The Economic and Monetary Union:

Constitutional and Institutional Aspects of the Economic Governance within the EU

Editors: Ulla Neergaard,
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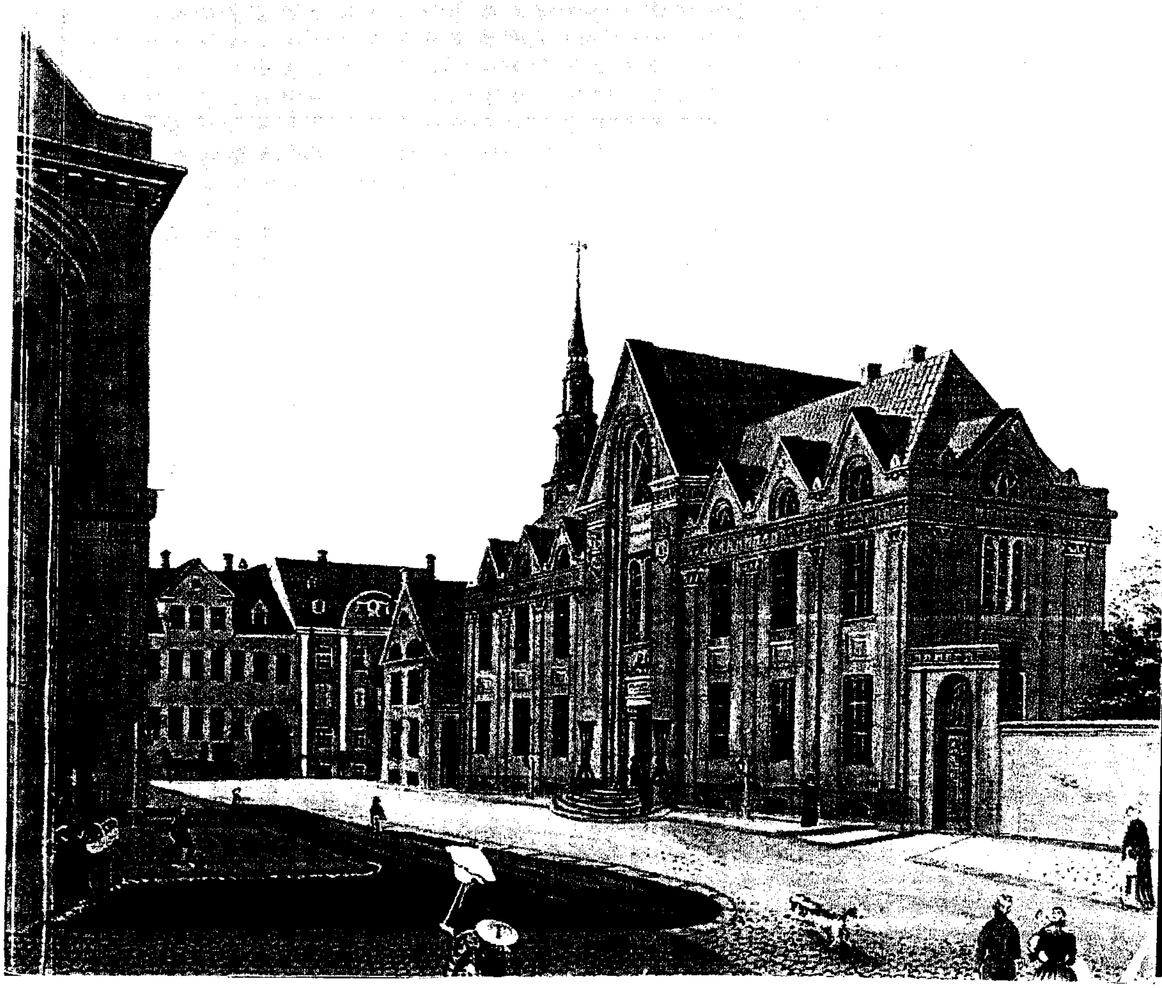

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Die Wirtschafts- und Währungsunion:

Konstitutionelle und institutionelle Aspekte der wirtschaftspolitischen Steuerung innerhalb der EU

L'Union économique et monétaire :

Les aspects constitutionnels et institutionnels de la gouvernance économique dans l'UE

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GREECE

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'Competition that stimulates, cooperation that strengthens, and solidarity that unites', Jacques Delors

Economic policy

EU legal order

Question 1

Article 3 of the TEU, when declaring the principles of the EU, mentions, among others, that '*the Union's aim is to promote peace, its values, and the well-being of its peoples*' as well as the establishment of an internal market. It declares that the Union 'shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress ...' and that 'it shall promote economic, social and territorial cohesion, and solidarity among Member States'.

In Part Three of the TFEU, entitled 'Union Policies and Internal Actions', Title I is dedicated to the Internal Market, Title VIII to the Economic and Monetary Policy, Title IX to the Employment, and Title X to the Social Policy. De-

1. Katerina Iliadou, Dr. juris, Lecturer at the Faculty of Law, University of Athens, Department of Public Law. Elias Karakitsos, Chairman of Global Economic Research, LLC, Associate Member of the Centre of Economic and Public Policy, University of Cambridge. Dimitris Tsibanoulis, Dr. juris, Managing Partner Tsibanoulis & Partners Law Firm, Member of the Board of Directors of the Hellenic Federation of European Law (FIDE-Greece). The core of the responses to the Questions has been prepared as follows: Questions 2, 11, 12 and13 by Elias Karakitsos; 3, 4, 6, 7 and 8 by Katerina Iliadou and 1, 5, 9 and 14 by Dimitris Tsibanoulis, who also had the overall coordination of the whole report.

spite the fact that the policies introduced by the provisions of each Title are, theoretically, legally equivalent, there is a significant material differentiation and gap as to the concretization by the respective legal provisions of their legal content and the means provided for the achievement of the respective declared goals and, accordingly, with respect to their implementation.

While those relating to the price stability aspect of monetary policy have a specific and, at least literally, indisputable content, other provisions remain as blanket norms or programmatic declarations. These include the provisions establishing some of the Treaties' fundamental principles, which from a legal policy point of view and hierarchical order are equivalent to the first, notably a highly competitive social market economy (entailing undistorted functioning of the internal market), price stability, full employment, and social progress and conditions favouring balanced economic growth.

Such imbalances (disequilibria) have been made especially clear by the eruption of the Eurozone crisis. When the euro was first conceived and designed, the concerns about crisis management were not institutionally addressed. Nor was a remedy for a possible euro pathology envisaged in the Treaties establishing the common currency. As a result, when troubles appeared, the Treaties' provisions hindered the adoption of decisive measures which could alleviate the consequences of the crisis and tackle issues of legal certainty and predictability throughout the Eurozone.

It should be noted that the financial stability objective is not identical to 'price stability'. It is broader, since it also entails the effective promotion of the goals of maximum employment. Thus, price stability and full employment should be understood as the two equivalent legs of financial stability. The financial crisis and, especially, the Eurozone crisis illustrated the boundaries set by the Treaties to the possibilities for EU bodies to effectively tackle the crisis. As long as monetary policy was understood in Manichaestic terms as entailing only the price stability objective, ignoring that of full employment, the achievement of financial stability was undermined. To tackle the Eurozone crisis, restoration of financial stability needed to be understood as implementing the achievement of price stability and full employment. That did not happen and the separation of monetary and economic policy threatens to be detrimental for the European Union. This is particularly so when the Treaties set limits to the ECB's role, preventing it from working in close cooperation with other competent EU institutions to achieve the one equally valid objective – the dual mandate of financial stability and full employment. Such an important lacuna threatens to worsen the institutional lameness of the EU, despite the ECB and the European Commission's efforts to restore equi-

librium through recent generous teleological interpretations of the Treaties to save Europe's weaker economies from sovereign default.

In that respect, it has been convincingly argued by Athanassiou that the measures taken (till then) conformed with the EU treaties and especially *that '(1) art. 125 TFEU is compatible with the extension of Union or Member State temporary financial assistance to Euro area Member States in difficulty; (2) art. 122(2) TFEU was an adequate and sufficient legal basis for the adoption of Council Regulation 407/2010, establishing the European Financial Stabilisation Mechanism, and for the extension of Union financial assistance to Member States in difficulty; (3) the Securities Markets Programme is consistent with the rationale and objectives of the monetary financing prohibition and purchases conducted under it do not circumvent art. 123 TFEU; (4) a Treaty amendment was indispensable to establish a Euro area support fund and the choice of art. 136 TFEU was appropriate also for clarifying the scope of art. 125 TFEU.'*[2]

Further, the Court of Justice of the EU in its Pringle Decision of 27 November 2012 (Case C-370/12) judged that Articles 4(3) TEU and 13 TEU, Articles 2(3) TFEU, 3(1)(c) and (2) TFEU, 119 TFEU to 123 TFEU, and 125 TFEU to 127 TFEU, and the general principle of effective judicial protection do not preclude the conclusion between the Member States whose currency is the euro of an agreement such as the Treaty between EU member states establishing the European stability mechanism concluded at Brussels on 2 February 2012 (the 'ESM Treaty') or the ratification of that treaty by those Member States.

Nevertheless, it is not feasible to handle the Eurozone crisis without the means and tools provided in the Treaties, using simply ad hoc contractual arrangements in the form of international agreements, as is the case so far.

EMU needs to be overhauled with new formal rules to achieve better budgetary, economic and financial surveillance, and supervision, followed by resolution tools, safeguarding timely action to avoid systemic crisis. Such mechanisms lack however the substantive content: the material ingredients needed to achieve a full economic, banking, fiscal, and political union, while safeguarding the fundamental principles of the Treaties.

The Treaties need mechanisms and tools to enable the creation of policies for real convergence and growth. Without these necessary material remedies

2. Phoebus 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 2011, 558.

against crisis, the vicious circle of tight monetary and fiscal policy cannot be broken and will ultimately lead to the disintegration of the euro.

Question 2[3]

At the root of the EU debt crisis lies the divergence in real magnitudes, of growth, productivity, and competitiveness between Member States, and in particular between periphery and core countries, during the first ten years of EMU.

Despite this, the EC's 'blueprint for a deep and genuine economic and monetary union'[4] is promoting the wrong remedies. With divergence as the cause of the crisis, policies to encourage convergence should have been the basis for overhauling the system.

Instead, the new architecture and its governance offer a reactive system, identifying and monitoring real divergence between Member States and taking measures to simply prevent the divergence from growing to levels that would trigger another crisis.

The measures are punitive: they impose austerity through corrective action on fiscal and monetary policy as now applied to periphery Member States. This punitive approach to preventing another crisis will certainly not reverse growing real divergence, reflected in increasing inequality of income between and within Member States. These negative conditions are resisted by national electorates who increasingly favour political parties that promote nationalism over federalism. The next financial crisis is not far away and it may well trigger the break up of the euro.

