The impact of intergovernmentalism in crisis management on the EU Treaties framework: the watering down of the no-bailout clause

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Abstract

The original architecture of the Economic and Monetary Union (EMU) did not take into account the scenario of a widespread sovereign debt crisis in Europe and did not provide for a common institutional framework to deal with it. Furthermore, the policy choices that assisted the creation of the EMU made it difficult for the Member States to cope with the crisis through the EU legal framework, forcing them to resort to extra EU solutions. This approach had a significant impact on the EU Treaty framework. The present paper is devoted to the analysis of one aspect of such an impact, i.e. the watering down of the no-bailout clause enshrined in Article 125(1) of the Treaty on the Functioning of the European Union (TFEU).
Summary

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1. Introduction: the Economic and Monetary Union and the quest for fiscal discipline

Fiscal discipline is a vital requirement for the viability of a currency, and this is particularly true in a monetary union with decentralised fiscal policies. This concept is clearly conveyed in the Delors report of 1989, which highlights that ‘an economic and monetary union could only operate on the basis of mutually consistent and sound behaviour by governments’, since ‘uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances’\(^1\).

Within the original design of the Economic and Monetary Union (EMU), fiscal discipline was meant to be ensured by means of a two-pronged approach, based on a combination of market mechanisms and legal rules. First of all, market forces have been attributed a significant role in monitoring of the health of national public finances, based on the premise that they are be able to detect the risks related to unsound national fiscal policies and react accordingly. The underlying idea is that if a State is engaging in an inadequate fiscal behaviour, the market would react by imposing to it less favourable terms of lending, as a compensation for the increased credit risk. Hence, if a State wants to be able to finance itself on the market, it is bound to pursue and maintain a budgetary discipline.

In addition to this, as a complement to market’s role, it was decided that no mechanisms of financial assistance would be accessible in the Eurozone\(^2\). The rationale for such a

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\(^2\) Article 104a of the Maastricht Treaty, now Article 125(1) TFEU, according to which the Union or a Member State ‘shall not be liable for or assume the commitments of central governments, regional, local
rule, also known as the ‘no bailout clause’, was to secure the effectiveness of market’s role by avoiding conducts of moral hazard on the part of the Member States. The basic idea is that if a Member State knows that, in case of need, it will be able to rely on the support of the EU or other countries, it might refrain from taking the actions required to ensure the sustainability of its public finance, thus neutralizing the effects of market’s control. In this sense, the choice of prohibiting financial assistance within the EU was meant at forcing Member States to rely, exclusively, on their capacity to finance themselves on the markets. The implicitly accepted consequence of such an approach is that if a euro area Member State is unable to conduct sound fiscal policies, it would be left in the lurch.

However, the fathers of the EMU were aware that market mechanisms are not 100% reliable, even if complemented with the prohibition of financial assistance. For this reason, they introduced other fiscal policy constraints, namely binding rules to impose upper limits on budget deficits of individual member countries, together with mechanisms for the coordination and surveillance of national fiscal policies. The relevant legal framework consists of both Treaty provisions and secondary legislation: detailed numeric criteria on the maximum government deficit and debt are set out, together with monitoring mechanisms and an enforcement procedure that might result in administrative and financial sanctions in case of infringements.

Such a combination of market control and binding fiscal rules seemed to suffice for ensuring a budgetary discipline on the part of the Member States. Nonetheless, when the crisis hit Europe, some design failures in the architecture of the EMU have been unveiled.

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3 See the Delors Report, cit., p. 20: ‘experience suggests that market perceptions do not necessarily provide strong and compelling signals’ and ‘market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive’.

4 As to the Treaty provisions, the reference is mainly to Article 104c of the Maastricht Treaty (now Article 126 TFEU), together with the Protocol on the excessive deficit procedure. With regard to secondary legislation, the relevant legal framework is set out in the Stability and Growth Pact, composed of a resolution and two regulations (Resolution of the European Council on the Stability and Growth Pact Amsterdam of 17 June 1997, Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure).

5 The legal framework has been renewed as part of a process of reinforcement of the economic governance of the EU, both through the adoption of secondary Union law measures (namely the ‘Six-Pack’ and the ‘Two-Pack’) and intergovernmental instruments (i.e. the ‘Treaty on Stability, Coordination and Governance in the Economic and Monetary Union’ and the ‘Euro plus pact’).
2. EMU versus crisis

The outbreak of the crisis in Europe showed that the original structure of the Eurozone was based on some wrong assumptions. First of all, it soon appeared clear that the confidence put in market discipline was misplaced. Markets proved to be unable to detect emerging potential risks in national fiscal policies and to react accordingly: they often responded belatedly or excessively, or even independently of the existence of actual risks. Eventually, market control turned out to be not so accurate as it was thought.

