Saving the Euro: Tensions with European Treaty Law in the European Union's Efforts to Protect the Common Currency

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Introduction

The 2008 Financial Crisis triggered a worldwide recession[1] that forced western economies to come to terms with realities they desperately tried to ignore.

The United States economy, victim to an overheated housing bubble fueled by artificially low interest rates[2] and risky investments in an expansive subprime mortgage market,[3] began contracting in December 2007.[4] Washington had to confront the short-term implications of a decade of mismanaged monetary policy, and the long-term dangers of a consumption-driven economy.[5]

Meanwhile, the European Union (EU) was struggling to preserve the value and stability of its common currency—the euro—in the face of mounting sovereign debt pressures. The fundamental dilemma confronting Brussels was how to balance the desire for deeper, long-term integration, with the challenge of coordinating divergent economies under one political roof.[6] The euro, accepted by seventeen EU members, is a cornerstone of the Economic and Monetary Union (EMU) that developed in the decade after the 1992 signing of the Treaty on European Union (TEU).[7] Helmut Kohl, Germany's former chancellor and a dominant figure in post-Cold War integration, called the euro a "guarantee for peace" throughout the historically divided and war-plagued continent.[8] Kohl brought Germany into the euro area in the face of substantial popular resistance, fighting a fierce public relations battle that contributed to his electoral defeat after sixteen years in power.[9] The German media feared heavily indebted

1. *See* Willem Buiter & Ebrahim Rahbari, *Greece and the Fiscal Crisis in the Eurozone*, 51 Pol'y Insight 1, 2 (Oct. 2010) ("[T]he worldwide recession . . . started in 2008 and lasted in most of the advanced industrial countries until the end of 2009.").

2. John B. Taylor, *Economic Policy and the Financial Crisis: An Empirical Analysis of What Went Wrong*, 21 Critical Rev. 341, 343 (2009).

3. Dean Baker, *The Housing Bubble and the Financial Crisis*, Real-World Econ. Rev., May 20, 2008, at 73–76, *available at* http://www.paecon.net/PAEReview/?issue46/Baker46.pdf.

4. Chris Isidore, *It's Official: Recession Since Dec. '07*, CNNMoney (Dec. 1, 2008), http://money.cnn.com/2008/12/01/news/economy/recession/index.htm.

5. Massimo Guidolin & Elizabeth A. La Jeunesse, *The Decline in the U.S. Personal Saving Rate: Is It Real and Is It a Puzzle?*, 89 Fed. Res. Bank St. Louis Rev., 491, 491 (2007), *available at* http://research.stlouisfed.org/publications/review/07/11/Guidolin.pdf.

6. Judy Dempsey, *Germany Vows to Defend Euro as Political Project*, N.Y. Times (Dec. 9, 2010), http://www.nytimes.com/2010/12/10/world/europe/10germany.html.

7. Consolidated Version of the Treaty on European Union art. 3, para. 4, Sept. 5, 2008, 2008 O.J. (C 115) 13 [hereinafter TEU].

8. Valentina Pop, *'Euro-Father' Kohl Defends Greek Bail-Out*, EUobserver (May 6, 2010), http://euobserver.com/19/30021.

9. Toby Helm, *Backing the Euro Cost Me Election, Says Kohl*, Telegraph (Nov. 20, 2000), http://www.telegraph.co.uk/news/worldnews/europe/germany/1375013/?Backing-the-euro-cost-me-election-says-Kohl.html.

states would join the euro and destabilize it with reckless borrowing.[10] German voters liked the strength and stability of their national currency and did not want others freeriding on their success.[11] Kohl tried to placate the electorate by successfully negotiating fiscal coordination rules into the TEU to curb excessive spending—the Stability and Growth Pact (SGP).[12]

Despite the safeguards, critics' fears gradually proved justified.[13] Ironically, Germany and France were the first to violate the fiscal coordination rules when they financed increases in social welfare and infrastructure spending in the late 1990s.[14] On balance, however, these and other North-European countries continued to save, control inflation, and check runaway sovereign debt. Germany, led by Gerhard Schröder's Social Democrats, enacted economic reforms in the early 2000s that reduced labor costs, cut income taxes, and restrained public spending.[15] Meanwhile, the French controlled annual budget deficits, and their household debt as a share of GDP was less than half that in Britain and the United States.[16] As these reforms were put into effect, peripheral euro members took up unsustainable financial obligations that heightened the risk of sovereign default.[17] By the time of the 2008 recession, Greece, Ireland, and Portugal faced economic collapse, burdened by enormous debt-to-GDP ratios.[18]

The EU, at an institutional and intergovernmental level, acted in an effective state of emergency to deal with the peripheral states' debt pressures.[19] It feared that the failure of the euro as a truly continental currency could cripple further economic integration and cause severe political division.[20] The more stable EU members, led by Germany, advanced proposals to force responsibility on their failing neighbors, to minimize other states' exposure to the peripherals' toxic debts, and to preserve the euro's value and long-term stability.[21]

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10. Patrick M. Crowley, The Stability and Growth Pact: Bad Economics and/or the Politics of Least Resistance? 2–3 (Mar. 2005) (unpublished manuscript) (on file with University of Pittsburgh), *available at* http://aei.pitt.edu/3197/1/SGP_3-05.pdf.

11. *Id.*

12. *Id.*

13. *See* Michele Chang, *Reforming the Stability and Growth Pact: Size and Influence in EMU Policymaking*, 28 J. EUR. INTEGRATION 107, 107–08 (2006), *available at* http://aei.pitt.edu/3159/1/Chang_2005_EUSA_paper.pdf.

14. *Id.*

15. Marcus Walker, *Is Germany Turning into the Strong, Silent Type?*, WALL ST. J. (June 27, 2011), http://online.wsj.com/article/SB10001424052702304259304576373281?798293222.html.

16. Editorial, *The French Model: Vive la différence!*, ECONOMIST, May 7, 2009, *available at* http://www.economist.com/node/13610197.

17. *See* Hans-Werner Sinn, *Rescuing Europe*, 11 CES IFO 1, 1 (2010).

18. Editorial, *The Euro Area's Debt Crisis: Bite the Bullet*, ECONOMIST, Jan. 13, 2011, *available at* http://www.economist.com/node/17902803.

19. Charles Forelle et al., *Europe Vows to Save Greece*, WALL ST. J. (Feb. 10, 2010), http://online.wsj.com/article/SB10001424052748703382904575058683608476508.html.

20. *Id.*

21. Ian Traynor, *Franco-German Bailout of Athens Expected to Avert Euro Collapse*, GUARDIAN, Feb. 10, 2010, at 14, *available at* http://www.guardian.co.uk/?world/2010/feb/10/greece-france-germany-euro.

This Note critically examines three relief mechanisms created by euro members and EU institutions to combat the debt crisis and save the common currency: the European Financial Stabilisation Mechanism, the European Financial Stability Facility, and the European Stability Mechanism. Although much has been written in the United States about the causes of the crisis and its implications for the euro, the literature takes an overwhelmingly economic focus and contains little in the way of comprehensive legal analysis. Beyond the economic implications of a debt default or the euro's devaluation for global markets, it is just as important to examine whether the EU and individual member states had the legal authority to take the actions they did. Should one read treaty provisions to accommodate the intense pressure upon European leaders to solve the debt problem in the wake of the 2008 downturn? Was there an economically and legally better alternative to the EU's chosen course? These are some of the questions this Note will consider. In so doing, it will not only contribute to the nascent American legal literature on the euro problem, but will also demonstrate how the will to keep a political project alive can push those in power to skirt open confrontation with established law.

I. Background

The unusually sharp recession in 2008 curtailed government revenues and boosted public-sector spending to stabilize declines in employment and national productivity.[22] Although losses to public finances were unprecedented, European leaders hoped market assessments concerning the fundamental stability of the euro area would assuage nervous investors.[23] Then, in October 2009, following a general election and change of government, Greece reported its annual budget deficit to be twice the amount disclosed to the EU on the eve of the election and three times the amount stated at the beginning of the year.[24] The country's debt-to-GDP ratio was 115 percent.[25] When it entered the Eurozone, Greece misstated data on the magnitude of its structural deficits to the European Commission.[26] As summarized by economist Paul Krugman: "[T]he [Greek] government behaved irresponsibly, lied about it and got caught."[27]

Greece, facing massive credit flight and looming insolvency, formally requested European financial assistance on April 23, 2010.[28] The EU

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22. *See* Buiter & Rahbari, *supra* note 1, at 2.

23. *See id.* at 4.

24. *Id.* at 3.

25. *Id.* at 1-2.

26. Beat Balzli, *Greek Debt Crisis: How Goldman Sachs Helped Greece to Mask its True Debt*, SPIEGEL (Feb. 08, 2010), http://www.spiegel.de/international/europe/?0,1518,676634,00.html.

27. Paul Krugman, *Can Europe be Saved?*, N.Y. TIMES, Jan. 16, 2011, at MM26, *available at* http://www.nytimes.com/2011/01/16/magazine/16Europe-t.html.

