THE RULE OF LAW IN MONETARY AFFAIRS

World Trade Forum

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The impact of sovereign debt on EU monetary affairs

ANNAMARIA VITERBO

A. Introduction

Sovereign insolvencies have always existed but, following the recent wave of crises, sovereign debt restructuring has gained centre stage in academic debate.[1] Economists, policy-makers and lawyers are discussing causes, common traits and consequences of sovereign debt crises, as well

[1] 'While there is no universally accepted definition, a sovereign debt restructuring can be defined as an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a formal process. Sovereign debt here refers to debt issued or guaranteed by the government of a sovereign state. One can generally distinguish two main elements in a debt restructuring: debt rescheduling, defined as a lengthening of maturities of the old debt, possibly involving lower interest rates; and debt reduction, defined as a reduction in the face (nominal) value of the old instruments' (IMF, 'A Survey of Experiences with Emerging Market Sovereign Debt Restructurings', 5 June 2012, p. 3).

On sovereign debt see, among others: M. Audit (ed.), *Insolvabilité des États et dettes souveraines* (Paris: LGDJ, 2011); C. A. Primo Braga and G. A. Vincelette (eds.), *Sovereign Debt and the Financial Crisis* (Washington, DC: World Bank, 2011); R. Kolb (ed.), *Sovereign Debt: From Safety to Default* (Hoboken, NJ: John Wiley & Sons, 2011); R. Olivares-Caminal, 'Sovereign Debt Restructuring', in N. Segal and L. Chan Ho (eds.), *Debt Restructuring* (Oxford University Press, 2011), pp. 379–459; E. C. Schlemmer, 'The Enforcement of Sovereign Debt', in M. Giovanoli and D. Devos (eds.), *International Monetary and Financial Law: The Global Crisis* (Oxford University Press, 2011), pp. 418–48; F. Sturzenegger and J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (Cambridge, MA: MIT Press, 2007); M. Waibel, *Sovereign Defaults before International Courts and Tribunals* (Cambridge University Press, 2011); K. Rogoff and J. Zettelmeyer, 'Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001', *IMF Staff Papers*, 2002; D. Carreau and M. Shaw (eds.), *La dette extérieure/The External Debt*, The Hague Academy of International Law, Recueil des Cours – Colloques, Vol. 17 (The Hague: Martinus Nijhoff, 1995). See also L. Buchheit and R. M. Lastra, 'Sovereign Debt', in ILA, *Committee on International Monetary Law*, Sofia Conference Report, 2012, www.mocomila.org; ILA, Sovereign Insolvency Study Group, State Insolvency: Options for the Way Forward, presented at the ILA The Hague Conference, 2010, www.mocomila.org.

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as preventive policy measures and legal instruments to proceed with orderly restructurings.

Currently, however, the legal framework on sovereign debt remains rather fragmented, its major flaw being the absence of either a single forum or a single procedure for the adjudication of disputes concerning restructurings or defaults.

Applicable rules and procedures are envisaged by many bodies of law, both at domestic level (for instance, national laws governing bond contracts, usually the laws of England or the State of New York) and at international level, with a major role played by the Paris and London Clubs, as well as the International Monetary Fund (IMF).

This fragmentation among different institutions, procedures and sources of law reflects the historical evolution of sovereign debt crises and the heterogeneity of creditors.[2]

As a result of this evolution, four restructuring tools are now in place: (i) the Paris Club, the leading institutional framework for restructuring external bilateral sovereign debt (in other words public or publicly-guaranteed debt owed to foreign governments);[3] (ii) the London Club, a less institutionalised process for the renegotiation of debt between a government and commercial banks;[4] (iii) the IMF, which, together with

[2] Das, Papaioannou and Trebesch provide a detailed classification of all sovereign debt restructurings since 1950 (U. S. Das, M. G. Papaioannou and C. Trebesch, 'Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts', *IMF Working Paper*, August 2012, WP/12/203).

[3] After World War II, governments largely relied on borrowing from other states through bilateral agreements rather than resorting to the private market. Negotiations over the public debt of a country began to be managed by the Paris Club in 1956, when it met for the first time upon request of Argentina. Since then this informal group of official creditors seeking coordinated and sustainable solutions for nations facing payment difficulties has negotiated more than 400 agreements for eighty-nine debtor countries. The scope of Paris Club negotiations covers the medium and long-term external public debt of a country, issued before an agreed cut-off date. Its work is based on a number of principles (such as the principle of comparability of treatment) agreed by creditor countries to facilitate decision-making processes and the adoption of rescheduling or cancellation agreements. Once consensus is reached at Paris Club level, the rescheduling terms and conditions are included in binding bilateral agreements.

[4] In the aftermath of the oil shock of the 1970s, commercial bank lending to developing countries boomed. Following the successful negotiations with Peru and Zaire of 1976, the London Club developed as an informal group of international commercial banks that gather to protect their claims against a sovereign debtor in distress: the debtor voluntarily initiates a process in which a Bank Advisory Committee or Steering Committee is appointed to conduct the negotiations. Chaired by a leading financial firm, the Committee includes representatives from other banks with large exposure to the debtor state. Once the restructuring agreement is signed, the Committee is dissolved.

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the World Bank and other multilateral institutions, provides debt relief to highly indebted poor countries;[5] and (iv) exchange offers typically aimed at restructuring the debt held by bondholders.[6]

Soft-law instruments also play an important role. The Institute of International Finance (IIF) and the United Nations Conference on Trade and Development (UNCTAD) have established principles to guide states and private creditors in debt management, under both normal conditions and severe financial distress.[7] They promote a restructuring process centred on the principles of good faith and fair treatment, and have been praised for their contribution to the overall transparency in sovereign finance, as well as to risk management and accountability.

Only a few of the instruments described above, however, proved useful in the context of the sovereign debt crisis affecting the European Monetary Union (EMU).

B. Sovereign debt restructuring in the EMU

I. The EMU's 'original sin'

The eurozone sovereign debt crisis is the most severe faced by Europe since World War II and the challenges it poses are enormous. According to many commentators, the crisis stems from the EMU's 'original sin': the introduction of a common currency in the absence of a common state.[8]

[5] The IMF and the World Bank launched the Heavily Indebted Poor Countries initiative (HIPC initiative) in 1996 and the Multilateral Debt Relief Initiative (MDRI) in 2005. As of late the IMF has been providing debt relief to wealthier countries too.

[6] In the 1990s the composition of sovereign debt changed again, shifting towards tradable debt securities held by international bondholders. It is worth noting that reliance on the issuance of sovereign bonds as a new source of finance brought new challenges. Sovereign debt restructuring involves institutional investors and thousands of individual creditors and retail bondholders. Such a dispersed creditor structure is prone to holdouts and vulture creditors risks and makes it extremely difficult to achieve high participation in exchange offers.

[7] On the IIF Principles for Stable Capital Flows and Fair Debt Restructuring, see R. Ritter, 'Transnational Governance in Global Finance: The Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets', *ECB Occasional Paper Series*, No. 103, April 2009.