Yet, the EMU can be salvaged if real convergence becomes the top priority policy objective and the current use of fiscal and monetary policy to reduce the negative impact of business cycles on real convergence is reviewed.

To save the euro we need to return to first principles, namely to the theoretical models that form the intellectual basis for real convergence and the use of fiscal and monetary policy in a monetary union. If these basic theoretical models have broken down, then we need to revise them to establish the new architecture of EMU. This is the aim of this report. It suggests how policies should be designed in the light of a breakdown of the Efficient Market Hypothesis (EMH) and the New Consensus Macroeconomics (NCM), models

3. The answer to this Question entails a brief analysis of the Economic Principles of the issues raised in the Questionnaire.
4. Communication from the Commission: A blueprint for deep and genuine economic and monetary union, 28/11/12.

which have formed the backbone of the old EMU architecture that led to the crisis. An analysis of the above is presented in the answers to questions 11 – 13.

Question 3

I. Union Legal Order

As already pointed out in the Commission's Blueprint, the primary EU legal order can provide the legal basis for steps towards a deeper EMU, mainly in respect of short and medium term. For example, considering the Commission Communication on the *introduction of a Convergence and Competitiveness Instrument – CCI* [COM(2013) 165 final], we may agree that Article 121 (6) combined with Article 136 (1) TFEU could be considered as an appropriate legal basis for the adoption of measures within the framework of the new contractual approach to the implementation of structural reform measures and mainly for the conclusion of mutually agreed 'contractual arrangements' on structural reforms envisaged by Member States facing difficulties where such reforms affect the entire Euro area. However, such arrangements would have no legally binding character, since legally binding agreements could be concluded only on the basis of the flexibility clause (Article 352 TFEU) and under the procedural and substantial conditions set therein.

The establishment of a 'financial support mechanism' seems to exceed the scope of application of the aforementioned Articles 121 (6) and 136 (1) (b) TFEU; this mechanism could be established as a 'Fund', designed to boost economic, social, and territorial cohesion in the EU as a whole, according to the provisions of Article 175 (3) TFEU in conjunction with Protocol No. 28, following the ordinary legislative procedure and under the condition of non violation of Article 125 TFEU. Ex ante coordination of national plans for economic policy reforms could also be based on Articles 121 (6) and 136 (1) (b) TFEU, bearing in mind that the final decisions would rely on national decisions, since the EU would only have non-binding coordination competencies (see the Commission Communication on '*Ex ante coordination of plans for major economic policy reforms*' – March 20th, 2013).

On the other hand, more decisive and ambitious steps towards budgetary and economic integration, such as the proposals on centralizing debt issuing in the Euro-area or on the establishment of an autonomous euro area budget, presuppose indisputable EU competencies and a clear mandate to proceed with the issuance of legally binding decisions. These could only be achieved through a related revision of the Treaties according to the ordinary procedure of Article 48 TFEU, to integrate into the primary EU legal order at least the basic characteristics, principles and mechanisms that will apply and to establish a clear institutional framework for the related necessary secondary legislation. A revision of primary EU law will create clarity, legal certainty, and stability, essential conditions to establish legal obligations for compliance by Member States and to justify control mechanisms.

II. Constitutional Legal Order

With respect to Greek Law, since the enactment of the Constitution of 1975 that preceded accession to the European Communities (1981), the Greek constitutional order has been constructed in a way that facilitates the process of European Integration. The relevant provisions are included in Article 28, as revised in 2001 and currently in force.

More specifically, two provisions included in this Article are considered to form the foundation for the participation of Greece to the European Integration Process viz: '*2. Authorities provided by the Constitution may by treaty or agreement be vested in agencies of international organizations, when this serves an important national interest and promotes cooperation with other States. A majority of three-fifths of the total number of Members of Parliament shall be necessary to vote the law sanctioning the treaty or agreement. 3. Greece shall freely proceed by law passed by an absolute majority of the total number of Members of Parliament to limit the exercise of national sovereignty, insofar as this is dictated by an important national interest, does not infringe upon the rights of man and the foundations of democratic government and is effected on the basis of the principles of equality and under the condition of reciprocity.*' To date, cumulative application of these two paragraphs, combining the procedural conditions of paragraph 2 and the substantial limits set out in paragraph 3, has been considered as formulating the appropriate constitutional framework allowing participation to the European Integration process without serious objections or constitutional problems and debates.

Due to its open character, the same constitutional provisions may be regarded as an appropriate basis for further progress towards a genuine and deeper EMU, as envisaged in the main policy documents. The same could also apply to the establishment of an eventual EU right of veto over national budgets as well as for the establishment of an autonomous euro area budget.

Nevertheless, budget powers are entrusted to the Parliament, which according to Article 79 of the Constitution is responsible for approving the annual State budget in the course of its regular annual session, further considerations arise: Objections could be raised that the attribution of budgetary powers to institutions beyond the directly elected Parliament constitutes a violation of the '*foundations of democratic government*', which set explicit limits on the attribution of powers to institutions beyond the national borders. Changes therefore have to address prima facie safeguards to ensure democratic legitimacy and accountability. This could be done through a constitutional amendment aiming at the enactment of specific rules stipulating the procedures and formalities regarding the participation of the national Parliament to the procedures established within the framework of an eventual enhanced EU cooperation on budgetary issues.

In this respect, Greek constitutional theory argues that the attribution of specific constitutional powers to supranational institutions according to Article 28 may be challenged before the national Courts. That specific issue has yet to be tested, but the possibility cannot be excluded for the future.

Within that framework we may consider the judicial approach expressed by the majority of the plenary session of the Council of the State in the Memorandum Case (case No. 668/2012). In order to affirm the constitutionality of the austerity measures imposed in compliance to the international assistance programme as well as the constitutionality of the procedure that was applied, the Court was based on arguments related to the extreme and exceptional circumstances of emergency due the current economic crisis that put the existence of the State itself at risk (see also under 9 II).

However similar arguments related to the emergency conditions could not apply easily in the future and with respect to standardized mechanisms of the deeper EMU, as proposed.

Question 4

Indisputably, the principle of democracy is one of the common values shared by all EU member States. It is also explicitly declared in Article 2 TEU as a fundamental principle of the EU legal order. Furthermore, according to Article 10 (1) TEU, '*the functioning of the Union shall be founded on representative democracy*'. For such purpose, representation of the EU citizens is ensured through the European Parliament, granting direct democratic legitimacy to its decisions. Additionally, specific procedures and rules are included in primary EU law to render at least indirect democratic legitimacy to the other institutions and mainly the Council, whose members remain accountable to their national parliaments (Article 10 (2) s. b TEU), and the Commission, which as a body is responsible to the European Parliament (Article 17 (8) TEU and 234 TFEU). A specific role is entrusted to the national parliaments, which according to Article 12 TEU shall '*contribute actively to the good functioning of the Union*', as further defined in Protocol 1 on the role of national parliaments in the EU. Moreover, the citizen's right to participate in the democratic life of the Union is provided in the EU Treaty which stipulates explicitly that '*decisions shall be taken as openly and as closely as possible to the citizen*' (Article 10 (3) TEU).

Recent developments as regards to the mechanisms and arrangements that have been adopted during the last years in order to combat the European sovereign debt crisis, aiming to strengthen the legal system of economic governance in the EU, demonstrate a shift of power within the EU institutions. A number of weaknesses in the structures of the EU and the EMU have been revealed and questions raised as to the need for legal modifications of the current system to protect the aforementioned principles and rules of democratic legitimacy. Focusing mainly on the Six- and Two-Packs, the Euro+ Pact, the ESM, and the Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union (Fiscal Pact), we may point out the following brief remarks:

- Inter-governmental methods and instruments – outwith the Community's methods – are opted for, to the detriment of the Treaty provisions, which hold that the European Council shall not exercise legislative powers (Article 15 (1) TEU) and provide for the European Parliament's involvement in the formulation of EU legislation. The European Council thereby acquired de facto key role within the framework of the EU institutional architecture.
- While the Commission's responsibilities regarding legislative initiatives seem to shrivel, it is instead given new powers with regard to monitoring and reporting on compliance with the fixed targets and procedures to the Commission, mainly to the detriment of the European Parliament's role; the latter often seems to remain a passive observer of developments. Practice also reveals the weakness of the European system of governance and the absence of clear political leadership.
- The scope of responsibilities of the ECJ is also expanded, since beyond its Treaty responsibilities regarding the interpretation and application of EU law, the Court is also entrusted with the responsibility to control compliance with provisions adopted beyond the EU legal order such as the obligations arising out of the Fiscal Compact (see Article 273 TFEU).
- National parliaments (at least most of them) have limited capabilities and cannot play an influential role (at least not ex-ante) in decisions adopted by the executive branch of the national governments via the European Council or the Council. This situation is evident in Greece, where various

techniques have been applied to skip the procedures of an in depth parliamentary debate on the obligations arising from the international assistance program.
- Citizens are often troubled by problems of daily routine due to the economic crisis and the 'Civil Society' seems reluctant or unable to participate effectively in public dialogue on the developments that take place. The complexity of the issues involved exacerbates this situation.

Institutional amendments that could eventually address the above described issues may include the following:

- The enhancement of the European Parliament's role as regards the enactment of new legislation. The attribution of new powers to the European Parliament acting together with the Council in order to initiate new legislation on economic and financial issues. This perspective however requires a Treaty revision, since even after the Lisbon Treaty the Commission remains the sole institution with the power to initiate new draft legislation. European Parliament participation in the decision-making procedures of the Council pursuant to Article 121 (2) TFEU may also be considered.
- The fusion of the mandate of the presidency of the Commission with the one of the presidency of the European Council, so as to reinforce the political legitimacy of this institution by ensuring accountability towards the European Parliament. This fusion could be achieved through the adoption of an inter-institutional agreement according to Article 295 TFEU and may be considered to be in line with the existing EU legislation and mainly with the obligation of the Council to take into account the results of the European elections in order to propose the president of the Commission (Article 17 (5) TEU). The perspective of applying direct universal suffrage that will provide direct democratic legitimacy requires a Treaty revision according to the ordinary procedure (Article 48 TEU).
- The clarification and enhancement (e.g. through the adoption of a related inter-institutional agreement) of the functions of the Inter-parliamentary Conference on Economic and Financial Governance (ECOFIN Conference), that was established pursuant to the provisions of Article 13 of the Fiscal Compact, as decided by the Speakers of the Presidents of all Parliaments in the European Union in Nicosia (April 2013). This seeks to increase parliamentary participation decisions on economic governance. As an alternative to this perspective of multilevel parliamentary cooperation, the establishment of a second parliamentary chamber, composed of dele-

gations of national MPs may also be considered. Yet, this requires a Treaty revision and poses questions as to the exact functions and organization of a new institution.
- As regards the Euro Group, possible modifications may include mechanisms aiming to ensure parliamentary control of the decisions adopted, i.e. the establishment of a vice-president of the Commission and of the Council that shall be responsible towards the European Parliament.

