

Outline of the legal chapter on Eurobonds

(state of the law as at 4 November 2011)

Executive summary

The TFEU's no bail-out provision probably is a hindrance for joint bonds issuance. A treaty amendment should relieve any doubts as to the validity of joint bond arrangements. Under their current legal provisions, the EFSF and its successor, the ESM, are not suitable as debt issuance agencies under normal circumstances. They constitute a first step towards joint operations on the financial markets in the context of States' public finance and are a sign that technical steps out the TFEU are possible. Yet, the proposed TFEU amendment allowing euro area Member States to establish the ESM seems to indicate that without TFEU amendment, progress towards joint issuance is not easy. The German Constitutional Court's decisions are major obstacles which may not be overcome by constitutional change in Germany, whereas constitutional change may also be required in other Member States. Constitutional change to anchor budgetary restraint is on the agenda, so this may provide a window of opportunity to incorporate authority for joint debt issuance. Also, limited Treaty change is on the agenda – a once-in-a-lifetime chance to clearly permit joint debt issuance.

Status of the text - disclaimer

Below, several legal matters surrounding the issue of Eurobonds are discussed. This text is intended as a draft chapter in, or annex to, an expert report on technical matters surrounding the issuance of Eurobonds. This text is not a legal opinion. It merely describes and offers tentative solutions to, the main issues and does not purport to give an exhaustive analysis of all legal aspects of such issue. It has been written in my academic capacity as a professor of the law of Economic and Monetary Union at the University of Amsterdam.

Outline

After a discussion of the no bail-out provision of the Treaty on the Functioning of the European Union (TFEU), other issues and provisions are discussed in the context of the joint issuance of 'EMU bonds', including the incidence of the Treaty establishing the European Financial Stability Facility (EFSF) and the Treaty establishing its proposed successor, the European Stability Mechanism (ESM), and national (i.e., State-centered) constitutional issues, such as the relevant judgments of the German Constitutional Court. Some possible directions for solutions of the legal problems encountered are also given.

Article 125 TFEU

Article 125 TFEU, which provides that "Member States [and the Union] shall not be liable for or assume the commitments of [other] Member States", implies that no direct assumption of another State's debt is allowed, nor is liability implicitly assumed. Nor is the EU itself liable

for Member State debt, and it is prohibited from assuming this debt. This provision seems a hurdle on the way to joint issuance of Eurobonds.

The only interpretation out of the constraint embodied in this provision is, in line with the thinking on the bilateral loan to Greece and the EFSF, that other Member States do not assume actual commitments but provide a loan, or guarantee, to the debtor Member State so that it is able itself to service its own commitment., i.e. to repay its own loans (bonds, bills). This line of interpretation, if upheld by the European and national (constitutional) courts, could enable issuance by an agency jointly and severally guaranteed by the participating Member States. After all, the Member States do not assume liability for each other's commitments but for the agency's issuance. But this narrow reading skirts the limits of the law. After all, it is a technical reading which does not do justice to reality: in fact, Member States jointly issue bonds through a central debt agency and effectively guarantee each other's commitments when accepting other States' participation in the joint bonds issuance scheme.

Similarly, the establishment of the EFSF can be seen as a way around the no bail-out clause¹ with the euro area Member States jointly issuing debt instruments the proceeds of which are on-lent to Member States that have lost access to the financial markets, i.e. can only fund themselves at penalising rates. Actually, the EFSF may be seen as the first joint issuance of bonds by the Member States, albeit that the EC/EU and the EIB have issued bonds for many years already, also in the context of on-lending to Member States, such as under the medium-term balance of payments assistance facility, open to non-euro area members only². With the enhanced role for the EFSF, decided in July and October 2011, including the guaranteeing of

¹ The assistance to Member States in need was also based on Article 122 (2) TFEU, which reads as follows:

2. 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.

When adopting the Decision on a proposed amendment to the TFEU to allow for the establishment of the ESM, as a successor to the EFSF and the EFSM, the European Council agreed that this provision *will* no longer be needed, and the Heads of State and Government agreed it *should* no longer be so used – which meant that Commission President Barroso dissented from his colleagues in the European Council: “(...) the European Council agreed that, as this mechanism is designed to safeguard the financial stability of the euro area as whole, Article 122(2) of the TFEU *will* no longer be needed for such purposes. The Heads of State or Government therefore agreed that it *should* not be used for such purposes.” – recital 4 of the preamble to the European Council Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, Official Journal L 91/1, 6.4.2011 (italics added, RS).