The second wrong assumption was that if the control exercised by market were insufficient to discipline public finances, the set of rules contained in the TFEU and the Stability and Growth Pact, based on monitoring, peer pressure and sanctions, would do the job. But as practice has shown, the weakness of the mechanism led to frequent violations of the rules. Criteria have been often breached and no sanctions have been adopted, since the decision on the imposition of fines rests ultimately with the Council, i.e. with a body in which ‘potential sinners pass judgment on actual sinners’. This led to a loose monitoring and caused the whole system of macro-economic surveillance to work inadequately.

Also, the decision not to allow Member States in difficulties to receive financial support was based on a misplaced assumption, viz. the belief that it is viable to leave a country to its own device without any negative consequences for the Eurozone. But the crisis showed the opposite, i.e. that the prospective default of a Member State can put the stability of the whole euro area at risk.

However, since the confidence in the success of the Maastricht policy choices led the creators of the EMU to overlook the scenario of an uncontrollable sovereign debt crisis, when the financial crisis hit Europe, the EU was faced with an overall lack of tools to properly face it. More specifically, due to the lack of a common institutional framework

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7 Idem.


10 According to Bini Smaghi, cit., ‘[s]everal academics and commentators are still flirting with the idea that a partial default could be organized in an orderly fashion, with minor repercussions on the country itself and on its neighbours. But financial markets have shown how exposed they are to contagion—contagion which, by the way, is not limited to the euro area. It’s global’. 
and the existence of a huge constraint in the Treaty (namely the prohibition of financial assistance), Member States were urged to resort to extra-EU solutions, i.e. to manage the crisis in an intergovernmental framework, by concluding international agreements between themselves.

One aspect of the intervention concerned the establishment of measures for providing financial assistance to Member States in difficulties. Such measures raised many legal questions as to their compatibility with the EU Treaty framework, in particular because they practically resulted into the downsizing of one of the key provisions of the EMU, the no-bailout clause.

The following paragraphs will be devoted to a brief analysis of the rescue mechanisms designed at intergovernmental level and to a scrutiny on the consequences arising from their establishment.

3. The establishment of rescue mechanisms

The outbreak of the crisis in Europe can be traced back in late 2009, when it was revealed that the Greek government had misreported some data concerning its debt and deficit in order for Greece to be able to join the euro. Such a discovery led to a quick deterioration in Greece’s financing conditions on the market and, given the strong interdependence of European economies, raised significant concerns about the sustainability of public finances in other countries. Risks of contagion and consequent fears for the future of the common currency urged the Eurozone countries to act.

The first reaction to the crisis was meant at avoiding the Greek default and took the form of the disbursement of bilateral loans to Greece. More specifically, when it was clear that Greece had practically lost its access to the market, the Ministers of the Eurogroup agreed on a loan scheme amounting to 80 billion euro to the country. The loans were based on ‘strong policy conditionality’, which means that Greece was required to implement specific measures at national level, on the basis of a programme negotiated with the European Commission and the IMF, in liaison with the European Central Bank. The European Commission was tasked with the pooling of the loans.

Already in the course of the Greek rescue, the huge market pressure affecting other European States urged Eurozone countries to start working on the establishment of a rescue mechanism with a wider application scope.


12 See Statement by the Eurogroup, cit..
The first instrument to be envisaged was the European Financial Stability Mechanism (EFSM), conceived to be introduced by means of a EU regulation. The regulation was based on Article 122(2) TFEU, according to which where a Member State is in difficulties or threatened with exceptional occurrences beyond its control, the Union may grant to it financial assistance, subject to several requirements. This instrument relied on the use of EU financial resources: more specifically, it allowed the Council to empower the Commission to borrow on the capital markets on behalf of the Union, using the EU budget as a collateral, and to transfer the proceeds to the beneficiary Member State.

Since the EFSM system was linked to the EU budget, the financial resources available under the mechanism were inevitably limited (around 60 billion euro). It should also be noted that the ESFM, as a EU 27 mechanism, implied the use of financial resources of the EU in order to address financial stability issues mainly affecting the Eurozone.