On the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing, see C. Espósito, Y. Li and J. P. Bohoslavsky (eds.), *Sovereign Financing and International Law: The UNCTAD Principles on Responsible Sovereign Lending and Borrowing* (Oxford University Press, 2013).

[8] Tommaso Padoa-Schioppa was among the first to warn of the dangers of a currency without a state: T. Padoa-Schioppa, *The Euro and Its Central Bank: Getting United after the Union* (Cambridge, MA: MIT Press, 2004), p. 36.

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This is the peculiar feature that distinguishes the eurozone from federal countries like the US (which have a single currency area, a federal budget and taxation powers).

The founding fathers of the EMU were aware of the intrinsic risks brought about by the introduction of a single monetary and exchange rate policy, while at the same time leaving full powers to each member over its national fiscal policies.[9]

As financial markets were unlikely to drive governments towards sustainable levels of public deficit and debt, the Maastricht Treaty was drafted so as to include a number of institutional arrangements for sound public finances. The following measures were introduced: the prohibition of monetary financing (now Article 123 Treaty on the Functioning of the European Union (TFEU)), the prohibition of privileged access to financial institutions (now Article 124 TFEU), the no-bailout clause (now Article 125 TFEU), fiscal provisions to avoid excessive government deficits and the excessive deficit procedure (now Article 126 TFEU).

In the late 1990s, countries were incentivised towards sound fiscal policies in order to qualify for the third stage of the EMU in compliance with the Maastricht convergence criteria; fiscal laxity led to exclusion from the single currency. Once participation in the eurozone had been decided on, the focus on fiscal discipline faded substantially, since a relaxation of budgetary efforts was perceived as having only negligible consequences on budget financing. In fact, in the eurozone integrated bond market, risk premiums no longer provided a true representation of the quality of national debts, giving rise to free-riding and opportunistic behaviours.

In 1997, the Stability and Growth Pact (SGP) was introduced through two Council Regulations.[10] The SGP rules were intended to counterbalance the waning attention to rigour, but did not have the desired

[9] Report on Economic and Monetary Union in the European Community (so-called 'Delors Report'), 12 April 1989: 'an economic and monetary union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries. In particular, uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community' (para. 30). Also, see F. Gianviti, 'Relationship between Monetary and Exchange Rate Policy', Chapter 21, this volume.

[10] Resolution of the European Council on the Stability and Growth Pact, 17 June 1997, eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML; Council Regulation (EC) 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2 August 1997, p. 1); Council Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2 August 1997, p. 6).

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effect. The fiscal rules contained in the SGP were only loosely enforced and were even relaxed in 2005 to introduce more flexibility and discretion in the corrective arm.[11] Germany and France – the two most fervent advocates for the adoption of the SGP – became the promoters of these changes after both countries proved unable to stay below the 3 per cent public-deficit-to-GDP threshold.

The SGP reform eroded the moral authority of Germany and France, which were no longer in a position to take firm action within the Council of Economy and Finance ministers (ECOFIN Council) against states pursuing unsound fiscal policies. Other EMU members felt justified in neglecting the fiscal parameters enshrined in the SGP. The rules were not the real problem: the problem was their lax implementation.[12]

II. *Sovereign debt in a monetary union*

In their study, Das, Papaioannou and Trebesch affirm that only a few instances of sovereign debt restructuring occurred within monetary unions.[13]

[11] See European Council, Brussels 22–23 March 2005, Presidency Conclusions, Annex II – Improving the Implementation of the Stability and Growth Pact, ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/84335.pdf; Council Regulation (EC) No 1055/2005 of 27 June 2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 174, 7 July 2005, p. 1); Council Regulation (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 174, 7 July 2005, p. 5). In 2005, the ECB recommended a rigorous application of the excessive deficit procedure (EDP) in the interests of fiscal prudence: ECB, 'The Reform of the Stability and Growth Pact', *ECB Monthly Bulletin* (August 2005), 59–74, at 70. See also J.-V. Louis, 'The Review of the Stability and Growth Pact', *Common Market Law Review* 43 (2006), 85–106 and J.-V. Louis, 'The Legal Foundations of the SGP in Primary and Secondary EC Law', in F. Breuss (ed.), *The Stability and Growth Pact: Experiences and Future Aspects* (Vienna: Springer, 2007), p. 3.

[12] See European Commission, 'A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate', COM(2012) 777 final/2, Brussels, 30 November 2012, p. 2. It should be noted, however, that the SGP was amended and complemented by the new set of rules on enhanced EU economic governance – the so-called Six Pack (five Regulations and one Directive) – which entered into force on 13 December 2011 (OJ L 306, 23 November 2011). In addition, on 23 November 2011, the Commission proposed two draft Regulations to strengthen the budgetary surveillance framework for all euro-area member states, in particular for those countries that have excessive deficits, that are experiencing or are at serious risk of financial instability, or that are under a financial assistance programme. Fiscal discipline was also reinforced by the adoption of the Treaty on Stability, Coordination and Governance (TSCG).

[13] Das *et al.*, 'Sovereign Debt Restructurings 1950–2010', pp. 55–6.

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The West African Economic and Monetary Union (WAEMU)'s largest member, Côte d'Ivoire, restructured its debt twice: in 1998 and in 2009. As regards the East Caribbean Currency Union (ECCU), three members defaulted and requested debt renegotiation: Dominica in 2004, Grenada in 2005 and Antigua and Barbuda in 2010.[14] Since the WAEMU was founded in 1994 and the ECCU in 1983,[15] the frequency of restructuring events so far appears to be rather high. However, the authors claim that those crises had no negative consequences for the stability of the respective monetary union. The same cannot be argued for the EMU. As demonstrated by the case of Greece, a debt crisis in any country of the eurozone undermines the financial and political stability of the area as a whole.

Members of a monetary union lose their capacity to issue debt in a currency over which they have full control.[16] De Grauwe illustrates the possible consequences of this loss of sovereignty when a member of a monetary union is hit by solvency problems. In this scenario, investors' loss of confidence or 'changing market sentiments can lead to "sudden stops" in the funding of the government debt, setting in motion a devilish interaction between liquidity and solvency crises'.[17] Liquidity is withdrawn from the national market, interest rates on sovereign borrowings are pushed up as are the spreads of state bonds and – in a self-fulfilling prophecy – the liquidity crisis turns into a solvency crisis. The state in distress is hampered in its capacity to decide on effective counter-cyclical budgetary measures. The loss of confidence in the capacity of the state to service its debt leads to an increase in interest rates, which in turn translates into a harsher recession

[14] Côte d'Ivoire, Grenada and Antigua and Barbuda agreed on a restructuring of their public external debt with the Paris Club.

[15] The WAEMU was established in the framework of the Economic Community of West African States (ECOWAS) with the Treaty of Dakar, Senegal, signed on 10 January 1994 by the heads of state and governments of Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, and Togo.

The ECCU was established in 1983 among the members of the Organization of Eastern Caribbean States (OECS): Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

[16] See also X. Debrun, 'Sovereign Debt Crises in Monetary Unions: Prevention, Prevention and Prevention', *Reflets et perspectives de la vie économique* 49:4 (2010), 59–69; K. Featherstone, 'The JCMS Annual Lecture: The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime', *Journal of Common Market Studies* 49:2 (2011), 193–217.