The justification of the primacy of EU law which triggers the MS obligation to comply with its requirements is connected to the basic principles of the rule of law. It presupposes both a predefined fundamental general framework defining the tasks and responsibilities of the institutions involved and the acknowledgement of the obligation to respect fundamental rights and liberties, to operate judicial control in an effective way, through the competencies of the national Courts and the EU jurisdiction. Establishing the right to challenge decisions before the Courts therefore seems imperative. Moreover, given the divergent opinions that may be adopted by the national Highest Courts coordination and control mechanisms for judicial competencies beyond national borders should arguably be considered. The organization of judicial systems in federal states may provide good ideas that could be adapted and applied at EU level.

Question 5

Financial sector integration in the European Union has deepened significantly following the introduction of the single currency. However, the international financial crisis revealed the weaknesses of the institutional framework of the European Internal Market, exposed the Eurozone's extreme vulnerability and proved that the Better Regulation target, aptly identified as a necessary and essential part of the FSAP, had failed to achieve necessary cohesion and consistency in the EU.

When the euro was first conceived and designed, concerns about crisis management were not institutionally addressed. The EU Treaty establishing the common currency did not envisage any remedy whatsoever for a possible euro pathology. As a result, when difficulties appeared, credibility was the first victim, due to a lack of legal certainty and predictability. The EU found itself unprepared to tackle what arguably constituted the biggest sovereign debt crisis of modern times.

And while signs of a slight recovery in the real economy began to appear in 2010, the same year the beginning of the sovereign debt crisis in Eurozone

periphery countries occurred. High sovereign debt levels eroded trust in the European banking system. For the weaker sovereigns, the situation became unbearable in summer 2011. The banking system was put under unprecedented pressure and job losses skyrocketed in many EU member states.

In reality, the crisis clearly highlighted the limits and failings of Europe's financial supervision system. The accumulation of excessive risk was not detected. Surveillance and supervision were not effective and not exercised in time. When transnational financial institutions faced problems, the coordination between national authorities was far from optimal. Weaknesses, revealed by the financial crisis have forced a reappraisal of the main macroeconomic forces at play in the euro area, and promoted a rethink of the architecture of EMU that has already led to a substantial overhaul of economic governance arrangements.

The Single Supervisory Mechanism (SSM) for the oversight of banks and other credit institutions, establishing one of the main elements of European Banking Union, was a first and necessary response to the problems in banking revealed by the crisis.

Prior to the introduction of the SSM the report of the European Commission's High-level Expert Group on Bank Structural Reform (Liikanen report) proposed a number of structural reforms, pursuing a significant change in the banking landscape in EU.

First, the proposed mandatory ring fencing mechanism, entailing the separation of retail banking from trading/investment activities, signals a return to traditional banking culture. The reform's proposal aims, inter alia to reduce risk arising from the mixing of two different banking management cultures. Banks will become simpler in structure and therefore easier to monitor. Risk should be reduced by easing banks' complexity and tackling interconnectedness. Corporate Governance of banking institutions will be simpler and more focused, to give a more feasible and coherent working environment. The tasks entrusted to governing and supervisory bodies will be reduced. Thus, a more coherent corporate governance paradigm should be achieved, free from the anomalies and conflicts of interest endemic to controversial and opposing banking objectives. As a result of such separation, funding has more chances to flow to the real economy, to support economic activity, and enhance growth.

Existing institutional disequilibria in the aftermath of the financial crisis and the Eurozone crisis led to a unique and unprecedented fragmentation of the single European Market. This fragmentation[5] was based on domestic market-driven characteristics predetermining the business possibilities and perspectives of banking entities and enterprises constituting a crucial obstacle to growth and recovery of the distressed Eurozone economies.

Market participants take into consideration de facto discriminatory country driven criteria, which in fact weaken or even invalidate the fundamental operating principles of the EU. For example, the specific conditions related to the local environment of a bank determine decisively its attractiveness for depositors and, accordingly, the interest rate it has to offer to win creditors. In the absence of a European Depositors Guarantee Scheme and under currency risk conditions, depositors are led to the banks of the strong Eurozone economies, where the State is able to intervene in case of a bank's default. Further, the recession in European countries effectively destroys the financing perspectives for local enterprises and the real economy in general. Domestic enterprises in weak Eurozone countries have poor chances to obtain financing and only under very expensive conditions.

The shortcomings in the institutional framework were evident and not supportive of the single market. Financial integration was not followed by the establishment of adequate regulatory and supervisory institutions and essential economic governance frameworks.

Under such circumstances, achieving growth in weak Eurozone economies and, thus, tackling and overcoming the financial crisis, resembles the fight against Lernaean Hydra, the many-headed beast. Addressing these issues is of crucial importance for the European Union and the effective preservation of the fundamental principles and concepts on which it is based.

Moreover, the process of integration in the internal market was also weakened by Member States' unilateral approaches to resolving the problems of their own national credit institutions. Accountable to their parliaments, national governments (as well as central banks and supervisors) cared only about the effects of ailing banks on their domestic financial systems.

The theoretical foundation for this behavior is provided by the financial trilemma:[6] that all three policy objectives – of maintaining global financial

5. Under the terms fragmentation and segmentation we mean the situation in which a business undertaking is required to pay a premium only because it belongs to a specific jurisdiction, irrespective of the undertaking's own risk profile.
6. See Dirk Schoenmaker, Post-Crisis Reversal in Banking and Insurance Integration: An Empirical Survey, Economic Papers 496/April 2013, Avgouleas, Emilios, and Arner, Douglas W., The Eurozone Debt Crisis and the European Banking Union: A

stability, fostering cross-border financial integration and preserving national authority for financial policies – are not compatible. Any two of the three objectives can be combined, but not all three together; one of the three objectives has to be abandoned.

Further, two negative loops have been accurately identified and recognized, exacerbating financial fragmentation: One between sovereigns and banks, where insolvent banks make the sovereign insolvent – and vice versa – and one between deposits and banks, where the risk of redenomination, due to the legal uncertainty surrounding Euro-exit requirements, induces the flight of deposits from the periphery to the core. The first topic was debated during the Euro area Summit of June 29th 2012, where the issue of the 'vicious circle between banks and sovereigns' was formally addressed for the first time at political level together with decisions to help resolve it. A new Bank recapitalisation scheme was to be realised through European direct investments, in order to break the vicious circle between banks and sovereigns. Banks' recapitalisation measures should not be solely national, but pan-European and market-oriented.

The breakthrough of the June 29th Summit's radical proposal constitutes a distinguishing feature of Eurozone policy to date: By participating effectively in the recapitalization of the banks, the Eurozone will be forced to effectively contribute in the economic growth endeavor. Acting as investor, it will inevitably abandon its hitherto impassive stance that leaves recovery under the control of each troubled member state. Accordingly, national factors that distort fair competition within the single market and hinder economic growth in weak states will be constrained.

Following the completion of bank recovery, the European Stability Mechanism (ESM) will be able to place its shares in recapitalized banks on the market, without incurring losses related to the conditions of the economy of the weak state in which the investment was made. If the economy of the weak state starts to recover, both the value of the banks and the ESM's participation increase. Consequently, the risk for the financing states' taxpayers, which currently constitutes a disincentive to financial unity, decreases. It will no longer be in Europe's interest to maintain depreciation of weak member states' economies to allow healthy states' enterprises to invest in them at low-prices; instead a collective interest would emerge, creating prospects for the effective operation of the national banking sector to support the troubled

Cautionary Tale of Failure and Reform (October 1, 2013). University of Hong Kong, Faculty of Law, Research Paper No. 2013/037. Available at SSRN: http://ssrn.com/abstract=2347937 or http://dx.doi.org/10.2139/ssrn.2347937.

states' economic recovery. This community of interests is a very promising success factor since it creates some necessary genuine growth prospects. It will be the first time after the outbreak of the sovereign crisis that the Eurozone operates on market terms to confront the problem. In particular, it will be asked to take effective measures to promote growth of the funded member-states because such measures will be fully consistent with the interests of the financially strong states. It is self-evident that the aforementioned mechanisms require the EU to play a more decisive role in the economic affairs of each state. That is to say, they require the endorsement of united economic and banking supervision, following recognition of the fact that a monetary union cannot survive without a fiscal union.

Apart from the ESM, which was established under a Treaty between member states, the establishment of a banking union, a Single Resolution Mechanism, which has been announced, and a pan-European Deposit Guarantee Scheme, currently under consideration though politically difficult, are necessary prerequisites for an integrated financial framework and a genuine economic and monetary union. All those instruments constitute core requirements for the restoration of a level playing field in the European financial services market and, consequently, for a sound development of the banking sector capable of financing the real economy.

However, there is another negative loop, between austerity and debt sustainability, which needs to be addressed. It has been ascertained that the deeper the austerity programme, the more unsustainable the debt. Imposition of austerity when the economy is in recession creates a deflationary downwards spiral and is a detrimental impediment for growth and convergence. Improvement of supervisory mechanisms is convergence neutral. Mechanisms and tools towards cohesion and creating growth and convergence conditions are the necessary supplement. Apart from the necessary Treaties' amendments, a new 'Financial Services Action Plan' is needed to create demand prerequisites and alleviate the causes of new financial fragmentation. Without it, fragmentation will continue to traumatise the internal market and create insuperable obstacles to growth and convergence. And without these latter prerequisites, no economic, monetary, banking, fiscal, and political union can be achieved.

Legal orders of the Member States

Question 6

The impact on the Greek legal order of the recently adopted EU rules on economic governance has been significant. Already in 2010 a far reaching revision of the system of Greek public expenditure had been initiated to meet the fiscal adjustments imposed due to the crisis. For that purpose, the Parliament enacted Law No 3871/2010, containing substantial amendments to the provisions of Law No 2362/1995 '*On public audit of the state expenditure and other provisions*', aiming at the reorganization of the procedure applicable to drafting and monitoring the execution of the national budget that applies to the Central Government and the regional entities.

The new law establishes the following general principles of fiscal governance: The principle of fair fiscal management, imposing the obligation to manage public revenues in a prudent manner, so as to ensure fiscal sustainability; the principles of accountability and responsibility; the principles of transparency and sincerity. Servicing the public debt in order to ensure fiscal stability is prioritized.

The respective duties and responsibilities of the Minister for Economy and of the State Treasury Office have been established and, moreover, detailed provisions have been included in the Law. Specific rules regarding drafting the National Budget have also been adopted. A 'Parliamentary Budget Office' has been established by the Parliament with the obligation to adopt and review 'Mid-term Strategic Fiscal Plans' to include the fiscal targets for the next three years. The Minister for Economy has been entrusted with detailed responsibilities for ensuring the appropriate execution of the budgets of all governmental bodies and authorities.

Additionally, the recently enacted Law No 4111/2013 included provisions as regards fiscal discipline of Public Enterprises and Private Entities owned by the State. In summary the Law provides:

- the obligation to establish the yearly budget no later than January 31st;
- the obligation to draft monthly execution plans for the budget and to set specific targets for every trimester with regard to each Ministry, including supervised legal entities;
- thorough monitoring of compliance with targets and prompt application of measures to avoid deviations from them;
- reporting obligations on a periodic basis (every trimester);

- possibility to enter into programmatic agreements with the Ministry of Finance in order to ensure budgetary discipline;
- possibility to cut public owned legal entities' budgets in the case of an eventual deviation of more than 10 % from targets and in the absence of correction measures;
- possibility to appoint a Supervisor of the financial operation of state owned legal entities that do not comply with fiscal obligations;
- the power to suspend remuneration of the management of such entities;
- automatic termination of the mandate of the members of the Boards of public enterprises and entities that have annual financial results diverging more than 10 % from the predefined targets.

Further developments, for example the establishment of a specific Committee within the framework of the State Treasury Office to ensure compliance of the national economic governance structures with the respective structures of the EU and the Euro-area, are currently under consideration. Proposals also include also the establishment of a new Fiscal Council with consultative functions (monitoring and reporting) on budgetary issues.

According to the January 2014 interim report of the Parliamentary Budget Office 'The new economic governance in the Euro-area and Greece – The mechanism of surveillance and solidarity under condition after the Memorandum' the new fiscal framework is estimated to be sufficiently appropriate to boost economic growth, on condition it not only limits political discretion on economic issues, but also as provides an opportunity to make structural changes in the country's productive base, improve its infrastructure offer finance to SMEs and stabilise the banking system. Structural problems however related to tax avoidance and evasion and poor collection mechanisms still persist.

Tackling the European Sovereign debt crisis has also stimulated debate on an eventual revision of the Constitution to incorporate provisions on fiscal issues, such as the balanced budget or the debt break rule.

Issues related to the characteristics of the Greek Constitution 1975/2001/2008, and the strict procedural limitations that apply to its revision (two-phase procedure that includes national elections; increased majority requirements; 5 years time period as a condition of an eventual subsequent revision) complicate this debate. Legal scholars point out that the enactment of fiscal rules in the Constitution may be conceived as the imposition of a predefined model of economic policy, contrary to the economic neutrality proclaimed by the Constitution. Moreover, such rules may constitute drastic limits to the Parliament's and to the Government's authority or powers in matters of economic and social policy. Other commentators cite the risk of using similar constitutional amendments to impose further restrictions on fundamental social rights enshrined in the Constitution, to the detriment of their normative force and of the social state in general.

In so far as constitutional fiscal rules are conceived as formulating rigid limits, their inclusion in the Constitution may be perceived as a fundamental infringement of constitutional rights and safeguards.

Question 7

The current economic crisis and the necessity to comply with the obligations arising from the international assistance agreements for Greece revealed a number of questions as to the democratic legitimacy of measures imposed by the Parliament and/or the Executive as well the techniques of their implementation. These include:

(a) The legitimacy of measures imposed through the Government by extensive use of the legislative delegation of powers to the executive. In particular, Article 43 par. 2 section b of the Constitution enumerates specific criteria for delegation: '*Delegation for the purpose of issuing regulatory acts by other (than the President of the Republic) administrative organs shall be permitted in cases concerning the regulation of more specific matters or matters of local interest or of a technical and detailed nature*'. In many cases it is doubtful whether implementing measures comply with the above provision of the Constitution.

(b) An extensive application of Article 44 par. 1 of the Constitution has been made, in order to precipitate the adoption of urgent measures. The above article provides for the Government the possibility to adopt 'Acts of Legislative Content', i.e. emergency legislation issued by the executive without statutory delegation, 'under extraordinary circumstances of an urgent and unforeseeable need'. Such measures have to be ratified later by the Parliament. The excessive use of such provision, taking into consideration the long duration of the economic crisis, deprived in reality from the Parliament the possibility to really discuss and analyse such measures, which have been quasi imposed to it.

(c) Finally, the Courts argued on the necessity of measures adopted by the Parliament having an impact on rights guaranteed by the Constitution by evoking the extreme financial problems of the State. Additionally, the national Courts did not enter in a control of procedural aspects of enactment of new legislation, with the explanation that such aspects are considered to constitute 'interna corporis' of the Parliament.

The legislative methods described above could not continue in the long term. Proposals to overcome similar deviations from the democratic principle may include:

(a) Rationalization and review of Article 43 paragraph 2 of the Constitution so as to provide a clear framework on the predefined conditions that shall apply with regard to legislative delegation to the Executive branch, including stable mechanisms that shall permit effective monitoring by the Parliament.
(b) Full compliance with the provisions of Law No 4048/2012 on Regulatory Governance – Principles, Procedures, and Means of Good Legislation.
(c) Establishment of control criteria that may be applied by the Courts to limit the immunity of procedures for new legislation.

Question 8

The Fiscal Compact was ratified by Law No 4036/2012. Therefore, according to the provisions of Article 28 of the Constitution the Fiscal Compact is an integral part of the Greek legal order and its provisions prevail over any contrary provisions of existing or future Statutes and secondary legislation issued by the Executive on the basis of a legislative delegation. Detailed provisions as regards the application of the obligations set out in the Fiscal Compact have not yet been enacted.

Question 9

I. Historical background

The Eurozone sovereign debt crisis, which immediately followed the global financial meltdown, began in Greece. Between 2009 and 2012 the country faced the most severe economic crisis of its recent history. With a large budget deficit and markets for new financing effectively closed, the state was faced with a disorderly default: unable to serve its sovereign debt, due and payable in June 2010.

To avoid a default – and related systemic risk in the Eurozone – Greece resorted to a combined European and international financial support mechanism, established *ad hoc* (2-9 May, 2010), following lengthy consultations

with European and international authorities. The Eurozone countries and the IMF, in consultation with national authorities, put together an urgent bail-out and adjustment programme and made available €110 billion of funds to help the country meet its obligations, fix the flaws in its economic policy, and re-enter the markets as quickly as possible. The strategic orientation of the programme focused mainly on the imposition of harsh austerity measures, designed to curb excessive demand and bring about internal depreciation, and parallel structural reforms to enhance competitiveness and boost productivity.

External and internal factors derailed this first economic adjustment programme. The policy mix proved inadequate: implementation was asymmetric (harsh austerity measures were fully enforced, while structural reforms lagged significantly behind) and generic faults in the policy design underestimated the fiscal results of a prolonged recession. In this sense the programme backfired.[7] Efforts to consolidate public finances and reduce the deficit led to a harsh recession and as a result fiscal revenue fell even further while public debt as a percentage of GDP increased.

In two consecutive Summits (11 and 25 March 2011) and by the *ad hoc* decision taken in the Summits of 21 July and 26 October 2011 regarding Greece, the Eurozone invited private investors to contribute to a solution for resolving the debt viability of Greece through the so called 'Private Sector Involvement', 'PSI' programme. At the same time, the financially robust States of the Eurozone were called to contribute further to the financing of the Greek economy. This principle of tripartite financing for the restructuring of Greek debt was adopted in the Summit on 26 October 2011.

Greek sovereign debt restructuring included (a) the bail-in leg, realized through the Greek Government Bonds' (GGBs) haircut (PSI), starting in February and completed in March 2012, and (b) the financing of Greece through the official sector of the EU and IMF. To this end, a company, the EFSF (now replaced by the ESM), owned by the Eurozone members, was established in Luxembourg.

The GGBs haircut has been realized via a voluntary GGBs exchange, by adoption and activation of Collective Action Clauses (CACs). The exchange was made by an exchange offer for GGBs and bonds guaranteed by the Hellenic Republic.

7. Structural reforms in labor and product markets, privatization, and measures to combat tax evasion were either not implemented or were implemented with delay and, at the same time, fiscal policy over-relied on tax increases instead of expenditure cuts, while the fiscal multiplier was underestimated.

The exchange of bonds was determined by Law No 4050/2012 (the 'Greek Bondholder Act') of 23 February 2012. This stipulated (a) the Invitation by the Hellenic Republic to bondholders for the exchange (swap) of their bonds against new securities, (b) the conditions under which the modification of the terms of the eligible bonds could be adopted by bondholders, including the introduction of CACs, and (c) the terms under which the bonds' exchange against new securities could be determined and effected. Bonds governed by Greek Law totalled approximately 177 billion Euros and bonds governed by foreign law some 28 billion Euros.

The Hellenic Republic's Invitation Memorandum promulgated under Law No 4050/2012 invited bondholders of the designated bonds to tender any and all of them in exchange for New, GDP-linked Bonds, GGBs and PSI Payment Notes, in accordance with the terms and subject to the conditions set out in the Memorandum. Simultaneously, other invitations were launched covering, together, GGBs and titles guaranteed by the Hellenic Republic, but governed by foreign law.

For GGBs governed by Greek Law (the 'Eligible Titles'), and subject to the modification / swap process, bondholders were called upon to decide collectively, within the deadline specified by the Invitation Memorandum, on the proposed modification of the Eligible Titles, i.e. on *the change or the addition of terms to one or more eligible titles or the exchange of one or more eligible titles with one or more new titles*. Addressees of the Invitation were the bondholders acting through the participants registered with the System for Monitoring Transactions in Securities in book-entry form operated by the Bank of Greece (account providers).

The Greek Bondholder Act also provided an optional collective action clause (CAC), for activation with bondholders' consent, to restrain the free rider / holdout problem in the restructuring effort. CACs could be activated by a quorum of at least ½ of the aggregate outstanding principal of all Eligible Titles specified in the *Invitation* (the 'Participating Principal') and a supermajority of at least (2/3) of the Participating Principal. The Act did not impose new terms on the bondholders and an exchange of bonds was not compulsory. Modification was voluntary: the decision for modification and/or exchange rested solely with the bondholders. But the Act provided for the bond loans' terms to be amended by qualified majority and specified quorum: the previous requirement of bondholder unanimity was abandoned.

Bondholders of approximately €172 billion principal issued or guaranteed by the Hellenic Republic tendered their bonds for exchange or consented to the proposed amendments in response to the invitations and consent solicitations announced on 24 February 2012. Of the approximately €177 billion of bonds governed by Greek law and subject to the invitation, the Hellenic Republic received tenders for exchange and consents from holders of approximately €152 billion face value 85.8 % of the outstanding face value. Bondholders of 5.3 % of the outstanding face value participated in the consent solicitation and opposed the proposed amendments. The Hellenic Republic notified its official sector creditors that, upon confirmation and certification by the Bank of Greece as process manager, it intended to accept the consents received and to amend the terms of all of its Greek law governed bonds, including those not tendered for exchange pursuant to the invitations, in accordance with the terms of the Greek Bondholder Act (article 1 par. 9 of Law 4050/2012).

