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The Sovereign Behind the Euro

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Abstract

The euro is widely believed to be a currency without a sovereign state. To make the euro a stable currency, many commentators recommend a move to a federal fiscal Europe by issuing eurobonds or levying European taxes. By contrast, we argue in this paper that the EU and the euro area member states are the joint sovereign behind the euro. The EU is not a state, but has evolved into a democratic polity of states and citizens, in which the sovereignty is shared and pooled. Consequently, the euro should be regarded as a currency *beyond* the state.

For the euro to have a stable sovereign, however, further political and fiscal reforms are needed. First, some, albeit limited, fiscal sovereignty needs to be shared under a credible stability mechanism operating between member states. The donor countries ought to sign up to a stability fund of sufficient size. The recipient country will have to accept temporarily suspension of sovereignty over the control over its economic policies (conditionality). Next, political decision-making should be speeded up. While sufficiently large amounts should be assigned *ex ante* to the stability fund, releases by the fund must be made by Qualified Majority Voting (QMV) rather than by unanimity.

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Unfortunately, sophisticated economists, public officials, authors of editorials, and market traders are the slaves of a defunct political thinker or historian, hence their unshakable faith in the Westphalian model of nation state.
(Tommaso Padoa-Schioppa)

1. Introduction

There has been a major upheaval about the euro in the markets, since the start of the Greek crisis in early 2010. The local sovereign debt crisis in Greece has cumulated into a full-blown sovereign debt crisis in the euro area. This crisis has been aggravated by the protracted stalemate over the budget in the USA. The key question that must be addressed in order to restore confidence in the euro area is which is the sovereign behind the euro?

The present debate is conducted on the assumption that the status of a currency is determined by the sovereign power of the state behind it. In the traditional Westphalian approach of the nation state,¹ the euro seems to be a currency without a state. This has led to discussions about the need for political and/or fiscal union in Europe. The general line of reasoning is that once a political/fiscal union is established, the euro will become a stable currency backed by the European Union (EU). The EU would then be the “sovereign state” behind the euro. In this perspective, the EU must become a federal state (with political and fiscal union) in order to be fully effective.

There can be no doubt that each currency needs a strong sovereign back-up to be credible (Goodhart, 1998). The power to tax (the “deep pockets”) is generally regarded as an important aspect of this sovereign back-up. Padoa-Schioppa (2010), however, suggests that new thinking on the concept of the state is much needed. The euro is under heavy attack by the market because the market does not believe in the viability of the post-Westphalian project that Europe has been pursuing for sixty years. The scepticism of the market is shared and reinforced by a global array of economists and commentators who predict the end of the euro because they do not believe that “a currency without a state” can survive. Some European politicians maintain the opposite and equally misguided view that it can last forever without further steps toward political union. What they share is the primitive belief that the Westphalian model is eternal and indestructible (Padoa-Schioppa, 2010).

In this paper, we explore the consequences of the new concept of a post-Westphalian order which has emerged in Europe. The EU has gradually evolved into a transnational democratic polity of states and citizens (Hoeksma, 2011). The EU is therefore a polity beyond the Westphalian definition of the nation state. Moreover, the Treaty on European Union (TEU) assigns to the EU the power to establish Economic and Monetary Union (EMU) that issues the euro (art 4(3) TEU). Should the EU thus be considered as the ‘sovereign’ behind the euro? This answer would be too easy. The present paper serves to argue that the euro is a currency beyond rather than without the state and that the EU and the member states of the euro area are the joint sovereign behind the euro. Our intention is to assess the consequences of this change in the concept of state sovereignty for the application of the principles of monetary and fiscal sovereignty (see also Lastra, 2006). We therefore review the various policy areas for the monetary and financial system: monetary policy, economic policy, fiscal policy, and financial stability and supervision. We also discuss the newly emerging European Stability Mechanism and examine whether the provisions of the proposed treaty will suffice to convince the international community and the financial markets that the EU and the member states of the euro area are indeed a shared and stable ‘sovereign’ for the euro.²

¹ The concept of the sovereign nation state was introduced by the 1648 peace of Westphalia (see section 2).

