



Doc. 12556

28 March 2011

Over-indebtedness of states: a danger for democracy and human rights

Report¹

Committee on Economic Affairs and Development

Rapporteur: Mr Pieter OMTZIGT, Netherlands, Group of the European People's Party (EPP/CD)

Summary

Public debt of European states has increased dramatically over the last few years and is still growing, with a risk of becoming unsustainable. In most western European countries, sovereign debt has exceeded a threshold fixed in the Stability and Growth Pact (that is 60% of GDP) and weighs heavily on development prospects. The very foundations of European economic structures are threatened and the quality of life of European citizens is eroding rapidly.

The report stresses the need to repair the system of economic and political governance that has failed to assess risk correctly and to perform responsibly in boom years. The major difficulties that the states at the hard core of European integration are facing should trigger a more concerted action in terms of political and economic governance. The states must exercise their role fully as key regulators and guarantors of the rule of law which underpins democracy, fundamental rights and a sound functioning of market economy.

Expressing concern over shortcomings in transparency and accountability by governments on the public debt situation, the report pleads for closer interaction and information exchange between national parliaments, governments and the Bretton Woods institutions, in particular when the latter's assistance is sought. Finally, it calls on the governments of member states to elaborate graduated strategies for public debt stabilisation and subsequent reduction, whilst spreading the effects of austerity measures fairly across the population and sparing vulnerable groups the weight of adjustments.

1. 2011 - Second part-session



Contents	Page
A. Draft recommendation	3
B. Explanatory memorandum by Mr Omtzigt, rapporteur	5
1. Introduction	5
2. An increasingly disturbing financial situation in member states, particularly during a period of economic crisis	5
3. The excessive debts of states: responsibility shared by rating agencies and states	7
3.1. Rating agencies' responsibility	7
3.2. States' responsibility	8
3.3. Structural weaknesses of the eurozone	8
4. The need to strengthen the democratic legitimacy of the outside bodies which influence the conduct of public policies	9
4.1. Financial markets' growing influence threatens the autonomy of political authority	9
4.2. Transfers of power to certain international organisations: the case of the IMF	9
5. Dangers to democracy	10
5.1. Citizens' socio-economic and civil rights under threat	10
5.2. Democracy imperilled by lack of transparency	11
6. Interstate debt and systemic risk	12
7. The way forward and concluding remarks	13
Appendix – Government debt and deficit for a selection of countries	15

A. Draft recommendation²

1. There can be no good governance without sound economic governance. In their quest for bringing European nations closer together, a group of states defined the rules of the Stability and Growth Pact and engaged in the euro project. However, the recent decade, in particular the last few years, revealed a worrying inability of many European governments to pursue prudent regulatory policies and keep public debt within reasonable limits as defined by the Pact. A dangerous vicious circle of excessive debt, large budget deficits and anaemic economic growth is now threatening the very foundations of European structures and the quality of life of European citizens.
2. The grand European undertaking originated from human tragedies and evolved through crises. The current problems encountered by the states at the hard core of European integration should serve as an impetus for more concerted action in terms of political and economic governance. There is a strong need to repair the economic system that failed to assess risk correctly and to perform responsibly in boom years. Although much power has shifted towards global financial markets and the private sector, the state remains the key regulator and the guarantor of the rule of law which underpins democracy, fundamental rights and the orderly functioning of market economy.
3. The Parliamentary Assembly is concerned that short-sighted national policy decisions have eroded public trust in state institutions, fuelled speculations about the viability of the European welfare model and raised tensions between the public and private sectors. Excessive reliance on the sprawl of financial services to the detriment of other economic sectors has generated macroeconomic imbalances and financial bubbles. Whilst some bank bailouts have been justified by the necessity to preserve economic stability, overall it is not fair to transfer private sector's losses onto the states and ultimately onto all their taxpayers. This distortion in market and governance has to be fixed to avert similar crises in the future.
4. The Assembly appreciates that increased international economic interdependence has led to closer multilateral co-operation, via the G20, aimed at improving regulation of the financial sector, strengthening the oversight of credit rating agencies, and curbing tax evasion. It welcomes the creation of the European Financial Stability Fund in May 2010 as a temporary measure and of the European Systemic Risk Board operational since January 2011, together with three European supervisory authorities for the banking, insurance and securities sectors. These authorities' supervision powers should help detect and correct at an early stage the emerging macroeconomic imbalances and enable better structuring of the activities of credit rating agencies registered in the European Union.
5. Moreover, the Assembly notes the intention of the European Commission to propose, in summer 2011, a comprehensive legislative framework for dealing with ailing banks (that are too big, complex and interconnected to be allowed to fail) so that these could be restructured or resolved without making taxpayers carry the burden. It similarly considers that options for a partial restructuring of excessive public debt should not be a taboo and that framework mechanisms for orderly restructuring should be examined.
6. The Assembly is aware that some of the Council of Europe member states have used dubious practices to minimise their short-term public deficit. These practices typically lack transparency and may have grave repercussions on future and long-term state indebtedness. Notably, derivatives can serve as a useful tool for state debt management but also help hide more public debt if they are misused. As disclosure regarding derivative activity by sovereign borrowers is extremely scarce, monitoring by "government shareholders" (that is to say, the taxpayers) can only be weak at best. This lack of disclosure makes governments less accountable as regards the public debt situation and reduces the transparency of national statistics.
7. The Assembly therefore stresses the importance of transparency in a democracy and market economy. Without transparency, democracy remains incomplete because only an adequately informed population can vote advisedly and thereby exercise political rights in full knowledge of the facts. In this context, the Assembly recalls the merit of the media as a watchdog of democracy, as they enable the public to react to potential overflows of political power or economic wrongdoing. As public finance management requires faultless transparency and the principle of consent to taxation is considered one of the sureties for democracy, governments must show proof of good intentions and ensure full transparency of state accounts in order to uphold democracy.