In view of the above, the Hellenic Republic announced that it had completed the exchange of approximately €177 billion outstanding principal amount of bonds governed by Greek law pursuant to its invitations of 24 February 2012. All holders of such bonds became bound by the proposed amendments pursuant to the Greek Bondholder Act upon the respective Council of Minister's Act on Friday, March 9, 2012, for the acceptance of the consents received by the Hellenic Republic by 9.00 pm CET on March 8, 2012. By delivering the consideration described in the invitations, the Hellenic Republic discharged in full its obligations to the holders of the amended Greek-law governed bonds.

We refer below to three significant cases related to the challenging of the above measures before the (Greek) Supreme Administrative Court ('Council of State'), one of which (the second in the series) was also debated before the European Court of Human Rights (ECHR).

II. The decision of the Council of State on the Memorandum (Plenary Session, Decision No 668/2012)

The Council of State decided on constitutional issues of Law 3845/2010, by which the Greek Parliament enacted the 'Memorandum of Understanding' as well as the three partial Memoranda,[8] concluded between the Hellenic Republic, on the one hand, and the Member States of the Eurozone, the ECB, and the International Monetary Fund (the so called 'troika') on the other hand.

8. i.e. a) the 'Memorandum of Economic and Financial Policies', b) the 'Memorandum of Understanding on Specific Economic Policy Conditionality', and c) the 'Technical Memorandum of Understanding'.

The Council of State rejected the application for annulment of legislative provisions that provide for wage and benefit cuts to public sector employees, in addition to pension cuts. The decision of the Council of State regarding the Memorandum comprised two parts. The first related to the issue of its ratification by the Greek Parliament and the second to the constitutionality of the substantive measures envisaged.

First, the Council of State held that the Memorandum does not constitute an international agreement, concluded between the Hellenic Republic, on the one hand, and the 'troika' on the other hand, falling within the scope of Article 28 (2) of the Constitution, since under the terms of the above law there is no transfer of powers, for which, under the Constitution, the Greek State (the government, the legislature, and the executive) is the only competent authority for granting powers to institutions of international organizations. Consequently the law should not have been voted by a three-fifths majority of the Parliament: a simple majority was adequate.

In the second essential part of the decision, the Court assessed the constitutionality of the measures enacted by laws 3833/2010 and 3845/2010, under the consideration that the adopted wage and benefit cuts of public sector employees in addition to pension cuts form part of a wider programme of fiscal adjustment and structural reform of the Greek economy. This entire programme, in the Court's view, is intended to address the country's economic emergency as well as its future fiscal and financial position.

The Court held that the imposition of the measures was justified because the aim was not merely to remedy the immediate acute budgetary problem, but also to strengthen the country's financial stability long term. The Council of State also referred to case law regarding reductions in salaries and pensions in several States against the same general backdrop of economic crisis. In addition, it observed that the applicants had not thoroughly claimed that their situation had deteriorated to such an extent that their very subsistence was at risk.

The Court in essence held that the measures were of pre-eminent public interest: in particular, it held that they serve, in principle, both substantial national public interest and, at the same time, the common interests of the Member States of the Eurozone, (given the obligations under EU law to maintain fiscal discipline and safeguard the euro area's stability as a whole). Such measures, by their very nature, have effect on levels of Member States' public expenditure. Given the prevailing circumstances at the time the measures were adopted, such measures could not be considered inappropriate for purpose or unnecessary, not least given that they would only be subject to marginal judicial review.

The Council of State held that the provisions at issue were not contrary to Article 1 of the First Additional Protocol nor to the principle of proportionality enshrined in Article 25 par. 1 section d of the Constitution. More specifically, the Council of State held that the non-temporary nature of wage and pension cuts was justified, since the aim of the legislature was not only to cope with the immediate severe financial crisis, but also to establish a sustainable basis for the entire financial apparatus of the State. It was also held that no breach of the property right protected by Article 17 of the Constitution, nor of the protected principle of trust, arose, provided the right to a given level of wages and pensions was not regulated by any constitutional or other provision, and the potential for differentiation in the level of wages and pensions according to circumstances was not ruled out.

As regards the alleged breach of the principle of equality in respect of the public burdens, the Court held that, in the circumstances prevailing at the time of publication of law 3845/2010, the imposition of measures cutting the pensions and wages of active employees did not breach the principle of equality enshrined in Article 4 par. 5 of the Constitution, as for the introduction of the settlement of outstanding tax affairs by law 3888/2010.

The Council of State was further invited to rule on decisions of European Union bodies relating to the 'bailout package' of Greece, as well as on the creation of a European stability mechanism to preserve financial stability in Europe. In its decision the Council of State cites substantial sections of the text constituting the so-called Greek 'bailout package', but makes no reference to the European Financial Stability Facility and expresses no concern as to whether a *de facto* amendment of the Treaty has occurred as a consequence of the Greek measures and related establishment of the Fund.[9]

III. The Decision of the European Court of Human Rights in the case Koufaki and Adedy v Greece (57665/12 and 57657/12) / Decision 7.5.2013 [Section I]

The European Court of Human Rights addressed the issue of a possible breach of Article 1 par. 1 of Additional Protocol No. 1 of the European Convention on Human Rights relating to the peaceful enjoyment of possessions as a result of the reduction in remuneration, benefits, bonuses, and retirement pensions of public servants. Two applicants challenged before the ECHR the

9. Theodora Antoniou, *The decision of the Plenary Council of State for the Memorandum of Understanding – A European affair without European approach,* 'To Syntagma' issue 1 of 2012.

above (earlier on I) austerity measures enacted by laws 3845/2010 and 3888/2010 to reduce public spending and react to the country's economic and financial crisis[10] including reductions in the remuneration, benefits, bonuses, and retirement pensions of public servants. The first applicant, Ioanna Koufaki, applied to the Court to annul her pay-slip from EUR 2,435.83 to EUR 1,885.79; the second applicant – the Public Service Trade Union Confederation – sought judicial review because of the detrimental effect of the measures on the financial situation of its members.

The European Court of Human Rights considered that the reduction of the first applicant's salary was not such that it would cause difficulties of subsistence as envisaged under the provisions of Article 1 of Additional Protocol No. 1. With regard to the above and to the particular climate of economic hardship in which it occurred, the interference at issue could not be considered to have placed an excessive burden on the applicant. As regards the second applicant, the removal of the thirteenth and fourteenth months' pensions had been offset by a one-off bonus. Substitute grounds alone did not make the disputed legislation unjustified. So long as the legislature did not overstep the limits of its margin of appreciation, it was not for the Court to say whether they had chosen the best means of addressing the problem or whether they could have used their power differently. Therefore, the European Court of Human Rights rejected the petition as inadmissible (manifestly ill-founded).

IV. Legal proceedings regarding the Greek PSI programme before the Greek Council of State

On 22 March 2013, the Council of State in plenary session discussed 28 petitions of minority bondholders for the annulment of the decision of the Council of Ministers for the enactment of the Private Sector Involvement (PSI) programme, i.e. the Council of Ministers' decision for the approval of the Greek Government Bonds' (GGBs) swap, implementing also the application of CACs and the Bank of Greece Act confirming the results of the GGBs' holders voting process.

The 28 petitioners were natural persons (Greek and Foreign bondholders), public legal persons and Social Security Funds, private companies, suppliers of the Greek State (notably pharmaceutical companies) as well as former em-

10. Previously judged before the Greek Council of State by the above mentioned Decision No 668/2012, which rejected several arguments based on the alleged breach of the principle of proportionality by the disputed measures, considering that the salary and pension reductions were not purely provisional measures.

ployees of Olympic Airways who received GGBs as a 'compensation' within the meaning of labour law, after their labour contracts were terminated within the framework of the privatisation of the national carrier.

The exchange of bonds governed by Greek Law was affected through Law No 4050/2012 (the 'Greek Bondholder Act'), enacted on 23 February 2012. This Law stipulated (a) the Invitation by the Hellenic Republic to the bondholders for the exchange (swap) of their bonds against new securities, (b) the conditions under which the modification of the terms of the eligible bonds could be adopted by the bondholders, including the introduction of CACs, and (c) the terms under which the bonds' exchange against new securities could be decided and implemented. With the invitation launched by the Hellenic Republic, bondholders of the designated bonds were invited to tender any and all of them in exchange for New, GDP-linked Bonds, GGBs and PSI Payment Notes in accordance with the terms and subject to the conditions set out in the Invitation Memorandum. Simultaneously, other invitations were launched covering, together, GGBs and titles guaranteed by the Hellenic Republic, but governed by foreign law.

Concerning GGBs governed by Greek Law (the 'Eligible Titles'), being subject to the modification / swap process, the Bondholders were called to decide collectively, within the deadline specified by the Invitation, on the proposed modification of the Eligible Titles, i.e. on *the change or the addition of terms to one or more eligible titles or the exchange of one or more eligible titles with one or more new titles*. Addressees of the Invitation were the bondholders acting through the participants registered with the System for Monitoring Transactions in Securities in book-entry form operated by the Bank of Greece (account providers).

The Greek Bondholder Act provided for the possibility to introduce, with the Bondholders' consent, a collective action clause, in order to restrain the free rider / holdout problem from appearing in the sovereign debt restructuring attempt. CACs could be activated if a quorum of at least ½ of the aggregate outstanding principal of all Eligible Titles specified in the *Invitation* was achieved (the 'Participating Principal') and a supermajority of at least (2/3) of the Participating Principal voted in favour of the modification. The Greek Bondholder Act did not impose new terms on the bondholders and an exchange of bonds was not compulsory. Modification was voluntary: the decision for modification and/or exchange rested solely with the bondholders. But the Act provided for the bond loans' terms to be amended by qualified majority and specified quorum: the previous requirement of bondholder unanimity, was abandoned.

The main legal ground put forth for the annulment was breach, as a result of the Greek Bondholders Law 4050/2012 introducing the Collective Action Clauses (CACs), of: (1) individual rights under the Greek Constitution and, explicitly, infringement of the right to property, the principle of equality, the justified reliance in on a fair public sector, the proportionality principle, and the freedom of contract; (2) individual rights arising from the European Convention of Human Rights (ECHR) and the EU Charter of Fundamental Rights (EUCFR); (3) bad use of discretionary power (in conjunction with breach of the principle of equality). The Court decision is still pending.