² The focus of this paper is on the well functioning of political structures. It should be noted that the way politicians are operating within these structures is also important for the ultimate stability of any political structure, including structures based on the traditional nation state. Examples of relatively unstable national state structures are Italy with many changes of government in the 1980s and the USA to some extent with the partisan bickering about the federal debt ceiling in Summer 2011.

2. The EU as a democratic polity

The assumption that the status of a currency is determined by the sovereign power of the state behind it, seems so self-evident that it needs no further explanation. In his recent book *The Globalization Paradox* the American economist Dani Rodrik (2011) argues without further ado that the nation state remains the only game in town, when it comes to a discussion about global governance. From a legal point of view, however, the validity of this assertion may be questioned. International lawyers will point out that the division of the world in states is a relatively modern phenomenon, that the concept of sovereignty may be not as absolute in a globalised world as it has been in previous centuries and that international organisations such as the WTO are already playing an important role in the present system of global governance.

The prevailing system of international relations was introduced by the 1648 Peace of Westphalia. In this system states are equal and sovereign. States do not have to recognise any higher authority than their own, while their relations with other states are conducted on equal footing. The Westphalian system of international relations has evolved over the centuries into the global standard for the conduct between states. It lies at the heart of the 1933 Montevideo Convention on Rights and Duties of States and forms the core of the United Nations Organisation (Van Gerven, 2005). Consequently, states are the norm in the present world and a large number of statal tasks and activities are organised on a national level. This goes not only for obvious fields such as defence and national security, but also for the economy as well as for financial and fiscal policies. It may therefore not come as a surprise that financial analysts and monetary experts tend to regard this model as eternal and indestructible, as noted by the late Padoa-Schioppa (2010).

The hallmark of the EU, however, lies in the sharing and pooling of sovereignty. Initially, six European states decided to share sovereignty in order to prevent war. The foundation in 1951 of the European Community for Coal and Steel, which placed the production of coal and steel under a common, supranational authority, has rightfully been described as a 'revolutionary breakthrough of the existing patterns of international relations' (Timmermans, 2008). In fact, the sharing of sovereignty is incompatible with the essence of the Westphalian system of international relations. In the early decades of the process of European integration, politicians and scholars choose not to emphasize this anomaly by describing the EU and its predecessors as an organisation sui generis. They argued that the end-goal or finalité politique of the EU was either to become a federal state or to establish itself as a confederal union of states. Whatever the outcome, in both cases it would become possible again to describe the EU in terms of the existing categories of the Westphalian system of international relations. The revolutionary breakthrough in international relations would consequently be of a limited nature and time.

This prospect was jeopardised by the rejection of the Constitution for Europe by the French and the Dutch electorates in 2005. Had the Constitution been approved, it would have remained possible to argue that the EU would become a federal state after all. However, the Lisbon Treaty which replaced the ill-fated Constitution for Europe, is constructing the EU as a democracy without turning the Union into a state. By virtue of articles 9-12 of the Treaty on European Union (TEU), the EU has become a democratic polity of states and citizens. The deviation of the Westphalian system of international relations is obvious. In the traditional model, democracy can only thrive within a sovereign state. In this approach, there is no political community beyond the borders of the nation state.

Although the traditionalist interpretation also seems to lie at the heart of the verdict of the German Bundesverfassungsgericht (2009) concerning the Lisbon Treaty, in which the Court emphasises that the constitution of the country does not allow for the Federal Republic of Germany to merge into a federal European state, the net effect of the verdict is that it forms an unequivocal endorsement of the principle of shared sovereignty. In the same vein, the German Kanzler Angela Merkel has time and again expressed the conviction that the EU is not destined to become a new state (see, for example, Merkel, 2009).

