

# Economic Governance Reform and Financial Stabilization in the EU and in the Eurosystem – Treaty-Based and Intergovernmental Decisions

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*The institutional framework and the tools for economic governance provided by the Treaty of Lisbon were inadequate for preventing or resolving the recent banking and sovereign debt crisis in the EU. For instance, the Treaty did not provide any instruments for stabilizing euro area finances, and the existing economic governance instruments, such as the Stability and Growth Pact or the Broad Economic Policy Guidelines, were not applied adequately by the Member States. In addition, the institutional decision-making procedures foreseen by the Treaty proved too sluggish during the crisis. Therefore, most of the measures taken to remedy the situation were agreed through intergovernmental decision-making, with the European Council evolving as the key player in the governance process, rather than through standard EU procedures (with the “Community Method”). The deepening of euro governance, alongside the EU governance framework, resulted from the fact that the euro area required a coherent and efficient economic governance structure. The willingness to offer financial solidarity within the euro area correlates with the willingness of distressed Member States to implement sustainable national fiscal policies. To ensure the long-term success of the euro, the euro area will, however, have to adopt a common overall strategy that adds more value to its economic success as an entity.*

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Overcoming the banking and sovereign debt crisis in the EU and in the euro area has put both the economic policy strategies of the EU and of its Member States as well as institutional decision-making to a severe test. The principal conditions governing the Economic and Monetary Union (EMU) framework laid down in the Maastricht Treaty have not been adapted. They thus remain the statutory framework on the basis of which measures may be taken at the EU level to combat the sovereign debt crisis. The economic policy framework in place certainly contains provisions whose expedient implementation could have mitigated or even prevented the current effects of the crisis (Wieser, 2011; Koll, 2011) – had all the Member States, especially the euro area countries, observed their self-imposed economic policy constraints.

Article 3 of the Treaty on European Union (TEU) lays down economic policy objectives for the EU, including “balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress.” EMU is based on an independent monetary policy oriented toward stability, whose primary objective is to maintain the price stability of the euro under Article 127(1) of the Treaty on the Functioning of the European Union (TFEU). When founding EMU, the Member States entered into a binding agreement that fiscal and economic policy would remain a national responsibility. The fiscal policy framework laid down in the Treaty of Lisbon and compliance with the Stability and Growth Pact were designed to secure the stability-oriented single monetary policy. Article 125 TFEU –

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the “no bailout” clause – in combination with Article 123 TFEU – the prohibition of monetary financing of budget deficits – is considered the prerequisite for fiscal discipline in all Member States and for the functioning of monetary policy (Potacs and Mayer, 2011). Otherwise, the Member States could be tempted to pursue unsound fiscal policies because they would not have to bear the consequences of such policies alone – such as high risk premiums on their sovereign debt or the inaccessibility of market financing. The above-mentioned fiscal discipline rules should be applicable both to economic governance under normal circumstances and to crisis management.

Many critics have noted that the Treaty of Lisbon did not contain sufficient provisions for preventive crisis management (e.g. Breuss, 2011). Actual crisis management and considerations for long-term crisis prevention have indeed brought to light institutional and structural shortcomings that the EU and the euro area have begun to address. Among other things, the Treaty of Lisbon does not explicitly establish financial solidarity among the Member States; only in the event of a serious threat caused by natural disasters or exceptional circumstances can a Member State receive EU financial assistance under the provisions of Article 122(2) TFEU. To fill this gap, the euro area took the initiative to establish a stability mechanism under which financial assistance may be granted to distressed euro area countries. Burden-sharing during crisis between Member States with sound economic policies and those with unsound practices and between monetary policy and fiscal policy has revealed contradictory eco-

nomical policy interests. To remedy this situation, the EU has since taken measures to enhance its economic governance framework. Moreover, the euro area has been criticized for its inefficient and slow crisis management and its sluggish crisis communication. The public and financial markets have decried the lack of clear solutions and have been confused by intransparent decision-making. The establishment of a separate euro governance structure shall rectify this situation.

This article provides an overview of the financial and economic policy measures taken from fall 2008 to fall 2011 in response to the sovereign debt crisis. A preliminary review of the reforms is made on the basis of the standard EU procedures as laid down in the Treaty of Lisbon and the initiatives taken by Member States. Perspectives for future developments are assessed.

## **1 The Treaty of Lisbon as the Point of Departure for Crisis Resolution and Reform**

### **1.1 EMU Institutional Framework and Governance during the Crisis**

On December 1, 2009, the new constitutional basis for the EU, the Treaty of Lisbon,<sup>2</sup> entered into force. The Lisbon Treaty applies to an enlarged EU of 27 Member States with 502.5 million EU citizens (Eurostat, 2011) and is intended to ensure a more efficient functioning of EU institutions. To what extent does the Treaty of Lisbon represent a suitable legal and institutional basis for efficient crisis resolution? Which EU bodies are involved in crisis management, and how do they interact?

<sup>2</sup> *The Treaty of Lisbon consists of the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), including the annexed protocols and declarations (OJ C 83, 30. 3. 2010, p. 1).*

### 1.1.1 European Council and Euro Summits

The First European Council was held in Paris in 1961 at the behest of Charles de Gaulle, then President of France. The Treaty of Lisbon formalized the European Council and transformed it into an institution of the EU.<sup>3</sup> Meetings of the European Council are attended by the Heads of State or Government of the 27 EU Member States, its President, the President of the European Commission and the President of the European Central Bank (ECB). As a rule, decisions are taken by consensus. The European Council does not exercise a legislative function (Article 15(1) TEU). Electing a full-time president of the European Council for 2½ years is intended to enhance consistency and continuity in the political management of the EU, as the political guidelines and priorities for EU action are decided top-down by the European Council (European Policy Centre, 2011). In EMU, the coordination of economic policies and employment policy programs also follows policy orientation given by the European Council; the European Council moreover assesses the implementation of these programs. These functions indicate the key role the European Council plays in EU crisis management. While the Heads of State or Government used to come together four times a year, they met more often during the crisis, many times at short notice.

