CEPS COMMENTARY

Thinking ahead for Europe

# Democracy vs. the Eurozone

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### 4 June 2012

The European Union is a voluntary, quasi-federation of sovereign and democratic states in which elections matter and the electorates in each country seek to determine their own destiny, regardless of the wishes and interests of their partner member states.

Last October, Greece's then-prime minister, George Papandreou, proposed a popular referendum on the second rescue package that had just been agreed at the EU's summit in Brussels. He was quickly told off by German Chancellor Angela Merkel and former French President Nicolas Sarkozy, who considered the referendum (especially its timetable) in breach of the agreement they had just concluded. So the Greeks never voted on it.

But, less than a year later, the referendum is *de facto* taking place anyway. In a union of democracies, it is impossible to force sovereign countries to adhere to rules if their citizens no longer accept them.

This reality has profound implications: all of those grandiose plans to create a political union to support the euro with a common fiscal policy cannot work as long as EU member countries remain both democratic and sovereign. Governments may sign treaties and make solemn commitments to subordinate their fiscal policies to EU rules (or to be more precise, to the wishes of Germany and the European Central Bank). But, in the end, the "people" remain the real sovereign, and they can choose to ignore their governments' promises and reject any adjustment programme emanating from 'Brussels'.

In contrast to the United States, the EU cannot send its marshals to enforce its pacts or collect debt. Any country can leave the EU, and thus the eurozone, when the perceived burden of its obligations becomes too onerous. Until now, it had been assumed that the cost of exit would be so high that it would never be considered. This is no longer true, at least for Greece.

But, more broadly, EU commitments have now become relative to national priorities. This shift in context implies that jointly guaranteed Eurobonds cannot be the silver bullet that some had hoped for. As long as member states remain completely sovereign, no one can fully reassure investors that in the event of a major recession or a eurozone break-up, some states will not simply refuse to pay, or at least refuse to pay for the others. In the light of this uncertainty, it is not surprising that bonds issued by

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the European Financial Stability Facility (the eurozone's rescue fund) are trading at a substantial premium over German debt.

All variants of Eurobonds come with supposedly strong conditionality. Countries that want to use them must follow strict fiscal rules. But who guarantees that these rules will actually be followed? François Hollande's victory over Sarkozy in France's presidential election shows that an apparent consensus on the need for austerity can crumble quickly. What recourse do creditor countries have if the debtor countries become the majority and decide to increase spending?

The recently agreed measures to strengthen economic-policy coordination in the eurozone (the so-called 'six pack') imply in principle that the European Commission should be the arbiter in such matters. Its recommendation can formally be overturned only by a two-thirds majority of the member states. But would a large member country feel bound by rulings from 'unelected official in Brussels'?

Spain's experience is instructive in this respect. After the recent elections there, Prime Minister Mariano Rajoy's new government announced that it did not feel bound by the adjustment programme agreed to by the previous administration. Rajoy was roundly rebuked for the form of his announcement, but its substance was proven right: Spain's adjustment programme is now being made more lenient.

The reality is thus that the larger member states are more equal than the smaller ones. This is of course not 'fair', but the inability of the EU to impose its view on democratic countries might actually sometimes be for the best, given that even the Commission is fallible.

The broader message from the Greek and French elections is that the attempt to impose a benevolent dictatorship of the creditors is now being met by a revolt of the debtors. Financial markets have reacted as strongly as they have because investors recognise that the 'sovereign' in sovereign debt is an electorate that can simply decide not to pay.

This scenario has already played out in the case of Greece, but the fate of the euro will be decided in the larger, systemically important countries like Italy and Spain. Only determined action by their governments, supported by their citizens, showing that they attach overriding priority to their membership in the eurozone, even under difficult circumstances, and that they thus merit unreserved support from the rest of the eurozone, will impress the financial markets. At this point, nothing less can save the common currency.