The conclusion - that the EU can no longer be described in terms of the Westphalian paradigm of international relation - requires a fundamental re-think of the character and qualities of the Union. Moreover, it should be endeavoured to analyse and comprehend specific elements of the EU, notably

the Economic and Monetary Union (EMU), within the overall framework of the EU as a Union of states and citizens, in which sovereignty is being shared between the Union and its member states. As the EU is a work in progress, the parameters of the transfer of sovereignty may change, but the principle can no longer be ignored.³

3. Powers for the Union's monetary and financial system

3.1 Powers behind a currency

The State has generally played a major role in the evolution and use of money (Goodhart, 1998). Money is backed by government regulations (among which legal tender laws) and fiscal powers (the government's ability to impose taxes payable in that fiat currency). How are these sovereign powers defined for the euro? The first power is well defined before the start of EMU. The Regulation on the Introduction of the euro (EC/974/98) defines the monetary law provisions, including the legal tender status of the euro, of the member states which have adopted the euro. By choosing the instrument of regulation, the monetary law provisions are binding in its entirety and directly applicable throughout the EU.

Turning to the second, fiscal powers are almost predominantly at the national level. The direct tax powers (income tax and corporate tax) are fully at the national level. The indirect tax powers (VAT and duties) are mixed. The member states are also in charge of collecting VAT, but have to redirect a small part of VAT revenue to the EU. Next, the EU has the right to raise customs duties on imports directly, but that is a very limited tax power. Finally, the EU has some power to harmonise taxes (notably indirect taxes) needed for a proper functioning of the internal market. In sum, we can distinguish three dimensions of fiscal union: i) budget and tax power of the EU (currently very limited); ii) budget and tax powers of the member states (very broad); iii) harmonisation of tax provisions (currently indirect taxes and potentially corporate taxes). The deep pockets for stability purposes are thus to be found at the national level with the member states.⁴ In section 4 below, we discuss how we can reconcile the EU's currency with national fiscal powers.

3.2 Policy areas

The current crisis is not a euro crisis, but a combination of a sovereign debt and a banking crisis (Hellwig, 2011). The sovereign crisis is most manifest in countries with unsustainable fiscal deficits, like Greece and Portugal. Next, there is a banking crisis in countries like Ireland and Spain where local banks financed the local real-estate bubble and became insolvent when the bubble burst. The banking problems turn into sovereign problems as the state refinances these ailing banks. More broadly, there is a latent banking crisis in countries like Germany and France where banks with fragile balance sheets have large exposures to sovereign debt from Southern Europe and/or to bank debt from Ireland and Spain.

As these crises are entangled with each other, an overall policy view on the wider monetary and financial system is needed. We review the division of labour (powers) between the EU and the member states in the various policy areas. The competences are written down in the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), both introduced by the Lisbon Treaty. Generally speaking there are four categories of power sharing:

1. Exclusive competence for the EU.
2. Shared competence between the EU and the member states.
3. Coordination of policies between member states within the EU.

³ As confirmed by the international conference about the nature of the EU and the place of the Union in international law, which has been held in the Peace Palace in The Hague on June 28th 2011, organised by the T.M.C. Asser Institute and the Carnegie Foundation (www.asser.nl).

⁴ While central banks can create unlimited amounts of liquidity by expanding their balance sheet, their capacity to absorb losses is confined to their capital. The deep pockets are thus with the government and not with the central bank.

4. Member states are in principle free to conduct policies of their own. In doing so, however, they are bound to respect the Treaties and to refrain from acts which may undermine the proper functioning of the internal market.

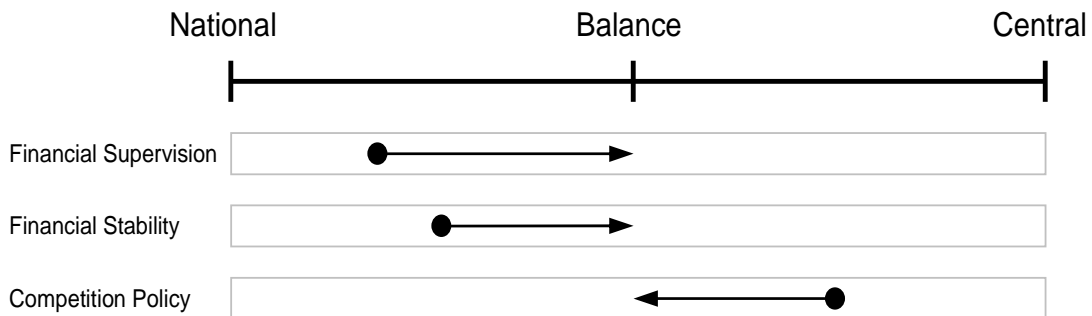
We can now examine which power sharing regime is applicable to each policy area:

- Monetary policy is category 1: Art 3(1)(c) TFEU specifies that the EU has exclusive competence for the monetary policy within the euro area.
- Economic policy is category 3: Art 5(1) TFEU indicates that member states should coordinate their economic policies within the EU. Art 5(2) TFEU further indicates that the EU may provide guidelines for this coordination.
- Fiscal policy is category 4: Apart from some minor tax provisions on the application and harmonisation of turnover taxes (articles 110-113 TFEU), there are no limits on the tax powers of the member states. There are, however, restrictions on budget deficits which are part of the economic policies (see above).
- Financial supervision and stability are category 2: The European System of Financial Supervision brings together the actors at the EU level and the national level. The European actors comprise the European Systemic Risk Board (ESRB) and the European Supervisory Authorities (ESAs) and are established by Regulations based on art 114 TFEU, which in turn refers to the Internal Market (art 26 TFEU).

The power sharing arrangements are evolving over time. The previous supervisory structure based on the so-called Lamfalussy committees provided for some loose coordination of national supervisors whereby each committee was chaired by one of the national supervisors. In the new set-up, which started 1 January 2011, the new ESAs have an independent chairman. The ESAs have also some direct tasks (e.g. supervising credit rating agencies) which can be expanded in future via Directives or Regulations. The balance is thus shifting from national to European. By contrast, competition policy is highly centralised with the European Commission (DG Competition) in charge. In 2004, the European Competition Network (ECN), consisting of the European Commission and national competition authorities, was created to cooperate and to delegate activities to national authorities where possible. Figure 1 illustrates the degree of centralisation in various policy areas. The key message is that arrangements between national and European actors are dynamic and evolving over time in response to economic needs as well as political deal making.

It should be added that the exercise of democratic control over decisions taken in these policy areas is under constant scrutiny. While a full description of the division of competences between national parliaments and the European Parliament falls outside the scope of this paper, it should be underlined that the powers of the EP are increasing per treaty and that art 12 TEU paves the way for national parliaments to contribute actively to the good functioning of the Union.

Figure 1. Degree of centralisation



Source: De Haan, Oosterloo and Schoenmaker (2009)

4. Organising the deep pockets in Europe

4.1 Stabilisation mechanisms

As the current crisis is a mix of a sovereign debt crisis and a banking crisis, both crises must be resolved to return to financial stability in the euro area and the wider EU. The euro needs a sovereign with deep pockets (Goodhart, 1998), as discussed in section 3. In a similar vein, European cross-border banks need an appropriate backstop. The financial trilemma states that financial stability, cross-border banking and national financial policies are incompatible (Schoenmaker, 2011). Any two of the three objectives can be combined but not all three; one has to give. To keep cross-border banks in Europe, powers for financial policies, in particular the power to rescue ailing banks, need to be coordinated at the European level. So the question at hand is how to organise the deep pockets for maintaining financial stability in Europe.

There are several options for organising the fiscal backstop (i.e. the deep pockets). The first is to agree a stability mechanism between member states, as currently agreed for Greece, Ireland and Portugal. The second is to issue eurobonds for investments and debt restructuring by euro area member states (Amato and Verhofstadt, 2011; Von Weizsäcker and Depla, 2011). The solvency of euro area members is then linked, as the eurobonds are jointly and severally guaranteed by participating euro area member states.⁵ Finally, the third option is to give the EU elaborate powers to tax. Some minor tax powers will not suffice; major tax powers are needed to create truly deep pockets. The latter two options, a common bond and a common tax, are supranational solutions confirming the move to a federal state. We are in agreement with Gros (2011), who argues that the eurobond would need a political union and would be the wrong solution to the current crisis. In this paper, we intend to explore the intermediate option of a stability fund or mechanism as instituted c.q. proposed by the European Council. The question which we will specifically address is whether the EFSF/ESM will be sufficiently robust in order to convince the international community and the financial markets that the euro is strong and stable enough to survive as a currency beyond the state.