As the stability of the euro was considered to be under threat, it quickly

became evident that the euro area would require a coherent approach to financial and economic crisis management. As early as October 12, 2008, Nicolas Sarkozy, then President of the EU Council, convened the historical first European Council of the Heads of State or Government of the euro area countries, the first Euro Summit (Schwarzer, 2009). The subsequent “Franco-German proposal”<sup>4</sup> for stronger economic and institutional governance of the euro area provided for regular meetings – at least two a year – of the Heads of State or Government of the euro area countries (“gouvernement économique”).<sup>5</sup> The Euro Summit of October 26, 2011, expanded this proposal to improve the governance of the euro area (chart 1). The measures were aimed at strengthening economic policy coordination and surveillance within the euro area, improving the effectiveness of decision making, and ensuring more consistent communication. In the past, the authorities often-times sent mixed messages about complex decisions to financial markets and the public. The Euro Summit on October 26, 2011, therefore decided that its President together with the President of the European Commission would be in charge of communicating decisions. The President of the Eurogroup together with the Commissioner for Economic and Monetary Affairs will be responsible for communicating the decisions of the Eurogroup. To reinforce cohesion between the euro area and the EU, the President of the Euro

<sup>3</sup> Article 15 TEU, Articles 235, 236 et seq. TFEU and the European Council Decision of 1 December 2009 adopting its Rules of Procedure L 315/51 (OJ 2009/882/EU) specify the functioning and competences of the European Council.

<sup>4</sup> As expressed in a communication by German Chancellor Angela Merkel and French President Nicolas Sarkozy (2011).

<sup>5</sup> Different EU Member States have their own understanding of what “gouvernement économique” means. France e.g. had already proposed an “economic government” when EMU was founded to establish a counterweight to the single monetary policy.

Summit will inform the European Council of the preparation and outcome of the Euro Summits. The President of the Euro Summit will ensure the preparation of the Euro Summit, in close cooperation with the President of the Commission. The President of the Euro Summit will be designated and the President of the European Council<sup>6</sup> will be elected at the same time, and their terms of office will be 2½ years.

### 1.1.2 The Ecofin Council

The Council in the composition of the economics and finance ministers (Ecofin Council) has European legislative authority over economic and financial matters, in some cases in codecision with the European Parliament. The 27 EU ministers, together with the Commissioner for Economic and Monetary Affairs, meet under the presidency of the Member State that holds the rotating EU presidency. Moreover, the governors of the national central banks attend the informal Ecofin Council.

Like all other Council bodies, the Ecofin Council takes decisions by a qualified majority, as laid down in the Treaty of Nice. This system will apply until November 1, 2014, when the “double majority” principle will be introduced. Double majority means that decisions taken by the Council of Ministers will require a majority of 55% of the Member States representing at least 65% of the EU’s population (Article 238 TFEU). To increase the EU’s capacity for action, the qualified majority principle was extended to some EMU areas in the Treaty of Lisbon, e.g. to decisions on excessive

deficits and to the appointment of the President, Vice-President and other members of the Executive Board of the ECB.

### 1.1.3 The Eurogroup

The Eurogroup, an informal gathering of the finance ministers of the 17 euro area countries, the Commissioner for Economic and Monetary Affairs and the President of the ECB, plays a pivotal role in euro area governance. This body was established already in 1998, as a “political counterweight” to the ECB, to meet the need for enhanced economic policy coordination among the euro area countries. The Eurogroup was later formalized in Article 137 TFEU and in a separate “Protocol on the Euro Group.”<sup>7</sup> The president<sup>8</sup> of the Eurogroup is elected for a term of 2½ years. In the “provisions specific to Member States whose currency is the euro,” the Treaty of Lisbon defines the areas in which the Eurogroup may take decisions autonomously. Euro area countries may adopt measures to set out economic policy guidelines and to strengthen the coordination and surveillance of budgetary discipline (Article 136 TFEU). The Eurogroup may, for example, issue special recommendations to its members about drawing up their stability programs and about the euro area entry of new members. When euro area countries’ finance ministers take final decisions on Eurogroup-related issues in the Ecofin Council, the finance ministers of the non-euro area countries do not take part in the vote (Martens, 2009).

<sup>6</sup> Herman Van Rompuy is currently President of the European Council; until the next election in June 2012 he will also preside over the Euro Summits.

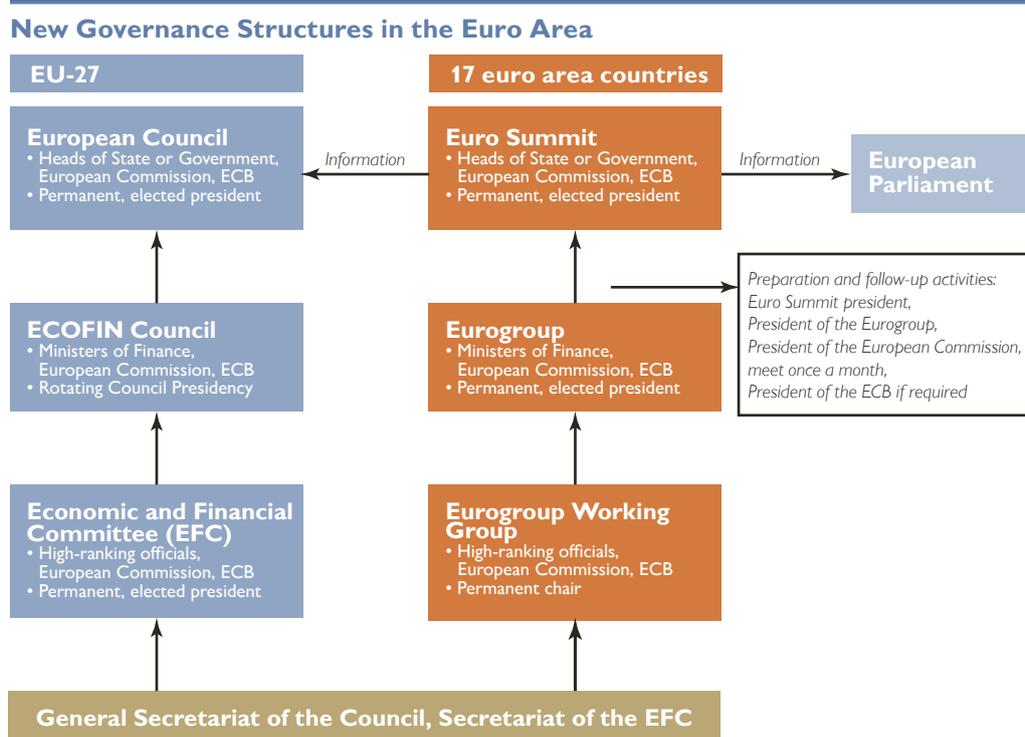
<sup>7</sup> Protocol (No 14) on the Euro Group (OJ C 83, 30. 3. 2010) codifies the practice followed before the Treaty of Lisbon entered into force.

