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The global financial crisis and the European Union

The financial crisis, which had started in July–August 2007 in the US subprime mortgage market before it spread to other segments of the financial markets and, becoming increasingly global, engulfed the real economy as well, revealed and accentuated some of the institutional weaknesses and – to a lesser extent – strengths of the European Union, in particular, those of the Economic and Monetary Union (EMU). This study analyses the effects and effect mechanisms of the global financial crisis, and within that especially of the sovereign debt crisis, on the institutions and operation of the European Union and the Economic and Monetary Union. The study focuses on the effective legal regulations and past processes, from which future-oriented conclusions are drawn. The analysis of solution proposals that are taking shape can be the subject of another study.

LEGAL REGULATION RELATING TO CRISIS MANAGEMENT

As it is reflected by recent developments, one of the most important weaknesses of European integration is that either from an institutional aspect or from the funding side *the EU and the EMU were not prepared for managing financial crisis situations.* In the Economic and Monetary Union, the room for manoeuvre of crisis management is restricted by a provision *[Article 123(1)]* of the Treaty on the Functioning of the European Union (TFEU) – a part of the Treaty of Lisbon –, which prohibits overdraft facilities or any other type of credit facility with the European Central Bank (ECB) or with the central banks of the Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States. This provision also prohibits the purchase of debt instruments of the aforementioned institutions directly by the European Central Bank or national central banks. *Accordingly, it is forbidden to finance the budget, or the general government in a wider sense, with central bank loans.* However, the above does not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, are given the same treatment by national central banks and the ECB as private credit institutions.

Pursuant of Article 125(1), 'The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any

Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.'

This is the so-called *no-bail-out clause.* It is important to emphasise that its provisions are not only applicable to the Member States of the Economic and Monetary Union, but also to all member countries of the European Union. It follows from the no-bail-out clause that in the European Union, particularly in the Economic and Monetary Union, there is a possibility, albeit theoretical, that sovereign debtors (i.e. the Member States) are unable to repay their debts and a *national bankruptcy* occurs.[1] First, neither the Community, nor the other Member States are obligated to help out a distressed Member State with financial transfer. Second, EU Member States cannot finance their budget deficits by issuing new money.

In the case of non-EU Member States, the state cannot go bankrupt because governments can cover the budget deficit by inflationary emission of money. However, as far as the European Union is concerned, according to one of the convergence criteria (which is included in the TFEU as well in an unchanged form) of the Treaty of Maastricht, inflation – measured by means of the consumer price index – in a Member State may exceed the arithmetic average of the rates of inflation of the three countries with the most stable prices (lowest inflation rate) observed over the same period by 1.5 percentage points at most, i.e. there are legal barriers to inflationary emission of money. The participation in the economic policy coordination also set forth in the Treaty is also an institutional barrier to excessive money supply that feeds inflation in the Member States, as the main priority of the economic policy of the Union is the achievement and maintenance of price stability.

In order to avoid national bankruptcy (and tensions of a smaller size as well), Member States undertook to *avoid excessive government deficits (Article 126)*. 'The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline...'

One of the objectives of the *Stability and Growth Pact* adopted in 1997 was to reduce the theoretical probability of the bankruptcy of sovereign debtors, by developing an early warning system, and through that by monitoring the general government balances of EU and EMU Member States as well as by sanctioning the infringements of general government discipline.

Further details are provided by Articles 143 and 144 of the TFEU. Pursuant to Article 143(1): 'Where a Member State with a derogation is in difficulties or is seriously threatened with difficulties as regards its balance of payments either as a result of an overall disequilibrium in its balance of payments, or as a result of the type of currency at its disposal, and where such difficulties are liable in particular to jeopardise the functioning of the internal market or the implementation of the common commercial policy, the Commission shall immediately investigate the position of the State in question and the action which, making use of all the means at its disposal, that State has taken or may take in accordance with the provisions of the Treaties. The Commission shall state what measures it recommends the State concerned to take. If the action taken by a Member State with a derogation and the measures suggested by the Commission do not prove sufficient to overcome the difficulties which have arisen or which threaten, the Commission shall, after consulting the Economic and Financial Committee, recommend to the Council the granting of mutual assistance and appropriate methods therefor.' Pursuant to paragraph (2) 'mutual assistance ... may take such forms as: a) a concerted approach to or within any other international organisations to which Member States with a derogation may have recourse; ... c) the granting of limited credits by other Member States, subject to their agreement.'[2]

The EU, in cooperation with the International Monetary Fund, extended loans to Hungary and Latvia in the autumn of 2008 on the basis of the quoted Article 143(2) c) of the Treaty.

On the strength of Article 143 of the TFEU, Council Regulation (EC) No 332/2002 of 18 February 2002 established *a facility providing medium-term financial assistance* for Member States' balances of payments. In other words, this Council Regulation concretised the provisions of Article 143, i.e. created the instrument and facility that allow the granting of assistance to Member States facing balance of payments problems. In case of necessity, the source of financial assistance is constituted by funds raised on the capital market (bond issue) or borrowings from financial institutions by the European Union (or rather by the European Central Bank), i.e. there is a guarantee of the European Union behind the bond issue. It is to be emphasised that this Regulation also applies only to the EU Member States that have not adopted the euro yet. The aforementioned Regulation had determined a loan ceiling of EUR 12 billion, which was raised to EUR 25 billion at the end of 2008, then to EUR 50 billion, and later to EUR 60 billion. In the event that the beneficiary fails to repay the loan, the guarantee for these loans has to be provided by those EU Member States that have not entered the Economic and Monetary Union yet. The interesting part of the matter is that even the United Kingdom, whose economic agents have Greek government securities and which country itself may need this credit facility, may have a payment obligation. *Article 143 of the TFEU and the related Council Regulation provide legal basis for assisting EU Member States that are not members of the EMU.* These legislations do not allow helping out the Member States of the Economic and Monetary Union.