In doing so, we would like to recall that the construction of the EU as such is based upon the principle of responsible membership. Countries wishing to accede to the EU should not only meet stringent criteria with respect to human rights and democratic governance on the moment of accession (art 49 TEU), but they are also required to continue to live up to these standards during their time of membership. Art 7 TEU contains a procedure for determining whether there is a clear risk of a serious breach by a member state of the values on which the EU is built. If the existence of a 'serious and persistent breach' is established, the European Council may decide to suspend the exercise of certain rights (e.g. voting rights) of the member state in question.⁶ Separately, Art 50 TEU opens the possibility for defaulting states to resume their full sovereignty by voluntarily withdrawing from the EU. Since the EMU forms part of the EU, these general principles of responsible membership are also applicable for the members of the euro area. Although the rules and regulations concerning the EMU do not contain a provision on voluntary withdrawal, it seems obvious that such a possibility should exist *a fortiori* for the EMU, as it has been introduced for the EU. Against this background, it seems also reasonable to suspend the exercise of certain rights of a member state, if and as long as that member state fails to respect the criteria and values on which the EMU is built. A case in point is the budgetary power of a member state. When a member state breaks the rules on budget deficits, it may get sanctions. When the fiscal position of a member state is deteriorating in such a way that it needs assistance, the other member states may grant such assistance under strict conditions (e.g. prior approval of government expenditures, which basically suspends that country's budgetary power). In the positive case that the member state concerned succeeds in restoring its capacity to meet the criteria of full membership, it will resume the exercise of the rights that had been suspended. In the negative case of persistent breach of obligations, voluntary withdrawal may prove to be the only

⁵ Under the legal concept of joint and several liability, a lender has the freedom to claim the full loan balance from the signatories as a group (not necessarily on a proportional or pro-rata basis) or from each of them individually. The lender may sue any signatory who has enough free assets to satisfy the lender's claim, without taking any action against the others.

⁶ Art 7 TEU has so far not been applied, although some diplomatic sanctions were taken against Austria (with the rise of Haider to power) in 2000.

remaining option for the member state concerned. It should be stressed that the exit option is available to a(ny) member state. The EU, or the Council, has not the right to expel a member state.

Seen from the perspective of the EU as a post-Westphalian polity, the stability mechanism should be regarded as an indispensable means to assist crisis-stricken member states in overcoming their financial problems. Rather than forming the basis for the issuance of euro-bonds the stability mechanism is meant to help member states in need to return to a situation of normality. Consequently, the ESF/ESM is not an exclusive instrument of the Union, but a joint product of the member states of the euro area and the EU. The contours of a stability mechanism based on burden sharing for euro area countries as well as for European banks can now be sketched as follows.

When establishing a stability mechanism, it is important to avoid turning such a mechanism into a (permanent) transfer union. The overarching goal of any stability mechanism is to preserve financial stability, which is a public good. The moral hazard can be contained in two ways: imposing *ex ante* strict governance on fiscal deficits and supervision of banks and *ex post* strong conditionality on financial assistance. Improving governance as part of a strengthened Stability and Growth Pact is much needed. A full discussion of the political economy of the Stability and Growth Pact is beyond the scope of this paper. Microprudential supervision of cross-border banks is strengthened through the new European Banking Authority and macroprudential supervision through the new ESRB. Moving to *ex post*, the Directorate General Competition has proved to be very effective in disciplining banks that received state aid during the 2007-2009 financial crisis. Europe is currently using the IMF experience for conditional assistance to countries. If and when the European Stability Mechanism is expanding, the EU will need to develop its own restrictions, such as the suspension of a member state's budgetary power. That is a very severe inroad into the fiscal sovereignty of a member state, justified by the extreme circumstances. The member state concerned has a strong incentive to improve its fiscal position, in order to remove the external guardianship over its budget.⁷ Alternatively, it can withdraw from the EU/EMU to regain full fiscal sovereignty (though the road towards sustainable finances is likely to be more difficult outside EU/EMU).

