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The EU debt crisis: Testing and revisiting conventional legal doctrine

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Abstract

Controversies surrounding the European sovereign debt crisis loom prominent in the public debate. From a legal perspective, the no-bailout rule and the ban on monetary financing constitute the main principles governing the legality review of financial assistance and liquidity measures. Interpretation of these rules are full of empirical claims. According to conventional legal doctrine, bond spreads only depend on the country's debt position, largely ignoring other causal factors including liquidity. We test the hypotheses implicit in conventional legal reasoning. We find evidence that a significant part of the surge in the spreads of the peripheral Eurozone countries was disconnected from underlying fundamentals and particularly from a country's debt position, and was associated rather strongly with market sentiments and liquidity concerns. We apply our empirical findings to the legal principles as interpreted by recent jurisprudence arguing that application of the no-bailout principle and the ban on monetary financing should be extended to capture non-debt related factors. Also, the empirical results suggest taking recourse to alternative legal grounds for reviewing the legality of anti-crisis instruments and allowing for a lender of last resort in the euro zone.

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The EU debt crisis: Testing and revisiting conventional legal doctrine

I. Introduction

The turmoil caused by the European sovereign debt crisis in Europe have also reached the arena of legal scholarship. The step-wise implementation of anti-crisis instruments led to lively controversies among legal commentators on the legality of these measures. While in the literature the debate has been prominent for some time already (for an overview: De Gregorio Merino (2012); Steinbach (2013)), on the level of highest jurisprudence the controversy has culminated into an open opposition more recently – the German Federal Constitutional Court (GFCC, 2014) and the European Court of Justice (ECJ, 2015) have rendered judgments coming to openly different findings on the legality of the European Central Bank’s Outright Monetary Transactions (OMT) programme programme.

At its core, the legal debate revolves around the interpretation of two legal norms laid down in the EU Treaties providing the ground for the legality review of EU anti-crisis mechanisms – the no-bailout principle, which prohibits the assumption of commitments of another Member State (Article 125 of the Treaty on the Functioning of the European Union (TFEU)) and the ban on monetary state financing through the ECB (Article 123 TFEU). According to conventional legal doctrine, both the no-bailout principle and the ban on monetary financing aim at ensuring that Member States are held liable for their fiscal conduct through market pressure. In this vein, the no-bailout rule

prohibits financial assistance because it would undermine fiscal responsibility. Similarly, the ban on monetary financing has been interpreted to ensure that markets apply their “assessment of creditworthiness and charge higher risk premiums if there are doubts about a State’s fiscal behaviour, resulting in increased interest rates” (Borger, 2016, p. 4).

Legal interpretation of these norms – both in legal scholarship as well as courts’ jurisprudence – is full of empirical claims. In a nutshell, legal doctrine assumes a stable and causal relationship exists between a country’s debt situation and the corresponding spreads. The doctrine further presupposes that only debt matters for a countries refinancing situation, that is no other determinants impact a country’s refinancing conditions – liquidity does not matter, nor does it affect countries’ refinancing conditions. In addition, there is the underlying notion that governments have exclusive control over their refinancing situations, as they decide on their deficit conduct, so that non-market interventions are undesirable.

The legal doctrine of these norms is thus inherently empirical and its claims can be re-phrased as testable hypotheses. Against this backdrop, the purpose of this paper is to challenge the empirical validity of conventional doctrine as it is accepted in parts of legal scholarship and the GFCC’s jurisprudence. The goal is to gain insight for an empirically sound interpretation of the relevant norms. To that end, we build on empirical literature indicating the fragility of the above claims. In De Grauwe (2011a, b), it had been shown that Eurozone countries are more prone to sovereign debt crises than non-members of a monetary union. And De Grauwe and Ji (2013) studies a range of economic fundamentals and how they determine a country’s bond spreads. They show how bonds spreads are disconnected from underlying debt parameters during the crisis. This conclusion has been confirmed by Saka, et al. (2015).

Based on our econometric analysis, we show that conventional legal interpretation of the no-bailout principle as well as the ban on monetary financing should be revisited in light of the fragility of the empirical assumptions. Also, our empirical findings highlight that anti-crisis instruments such as the European Stability Mechanism (ESM) and the OMT programme offer the necessary flexibility to react to deviations from the conventional claims on the relation between debt and spreads in times of crisis, which supports a re-interpretation of the above norms depending on factors causal for bond spreads. Moreover, other legal provisions in the EU Treaties that loom less prominent in the discussion, such as the “emergency clause” under Article 122 TFEU might capture empirical reality more accurately. Finally, an interpretation of EU rules allowing the ECB to act as lender of last resort would reduce the impact of non-fundamental factors on bond spreads.