2. Draft recommendation adopted by the committee on 16 March 2011.

8. In this respect it is extremely worrying that member states have been forced to guarantee each other's sovereign debt, for instance in the cases of Iceland and Greece. State debt has thus become interstate debt. This is only acceptable in truly exceptional circumstances and should be a very temporary emergency measure. Interstate debt and guarantees increase systemic risk within Europe as default of a state may lead to a chain reaction of debt restructuring, emergency budgets, increase in money supply and great suffering for European citizens.

9. The risk of state guarantees and other guarantees should not be obscured in the accounts, as they are a real risk to public finances. The crises in both Ireland and Iceland were the direct consequences of unbearable guarantees. Those guarantees should therefore be reported in full and separately from other business to the parliaments of the member states. Countries that guarantee sovereign debt and other debt should fully report in an internationally consistent way on those guarantees. This also concerns deposit guarantee systems and loans and guarantees to the financial sector. Off-balance book-keeping has been a problem in the build up of the crisis and should thus be avoided in the state accounts. Therefore, the Assembly invites the Organisation for Economic Co-operation and Development (OECD) and the Eurostat to issue methodological guidelines to states with regard to a more transparent reporting on state guarantees, no later than within six months from the adoption of this recommendation.

10. The influence of the financial markets on the state governance, the public interest, the public conduct of economic policies and the European democratic institutions is worrying. The Assembly considers that it is necessary to continue the discussions of this issue further within the Council of Europe, including through the Forum for the Future of Democracy, and in member states' national parliaments. It underscores the need for closer interaction and information exchange between national parliaments, governments and the Bretton Woods institutions, in particular when the latter's assistance is sought.

11. The Assembly recommends that the Committee of Ministers ask the governments of member states to:

11.1. ensure full transparency and accountability for state guarantees and to prepare plans for a gradual scaling down of such guarantees;

11.2. contain the erosion in the living standards and citizen's socio-economic rights by making every effort to spread the effects of austerity measures fairly across the population and to spare vulnerable groups the weight of adjustments;

11.3. show realism in devising graduated strategies for public debt stabilisation and subsequent reduction through continued fiscal consolidation combined with structural reforms, sustained stimulus for growth sectors, improved tax administration and enhanced correlation between the level of welfare benefits and state revenue;

11.4. have a closer look at the integrity of economists whose advice to policymakers is as indispensable as it is dubious, or even manipulative, at times. The Assembly is convinced that the ethics and responsibility of this profession could be strengthened, for example by inviting competent bodies to draw up a global, or at least European, code of conduct, which includes disciplinary measures.

B. Explanatory memorandum by Mr Omtzigt, rapporteur

1. Introduction

1. Many observers, political leaders and individuals believed that the economic and financial crisis was behind us or was coming to an end and that recovery was around the corner. That is not the case, however. The problems encountered by Greece, Ireland, Portugal and Spain, concerns about public debt management in Belgium and Italy, and the austerity measures announced in France, the United Kingdom and many other countries are all bringing home to people a terrible truth: the worst may yet be to come and the economic difficulties are only just beginning. From the sub-prime crisis to the crisis in the international economic system, we have moved from excessive household and private sector debt to excessive government debt.

2. In what must now be called a global recession, many European states faced 2010 in a vulnerable position. Their public debt³ has reached unprecedented levels and is still growing (see the table in the appendix). In 2010, public debt was expected to be around 131% of GDP in Italy, 129% in Greece, 125% in Iceland, 105% in Ireland, 103% in Belgium, 93% in Portugal, 92% in France, 81% in the United Kingdom and 80% in Germany.⁴ The debt situation of central and eastern European states is much better, except for Hungary. Beyond Europe, investor worries accumulate around the United States, which has received repeated warnings about the possible downgrading of its credit rating if the national debt (of about 96% of GDP for 2010) kept growing, and Japan – deemed by some analysts as “a debt time bomb that is waiting to explode”⁵ – with its sovereign debt at 198% of GDP in 2010. The level of debt deemed sustainable (or not penalising development) by many economists is 60-70% of GDP.

3. Some economies are now at risk of collapse and are being forced by excessive debt levels to make painful political, economic and social choices which affect millions of Europeans and undermine their fundamental rights. As credit-worthiness of states is eroding, concerns about shifts of power from nation-states to global financial markets raise significant challenges to democracy and development prospects. This distressing reality is the second largest economic shock in modern history after the Great Depression of the 1930s, with repercussions reaching wide and deep across society.

4. This report will therefore look at major policy challenges that many European governments are currently facing in the light of the precarious state of public finances. It will, to some extent, complement this Assembly's reports on the political consequences of the economic crisis and on the challenges of the financial crisis to the world economic institutions.⁶ I appreciate the valuable input into this report by the participants of the hearing held by the Committee on the Economic Affairs and Development on 29 November 2010⁷ in Paris.

2. An increasingly disturbing financial situation in member states, particularly during a period of economic crisis

5. The current economic crisis, which follows the financial crisis, has brought to public attention some worrying situations for numerous states. This second phase provides a little more evidence of the failures of the policies pursued previously and of the economic models applied for forty years, especially the one which seems to think that the market, alone, can regulate the global economy.

6. Public finance difficulties are far from new in Europe – the creeping indebtedness has been a latent problem – and challenge – for decades as budget deficits persisted. The private sector's debt escalated more recently due to excessive bank leveraging and cheap credit as a result of over-accommodative public monetary policies and regulation. In addition, over 2009-2010, we have seen vast private-to-public debt transfers, with massive liquidity injections by the central banks into the financial markets to support asset

3. Government liabilities to domestic and external creditors.

4. OECD, *Economic Outlook*, November 2010.

5. Quotation from the article on “Europe's crisis weighs on U.S. and Japan”, *International Herald Tribune*, 27 January 2011.

6. Respectively, [Doc. 12282](#) prepared by the Political Affairs Committee (rapporteur: Mr Emanuelis Zingeris, Lithuania, Group of the European People's Party) and [Doc. 11944](#) by the Committee on Economic Affairs and Development (rapporteur: Mr Kimmo Sasi, Finland, Group of the European People's Party).