[17] P. De Grauwe, 'The Governance of a Fragile Eurozone' (2011), www.econ.kuleuven.be/ew/academic/intecon/Degrauwe/PDG-papers/Discussion_papers/Governance-fragile-eurozone_s.pdf, p. 7.

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and even greater budget deficit, leading to deflation and a crisis of the banking system.

Conversely, in countries retaining full powers over their own currency, the central bank can always provide liquidity that, although it causes inflation, greatly reduces the risk of a default.[18]

According to Gianviti *et al.*:

> The greater possibility of sovereign default in a monetary union is just the dark side of the well-known argument that highly indebted countries benefit from euro-area membership in terms of lower interest rates paid on their public debt because the monetary union makes the commitment to low inflation more credible. By closing the inflation channel, monetary union leaves a country with only three ways out of a situation of excessive debt: severe and harmful fiscal retrenchment, default, and being bailed out by the other members of the monetary union.[19]

III. The actions taken so far: the Greek sovereign debt restructuring

In late 2009, fears of a default by Greece, which was no longer in a position of being able to service its huge public debt, marked the beginning of the eurozone sovereign debt crisis. Despite the adoption of an initial rescue package by the IMF and eurozone countries (the so-called Greek Loan Facility) coupled with drastic austerity measures,[20] in February 2012 Greece was forced to partially restructure its debt under the Private Sector Involvement voluntary deal (PSI deal).[21]

The PSI deal was 'voluntary' in the sense that its terms and conditions were negotiated *ex ante* between the Greek government, the representatives of the private creditors (see below on the IIF involvement) and in

[18] In this sense, see *ibid.*, p. 27. However, it is also possible that the central bank will generate hyperinflation, triggering a complete loss of confidence in the government and the monetary authority. In these circumstances, the public will refuse to hold any money and bonds issued by the authorities. A default by the government in that case will thus be inevitable (in this sense G. Rich, 'Comment on "The Impact of Sovereign Debt Monetary Affairs" by Annamaria Viterbo', WTI, World Trade Forum 2012, Bern, 12–13 October 2012).

[19] See F. Gianviti, A. O. Krueger, J. Pisani-Ferry, A. Sapir, and J. von Hagen, 'A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal', *Bruegel Blueprint Series* (2010), 6, www.bruegel.org/publications/publication-detail/publication/446-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal.

[20] In the period 2009–11, Greece's fiscal adjustment amounted to almost 12.6 per cent of its GDP, an unprecedented level in economic history.

[21] Euro Summit Statement, Brussels, 26 October 2011.

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consultation with the official sector (eurozone authorities, EU institutions and the IMF).

The heads of state or government of the eurozone had already agreed upon the PSI deal on 26 October 2011: while deeming the PSI deal necessary, they affirmed it was being adopted because Greece's situation was exceptional and unique.[22]

Only a minority of the outstanding bonds had been issued under English law, while approximately 90 per cent of them were governed by Greek law, which did not include collective action clauses (CACs).[23]

CACs became common after the IMF's proposal to create a Sovereign Debt Restructuring Mechanism (SDRM) was rejected in 2003.[24] Governments preferred to rely on a contractual approach, which bases sovereign debt restructuring on privately negotiated agreements between a sovereign and its creditors, rather than on an institutional approach. CACs are designed to streamline the restructuring process and limit the possibility for individual bondholders to initiate disruptive litigation. These clauses make the amended terms of a renegotiated debt agreement binding upon all creditors if approved by a qualified majority of bondholders, thus not leaving minorities with the power to obstruct the process.[25]

On 23 February 2012, the Greek Parliament introduced Law 4050/2012 on 'Rules on the Modification of Titles Issued or Guaranteed by the Greek State with the Bondholders' Agreement' (the so-called Bondholder Act),[26] by which CACs were to be retroactively introduced

[22] On the Greek debt restructuring debate, see M. G. Gulati and J. Zettelmeyer, 'Making a Voluntary Greek Debt Exchange Work', *Capital Markets Law Journal* 7:2 (2012), 169–83; L. C. Buchheit and M.G. Gulati, 'Greek Debt – The Endgame Scenarios', (2011), ssrn.com/abstract=180701; L.C. Buchheit and M.G. Gulati, 'How to Restructure Greek Debt', (2010), ssrn.com/abstract=1603304.

[23] Nor did they include *pari passu* or cross-default clauses.

[24] In 2001, following the outbreak of the Argentinian crisis, Anne Krueger, at the time First Deputy Managing Director of the IMF, proposed the creation of a Sovereign Debt Restructuring Mechanism (SDRM), which was rejected in 2003 (see the IMFC Communiqué of 12 April 2003). For a description of the SDRM, see, in particular, IMF, 'Proposed Features of a Sovereign Debt Restructuring Mechanism', 12 February 2003. See also S. Hagan, 'Designing a Legal Framework to Restructure Sovereign Debt,' *Georgetown Journal of International Law* 36:2 (2005), 299.

[25] See J. Dey, 'Collective Action Clauses: Sovereign Bondholders Cornered?', *Law and Business Review of the Americas* 15 (2009), 485–529.

[26] Law 4050/2012 'Rules of Amendment of Titles Issued or Guaranteed by the Hellenic Republic with the Bondholders' Agreement,' published in Government Gazette A 36/23.02.2012 of the Hellenic Republic. See also ECB Opinion of 17 February 2012 on the Terms of Securities Issued or Guaranteed by the Greek State (CON/2012/12), www.ecb.int/ecb/legal/pdf/en_con_2012_12_f_sign.pdf.

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on all Greek bonds issued before 31 December 2011. The aim was to force bondholders to accept the exchange offer, which was to be launched by the Hellenic Republic.

On 24 February 2012, Greece announced a debt exchange operation for bonds with an aggregate outstanding face value of approximately € 200 billion, which would have substantially reduced its debt level and interest expenditure, thus contributing to the sustainability of government debt and a return to financial stability.

Pursuant to the Bondholder Act, the high level of participation – 83.5 per cent of private creditors accepted the debt swap offer – was sufficient to allow the activation of the CACs.[27] On 9 March 2012, the Greek Council of Ministers acknowledged that the decision by a large majority to accept the swap had become binding upon all holders of Greek bonds, thus forcing also creditors who had refused the deal to suffer a nominal haircut of 53.5 per cent on their principal. As a result, Greece received a seemingly unprecedented large reduction of its debt (amounting to € 106 billion, almost 50 per cent of its GDP), which was, however, counterbalanced by a corresponding increase in its indebtedness associated with the second support programme.

The debt exchange operation covered € 177 billion of bonds regulated by Greek law, € 8 billion of foreign law bonds and € 9.5 billion of debt issued by state-controlled enterprises guaranteed by the Greek government. The terms of the PSI deal included:

(i) a 53.5 per cent reduction in the nominal value of eligible Greek government bonds, for which bondholders received in exchange:
  (a) new bonds with a face value amounting to 31.5 per cent of the face value of the debt exchanged,[28] and
  (b) European Financial Stability Facility (EFSF) short-term notes maturing within twenty-four months amounting to 15 per cent of the face value of the debt exchanged;

(ii) a 2 per cent fixed-rate annual coupon to be paid on the new bonds in 2013–15, increasing to 3 per cent in 2016–20, 3.65 per cent in 2021 and reaching 4.3 per cent from 2022 onwards; and

(iii) GDP-linked securities of a nominal amount equal to the face value of the new bonds, capped at 1 per cent of the notional amount of new bonds.[29]

[27] With the activation of the CACs, private creditors' participation reached almost 97 per cent.