28. Dina Kyriakidou & Michael Winfrey, *Greece Presses "Help" Button, Markets Still Wary*, REUTERS (Apr. 23, 2010), http://www.reuters.com/article/2010/04/23/us-greece-idUSTRE63M1LV20100423.

responded with a €110 billion emergency rescue package.[29] The International Monetary Fund (IMF) also contributed €30 billion to the effort, and, together with the European Central Bank (ECB), drafted strict austerity and reform measures for Athens to adopt.[30]

On May 10, 2010, in response to the Greek crisis and under pressure to create a longer-term relief mechanism, the European Council (Council) promulgated regulation 407/10 that established a European Financial Stabilisation Mechanism (EFSM). The EFSM seeks to preserve financial stability across the EU and to improve the borrowing capacities of debt-ridden member states.[31] Article 2 authorizes the European Commission (Commission) to contract borrowings on the capital markets or with financial institutions on the Union's behalf.[32] Specifically, once a qualified majority of the Council decides to aid a member state through the EFSM, the Commission can borrow up to €60 billion on the markets and issue the raised funds to the state as loans or a credit line.[33] The Council bases its decision on an assessment of a member's aid application to the Commission and the EU Economic and Financial Committee (ECOFIN).[34]

As with the EU's direct aid to Greece, the IMF signaled its ability to supplement EFSM funds and coordinate the conditions of austerity programs attached to any decision to extend relief.[35] The EFSM includes an explicit provision requiring beneficiary states to consult with the Commission before turning to the IMF.[36]

EFSM Article 3 states that a conclusion to grant relief should be partly based on "general economic policy conditions which are attached to the Union financial assistance with a view to re-establishing a sound economic or financial situation in the beneficiary Member State and to restoring its capacity to finance itself on the financial markets."[37] These conditions are determined in consultation between the Commission and the ECB.[38] The beneficiary state must implement an adjustment program to meet the conditions.[39]

Article 8 gives the Commission and the ECB full authority to administer assistance.[40] Member states must open special accounts with their national central banks where they deposit all principal and interest paid on

29. *See Agreed EU Support Model Boosts Confidence, Says IMF*, IMF SURV. MAG. (May 11, 2010), http://www.imf.org/external/pubs/ft/survey/so/2010/new051110a.htm [hereinafter *EU Support Model Boosts Confidence*].

30. *See id.*

31. Council Regulation 407/2010, 2010 O.J. (L 118) 1 (EU).

32. *Id.* at 2.

33. *Id.*; *European Financial Stabilisation Mechanism (EFSM)*, EUR. COMMISSION, http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm (last visited Nov. 6, 2011).

34. Council Regulation 407/2010, 2010 O.J. (L 118) 2 (EU).

35. *EU Support Model Boosts Confidence*, *supra* note 29.

36. Council Regulation 407/2010, 2010 O.J. (L 118) 2 (EU).

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 3.

their loans.[41] The banks then transfer the payments to an ECB account.[42] The Commission and the European Court of Auditors have responsibility for managing the administration of loans.[43]

As a compliment to the EFSM, the Eurozone member states created a framework agreement for a European Financial Stability Facility (EFSF)—a Luxembourg company and special purpose vehicle authorized to grant loans to the euro area.[44] The company has a maximum capitalization of €440 billion, and extends relief after a member state completes a memorandum of understanding with the Commission on an economic reform program similar to the one required under the EFSM.[45]

Unlike the EFSM, which gives the Commission authority to raise money backed by the EU budget, the EFSF leaves much of this power in the hands of the signatory member states. Specifically, the EFSF may issue bonds, notes, debt securities, and other instruments backed by "irrevocable and unconditional" guarantees of participating members.[46] These obligate the guarantor states of EFSF-issued funding instruments to duly pay all principal and interest to bondholders or creditors. Guarantors that have 'stepped-out' of the agreement, whether due to political considerations or an inability to meet their contribution targets, are excluded from guarantee obligations.[47]

EFSF Article 2(6) notes that guarantees are "irrevocable and firm and binding."[48] If the EFSF issues instruments toward a qualified program and subsequently suffers repayment problems, it will calculate individual guarantor states' share of the shortfall.[49] Lenders can then demand, in writing, direct payment from the guarantors.[50] This language, implying a form of joint liability for each guarantor, is qualified by additional language limiting the guarantors' exposure to the maximum of their aggregate guarantees.[51] Contractual documentation or offering materials will clarify which guarantors are liable for which guarantees under any given EFSF program.[52]

The EFSF may also require guarantors to issue guarantees for "other purposes" that are "closely-linked to an issue of Funding Instruments," and that facilitate the "obtaining and maintenance of a high quality rating" for

41. *Id.*
42. *Id.*
43. *Id.*
44. European Financial Stability Facility Framework Agreement, C-N° 1189 Journal Officiel Grand-Duché de Luxembourg (June 7, 2010), *available at* http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf [hereinafter EFSF Agreement].
45. *Id.* at 1.
46. *Id.* at 2.
47. *See id.* at 15.
48. *Id.* at 6.
49. *Id.* at 12.
50. *Id.* at 12.
51. *Id.* at 6, 29.
52. *Id.* at 4–5.

the instruments.[53] The maintenance of a high quality AAA bond rating is critically important to the EFSF's success, since it allows the company to issue loans to troubled euro states at favorable interest rates.[54]

With the EFSF and EFSM slated to expire in June 2013, Eurozone finance ministers signed a treaty on July 11, 2011, establishing a permanent European Stability Mechanism (ESM).[55] It incorporates many of the governance and finance rules of the EFSF, which avoids borrowing against the EU budget and leaves decision-making in the hands of the individual treaty signatories rather than European institutions.[56] It also advocates strict adherence to the SGP and any additional economic governance reforms.[57]

Since the ESM is not yet active, and the other two relief measures have existed for little more than a year, their economic impact on the debt crisis is difficult to assess fully. This Note, however, deemphasizes the economics and focuses instead on the legal tensions between the three measures and European Union treaty law. While some of the conflicts with the European Union's two foundational treaties—the TEU and the Treaty on the functioning of the European Union (TFEU)[58]—can be avoided by reinterpreting the treaties' plain text and adopting broad readings of certain key provisions, other obstacles are harder to overcome.

New economic governance rules proposed by the Council may bind non-euro area states to the ESM in a way that violates TEU Article 136. Additionally, the Commission's attempt to assign almost exclusive blame for the debt problem to the 2008 recession in order to ground the EFSM in TFEU Article 122(2) is difficult to defend. Beyond exploring these issues, this Note also proposes a legally safer and economically better alternative to the EU's rescue plans. Debtor states would temporarily leave the Eurozone, restore their national currencies, default, and undergo competitive devaluations. Although the probable short-term outcome would include substantial inflationary pressure, damage to pensions and personal savings, and recession, this approach is the only feasible way for states that cannot possibly meet their euro-debt obligations to place themselves on the road to long-term recovery. Keeping countries locked in a currency whose requirements do not fit political, economic, and cultural fundamentals is dangerous, and contributes to resentment among citizens who fear decisions made for them by distant individuals they did not elect.

53. *Id.* at 5.

54. *The EFSM and the EFSF: Now and What Follows*, at 2–3, Eur. Parl. Doc. IP/A/ECON/FWC/2009_040/C7 (Sept. 8, 2010) (by Anne Sibert), *available at* http://www.europarl.europa.eu/document/activities/cont/201009/20100908ATT81666/20100908ATT81666EN.pdf [hereinafter *Sibert Paper*].

55. *See generally* Treaty Establishing the European Stability Mechanism (ESM), July 11, 2011, O.J. (L 91), *available at* http://consilium.europa.eu/media/1216793/?esm%20treaty%20en.pdf [hereinafter ESM Treaty].

56. *See id.* pmbl.

57. *Id.*

58. Consolidated Version of the Treaty on the Functioning of the European Union art. 122, para. 2, May 9, 2008, 2008 O.J. (C 115) 47 [hereinafter TFEU].

Especially for the EU's worst affected members, based on their bond ratings, anemic to nonexistent growth, and inability to follow austerity measures already in place, default and devaluation are necessary to restore creditworthiness and confidently reenter the bond markets.

Part II of this Note examines the legal questions surrounding the EFSM, beginning with its grounding in TFEU Article 122(2). This provision allows the Union to give financial assistance to member states that are undergoing, or are seriously threatened by, severe difficulties "caused by natural disasters or exceptional occurrences beyond [their] control."[59] This Note argues that Article 122(2) should not have been used to justify the EFSM due to Greece and Ireland's economic policy in the years before the 2008 crisis, the long-standing EU interpretation of Article 122(2), and the Article's subsequent rejection as a basis for future financial assistance under the ESM.

Part III addresses the EFSF's compliance with TFEU Articles 124 and 125. The first provision prohibits privileged access to financial institutions by EU members outside of "prudential considerations."[60] The second provision, interpreted as a no bailout clause, provides that the Union and member states "shall not be liable for or assume the commitments of . . . public undertakings of any Member State."[61] This Note argues that the EFSF's guarantees to provide the facility with a high credit rating, and thus enable troubled states to borrow at low interest rates, may violate Article 124. Nevertheless, given valid arguments about the magnitude of the current crisis, a Court could block such a legal challenge by seizing upon the Article's "prudential considerations" language.

The Article 125 analysis is more complicated. Until the March 11, 2011 Pact for the Euro, European leaders could have argued that the EFSF adheres to the Article's literal language. Now, however, an amendment to the EFSF Agreement, allowing the facility to directly intervene in troubled members' primary debt markets, casts doubt on this compliance.