The no-bail-out clause may also have been attributable to the consideration that the deterring force of the Stability and Growth Pact would be impaired if there was a possibility to assist the countries of the Economic and Monetary Union that are in trouble. Nevertheless, it is still possible to assist EMU Member States, as, pursuant to Article 122(2) of the TFEU: 'Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken.' This regulation applies to all EU Member States, including those constituting the Economic and Monetary Union. Consequently, *although the EU Member States and the EU as such are not responsible for Member States' commitments, the – loophole – provision of the TFEU referring to exceptional occurrences beyond Member States' control still does not assume or allow national bankruptcy in Member States.*

However, in terms of the legal problem of national bankruptcy it also has to be considered that, first, the *meeting of the inflation criterion* by the countries that intend to enter the EMU is strictly checked with regard to a certain period of time preceding the entry. If there is no other possibility, a country that intends to become a member of the EMU and is affected by the economic crisis may resort to inflationary emission of money in order to avoid 'national bankruptcy'. It only risks joining the EMU at a later date. Second, there is no Community legal provision that would allow the Community to apply sanctions against countries that breach the inflation criterion of the Maastricht Treaty following their entry into the EMU. Third, the objective of the monetary policy of the European Central Bank is the maintenance of price stability. In addition, economic policy coordination within the European Union imposes a rather narrow scope for action on Member States in terms of inflation, which also limits inflationary emission of money. However, there is no efficient legal or economic sanction against Member States that breach their commitments in this case either. Actually, the no-bail-out clause has not been used in practice yet. Many experts doubt that its application would be insisted on in a serious crisis situation as well, i.e. its credibility is questionable. The possibility of assistance is taken into account by money and capital markets as well in an implicit manner.

Raising the issue of national bankruptcy only makes sense because – we emphasise that theoretically – *default risk also has to be taken into account* upon rating the risks of government securities in the case of EMU Member States. Relevant large international credit rating agencies (Standard and Poor's, Moody's etc.) take this possibility into consideration when they evaluate the various government securities of EMU Member States. In the new period of the global financial crisis ushered in by the collapse of a US investment Bank, Lehman Brothers, in the autumn of 2008, the bankruptcy of sovereign debtors ceased to be a theoretical possibility; it became a real, albeit relatively unlikely, risk.

The issue of l*eaving the EMU* came to the fore in connection with the Greek government debt. In the opinion of the ECB it is legally possible to withdraw from the EU through negotiations (it is allowed by the Treaty on the Functioning of the European Union). However, withdrawing from the EMU and remaining a Member State of the EU at the same time is inconceivable. The ECB also concluded that although it is conceivable with indirect means, legally it is not possible to exclude a country from the Economic and Monetary Union. Moreover, the possibility of exclusion would undermine the EMU, as this would be a message to financial markets that the EMU is not a real union, but only a specific exchange rate mechanism that may be joined or left by individual countries, depending on their momentary economic situation.[3]

Apart from economic effects, withdrawal from the EMU and the EU also raises legal problems relating to private law contracts. Contracts concluded on the basis of the legal system of the country leaving the EMU can be amended and redenominated to the new currency relatively easily. However, in the contracts concluded on the basis of the legal regulations of other countries the euro cannot be redenominated independently of the exchange rate of the new currency. Perhaps the only solution to this problem for the country withdrawing from the EMU is to peg the exchange rate of its new currency to one of the major currencies, for example the US dollar.[4] However, in this case it does not make sense to withdraw from the EMU.

SOME OF THE REASONS FOR NEGLECTING CRISIS MANAGEMENT

When the Economic and Monetary Union was established, it was assumed that the introduction of the euro would protect Member States from financial imbalances and crises through the elimination of the exchange rates of national currencies, and through the enforcement of the strict operating rules of the EMU, including those controlling the public balances of Member States, subsequently also reinforced by the Stability and Growth Pact. Considering that all the convergence criteria laid down in the Treaty of Maastricht and most of the provisions of the Stability and Growth Pact eventually also apply to the EU Member States that have not entered the EMU yet, the legal-institutional regulation is more or less satisfactory for the European Union as a whole. *The implicit assumption may have been that in case of adequate operation the institutional system contains appropriate guarantees against financial (and economic) crises.* The founders may also have assumed that in the event of a crisis the governments of member countries are able to manage the crisis, can manage financial crises and economic downturns relying on their own resources and using their own means, thus there is no need for Community funds. Limiting the external effects of Member States' undisciplined fiscal policies was also an objective of the no-bail-out clause. Possible current account deficits may be covered from international money and capital market sources. In the light of subsequent analysis, the magnitude of funds that can be raised was determined at a rather low level. In addition, those developing this financing facility probably failed to foresee that the conditions of obtaining funds from international money and capital markets may become tighter in a global financial crisis situation, with substantially increased costs.

This approach differed from the principles of the Economic and Monetary Union specified in the Werner Plan, which was adopted in 1970 only to fail later owing to external global economic reasons. Namely, those who elaborated the Werner Plan considered it necessary to create *monetary reserve funds* to bridge imbalances that may occur in current accounts. It should be noted that the setting up of a USD 2 billion fund under the Werner Plan was not expressly intended to address financial or economic crises, either.

Neglecting crisis management may also have been motivated by the fact that most of the recessions following the Second World War, and especially in the *period directly preceding the signing of the Maastricht Treaty establishing the EMU were rather mild compared with the 1929–1933 global economic crisis.* It is worthy of attention that even following the severe crisis of the European Monetary System (EMS) and its component, the Exchange Rate Mechanism (ERM) in 1992–1993, no provisions regarding crisis management or setting up a financial fund were inserted in the Maastricht Treaty. It cannot be excluded that the elimination of developments similar to the EMS crisis was expected of the establishment of the EMU.