[28] The new bonds issued by Greece contain a CAC in line with the new EU standards, and are made subject to English law and UK jurisdiction.

[29] Source: IMF, 'Country Report on Greece,' No. 12/57, March 2012, p. 88.

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As part of a package of measures approved by the Eurogroup on 27 November 2012,[30] Greece offered to buy back various categories of its sovereign obligations with a view to lowering its debt from a projected 190 per cent in 2014 to 124 per cent of GDP by 2020. Through the debt-buy-back scheme (DBB), the Greek government purchased back about € 30 billion in debt owed to private creditors – about half of the outstanding bonds – at a third of their face value. The operation was a precondition for unlocking the release of the next disbursement of loans from the eurozone and the IMF.

It is worth noting that the IIF took part in the negotiation process of the PSI deal, first through the Task Force on Greece and later through the Private Creditor–Investor Committee (composed of representatives of about thirty of the largest private investors in Greek sovereign bonds).[31] The IIF Principles for Stable Capital Flows and Fair Debt Restructuring served as a framework for the negotiations and demonstrated the validity of the voluntary, cooperative and market-based approach (as opposed to a unilateral, top-down approach). However, some features of the Greek restructuring raised concerns and made it more difficult to fully adhere to the IIF core Principles (open dialogue, transparency, good faith and the fair and comparable treatment of all creditors). The issues of major concern included: the complexities deriving from Greece being a member of a currency union; the exemption from the debt exchange of bonds held by EU official entities and the subordination of private investors' claims (considered not fully consistent with the equal treatment of creditors); and the retroactive introduction of a collective action mechanism in bonds issued under domestic law (which threatened the sanctity of financial contracts).[32]

[30] Eurogroup Statement on Greece, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/133857.pdf. See also Hellenic Republic, Ministry of Finance, Press Releases, 3 December 2012 and 10 December 2012.

[31] IIF, 'Report on Implementation by the Principles Consultative Group', October 2012, pp. 12–13.

[32] IIF, 'Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Restructuring', October 2012. The Greek experience was carefully assessed in order to revise the existing framework for sovereign debt crisis prevention and resolution (see in particular the Addendum to the IIF Principles endorsed by the Group of Trustees of the Principles at its Annual Meeting in Tokyo, 14 October 2012 and published in the above-mentioned IIF Report).

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First, membership in the EMU and its institutional features were considered to impose policy constraints and add a layer of complexity that resulted in longer discussions and less effective decision making.

Second, the ECB and the national central banks (NCBs) of the Eurosystem were *de facto* awarded senior creditor status and their holdings of Greek bonds – mainly acquired under the Securities Markets Programme (on which see Section V) – were shielded from bearing any losses.[33] In fact, before the exchange offer was launched, the ECB and the NCBs swapped their Greek bonds for new bonds of identical structure and nominal value, but with different International Securities Identification Number (ISIN) numbers that, at a later stage, would not be involved in the application of retroactive CACs. Also the holdings of the European Investment Bank (EIB) were carved out of the restructuring. These decisions raised the spectre of discriminatory treatment to the detriment of private creditors.[34] On 8 March 2012, the President of the ECB, Mario Draghi, explained that:

> the SMP was a monetary policy instrument. So the purchases of Greek bonds done under that program responded to public interest policy – general policy considerations. And as such, they deserve protection. This is one reason. The other reason is that I think the balance sheet of the ECB should be protected, because only through the integrity of the balance sheet of the ECB you can have the ECB independence in pursuing price stability in the whole of the euro area, and price stability is in the interest of all the members. So I think that's one other reason why this exchange of bonds was quite right to do. But there is a third reason, I think, that people rarely think about this. I mean, we forget that this money is taxpayers' money. And so the ECB has, in a sense, the duty to do everything to protect the taxpayers' money that was entrusted with it. So this exchange of bonds was actually the right thing to do from this point of view as well.[35]

[33] IMF, 'Euro Area Policies: 2012 Article IV Consultation – Selected Issues Paper', IMF Country Report No. 12/182, July 2012, 47. For a brief study of the role of the NCBs within the Eurosystem in time of crises, see also, J-V. Louis, 'Monetary Union and the Law: Some Comments', Chapter 5, this volume.

[34] The ECB, NCBs and EIB holdings amounted to more than 20 per cent of the total outstanding bonds. According to the IIF Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution, 'the exclusion of the ECB holdings from the debt exchange could be rationalized . . ., but the exclusion of the official body holdings [NCBs and EIB] deviated from the normal principle of non-discrimination' (IIF, Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Restructuring', October 2012, p. 52).

[35] Mario Draghi, President of the ECB, 'Transcript of the Press Conference', 8 March 2012, www.ecb.int/press/pressconf/2012/html/is120308.en.html.

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Another argument in favour would have been based on Article 123 TFEU (on which see Section V): this provision can be interpreted as preventing the ECB from accepting losses deriving from the restructuring of Member States' sovereign bonds. It follows that any voluntary restructuring or rescheduling of the ECB's holdings could amount to monetary financing if a dogmatic interpretation of Article 123 TFEU were to be favoured over one that is more in tune with the prevailing exceptional circumstances. In fact, Article 123 TFEU (as well as Article 125 TFEU) has essentially a preventive nature, its objective being to reduce as far as possible the risk of public debt crises.[36] This provision, however, was drafted with normal rather than turbulent times in mind, and at a time when a sovereign debt crisis in the eurozone was unforeseeable. If the fiscal discipline objectives of Article 123 have not been attained in normal times (which is clearly the case with Greece), to insist on strict compliance with the monetary financing prohibition at a time of acute, almost existential, crisis is to actively counteract the efforts of indebted Member States to return to fiscal discipline. If the participation of the ECB and NCBs in an Official Sector Involvement (OSI)[37] or a debt-buy-back scheme can help Greece (or, in the future, other troubled sovereign states) to return to fiscal discipline (rather than to default), the main goal of Article 123 will be not only preserved, but also well served.

Third, the retroactive insertion of CACs in the outstanding domestic bonds changed the original terms of their issuance contract. This might be deemed inconsistent with the obligations taken on in the investment treaties ratified by Greece (more than forty bilateral investment treaties (BITs), with both EU and non-EU countries). Most Greek BITs contain a broad definition of investment, which does not explicitly exclude sovereign debt instruments from the scope of their application. Moreover, to protect domestic creditors from the risk of a so-called double adjustment (i.e., the losses due to the haircut on their claims and the costs associated with austerity measures, unemployment and high interest rates), they were offered preferential conditions as compared with foreign bondholders. This, however, could be construed as a breach of the standard of

[36] See ECJ Judgment (Full Court), *Thomas Pringle* v. *Ireland*, Case C-370/12, 27 November 2012, para. 59.