The article is structured as follows: Section 2 discusses the legal issues surrounding the European debt crisis and identifies the empirical hypotheses enshrined in the conventional legal doctrine of the no-bailout clause and the ban on monetary financing. Section 3 describes the econometric testing procedure and explores the explanatory power of different variables. Section 4 evaluates the relevance of the empirical results for an interpretation of the legal norms. Section 5 concludes.

II. Legal background

The different types of anti-crisis instruments have gradually expanded over the last few years. Initially, Member States granted bilateral loans to crisis countries; then, the European Financial Stability Facility (EFSF) was created;

later, the European Stability Mechanism (ESM) was added; the European Central Bank's Securities Markets Programme (SMP) covering bond purchases since May 2010 and finally the announcement by the ECB that it would purchase an unlimited number of government bonds if necessary (OMT programme). The ECJ subsequently approved these instruments. In *Pringle*, the ECJ paved the way for the creation of the ESM. Under the ESM, financial assistance is exceptionally permitted when such support is "indispensable to safeguard the financial stability of the euro area as a whole and of its Member States" (ECJ, 2012, para. 142), and the grant of the support is subject to strict conditionality (Adam/Perras, 2013). Subsequently, the ECB's OMT programme was brought before the GFCC for allegedly infringing the ban on monetary financing. The GFCC referred the case to the ECJ asking whether the EU treaties permit the ECB to adopt a programme such as OMT that would foresee purchases of government bonds on the secondary market for the purpose of ensuring the smooth functioning of monetary policy (GFCC, 2014). While the GFCC expressed its doubts as to the compatibility of OMT with the ban on monetary financing, the ECJ (in *Gauweiler*) found the ECB to remain within its monetary policy mandate (ECJ, 2015; Adamski, 2015).

The controversy of the two courts is representative both in regard the opposing views within legal scholarship more broadly as well as the contradictory views on the empirical foundations of their jurisprudence offering a rationale for purchasing government bonds or not. This controversy is rooted in the meaning (and the underlying empirical assumptions) one gives to the no-bailout clause and the prohibition of monetary financing and which can be traced along the jurisprudence on the ESM (*Pringle*) and the OMT (*Gauweiler*). These reveal a number of testable empirical claims. The first pertains to the causal relationship between the debt position and the bond spreads. The interpretation of Articles 123 and 125 TFEU aiming at keeping budgetary

discipline is widely shared in legal literature (Borger, 2016; Palmstorfer, 2012; Ruffert, 2011). Both the GFCC and ECJ agree in principle of the “telos of market pressure” of the two norms begging the question on whether this claim holds empirically (ECJ, 2015, para. 61; GFCC, 2014, para. 71).

Second and closely related (but controversial between GFCC and ECJ and among scholars) is whether other factors can disrupt the relationship between debt and spreads. In this regard, the GFCC found that “such interest rate spreads *only* reflect the scepticism of market participants that individual Member States will show sufficient budgetary discipline to stay permanently solvent” (GFCC, 2014, para. 71). The GFCC thus rejects the possibility that other than debt-related parameters significantly influence the bond spreads and that it considers it impossible to identify the justified and excessive parts of bond spreads – an analysis that is shared by some legal scholars (Siekmann, 2015; Ruffert, 2011) but stands in contrast to the findings of a number of empirical studies (Poghosyan, 2012; Santis, 2012) as well as the assessment of the ECJ. In this respect, the ECJ contradicted the referring court’s argument that the premia simply envisage differences in macroeconomic fundamentals between various euro area Member States (ECJ, 2015, para. 72). Again, the difference in arguments between the courts is empirical in nature – are other factors such as non-fundamentals or liquidity reasons really irrelevant for the determination of bond spreads as argued by the GFCC? And are the observed bond spreads justified or excessive parts of bond spreads?

Third, and connected to it, is the question of control over bond determinants. Interpreting Articles 123 and 125 TFEU as to set incentives for states to keep their budget in order necessarily requires entire control over the determinants of bond spreads by the respective country. The strict ban on interventions derived from Articles 123 and 125 TFEU only makes sense if governments keep

the determinants influencing the bond spreads under control because otherwise the prohibition of intervention would not reach its goal in setting the right incentives. This raises an additional empirical question, namely whether the factors influencing the bond spreads can be steered by governments, especially during times of crisis.

III. Empirical part

To analyze the determinants of the interest rate spreads in the EMS and the Eurozone, we specify the following fixed-effect econometric model.

$$S_{it} = a + bF_{it} + a_i + u_{it} \quad (1)$$

where S_{it} is the interest rate spread of country i in period t . The spread is defined as the difference between country i 's 10-year government bond rate and the German 10-year government bond rate. a is the constant term and a_i is country i 's fixed effect. The latter variable measures the idiosyncrasies of a country that affect its spread and that are not time dependent. For example, the efficiency of the tax system, the quality of the governance, the population structure and many other variables that are country-specific are captured by the fixed effect. F_{it} is a set of fundamental variables. A fixed effect model helps to control for unobserved time-invariant variables and produces unbiased estimates of the "interested variables".