<sup>8</sup> The current president of the Eurogroup is Luxembourg’s Prime Minister, Jean-Claude Juncker. His term ends in July 2012.

Since the intensification of the sovereign debt crisis, euro area countries have been coordinating their actions much more closely. The pooled bilateral loans to Greece, the establishment of the European Financial Stability Facility (EFSF) and those areas of economic governance that concern only euro area countries may be cited as cases in point. To effectively overcome the current problems and to ensure closer integration, the Euro Summit agreed on a new economic governance framework for the euro area while preserving the integrity of the EU as a whole. Under this new framework, the Eurogroup will ensure greater fiscal coordination and will promote financial stability. The decision on whether the Eurogroup president should be elected from among Eurogroup members or whether the president should be a full-time official

based in Brussels will be taken when the current incumbent's mandate expires. The Eurogroup will also be in charge of preparing, and following up on Euro Summits. The President of the Euro Summit, the President of the Commission and the President of the Eurogroup will meet regularly, at least once a month. The President of the ECB may be invited to participate. The presidents of the European supervisory agencies and the CEO of the EFSF or the Managing Director of the European Stability Mechanism (ESM) may be invited ad hoc. The Eurogroup Working Group (EWG) will be tasked with work at the preparatory level, drawing on expertise provided by the Commission. The EWG will be chaired by a full-time Brussels-based president, who will as a rule be chosen at the same time as the chair of the Economic and Financial Committee.

Chart 1



Source: OeNB.

#### 1.1.4 ECB

Article 13(1) TEU names the ECB as one of the EU's institutions. The provisions regarding the ECB in the Treaty of Lisbon (Articles 127 through 133 TFEU) and the ESCB/ECB Statute<sup>9</sup> call for personal, operational, financial and legal independence of the ECB. The ECB is consulted on any proposed EU act in its competence, such as the six legislative proposals of the European Commission to reform economic governance (the "six-pack"). The ECB is represented in all key decision-making bodies of the euro area, such as the Euro Summits or the Eurogroup, as well as in those of the EU. The Governing Council of the ECB, the main decision-making body of the ECB, consists of the six members of the Executive Board of the ECB and the 17 governors of the euro area NCBs. Votes are taken by a simple majority of the unweighted votes<sup>10</sup> of the Governing Council's members. Compared to the Eurogroup, the Governing Council of the ECB, with its streamlined decision-making and communication structure, is able to act very quickly during a crisis.

#### 1.1.5 Role of the European Commission

The European Commission ensures the application of the Treaties, has the sole right to propose legislative acts, and oversees the application of EU laws (Article 17 TEU) (Schusterschitz, 2009). The European Commission has always been a driving force behind EU integration, proposing legislation by virtue of its status as a supranational institution independent of the individual Member States. The Commission exercises its right of initiative autonomously of the Member States' national inter-

ests, as was the case with economic governance reform. While the Task Force on Economic Governance was still negotiating, the European Commission already presented six legislative proposals frequently referred to as "the six-pack" (box 1).

However, many observers note that the European Commission has – to a certain extent – lost its role in crisis management. Proposals to resolve the crisis and initiatives for deepening integration, such as the Euro Plus Pact, were made by the Member States themselves, above all as a result of German-French cooperation. With a separate euro governance in place, the European Commission faces two particular challenges: The Commission will have to ensure coherence among the EU-27 while at the same time fulfilling special tasks for the euro area. The European Council already addressed this duality at its meeting of October 23, 2011, emphasizing that the European Commission was responsible for the efficient functioning of the EU by ensuring compliance of all 27 Member States with EU legislation. Any Treaty changes initiated by euro area countries have to be agreed by all 27 Member States. The European Council also took note that the Euro Summit intended to reflect on further strengthening economic convergence within the euro area. In this context, the Commission will prepare proposals and will strengthen the role of the Commissioner for Economic and Monetary Affairs in the Commission.

#### 1.1.6 Strengthened Role of the European Parliament

With the establishment of the codecision procedure (Articles 294 et seq. TFEU) as the primary legislative pro-

<sup>9</sup> Protocol No 4 of the Treaty of Lisbon: Statute of the ESCB/ECB.

<sup>10</sup> In precisely defined cases, voting is according to the capital key, e.g. for the distribution of profit.

cedure in the EU, the European Parliament became a legislator on an equal footing with the Council. The outcome is a higher degree of control and democratic legitimacy, also in the field of economic and fiscal policy. In this vein, the European Parliament called for extensive amendments to the “six-pack” legislation on economic governance reform (box 1). The European Parliament only had to be consulted on the establishment of the European Stability Mechanism (ESM). The European Parliament was not called upon to act as a legislator for short-term crisis management in the euro area. However, it was agreed that the Euro Summit president would inform the European Parliament about the results of the meetings.

The expansion of the regular legislative procedure to include the European Parliament on an equal footing promotes decisions of a supranational nature at the EU level, but during the economic and financial crisis, the rapid action of the European Council and the Euro Summit were required. The upshot was that more and more decisions, such as the decision to establish EU-IMF financial assistance for EU/euro area countries, were agreed during intergovernmental negotiations. Therefore, decision makers will have to weigh the importance of acting rapidly against greater cohesion among the Member States and democratic legitimacy that a regular legislative procedure confers.