In crisis prevention, the institutional system of the Economic and Monetary Union focused onesidedly on the government/public sector. In the meantime, it ignored the imbalances accumulated in the private sector, including the credit and real estate market bubbles. The examples of several EU Member States (e.g. Spain and Ireland) also confirm that sovereign debtors may find themselves in crisis situations in spite of disciplined public finance policies. The events of the last one or two years confirm that crisis prevention does not render crisis management unnecessary.

SHORTCOMINGS AND CONSEQUENCES OF THE INSTITUTIONAL SYSTEM

The financial crisis, which had started off from the US subprime mortgage market in the summer of 2007 before it became increasingly global and engulfed other countries as well as the real economy, also revealed the shortcomings, weaknesses and dysfunctional operation of other elements within the institutional system of the Economic and Monetary Union. It has gained importance subsequently, in the light of the crisis, that pursuant to its mandate, *Eurostat may examine the reports of Member*

States only from a statistical aspect. For example, it was not authorised to check whether the records of the Greek government debt management were kept in a correct manner and whether official statistical figures were reliable. Otherwise, this is an important structural weakness of the SGP, to which attention was already called earlier. Namely, the SGP encourages Member States to present their respective general government deficits as low as possible.[5]

In Greece, *derivative transactions,* which normally serve risk management purposes, were also used to make the situation of the Greek general government appear more favourable than it actually was. Experts presume that before joining the EMU, by means of a foreign-exchange swap transaction in 2002 Greece managed to reduce, at least temporarily, the government debt-to-GDP ratio to 104.9 per cent from the 107 per cent observed in 2001.[6] The Greek crisis may result in the enhancement of auditing powers. A Commission initiative was aimed at this issue in 2005 already, but it was not approved by the heads of state and government.

Another deficiency *of the institutional system is related to the reference interest rate of the European Central Bank and to EMU Member States' reaction to it.* Based on the experiences collected during the existence of the EMU to date, the inflation target of the European Central Bank (Harmonised Index of Consumer Prices between 0 and 2 per cent, closer to the upper edge of the band) and the reference interest rate – which applies to the whole Economic and Monetary Union – determined in order to achieve this objective do not – and as a matter of course cannot – take into account deviations from the average and the peculiarities of individual Member States. Based on model calculations, with the increase in size and liquidity of the financial market, the adoption of the euro contributed to the lowering of real interest rates (interest rates adjusted for the inflation rate) in the EU, not only in government securities markets. In the countries where domestic demand was weak and inflation was low, real interest rates were high (which already led to deflationary pressure, for example in Germany). However, in the countries with buoyant domestic demand and high inflation the trend was just the opposite of the above, i.e. low or even negative real interest rates were observed.The lower interest rates, in turn, encouraged borrowing and thus investment and construction activity as well. Accordingly, they also added to the lending and within that to the real estate market bubble, thus strengthening the business cycle especially in the less developed South European member countries of the EU and in Ireland.

During the years of accelerated economic activity that preceded the crisis, owing to low or negative real interest rates prices and wages increased faster in Greece, Portugal, Italy and Spain (and to some extent in Ireland) than the EMU average, weakening the international competitiveness of these countries. Wages are determined centrally in Greece, Spain and Italy, without paying much attention to the differences in productivity of individual industrial sectors and companies. As the euro is the common currency in these countries, the deterioration in international competitiveness could not be mitigated by the devaluation of the national currency.

The success of the euro has contributed to the public debt crisis threatening the South European Member States of the EMU at least as much as its imperfections. The euro was intended to be a more favourable debt financing instrument than the former national currencies, and it fulfilled that role. The success of the EMU also delayed the long overdue implementation of general government reforms. The implications of this are most evident in the case of some South European countries (primarily Greece, Portugal and Italy), which *were able to finance* *their general government deficit and government debt at a low real interest rate for a long time*, thereby generating disincentives to structural reforms.

However, in integrated government securities markets there is nothing to prevent individual EMU Member States from moving their sovereign risk – or a part of it – across the border.[7] In addition, the Maastricht Treaty, which established the Economic and Monetary Union, was too lenient about admitting countries with a poor financial history.[8] However, it would not be justified to hold the European Central Bank and its monetary policy directly and exclusively responsible for the equilibrium problems of South European Member States. The fiscal policies of these countries also contributed to the problems, as well as the fact that *the Stability and Growth Pact did not contain sufficient compelling force to ensure that EMU Member States achieve budget surpluses during the period of economic boom*. This is why they had no reserves to address the crisis situation with fiscal means.

Since in most EMU Member States the conversion rate of the national currency against the euro was properly chosen, it took a relatively long time for the above divergences to surface. The problems were temporarily concealed by the fact that the Member States concerned were able to finance their increasing external imbalances with inflows of speculative capital. Once the credit and real estate market bubbles burst, this practice could not maintained any longer.

While the above policies and the related rules encourage primarily EMU Member States to pursue *non-cooperative strategies*[9], their implications affect the entire European Union. Non-cooperative strategies are typical in the fields of *competitive wage cuts, the curtailment of pensions and services provided by the state and fiscal competition* (reduction of taxes and the general government deficit), and as such, represent new forms of *competitive disinflation*. Even before the establishment of the Economic and Monetary Union there had been antecedents of non-cooperative strategies, including competitive currency devaluation or depreciation. However, while it was countries with weak currencies that took recourse to the policy of competitive devaluation or depreciation at the time, all EU Member States take advantage of the existing non-cooperative policies today. Some experts also call this *internal devaluation*. While the costs of external devaluation are covered by external creditors, the costs of internal devaluation are paid by households. Such strategies applied by major EU Member States exacerbate unemployment in the EU, and undermine the European social model. Today, by emphasising the differences, they jeopardise the viability of the single currency as well. As the EMU does not have a sufficient common budget, or adequately coordinated tax and expenditure policies to tackle the impacts of the crisis, the economic – in particular, the fiscal – policy of Germany, the largest and strongest Member State, plays an especially important role. German policies in general and Germany's restrictive income policy in particular, proved to be especially dysfunctional from the perspective of the Economic and Monetary Union.

