

EDITORIAL COMMENTS

Debt and democracy: “United States then, Europe now”?

Almost three years into the sovereign debt crisis, it is becoming more and more evident that apart from fiscal stability, democratic legitimacy is at stake in the management of the crisis. The apparent need for swift and effective responses to volatile markets is generally difficult to reconcile with cumbersome democratic procedures. More importantly for the EU, the fragmentation of democratic accountability for budgetary decisions along national lines is hardly compatible with the cross-border dimension of both the causes and the remedies for the crisis. This problem seems to lie at the core of the resistance met by any European response to the crisis, however reasonable it may be. On the one hand, in Member States struggling to regain confidence of creditors, there is a widespread resentment against austerity measures forced upon citizens with barely any meaningful consent by their own countries' legislatures. On the other hand, citizens of Member States that have so far been able to defend their creditworthiness object to the imposition of risks and costs resulting from decisions on public borrowing that were not made by their own elected representatives. Considering the fiscal and economic interdependency of Member States in a single market and, as far as the eurozone is concerned, with a single currency, it is tempting to think of the crisis as a chance for strengthening both the powers and the democratic legitimacy of the EU. Would not the clearing of the fallout of the crisis and the instruments for securing financial stability in the future best be placed in the hands of democratically accountable institutions at the EU level? Indeed, in his Nobel Prize lecture titled “United States Then, Europe Now”, economist Thomas J. Sargent suggested the federal bailout of States negotiated by Alexander Hamilton in the aftermath of the American War of Independence as an example for the EU.¹ We are not in a position to tell who, if any, of the present cast of EU leaders could possibly qualify for Hamilton's heroic part. But we may venture some thoughts on institutional aspects of a development

1. Thomas J. Sargent, “United States Then, Europe Now”, Nobel Prize Lecture delivered on 8 December 2011, available at: www.nobelprize.org/nobel_prizes/economics/laureates/2011/sargent-lecture.html (last visited 22 Oct. 2012). For a deeper analysis of the American experience see James, “Lessons for the Euro and its Governance from History”, in Poirares Maduro, De Witte and Kumm (Eds.), *The Democratic Governance of the Euro*, RSCAS Policy Papers 2012/08, p. 33.

towards a democratically fully legitimate financial regime for Europe. In the present situation, three ways of reacting to the crisis have emerged that deserve our attention: the intergovernmental approach as exemplified by the European Stability Mechanism, the measures taken by the European Central Bank, and the rocky path “Towards a Genuine Economic and Monetary Union”.²

The European Stability Mechanism: Shortcomings of the intergovernmental approach

Following the example of the Greek loan facility agreement and the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) has been established by the ESM Treaty as an intergovernmental mechanism of financial assistance.³ The ESM is an international organization that will be endowed with a capital of 700 billion euros, with paid-up shares amounting to 80 billion euros, while the rest is covered by callable shares.⁴ The capital is raised from ESM members with contributions ranging from 0.0731 percent (for Malta) to 27.1464 percent (for Germany).⁵ The most important body of the ESM is the Board of Governors, composed of the finance ministers of each ESM member.⁶ The Board of Governors has some far-reaching powers. Not only may it decide on the activation of financial assistance in the form of the instruments set out in the ESM Treaty, but it may also make changes to the list of available instruments.⁷ As far as the capital stock is concerned, it may decide to change the authorized capital stock and to adapt the maximum lending volume⁸ and to issue shares other than those initially subscribed on terms other than at par.⁹ There is no doubt that these provisions help make the ESM more effective in securing the creditworthiness of its members than a “static” arrangement fixing the available capital and the available tools, once and for all. Even 700 billion euros may not be enough to calm down markets if bigger Member States need assistance, and, as could be seen in the case of

2. This is the title of the Report by the President of the European Council of 26 June 2012, EUCO 120/12, and of the subsequent Interim Report of 12 Oct. 2012 by the President of the European Council, available at: <www.consilium.europa.eu/press/press-releases/latest-press-releases?id=363&lang=en> (last visited 22 Oct. 2012).

3. For a more complete appraisal of these instruments (and of the European Financial Stability Mechanism, which is part of EU law) see de Gregorio Merino, “Legal developments in the Economic and Monetary Union during the debt crisis: The mechanisms of financial assistance”, 49 CML Rev. (2012), 1613.