For this reasons, in May 2010, the representatives of Eurozone countries decided to establish another instrument, the European Financial Stability Facility (EFSF). The mechanism, meant to be temporary, was put in place through a decision of the Representatives of the Governments and established as a private company under Luxembourg law. Notwithstanding the fact that the EFSF was an extra-EU facility, both the Commission and the ECB were significantly involved in its operation, with regard to the negotiation of the policy requirements, the preparation of the agreement and the monitoring of compliance with policy conditionality.

The EFSF could rely on more financial resources than the EFSM (around 440 billion euro), since it was financed with the budget of the participating Member States. However, while the legality of the EFSM could be derived from a provision of primary law (Article 122(2), that could be interpreted as a derogation of the no-bailout clause), the EFSF was allegedly infringing the prohibition of financial assistance enshrined in the Treaty.

Taking into account this concern, the German government pushed for an amendment of the Treaty. In particular, it asked for the insertion of a provision to authorise Eurozone countries to establish a permanent stability mechanism to safeguard the stability of the

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14 See the Decision of the Representatives of the Governments of the Euro Area Member States meeting within the Council of the European Union of 10 May 2010.

euro area. Such events led, in 2012, to the conclusion of the Treaty establishing the European Stability Mechanism (ESM) between the euro area Member States. The ESM has a maximum lending capacity of 500 billion euro. It is entitled to grant several forms of loans to its Members, always subject to strict conditionality. As in the case of the EFSF, despite the ESM being an instrument of intergovernmental nature, the EU Institutions play a key role in its operation.

Hence, three out of four rescue mechanisms have been set up in an intergovernmental framework. The reasons for that should already be clear, but it is worth elaborating a bit more on them, in order to clarify the elements that pushed Eurozone countries to shape their reaction within the intergovernmental path.

4. Why the intergovernmental path?

The first intervention, i.e. the Greek Loan Facility Agreement (LFA), was developed in a situation of urgency, when there was no time to envisage other more elaborated solutions. In that case, the intergovernmental framework looked particularly suitable, because it offered Eurozone countries a quick decision-making and implementation environment.

However, the LFA was an instrument meant at serving the purpose of the Greek rescue only, while a mechanism of a wider application scope was needed. Hence, Member States started working on the establishment of a general instrument, this time based on EU law, the EFSM. They tried to neutralise the no-bailout clause by basing such an instrument of another primary law provision, but doubts arose as to the suitability of the chosen legal basis. In fact, while Article 122(2) legitimises financial assistance where a State is dealing with exceptional occurrences beyond its control, it is questionable whether a sovereign debt crisis could count as an event that escapes the State’s control. One could argue, on the contrary, that government actions contribute to determine it, and thus the legal basis of the EFSM appears a bit shaky. In addition to this, the resources available under the EFSM were limited, as they were related to the EU budget. Furthermore, as a EU law instrument, the EFSM implied the use of financial

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16 See Article 1 of 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.
18 With the establishment of the ESM, both the EFSF and the EFSM were supposed to be discontinued: see the European Council Conclusions of 16-17 December 2010, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf, p. 1. However, while the EFSF has actually ceased to provide financial assistance, the EFSM is still active and has been used in the framework of the third Greek bailout.
resources of the EU (i.e. of all Member States), in order to deal with issues mainly affecting the Eurozone.

For this reasons, in parallel with the establishment of the EFSM, Eurozone countries started developing an intergovernmental instrument applicable to Eurozone countries only and guaranteed with national budgets. They chose to establish it by means of an agreement concluded in simplified form, in order to avoid undergoing national ratification processes and to establish it as soon as possible. The mechanism was conceived to be temporary and meant to expire after a period of three years. However, the choice for the intergovernmental path did not solve the issue of the compatibility of the EFSF with the no-bailout clause. In fact, according to the principle of primacy, even when concluding international agreements, EU countries are required to comply with the obligations that EU law imposes on them.

For this reasons, Members States started working on the creation of an explicit legal basis for a new –this time permanent– rescue mechanism. So, in March 2011, they agreed on the introduction, in the TFEU, of a provision authorizing Eurozone countries to ‘establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole’\textsuperscript{19}.

Such a mechanism was meant to be established in an intergovernmental framework. This choice can be attributed to several factors. First of all, the decision to set up the ESM by means of an international agreement allowed the Member States to amend the Treaty via the simplified revision procedure\textsuperscript{20}, whose use is subject to the condition that the proposed amendment does not increase the competences conferred on the Union. Since the competence of the Union in that field was highly disputed, the establishment of the ESM by means of a EU legal act would have implied going through the cumbersome ordinary revision procedure. Furthermore, a EU legal instrument would have faced the same financial constraints of the EFSF, being dependent on the EU budget.