[37] According to many observers and analysts, Greece may face a further restructuring, possibly involving the official sector creditors, which now hold around four-fifths of Greece's debt.

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national treatment contained in investment treaties.[38] Also at stake is the standard of fair and equitable treatment, due to the 'take it or leave it' nature of the debt exchange offer. The Bondholders Act might also be challenged on the grounds of the umbrella clause: in fact, Greece unilaterally amended the terms of a contractual obligation by a sovereign act. Last but not least, a breach of the free transfer of funds clause and a form of indirect expropriation are to be considered.

The possibility of opting for investor–state arbitration to challenge debt restructuring was further grounded by the decision of the International Centre for Settlement of Investment Disputes (ICSID) Tribunal in the *Abaclat et al.* v. *Argentina* case, which opened a Pandora's box[39] by upholding jurisdiction to hear the claims of more than 60,000 bondholders on the alleged breach of the Italy–Argentina BIT.[40] It is, therefore, likely that German bondholders will bring a claim before an ICSID tribunal on the basis of the 1961 Germany–Greece BIT.[41] This also raises the question of discrimination among EU investors, as not all of them have the possibility of resorting to arbitration under a BIT.

[38] See E. Norton, 'International Investment Arbitration and the European Debt Crisis', *Chicago Journal of International Law* 13 (2012), 291–315; D. Strik, 'Investment Protection of Sovereign Debt and Its Implications on the Future of Investment Law in the EU', *Journal of International Arbitration* 29:2 (2012), 183–204. See also M. Waibel, *Sovereign Defaults before International Courts and Tribunals* (Cambridge University Press, 2011), pp. 273 ff.; A. Caliari, 'Risk Associated with Trends in the Treatment of Sovereign Debt in Bilateral Trade and Investment Treaties', in UNCTAD, *Compendium on Debt Sustainability and Development* (New York and Geneva: UN Publications, 2009), p. 211; K. Cross, 'Arbitration as a Means of Resolving Sovereign Debt Disputes,' *American Review of International Arbitration* 17:3 (2006), 335–82.

[39] Waibel anticipated this development in M. Waibel, 'Opening Pandora's Box: Sovereign Bonds in International Arbitration', *American Journal of International Law* 101 (2007), 711–59.

[40] *Abaclat and others* v. *Argentina* (case formerly known as *Giovanna A. Beccara and others* v. *Argentina*), ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, 4 August 2011 and Dissenting Opinion of the arbitrator Georges Abi-Saab, 28 October 2011. The decision on the merits is still pending. See also *Giovanni Alemanni and others* v. *Argentina*, ICSID Case No. ARB/07/8 and *Giordano Alpi and others* v. *Argentina*, ICSID Case No. ARB/08/9.

The *Abaclat* decision was fiercely criticised: see, among others, S. Manciaux, 'Decisions et sentences commentées: Abaclat et a. c. Argentine', *Journal du droit international* 139: 1 (2012), 286–316; A. De Luca, 'Collective Actions in ICSID Arbitration: The Argentine Bonds Case', *Italian Yearbook of International Law* 21(2011) (published 2013), 211–39; J. Beess und Chrostin, 'Sovereign Debt Restructuring and Mass Claims Arbitration before the ICSID: The Abaclat Case', *Harvard International Law Journal* 53 (2012), 505–17.

[41] See J. Wilson and G. Wiesmann, 'Germans Seek Lawsuits over Greek Debt Swap', *Financial Times*, 12 March 2012.

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Moreover, a mass claim is going to be brought before the ECHR by a group of Italian holders of Greek bonds claiming a violation of the right to property (Article 1 Protocol 1).[42]

IV. *The actions taken so far: the inclusion of CACs in European bonds*

As noted above, the majority of Greek sovereign bonds were issued under domestic law and did not contain CACs. This is not uncommon in Europe, where – before the crisis – government bonds were predominantly issued under domestic laws and the inclusion of CACs remained an exception. The Greek debt restructuring, though, showed how critical CACs were.

As early as 2003, to promote orderly restructurings in the event of sovereign debt crises, EU Member States had agreed to include CACs in government bonds issued under a foreign jurisdiction and/or governed by a foreign law.[43] European CACs would have been consistent with the recommendations adopted by the G-10 Working Group on Contractual Clauses in its report of September 2002.[44] However, this development concerned only international sovereign bonds and – as we have seen – the majority of European bonds continued to be regulated by domestic law.

In 2010, the worsening Greek crisis drove the Eurogroup to take a more decisive step towards the adoption of CACs. The issue was included in the discussions on the European Stability Mechanism (ESM).[45]

[42] See www.bondgreci-azionilegali.it.

[43] See the speech by the ECOFIN President to the IMFC in April 2003.

[44] G-10, 'Report of the Working Group on Contractual Clauses' (the so-called 'Quarles Group'), 26 September 2002.

[45] Eurogroup Statement of 28 November 2010, 'General Features of the Future Mechanism', annexed to the Conclusions of the European Council of 16–17 December 2010, EUCO 30/1/10 REV 1, p. 9, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf.

The decision of the Eurogroup was later confirmed by the Eurosummit and the European Council: Conclusions of the Heads of State of Government of the Euro Area of 11 March 2011, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119809.pdf; and Conclusions of the European Council, Annex II 'Term Sheet on the ESM', para. 2, 24/25 March 2011, EUCO 10/1/11, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf.

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The seventeen eurozone countries signed the first version of the ESM Treaty on 11 July 2011, and the second version (now in force) on 2 February 2012.[46] Both versions included a recital whereby identical and standardised CACs would be mandatorily included in all new eurozone government securities (bills, bonds, debentures, notes and other debt securities) with maturity beyond one year.[47]

The Sub-Committee on EU Sovereign Debt Markets of the Economic and Financial Committee (EFC) was entrusted with the task of drafting standardised and identical CACs consistent with those contained in New York and English Law bonds. On 18 November 2011, the EFC agreed on a draft text and a final version of the model clause was published in February 2012 after having taken into account comments received as part of a public consultation process.[48]

The eurozone CACs draw a distinction between modification of reserved and non-reserved matters, the latter concerning the less important terms and conditions and requiring a lower majority of bondholders' affirmative votes.[49] Moreover, the modification could be proposed in relation to either a single series of bonds or different series (cross-series modification), with different approval thresholds applicable.

[46] The European Stability Mechanism (ESM) is an international organisation that provides financial assistance to members of the eurozone in financial difficulty. The ESM is intended to replace the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). The ESM Treaty entered into force on 27 September 2012, following the deposit by Germany of its instrument of ratification. The text of the ESM Treaty is available at www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf. On the ESM, see ECB, 'The European Stability Mechanism', *ECB Monthly Bulletin*, July 2011, 71–84; A. Viterbo and R. Cisotta, 'La crisi del debito sovrano e gli interventi dell'UE: dai primi strumenti finanziari al Fiscal Compact', *Diritto dell'Unione europea* 2 (2012), 325–68.