² Based on Article 143 TFEU and Council Regulation 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, Official Journal L 53/1, 23.2.2002, as amended by Council Regulation (EC) No 1360/2008 of 2 December 2008, Official Journal, L 352/11, 31.12.2008, and by Council Regulation (EC) No 431/2009 of 18 May 2009, Official Journal L 128/1, 27.5.2009. See: http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm.

20% of the debt issued by Member States that are not subject to a joint EU/IMF programme, a similar situation arises: the guarantee issued to the EFSF serves to assist market access for Italy and Spain.

Of course, the assumptions underlying the scheme adopted in Maastricht (1991), implying that “each Member State is are ‘on its own’”³, have proven wrong. Markets do not exercise healthy discipline on States finances – during the first ten years of EMU the spread between *Bunds* and Greek debt instruments was negligible, after which markets overreacted and Greece was downgraded to below junk bond status. As set out by ECB Board member Lorenzo Bini Smaghi⁴, most assumptions didn’t hold – and the market infection spreading from one Member State to another, dragging each other down under and thereby undermining EMU, could not have been foreseen. In the worst financial crisis since the 1930s, leaving States to fend for themselves proved irresponsible, thus pushing other States to come to their assistance in the interest of the stability of the euro area and the EU as a whole⁵. These changed circumstances, or assumptions proven wrong, may permit the EU and its Member States to act out of necessity, making it unlikely that measures adopted would be considered unconstitutional or contrary to the Union legal order. Yet, these changes do not legislate for the future or grant new powers of joint debt issuance. Thus, a change in Treaty provisions may be the best safeguard against legal uncertainty surrounding “EMU bonds”. The European leaders considered it necessary to give the ESM firm legal grounding by adopting not only a treaty amongst the 17 establishing this new entity but, also, amending the TFEU among all 27 to include the following paragraph to Article 136:

"3. The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

This proposed amendment seems to imply that, without this, there is no freedom to establish a crisis mechanism amongst euro area Member States, let alone a joint debt issuance authority.

The above implies that a technical Treaty change would be welcome to firmly establish the legality, under EU law, of joint bonds issuance. Such a provision could read as follows:

³ René Smits, *The European Central Bank – institutional aspects*, thesis, 1997, 200 reprint, p. 77.

⁴ *Challenges for the Euro Area, and the World Economy*, Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB at “The Group of Thirty”, 63rd Plenary Session, Session I: The Crisis of the Eurosystem, Rabat, 28 May 2010, at: <http://www.ecb.europa.eu/press/key/date/2010/html/sp100528.en.html>.

⁵ See Jean-Victor Louis, *Guest editorial – The no bail-out clause and rescue packages*, *Common Market Law review* 47: 971-986, 2010.

Articles 125 (3)

Paragraph 1 shall not prevent Member States whose currency is the euro from jointly issuing debt instruments and, in this context, jointly guaranteeing such issuance, provided the Member States participating in this issuance ensure an equitable distribution of the proceeds and respect Article 126 [*the obligation to avoid excessive deficits, RS*].

The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure⁶ and after consulting the ECB and the European Systemic Risk Board (ESRB) adopt the measures necessary or conducive for the joint issuance of debt instruments.

Only members of the Council representing Member States whose currency is the euro shall take part in the vote.

Decision of the *Bundesverfassungsgericht* (BVerfG, German Constitutional Court)

The recent decision of the German Constitutional Court⁷, which rejected a constitutional complaint against German participation in the bilateral Greek loan and the EFSF, limited the freedom of the German Government, and Parliament, in respect of rescue measures for other EU States. The decision should be seen in the context of the earlier case law of the *BVerfG* (Maastricht and Lisbon Treaty decisions) in which the Court insisted that Germany is a State and may not, by treaty or otherwise, give up statehood. The German Constitutional Court required several elements of statehood, including economic policy-making, to remain subject to the sovereignty of the German Parliament in order not to violate the German citizens' constitutionally guaranteed voting rights. (The German Constitutional Court's most recent injunction against the delegation to a committee of the *Bundestag* of decision-making in the context of the EFSF⁸ does not, as yet, seem to be relevant in this context as it is apparently only concerned with the internal allocation of parliamentary powers). In the current context, it is not feasible to give a summary or an authoritative interpretation of the lengthy decision of 7 September 2011. It permitted the German participation in the EFSF and circumscribed how the budgetary powers of the German parliament can be safeguarded. All this against the background that German voters may not be deprived of their constitutional rights to influence the budget. I limit myself to a few quotes.

⁶ I.e., in co-decision.

⁷ *BVerfG*, 2 BvR 987/10, decision of 7 September 2011, available at: http://www.bverfg.de/entscheidungen/rs20110907_2bvr098710.html; English press release at: <http://www.bundesverfassungsgericht.de/en/press/bvg11-055en.html>.

