany withdrawing from the currency union.[4]

So clearly defining the currency union's rules of life and bestowing them with constitutional status should have generated a feeling of certainty about the solidity of the enterprise; that the currency union would indeed be, to use the language of the *Bundesverfassungsgericht*, a community based on stability. Yet, the line between certainty and a false sense of security can be very thin. On the eve of the launch of the single currency, Matthias Herdegen explained in the *Common Market law Review* why:

> 'Economic wisdom is what economic science in a given moment suggests as economically sound. Freezing institutional rules and substantive principles on this basis implies an obvious risk which is inherent in all dictates of economic wisdom:

▪ This chapter contains and/or builds on previously published work by the author. See especially Vestert Borger, 'Outright Monetary Transactions and the Stability Mandate of the ECB: *Gauweiler*' (2016) 53 CML Rev 139.

1 BVerfG, Cases 2 BvR 2134/92 & 2159/92 of 12 October 1993, as translated in [1994] 1 CMLR 57 (BVerfG *Maastricht*).

2 BVerfG *Maastricht* (n 1) para 80.

3 BVerfG *Maastricht* (n 1) para 90.

4 BVerfG *Maastricht* (n 1) paras 89, 90.

> subsequent falsification by new empirical messages or scenarios that have not been anticipated.'[5]

This risk did not materialise immediately. The first ten years following the launch of the euro on 1 January 1999 passed without great disturbances. In fact they gave rise to joy and optimism. The currency union had beaten the odds by taking off with a larger group of participants than most experts thought possible.[6] A year before the launch, several German professors had still gone to Karlsruhe to challenge the transition to the 'third stage' of monetary union, or at least Germany's participation in it, as they considered that the member states had failed to bring about the required convergence of their economies.[7] Yet, they had been unsuccessful. The *Bundesverfassungsgericht* had stressed the discretion inherent in 'the overall assessment of a high degree of lasting convergence' and the fact that this necessitated political decisions 'in which factual findings, empirical values and deliberate creativity are mixed in fluid transitions'.[8]

Little surprise, therefore, that of the member states wanting to join all but one had managed to get in.[9] Some had still been recording debts well above the 60% of GDP limit, in the case of Italy and Belgium even exceeding 120%, yet the Commission and Council had resorted to the escape clause in Article 126(2)(b) TFEU (ex Art 104c(2)(b) EC), arguing that these debt ratios were nonetheless 'sufficiently diminishing and approaching the reference value at a satisfactory pace'.[10] Only Greece had remained outside as it did not fulfil any of the convergence criteria.[11] But this state had also been able to join only 2 years later, just in time to see euro paper money and coins going into circulation the following year.[12] The currency union had subsequently witnessed a further expansion with the entry of Slovenia in 2007 and Cyprus and Malta in 2008.[13]

5 Matthias J Herdegen, 'Price Stability and Budgetary Restraints in the Economic and Monetary Union: The Law as Guardian of Economic Wisdom' (1998) 35 CML Rev 9.

6 Martin Heipertz and Amy Verdun, *The Politics of the Stability and Growth Pact* (CUP 2010) 114.

7 BVerfG, Cases 2 BvR 1877/97 & 2 BvR 50/96 of 31 March 1998 (BVerfG *EMU stage III*).

8 BVerfG *EMU stage III* (n 7) para 100.

9 Council Decision of 3 May 1998 in accordance with Article 109j(4) of the Treaty [1998] OJ L 139/30.

10 See Commission, 'Convergence Report 1998' (European Economy No 65, 1998) 82ff.

11 Council Decision 98/317/EC of 3 May 1998 in accordance with Article 109j(4) of the Treaty [1998] L 139/30.

12 Council Decision 2000/427/EC of 19 June 2000 in accordance with Article 122(2) of the Treaty on the adoption of Greece of the single currency on 1 January 2001 [2000] OJ L 167/19.

13 Council Decision 2006/495/EC of 11 July 2006 in accordance with Article 122(2) of the Treaty on the adoption by Slovenia of the single currency on 1 January 2007 [2006] OJ L 195/25; Council Decision of 10 July 2007 in accordance with Article 122(2) of the Treaty on the adoption by Cyprus of the single currency on 1 January 2008 [2007] OJ L 186/29;

The performance of the European Central Bank had very simply been impressive. Prior to the start of the currency union, critics had voiced concern about its ability to deliver on its stability mandate. But during the first decade of its existence it had proven them wrong as it managed to keep average inflation very close to its 2% target, a stunning accomplishment for a young bank having to build up its reputation from scratch.[14] Moreover, the euro had boosted financial integration and had rapidly positioned itself as one of the world's major currencies.[15] Looking at all these successes and achievements, commissioner Joaquín Almunia, responsible for economic and monetary affairs, declared in early 2008 in his report assessing the first ten years of the euro's existence:

> 'A full decade after Europe's leaders took the decision to launch the euro, we have good reason to be proud of our single currency. The Economic and Monetary Union and the euro area are a major success. For its member countries EMU has anchored macroeconomic stability, and increased cross border trade, financial integration and investment. For the EU as a whole, the euro is a cornerstone of further integration and a potent symbol of our growing political unity.'[16]

Only months later Europe would be thrown into the worst financial crisis since the Great Depression of the 1930s, followed by the debt crisis late 2009. An unanticipated scenario *par excellence*.

This chapter examines several flaws in the most essential assumptions underlying the single currency's original stability set-up that were exposed by the debt crisis. The first appeared in the instrument of market discipline. Forcing states to turn to the markets for their financing, so treaty drafters thought, will induce them to fiscal prudence. When markets question a state's fiscal health they will charge higher interest rates, which compels the state to change track. The crisis, however, has cast serious doubt on the disciplining nature of markets. Prior to the crisis, it looked as if they were blind to differences in fiscal positions and competitiveness as they charged similar interest rates for all members of the currency union. When the crisis struck they seemed, on the contrary, to be in a state of panic as they asked excessively high risk premia for bonds of certain states, making them hard pressed for money and necessitating extensive aid measures. This chapter looks at some of the key

---

Council Decision 2007/504/EC of 10 July 2007 in accordance with Article 122(2) of the Treaty on the adoption by Malta of the single currency on 1 January 2008 [2007] OJ L 186/32.

14 Paul De Grauwe, 'The euro at ten: achievements and challenges' (2009) 36 Empirica 5, 6.

15 Commission, 'EMU@10: successes and challenges after 10 years of Economic and Monetary Union' (European Economy No 2, 2008) 22-23, 94-105, 117-132.

16 Commission, 'EMU@10' (n 15) iii.

explanations for this whimsical behaviour of markets, in particular those professed by the Bank.

That markets have fallen short of expectations in terms of their disciplining force would not have been such a big problem if the single currency's second disciplining device, that of public discipline, had compensated for it. But this instrument has flaws of its own. The Commission's struggle to enforce the Stability and Growth Pact on France and Germany back in 2003 is etched in our memories. In fact, until the debt crisis, the court case to which this struggle gave rise was one of the rare instances in which the monetary union became subject of legal debate.

But even if the instruments of market and public discipline had delivered to the maximum extent possible, they would not have been able to save the single currency from all misery. In its preoccupation with ensuring fiscal prudence, the single currency's legal set-up was blind to risks stemming from other corners of the economy. One of the key factors why markets lost faith in the creditworthiness of some member states in 2010 was that their fiscal record had strongly, and suddenly, deteriorated as a result of financial sector problems. Indeed, it is the combination of troubled sovereign fiscal records and ailing banks that has pushed the currency union to the brink of collapse.

The fourth flaw is the cardinal one which brings the others together. Geared to safeguarding price stability, the single currency's legal set-up left another stability dangerously exposed: *financial* stability. This chapter will demonstrate the importance of financial stability and why the Union and its member states have been searching for mechanisms to protect it. This search will prove the connecting thread for the transformation of the euro that will be discussed in subsequent chapters.

Finally, a word about the nature of this chapter. It neither discusses all the essential moments of the crisis, nor the intricate legal character of the solidarity displayed by the member states and the bond buying action of the Bank to which this led. All that is left for later. What matters now is to gain an understanding of the fundamental flaws of the original stability set-up.

2 The whimsicality of markets

2.1 From extreme tranquillity to absolute panic

The first weakness of the stability framework concerns the instrument of market discipline laid down in Articles 123-125 TFEU. As the previous chapter explained,[17] the prohibitions on monetary financing, privileged access and

17 See text to n 274 (ch 3).

bail-out together intend to induce member states to fiscal prudence by forcing them to finance themselves on the markets just like private entities. Markets, by charging higher interest rates for bonds of states with weaker fiscal records, would force them to keep their budgets within acceptable parameters. Developments on euro area government bond markets both *before* and *after* the start of the financial turmoil cast serious doubt on the ability of markets to discharge this task.

Interest rate, or 'yield', developments for 10-year government bonds tell the story, in particular their 'spreads', that is: the difference in yields. In the currency union, yields on the German *Bund* often serve as a benchmark to assess these spreads, as this bond is generally considered to carry no risk of 'default'.[18] The spread between the *Bund* and other euro area government bonds is influenced by a host of factors,[19] but especially important is the 'credit premium', which reflects 'the compensation that investors demand in order to bear the risk of a government default'.[20] Since the launch of the currency union and up to the start of the financial crisis in 2007-08, euro area government bond spreads were minor, creating the impression that markets considered the default risk to be nearly identical for the various members of the currency union.[21] Yet, they took a dramatic turn for the worse once the crisis started, especially when it developed into a debt crisis during 2010. Yields for certain government bonds, in particular those for states in the currency union's 'periphery', skyrocketed, which made it increasingly difficult for them to obtain financing in the market.

Greece is a telling case. After its adoption of the single currency on 1 January 2001, and until mid-2008, the spread between 10-year Greek and German bonds reached a low of, on average, 30 basis points (0.3%).[22] Since then, however, the spread has taken a horrifying turn for the worse. In July 2011, a year after Greece had received its first assistance package, the spread stood at 1600 basis points (16%).[23] Although not as extreme as Greece's situation, several

18 Paul De Grauwe and Yuemei Ji, 'Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone' (2012) 50 JCMS 866, 866.

19 See eg European Central Bank, 'The determinants of euro area sovereign bond yield spreads during the crisis' (ECB Monthly Bulletin, May 2014) 68; Maria-Grazia Attinasi, Cristina Checherita and Cristiane Nickel, 'What Explains the Surge in Euro Area Sovereign Spreads During the Financial Crisis of 2007-2009?' (ECB Working Paper Series 2009, No 1131) 8; Simone Manganelli and Guido Wolswijk, 'What Drives Spreads in the Euro Area Government Bond Market?' (2009) 24 Economic Policy 191, 194; Kerstin Bernoth, Jürgen von Hagen and Ludger Schuknecht, 'Sovereign risk premiums in the European government bond market' (2012) 31 Journal of International Money and Finance 975, 978.

20 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 68-69.

21 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 74 (where the ECB looks back at that period, causing it to think investors 'underpriced' risk).

22 See Attinasi, Checherita and Nickel (n 19) 7.

23 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 77.

other member states have also witnessed sharp increases of the yield difference relative to Germany. In July 2012, at the absolute height of the crisis, the Spanish spread, for example, had risen to 600 bps (6%).[24] The Italian spread had experienced a significant rise too, reaching 500 bps (5%).[25]

This panicky behaviour of markets, characterised by sudden and sharp increases in interest rates, did not come as a total surprise. In fact, the Delors Report had already warned of it, arguing that one should not rely solely on the markets as a disciplining device. It stated in this regard:

> 'To some extent market forces can exert a disciplinary influence ... However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces may either be too slow and weak, or too sudden and disruptive.'[26]

Given that the unreliability of markets was to some extent already foreseen at the time of the drafting of the Treaty of Maastricht, a more interesting and pressing issue is whether markets were right in behaving the way they did during the crisis. In other words: does the classic idea hold that markets, as rationally operating economic agents, at all times adequately price government bonds?

2.2 Searching for an explanation …

Throughout the past years economists have racked their brains about this question. A particularly interesting answer to it is given by Paul De Grauwe and Yuemei Ji.[27] They argue that the currency union's government bond markets suffer from an in-built 'fragility' which prevents them from correctly pricing risk at all times.[28] On the contrary, they are susceptible to the development of 'bubbles' which cause them to charge interest rates that do not correspond to a state's economic health.[29]

---

24 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 77-78.
25 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 77-78.
26 Committee for the study of economic and monetary union, *Report on economic and monetary union in the European Community* (17 April 1989) para 30 (Delors Report).
27 De Grauwe and Ji, 'Mispricing of Sovereign Risk' (n 18). The ideas set out in this article have subsequently been further elaborated on by the authors themselves. See eg Paul De Grauwe and Yuemei Ji, 'Self-fulfilling crises in the Eurozone: An empirical test' (2013) 34 Journal of International Money and Finance 15.
28 De Grauwe and Ji, 'Mispricing of sovereign risk' (n 18) 877-878.
29 De Grauwe and Ji, 'Mispricing of sovereign risk' (n 18) 877-878.

To show the existence of such bubbles during the crisis De Grauwe and Ji identify several 'economic fundamentals' that may affect a state's solvency, such as its debt to GDP ratio and 'fiscal space' (the 'ratio of government debt to total tax revenues'),[30] and examine whether the shocking development of euro area government bond spreads between 2008 and 2011 corresponds to them. Although prior to the financial crisis these fundamentals influenced the spreads to some extent, markets became much more sensitive to them after 2008.[31] Interestingly, however, De Grauwe and Yi also find that a considerable portion of the quick and sudden hike in spreads, especially after the start of the sovereign debt crisis in spring 2010, had no connection to weakening fundamentals.[32] This is particularly true for member states in the currency union's 'periphery'.[33]

On the basis of these findings, De Grauwe and Ji argue that the 'mispricing of risks' forms an 'endemic feature' of markets in the currency union.[34] Prior to the crisis, they were blind to the differences in economic fundamentals, which caused them to underestimate the risk of purchasing bonds of certain member states.[35] However, after its outbreak they overestimated risks, and spreads started to exceed what could be explained by fundamentals.[36] Markets were not operating rationally, but acted out of fear and anxiety.

As an explanation of this market tendency to lapse into panic De Grauwe and Ji point out that the currency union suffers from an in-built fragility: its participants 'issue debt in a currency over which they have no control'.[37] This lack of control makes them 'susceptible to movements of distrust' on the markets which can generate 'self-fulfilling' crises.[38] Whereas states which do control their own currency can (implicitly) guarantee their creditors that they will always be able to respect their financial commitments by having recourse to their central banks, the members of the currency union cannot.[39] When investors get concerned about a default, for example due to a rise in a state's debt to GDP ratio, they will start to dispose of their bonds, resulting

30 Other fundamentals that are taken into account are a state's current account position, real effective exchange rate and economic growth rate. See De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 20-21.
31 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 26.
32 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 30-31.
33 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 30-31. The authors explain that the exception is Greece where around 60% of the spread's rise is related to weakening fundamentals.
34 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 27.
35 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 27.
36 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 27.
37 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 16.
38 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 16-17.
39 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 16.

in a liquidity crisis.[40] If caught by panic this can lead to such high interest rates that the liquidity crisis becomes a solvency crisis.[41] In this way fears of default increase the probability that it will materialise.

