CLEARY GOTTLIEB

Alert Memo

BRUSSELS NOVEMBER 5, 2010

www.clearygottlieb.com

EU Agrees Economic Governance Changes for Eurozone

On October 29, 2010, the European Council -- comprising the Heads of State or Government of the 27 EU Member States -- issued conclusions[1] calling for a "fundamental shift in European economic governance" including the creation of a "permanent crisis mechanism" for the Eurozone to replace the European Financial Stability Facility, which was established in May 2010 and is due to expire in 2013. The European Council endorsed the report of the Task Force on economic governance entitled "Strengthening Economic Governance in the EU"[2] and called for a "fast track" approach to adopting the necessary legislation by the summer of 2011.

In its December 2010 meeting, the European Council plans to take a final decision on the outline of the crisis mechanism and on a "limited Treaty amendment" (which the European Council insists will not involve a change to the "no bail-out" clause of the Treaty on the Functioning of the European Union ("TFEU")) to allow for ratification by mid-2013.

The main outlines of the proposed changes are discussed below.

I. BACKGROUND

Monetary union in Europe began in 1979 with the creation of the Exchange Rate Mechanism ("ERM") to reduce exchange rate variability and achieve monetary stability between Member States of the European Community (as it was then). Exchange rates were based on the European Currency Unit ("ECU"), a common exchange rate based on a basket of national currencies. On December 31, 1998, ECU exchange rates were frozen, and the euro succeeded the ECU at par value on January 1, 1999. Also in 1999, the ERM II Central Bank Agreement created a second Exchange Rate Mechanism ("ERM II") for future EU Member States.

Sixteen of the 27 EU Member States, known as the "Eurozone", now use the euro as their currency. Eurozone States have transferred monetary sovereignty to EU institutions with responsibility for monetary policy, principally the European Central

1 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117496.pdf

2 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf

Bank ("ECB"), which was established by the 1997 Treaty of Amsterdam and came into existence in 1998. The ECB is now governed by the TFEU, which entered into force in 2009.

Under the TFEU, Member States' national central banks ("NCBs") remain in existence within the European System of Central Banks (the "ESCB"). The ESCB is the central banking system of the EU, and comprises the ECB and the NCBs of all EU Member States.

Eurozone members are subject to two EU Regulations that together constitute the "Stability and Growth Pact" ("SGP").[3] The SGP was designed to ensure that only EU States with sound economic fundamentals would be allowed to join the euro and thereafter to keep deficits within certain pre-agreed limits. In particular, the ratio of annual government deficit to GDP should not exceed 3% at the end of the preceding fiscal year, and gross government debt to GDP should not exceed 60% over the same period. Certain Eurozone states regularly breach these rules. Althouth the SGP provides for the imposition of sanctions on non-compliant States, such sanctions have never been applied.[4]

Article 125 TFEU (the "no bail-out" clause) prohibits either the EU itself or Member States from being liable for or assuming the obligations of other Member States. Nonetheless, on October 11, 2008, Eurozone Heads of State or Government held an extraordinary summit in Paris to agree a joint action plan with the ECB to stabilize the European economy. EU Member States agreed a 14-point program that, acting on a national basis, they would take equity shares in banks and supply additional capital and temporarily guarantee bank financing and interbank lending to ease credit markets.

On March 25, 2010, the European Council agreed on a bailout for Greece and, with the approval of the European Council, for any other country in need of it. The majority of the funds came from bilateral contributions from Eurozone members, with substantial additional contributions from the International Monetary Fund ("IMF"). In April 2010, Greece triggered the bailout mechanism and requested a €30 billion loan.

---

[3] No 1466/97 [1997] OJ L209/1, http://eurlex.europa.eu/LexUriServ/site/en/consleg/1997/R/01997R1466-20050727-en.pdf.

and No 1467/97 [1997] OJ L209/6.

http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1997/R/01997R1467-20050727-en.pdf

[4] In *Commission v. Council* the Commission brought proceedings against the Council for failing to impose sanctions on France and Germany after those countries incurred excessive government deficits. The ECJ held that while the SGP is legally enforceable, the Council was under no obligation to accept the Commission's recommendations to impose sanctions. Case C-27/04, July 13, 2004.

