POLITICAL, FISCAL and BANKING UNION

IN THE EUROZONE?

Edited by
Franklin Allen, Elena Carletti & Joanna Gray

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European University Institute
Department of Economics
European University Institute
Robert Schuman Centre for Advanced Studies
Wharton University of Pennsylvania
Financial Institutions Center

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AUTHORS
Edmond Alphandéry
Tony Barber
Andrea Enria
Luis Garicano
Daniel Gros
Mitu Gulati
Richard J. Herring
Robert P. Inman
Jan Pieter Krahnen
Mattias Kumm
Peter L. Lindseth
Patrick O'Callaghan
Richard Parker
Hélène Rey
Philip Wood

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and
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University of Pennsylvania, Philadelphia, USA

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The Contributors

Franklin Allen
University of Pennsylvania
Franklin Allen is the Nippon Life Professor of Finance and Professor of Economics at the Wharton School of the University of Pennsylvania. He has been on the faculty since 1980. He is currently Co-Director of the Wharton Financial Institutions Center. He was formerly Vice Dean and Director of Wharton Doctoral Programs and Executive Editor of the Review of Financial Studies, one of the leading academic finance journals. He is a past President of the American Finance Association, the Western Finance Association, the Society for Financial Studies, and the Financial Intermediation Research Society, and a Fellow of the Econometric Society. He received his doctorate from Oxford University. Dr. Allen's main areas of interest are corporate finance, asset pricing, financial innovation, comparative financial systems, and financial crises. He is a co-author with Richard Brealey and Stewart Myers of the eighth through tenth editions of the textbook Principles of Corporate Finance.

Edmond Alphandéry
Nomura
Edmond Alphandéry is President-elect of the Centre for European Policy Studies (CEPS) based in Brussels. He sits on the Board of GDF SUEZ and is the President of its Strategic Committee. He served as Chairman of CNP Assurances in Paris from 1998 to 2012. Prior to this appointment he was Chairman of Electricité de France. From 1993-1995 he worked as a Minister of the Economy in the Government of Edouard Balladur, where he launched a widespread program

of privatization, including BNP, Elf, and Renault, and gave its independence to the Banque de France. Mr. Alphandéry graduated in 1966 from Institut d'Etudes Politiques de Paris, and after studying at the University of Chicago and the University of California, Berkeley, he obtained his French Ph.D. in Economics in 1969 and his "Agrégation" in Political Economy in 1971. He served as a Professor of Political Economy at the University of Paris II. A former Member of the Consultative Committee of RWE AG, Mr. Alphandéry is presently a Board Member of Crédit Agricole CIB, of NEOVACS, sits on the European Advisory Panel of NOMURA Securities, and is on the advisory committee of A.T. Kearney, France. He also attends the Consultative Committee of the Banque de France and belongs to the French section of the "Trilateral Commission." He is the author of numerous articles and books devoted to economic and monetary affairs, as well as the founder of the "Euro50 Group" which gathers leading European personalities concerned with monetary policy of the European Central Bank.

Tony Barber
Financial Times
Tony Barber is Europe Editor and Associate Editor at the Financial Times in London. He joined the newspaper in 1997 and served as bureau chief in Frankfurt (1998-2002), Rome (2002-2007) and Brussels (2007-2010). He started his career in 1981 at Reuters news agency, serving as a foreign correspondent in New York, Washington and Chicago (1982-83), Vienna (1983), Warsaw (1984-85), Moscow (1985-87), Washington (State Department correspondent, 1987-88) and Belgrade (bureau chief, 1989). He worked from 1990 to 1997 at The Independent in London, where he was successively East Europe Editor and Europe Editor. He studied from 1978 to 1981 at St John's College, Oxford University, where he received a BA First Class Honours degree in Modern History. He was born in 1960 in London.

Elena Carletti
European University Institute
Elena Carletti is Professor of Economics at the European University Institute, where she holds a joint chair in the Economics Depart-

ment and the Robert Schuman Centre for Advanced Studies. She is also Research Fellow at CEPR, Extramural Fellow at TILEC, Fellow at the Center for Financial Studies at CesIfo, and at the Wharton Financial Institutions Center. Her main areas of interest are financial intermediation, financial crises, financial regulation, corporate governance, industrial organization and competition policy. She has published numerous articles in leading economic journals, and has recently coedited a book with Franklin Allen, Jan Pieter Krahnen and Marcel Tyrell on Liquidity and Crises. She has worked as consultant for the OECD and the World Bank and participates regularly in policy debates and roundtables at central banks and international organizations.

Andrea Enria
European Banking Authority
Mr Andrea Enria took office as the first Chairman of the European Banking Authority on 1 March 2011. Before that date he was the Head of the Regulation and Supervisory Policy Department at the Bank of Italy. He previously served as Secretary General of CEBS, dealing with technical aspects of EU banking legislation, supervisory convergence and cooperation within the EU. In the past, he also held the position of Head of Financial Supervision Division at the European Central Bank. Before joining the ECB he worked for several years in the Research Department and in the Supervisory Department of the Bank of Italy. Mr Enria has a BA in Economics from Bocconi University and a M. Phil. in Economics from Cambridge University.

Luis Garicano
London School of Economics
Professor Garicano is Head of the Managerial Economics and Strategy Group within the Department and Programme Director for the MSc Economics and Management| programme. He earned two bachelor's degrees, one in economics in 1990 and one in law in 1991, both from Universidad de Valladolid in Spain. He earned a master's degree in European economic studies from the College of Europe in Belgium in 1992. He then moved to the United States, where he earned a master's degree in economics in 1995 and a PhD in

economics in 1998, both from the University of Chicago. He joined the faculty of the University of Chicago Booth School of Business in 1998, initially as Assistant Professor, progressing to Associate Professor in 2002 and full Professor in 2006. During his time at Chicago Booth he took leave to teach at the Sloan School of Management at the Massachusetts Institute of Technology (MIT), as well as London Business School. He joined LSE in 2007, initially as Director of Research in the Department of Management. He has also worked as an economist for the Commission of the European Union and has been involved in efforts to promote structural reforms in the Spanish economy. In particular he has co-authored proposals to reform the labour markets, housing markets, and the pension and health systems, as well as a recent study with McKinsey on the Growth perspectives for the Spanish economy. He also currently co-edits the most widely read economics blog in Spanish, NadaesGratis.es.

Joanna Gray
University of Newcastle
Is Professor of Financial Regulation, Newcastle Law School, University of Newcastle upon Tyne and has many years experience lecturing, publishing and consulting in the broad areas of financial markets law and corporate finance law. She has taught and supervised students at undergraduate, Masters and PhD level at leading universities including UCL, London, Universities of Glasgow, Strathclyde, Dundee and Newcastle University. She has also conducted executive education and CPD activity for City of London law firms, for clients in the banking and finance sectors and for the IMF, Reserve Bank of India, Turkish Capital Markets Board, the Moroccan Capital Markets Board and financial regulatory staff on the Global Governance Programme at the European University Institute. She has participated in high level policy seminars as an academic expert with the Bank of England (2013), UK Financial Services Authority (2012) and the Australian Prudential Regulatory Authority (2011). Her published work includes Implementing Financial Regulation: Theory and Practice (Wiley Finance: 2006), and is co-editor of a collection of essays Financial Regulation in Crisis: The Role of Law and the Failure of Northern Rock (Edward Elgar Financial Law Series: 2011). She has written extensively for both academic Journals such as Journal of Corporate Law Studies, Capital Markets Law Journal, Law and

Financial Markets Review, Journal of Law and Society, Journal of Banking Regulation and industry Journals such as the Journal of Financial Regulation and Compliance. Her current research looks at the operationalization of the macro prudential regulatory agenda into legal systems and the challenges that might pose to legal culture. She graduated in 1982 with LL.B. (Bachelor of Laws) Degree 1st Class Honours, Newcastle University, and in 1983 with an LL.M. (Master of Laws) Degree 1983 Yale Law School, USA where she was a Fulbright Scholar and Graduate Fellow. In 1984 she passed her Law Society Finals Course passed with First Class Honours and was admitted as Solicitor of the Supreme Court of England and Wales after a two year training contract period with Herbert Smith, City of London Solicitors 1987-1989 and has also worked for Arthur Andersen/Andersen Legal in the area of retail finance.

Daniel Gros
Centre for European Policy Studies (CEPS)
Daniel Gros is the Director of the Centre for European Policy Studies (CEPS), a post he has held since 2000. Among other current activities, he serves as adviser to the European Parliament and is a member of the Advisory Scientific Committee of the European Systemic Risk Board (ESRB), the Bank Stakeholder Group (BSG) of the European Banking Authority (EBA) and the Euro 50 Group of eminent economists. He also acts as editor of Economie Internationale and International Finance.
In the past, Daniel Gros worked at the IMF (1984-86) and at the European Commission (1989-91) as economic adviser to the Delors Committee, which developed the original plans for the Economic and Monetary Union. He has been a member of high-level advisory bodies to the French and Belgian governments and provided strategic advice to numerous governments, including Downing Street and the White House at the highest level. From 2009-2011, he served on the Supervisory Board of Central Bank of Iceland.
Gros holds a PhD. in economics from the University of Chicago, has taught at prestigious universities throughout Europe and is the author of several books and numerous contributions to scientific journals and newspapers. Since 2005, he serves as an independent member on the board of Eurizon Capital Asset Management (Milan).

Mitu Gulati
Duke University School of Law
Mitu Gulati is on the faculty of the Duke University School of Law in North Carolina. His current research focuses on the historical evolution of sovereign debt contracts. He has authored articles in journals such as the Tulane Law Review, the University of Missouri Law Review and the Maine Law Review.

Richard J. Herring
University of Pennsylvania
Richard J. Herring is Jacob Safra Professor of International Banking and Professor of Finance at The Wharton School, University of Pennsylvania, where he is also founding director of the Wharton Financial Institutions Center. From 2000 to 2006, he served as the Director of the Lauder Institute of International Management Studies and from 1995 to 2000, he served as Vice Dean and Director of Wharton's Undergraduate Division. During 2006, he was a Professorial Fellow at the Reserve Bank of New Zealand and Victoria University and during 2008 he was the Metzler Fellow at Johann Goethe University in Frankfurt. He is the author of more than 100 articles, monographs and books on various topics in financial regulation, international banking, and international finance. His most recent book, The Known, the Unknown & the Unknowable in Financial Risk Management (with F. Diebold and N. Doherty) has just been recognized as the most influential book published on the economics or risk management and insurance by the American Risk and Insurance Association. At various times his research has been funded by grants from the National Science Foundation, the Ford Foundation, the Brookings Institution, the Sloan Foundation, the Council on Foreign Relations, and the Royal Swedish Commission on Productivity. Outside the university, he is co-chair of the US Shadow Financial Regulatory Committee and Executive Director of the Financial Economist's Roundtable, a member of the Advisory Boards of the European Banking Report in Rome, and the Institute for Financial Studies in Frankfurt. In addition, he is a member of the FDIC Systemic Risk Advisory Committee, the Systemic Risk Council and the Stanford University Working Group on Resolution. He served as co-chair of the Multinational Banking seminar from 1992–2004 and was a Fellow of the World Economic Forum in Davos from

1992–95. Herring received his undergraduate degree from Oberlin College in 1968 and his PhD from Princeton University in 1973. He has been a member of the Finance Department since 1972.

Robert P. Inman
University of Pennsylvania
Robert P. Inman is the Richard K. Mellon Professor of Finance, Economics, and Public Policy, Wharton School, University of Pennsylvania, and Research Associate, National Bureau of Economic Research. His research, focusing on the design and impact of fiscal policy, has been published in the leading academic journals in economics, law, and public policy. He is the editor of three books, The Economics of Public Service (with Martin Feldstein), Managing the Service Economy, and Making Cities Work: Problems and Prospects for Urban America. In addition to the University of Pennsylvania, he has taught at Harvard, University of California, Berkeley, Stanford, University of London, and the European University Institute. He is an advisor to the Federal Reserve Banks of Philadelphia and New York and has advised the states of New York, Pennsylvania, and California, the U.S. Treasury and U.S. Departments of Education and Housing and Urban Renewal, the World Bank, the government of South Africa, and the National Bank of Sri Lanka on fiscal policy.

Jan Pieter Krahnen
Goethe University
Krahnen is a Professor of Finance at Goethe University's House of Finance, located in Frankfurt, Germany. He is also a Director of the Center for Financial Studies (CFS), a CEPR Fellow, and the 2011 President of the European Finance Association. His current research interests focus on the implications of the 2007-2010 financial turmoil for banking, systemic risk, and financial market regulation. His publications appeared, among others, in the Review of Economic Studies, the Journal of Financial Intermediation, the Journal of Banking and Finance, and Experimental Economics. Krahnen has been involved in policy advisory on issues of financial market regulation, most recently as a member of the Issing-Commission, advising the German government on the G-20 meetings 2008-2011. He is also a member of the Academic Advisory Board, German Federal Ministry of Finance, a member of the Group of Economic Advi-

sors (GEA) at the European Securities and Markets Agency (ESMA), Paris, and a member of the High Level Expert Group on Structural Reform of the EU Banking Sector (Liikanen Commission), Brussels.