The currency union's fragility, De Grauwe and Yi argue, creates the potential for 'multiple equilibria'.[42] If a state has the confidence of investors it will experience a 'good' equilibrium, in which it has no problem in attracting liquidity and benefits from favourable interest rates when (re)financing its debt.[43] Yet, if it is distrusted it will suffer from a 'bad' one, characterised by high interest rates that necessitate a regime of austerity, which in turn sets off a recession and weakens its fiscal position.[44] Default then becomes a self-fulfilling prophecy in which markets, caught by panic, 'push' a state into default despite its initially solid fundamentals.[45] The cruelty of a currency union, moreover, is that problems may not stay confined to a single state. Once panic takes hold of markets a distrusted member may 'contage' others,[46] triggering developments unrelated to fundamentals there as well.[47]

In support of their fragility hypothesis, De Grauwe and Ji contrast the situation in the currency union with that of developed states having their own currency.[48] Despite the fact that some of these states have debt positions worse than the euro area average, their spreads vis-à-vis the German *Bund* are only influenced by them to a limited extent.[49] What is more, during the crisis these spreads did not experience large and abrupt increases in excess of what can be explained by fundamentals.[50] In contrast to distressed states in the currency union, De Grauwe and Ji argue, those having their own currency 'seem to

40 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 16-17; De Grauwe and Ji, 'Mispricing of Sovereign Risk' (n 18) 877-878.

41 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 17.

42 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 17.

43 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 17.

44 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 17.

45 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 17.

46 As Vítor Constâncio, vice-president of the European Central Bank, explains: '[F]inancial contagion refers to a situation whereby instability in a specific market or institution is transmitted to one or several other markets or institutions ... Criteria that have been used in the literature to identify contagion include: (i) the transmission is in excess of what can be explained by economic fundamentals….' See Vítor Constâncio, 'Contagion and the European debt crisis' (Banque de France, Financial Stability Review No 16, April 2012) 110-111 (footnotes omitted). See also ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 71.

47 De Grauwe and Ji, 'Mispricing of Sovereign Risk' (n 18) 877-878.

48 Australia, Canada, the Czech Republic, Denmark, Hungary, Japan, South Korea, Norway, Poland, Singapore, Sweden, Switzerland, the UK and the US. See De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 19.

49 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 15-16, 20.

50 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 20.

be able to "get away with murder" and still not be disciplined by financial markets'.[51]

2.3 … that fits central bank action

Now, this study does not necessarily wish to defend De Grauwe and Ji's analysis or claim that it presents the most accurate account of what happened on euro area government bond markets during the crisis.[52] Certainly, their hypothesis about the currency union's fragility has been subscribed to by some authoritative colleagues.[53] Again others, moreover, do not necessarily subscribe to this hypothesis but do find that the currency union is susceptible to self-fulfilling crises that are unrelated to fundamentals.[54] But some economists, using other variables and models, reach different conclusions. According to Bernoth, von Hagen and Schuknecht, for example, the rise in the spreads of Greece and Ireland, at least until mid-2009, was to a large extent due to the fact that after the collapse of Lehmann in 2008 markets became much more sensitive to poor fiscal records.[55]

This study singles out De Grauwe and Ji's analysis because its reading of multiple equilibria corresponds best to the reasoning of the European Central Bank to justify purchases of government bonds on the secondary

51 De Grauwe and Ji, 'Self-fulfilling crises in the Eurozone' (n 27) 26.

52 For an overview of different explanations of the surge in bond spreads during the crisis see Leo de Haan, Jeroen Hessel and Jan Willem van den End, 'Are European Sovereign Bonds Fairly Priced? The role of modeling uncertainty' (DNB Working Paper No 399, November 2013) 5-7; ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 67ff.

53 Paul Krugman, for example, states that: '[T]he proposition [*is*, ed] that countries without a printing press are subject to self-fulfilling crises in a way that nations that still have a currency of their own are not. The point is that fears of default, by driving up interest costs, can themselves trigger default – and that's because there's a crossing-the-Rubicon aspect to default, once a country crosses that line it will probably impose fairly severe losses on creditors. A country with its own currency isn't in the same position….'. See Paul Krugman, 'The Printing Press Mystery' *New York Times* (17 August 2011) <krugman.blogs.nytimes.com/2011/08/17/the-printing-press-mystery/> accessed 5 April 2017. See also Paul Krugman, 'Currency Regimes, Capital Flows, and Crises' (2014) 62 IMF Econ Rev 470, 473-475; Daniel Gros, 'On the Stability of Public Debt in a Monetary Union' (2012) 50 JCMS 36, 37-38; Willem Buiter and Ebrahim Rahbari, 'The European Central Bank as a Lender of Last Resort for Sovereigns in the Eurozone' (2012) 50 JCMS Annual Review 6, 6-8, 18.

54 See eg Peter Hördahl and Oreste Tristani, 'Macro factors and sovereign bond spreads: a quadratic no-arbitrage model' (mimeo, 10 May 2013) <hkimr.org/uploads/seminars/469/paper_08-08.pdf> accessed 5 April 2017; Manfred Gärtner and Björn Griesbach, 'Rating agencies, self-fulfilling prophecy and multiple equilibria? An empirical model of the European sovereign debt crisis 2009-2011' (Universität St. Gallen Discussion Paper No 2012-15, June 2012). See also ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 73-74 for further references.

55 Bernoth, Von Hagen and Schuknecht (n 19) 984-985.

market, a crucial element of the currency union's transformation that will be discussed in detail in chapter 6.[56] Indeed, shortly before the Bank announced the details of its most far-reaching intervention, called 'Outright Monetary Transactions', President Draghi explained in an opinion piece in *Die Zeit* on 29 August 2012 how the panic on government bond markets had prevented the Bank from delivering on price stability, forcing it to resort to 'unconventional' measures:

> '[I]t should be understood that fulfilling our mandate sometimes requires us to go beyond standard monetary policy tools. When markets are fragmented or influenced by irrational fears, our monetary policy signals do not reach citizens evenly across the euro area. We have to fix such blockages to ensure a single monetary policy and therefore price stability for all euro area citizens. This may at times require exceptional measures. But this is our responsibility as the central bank of the euro area as a whole.'[57]

At a press conference right after the Governing Council had announced its intervention, on 6 September 2012, Draghi again referred to the dysfunctioning of markets in defence of the Bank's exceptional move:

> '[T]he assessment of the Governing Council is that we are in a situation now where you have large parts of the euro area in what we call "a bad equilibrium", namely an equilibrium where you may have self-fulfilling expectations that feed upon themselves and generate very adverse scenarios. So, there is a case for intervening, in a sense, to "break" these expectations, which, by the way, do not only concern specific countries, but the euro area as a whole. And this would justify the intervention of the central bank.'[58]

According to the Bank, therefore, market panic was driving up bond spreads to such heights that it caused 'financial fragmentation', characterised by 'divergent borrowing costs' for individuals and companies, making it very difficult to have its monetary policy reach out to all corners of the currency union.[59] What is more, in the summer of 2012, right before the launch of its far-reaching intervention, spreads were even so extreme that markets seemed

56 According to Martin Wolf, chief economics commentator at the *Financial Times*, the Governing Council's decision to establish the Outright Monetary Transactions programme 'marks belated acceptance of strong arguments made by the Belgian economist, Paul de Grauwe, at the London School of Economics'. See Martin Wolf, 'Draghi alone cannot save the euro' *Financial Times* (12 September 2012).

57 Mario Draghi, 'So bleibt der Euro stabil!' *Die Zeit* (30 August 2012). English translation available at <ecb.europa.eu/press/key/date/2012/html/sp120829.en.html> accessed 13 May 2017.

58 Introductory statement to the press conference (with Q&A) (ECB, 6 September 2012). See also Paul De Grauwe and Yuemei Ji, 'From Panic-Driven Austerity to Symmetric Macroeconomic Policies in the Eurozone' (2013) 51 JCMS 31, 31.

59 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 81.

to anticipate a collapse of the currency union as bond rates started to reflect a 'currency redenomination risk premium'.[60] This means that investors were requesting 'compensation' for the, in the eyes of the Bank unfounded, scenario that one or more states would have to leave the currency union and live on with a new, devalued currency.[61]

Why were these high bond rates so problematic for the transmission of monetary policy, as the Bank argued? The answer is that its policy rates are 'transmitted' to the 'real economy' via several 'channels'.[62] In normal times the channels work well, but during the crisis some of them were 'dysfunctional' due to the high rates for certain government bonds, as a result of which the Bank's policy 'signals' were no longer effective in all parts of the currency union.[63] Philippine Cour-Thimann and Bernhard Winkler identify three dysfunctional transmission channels with special relevance.[64] The first concerns the 'price channel'.[65] As the previous chapter explained,[66] states 'compete' with banks on the markets for capital.[67] Higher government bond rates can therefore also drive up those for banks, which in turn may lead to higher 'bank lending rates'.[68] The second channel relates to 'liquidity'.[69] Government bonds are much used as collateral for lending operations between banks.[70] They also figure as 'benchmarks' to decide the value of other collateral assets in such operations.[71] A hike in government bond rates can therefore make it more difficult for banks to obtain liquidity as it affects the 'eligibility' of their assets as collateral.[72] The third and final channel has to do with the 'balance sheets' of banks.[73] Changes in the price of government bonds can seriously weaken a bank's capital position, which negatively affects its ability to provide credit to customers.[74]

---

60 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 77-78.
61 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 78.
62 Philippinne Cour-Thimann and Bernhard Winkler, 'The ECB's non-standard monetary policy measures: the role of institutional factors and financial structure' (2012) 28 Oxf Rev Econ Policy 765, 774.
63 Cour-Thimann and Winkler (n 62) 774, 778.
64 Cour-Thimann and Winkler (n 62) 774-775.
65 Cour-Thimann and Winkler (n 62) 774.
66 See text to n 250 (ch 3).
67 Cour-Thimann and Winkler (n 62) 774.
68 Cour-Thimann and Winkler (n 62) 774. See also European Central Bank, 'Assessing the retail bank interest rate pass-through in the euro area at times of financial fragmentation' (ECB Monthly Bulletin, August 2013) 86-87.
69 Cour-Thimann and Winkler (n 62) 775.
70 Cour-Thimann and Winkler (n 62) 775.
71 Cour-Thimann and Winkler (n 62) 775.
72 Cour-Thimann and Winkler (n 62) 775.
73 Cour-Thimann and Winkler (n 62) 775.
74 Cour-Thimann and Winkler (n 62) 775. See also Gros (n 53) 39.

The European Central Bank thus sees its government bond purchases as necessary to secure the 'transmission' and 'singleness' of its monetary policy in view of the panic on bond markets.[75] They would therefore fall squarely within its monetary policy mandate. Critics, however, argue that this is not all there is to the Bank's motivation to intervene. Rather than pursuing a monetary policy objective, its bond purchases would aim to provide distressed states with a 'lender of last resort', thereby setting foot on the terrain of economic policy. At the end of this chapter this view will be further analysed. First, however, it is necessary to take a look at the second disciplining device of the original stability framework, that of public discipline. After all, if Greece had not had such a weak fiscal record in the first place, chances are that markets would not have lapsed into panic. But just as markets had not been able to induce states to fiscal prudence prior to the crisis, the instrument of public discipline had fallen short too.

3 The weakness of public discipline

3.1 Fiscal politics under the original Pact

The Delors Committee had already anticipated the unreliability of markets, and it had advised that any lack of discipline provided by them should be compensated for by putting limits on the fiscal powers of member states. Such public discipline would not only add to that provided by markets, it would also strengthen it. Neglect of fiscal rules and reprimands by authorities would 'guide' markets in assessing the fiscal performance of states.[76]

As the previous chapter showed,[77] the Union Treaties consolidate public discipline in Articles 121 and 126 TFEU (ex Arts 99 and 104 EC). The first provision creates a framework for the coordination of national economic policies, in particular through the multilateral surveillance procedure set out in its third to fifth paragraphs. The second curbs the fiscal powers of member states by obliging them, subject to certain exceptions, to avoid deficits and debts exceeding the limits of 3% and 60% of GDP respectively and, moreover, by setting out the excessive deficit procedure to examine compliance with these limits. Both procedures, the multilateral one and that for excessive deficits, are specified in the Stability and Growth Pact. The Pact's preventive arm, laid down in Regulation 1466/97, details the multilateral surveillance procedure, in particular by requiring states to pursue medium-term budgetary objectives

75 ECB, 'The determinants of euro area sovereign bond yield spreads' (n 19) 81: 'The goal of OMTs is to ensure an appropriate monetary policy transmission and the singleness of the monetary policy'.
76 Manganelli and Wolswijk (n 19) 196-197.
77 See text to n 294 (ch 3).

so as to avoid excessive deficits. The corrective arm, governed by Regulation 1467/97, speeds up and clarifies the excessive deficit procedure by defining the exceptions to the obligation to avoid deficits, attaching time limits to the different phases of the procedure and specifying sanctions for violations of the fiscal rules.

Did this system succeed in imposing public discipline on member states, in particular on those belonging to the currency union? Interestingly, in the run-up to the launch of the single currency, before the Pact had come into force, states managed to significantly improve their fiscal records. Keen on qualifying for membership of the currency union, they put great effort into bringing their budgets in line with the convergence criteria, in particular by pushing down their deficits below the limit of 3% of GDP.[78] All states that were first to join the currency union on 1 January 1999 recorded deficits below this limit at the time of entry. Even Italy, still with a deficit of 9.5% in 1993, had managed to reduce it to 2.5% by 1998.[79]

But once the single currency had taken off, fiscal 'fatigue' set in.[80] In part this resulted from the fact, as stability hardliners had predicted at the time of the treaty negotiations on monetary union,[81] that the carrot of euro area membership had lost its appeal for those states that had managed to get 'in'.[82] Having succeeded in passing the 'convergence' test, they were now less eager to pursue fiscal prudence. Yet, it was also a consequence of the changeover of Europe's political landscape at the turn of the millennium.[83] In many capitals conservative governments were replaced by leftist, social-democratic ones, with different perceptions of the role and function of fiscal policy.[84]

Germany is a prime example. After 16 years of Christian-liberal rule, in 1998 the Kohl government made way for one consisting of social democrats and greens, led by Gerhard Schröder. As a result, Germany's position on fiscal issues changed significantly.[85] Whereas former Finance Minister Theo Waigel had argued for a stability pact to avoid fiscally imprudent states from threatening price stability and central bank independence, his social-democrat

78 Ludger Schuknecht and others, 'The Stability and Growth Pact: Crisis and Reform' (ECB Occasional Paper Series No 129, September 2011) 9. The same cannot be said of their debt to GDP ratios as some of these were still far above 60%. See also text to n 9 (ch 4).

79 Commission, 'Convergence Report 1998' (European Economy No 65, 1998) 81. See also Schuknecht and others (n 78) 9.

80 Antonio Fatás and Ilian Mihov, 'On Constraining Fiscal Policy Discretion in EMU' (2003) 19 Oxf Rev Econ Policy 112, 121. See also Charles Wyplosz, 'European Monetary Union: The Dark Sides of a Major Success' (2006) 21 Economic Policy 207, 230-231; Heipertz and Verdun (n 6) 115.

81 See text to n 314 and 449 (ch 3).

82 Fatás and Mihov (n 80) 120-124; Wyplosz (n 80) 230-231.

83 Heipertz and Verdun (n 6) 114.

84 Heipertz and Verdun (n 6) 114.

85 Heipertz and Verdun (n 6) 114.

successor, Oskar Lafontaine, was not convinced of such monetarist ideas.[86] Faced with Germany's highest unemployment rate in decades – 4 million – almost immediately after taking office, he pressured the European Central Bank to lower its interest rates arguing that 'Monetary policy is certainly the preferred instrument to respond to this shock'.[87] 'If it is not used', he continued, 'fiscal measures cannot be ruled out, because the option of doing nothing could turn out to be extremely expensive'.[88] Lafontaine's remarks failed to impress Wim Duisenberg, the Bank's first president. Eager to establish the credibility of the new monetary authority, he replied that 'The main cause of unemployment is not a lack of domestic demand. It is structural. Monetary policy can do nothing about it, and neither can demand-side policies. Labour and goods markets must become more flexible…'.[89]

Schröder eventually realised this too. In 2003 his government embarked on a major reform agenda for the German labour market.[90] Known as the '*Hartz*-reforms', the changes introduced by the government struck at the very core of Germany's welfare system, not in the least by economising unemployment and social welfare benefits.[91] Whereas the reforms would revitalise the German economy in the long-run, they negatively impacted the budget in the short term.[92] Schröder therefore became increasingly sceptical of the fiscal constraints imposed by the Pact, which in his view left too little room for investments that would ultimately benefit the economy.[93]

The change in views on fiscal policy did not immediately show up in 'nominal' fiscal data.[94] During the first two years of the single currency's existence, Europe experienced growth 'above trend' which allowed member states to

86 Heipertz and Verdun (n 6) 114.

87 Quoted in 'Comment & Analysis: Germany's blame game' *Financial Times* (24 February 1999).

88 Quoted in 'Comment & Analysis: Germany's blame game' *Financial Times* (24 February 1999).

89 Quoted in 'Comment & Analysis: Germany's blame game' *Financial Times* (24 February 1999).

90 See Abraham Newman, 'The Reluctant Leader: Germany's euro experience and the long shadow of reunification' in Matthias Matthijs and Mark Blyth (eds), *The Future of the Euro* (OUP 2015) 127.