On May 9, 2010, the EU established the European Financial Stability Facility ("EFSF"). The EFSF is a Luxembourg special purpose vehicle governed by a Framework Agreement under English law and funded with up to €440 billion.[5] The EFSF can provide financial assistance to Eurozone States in difficulty, issuing debt backed by guarantees from Eurozone states. The interest rate charged covers only the cost of funding, with a margin for guarantors. There are no sanctions, but any money raised is only lent to Eurozone states after a restructuring program is agreed with the IMF. The EFSF will expire in 2013.

II. PROPOSED ECONOMIC GOVERNANCE CHANGES

The Task Force recommendations endorsed by the European Council can be divided into five main initiatives:

- Greater fiscal discipline. The Task Force recommends reinforcement of the Eurozone's budgetary surveillance mechanism and compliance through reforms in four main areas:
  - Broadening the SGP's budgetary surveillance mechanism to include a focus on public debt.
  - Reinforcing the SGP's sanctions regime, by creating a progressive range of sanctions and measures of a financial and reputational/political nature. Recommended financial sanctions range from interest-bearing deposits to fines. The medium-term objective would be to cover all EU Member States, but a two-stage approach, starting with the Eurozone, is considered more pragmatic.
  - Introducing a new decision-making procedure, including reverse majority rule for the adoption of enforcement measures. In practice, Commission recommendations would be adopted unless a qualified majority of Member States in the Council votes against within a given deadline.
  - Adopting an agreed set of minimum requirements for national fiscal frameworks -- covering public accounting systems and statistics, numerical rules, forecasting systems, medium-term budgetary frameworks and general government finances -- to be implemented no later than the end of 2013, followed by non-binding additional standards covering the use of top-down budgetary processes, fiscal rules and the role of public bodies.

[5] http://www.efsf.europa.eu/attachment/efsf_framework_agreement_en.pdf; http://www.efsf.europa.eu/attachment/faq_en.pdf

- Broader economic surveillance. The Task Force recommends the introduction of a new legal framework for economic surveillance alongside the SGP. This process would involve an annual assessment of the risk of macroeconomic imbalances and vulnerabilities, including an alert mechanism based on a scoreboard covering a limited number of indicators and economic analysis. In case of actual or potentially excessive imbalances, the Commission should conduct an in-depth analysis. In particularly serious cases, the Council should launch an "excessive imbalance position," giving the State in question a deadline to take action. Eurozone States may ultimately face sanctions in case of repeated non-compliance.

- Deeper and broader coordination. One Task Force recommendation, a reinforced cycle of policy coordination called the "European semester," has already been adopted and will be implemented in 2011. This cycle of reinforced cooperation covers all elements of economic surveillance, including policies to ensure fiscal discipline, macroeconomic stability, and growth. This process will allow a simultaneous assessment of both budgetary measures and structural reforms.

- Crisis management framework. The Task Force calls for creation of a credible Eurozone crisis resolution framework capable of addressing financial distress and avoiding contagion. The Task Force provides few details, acknowledging that the precise features and operational means of the crisis mechanism require further work, including on the respective roles of the EU, the Eurozone and Eurozone Member States. The Commission will prepare recommendations on the general features of the mechanism, including the role of the private sector, the role of the IMF and the "very strong conditionality" under which relevant programs would operate. As noted, the European Council intends to take a final decision on the outline of the crisis mechanism and the related TFEU amendment in December 2010. The TFEU amendment should be ratified in 2013.

- Stronger economic governance institutions. The Task Force calls for strengthening the role of public institutions to improve economic governance. At the national level, public institutions should provide independent analysis, assessments and forecasts on domestic fiscal policy matters as a way to reinforce fiscal governance and ensure long-term sustainability.

III. CONCLUSION

The Task Force recommendations endorsed by the European Council represent the most coordinated, systematic effort so far to reform the governance structure supporting the euro. This structure, which from the outset has suffered from the lack of a meaningful enforcement mechanism for the SGP, has come under increasing strain since the beginning of the financial crisis. Although the Member States finally agreed on the EFSF to address the Greek financial crisis, the EFSF was only a stop-gap solution.

Of all the initiatives outlined in the Task Force's report, the creation of a permanent mechanism to deal with financial crisis in a Eurozone State is likely to be the most controversial, but also the most significant. Strikingly, of all the initiatives proposed by the Task Force, the operation of the new crisis mechanism is the least detailed. Further details are expected to become available before the December European Council meeting, but even then the European Council is aiming only to establish the "outline" of a crisis mechanism. The European Council conclusions and the Task Force report are thus only the first steps in a process that will stretch into 2011 and 2012.

* * *

For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Banking and Finance", "Antitrust" or "Sovereign Governments and International Institutions" in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax