Mario Einaudi
Center for
International
Studies

No. 1-12

Working Paper Series

The EU Financial Crisis – European Law and Constitutional Law Implications

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June 2012

Mario Einaudi Center for International Studies • www.einaudi.cornell.edu
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Abstract

The EU Financial Crisis is not only an economic crisis, but also a crisis of the rule of law and of democracy. This paper, which deals with the European Law and the Constitutional Law Implications of the EU Financial Crisis, was presented as a lecture in the Berger International Speaker Lectures Series at Cornell Law School on April 11th, 2012. It outlines the core elements of the crisis and presents the strategies adopted by the EU and the Member States for coping with the crisis. After that, the author turns to the struggle with the rule of law that the crisis has led to and argues that Europe has taken some steps in order to rest the new fiscal policy rules and the rescue mechanisms on a legal framework, but that – on the whole – we are still on the way to reaching a satisfying level of compliance with the rule of law and corresponding clarity again. The great remaining challenge is the challenge of democratic legitimacy. Insofar, it is argued that the ESM can be democratically legitimized, at least in the case of Germany. However, the financial crisis gives rise to further questions regarding the future democratic foundation of the EU and regarding – as the German Federal Constitutional Court put it – the future ability of a constitutional state to democratically shape itself. The decisive question will eventually be whether the fiscal discipline aspect or the bail-out aspect of the current political process will actually shape the Union. Complementing the monetary union by a transfer and debt union would have a detrimental effect on the future development of Europe. Therefore, financial support for a member state has to remain an exception, and it has to be granted under strict conditionality. State insolvency should remain an option.

About the Author

Hanno Kube is Professor of Public Law, European Law, Finance and Tax Law at Mainz University, Germany. After graduation from Heidelberg University in 1994 he received an LL.M. from Cornell University in 1995 and worked as research assistant at the Institute for Finance and Tax Law in Heidelberg (chair of Paul Kirchhof, Federal Constitutional Court Justice). Hanno Kube received a doctorate degree from Heidelberg University in 1998 (summa cum laude) and was Visiting Scholar at Berkeley School of Law in the same year. In 2001, he spent six months as Jean Monnet Fellow at the European University Institute in Florence before finishing his habilitation at Heidelberg University in 2003. From 2004 to 2005 Hanno Kube was Professor of Public Law and European Tax Law at the Catholic University Eichstaett-Ingolstadt. Since 2005, he holds his current position. Hanno Kube is, among others, member of the International Fiscal Association and the European Association of Tax Law Professors. He works as counsel for the German Government in finance and taxation matters and represents the German Government at the Federal Constitutional Court and the European Court of Justice. Hanno Kube teaches Constitutional Law, Administrative Law, European Law and Tax Law. His main research interests are in the fields of Constitutional Law as well as Finance and Tax Law.

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The EU Financial Crisis – European Law and Constitutional Law Implications[1]

By Professor Dr. Hanno Kube

The topic of my talk is the EU Financial Crisis, a topic which everybody is aware of and a topic that I have been asked about a lot during the last few weeks in Ithaca. Just a few days ago, the Einaudi Center for International Studies hosted an international conference on the implications of the EU financial crisis inside and outside the Euro zone. And this conference, as all other contributions to the topic, clearly showed that we can only cope with the crisis on the basis of an interdisciplinary approach. Any meaningful crisis management and any longer-term development of the EU, the Euro zone and the financial sector will have to take the form of regulations – something lawyers know best. At the same time, the origins of the crisis and the effects of possible regulation can – if at all – only be assessed by economists and political scientists.

I will speak to you as a lawyer and I will concentrate on the European law and the constitutional law implications of the crisis. So I do not claim that I will comprehensively explain the crisis and offer full-fledged solutions. But I do hope that I can shed some light on the legal framework that governs the measures taken by or to be taken by the institutions involved. This might also explain some of the aspects of how the Euro crisis is currently being discussed in the EU and in the Member States.

I have organized my talk in five parts. I will – first – briefly speak about the crisis itself. Second, I want to present to you the core elements of the strategy adopted by the EU and the member states for coping with the crisis. Third, I will turn to the struggle with the rule of law that the crisis has led to. Forth, I want to show you that a great remaining challenge is the challenge of democratic legitimacy. And finally, fifth, I will draw some future perspectives with regard to bail-outs and fiscal discipline.