In the second step, following De Grauwe and Ji (2013), we introduce time dummies into the basic model and the specification is as follows:

$$S_{it} = a + bF_{it} + a_i + e_t + u_{it} \quad (2)$$

where e_t is the time dummy variable. This measures the time effects that are unrelated to the fundamentals of the model or (by definition) to the fixed effects. If significant, it shows that the spreads move in time unrelated to the fundamental forces driving the yields. It will allow us to evaluate the importance of fundamental economic factors and time effects. The latter can be interpreted as market sentiments unrelated to fundamentals.

The set of economic and monetary variables F_{it} include the most common fundamental variables found in the literature on the determinants of *sovereign bond spreads*¹ are: variables measuring the sustainability of government debt. We will use the debt to GDP ratio. In addition, we use the current account position, the real effective exchange rate and the rate of economic growth as fundamental variables affecting the spreads. The effects of these fundamental variables on the spreads can be described as follows.

- When the *government debt to GDP ratio* increases the burden of the debt service increases leading to an increasing probability of default. This then in turn leads to an increase in the spread, which is a risk premium investors demand to compensate them for the increased default risk. We also add debt to GDP ratio squared. The reason of focusing on the non-linear relationship comes from the fact that every decision to default is a discontinuous one, and leads to high potential losses. Thus, as the debt to GDP ratio increases, investors realize that they come closer to the default

¹ Attinasi, M., et al. (2009), Arghyrou and Kontonikas(2010), Gerlach, et al.(2010), Schuknecht, et al.(2010), Caceres, et al.(2010), Caporale, and Girardi (2011), Gibson, et al. (2011), De Grauwe and Ji (2012), Aizenman and Hutchinson(2012), Beirne and Fratzscher(2012). There is of course a vast literature on the spreads in the government bond markets in general. See for example the classic Eaton, Gersovitz and Stiglitz(1986) and Eichengreen and Mody(2000). Much of this literature has been influenced by the debt problems of emerging economies. See for example, Edwards(1984), Edwards(1986) and Min(1998).

decision, making them more sensitive to a given increase in the debt to GDP ratio (Giavazzi and Pagano(1990)).

- The *current account* has a similar effect on the spreads. Current account deficits should be interpreted as increases in the net foreign debt of the country as a whole (private and official residents). This is also likely to increase the default risk of the government for the following reason. If the increase in net foreign debt arises from the private sector's overspending it will lead to default risk of the private sector. However, the government is likely to be affected because such defaults lead to a negative effect on economic activity, inducing a decline in government revenues and an increase in government budget deficits. If the increase in net foreign indebtedness arises from government overspending, it directly increases the government's debt service, and thus the default risk. To capture net foreign debt position of a country, we use the accumulated current account GDP ratio of that country. It is computed as the current account accumulated since 2000Q1 divided by its GDP level.
- The *real effective exchange rate* as a measure of competitiveness can be considered as an early warning variable indicating that a country that experiences a real appreciation will run into problems of competitiveness which in turn will lead to future current account deficits, and future debt problems. Investors may then demand an additional risk premium.
- *Economic growth* affects the ease with which a government is capable of servicing its debt. The lower the growth rate the more difficult it is to raise tax revenues. As a result a decline of economic growth will increase the incentive of the government to default, raising the default risk and the spread.

We run a regression of equation (2) using a sample of the ten original Eurozone countries (without Luxembourg) during 2000-2015 (quarterly data). After having established by a Hausman test that the random effect model is inappropriate, we used a fixed effect model to analyze the long-term bond spreads in the Eurozone. Table 1 presents regressions of the Eurozone countries using the proposed fixed effect model.

Table 1: Estimation Results on Spread (%)

Sample period: 2000Q1-2015Q2
Standard errors in brackets

Debt GDP ratio (%)	-0.0745*** [0.0111]
Debt GDP ratio squared	0.0005*** [0.0001]
Real effective exchange rate	-0.7420* [0.4196]
Accumulated current account GDP ratio (%)	-0.4856*** [0.1061]
Growth rate of GDP	-0.2259*** [0.0310]
Time fixed effects (quarterly)	Controlled
Country fixed effects	Controlled
Number of Observations	620
Number of countries	10
R²	0.8662