91 European Central Bank, 'The short-term fiscal implications of structural reforms' (ECB Economic Bulletin No 7, 2015) 65-66.

92 ECB, 'The short-term fiscal implications of structural reforms' (n 91) 66. Matthias Matthijs therefore relativises Germany's shift away from ordoliberalism under the sceptre of Schröder. He argues that 'while seemingly moving away from ordoliberalism on the budgetary front, Schröder's government was doubling down on it through structural reform'. See Matthias Matthijs, 'Powerful rules governing the euro: the perverse logic of German ideas' (2016) 23 Journal of European Public Policy 375, 381 (footnote omitted).

93 See text to n 118 and 201 (ch 4).

94 Heipertz and Verdun (n 6) 116.

keep up appearances by running budgets below the 3% limit.[95] However, most of them failed to reach the far more ambitious target in the Pact's preventive arm of a budget that is 'close to balance or in surplus'.[96] What is more, they did not use the time of favourable growth for 'structural improvement' of their budgets, instead resorting to loose fiscal policies through increased spending and tax relief.[97] In some large states structural positions even worsened, which left them ill-prepared for less rosy times.[98]

From a legal point of view it is hard to blame the Pact, in particular its preventive arm, for this fiscal fatigue. Of course, one can argue that it failed because states dragged their feet in reaching their medium-term objectives of running a budget that is in balance or surplus.[99] Yet, such criticism disregards the fact that Article 121 TFEU, the legal basis for the Pact's preventive arm, offers no room for imposing hard obligations to achieve precise fiscal results.[100] It is in the nature of a system that has to rely on benchmarking, peer pressure and promises to perform to the best of one's ability – the so-called 'open method of coordination' –[101] that results can be off target, in particular when it concerns a most sensitive area like fiscal policy.[102] But even from a non-legal, practical point of view it is difficult to criticise the Pact's preventive arm as the impossibility to verify what fiscal policy would have looked like without it makes it hard to assess its effectiveness.[103] Without the Pact, fiscal records may have even been worse!

Where public discipline has more clearly fallen short, especially from a legal point of view, is in the operation of the excessive deficit procedure and the Pact's corrective arm. The lack of ambition in bringing down deficits after

95 Commission, 'Public Finances in EMU 2001' (European Economy No 3, 2001) 11.

96 Heipertz and Verdun (n 6) 114.

97 Heipertz and Verdun (n 6) 116-117.

98 Commission, 'Public Finances in EMU 2001' (n 95) 11-12.

99 In particular given the fact that in the political Resolution on the Pact states had committed themselves to 'respect' their medium-term objectives and 'to take the corrective budgetary action they deem necessary'. See Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997 [1997] OJ C 236/1 (section 'member states', point 1).

100 A different issue is whether it provides a legal basis for the imposition of sanctions for failing to observe the adjustment path towards the medium-term budgetary objective. See n 272 (ch 5).

101 For an analysis of the OMC method in the context of the Pact in its original form Fabian Amtenbrink and Jakob de Haan, 'Economic Governance in the European Union: Fiscal policy discipline versus discipline' (2003) 40 CML Rev 1075, 1079-1085.

102 This is not to say that hard law obligations would necessarily lead to better results or be more desirable. Dermot Hodson and Imelda Maher, for example, argue that soft law may be the best instrument for economic policy given the 'uncertainty' over how to 'measure' respect of the medium-term budgetary objective. See Dermot Hodson and Imelda Maher, 'Soft law and sanctions: economic policy coordination and reform of the Stability and Growth Pact' (2004) 11 Journal of European Public Policy 798, 801, 803-804.

103 Wyplosz (n 80) 230. On the basis of an indirect evaluation, however, Wyplosz himself argues that the Pact failed to bring about fiscal discipline during the years following the launch of the euro.

the launch of the single currency was bound to create problems once the economy took a turn for the worse. Luck had to run out at some point. And indeed, from 2001 onwards growth conditions worsened and started to negatively affect national budgets, in particular of those member states that had failed to bring down their deficits in the years before.[104] Portugal was the first to run into serious trouble.[105] With little room to accommodate the cyclical downturn, its deficit went up from 2.4% in 1999 to 4.1% in 2001, well above the 3% limit.[106] As it feared that the state would exceed the limit for a second year in 2002, the Council adopted a decision on the basis of Article 104(6) EC establishing the existence of an excessive deficit on 5 November 2002.[107]

Soon, larger member states came under pressure as well.[108] Having managed to escape the initiation of an excessive deficit procedure in 2001 by a narrow margin, Germany had to capitulate on 21 January 2003 when the Council established the existence of an excessive deficit of 3.7% for the year 2002 and recommended measures for its reduction.[109] It subsequently did the same with France on 3 June 2003 when, despite having issued an early warning under the Pact's preventive arm in January,[110] it identified an excessive deficit of 3.1% for the previous year.[111]

Being subject to the excessive deficit procedure, a divide took place between Portugal on the one hand, and France and Germany on the other.[112] Portugal used the procedure as an 'external constraint' to justify fiscal reform efforts.[113] Illustrative is the following remark of José Manuel Barroso, at the time the state's prime minister. Having succeeded in cutting down the deficit from 4.4%

104 Heipertz and Verdun (n 6) 119.
105 Heipertz and Verdun (n 6) 119, 131.
106 Recital 7 Council Decision 2002/923/EC of 5 November 2002 on the existence of an excessive deficit in Portugal – Application of Article 104(6) of the Treaty establishing the European Community [2002] OJ L 322/30 (Council Decision 2002/923/EC).
107 Council Decision 2002/923/EC.
108 Heipertz and Verdun (n 6) 128ff.
109 Council Decision 2003/89/EC of 21 January 2003 on the existence of an excessive deficit in Germany – Application of Article 104(6) of the Treaty establishing the European Community [2003] OJ L 34/16 (especially Recital 7); Council Recommendation of 21 January 2003 with a view to bringing an end to the situation of an excessive government deficit in Germany – Application of Article 104(7) of the Treaty Establishing the European Community, Brussels 28 January 2003, No 5540/03.
110 Council Recommendation 2003/90/EC of 21 January 2003 with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit [2003] OJ L 34/18.
111 Council Decision 2003/487/EC of 3 June 2003 on the existence of an excessive deficit in France – application of Article 104(6) of the Treaty establishing the European Community [2003] OJ L 165/29 (especially Recital 7); Council Recommendation to France with a view to bringing an end to the situation of an excessive government deficit – Application of Article 104(7) of the Treaty, Brussels 18 June 2003, No 10125/03.
112 Heipertz and Verdun (n 6) 149-151.
113 Heipertz and Verdun (n 6) 128, 149.

in 2001 to 2.7% the following year,[114] he praised the Pact for its restraining force by attributing it mythical strengths:

> 'It's like the legend of Ulysses….The pact helps a government to tie itself to the mast and resist the sirens who are trying to lure us to destruction with seductive songs of more state spending and bigger bureaucracies.'[115]

Germany and France, however, were hostile to the procedure. As the most powerful member states they were not prepared to be lectured to by the Union on fiscal policy. Yet, each of them justified their refusal differently.[116] France went for a face-to-face confrontation. Even before it was formally placed under the excessive deficit procedure its Prime Minister Jean-Pierre Raffarin had made it clear that he would not 'conduct a policy of austerity'.[117] Germany sought a more conciliatory stance. Having fought hard to introduce the Pact to convince the rest of Europe of the virtues of 'stability' only several years earlier, it did not want to publicly abandon it.[118] Instead, it argued that it should be interpreted 'in an economically sensible way'.[119] Focused on implementation of the *Hartz*-reforms, Chancellor Schröder stressed that the Pact was a 'stability *and* growth pact…', and that in times of a slackening economy it was 'necessary to take measures to stimulate growth'.[120] Germany was therefore still 'acting in the spirit of the pact'.[121]

Despite this difference in language, both states refrained from reducing their deficits in line with the recommendations of the Council. Over the course of 2003 it became clear that Germany's deficit would not go down to 2.75% as recommended by the Council, but rise to 4.2%, making it very unlikely that the state would manage to push it below the 3% limit in 2004.[122] The French budget too significantly overshot the target set by the Council. Contrary to

---

114 See Recital 5 of Council Decision 2006/135/EC of 11 May 2004 abrogating the decision on the existence of an excessive deficit in Portugal [2005] OJ L 47/24.

115 Quoted in Peter Wise, 'Portugal learns to love stability pact' *Financial Times* (29 January 2003). See also Heipertz and Verdun (n 6) 137.

116 Heipertz and Verdun (n 6) 142, 149-150.

117 Quoted in Martin Arnold, Francesco Guerrera and Jo Johnson, 'France refuses to take steps to curb budget deficit' *Financial Times* (26 February 2003).

118 See also George Parker, 'EU haunted by spectre of pact no one will let die' *Financial Times (FT.Com)* (2 July 2003).

119 Quoted in Hugh Williamson, '"Many countries" back easing stability pact' *Financial Times (FT.Com)* (28 August 2003). See also Heipertz and Verdun (n 6) 142.

120 Quoted in Hugh Williamson and Bettina Wassener, 'Transcript of the interview with Gerhard Schröder' *Financial Times (FT.Com)* (11 July 2003) (emphasis added).

121 Quoted in Williamson and Wassener, 'Transcript of the interview with Gerhard Schröder' (n 120).

122 Commission, 'Recommendation of 18 November 2003 for a Council decision establishing, in accordance with Article 104(8) of the EC Treaty, that the action taken by Germany in response to the recommendations made by the Council pursuant to Article 104(7) of the Treaty is proving to be inadequate' SEC (2003) 1316 final (explanatory memorandum).

cutting its deficit in 2003 to bring it below the red line of 3% in the following year, France expected its deficit to reach 4%.[123] Moreover, Raffarin indicated he had no intention of bringing the budget into safe havens already in 2004, trivialising the Pact's fiscal rules as the 'obsession of "notaries" in Brussels'.[124]

Fearing a breach of the Pact for a third year in a row, the Commission decided to step up the excessive deficit procedures of France and Germany, thereby bringing closer, at least in theory, the imposition of sanctions by the Council. On 8 October 2003 it recommended the Council to issue a recommendation on the basis of Article 104(8) EC establishing that France had taken no effective action in response to its earlier recommendations.[125] Subsequently, on 21 October 2003, it also recommended the Council to give notice to the state under Article 104(9) EC to take measures to reduce its deficit.[126] Similar steps were taken in relation to Germany on 18 November 2003.[127]

By taking the procedure to another level, the Commission forced a tug-of-war in the Council between member states supporting and opposing sanctions.[128] The Netherlands was perhaps the most arduous proponent. Its Finance Minister Gerrit Zalm, having introduced serious budgetary cuts himself in order to stay in line with the Pact's requirements in 2004,[129] argued that that the Union's fiscal rules were 'crucial to monetary and economic stability in Europe, and therefore have to be respected by all EU member states'.[130] Yet, he would taste defeat when the Commission recommendations were put

123 Commission, 'Recommendation of 8 October 2003 for a Council decision establishing, in accordance with Article 104(8) EC, whether effective action has been taken by France in response to recommendations of the Council according to Article 104(7) EC of the Treaty establishing the European Community' SEC (2003) 1083 final (explanatory memorandum, para 2).

124 Jo Johnson and George Parker, 'France given more time to pull back budget deficit' *Financial Times* (21 October 2003) (using these words to describe Raffarin's position).

125 SEC (2003) 1083 final.

126 Commission, 'Recommendation of 21 October 2003 for a Council decision giving notice to France, in accordance with Article 104(9) of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit' SEC (2003) 1121 final.

127 SEC (2003) 1316 final; Commission, 'Recommendation of 18 November 2003 for a Council decision giving notice to Germany, in accordance with Article 104(9) of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit' SEC (2003) 1317 final.

128 Heipertz and Verdun (n 6) 147, 150-152.

129 Heipertz and Verdun (n 6) 144.

130 Quoted in Ian Bickerton, 'Dutch slash spending to haul economy out of crisis' *Financial Times* (17 September 2003).

to a vote on 25 November 2003. With mostly small member states voting in favour, the Council failed to adopt them.[131]

Interestingly, however, the Union's fiscal rules had not lost all of their normative appeal. Instead of issuing recommendations the Council adopted 'conclusions' on the basis of the same voting procedure as for recommendations under Article 104(9) EC.[132] In these conclusions it took note of 'public commitments' made by Germany and France to take the required measures to correct their excessive deficits and set the deadline for correction at 2005, thereby granting both another year to put their fiscal house in order.[133] The Council subsequently stated that, taking into account these commitments, it had decided 'not to act, at this point in time' on the Commission recommendations for Council decisions under Article 104(9) EC.[134] Instead, and parallel to the arrangements in the Pact's corrective arm, it decided to hold the excessive deficit procedure 'in abeyance for the time being', although it indicated that it was ready to act under Article 104(9) EC if the two member states did not live up to their commitments.[135] The Council ended its conclusions by confirming its continuing 'strong commitment to sound public finances' and to the Pact 'as the framework for the coordination of budgetary policies in the European Union…'.[136]

For a stability hardliner like Dutch Finance Minister Zalm, however, these salvaging final words were no more than a cynical way of covering the Pact's ineffectiveness with the cloak of charity. When he came out of the meeting he was furious and told the press how the Franco-German coalition had managed to assemble a 'blocking minority' in the Council,[137] arguing that 'some ministers may have been intimidated by those two big countries'.[138] Zalm's anger was shared by the Commission. As 'guardian' of the Treaties

131 Heipertz and Verdun (n 6) 147, 150-151. The group of states voting in favour differed depending on whether the voting concerned a recommendation under Article 104(8) (now Art 126(8) TFEU) or 104(9) EC (now Art 126(9) TFEU) as Arts 122(3) and 122(5) EC (now Arts 139(2)(c) and 139(4) TFEU) determined that only members of the currency union could vote on the latter. As a result, the coalition of states voting in favour of the recommendations under Art 104(8) EC consisted of Belgium, Denmark, Greece, Spain, the Netherlands, Austria, Finland and Sweden, whereas only Belgium, Greece, Spain, the Netherlands, Austria and Finland supported the recommendations under Art 104(9) EC. See also the Council minutes in 2546th Council meeting (ECOFIN), Brussels, 25 November 2003, 14492/1/03 REV1, 15ff (English version).