7. Mr Frédéric Bonneval, Economist, Associate-Expert at Anthea Partners and at Institute Moutaigne; Mr Gustavo Piga, Professor of Economics at the University of Rome Tor Vergata; Mr Gilles Noblet, Deputy Director General for International and European Relations of the European Central Bank; and Mr Emmanuel van der Mensbrugghe, Director of the IMF Offices in Europe, took part in the hearing.

prices and unfreeze credit channels, as well as stimulus programmes for national economies amounting to roughly 2% of GDP for most western countries. I wish to set out in this report the main reasons why European public finances seem to struggle to strike a balance.

7. The size and recurrent nature of public deficits is to some extent due to the difficulties being experienced by most European social systems. As the population ages and the birth rate falls, the desire to reform retirement pension and health-care systems have for several years been central to debate in many European countries. Moreover, as unemployment has been rising across Europe, so did the payouts of unemployment benefits, whilst tax revenue base was shrinking. The funding of pay-as-you-go social systems thus has a significant impact on state budgets, with consequences on the current and future debt levels of the countries concerned.

8. What we may today call the crisis of the welfare state determines the possibilities for European states to implement or not certain policies. It would in fact seem that states no longer have the means of keeping their “promises in respect of health and retirement made to the ageing baby boom generation”. It is in fact my view that realism will have to be shown from now on in order to reform the welfare state and make it viable in the long-term. No reference is made here to the elimination of the state, since this would ignore the lessons of the crisis. I actually think that it is time to rehabilitate the state in its regulator’s position and to define “new boundaries between the state and the private sector”.⁸ The fact is that “only the public authorities can, on the required scale, respond to the problems thrown up by globalised competition”, so it would be reckless to eliminate all the obstacles to the free working of the market. Indeed, the private sector cannot adopt the necessary detachment to enable society as a whole to function in the best possible way.

9. For some states, poor economic performance insufficient to meet society’s needs may be blamed. The problem highlighted in this report stems from many European states’ tendency to live beyond their means. This tendency leads to “structural deficits in public finances [for countries such as Greece, which] since it joined the euro, in 2001, [has] reported only one deficit of less than 3% of GDP”.⁹ This is a relatively common situation in Western countries, which are continuing to increase the speed of their expenditure despite the slowing down of their economies over the past few decades. Military spending is also an important item in some countries that may require additional public scrutiny.

10. I wish to emphasise here that not every case of use of the public deficit gives rise to situations of over indebtedness. Each state’s GDP growth rate is a variable to be taken into account when analysing the impact of budget deficits. Hence the expectation that states’ budgets will move in line with their level of economic activity. Generally speaking, even predictions of low growth levels may cause investors to take an overcautious approach. “Some analysts in fact consider that the current level of debt in the eurozone cannot be offset by expected growth, which is too weak”,¹⁰ and this explains the flight of capital to safer investments.

11. Furthermore, the budgetary situation always tends to worsen during a crisis through operation of the natural mechanism of economic stabilisers. As economic activity slows down, tax revenue declines and expenditure rises, particularly on social protection. In Finland, for instance, “[D]ue to strong automatic stabilisers and stimulus, the fiscal position has deteriorated more rapidly than in any other OECD country”,¹¹ and this notwithstanding a fairly favourable pre-crisis economic situation.

12. All the aforementioned factors of budgetary imbalance lead directly to a deterioration in states’ financial situations simply through the effect of the interest added each year to the debts incurred. Only rarely do states instinctively balance their budget during growth periods to prepare to cope with economic crises like the one currently being experienced in Europe. On this subject, Latvian Prime Minister Mr Valdis Dombrovskis, has expressed regret about Latvia’s failure to take advantage of the pre-crisis years during which annual GDP growth exceeded 10%.¹²

13. Current deficit and public debt predictions are alarming. The Organisation for Economic Co-operation and Development (OECD) forecasts gross government debt in 2011 of 97% of GDP for France, 104% for Belgium, 113% for Ireland, 133% for Italy and 137% for Greece.¹³ As the economic crisis is not over, there is

8. Both quotations are from Anatole Kaletsky’s “L’Etat n’a plus les moyens de faire du social”, published in *Courrier International*, September 2010.

9. “Peur sur les PIIGS”, *Les Echos* website, article updated on 15 July 2010.

10. Claire Gatinois and Marie de Vergès, “L’Union monétaire en danger, l’euro attaqué”, *Le Monde*, 6 February 2010.

11. “Economic Survey of Finland 2010”, OECD Observer, April 2010.

12. Interview with Mr Valdis Dombrovskis, Prime Minister of Latvia, *Le Monde diplomatique*, September 2009.

13. *OECD Economic Outlook*, appended table updated in December 2010.

a need to think straight and try to take the necessary policy decisions, bearing in mind the short- and long-term effect of not only public debt, but also the restrictive budgetary policies introduced to stabilise public finances.

3. The excessive debts of states: responsibility shared by rating agencies and states

3.1. Rating agencies' responsibility

14. "The rating agencies, of which there are three, Standard & Poor's, Moody's and Fitch, are American institutions which rate states, businesses, authorities and financial transactions so as to give investors an overview of the solvency risk of economic players".¹⁴ They award financial ratings to both businesses and states.

15. These financial ratings are referred to by investors purchasing shares or government bonds. Thus the rating agencies control the financial destiny of nations and their millions of citizens. So when, on 29 April 2010, Spain was downgraded from AAA (the top rating) to AA, something that had been just a possibility – the threat of economic collapse – was very close to becoming a reality.

16. Without being the cause of the rise in public debt, the rating agencies nevertheless bear great responsibility for the worsening economic conditions of certain European states and for the renewed speculation which has gripped the trading rooms over recent months. For example, downgrading of a country's sovereign debt rating entails a rise in the interest rates that the country concerned will have to pay on its debt. It is therefore the states in the greatest economic difficulty which have to pay higher interest rates to service their debt, and hence find themselves in even more difficult situations. This vicious circle in practice brings a worsening of the financial situation of states already in difficulty, since they are forced to pay what might be termed a risk premium. It certainly makes economic sense for there to be a correlation between risk and interest rate, but speculation gives rise to situations that are not always justified by a tangible risk of failure to pay.