4. See Art. 8 ESMT.

5. See Annex I of the ESMT.

6. Art. 5(1) ESMT.

7. Art. 19 ESMT.

8. Art. 10(1) ESMT.

9. Art. 8(2) ESMT.

the direct recapitalization of Spanish banks,¹⁰ specific remedies may be appropriate if circumstances so require and certain conditions (namely the establishment of a banking union) are met. If the ESM Treaty had to be amended each time by its members in a regular ratification process, this would deprive the ESM of the flexibility needed to inspire confidence in the financial stability of its members. This would not only hamper the functioning of the ESM in emergency situations, but also generally reduce its dampening effect on increases of interest rates caused by speculation against weaker members that do not appear to be fully protected by the ESM.

However, the question remains how the decisions made under this arrangement are democratically controlled. By choosing an intergovernmental mechanism established by an international treaty, the participating Member States placed the ESM outside the EU framework. Leaving aside the fundamental issue of the compatibility of this approach with EU law, which is pending before the Court of Justice,¹¹ suffice it to make the obvious point that there is no role whatsoever for the European Parliament to play in this game. The only thread of democratic legitimacy runs between the ESM and its members. As far as conditions attached to financial assistance that regularly require legislative steps (such as budget cuts and structural reforms) are concerned, the involvement of national parliaments is the main source of democratic control in the recipient countries. But what about potential losses for members whose contributions are put at risk by decisions under the ESM? The ESM Treaty provides that the most important decisions of the Board of Governors, including decisions to change the available instruments and the capital stock, are taken “by mutual agreement”, i.e. unanimously.¹² Naturally, the ESM Treaty is not concerned with the design and the intensity of democratic control of the ministers representing the Member States in the Board of Governors within their domestic legal systems. This is for the Member States to decide. As the sensitivity towards this topic very much depends on how much a Member State may lose in the ESM (in terms of contributions), and how little it is likely to get from it (in terms of financial assistance), it comes as no surprise that in its recent interim decision on the ratification of the ESM Treaty and of the Fiscal Compact,¹³ the German Constitutional Court took utmost care to ensure that the German *Bundestag*’s overall budgetary responsibility was respected, which, according to prior case

10. See the Euro Area Summit Statement of 29 June 2012, available at: <www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf> (last visited 22 Oct. 2012).

11. Case C-370/12, *Pringle v. Ireland*, pending.

12. See Art. 5(6) together with Art. 4(3) ESMT.

13. BVerfG, Judgment of 12 Sept. 2012, Cases 2 BvR 1390/12 etc., available at: <www.bverfg.de/entscheidungen/rs20120912_2bvr139012en.html> (English translation, last visited 22 Oct. 2012). The Fiscal Compact refers to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed on 2 March 2012.

law, may not be transferred to others in a way that “may result in incalculable burdens with budget relevance”.¹⁴ The Constitutional Court therefore only allowed ratification of the ESM Treaty if it was ensured that Germany’s overall payment obligations arising from the Treaty would not exceed the total amount of its stipulated contribution without the agreement of its representative, and that the provisions on privileges, immunities and professional secrecy in the ESM Treaty would not stand in the way of the comprehensive information of the German legislature. While this decision caused an immediate sigh of relief (and an increase in stock prices) as the ESM was allowed to go ahead, it should not be overlooked that the assent required from the *Bundestag* (via the German representative) for every specific granting of assistance in order to prevent the ESM from becoming a “permanent mechanism” under international law which is “tantamount to accepting liability for decisions by free will of other States”¹⁵ will probably affect the swiftness of procedures under the ESM. As there is always a trade-off between fast and effective decision-making and the intensity of democratic control, this is not a specific weakness of the intergovernmental approach.

It is submitted that another aspect of the ESM is more likely to cause continuous discontent with its operations. Under the ESM framework, with a unanimity requirement and no neutral party as arbiter in place, decisions on financial assistance will probably continue to follow the logic of bilateral negotiations on loans. Despite the fact that they are formally shareholders in a joint venture, members are still likely to act like lenders and borrowers – who naturally have opposing interests as far as collateral and the interest to be paid are concerned. As always in such negotiations, the outcome very much depends on the scenario that prevails if no agreement is reached. To put it bluntly, the side that has more to lose in case of default will eventually have to give in. This has an important impact on the perception of the democratic legitimacy of the ESM operations: even if all members gave their assent to any particular measure with national parliamentary backing, the resulting decision would in fact be determined by the superior bargaining power of the side that can inflict more damage on the opposing party than suffered by itself in case of a failure to reach an agreement. If a credit default is eventually most harmful for the defaulting member, the threat point (as bargaining theorists call it) is more favourable to “lenders” who can impose their conditions. However, the situation will reverse if “lenders” find themselves in a hold-up

14. BVerfG, Judgment of 7 Sept. 2011, Cases 2 BvR 987/10 etc. available at: <www.bverfg.de/en/decisions/rs20110907_2bvr098710en.html> (English translation, last visited 22 Oct. 2012), para. 125.