⁸ *BVerfG*, 2 BvE 8/11, injunction (*einstweilige Verfügung*) of 27 October 2011, available at: http://www.bverfg.de/entscheidungen/es20111027_2bve000811.html.

It is not permissible to establish permanent mechanisms under international law that lead to the assumption of liability for voluntary decisions of other States, notably if they have consequences that are hard to oversee (*“Es dürfen keine dauerhaften völkervertragsrechtlichen Mechanismen begründet werden, die auf eine Haftungsübernahme für Willensentscheidungen anderer Staaten hinauslaufen, vor allem wenn sie mit schwer kalkulierbaren Folgewirkungen verbunden sind.”*).

Every individual measure of assistance on the basis of solidarity undertaken by the federal government at the international level or within the EU must receive the assent of the Bundestag (*“Jede ausgabenwirksame solidarische Hilfsmaßnahme des Bundes größeren Umfangs im internationalen oder unionalen Bereich muss vom Bundestag im Einzelnen bewilligt werden”*). Moreover, sufficient parliamentary influence on how funds made available are being dealt with must be secured.

Recalling that the EU treaties are based on the national budgetary autonomy and reiterating that EU decisions need sufficient democratic legitimacy for their validity in Germany and, also, recalling that monetary union as a community of stability is of the essence for German assent to the Maastricht Treaty (*“Die vertragliche Konzeption der Währungsunion als Stabilitätsgemeinschaft ist Grundlage und Gegenstand des deutschen Zustimmungsgesetzes”*), the court recalls that the independence of the ECB and its primary objective of price stability are permanent constitutional requirements for German participation in monetary union pursuant to Article 14 of the German Constitution (*“Art. 14 Abs. 1 GG (...), der die Beachtung der Unabhängigkeit der Europäischen Zentralbank und das vorrangige Ziel der Preisstabilität zu dauerhaft geltenden Verfassungsanforderungen einer deutschen Beteiligung an der Währungsunion macht”*).

For the *present-day* (italics added, RS) configuration of monetary union the autonomy of national budgets is considered ‘constitutive’ (*“dass die Eigenständigkeit der nationalen Haushalte für die gegenwärtige Ausgestaltung der Währungsunion konstitutiv ist”*, underlining added, RS).

Assumption of liability for voluntary decisions of other Member States – through direct or indirect pooling of national debt – goes beyond the foundations of legitimacy of the association of States [a qualification given to the EU by the German constitutional court: it is not a *Verbundsstaat* (federal State) but a *Staatenverbund* (a confederal association of states)] and should be prevented. (*“und dass eine die Legitimationsgrundlagen des Staatenverbundes überdehnende Haftungsübernahme für finanzwirksame Willensentschliefungen anderer Mitgliedstaaten - durch direkte oder indirekte Vergemeinschaftung von Staatsschulden - verhindert werden soll”*).

These paragraphs make clear that any German participation in joint debt issuance may require constitutional change in Germany, on top of a Treaty amendment at the Union level. Even then, it is not clear whether such an amendment, assuming it could pass the German Parliament, would be upheld by the German Constitutional Court. It is not only the *BVerfG*’s own previous, conservative decisions but also the *Ewigkeitsklausel* (eternity clause) of the German constitution which engender doubts in this respect. This provision declares inadmissible constitutional changes that affect principles on which the German post-war political order is based⁹. These principles include basic human rights and a provision (Article

⁹ Article 79 (3) of the *Grundgesetz* (Constitution): Eine Änderung dieses Grundgesetzes, durch welche die Gliederung des Bundes in Länder, die grundsätzliche Mitwirkung der Länder bei der Gesetzgebung oder die in

20) which seeks to guarantee German democracy for ever, with a right to secession if this right is trampled upon¹⁰. A recent, post-decision interview with the President of the German Constitutional Court in the *Frankfurter Allgemeine Zeitung* makes clear that the Constitution hardly allows for “more Europe”¹¹. He specifically addresses Eurobonds and cites his court’s own paragraphs quoted above¹².

This discussion of the German constitutional context makes clear that the issuance of Eurobonds may be very problematic and may require fundamental constitutional changes.