Box 1

#### **Economic Governance Reform – EU Codecision Procedures Result in Complex Interinstitutional Cooperation**

*On March 25, 2010, the Heads of State or Government of the euro area countries agreed that economic governance needed to be improved. To this end, the Task Force established by the March 2010 European Council held its first meeting May 21, 2010. The European Council President Herman Van Rompuy chaired the meeting, which – in close cooperation with the European Commission – elaborated reform proposals on the basis of Treaty provisions. The European Commission adopted six legislative proposals to strengthen economic governance in the EU already on September 9, 2010, that is, even before the Task Force presented its report to the European Council on October 21, 2010. The substance of the legislation was, however, closely coordinated with the report.*

*At its meeting on March 15, 2011, the Ecofin Council reached agreement on the European Commission’s package of six legislative proposals on economic governance. Before this breakthrough, the proposals applicable to the euro area had been debated within the Eurogroup.*

*On September 28, 2011, the European Parliament adopted the legislation. The adoption of the laws was preceded by numerous tripartite negotiations between the European Parliament, the Ecofin Council and the European Commission to clarify contentious issues. To illustrate just how rocky the road was: the European Parliament had submitted some 2,000 amendments. On October 23, 2011, the European Council welcomed the agreement, and on November 8, 2011, the Ecofin Council formally adopted the six legislative proposals. The six laws entered into force on January 1, 2012, and will strengthen the economic policy pillar of EMU. It took nearly two years after the European Council had started its reform initiative before these laws went into effect. However, the measures are not to be seen as immediate crisis management tools.*

## 1.2 Distribution of Competences and Cooperation between the EU Institutions on EMU-Related Issues

The distribution of powers between the Member States and the EU as well as among EU institutions is a key determinant of the overall economic and fiscal policy strategy of the EU and of the euro area (chart 2). On the basis of the Treaty of Lisbon, the Member States devolve powers to the EU for the purpose of realizing common economic and fiscal policy objectives. All of the powers that are not conferred upon the EU in the Treaties remain with the Member States. Hence, the principle of conferral (within the limits of the competences defined by the Treaties) while preserving the subsidiarity principle

applies (Article 5 et seq. TEU, Protocol No 2). The Treaties distinguish between exclusive competences, shared competences (shared with the Member States) and competences to carry out action to support, coordinate or supplement the actions of the Member States (Title I, Articles 2 to 5 et seq. TFEU). The exclusive competences of the EU (Article 2(1), Article 3 TFEU) include monetary policy for the Member States whose currency is the euro. The Member States regard their economic policies as a matter of common concern (Article 121 TFEU). Consequently, Member States coordinate their economic and employment policies. For example, the Europe 2020 initiative uses the “open method of coordination” (OMC)<sup>11</sup> along the lines of

Chart 2

### Economic Governance Architecture and Legal and Institutional Basis of EMU



Source: OeNB; Breuss, 2011; Obwexer, 2011.

<sup>11</sup> The OMC uses instruments like common objectives, benchmarks, best practices and progress reports to attain objectives.

Article 2(3) and Article 5 et seq. TFEU. By introducing the European semester in January 2011, the EU has fine-tuned economic governance and ex-ante coordination at the EU level (chart 2). Member States may be given fiscal and structural policy targets even before the respective parliaments have adopted the national budgets (Köhler-Töglhofer and Part in this issue). Another cooperation instrument is “enhanced cooperation” (Article 20 TEU and Articles 326 to 334 et seq. TFEU), which allows for a group of Member States to cooperate more closely in a particular area. Enhanced cooperation must take place within the framework of the EU’s nonexclusive competences and is not suited to overcoming EMU design defects embodied in the Treaty (Fischer-Lescano and Kommer, 2011). On December 9, 2011, the euro area Heads of State or Government agreed to make more active use of enhanced cooperation without undermining the internal market.

The institutional reforms of the Treaty of Lisbon and the abolition of the three-pillar structure<sup>12</sup> of the EU have made it more difficult to strictly classify the EU’s decisions as supranational or intergovernmental (Monar, 2010). Moreover, the Treaty of Lisbon did not sufficiently reinforce the economic and financial policy competences of EU institutions, i.e. of the European Commission and European Parliament. In practice, therefore, the crisis strengthened the role of the European Council, above all in its euro area configuration, because the crisis called for rapid economic policy decisions within the framework of more flexible inter-

governmental agreements and outside the regular legislative process (Emmanouilidis and Janning, 2011). On December 9, 2011, 26 EU Member States agreed to establish a “fiscal stability union.” A Treaty change with the intention of establishing this stability union within primary law and in secondary law is currently being blocked by a U.K. veto. Therefore, the 26 Member States have decided to conclude an intergovernmental treaty, or “fiscal compact” on stricter fiscal rules as a first step.

Given the large number of powerful decision makers involved in European Council meetings – among them the President of the European Council, the President of the European Commission, the German Chancellor, the French President, the Eurogroup President and the President of the ECB – the standard EU governance has increased in complexity, too. In order to improve working methods and enhance crisis management in the euro area the President of the European Council, in close consultation with the President of the Commission and the President of the Eurogroup, has therefore been charged with making concrete proposals (European Council, Conclusions, October 23, 2011).

## **2 Financial Stabilization and Economic Governance in the Euro Area – Deepening of the Economic Policy Strategy?**

The constraints imposed by the fiscal and monetary governance framework of the Treaty and the discipline imposed by the financial markets had evidently failed to provide an adequate

<sup>12</sup> Under the Treaty of Maastricht, the EU did not have legal personality in its own right, but provided the institutional framework for the EU’s three “pillars”: the European Communities (ECSC, EC, Euratom) with supranational decision-making powers, the Common Foreign and Security Policy (CFSP), and cooperation in the field of justice and home affairs based on intergovernmental decision-making.

backstop (Bini-Smaghi, 2011). The architects of monetary union had not expected that countries would infringe established rules, that supervision by multilateral institutions would be inadequate, that unsustainable macroeconomic imbalances and high public debt would be built up, and that the financial markets would underestimate sovereign credit risk. The EU reacted to these infringements by taking far-reaching financial stabilization measures and by deepening coordination and economic governance without changing the economic policy objectives of the Treaty.

## **2.1 Financial Stabilization of the EU and the Euro Area**

### **2.1.1 The First Measures to Counteract the Crisis and the Role of the IMF**

When the crisis spilled over from the U.S.A., some Central and Eastern European countries were among the first to be hit. The EU was well equipped to provide financial support to these countries. For example, the European Commission is empowered to borrow funds on financial markets on behalf of the EU to assist countries threatened with balance of payments difficulties (Article 143 TFEU). To stabilize the region, the EU balance of payments support for non-euro area EU Member States was quadrupled from 2008 to mid-2009, rising from EUR 12 billion to EUR 50 billion.

From the outset of the crisis, the IMF played an important role in the financial stabilization of non-euro area EU Member States, later also in that of euro area Member States. Use of IMF financial support is in principle permitted under Article 219(4) TFEU (Deutscher Bundestag, 2010a) for euro area countries; they are exercising their sovereign rights as IMF members. Moreover, with its extensive technical

expertise on economic and fiscal policy analysis and its clout in pushing through structural adjustment programs, the IMF is a key partner for the European Commission and the ECB. Cooperating with the IMF presented the two institutions with new challenges. One example is the need to agree on the economic policy conditions under which a country is eligible for funds. In a first step, the IMF Executive Board and the Ecofin Council/Eurogroup coordinate their decision on a country's qualification for an Economic Adjustment Programme. Then, the so-called troika – the IMF, the European Commission and the ECB – monitor countries' compliance with these conditions.