[47] See Recital 11 and Article 12.3 of the ESM Treaty. On European CACs, see L. C. Buchheit and M. G. Gulati, 'Drafting a Model Collective Action Clause for Eurozone Sovereign Bonds', *Capital Markets Law Journal* 6:3 (2011), 317–25; J. B. Gott, 'Addressing the Debt Crisis in the European Union: The Validity of Mandatory Collective Action Clauses and Extended Maturities', *Chicago Journal of International Law* 12 (2011), 201–28; J. -V. Louis, 'The Unexpected Revision of the Lisbon Treaty and the Establishment of a European Stability Mechanism', in D. Ashiagbor, N. Countouris and I. Lianos (eds.), *The European Union After the Treaty of Lisbon* (Cambridge University Press, 2012), pp. 284–320, at 314–19.

[48] EFC, 'CACs Common Terms of Reference', 17 February 2012, europa.eu/efc/sub_committee/pdf/cac_-_text_model_cac.pdf. See also EFC, Supplemental Provisions, 17 February 2012, europa.eu/efc/sub_committee/pdf/cac_-_supplemental_provisions.pdf.

[49] The modification of a reserved matter requires an affirmative vote of not less than 75 per cent of the aggregate principal amount of the outstanding bonds represented at a duly called meeting.

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Disenfranchisement became a very hot topic in the context of the EU after the ECB started buying sovereign bonds on the secondary market within the framework of the Securities Markets Programme (SMP) (see below).[50] A disenfranchisement clause bars certain bondholders from voting on restructuring plans, excluding them from quorums and majorities needed for amendments. Therefore, the disenfranchisement of bonds directly or indirectly owned or controlled by a sovereign issuer and its public entities is a way to protect ordinary creditors from manipulation of votes.

Some suggested including a disenfranchisement clause in European CACs for investors with interests similar to those of the issuer, who predictably would vote in favour of modifications or who are likely to be motivated by circumstances other than the direct effect of a modification on the value of their holdings.[51] The latter is the position in which the ECB – or a national central bank – would find itself when holding foreign state bonds in its portfolio.

According to the EFC Sub-Committee on EU Sovereign Debt Markets, since the ECB and the Eurosystem NCBs are independent from governments' interference, their holdings of eurozone public securities do not have to be disenfranchised under the model CACs. This is because:

> Article 130 TFEU and Article 7 of the ECB Statute expressly prohibit euro area national central banks and members of their decision-making bodies from seeking or taking instruction from European Union institutions or bodies, from any government of a Member State of the European Union or from any other body. As a result, a euro area national central bank's decision to vote for or against the proposed modification of securities acquired in connection with, for instance, its Eurosystem operations must, as a matter of law, be made by the bank acting in its own interest.[52]

The Sub-Committee focuses therefore on one of the key principles of the EMU: the independence of the ECB and of NCBs. This same principle, though, could be interpreted in the opposite way, as to motivate their disenfranchisement. In fact, due to its independence, the ECB should not be forced to accept the outcome of a majority vote that might result in the central bank bearing losses.[53] Moreover, the ECB could find itself in the

[50] See K. Drake, 'Disenfranchisement in Sovereign Bonds', *Duke Law Working Paper* (2012), papers.ssrn.com/sol3/papers.cfm?abstract_id=2007294.

[51] EFC Sub-Committee on EU Sovereign Debt Markets, 'Model Collective Action Clause Supplemental Explanatory Note', 26 March 2012, europa.eu/efc/sub_committee/pdf/supplemental_explanatory_note_on_the_model_cac_-_26_march_2012.pdf.

[52] *Ibid.* [53] Said losses might result in a breach of Article 123 TFEU.

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awkward position of having to increase its bond holdings in order to influence majority decisions in which it is enfranchised.

All the issues related to disenfranchisement highlight the challenges posed by the new role that quasi-sovereigns are acquiring as active participants in the sovereign debt market.[54]

V. *The actions taken so far: the ECB's intervention in the public debt securities market*

Together with other non-standard monetary policy measures, in May 2010 the ECB began to purchase outright, through the SMP, European sovereign bonds in the secondary market.[55] In adopting this purchasing programme, the ECB reversed its long-held policy of avoiding intervention in sovereign bond markets, which it deemed compromising for its independence.

Under the SMP, the ECB and the Eurosystem NCBs were to purchase, on the secondary market, eligible debt instruments issued by central governments or public entities of the eurozone, as well as private debt securities.

The ECB Governing Council adopted the SMP decision due to 'the exceptional circumstances in financial markets, characterized by severe tensions in certain market segments, which were hampering the monetary policy transmission mechanism and thereby the effective conduct of monetary policy oriented towards price stability'.[56]

The SMP was to be applied temporarily and, *de facto*, it was discontinued in September 2012,[57] when the ECB announced the introduction of the new Outright Monetary Transactions programme (OMT programme).

[54] A. Gelpern, 'Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt', *Yale Law Journal* 121 (2012), 888–942: the author investigates recent proposals to adapt bankruptcy institutions for US states and members of the European Union, that to different degrees have ceded important aspects of their sovereignty to a central government or supranational institution in the name of economic and political integration.

[55] See ECB, 'The ECB's Non-Standard Measures – Impact and Phasing Out', *Monthly Bulletin* (July 2011), 66; D. Zandstra, 'The European Sovereign Debt Crisis and Its Evolving Resolution', *Capital Markets Law Journal* 6:3 (2011), 285–316, 291.

[56] Recital 2 of the ECB Decision of 14 May 2010 establishing a securities markets programme (ECB/2010/5), OJ L 124/8, 20 May 2012.

[57] According to the Eurogroup Statement on Greece of 27 November 2012, starting from 2013 member states would pass on to Greece (in a segregated account) an amount equivalent to the profits on the SMP holdings of Greek bonds held by their national central bank. States receiving financial assistance are not required to participate in the scheme.

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Under the OMT programme, the ECB and the NCBs will conduct outright transactions in secondary sovereign bond markets with the aim of safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. Interventions by the ECB on the secondary market will be carried out only for countries that have requested EFSF/ESM support,[58] and provided that the request is approved by the Eurogroup. The ECB would purchase bonds on the secondary market, while the EFSF/ESM would conduct primary market purchases. No *ex ante* quantitative limits are set on the size of OMTs, and both the amount of holdings and their market values will be disclosed.[59]

The argument put forward by the ECB is that the divergence in government bond yields is hampering monetary transmission in the whole eurozone and therefore also its efforts at maintaining price stability, which is the ECB's primary objective. Therefore, even though the purchase of bonds will concern only countries receiving EFSF/ESM support, the singleness of the monetary policy will be safeguarded.

The main qualitative difference between the SMP and the OMT is that countries whose bonds are being purchased by the ECB through the OMT will be subject to stricter conditionality.[60] Conditionality will be defined in the context of an EFSF/ESM macroeconomic adjustment programme or of a precautionary programme.