17. Having already been criticised in our colleague Viktor Pleskachevsky's report under preparation (on the underground economy: a threat to democracy, development and the rule of law) for the positive ratings that they had assigned to private firms (insurers) or banks which held toxic assets, the rating agencies are now rightly coming under fire for their alarmist assessments of the economic health of several European countries, which seem to become self-fulfilling prophecies.

18. I should like at this point to raise the question of these agencies' status and independence. Indeed the United States Senate did a great deal of work on these matters in the wake of the sub-prime crisis, without any reaction from the international community. But the risk of a conflict of interest resulting from the fact that these agencies are paid by the issuers of the securities which are to be rated is, in my opinion, one of the main points which needs to be examined.

19. It is nevertheless impossible to advocate the elimination of these agencies, "which should, in theory, be a factor of stability on stock exchanges". In absolute terms, the agencies enable private individuals' investments to be made safe, and the level of investment would otherwise be insufficient to finance the functioning of the economy. The question that I wish to raise here is that of the concentration of the rating agencies' market, which can soon lead to misuse of power. Clearly, the oligopoly within which they operate makes it possible for them to use their reconnaissance role for profit-making purposes. No clear link can be established between speculation and rating, but "the way in which downgradings sometimes coincide with feverish speculation has some puzzling aspects".¹⁵

20. In this context, we should recall the resolve of G20 leaders, at the November 2010 Seoul Summit, to strengthen the regulation and supervision of credit rating agencies, as well as efforts to reduce the reliance of various stakeholders (including standard setters, market participants, supervisors and central banks) on external credit ratings.

14. Guillaume Errard, "Barnier pour une agence de notation européenne", *Le Figaro*, 30 April 2010.

15. Both quotations are from Philippe Bruneau and Frédéric Bonneval, "Le jeu dangereux des agences de notation", *Le Figaro*, 18 May 2010.

3.2. States' responsibility

21. European states were lending to national banks at unbeatable rates, enabling those banks to grant more loans and subsequently to increase their profits considerably. But when it became necessary to lend to states, and hence to their people, in order to save public systems and health services and to avoid pension cuts, the rates were far higher. So how could "the financial sector [...] make a fair and substantial contribution towards paying for any burdens associated with government interventions to repair the banking system"?¹⁶

22. The intrinsic difference between an economic player and a state cannot be ignored: the former endeavours to make its activity as profitable as possible, while the latter is duty bound to adopt an approach which covers its whole population. Consequently, subsequent negotiation based on the rescue of banks by states had little chance of achieving participation by the financial system.

23. Yet states could have benefited from the rescue of the banks, and without jeopardising their own finances. In practice, the budgetary situation was already alarming for many states, and it is my view that this state of affairs should have encouraged them to demand more favourable interest rates.

24. Furthermore, as noted by Henri Sterdyniak,¹⁷ "[T]he fact that ratings are watched so closely is because states have been incapable of regulating the financial markets and banning speculation". This is why, as the assessment of public finances deteriorated rapidly on the financial markets of the European countries known as the "PIIGS" (Portugal, Italy, Ireland, Greece and Spain), speculation continued thus aggravating further the economic difficulties that were plunging many citizens into considerable economic and social hardship in the short and medium term.

25. I regret that the major statements about strengthening the international system of financial regulation made during the Pittsburgh G20 in September 2009 were not really followed by practical and effective action to control the financial markets, regulate their activities and actually restrict speculation.

3.3. Structural weaknesses of the eurozone

26. Where the eurozone is concerned, we should note that in addition to the persisting lack of convergence of national economies and the absence of effective co-ordination of economic policies among the states, the Greek crisis revealed, if not a lack of solidarity, at least a lack of reactivity. The situation required a speedy response, and some political leaders, fearful of upsetting public opinion at home during a pre-election period, opted to prevaricate rather than to come to Greece's assistance. In the specific case of Germany, I should like to make clear that its economic policy tradition makes Germany one of the most virtuous countries within the eurozone when it comes to fighting inflation and preserving budgetary balance. As this is not enough to curb its neighbours' inflationary tendencies and improvident spending, it is understandable that there was more marked hesitancy in Germany.

27. The European sovereign debt crisis began with anxieties about Greece's ability to repay its debt. It then spread to other countries of the eurozone, particularly Ireland and Portugal, causing the euro to slide against the dollar and bringing panic on the financial markets. The aid plan drawn up in May 2010 by the European Union, with the International Monetary Fund's (IMF) help, was at first very well received by the financial markets, but did not enable the situation to be truly stabilised. This is why the European Union institutions sought to set up an intervention system – in case a risk arose of a state defaulting on its payments – with the possibility of financing by other states.

28. Yet, the mere launch of the European Financial Stability Fund (EFSF) endowed with €440 billion (of which €250 billion is available in loans) will not be enough to stave off this sovereign debt crisis: posing a threat to the viability of the common currency, the crisis made states realise that it was impossible to continue integration without ceding to the Union some powers of budgetary control or co-ordination. We should note a recent decision by Eurostat that the funds raised in the framework of the EFSF must be recorded as the gross public debt of the states participating in a support operation, in proportion to their share of the guarantee given.¹⁸ This decision will allow for the greater transparency of public accounts but will also show higher levels of state debt across the eurozone.

16. Statement issued after the Pittsburgh Summit (G20), September 2009.

17. Director of the Globalisation department at the French Economic Observatory (OFCE).

18. Eurostat news release 13/2011 of 27 January 2011.

29. Some economists propose that the eurozone countries consider issuing Eurobonds, that is to say, a common debt instrument for the members of the European Monetary Union (EMU). It is argued that Eurobond issue could serve as a workable tool of fiscal coordination in those countries and help shield them against capital market uncertainties. This approach would require the participating states to define an adjustable fiscal plan and debt issue framework in the long term, to create a common debt agency (in charge of issuing Eurobonds), to agree a reimbursement agenda for each participating country, to select strategic cross-border investment projects (aiming to reduce economic asymmetries in the EMU), and to progressively replace all the existing sovereign debt stock with Eurobonds in order to minimise moral hazard.¹⁹ I reject this idea as in these countries not even local municipalities pool their debt: each one is responsible for its own debt. A Eurobond would mean far-reaching fiscal and economic integration, way beyond what is now foreseen in the European Union treaties.