Mattias Kumm
New York University
Mattias Kumm is the Inge Rennert Professor of Law and has taught at NYU since 2000. His research and teaching focuses on basic issues in Global, European and Comparative Public Law. He also holds a Research Professorship on "Rule of Law in the Age of Globalization" and is Managing Head of the Rule of Law Center at the WZB in Berlin and a Professor of Law at Humboldt University. He was a Visiting Professor and John Harvey Gregory Lecturer on World Organization at Harvard Law School and has taught and lectured at leading universities worldwide. Kumm holds a JSD from Harvard Law School and has pursued studies in law, philosophy and political sciences at the Christian Albrechts University of Kiel, Paris I Pantheon Sorbonne and Harvard University before he joined NYU.

Peter L. Lindseth
University of Connecticut
Peter Lindseth is the Olimpiad S. Ioffe Professor of International and Comparative Law and the Director of International Programs at the University of Connecticut School of Law. His courses include Administrative Law, Civil Procedure, European Union Law, International Business Transactions, Comparative Legal History, and Torts. His research focuses on the historical evolution of the administrative state in the nineteenth and twentieth centuries as well as the relationship of administrative governance to the process of European integration. He holds a B.A. and J.D. from Cornell, and an M.A., M.Phil., and Ph.D. in European history from Columbia. Professor Lindseth has previously served as the Daimler Fellow at the American Academy in Berlin; visiting professor at Yale Law School; fellow and visiting professor in the Law and Public Affairs (LAPA) Program at Princeton University; visiting fellow (Stipendiat) at the Max Planck Institute for European Legal History in Frankfurt, Germany; Jean Monnet Fellow at the Robert Schuman Center for Advanced Studies as well as lecturer at the Academy of European Law, both at the European University Institute (EUI) in Florence, Italy; and visiting

professor in the faculty of law at both the Université Panthéon-Assas Paris II and the Université de Droit, d'Economie, at des Sciences d'Aix-Marseille, France.

Patrick O'Callaghan
Newcastle University
Dr Patrick O'Callaghan is senior lecturer in law at Newcastle Law School, Newcastle University. Before joining Newcastle, he was researcher at the Centre for European Law and Politics (ZERP) at the University of Bremen. Dr O'Callaghan's research interests are in the areas of legal theory (particularly connections between law, epistemology and cognitive theory), tort law, and EU law.

Richard Parker
Harvard Kennedy School
Richard Parker is Lecturer in Public Policy and Senior Fellow of the Shorenstein Center. An Oxford-trained economist, his career before coming to the Kennedy School in 1993 included journalism (he co-founded the magazine Mother Jones as well as Investigative Reporters & Editors, and chairs the editorial board of The Nation); philanthropy (as executive director of two foundations he donated more than $40 million to social-change groups); social entrepreneurship (he grew environmental group Greenpeace from 2,000 to 600,000 supporters, helped launch People for the American Way, and raised over $250 million for some 60 non-profits), and political consulting (advising, among others, Senators Kennedy, Glenn, Cranston, and McGovern). From 2009 to 2011 he was an economic advisor to Greek Prime Minister George Papandreou. His books include The Myth of the Middle Class, an early study of widening U.S. income and wealth distribution and Mixed Signals: The Future of Global Television, a critical assessment of the spread of satellite-based news and its political impacts. His intellectual biography, John Kenneth Galbraith: His Life, His Politics, His Economics, which traces the history of 20th century economic theory and policy through the career of Harvard's most famous economist, was described by William F. Buckley as "the best biography of the century," by Sean Wilentz as "the best progressive history I've read in 15 years," and by Keynes' biographer Robert Skidelsky as "an unparalleled achievement." His

academic articles appear in numerous academic anthologies and journals and he writes regularly for magazines and newspapers, including the New York Times, Washington Post, Los Angeles Times, New Republic, Nation, Harper's, Le Monde, Atlantic Monthly, and International Economy, among others. He received the Kennedy School's Carballo award for outstanding teaching in 2011 and ALANA's Teacher of the Year award in 2007 from the School's students of color.

Hélène Rey

London Business School

Hélène Rey is Professor of Economics at London Business School. Until 2007, she was at Princeton University, as Professor of Economics and International Affairs in the Economics Department and the Woodrow Wilson School. Her research focuses on the determinants and consequences of external trade and financial imbalances, the theory of financial crises and the organization of the international monetary system. She demonstrated in particular that countries gross external asset positions help predict current account adjustments and the exchange rate. In 2005 she was awarded an Alfred P. Sloan Research Fellowship. She received the 2006 Bernácer Prize (best European economist working in macroeconomics and finance under the age of 40). In 2012 she received the inaugural Birgit Grodal Award of the European Economic Association honoring a European-based female economist who has made a significant contribution to the Economics profession. Professor Rey is a Fellow of the British Academy. She is on the board of the Review of Economic Studies and associate editor of the AEJ: Macroeconomics Journal. She has been elected member-at-large of the Council of the European Economic Association. She is a CEPR Research Fellow and an NBER Research Associate. She is on the Board of the Autorité de Contrôle Prudentiel, a member of the Commission Economique de la Nation and of the Bellagio Group on the international economy. She writes a regular column for the French newspaper Les Echos. Hélène Rey received her undergraduate degree from ENSAE, a Master in Engineering Economic Systems from Stanford University and her PhDs from the London School of Economics and the Ecole des Hautes Etudes en Sciences Sociales.

Philip Wood
Allen & Overy

Philip Wood is one of the world's leading experts in comparative and cross-border financial law, a celebrated speaker, a well-known writer and an experienced practitioner. He works full-time for Allen & Overy in the firm's London office. He has written around 18 books, including nine volumes in the series Law and Practice of International Finance published in 2007. His university textbook on international finance has been translated into Chinese. He was a partner in Allen & Overy from 1973 to 2002 and was, for ten years, head of Allen & Overy's Banking department. He is chairman of the Sovereign Bankruptcy Group of the International Law Association and a member of the Market Monitoring Committee of the Institute of International Finance. One of his recent assignments was acting for the steering committee of the bondholders in relation to the bankruptcy of Greece. In a recent period of about a year, he delivered about 140 lectures in 30 countries. He is on the editorial board of many law journals and on the advisory council of law faculties at universities in India and Hong Kong. His 40 years' experience in the firm includes most aspects of international banking and finance, including financial regulation, risk management, bank loan syndications, project finance, asset-based finance, leasing, securitisations, insolvency and debt restructuring, netting, clearing houses, payment systems, trade finance, derivatives, security interests, capital market issues, sovereign insolvencies, expert witness in litigation and law reform.

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PREFACE

The European University Institute (EUI) and the Wharton Financial Institutions Center (FIC, Wharton School, University of Pennsylvania) organised a conference entitled "Political, Fiscal and Banking Union in the Eurozone" at the EUI in Florence, Italy, on 25 April 2013. The event was financed by the PEGGED project (Politics, Economics and Global Governance: The European Dimension) and a Sloan Foundation grant to the FIC. The conference brought together leading economists, lawyers, political scientists and policy makers to assess the prospects and potential for, as well as obstacles to, the various forms and degrees of integration needed within the Eurozone in order to address the root causes of Europe's current malaise. The aim was for open discussion and debate on the relationships between these different levels of union. Was one type of union achievable without the other? Or would the intractable difficulties of achieving each level of union spill over to lessen the chances of the other ever being a likely practical possibility?

The President of the EUI, Marise Cremona, opened the event, which consisted of three panels, a keynote speech and a dinner speech. The first panel, chaired by Elena Carletti (EUI), considered the current state of the emergent Banking Union in the

Eurozone. Luis Garicano (London School of Economics) first discussed whether the measures being implemented to bring about the Banking Union will in fact succeed in breaking the vicious circle that exists between banks and sovereigns. Richard Herring (Wharton School, University of Pennsylvania) then gave an assessment of the European initiatives on resolution frameworks and creditor bail-in. Jan Pieter Krahnen (Goethe University Frankfurt) reflected on the future of European banking following the report of the Liikanen group (of which he was a member) and Philip Wood talked about some fundamental legal aspects of implementation of banking union measures often obscured in the constant flow of technical proposals and measures.

In the keynote address to the conference, Andrea Enria (Chair of the European Banking Authority) noted the significance of the policy shift that the establishment of the EBA, the agreement to move to a Banking Union and the centralisation of supervisory responsibilities all represented. However, he counselled, remedial institutional work is still needed and the pressures and exigencies of crisis management ought not to detract from that. Repair work is made all the more necessary by the need to combat the vicious and destructive loop between banks and sovereigns as well as to combat the growing balkanisation of the Single Market. He assessed the steps taken to date in developing the Single Supervisory Mechanism and highlighted challenges to greater integration of other parts of the necessary safety net. Finally, he reminded the audience of the Europe beyond those countries participating in the Banking Union and the need to strengthen the functioning of the Single Market as a whole, especially resolution frameworks.

The second panel, chaired by Franklin Allen (Wharton School, University of Pennsylvania) considered both the mechanics and possibilities of achieving any real Fiscal Union in the Eurozone in the areas of fiscal policy and taxation. Daniel Gros (Centre for European Policy Studies) discussed the links between monetary policy, supervision and fiscal policy. Robert Inman (University of Pennsylvania) then provided a comment on the historical experience with Balanced Budget laws and considered what lessons emerge from this for Europe today. Mattias Kumm (NYU, Social Science Research Center Berlin and Humboldt University) then considered the need for a genuinely European tax competence to match European level competences in banking and financial markets and made the case against any Transfer Union and for an Economic Justice Union instead. Finally Hélène Rey (London Business School) talked about the economics of growth and austerity, and the handling of the crisis by creditors in the international monetary system.

The final panel, chaired by Joanna Gray (Newcastle University), considered some of the historical, cultural and practical policy aspects to Political Union in the Eurozone and provided an opportunity for a more general and less technical perspective than the preceding two.

Mitu Gulati (Duke University Law School) presented the results of detailed analysis of key contract terms in euro area sovereign debt contracts between 1990 and 2011 and argued that the evidence challenges the rationale behind the recent introduction of mandatory collective action clauses. Edmond Alphandery (Nomura Securities) considered the effect of the Eurozone crisis on the Franco-German axis and how new alignments and alliances are taking shape within both the Eurozone and the EU which was for so long the pivotal relationship in Europe. Peter Lindseth (University of Connecticut) highlighted different meanings of "Political Union," the tensions between "De facto" and "De jure" forms of union as well as barriers to real political union and their sources. Finally, Richard Parker situated the Eurozone crisis in a constellation of crises besetting what he termed modern democratic republicanism, which he traced through its various historical stages of evolution.

At dinner, Tony Barber (Financial Times) spoke of the Eurozone crisis as a series of morbid symptoms as the old European order yielded place to a new European reality of which and about which we are all still profoundly uncertain. The Euro has confounded expectations and begun to raise doubts in the hearts and minds of even the technocratic elites of Italy, Germany and France as each country feels the effects of and hence perceives the Eurozone crisis differently. This challenges the European identity of each and every citizen in each and every member state.

The book ends with a postscript, "Monologic Thinking during the Eurozone Crisis," contributed by one the rising generation of Europeans, Dr Patrick O'Callaghan (Newcastle University) who participated in the conference. It considers the various alternative and competing narratives of the Eurozone crisis which have taken root and concludes with a plea for more imaginative ways to regenerate trust among EU citizens. He identifies the plight of the young unemployed in Europe as being the deepest scar of the persistent policy failures and challenges considered during the day's proceedings.

The conference follows the 2012 conference, "Governance for the Eurozone: Integration or Disintegration" and that of 2011, "Life in the Eurozone With or Without Sovereign Default." As with those two conferences, the debate after each panel and guest speakers was lively and thoughtful. We prefer not to take a stance here on any of the issues but simply present all the papers presented and let the reader draw his or her own conclusions.

1
In Spain, the Diabolic Loop is Alive and Well

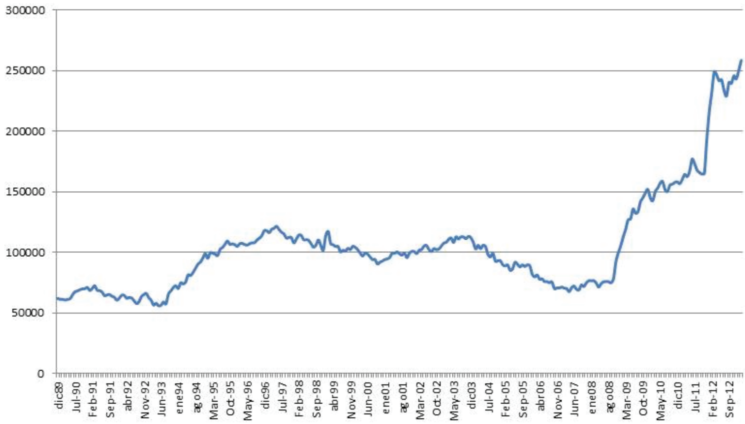
Luis Garicano

Since the start of the crisis, the link between banks and their sovereigns has only been strengthening, with dire consequences for the periphery's economies. To focus on Spain, in October 2008, the Spanish financial system had 78bn of Spanish government bonds. By February 2013, these holdings had increased to 259bn, almost 30% of GDP, according to Bank of Spain data (see Figure 1). Additionally, the banks direct lending to all government levels, which was a negative 22bn in 2008 (government deposits were larger than loans), was 49bn by February 2013 (see Figure 2).