5. Rescue mechanisms and EU law

From a theoretical point of view, the decision to resort to international agreements on the part of the Member States should not be seen as problematic. In fact, as a general rule, Member States are allowed to conclude inter se agreements in all fields not covered by an exclusive competence of the EU. However, when concluding international agreements, Member States are required to comply with the obligations arising from EU law.

\textsuperscript{19} Article 136(3) TFEU.
\textsuperscript{20} Article 48(6) TEU.
In the case of financial assistance mechanisms, the major concern is represented by the prohibition of financial assistance enshrined in Article 125(1) of the Treaty. As already seen, this provision codifies the well-known no-bailout clause, according to which the Union or 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’.

After reading the provision, no doubts seem to arise as to the actual content of the ban: financial assistance within the EU is prohibited. And the very fact that the Member States decided to introduce a Treaty amendment to ensure the compatibility of the ESM with EU law says a lot for it. Hence, should one conclude that all the mechanisms set up before this Treaty amendment were illegal?

Some scholars have been very assertive in stating that Article 125(1) rules out any kind of financial support granted by a Member State to another, being the wording of the provision rather clear in the point\textsuperscript{21}. Such a reading focuses also on the aim of the prohibition: if Member States are to be disciplined by the markets, any kind of financial support would distort the functioning of this mechanism.

Nonetheless, another interpretation has been proposed, according to which the ban applies only when a direct relationship with the creditors of a Member State is established, as in the case of a guarantee or subrogation; instruments of financial assistance such as loans or credit lines would not fall into the scope of the prohibition, since they do not imply a liability or an assumption of commitments, at least insofar as the recipient is bound to pay the money back\textsuperscript{22}. If such a view is accepted, the aim that Article 125(1) pursues, i.e. ensuring a budgetary discipline, could be achieved by means of establishing a severe conditionality, implying also measures of budgetary adjustment that could minimize the risk of moral hazard.

Such a reading has been upheld by the Court of Justice in the famous Pringle case\textsuperscript{23}, in which European judges were asked to rule, inter alia, on the compatibility of the ESM Treaty with the no-bailout clause. The plea for annulment was justified by the fact that,


\textsuperscript{23} Judgment of the Court (Full Court) of 27 November 2012, Thomas Pringle v Government of Ireland, Ireland and The Attorney General, Case C-370/12. The case originated from the decision of the Irish government to ratify the ESM Treaty without submitting it to a referendum. A Member of the Irish Parliament, Mr. Thomas Pringle, brought a legal action before the High Court, arguing not only that a referendum was required, but also that the conclusion of the ESM amounted to a violation of the EU Treaties.
at the time when the legal action was brought, the EU Treaty amendment meant at ensuring the compatibility of the ESM with EU law was not yet in force.

It not a mystery that, in Pringle, the Court was burdened with a very tough decision and also left with little room for choice: an invalidation of the ESM could have had severe consequences on the market and possibly led to a further worsening of the crisis. For this reason, the rejection of all grounds of unlawfulness of the ESM came as no big surprise\textsuperscript{24}.

With regard to the compatibility of the mechanism with the no-bailout clause, the Court noted that Article 125(1) is not intended to ban any forms of financial assistance, but only the assistance as a result of which the incentive of a Member State to conduct a sound budgetary policy is diminished\textsuperscript{25}. Basically, what the Court did was trying to preserve, somehow, the ratio of the prohibition of financial assistance, i.e. to make sure that a State remains subject to the logic of the market when entering into debt, since that would force it to maintain a budgetary discipline.

In the Court’s view, two are the conditions under which the prohibition of Article 125(1) does not apply: first of all, when the beneficiary remains responsible towards its creditors; secondly, when the granting of financial assistance is made subject to strict conditionality, i.e. the implementation of economic policy measures aiming at restoring a budgetary discipline\textsuperscript{26}.

By means of this loose interpretation, the Court managed to save the ESM. However, the issue deserves further considerations. In particular, it is not possible to ignore the fact that this reading of Article 125 amounts, practically, to a denial of the bailout prohibition and of the core policy choice enshrined in it.