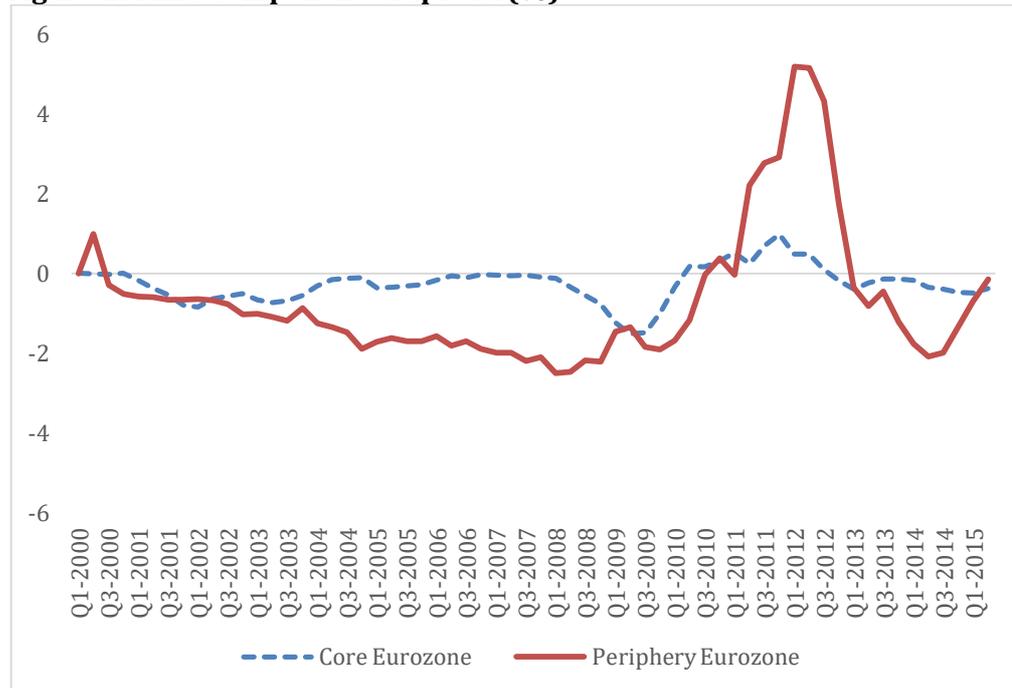
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Data sources: the government debt to GDP ratio, the real effective exchange rate (defined as the relative unit labour costs), the current accounts and the growth rate of GDP are all obtained from Eurostat.

We find that the fundamental variables have a significant effect on the spreads. Increasing government debt ratios lead in a non-linear way to higher spreads; a real appreciation of the currency reduces competitiveness and in so doing raises the spreads; a decline in economic growth raises the spreads as it reduces the capacity of governments to generate tax revenues necessary to service the debt. We also find a significant effect of accumulated current accounts on the spreads, however, the coefficient has the wrong sign. We therefore reject that the accumulated current account deficits lead to an increase in the spreads.

Statistical significance is one thing; economic significance is another one. We also want to know what the economic significance is of the fundamental variables. Put differently, we want to measure the quantitative importance of the fundamental variables in explaining the movements in the spreads.

In order to obtain information on the economic significance of the fundamentals we have to compare these with the effect of the time dummy variable. An F test confirms that there are significant time components in the regression. In order to differentiate the core (Austria, Belgium, France, Finland, the Netherlands and Italy) and periphery (Spain, Ireland, Portugal and Greece) Eurozone groups, we assume that the time components of the two groups can be different. We show the estimated time components (associated with the regression results in Table 1) in Figure 1. It confirms the existence of significant time components that led to deviations of the spreads from the underlying fundamentals. This time effect is especially pronounced in the peripheral countries. In particular we find that in the periphery countries, there was a surge of the spreads during the sovereign debt crisis from 2010 to 2012 that was independent of the movements in the fundamentals. In 2012 there was the OMT-announcement, and we observe that the spreads decline forcefully, again independently of the movements of the fundamentals. Thus, it appears that the announcement of OMT by itself, triggered a large decline in the spreads that could not be associated with improvements in the fundamentals.

Figure 1: Time Component of Spread (%)