The loop is also strengthening in the other direction. The hidden losses in the banking system are starting to materialize, with 37bn injected this year by the Spanish state plus a stock of slightly over 100bn of state guaranteed bank debt that existed by the end of 2012 (see Figure 3).

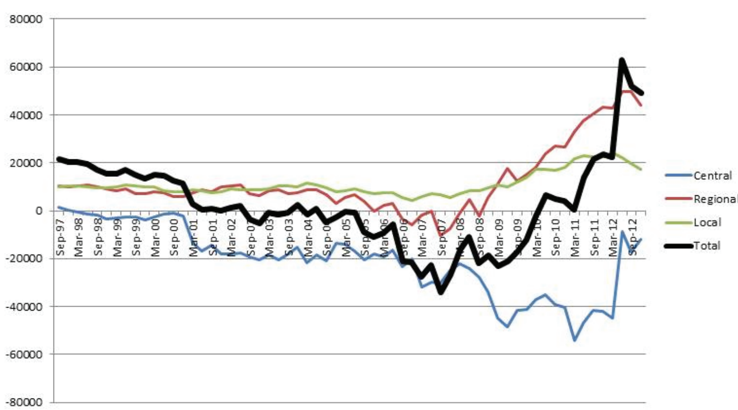
The European leaders are aware of the growing danger of these connections and committed themselves at the June 2012 Euro Summit to "break the vicious circle between banks and sovereigns." Specifically, they promised that "when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly."

Figure 1: Bank holdings of public debt, Spain
(Current Euros, Dec 89-Feb 13)



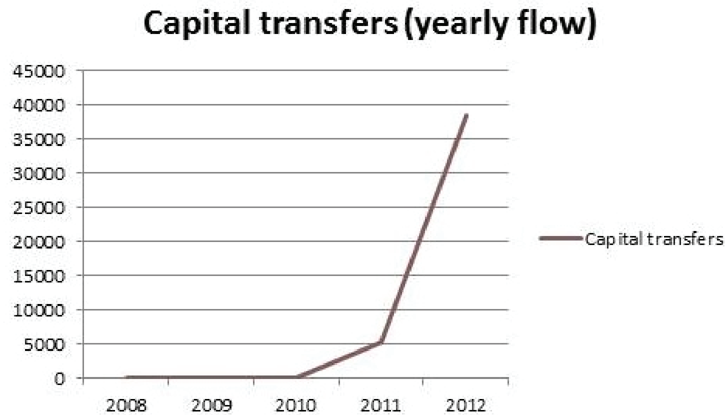
Source: Bank of Spain. OTHER MONETARY FINANCIAL INSTITUTIONS 8.5 Assets. Domestic B) Aggregated balance sheet according to the euro area returns Debt securities: general government
http://www.bde.es/webbde/es/estadis/infoest/a0805e.pdf

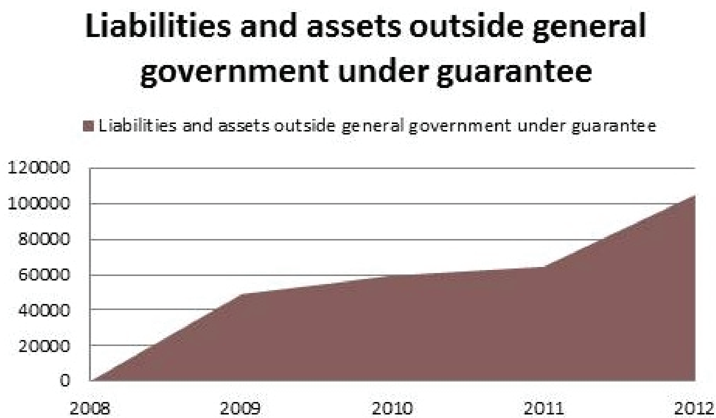
Figure 2: Net bank lending to governments
(Loans-Deposits, Current Euros, Dec 97 - Feb 13)



Source: Bank of Spain. Own calculation 8. OTHER MONETARY FINANCIAL INSTITUTIONS 8.25 Loans to/deposits held by general government C) Breakdown of assets and liabilities from/with other MFIs, by sub-sector
http://www.bde.es/webbde/es/estadis/infoest/a0825e.pdf

Figure 3: Bank Failures and Government Solvency





Source: Eurostat, Supplementary tables for the financial crisis Spain: 10/4/2013

Regrettably, this good purpose was quickly "clarified." A senior EU official told the Wall Street Journal only a few days after the summit (on July 6th), "I need to make clear what the ESM can do: the ESM is able–if one were to decide ever on such an instrument–to take an equity share in a bank. But only against full guarantee by the sovereign concerned … Does it still remain the risk of the sovereign or [does it go to] the ESM? It remains the risk of the sovereign." Later, the Dutch, Finnish, and German Summit finance ministers, at a summit on September 29, 2012, stated that "(2) the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities(...) "

Mr Wolfgang Schauble has been backpedalling other hopes for a banking union and trying to turn it into a banking union "on the cheap." In the recent Dublin summit, he said Banking Union "only makes sense… if we also have rules for restructuring and resolving banks. But if we want European institutions for that, we will need a treaty change." Other rules cheapening the banking union include no deposit insurance, and no resolution authority for the ECB without (certainly hard to envision and long in coming) Treaty changes. In fact, the only decision that has been made is the one that ostensibly involves no cost, the new Single Supervisory Mechanism to start in March.

Sadly, Mr Schauble has it exactly backwards. The key to restart growth and ensure the survival of the Euro process is to recognise that "mistakes were made" by all in the design of the Euro, and that these mistakes have had very severe consequences for a number of countries (the debtors) which are now spreading to the rest. In other words, sharing of legacy debts is fair, and, provided the institutions are firmly put in place to avoid future credit bubbles, growth enhancing.

We can again turn to Spain for evidence that the deterioration of the aggregate sovereign-finance balance sheet is at the root of the current contraction. In spite of the improved credit access by the state caused by the lax monetary policies and the OMT threat by Mario Draghi, credit conditions are tight, and families and business are still struggling.
Spain has been applying the German receipe to the letter. First, before the SSM is constituted, Spain has been trying to clean up its own mess with state funds. In the current round, the subordinated liability exercises raised 12.7bn euros and the state injected €37bn for nationalized Cajas (Q4 12), plus €1.8bn (Q1 13) for surviving ones, for a total of around 5% of GDP. The 3 to 1 public to private participation ratio is similar to the SNS Reaal recap using the new

Dutch intervention act, which invested 3.7 bn in the Dutch state, and subordinated debt for €1 billion. Spain, moreover, set up a bad bank whereby the weaker Cajas and Banks transferred a gross total of over 100bn, for a net asset value of €50.781bn (transfer finished March 2013) in assets. Senior creditors have benefited from all existing (SLE) bail in exercises. Regrettably, the liability exercise again left out senior creditors, who are in fact the ones who have the best monitoring ability (thus able to provide good incentives to countries) and loss absorption capacity

But the bank recap combined with Draghi's magic words about improving credit access is not improving credit access. True, the OMT means the state is financing itself at much better rates, with cheaper and better credit to banks and a halving of risk premia. But the Bank Lending Survey from the Bank of Spain for January shows that 22% of banks have tightened their lending to large companies, and 10% to SMEs, and to families for both home purchases and consumption. The most recent data show that lending to corporations is falling by about 6% per year and this fall will continue, or accelerate, this year. Aggregate figures show a huge rise in credit to general government and a brutal drop in credit to businesses and households. But, of course, credit drops could be, regardless of what surveys say, caused by lack of demand, rather than excessive supply restrictions.

Evidence of the causal link between supply restrictions and growth in Spain is provided by a recent trio of papers. In a recent AER publication, Jiménez, Ongena, Peydró and Saurina show that weaker Banks deny more loans, even when the loans are identical (which helps identify the supply, rather than demand channel) and that businesses cannot in general replace the absent loan from a weak bank by going to another bank. Also, in a recent (April 2013) working paper, Bentolila, Jansen, Jiménez and Ruano show that businesses whose credit came from weak financial entities that later received intervention(the old "Cajas") reduced employment by an additional 3.5 to 5 percent points relative to those whose credit came from the strong ones. Finally, in a paper co-written with my colleague at the London School of Economics, Claudia Steinwender (Survive another day: Does Affect the financing uncertain composition of investment?, Center for Economic Performance, LSE) we show that Spanish owned companies reduce employment substantially more (6%) and increase investment by much more (by 19%) than the Spanish operations of foreign companies, pointing out the key role played by investment.

In sum, the Spanish state owns more bank risk, the banks own more of the public sector debts, credit is being restricted, and growth is suffering. The low cost banking union being proposed shifts the cost of the clean up on the individual member states, in an attempt to address through these problems. Several of the key Schaubleian nostrums must be rejected:

– Legacy debt cannot possibly be absorbed by individual states. The Eurozone countries must recognize that they signed up for a flawed Eurozone and that we are where we are today, at least in part, as a result of these flaws. The two key objectives being pursued, minimizing taxpayer and EMS involvement, as well as ensuring an adequate credit supply, are in contradiction. Maintaining the supply of credit across the Eurozone must be the priority.

– As Cyprus shows, member states cannot individually guarantee deposits, and deposit insurance which right now is completely off the table, must be part of the union.

– Some instrument for joint lending (a form of Eurobonds) that may allow the gradual easing of the link between banks and sovereigns is necessary. I have proposed, with a group of European economists, the ESBies, a solution based on securitization that avoids joint liability. This solution generates a large liquidity premium shared by all and redirects flight-to-safety flows from across national borders to across tranches.

– A banking union needs strong centralized resolution powers within the supervisor. As the Cajas debacle showed, local authorities are too close to management and do not internalize cost to the system of wobbly banks. Moreover, the ESM must have ability to directly inject funds into banks, at market prices, and also lend to local deposit insurance schemes, but sharing costs requires centralized decision making.

– A deposit guarantee scheme is needed to break the link between sovereigns and banks. Its cost, with a credible resolution framework able to impose losses on creditors and uninsured depositors, does not have to be excessive.

After the German elections, Europe has a short window of opportunities to rescue the Euro project. It is now the time for Germany to accept what it originally signed up for when it joinied the Euro, or leave.

Note: A version of this article appeared in the Economist blog Free Exchange as "Banking Union on the Cheap will Fail"

2
The Danger of Building a Banking Union on a One-Legged Stool

Richard J. Herring*

Introduction

The initiative to build a European banking union, announced by the Heads of State of the euro area on June 29, 2012,[1] aims to achieve two worthy objectives: first, to advance and deepen the Single Market in Financial Services and second, to break the toxic interactions between weak banks and weak sovereigns in order to ease the crisis in the euro area.

The European Commission (2012) proposed a three stage approach: first, the establishment of a Single Supervisory Mechanism (SSM); second, the establishment of a Single Resolution Mechanism (SRM); and third, in the indefinite future, some sort of common, euro-area deposit guarantee scheme (CDGS).[2] Plans for the SSM have ad-

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* Jacob Safra Professor of International Banking at the Wharton School, University of Pennsylvania. I would like to thank (without implicating) Jacopo Carmassi for valuable comments on an earlier draft.

1 This was preceded by the "Four President's Road Map" (Van Rompuy, 2012).

2 Most of these proposals are crafted to include the entire European Union not just the euro area. Nonetheless, Great Britain, the home of the largest financial markets in the EU, is unlikely to participate fully in the SSM, SRA or the CDGS in the foreseeable future. For simplicity and because this chapter focuses on the euro crisis, the implications for the broader European Union are generally ignored.

vanced rapidly, but as of May 2012, the future of the SRM is much less certain and the CDGS seems to be simply an aspirational goal. This chapter argues that it is important the SSM be accompanied not only by an SRM, but also by a centrally backed CDGS.

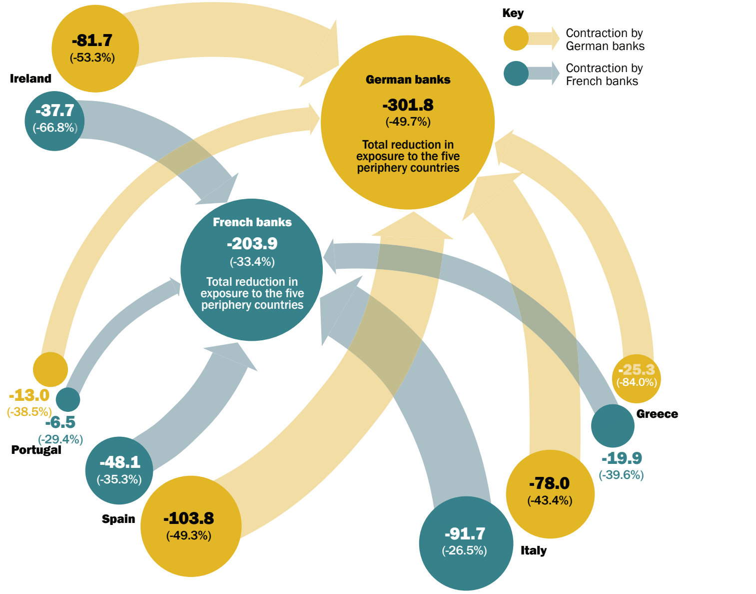
The initiative to form Single Market in Financial Services lost forward momentum not long after it was launched. It began with a bold move intended to increase cross-border competition and integrate national markets. Subject to minimum levels of safety and soundness, a bank that established a subsidiary in any one member state gained a "single European passport" that would enable it to branch into any other member state. This approach was intended to cut through existing barriers that insulated national markets. In time, however, national governments found ways to protect domestic financial firms, often on grounds of consumer protection. In addition, many governments managed to protect "national champions" by erecting regulatory barriers to obstruct some cross-border mergers. Although considerable progress was made in harmonizing interest rates across the euro area, national markets remained distinctive in terms of institutional frameworks and indeed legal frameworks for consumer protection and bank resolution. And, although all countries are subject to the same capital requirements, enforcement of these and other prudential regulations has been uneven.