It should be noted that both the EFSF and the ESM envisage a role for the European Commission and the IMF in designing conditionality. In particular, the conditionality attached to ESM financial assistance

[58] The European Financial Stability Facility (EFSF) is a special purpose vehicle established on 9 May 2010 by the eurozone countries to safeguard financial stability in Europe by providing financial assistance to member states in economic difficulty. The EFSF is also authorised to intervene both in the primary and secondary markets, usually upon request from the member state concerned to the President of the Eurogroup. In particular, intervention on the secondary market serves to support the functioning of the debt markets and appropriate price formation in government bonds in exceptional circumstances where the limited liquidity of markets threatens financial stability and pushes sovereign interest rates towards unsustainable levels. See EFSF, 'Guideline on Interventions in the Secondary Market', 29 November 2011, www.efsf.europa.eu. Once the European Stability Mechanism (ESM) is fully operational, the EFSF will only remain active in financing previously started programmes.

[59] See ECB Press Release, 'Technical Features of Outright Monetary Transactions', 6 September 2012, www.ecb.int. The ECB Governing Council has not yet adopted a decision detailing the legal framework for the OMT programme.

[60] An element of conditionality was also present in the context of the SMP (see Recital 4 of Decision ECB/2010/5).

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instruments will be detailed in a Memorandum of Understanding (MoU) adopted pursuant to the procedure set out by Article 13(3) of the ESM Treaty: the European Commission, in connection with the ECB, and 'wherever possible' together with the IMF (the so-called 'Troika') will be entrusted by the ESM Board of Governors[61] with the task of negotiating the MoU with the ESM member concerned.[62] Furthermore, the Troika will also be responsible for monitoring compliance with the conditionality attached to the financial assistance facility. The European Commission and the IMF would therefore become relevant players in the design and monitoring of conditionality, putting the ECB's independence at stake. This is especially so because the ECB will terminate its OMTs when the member country fails to comply with the macroeconomic adjustment or precautionary programme.

According to the ECB, however, its independence will be safeguarded since the Governing Council has full discretion to decide on the start, continuation and suspension of the OMTs in accordance with its monetary policy mandate (OMTs will only be used to achieve the objective of maintaining price stability).[63]

Doubts may also be raised on the consistency of both the SMP and the OMT programmes with the prohibition of monetary financing enshrined in Article 123 TFEU (on which see also Section III). This provision explicitly forbids the ECB and the NCBs to purchase debt instruments from central governments and other public authorities, but it only applies if these instruments are purchased 'directly'. Under the prevailing interpretation of Article 123 TFEU, although it is prohibited from purchasing in the primary market, the ECB would still be allowed

[61] The ESM Board of Governors is composed of the Ministers of Finance of the euro area member states as voting members, with the European Commissioner for Economic and Monetary Affairs and the ECB President as observers (its composition is therefore similar to that of the Eurogroup). The Board of Governors is chaired by the President of the Eurogroup, Jean-Claude Juncker, while Klaus Regling is the ESM Managing Director.

[62] Pursuant to Article 5 of the ESM Treaty, the Board of Governors adopts, among others, the following decisions by mutual agreement (unanimity): the decision to provide stability support by the ESM, including the economic policy conditionality as stated in the MoU, and to establish the choice of instruments and the financial terms and conditions; the decision to give a mandate to the European Commission to negotiate, in liaison with the ECB, the economic policy conditionality attached to each programme of financial assistance.

[63] ECB, 'Compliance of Outright Monetary Transactions with the Prohibition on Monetary Financing', *Monthly Bulletin* (October 2012), 7–9.

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by the adverb 'directly' to operate in the secondary market in the fine-tuning of its monetary policy (Article 18 ECB Statute).[64]

The recent German Federal Constitutional Court (FCC) decision on the ESM, however, while it has shed new light upon the issue, has also given rise to new concerns.[65] The FCC explains – in an *obiter dictum* – that Article 123 TFEU prevents the ECB from '[using] the funds at its disposal for *direct* financial stabilization of its members', adding that 'an acquisition of government bonds on the secondary market by the ECB aiming at financing the Members' budgets independently of the capital markets is prohibited as well, as it would circumvent the prohibition of monetary financing' (para. 246).[66] This leaves open the question of what conclusions the FCC will draw in its final judgment, since if the ECB ever took part 'voluntarily' in a debt restructuring, this would be construed as monetary financing, as the OMT is also a monetary instrument.

To determine whether the OMT purchases might indirectly infringe the monetary financing prohibition, it has been suggested that it would be necessary to look at its rationale and objectives,[67] namely to safeguard: (i) the ECB's ability to maintain price stability, (ii) fiscal discipline, and

[64] M. Ruffert, 'The European Debt Crisis and European Union Law', *Common Market Law Review* 48:6 (2011), 1777–805, at 1787–8.

[65] Decision on the application for a temporary injunction of the German Federal Constitutional Court (Bundesverfassungsgericht) of 12 September 2012, 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvE 6/12, paras. 246–7. At the time of writing, the Court has not yet ruled on the merits. On 14 January 2014, the German FCC separated from the proceedings related to the ESM and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the so-called 'Fiscal Compact') the matters related to the SMP and OMT programme. Furthermore, the proceedings related to the SMP/OMT were stayed and a referral for a preliminary ruling was submitted by the German FCC (for the first time in its history) to the Court of Justice of the European Union on the OMT consistency with EU law: according to the GFCC, the OMT programme falls outside the Monetary policy mandate of the ECB and is incompatible with the monetary financing prohibition set forth by Article 123 TFEU (BVerfG 2 BvR 2728/13 14 January 2014 Absatz-Nr. (1–105), www.bverfg.de/entscheidungen/rs20140114_2bvr272813en.html).

[66] Reference should also be made to the 7th Recital of Council Regulation (EC) No. 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Maastricht Treaty (renumbered after the Lisbon Treaty as Article 123 and 125 TFEU), OJ L 332/1 31 December 1993. According to said recital 'purchases made on the secondary market must not be used to circumvent the objective of Article 104 of the Treaty [now Article 123 TFEU]'.

[67] See ECB, 'Compliance of Outright Monetary Transactions with the Prohibition on Monetary Financing', *ECB Monthly Bulletin* (October 2012), 7–9 and P. Athanassiou, 'Of Past Measures and Future Plans for Europe's Exit from the Sovereign Debt Crisis: What is Legally Possible (and What is Not)', *European Law Review* 4 (2011), 566–7.