To ensure that the IMF would have adequate resources during the financial crisis, on December 9, 2011, the Euro Summit announced its intention, to provide the IMF with additional resources through bilateral loans of up to EUR 150 billion. The bilateral loans of the entire EU could amount to EUR 200 billion. Within the G-20, non-EU countries are also expected to contribute to boosting the IMF's lending resources.

At the beginning of 2010, there were no EU financial stabilization mechanisms in place for euro area countries. As already mentioned, all the experts assumed that euro area countries would always have sufficient access to market finance. But given the financial situation in Greece, as early as March 25, 2010, the euro area Heads of State or Government declared their willingness to take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole. At the same time, they determined that any financial support would be subject to strong conditionality. Article 125 TFEU ("no bailout" clause) does, indeed, not fully rule out

voluntary financial support among euro area Member States (Deutscher Bundestag, 2010b).

In May 2010, a joint financial support package for Greece was agreed, consisting of pooled bilateral loans by euro area Member States for a total amount of EUR 80 billion plus an additional EUR 30 billion of financing by the IMF under a Stand-By Arrangement. The European financial assistance is based on a contract concluded between Greece and its creditors, the other euro area Member States. Many authors note that, given Article 125 TFEU, such lending is not entirely unproblematic (Potacs and Mayer, 2011), as the loans are granted at a politically determined rate of interest rather than at market conditions. Furthermore, doubts had already been expressed about Greece's ability to repay the loans when the credits were extended. On the other hand, the loans to Greece are voluntary; Slovakia, for example, did not participate in the bilateral lending agreement. Prior to lending, the IMF and the European Commission performed a debt sustainability analysis of Greece in line with international standards.

As the authorities could not rule out contagion of other euro area countries, three key financial decisions were made in 2010 (Nauschnigg and Schieder in this issue) that had an impact on the fiscal policy of the euro area as well as on the single monetary policy:

1. The Ecofin Council/Eurogroup and the European Council adopted a three-year financial stabilization program encompassing the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF).

nism (EFSM) and the European Financial Stability Facility (EFSF).

2. The EFSM and the EFSF were to be replaced by the European Stability Mechanism (ESM) in 2013.
3. The ECB adopted the Securities Markets Programme (SMP) for euro area countries' debt securities.

### 2.1.2 The European Crisis Mechanism: EFSM, EFSF and ESM

Under the EFSM, the European Commission is empowered by all 27 EU Member States to raise up to EUR 60 billion in the capital market and to lend these funds to distressed euro area countries. European Commission borrowing on behalf of the EU is backed implicitly by an EU-27 budget guarantee. The EFSM is based on Article 122(2) TFEU, under which the economic and financial crisis is interpreted as an exceptional circumstance beyond the control of Member States.

The EFSF set up as a Luxembourg-registered company, is backed by guarantee commitments from the euro area Member States for a total of EUR 780 billion and has a lending capacity of EUR 440 billion. EFSF bonds have been assigned a AAA rating. Further, the available resources are to be leveraged to as much as EUR 1,000 billion. To this end, the Eurogroup has already agreed on two options to leverage EFSF funds with the support of international investors.<sup>13</sup> Given the complexity of both instruments, it currently appears unlikely that leverage will raise lending capacity to up to EUR 1,000 billion.

As guarantors, euro area countries have a pro-rata liability in line with their ECB capital key. If a country steps

<sup>13</sup> The two options consist of credit enhancement and/or the establishment of one or more Co-Investment Funds (CIFs) for public and private investors who wish to place funds in the EFSF.

out (“stepping-out guarantor”),<sup>14</sup> its guarantee commitment is suspended and guarantees are allocated among the remaining countries.

EFSF lending is conditional on compliance with economic and fiscal requirements that the European Commission monitors. In the course of the crisis, the lending conditions were relaxed somewhat. To improve the borrowers’ debt-servicing capacity, EFSM and EFSF interest rates were lowered to those of EU balance of payments assistance, i.e. about 3.5%, but not below the EFSF’s own funding cost. Moreover, the EFSF instruments were made more flexible to meet the need for various funding purposes. The EFSF may now purchase government bonds in the secondary or primary markets, may recapitalize banks and may provide funds for precautionary programs.

The agreement on a permanent European Stability Mechanism (ESM) represents a decisive step toward financial solidarity among Member States. The ESM is an international financial institution that is based on Article 136(3) TFEU and is established by a treaty<sup>15</sup> among all euro area countries. The ESM has a capital stock of EUR 700 billion and a lending capacity of EUR 500 billion. The ESM’s preferred creditor status implies priority repayment of financial assistance even in the event of sovereign insolvency. After assessing the debt-servicing capacity of a borrower the ESM might seek private sector involvement in line with IMF practice. In addition, starting in June 2013, the terms and conditions of all new government bonds must include standardized and identical collective

action clauses (CACs) to allow for rapid debt restructuring, if necessary. As agreed by the European Council on December 9, 2011 the ESM should already become effective at the latest in mid-2012. Possibly, the EFSF and the ESM will work in parallel for a limited period of time.

### 2.1.3 ECB/Eurosystem: Securities Markets Programme (SMP)

Under the Securities Markets Programme (SMP), the ECB buys sovereign debt instruments issued by euro area governments to ensure depth and liquidity in dysfunctional sovereign bond market segments. Under Article 123 TFEU, overdraft or other credit facilities with the ECB or the NCBs are prohibited for central governments. However, the ECB may purchase government bonds in the secondary markets. From May 10, 2010, the ECB has bought Greek, Irish and Portuguese government bonds; from August 7, 2011, it has also purchased Spanish and Italian government bonds. The bond purchases total some EUR 211 billion.<sup>16</sup> In parallel, the ECB conducts weekly liquidity-absorbing operations to sterilize the liquidity provided through the SMP (ECB, July 2011) and to ultimately prevent risks to price stability.