Strains caused by the crisis in the euro area

The crisis has actually reversed much of the initial progress and caused euro area banking markets to disintegrate. Figure 1 shows that banking flows from the stronger euro-area countries – France and Germany – to the troubled peripheral countries have not only declined, but also reversed dramatically. Undoubtedly this has reflected the concerns of creditor banks about the declining creditworthiness of these regions, but it also reflects pressures from national regulators in creditor countries who wish to insulate their economies as much as possible from troubles in the peripheral countries. Evidence of disintegration within the euro area can be observed in the widening spreads paid by peripheral countries over the benchmark, 10-year German Bund rate.

Figure 1: Crisis has caused a disintegration of European Banking Markets

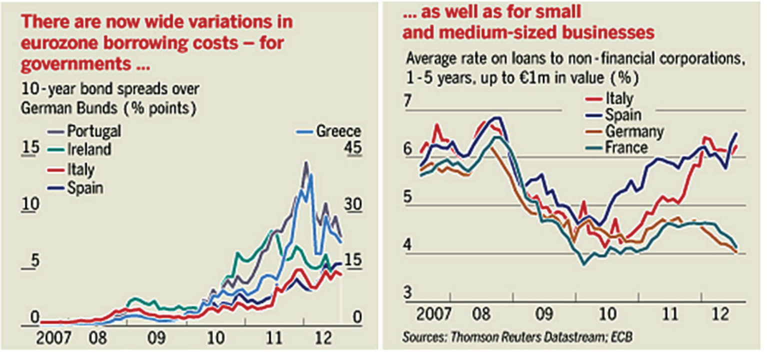
German and French banks' falling exposure to crisis-hit eurozone countries Change between Q1 2008 and Q1 2012 (€bn)



Even more worrisome, the average interest rates paid by small and medium-sized enterprises (SMEs) in peripheral countries have increased sharply relative to rates paid by SMEs in France and Germany. (See Figure 2.) Since SMEs are the main engine of growth in most of Europe, the widening risk premiums paid by SMEs in peripheral countries mean that recovery in those countries will be much slower and weaker than in the stronger countries. Moreover, these differences in the flow of credit to SMEs will exacerbate existing disparities in growth rates and standards of living among member states. This disintegration of credit markets also means that expansionary monetary policy initiatives by the European Central Bank are likely to have only limited impact in the peripheral countries because the interest rates paid by SMEs in those countries are largely attributable to the risk premium rather than the level of the euro-area risk-free interest rate.

The toxic interaction between weak banks and their weak home-country sovereigns became painfully obvious as the crisis unfolded. It surfaced most dramatically in Ireland. When the Irish government issued a blanket guarantee to protect its banks from a run, it quickly transformed a banking crisis into a sovereign debt crisis.

Figure 2. Crisis has caused a disintegration of SME Lending



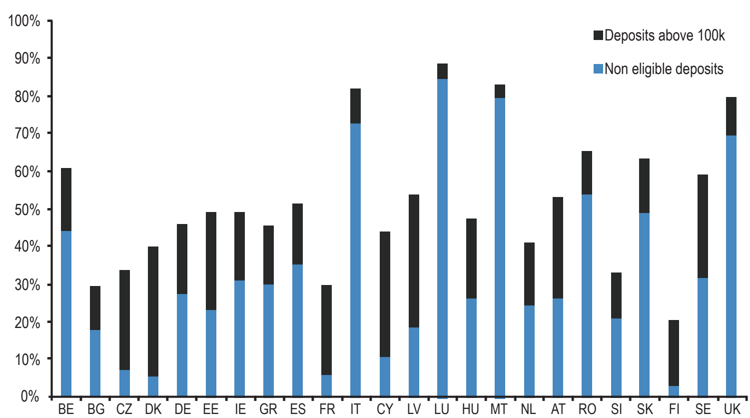
This dynamic has unfolded with variations in many of the other peripheral countries. (See Figure 3.) Banks tend to hold large concentrations of claims on the governments in which they are headquartered for a number of reasons including political pressures from home country governments that wish to place their bonds at least possible cost. These pressures were reinforced by the framework for evaluating capital adequacy, which placed zero risk-weights on such bonds in the calculation of risk-weighted assets. When the home country's creditworthiness declines, so does the value of its bonds. This causes losses to all holders of its debt including banks. Moreover, when a country's creditworthiness declines, its prospects for growth and the profitability of most of its firms decline as well. Thus loan losses are likely to rise, putting further strain on the capital positions of banks in that country.

Figure 3: Toxic Interactions Between Banks & Their Sovereigns

Many European banks are funded to a substantial extent by non-deposit liabilities or uninsured deposits. (See Figure 4 showing the proportion of large, uninsured deposits in various countries in the EU.) Because these funds are not protected by explicit deposit insurance, they tend to disappear when market participants become concerned about the creditworthiness of the bank. (Typically providers of wholesale funds tend to rely primarily on quantity rationing and only to a limited extent on price rationing.) These liquidity pressures will cause banks to pay more for whatever funding they can attract and will be forced to sell assets to meet the cash demands of funders that wish to flee when their uninsured bank deposits or non-deposit liabilities mature. When liquidity reserves are drawn down and the bank has exhausted its ability to undertake refinancing with the ECB, it will have no choice but to sell illiquid assets into thin, illiquid markets, incurring substantial losses from distress sales, which further erode capital. While the ECB has the possibility of providing emergency liquidity assistance it must act through the national central bank, which will be obliged to accept the credit risk in the transaction, thus adding to the national debt burden.

Figure 4: Large & Uninsured Deposits Roughly 50% of Total Deposits

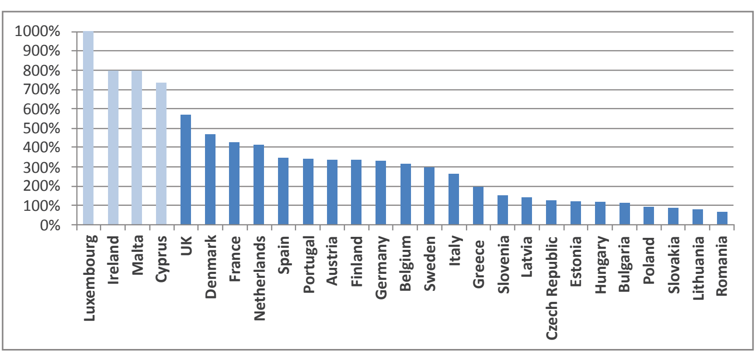
In percent as of December 2007



Source: European Commission, J.P. Morgan

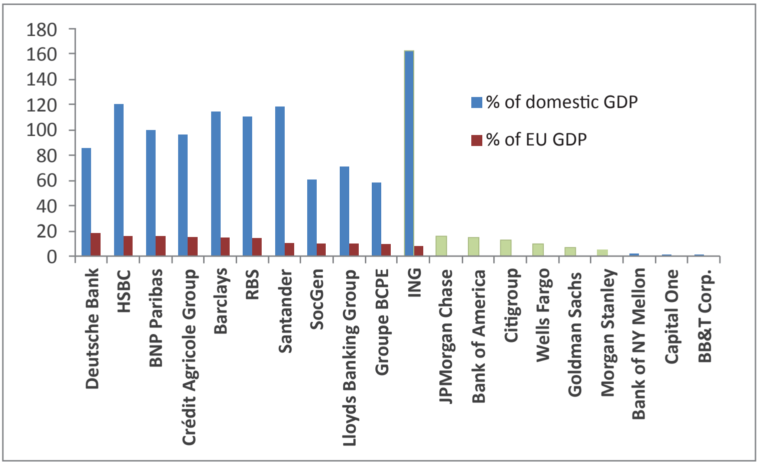
Of course, banking problems can arise without sovereign debt problems, but if the size of the banking system is a multiple of GDP, as is true in many European countries, widespread problems in the banking sector can quickly cause trouble for the sovereign as well. Moreover, several European banks are large relative to the size of national GDP. (See Figures 5a and 5b.) First, if banks need to seek emergency liquidity assistance, it must be channeled from the ECB to the national central bank, which is obliged to take on the credit risk. Second, if confidence in banks diminishes to the point that even insured depositors start to run, the deposit guarantee fund will be tested. In some countries these guarantees are not pre-funded and in most countries they are not funded adequately. And so this is likely to lead to additional borrowing by the government to make good on deposit guarantees. Third, if banks must be recapitalized, it usually falls on the government to provide initial funding and can often be a very substantial proportion of GDP. Fourth, a weak banking sector is likely to diminish aggregate demand, which in turn will diminish tax revenues and increase transfer payments to compensate for the decline in demand. When the government runs a fiscal deficit and the country has a current account deficit, it will have no choice but to sell assets to foreigners or, more typically, borrow from foreigners. When foreign borrowing increases too rapidly relative to the country's ability to service its debt, its debt rating will fall as will the prices of its debt in international markets. At some point it may not be able to borrow at any price.

Figure 5a: Total assets of MFIs in the EU, by country (in % of national GDP)



Notes: Assets as of March 2012, GDP data for end 2011. Based on aggregate balance sheet of monetary financial institutions (MFIs). Vertical axis cut at 1000% (ratio for Luxembourg is 2400%). Data on MFI includes money market funds.
Source: ECB data. Eurostat for GDP data.

Figure 5b: Total assets of the largest EU and US banking groups (2011, in % of GDP)



Why start with the SSM?

In the context of this toxic interaction between weak banks and weak sovereigns, an outsider is tempted to pose a naïve question: Why start the European Banking Union with an SSM? Wouldn't an SRM be more helpful since the ability of a country to resolve a weak bank would no longer depend on the financial resources of the national government? Or, indeed, wouldn't it be better to begin with a CDGS[3] so that an insured bank depositor has no reason to prefer the deposits in one member state over another?

Under current conditions the quality of deposit insurance depends on the creditworthiness of the national government.[4] Moreover, the

3 Goyal et al (2013) note that existing deposit guarantee schemes are national, with varying coverage limits, contributions and fund sizes. "Most schemes are underfunded. The EU Directive on Deposit Guarantee Schemes has set minimum standards on coverage … and the payout period. The … EC has proposed harmonizing national schemes (e.g., introduce common standards on financing and set a target fund size of 1.5% of eligible deposits) and clarifying responsibilities (e.g., improve insurance payments for cross-border banks), with the possibility of borrowing arrangements across national schemes with adequate safeguards." Note that even this ambitious agenda does not contemplate a CDGS.

4 Of course, if a country has a sufficiently large, pre-funded deposit guarantee scheme, this burden need not fall on the government. But an event large enough to deplete the pre-funded scheme is certain to have an impact on the government's creditworthiness because insured deposits are an implicit liability of the government.

scope of coverage may vary from state to state. Some categories of deposits are insured in one country, but not another. When depositors become apprehensive – precisely the time when deposit guarantees matter most – depositors will have an incentive to shift their funds to nations with stronger credit-standing or a more expansive definition of insured deposits.[5]

This, of course, has a strong relation to resolution policy. If losses must be allocated – which will inevitably occur if banks are not closed promptly before the point of insolvency – what classes of creditors should be bailed in? Is it possible to establish a predictable waterfall of claims, starting with equity and extending to preferred shares and subordinated debt and then to general unsecured creditors, that will enable market participants to understand precisely what to expect in the event of insolvency? But this highlights a difficult problem that was exposed by the crisis in Cyprus. Under current laws in most countries in the euro area, uninsured depositors stand *pari passu* with unsecured creditors. Although during the Cypriot crisis many commentators expressed the view that depositors should have preference, it is not yet a matter of law and the ambiguity is likely to intensify uncertainty in a crisis.

The adoption of the SSM alone cannot be expected to mitigate the toxic interactions between weak banks and the weak countries in which they are domiciled. Indeed, it is doubtful that an SSM can be effective without an SRM or CDGS. Even under ideal conditions, the SSM should not be expected to dampen the toxic interactions between weak banks and weak sovereigns. But the circumstances under which the SSM will be launched are likely to be far from ideal.

In principle, the supervision authority should be highly integrated with the resolution authority since they both require the same information and the ability of the SSM to take appropriate action with regard to a distressed bank depends on the ability of the SRA to resolve the distressed bank efficiently without causing disruptive spillovers to the rest of the financial system. I would argue that close

5 Di Noia (2013) makes the case that "Even with perfectly functioning supervision and crisis resolution, [the] banking union is likely to fail without an EU deposit guarantee scheme."