Source: own calculations

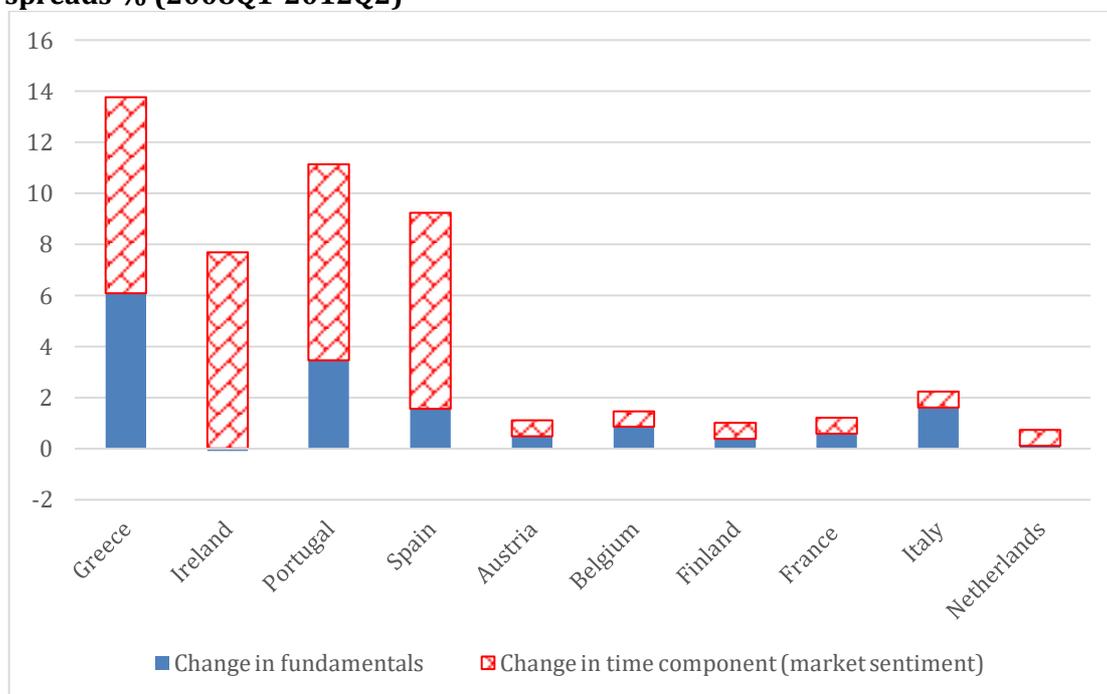
The next step in the analysis consists in estimating the contribution of the fundamentals and the time dummy in explaining the movements in the spreads. We will perform this exercise during two periods. The first one is the crisis period, starting from 2008Q1 until 2012Q2 (just before the OMT-announcement). The second (post-OMT) period runs from 2012Q3 to 2015Q2. We show the results in Figures 2 and 3.

We find that during the crisis period, the time dummy is by far the largest explanatory factor in explaining the surge of the spreads for Ireland, Portugal and Spain. In the case of Greece, fundamentals have a somewhat higher importance: they explain 44% of the surge in the Greek spread.

The post OMT-period shows a similar pattern. The time variable explains by far the largest part of the decline in the spreads observed since 2012, suggesting that the decline in the spreads was made possible mostly by the

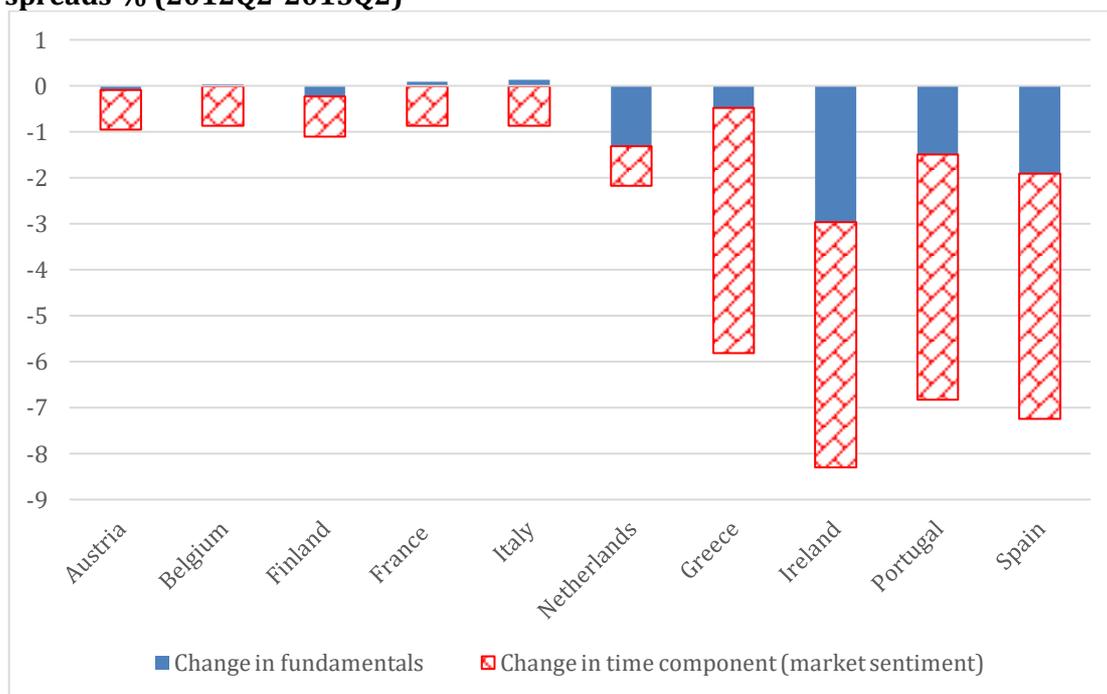
OMT-announcement. Changes in the fundamentals do not seem to have contributed much in explaining this decline.