15. BVerfG, cited *supra* note 14, para. 128.

situation where, in particular due to outstanding debts held by them and direct or indirect repercussions on their trade, they will be hit harder by a default than the defaulting State itself. This seems to be the rational core of the feeling of disenfranchisement that, as a reaction to rescue measures that have so far been implemented, is widespread in the electorates of both “borrower” and “lender” States. Even the most elaborate parliamentary participation at national level cannot conceal the fact that the outcome tends to be dictated by the logic of intergovernmental bargaining and may only be rubber-stamped by national legislatures. It has to be feared that this will not change if financial assistance is granted (or refused) by the ESM.

The European Central Bank: Not the least dangerous branch

An escape route that allows macro-economic reason to prevail over bargaining power seems to be provided by the European Central Bank. Judging from the reaction of markets to measures introduced so far by the ECB in the context of the debt crisis, there is reason to believe that the instruments available to the ECB can easily match intergovernmental arrangements in terms of a reassuring effect on nervous investors. A suitable example is the decision of the Governing Council of 6 September 2012 on the modalities for undertaking so-called Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area, i.e. in markets where previously issued bonds are traded. While the ECB made clear that it would only buy short-term government bonds (with maturities of between one and three years) and that OMTs were conditioned by appropriate EFSF/ESM programmes that include the possibility of EFSF/ESM primary market purchases, the decision has not been limited to any maximum amount to be spent on bond purchases by the ECB.¹⁶ This did not fail to impress market participants.¹⁷ But one may wonder whether such measures keep within the limits of the ECB’s mandate.

As could be expected, when explaining the OMTs, the ECB was careful to stress that “to comply with the monetary financing prohibition (Art. 123 TFEU), purchases will be conducted in the secondary market only” and that, “in deciding on these transactions, the ECB acts with the aim of countering risks to price stability”.¹⁸ However, this legal assessment may not remain unchallenged. In its ESM decision, the German Constitutional Court took the position that “an acquisition of government bonds on the secondary market by

16. See ECB, Monthly Bulletin September 2012, p. 10.

17. Cf. the summary of reactions in the Wall Street Journal blogs of 6 Sept. 2012, <blogs.wsj.com/eurocrisis/2012/09/06/band-aid-or-leap-forward-reactions-to-ecb-plans> (last visited 22 Oct 2012).

18. ECB, *supra* note 16, p. 11.

the European Central Bank aiming at financing the Members' budgets independently of the capital markets is prohibited as well, as it would circumvent the prohibition of monetary financing".¹⁹ Pre-announced purchases of bonds from investors on the secondary market may indeed have the same effect as a direct acquisition of bonds by the ECB from Member States on the primary market if they neutralize the disciplinary effect of risk-based interest rates on State budgets by simply removing the risk of a default from investors. The purpose of Article 123 TFEU would therefore be defeated if the ECB unconditionally declared it would buy from investors bonds issued by a heavily indebted Member State for an unlimited amount. However, in the case of the OMTs announced by the ECB on 6 September 2012, the compatibility with Article 123 TFEU cannot be denied on such simple grounds, as bond purchases are linked to ESM or EFSF measures that are meant to restore fiscal discipline, and the reasons given by the ECB for its claim to act exclusively in the name of price stability deserve to be examined on their merits. Member States (under Art. 263 TFEU) or national courts including the German Constitutional Court (under Art. 267 TFEU) are free to bring this complex issue before the Court of Justice.

For the purposes of this comment, we may restrict ourselves to a basic observation on why, despite its obvious expertise and immense clout in financial markets, the ECB neither is nor claims to be a *deus ex machina* that can overcome the bargaining game between debtors and creditors on its own without the development of political mechanisms that tackle the crisis. According to Article 130 TFEU and to Article 7 of the Statute of the ESCB and the ECB, "neither the ECB, nor a national central bank, nor any member of their decision-making bodies may seek or take instructions from Union institutions or bodies, from any government of a Member State, or from any other body". The independence of the ECB and the members of its decision-making bodies can only be said to be democratically legitimate if the ECB sticks to its mission of maintaining price stability. Redistributing the risks and costs resulting from national budgetary decisions by purchasing assets or relaxing collateral requirements is therefore not only macro-economically contentious – as this may, like any other insurance scheme for beleaguered debtors, create the risk of moral hazard.²⁰ If taken by the ECB without underpinning political measures, such an approach would also run the risk of going beyond the competence of an institution that can only

19. BVerfG, *supra* note 13, para. 247.

20. For an instructive economic analysis of this point see Brunnermeier and Sannikov, "Redistributive Monetary Policy", Paper presented at the 2012 Jackson Hole Symposium, available at: <www.kansascityfed.org/publicat/sympos/2012/mb-ys.pdf> (last visited 22 Oct. 2012).

be exempt from democratic control if this is in order to perform a limited task. Although it may seem comfortable to let the ECB do the job of dealing with the crisis with instruments of monetary policy, the long-term damage of such a strategy to the democratic legitimacy of the EU could be considerable.