[1] This paper was presented as part of Berger International Speaker Lectures Series at Cornell Law School on April 11th, 2012.

I. The Crisis

First, the crisis: The EU financial crisis is primarily a European sovereign-debt crisis. For quite a number of years, most of the member states – as most states in the world including the U.S. – have borrowed money excessively. Today, 23 out of the 27 member states are in the so-called "excessive deficit procedure", a mechanism established in the EU Treaties obliging countries to keep their budget deficits below 3 % of GDP and government debt below 60 % of GDP. This is especially alarming insofar as some of the member states, in particular states in the Euro zone, appear not to be competitive, with regard to the wages/productivity-ratio and also with regard to the balance of payments. Of course, the financial markets may have been hypersensitive and partly dysfunctional after the Lehman collapse. But essentially, the behavior of private investors and also the speculations have brought to light what had been tabooed beforehand: The fact that some of the economies in the Euro zone might be too weak to survive within this zone.

Greece, obviously the country that is worst off, saw growth rates of -3.3 % of GDP in 2009, -3.4 % in 2010 and -6.9 % in 2011; the unemployment rate grew to nearly 20 % in the end of 2011, youth unemployment to more than 40 %; at that time, the country had accumulated public debt amounting to 160 % of GDP.

In Ireland, the crisis was mainly based on the fact that the state had bailed out the main Irish-based banks that had lost about 100 billion Euros after financing a property bubble and after a large number of property developers and homeowners defaulted on their loans. After that the Irish economy collapsed in 2008, unemployment rose to 14 % in 2010, the public debt went from 25 % of GDP in 2008 to nearly 100 % in 2011.

Similarly, Portugal was on the verge of bankruptcy in the beginning of 2011 after pressure from the markets had built up, and despite solid economic performance in the first half of 2010.

And as you know, the crisis spread to other countries with much larger economies, too, in particular Italy and Spain. The public debt of Italy has – on average – quite a long maturity and a substantial share of it is held by domestic investors; however, the economic growth was lower

than the EU average for more than a decade and debt has increased to about 120 % of GDP in 2010. Spain has a comparatively low total debt; nevertheless, economic growth was weak recently; unemployment just rose to 23 %, youth unemployment to more than 50 %, and domestic as well as international pressure increased; so there have been continuous rumors that the country will apply for a bail-out.

II. EU and Member States Strategies

The EU, the member states and also other institutions such as the IMF have developed strategies to deal with the crisis:

In the area of fiscal policy, the member states have adopted austerity measures and programs initiating or accelerating structural fiscal adjustments, in particular by prioritizing investment expenditure in future growth; an impressive example is the reform plan by Monti in Italy. Another important issue in some member states, for example in Greece, is the improvement of the efficiency of tax collection and the tackling of tax evasion and tax benefits fraud. All this has been complemented by EU measures aimed at more fiscal discipline and control: The European Semester procedure requires the members states to hand in their budget planning to the Commission for approval. The so-called “six pack” of regulations and directives adopted in November 2011 is aimed at reinforcing the Stability and Growth Pact with a new set of rules for economic and fiscal surveillance. And furthermore, all EU states except for the UK and the Czech Republic have – on the 2nd of March 2012 – signed the Fiscal Compact which also contains regulations aimed at more fiscal discipline. The Pact puts a cap on the yearly structural public deficit (0,5 % of GDP) and requires a reduction of total debts exceeding 60 % of GDP; it also obliges the signatory states to adopt national rules on maximum borrowing, interestingly at the constitutional level.

In an attempt to increase competitiveness, some of the member states have reviewed the growth incentives in their tax codes and have tried to develop further strategies of economic governance.

On the EU level, the so-called Euro Plus Pact has been signed, in which the member states commit themselves to increasing competitiveness and employment, to securing the sustainability of public finances, to reinforcing financial stability and to coordinating tax policies.

Besides fiscal policy and competitiveness, member states as well as the EU took significant steps to reform financial market regulations, in order to guarantee the functioning of the markets and to frustrate harmful speculation. New agencies as the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) have been set up, the regulatory framework has been improved, just as the U.S. has done with the Dodd-Frank Act, and stress tests have been undertaken und recapitalization mechanisms have been installed.

