There is little legal basis for Wolfgang Schäuble's claim that debt restructuring is incompatible with euro membership

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One of the key legal arguments in relation to the Greek debt crisis is whether a restructuring of Greece's debt would be compatible with the rules contained in the EU's treaty framework. **Carsten Gerner-Beuerle** *writes that while several actors, notably the German Finance Minister Wolfgang Schäuble, have argued that a debt cut is incompatible with membership of the Eurozone, there is no consensus on this principle and the interpretation taken by the European Court of Justice in other cases suggests that debt relief may be covered by the treaties.*

Time and again the German government has emphasised that European monetary union is about rules-based governance, that these rules are designed to prevent irresponsible borrowing and lending decisions and reinforce the market mechanism in pricing sovereign debt. This reasoning underlies the leaked internal position paper of the German finance ministry of 10 July 2015 commenting on the Greek debt proposals of the previous day.

Indeed, the paper explicitly mentions one of the cornerstones of the regulatory framework of Economic and Monetary Union, the so-called 'no bail-out clause', laid down in Article 125 of the Treaty on the Functioning of the EU (TFEU). Art. 125 TFEU states, in relevant part, that Member States 'shall not be liable for or assume the commitments of… another Member State'. From here, a seemingly compelling, if somewhat merciless, logic unfolds in the position paper.

Two ways forward are identified: Either Greece remains in the Eurozone, in which case the country's immense debt burden cannot be restructured because any debt relief would be in violation of Art. 125 TFEU. Therefore, Greece is required to undertake strenuous efforts to attain debt sustainability in other ways, including the hiving off of 50 billion euros of 'valuable Greek assets' to an external fund, which would then sell the assets and use the proceeds to pay down the debt. Alternatively, Greece exits the Eurozone (the paper speaks of a 'time-out' of five years) so that debts can be discharged or restructured outside the confines of the monetary union.

While the choices are harsh – continuation of Greece's membership in the Eurozone, but far-reaching privatisations and a considerably more extensive loss of sovereignty than under prior proposals and assistance arrangements, or alternatively, exit from the Eurozone, but debt relief – the paper is ostensibly candid and drafted with the desire to find a solution to an extraordinarily complex political and economic problem within the constitutional constraints of a Eurozone based on the rule of law.

Greece, of course, has made it abundantly clear that it wishes to remain within the Eurozone, which leaves the Greek government with one choice only. However, following the logic of the position paper, this is not a function of blackmail, as alleged by some commentators, but of the necessity to uphold the rules-based framework of monetary union, without which it could not function properly.

By the same reasoning, German finance minister Wolfgang Schäuble continues to emphasise that a Greek exit from the Eurozone would be the better option after agreement was reached at the Eurozone summit of 12 July. Schäuble stated that Greece's debt could then be restructured, while a 'debt cut is incompatible with membership of the currency union'. Indeed, as has been reported in the financial press, Berlin has signalled that 'Germany would generously support Athens, including with a debt cut' in the case of a Grexit.

The problem with this logic is that it is based on a false premise: that there is one evidently correct interpretation of Art. 125 TFEU, and this interpretation prohibits debt relief of a Eurozone Member State. The legal questions are by

no means settled, but a leading decision of the Court of Justice of the EU on a related matter, the compatibility of ESM assistance with Art. 125 TFEU, gives some guidance.

Wolfgang Schäuble, Credit: EU Council Eurozone (CC-BY-SA-ND-NC-3.0)

In *Pringle*, the Court explains that Art. 125 TFEU 'is not intended to prohibit either the Union or the Member States from granting any form of financial assistance whatever to another Member State'. The Court therefore distinguishes between the assumption of an existing commitment and the creation of a new one. The latter is in line with the Treaty, 'provided that the conditions attached to [the] assistance are such as to prompt that Member State to implement a sound budgetary policy.' Thus, neither financial support in the form of a credit line or loans, nor purchases of government bonds on the primary market amount to the assumption of a Member State's existing debts. Similarly, the purchase of bonds on the secondary market is not in breach of the no-bailout clause because the price paid is determined by the 'rules of supply and demand on the secondary market of bonds', i.e. the risk of default is presumably already priced in.

It is controversial whether Art 125 TFEU should be interpreted as literally as the quotes above seem to indicate (for an overview of this debate in the German literature, see the contribution by Eberhard Grabitz, Meinhard Hilf and Martin Nettesheim here). The Court itself in *Pringle* may be interpreted as raising some doubts when it mentions that under the ESM Treaty, 'any financial assistance… must be repaid to the ESM by the recipient Member State and… the amount to be repaid is to include an appropriate margin'.

However, it is clear from the judgment that the permissibility of assistance measures should be assessed against the objective of Art. 125 TFEU. The provision is intended to address the problem of moral hazard that arises when debts are mutualised by incentivising Member States to maintain budgetary discipline. To achieve this aim, it is essential that the Member State is subject to market discipline *ex ante*, i.e. the market does not price government bonds on the basis of the expectation that the Member State will receive financial assistance when it experiences a liquidity crisis. On the other hand, whether the ESM is repaid in full, and whether it charges an appropriate margin, does not influence the expectations of the market and, hence, the incentives of Member States to maintain budgetary discipline before a liquidity crisis occurs.

These ambiguities of *Pringle* notwithstanding, the interpretation of the Court of Justice is, of course, binding on the Member States. For several reasons, the Court's decision suggests that debt relief is covered by the Treaty. If the granting of financial assistance in the form of the creation of a new debt, under strict conditionality, is not to be qualified as assuming the commitments of another Member State, it is difficult to argue that the granting of further assistance in the form of the reduction of that same debt by the same creditor, again under strict conditionality, should be judged differently. In addition, it seems to be fairly well accepted that the re-profiling of debt by extending maturities is possible under the existing legal framework. If this is the case, it is hard to understand why an operation that has the same economic effect, namely the reduction of the nominal amount owed, should be illegal.

Finally, as the Advocate General in *Pringle* pointed out, since the wording of the provision is not entirely clear, we should be mindful that one of the overarching objectives of the Union is the promotion of 'solidarity among Member States' (Art. 3(3) Treaty on European Union) which militates against a broad interpretation of Art. 125 TFEU. It may be contended that these arguments do not settle the question, but it is clearly problematic to assert that Art. 125

TFEU unequivocally prohibits the restructuring of a Member State's debts and disregard any alternative interpretation, in particular one that would promote a fundamental principle of the Union.

If this view is correct, and given that it is almost universally accepted that Greece needs to receive partial debt relief, including by the German government, one is left wondering: Why did Germany, erstwhile one of the foremost champions of European integration, adopt such an uncompromising, one-sided stance? It is not useful to engage in speculation; just one point shall be made. Whatever the underlying motivation, the real problem with the approach of the German government is that it invites the contemplation of certain uncomfortable possibilities: we read of dealings between the Member States dominated by vindictiveness, deterrence, and bullying. It is difficult to assess the truth of these claims, but the fact that we have come here does not bode well for the European project.

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