Figure 2. Contribution of fundamentals and time dummies to predicted changes in spreads % (2008Q1-2012Q2)



Source: own calculations

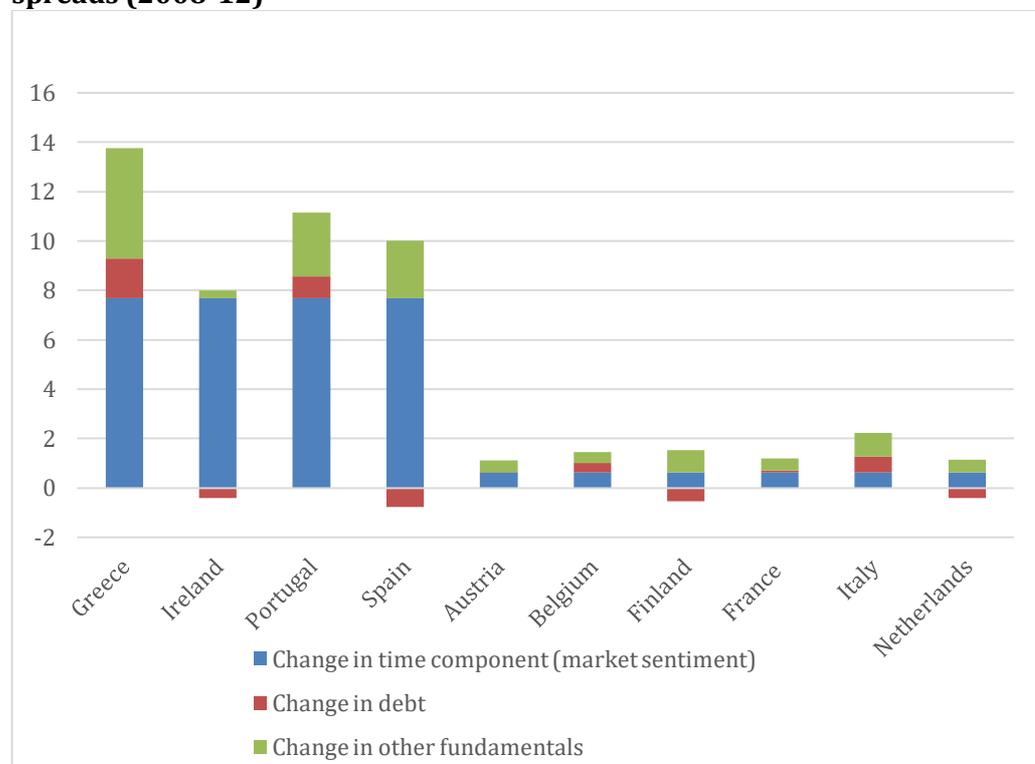
Figure 3. Contribution of fundamentals and time dummies to predicted changes in spreads % (2012Q2-2015Q2)



Source: own calculations

Since the legal arguments focus on the influence of the government debt to GDP ratio it will be useful to repeat the previous exercise and to isolate the separate effect of the debt to GDP ratio on the spreads during the two periods. We show the results of this exercise in Figures 4 and 5. Figure 4 shows the decomposition during the crisis period 2008-12. We find that the changes in the government debt to GDP ratio observed during that period contributed very little to the surge of the spreads. This surge is mainly explained by the time dummy, measuring market sentiments, and to a lesser degree by the deterioration of the other fundamentals (economic growth and competitiveness). This suggests that the surge of the spreads during the crisis was unrelated to the movements of the most important fundamental variable, i.e. de government debt to GDP ratio.