The situation in other Member States has not been investigated. It may not be so marked but I assume that constitutional amendments may be necessary in several other States. Of course, the requirement under one of the ‘six-pack’ pieces of legislation to reinforce EU economic governance that national budgetary laws are amended may provide an opportunity to go ahead and also amend national constitutions for the introduction of Eurobonds. I refer to the Directive on requirements for budgetary frameworks of the Member States which requires, before 2013, effective budgetary frameworks with independent forecasting and auditing in each Member State¹³. Additionally, the agreement during the recent Euro Summit (26 October) indicates that Member States whose currency is the euro should go beyond what this

den Artikeln 1 und 20 niedergelegten Grundsätze berührt werden, ist unzulässig. (Translation: 3) Amendments to this Basic Law affecting the division of the Federation into *Länder*, their participation on principle in the legislative process, or the principles laid down in Articles 1 and 20, are inadmissible.

¹⁰ Artikel 20 (Source: http://www.bundestag.de/dokumente/rechtsgrundlagen/grundgesetz/gg_02.html)

(1) Die Bundesrepublik Deutschland ist ein demokratischer und sozialer Bundesstaat.

(2) Alle Staatsgewalt geht vom Volke aus. Sie wird vom Volke in Wahlen und Abstimmungen und durch besondere Organe der Gesetzgebung, der vollziehenden Gewalt und der Rechtsprechung ausgeübt.

(3) Die Gesetzgebung ist an die verfassungsmäßige Ordnung, die vollziehende Gewalt und die Rechtsprechung sind an Gesetz und Recht gebunden.

(4) Gegen jeden, der es unternimmt, diese Ordnung zu beseitigen, haben alle Deutschen das Recht zum Widerstand, wenn andere Abhilfe nicht möglich ist.

Translation (source: <http://www.iuscomp.org/gla/statutes/GG.htm#20>):

Article 20 [Basic institutional principles; defence of the constitutional order]

(1) The Federal Republic of Germany is a democratic and social federal state.

(2) All state authority is derived from the people. It shall be exercised by the people through elections and other votes and through specific legislative, executive, and judicial bodies.

(3) The legislature shall be bound by the constitutional order, the executive and the judiciary by law and justice.

(4) All Germans shall have the right to resist any person seeking to abolish this constitutional order, if no other remedy is available.

¹¹ *Im Gespräch: Andreas Voßkuhle „Mehr Europa lässt das Grundgesetz kaum zu“* See:

<http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/im-gespraech-andreas-vosskuhle-mehr-europa-laesst-das-grundgesetz-kaum-zu-11369184.html>.

¹² “Depending on how Eurobonds are constructed, our response should therefore be quite clear.” (“*Je nachdem, wie Eurobonds konstruiert sind, dürfte unsere Antwort somit recht eindeutig sein.*”)

¹³ Albeit with special exemptions for the United Kingdom. For the text of this Directive as adopted by the Council and the European Parliament, see:

http://ec.europa.eu/economy_finance/economic_governance/index_en.htm.

Directive requires. They should adopt “rules on balanced budget in structural terms translating the Stability and Growth Pact into national legislation, preferably at constitutional level or equivalent, by the end of 2012”, “[consult] the Commission and other euro area Member States before the adoption of any major fiscal or economic policy reform plans with potential spill-over effects” and “[commit] to stick to the recommendations of the Commission and the relevant Commissioner regarding the implementation of the Stability and Growth Pact”¹⁴. Such far-reaching undertakings restrict national budgetary autonomy or, at least, bind them firmly into a European Union framework. Member States may see a window of opportunity to amend their constitutional frameworks regarding budgets also to allow for the issue of Eurobonds.

Interpretation of the EFSF and ESM treaties

The legal instruments governing the ESFS and its successor, the ESM, provide the framework for attracting finance for Member States in difficulties through a special common legal entity.

The Treaty establishing the EFSF provides for the granting of financial assistance to members in need on strict conditionality on the basis of guarantees by the shareholders. In case of a shortfall, the EFSF is to notify a State of “its share of the shortfall under the terms of this Agreement and the relevant Guarantee and [to] demand in writing each Guarantor to remit to EFSF its share of such shortfall” (Article 6). The guarantees are set out in an Annex to the EFSF Treaty. But in case of need, a guarantor can “step out”: “In the event that a Guarantor experiences severe financial difficulties and requests a stability support loan or benefits from financial support under a similar programme, it (the "**Stepping-Out Guarantor**") may request the other Guarantors to suspend its commitment to provide further Guarantees under this Agreement.” (Article 8 (2)). Then, “[t]he remaining Guarantors, acting unanimously and meeting via the Eurogroup Working Group may decide to accept such a request and in this event, the Stepping-Out Guarantor shall not be required to issue its Guarantee or incur any new liabilities as Guarantor in respect of any further issues [or other EFSF-related liabilities]”. Thus, the current list of guarantors, whose exposures range from €211 billion (Germany), €158 billion (France), €139 billion (Italy), €93 billion (Spain) and €44 billion (Netherlands) to €0.7 billion (Malta), is not the real picture, as the footnote to Annex I makes clear:

¹⁴ Paragraph 26 of the Conclusions of the Euro Summit, 26 October 2011, available at: <http://www.european-council.europa.eu/home-page.aspx?lang=en>.

The Hellenic Republic, Ireland and the Portuguese Republic have become Stepping-Out Guarantors. Portugal remains liable as Guarantor in respect of Notes issued prior to the time it became a Stepping-Out Guarantor. The Republic of Estonia is only a Guarantor in respect of Notes issued after the Effective Date of the Amendments.

This means that as of the Effective Date of the Amendments the aggregate of the active Guarantee Commitments for the Guarantors which are not Stepping-Out Guarantors is EUR 726,000.00 million [instead of the sum total of original guarantees, which was €780 billion, RS].

The EFSF Articles of Incorporation make clear that it is not intended as an agency for debt issuance but as a special purpose vehicle “to facilitate or provide financing to Member States of the European Union in financial difficulties whose currency is the euro and which have entered into a memorandum of understanding with the European Commission containing policy conditionality”, for the purpose of which the EFSF is “entitled to raise money by issuing financial instruments or by entering into financing arrangements with its shareholders or third parties [in respect of which guarantees will be given or collateral arranged]” (Article 3) . The foregoing makes clear that the EFSF is not an agency for joint debt issuance which could operate as an EMU bonds issuer.

The Treaty establishing the ESM mandates it “to mobilise funding and provide financial assistance, under strict economic policy conditionality, to the benefit of ESM Members which are experiencing or are threatened by severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole.” (Article 3). Its authorised capital stock of €700 billion will only be paid up for €80 billion (Article 8). As one may recall, Germany insisted on a phased payment of this capital: “(...) payment of paid-in shares of the amount initially subscribed by each ESM Member shall be made in five annual instalments of 20 % each of the total amount.” (Article 36). Capital is distributed among members on the basis of a key which contains temporary elements for the first twelve years after adoption of the euro by the member (Article 37). The ESM’s purpose is providing financial assistance to a member (Article 12 (1)). It has not been established to jointly finance its members budgets. Even though the Euro Summit on 26 October said that PSI was the exception for Greece only¹⁵, the ESM Treaty makes clear that “[a]n adequate and proportionate form of private-sector involvement shall be sought on a case-by-case basis where financial assistance is received by an ESM Member, in line with IMF practice.” (Article 12 (2)). The ESM Treaty makes clear

¹⁵ The Euro Area statement says:

“15. As far as our general approach to private sector involvement in the euro area is concerned, we reiterate our decision taken on 21 July 2011 that Greece requires an exceptional and unique solution.

16. All other euro area Member States solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature and all their commitments to sustainable fiscal conditions and structural reforms. The euro area Heads of State or Government fully support this determination as the credibility of all their sovereign signatures is a decisive element for ensuring financial stability in the euro area as a whole.”

that the ESM's functioning does not rest on guarantees but on subscribed capital. There is no analogy to be drawn for the issuance of Eurobonds. Yet, the ESM could function as an agency for such issuance, provided its founding Treaty and the TFEU are amended. The necessity of TFEU amendment flows from the narrow wording of the third paragraph of Article 136. This allows for the establishment of "a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole", not for a joint bond issuance mechanism.

The discussion of the EFSF and the ESM make clear that *joint and several* guarantees are not necessary to jointly fund governments since *partial* guarantees are the mechanism in use for the EFSF and *shareholders' liability* for the ESM. They also make clear that joint and several liability has not yet been assumed in the legal sense. Practically, a joint stock entity that issues debt instruments to finance budgets of a member – even only in crisis, to protect the stability of the euro area as a whole, and on strict conditionality – comes close to a joint liability for (part of) a Member State's debt. The provisions governing the EFSF and the ESM do not permit far-reaching conclusions on the acceptability of joint and several liability in the context of joint debt issuance. Neither are these entities apt to act as a joint debt agency for normal government financing. As they operate in a sense as a joint debt agency, they do pave the way for EMU bonds issuance later.

Tentative conclusions

Treaty change seems necessary, as does national constitutional change, to provide a firm legal basis for joint debt issuance by EU, or euro area Member States. The German position is most precarious here. Constitutional amendments to anchor budgetary restraint that are advocated, and Treaty change that is being explored, may provide a window of opportunity to adopt the necessary provisions to give a sound legal basis for the joint issue of "stability bonds".