Against the background of internal devaluation, including the restrained increase in domestic income – especially wages –, exports became the main source of demand. This resulted in a considerable polarisation of general government positions. Germany (as well as the Netherlands and Austria) accumulated a substantial *current account surplus*; while other countries (such as Ireland, Greece, Spain and Portugal) piled up *high deficits* simultaneously. Although the German fiscal policy became looser in the last two years as a result of the crisis, the steps taken so far have been insufficient to correct the polarisation. Obviously, further analysis is required to assess the nature of the deficits. It is not irrelevant, for example, whether the deficit is financed by debt-generating or non-debt generating capital inflows (foreign direct investment), or whether the deficit finances investment or consumption, etc. It is unfortunate to build policies exclusively upon quantitative criteria.

Although inflation was rather low in the Economic and Monetary Union, restrictive German policies brought the country's inflation rate well below the 2 per cent target of the European Central Bank. As a result, many partner countries of Germany faced significant losses in competitiveness. As currency devaluation at Member State level is not possible in the EMU because of the single currency, the only way for these countries to restore their former competitiveness would have been through deflation. Under these circumstances, new equilibrium can be created at a lower level, with declining GDP and increasing unemployment.

We might also interpret the developments outlined above as *having a substantial current account surplus, Germany used to supply the EMU with cheap credit which, in turn, increased demand for the products of the German manufacturing industry.* This model stopped working once the creditworthiness of the buyer (the South European countries with increasing current account deficits) became questionable. Now the balance of payments surplus of Germany has to be reinvested outside of the European Union. As long as the imbalances among EMU Member States are unsolved, official capital flows will play a greater role in maintaining the status quo. All Germany can do is extend its own credit rating to Greece or other EMU Member States until either they become 'look-alikes' of Germany in terms of competitiveness, or Germany becomes 'Anglo-Saxon' based on its consumption habits. Accordingly, Germany plays a very important role in maintaining the Economic and Monetary Union. One might also come to the conclusion that the management of the sovereign debt crisis may also result in the strengthening of *'deglobalisation'*, once cross-border private capital flows are replaced by the flow of state capital, i.e. *global capital is replaced by regional or national capital* amid the escalating risks of the target country. In addition, the sovereign debt crisis has brought a change in the sense that user costs have become or are becoming less determined at EMU level by the integration which was implicitly subsidised by Germany, and the newly evolving user cost level will better reflect the economic fundamentals of individual EMU Member States.

The consequences of non-cooperative strategies were fairly significantly exacerbated by *large transnational companies*. These firms have a vested interest in the tax competition among Member States, especially as it relates to the reduction of the corporate tax burden. As large transnational companies pursue global strategies, they are less motivated in the increase in the domestic demand of EU Member States. Consequently, they tend to reduce wage costs in their respective home countries. In both regards, large transnational companies registered in the Member States of the European Union reap the benefits of the current situation, while they hinder further integration.

The imbalances that evolved in the Economic and Monetary Union obstruct efficient responses to internal and external challenges. Demand should be strongly increased in the EU to tackle rising unemployment; however, this hinges on the moderation of the imbalances between Germany and its trading partners. Germany should therefore switch its economic policy to encourage domestic demand instead of endorsing net exports. In order to implement such a change, the lowest incomes should be aggressively increased, while incentives for the creation of low-income areas should be eliminated. For the time being it is unforeseeable how permanent the recovery observed from the second quarter of 2010 in domestic demand will be.

The lack of a coherent budget policy is the main obstacle to an efficient macroeconomic response to the crisis, which could imply a serious threat even to the Economic and Monetary Union over the long term. What is considered to be one of the biggest weaknesses of the Economic and Monetary Union is that raising the monetary policy to community level was not followed by fiscal federalism which, in turn, undoubtedly presupposes political union over the longer term. In addition to eliminating free riders, the Stability and Growth Pact was intended to make up for one of the most important elements of political union by adopting rules for fiscal policy, which is the most important tool of national economic sovereignty. The provisions of the Stability and Growth Pact and the general government criteria laid down in the Maastricht Treaty (the general government deficit has to be below 3 per cent of GDP) considerably restrict the room for manoeuvre available to the fiscal policies of EU Member States. Moreover, this system of rules is combined with very *limited fiscal federalism*; the expenditure and revenue sides of the EU budget barely exceed 1 per cent of the aggregate GDP of Member States, i.e. the tight fiscal room for manoeuvre in Member States is not offset by the Community budget. At the same time, developments in recent years raise concerns about the credibility of the SGP itself.

For a monetary union to function smoothly there must be tools and mechanisms in place for handling the diverging development trends of member states. In this respect, some kind of *coordinated or central budgetary authority* is indispensable. This necessity was ignored when the Economic and Monetary Union was established, as the founders surmised that market economies stabilise themselves automatically. The maintenance of stability can then be ensured by simply avoiding the accumulation of excessive deficit. The validity of these assumptions has been refuted by the current global financial and economic crisis. The European Central Bank has proposed to set up an independent fiscal authority or some kind of other body.

RESPONSE TO THE CRISIS

Largely reflecting the German position, which attaches great importance to fiscal discipline, the EMU has been based upon *three pillars* thus far. The first pillar is the independent European Central Bank, the primary objective of which is to achieve and maintain price stability. The second pillar is the Stability and Growth Pact, which is designed to enforce fiscal discipline, and the third pillar is the no-bail-out clause, which prohibited the ECB as well as EU institutions and Member States from assisting other Member States.

This structure has weakened in the wake of the global financial and economic crisis, although the credibility of the no-bail-out clause and the Stability and Growth Pact had been called into question even earlier. The major EMU states (Germany and France) managed to breach the latter without any consequences; granted, they did not destabilise the Pact or the EMU by doing so.