132 ECOFIN minutes in 2546th meeting, 25 November 2003, 15ff. See also Heipertz and Verdun (n 6) 148.

133 ECOFIN minutes in 2546th meeting, 25 November 2003, 17, 20.

134 ECOFIN minutes in 2546th meeting, 25 November 2003, 17, 21.

135 ECOFIN minutes in 2546th meeting, 25 November 2003, 17, 21.

136 ECOFIN minutes in 2546th meeting, 25 November 2003, 17, 21.

137 On this 'blocking minority' see Heipertz and Verdun (n 6) 151.

138 Quoted in Bertrand Benoit and others, 'Sanctions deal leaves euro pact in tatters' *Financial Times* (26 November 2003). See also Heipertz and Verdun (n 6) 148.

it felt bullied and humiliated by the Council.[139] To underline its discontent with the course of events it had a statement inserted in the minutes of the Council meeting, saying:

> 'The Commission deeply regrets that the Council has not followed the spirit and the rules of the Treaty and the Stability and Growth Pact that were agreed unanimously by all Member States. Only a rule-based system can guarantee that commitments are enforced and that all Member States are treated equally. The Commission will continue to apply the Treaty and reserves the right to examine the implications of these Council conclusions and decide on possible subsequent actions.'[140]

Soon it became clear what kind of 'actions' the Commission had in mind: it took the Council to Court.

3.2 Testing public discipline in court

The Commission requested the Court to do two things.[141] It asked the Court to annul the decisions of the Council not to follow the Commission's recommendations under Articles 104(8) and 104(9) EC. And it sought annulment of the Council's conclusions to the extent that they held the excessive deficit procedures for France and Germany in abeyance, had recourse to an instrument not provided for by the Treaty and modified the Council's own recommendations under Article 104(7) EC. The Council, in turn, requested the Court to declare the action inadmissible.

The Court, sitting in full and acting under an expedited procedure, took a balanced approach to the politically delicate matter, acknowledging some of the Commission's grievances, but at the same time underlining the Council's discretion at crucial points of the excessive deficit procedure. It began by declaring the Commission's action inadmissible in as far as it concerned the annulment of the Council's inability to adopt the instruments set out in the Commission's recommendations.[142] The essence of the Court's reasoning was clear and simple:

> '[W]here the Commission recommends to the Council that it adopt decisions under Article 104(8) and (9) EC and the required majority is not achieved within the Council, no decision is taken for the purpose of that provision'.[143]

139 Bertrand Benoit and others, 'Sanctions deal leaves euro pact in tatters' (n 138).
140 ECOFIN minutes in 2546th meeting, 25 November 2003, 22. See also Heipertz and Verdun (n 6) 148.
141 Case C-27/04 *Commission v Council* [2004] EU:C:2004:436, para 22 (*SGP* case).
142 *SGP* case (n 141) para 36.
143 *SGP* case (n 141) para 31.

Consequently, there is no act that could give rise to an annulment action under Article 230 EC (now Art 263 TFEU).[144]

Yet, the Court supported this conclusion with another argument focusing on the fact that nowhere does Union law lay down 'a period on the expiry of which an implied decision under Articles 104(8) and 104(9) EC is deemed to arise…'.[145] It recognised that one of the aims of Regulation 1467/97, the corrective arm of the Pact, was to speed up the excessive deficit procedure by attaching time limits to its different stages,[146] but argued that their expiration does not preclude the Council from adopting the acts at a later point in time.[147] In fact, a 'lapse' of the Council's power to act on expiration of the deadline would run counter to the objective of speeding up the procedure as it would necessitate relaunching the procedure afresh.[148]

This part of the Court's reasoning may be strained. Whilst the conclusion that the expiration of deadlines set by the Pact, in its pre-crisis form,[149] did not lead to an implied decision is sound,[150] the purposive argument used in support of it is much less so.[151] Of course, and as Advocate General Tizzano noted in his View on the case, the political balance of power within the Council may change at short notice.[152] Those who find themselves in a minority position today can form a majority tomorrow. The expedience of the excessive deficit procedure would be negatively affected if due to such a brief lack of support the Council was to forego its power to adopt the act. But voting coalitions may equally well stay unchanged for long periods of time. Seen from that perspective, the purposive reasoning of the Court is rather cynical,

144 *SGP* case (n 141) paras 31, 34.

145 *SGP* case (n 141) para 32.

146 See in this regard text to n 365 (ch 3).

147 *SGP* case (n 141) para 33.

148 *SGP* case (n 141) para 33.

149 The system has changed significantly as a result of the amendments that have been introduced to the Pact since the crisis, in particular through the introduction of reversed majority voting. See text to n 224 (ch 5).

150 See in this regard the View of AG Tizzano which contrasts the situation under the excessive deficit procedure with the *Eurocoton* case (C-76/01P, ECLI:EU:C:2003:511) which dealt with the Council's failure to adopt a proposal for a Regulation imposing a definitive anti-dumping duty. In that case the Court found that the failure to act did form an implied decision as the applicable Reg (Art 6(9) Reg 384/96 [1996] OJ L 56/1, repealed by Reg 1125/2009 [2009] OJ L 343/51) determined that a failure to take a decision turned into a definitive Council position following lapse of the deadline. Reg 1467/97 did not contain such an arrangement. As a result, the Council could still adopt the instruments contained in the Commission recommendations under Arts 104(8) and 104(9) EC, even though the deadlines set out in the Pact's corrective arm had expired. See *SGP* case (n 141), View of AG Tizzano, paras 25, 35-47.

151 See also Imelda Maher, 'Economic policy coordination and the European Court: excessive deficits and ECOFIN discretion' (2004) 29 EL Rev 831, 836-837; Dimitrios Doukas, 'The Frailty of the Stability and Growth Pact and the European Court of Justice: Much Ado about Nothing?' (2005) 32 LIEI 293, 300-301.

152 *SGP* case (n 141), View of AG Tizzano, paras 44-45.

as it allows the Council to delay the excessive deficit procedure for a prolonged period of time just because of the mere possibility that its internal power balance may change.[153]

Having declared the action inadmissible in as far as it concerned the Council's failure to act, the Court turned to the Commission's second request: annulment of the conclusions. And contrary to the first, it considered this one admissible.[154] Basing itself on 'settled case law' that an action for annulment must be available in the case of all measures of institutions 'intended to have legal effects', the Court considered as essential the fact that the Council had made holding the excessive deficit procedures of France and Germany in abeyance conditional on compliance by these states with their own commitments.[155] As a result, the conclusions did not 'merely confirm' that the procedure was '*de facto* held in abeyance' due to the absence of the required majority of votes to adopt the acts recommended by the Commission under Articles 104(8) and 104(9) EC.[156] Holding the procedure in abeyance was now conditional on 'unilateral' commitments of France and Germany.[157] What is more, the Council thereby effectively changed the procedure's nature. Any decision of the Council to give notice on the basis of Article 104(9) EC would no longer have as point of departure its earlier recommendations under Article 104(7) EC, but these French and German commitments.[158] The Council's conclusions therefore 'in reality' even changed these previous recommendations as they postponed the deadline for the correction of excessive deficits with one year.[159]

On substance the Court found the conclusions to be unlawful, and consequently annulled them for two reasons that were strongly linked to its admissibility analysis. The first concerned the holding in abeyance of the excessive deficit procedure. This procedure, the Court reasoned, is exclusively governed by Article 104 EC (now Art 126 TFEU) and Regulation 1467/97. Consequently, either the procedure is *de facto* held in abeyance due to the absence of the required majority in the Council to adopt Commission recommendations, or it is held in abeyance on grounds mentioned in Regulation 1467/97.[160] The only grounds mentioned in this Regulation were action by the state concerned in compliance with a Council recommendation made under Article 104(7) EC or a notice issued by this institution on the basis of Article 104(9) EC.[161] Making the holding in abeyance of the procedure conditional

153 See also Doukas (n 151) 301.
154 *SGP* case (n 141) para 51.
155 *SGP* case (n 141) paras 46-47.
156 *SGP* case (n 141) para 47.
157 *SGP* case (n 141) paras 47-48.
158 *SGP* case (n 141) para 48.
159 *SGP* case (n 141) para 49.
160 *SGP* case (n 141) paras 84-86.
161 See Art 9(1) Reg 1467/97 (unamended).

on compliance by Germany and France with their unilateral commitments was a move unforeseen by the Regulation, and therefore unlawful.[162]

The second reason for annulling the conclusions related to the modifications made by them to previous recommendations of the Council under Article 104(7) EC. Building on its previous finding that the excessive deficit procedure is solely governed by Article 104 EC and the Pact's corrective arm, the Court pointed out that Article 104(13) EC indicates that recommendations under Article 104(7) EC could only be adopted on the basis of a Commission recommendation.[163] Once the Council has adopted such a recommendation it cannot subsequently modify them without a new recommendation of the Commission as this would run counter to the latter's right of initiative under the procedure.[164] Yet, this is precisely what the Council had done by unilaterally postponing the deadline for the correction of the excessive deficits of France and Germany.[165] Moreover, in doing so it had resorted to the wrong voting procedure, that in Article 104(9) EC which only allows members of the currency union to vote, whereas it should have used the one in Article 104(7) EC.[166]

3.3 Changing the Pact: flexibility versus discipline

By declaring the case partly inadmissible whilst at the same time annulling the Council's conclusions, the Court issued a 'Solomonic ruling' allowing both Commission and Council to claim triumph.[167] The Commission could point to the condemnation of the Council's decision to abandon the excessive deficit procedure by adopting its own 'conclusions' on the fiscal positions of France and Germany. Given the importance attached by the Court to sticking to the terms of the procedure, the Commission could even argue that the judgment had strengthened its position. It sits behind the steering wheel as every step of the Council is dependent on a previous step it has taken, without the ministers of finance being able to withdraw from this regime. However, if the

162 *SGP* case (n 141) paras 85, 87-89. The Court was quick to add in para 90 that by accepting that the excessive deficit procedure can *de facto* be held in abeyance it did not pronounce on whether the Council could be forced, on the basis of an action for failure to act under Article 232 EC (now Art 265 TFEU), to adopt a decision under Art 104(9) EC where a state 'persists in failing to put into practice recommendations under Article 104(7) EC…' It seems highly unlikely, however, that the Court could establish a failure to act given the discretion of the Council in making up its mind about a state's fiscal position and the underlying economic data, a fact also recognised by the Court itself in para 80. See also Doukas (n 151) 303-304.

163 *SGP* case (n 141) para 91.

164 *SGP* case (n 141) para 92.

165 *SGP* case (n 141) para 94.

166 *SGP* case (n 141) para 95.

167 'Solomonic ruling: The possibility of a sensible eurozone reform is preserved' *Financial Times* (14 July 2004). See also Maher (n 151) 831; Heipertz and Verdun (n 6) 162.

Commission is in charge of steering the wheel, the Council controls the pedals. The Court confirmed that the procedure can *de facto* be held in abeyance when the required majority in the Council for the adoption of an act is missing. This makes public discipline, in particular the imposition of sanctions, susceptible to political horse trading. Or to put it in the more carefully chosen words of the Court: '[R]esponsibility for making Member States observe budgetary discipline lies essentially with the Council'.[168]

To many, in particular those who are inclined to assess the Pact solely in terms of efficiency and discipline, it was this latter element of the judgment that really mattered. In their view, the Council came out of the dispute as the real winner.[169] But even if that is the case, the Court can hardly be blamed for it. Right from the start of the monetary union one realised that when things came to a crunch, it would be the Council pulling the strings. In fact, and as the previous chapter showed,[170] putting the Council in this position was a deliberate choice of the treaty drafters. If there is therefore one thing that the Court's judgment made clear, or rather reminded us of, it is that the Pact does not exist merely by the grace of its sanctioning mechanism. On the contrary, the Treaty system of public discipline functions best if its economic rationale is sound, making member states want to play by its rules.[171]

The Commission realised this all too well and consequently found itself being torn in two directions. It had challenged the Council before court in order to uphold the system's legal integrity, but knew that in their present form the fiscal rules would not work.[172] In fact, long before initiating legal proceedings, in the fall of 2002, its President Romano Prodi had called the Pact 'stupid' for seeking to squeeze all member states into the same fiscal straightjacket of keeping deficits below the 3% limit and reaching budgets that are in balance or surplus over the medium term.[173] The Court's judgment only made the Commission more convinced of the necessity of reform. But political room for reform was limited. Although most states were seeking a change in the Union's system of public discipline, they had little appetite in

168 *SGP* case (n 141) para 76.

169 An example of such a view is that of Wolfgang Münchau, according to whom 'the part of the judgment that really matters for economic policy is that European finance ministers can, in effect, do whatever they like. They can apply the rules or not'. See Wolfgang Münchau, 'A great chance for Europe to get its act together' *Financial Times* (19 July 2004).

170 See text to n 309 (ch 3).

171 Some even take the extreme view that the Union could do without the excessive deficit procedure in Art 126 TFEU and the Pact's corrective arm, focusing completely on 'soft' policy coordination through peer and public pressure. See Henrik Enderlein, 'Break it, Don't Fix it!' (2004) 42 JCMS 1039, 1044-1045.

172 Heipertz and Verdun (n 6) 155.

173 Quoted in George Parker, 'Euro rules 'stupid', says Prodi' *Financial Times* (18 October 2002). See also Heipertz and Verdun (n 6) 135.

a complete overhaul of its constitutional fundamentals.[174] What is more, at the intergovernmental conference on a Constitution for Europe, on which political agreement had been reached just months before the Court gave its interpretation of the excessive deficit procedure,[175] political leaders had left these fundamentals mostly untouched.[176] No wonder, therefore, that right after the Court's judgment, the Commission issued a statement in which it expressed only modest ambitions for reform, writing that it perceived the judgment as a confirmation to work on 'proposals for strengthening and clarifying the implementation of the Stability and Growth Pact…'.[177]

This strengthening and clarification came in the form of two Regulations amending the Pact's preventive and corrective arms.[178] Since the previous chapter has already discussed the Pact as it stood after its first amendment in 2005,[179] only the most notable changes will be highlighted here. Central to these changes, as the Council made clear in its report accompanying the amendments,[180] was the desire to 'enhance the economic underpinnings' of

174 See also Fabian Amtenbrink and Jakob de Haan, 'Reforming the Stability and Growth Pact' (2006) 31 EL Rev 402, 407-408; Jean-Victor Louis, 'The Review of the Stability and Growth Pact' (2006) 43 CML Rev 85, 85-86.

175 Political agreement on the final text was reached under the Irish presidency in June 2004. See European Council, Conclusions, Brussels, 17-18 June 2004, para 4. The constitution was signed by the member states on 29 October 2004 in Rome. Needless to say, however, it has never entered into force, not in the least due to the negative outcome of referenda on the constitution in France and the Netherlands.

176 For a thorough analysis of the changes the constitution would have introduced in the area of economic policy see René Smits, 'The European Constitution and EMU: An Appraisal' (2005) 42 CML Rev 425, 439-444. Most of these changes have eventually ended up in the Union Treaties through the Lisbon Treaty.

177 Commission, 'Statement on the Court of Justice ruling relating to the excessive deficit procedure' (IP/04/897, 13 July 2004). This phrase corresponds exactly to the one adopted by the intergovernmental conference on a Constitution for Europe, which calls on the Commission to introduce such proposals. See Declaration 17 on Article III-184 attached to the Treaty establishing a Constitution for Europe [2004] OJ C 310/01. For the document setting out the Commission's view on how to strengthen and clarify the Pact see Commission, 'Communication of 3 September 2004 to the Council and the European Parliament on strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' COM (2004) 581 final.

178 Council Regulation 1055/2005 of 27 June 2005 amending Regulation 1466/97 on the strengthening of the surveillance of budgetary position and the surveillance of and coordination of economic policies [2005] OJ L 174/1 (Reg 1055/2005); Council Regulation 1056/2005 of 27 June 2005 amending Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure [2005] OJ L 174/5 (Reg 1056/2005).

179 See text to n 334 (ch 3).

180 As the previous chapter noted, this report, adopted by the Ecofin Council in March 2005, also forms an integral part of the Pact. See text to n 335 (ch 3).

the Union's fiscal framework so as to 'strengthen credibility and enforcement'.[181] Clearly, the Court's judgment and the realisation that the Pact works best if member states support its rationale were resonating here.