Part IV examines the ESM. First, it addresses the simplified amendment procedure under TEU Article 48(6) to create the mechanism through the addition of a paragraph to TFEU Article 136. Second, it considers how the ESM's connection to substantial EU-wide economic governance reforms may indirectly affect non-euro area states in ways that violate Article 136.

Part V argues that the default-and-euro-separation alternative to the current EU relief strategy is both legally safer and economically better. It agrees with the unsustainability of keeping economies as different as Greece and Germany locked into a common monetary policy, and argues for a smaller, more stable Eurozone made up of Germany, France, and other responsible, primarily Northern-European states.

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59. *Id.* art. 122, para 2.
60. *Id.* art. 124.
61. *Id.* art. 125, para. 1.

II. The EFSM and TFEU Article 122(2)

A. Pre-Crisis Economic Mismanagement in Greece and Ireland

Council regulation 407/10[62] legally grounded the EFSM in TFEU Article 122(2).[63] The official Council press release placed the fiscal crises in euro area states such as Greece and Ireland under the Article by characterizing them as "exceptional circumstances beyond Member States' control."[64] The regulation explicitly brings within the Article's scope difficulties caused by a "serious deterioration in the international economic and financial environment."[65]

The Council's rationale is questionable. It stretches the ordinary meaning of Article 122(2) to imply that the debt crises in Greece, Ireland, and other euro area states, which the EFSM is designed to alleviate, are entirely or largely caused by the 2008 recession. How else can the regulation's mention of a serious deterioration in the economic environment be reconciled with the Article's explicit provision for occurrence beyond a euro area state's control? If an occurrence were foreseen by a member state, there is a reasonable expectation that corrective or preparatory action would have been taken.

Similarly, if the occurrence extended over a long period, a euro area state would have opportunities to adjust its fiscal policy.[66] Thus, the deterioration that the regulation mentions must presumably have been unforeseen and sudden; this would focus attention squarely on the financial crisis and its aftermath. Indeed, the regulation explicitly mentions the crisis in the third and fourth clauses of the introductory chapeau.[67] In clause five, the regulation directly links the crisis to the Article: "In order to address *this exceptional situation* beyond the control of the Member States, it appears necessary to put in place immediately a Union stabilisation mechanism . . . ."[68]

Article 31 of the Vienna Convention on the Law of Treaties states: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to [its] terms . . . and in light of its object and purpose."[69] This requirement, the regulation's explicit link between the crisis and the EFSM, and the plain language of Article 122(2), reasonably lead to only one conclusion: The Council considers states' debt problems to be a direct byproduct of the 2008 downturn.

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62. *See* Council Regulation 407/2010, 2010 O.J. (L 118) 1 (EU).
63. Formerly article 100 of the Treaty establishing the European Community.
64. Press Release, Council of the European Union: Economic and Financial Affairs Committee, European Stabilisation Mechanism to Preserve Financial Stability (May 10, 2010).
65. Council Regulation 407/2010, 2010 O.J. (L 118) 1 (EU).
66. The ECB sets monetary policy for the euro area. *See, e.g.*, Protocol on the Statute of the European System of Central Banks and of the European Central Bank, 2004 O.J. (C 310) 225, 225–28.
67. Council Regulation 407/2010, 2010 O.J. (L 118) 1 (EU).
68. *Id.* (emphasis added).
69. Vienna Convention on the Law of Treaties art. 31, May 23, 1969, 1155 U.N.T.S. 331.

There is, however, evidence to suggest that neither the Greek nor the Irish case bears this conclusion out. Fiscal mismanagement and chronically high deficits were prominent features of the Greek economy for three decades. Before the 1979 inauguration of the Papandreou government, Greece maintained a relatively low and constant debt-to-GDP ratio of 25 percent.[70] Papandreou effectively put in place a new fiscal regime. In order to stimulate aggregate consumer demand and increase living standards, his government extensively borrowed from capital markets.[71]

A study by economists Stelios Makrydakis, Elias Tzavalis, and Athanassios Balfoussias shows how the Greek government gradually failed to satisfy its intertemporal budget constraint and put itself on a path of unsustainable deficits.[72] They trace these problems to approximately the point of political change in 1979.[73] Greece misreported its economic data in the ten years preceding the 2008 downturn, when the government took advantage of relatively higher growth rates to increase foreign borrowing; this reduced the country's credibility within the EU and would, as previously mentioned, make relieving it a much more pressing issue than originally believed.[74]

Beyond the excess borrowing, Greece's deficit problem was compounded by high entitlement spending, poor tax administration, and a bloated public sector.[75] Greek industry, weakened by high labor costs, consistently underperformed in global economic rankings (e.g., the World Economic Forum's Global Competitiveness Report).[76] These problems forced Greece to issue short-term bonds at higher interest rates than fellow euro area states (particularly Germany).[77] This, and its inability to use temporary growth to curb domestic spending, led capital markets to view Greece as a high-risk state for sovereign default.[78] As a result, Greece's ability to borrow was already in decline by the time the crisis and the EU rescue efforts came.[79] In other words, the endogenous weaknesses of the Greek economy laid the groundwork and magnified the problems caused by the crisis.

The Irish case is more nuanced. Ireland's structural deficits, shifting from positive territory in 2007 to between 11 and 12 percent of GDP in

70. Georgios P. Kouretas & Prodromos Vlamis, *The Greek Crisis: Causes and Implications*, 4 PANOECONOMICUS 391, 394 (2010) (discussing the last forty years of Greek fiscal policy).

71. *Id.*

72. *Id.* at 395 (citing Stelios Makrydakis et al., *Policy Regime Changes and the Long-Run Sustainability of Fiscal Policy: An Application to Greece*, 16 ECON. MODELLING 71, 83–84 (discussing Greece's intertemporal budget constraint and deficit policies)).

73. *Id.*

74. Krugman, *supra* note 27.

75. Buiter & Rahbari, *supra* note 1, at 3.

76. *Id.*

77. Kouretas & Vlamis, *supra* note 70, at 395; *see* Michael G. Arghyrou & John D. Tsoukalas, *The Greek Debt Crisis: Likely Causes, Mechanics, and Outcomes*, 34 WORLD ECON. 2, 180–81 (2011).

78. *See* Kouretas & Vlamis, *supra* note 70, at 395.

79. *See id.* at 395–96.

2009 and 2010, stemmed from a massive consumption bubble on the heels of a decade-long growth spurt.[80] Similar to the U.S. mortgage crisis, the bubble arose from an overheated housing market that produced a temporary property boom.[81] As Irish economist Philip Lane notes:

> Since the property boom was financed through aggressive lending by the Irish banking system, the decline in property prices and the collapse in construction activity has resulted in severe losses in the Irish banking system. In turn, this has contributed to the economic crisis through a credit squeeze and the fiscal crisis, both directly through the costs of recapitalising the banking system and indirectly through the loss of asset-driven revenues.[82]

Finance specialist Edward Harrison, who compared the Irish and Spanish debt cases for *Business Insider*, wrote: "[T]hey both suffered from *euro zone rates* that were too low during the property bubble. Their economies overheated and crashed, leaving behind a mountain of debt, unfavourable wage rates and huge overinvestment in the property sector."[83] The ECB set the Eurozone rates, and since states cannot devalue within the same currency area,[84] an important corrective measure Ireland should have taken to deflate the bubble was unavailable.

Although not dispositive, the evidence of Irish and Greek fiscal mismanagement weakens the Council's position that the debt crisis effectively grew out of the 2008 recession. The economic data suggests that Greece, Ireland, and other peripheral euro members were en route to possible default years before the housing market collapsed.

B. Article 122(2)'s Long-Standing Interpretation and Implied Substantiality Element

One could argue that Article 122(2)'s literal language allows an EFSM whether or not the Council intentionally understated the contribution of Greece and Ireland's past policies to their current problems. The provision requires only that the severe difficulty be *caused* by a "natural disaster[ ]" or "exceptional occurrence[ ]" beyond a member's control before the Union can grant financial assistance.[85] Nowhere does it say the exceptional occurrence should be a *primary* or *substantial* cause of the difficulty. In other words, Article 122(2) does not contain an explicit substantiality ele-

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80. Philip R. Lane, *The Irish Crisis*, *in* THE EURO AREA AND THE FINANCIAL CRISIS (Miroslav Beblavý et al. eds., forthcoming Oct. 2011), manuscript at 2, *available at* http://www.tcd.ie/iiis/documents/discussion/pdfs/iiisdp356.pdf.

81. *Id.* manuscript at 2–3.

82. *Id.*

83. Edward Harrison, *Why the Irish Debt Crisis Could Be Worse than Spain, England, and even Iceland*, BUS. INSIDER (Sept. 23, 2010), http://www.businessinsider.com/why-the-irish-debt-crisis-could-be-worse-than-spain-england-and-even-iceland-2010-9.

84. Devalue here means to reduce the value of one currency relative to another through depreciation; this could stem from a reduction of interest rates by a central bank or an active expansion of the money supply. *See* Lorenzo Bini Smaghi, Member, Executive Board of the European Central Bank, Speech at the Goldman Sachs Global Macro Conference (Feb. 22, 2011) (transcript available at the European Central Bank online press database).

85. TFEU, *supra* note 58 art. 122, para. 2.

ment. Since one would be hard pressed to argue that the 2008 downturn contributed nothing to the current situation, there seems to be no apparent clash between the Article and the EFSM.

Nevertheless, this interpretation ought to be rejected for three reasons.

First, there is the long-standing interpretation that Article 122(2) does not apply to debtor states seeking financial assistance.[86] This seems to foreclose use of the Article to help Greece and Ireland if their problems had predictable or preventable roots, such as past fiscal mismanagement. In other words, the EU has consistently held the Article to apply only in truly exceptional circumstances, where nothing could be done to prevent severe harm to member states. The Council's use of Article 122(2) to solve members' debt problems appears to turn this view on its head.

Furthermore, a deeper reading of Article 122(2) suggests that a substantiality element is implied. If all the Council needed to invoke the Article were some or any cause, it likely would have structured its regulation authorizing the EFSM accordingly. Instead, it weighed causes in the preamble's fourth clause: "The deepening of the financial crisis has led to a *severe deterioration* of the borrowing conditions of several Member States *beyond what* can be explained by economic fundamentals."[87] The clause then contends that this deterioration is a potentially "serious threat to the financial stability of the European Union as a whole."[88] The normative judgment made through the use of the language "beyond what" is nonsensical unless the Council believed Article 122(2) contained a substantiality requirement. Otherwise, it could have simply written the clause to say that the crisis, while exceptional, was one of several causes of the severe deterioration of borrowing conditions. It could have then noted that since substantiality is not required in Article 122(2), and since the financial crisis is a cause of the current problem, no legal obstacles stand in the way of the EFSM's creation.

C. Article 122(2) Dropped as a Legal Basis for a Future ESM

Second, the Council belatedly acknowledged that it might have improperly grounded the EFSM upon Article 122(2). A decision in December 2010 seemed to show its unease with originally relying on the provision and its desire to find something better for the permanent ESM.[89] In the first paragraph of the section concerning economic policy, the Council noted that "[T]he [TFEU] should be amended in order for a permanent mechanism to be established by the Member States of the euro area to safeguard the financial stability of the euro area as whole (European Stability Mechanism)."[90] It then shifted focus to Article 122: "As [the ESM] is designed to safeguard the financial stability of the euro area as a whole, the

86. Sinn, *supra* note 17, at 5.
87. Council Regulation 407/2010, 2010 O.J. (L 118) 1 (EU) (emphasis added).
88. *Id.*
89. *See generally* Council Conclusions (EC) EUCO 30/1/10 Rev 1 of 16–17 Dec. 2010, at 1.
90. *Id.*

European Council agreed that Article 122(2) TFEU will no longer be needed for such purposes. Heads of State or Government therefore agreed that it *should not be used* for such purposes."[91]

The language change between the Council's reference to its view of Article 122 and that of European heads of state appears significant. The Council could have written the paragraph to say that it and European heads of state agreed to stop using Article 122 to justify the ESM and, by implication, any new euro rescue measures. Instead, it not only referenced the heads of state in a separate sentence, but also used normative language to describe their views. The fact that European leaders negotiated with EU institutions to formally amend the TFEU to ground the ESM already suggests massive unease with using existing treaty provisions to justify euro rescue efforts.

But was the Council trying to signal a belated mea culpa over using Article 122, or is this just an overly textual reading of the decision? Evidence for the former view comes from a Euro-Summit last October, two months before the Council's decision, in Brussels.[92] There, European leaders acknowledged that the creation of the EFSM might have been at odds with EU treaty law and that a permanent crisis mechanism should not be grounded in the Article.[93] Since EU heads of state comprise the Council, treating its opinion on the issue as something fundamentally different from the collective view of European leaders seems unreasonable.[94]

D. Article 122(2)'s "Exceptional Occurrences" Language

Third, one should stress the importance of Article 122(2)'s "exceptional occurrences" language. A report prepared for the European Parliament's Committee on Economic and Monetary Affairs linked "natural disasters" and "exceptional occurrences" to cause.[95] Report author Anne Sibert wrote:

> [I]n the case of the European sovereign debt crisis it is difficult to argue that the severe difficulties faced by some member states where akin to being hit by hurricanes or earthquakes, rather than being mostly of their own making. Presumably, little issue was made of the question of legality because of the small size of this facility.[96]

In other words, the causal language of Article 122 might not even be relevant in determining its applicability to the EFSM.

91. *Id.* (emphasis added).

92. *See* André ten Dam, *Saving the Euro(zone): The Matheo Solution*, INMAXXA, 3-4 (Nov. 25, 2010), http://www.inmaxxa.nl/file_library/Saving%20the%20euro%20?The%20Matheo%20Solution%2025_11_2010.pdf.

93. See *id.*

94. *The European Council–An Official Institution of the EU*, EUROPEAN COUNCIL, http://www.european-council.europa.eu/the-institution.aspx?lang=en (last visited Nov. 12, 2011).

95. *Sibert Paper*, *supra* note 54, at 3.

96. *Id.*

Even without a substantiality element, it would appear strange to argue that the 2008 recession was an event akin to an earthquake or hurricane. Although it caused substantial individual and commercial loss, the downturn was not something before which human beings were completely powerless, or which they could not have prevented well in advance.[97] Furthermore, the fact that Sibert, the European Parliament's own reporter, suggests EU institutions essentially disregarded the obvious conflict between the EFSM and Article 122 because of the mechanism's "small size" should give readers serious pause.

A political emergency, no matter how great, does not justify distorting historical evidence, and equating an economic downturn with a natural disaster such as a hurricane, to circumvent or ignore open conflicts with treaty law. Especially given legally safer alternatives, the EU's attempt to validate the EFSM under Article 122(2) appears legally untenable.

III. The EFSF

A. TFEU Article 124

1. *Broad Reading of "Prudential" to Overcome Compliance Problems*

One legal concern with the EFSF is its compliance with TFEU Article 124, which restricts privileged access by Union bodies or public undertakings of member states to financial institutions.[98] The main issue is the company's maintenance of a AAA credit rating.[99] On the eve of the EU rescue measures, Standard & Poor's downgraded Greek bonds to junk status and Moody's cut Ireland's rating to just above the lowest level.[100] In other words, few if any financial institutions were willing to lend to either country, and, if they did, Athens and Dublin would have had to accept prohibitive yield rates.

The EFSF Agreement made securing a AAA rating a top priority.[101] First, signatory states contribute to the EFSF up to their share of paid-in capital to the ECB.[102] Each state is supposed to guarantee 120 percent of its ECB share.[103] There is an additional cash reserve accumulated from fees paid by troubled states when they access the facility.[104] Second, as

97. Putting aside the long-standing interpretation and past reading of Article 122(2), an attempt to separate "exceptional circumstances" from "natural disasters" and justify the EFSM solely based on the former would fail to overcome the "beyond the [member state's] control" qualifier. Debt or currency crises cannot emerge completely independent of states' fiscal and monetary policy decisions.

98. TFEU, *supra* note 58 art. 124.

99. *Sibert Paper*, *supra* note 54, at 3.

100. Lefteris Papadimas & Dave Graham, *S&P Cuts Greek Debt to Junk, Downgrades Portugal*, REUTERS (Apr. 27, 2010), http://www.reuters.com/article/2010/?04/27/us-greece-idUSLDE63P0LU20100427; Dominic Lau, *Moody's Rating Cut Hit Euro, Irish Bonds*, REUTERS (Apr. 15, 2011), http://uk.reuters.com/article/2011/04/15/?markets-global-idUSLDE73E07W20110415.

101. *See Sibert Paper*, *supra* note 54, at 3.

102. *Id.*

103. *See* EFSF Agreement, *supra* note 44, at 10.

104. *Sibert Paper*, *supra* note 54, at 3.

previously mentioned, states cannot receive an EFSF loan unless they conclude a memorandum of understanding with the Commission and agree to strict austerity measures coordinated with the ECB and the IMF. The final determination to initiate EFSF borrowing and extend a loan is made by the facility's board of directors.[105]

The EFSF sought to overcome three obstacles to a top rating. First, since not all signatories have high ratings on their bonds, the strength of their individual guarantees is suspect.[106] Second, the EFSF's ability to maintain a high rating is linked to the probability that a troubled state will duly repay its loan.[107] Third, the EFSF can only issue debt after a troubled state requests a loan, making that state's creditworthiness at the time it applies for aid especially awful.[108] The cash reserve, strong political commitment to make the facility work, faith in austerity measures, and the 20 percent extra guarantee combined to overcome creditors' fears. On January 19, 2011, the three largest credit rating agencies gave the EFSF an AAA rating.[109]

The EFSF's credit status ensures that Greece, Ireland, and other troubled states will be able to borrow from the facility at much lower rates than they would independently receive on the open market.[110] Troubled states are able to transfer some of their risk to more stable members, particularly France and Germany, which may end up paying a much higher percentage of the EFSF's debt in the event that enough countries are forced to step out of their guarantees.[111] While this arrangement provides a significant incentive for troubled states to accept assistance rather than default, the arrangement arguably violates Article 124's privileged access prohibition.

A way to handle this issue would be to argue for an expansive reading of the Article's "prudential" language. European leaders could make a convincing argument that easing borrowing pains for troubled states is more than prudential considering the systemic risk posed by sovereign default, the consequences of overexposure by European banks to toxic debt, and the threat the current crisis poses to EU political integration. In other words, while an issue that needs addressing, the EFSF could overcome an Article 124 challenge.[112]

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105. *See* EFSF Agreement, *supra* note 44, at 16–17.

106. Sibert Paper, *supra* note 54, at 3.

107. *See id.*

108. *Id.*

109. Press Release, European Financial Stability Facility, Top Credit Rating for EFSF's Debut Debt Issuance (Jan. 19, 2011), *available at* http://www.efsf.europa.eu/?mediacentre/news/2011/2011-003-top-credit-rating-for-efsfs-debut-debt-issuance.htm.

110. Antonis Antoniadis, *Debt Crisis as a Global Emergency: The European Economic Constitution and Other Greek Fables*, *in* THE EUROPEAN UNION AND GLOBAL EMERGENCIES: A LAW AND POLICY ANALYSIS 167, 181 (Antonis Antoniadis et al. eds., 2011).

111. *See* Sinn, *supra* note 17, at 2.

112. This does not mean that the European Court of Justice, the final arbiter of EU treaty law, will *necessarily* agree with an expansive interpretation.

B. TFEU Article 125

1. No Clear Conflict with the Original Language

Another legal issue involves TFEU Article 125, which prohibits the Union and member states from being "*liable for or assum[ing] the commitments of* central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, *without prejudice to mutual financial guarantees for the joint execution of a specific project*."[113]

TFEU 125, formerly Article 103 of the Treaty establishing the European Community, has consistently been interpreted as a no bailout clause.[114] The Nice Treaty included a declaration referencing this provision in the context of TFEU 125:[115] "The Conference recalls that decisions regarding financial assistance, such as are provided for in Article 100 and *are compatible with the 'no bail-out' rule laid down in Article 103*. . . ."[116] In 2001, MEP Erik Meijer sent a question to the Commission about tensions between the euro and different member states' pension policies.[117] The Commission's answer included a statement that "[t]he EC Treaty (Article 103) contains an explicit *'no bail out clause'* prohibiting one Member State[ ] from assuming the liabilities of another Member State."[118] The ECOFIN understands Article 103 to mean that "governments will continue to be liable for their own debts and will have to ensure that their fiscal policies are sustainable."[119]

Excluding a recent amendment to the EFSF, which apparently governs its use until the facility expires in 2013,[120] there seems to be no conflict with the literal language of Article 125.

First, the EFSF cannot extend grants to troubled states, but rather loans repayable with interest. In a speech to Berlin's Humboldt University, German Finance Minister Wolfgang Schäuble asserted that "[t]he loans are not transfers. And they are not gifts. . . . And the conditionality is such that the country is compelled to enforce measures that would have been unthinkable before the event."[121] An EFSF memorandum answering questions about the facility notes that it "provides loans to countries in finan-

113. TFEU, *supra* note 58 art. 125(1) (emphasis added).

114. *Id.*

115. This was formerly Article 103 of the Treaty of European Economic Community.

116. Treaty of Nice Amending the Treaty on European Union, The Treaties Establishing the European Communities and Certain Related Acts, Oct. 3, 2001, 2001 O.J. (C 80) 78 (emphasis added).

117. Question by Member Meijer, 2002 O.J. (C 40 E) 86 (June 14, 2001) (European Parliamentary Debates).

118. *Id.* at 87 (emphasis added).

119. *Myths and Facts*, Eur. Commission: Econ. & Fin. Aff., http://ec.europa.eu/?economy_finance/emu10/facts4_en.htm (last visited Nov. 11, 2011).

120. Memorandum from the European Financial Stability Facility 4 (Aug. 2, 2011), *available at* http://www.efsf.europa.eu/attachments/faq_en.pdf.

121. German Federal Minister of Finance Dr. Wolfgang Schäuble, Speech at the Walter Hallstein-Institut of the Humboldt-Universität in Berlin (Jan. 26, 2011), *available at* http://www.bundesfinanzministerium.de/nn_103148/EN/Press-and-publications/?Speeches-and-interviews/Speeches/26012011-Humboldt-Uni.html.

cial difficulties. But it could be agreed with a Member State that receives funds to use them to stabilise the banking sector."[122] The EFSF, therefore, creates a separate obligation for troubled states—the low interest loan—while helping them repay their government bondholders. Since loans are not handouts, EFSF members would not be assuming debt obligations directly and could avoid Article 125 problems. Second, if Greece, Ireland, and other troubled states were to default before paying back their EFSF loans, the guarantors would only be liable for the EFSF's debts to third-party creditors that bought the facility's bonds. A memorandum by the Herbert Smith law firm contends that this feature ensures signatories do not make guarantees either directly to sovereign (i.e., Greek and Irish) bondholders or to fellow members contributing to the EFSF.[123]

But is this really substantive compliance with Article 125 or just a clever circumvention? The EFSF could be considered little more than a means by which creditors, fearful of buying junk rated bonds directly from troubled states, indirectly finance them at reduced risk courtesy of the euro area's more stable members. Instead of viewing EFSF loans as obligations running from the troubled states to the EFSF as a separate entity, why not regard them as obligations running from the troubled states to the third party creditors (i.e., not regarding the EFSF as a separate entity, but merely a delivery vehicle)? The EFSF's sole purpose is to lend to troubled states and all repaid loans go straight back to the facility's creditors. The Herbert Smith memorandum hinted that this conceptualization is at least possible.[124]

Nevertheless, the EFSF does offer actual advantages to borrowing states that would probably make it more than just a delivery vehicle or empty shell. Furthermore, it is a registered Luxembourg corporation and should formally be considered a legal entity. Therefore, its signatories could make a legitimate case that no Article 125 problems would arise if troubled states were to default after receiving assistance.

C. Compliance Threatened by Debt Market Intervention Amendment

The EFSF was recently amended in a way that threatens its compliance with Article 125. Euro area member states concluded a Pact for the Euro on March 11, 2011.[125] Along with a discussion on strengthening economic governance and recommendations for organizing the ESM, the signatories included a change to the EFSF: "Financial assistance from the ESM and EFSF will take the form of loans. However, to maximize the cost efficiency of their support, the ESM and *the EFSF may also . . . intervene in the*

122. Memorandum from the European Financial Stability Facility, *supra* note 120, at 3.

123. *See European Financial Stability Measures and EU Law*, HERBERT SMITH (July 2010), http://www.herbertsmith.com/NR/rdonlyres/BA7C5FA2-BBB5-4B8D-9971-23AF97BBB678/0/8339Europeanfinancialstabilitymeasuresbriefing.pdf.

124. *See id.* at 4.

125. Conclusions of the Heads of State or Government of the Euro Area of 11 March 2011 (EC), ¶ 1, *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/?pressdata/en/ec/119809.pdf [hereinafter Pact for the Euro].

debt primary market in the context of a programme with strict conditionality."[126] EU heads of state concluded an agreement on June 24, 2011,[127] allowing primary market intervention on an exceptional basis and amended the EFSF framework agreement accordingly.[128] German Chancellor Angela Merkel confirmed that the EFSF can purchase government bonds on the primary market.[129]

Expansion into the primary market appears to make the EFSF a separate creditor of troubled states seeking assistance. This would not seem to implicate Article 125 because the EFSF is formally a registered corporation with a chief executive officer and board; it is not a political institution or a government capable of making bilateral loans as conceived by the TFEU. It is distinguished from a private corporation mainly in its source of paid-in capital (exclusively euro area signatories to the framework agreement) and its ability to spend that capital (assisting distressed euro area states). European leaders could argue these distinctions are insignificant and the EFSF should be treated like any stand-alone company, where losses suffered due to a distressed state's default would be absorbed and liquidated by the facility as with any other firm. In other words, it should not matter that the EFSF used paid-in capital to buy the government bonds that are rendered worthless by default.

This argument is persuasive if EFSF members' guarantees under the framework agreement are limited to instruments the facility itself issues, which occurs when it sells its own bonds to third parties in order to raise additional capital. The agreement, however, extends guarantees to "bonds, notes, . . . [and] other *financing arrangements*" that the facility "issu[es] or *enter[s] into*."[130] A court could read this to mean that the agreement imposes on the EFSF an obligation to pay, even where the facility issues no bonds or instruments in a transaction. Stated differently, it appears to foist debtor states' obligations to pay their creditors onto the EFSF if the facility directly purchases these states' bonds.

If the EFSF buys government bonds from Greece or Ireland using only its paid-in capital, could this be a "financing arrangement" encompassed by the agreement? If yes, and these countries default, then the terms of the framework agreement would require EFSF members to cover each other's losses; this would, in all but name, create a situation where EFSF members take on obligations in violation of Article 125. A similar scenario would exist if the EFSF bought government bonds and resold them on the secondary debt market to third-party creditors, with the issuing debtor states

126. *Id.* at 3 (emphasis added).

127. Memorandum from the European Financial Stability Facility, *supra* note 120, at 3.

128. Amendment to the EFSF Framework Agreement ¶ 1(49), July 21, 2011, *available at* http://www.gruene.at/uploads/media/efsf_framework_agreement_?amendment_agreement.pdf [hereinafter EFSF Amendment].

129. Patrick Legland & Michala Marcussen, *The Euro Zone Debt Crisis Not Over Yet*, CNBC GUEST BLOG (Mar. 16, 2011), http://www.cnbc.com/id/42088953/?Blog_The_Euro_Zone_Debt_Crisis_Not_Over_Yet.

130. EFSF Agreement, *supra* note 44, at 2 (emphasis added).

defaulting later. Here, as with direct purchases, the EFSF would not issue any instruments itself to finance the transaction.

European leaders could potentially work around this issue by pressing a court to deemphasize—or narrowly read—the "entering into" language, and focus instead on the instruments the EFSF can independently issue. They could also ask a court to stress form over substance. This would involve arguing that obligations to pay in the event of default would run to the EFSF members not from the defaulting state, but from the facility itself. In other words, even though the EFSF would be the buyer in a primary debt market transaction, it could make a promise to pay itself back in the event of default. Thus, whenever EFSF members have to make up its losses, they would be acting on the corporation's obligations rather than those of the bond-issuing state, thereby avoiding Article 125.

Whether a court would accept this argument is an open question, especially considering the strangeness of saying a corporation could obligate itself to pay itself when it suffers losses as a result of a debtor's inability to repay its debt. This obligation to pay oneself seems to come out of thin air, with little connection to the substance of the actual transaction or the underlying reason for the corporation's losses. European leaders may try to underscore the fact that intervention would occur only in exceptional circumstances, but because the amended framework agreement leaves this term undefined, a court could cite this for possible abuse.[131] Even former commissioner Stefano Micossi, who favors a narrow reading of Article 125 and believes it allows much more intervention than its literal language suggests, draws the line at primary debt purchases: "[Article 125] seems . . . to ban any direct purchases of sovereign debt in the primary market, which could entail a direct assumption of the commitments of one member state."[132]

The EFSF would have problems overcoming a TFEU Article 125 challenge if a court were to take a broad reading of the framework agreement's "guarantees" language. If the facility's obligations extend to any arrangement it enters, whether or not involving instruments or securities it issues, then it would be at odds with the substance of the Article whereby EFSF members would be forced to guarantee defaulting debtor states' obligations.

IV. The ESM and TFEU Article 136

A. Revision Procedure to Amend Article 136

Recognizing both the Article 122 and 125 challenges to the EFSM and EFSF, and the temporary nature of the measures, in December 2010, the Council began negotiations toward a new, permanent relief mechanism.[133] The new European Stability Mechanism, modeled on the EFSF to avoid

131. *See id.* at 2–3.

132. Stefano Micossi, *On the Tasks of the European Stability Mechanism*, VOX (Mar. 15, 2011), http://www.voxeu.org/index.php?qNºde/6217.

133. Council Conclusions (EC) EUCO 30/1/10 Rev 1 of 16–17 Dec. 2010.

reliance on the EU budget, is legally grounded in an amendment under TEU Article 48(6).[134] This provision allows a simplified revision procedure to Part Three of the TFEU, which covers the Union's internal policies and action, through a unanimous Council decision in consultation with the ECB, the European Parliament, and the Commission in the event of changes to the monetary area.[135] The second and third paragraphs prevent a revision from entering into force without member state approval in accordance with national constitutional requirements, and prohibit the revision from increasing the Union's competencies.[136]

The revision alters TFEU Article 136, which allows the Council to adopt measures specific to euro area states "to ensure the proper functioning of economic and monetary union" in the areas of budgetary surveillance and economic policy guidelines.[137] The January 11, 2011, Council decision added a new paragraph to the Article:

> [T]he Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole and stating that the granting of any required financial assistance under the mechanism will be made subject to strict conditionality.[138]

Following an intergovernmental agreement and consent by the European Parliament, the Council approved the ESM in a decision on March 25, 2011.[139] The seventeen euro states signed the Treaty Establishing a European Stability Mechanism on July 11, 2011.[140]

B. Article 136 Violations through Indirect Obligations on Non-Euro Area States

1. *Euro-Plus Pact*

Although ambiguous, the ESM may face legal obstacles stemming from its demands on non-euro area states. Officially, the March 25th decision makes involvement strictly voluntary. Non-euro area states can "participat[e] on an ad hoc basis alongside the ESM in a financial assistance operation for euro area Member States . . . ."[141] They are exempted from the "Euro-Plus Pact," an intergovernmental agreement spearheaded by France and Germany to coordinate fiscal policy across the Eurozone.[142] This agreement, expanding on the Pact for the Euro, was considered a prerequisite to get Germany to accept the ESM and tentatively agree to

134. TEU, *supra* note 7 art. 48(6).
135. *Id.*
136. *Id.*
137. TFEU, *supra* note 58 art. 136.
138. Council Conclusions (EC) EUCO 30/1/10 Rev 1 of 16-17 Dec. 2010, at 6.
139. Council Conclusions (EC) EUCO 10/11 of 24-25 Mar. 2011.
140. ESM Treaty, *supra* note 55.
141. *Id.* pmbl.
142. *See* Council Conclusions (EC) EUCO 10/11 of 24-25 Mar. 2011, at 13-20.

increase its capitalization in the future.[143] Hungary, the Czech Republic, and Sweden refused to join the Pact.[144] The United Kingdom also declined to join, and the House of Lords supported the British government's vote in favor of amending Article 136 only after concluding that no new competence would be transferred from Parliament to Brussels.[145]

2. *European Council Taskforce's Economic Governance Reform Proposals*

The ESM and the package of reforms necessary for its existence may, nevertheless, indirectly bind non-euro area states in ways that hollow out the Council decision's literal language. A source of concern, potentially implicating the competence requirement of Article 48(6), is the ESM's connection to a package of EU economic governance reforms. A Council taskforce, organized by President Herman van Rompuy, announced recommendations to overhaul the Stability and Growth Pact last October.[146] That mechanism, consisting of two Council regulations and a Council decision, authorized oversight of member states' budgets to monitor and correct excessive deficits.[147] The SGP was meant to incentivize states to run balanced budgets or have surpluses over the medium term, which was overseen through submission to the Commission of stability (euro area states) or convergence (non-euro area states) programs with medium-term budgetary objectives.[148] Excessive deficit determinations are based on criteria found in Protocol 12 to the TFEU (i.e., 3% for the government deficit-to-GDP ratio and 60% for the debt-to-GDP ratio).[149]

The original regulation 1466/97 authorized the Council to monitor non-euro area states' budgets through their submitted convergence programs to ensure their policies were "geared to stability and . . . to avoid real exchange rate misalignments and excessive nominal exchange rate fluctuations" with euro area states.[150] The Council may publicly recommend a member state to adjust its fiscal policy when it significantly diverges from the submitted objective.[151] The original regulation 1467/97, which detailed a sanctions regime against member states unable to correct exces-

143. *See* Editorial, *Pact for the Euro: What's in a name?*, ECONOMIST (Mar. 25, 2011), http://www.economist.com/blogs/charlemagne/2011/03/pact_euro.

144. *'Euro-Plus Pact' Divides Non-Eurozone Members*, EURACTIV.COM (Mar. 25, 2011), http://www.euractiv.com/euro-finance/euro-plus-pact-divides-non-eurozone-members-news-503526.

145. *Id.*; *see* EUR. UNION COMMITTEE, AMENDING ARTICLE 136 OF THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION 5–7 (2010) (U.K.) (prepared as the 10th Report of Session 2010-11 of the House of Lords).

146. STRENGTHENING ECONOMIC GOVERNANCE IN THE EU: REPORT OF THE TASK FORCE TO THE EUROPEAN COUNCIL (Oct. 21, 2010), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf [hereinafter TASK FORCE REPORT].

147. MARTIN HEIPERTZ & AMY VERDUN, RULING EUROPE: THE POLITICS OF THE STABILITY AND GROWTH PACT 3–4 (2010).

148. Council Regulation 1466/97, 1997 O.J. (L 209) 3 (EC).

149. Protocols to the Treaty on the Functioning of the European Union, Sep. 5, 2008, 2008 O.J. (C 115) 279–80.

150. Council Regulation 1466/97, 1997 O.J. (L 209) 3 (EC).

151. *Id.* at 4.

sive deficits, imposed non-interest bearing deposits as a rule.[152] These would convert to fines if corrective action against the excessive deficit were not taken within two years after imposition of the deposit.[153] Article 16 of the regulation deals with the distribution of collected sanctions: "Interest on the deposits, and the fines . . . constitute other revenue . . . and shall be *distributed among participating Member States without a deficit that is excessive*."[154]

The van Rompuy taskforce proposed substantial changes to regulations 1466/97 and 1467/97. First, member states should adopt "minimum requirements for national [fiscal] frameworks" to "strengthen . . . ownership of EU fiscal rules."[155] In other words, states would have to coordinate their fiscal policies toward common practices in: (1) public accounting systems and statistics; (2) numerical rules; (3) forecasting systems; and (4) coverage of government finances.[156] The Commission and Council would review the progress of coordination and pressure lagging states to adjust faster.[157] Second, while the original regulation 1467/97 gave member states six months to correct excessive deficits after notice by the Council, the taskforce opened the door to automatic sanctions, based on a Commission report, if a member state's Excessive Deficit Position showed "serious policy slippages."[158] Third, public bodies would be created at the national level to provide "independent analysis, assessments and forecasts on domestic fiscal policy," and reinforce compliance with the taskforce's proposals.[159] Fourth, even if their deficits are below the three percent benchmark, euro area states would face sanctions if their budgets significantly deviated from an adjustment path foreseen by the SGP.[160]

The taskforce recommendations were incorporated into two Commission proposals for new Council regulations to amend old regulations 1466/97 and 1467/97.[161] The Council generally accepted the proposals and promulgated regulations in consultation with the European Parliament on September 28, 2011.[162] Particularly important are the suggested changes to Articles 11 and 16 of regulation 1467/97. The Commission seeks to change the default sanction from non-interest bearing deposits to

152. Council Regulation 1467/97, 1997 O.J. (L 209) 8 (EC).
153. *Id.* at 9.
154. *Id.* (emphasis added).
155. Task Force Report, *supra* note 146, at 7.
156. *Id.*
157. *See id.* at 8.
158. *Id.* at 6, 9.
159. *Id.* at 11.
160. Task Force Report, *supra* note 146, at 4, 6.
161. *Commission Proposal for a Council Regulation (EU) Amending Regulation (EC) No 1467/97 on Speeding up and Clarifying the Implementation of the Excessive Deficit Procedure*, COM (2010) 522 final (Sept. 29, 2010) [hereinafter *Commission Proposal 1467/97*]; *Commission Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1466/97on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies*, COM (2010) 526 final (Sept. 29, 2010).
162. Eur. Parl. Doc. (CNS 0276) (2011), *available at* http://www.europarl.europa.?eu/oeil/FindByProcnum.do?lang=2&procnum=CNS/2010/0276.

fines;[163] this increases the amount of sanctions the Union can collect, while decreasing the chance that punished members will be reimbursed upon taking corrective action against excessive deficits. The amended Article 16 would treat fines as other revenue, like the old regulation, and distribute them among the participating member states that do not have excessive deficits and are not subject to an excessive imbalance procedure.[164]

3. *Taskforce Proposals and the ESM: Backdoor Contributions from Non-Euro Area States*

Both the old and proposed regulation 1467/97 limit the imposition of financial sanctions to "participating" (i.e., euro area) states. Yet the taskforce recommendations indicate that non-euro states would also face sanctions as part of SGP reform:

> The recommended financial sanctions range from interest-bearing deposits to fines. They will be first applied to euro area Member States only. As soon as possible, and at the latest in the context of the next multi-annual financial framework, the enforcement measures will be extended to all Member States, by making a range of EU expenditures *conditional upon compliance* with the SGP.[165]

This language is noteworthy because, while not explicit, the taskforce clearly hints at including financial sanctions in the new enforcement measures that non-euro area states will eventually face.

The taskforce noted the need to differentiate the timing and degree of SGP enforcement between euro and non-euro area states, but also stressed that the final enforcement mechanism must ensure "[f]airness, proportionality and equal treatment between Member States."[166] Apparently in line with the taskforce's two-stage approach, which applies the new enforcement mechanism to euro area states first, both the Commission proposals and the Council's decisions limit their sanctions discussion to these countries.[167] The second stage would, however, see all member states (exemptions preserved for the U.K.) included in the enforcement mechanism over the medium-term.[168] Thus, there is every reason to believe that non-euro area states will face financial sanctions under a reformed SGP sooner or later.

The Council directly linked SGP reform to the ESM. The January 11th decision stated that the ESM will "complement the new framework of reinforced economic governance."[169] The March 25th decision required euro area member states to "give to the ESM the financial sanctions received

163. *Commission Proposal 1467/97*, *supra* note 161, at 14.
164. *Id.* at 15.
165. *See* Task Force Report, *supra* note 146, at 1 (emphasis added). The United Kingdom is exempt under TFEU Protocol 15.
166. *Id.* at 5.
167. *See id.*
168. *Id.*
169. Council Conclusions (EC) EUCO 30/1/10 Rev 1 of 16–17 Dec. 2010, at 8.

under the Stability and Growth Pact and the Macroeconomic Imbalances procedures."[170] The significance of the language "give to the ESM the financial sanctions" is explained in a Council press release issued March 15, 2011: "Fines collected in the context of both the excessive imbalance and excessive deficit procedures would be transferred to the crisis fund created for the euro area to provide financial assistance to member states in difficulty (i.e. the European Financial Stability Facility and the future European Stability Mechanism)."[171] The March 25th decision makes clear that SGP fines will directly fund the ESM: "Such sanctions will form part of the [member states'] paid-in capital."[172]

The Pact for the Euro and the Euro-Plus Pact, negotiated to coordinate member states' fiscal policies at the national level, effectively made passage of governance reforms a prerequisite to the ESM's adoption. While the Pact for the Euro demanded the ESM be negotiated in a way to "strictly adhere to and fully implement" the reforms, the Euro-Plus Pact aims to bring added value to reforms by incorporating all intergovernmental fiscal policy changes into national reform, stability, and convergence programs sent to the Commission under the SGP.[173] There were reports during the negotiations of the pacts that core Eurozone states, particularly Germany, explicitly made acceptance of the ESM contingent on governance reform guarantees.[174]

The pacts and the January 11th decision appear to link SGP reforms to the ESM in a way that makes one impossible without the other. More revealing is the "sanctions" language in the March 25th decision.[175] As previously mentioned, Article 48(6) allows a treaty revision so long as the competencies of the Union do not increase. One must examine the article amended (i.e., Article 136) to determine whether an increase occurs. No change to the TFEU that binds non-euro states is permitted under Article 136.

The SGP's surveillance arm applies to all EU members.[176] While the U.K. retained exemptions from the taskforce recommendations, other non-euro area states will be subject to the gamut of proposed changes.[177] These include: (1) the possibility of automatic sanctions if states have "particularly serious imbalances" when placed in an Excessive Deficit Position by the Council, which gives the Commission far greater oversight than was permissible under the original regulation 1466/97; and (2) the minimum

170. Council Conclusions (EC) EUCO 10/11 of 24–25 Mar. 2011, at 22.

171. Press Release, European Council, Council Reaches Agreement on Measures to Strengthen Economic Governance (Mar. 15, 2011), *available at* http://www.consilium.?europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119888.pdf.

172. Council Conclusions (EC) EUCO 10/11 of 24–25 Mar. 2011, at 22.

173. *See* Pact for the Euro, *supra* note 125, at 2; Council Conclusions (EC) EUCO 10/11 of 24–25 Mar. 2011, 14.

174. *See* Editorial, *Pact of Uncompetitiveness*, ECONOMIST, Feb. 10, 2011, *available at* http://www.economist.com/node/18114465; *see also 'Euro-Plus Pact' Divides Non-Eurozone Members*, *supra* note 144.

175. Council Conclusions (EC) EUCO 10/11 of 24–25 Mar. 2011, at 22.

176. *See* TASK FORCE REPORT, *supra* note 146, at 5.

177. *Id.*

guidelines requirement that effectively allows the Commission to craft common fiscal policy rules across the entire Union.[178]

There is also the ambiguous language on whether non-euro area states will face financial sanctions under SGP reform. The taskforce appears eager to bring all member states within the entire enforcement mechanism.[179] If non-euro area states will face sanctions under a new SGP, and these are distributed amongst other member states and given to the ESM as part of euro-area states' paid-in capital, then EU members officially exempt from the ESM under Article 136 will nevertheless be contributing to the program through a backdoor (i.e., indirectly with their sanctions). In other words, non-euro area states will unwittingly participate in the ESM whenever they incur fines or interest on deposits under the SGP; this seems to bind non-euro area states in a way not authorized by the literal language of Article 136 and makes the ESM amendment under Article 48(6) unjustified.

V. Default-and-Euro-Separation Alternative

A. EU Rescue Measures Delaying the Inevitable

The EFSM, EFSF, and ESM, if nothing else, show the intense political will of euro area leaders to preserve the common currency and thwart a wave of defaults that would put future political integration in jeopardy. French President Nicholas Sarkozy said at this year's Davos World Economic Forum that he and German Chancellor Merkel will "never, never . . . turn our backs on the euro . . . . We will never let the euro go or be destroyed."[180] In the short-term, some stability will probably be restored.[181] The EFSF's expansion into primary debt markets and the ECB's indirect purchase of troubled states' bonds may delay default.[182] Delay, however, does not mean long-term recovery.

There are serious doubts that the EU's measures, while substantial, will restore troubled states' competitiveness and prevent them from making the same mistakes again. Legal consulting firm manager and euro researcher André ten Dam believes that Greece will never be able to repay its EFSM and EFSF loans unless it finds a way to instantly restore its competitive position.[183] The bigger problem, however, was best explained by *Daily Telegraph* columnist Peter Oborne:

> The experiment of imposing a single currency and a single monetary policy upon economies as divergent as those of Germany and Greece has gone tragically wrong. Germany, bolstered by an artificially low exchange rate and rock-bottom interest rates, is enjoying a boom. But the economies of Ireland,

178. *Id.* at 9.
179. *See id.* at 5–7.
180. Peter Oborne, *Some European Countries Are in the Habit of Going Bankrupt*, TELEGRAPH (Mar. 24, 2011), http://blogs.telegraph.co.uk/news/peteroborne/100081316/?some-european-countries-are-in-the-habit-of-going-bankrupt.
181. *Id.*
182. *See* Legland & Marcussen, *supra* note 129.
183. ten Dam, *supra* note 92, at 5.