As far as the *first pillar* is concerned, in an effort to mitigate the turmoil in securities markets, in the middle of May 2010 the European Central Bank decided to disregard its former rules and start purchasing – by way of money creation – the government securities of distressed countries in the secondary market, i.e. bail them out despite statutory provisions. Purchasing the government securities of countries struggling with liquidity problems does not belong to the competencies of monetary policy in a traditional sense. What this is about, however, is that the ECB allocates certain funds to certain creditors and borrowers at the expense of others. Being independent of governments, ensuring price stability and thereby facilitating economic growth is a part of the responsibilities of this institution, while such allocation of loans is not. Some experts believe that the ECB made this decision under political duress, which compromises its independence. It is closer to the truth, however, that the ECB acted under the pressure of circumstances at a time when governments procrastinated in tackling the crisis, and the heads of states and governments of the EU failed to adopt coordinated and timely decisions. The ECB itself considered the bond purchase programme a temporary crisis management tool rather than a permanent practice. It was necessary only until the European Financial Stability Facility started functioning.

Another change introduced by the ECB deviating from its original rules was to extend the scope of eligible collaterals to lower-rated government securities (those issued by governments with a lower creditworthiness, e.g. Greek, Portuguese and Irish government papers). If – in an effort to avoid quantitative easing – the ECB decides to offset the purchase of Greek and other lower-rated government securities by selling other government securities, the tax burdens of the countries concerned will increase.[10] With a view to reducing the inflationary effects of its government security purchases, the ECB sells other papers to 'sterilise' the money created by the purchase of Greek, Portuguese and Spanish government securities with a typical maturity of 1 to 3 years. Nevertheless, many are concerned that continuing this practice will lead to quantitative easing which, given its inflationary effects, has been considered undesirable by the ECB until now. Moreover, the more government securities are bought by the ECB, the more difficult it will be to say no to further demands. All this, however, would match the profile of the proposed European Monetary Fund[11], which is to be funded by the governments of Member States.

It is justified criticism that the turnaround in the ECB's monetary policy was not aligned to the economic programme adopted by Member States for the next several years in relation to fiscal austerity; addressing the bad debts in the portfolio of Member States' commercial banks; labour market reforms, the reform of the control system of the EMU and the establishment of a single government securities market, even though the programme could have legitimised the open-market operations of the ECB.[12]

As a possible consequence of such *monetisation* of *government debts*, the shareholders of the ECB could face considerable losses if the states whose government securities the ECB purchased were unable to meet their payment obligations. The losses could be covered either by fiscal means or by the issuance of money. In the first case the burden is borne by the taxpayers, mainly Germans, as Germany is the biggest shareholder. In the second case the outstanding debt of the ECB is inflated, i.e. socialised, which means that consumers are made to pay for it through higher prices.

Finally, liquidity does not translate into solvency. The opportunities provided by the ECB do not reduce general government deficits, which would require further fiscal and economic policy steps.

As far as the *second pillar* is concerned, the global financial and economic crisis brought the weaknesses of the Stability and Growth Pact to the surface; the Pact's system of rules failed to ensure discipline in public finances at the level of the integration due to deficiencies in the enforcement of rights and, in the lack of adequate national incentives, in individual Member States' compliance with the relevant legal regulations of the European Union. The evaluation of the *Stability and Growth Pact* is controversial in literature; its presentation exceeds the content and scope of this study.[13] Without being exhaustive, a shortcoming to be highlighted in the context of the global financial and economic crisis is that the SGP was unable to enforce the rule which requires the Member States of the Economic and Monetary Union to reduce the government debt-to-GDP ratio, and accumulate a surplus in the general government balance in the rising stage of the economic cycle, bearing in mind the lean years ahead.

Another shortcoming of the SGP is that, *with an exclusive focus on public finances,* it did not pay adequate attention to other elements of the macroeconomic criteria system. Spain and Ireland had pursued a disciplined general government policy for a long time. From 2008, however, the deficit and government debt started to accumulate fast as the state had to take on the burden of rescuing a banking sector reeling from the consequences of the crisis, i.e. socialise private sector debt. Total debt reflects the equilibrium position of individual countries better than the general government debt-to-GDP ratio. In the case of the United Kingdom, for example, the total debt of the public and private sectors as a proportion of GDP increased from 350 per cent in 2000 to 449 per cent in 2009. [14]

The evaluation of the situation may be refined further by taking account of the so-called floating debt, the majority of which resides in the banking sector. In Germany, for example, the amount of bad debts of banks controlled by federal states was estimated to be EUR 800 billion, i.e. one third of Germany's GDP.[15] Spanish savings banks (Cajas) are struggling as well, and even French, Belgian and Austrian banks are undercapitalised for the most part.Therefore, transparency is of utmost importance and may be improved by the stress tests on which, urged by many experts, the European Council decided at its meeting in June 2010. At the same time, owing to the rather lenient boundary conditions, many experts do not consider the results of the stress tests published in the summer of 2010 realistic. It also deserves attention that the European Central Bank proposed to set up an independent supervisory authority within the European Commission.[16]

Sanctioning was not a lucky step either, because suspending the disbursement of certain Community funds in the case of non-EMU members and ordering the payment of penalty in the case of EMU Member States would only add to the general government deficit of the countries concerned.

The ideas to amend the SGP are aimed at reinforcing automatisms through, for example, a stricter supervision of general government positions, the tightening of implementation rules and procedures, a more thorough preliminary assessment of Member States' budgets by EU institutions, incorporating the rules regarding national budgets into law and a stricter sanctioning of Member States that violate European Union legislation.[17] The proposal regarding the suspension of the voting right of countries that breach general government discipline is not reasonable. It is also being considered that greater importance would be attached to government debt as well as the current account and external debt than to general government deficit.