Burden sharing for euro area countries

In May 2010, the European Financial Stability Facility (EFSF) was created to provide financial assistance to Greece. The EFSF was subsequently broadened to support other euro area countries in need. The legal basis is provided by a framework agreement agreed between the euro area member states and the EFSF, a special purpose vehicle domiciled in Luxembourg. The EFSF is of a temporary nature and will be succeeded by the European Stability Mechanism (ESM) after June 2013. The ESM will be based on a Treaty of the euro area member states. A legal basis for this new Treaty is created by adding a new article 136(3) in the TFEU: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality".

So far the legal imbedding. The underlying economic principle of the EFSF and the ESM is burden sharing between the euro area member states to safeguard the stability of the euro area. The burden sharing is based on the adjusted ECB capital key (see Goodhart and Schoenmaker (2009) for a discussion of burden sharing keys). This choice of burden sharing key is sensible. In good times, the ECB capital key is used to share the benefits of monetary union, the seigniorage. In bad times, the same key is used to share the (potential) costs of keeping the monetary union together.

The question is whether such arrangements provide sufficient deep pockets. The initial maximum lending volume of the ESM is set at EUR 500 billion. The ESM Treaty provides for further increases of the lending volume, when needed. The effectiveness of this provision depends very much on the procedure and voting rules for such increases (see next sub-section). An estimate for the appropriate size of the stability mechanism is difficult to give. On the one hand, the size should be sufficiently impressive that the markets believe that the stability mechanism can deal effectively with member

⁷ This is comparable to the power that central governments often exercise over lower levels of government when they are applying for special financial assistance. In the Netherlands, for example, Art 12 Financiële Verhoudingen Wet allows for prior approval of all municipal expenditures by the central government in case of special financial assistance.

states in difficulties. If a sufficiently large stability mechanism (“deep pockets”) is established, there may even be less need to use it as markets have then less of an incentive to test the credibility of the deepness of the pockets. Willem Buiter (2011) suggests an enlargement to at least EUR 2,500 billion. On the other hand, there are political and rating constraints. The size of the fund has to be approved by national parliaments. A fund of EUR 2,500 billion would amount to a contribution of about 25% of GDP for each participating member. Next, the AAA rating of some core countries (notably France, Germany and the Netherlands) may come under threat with such high contingent liabilities (RBS, 2011). Finally, financial assistance should, and could, not be unlimited. When the debt service - even at low interest rates - becomes unsustainable for a country, that country will need to restructure its debt to restore economic growth. Financial assistance is thus by definition limited. In sum, the volume of the ESM will need to be expanded substantially, to at least EUR 1,500 billion, to quell the unrest in the financial markets.

Another question is whether these arrangements provide sufficient flexibility in the form of the financial assistance. The basic forms are loans to the Member State in difficulties and primary market support. But in practice there is flexibility. In the summit at 21 July 2011, the European Council, for example, decided to improve the effectiveness of the EFSF and the ESM by allowing them to finance recapitalisations of banks through loans to governments and to intervene in the secondary market. The first concession could facilitate the much needed recapitalisation of the European banking system. The second concession could stabilise the bond market (which has been done so far by the ECB through its Securities Market Programme) and facilitate debt restructuring as the EFSF can buy the bonds at market prices.

Burden sharing for European banks

In the current 2010-2011 sovereign crisis, several national banks are undercapitalised. The Irish banks and the Spanish cajas are exposed to a local housing prices bubble. This is mostly a domestic banking issue, as the large cross-border banks, such as Santander and BBVA, are internationally diversified (Allen *et al*, 2011). Moreover, banks in euro area member states which are experiencing financing problems may also suffer losses, as these banks typically carry bonds issued by their own government. It is therefore sensible that the European Council at its July 2011 summit decided to support governments with loans in case they need to recapitalise their banks.

A very different case arises when cross-border banks experience financing problems. Some major European cross-border banks, such as Fortis and Dexia, suffered large losses in the aftermath of the Lehman collapse. Improvised coordination between the relevant countries to rescue a failing bank may lead to an underprovision of recapitalisations, as each country has an incentive to understate its stake so that a collective solution becomes impossible. Claessens *et al* (2010) provide some illustrative cases studies of Fortis and Dexia during the 2008-2009 financial crisis. In the case of Fortis, a collective solution among the Belgian and Dutch authorities was not feasible due to a lack of common understanding. By contrast, the Belgian and French authorities were able to provide a joint rescue package for Dexia, as their interests were aligned.