6. The watering down of the no-bailout clause

When commenting on the outcomes of the Pringle case, one should bear in mind that a ruling against the ESM would have had devastating effects in the euro area, to the point


\textsuperscript{25} See Pringle case, cit. paras 130-136. Such a finding has been supported through a reference to Articles 122(2) and 123 TFEU. The first provision allows the Union to grant financial assistance to a State which is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control. In the Court’s view, the fact that this provision does not contain an explicit derogation to Article 125(1) implies that the latter does not prohibit any kind of financial support. The second Article is the one prohibiting monetary financing by the ECB and the central banks, that explicitly includes in the ban ‘overdraft facilities or any other type of credit facility’. According to the Court, the fact that Article 125(1) does not contain any similar specifications implies that it ‘is not intended to prohibit any financial assistance whatever to a Member State’.

\textsuperscript{26} See Pringle case, paras 137-143.
that no other options were actually feasible. However, it is not possible to overlook the extent to which the whole chain of events affected the EU Treaty framework.

As seen, according to the original model of the EMU, Member States cannot rely on the chance of being bailed out, since this will frustrate the aim of market control, i.e. to ensure that States maintain a budgetary discipline and do not engage in conducts of moral hazard. Placed in its context, the content of the ban appears crystal-clear, together with the fact that such a rule does not tolerate any exceptions. In fact, if a State knows that there is a chance of receiving financial assistance, this will decrease its sense of budgetary responsibility if compared to a State for which no bailout is available; and this is true also when financial support is made subject to strong conditionality, since the consequences of a prospective default are clearly tougher than the cost of austerity measures required to receive financial assistance.\(^{27}\)

Against this background, it is easy to understand the impact that intergovernmental rescue mechanisms produced on the EU Treaties: as a result of Member States’ actions, the EMU has moved from a no-bailout principle to a ‘conditional bail out policy’\(^{28}\).

From a constitutional perspective, what happened is that Eurozone countries, acting at international level, breached one of the key provisions of the EMU, while later on, factual circumstances practically obliged the Court of Justice to justify such a violation, by offering a loose interpretation of the infringed provision.

Although the history of European integration has already seen several informal Treaty amendments promoted by the case law of Court of Justice and subsequently incorporated in the text of the Treaties, in the case of the no-bailout clause one can notice a major difference: the Court did not act on its own motion, but was bound to endorse the Member States’ action. The final outcome is, basically, a Treaty revision carried out outside the specific procedures provided for by the Treaties.

### 7. Conclusive remarks

Now that the critical phase seems to be over, the attention is to be devoted to the reforms that can correct the structural shortcomings of the Eurozone’s design and align the text of the Treaties to the factual developments.

Recently, such a need has been expressed in a report prepared by the President of the European Commission in cooperation with the Presidents of the Euro Summit, the


\(^{28}\) Dabrowski M., cit., p. 24.
Eurogroup, the ECB and the European Parliament. The report sets a roadmap for completing the EMU, at the latest by 2025, by identifying a number of initiatives to be taken within specific timeframes.

With regard to the actions undertaken by Member States in the midst of the crisis, the Report affirms: ‘[a]t the height of the crisis, far-reaching decisions had often to be taken in a rush, sometimes overnight. In several cases, intergovernmental solutions were chosen to speed up decisions or overcome opposition. Now is the time to review and consolidate our political construct – and to build the next stage of our Economic and Monetary Union’.

Furthermore, the report highlights the need of integrating such intergovernmental arrangements into the legal framework of the EU: with specific regard to the ESM, it points out that its ‘governance and decision-making processes are complex and lengthy’, mainly due to its intergovernmental structure; for this reason, ‘its governance should […] be fully integrated within the EU Treaties.

According to the roadmap set out in the Report, the integration of the ESM into the EU law is expected to take place during stage 2 of the process, i.e. after June 2017. Priority has been given to other more critical issues, such as actions to boost convergence, job and growth, the completion of the banking union, the creation of a new advisory fiscal board, the reorganization of the European Semester and the reinforcement of the external representation of the euro area. Therefore, the debate on how the ESM will be integrated into the EU legal order has not yet started and it is not supposed to start soon. This has been confirmed in the European Council conclusions of 17-18 December 2015, in which the Institution stated that it will come back on the long-term measures contained in the Five Presidents’ Report in the future, at the latest by the end of 2017.

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31 Five Presidents' Report, cit, p. 17.
32 See Five Presidents' Report, cit, p. 18.
33 See Annex 1 of the Five Presidents' Report, cit., p. 21.
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