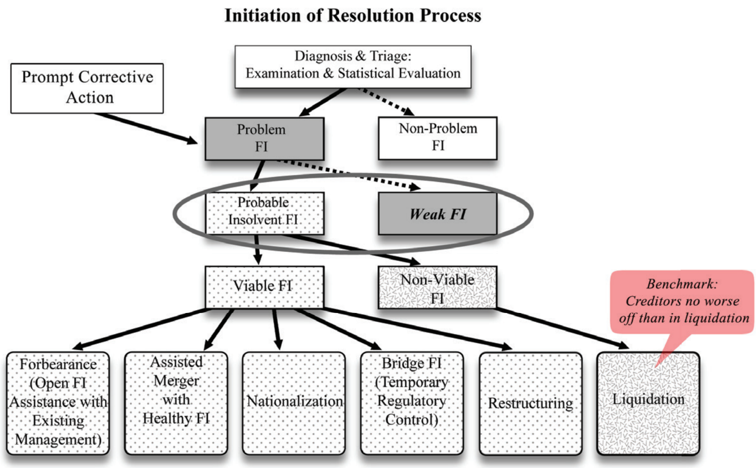
coordination with the CDGS is equally important. If the SSM and the SRM do not take account of the interests of the CDGS, they are likely to delay intervention, unduly increasing costs that must be borne by the CDGS. This interdependence is recognized in the US and some other countries by placing resolution powers with the deposit guarantor.[6]

Ideally the primary supervisor should monitor banks and try to distinguish sound banks from weak banks that require deeper scrutiny. It must then decide which weak banks can be rehabilitated and which should be resolved. Once it is determined that at least parts of an institution are viable, the resolution authority can choose from among a variety of resolution techniques. In the US, the resolution authority is required by law to estimate the cost of each approach and choose the approach that is least costly to the deposit insurance fund – unless a systemic risk exception is invoked. (A least cost standard is under discussion in Europe.) If the institution is not viable, it should be liquidated. This is seldom the optimal outcome for creditors or for society because banks usually have at least some salvageable going concern value. But it is an important benchmark to be measured because it represents the minimum that creditors should receive if the authorities choose a different resolution approach. (See Figure 6.)

Under the current plan, the general policies regarding banking supervision will be set by the European Council, and proposed as legislation by the European Commission with the final law to be agreed with the Council of the European Union and the European Parliament. The European Banking Authority (representing all the members of the EU and located in London) will set the rules and write the supervisory handbook. The SSM will implement the rules in the euro area (and in other member states that opt to join the regime). The ECB, through its newly-established Supervisory Board, will have direct oversight of the largest banks (140 in total) and indirect oversight of the remaining smaller banks. With regard to the smaller banks, the national supervisory authorities will have the primary role, but the ECB can intervene if systemic concerns arise.

6 In a cogent and comprehensive critique of the EC proposal for the transfer of supervisory responsibilities to the ECB, Carmassi, Di Noia and Micossi (2012) argue that the European deposit insurance fund should become a separate “section” of the European Stability Mechanism.

Figure 6: Supervision Process & Range of Resolution Tools



The perils of launching an SSM without an SRM and CDGS

How much can the SSM be expected to accomplish? A common set of rules and consistent enforcement can help integrate the banking market within the euro area. But without an SRM and a CDGS, it can do little to ease the euro crisis.

If the SSM intends to fulfill its function rigorously, it will need to intervene in a faltering bank before the point of insolvency. Unfortunately, the Financial Stability Board's "Key Attributes of Effective Resolution for Financial Institutions" is unnecessarily vague and possibly contradictory regarding the intervention point. It recommends that "Resolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so." Given the self-interested optimism of management, shareholders, and often of auditors and supervisors as well, waiting to intervene until there is "no reasonable prospect of becoming viable" will almost certainly result in massive losses to creditors, the deposit insurer and possibly taxpayers as well.

Fortunately, the European Commission's proposal (2012) takes a more precise view of the trigger point, emphasizing that early intervention measures should be instituted "…when a bank is in breach of, or is about to breach, regulatory capital requirements." If these metrics require intervention while the bank still has true economic value as a going concern this may work. But the lesson from the application of an early intervention strategy in the US is that even when the intervention point is stated precisely in quantitative terms, if the measure of regulatory capital is based on accounting values, it will tend to overstate economic capital markedly, leading to delayed intervention that can be very costly. Unfortunately, the European Commission's Proposal stops short of defining a precise metric that will ensure pre-insolvency intervention, preferring instead to retain a substantial measure of discretion for the regulatory authorities. Given the inevitable pressures to forbear, this is a worrisome omission.[7]

In addition, the authorities may lack the statutory powers to seize the control rights of shareholders before bankruptcy. In such circumstances, shareholder rights clearly conflict with the broader interests of society.[8] But intervention must occur before insolvency in order to avoid losses to creditors and taxpayers. The delays caused by a shareholder suit in Belgium during the resolution of Fortis in 2009 raised the question of whether each member state has an appropriate legal framework to permit early intervention and require prompt corrective action (Claessens et al, 2010).

Worse still, without an SRM and CDGS in place, an SSM may be unwilling to act even if it has the legal authority to do so. When confronted with a weak bank in a weak country, the SSM may perceive that it has no good choices. So long as resolution and deposit insurance remain the responsibility of the country in which the bank is headquartered, funding may be inadequate to preserve financial stability. On the other hand, if the SSM chooses to forbear, the weak bank will likely need access to emergency liquidity assistance eventually. While the ECB can provide such assistance, under current arrangements it must be channeled through the national central bank, adding to the burden of national debt. This would exacerbate the

7 Carmassi, Di Noia and Micossi (2012, 2013) emphasize the importance of adopting a clear prompt corrective action
8 Elliott (2012) emphasizes this trade-off.

link between weak banks and the creditworthiness of the country in which they are headquartered.

Moreover, without the ability to mutualize resolution and deposit insurance costs across the euro area, the SSM is likely to be reluctant to implement appropriate prudential regulations. For example, one of the key weaknesses in current prudential standards is that they have failed to constrain very large accumulations of bonds issued by the home country government. Indeed, because a zero risk weight is applied to such holdings for the purpose of computing regulatory capital requirements, regulation has actually implicitly encouraged such imprudent behavior. To be credible, the SSM should curb these concentrations of sovereign risk.

Huertas (2013) has posed three examples that highlight how unlikely such reforms are likely to be. Appropriate prudential regulations would: (1) require that banks hold government bonds in their trading books that must be marked to market; (2) subject holdings of government bonds to capital requirements for interest rate risk; and (3) impose exposure limits on a single borrower to holdings of government bonds. It seems unlikely that the SSM would consider adopting any of these sensible measures without an SRM and CDGS in place because of the possibility of further destabilizing banks in the peripheral countries. If they do not, however, banks in peripheral countries will continue to accumulate sovereign debt, exempt from limits on large exposures and subject to a zero risk weight in the computation of regulatory capital requirements. And the damaging link between weak sovereign and weak banks will increase.

When the plan was first announced in June 2012 many politicians seem to have adopted the optimistic view that the European Stability Mechanism (ESM) would recapitalize weak banks so that the SSM could be launched within a well-capitalized euro-area banking system. This may be an example of the achievement of an agreement through avoidance of the use of excessively clear language, but the idea had widespread appeal – except in the key creditor countries that would need to fund the recapitalization.[9] In retrospect, the key creditor countries appear to have believed that they were agreeing to mutualize the costs of bank resolution going forward, after banks had qualified for the new regime with an SSM, not to fund repairs to capital structures inherited from the past under different national regulatory regimes. In any event, terms of access to the ESM have not notably eased.

The European Central Bank has outlined an admissions process to ensure that banks are strong enough to enter the new regulatory regime overseen by an SSM. Although the EBA has conducted stress tests, these have not allayed fears about the quality of assets on the balance sheets of many euro area banks. Indeed, weak capitalization rather than lack of liquidity may be the main constraint on the revival of bank lending. (This would certainly be consistent with evidence from Japan and several other countries.) The European Central Bank has announced comprehensive review of the balance sheets of the 140 banks that are to be supervised by the SSM. To enhance the credibility of the balance sheet review, the work of national supervisors will be checked by peers from other countries. Once balance sheets have been reviewed and appropriately adjusted, the EBA will conduct another stress test to identify banks that need to be recapitalized before they enter the new regime.

This raises the awkward question of how banks that fall short of the capital standard will be recapitalized. It should be noted that the US was able to increase confidence through a stress test in which, paradoxically, 11 of 19 banks failed. This was a confidence boosting measure only because the banks that failed were mandatorily recapitalized by the US government. The comparable mechanism for recapitalization of European banks remains unclear. The creditor

9 The language of the document appears to envision the ESM facility working after the SSM is established. On June 20, 2013, the President of the Eurogroup (ESM, 2013) clarified the contemplated role of the ESM in bank recapitalization. A subsidiary of the ESM, with €60 billion, will, under certain circumstances, stand ready to help recapitalize systemically important banks in member states, when the member state is unable to do so and when there are insufficient amounts of credit to be bailed in. Although potential retroactive funding may be considered on a case-by-case basis, this still leaves open how inadequately capitalized banks will be able to meet the entry requirements to join the SSM.

countries appear to believe that each national government should be responsible for recapitalizing its own banks before they can qualify for entry into the new system. Some of the weaker countries appear to believe that the ESM can be used for such purposes. Whether the ESM can or will supply sufficient funds – or, indeed, whether countries would want to borrow such funds under the conditions required from previous borrowers – remains unclear. But, if the balance sheet reviews and stress tests are honestly conducted, the ECB procedure is likely to expose capital deficits that cannot be ignored.

The European Central Bank has recognized the danger in proceeding with the SSM without having an SRM in place. Both Mario Draghi, President of the European Central Bank (ECB), and Benoît Coeuré, member of the Executive Board of the ECB, have stressed the importance of establishing an SRM promptly. Although the Bank Recovery and Resolution Directive remains to be finalized by the European Commission, the European Council and the European Parliament, the ECB has stressed that timely resolution should minimize spillovers from one weak bank to others and safeguard the stability of the European financial system.[10] The ECB fears that it will have the authority to declare a bank in the eurozone insolvent, but no real power to prevent potential spillovers except to urge the national authority to deal with them.

Two contrasting views of the SRM

The European Commission (EC) has recently outlined its SRM proposal.[11] The EC believes that it is the best placed institution to make all relevant decisions related to discretionary resolution. A newly created resolution body would prepare, propose and enforce decisions via an Executive Board (EB) that would have access to a single bank resolution fund that would be backed by the assets of euro area banks. The EB would be dominated by appointees from the EC and the ECB – not the member states. The EC would have

10 The IMF has taken a similar view (Goyal et al, 2013).

11 This summary relies on reports of the Commission discussion paper presented to EU Commissioners on May 29 that were published in the Financial Times (Spiegel and Carnegy, 2013) and the Wall Street Journal (Fairless, 2013). The official document has not yet been released and the details may change as a result of internal debate.

the power to overrule a bank's home country and use funds from a central, euro-area single bank resolution fund (SBRF) to implement its decisions. The fund would have the power to borrow from markets, using the "assets of euro area banks" as a guarantee and backstop. Once the EC decides that a bank should be shut down, the policy can be implemented by the member state subject to oversight by the EB. The intent is to ensure the ability of the SRM to take decisions without giving a veto power to individual member states. The proposed framework also circumvents the ECB.

This is the opening salvo in what looks to be a very tense debate as the euro area tries to agree on how to resolve banks by the end of June 2013. After a Paris meeting between French President, François Hollande, and German Chancellor, Angela Merkel, the two leaders issued a "contribution" (Bundesregierung, 2013) that sketches a strikingly different vision for a European approach to resolution. They described their concept as "a single resolution board involving national resolution authorities."

This cedes much less power to the EC. The French won German agreement to a "Single Resolution Board" and to authorize the €500 billion ESM to serve as a "public backstop" to fund bank recapitalizations if individual countries cannot do it on their own. In most other respects, however, this "contribution" reflected the German view of the new resolution authority, rather than the vision of the EC.

Although both plans envision a resolution board, the composition and powers of the two boards are entirely different. The Franco-German Single Resolution Board would be comprised of the individual national authorities and would be a coordinating body, not a new, independent EU agency with independent power to restructure and recapitalize banks. The German opposition to the more powerful, independent EU agency is based on its interpretation of existing European treaties. They believe that the existing treaties, which provide for the involvement of the ECB in prudential supervision, do not give the EC the authority to close banks and seize assets. (One suspects that the Germans may have an additional objection. As the likely main backstop for the proposed single bank resolution fund, the Germans are not eager to cede control over expenditures from the fund to an independent authority that does not give Germany a role commensurate with its financial liability.)

In addition, while the Franco-German agreement to permit the ESM to serve as a backstop for funding bank resolutions may seem like a move toward the EC concept of an SBRF, it has a very important difference. Under the voting rules in the ESM, the three largest countries in the euro area – Germany, France and Italy – have a veto. Thus using this mechanism could limit Germany's financial liability in a way that the SBRF controlled by an independent SRM would not.

A number of the large banks in the euro-area hold a higher proportion of their assets outside than inside their home country. (See Figure 7.) This number of such institutions is much higher than in either the United States or Japan. Thus it is especially important that European bank regulators have clear, credible plans for resolving banks that have substantial cross-border holdings. Experience in the recent past – for example, the clumsily managed collapses of Fortis and Dexia during the crisis – suggests that they do not. Thus continued uncertainty about how bank resolution will be managed in the euro area could be very damaging if another crisis should occur.