Regarding the *third pillar*, the no-bail-out clause was overruled by the crisis as, in addition to the financial assistance of EUR 110 billion provided to Greece earlier, in May 2010 the European Council adopted a financial package amounting to EUR 750 billion to manage and contain the Greek sovereign debt crisis. EUR 440 billion of it is disbursed through the so-called *European Financial Stabilisation Mechanism* (EFSM)[18] , EUR 60 billion is allocated to the facility regulated by Council Regulation (EC) No 332/2002, and EUR 250 billion is provided by the International

Monetary Fund. *This can also be viewed as an initial set of tools and institutional system for community-level crisis management.*

The EFSM is based on Article 122(2) of the Treaty on the European Union. Pursuant to Council Regulation (EU) No 407/2010 on establishing the mechanism, for a period of three years, Member States are prepared to grant assistance to an EMU Member State threatened with difficulties caused by occurrences beyond its control. Obviously, the mechanism applies to the Member States of the EMU. Assistance is provided in the context of a joint EU/International Monetary Fund support. The mechanism does not affect the validity of the facility regulated by Council Regulation (EC) No 332/2002, designed to provide assistance to EU Member States outside the euro area. Within the framework of the EFSM, implementing powers are exercised by the Council of the European Union. It is the European Commission that borrows on behalf of the European Union in the capital market and from financial institutions. The loan or credit facility can be provided under strict economic policy conditions that serve the sustainability of public finances. The European Commission and the Economic and Financial Committee (ECOFIN) provide an opinion on the economic and financial adjustment plan prepared by the beneficiary Member State, and the implementation of the programmes is reviewed by the Commission. The financial assistance is granted by a decision adopted by the Council, acting by a qualified majority on a proposal from the Commission. In addition to the 16 Member States of the EMU, Poland and Sweden also participate in the mechanism. The EFSM is a temporary, provisional scheme, envisaged to operate for three years.

In practice, the EFSM is a Luxembourg-registered *limited liability company* set up for a duration of three years with the capacity to issue bonds, and it is owned by EMU Member States. EU decision-makers would like the company to receive AAA, i.e. first-class rating from international credit rating agencies. The company will be activated when it is approved by the national parliaments representing 90 per cent of the registered capital. All EMU Member States (as well as Poland and Sweden) will be required to guarantee the debt instruments of the EFSM. In the event that an EMU Member State needs a loan prior to the setting up of the mechanism, it may temporarily use the EUR 60 billion facility intended for the remedy of current account deficits of non-EMU Member States, which is guaranteed by the EU budget. In practice, it will be difficult to abide by the duration of three years, as withdrawing from the obligations undertaken under the EFSM will not be an easy matter.

In many respects, the philosophy behind the European Financial Stability Facility calls to mind Article 5 on mutual defence of the North Atlantic Treaty signed in Washington, which can also be interpreted as the beginning of the institutionalisation of solidarity among Member States.[19] Many experts believe that *the no-bail-out clause thus became a clause designed to prevent the bankruptcy of sovereign debtors*, which transformed the Economic and Monetary Union into a *'hidden transfer union', which* lacks wider social legitimacy at that. In this context, however, some politicians claim that the package is not an aid but a loan to be repaid; and as such, this exercise cannot be considered *assistance in the 'classical' sense*.[20] Together with other European Union measures adopted in recent months with a view to uniting the resources of the EMU Member States, the European Commission and the ECB, the EFSM goes beyond the Stability and Growth Pact, and can even be considered as a shift in the direction of fiscal federalism.[21] At the same time, operating the EFSM is mainly based on intergovernmental cooperation (the implementation rights are in the hands of the European Council), rather than Community legislation, which is probably due to the fact that Germany wanted to maintain its controlling role in the scheme.

At the time this study was prepared it was not clear whether the European Financial Stabilisation Mechanism would be allowed to borrow from the money and capital markets even before a Member State had officially submitted its urgent request for assistance. It is also not clear what lending rate will be applied. The interest rate of the EUR 110 billion facility approved for Greece was defined at 5 per cent.[22] The AAA rating, which the EU considers justified although there is no guarantee for getting it, would be more favourable than the average of individual EMU member countries – that is, if individual countries did not act in a coordinated manner – since only Germany and France have an AAA rating.

Another weakness of the scheme is that *it is intended to ease liquidity tensions at a time when the South European EMU Member States are struggling with a payment crisis*. The facility improves liquidity, but it does not provide a long-term solution to the solvency problem or to the prevention of further debt accumulation in an already indebted country.The mechanism *postpones the debt problem rather than resolves it.* It intends to remedy a large debt with an even larger one. The structural problems and risks of the scheme will become apparent once assisting a larger country is put on the agenda. The mechanism is inherently controversial in that a group of countries struggling with financial problems are expected to assist countries in a similar predicament.

Obviously, in the case of a national bankruptcy a redistribution of income will take place from Northern Europe to Southern Europe. Thus far, the sovereign debt crisis has not imposed costs on EU taxpayers. This may change in the event of a restructuring or rescheduling of the Greek government debt, in which case the bulk of the Greek government debt will be held by the European Financial Stabilisation Mechanism.

It is a risk factor that the Constitutional Court in Germany may find the EFSM unconstitutional. To ward it off, in October 2010 the German Chancellor proposed that the TFEU should be amended. The proposal is unacceptable for many EU Member States. They intend to mitigate the risk of a guaranteeing country not paying up the amount it is committed to by raising the contributions to the subscribed capital of the ECB by an additional 20 per cent, which means that Member States have to pay 20 per cent more than the share determined for them. Conceivably, this will become necessary right at the beginning, considering that the new government and parliament of Slovakia said no to the payment of the EUR 816 million Community contribution undertaken by the previous cabinet to assist Greece.