4. The need to strengthen the democratic legitimacy of the outside bodies which influence the conduct of public policies

4.1. Financial markets' growing influence threatens the autonomy of political authority

30. The omnipresence and pressure of the financial markets in the public conduct of economic policies are symptomatic of the exhaustion of our economic models. They constitute both a worrying consequence of governments' lack of room for manoeuvre when planning and implementing their economic policies and a reflection of the extreme dependence of European economies on the international finance system, unregulated and caring little about the public interest.

31. The emergency press conference convened by Spanish Prime Minister José Luis Rodríguez Zapatero on 4 May 2010 to deny that Spain had been granted €280 billion in IMF funding, as had been claimed in market circles, demonstrates this vulnerability of states to speculation. The nervousness about intervening and "rescuing" Greece shown by the states of the eurozone can also be interpreted as confirming this.

32. In terms of putting an end to the reckless behaviour of the global finance system, most observers had high hopes of the ambitious declarations made at G20 meetings, particularly the London meeting in September 2009, calling for greater financial regulation. However, it has to be recognised that these ambitious declarations have not been followed by action.

4.2. Transfers of power to certain international organisations: the case of the IMF

33. There is no need for any demonstration of the influence that the International Monetary Fund has on the conduct of public policies. The question arises of the legitimacy of this influence, which ranges from simple recommendations to unchallengeable decisions. This "power-sharing" is called into question simply because the IMF, as a lender of last resort, is always in a position to ask for something in return – something that may have detrimental effects on the population at large.

34. My concerns about the IMF stem from our discussions on the subject in the Committee on Economic Affairs and Development in the presence of Mrs Sonia Escudero, Secretary General of the Latin American Parliament and a member of the Argentine Senate. Those discussions, partly based on experience of the 2001-2002 Argentinian crisis, led the members of our committee to wonder "what is left of democracy if parliaments delegate their powers to the IMF".

35. As far as IMF prescriptions to European states are concerned, examples are legion and clearly illustrate the problem of the shift in power towards this organisation without sufficient legitimate justification or accountability, constituting a danger to democracies. During May 2010, the IMF asked Spain to "do better and act more quickly to make its labour market more flexible, consolidate its banking sector and get public finances back under control".²⁰ I wonder how much room for manoeuvre was left for the Spanish Government, which represents the Spanish people, to devise a policy appropriate to its specific national situation.

36. The Committee on Economic Affairs and Development has already raised this question of legitimacy in its previous work. Mr Kimmo Sasi wondered in 2009 about the possible need for greater interaction between the IMF and national parliaments.²¹ I nevertheless note that the IMF is currently changing, and I welcome the

19. "Moral hazard" defines a tendency to take risk less carefully and without assuming full responsibility for such an action, which leaves other parties to share the responsibility for the consequences.

20. Cécile Chambraud, "L'urgence contraint les Etats à des plans d'économies draconiens", *Le Monde*, 26 May 2010.

reforms carried out in recent years to give the Fund greater legitimacy through improved quota-sharing to remedy the under-representation of some countries, the rebalancing of the IMF executive board and an increased openness to dialogue with national parliaments.

37. It is a fact that we cannot do without an institution like the IMF, which remains the lender of last resort, and which “deals with countries to which nobody wants to lend money”.²² The IMF thus effectively finds itself in a monopoly situation, which may explain why the conditions set for states can be so stringent. Indeed many countries turn to the IMF for help when they are confronted with enormous financial imbalances after having delayed adjustments so long that the need for fiscal austerity is at its peak; in the absence of IMF funding, such countries would be facing far greater and much more painful adjustments.²³ Nevertheless, I feel that thought needs to be given to the IMF’s decision-making structures, so as to find out to what extent citizens’ wishes could be better taken into consideration.

38. For several years the IMF has been striving to show its commitment to greater “transparency in its work, to explaining itself, and to listening to the people whose lives it affects”.²⁴ To this end, the IMF has, since 2004, been developing its relations with member states’ parliamentarians, in order to improve understanding of its action. I nevertheless believe that the situation can be further improved, not least through closer interaction and information exchange between national parliaments, governments and the IMF whenever the IMF assistance is sought. The Assembly should therefore encourage the IMF to continue along this path.

39. Furthermore, Mr Kimmo Sasi’s report stated that IMF interaction with parliamentarians “should include regular scrutiny of the activities of the Bretton Woods institutions by the Assembly in accordance with the terms of reference of the Parliamentary Assembly Committee on Economic Affairs and Development”. I believe that this observation is still relevant, and that parliamentarians should continue to take initiatives to this end.

40. Having said all this, there is at present no credible alternative to the IMF. Greece, for instance, clearly got into trouble because its own politicians failed miserably in maintaining a sustainable budget and deficit. Similarly, Irish politicians seemingly did not raise the alarm when the government issued large guarantees to the financial sector. For all this, there is no alternative to IMF intervention. The IMF itself should be fully aware of its powerful position.

5. Dangers to democracy

5.1. Citizens’ socio-economic and civil rights under threat

41. The austerity policies applied in response to the crisis of state over-indebtedness are liable to worsen further the difficult living conditions of the citizens, already afflicted by recession. Three options could be envisaged for streamlining public finances: governments can either increase public resources (revenue), reduce expenditure, or try to combine the two. In any of these cases, the measures taken may be to the detriment of many citizens.

42. The possibilities for increasing state resources are manifold and of varying complexity. That said, governments tend to increase taxes and dues to achieve this objective. It is therefore difficult to generalise about the impact of measures of this type, since everything actually depends on the tax as such and on the public affected by it. However, a distinction can be drawn between taxes that affect individuals and those directed at businesses. Increasing corporate taxation seems inadvisable at a time of recession because it would have the significant consequence of adding a handicap to the hardships that already beset economic activity and at the same time prejudicing employment. In other words, to avoid measures whose direct consequence would be to delay economic revival, governments would be more inclined to increase personal taxation. Many governments have chosen to raise the level of indirect taxation through the value-added tax which affects all economic actors.