Figure 7: Large European Banks with >50% of Assets Outside Home Country

Banking groups	Total assets	World assets rank	Home country	Rest of region	Rest of world
	in US$ billion		as % of total assets	as % of total assets	as % of total assets
1. Deutsche Bank (Germany)	2,800	1	34%	32%	34%
2. HSBC (UK)	2,556	3	35%	11%	54%
3. BNP Paribas (France)	2,543	4	49%	34%	17%
4. Barclays (UK)	2,417	7	34%	27%	39%
5. Citigroup (US)	1,874	14	36%	21%	43%
6. Banco Santander (Spain)	1,619	17	27%	41%	32%
7. UBS (Switzerland)	1,508	19	36%	20%	44%
8. ING Bank (Netherlands)	1,244	23	40%	38%	22%
9. UniCredit (Italy)	1,199	24	42%	56%	2%
10. Credit Suisse Group (Switzerland)	1,115	25	21%	26%	53%
11. Nordea Group (Sweden)	927	27	21%	74%	5%
12. Standard Chartered (UK)	599	41	15%	4%	81%

Concluding comment

To return to the original naïve question posed earlier in this chapter: why start a single banking area with an SSM, rather than an SRM and CDGS? Presumably, the optimistic answer is that by establishing a roadmap to a new, workable euro-area banking union, officials will help stabilize the current situation. Forward-looking markets will price expectations of future stability in today's asset prices and reduce pressures on weak member states. Perhaps, but this surely depends on whether shocks occur while the road is under construction and on whether construction is delayed.

A more pessimistic view is that the reason for this three-stage approach is one of expediency. It is much easier to agree on an SSM than on an SRM or CDGS that may involve potentially open-ended fiscal commitments or loss of sovereignty over decisions regarding key domestic institutions. Moreover, if one accepts the German interpretation of existing treaties, it may be technically easier as well. Although members of the EU agree that an SSM, with the participation of the ECB, can be soundly based on existing treaties, an SRM or a CDGS may require treaty amendments or, indeed, a new treaty. The ratification process would require unanimous consent and might involve referenda in some countries. Thus stages two and three are technically more difficult to accomplish as well as requiring a greater willingness to cede sovereignty over bank resolution and fiscal transfers to centralized, EU institutions. The ongoing dispute over how to deal with legacy losses before launching the SSM indicates that moving from the SSM to the SRM and CDGS will not be easy.

The analogy with the monetary union is obvious, but unsettling. Some of the early proponents of the European Monetary Union realized that it was incomplete unless it was accompanied by a fiscal union and a much more cohesive political union. The second two measures seemed completely out of reach when the Maastricht Treaty was negotiated, but some of the more optimistic proponents argued that if a monetary union were achieved, market pressures and greater integration in the euro-area markets would make it easier to achieve a fiscal union and the shifting of greater political power to euro- level institutions. Unfortunately, that has proven to be excessively optimistic to date. Persistent disparities in growth rates and standards of living within the euro area have threatened instead to disintegrate the euro area rather than leading to greater harmonization of fiscal policies and centralization of political power.

The parallel risk is that achieving an SSM may not lead readily to an SRM or a CDGS. Instead it may lead to a supervisory regime that is likely to forbear because the costs of a bank resolution cannot be efficiently managed. An SRM and the concept of allocating losses and implementing bail-ins would lead to a sharp break with past traditions in the euro area. In general there has been a strong predisposition to prevent any bank from being liquidated, no matter how small. In addition, the authorities have tended to guarantee all liabilities so that no depositor or lender loses money because of bank insolvency. And generally the authorities have dealt with troubled financial institutions by subsidizing a merger or acquisition or by making a direct capital infusion. The SRM is intended to implement a new approach that would bail-in at least some creditors and, if uninsured liabilities are insufficient to cover the loss, advance a loan to facilitate the resolution that would be repaid by the banking industry. Taxpayers would be protected from the heavy costs they suffered during the recent financial crisis.

This cannot be achieved by creating an SSM alone. Without a credible SRM and a trustworthy CDGS, these objectives cannot be accomplished. A stool with only one leg is certain to be unstable.

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3
Banking Union in the Eurozone? A panel contribution

Jan Pieter Krahnen[1]

1. Introduction

The organizers have asked me to reflect on the post-Liikanen future of European banking. This is a good moment to carry out such a reflection, as the Liikanen report and its proposals have been out for almost six months, while the official response by the European Commission, the addressee of the report, is not expected until later this year. It is thus a good time to speculate about the implementation of the main proposals contained in the Liikanen report and its possible impact on European banking.

Several aspects of the bigger picture of an emerging Banking Union (BU) are still in limbo. Of the four elements defining the BU -- the resolution and recovery directive (RRD), the unified microprudential supervision (SSM), the unified resolution agency-cum-fund (SRA), and the deposit guarantee scheme (DGS) -- only the first two are reasonably well defined and their implementation is reasonably

1 Professor of Finance, Goethe University Frankfurt (www.finance.uni-frankfurt.de), and Center for Financial Studies (CFS), SAFE (www.safe-frankfurt.de), CEPR krahnen@finance.uni-frankfurt.de. In 2012, he has been a member of the High Level Expert Group (Liikanen Group).

likely. In both cases, legal robustness raises some questions, relating to its significance for banks currently supervised by national agencies. Officially, there are only vague plans for a European resolution agency, and no plans for a European deposit guarantee scheme. The reluctance to move forward on these two issues is largely due to the fear of losing national influence, shared by many.

For example, in the case of Germany, the transfer of decision power and resolution discretion from the national to the European (or trans-national) level is seen by key players both in the political arena as well as in parts of the industry, as a threat to the existing structure of the so-called three-pillar banking system[2]. It is therefore likely that these agenda points, despite their high importance for a functional banking union, will not be pursued in the foreseeable future. One might label this financial protectionism: it describes the tendency of national policies vis-à-vis the European BU project to push the interest of national champions, irrespective of a possibly damaging effect on a European level playing field.

Since the BU project will hardly advance further without support from its biggest stakeholders, notably Germany, a considerable delay of a workable BU project is very likely now. A BU project is *workable* if all four institutional features mentioned above -- SSM, RRD, SRA and DGS -- are simultaneously in place. The four features are complementary to each other and if several of them are not implemented, the market discipline that is expected to emerge from a BU project's existence will not develop because the existence of proper resolution mechanisms without automatic and credible government bailout will be in doubt.

At the time that I am writing this essay, it seems unlikely that the Banking Union will be fully operative without a major "conciliatory moment." Such a historical moment is unlikely to arise outside

2 Private banks, two cooperative bank groups, and one state-owned/community-owned savings bank group make up roughly 30%, 25% and 45% of the banking system. The question of whether the groups are to be seen as a consolidated entity or as a loose grouping of hundreds of independent institutions is a major controversial issue. Traditionally, the Ministry of Finance has represented the interests of the incumbent associations.

a major financial crisis, since the coordination problem among 17 contracting partners with significant "skin in the game," i.e. significant own stakes, are excessive. A conciliatory moment, i.e., a widely shared willingness to compromise, might follow from a shock to the financial system, e.g., a significant rise of short term interest rates, or a shock to the political system, e.g., an unconditional rejection of the OMT (Outright Monetary Transactions of the ECB) by the German constitutional court[3].

In the remainder of this text, I will abstract from the implementation problems surrounding a banking union, focusing instead on two additional elements in a future framework for a sustainable banking system in Europe, which is also the key content of the Liikanen proposal.

2. Explaining structural reform proposals for EU banking

The proposals contained in the Liikanen Report have to be read against the background of the crisis narrative laid out in the first part of the report. It emphasizes the role of systemic risk in banking markets. The new quality of systemic risk in the financial system derives from a greatly increased level of interconnection between financial institutions, if compared to banking in earlier times. Over the past 25 years, the growth of derivative markets and the increased role of secured and unsecured interbank lending has augmented the interdependencies among financial institutions considerably. Additional contributors to inter-bank dependencies are indirect relationships, like correlations among marked-to-market assets on bank balance sheets, as well as liquidity-sensitive market prices in case of fire sales of these assets. Direct and indirect bank interdependencies, in turn, contribute to the risk of a joint breakdown (distress) of financial institutions, and thus a breakdown of basic financial services for the real economy.

The expectation of such a breakdown is called systemic risk, and its occurrence almost always requires government intervention to avoid significant costs to the real economy. Keeping the level of systemic

3 A decision by the court is not expected before fall 2013.

risk at a low level is therefore a major task for regulators and supervisors. This is because if the market expects government interventions, there will be anticipatory effects in bank funding markets. In particular, the anticipation of a possible bailout of junior and senior bank creditors will lower funding costs and distort risk pricing more generally. The underpricing of bank default risk has been documented by Schweikhard/Tsesmelidakis (2012), among others.

These underpricing effects feed back into risk taking decisions by individual banks, and thus may increase the level of systemic risk. The Liikanen proposal tries to break through this vicious circle by facilitating the resolvability of individual banking institutions and, at the same time, limiting the contagious effects caused by potential creditor bail-ins. If the resolution of banks without creditor bailout is credible, or so it is hoped, it will lead the bank to select less risky strategies and will therefore reduce systemic risk. The report suggests two main measures[4] in order to enhance the restructuring of distressed institutions with minimal recourse to taxpayers' money: the separation of trading activities and the issuance of bonds with holding restrictions.

Separation of trading from universal banking

The first proposal is to break up large complex financial institutions by forcing major trading activities into a legally separate broker-dealer unit. The broker-dealer unit may be put under the same holding. However, its capitalization and its funding must be separate. The main objective of this measure is not to reduce trading activities *per se*, but rather to limit a possible implicit subsidization of funding if carried out together with the traditional deposit taking business. Just as any other banking activity, trading should earn its risk adjusted cost of capital.

Further details of the separation proposal specify a *de-minimis* rule relating to the absolute size of the bank (€100 billion) and the relative size of its trading assets (15-20% of balance sheet total). Most

4 There is a small number of other recommendations, including increased capital buffers for trading activities, and several improvements of corporate governance instruments.

importantly, no distinction is made between proprietary trading and client business or market making. It is argued that proprietary and client-related trading activities will be hard to distinguish since market making in less-than-perfectly-liquid markets consists essentially of a sequence of trades that end up on the bank's own book.[5]

The separation of market making and proprietary trading activities of large banks has raised considerable opposition from the industry. It is argued that trading activities have not been at the center of the crisis, nor were banks with large trading books any more affected by the crisis than other institutions. Why, then, should trading be singled out for separation rendering universal banking less attractive as a business model? In addition, competition on an international market is much more difficult, unless there is a level playing field.

The reason for pushing for the separation of trading from universal banking is to increase the chances for resolution and creditor bail-in. International universal banks have become very complex internally, and trading activities have played a special role in this development. Any attempt to restructure a failing bank over a short weekend, the infamous Friday-to Sunday emergency events, will be hard to do if trading and banking are densely interrelated.

Over the past two decades, large international banks have become specialists in risk management and hedging services. Due to large order flows and a strong position in many derivatives and securities markets, they are in a position to offer quick execution of customer orders, offering liquidity to their clients. By extensively using netting possibilities, and innovative ways to internalize netted transaction flows, a bank is able to reduce the number and volume of hedging transactions with third parties. The embedded spreads and risk premiums translate into bank earnings. It is such an integrated commercial-cum-trading bank with its complex internal portfolio (of exposures) that renders a quick restructuring difficult.

A separation of trading from banking, in contrast, will create two distinct institutions: a trading house (or broker-dealer), and a remain-

5 In the US, the Volcker rule as part of the Dodd-Frank-Act requires a full separation of the proprietary trading desk, while market making and client business remain unaffected.

ing (i.e., universal) bank. Both institutions will have their own equity capital, possibly provided by a mutual bank holding firm. While the universal bank will be refinanced as before by deposits, bonds and unsecured credit, the trading house will have its own funding, probably from bond or wholesale markets. It will not have access to the deposit market, and therefore will not enjoy an implicit government guarantee.

Mandatory issue of bonds with holding restrictions

The second main proposal contained in the Liikanen report is, in my opinion, the main proposal of the entire report, as it addresses directly the reason for the ubiquity of systemic risk in today's banking industry. It requires banks to issue a minimum amount of unsecured bonds with specific holding restrictions. Forcing banks to issue subordinate debt is by itself not unusual, as most financial institutions have already a host of junior or hybrid instruments outstanding.

The main innovation of the Liikanen proposal concerns the embedded holding restriction: the mandatory junior debt should not be held at any time by an institution inside the banking system, i.e., by an institution subject to bank systemic risk. By implication, the transfer the default risk of such junior debt into the banking system, e.g., via credit default swaps or other derivative contracts, will not be allowed.

By allocating junior debt outside the banking system, losses exceeding the equity of the affected institution will be borne by investors without a direct contagious feedback effect. A supervisor considering creditor bail-in will be confident that its bail-in decision will not trigger the next systemic banking crisis – and will thus be encouraged to carry out the bail-in. In anticipation, creditors will know that the threat of losing part of their capital in a default case is real and, therefore, market prices will reflect actual default risk. The disciplinary effect of debt markets will be resurrected.

The strict holding restriction may be replaced by a somewhat weaker formulation, giving banks the option to invest in such junior bank debt, provided that it is fully backed by equity (i.e. risk weight is 1250%). Both formulations lead to essentially the same thing: junior ("bail-in") bank debt will be held outside the banking system, minimizing systemic feedback effects of bail-in operations.