Goodhart and Schoenmaker (2009) suggest to apply *ex ante* burden sharing arrangements for cross-border banks to overcome the *ex post* coordination failure between governments. Given their strong banking connections (e.g. Nordea Bank and Danske Bank are operating throughout the Nordic and Baltic region), the Nordic and Baltic authorities are pioneering burden-sharing (Nordic Baltic Memorandum of Understanding, 2010). Under this burden-sharing scheme, the ministries of finance share the costs of a possible bank failure according to a burden-sharing key reflecting the distribution of their assets over the different countries. Enforcement of burden-sharing mechanisms is important. While the EFSF and ESM are legally binding, the Nordic Baltic MoU is not legally binding.

The European financial supervision and stability arrangements are regarded as part of the Internal Market for Banking, as discussed in Section 3.2. Accordingly, any burden sharing arrangements for European cross-border banks could be based on art 114 TFEU. More broadly, Allen *et al* (2011) and Posen and Véron (2009) suggest to establish European deposit insurance and a European resolution authority for European banks. These arrangements could also be based on art 114 TFEU.

4.2 Powers and voting rules

As indicated in Section 2, the parameters of the transfer of sovereignty may change over time. We propose to move from the current loose arrangements for the fiscal powers (based on a mix of category 3 and 4 power sharing) to a shared competence between the EU and the member states (category 2 power sharing). In that way, the EU and the member states would become the joint sovereign behind the euro. Our proposal is obviously different from suggestions to move to a full-blown federal European state, in which the EU would be the single sovereign behind the euro.

So how to structure the stability mechanisms as a shared competence of the EU and the member states? A good starting point is the current informal division of power. The European Council defines the strategic priorities and interests of the Union and is *de facto* in charge in the EU. Following the Lisbon Treaty, the European Council comprises the Heads of State or Government representing the member states and its permanent president and the president of the European Commission both representing the EU (art 15 TEU). The current president Herman van Rompuy (2010) indicates that the European Council is not an intergovernmental body but rather ‘an institution, acting in the legal framework of the Union with its checks and balances’.⁸

The envisaged European Stability Mechanism is almost completely an affair of the member states. The governors are nominated by the member states (art 5(1) ESM Treaty). The European Institutions (the European Commission, the ECB and the president of the Euro Group) have only observer status (art 5(3) ESM Treaty). The Board of Governors appoints the chair and has the choice to elect the president of the Euro Group or to elect a chair from among its members (art 5(2) ESM Treaty). At a minimum, the president of the Euro Group should be invited to chair the ESM. That is possible under the current draft of the ESM Treaty. Moreover, a better mix of member state and Union representatives should be achieved. We suggest giving the European Commission Member for Economic and Monetary Affairs and the President of the ECB full member status. There will be an independent Managing Director (art 7(1) ESM Treaty). The Managing Director will in tandem with the European Commission prepare a proposal for financial assistance subject to strict economic policy conditionality (articles 12 and 13 ESM Treaty).

To be effective on the stability front, the ESM should be able to muster large amounts when needed. To prevent moral hazard, strong conditionality is crucial, so that any euro area member would want to avoid going to the ESM. If and when the ESM could be created on these lines, the EU would have a strong European Monetary Fund forming the necessary “deep pockets” of the euro.

Similarly, there is a need to strengthen the governance arrangements on the Stability and Growth Pact, with more powers for the Union dimension. A full discussion of the SGP powers is beyond the scope of this paper.