21. The challenges of the financial crisis to the world economic institutions, rapporteur: Mr Kimmo Sasi, 8 June 2009 (Doc. 11944).

22. Mr Valdis Dombrovskis, Prime Minister of Latvia, “Le FMI ne cesse de nous dire que l’absolue priorité est la réduction du déficit”, *Le Monde diplomatique*, September 2009.

23. In the cases of Greece and Ireland, the support that the IMF is providing is exceptional and huge. As the Fund is a quota-based institution, the normal size of the Fund’s support is twice the country’s quota. Yet IMF assistance to Greece equals 31 times its quota and to Ireland, 23 times its quota: this is far in excess of the standard IMF funding policy.

24. IMF, External Relations Department, “The IMF and Legislators”, August 2010.

43. To decrease public spending, the choices are equally limited. What we usually witness are public service budget cuts and a decrease in salaries (internal devaluation),²⁵ reduction of welfare benefits, or freezing of certain large public investment linked with the modernisation of infrastructures, for instance. I consider this kind of policy inappropriate at a period of deep recession. Indeed, these choices would lead to deterioration of the citizens' living conditions for one thing, as well as being unfavourable to economic recovery.

44. The inherent risks of these two alternatives for safeguarding civil and socio-economic rights are of various kinds. At this juncture, a distinction should be drawn between immediate effects and those that may become evident some time later. Among the immediate effects, I consider that these policies, if they delay economic recovery, will curtail for example the right to earn a living through their negative impact on employment. Where vulnerable populations are concerned, these policy choices can have a knock-on effect on the right to live in decent circumstances, firstly because of a possible income loss and secondly because of deterioration in infrastructures and public services (hospitals, prisons, etc.).

45. The question of freezing public spending, when it comes to cancelling capital expenditure, is problematic. Situations where governments seek to rationalise their spending are fully justified, and this avenue should be favoured over cancelling capital expenditure. I think that the future loss of advantages that may result from abandoning modernisation projects is underestimated by European governments. In this perspective, the OECD advocates gradual, co-ordinated ways out of recession, favouring reduction of deficits without neglecting the structural reforms which are indispensable for future growth and better living.²⁶

46. Excessive government debt can have harmful political consequences for a country's democratic stability. In Argentina in 2001, an unprecedented economic recession led to a flight of capital, discredited the political classes and triggered economic and political chaos. Against the background of the austerity measures recommended by the IMF, in particular the freezing of bank deposits, 35 people were killed in riots on 19 and 20 December 2001.

47. It is disturbing to see similar situations emerging in various European countries with the attendant hazards to Europe's democratic stability. In Iceland, after the country's financial meltdown, rioting broke out in Reykjavik in January 2009, the like of which had not been seen since 1949 when Iceland joined NATO. More recently, one of the general strikes in Greece following the announcement of the austerity measures ended with three people being killed when a bank was set on fire in Athens on 6 May 2010. There are many such examples, and the spate of austerity plans throughout Europe has plainly caused its share of demonstrations, demands and riots with a sometimes tragic outcome (see [Doc. 12282](#) on the political consequences of the economic crisis).

5.2. Democracy imperilled by lack of transparency

48. At the time of the Greek crisis, the falsification of state accounts was exposed. Greece is thought to have been disguising the condition of its public budget for some years so as to avoid European Union sanctions under the excessive deficits procedure and the Stability and Growth Pact.

49. The following problem is emphasised: the malpractice condemned on the European and international scene is not new, and was even the subject of a study by the Council on Foreign Relations (United States) and the International Securities Market Association (ISMA) in 2001. However, the absence of change in state practices is perplexing. States seem to have been using this method for ten years or so without any ethical qualms about the transparency of public finances or the considerable impact which these transactions have on the national debt.

50. At the time, Gustavo Piga, a Doctor of Economics, published a book as part of this inquiry, *Derivatives and public debt management*,²⁷ highlighting the dubious practices whereby states could minimise their short-term public deficit. These practices are typified by their lack of transparency and have grave repercussions on future and long-term state indebtedness. For instance, derivatives can be not only a very useful tool for state debt management but also help hide more public debt if they are misused.

25. Internal devaluation was tried and seems to have worked in the Baltic states.

26. Anne Cheyvalle, "Sortie de crise: l'OCDE insiste sur la réduction des déficits", *Le Figaro* newspaper, 11 March 2010.

27. Gustavo Piga, "Derivatives and public debt management", International Securities Market Association (ISMA), Zurich, 2001.

51. Some governments have used the derivative transactions to secure their countries' entry to the European Monetary Union by postponing the rising public debt to future years; they continued such window-dressing strategies once they were in the EMU to avoid sanctions because of the excess public deficit and the debt-over-GDP ratio. As disclosure regarding derivative activity by sovereign borrowers is extremely scarce, monitoring by "government shareholders" (that is to say, the taxpayers) can only be weak at best. This lack of disclosure makes governments less accountable as regards the public debt situation and reduces the transparency of national statistics. In a way, the financial markets propose the derivative "tricks" to governments and later bully them when the public debt situation spins out of control.

52. I stress the importance of transparency in a democracy. Without transparency, democracy remains incomplete because an uninformed population is one which cannot vote advisedly. In that respect, I recall the merit of the media as watchdog of democracy, as they enable the public to react to potential overflows of political power.

53. In the situation described above, lack of transparency affects public financial management, an area that quintessentially requires faultless transparency. That is why the principle of consent to taxation, asserted for the first time in *habeas corpus*, has ever since been considered one of the sureties for democracy. Consequently, whether taxes are to be levied or funds raised, I consider that governments must show proof of good intentions in order to safeguard democracy.

54. Moreover, having regard to the social consequences of public debt, the citizens must be properly informed of their state's funding strategies. They would thus have all the requisite information for forming a personal and civic opinion and could thereby exercise their political rights in full knowledge of the facts. Failing that, I think our democracies will never be complete, and I would stress that lack of transparency means domination of the people by the elite, which is incompatible with their mission of representation conferred by their election. Leaving aside imperative mandates, only political ethics and democratic values are at issue here.