Of course, this ECB measure attracted criticism. Belke (2010) argues that unlimited purchasing programs involving high risk could undermine long-term confidence in the political and financial independence of the ECB and the Eurosystem. In the whereas recitals of its decision to establish the SMP, which is based on Article 127(2) TFEU, the ECB explains that the SMP

<sup>14</sup> One reason a country might not participate as a guarantor is that it has to implement an adjustment program itself; another reason is that the country’s own financing costs are above those of the EFSF.

<sup>15</sup> The ESM was negotiated by all 27 EU Member States.

<sup>16</sup> Holdings as on December 23, 2011 ([www.ecb.int](http://www.ecb.int)).

forms part of the Eurosystem's single monetary policy and will apply temporarily. This nonstandard measure would be phased out as soon as markets were working more normally again (Trichet, 2010). In a further recital, the ECB refers to a statement of the euro area governments that they would take all measures needed to meet their fiscal targets and would accelerate fiscal consolidation and ensure the sustainability of their public finances. The ECB explicitly referred to this framework because such secondary market purchases have an impact on the financing conditions for governments (Bini-Smaghi, 2011); in particular, they may lead to moral hazard problems with fiscal policy in the countries concerned. Therefore, in August 2011, ECB President Trichet and the respective NCB governor addressed a letter to the heads of government of Italy and Spain calling for sustainable economic and fiscal adjustment measures. The Euro Summit of October 26, 2011, called for particular reform efforts by Spain and Italy, as these countries were experiencing tensions in sovereign debt markets. In the case of Italy, the Euro Summit called on the European Commission to not just assess the measures taken by Italy, but also to monitor their implementation.<sup>17</sup>

#### 2.1.4 Mutualization of Risk in the Euro Area

The comprehensive financial stabilization measures imply a risk transfer to those euro area countries providing assistance, and hence a large step toward the mutualization of risk (Deutsche

Bundesbank, 2011a, b). Every credit given or every guarantee assumed is counted toward the debt ceiling under the Treaty of Maastricht. The conditions for financial assistance determine the degree of risk redistribution across euro area countries and hence increase the consolidation need – e.g. for the Austrian<sup>18</sup> budget. Reducing the interest rates for the EFSM, EFSF and ESM, and easing the conditions of some financing instruments has further intensified risk transfer. Furthermore, under Article 32.4 of the Statute of the ESCB and of the ECB, any risks from holdings of SMP securities, if they were to materialize, should be shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key.<sup>19</sup>

The willingness of euro area countries with sound economic policies to assume mutualized risk depends on two factors in particular – first, to what degree does mutualized risk affect the country's own creditworthiness; and second, how can adequate implementation of sound economic policies throughout the euro area be ensured? In this respect, the German Federal Constitutional Court of September 7, 2011, ruled that Germany was prohibited from agreeing on international measures that result in taking over responsibilities for other states' sovereign decisions. The court allows the German Bundestag a certain "margin of maneuver" in assuming such responsibilities as long as the stability orientation of EMU and German economic performance are taken into account.

<sup>17</sup> At the G-20 summit on November 3 and 4, 2011, Italy agreed to let the IMF carry out a quarterly monitoring of its policy implementation and to have these surveillance reports be discussed by the IMF Executive Board.

<sup>18</sup> In Austria, the *Zahlungsbilanzstabilisierungsgesetz* (Balance of Payments Stabilization Act) represents the legal basis for financial assistance granted by Austria to other euro area countries.

<sup>19</sup> OeNB Annual Report 2010. Notes to the Balance Sheet. Asset item 7.1 Securities Held for Monetary Policy Purposes, p. 81–82.

## 2.2 Economic Governance Reform

The sovereign debt crisis exposed glaring weaknesses in euro area economic governance: The countries did not comply with the provisions of the Stability and Growth Pact (SGP). Many countries neglected to establish sustainable public finances in the years before the crisis. Implementation of the Lisbon strategy was biased toward structural reform, although the program did include social policy objectives (Koll, 2011). Economic governance did not take account of growing external imbalances and the divergence of wage and price developments. Fiscal and structural policies were largely national, which made a consistent policy mix at the euro area level very difficult to achieve. Reacting to these deficiencies, “coercive elements”, like requiring “reverse qualified majority voting”<sup>20</sup> for Ecofin decisions, were expanded. Economic governance has been extended to apply not just to fiscal policy, but also to macroeconomic imbalances. Finally, improved coordination of economic and budget policy over an annual cycle (the European semester) is designed to ensure more consistency in the economic policy mix at the EU and euro area level. Agreements between individual countries are also being sought to harmonize the revenue side of budgets; proposals include harmonizing the corporate tax base<sup>21</sup> or introducing a financial transaction tax. Overall, the agreed and planned measures are targeted at deepening Economic Union in the euro area.

### 2.2.1 Economic Governance Reform – The “Six-Pack”

In March 2010, the European Council installed a Task Force on Economic Governance. On January 1, 2012, six legislative proposals (“six-pack”) came into force, as proposed by the European Commission, in close cooperation with the task force. The key elements of the “six-pack” are a reform of the SGP and the introduction of a new macroeconomic imbalances surveillance procedure:

- As countries’ debt levels affect their market refinancing options, the excessive deficit procedure applicable to public debt higher than 60% of GDP was tightened.
- To reduce existing macroeconomic imbalances and prevent the occurrence of new ones, a new macroeconomic scoreboard will use indicators (such as the current account balance, the net external position, the real effective exchange rate based on unit labor costs, real house price increases and private sector debt) to identify imbalances.
- The respective national budget performance must fulfill comparable minimum quality standards.
- Early and gradual sanctions (adopted by reverse qualified majority voting) for euro area countries have been introduced to the SGP.
- Euro area countries are now subject to financial sanctions already under the preventive arm of the SGP and when experiencing excessive macroeconomic imbalances.

Regardless of the introduction of “coercive elements”, the success of these re-

<sup>20</sup> A reverse qualified majority voting procedure implies that unless the Council takes a qualified majority vote against a European Commission decision to impose financial sanctions within ten days of this decision, the decision will be adopted.

<sup>21</sup> When the program funds were allocated, Ireland was not formally forced to agree to a harmonization of corporate taxes (development of a common consolidated corporate tax base), but it committed itself to participating constructively in the discussion.

forms continues to depend on countries' political commitment to implement the rules at the national level.