As far as the Pact's preventive arm is concerned, three changes stood out.[182] The first addressed the desire to make the Pact more tailor-made.[183] Instead of requiring all member states to pursue the same medium-term objective, the Pact now determined that each state should have its own target, stretching between close to balance or in surplus. For states participating in the currency union or in the second Exchange Rate Mechanism this objective was further defined as ranging 'between -1% of GDP and balance or surplus',[184] the idea being that member states with modest debts and high growth would be allowed to run budgets closer to the lower bound whereas those with weaker records should aim for the higher end.[185] Importantly, the objective was defined in 'cyclically adjusted terms' in order to avoid that states, as they did in the years following the launch of the euro,[186] would use 'one-off measures' to bring down their budgets without improving them structurally.[187]

The second change related to the adjustment path towards the medium-term objective. In its original form, the Pact's preventive arm had left undefined how states were to reach their targets, which had enabled them to procrastinate with adjustment efforts. Since its amendment in 2005 it made clear that members of the currency area or the second Exchange Rate Mechanism had to ensure, as a minimum, a yearly adjustment in structural terms of '0.5% of GDP as a benchmark'.[188] They were expected, however, to achieve a 'higher adjustment' in good times so as to prevent pro-cyclicality.[189] A deviation from the adjustment path, and this leads to the third change, was possible, provided that it was due to 'structural reforms', still allowed a state's budgetary position to return to the objective within the period covered by the programme and kept a 'safety margin' from the limit of 3% of GDP.[190] More-

181 Council report to the European Council, *Improving the implementation of the Stability and Growth Pact*, Brussels, 21 March 2005, 7423/05, 3 (Council report of 21 March 2005 on improving the Pact).
182 See also Heipertz and Verdun (n 6) 167-168.
183 Amtenbrink and De Haan, 'Reforming the Stability and Growth Pact' (n 174) 408; Louis (n 174) 92.
184 Art 2a Reg 1466/97, as amended by Reg 1055/2005.
185 Council report of 21 March 2005 on improving the Pact (n 181) 9.
186 See also text to n 94 (ch 4).
187 See also Amtenbrink and De Haan, 'Reforming the Stability and Growth Pact' (n 174) 410.
188 Arts 5(1) and 9(1) Reg 1466/97, as amended by Reg 1055/2005.
189 Arts 5(1) and 9(1) Reg 1466/97, as amended by Reg 1055/2005. See also Council report of 21 March 2005 on improving the Pact (n 181) 10-11; Amtenbrink and De Haan, 'Reforming the Stability and Growth Pact' (n 174) 408; Louis (n 174) 93.
190 Arts 5(1) and 9(1) Reg 1466/97, as amended by Reg 1055/2005.

over, these reforms had to be such that they would improve a state's fiscal position in the long run.[191]

Changes to the corrective arm were more eye-catching, which is not very surprising given that this part of the Pact had caused most political stir. They all reflected the changed political perception of the Pact. Telling is the description of the procedure's purpose given by the Council in its report on the Pact's reform. In sheer contrast to the intentions of the Pact's originator, Theo Waigel,[192] this purpose was 'to *assist* rather than to *punish*' by creating 'incentives' for fiscal discipline.[193] The notion of assistance now used in tandem with that of discipline, some of the most profound changes to the Pact's corrective arm led to a significant easing of fiscal rigour.[194]

Take the definition in Article 126(2)(a) TFEU of an 'exceptional and temporary' budgetary excess over the 3% limit, allowing member states to avoid becoming subject to the excessive deficit procedure. In its original form, the Pact's corrective arm had stated that an excess could be considered exceptional when it resulted from a 'severe economic downturn' in the form of 'an annual fall of real GDP of at least 2%'.[195] States could show that a fall of less than 2% was also exceptional 'in light of supporting evidence',[196] yet in the political Resolution on the Pact they had committed themselves not to make use of this possibility if it was below 0.75% of GDP.[197] After all that had happened with France and Germany, however, the Council considered this arrangement 'too restrictive'.[198] As a result, it changed it to the effect that any 'negative growth rate' could now form a severe downturn.[199] Even an 'accumulated loss of output during a protracted period of very low growth relative to its potential' could do so.[200]

An easing of pressure also occurred through clarifying the 'other relevant factors' which Article 126(3) TFEU requires the Commission to take into account when drawing up its report on the existence of an excessive deficit. Originally, the Pact's corrective arm had left these factors undefined. Yet, as a follow-up to his demand that the Pact should secure a better balance between growth and stability,[201] Chancellor Schröder argued that the provision should be

191 Arts 5(1) and 9(1) Reg 1466/97, as amended by Reg 1055/2005. Structural reforms are not only taken into account for states that deviate from their adjustment path, but also for those that have already achieved it and temporarily backtrack from it.
192 See text to n 314 (ch 3).
193 Council report of 21 March 2005 on improving the Pact (n 181) 12 (emphasis added).
194 For an overview see also Heipertz and Verdun (n 6) 168-169.
195 Arts 2(1) and 2(2) Reg 1467/97 (unamended)
196 Art 2(3) Reg 1467/97 (unamended).
197 See text to n 362 (ch 3).
198 Council report of 21 March 2005 on improving the Pact (n 181) 14.
199 Art 2(2) Reg 1467/97, as amended by Reg 1056/2005.
200 Art 2(2) of Reg 1467/97, as amended by Reg 1056/2005.
201 See text to n 118 (ch 4).

operationalised. States with deficits exceeding the 3% limit, he wrote in an opinion piece in the *Financial Times* in the run-up to the Pact's reform, should escape the excessive deficit procedure if the excess was due to policies promoting growth and employment.[202] More specifically, the Commission should turn a blind eye to deficits caused by expenses related to i) social security, labour market and tax reforms as well as research and development, ii) cyclical incentives and iii) the promotion of solidarity within and between member states, in particular German reunification.[203] Being convinced that 'The pact will work better if intervention by European institutions in the budgetary sovereignty of national parliaments is only permitted under very limited conditions',[204] the chancellor argued that a member state fulfilling these criteria should be able to decide on its own when and 'how to bring its deficit ratio below 3 per cent'.[205]

The Pact's amended corrective arm paid considerable tribute to Schröder's proposal. When drawing up its report under Article 126(3) TFEU, the Commission had to take into account a host of factors broadly corresponding to the chancellor's list.[206] What is more, it had to pay due consideration to 'any other factors' which the state in question considered 'relevant' for assessing the transgression of the 3% limit.[207] These factors should also be taken into account in all other steps of the excessive deficit procedure, except for the Council's decision on the basis of Article 126(12) TFEU to abrogate all are some of its decisions taken.[208] The difference with the chancellor's proposal, however, lay in the fact that these factors did not amount to 'block exemptions' to be deducted from a state's deficit before deciding whether or not it was excessive.[209] Only after having established that a state's deficit was 'exceptional and temporary' and stayed 'close to the reference value' within the meaning of Article 126(2)(a) TFEU, could the Council take them into account when deciding on the existence of an excessive deficit on the basis of Article 126(6) TFEU.[210] This made the arrangement less permissive of growth and employment than Schröder had hoped for.

The third notable change to the Pact's corrective arm concerned the issue of deadlines. Before its amendment, the Pact's corrective arm had required that excessive deficits should be corrected in the year following their identifica-

202 Gerhard Schröder, 'A Framework for a Stable Europe' *Financial Times* (17 January 2005). See also Louis (n 174) 95-96.
203 Schröder (n 202).
204 Schröder (n 202).
205 Schröder (n 202).
206 Art 2(3) Reg 1467/97, as amended by Reg 1056/2005.
207 Art 2(3) Reg 1467/97, as amended by Reg 1056/2005.
208 Arts 2(4) and 2(6) Reg 1467/97, as amended by Reg 1056/2005.
209 Louis (n 174) 97. See also Heipertz and Verdun (n 6) 169.
210 Art 2(4) Reg 1467/97, as amended by Reg 1056/2005; Council report of 21 March 2005 on improving the Pact (n 181) 15.

tion by the Council under Article 126(6) TFEU, unless there were special circumstances.[211] More specifically, 10 months could pass between identification and rectification.[212] After the changes to the Pact in 2005, a state was in principle still required to bring its deficit under the red line of 3% in the following year, yet the period that could lapse between identification and correction had been extended to 16 months.[213] Moreover, a state had to achieve a minimum annual structural improvement of 0.5% of GDP so as to facilitate correction of the excessive deficit within the deadline set by the Council.[214] Yet, if despite having taken effective action it failed to meet the deadline due to 'unexpected adverse economic events', the Council could, depending on the stage of the procedure, issue a revised recommendation or notice extending the deadline by one year.[215] The Pact here clearly came to terms with the Court's judgment that the Council had the power to hold the excessive deficit procedure *de facto* in abeyance.[216] It was better to have the Council extending deadlines within the confines of the procedure, instead of forcing a stand-still or even another adventure outside its boundaries.

Did the amended Pact fare any better? Again, it is hard to answer such a question regarding effectiveness,[217] yet it is fair to say that views on the Pact after its first amendment in 2005 were not undividedly positive. Jürgen Stark, former member of the European Central Bank's Executive Board, argued together with several other economists that its implementation was 'lenient' and that member states made 'little further progress towards sound public finances…', leaving them ill-prepared for the crisis.[218] And judging by the number of member states that were subject to an excessive deficit procedure by the end of 2010 – 26 out of (then) 27 – it is hard to disagree with them.[219] No surprise, therefore, that many of the post-crisis structural reforms to the legal framework underpinning the single currency focus on strengthening the instrument of public discipline. As this study will show in chapter 5,[220] several of the key reforms of this instrument concern the introduction of voting arrangements that aim to prevent a reoccurrence of the French and German

211 Art 3(4) Reg 1467/97 (unamended).
212 Louis (n 174) 99. See also text to n 365 (ch 3).
213 Art 7 Reg 1467/97, as amended by Reg 1056/2005.
214 Arts 3(4) and 5(1) Reg 1467/97, as amended by Reg 1056/2005.
215 Arts 3(5) and 5(2) Reg 1467/97, as amended by Reg 1056/2005.
216 Heipertz and Verdun (n 6) 169.
217 See text to n 103 (ch 4).
218 See Schuknecht and others (n 78) 10-11.
219 An overview of all ongoing and closed excessive deficit procedures can be found at the site of the Commission's DG ECFIN. See <ec.europa.eu/info/departments/economic-and-financial-affairs_en>.
220 See text to n 224 (ch 5).

fiscal saga by making sure that the excessive deficit procedure can no longer *de facto* be halted due to a shortage of votes in the Council.

At the same time, however, it would be wrong to think that the debt crisis is solely due to lenient fiscal policies of member states and that future crises could simply be prevented by tightening the fiscal rules. Certainly, Greece's problems, which triggered the crisis, are to a large extent due to fiscal negligence and a persistent fiddling with budgetary data. But this cannot be said of all states that have fallen victim to the markets. They were certainly also struggling with worrying fiscal problems, but these problems did not necessarily have public roots. They were private too.

4 THE FIXATION ON FISCAL POLICY

4.1 The private roots of fiscal problems

Understanding the private roots of sovereign fiscal problems and their relation to Union law requires a return to the key driving forces behind the single currency's original legal set-up. The previous chapter explained how a swing towards monetarism as well as Germany's strong negotiating position contributed to the currency's modest set-up in terms of economic policy, especially outside the fiscal sphere.[221] As a result of these two forces teaming up, the Union received only few economic competences in Article 121 TFEU, allowing it to steer national policies through broad guidelines, early warnings and recommendations, but falling short of having a real policy of its own. This limited armoury was, moreover, not put to full use at the level of secondary law. Whereas the multilateral surveillance procedure in Articles 121(3)-(4) TFEU may in principle cover a range of economic issues, the Union legislator chose to largely focus it on fiscal policy. Set out in the Pact's preventive arm, the procedure originally aimed first and foremost at the prevention of excessive deficits, pushing other issues to the background.

Doubts already existed before the launch of the single currency as to whether this set-up would suffice to guarantee the currency union's viability. An issue of particular concern was whether the Union would manage to ensure a sufficient degree of convergence of national economies. Although Article 121(3) TFEU pays tribute to convergence, just as the Pact's preventive arm in its pre-crisis state,[222] it was seriously questioned whether the instrument of multilateral surveillance would suffice to bring differing national economies

221 See text to n 224 (ch 3).

222 See eg Recital 11 Reg 1466/97, as amended by Reg 1055/2005. It goes without saying that for states outside the currency union, in particular those with a derogation, achieving a sufficient degree of convergence is a primary objective of the multilateral surveillance procedure, which also shows in the fact that they have to submit 'convergence programmes'.

into line. These concerns only increased once the currency union had taken off. Contrary to the view of many specialists that only a limited group of states – say Germany, the Netherlands, Austria, France, Luxembourg, Finland, and Belgium[223] – was fit for sharing a currency, from all those willing to join only Greece did not make it to the first group. All others had managed, in the view of the Council, to comply with the convergence criteria and consequently joined the currency union right from the start. Greece then followed just two years later, in 2001. Even if the optimality of a currency union is a highly theoretical question, few would argue that the euro area was close to optimum with this composition.[224]

Why was convergence attributed such importance? One reason relates to the risk of a 'one-size-fits-all' monetary policy.[225] In a currency union with greatly differing national economies the central bank may be unable to cater for the needs of participating members. This may particularly occur when these members have diverging inflation rates.[226] In such a situation the central bank's uniform policy may translate into different real interest rates – the nominal interest rate minus inflation – across the currency union, which could set off diverging developments. Fear of such developments was an important argument for the United Kingdom not to join the currency union. In fact, Thatcher's chief economic advisor, Alan Walters, had already used it to discourage his prime minister from allowing the pound to enter the Exchange Rate Mechanism. In his book *Sterling in Danger* he describes the essence of his fear in clear, simple terms:

> '[T]he EMS forces countries to have the same nominal interest rates. If, however, Italy is inflating at a rate of 7 per cent and Germany at a rate of 2 per cent……then there is a problem of perversity. With the same interest rate at, say, 5 per cent, the *real* rate of interest for Italy is *minus* 2 per cent and for Germany *plus* 3 per cent. Thus Italy will have an expansionary monetary policy while Germany will pursue one of restraint. But this will exacerbate inflation in Italy and yet restrain further the already low inflation in Germany. This is the opposite of "convergence", namely, it induces divergence.'[227]

In other words, Walters feared that a uniform policy rate would cause states with relatively high rates of inflation to experience a lower real interest rate,

223 See eg Barry Eichengreen, 'European Monetary Integration with Benefit of Hindsight' (2012) 50 JCMS 123, 124-125.

224 See also Jean Pisany-Ferry, 'The Known Unknowns and Unknown Unknowns of EMU' (Bruegel Policy Contribution No 18, October 2012) 2: 'The first thing everyone knew was that the countries participating in the monetary union were no siblings'.

225 Pisani-Ferry, 'The Known Unknowns and Unknown Unknowns' (n 224) 2. See also Eichengreen (n 223) 124, 126-127.

226 Eichengreen (n 223) 127.

227 Alan A Walters, *Sterling in Danger: The Economic Consequences of Pegged Exchange Rates* (FONTANA/Collins 1990) 79-80.

in turn triggering 'pro-cyclical' policies, spending booms and even higher inflation.[228]

Did these fears indeed materialise? They did in as far as following the euro's introduction member states in the currency union's periphery did indeed experience a significant decline in their real interest rates.[229] This led to a massive expansion of lending to the private sector, spurring the build-up of debt in this corner of the economy.[230] The story of Spain and Ireland is particularly interesting. In both member states 'domestic' banks – relying considerably on foreign funds, thereby contributing to growing current account imbalances – greatly expanded their extension of financing to private operators, fuelling 'construction booms' and 'housing bubbles'.[231] With the onset of the financial crisis, these bubbles burst. All of a sudden banks had to take significant losses, even to such an extent that governments had to step in with state guarantees and recapitalisation measures.[232] In combination with a recession setting in, this led to plunging fiscal positions. Between 2007 and 2010 Spain saw its budgetary surplus of 2% of GDP transforming into a deficit of 9.4%.[233] Ireland's situation is even more shocking. Whereas it still ran a surplus of 0.2% in 2007, its budget noted a sky-rocketing deficit of 32.4% in 2010. Its debt position met with a similar fate over the same period, going up from just 24% of GDP to 87.4%.[234]

All this reveals an important blind spot of the single currency's original set-up. Treaty drafters were right in trying to prevent member states from building up unsustainable fiscal positions, but they were wrong in thinking

228 Pisani-Ferry, 'The Known Unknowns and Unknown Unknowns' (n 224) 2. See also Francesco P Mongelli and Charles Wyplosz, 'The euro at ten: unfulfilled threats and unexpected challenges' in Bartosz Maækowiak and others (eds), *The Euro at Ten: Lessons and Challenges* (Fifth ECB Central Banking Conference, Frankfurt, 2009) 39.