With respect to the jurisdictional grounds of rebuttal presented to the Court, the first issue raised was the disputed competence of the Council of State. The basic arguments were the private – and not administrative – law nature of the challenged acts, the fact that the Hellenic Republic as GGB issuer was no different from any other corporate issuer in distress, and was not in the exercise of its public power, and the role of Bank of Greece, which acted in the whole PSI process as 'fiscus' (as any other private sector CSD) and not as an authority exercising public power (BoG received orders of participation to the PSI program, calculated and affirmed participation percentages, erased the initial bonds from the accounts of its System and registered the New Bonds).

As to the petitioners' argument on breach of freedom of contract and economic freedom, the issue raised, in this regard, is whether the CACs activation should be considered as a measure of state intervention or as recovery measure in the framework of restructuring procedures.

The bondholders' arguments were the illegal intervention by the legislator, by means of the retroactive insertion of CACs in pre-existing contracts (bonds) without the consent of the bondholders and the CACs changing the terms of pre-existing contracts retrospectively.

The counter arguments were the non-retroactive imposition of CACs and their voluntary nature. The exchange of old bonds to new bonds was not compulsory since the holders of Eligible Titles were invited to tender any and all Eligible Titles in exchange for New Titles. The bondholders voted for the modification of the bonds' terms through the insertion of CACs: they decided to accept the majority rule and exchange the old bonds with new bonds in accordance with the majority principle. CACs were necessary and, from this point of view, in conformity with the proportionality (stricto sensu) principle, in order to cope with the free rider/holdout and the moral hazard issues. The CACs updated old-fashioned loan schemes and delimited possible speculative actions. In that sense, it has been argued that without CACs the bondholders would have had to pay a higher price.

As to the petitioners' argument on *deprivation of property* against a) the principles of the Constitution, demanding full compensation upon Court Decision, and b) the Human Rights Convention, the counter arguments were the following:

a) No deprivation by means of public act occurred, rather than a change of GGB's terms through contractual means upon the Bondholders' qualified majority decision to change the contractual relationship' structure of the bondholders with the issuer and the bonds' terms.
b) The fact that the haircut was not harmful to the bondholders' interests, given the rather unlikely perspectives of the issuer fulfilling its obligations without such restructuring and also the fact that if restructuring failed, the bondholders would probably lose more (if not all) of the value of their bonds, especially in the likely case of a Greek 'bankruptcy' or exit from the Eurozone.
c) New Bonds delivered to the bondholders constituted adequate, prompt, and effective compensation because the property of the bondholders had not been reduced or unfairly reduced: new bonds had, in essence, at least the same market value as the old ones on the day when the exchange took place, as well as a better rating.
d) The valuation method and procedure was reasonable, since the respective decision was taken by the supermajority of bondholders and, thus, had to be considered fair, given the circumstances.
e) Bondholder's interest was protected, considering the consequences of a possible disorderly insolvency on the value of the old bonds.

Therefore, the counter arguments were that PSI and CACs procedure was fully balanced and justified taking into account the pre-eminent public interest involved, prevailing over individual rights to property.

A further petitioner's argument was the *breach of the principle of equality*, since the Greek Government excluded from the PSI the Treasury Bills and, indirectly, provided different treatment for GGBs held by the Eurosystem: the invitation addressed to bondholders for the exchange of bonds did not include bonds held by the ECB and the National Central Banks, since those bonds were previously substituted by other bond series. The Greek State and the Bank of Greece argued as follows on these points:

a) The exclusion of Treasury bills of six and three months duration was essential, since these titles constitute money market instruments and are intended to cover short-term cash needs of the issuer. They differ in qualitative terms, as to their maturity, from the other titles with a maturity of over one year which are identified as capital market instruments. This differentiation is reflected in secondary EU law, in relation to the risk weight of titles depending on their duration. Moreover, the exclusion of treasury bills from the exchange programme was necessary for practical reasons: their inclusion in the exchange program would have meant that nobody would acquire treasury bills of three or six months duration in the last six months prior to the restructuring of the public debt, announced as an option in July 2012. As a result, the public would have been unable to cover short-term needs. It is, moreover, international practice for short-term money market instruments, such as treasury bills, to be excluded from restructuring programs.

b) Further, it was argued that the different treatment of GGBs held by Eurosystem NCBs was justified by the purpose for which such GGBs were acquired by the Eurosystem. Such purpose was identified as the serving of the public interest and the objectives of the European Union, in the context of the monetary policy of the Eurozone. By contrast, the investments of other bondholders were profit driven. Thus there was an essential difference between the reasons behind the Eurosystem GGBs purchases in the secondary market and those of the other bondholders, which justified different treatment.

Question 10

As Greece is a Member State of the Eurozone, the question is not applicable.

Monetary policy

Questions 11, 12, and 13

Following the introduction presented under the Answer to Question 2, Section 1 reviews the architecture of the overhaul of EMU by the EC. Section 2 scrutinises the policies pursued as to whether they lead to real convergence or divergence. Sections 3 and 4 analyse the role of demand management in reducing the amplitude of business cycles and enhancing real convergence. In particular, Section 3 analyses the role of fiscal policy for a Member State and Section 4 suggests how the statutory objectives of the ECB should be redefined. Section 5 summarises and concludes.

I. The architecture of the overhaul of EMU

The peripheral sovereign debt crisis is a core banking crisis in disguise. The single currency brought about significant divergence in competitiveness and growth between the core and the periphery. This was manifested in growing current account deficits in the periphery, the mirror image of which was current account surpluses in the core. Core banks recycled these surpluses in the form of loans to the periphery. The borrowing appetite of the periphery was huge as they made a one-off adjustment from the high real interest rates of the pre-monetary union era to the low interest rates of the single currency era.

This borrowing appetite financed housing bubbles in Spain and Ireland and a state bubble in Greece, an unprecedented event. Portugal did not go on a credit spree, but nonetheless was condemned to a permanent erosion of living standards in the first ten years of EMU as productivity fell behind the core.

The periphery sovereign debt crisis was an accident waiting to happen with increasing probability through time, a transformation of the previous international debt crisis of 2007-08. Governments bailed out their financial system and pursued easy fiscal policy to fight the recessionary impact of the 2007-08 crisis, thereby giving rise to the sovereign debt crisis by exposing themselves to the threat of insolvency.

The overhaul of EMU attempts a full economic, banking, fiscal, and political union through budgetary surveillance, economic policy surveillance, financial regulation and supervision, and crisis resolution mechanisms. Budgetary surveillance seeks strict control of the Stability and Growth Pact (SGP) to ensure sustainable public finances. The SGP has been reinforced by introducing a spending rule anchoring public expenditure to potential output; and by the launch of the Excessive Deficit Procedure (EDP) to prevent unfavourable trends in public debt and budget deficits. The approach differs from the past tradition of peer pressure and recommendations: it envisages punitive sanctions for divergence from the guidelines. The economic policy surveillance is armed with a new Macroeconomic Imbalances Procedure (MIP) and a new Excessive Imbalance Procedure (EIP) to prevent real divergence escalating to a crisis.

The budgetary and economic surveillance programmes would effectively deny a Member State the use of fiscal policy to counter even cyclical divergence in real magnitudes arising from adverse asymmetric shocks or from common external shocks that hit each country differently. Austerity measures aiming to enhance competitiveness by cutting wages and prices (internal devaluation) would be imposed on an economy that develops economic imbalances or attempts to ameliorate the economic and social effects of a cyclical weakness by expanding the productive capacity of the economy through fiscal policy or improving infrastructure and strengthening sectors with competitive advantage.

The overhaul by the EC will make poor countries even poorer (widening the income inequality between Member States) by sacrificing their existing productive capacity (a reduction of potential output) on the altar of futile economic efficiency. To escape lower living standards the able part of the labour force will emigrate, further undermining the capacity of the country to recover. Higher unemployment and lower wages for the remaining labour force will widen income inequality within a country. The envisaged overhaul is an unsustainable path to remaining in EMU and will be exploited by nationalist political parties favouring isolation over EU economic, social, and political union.

Financial regulation and supervision aim to make financial markets and institutions more stable, more competitive and more resilient to shocks, by increasing the required capital base of banks and improving the quality of assets that comprise the capital base (CRD4/CRR). Micro-prudential and macro-prudential regulation and common resolution rules would ensure that bubbles would not be created in the future.

Yet, the downside is also evident. In the upswing of the cycle (the first ten years of EMU) financial integration meant under-pricing of risk and easier monetary conditions for Member States with booming economies and high inflation. In the current downswing there is overpricing of risk in the periphery with tight monetary conditions that exacerbate the austerity programmes. The financial fragmentation that has emerged will consequently persevere in the future, with core countries facing easy monetary conditions and periphery countries tight monetary conditions. As monetary policy is conducted on the basis of average market conditions, the rising inflation in the core would necessitate tight monetary conditions that would further restrict the ability of the periphery to recover.

The overall conclusion is that the suggested overhaul would not simply deter bubbles in the periphery in the future, but would also exacerbate the vicious circle of tight monetary and fiscal policy in the periphery leading ultimately to the disintegration of the euro.

II. Policies for real convergence

The intellectual basis of EMU rests on the pillars of the Efficient Market Hypothesis (EMH) and the New Consensus Macroeconomics (NCM) or Neo-

Wicksellian models. According to EMH all unfettered markets clear continuously thereby making it highly unlikely that disequilibria, such as bubbles, would ever arise. Markets, so goes the hypothesis, are self-regulating, efficient, and self-correcting and therefore trusted to impose discipline on the extravagance of periphery governments. In NCM models Say's law is not valid in the short run, but holds true in the long run: demand ultimately adjusts to supply (or potential output). The latter is determined by factors exogenous to the system, such as multi-factor productivity and the growth rates of the labour force and capital. None of these supply factors are affected by monetary and fiscal policy (policy neutrality).

This view of the world has downgraded the importance of fiscal policy in demand management and has given legitimacy to SGP and the architecture and governance of the new EMU. In this framework, the role of fiscal policy is to balance the budget and reduce the share of public debt in GDP to enable markets to work more efficiently. The existence of temporary nominal rigidities in the form of sticky wages, prices, and information, or some combination of these frictions, permits monetary policy to have an effect on inflation both in the short and the long run, but not on output and unemployment in the long run.

The experience at least in the 21st century casts doubt on this view of the world. 'In the age-old discussion of the relative roles of markets and the state, the pendulum has swung – at least a bit – toward the state' (Blanchard, 2011, p1). Stiglitz (2011) commenting on the need to reform the NCM, argues along similar lines: 'They failed to predict the crisis; standard models even said bubbles couldn't exist – markets were efficient. Even after the bubble broke, they said the effects would be contained. Even after it was clear that the effects were not 'contained', they provided limited guidance on how the economy should respond. Maintaining low and stable inflation did not ensure real economic stability. The crisis was 'man-made'. While in standard models, shocks were exogenous, here, they were endogenous'. (p. 1).