A last, but important topic on the agenda was and still is crisis management. Here, the member states, the EU and also other institutions, primarily the IMF, work hand in hand. In May 2010, the Euro states and the IMF agreed to grant Greece a 110 billion Euro three year loan on the condition that Greece introduce a series of austerity measures. A few days later, the European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF) were installed in order to support other countries that face financial difficulties. The EFSF was organized as a private corporation under Luxemburg law, with all the Euro states holding shares in the corporation. The EU regulation on the EFSM gives the EU commission the power to grant up to 60 billion Euros in financial support to individual Euro states. In total, the EFSF is authorized to issue up to 440 billion in loans until June 2013. The EFSF refinances these loans on the capital markets, and the Euro states guarantee this refinancing. Supplementing this provisional safety-net, the IMF agreed to provide further loans of up to 250 billion Euros.

After it became clear that the effective lending capacity of the EFSF might be lower than planned due to changing ratings by the major rating agencies, member states increased its effective lending capacity by guaranteeing loan refinancing up to an amount of 780 billion euros.

As the EFSF can only lend money to Euro states until mid-2013, the European Council decided to install the European Stability Mechanism (ESM) as a successor to the EFSF. The ESM is not structured as a private corporation, but as an intergovernmental organization under public

international law. The ESM has an authorized capital stock of 700 billion euros, which allows it to grant loans of up to 500 billion euros and which guarantees the refinancing of those loans on capital markets. The initial nominal value of paid-in shares was set at 80 billion euros, which must be purchased by member states in proportion to their interest in the European Central Bank. The remaining authorized 620 billion euros are due when called in by the board of governors, which is the decision-making body of the ESM. The liability of each ESM member state is limited to its portion of the authorized capital stock at its issue price. Nonetheless, the remaining 620 billion authorized Euros can be called in by the board of governors at any time.

The board of governors consists of governors, one appointed by each member state. All important decisions have to be taken unanimously. However, an emergency voting procedure is used where the Commission and the European Central Bank both conclude that a failure to urgently adopt a decision to grant financial assistance would threaten the economic and financial sustainability of the euro area. Under the emergency procedure, a decision by the Board of Governors only requires a qualified majority of 85% of the votes cast.

On this basis, the ESM, that is, the board of governors, can grant precautionary financial assistance in the form of precautionary or enhanced conditioned credit lines; it can grant financial assistance in the form of a loan to an ESM member state – even for the purpose of recapitalizing that member state's financial institutions – and it can purchase the bonds of an ESM member state on the primary or secondary market. All of these instruments are subject to the requirement that the support granted is indispensable to safeguard the financial stability of the euro area as a whole and of its member states. Furthermore, ESM support is coupled with strict conditions, which can range from a macro-economic adjustment programs to maintaining pre-established eligibility conditions.

It is worth noting that the Board of Governors has to review the ESM's maximum lending volume and the adequacy of its authorized capital stock on a regular basis. On the basis of its findings, it may decide to change the authorized capital stock at any time.

In this context, it is important to know that the member states have recently agreed to put the ESM into effect one year earlier than originally planned, by mid-2012, so that the lending capacities of the EFSF and the ESM overlap. Considering the pressure currently exerted by the OECD and other institutions, it seems likely that the ESM and the EFSF might actually both become permanent rescue funds side by side. A few days ago, the member states in Copenhagen decided to increase the effective aggregate lending capacity of the funds to 800 billion euros, which is more than 1 trillion dollars.

As another element of crisis management, the European Central Bank purchased more than 200 million Euros worth of bonds from EU member states on the secondary market. Just recently, the ECB started the biggest infusion of credit into the European banking system in its history, loaning 489 billion euros for a period of three years at a rate of 1 % and then, at the end of February 2012, another 529,5 billion euros under similar conditions – hoping that the banks would then purchase state bonds with that money. However, the IMF just pointed to the fact that there might already be a shortage of sufficiently secure bonds to invest in. The great imbalances in the Target2 payment system of the European System of Central Banks, which amount to hundreds of billions of euros, would also result in unpaid liabilities should the monetary union fall apart.