55. I am aware that lack of transparency in public financial management is not the sole cause of the citizens' growing disinterest in politics. I nevertheless believe that if the citizens were given greater consideration in these matters, they might perhaps be more motivated to involve themselves in public affairs.

6. Interstate debt and systemic risk

56. Countries transformed state debt into interstate debt on an unprecedented scale, first via temporary emergency measures and then in a more permanent way. Iceland became a debtor of the United Kingdom and the Netherlands when Icesave collapsed. Afterwards, European Union countries and the IMF scrambled with emergency loans to Greece when markets were unwilling to issue loans to the country.

57. The European central banks also joined in by buying bonds from troubled countries. Private market parties, such as weakened financial institutions, were thus able to offload their risky assets as the European Central Bank effectively set a floor in bond prices and capped the maximum interest payable. European governments are under extreme public pressure not to give more assistance to troubled banks, but this is an indirect channel through which they do so on quite a large scale. It is questionable whether this is an efficient practice.

58. The first protocol to the European Convention on Human Rights severely limits repossession of assets by the state. One clearly wonders now why it does not limit repossession of debt by states. Whereas repossession of an individual asset violates the right of an individual citizen, repossession of debt may violate the rights of all tax payers.

59. In the current construct, the debtor country may be the stronger party in negotiations. It knows that if and when it refuses to pay, its government may increase its popularity at home and harm the government of the creditor state. Although Iceland is not the best example, the negotiations on the Icesave deal demonstrate this well: Iceland is able to negotiate a reduction in the interest due in every round. Similar developments will take place with the interest rate countries like Greece and Ireland pay on their debt.

60. Also related to this issue is the behaviour of the financial sector. The fact that bonuses have returned (like at ING) and that banks are once again threatening to leave their home country (in the case of the United Kingdom), is appalling. They have received direct state support. They now receive indirect state support as states and the ECB are taking over their bad assets. Moderation on the part of the banking sector itself is highly warranted.

61. I am worried about the increase in systemic risk due to the mutualisation of state debt. If one of the states is unable or unwilling to repay, all the others states in the European Union will share the burden. Citizens in those countries will be angered to find out that, at a time of tax increases in their own country, they are forced to pay for other countries as well, and in particular for countries that have not behaved responsibly. This could potentially lead to an enormous backlash against co-operation across Europe and jeopardise the European project.

7. The way forward and concluding remarks

62. My first suggestion is to take the same course as the G20 of September 2009 concerning financial regulation, by reflecting on a means of improving the international financial regulation system.²⁸ For the purposes of this reflection, I stress the importance of controlling financial speculation on sovereign debts. For that to be possible, the power of the rating agencies with regard to state assets absolutely must be curbed. Governments are also invited to take measures to improve the transparency of public financial management policies, and to do so by increasing the reliability of the statistics on public finances in order to allay investors' suspicions and win back the trust of the citizens. The trustworthiness and transparency of information on public finances must be restored because the problem confronting state authorities concerns the citizens first and foremost. This itself would also take away the power from the rating agencies.

63. Furthermore, it is necessary to regulate more strictly the use of derivatives to avert untoward manipulations such as the one condemned by Gustavo Piga in the case of Italy and replicated by Greece with Goldman Sachs.²⁹ For better regulation, an international apparatus could be devised in order to standardise swap transactions at the European level and thereby permit better containment of the risks run by states. In any case, citizens and investors should have full insight into derivatives positions.

64. I realise that in the short term there is no magic solution for reducing government debt, especially in the present context. The pressing question is therefore how to react to this economic crisis without sacrificing human rights. The Parliamentary Assembly is not the only institution addressing this question; in the United Nations for instance, a high-level round table to discuss the impact of economic and financial crises on the realisation of human rights was organised on 1 March 2010. One of the keypoints of the conclusions is to regard human rights as the "ethical reference"³⁰ or "moral compass" for guiding official policies, even austerity policies.

65. A report jointly drafted by several organisations of civil society³¹ provides some useful answers to the present enquiry. Firstly, states cannot avail themselves of the crisis to justify encroachments on human rights or a more permissive stance in their protection. It is proposed to devise fiscal policy instruments to avert erosion of rights and aggravation of funding needs concerning education, housing or health care, in particular for the vulnerable segments of the population. They say that a set of economic recovery measures ensuring equal access to these rights for all could boost employment and income-generating programmes.³² States should accordingly take care not to implement measures that would have the effect of penalising society's most vulnerable members such as women, children and the elderly.

66. Here attention is drawn to the broad construction which the United Nations Human Rights Council places on human rights issues, more so than the Council of Europe, since the participants in the aforementioned high-level round table also addressed the question of economic and social rights. Indeed, in a situation of economic recession and having considered the consequences of state over-indebtedness, plainly the protection of these rights comes to the fore.

67. I stress the need to rationalise public finances to avert still more severe consequences for the future generations, but consider that the European states should take no radical steps without first analysing their short-term and long-term effects. The interests at stake here are too momentous to risk negative repercussions in the long term. That is why financial rationalisation must be properly thought out and European citizens' fundamental – civil, economic and social – rights safeguarded.

28. Statement issued after the Pittsburgh Summit (G20), September 2009.

29. Louise Story, Landon Thomas Jr and Nelson D. Schwartz, "Wall St. Helped to Mask Debt Fuelling Europe's Crisis", *The New York Times*, published in *Courrier international* weekly, No. 1007, February 2010.

30. Irene Khan, former Secretary General of Amnesty International.

31. Aldo Caliarì, Sally-Anne Way, Natalie Raaber, Anne Schoenstein, Radhika Balakrishnan and Nicholas Lusiani, *Bringing Human Rights to Bear in Times of Crisis*, March 2001.

32. United Nations Non-Governmental Liaison Service, "Réagir à la crise économique sans sacrifier les droits de l'homme", 8 June 2010.