The crisis has revealed the deficiencies in the original design of EMU. In particular, three negative loops have emerged that threaten the euro with disintegration. The negative loop between sovereigns and banks, where insolvent banks make the sovereign insolvent; and vice versa. The negative loop between deposits and banks, where the risk of redenomination induces flight of deposits from the periphery to the core exacerbating the financial fragmentation. The negative loop between austerity and debt sustainability, where the deeper the austerity programme, the more unsustainable the debt.

The importance of breaking the first two negative loops has been recognised, but not of the third – at least not to the level that it has elicited a call for immediate action. The consensus now accepts the old criticism that a monetary union cannot survive without a fiscal union. The second negative loop requires a banking union. The debate is now raging as to whether or not Europe should proceed first with a banking or a fiscal union with the second union delayed until convergence on budget deficits and debts and political union have been achieved. This is a futile debate stemming from mistrust between the core and the periphery. The core fears that the periphery would indulge in a spending spree, passing the bill to the core, and aims to redesign EMU to prevent this from happening again in the future. The periphery fears that austerity is used by the core to exploit the periphery. But where there is a will there is a way. A compromise can be reached where the fears of both parties can be assuaged.

The hitherto experience of EMU has shown that the Efficient Market Hypothesis is discredited. Financial markets far from being efficient, have contributed to the crisis by lending to governments and the private sector of the periphery at an increasing pace until the crisis. As risk was underpriced in the first ten years of EMU, risk is now overpriced condemning the periphery to destitution, thereby increasing the likelihood of a euro disintegration. This calls for more not less mutual state support.

It is to the credit of European leaders that they have stood up to this challenge, although more work needs to be done. The new architecture for the EMU is backward looking. It attempts to close the loops of periphery governments' and banks' extravagance in an effort to avoid another crisis. But the risk has now shifted from one of inflation and excessive spending to one of deflation. It is deflation that now threatens to break up the euro. The new architecture should be at least balanced, if not biased, to address the forward risk of deflation.

The validity of the NCM models, which formed the intellectual basis for the conduct of monetary and fiscal policy in the first ten years of monetary union, has been questioned by the crisis itself. The reformulated NCM model can address both the inflationary and deflationary risk (see Arestis and Karakitsos, 2013, Karakitsos, 2008, 2009).

The revised NCM model can be of use in guiding policies that would ensure real convergence in the long run. The core-periphery divide is most of the time said to be structural in nature. For example, high unemployment in Spain is thought to be structural. This premise has its roots in the notion embedded in the original NCM models that demand adjusts to an exogenous supply (Say's law holds true in the long run). Yet, this is not true. A deep and protracted recession destroys the productive capacity of an economy by the closure of companies; it does not simply result in a change of ownership.

Therefore, though supply adjusts to demand, it is not exogenous as assumed in the NCM models. The destruction of productive capacity would make the resulting unemployment look structural, when in reality it is the result of low demand. This was also the case in the 1980s when high unemployment in Europe was attributed to euro-sclerosis (high minimum wages, inflexible labour markets, and a welfare state). But when German fiscal policy was eased to tackle the unification issue, unemployment in the whole of Europe fell. The problem of high unemployment was not euro-sclerosis, but deficient aggregate demand.

Supply responds to demand not only in the downswing, but also in the upswing. The prospect of profits would expand the productive capacity and this depends on demand. If the demand outlook is poor, companies will not invest and supply will not expand. Thus, in both cases supply adjusts to demand and not the other way round. Say's law is invalid, not only in the short run, as assumed in the NCM models, but also in the long run. Hence, real convergence requires policies that promote growth as demand drives supply.

It is further argued that growth depends on competitiveness, which, in turn hinges exclusively on wages and prices. This is a very narrow interpretation of competitiveness. It would be a mistake to assume, for example, that Greece would become competitive if wages and salaries were lowered to China's levels. For good or bad, Greece bypassed the industrialisation phase of development and its highly educated labour force is used predominantly in services. Forcing lower wages to make Greece more competitive would simply lead its more able skilled labour force to leave the country, a trend that is already in progress. This would lead to further real divergence, not convergence, and ultimately condemn Greece to poverty.

The overall conclusion is that growth should be the number one policy priority to promote real convergence within the monetary union.

III. Fiscal policy in demand management

The theoretical ineffectiveness of fiscal policy on demand rests on the Ricardian Equivalence Hypothesis (REH). In the REH the impact on real GDP of a higher budget deficit, triggered by an increase in public spending or lower taxes, is fully offset by a corresponding increase in private savings even in the short run. According to the REH, households view the increase in budget deficit today as an increase in taxes in the future to balance the budget and adjust their behaviour to neutralise the impact of fiscal policy. There are two extreme assumptions in the REH. First, that households are infinitely lived and assign equal priority to the present and the future. Second, the REH ignores the self-financed element of an increase in budget deficit.

With the exception of a tiny minority, the economics profession at large accepts that fiscal policy is an effective tool of demand management. Fiscal policy aims to influence the level of demand in the economy so that it can reduce the amplitude of business cycles. In particular, fiscal policy should be tight when the economy grows faster than potential (i.e. when GDP growth exceeds the rate of growth of potential output) and easy when the economy is in recession or operates with spare capacity (GDP growth less than potential). In the short run, the fiscal multiplier is slightly greater than unity for most economies, implying that a one percent change in the budget deficit affects output (real GDP) in the same direction by a little bit more than one percent. The balanced budget multiplier (an increase in spending matched by a corresponding increase in taxes so that the budget deficit remains unchanged) is positive and not zero as implied by the REH.

There are five remarks regarding the use of fiscal policy in demand management. First, policymakers should never attempt to balance the budget (through austerity measures) when the economy is in recession or with spare capacity because they thereby negate their own efforts to stimulate the economy. Unfortunately, this is exactly how Europe has responded to the credit crisis. Second, the fact that easy fiscal policy would increase the budget deficit and public debt is not prima facie evidence against using fiscal policy when the economy is in recession. It simply becomes imperative to tighten fiscal policy when the economy is booming, as otherwise public debt would be increasing in successive business cycles. At some point in time, when public debt is high capital markets would refuse to provide any additional borrowing to the government making it insolvent, such as occurred with Greece and the other periphery countries in Europe. Third, even if the government does not become insolvent for a long time, like Italy, the economy is operating less and less efficiently the higher the share of government in GDP. Therefore, it is imperative that fiscal deficits created in the downswing are corrected in the upswing of the cycle. Otherwise, the debt will continue to soar, thereby making insolvency unavoidable in the long run. Fourth, an inefficient economy will result even if the government always uses a balanced budget stimulus, because on each stimulus the share of the public sector in GDP increases. Fifth, there is a trade off between the short to medium term impact and the long-term effects of fiscal policy. Easy fiscal policy boosts output in the short to medium term, but has a negative impact in the long run by cutting the rate of growth of potential output.

The negative impact of fiscal policy in the long run stems from its influence on potential output. The latter depends on the size and quality of the labour force, on the stock of productive capital (such as factories, vehicles, and computers), and on the efficiency with which labour and capital are used to produce goods and services – otherwise called multi-factor productivity, which is the joint productivity of labour and capital. Fiscal policy affects potential output by influencing the amount of national saving and hence the supply of capital in the long run. A budget deficit represents negative public saving, but it can also influence private saving. Larger deficits would imply less public saving, but that would induce a small increase in private saving, as a result of higher interest rates and increases in disposable income, which can boost both spending and saving. This positive increase in private saving is not sufficient to offset the reduction in public savings and therefore national saving declines. The consensus estimates of the negative impact on GDP through lower potential output are between -0.5 % and -1 %. Therefore, unless policy is reversed in the course of the business cycle, the overall effect is zero to negative. This gives legitimacy and credence to the SGP in the long run, but no excuse for applying it in the downswing of the business cycle or demanding immediate adjustment in countries with high budget deficits and public debt.

The use of fiscal policy in demand management at the federal level requires a fiscal union with a strong fiscal budget. The small EU budget is a testament of the inability to use fiscal policy at the federal level. It is utopian to believe that countries should first converge in deficits and debts before a federal fiscal authority can operate and debt mutualisation occur. The risk is high that EMU would not see the day of convergence. It would simply collapse under the burden of current hardships and the high probability of another financial crisis within the next five years.

A pragmatic approach is for Member States to be allowed to use their own fiscal policy. The finance can come from a balanced budget multiplier or by drawing from an insurance fund,[11] or finally from financial transfers from the

11. The concept of an insurance fund was introduced by Notre Europe, a think tank under the guidance of Jacques Delors, and Gaynor and Karakitsos (1997) to alleviate the effects of endogenous asymmetries or macroeconomic imbalances (see also Completing the Euro: Report of the Tommaso Padoa-Schioppa Group, June 2012). The insurance fund would operate outside the EU budget and it would be financed by Euro Area Member States. Countries would have to pay a standard amount in good business cycles and proportionately more when they are overheated. The insurance fund is not an

core for a short period of time, subject to strict conditionality for long term convergence of budget deficits and public debts.

IV. Monetary policy in EMU

In NCM models inflation is a monetary phenomenon and therefore price stability can be achieved by central banks changing nominal short term interest rates. These models combine intertemporally optimising agents from the real-business-cycle school with imperfect competition and nominal rigidities from traditional Keynesian models, thereby achieving maximum consensus within the economics profession; hence the acronym. Woodford (2003) has described these models as Neo-Wicksellian, because changes in *nominal* interest rates affect *real* interest rates due to nominal rigidities. These changes in real rates affect output (real GDP) and hence inflation. As the NCM models are derived from intertemporal optimisation, the emphasis is on the interdependency between current economic variables and expectations about their future realisations. Thus, current output and inflation depend upon the entire path of expected future interest rates. This feature has had a significant impact on the theory and practice of monetary policy, as it assigns a major role to the management of private sector expectations and, consequently, to the credibility of the central bank as an important element in anchoring inflation expectations (see, for example, King, 2005; Weber et al, 2008).

Neo-Wicksellian models adopt all the principles of the original Wicksellian theory. Money is neutral in the long run, not because money is a 'veil', but because inflation is influenced by the interest rate gap, and not by the forces of demand for and supply of money. Say's Law does not hold in the short run; it does, though, hold in the long run. Consequently, disequilibrium in one market (money or goods) is transmitted to the other in the short run; but not in the long run. In Neo-Wicksellian models the central bank controls the rate of inflation through changes in the rate of interest, which affects the output gap – the discrepancy between an endogenous demand for goods and an exogenous supply – with the latter affecting prices and price expectations in the short run. The assumption of an exogenous supply of goods and the requirement that in the long run the output gap should be zero implies that demand is always adjusting to supply (Say's law) and ensures the neutrality of monetary policy. Monetary policy can influence the rate of inflation, but not output (or

instrument for permanent transfers, but for alleviating cyclical macroeconomic imbalances.

the growth rate of the economy) and unemployment in the long run, i.e. the Philips curve is vertical. The rate of growth is determined in the long run by supply considerations, such as multi-factor productivity, the rate of growth of the labour force, market flexibility, especially labour market etc., all of which are beyond the control of the monetary and fiscal authorities. With output converging to its exogenously given supply, unemployment will, so the model urges, always converge to its exogenously given NAIRU.[12]

The supposed validity of the NCM models gives legitimacy and credibility to ECB inflation targeting. Control of inflation will ensure that growth in the economy converges in the long run to the rate of growth of potential output; and unemployment to its exogenously given NAIRU. The ECB does not need any other statutory targets, such as output (growth) or unemployment. The validity of the NCM models also gives legitimacy and credibility to the view of an immediate fiscal adjustment programme through austerity, as in the long run it makes no difference at which phase of the business cycle the adjustment begins.