The second bailout package for Greece, the latest element of crisis management, included the private holders of Greek bonds accepting a haircut of 53,5 % and the EU member states agreeing to an additional retroactive lowering of the bailout interest rates.

III. Struggling with a founding principle of European Integration: The Rule of Law

Looking at all this from the perspective of European law as well as constitutional law, the main focus certainly has to lie on the developments in the area of fiscal policy and on measures taken to deal with the crisis.

Augustine of Hippo once said: “The rule of law being taken away what are states but bands of robbers.” The creators of the European Union, Konrad Adenauer and Charles de Gaulle, also

Robert Schuman and Jean Monnet, in the end of the 1940s and beginning 1950s relied on the rule of law as the founding principle of the Union, as a common denominator that would bring the European states together again, that would foster mutual trust and exchange. From the outset, the Union was based on legal treaties, its instruments were regulations and directives, the European Court of Justice was erected in order to judge upon the legality of measures taken by the EU institutions. The language of law has ever since been the language shared by all member states. And it can be argued that on-going discussions about the extent of the powers granted to the EU, about the application of the fundamental freedoms and about the supremacy of EU law over member states' law are only on their surface a conflict about the rule of law; and that in reality, these discussions actually confirm that the rule of law is of central importance in the Union and that disputes about it in fact make the system stronger. Hence, the rule of law is the backbone of the European Union.

Against this background, it is alarming that some of the measures taken in the course of the financial crisis have clearly deviated from the rule of law principle. The loans that the EU Commission has granted to Greece have no foundation in EU treaties. The guarantees that the member states accepted equally violate treaty law, as Art. 125 sec. 1 cl. 2 of the Treaty on the Functioning of the European Union (TFEU) explicitly prohibits mutual bail-outs. It essentially reads: "A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities … of another Member State …" The no bail-out clause is a central element of the monetary union because it is guarantees fiscal discipline by the member states, which is a pre-requisite for the functioning of a monetary union that is not accompanied by harmonized economic policy. The actual reason for why the EFSF was founded was to circumvent the no bail-out clause. Here, the member states do not formally guarantee the debt of other member states, but rather the debt of the EFSF as it is refinanced in capital markets. However, Art. 125 TFEU is nevertheless violated, as the money borrowed by the EFSF is transferred directly to member states with liquidity problems. A counter-argument put forward in this context is that it makes sense to bundle the borrowing power of all Euro states; but this is – in my view – not sufficient to justify the violation of Art. 125. Some even argue that the bail-out could still be legally justified by the general principles and goals of the common market; but this is an inconsistent argument, because the provisions in Art. 119 ff. TFEU

concretize the principles and goals for economic and monetary policy. And some go even further and hold that the crisis is a form of emergency that allows for measures beyond the law. But here, we are getting close to Carl Schmitt and his notion of the "state of emergency" – Carl Schmitt was neither a friend of democracy nor of the rule of law.

So, Angela Merkel, Nicolas Sarkozy and at that time also Christine Lagarde did not even try to seriously assert that the bail-outs are compatible with the treaties. Instead, the politicians chose to separate the world of law (formal, cumbersome) from the world of politics (pragmatic, constructive). It was emphasized that "if the euro collapses, the EU will collapse", and that the measures taken were therefore "without any alternative". In fact, the word "alternativlos" (with no alternative) was voted the "most disapproved word of the year 2010" in Germany. This deliberate departure from the rule of law was dangerous, because it undermined the foundations of the European Union, the common ground, the basis of communication. And it may be added that strict compliance with the rule of law could have prevented the crisis from escalating, as it would have been clear from the outset that the member states would not bail out other member states. And looking back 10 years, adhering to the rule of law would have also prevented Greece from joining the Euro zone, based on the actual figures.

It is therefore good to see that the heads of government, in the European Council, have in March 2011 decided to give the bail-out measures a new legal foundation, at least for the future. Art. 136 sec. 3 TFEU, which is currently in the course of being ratified by all member states, regulates: "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."