“Towards a Genuine Economic and Monetary Union”: The need to strengthen democratic legitimacy and accountability

Considering that intergovernmental arrangements are bound to be regarded as strangling democratic deliberation at the national level, and that the ECB has entered a democratic danger zone with its measures, there is reason to believe for all those who are still convinced of the overall desirability of European integration that the only way forward is to go beyond the fragile state of a currency union without the necessary financial, fiscal and economic underpinnings towards a real Economic and Monetary Union. Following a report presented by the President of the European Council,²¹ a start signal for this project was given by the June European Council when “the President of the European Council was invited to develop, in close cooperation with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union”.²² The building blocks for the future EMU set out by the President of the European Council include an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and, last but not least, a strengthening of democratic legitimacy and accountability.

However, these building blocks do not appear to fall into place at the same speed. In his interim report of 12 October 2012,²³ the President of the European Council referred to the well advanced preparations for an integrated financial framework, in particular to the draft legislation put forward to establish a single supervisory mechanism for banks hosted by the European Central Bank. Regarding an integrated budgetary framework, he reported improvements that have already been enacted or agreed (the so-called “Six-Pack” and Treaty on Stability, Coordination and Governance) or are at least in the legislative process (“Two-Pack”). He also suggested key features of a new fiscal capacity for the EMU and, laboriously avoiding the controversial word “Eurobonds”, “a safe and liquid financial asset for the euro area”. As to the creation of an integrated economic policy framework, the interim report could point to reforms of the EU surveillance framework,

21. *Supra* note 2.

22. Conclusions of the European Council of 28/29 June 2012, EUCO 76/12, p. 3.

23. *Supra* note 2.

namely the European Semester, that have already been achieved, and to the June 2012 Growth and Employment Compact. In comparison to these rich and fairly concrete propositions, the ideas on democratic legitimacy and accountability presented in the interim report are somewhat pale and disappointing. Except for the suggestion that “a debate in the European Parliament and in national parliaments on the recommendations adopted in the context of the European Semester should be explored”, there are no concrete proposals, but merely general reminders that “a further strengthened role of EU institutions must be accompanied with a commensurate involvement of the European Parliament in the EU procedures” and that “a number of concrete steps to increase the level of cooperation between national parliaments and the European Parliament can also be taken”.

The paucity of the conclusions of the European Council held at 18/19 October 2012 on the democratic foundations of the EMU²⁴ shows that issues of democratic legitimacy and control are not placed as high on the agenda as other elements of the EMU. But it is submitted that they should, and eventually will, be treated with the same priority as financial, budgetary and economic issues. In a “genuine Economic and Monetary Union”, as envisaged by the European Council, Member States with unsustainable fiscal policies will have to submit to severe adjustments by the EU, and Member States that have so far been among the winners of the crisis will be forced to take part in some kind of burden sharing, no matter whether it comes in the guise of Eurobonds or under another name. It is hard to imagine that these sacrifices will be made without a mechanism of genuine European collective decision-making in place that ensures proper democratic legitimacy of the decisions taken in the EMU framework. Admittedly, the debate on how this could be done has only just begun, and feasible concepts are still sketchy.²⁵ But this is not a reason to neglect the democratic question: the answer may ultimately decide the success or failure of the EMU.

24. Cf. the conclusions of the European Council of 18/19 October 2012, EUCO 156/12, para. 17.

25. Cf., however, a number of suggestions that cannot be further explored in this comment, made by Miguel Póiares Maduro, Bruno De Witte and Mattias Kumm, “The Euro Crisis and the Democratic Governance of the Euro: Legal and Political Issues of a Fiscal Crisis”, in RSCAS Policy Papers 2012/08 (cited *supra* note 1), p. 3, at pp. 7–11. See also Christopher Lord, “On the Legitimacy of Monetary Union”, Swedish Institute for European Policy Studies (SIEPS) Report No. 2012:3, pp. 46–56.