The NCM models are valid in demand- or supply-led business cycles, which were the norm throughout the post World-War II era until the late 1990s. The NCM models are not valid, though, in asset-led business cycles, which are driven by excessive liquidity.

Asset-led business cycles, like the recent one, Japan in the 1990s and the US in the 1930s, produce a larger variability in output than inflation. In the upswing of the cycle output growth surpasses historical norms giving the impression that potential output growth has increased, thus creating a general feeling of euphoria and prosperity, as it did in the second half of the 1990s in the US. But in the downswing the recession is deeper than normal, and even more important, it lasts for a long time with many false dawns, as in the case of Japan in the 1990s and the 2000s and in the US recovery after the 2007-09 recession. As asset prices fall the past accumulation of debt becomes unsustainable as households, banks, and businesses engage in a debt reduction process by retrenching – asset and debt deflation. This depresses demand putting a new downward pressure on asset prices thus creating a vicious circle – a balance-sheet recession. The policy implication is that in asset-led business cycles guiding monetary policy by developments in inflation alone will not

12. NAIRU is the non-accelerating inflation rate of unemployment, a steady rate of inflation associated with equilibrium in the labour market, which nonetheless implies a natural rate of unemployment. This level of unemployment, though, is purely voluntary. The hardship of unemployment in the real world is therefore self-inflicted.

prevent the bubble from becoming bigger than otherwise. Monetary policy should be formulated with at least two targets: inflation and the output gap.

Excessive liquidity has financed a series of bubbles in the first ten years of the new millennium – internet, housing, commodities, and even a state bubble in the case of Greece – and minor ones in terms of their macroeconomic impact – private equity and shipping. This excessive liquidity was created gradually following the deregulation and financial liberalization in the US and the UK in the 1970s and 1980s, a process that spread to the rest of world. This laid the foundations for financial engineering, which went into an overdrive with the repeal of the Glass-Steagall Act in 1999. In this environment, as King (2009) suggests 'inflation targeting does not guarantee stability of the economy as a whole' and 'inflation targeting is a necessary, but not sufficient condition for stability of the economy as a whole' (p. 5; see also Bean et al, 2010). Therefore, the conclusion is that financial stability and monetary policy should be the responsibilities of the central bank – a feature that is recognised in the Blueprint of the EC. Such an additional target, though, requires that the ECB augment its statutory targets to include, in addition to price stability, the output gap and probably asset inflation. The justification of these additional targets follows from a reformulation of the NCM models to account for their deficiencies. Arestis and Karakitsos (2013) allow for an endogenous potential output by an explicit consideration of the capital accumulation process; an endogenous natural rate of interest as the real profit rate reinstating the original insight of Wicksell; the introduction of wealth effects in consumption to account for the impact of excessive liquidity on the spending and saving decisions of households; and an explanation of housing and financial wealth.

In the reformulated NCM model a central bank that targets inflation and the output gap succeeds in achieving financial stability. However, such a response leads to instability in a highly leveraged economy, as has been the case in the 21st century (see Karakitsos, 2009). In a leveraged economy the response of net wealth to interest rates and profitability is elevated; in fact, the more leveraged the economy, the higher these sensitivities. A high response of net wealth to interest rates and profitability would prolong the credit crisis, as the central bank is forced to move interest rates up and down the target rate. An ever increasing response of net wealth to interest rates and profitability makes the system unstable and the economy never converges to its initial steady-state, following a temporary credit crisis. The oscillatory central bank behaviour, which ultimately causes instability, is due to the cyclical pattern of profitability. Given the differential speed of the economy to a change in interest rates and profitability, with the former impacting slowly while the latter rapidly, central bank action would delay, if not cause instability, leading to a credit crisis. This differential speed of adjustment is not just a feature of the reformulated NCM model, but a stylised fact of the real world and especially of EMU. Given that the real profit rate plays an important role in stabilising the economy, as it moves faster than interest rates, and given the influence of the interest rate on the real profit rate, which is responding to economic developments, it is not unreasonable that the central bank may destabilise a highly leveraged economy. Arestis and Karakitsos (2011) and Karakitsos (2008) show that this instability can be avoided if the central bank has a mild target for net wealth, in addition to the traditional targets of inflation and output gap. A mild net wealth target is equivalent to an asset inflation target in a way that does not impede the functioning of free markets and does not prevent 'good' financial innovation. It is also better than the overregulation envisaged by the Blueprint of the EC. Since securitization implies the transfer of assets and the risk to the personal sector, the ideal target variable for a central bank is the net wealth of the personal sector as a percent of disposable income, which is a stationary variable and for which a target range can be set. A net wealth target implies that the central bank would tighten monetary policy via hiking interest rates when net wealth exceeds a particular threshold and loosen monetary policy when net wealth falls below the target level. In this way the central bank will monitor the implications of financial innovations as they impact net wealth, even if it is ignorant of these innovations as in the case of Structured Investment Vehicles (SIV), which were responsible for the creation of excessive liquidity leading to the credit crisis. With a wealth-target the central bank will act pre-emptively to curb an asset upswing cycle from becoming a bubble.

Although the introduction of additional targets would take care of the conduct of monetary policy at the federal level, it leaves open the question of how the ECB should tackle the existing fragmentation of the financial system, where monetary conditions are not uniform. In the periphery they are tight with the cost of money being hundreds of basis points above the ECB target rate; in the core monetary conditions are easy.

The ECB has introduced a number of measures, such as the LTROs and OMT and has provided justification for its special measures by invoking the need to:

- safeguard the monetary policy transmission mechanism in all countries of the euro area;
- preserve the singleness of ECB's monetary policy;

- ensure the proper transmission of ECB's policy stance to the real economy throughout the area;
- address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro. If not addressed, these conditions would have severe consequences for the maintenance of price stability.

But legal doubts remain and the Bundesbank has opposed OMT as it runs against the prohibition of monetary financing for Eurosystem central banks. Art. 123 of the EU Treaty prohibits the Eurosystem from making 'direct purchases of public debt instruments'. Moreover, an implementing Council Regulation prohibits the circumvention of such prohibition in cases of secondary market purchases. This calls for a revision of the legal framework within which such special measures would be undertaken.

V. Conclusions

The first fifteen years of the monetary union have been very turbulent. In the first ten years the divergence in real magnitudes between periphery and core favoured the periphery, as core banks recycled the current account surpluses into loans to the periphery. This liquidity financed bubbles in the periphery, which masked the real divergence and created a chimera of euphoria based on utopia. Since the eruption of the sovereign debt crisis the real divergence has continued, as liquidity has dried up and austerity has been imposed in the periphery, while the euphoria has evaporated.

The aim of EMU is to provide a framework in which the peoples of the EU Member States can prosper. This aim can only be served if the central objective of policy is to promote growth and employment within price stability for all Member States. Mistrust between the core and the periphery has resulted in a divergence from this objective. The new architecture and its governance are focusing on a system that would identify and monitor real divergence between Member States and take measures to prevent the divergence from growing to levels that would trigger another crisis. The measures are punitive in nature as they imply austerity through corrective action on fiscal and monetary policy as applied to periphery Member States.

Mistrust leads to a Nash equilibrium, as Member States adopt the worst strategy for themselves in ignorance as to what the others would do – the prisoner's dilemma. The Nash equilibrium implies the break up of the euro. This can be avoided by coordination and collaboration that would result in a Pareto equilibrium. This requires compromise between the two parties.

Basic models can provide the principles of this compromise and be a guide for the architecture of the overhaul of EMU. These basic models reject the EMH and the basic tenets of the NCM models, which served as a framework of the old deficient structure and the basis of policy.

The vision of an economic, monetary, banking, fiscal, and political union need not be accomplished in small steps or at once. Real convergence between Member States would make sure that the electorate would endorse this vision when it comes to decide. But at the moment we are building on growing real divergence.

Fiscal policy should be allowed to operate as a tool of demand management either by an individual state or in small steps at the federal level. The small EU fiscal budget is a testament to the inability at the federal level to exercise fiscal policy. It is of secondary importance whether the fiscal stimuli in the periphery should be financed with a balanced budget or by financial transfers from the core to the periphery or a mixture of both. The issue of debt mutualisation and of a fiscal union is again blurring the central issue that the periphery must return to growth. These issues are putting the cart before the horse by ignoring that the central issue is real convergence.

The imposed austerity on the periphery violates the principles of a wise use of fiscal policy in demand management. Budget deficits should be cut and public debt should be trimmed to sustainable levels when the economy is in recovery or booming. Imposition of austerity when the economy is in recession creates a deflationary spiral that imposes unnecessary hardship and impoverishes a nation. This has destroyed the mutual support system, without which no union can survive. The fiscal adjustment of the periphery should be spread between business cycles rather than imposed immediately irrespective of the state of the economy in the business cycle. The compromise of the periphery is to adopt conditionality for the privilege of being allowed to use its fiscal policy in demand management. The core can set the conditions that would satisfy them, but it is the responsibility of its leaders to sell it to their people.

The statutory objectives of the ECB should be enlarged to include at least the output gap and maybe an asset inflation target in the form of a mild net wealth target as a proportion of the disposable income of households, on top of price stability. The financial fragmentation should be dealt with by giving legitimacy to the special programmes of the ECB.

Question 14

The European Treaties adopt general terms with a view to establishing policies and fundamental principles. Such indefinite legal terms produce non-resolvable indeterminacy by the interpretative task and inevitably create the need for values' and interests' weighing between, on the one hand, the fundamental principles inherent to those terms and, on the other hand, their practical impact. The fact that the EU Treaty establishing the common currency did not provide for tools and means for managing potential pathology and for tackling euro crisis phenomena, gives rise to the need for creative interpretations by the Court of Justice of the European Union, in order to fill the gaps of the Treaty, not only by rendering monetary and economic policy principles consistent with each other but also with the multitude of the fundamental European principles, and safeguard thus the cohesion of the European Union and of the Eurozone. Such creative flexibility has been shown in the Pringle judgment and it is very likely that it will be manifested again in the future in cases relating to monetary and economic policy issues.

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