229 Pisani-Ferry, 'The Known Unknowns and Unknown Unknowns' (n 224) 3. For a detailed analysis of the extent to which Walters' fear has materialised see Mongelli and Wyplosz (n 228) 39-41, 44-50.

230 Pisani-Ferry, 'The Known Unknowns and Unknown Unknowns' (n 224) 3.

231 Francesco Giavazzi and Luigi Spaventa, 'Why the current account may matter in a monetary union: lessons from the financial crisis in the euro area' in Miroslav Beblavý, David Cobham and L'udovít Ódor (eds), *The Euro Area and the Financial Crisis* (CUP 2011) 211-216. See also Zsolt Darvas, 'The Euro Crisis: Ten Roots, but Fewer Solutions' (Bruegel Policy Contribution No 17, October 2012) 3-4.

232 For specific analyses of the crisis in Ireland and Spain see Philip R Lane, 'The Irish crisis' in Miroslav Beblavý, David Cobham and L'udovít Ódor (eds), *The Euro Area and the Financial Crisis* (CUP 2011) 59; Angel Gavilán and others, 'The crisis in Spain: origin and developments' in Miroslav Beblavý, David Cobham and L'udovít Ódor (eds), *The Euro Area and the Financial Crisis* (CUP 2011) 81.

233 These figures have been obtained from Eurostat. See <ec.europa.eu/eurostat/web/main/home>.

234 These figures have been obtained from Eurostat. See <ec.europa.eu/eurostat/web/main/home>.

that such positions always have public 'roots'.[235] The case of Ireland and Spain shows how states that are best performers in terms of fiscal policy can very abruptly suffer from indebtedness when they have to take responsibility for private sector problems. Neither primary law nor the Pact provided the necessary tools to deal with such 'contingent liabilities' stemming from macroeconomic imbalances outside the realm of fiscal policy.[236]

4.2 The stifling embrace between states and banks

The sudden reversal of fiscal positions points to an even more severe problem. Despite states forming part of a currency union, their bonds are still largely held by 'domestic banks'.[237] After the launch of the single currency bond holdings certainly diversified, but banks kept investing in bonds of their own state to a significant extent.[238] After the start of the financial crisis this 'home bias' only intensified, especially in peripheral states, as foreign banks disposed of the bonds of these states, which in turn passed into the hands of domestic ones.[239]

The resulting picture, then, is one of banks and states holding each other in a suffocating 'embrace'.[240] Given that the onus of saving banks rested on the states in whose 'jurisdiction' they were located,[241] and that these states often had no choice but to do so when the ailing banks were considered 'too big to fail',[242] their fiscal position could quickly take a horrifying turn for the worse.[243] Banks, on their part, could suffer brutally too due to their 'sovereign exposure'.[244] Having invested considerably in their own state's bonds, a rise in the 'risk premium' for these securities could seriously harm their own operations.[245] This, in turn, caused them to scale down their provision of liquidity to other banks, which further upset the banking sector.[246]

---

235 Darvas (n 231) 3-4.
236 Marco Buti and Nicolas Carnot, 'The EMU Debt Crisis: Early Lessons and Reforms' (2012) 50 JCMS 899, 903-905.
237 Jean Pisani-Ferry, 'The Euro Crisis and the New Impossible Trinity' (Bruegel Policy Contribution No 1, January 2012) 6-7.
238 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 7.
239 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 7. See also Hans Geeroms, Stefaan Ide and Frank Naert, *The European Union and the Euro: How to Deal with a Currency Built on Dreams* (Intersentia 2014) 172-173.
240 Geeroms, Ide and Naert (n 239) 172.
241 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 6.
242 Geeroms, Ide and Naert (n 239) 173-174.
243 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 6.
244 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 7.
245 Gros (n 53) 39. See also text to n 73 (ch 4).
246 Gros (n 53) 39.

As it turned out, the substantial current account imbalances and the 'vicious circle' between states and banks together created a toxic cocktail with the capacity to deprive entire states – public and private entities alike – from financing.[247] Uncertainty about the solvency of governments (Greece) could 'spill over' to their banking sectors and vice versa (Ireland, Spain),[248] eventually culminating in enormous 'flights' of capital, called 'sudden stops', and huge threats to financial stability.[249]

Whereas one may criticise treaty drafters for leaving the currency union ill-equipped to deal with solvency risks stemming from private sector imbalances, one can hardly blame them for having failed to anticipate the spectacular breakdown of capital movements during the crisis.[250] The prevailing opinion was that these sudden capital flights usually occur in balance of payments crises, characterised by foreign investors pulling out funds when they start panicking about the amount of debt piling up in a state, and that such crises could no longer take place in a currency union.[251] With a single currency, so one thought, any creditworthy entity would be able to obtain financing, no matter its location.[252]

A look at some of the key documents on European monetary integration suffices to see how strongly entrenched this idea was among policy-makers and economists.[253] The Werner Report, paving the way for Europe's first attempt at achieving a single currency, stated that with the advent of a currency union 'only the global balance of payments of the Community vis-à-vis the outside world is of any importance'.[254] Twenty years later, minds had not changed much. In its *One Market, One Money* report the Commission similarly reasoned that 'A major effect of EMU is that balance of payments will disappear in the way they are experienced in international relations. Private markets will finance all viable borrowers…'.[255] No wonder, therefore, that with the start of the third stage of monetary union only member states outside the currency union could still qualify for balance of payments assistance under

247 Pisani-Ferry, 'The Known Unknowns and Unknown Unknowns' (n 224) 5-6. The notion 'vicious circle' is used by Pisany-Ferry in other publications. See eg Pisani-Ferry, 'The New Impossible Trinity' (n 237) 10.

248 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 10.

249 For analysis of capital 'flight' and 'sudden stops' see Sylvia Merler and Jean Pisani-Ferry, 'Sudden Stops in the Euro Area' (Bruegel Policy Contribution No 6, March 2012).

250 Pisani-Ferry, 'The Known Unknowns and Unknown Unknowns' (n 224) 6.

251 Merler and Pisani-Ferry (n 249) 2-3.

252 Benedicta Marzinotto, Jean Pisani-Ferry and André Sapir, 'Two Crises, Two Responses' (Bruegel Policy Brief No 1, March 2010) 5; Giavazzi and Spaventa (n 231) 202, 208; Merler and Pisani-Ferry (n 249) 2.

253 See also Marzinotto, Pisani-Ferry and Sapir (n 252) 5; Merler and Pisani-Ferry (n 249) 2.

254 Werner Group, *Report to the Council and the Commission on the realization by stages of Economic and Monetary Union in the Community* (Luxembourg 8 October 1970) 10.

255 Commission, *One Market, one money: An evaluation of the potential benefits and costs of forming an economic and monetary union* (DG ECFIN, October 1990) 24.

Article 143(2) TFEU.[256] No one simply imagined that states sharing a currency could experience similar capital flights.[257]

This leads to the fourth and final flaw in the single currency's original set-up: its limited reading of *stability* as an objective and the resulting absence of adequate insurance mechanisms to take on crises.

5 The narrow reading of stability

5.1 Financial stability and the lender of last resort

The fourth, and last, pitfall of the single currency's original set-up, in particular its economic branch, follows on from the previous ones and ties them all together. Strongly focused on safeguarding price stability, the system lacked the instruments to fight a debt crisis once it occurred. Inspired by the idea that the stability of the currency union would be guaranteed as long as member states displayed fiscal prudence, it left the Union ill-equipped to deal with the system being hit by any calamity. Paul De Grauwe explains it as follows:

> 'The official doctrine in the Eurozone has been that an insurance mechanism is not necessary for a smooth functioning of the Eurozone ... just make sure that countries abide by the rules. If they do so, i.e. if they are always well-behaved, there is no need for an automatic insurance mechanism provided by a centralized budget, or by a European Monetary Fund. This is like saying that if people follow the fire code regulations scrupulously there is no need for a fire brigade. The truth is that there will always be some people who do not follow the rules scrupulously, making a fire brigade necessary.'[258]

In other words, the system put almost all its eggs into the basket of prevention and consequently lacked the means to deal with situations in which prevention failed. The debt crisis shows the short-sightedness of this policy set-up in two

256 See also text to n 458 (ch 3).

257 The unwinding of capital flows became very visible in TARGET2, the Eurosystem's settlement instrument for payments in euros, which operates through the ECB and national central banks. Due to the fact that the interbank market became dysfunctional as investors became increasingly sceptical about investing in certain parts of the currency union, there was a huge increase in TARGET liabilities and corresponding claims of national central banks. This shows the importance of the ECB's enhanced liquidity provision to the banking system (see text to n 22 (prologue) and n 326 (ch 4)). If it had not been for the ECB's decisive action, the consequences of this massive capital flight would have been disastrous. For an extensive analysis of TARGET balances during the crisis see Philippine Cour-Thimann, 'Target balances and the crisis in the euro area' (April 2013) 14 CESifo Forum Special Issue 5.

258 Paul De Grauwe, 'Fighting the wrong enemy' (*Vox*, 19 May 2010) <voxeu.org/article/europe-s-private-versus-public-debt-problem-fighting-wrong-enemy> accessed 6 April 2017.

ways. The first has already been extensively discussed and concerns the idea that states always play by the fiscal rules. Greece's case showed the foolishness of this view during the crisis, just as Germany's and France's had already done much earlier. The second reason is even more profound and touches upon the system's very essence. In its desire to safeguard price stability, it left another stability dangerously exposed: *financial* stability.

In general terms, financial stability relates to the stability of the financial system, whose 'main task is to channel funds from sectors that have a surplus to sectors that have a shortage of funds'.[259] This system, in turn, consists of all 'financial intermediaries and financial markets and their relations with respect to the flow of funds to and from households, governments, business firms, and foreigners'.[260] Giving a specific definition, however, is very difficult. Unlike price stability, which the European Central Bank has defined as a rate of inflation of below, but close to 2% over the medium term,[261] financial stability cannot easily be captured in a standard measure or phrase.[262] It is for this reason that economists often prefer to define the notion negatively by identifying situations of its absence. Illustrative is the following remark by the economist Tommaso Padoa-Schioppa, made at the time he served on the Bank's Executive Board:

> 'While monetary stability simply means price stability, no such straightforward definition exists for financial stability. Defining financial stability is notoriously difficult and that is why people find it more convenient to define financial *in*stability.'[263]

Central to many definitions of financial instability is the notion of 'systemic risk', which the G10 has defined as 'the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainties about, a substantial proportion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy'.[264]

259 Jakob de Haan, Sander Oosterloo and Dirk Schoenmaker, *Financial Markets and Institutions: A European Perspective* (2nd ed, CUP 2012) 5.

260 De Haan, Oosterloo and Schoenmaker (n 259) 33.

261 See also text to n 205 (ch 3).

262 Jakob de Haan, Sander Oosterloo and Dirk Schoenmaker (n 259) 405 state in this regard that 'threats to financial stability are often surrounded by major uncertainty and are therefore difficult to capture in a quantitative analysis'.

263 Tommaso Padoa-Schioppa, 'Central Banks and Financial Stability' (Speech given in Jakarta, 7 July 2003) (emphasis added).

264 Group of Ten, *Report on Consolidation in the Financial Sector* (January 2001) 126. See also De Haan, Oosterloo and Schoenmaker (n 259) 394; Sylvester Eijffinger, 'Defining and Measuring Systemic Risk' in Syvester Eijffinger and Donato Masciandaro (eds), *Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis* (Edward Elgar 2011) 316-317.

Without such risks the financial system is presumed 'stable', which means that it has the ability to absorb 'shocks' that could otherwise have a negative impact on its ability to channel 'savings to profitable investment opportunities'.[265]

Opting for a negative definition of financial stability is not simply a language game. On the contrary, it has important consequences for the instruments needed to protect financial stability and therefore ultimately for the law. Due to the fact that financial stability is best understood by focusing on risks to it, it is hard to protect it merely through prohibitions requiring authorities and private entities to refrain from certain behaviour. There can be many situations in which financial stability can be at risk, and preventing them *ex ante* through all-encompassing prohibitions is extremely difficult, if not impossible.[266] In addition, combating risks that have already materialised often requires *action*.

A doctrine from which this becomes clearly apparent is that of 'lender of last resort'. This doctrine is an old one, dating back to the 19th century when it was extensively discussed by Walter Bagehot. In his book *Lombard Street* Bagehot sheds his light on the world of finance and banking.[267] He argues that in a liquidity crisis, characterised by an acute shortage of funds, the onus is on the central bank to secure the stability of the financial system by acting as lender of last resort. The classic, straightforward example of such a crisis concerns a 'bank run'.[268] Traditionally, a bank's assets usually consist of loans that are not 'readily marketable', whilst their liabilities are made up of deposits that can be withdrawn by customers at the blink of an eye.[269] In normal times

265 De Haan, Oosterloo and Schoenmaker (n 259) 394-395 (reference omitted). It is precisely the prevention and mitigation of such risks to financial stability that form the essence of the mission entrusted to Europe's macro-prudential watchdog that has been established in response to the financial crisis of 2007/8: the European Systemic Risk Board (ESRB). See Art 3(1) of Regulation (EU) 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L 331/1.

266 For an overview of indicators of systemic risk see De Haan, Oosterloo and Schoenmaker (n 259) 400-407.

267 Walter Bagehot, *Lombard street: a description of the money market* (London 1875). Bagehot was, however, not the first to introduce the doctrine. This honour falls to Henry Thornton, who discussed it in his book *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* of 1802. See also Charles Goodhart, 'Myths About the Lender of Last Resort' in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort: A Reader* (OUP 2002) 227-228.

268 For a detailed analysis of the underlying dynamic of 'bank runs' see Douglas W Diamond and Philip H Dybvig, 'Bank Runs, Deposit Insurance and Liquidity' (1983) 91 Journal of Political Economy 401.

269 Xavier Freixas and others, 'Lender of Last Resort: A Review of the Literature' in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort: A Reader* (OUP 2002) 28.

this 'maturity mismatch' is of no concern as depositors will not demand their money back all at once.[270] During a crisis, however, things are different. Since depositors realise that if others ask their money back at an early stage the bank may not be able to pay out all of them, they rush to the bank to get their money out first.[271] Any exogenous shock can create such panic, which can get even solid banks into serious trouble.[272]

The 'classical position' on the lender of last resort prescribes that in such crisis situations a central bank needs to step in as follows.[273] It should prevent the collapse of 'temporarily illiquid but solvent banks' by granting them short-term liquidity support.[274] Moreover, it should indicate beforehand that it is prepared to do this.[275] Any bank that can provide 'good collateral, valued at pre-panic prices', should qualify for the support.[276] In order to prevent moral hazard – profiteering from insurance paid by others – the central bank should only lend at a 'penalty rate'.[277] Finally, it operates as a lender of last resort out of its responsibility for the financial system as a whole, not to protect individual banks.[278] This means that it should particularly act when the failure of an illiquid bank carries the risk of contaminating others, thereby upsetting the financial system at large.[279]

Bagehot's views have significantly influenced central banking practice, even though they have been debated and modified considerably over time, on two counts notably. The first concerns the requirement that only solvent institutions should be helped out. This is not always followed in modern practice. The urgency surrounding last resort operations often makes it very hard to decide on-the-spot whether a bank is merely illiquid or insolvent.[280] Moreover, with today's sophisticated interbank markets, a bank usually faces a liquidity shortage when other funding channels have already closed, which shows that it is at least considered insolvent by other market participants.[281] Yet if insol-

---

270 Kleopatra Nikolaou, 'Liquidity Risk Concepts: Definitions and Interactions' (ECB Working Paper Series No 1008, February 2009) 24-25.
271 Freixas and others (n 269) 28-29.
272 Freixas and others (n 269) 29.
273 Michael D Bordo, 'The Lender of Last Resort: Alternative Views and Historical Experience' in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort: A Reader* (OUP 2002) 111-112. See also Rosa M Lastra, 'Lender of Last Resort, an International Perspective' (1999) 49 ICLQ 340, 341-342; Freixas and others (n 269) 27.
274 Lastra, 'Lender of Last Resort' (n 273) 342.
275 Lastra, 'Lender of Last Resort' (n 273) 342.
276 Lastra, 'Lender of Last Resort' (n 273) 342.
277 Lastra, 'Lender of Last Resort' (n 273) 342.
278 Lastra, 'Lender of Last Resort' (n 273) 342.
279 Lastra, 'Lender of Last Resort' (n 273) 342.
280 Lastra, 'Lender of Last Resort' (n 273) 346-347; Freixas and others (n 269) 36-37.
281 Charles Goodhart and Dirk Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision Be Separated?' (1995) 47 Oxford Economic Papers 539, 548-549; Lastra, 'Lender of Last Resort' (n 273) 346.

vent, it may still pose a contagion risk to the financial system as a whole. In such a situation it therefore falls on the central bank to balance the benefits of granting assistance for financial stability at the cost of helping out a failing bank.[282]

A second issue surrounding the lender of last resort concerns the question of whether its operations should only target the market in its entirety, via open market operations using general monetary policy instruments, or could also focus on specific institutions.[283] Those adhering to the first view, argue that the lender of last resort should step in particularly when the interbank market faces a general liquidity crisis.[284] They contend that this market operates with such precision that it will channel the injected liquidity to banks in need.[285] Others, however, consider that a central bank should also be in a position to extend credit to specific institutions.[286] Due to market deficiencies, general injections of liquidity may not reach distressed banks, necessitating targeted lending operations.[287] In fact, as systemic liquidity injections take place via normal monetary policy operations, making it very difficult to determine whether they pursue a strictly monetary purpose or provide last resort support, some argue that only lending to specific banks should qualify as last resort action.[288]

Despite the fact that being a lender of last resort is nowadays considered one of the key responsibilities of a central bank, the Union Treaties are silent about the issue. In fact, they hardly attribute the European Central Bank with any responsibility for financial stability at all.

5.2 The search for a lender of last resort for banks ...

'[P]rice and financial stability', Dirk Schoenmaker argues, 'are equally important and affect the economy at large'.[289] What is more: they are connected,

282 Goodhart and Schoenmaker (n 281) 548-549; Lastra, 'Lender of Last Resort' (n 273) 346-347; Freixas and others (n 269) 37-38.

283 Freixas and others (n 269) 35-37; George G Kaufman, 'Lender of Last Resort: A Contemporary Perspective' in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort: A Reader* (OUP 2002) 180-181.

284 Marvin Goodfriend and Robert G King, 'Financial Deregulation, Monetary Policy, and Central Banking (excerpts)' in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort: A Reader* (OUP 2002) 153-156, 158-159.

285 Goodfriend and King (n 284) 155, 158-159.

286 See Freixas and others (n 269) 36-37.

287 Freixas and others (n 269) 36.

288 See eg Goodhart (n 267) 230-231.

289 Dirk Schoenmaker, 'Central Banks Role in Financial Stability' in Gerard Caprio Jr (ed), *Handbook of Safeguarding Global Financial Stability: Political, Social, Cultural and Economic Theories and Models, Vol 2* (Elsevier 2013) 273.

as monetary policy may have an impact on financial stability and vice-versa.[290] Yet, before the debt crisis financial stability clearly lost out to price stability at the level of primary law.[291] In contrast to price stability, which was central to the single currency's set-up, the only reference to financial stability in the TFEU could be found in Article 127(5).[292] The provision states that the European System of Central Banks shall, as one of its 'non-basic' tasks,[293] 'contribute to the smooth conduct of policies pursued by the competent authorities relating to prudential supervision and the stability of the financial system'. A similar formula appears in Article 3.3 of the Statute. Article 25.1 of the Statute further specifies that the European Central Bank 'may offer advice to, and be consulted by the Council, the Commission and competent authorities of the Member States on the scope and implementation of Union legislation relating to prudential supervision of credit institutions and to the stability of the financial system'. Not a word about the possibility of having the Bank operate as a lender of last resort.

How to explain this meagre attention to financial stability? Monetarist ideas as well as Germany's strong treaty bargaining position are again key. 'Traditionally', Schoenmaker explains, 'central banks have two major objectives: monetary stability and financial stability'.[294] But when the Treaty of Maastricht was negotiated, the latter kind of stability had been snowed under by the first. Due to the high rates of inflation prevailing during the 1970s and the coming into fashion of monetarism, treaty drafters were primarily concerned with ensuring price stability, neglecting its financial counterpart.[295] What is more, there were serious concerns that attributing the Bank with considerable tasks in the area of financial stability could hamper its ability to keep inflation in check.[296] Lending money to a bank in difficulty could

290 Schoenmaker, 'Central Banks Role in Financial Stability' (n 289) 273-274.

291 Some call this a consolidation of a 'narrow' concept of central banking, according to which the central bank should focus on the single objective of price stability, as opposed to a 'broad' concept on the basis of which the bank should also pursue the objective of financial stability. See David Folkerts-Landau and Peter M Garber, 'The European Central Bank: A Bank or a Monetary Policy Rule' (NBER Working Paper Series No 4016, 1992) 3; Alessandro Prati and Garry J Schinasi, 'Financial Stability in European Economic and Monetary Union' in CAE Goodhart (ed), *Which Lender of Last Resort for Europe?* (Central Banking Publications 2000) 87.

292 See also Lorenzo Bini Smaghi, 'Who Takes Care of Financial Stability in Europe?' in CAE Goodhart (ed) *Which Lender of Last Resort for Europe?* (Central Banking Publications 2000) 227-228.

293 For the distinction between 'basic' and 'non-basic' tasks see n 199 (ch 3) and text to n 274 (ch 7).

294 Schoenmaker, 'Central Banks Role in Financial Stability' (n 289) 272.

295 Schoenmaker, 'Central Banks Role in Financial Stability' (n 289) 272.

296 Charles Goodhart and Dirk Schoenmaker give an overview of the risks and benefits associated with having the central bank in charge of securing both price and financial stability. On balance, however, they opt for a system in which the central bank is in charge of both, making it possible to 'internalise' any conflicts, instead of having two separate

lead to a higher 'net inflow' of central bank money to the financial system, reaching levels that are undesirable from a monetary policy perspective.[297] Likewise, keeping interest rates low out of a concern for the stability of the financial system could conflict with the demands of price stability.[298] Moreover, a failure to perform on its financial stability mandate could negatively affect the central bank's good name, leading to lower expectations among the public that it is able to control inflation.[299]

These concerns were felt particularly strongly by Germany. It was heavily opposed to an initial draft of the Statute of the Bank, drawn up by the Committee of Central Bank Governors, which attributed the System of Central Banks with bolder powers concerning financial stability.[300] Listing it as a 'basic' task, the draft stated that it should 'participate as necessary in the formulation, co-ordination and execution of policies relating to prudential supervision and the stability of the financial system'.[301] This led to fears that the system would impinge on the supervisory powers of national authorities and could possibly be put in a spot where it would have to make calls at odds with price stability.[302] At the intergovernmental conference, member states therefore decided to significantly soften the text.[303] Not only did they change the supervisory task from a basic one into a non-basic one, they also made clear that most competences in this area would stay at the national level.[304] The words 'formulation' and 'execution' did not make it to the final text of Articles 127(5) TFEU and 3.3 of the Statute, instead having to give way to the phrase that the system should 'contribute' to the policies of 'the competent authorities'. At the same time the treaty drafters did decide to put in place a provision, now laid down in Article 127(6) TFEU, enabling the Council 'to confer specific tasks upon the European Central Bank concerning policies relating to the prudential

institutions each focusing on one stability objective. See Goodhart and Schoenmaker (n 281) 545-549. See also René Smits, *The European Central Bank: Institutional Aspects* (Kluwer Law International 1997) 323-327.

297 Goodhart and Schoenmaker (n 281) 545.

298 Goodhart and Schoenmaker (n 281) 546.

299 Goodhart and Schoenmaker (n 281) 546; Smits, *The European Central Bank* (n 296) 325-326.

300 Rosa M Lastra, 'The Governance Structure for Financial Regulation and Supervision in Europe' (2003/2004) 10 Colum J Eur L 49, 56.

301 Art 3 Committee of Governors of the Central Banks of the Member States, 'Draft Statute of the European System of Central Banks and of the European Central Bank' (Agence Europe No 1669/1670, 8 December 1990) (Draft Central Bank Statute).

302 Smits, *The European Central Bank* (n 296) 336-337; Lastra, 'The Governance Structure for Financial Regulation' (n 300) 56.

303 This leads Dirk Schoenmaker to conclude that 'The ECB is largely modelled after the Bundesbank and follows the narrow central banking concept focusing on monetary stability'. See Schoenmaker, 'Central Banks Role in Financial Stability' (n 289) 280.

304 See also Smits, *The European Central Bank* (n 296) 337-338.

supervision of credit institutions' in case future developments in the area of financial integration would make this necessary.[305]

Nonetheless, the silence about the lender of last resort issue does not mean that the European Central Bank or national central banks cannot perform this task. At the start of the currency union, several economists argued that this silence fits the tradition of 'constructive ambiguity' that should surround any lender of last resort.[306] By keeping financial institutions in the dark about whether, how and when the central bank will exercise its lender of last resort powers, they cannot know for certain that it will help them out in the event of need, which reduces the risk they will engage in morally hazardous conduct.[307] Legally, however, the situation is more complicated and necessitates a distinction between lending to specific institutions and general injections of liquidity.

As far as assistance to specific institutions is concerned, Article 14.4 of the Statute is key.[308] It provides that national central banks 'may perform functions other than those specified in the Statute, unless the Governing Council of the European Central Bank finds, by a two thirds majority of votes cast, that these interfere with the tasks and objectives of the ESCB'. Such functions,

---

305 Note, however, that this enabling clause is also a watered down version of the one included in the draft statute prepared by the Committee of Central Bank Governors. Whereas the committee had envisaged the inclusion of all credit and other financial institutions (see Draft Central Bank Statute, Art 25(2)), in its final form Article 127(6) TFEU explicitly excludes insurance undertakings from its scope. See also Smits, *The European Central Bank* (n 296) 338.

306 According to Tommaso Padoa-Schioppa, for example: 'Indeed, it may be even advisable not to spell out beforehand the *procedural and practical details* of emergency actions ... I know of no central bank law within which the lender-of-last-resort function is explicitly defined'. See Tommaso Padoa-Schioppa, 'EMU and Banking Supervision' (1999) 2 International Finance 295, 306. See also Smits, *The European Central Bank* (n 296) 270; Willem H Buiter, 'Alice in Euroland' (1999) 37 JCMS 181, 201 (arguing that this stance is 'unduly coy'). But there are certainly counterarguments as well. In particular, one can argue that the notion of constructive ambiguity relates to the situations in, and the terms on the basis of which, the central bank will act as lender as last resort. In other words: it relates to the use of a discretionary power. However, as regards the ECB the question is not simply when and how it will use such a power, but whether it actually has this power in the first place. See Michel Aglietta, 'A Lender of Last Resort for Europe' in CAE Goodhart, *Which Lender of Last Resort For Europe* (Central Banking Publications 2000) 55; Prati and Schinasi (n 291) 114-116.

307 See eg Freixas and others (n 269) 40-42.

308 In its annual report of 1999 the ECB made clear that individual support belongs to the responsibility of national central banks within the limits set out by Art 14.4 Central Bank Statute. See European Central Bank, *Annual Report 1999* (ECB 2000) 98. Nonetheless, several scholars argue that the ESCB in principle also has the competence to provide individual support. See Smits, *The European Central Bank* (n 296) 269-270; Rosa M Lastra, 'The division of responsibilities between the European Central Bank and the National Central Banks within the European System of Central Banks' (2000) Colum J Eur L 167, 174-175; Armin Steinbach, 'The Lender of Last Resort in the Eurozone' (2016) 53 CML Rev 361, 370-371.

the provision makes clear, are 'performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB'. The Governing Council has indeed used this provision to put in place a procedure for individual support, called Emergency Liquidity Assistance (ELA), by national central banks.[309]

During the crisis national central banks, especially those in distressed member states, made extensive use of the emergency facility. This also created the possibility for the European Central Bank to steer economic policy developments in these states.[310] As its Governing Council can turn down the extension of emergency liquidity, it has the power to make the provision of this support *de facto* conditional on states pursuing a certain course of action. Cyprus forms a case in point.[311] On 25 June 2012 it formally lodged a request for financial assistance with the Eurogroup.[312] Yet, it was dragging its feet in reaching agreement on an adjustment programme which, as this study will discuss in the next chapter, is a prerequisite for receiving assistance from European assistance funds.[313] At the same time, Cypriot banks were greatly dependent on emergency liquidity support as they held large amounts of Cypriot government bonds which no longer met the collateral requirements for liquidity operations of the Bank.[314] On 21 March 2013, however, the Governing Council decided to maintain the current level of emergency assistance only until 25 March.[315] Hereafter, and given the fact that it no longer considered Cypriot banks solvent, assistance would be dependent on the Cypriot government reaching agreement on an adjustment programme contain-

309 For a general overview of the content of the procedure see European Central Bank, 'ELA Procedures' (21 February 2014) .

310 See extensively Thomas Beukers, 'The New ECB and Its Relationship with the Eurozone Member States: Between Central Bank Independence and Central Bank Intervention' (2013) 50 CML Rev 1579, 1593-1594.

311 Cyprus is by no means the only state that had to face such ECB pressure. Ireland and Greece, for example, have experienced it too. See Steinbach (n 308) 362.

312 Statement by the president of the Eurogroup, 25 June2012.

313 See text to n 89, n 108, n 192 and n 308 (ch 5).

314 Former Cypriot Central Bank Governor Athanasios Oprhanides explains that by refusing to ease collateral requirements for Cypriot government debt, as it had done earlier for Greek, Irish and Portuguese debt, the Bank forced the Cypriot government to request financial assistance in June 2012. He states in this regard: 'In the case of Cyprus, the ECB decided not to suspend the eligibility rule. This was important because if Cyprus debt had remained eligible as collateral, Cyprus banks could continue to buy treasury bills and continue financing the needs of the country for some time. The ECB was trying to convince the Cypriot government that it had to make structural adjustments and fiscal adjustments and by that point in June, get into a programme'. See 'An interview with Athanasios Orphanides; What happened in Cyprus' *The Economist* (*Economist.com*) (28 March 2013). See also Beukers, 'The New ECB and its Relationship with the Eurozone Member States' (n 310) 1593-1594; Daniel Wilsher, 'Ready to Do Whatever It Takes? The Legal Mandate of the European Central Bank and the Economic Crisis' (2012-2013) 15 CYEL 503, 512.