### 2.2.2 Economic Governance and Euro Plus Pact<sup>22</sup>

As the sovereign debt crisis progressed, the tightening of economic policy measures under the six-pack no longer appeared stringent enough. On the basis of a German-French initiative, the European Council adopted the Euro Plus Pact in March 2011 with the intention of further strengthening the economic pillar of EMU. Core objectives are enhancing competitiveness, fostering employment, contributing to the sustainability of public finances, reinforcing financial stability and preventing macroeconomic imbalances in the euro area. The measures taken by the participating countries under the Euro Plus Pact must be integrated into their national reform and stability programs.

In August 2011, German Chancellor Angela Merkel and French President Nicolas Sarkozy presented details of their Euro Plus Pact proposals calling for the following measures:

- Taking key policy decisions to counteract crises.
- Monitoring SGP implementation and enhancing competitiveness. The measures include e.g. the introduction of binding upper limits for the level that the structural deficit may reach annually (“debt brakes”). By the end of 2011, euro area Member States running an excessive deficit should submit adjustment programs for reducing their debt below the reference value. Payments from the structural and cohesion funds to countries that do not respect the

EDP recommendations are to be suspended.

- Stepping up coordination of tax policies. Germany and France intend to harmonize their corporate taxes as early as 2013. Discussions on proposals for a financial transaction tax started in fall 2011.

The Pact is currently based on an intergovernmental agreement and is not enshrined in the Treaty. But the countries are trying to achieve conformity with the Treaty by seeking to implement EU legal acts with the simplified amendment procedure under Article 136 TFEU and within the framework of enhanced cooperation. Integration of the Euro Plus Pact into the European semester associates the Euro Plus Pact more closely with Community decision making.

### 2.2.3 Fiscal Stability Union

On December 9, 2011, 26 EU Member States (except for the U.K.) concluded an intergovernmental agreement to move toward a “fiscal stability union.” This new “fiscal compact” represents a further step toward strengthening the economic pillar of EMU. In essence, it reinforces monitoring of national fiscal discipline and coordinating fiscal policies:

- The annual structural deficit in public finances must not exceed 0.5% of nominal GDP.
- This rule must be introduced in Member States' national legal systems at the constitutional level (“debt brake”), including an automatic correction mechanism, should the target be missed. The European Court of Justice will verify implementation of the rule at the national level.

<sup>22</sup> In addition to the 17 euro area countries, Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania are participating in the Euro Plus Pact.

- Member States in EDP must submit an economic partnership program detailing reforms to the European Commission and the European Council. The sustainable implementation of the program will be monitored by the European Commission and the European Council.
- Member States will publish a detailed debt issuance calendar up front.
- Measures and sanctions for Member States in EDP will be decided by a quasi-automatic procedure, mirroring the “reverse qualified majority voting” rule.

The European Commission has tabled two further legal proposals to tighten fiscal discipline. The proposals regard the monitoring and assessment of draft budgets in euro area Member States, and the strengthening of budgetary surveillance of euro area Member States<sup>23</sup> experiencing serious difficulties with respect to their financial stability.

### 3 Further Development of Economic Governance and Financial Assistance

At present, the implementation of proposals for further financial assistance is linked to the enforcement of sound economic and fiscal policies in euro area countries and with suitable and credible financial market involvement in crisis resolution. However, any proposal requiring a Treaty change must be seen as taking some time to implement.

#### 3.1 Enhanced Financial Assistance to Stabilize Public Finances with Private Sector Bail-In

Bini-Smaghi (2011) and Buiters (2011) assume that the euro area countries

could experience both liquidity and solvency problems, bearing in mind that the sovereign debt crisis and the banking crisis mutually reinforce each other. The type of financial assistance available should address both of these problems. Gros and Mayer (2011) propose to make the EFSF the main eligible counterparty of the Eurosystem to achieve leverage in EFSF lending. On this issue, the ECB (2011) notes that this would be an infraction of Article 123 TFEU, which prohibits monetary financing of fiscal deficits. However, the ESM could be transformed into a European Monetary Fund (EMF). The EMF should have access to ECB funding on the one hand, and on the other should be able to issue bonds for countries with solvency problems (Gros and Mayer, 2011). This proposal has, however, already been rejected at the political level. Buiters (2011) proposes expanding EFSF funding to EUR 2,000 billion to enable the ECB to discontinue its SMP. All of these proposals virtually disregard the ability of monetary policy and fiscal policy in sound euro area economies to bear the burden of crisis financing. Furthermore, the proposals do not provide a solution to moral hazard problems that generous financial aid might invoke for the fiscal policy of the country concerned and for the financial sector itself.

In EMU, the capital markets assume their function of imposing discipline on national fiscal policies only if there is a credible perspective of “bailing in” investors if a euro area country becomes insolvent (Deutsche Bundesbank, 2011a, b). However, the TFEU does not contain any rules for handling the insolvency of an EU Member State. On the contrary, with a stability imper-

<sup>23</sup> Currently, Italy is such a country. Its budget is already subject to special monitoring by the European Commission and the Eurogroup.

ative and fiscal discipline the TFEU lays down rules to prevent Member States' insolvency.<sup>24</sup>

Not only Germany, but also economic policy analysts (Kern, 2009; Pisani-Ferry, 2011) have recently called more strongly for private sector bail-in to be integrated into the EU legal framework in the form of an EU insolvency regime. Up to now, experience with sovereign debt default and restructuring relates largely to emerging markets (e.g. IMF, 2006). While this experience offers guidance that may be helpful to manage the current sovereign debt crisis, it cannot be applied directly to the situation in the euro area (Darvas, 2011). Kern (2009) developed a formal procedure to handle sovereign debt restructuring and the establishment of an EU sovereign debt agency. Pisani-Ferry (2011) proposes a procedure including the establishment of an administrative body that manages the legal settlement of sovereign default, an economic body (e.g. the European Commission, the ECB, the IMF) that assesses the degree of default and the ESM, which provides financial support to the sovereign in this phase.

The proposals to issue eurobonds or “stability bonds” go even further; such bonds would introduce joint financing of all euro area countries and differ in terms of the degree of common financing and with regard to the type of guarantee (European Commission, 2011a). Eurobonds – above all eurobonds issued with a joint and several guarantee – cannot be introduced without an amendment of the Treaty, as they are inconsistent with the “no bailout” clause of Article 125 TFEU. In addition, euro-

bonds are unsuitable for crisis financing: problem country debt has shot up to far more than 60% of GDP, so that the financial markets would demand high risk premia on all bonds other than the collectively guaranteed eurobonds. Eurobonds could give problem countries some breathing space, but do not provide national fiscal policymakers with incentives to consolidate and make public finances more sustainable. Moreover, collectively backed eurobonds are not suitable for Member States with solvency problems (Buiter, 2011).