However, we are still struggling with the rule of law, and several important questions remain open:

First: It is quite unclear whether or not the ESM, which on its face is a treaty under public international law, is an integral part of European law or not. This has consequences for

determining whether the principle that EU law takes precedence over member state law applies to the ESM. And this has consequences for the ratification procedures in the member states, also in Germany, as EU law can modify the member states constitutional law including budget-related provisions. From a formal point of view, it can be argued that Art. 136 sec. 3 TFEU only confirms the member states' power to conclude an international treaty on the ESM, so that the treaty is not part of EU law itself; just as the Schengen treaty was a treaty under international law first. On the other hand, it can be argued, that Art. 136 sec. 3 TFEU, by envisioning and initiating the ESM, actually incorporates the ESM into EU law.

Second, it is currently just as unresolved, how the Fiscal Compact mentioned beforehand in the context of new fiscal policy strategies relates to EU treaty law and the member states law. Unlike the ESM which is directly connected to EU law by Art. 136 sec. 3 TFEU the Fiscal Compact has no direct link to EU law. In fact, the compact was meant to become a treaty modifying EU law, but was eventually signed as a treaty under international law, because the procedural requirements for amendments of EU law could not be met – as the UK and the Czech Republic refused to sign. Insofar as the Fiscal Compact deviates from EU law, for example with regard to its modification of the excessive deficit procedure, the question arises, whether these deviations are valid for all signatory states, excluding the UK and the Czech Republic, or whether these deviations are simply invalid because they violate EU law, which takes precedence over the Fiscal Compact. I would hold that the excessive deficit procedure according to Art. 126 TFEU constitutes a complex and exclusive system on voting procedures and sanctions, which can technically not be modified just for some member states. Things become even worse here, as the so-called "six pack" regulations that also amend fiscal policy regulations of the TFEU are only binding for the Euro zone states. So we end up with rules on the same subject matter, some binding for all member states, some for the Euro zone states only, and some for all member states except the UK and the Czech Republic.

And finally, third, it is unclear to what extent the activities of the European Central Bank, primarily the purchasing of member states bonds, can be justified under the applicable treaty provisions.

We can summarize that Europe has taken some steps in order to rest the new fiscal policy rules and the rescue mechanisms on a legal framework, in particular by adopting Art. 136 sec. 3 TFEU. But on the whole, we are still struggling to reach a satisfying level of compliance with the rule of law and corresponding clarity again.

IV. A great remaining challenge: Democratic Legitimacy

A great remaining challenge is the challenge of democratic legitimacy. Many say that the Financial Crisis has quite plainly illustrated, where we stand with regard to the relationship between the Union and the member states. It was not the Commission that came up with the decisive ideas, and that developed real political thrust, but the heads of the member states, cooperating in the European Council, foremost Merkel, Sarkozy and Monti.

And it is also true that the democratic legitimacy of the European Union is still essentially derived from the democratic procedures within the member states. The Union is still lacking a European people which would legitimize the EU institutions and their decision-making on the European level. Therefore, the Union still is a confederation of sovereign states, and not a state by itself.

Its authority depends entirely on the transfer of authority by the member states. This transfer is valid only if it is reconcilable with the constitutional law of the member states and if it is approved by democratic decision in the member states. When viewed in this light, the current developments raise serious questions.

In Germany, parliament only ratified the Maastricht Treaty under the condition that the Monetary Union was conceived of as a stability union and that the ECB would act prudently. Then, in 2009, the German Federal Constitutional Court ruled on the constitutionality of the Act of Accession to the Lisbon treaty and stated that it would violate the principle of democracy and the right to elect the German Bundestag, if budget-related decisions were supranationalized to a considerable extent. Budget sovereignty, the Court held, means that political decisions are planned to combine economic burdens with benefits granted by the state. … Not every European

or international obligation that incidentally affects budget planning endangers the Bundestag's status as the legislature responsible for approving the budget. Germany's openness to European integration, which the German Constitution calls for, requires current legislatures to adapt to parameters laid down and commitments made by prior legislatures when designing current budgets. Instead, what is necessary under the German Constitution is that the Bundestag maintains the overall responsibility for determining budget commitments, with sufficient political discretion regarding revenue and expenditure.