68. As the creditworthiness and finances of many European states have dwindled, challenges for the eurozone economies are particularly daunting. The euro promise of greater stability and shared prosperity has turned into the “euro-mess” in the absence of credible economic governance, or at least co-ordination of policies. A mountain of debt that many European economies are facing will not melt away without concerted and orderly action. The immediate challenge is to at least to stop the public debt from growing, to devise credible strategies for debt reduction over the medium to long term and to rebuild trust in the economic system by repairing past failures in governance and regulation.

69. The creation of the European Financial Stability Fund in May 2010 was a welcome development that helped appease the financial markets for some time. In addition, the newly created watchdogs – the European Systemic Risk Board and three European supervisory authorities for the banking, insurance and securities sectors – became operational from January 2011. They have exclusive centralised supervision powers that should help detect and correct early any emerging macroeconomic imbalances. The European Securities and Market Authority has also been tasked with overseeing the activities of credit-rating agencies registered in the European Union. Moreover, we should note the intention of the European Commission to propose, in summer 2011, a comprehensive legislative framework for dealing with ailing banks (that are too big, complex and interconnected to be allowed to fail) so that these could be restructured or resolved without making taxpayers carry the burden.³³

70. Further to these European governance measures, I feel it is worth examining options for the gradual de-escalation of sovereign debt problems, including by considering early partial restructuring of state liabilities (to share the state debt burden with private investors and preserve growth prospects), some monetary easing, continued fiscal consolidation combined with structural reforms and sustained stimulus for growth sectors. And finally, states should be extremely aware of the moral hazard issues in underwriting each other's debt. In case of a default, such underwriting will come at a heavy economic and political price.

71. Banks themselves will have to take a closer look at their public support. They are no longer private sector institutions as they once were and are now able to offload losses to the public. This means that they must be publicly accountable and show moderation to themselves. Repossession on failing mortgages will also occur in Europe and will look particularly ugly when it goes hand-in-hand with unexplainable and inexcusable behaviour of the management whose jobs and banks were often rescued by the public at large.

72. We also need to have a closer look at the integrity of economists whose advice to policymakers is as indispensable as it is dubious, or even manipulative, at times. Of course, economics is not an exact science but the ethics and responsibility of this profession could be strengthened, such as by devising a global code of conduct.

73. This report therefore comes at a crucial time when key economic decisions are being taken which will determine the health and growth of Europe's nations in the years ahead, as well as the development of our societies, living conditions and respect for Europeans' fundamental rights. The decisions which our governments must now take will have an irreversible impact on the building of 21st century Europe and on the quality of the lives of future generations.

33. News release IP/11/10 of 6 January 2011.

Appendix – Government debt and deficit for a selection of countries

Country	Government debt, as % of GDP				Government deficit/surplus, as % of GDP			
	2007	2008	2009	2010*	2007	2008	2009	2010*
Austria	59.3	62.3	67.5	76	-0.4	-0.5	-3.5	-4.4
Belgium	84.2	89.6	96.2	103	-0.3	-1.3	-6.0	-4.9
Bulgaria	17.2	13.7	14.7		1.1	1.7	-4.7	
Czech Republic	29.0	30.0	35.3	49	-0.7	-2.7	-5.8	-5.2
Cyprus	58.3	48.3	58.0		3.4	0.9	-6.0	
Denmark	27.4	34.2	41.4	54	4.8	3.4	-2.7	-4.6
Estonia	3.7	4.6	7.2		2.5	-2.8	-1.7	-1.5**
Germany	64.9	66.3	73.4	80	0.3	0.1	-3.0	-4.0
Greece	105.0	110.3	126.8	129	-6.4	-9.4	-15.4	-8.3
Finland	35.2	34.1	43.8	58	5.2	4.2	-2.5	-3.3
France	63.8	67.5	78.1	92	-2.7	-3.3	-7.5	-7.4
Hungary	66.1	72.3	78.4	89	-5.0	-3.7	-4.4	-4.2
Ireland	25.0	44.3	65.5	105	0	-7.3	-14.4	-32.3
Italy	103.6	106.3	116.0	131	-1.5	-2.7	-5.3	-5.0
Latvia	9.0	19.7	36.7		-0.3	-4.2	-10.2	-8.0**
Lithuania	16.9	15.6	29.5		-1.0	-3.3	-9.2	-7.2**
Luxembourg	6.7	13.6	14.5	21	3.7	3.0	-0.7	-2.2
Malta	61.7	63.1	68.6		-2.3	-4.8	-3.8	
Netherlands	45.3	58.2	60.8	75	0.2	0.6	-5.4	-5.8
Poland	45.0	47.1	50.9	64	-1.9	-3.7	-7.2	-7.9
Portugal	62.7	65.3	76.1	93	-2.8	-2.9	-9.3	-7.3
Romania	12.6	13.4	23.9		-2.6	-5.7	-8.6	-6.8**
Slovenia	23.4	22.5	35.4		0	-1.8	-5.8	-5.7**
Slovak Republic	29.6	27.8	35.4	47	-1.8	-2.1	-7.9	-8.1
Spain	36.1	39.8	53.2	72	1.9	-4.2	-11.1	-9.2
Sweden	40.0	38.2	41.9	51	3.6	2.2	-0.9	-1.2
United Kingdom	44.5	52.1	68.2	81	-2.7	-5.0	-11.4	-9.6
EU-27	58.8	61.8	74.0	91.6	-0.9	-2.3	-6.8	-6.3
Croatia	32.9	28.9	35.3		-2.5	-1.4	-4.1	-4.7**
Iceland	29.1	57.4	...	125	5.4	-13.5	-9.1	-6.3
Russian Federation**	7.2	6.5	8.5		6.0	4.9	-6.2	-5.3
Switzerland*	46.5	44.3	42.2	42.1	1.7	2.3	1.2	-0.7
Turkey	39.4	39.5	45.4		-1.0	-2.2	-6.7	-4.1**

Figures in **bold** type indicate government debt levels in excess of 60% of GDP.

Source: Eurostat; *OECD data, unless otherwise indicated (OECD definition of gross government debt differs from the Maastricht definition used by EU/Eurostat); **EBRD data