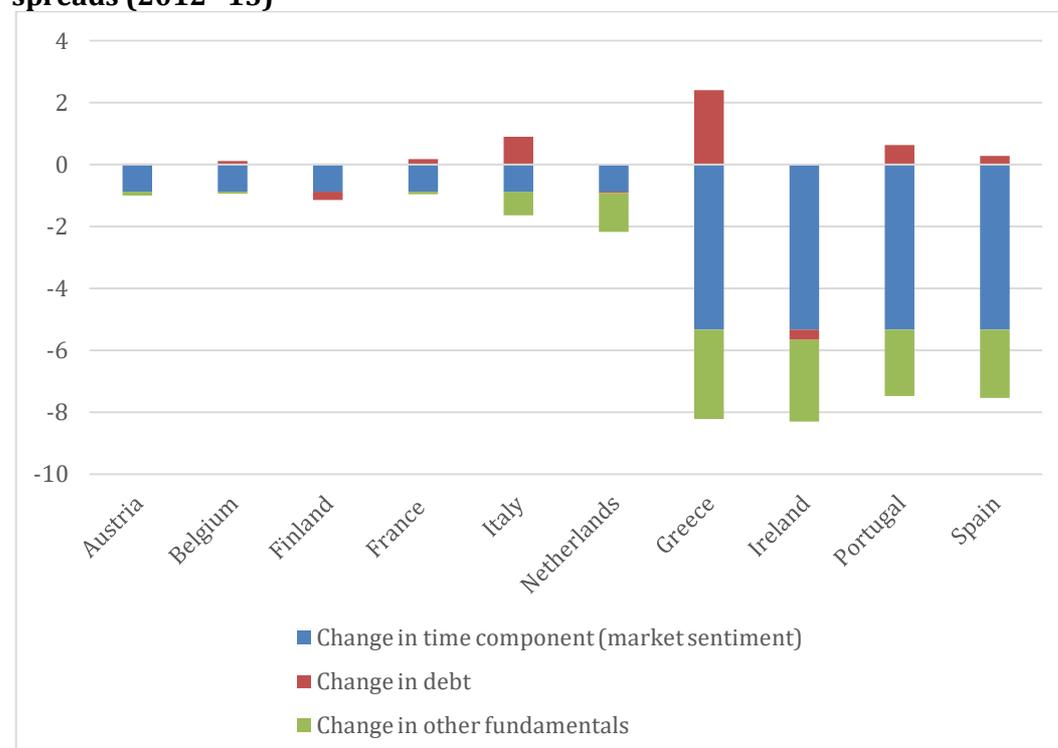
Figure 4: Contribution of debt, other fundamentals and time dummy in changin spreads (2008-12)



Source: own calculations

Figure 5 shows the same decomposition during the post-OMT period (2012-15). Again we find that the changes in the government debt ratio explain only a small fraction of the decline in the spreads. This decline is mainly driven by the market sentiment variable and by the other fundamental variables, economic growth and competitiveness. As the latter improved somewhat they tended to reinforce the effect of market sentiments.

Figure 5: Contribution of debt, other fundamentals and time dummy in changing spreads (2012--15)



Source: own calculations

In this empirical section we have provided evidence showing that during the sovereign debt crisis the surge of the spreads was determined mostly by market sentiments, which we measured by time dummies that are independent from underlying economic fundamentals. In addition, we found that the changes in the debt to GDP ratios observed during this period had practically no influence on the increase in the spreads. Other fundamentals, in particular the decline in economic growth and the deterioration of competitiveness had some, but relatively small influence.

The conclusions from the empirical analysis of the post-OMT period are similar. The rapid decline in the spreads during 2012-15 was triggered mainly by positive market sentiments, which are likely to have been the result of the OMT-announcement. The changes in the fundamentals, and in particular the changes in the debt to GDP ratios, had very little impact on the spreads.

These empirical results suggest that the sovereign debt crisis that erupted in 2010 and that led to spectacular increases in the sovereign bond rates of a number of countries was not the result of deteriorating government debt positions, but from market sentiments of panic and fear, and to lesser degree a decline in growth and competitiveness. Put differently, the surge of the spreads during 2010-12 was reflecting market sentiments in which panic and fear led investors to massively sell government bonds. These then in a self-fulfilling way triggered a liquidity squeeze making it increasingly difficult for the governments concerned to rollover their debt.

IV. Legal implications of empirical findings

The above empirical results offer insight for the legal interpretation of the no-bailout clause (Article 125 TFEU) and the ban on monetary financing (Article 123 TFEU). A number of legal inferences can be made from the empirical analysis as to the scope of these norms and their application to review the lawfulness of EU debt crisis instruments.

First, the conventional interpretation of the no-bailout principle and the ban on monetary financing assuming a stable and causal relationship between a country's debt position and its refinancing possibilities should be rejected. This

applies particularly in times of crises, when the impact of debt indicators become marginal (and even have an ambivalent effect). A purely debt-focused interpretation of these norms is thus not in line with empirical evidence.