> Portugal, Greece and others are being destroyed—businesses closing, unemployment surging, dependent on bailouts, all self-respect and independence gone.[184]

In other words, the entire foundation of the common currency may have set the stage for its own demise. When different economies with different public policy priorities must maintain a single currency, with interest rates controlled by one central bank, coordination problems might overtake the system.

Although André ten Dam, prominent German economist Hans-Werner Sinn, and other critics of the EU's rescue efforts oppose the alternative of letting troubled states drop the common currency and default, not everyone believes this will lead to catastrophe. British MEP Nigel Farage argues that the euro was doomed from the start and that assisting countries like Greece and Portugal keeps them trapped in an "economic prison."[185] Peter Oborne is more specific:

> [W]ere these countries outside the eurozone, there would be no real problem. The IMF could intervene, reschedule their debts and allow the national currencies to float until they reached a competitive level. In the case of Greece, this level would be well under half where it stands today as a member of the euro.[186]

B. Legal and Economic Benefits

A default-and-separation alternative to the EU's current measures, where distressed states can reclaim their national currencies, undergo competitive devaluations, and limit engagement with the Eurozone to a purely political level, would generate numerous economic and legal benefits.

First, it would leave the euro in the hands of those stable states (e.g., Germany, France, and the Netherlands) capable of maintaining it; this capability stems not only from stark differences in economic performance between these states and their peripheral neighbors, but also from cultural incompatibilities.[187] Noted New York Times columnist, Thomas Friedman, discussed this in a recent article:

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184. Oborne, *supra* note 180.

185. Nigel Farage, Remarks at the European Parliament in Brussels (June 16, 2010) (available to watch at http://www.youtube.com/watch?v=nbp8UunIReY).

186. Oborne, *supra* note 180.

187. There are important differences between the European Union and economic and monetary unions within nation-states, such as Canada and the United States, to make the former far more unstable and difficult to maintain over the long-term in its current form. *See, e.g.*, Philip Whyte, *The Eurozone and the U.S.: A Tale of Two Currency Zones*, FOREIGN POLICY FORUM (Nov. 21, 2011) ("So the US is a fully-fledged federation with a relatively flexible central bank, while the eurozone is a fiscally decentralised confederation with a conservative and limited purpose central bank. These differences are critical to understanding why the eurozone is the focus of market turmoil and the US is not."); Michael D. Bordo, *The United States as a Monetary Union and the Euro: A Historical Perspective*, 24 CATO J. 163, 166–68 (2004).

> Germany is the epitome of a country that made itself rich by making stuff. Greece, alas, after it joined the European Union in 1981, actually became just another Middle East petro-state—only instead of an oil well, it had Brussels, which steadily pumped out subsidies, aid and euros with low interest rates to Athens.[188]

Reports from Greece, after it requested a second assistance package several months ago, provide little optimism for an impending reduction of the cultural gap.[189]

Second, without the problem of propping up a continental currency, the peripheral states can more easily take advantage of collective-action clauses in their government bonds to overcome bondholder problems and restructure their debts.[190] The surprise showing of the euroskeptic True Finns in Finnish elections, who campaigned on a strong anti-bailout platform, indicates that continuing the current EU policy may be more detrimental to future political integration than the default alternative.[191]

Third, the default alternative would minimize discord between stable euro members, protect their taxpayers' interests, and allow those who took unnecessary investment risk and became overleveraged to pay for their losses. As it stands, the EU's rescue measures have artificially spread risk[192] and heightened tensions between stable euro members, while peripheral states remain incapable of paying their loans and default continues to loom despite billions in assistance. Major German bankers believe that the rescue measures' primary beneficiaries are not debt-ridden Greeks, but large French banks with the most extensive exposure to Greek and Irish debt.[193] German Chancellor Merkel barely agreed to a deal on new assistance to Greece in June 2011, after France, the ECB, and most other euro members demanded she drop her insistence that private investors fund most of the package.[194]

Meanwhile, the EU's actions have sparked constitutional challenges in national courts. Germany's Constitutional Court recently began hearing a case, brought by euro-skeptic parliamentarians and professors, challenging the rescue measures and last year's bilateral loans to Greece for violating

188. Thomas L. Friedman, *Can Greeks Become Germans?*, N.Y. TIMES, July 20, 2011, at A27, *available at* http://www.nytimes.com/2011/07/20/opinion/?20friedman.html.

189. Ingrid Melander, *Greece to Miss 2011 Deficit Target, Privatization Goals in Doubt*, REUTERS (Sept. 1, 2011), http://www.reuters.com/article/2011/09/01/us-greece-imf-eu-idUSTRE7804V720110901.

190. Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, 8 FIN. STABILITY REV. 142, 142–43 (2000).

191. John Ellis, *True Finns Gain 34 Seats, Everyone Else Loses Seats*, BUS. INSIDER (Apr. 17, 2011), http://www.bbc.co.uk/news/world-europe-13107620; *Nationalist True Finns Make Gains in Finland Vote*, BBC (Apr. 18, 2011), http://www.bbc.co.uk/news/world-europe-13107620.

192. Such as the below-market borrowing privileges provided by the EFSF.

193. Joe Weisenthal, *Top German Bankers See Plot to Funnel Bailout Money to French Banks*, BUS. INSIDER (May 29, 2010), http://www.businessinsider.com/top-german-bankers-see-plot-to-funnel-bailout-money-to-french-banks-2010-5.

194. Michael Birnbaum & Anthony Faiola, *Germany, France Strike Deal on Greek Bailout*, WASH. POST (June 17, 2011), http://www.washingtonpost.com/business/?germany-france-strike-deal-on-greek-bailout/2011/06/17/AGDVLnYH_story.html.

both EU treaty law and German property rights.[195] The Court's decision on September 7, 2011 gave qualified support to Germany's participation in financial assistance efforts.[196] While upholding the fundamental legality of the relief efforts under Germany's Basic Law, the Court required the government to get parliamentary approval ahead of future actions.[197]

A smaller Eurozone should not mean the end of EU political integration. It should be recalled that some states, most notably Greece, effectively lied about the magnitude of their obligations when they applied to join the euro.[198] Britain's retention of the pound sterling and Sweden's derogation from the euro did not prevent adoption of the Lisbon Treaty and greater Union cooperation on common security matters.[199] In other words, the economies the EU is attempting to save might have refused to accept the common currency in the first place.

From a legal standpoint, the default alternative would avoid all the indirect and apparent conflicts with EU treaty law discussed in this Note. EU institutions would no longer need to pretend that peripheral states had virtually nothing to do with the current crisis or that amassing unsustainably large debt is equivalent to being struck by an earthquake or hurricane. Debtor states would have to solve their own problems with their own currencies, avoiding confrontation with Article 125's no bailout clause. Non-euro states would also know that, even if economic governance reforms would impose new fines and bind them to the Eurozone in previously unforeseen ways, the chance of their money being used to take on other members' debt obligations would be much reduced.

While a politically difficult alternative in the short-run, the long-run consequences of letting troubled states drop the euro, default, restructure their debts, and possibly return to the currency when they are deemed stable enough to maintain it might not be so disastrous. A smaller Eurozone made up of stable countries may well be better than a large Eurozone plagued by recurring crises.

Conclusion

The EU's attempts to save the euro with the EFSM, EFSF, and the future ESM demonstrate incredible political will in the face of crisis.

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195. Helen Pidd, *Greek Bailout Challenged in Germany's Constitutional Court*, GUARDIAN, July 5, 2011, at 25, *available at* http://www.guardian.co.uk/business/2011/?jul/05/germany-greek-bailout-legal-challenge-constitutional-court.

196. Henry Chu, *Germany's Constitutional Court Upholds Eurozone Bailout*, L.A. TIMES (Sept. 7, 2011), http://articles.latimes.com/2011/sep/07/world/la-fgw-german-ruling-20110907.

197. *Id.*

198. Krugman, *supra* note 27.

199. *See generally* VAUGHNE MILLER & CLAIRE TAYLOR, RESEARCH PAPER 03/68: THE SWEDISH REFERENDUM ON THE EURO 3–68 (Sept. 15, 2003); Fraser Cameron, *The Future of the Common Foreign and Security Policy*, 9 BROWN J. WORLD AFF. 115 (2003); Leandro P. Silva, The UK and the Euro: Better Together or Apart? (São Paulo Research Foundation, 2011), *available at* http://www.saopaulo2011.ipsa.org/sites/?default/files/papers/paper-994.pdf.

Although these measures tread on legally questionable ground, European leaders appear determined to avoid open clashes with EU treaty law and to take decisive action for want of politically palatable alternatives. This Note examined a number of legal issues in the background of the EU's actions. Article 122(2) should not be used to justify the EFSM, with or without a substantiality element read into the provision's "cause" language. European leaders belatedly acknowledged problems with using the Article and moved to formally amend the TFEU when creating the ESM. Although the EFSF will likely overcome an Article 124 challenge, the addition of an amendment allowing its intervention into the primary debt market exposes it to attack from Article 125. Specifically, if a court were to read the "guarantee" language broadly, EFSF members may be forced to take on obligations in the event of a debtor state's default in contravention of the no bailout clause. The ESM may have difficulty overcoming an Article 136 challenge if financial sanctions are imposed on non-euro area states as part of a final EU economic governance reform. In light of these difficult legal issues, this Note presented the default-and-euro-separation alternative to the EU's current approach, arguing that its long-term economic and legal benefits outweigh its short-term costs.