3. What are the consequences for the banking industry?

Much of the regulatory reform project of the past couple of years has been welcomed by the financial industry; e.g., there was a positive reception for the Basle III innovations relating to a strengthening of equity capital, and the introduction of a leverage ratio. The banking union project with its focus on a level playing field for supervision and resolution, within the European Union, has met broad support on a general level, combined with strong opposition on specific issues of concern for national players and their business models. There is also some concern about the future role of the national supervisor. As a result, there is a general lack of willingness to transfer authority from the national to the supranational level.[6]

The Liikanen proposals, in contrast, have received a more negative reaction, at least concerning the separation proposal. In Germany, for example, the associations of all three (so-called) pillars of the banking system, the savings banks, the private banks, and the cooperative banks, have argued that a separation of trading activities would endanger the time-proven model of universal banking. The arguments presented by all three groups differ from each other since their organizational model differs as well.

While a true impact study would be extremely helpful, I will comment below on some of these arguments – with due restraint, since the arguments are based on theorizing rather than hard evidence.

6 In the case of the SSM, it has remained unclear to date what the power of the ECB (as supervisor) for the largest banks will be, and which decision or veto rights will remain with the national authorities. This is particularly important for decisions that may have budgetary implications. In the case of an SRM, the single resolution agency, the transfer of decision power has not been determined yet.

Reduced profitability?

One commonly heard argument refers to the profitability of a stand-alone broker-dealer. Some commentators have argued that stand-alone funding, as it is implied in the separation concept, will lead to increased funding costs of the broker-dealer, lowering the profitability of market making and, therefore, reducing the provision of liquidity in markets dominated by market makers. An impact study carried out in the US, on behalf of the Chamber of Commerce, analyzes the consequences of implementing the Volcker Rule. It supports a negative conclusion concerning market liquidity (see Thakor 2012).

The latter study is not wholly convincing, as the general equilibrium repercussions of a general rule change, rather than an isolated cost increase for a single player, has not been considered. In other words, separating trading (and more importantly, market making) for all players in the market is likely to change other prices as well, not just broker-dealer funding costs. In particular, one would expect that after such a rule change, the price of market making services may go up as well, thereby increasing the spread earned by the intermediary. The overall effect on profitability of the broker-dealer has to encompass three adjustments: funding costs (up), price for market making services (up), transaction volume (down, presumably). The resulting spread and, hence, the profitability of the broker-dealer is therefore difficult to predict. It is even conceivable that a new market environment defined by legislation separating market making and prop trading from universal banking may increase profitability from trading, while at the same time reducing the number of institutions offering these services.[7]

Regulatory arbitrage?

Another argument raised against the separation rule challenges the Report's *de-minimis* rule, according to which only banks with significant trading books are subject to the separation. The Report has suggested drawing the line at an absolute size of the trading book of € 100 billion (or a trading book exceeding 15-25% of total assets).

7 E.g., due to positive scale economies for broker-dealers.

Wouldn't such a generous *de-minimis* rule invite mid-sized banks to expand their trading activities to a level just under the critical level? And wouldn't such a market development take away significant business volume from the larger institutions, rendering their separated broker-dealer entity ineffective, and indeed unprofitable?

My take on this arbitrage-oriented argument is that while the above scenario cannot be ruled out, it is not likely to happen if there are indeed economies to scale in the broker-dealer industry. However, absent these economies, the resulting decentralized trading architecture will prevail anyway, and there is no (further) negative effect on bank resolvability – as the complexity of universal banks with relatively small trading business is believed to be manageable.

Conversely, however, if a few large broker-dealer institutions prevailed in the future, these institutions would represent a significant systemic risk, given their high degree of interconnection with many non-broker-dealer banking institutions across Europe. As a consequence, the Liikanen report has recommended imposing additional capital charges on trading institutions.

Reduced liquidity?

Major providers of market liquidity in today's financial markets are large international universal banks with significant trading books (available for sale; held to maturity). To what extent is their business model dependent on unrestricted access to customer order flow? Put differently, is it possible to rebuild the current set of services to clients provided by such a bank even after the trading entity has been separated into a broker-dealer institution?

It seems at least conceivable that a newly separated broker-dealer continues to advise the universal bank with respect to financial strategy and risk management, leaving partly or entirely the execution to peer broker-dealers in the market. While this may lower overall profitability of broker-dealer services in the economy, the decrease of profitability is not assured. In principle, profits may also remain unchanged, for example if execution prices rise, or if the advisory services remaining with the "old" broker-dealer are paid for and command a reasonable price. These equilibrium price effects are difficult to forecast, however, as there may well be market entry in broker-dealer markets, causing pressure on profitability.

Reduced risk transfer?

The absence of true risk transfer outside the banking system was at the root of the early stage of the financial crisis, as was evidenced by the allocation of tranches from asset backed securities transactions (see for example Franke and Krahnen 2009). Rather than transferring risk to investors, risk was at least partly shifted between financial institutions, contributing to interconnection, contagion and systemic risk.

The Liikanen proposal prohibits banks from holding junior debt of other banks, and at the same time forces banks to issue such debt -- this will indeed contribute to a significant transfer of risk. This is actually the main objective of the (inappropriately labeled) "bail-in debt." Creating a layer of subordinate bank debt that cannot cause contagion among banks represents *by construction* a form of *non-systemic risk*. The resulting risk transfer is therefore credible, as a rescue of the bondholder by government intervention is not to be expected.

Indeed, it will be the special duty of the markets supervisor to ensure the bail-in-ability of such designated subordinate bank debt. In this respect, the supervisor has to make note of the holders of such form of debt, its identity, and its loss-absorbing capacity. Furthermore, the supervisor has to ensure that risk is actually borne by the recorded holders – rather than being transferred back to an agent inside the banking system.[8]

It should also be emphasized (emphasized!) that despite the term "bail-in debt," which has been introduced in the Liikanen Report, the term does not imply that all other sources of (bank) debt will be

8 Risk transfer back into the banking system could be due, e.g., to a swap transaction where a bank sells credit protection to a bondholder for a fee.

in the form of bailout debt. The opposite is true. According to the Report, all bank debt is bail-in-able, in the order defined by seniority. Only the most junior tranche, which has been called bail-in debt, is required to have a minimum size (e.g., 5% of total assets) and is subject to the specific holding restriction explained in the last paragraph.

4. Conclusion

The post-Liikanen future of European banking will to a large extent hinge upon the commitment of Europe's policy makers to implement simple but strict structural rules aimed at a revival of market discipline. The Liikanen proposal of non-systemic, subordinate debt, characterized by clearly defined and constantly monitored holding restrictions, is not only simple but also likely to be effective in revitalizing a sustainable financial intermediation system in Europe.

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4
European Banking Union: A Lawyer's Personal Perspective

Summary of address given by Professor Philip Wood QC (Hon) prepared by Joanna Gray (Newcastle Law School, Newcastle University)

Philip Wood QC (Hon)

Why Law Matters.

My assessment of the current proposals to implement a European Banking Union which follows is guided by a strong belief in the universal human desire for survival in an uncertain world with scarce resources, which cuts across legal jurisdictions and political cultures and groups. Equally important is the nearly universal human belief in the idea of law. The following two lessons from history illustrate the strength of this belief.

147 people boarded the lifeboat of the ill-fated vessel Medusa in July 1816 after it was wrecked off the coast of Senegal, West Africa. Only 15 survived. Most of the others were killed while fighting for the brandy and biscuits. The captain left the raft to float around helplessly in the sea without navigation, without leadership. He rowed to the shore in the ship's boat. There is a rule that captains do not leave the ship, a custom of the High Seas that has assumed the status of a universal rule of law. There is also a rule that if you are on

the lifeboat following a shipwreck, food and drink rations must be shared equally.

Both of these rules were adhered to when some 30 or so Chilean miners were trapped in their mine in 2009. They elected a leader and the leader required an equal allocation of the available food every day. The miners were trapped for about the same period of time as the hapless people on the lifeboat of the Medusa but, unlike those castaways, they all survived. These examples provide a simple illustration of the superiority of law and rules over the unconstrained panic that reliance on immediate survival instincts causes.

The law is, of course, far more than just a fundamental survival requirement in cases of terrible emergencies. The rules of law also apply to the behaviour and nature of money, central banks, banking, financial affairs, and currencies.

Money is a public utility. It is the product of our labour and work. It connects us to our future. It connects the peoples of the world, one to another.

European Banking Union: the Good and the Bad.

The practical arguments in favour of a European banking union are powerful and ultimately credible and cogent. The functional reasons are (1) that combined sovereign resources are needed to deal with a systemic collapse since the assets of European banks are probably about three times the European GDP, (2) that it is necessary to denationalise a rescue in order to avoid a paralysing struggle of one sovereign state against another and (3) that it is much more efficient to have a common set of rules and a common comprehensible set of bail-out principles.

However, total mutualisation across national borders within the Banking Union, never mind the wider EU, is clearly unlikely in the near future. Now is not the time to assess the likelihood or otherwise of the realisation of the banking union. Rather it is useful to highlight what I see to be some of be major defects in the way the banking union is being built.

Common Regulatory Rules

The first plank of the banking union is that there should be a common set of regulatory rules, i.e. single supervision via a European authority, supposedly with the European Central Bank at the apex. However, the regulatory rules which have been put in place or proposed in response to the financial crisis are inappropriate for a number of reasons.

There is nothing wrong with the proposal to increase the capital cushion substantially. Better liquidity is not a bad idea but the current proposals are considered extreme. The in-built design flaw of maturity mismatch in a bank is a fact of life: much like many useful phenomena, energy, for example, which is sometimes dangerous but fundamental to the atom. Many of the new regulations and proposals represent an outdated view of banking and look backwards rather than forwards. They hark back to a simple 19th century world of narrow banking and are mainly designed to protect retail depositors, and are therefore populist in tone. This is true, for example, of the Volcker Rule and its European variants, ring-fencing according to Vickers and Liikanen, derivatives push-out, the demolition of securitisations, and resolution bail-in.

In 1990, the GDP of the world was three football fields of $10 trillion each. At the time of the crisis, it was five or six football fields. Absent some catastrophic event, by 2030 it could be ten or 12 or 15 football fields in scale. No doubt this means more prosperity but the vast wall of money created has to find a home. It will go into banks, capital markets, and funds, resulting in a financial landscape very different from what we have now. Thus, just as you can insure your car against a crash or your house against fire, you should be able to insure your financial assets against risks by derivatives. Securitisations are no more than an extension of ancient factoring or discounting of debts widely practiced at the time of the Medicis in the Italian Renaissance. A simpler transaction is hard to imagine.

The idea that banks' securitisation activity should be prohibited or curtailed bears no examination. The idea, too, that it should all be split up is doubtful. If you split a bank of 100 into ten separate pieces of ten each, you still have 100.

Functionally, many of the current regulatory reforms and proposals around bank reform prioritise the protection of the state versus crucial suppliers of private credit in the form of senior bondholders. It would be a simpler solution just to promote depositors in the bankruptcy ladder of priorities. In addition, the moves override the idea of a bank. A bank collects the money of the people, as a lake collects water, with to the goal of irrigating the land. It is the people's money that builds the power stations and it is the people who are the creditors and it is the people who are hurt if the productive use of their money is thwarted and frustrated.

The sheer volume of regulation, too, is disproportionate, with the size and complexity of both the Dodd-Frank Act and the growing body of European Banking Union reforms, detracting from the value of simple and comprehensible law-making. For what went wrong was a breach of two very simple rules. These rules were that central banks should not normally price money at nothing because this creates the risk of a bubble, and that banks should not irresponsibly lend into what could easily become an asset bubble, in this case housing, the most basic of assets.

To this critique of complexity and obfuscation of the simple and obvious might be added the fact that some of the capital rules are written in a patois "pidgin" mathematics, an argotic "quantbabble" rather than generally accessible language.

Common Bank Resolution

Coercive bank resolution statutes originated in the United States in 1933, at the height of the resentment and rancour ignited by the Great Depression. These laws nationalise bankruptcy law in a very important sector of modern economies. They do away with the courts, creditor control and a proper legal framework and substitute regulatory discretion instead. Laws of this importance which confer arbitrary discretion to government agencies are suspect. The Europeans have spent the last 2000 years or so discussing despotism and whether it is good or bad. Clearly in some circumstances, emergency laws are sometimes needed, such as the lifeboat example, and they can be effective. However, whether or not these coercive bank resolution statutes will operate for the greater benefit of us all, is a major issue. The regulators often refer to having adequate "tools" - as if resolution statutes were like the honest humble artisan trying to fix a leaky tap, instead of what they really are, a sledge-hammer smashing a stained-glass window of settled and intricate patterns of risk allocation and pricing.

There are two points, however, worth making, both with functionality being the bedrock of the rule of law. The first is, how does anybody assess counterparty risk or do a credit rating of a bank when regulators can split assets and liabilities, as they are permitted to do under the statutes? Counterparty risk becomes a matter of guesswork.

Secondly, what of cross-border bankruptcy comity if each national regulator can do what it likes? In practice, it is highly likely that each national regulator will seek to protect local retail depositors, at the expense of foreign creditors. So the resolution of a large bank could risk becoming a nationalistic free- for- all. This is one area which unquestionably needs rules if cross-border risk is to be constrained.

In Conclusion

The notion that a European banking order will solve the problems of the Eurozone and de-couple sovereign credit from bank risk seems unrealistic. Sovereign credit is inevitably bound up with the safety of banks and, if GDP does grow as forecast, this will become even more so the case.