Second, market fears become a predominant driver of spreads in times of crisis highlighting the relevance of liquidity issues. This implies that interpreting Articles 123 and 125 TFEU as enforcing a market logic through strict application of these norms without considerations to liquidity and other non-debt related indicators does not capture the multiple factors causing a country's refinancing difficulties. Rather, the dominance of liquidity concerns as drivers for government spreads underscores that a lender of last resort is necessary to intervene in times of liquidity dry-up (De Grauwe, 2011b; Steinbach, 2016). This should particularly be reflected in the interpretation of Article 123 TFEU governing the ECB's scope for interventions. The prohibition of monetary financing should not apply to situations where liquidity (not solvency) is the driving force. Similar to the no-bailout rule, the ban's intention to maintain market pressure must be assessed in light of the factors impeding the smooth functioning of monetary policy – this extends to unjustified spreads due to market sentiments as shown above.

Third, the conventional interpretation of the above norms presume a country's control over the parameters causing certain spread patterns. In that view, market pressure preserved through strict prohibition of bailouts ensure proper incentives to solid economic policy. This view should not only be rejected given the marginal relevance of debt for spreads. Also, other fundamentals are of limited relevance and often they cannot be directly influenced, as competitiveness (e.g. wage bargaining) and economic growth depend heavily on factors outside of a government's reach. In addition, liquidity shortages reflecting market fears are disconnected from government's policy influence.

Fourth, an interpretation of the above norms allowing account for non-debt related parameters (and particularly for liquidity concerns) suggests the lawfulness of the policy instruments adopted to counter liquidity shortages, in particular the ESM and the OMT programme. Both of these measures have been setup to address the above phenomenon of liquidity shortages. However, in its judgment on the OMT programme, the GFCC relied on the the argument made by the German *Bundesbank*, according to which it is impossible to “divide interest rate spreads into a rational and an irrational part” (GFCC, 2014, para. 71). In the proceedings, the *Bundesbank* had criticized the unfeasibility of determining to what extent risk premiums reflect economic fundamentals or other factors. The above empirical analysis rejects this point of view and rather supports the ECB’s intention to restore regular monetary policy transmission mechanisms by neutralising unjustified interest spreads on government bonds. Thus, an empirically sound legal assessment should consider both nature and scope of factors underlying bond spreads. The ECJ’s interpretation of Article 123 TFEU to accept unjustified interest rates to hamper monetary policy even if potentially lifting budgetary pressure is in line with above demonstration of empirical findings.

Fifth, further legal inferences can be drawn as to the appropriate legal basis for reviewing the legality of crisis tools. As mentioned above, the scope of no-bailout principle and the ban on monetary financing have to be widened abandoning a purely debt focus and making the application of these norms dependent on non-debt related parameters. Moreover, Article 122 TFEU (the so-called emergency clause) might capture the empirical reality more accurately than the no-bailout principle. This provision allows a bailout activity of the EU via financial assistance “where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural

disasters or *exceptional occurrences beyond its control ...*.² This legal provision offers leeway in taking into account a variety of factors going beyond the debt focus of Article 125 TFEU. More specifically, liquidity issues impeding a country's refinancing ability may then be considered in times of crisis as "exceptional occurrences" within the meaning of this norm. Also, the norm's requirement of "beyond its control" is respected where market sentiments are entirely disconnected from fundamental as shown above. The emergency provision should thus be interpreted as allowing financial assistance in case of temporary liquidity problems (von Lewinski, 2011).

V. Conclusions

Controversies surrounding the legality of financial assistance to countries in crisis have loomed prominently over the last few years. However, both legal analysis as well as relevant jurisprudence rarely (or insufficiently) care about the validity of the empirical claims underlying their legal findings. This analysis sought to fill this gap and discuss the most relevant norms governing the debt crisis in the euro zone by testing the empirical hypotheses implicit in the conventional legal doctrine, which heavily relies on the relationship between a country's debt position and the spreads.

Our econometric study has highlighted the fragility of the legal reasoning and suggested a re-interpretation of the relevant norms. Most importantly, a legal regime governing the lawfulness of financial assistance cannot be limited to debt parameters but must consider the impact of other fundamentals on

² (emphasis added). This exception was used as a legal basis for the EFSM Regulation 407/2010. The EU viewed that the difficulties within the meaning of Article 122 TEU may be caused by a serious deterioration in the international economic and financial environment, see Regulation 407/2010, paras. 2-5.

spreads and, in particular, the liquidity situation as a result of market sentiment. Taking into account non-debt related factors suggests an application of the no-bailout principle and the ban on monetary financing to the effect that crisis instruments allowing liquidity supply (OMT) and financial assistance (ESM) can empirically be justified and should be considered lawful. Future application of legal standards should incorporate the emergency clause laid down in Article 122 TFEU as legal basis for exceptional financial assistance to account for factors out of a country's control causing financial distress (e.g. extreme market fears), which a narrow interpretation of the no-bailout principle is unable to capture. Finally, the ban on monetary financing (Article 123 TFEU) should be interpreted as compatible with the ECB acting as lender of last resort in order to reduce the impact of non-fundamental impact on government spreads.

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