315 ECB Press Release, 'Governing Council decision on Emergency Liquidity Assistance by the Central Bank of Cyprus' (ECB, 21 March 2013).

ing conditions for the recapitalisation of its banks.[316] Cornered as a result of this pressure, the Cypriot government then reached a political agreement with the Eurogroup on the key features of such a programme on 25 March 2013.[317]

What about general, system-wide, liquidity injections through monetary policy operations? Initially, some took the view that Article 25.1 of the Statute regulates exhaustively the ways in which the System of Central Banks can discharge its prudential task in Articles 127(5) TFEU and 3.3 of the Statute.[318] Consequently, the only way in which it could contribute to policies of the national authorities relating to prudential supervision and financial stability is through the issuance of advice by the European Central Bank on the scope and implementation of Union legislation on these topics.[319] Others, however, were not convinced by such a restrictive interpretation. According to René Smits, for example, textual as well as purposive arguments would justify a wider range of instruments than those specifically mentioned in Article 25.1 of the Statute.[320]

Textually, there are some notable differences between Articles 127(5) TFEU and 3.3 of the Statute on the one hand, and Article 25.1 of the Statute on the other. Whereas the latter provision only concerns the European Central Bank, the former two address the System of Central Banks in general. By limiting the latter's contribution to the issuance of legislative advice by the Bank, Smits argues, it is deprived of playing its complete role as there is no involvement of the national central banks.[321] Moreover, Article 25.1 speaks about 'legis-

316 ECB Press Release, 'Governing Council decision on Emergency Liquidity Assistance by the Central Bank of Cyprus' (ECB, 21 March 2013).

317 Eurogroup Statement on Cyprus, 25 March 2013.

318 It should be noted that there is an inconsistency in the applicability of, on the one hand, Arts 127(5) TFEU and 3.3 Central Bank Statute and, on the other hand, Art 25.1 Central Bank Statute. According to Arts 139(2)(c) TFEU and 42.1 Central Bank Statute the first two provisions do not apply to states with a derogation. The same goes for the UK and Denmark (see point 1 of Protocol No 16 and points 4 and 7 of Protocol No 15). However, Art 25.1 Central Bank Statute does apply to these states. To put it in the words of René Smits: 'This arrangement is clearly an oversight of the authors of the EC Treaty. As consultation under Article 25.1 was considered to be the primary instrument for the ESCB with which to exercise its supervisory task, it is an anomaly not to grant the task and yet to give the instrument'. See Smits, *The European Central Bank* (n 296) 352.

319 This also seems to be the view taken by the Committee of Central Bank Governors. In its commentary on the draft Statute it stated that 'Article 25 specifies the activities which might be undertaken by the ECB when carrying out the tasks mentioned in Article 3, indent 5, in respect of prudential supervision'. See Draft Central Bank Statute (n 301) 25.

320 See Smits, *The European Central Bank* (n 296) 339-343.

321 Smits, *The European Central Bank* (n 296) 339-340. One can have doubts, however, about the conclusiveness of this argument. The ESCB generally functions on the basis of a division of responsibilities between the ECB and NCBs (see also n 191 (ch 3)). One could argue, therefore, that limiting the role the ESCB can play in the context of Art 127(5) TFEU to the giving of legislative advice by the ECB fits this tradition.

lation' while Articles 127(5) TFEU and 3.3 of the Statute employ the more general, and broader notion of 'policies'. This too would support a wider range of instruments than mere legislative advice.[322] *Purposively*, one can point out that one of the reasons for involving the System of Central Banks in prudential supervision and the maintenance of financial system stability is that these are basic prerequisites for an effective monetary policy.[323] As a result, liquidity operations carried out on the basis of Article 18.1 of the Statute would not only be possible for strictly monetary purposes, but also for securing financial stability.[324] Such last resort injections of liquidity could take place provided they do not conflict with the Bank's primary objective of maintaining price stability.[325]

In hindsight one can say that the latter interpretation has prevailed, as the Bank's crisis policy of 'enhanced credit support' is widely seen as lender of last resort action.[326] What is more, this is how the Bank views it. The following statement of Vice-President Vítor Constâncio is telling:

> 'The provision of liquidity to prevent a collapse of sound financial institutions during a liquidity crisis is also consistent with the broader ESCB's responsibility to contribute to financial stability. This is in line with the provisions in the Treaty, which gives the ESCB the competence, without prejudice to the primary objective of price stability and to the ECB independence, to support the general economic policies of the European Union and notably to contribute to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system. Most central banks have performed such a role as financial lender of last resort to the banking sector in history when severe crises struck.'[327]

322 Smits, *The European Central Bank* (n 296) 340.

323 Smits, *The European Central Bank* (n 296) 324-327, 340-341.

324 The question is, then, whether the liquidity injection would fall under the task of monetary policy set out in Art 127(2) TFEU or the financial stability task in Art 127(5) TFEU. Art 127(2) TFEU also comes into play when the supply of liquidity is necessary to safeguard the stability of the payment system (TARGET, see n 257 (ch 4)) as this provision also provides the ESCB with the task to ensure 'the smooth operation of payment systems'. See also Steinbach (n 308) 366-368. From a practical point of view, there is no immediate need to answer this question given that Art 18 Central Bank Statute allows for open market and credit operations in relation to all the tasks entrusted to the ESCB.

325 Smits, *The European Central Bank* (n 296) 268-269, 348-349. See also Lastra, 'The Division of Responsibilities' (n 308) 175.

326 See eg Schoenmaker, 'Central Banks Role in Financial Stability' (n 289) 281; Alex Cukierman, 'Reflections on the Crisis and on its Lessons for Regulatory Reforms and for Central Bank Policies' in Sylvester Eijffinger and Donato Masciandaro (eds) *Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis* (Edward Elgar 2011) 82-83; Rosa M Lastra, 'The Evolution of the European Central Bank' (2011-2012) 35 Fordham Int'l L J 1260, 1270-1272. For an overview of 'enhanced credit support' measures, especially during the financial crisis, see text to n 34 (prologue).

327 Vítor Constâncio, 'Challenges to monetary policy in 2012' (Speech at the 26th International Conference on Interest Rates, Frankfurt, 8 December 2011).

5.3 ... and possibly for states too

The Union's search for a lender of last resort perhaps does not end with banks. Some argue that the crisis shows that member states also need one. Jean Pisany-Ferry sketches the problem by means of an 'impossible trinity', a favourite among economists to point out a system's flaws by breaking it down into three each digestible, yet inconsistent elements.[328] He argues that the currency union suffers from a 'unique' trinity consisting of bank-state interdependence, a no-bailout clause and a prohibition on monetary financing.[329] Given that states in the currency union were primarily the ones having to take responsibility for the rescue of banks in their jurisdictions, they were vulnerable to greatly, and suddenly, deteriorating fiscal records.[330] Earlier on, this chapter explained how such weak records may cause serious problems for states.[331] Since they do not control their central bank they cannot (implicitly) guarantee their bondholders that they will always have enough liquidity to honour their financial commitments. This uncertainty may generate crises of liquidity, even solvency, on government bond markets, of a self-fulfilling nature. To prevent such crises states, just like banks, would need a lender of last resort capable of fighting any 'liquidity squeeze' and safeguarding financial stability.[332] Unfortunately, the prohibitions on monetary financing and bail-out in Articles 123 and 125 TFEU seem to rule out such a lender, at least on the face of it.

Now, in theory, the problems flowing from an inconsistent trinity can be solved by radically eliminating one its elements, leaving intact the other two. But such clean solutions rarely apply in practice. Especially in crisis situations action is often improvised, intuitive and takes place on more than one front at the same time. The debt crisis forms a case in point as each of the currency union's inconsistent elements is subject to change. The banking union, about which more will be said in chapter 6, aims to tackle the vicious circle between banks and states. One of its constituent pillars, the Single Resolution Mechanism

328 Another such trinity, for example, is the one presented in the former chapter concerning the co-existence of free movement of capital, fixed exchange rates and monetary autonomy. See text to n 79 (ch 3). Lately, Dirk Schoenmaker has pointed to another inconsistent trinity relating to financial stability, international banking and national financial policies. See Dirk Schoenmaker, *Governance of International Banking: The Financial Trilemma* (OUP 2013) 7.

329 Pisani-Ferry, 'The New Impossible Trinity' (n 237) 4-9.

330 Which in turn, as has been discussed above, may backfire on these banks in as far as they are exposed to their states. See text to n 240 (ch 4).

331 See text to n 27 (ch 4).

332 See Paul De Grauwe, 'The European Central Bank as Lender of Last Resort in the Government Bond Markets' (2013) 59 CESifo Economic Studies 520, 520-522. See also Buiter and Rahbari (n 53) 6-9, 18; Thomas Mayer, *Europe's Unfinished Currency: The Political Economics of the Euro* (Anthem Press 2012) 150-151; Pisani-Ferry, 'The New Impossible Trinity' (n 237) 6, 9; Krugman, 'Currency Regimes' (n 53) 473-475.

(SRM), addresses this problem by lifting responsibility for the rescue of banks from national to European level. Its other pillar, the Single Supervisory Mechanism (SSM), is based on the enabling clause in Article 127(6) TFEU.[333]

This study is more interested in changes concerning the other two elements: the no-bailout clause and the prohibition on monetary financing. In their effort to combat the crisis, both the Union and its member states have taken actions that could be seen as lender of last resort moves targeting financial stability. This is particularly true for the assistance operations carried out by emergency funds and the bond purchases of the European Central Bank, especially its 'Outright Monetary Transactions'. In this regard, an interesting divide is taking place. The emergency funds, as the next chapter will show, all operate on a legal mandate making financial stability their primary aim. But the Bank's bond purchases do not. In fact, shortly after taking office, and prior to the launch of 'Outright Monetary Transactions', President Draghi was adamant in stressing that the Bank would not be turned into a lender of last resort. In reply to a journalist's question about this issue he stated:

> '[W]hat makes you think that the ECB becoming the lender of last resort for governments is what is needed to keep the euro area together? No, I do not think that this is really within the remit of the ECB. The remit of the ECB is maintaining price stability over the medium term.'[334]

After the launch of the programme the Bank kept insisting, as discussed earlier, that the instrument is chiefly focused on price stability.[335] In line with an increasing number of economists who argue that financial stability concerns should play a role in monetary policy,[336] it targets this stability as its purchases aim to remedy dysfunctioning bond markets.[337] Yet, it does not pro-

333 Gijsbert Ter Kuile, Laura Wissink and Willem Bovenschen argue that by basing the SSM on Art 127(6) TFEU the Union legislator has opted for a 'wide' interpretation of this provision as opposed to a 'narrow' one. They make clear that 'One could take a narrow or a wide reading of this Article, which would be of influence on the appropriateness of the legal basis. A narrow reading might lead one to object to granting the ECB supervisory powers ... The reasoning would then probably be that the provision only allows the ECB to develop policies rather than actually supervise'. See Gijsbert Ter Kuile, Laura Wissink and Willem Bovenschen, 'Tailor-made Accountability Within the Single Supervisory Mechanism' (2015) 52 CML Rev 155, 162.

334 'Introductory statement to the press conference (with Q&A)' (ECB, 3 November 2011). See also David Marsh, 'Unfair to mark out Bundesbank chief on OMT credibility' *Financial Times* (25 October 2012).

335 See text to n 56 (ch 4).

336 See also Matthias Goldman, 'Adjudicating Economics? Central bank independence and the appropriate standard of judicial review' (2014) 15 GLJ 265, 269-270.

337 That reasoning is supported by central bank theory. Garry Schinasi, for example, argues that 'the banking system is the transmission mechanism through which monetary policy has its effect ... For this reason alone central banks have a natural interest in sound financial

vide an implicit guarantee that a member state will always be able to pay off its creditors. Its purchases serve the transmission and singleness of its monetary policy and therefore ultimately its primary objective of price stability.[338] They can only occur to the extent they are warranted from that perspective, and to the extent that yields exceed a state's fundamentals, thereby ruling out that it acts as a lender of last resort for member states.[339]

Not surprisingly, though, several prominent economists regard it as a last resort operation aimed at safeguarding financial stability.[340] Read Paul De Grauwe, shortly after the announcement of the programme:

> 'Central banks were created to deal with the endemic problem of financial capitalism: its instability and the impact this has on the banking system. This has led to the consensus that the central bank should be a lender of last resort in the banking system to ensure that the bubbles and crashes that are part and parcel of capitalism do not bring down the banking system. Should this lender of last resort also be extended to the government? It must be, if financial stability is to be maintained, because the sovereign and the banks hold each other in a deadly embrace ... The eurozone did not have such a contract between the sovereigns and the common central bank, explaining its fragility. It now has one with the OMT programme.'[341]

Both kinds of actions, the rescue funds and the Bank's bond programmes, therefore raise the question of whether, and to what extent, the prohibitions on bail-out and monetary financing can accommodate greater attention for financial stability. In fact, this issue is central to the legal analysis in subsequent chapters of the transformation experienced by the Union during the crisis.

6 CONCLUSION

By signing and ratifying the Treaty of Maastricht, the member states committed themselves to a currency union imbued by the desire to safeguard price

---

institutions and stable financial markets'. See Garry J Schinasi, 'Responsibility for central banks for stability in financial markets' (IMF Working Paper No 03/121, June 2003) 8.

338 Former ECB President Trichet stated in this regard: '[W]e had to consider that there is a serious problem of the transmission of our monetary policy because financial stability is not ensured at the level of the euro area as a whole and because we have a number of countries which have their own "risk-free" benchmark rates at levels that are different from country to country'. See 'Introductory Statement to the press conference (with Q&A)' (ECB, 6 October 2011).

339 Both these elements will be discussed extensively in chs 6 and 7 where the Bank's bond purchases, as well as the Court's view on them, are discussed in greater detail.

340 See references in n 53 (ch 4).

341 Paul De Grauwe, 'Stop this guerrilla campaign against the ECB policy' *Financial Times* (23 October 2012).

stability. When the crisis hit, it painfully exposed the flaws op this set-up. This chapter has singled out four of them. The first concerns the instrument of market discipline, more specifically the idea that markets always adequately price risk. The crisis has thrown the rationality of markets into doubt as they went from extreme tranquillity to absolute panic which, according to the European Central Bank, bestowed the debt crisis with a self-fulfilling nature.

The second relates to public discipline. Markets might not have lapsed into panic if member states had had solid fiscal records. But they did not. Greece stands out. Having fiddled with its budgetary figures for years, it lost all trust from markets when it revealed its true state of affairs late 2009. After the trouble with enforcing public discipline on France and Germany, this once more showed the difficulty of making states pursue a certain fiscal course of action within the confines of the Union's original economic policy set-up.

At the same time, however, fiscal negligence only tells part of the story. Another important cause of the crisis concerns the indebtedness of the private sector, the burden of which can very quickly shift to the public sector due to financial rescue operations by the state. Such 'contingent' liabilities of states were not on the radar of the single currency's legal set-up and were a major cause of financial actors' fear to invest in certain parts of the currency union during the crisis. Somewhat paradoxically, then, the original stability set-up did not always achieve what it desired – public discipline – whilst this desire made it blind to other, probably even more dangerous, threats to stability.

All of the above come together in the original set-up's narrow reading of stability as an objective. The set-up was indeed aiming for stability, but only a specific kind: price stability. Its important counterpart, financial stability, received little attention. The crisis has forced the Union and its member states to better safeguard this second kind of stability. European rescue funds are aimed at it and the European Central Bank has served it by acting as lender of last resort for banks, and perhaps for states too. Each of these actions, however, in particular those aimed at states, raises questions of legal compatibility that reach the very heart of the original stability framework.

This in turn demonstrates the problematic nature of legally consolidating the currency union's design to extreme degrees. When the member states signed and ratified the Treaty of Maastricht back in the 1990s, this may have seemed the safest route to stability. But when the crisis hit, as the next chapter will show, it actually made achieving this much harder.