For the sake of completeness, it should be noted that beside the revaluation of the ECB's role, more stringent fiscal rules and crisis management mechanisms, the EU attaches great importance to the incentives for economic growth and competitiveness. To this end, work is under way to develop the *Europe 2020 Strategy* for the replacement of the Lisbon Strategy, which was launched in 2000 and is set to expire this year. Finally, it is also imperative to address the governance of the EMU. In the current structure, none of the institutions has adequate control functions.

Based on the analysis of economic growth and general government trends, studies focusing on the sovereign debt crisis do not exclude the possibility of an eventual government debt restructuring or rescheduling in Greece[23] and/or Portugal. Although apparently the ECB does not support the restructuring or rescheduling of the debt – as it would be an easy solution for countries that have lost control over public finances and would increase the moral hazard weakening general government discipline –, it is necessary to consider the establishment of certain institutions and mechanisms which would not only allow for the restructuring or rescheduling of the government debt of EMU Member States, but also minimise moral hazard. Further research should focus on analysing whether a reasonable solution could be provided from a political and economic perspective by a potential cross subsidy between EMU Member States, which would ensure the avoidance of the restructuring or rescheduling of government debt. There have been discussions about setting up a *European Monetary Fund*, however, it has not been included in the official objectives of the EU to date, and its analysis would exceed the content and scope of this study.

SUMMARY, CONCLUSIONS

The US mortgage market crisis, which started in the summer of 2007 before it engulfed the real economy and became global, revealed the institutional and operational deficiencies of both the European Union and the Economic and Monetary Union. Originally laid down in the Maastricht Treaty and subsequently adopted in the same format by amended and supplemented versions of the Treaty, the initial objective of the *no-bail-out clause* as a general rule was to enforce and guarantee general government discipline. While it also entailed the bankruptcy of sovereign debtors, such eventuality was considered to be extremely unlikely, a mere theoretical possibility. *The EMU did not have any crisis management institutions or mechanisms;* partly because its designers must have assumed that the provisions of the Maastricht Treaty, the Stability and Growth Pact, economic policy coordination and other complementary statutory provisions would provide sufficient institutional guarantee for the avoidance of sovereign debtors' crises. At the same time, the successive Treaties include a provision legalising assistance to distressed Member States in case of force majeure. Therefore, within certain limits, developing the institutions and tools of crisis management does not require any amendments to the Treaties.

However, in the wake of the global financial and economic crisis the bankruptcy of sovereign debtors has become a valid risk and a real possibility, which can be primarily attributed to the nature of the crisis itself (the recession leads to a decline in tax revenues, while the recapitalisation of the affected banks and a number of other factors generate an increase in general government expenditures).

Institutional and operational deficiencies also contributed to this. Such deficiencies included *the potential creative applicability of general government statistics* and *the pass-through of the numerous dysfunctional effects of the ECB interest rate to the EMU as a whole*, which did not occur on their own, but were transmitted partly by the economic policies of the Member States concerned, and partly by the shortcomings of the Stability and Growth Pact.

Such a dysfunctional effect was that high real interest rates evolved in the countries where inflation was low, and low real interest rates evolved in countries with high inflation, i.e. mainly in the less developed South European Member States and Ireland. The low real interest rates fuelled the economic activity in the latter countries, which generated credit market, real estate market and securities market bubbles, while their international competitiveness deteriorated in the context of increasing price and wage levels. *Low real interest rates* ensured the cheap financing of general government deficit and government debt, which generated disincentives to the long overdue structural reforms. In addition, with a view to improving competitiveness internationally and within the EMU, several developed Member States, mainly Germany, also resorted to *internal devaluation* (disinflation, relative wage reduction etc.) randomly, i.e. not driven by any competitive strategy. This increased the *differences between current account balance positions* within the EMU, and the growing surpluses of northern, more developed Member States (Germany, the Netherlands, Austria) restricted export opportunities for those with a deficit: South European Member States and Ireland. As long as the imbalances among EMU Member States remain high, official *capital flows* will play a greater role in maintaining the status quo. Amid escalating risks, cross-border private capital flows are being replaced by the flow of state capital, i.e. global capital is being replaced by regional or national capital. In addition, the sovereign debt crisis has brought a change in the sense that *user costs have become or are becoming less determined at EMU level by the integration* which was implicitly subsidised by Germany, and the newly evolving user cost level will better reflect the economic fundamentals of individual EMU Member States.

The global financial and economic crisis altered the three pillars of the EMU as well. As far as the first pillar, *the independence of the common bank* is concerned, in the context of crisis management the European Central Bank started to purchase government securities of Member States, including those with low credit ratings. First, the proper legitimacy of this activity is questionable as it does not comply with the medium-term economic strategy adopted by the Member States. Second, it raises concerns about the independence of the ECB. The monetisation of government debts increases the risk of growing inflationary pressures, and may also lead to a redistribution of government debt within the EMU if the governments that issued the securities purchased become insolvent. The system of *rules of the Stability and Growth Pact,* which constitutes the *second pillar,* failed to ensure discipline in public finances at the level of the integration due to deficiencies in the enforcement of rights and, in the lack of adequate national incentives, in individual Member States' compliance with the relevant legal regulations of the European Union. Moreover, with an excessive focus on public finances and government debt, it paid less attention to the imbalances and indebtedness of the private sphere. Finally, the crisis overruled the third pillar of the EMU – the *no-bail-out clause* – as a result of the creation of the European Financial Stabilisation Mechanism.

Thus far, the EU and the EMU have responded to the global financial and economic crisis under the duress of circumstances. The responses were mostly reactions by nature, did not form parts of a coherent strategy, and very often lacked coordination. Consequently, it is reasonable to assume that the costs of crisis management (especially those of the Greek sovereign debt crisis) were higher than necessary. As a result of the changes and drafts adopted in recent months, *the conceptional and institutional outlines of a crisis management has started to take shape along with its own toolkit*; however, following from its nature, it is still surrounded by much uncertainty and a great number of risks. It is promising that beside crisis prevention crisis management is also being addressed, and beside the financial sector the ideas cover the real sector as well. Accordingly, aligned to the Europe 2020 Strategy currently in preparation, the concepts include a long-term incentive to competitiveness. The EFSM may become a suitable basis for a crisis management institution to be developed.