### 3.2 Sovereignty Rights and Fiscal Policy

Former German Minister of Finance Peer Steinbrück<sup>25</sup> can envisage limited eurobond issues provided countries relinquish some sovereign fiscal policy rights. Countries would have to give up some of their fiscal powers to an independent institution, would have to gain approval already for budget drafts, and would be subjected to macroeconomic surveillance. A similar proposal by Dutch Prime Minister Mark Rutte provides for the establishment of an “independent fiscal institution” that would have the power to put noncompliant countries under guardianship and their fiscal decisions under the direct control of an EU Commissioner.<sup>26</sup> Former ECB President Trichet (2011) called for a European finance ministry with responsibilities in three areas, namely the surveillance of fiscal and competitiveness policies, above all of euro area countries, the supervision and regulation of the EU financial sector, and representation of the euro area in international financial institutions.

<sup>24</sup> Only in the case of Greece, the granting of additional public funds was linked to a nonrecurring and voluntary private sector participation.

<sup>25</sup> *Der Spiegel*: Natürlich müssen die Deutschen zahlen. September 12, 2011.

<sup>26</sup> *Frankfurter Allgemeine Zeitung*. September 9, 2011.

The Euro Summit of October 26, 2011, already vested the Ecofin Council and the European Commission with enhanced governance powers: they are authorized to examine national draft budgets and adopt an opinion before a national parliament passes the budget, they have the power to monitor budget execution, and they may, if necessary, suggest amendments. In the event of divergences, surveillance may be stepped up. The presidents of the European Council, the European Commission and the Eurogroup received a mandate to propose a further strengthening of the economic pillar of EMU, including the option of limited amendments to the Treaty (see “fiscal stability union”).

### 3.3 Withdrawal or Expulsion from the Euro Area

German Chancellor Angela Merkel demanded that the Lisbon Treaty include a mechanism to expel individual countries from the euro area.<sup>27</sup> However, a general opt-out of the euro area would contradict the principle of the Maastricht Treaty and the Protocol on the transition to the third stage of economic and monetary union under which all Member States have declared the irreversible character of the move to Stage Three. Had EU law provided for exiting euro area, it never would have been possible to gain the trust of the markets and the public in the stability of the single currency.

Article 50 TEU provides for an exit clause for Member States to withdraw from the EU as a whole in a two-year process. During the course of these two years, a withdrawal agreement determining the political and economic relations between EU Member States and the exiting Member State must be drafted. The withdrawal option does

not establish the right of expulsion; therefore, it is not a legitimate means to discipline difficult Member States. However, it is not possible for a country to exit a subset of the EU, like EMU, while retaining its membership in the remaining areas (Athanasidou, 2009). In such a case, a country would have to re-enter the EU, implying that it has to undergo the entire admission procedure under Article 49 TEU, including ratification by all Member States (Kumin, 2011).

## 4 Conclusions

When it was set up, the Treaty of Lisbon took account of the institutional needs of the EU-27 and provided them with sufficient capacity for action. The question raised earlier as to whether the Treaty of Lisbon provided an adequate legal and institutional basis for crisis resolution can be answered as follows: The Treaty of Lisbon failed to provide appropriately for preventing and combating crises. The complexity of decision making and the large number of economic policymakers slowed down the reaction, above all of the euro area, to the sovereign debt crisis. The European Council, primarily as a Euro Summit, and its president gradually emerged as the core of European economic governance (Schwarzer, 2009). With their centralized decision-making structures, the ECB and the Eurosystem were in a position to react more rapidly, as the Securities Markets Programme proved.

The euro area’s method of operation must be improved to make crisis management coherent and to communicate to the public and financial markets with a single voice. Otherwise, confidence in crisis management and credibility of EU institutions will be

<sup>27</sup> *Financial Times Germany*. Online issue of April 25, 2010.

weakened. In this context it remains to be seen how the new framework of euro governance passes the test of practice. As an amendment to the Treaty is no longer completely out of the question, broader avenues of reform have opened up for the medium term. Such reforms could enshrine the new institutional processes for the euro area in the Treaty.

The crisis clearly exposed the defects in the design of EMU: Economic Union and the surveillance and enforcement of budget discipline at the national level is much too weak. Under these circumstances, implementing a comprehensive economic strategy for the euro area that represents more than the sum of its parts is nearly impossible. The EU bodies have meanwhile zeroed in on this flaw, because the only way to secure credibility among the general public and trust of the financial markets is to step up the economic and financial integration of the EU, and above all of the euro area.

Moreover, it would be crucial to create a European Crisis Resolution Mechanism (ECRM) to boost the efficiency of crisis resolution in the future. Cost-benefit considerations should be at the heart of such a concept to ensure that the mix of financial and economic policy measures addressing crises is well-balanced and to safeguard the credibility of EU institutions, especially the ECB. The willingness of countries with sound economic finances to fund a stability mechanism correlates with the willingness of those countries that have come under financial market pressure to implement sustainable economic and fiscal policies. It

remains to be seen exactly what type of “coercive elements” and institutional structures will be laid down in law to ensure that euro area countries enforce sound fiscal and structural policies. The reformed Stability and Growth Pact, the surveillance of macroeconomic imbalances, the Euro Plus Pact, the European semester and the fiscal stability union point toward a better integration of economic and fiscal policies in the euro area. One outcome may well be that emerging EU market economies will not be able to “afford” euro area membership because it could cause them to lose competitive advantages.

The European Commission will have the difficult task of securing the cohesion of the EU-27 and at the same time of providing counsel and initiatives for the 17 euro area countries. By now, the anatomy of the EU has become even more complex – in the Euro Plus Pact, 17 plus an additional 6 countries have agreed on a common approach, while 26 of the 27 Member States endorse the “fiscal stability union.” Basic reforms are increasingly being implemented by groups of Member States. This might lead to the euro area becoming increasingly separate from the other EU Member States. The Commission will therefore insist more rigorously on the use of the Community Method. Consequently, the reformed institutional and economic governance architecture of EMU must be laid down in the Treaty in the form of an amendment, to guarantee EU cohesion, the continued success of the EU economy and its democratic legitimacy.

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