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(iii) central bank independence. If caution is needed in assessing the OMT impact on the ECB's independence for the reasons stated above, certainly the other objectives of the monetary financing prohibition are not impaired by the OMT programme, which on the contrary is conducive to their achievement.[68]

It is worth noting that, when it is purchasing bonds issued by eurozone countries through the OMT programme, the ECB will accept being *pari passu* with ordinary creditors,[69] in accordance with the terms of the bonds (the same does not apply to SMP bond holdings).[70] On this issue, it was observed that 'the ECB can promise to be *pari passu*, until

[68] According to Georg Rich, monetary financing may be conducted in two different ways. The first method entails the central bank purchasing sovereign debt in order to lower the costs to the government of financing. If the government's financing needs are large, the central bank may be prompted to expand the money supply excessively, fuelling inflation. Inflation will reduce the real value of currency and sovereign debt held by the public, which will thus be forced to accept capital losses and to bear the costs of the central bank absorbing such debt. However, monetary financing may also involve purchases of sovereign debt without the central bank engendering inflation. The central bank may be able to neutralise the effects of the debt purchases on the money supply by selling other assets or by issuing its own interest-bearing securities. If ailing governments default on their debts, the central bank will see its profits shrink or it may even incur losses. Therefore, resources will be shifted from the central bank to the ailing government, without any necessity for inflation to rise. Once again, taxpayers ultimately have to pick up the bill by incurring capital losses on their own holdings of sovereign debt and by an increase in taxes required to offset the fall in central bank profits that would otherwise accrue to the government. The ECB seems to be mainly concerned about the second variant of monetary financing as the prospect of a significant rise in inflation is small – at least at present. Nevertheless, worried observers ask themselves whether the ECB is not taking an overly big gamble. When in the more or less distant future the eurozone economy starts to recover and the need for tightening monetary policy arises, will the ECB be able to quickly reduce the money supply? Will the ailing countries have gained sufficient health to allow the ECB to sell their sovereign debt? If that debt cannot be sold without rekindling the fiscal crisis, does the ECB possess a sufficiently wide range of other instruments for reducing the money supply? At the moment, there are no clear-cut answers to these questions. But one thing is certain: the risk that the ECB's current purchases of ailing government debt will ultimately evolve into monetary financing of the first or second kind or both is substantial (G. Rich, 'Comment on "The Impact of Sovereign Debt Monetary Affairs" by Annamaria Viterbo', WTI, World Trade Forum 2012, Bern, 12–13 October 2012).

[69] The ECB will not claim preferred creditor status as compared to private investors. See ECB Press Release: 'Technical features of Outright Monetary Transactions', 6 September 2012, www.ecb.int. The ECB Governing Council has not yet adopted a decision detailing the legal framework for the OMT programme.

[70] See M. Draghi, President of the ECB, and V. Constâncio, Vice-President of the ECB, 'Introductory Statement to the Press Conference (with Q&A) of 6 September 2012', Frankfurt am Main, www.ecb.int.

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a default threatens and it can then pressure "Euritania" to let it swap into local or international bonds without CACs that receive special treatment, exactly as it did with Greece'.[71] In this case, if a proper *pari passu* clause was contained in the bond contract, the other creditors could claim breach of contract.[72]

Last but not least, it is interesting to note that, in the 2012 Article IV Report on the eurozone, the IMF seems to imply that the ECB exemption from the Greek PSI deal (even if unique and exceptional) might have made the SMP (and now the OMT) less effective due to subordination risk.[73]

VI. What could have been done: a European Crisis Resolution Mechanism (ECRM)

Since a debt crisis within a eurozone country can undermine financial stability and the common currency, it has been argued that a permanent European mechanism for sovereign debt crisis resolution should be put in place.[74]

In November 2010, François Gianviti and other distinguished scholars put forward the proposal to create a European Crisis Resolution Mechanism (ECRM).[75] The ECRM would have been activated upon request of a government whose debt had reached unsustainable levels. The country in question would immediately stop servicing its debt to national and international creditors and there would be a stay on litigation for individual creditors seeking repayment. The mechanism would provide a framework for negotiations only between the debtor and its private creditors, while bilateral creditors would continue to refer

[71] D. Nowakowski, 'How Can the ECB Address Concerns on Seniority?', *Roubini Global Economics*, 5 September 2012.

[72] The sovereign bonds issued under Greek law before the restructuring did not contain a *pari passu* clause. On the *pari passu* clause, see L. Buchheit and J. Pam, 'The Pari Passu Clause in Sovereign Debt Instruments', *Emory Law Journal* 53:3 (2004), 869; R. Olivares-Caminal, 'To Rank Pari Passu or Not to Rank Pari Passu: That Is the Question in Sovereign Bonds' (2008), ssrn.com/abstract=1291751. See, in particular, United States Court of Appeals, Second Circuit, *NML Capital LTD* v. *Argentina*, 26 October 2012, 2012 WL 5275014 (CA2 (NY).

[73] IMF, 'Euro Area Policies: 2012 Article IV Consultation – Selected Issues Paper', IMF Country Report No. 12/182, July 2012, pp. 47 ff. It is noteworthy that the ESM will have a preferred creditor status second only to that of the IMF: this, however, might have an adverse effect on the perceived credit risk of new issues of euro area sovereign bonds.

[74] For an overview of proposals for a sovereign insolvency framework, see Das *et al.*, 'Sovereign Debt Restructurings', p. 88.

[75] Gianviti, *et al.*, 'A European Mechanism for Sovereign Debt Crisis Resolution', p. 21.

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to the Paris Club. Binding decisions on behalf of all creditors were to be taken by a supermajority, thus locking in potential holdouts. The proposed ECRM would have been made up of three organs: (i) a legal body responsible for the settlement of disputes; (ii) an economic body to guide negotiations and assess debt sustainability; and (iii) a financial body entrusted with the task of providing interim financial assistance on behalf of the EU.

The foregoing proposal attracted criticism from other economic scholars, who argued that it would raise a moral hazard issue and that it would attract speculative pressure, to the point of precipitating a crisis, with contagion spreading to solvent countries as well.[76]

C. Conclusions

Only some of the tools available under international law for sovereign debt restructuring have been applied in the context of the European crisis.

To tackle the eurozone debt crisis, the leaders of EU countries relied on a variety of measures: the Greek sovereign debt restructuring, the introduction of CACs in European government bonds, the ECB's non-standard measures and the adoption of financial assistance mechanisms (like the EFSF and the ESM), as well as the reform of the European economic governance and of the SGP, the Fiscal Compact, and the project for a banking union.

Similar to what happened at the beginning of the 2000s for the SDRM proposal,[77] the creation of the ECRM drew attention, but not enough consensus to move beyond political discussions.

The contractual approach therefore remains the preferred one, even if, within the EU legal framework, the introduction of a mechanism with a stronger element of public authority could have been expected.[78] This leaves the ECB in the difficult position of safeguarding monetary stability in the whole eurozone with few policy tools at its disposal, and which are often stretched to their limits.

[76] See Louis, 'The Unexpected Revision of the Lisbon Treaty', p. 37.

[77] See above footnote 24.

[78] See A. von Bogdandy and M. Goldmann, 'Sovereign Debt Restructurings as Exercises of International Public Authority: Towards a Decentralized Sovereign Insolvency Law', paper presented at the ESIL-IEL-IG Workshop of Valencia, 13 September 2012 (on file with author).

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The European sovereign debt crisis demonstrates therefore that the EMU project – a common currency without a state – did not take into account all of the possible implications. As a matter of fact, 'the European Union is [still] only a polity in the making, lacking important functions and constitutional characteristics of a political union and retaining some features of an old model of strategic contest between independent states'.[79] The EMU and the EU are at a crossroads: the choice is between leaving out non-compliant states, putting both the EMU and the EU at risk of disintegrating, or decisively moving towards further integration, in particular through the establishment of a fiscal union and greater tax cooperation. Are we ready for a federal European government?

[79] T. Padoa-Schioppa, *The Euro and Its Central Bank: Getting United after the Union* (Cambridge, MA: MIT Press, 2004), p. 50.

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