At the same time, there are many tensions and problems to be resolved. One of them is – mainly in the context of Greece and Portugal – the need to *develop mechanisms for the restructuring or rescheduling of government debt*, which appears to be unavoidable over the medium term (indeed, the EU has merely gained some time by setting up the EFSM, which does not provide a solution in itself). Another issue is the need to reduce non-cooperative strategies, such as those based on internal devaluation, and hence, the imbalances (current account surpluses and deficits) within the EMU. The governance of the EMU, including the reform of the Stability and Growth Pact, needs to be addressed as well. *Although the events related to the sovereign debt crisis have put the EMU to the test in recent months, its dissolution is unlikely at the moment.* Despite its controversial crisis management, EMU membership remains attractive, as confirmed by Estonia's forthcoming accession and Iceland's interest in EU and EMU membership.

Notes

[1] In a general sense, national bankruptcy (which, in my opinion, is an inept expression that requires careful interpretation) means that the state is unable to meet its payment obligations. They may be external and internal payment obligations (vis-à-vis non-residents and domestic economic agents, respectively). Pursuant to the relevant articles of the TFEU, this is a limited interpretation of national bankruptcy, when a given state is unable to raise external and internal funds to finance the general government deficit and the government debt, i.e. it cannot meet its interest and principal repayment obligations stemming from the debt denominated in euro on schedule. In practice, this may be some kind of moratorium regarding the interest repayment as well as a restructuring of government debt and an amendment to the conditions of repayment. Some experts believe (George Magnus: The spectre of sovereign default returns to rich world, Financial Times, 14 January 2010, p. 30) that national bankruptcy can have a milder, more lenient form as well, which occurs in the wake of a significant acceleration of inflation through the redenomination of the legal tender (for example, by slashing two or three zeros off the numbers on the banknotes in circulation), restrictions on capital flows and the imposition of special taxes that break private contracts. Others also consider the restructuring of government debt a form of national bankruptcy, except if it takes place on the basis of an agreement. Instead of restructuring, rescheduling may be a solution, when short- and long-term debts are converted into long-term ones.

[2] The source of this train of thought and the next one is: Daniela Schwarzer: Getting around the no-bail-out-clause. Eurozone Watch, 20 February 2009. http://www.euro-area.org/blog/?p=198

[3] Tony Barber: Danger zone. Financial Times, 17 May 2010, p. 7

[4] Jennifer Hughes: Greek woes raise eurozone questions. Financial Times, FM Supplement, 12 April 2010, p. 3

[5] Jürgen von Hagen – Guntram Wolff: What Do Deficits Tell Us About Debt? CEPR Discussion Paper 4759, November 2004. When the German federal government took over the debt stock of the East German privatisation agency in 1995, it did not state it as a deficit of the given year, but put it in a special fund. However, this transaction was reflected in the public debt.

[6] Satyajit Das: Greek window dressing puts derivatives' role on full display. Financial Times, 18 February 2010, p. 26

[7] Data released by BIS indicate that the total value of Greek, Irish, Portuguese and Spanish government securities within the portfolio of banks registered in GMU Member States was EUR 1,579 billion at the end of 2009. The share of French and German banks amounted to 61 per cent.

[8] Kenneth Rogoff: Europe finds that the old rules still apply. Financial Times, 6 May 2010, p. 11

[9] EuroMemorandum Group 2010: Europe in Crisis: A Critique of the EU's Failure to Respond and Alternative Proposals in Times of Crisis. http://www.lwbooks.co.uk/ebooks/EUROMEMORANDUM%202009-2010.pdf , p. 42

[10] John Taylor: Central banks are losing credibility. Financial Times, 12 May 2010, p. 9

[11] Daniel Gross. – Thomas Mayer: How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund. CEPS Policy Brief, No. 202/February 2010

[12] Wolfgang Münchau: History warns over slippery slope of debt monetisation. Financial Times, 13 May 2010, p. 4

[13] Of the latest see: European Central Bank: Reinforcing economic governance in the euro area. Frankfurt, 10 June 2010

[14] McKinsey Global Institute: Debt and deleveraging: The global credit bubble and its economic consequences, January 2010

[15] Wolfgang Münchau: Give us the figures on Europe's toxic banks. Financial Times, 21 June 2010, p. 11

[16] Jean Pisani-Ferry: Towards a system to secure the euro. Financial Times, 23 June 2010, p. 9

[17] European Central Bank: Reinforcing economic governance in the euro area. Frankfurt, 10 June 2010, p. 14. European Commission: Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance. Brussels, COM(2010) 327, p. 14

[18] Council Regulation (EU) No 407/2010 of 11 May 2010 on establishing a European financial stabilisation mechanism. Notably, as of early 2010 until 2012 Spain, Greece, Portugal and Ireland have to raise EUR 448 billion, EUR 158 billion, EUR 70 billion and EUR 69 billion, respectively, to renew government debt.

[19] The opinion of the French Minister Pierre Lelouche is quoted by: Ben Hall: Eurozone bail-out plan 'alters EU treaty', Financial Times, 28 May 2010, p. 1

[20] José María Aznar: Europe must reset the clock on stability and growth. Financial Times, 17 May 2010, p. 9

[21] Romano Prodi: A big step towards fiscal federalism in Europe. Financial Times, 21 May 2010, p. 9

[22] Tony Barber: A tent to attend to. Financial Times, 17 June 2010, p. 9.

[23] Lee C. Buchheit – G. Mitu Gulati: How to restructure Greek debt. May 7 2010. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304