In another decision from September 2011, the Federal Constitutional Court then concretized this for the case of European bail-out mechanisms. According to the Court, Art. 38 of the German Constitution – which guarantees the right to vote on the federal level – demands, in connection with the principle of democracy (Art. 20 sec. 1 and 2, Art. 79 sec. 3 Basic Law), that decisions on revenue and expenditure of public funds remain in the hand of the German Bundestag as a fundamental part of the ability of a constitutional state to democratically shape itself. As elected representatives of the people, the Members of Parliament must remain in control of fundamental budget policy decisions even in a system of intergovernmental governance as well, such as the EU. When establishing mechanisms of considerable financial importance that can lead to incalculable burdens on the budget, the German Bundestag must therefore ensure that a later legislature will separately approve these financial burdens as they arise. In this context, the Bundestag is prohibited from establishing permanent mechanisms that result in an automatic assumption of liability for other states' voluntary decisions, especially if they have consequences whose impact is difficult to calculate. Every larger scale aid measure taken in a spirit of EU solidarity and involving public expenditure at the international or EU level must be specifically approved by the Bundestag. The Bundestag must also ensure that it maintains sufficient parliamentary influence over the manner in which funds it makes available are dealt with.

Applying this standard of scrutiny, the ESM is compatible with the German Constitution, as long as the German governor in the Board of Governors is bound by the requirement of parliamentary approval of his decision-making and as long as important decisions by the Board of Governors have to be taken unanimously. Regarding the emergency procedure, which allows the adoption

of a decision by a qualified majority of 85% of the votes cast, Germany can – according to this standard – only ratify the ESM as long as Germany holds more than 15 % of the voting rights and can therefore block decisions, which is currently the case.

So it appears that the Bundestag will adopt the Act of Accession to the ESM in the end. There are some technical questions still open. One is whether the adoption of the Act requires a two thirds majority in the Bundestag and the Bundesrat (the Senate), because the ESM effectively amends the constitution. The other question concerns the exact way in which parliament has be involved in the future decision-making by the German representative in the board of governors. But these questions are probably of domestic interest only.

V. Future Perspectives

While the ESM can therefore be legitimized, at least in the case of Germany, the whole financial crisis gives rise to further questions regarding the future democratic foundation of the EU and regarding – as the Federal Constitutional Court put it – the future ability of a constitutional state to democratically shape itself. When seen in context, the ESM, the measures taken by the ECB, and also the six-pack regulations and the Fiscal Compact are elements of a broader process that has two sides: On the one side this process can effectuate more fiscal control and discipline in Europe, which is a necessary complement to a monetary union; on the other side, member states may rely on the rescue mechanisms, which could undermine the regulations demanding more fiscal discipline and which could eventually bring about a transfer union with a lot of negative incentives attached to it.

From the perspective of German constitutional law, the substantive limits to constitutional amendments set by Art. 79 sec. 3 of the German Constitution, the so-called perpetuity clause, come into play here. The president of the Federal Constitutional Court, Andreas Vosskuhle, recently indicated that the Court will at some point have to rule that another measure leading to budgetary integration violates the principle of democracy as guaranteed by Art. 79 sec. 3 and that the only way out might be to adopt a new constitution, which is actually envisaged by Art. 146 of the Constitution.

As a constitutional lawyer, I think that we can find ways to accommodate the requirements of more European fiscal discipline with the Constitution. What I am more concerned about, as a European, is the question whether the fiscal discipline aspect or the bail-out aspect of the current political process will actually shape the Union. For 60 years, Europe has grown and flourished on the basis of the member states cooperating and being responsible for the political and fiscal consequences of their decision-making. The introduction of the Euro has, of course, promoted the well-being and growth of the union. But complementing the monetary union by a transfer and debt union would, as I am convinced, have a detrimental effect on the future development of Europe. Therefore, financial support for a member state has to remain an exception, and it has to be granted under strict conditionality. State insolvency should remain an option. The ESM treaty contains a provision, according to which loans can only be granted to member states that have also signed the fiscal compact; this is an important nexus.

In Germany, we have a lot of experience with the equalizing of revenue between our States and also with bail-outs. The US was wise when it refrained from establishing a system for equalizing States' revenue and when it required Federal Reserve Banks to clear their mutual claims and obligations periodically. A transfer and debt union will not lead us anywhere. What we need is fiscal discipline and responsibility, supplemented by sound economic governance. A European Union which is based on clear rules and solid financing will adhere to the rule of law, can be legitimized by the member states and will also remain a good political and economic partner for the U.S.