Another vital element is the voting rule. True progress on the Internal Market was only achieved after the Single European Act of 1986 moved away from the principle of unanimity for the harmonisation of legislation. Minimum harmonisation (in combination with mutual recognition) and majority voting have been the main drivers of the Internal Market. The EFSF and the ESM are both based on unanimity, called mutual agreement (art 4(3) ESM Treaty). Major decisions, such as granting financial assistance or expanding the capital stock and the maximum lending volume, have to be taken by mutual agreement (art 5(6) ESM Treaty). Under unanimity voting rules, any Member State can block financial assistance, as we have witnessed with the rise to power of nationalist parties in countries such as Finland, Denmark and the Netherlands. Unanimity hampers the swift operation of the ESM and consequently feeds the mistrust of the markets in the new way of decision-making. It is therefore necessary if not imperative to bring decisions concerning the expansion of the capital stock and the provision of financial assistance under the rules of Qualified Majority Voting as foreseen in art 4.4 ESM Treaty.

⁸ In the setting with the current politicians, it seems that the Head of State of the two most powerful euro area members are calling the shots, vide the German-French deal ahead of the 21st July Summit. Nevertheless, the president of the European Council called the Summit to which he is empowered (art 15(3) TEU). It should be noted that the most powerful European Commission president in recent history, Delors, was allowed by the German and French Heads of State to play his role. On important decisions, Delors ensured himself of the backing of Kohl and Mitterand.

5. Conclusions

In a discussion with the then minister of Foreign Affairs of Germany Joschka Fischer at the start of the constitutional debate about the EU in 2000, the French minister Chevènement famously stated that 'Europe is a thing for which lawyers have no name' (Hoeksma, 2011). His words echoed the widespread confusion about the nature of the EU, which has overshadowed the process of European integration from the beginning in the early fifties of the previous century. Should the EU evolve into one federal European State or was the Union to establish itself as a confederation? It appears that the present leaders of the institutions of the EU are still in disarray over this question. The President of the European Commission recently described the EU as a non-imperial empire, while the President of the European Council compared the EU to a convoy of ships and the President of the European Central Bank called it a Union of sovereign states. In the light of this divergence among European leaders themselves, it seems hardly surprising that foreign governments and market participants do not tend to place an unlimited confidence in the EU and the euro area. Rodrik is exemplary in qualifying the EU as 'experimentalist governance' (Rodrik, 2011).

In his essay Naming and Defining the EU, Hoeksma (2009) argues that the Lisbon Treaty signifies the evolution of the EU from more or less traditional confederation into a democratic polity of states and citizens. The hallmark of the EU lies in the sharing and pooling of sovereignty. While the process of European integration started with the transfer of sovereignty in the field of the production of coal and steel, the Lisbon Treaty ensures the exercise of transferred sovereignty will also be controlled in a democratic manner. The EU is not only a union of democratic states, but also constitutes a democracy of its own. Although the nature of a transnational democracy must necessarily differ from that of a national state, there is convincing evidence for the conclusion that the EU has overcome the traditional Westphalian system of international relations and has established itself as a post-Westphalian polity.

As the Economic and Monetary Union forms part of the Lisbon Treaty, it follows that the concept of shared sovereignty is being applied to the euro as well. Just like the EU has not become a state and yet forms a democracy, the euro has developed into the common currency of the Union without the member states having evaporated into a federal state. The purpose of the present paper is to demonstrate that the Lisbon Treaty has organised the governance of the euro area in such a manner that sovereignty is being shared between the EU and the member states of the euro area. State-like solutions should therefore not be pursued. The present discussions about the sovereign debt crisis seem to indicate that Europe's leaders are slowly coming to terms with these new financial and monetary realities. Although some politicians are still advocating 'federal' options such as the issuance of eurobonds, others are exploring innovative ways to convince the markets and notably the rating agencies of the commitment of the EU and the member states of the euro area to share sovereignty over the euro. Unfortunately, the markets have neither patience nor time to await the outcome of this sophisticated debate. They want the euro to live up to the aspirations of the EU. As shown above, the ESM may well prove to be the kind of non-statal instrument with which the goal of a stable and reliable common currency may be realised. At the same time, however, the petty bickering over the Finnish contribution to the bail-out of Greece indicates that the principle of unanimity is certain to undermine the effectiveness of the ESM. Consequently, a more balanced governance structure for the European Stability Mechanism including Qualified Majority Voting, will be indispensable. The progress that has been brought about by the Lisbon Treaty, is that politicians, bankers and the markets are now able to discuss policy options for the EU and the euro area beyond the constraints of the Westphalian system of international relations.

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