The solution is to adhere to some very simple common sense rules about risk, as explained. These principles are so elementary that both political leaders and people have declined to recognise them for the reason that the simple rules are the toughest. Two examples bear this out.

The first relates to 2001 or thereabouts when the Federal Reserve priced money at nothing. Maybe they did so because inflation did not seem to be a risk and therefore they chose to deliver cost-free money to prospective homeowners and the corporate sector and to lower the cost of borrowing from China and elsewhere? Sound economic reasons. Nevertheless, what was not made explicit was that the Fed was pricing other people's money, the money belonging to savers, an action comparable in substance to forcibly selling someone's car at half-price, and therefore playing Robin Hood. The central bank was in effect adopting a policy of redistribution from the rich to the poor.

While this may seem a legitimate policy choice, since all states redistribute resources, it was problematic in this case: the Fed did not seem to realise that they were creating a redistribution because it was not effected through the tax system. The public also did not understand that this was happening. As a result, this policy undermined the democratic legitimacy of political action.

The second example relates to Greece. Here was a country, a developed country with a long and noble historical tradition, which paid a cash dividend to its bondholders of 15%, supplied by 16 other countries, and which extended to its private creditors a junior subordinated note payable after 30 years. This was not some destitute failed state with no resources and an uneducated population. So was this a situation where a developed country got in a fiscal muddle and simply suffered a temporary setback amenable to technocratic fix? Or else was this the first signal of a very fundamental problem in the approach to public finance, common to most of the sovereigns in the West and Japan?

One of the greatest achievements of Europe is that, of approximately 320 jurisdictions in the world, about 270 of them have a legal system based on Western European models. In light of this great history, it is regrettable to see how little attention Western Europe is now paying to the need to preserve the role of some simple and eternal fundamental truths about law in response to our common predicament.

5
Establishing the Banking Union and repairing the Single Market

Andrea Enria

1. Introduction

Discussions on the integration of banking supervision into the European System of Central banks (ESCB) date back to the time of the Delors Committee, whose 1989 report gave shape to the project of a European Monetary Union. The decision to leave supervision at the national level has led to a unique institutional setup – what Tommaso Padoa-Schioppa (1999) labelled a "double separation," functional and geographical, between the jurisdiction of monetary policy and that of banking supervision. The underlying idea was that the Single Market mechanism, in particular the single passport and the cooperation between national authorities, would have provided a sufficiently integrated system, able to step up to the challenges of an integrated banking market and to provide unified policy responses whenever needed. The experience of the recent past has shattered the belief that minimum harmonisation and cooperation amongst national authorities would be effective in preventing and managing financial crises in an integrated market.

The establishment of the European Banking Authority (EBA) in 2011 and the agreement to move to a Banking Union in 2012 have marked a major policy shift towards maximum harmonisation (the so-called Single Rulebook) and centralisation of supervisory responsibilities at the European Central Bank (ECB). The process of institutional repair is not complete, though. And it is important that as the pressure of the crisis weakens, policy makers do not lose momentum and remain committed to completing an ambitious reform of our institutional architecture.

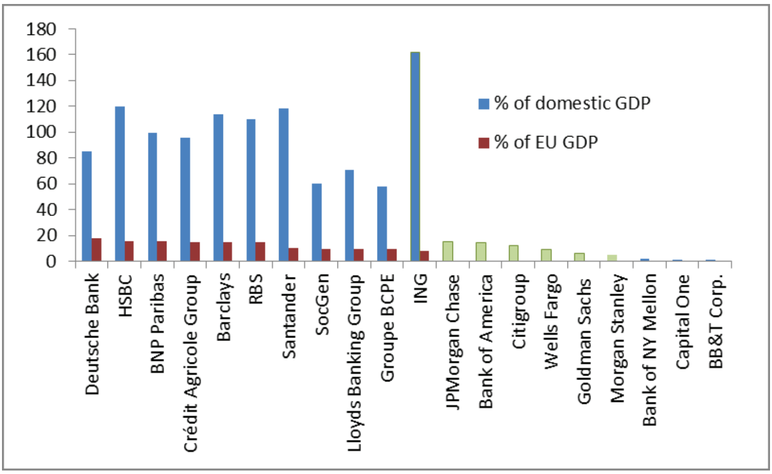
I will first focus my attention on the rationale for institutional repair, identifying two main drivers: (i) the need to counteract the adverse loop linking banks and their sovereign; and (ii) the trend towards balkanisation of the Single Market. Then, I will assess the important steps already accomplished in building up the Single Supervisory Mechanism (SSM) and the challenges in achieving greater integration in other components of the safety net. Finally, I will argue that as the Banking Union will not cover all Member States, it is essential to devote efforts to strengthening the legal underpinnings for the functioning of the whole Single Market, in particular in the area of resolution.

2. The need for institutional repair

In building up the Single Market and the Economic and Monetary Union (EMU), European policy makers gave a clear signal to the banks: they were invited to consider the EU as their domestic market and to create a dimensional and organisational structure reflecting the new institutional setup. The wave of mergers that characterised European banking in the early 2000s effectively brought European banks to a dimension commensurate with the new boundaries of their reference market. But when the crisis broke out, policy makers decided that bailing out banks was the exclusive responsibility of national governments – the option of joining up forces and providing an integrated support mechanism was briefly considered, but discarded as incompatible with the national responsibility for supervision, and because of the political sensitivity involved in the issue of using taxpayers' money in supporting banks, especially from other Member States. At that point, it became increasingly clear that while taking a European dimension, banks had also grown disproportionately large with respect to the fiscal capacity of their home country.

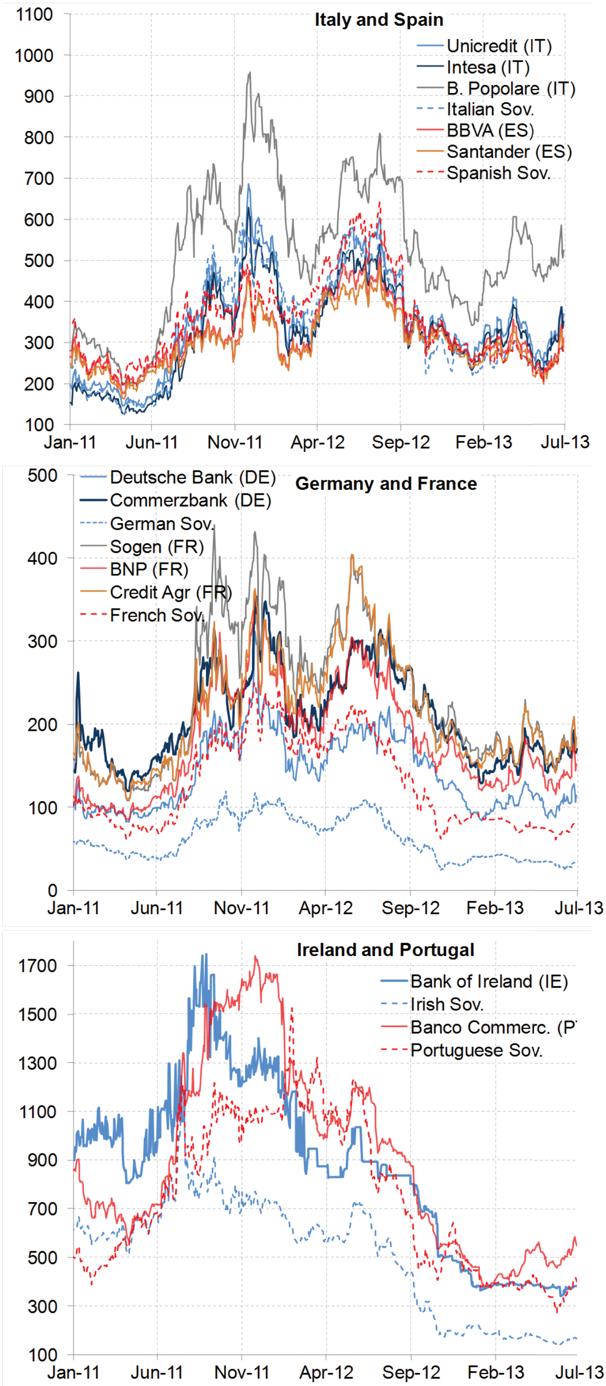
Fig. 1, taken from the report of the High Level Group on Bank Structural Reform (the so-called Liikanen Group), shows this inherent contradiction very clearly: the dimension of European banks, as measured by the assets to GDP ratio, is not dissimilar from that of their US peers, if we take the EU GDP (i.e., the dimension of the domestic market) as a benchmark; but it is extremely different, with 10 banks having a ratio greater than 50% and 5 greater than 100%, if we consider instead the home country's GDP (i.e. the fiscal capacity of their sovereign).

Figure 1



The national origin of the banks was also visible in the composition of the sovereign portfolio on the assets side, which showed a significant bias towards securities issued by their home government. Hence, following the national approach to bail-outs, market participants started assessing banks on the basis of the credit standing of the sovereign providing them with the safety net, and of the quality and concentration of their sovereign exposures. This has generated an inextricable bond between the banks and their sovereigns: the deteriorating conditions of the banks generated extreme pressure on the fiscal position of their home countries, while raising spreads for highly indebted sovereigns had a severe adverse impact on funding conditions, and therefore on the ability to lend, of banks headquartered in those countries. This increasing correlation is easily captured by the behaviour of sovereign and bank CDS spreads (Fig. 2).

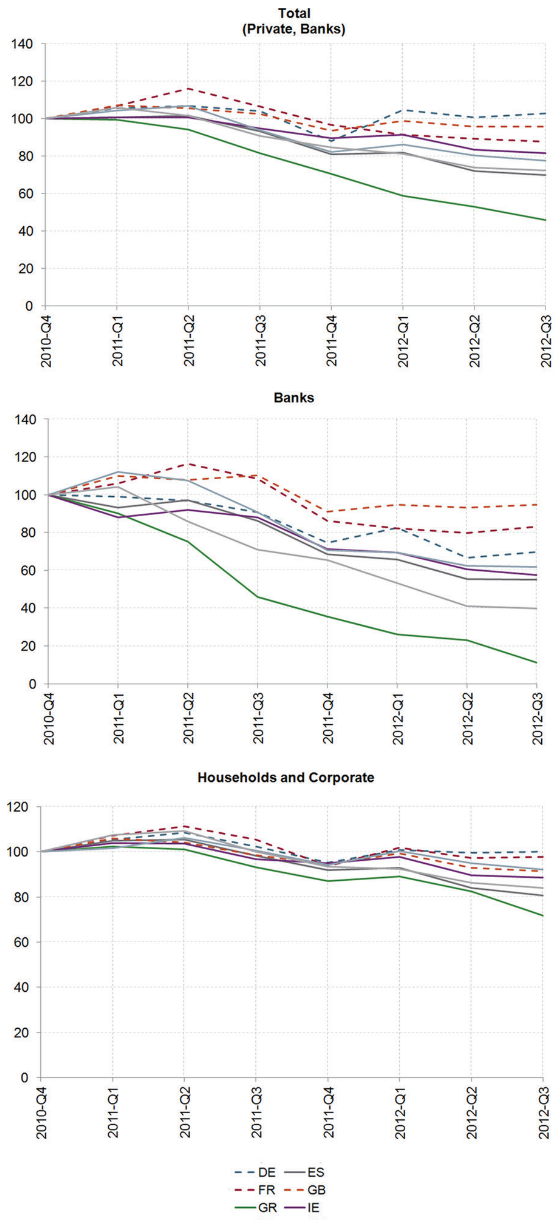
Figure 2


Italy and Spain
1100
1000
900
800
700
600
500
400
300
200
100
Jan-11
Jun-11
Nov-11
Apr-12
Sep-12
Feb-13
Jul-13
Unicredit (IT)
Intesa (IT)
B. Popolare (IT)
Italian Sov.
BBVA (ES)
Santander (ES)
Spanish Sov.
Germany and France
500
400
300
200
100
0
Deutsche Bank (DE)
Commerzbank (DE)
German Sov.
Sogen (FR)
BNP (FR)
Credit Agr (FR)
French Sov.
Ireland and Portugal
1700
1500
1300
1100
900
700
500
300
100
Bank of Ireland (IE)
Irish Sov.
Banco Commerc. (P
Portuguese Sov.

The disappearance of a functioning area-wide money market had a major impact, in terms of funding conditions, on the functioning of the Single Market, which started fracturing along national lines. The alignment of banking business with the domestic safety net led to what has been labelled as the "balkanisation" of the Single Market. This characterisation is pretty harsh, as in its geo-political meaning "balkanisation" refers to a region that splits into a set of smaller entities often hostile or non-cooperative with each other. But it captures an element of truth, as the reduction in cross-border banking has also, to some extent, been accompanied by actions of national authorities: home supervisors have pushed banks to de-risk in foreign jurisdictions and refocus on domestic markets, while host supervisors have often adopted measures to increase the amount of capital and liquid assets that is expected to remain in the balance sheet of local subsidiaries.

The reduction in cross-border claims of European banks has been mainly driven by the sharp contraction in lending to foreign banks (Fig. 3). To a large extent, this reflects the collapse in the euro area interbank market, due to the lack of trust amongst banks, which was replaced by the extraordinary measures introduced by the ECB, especially the Long Term Refinancing Operations (LTROs). As long as the policy measures taken to address the crisis restore a well functioning interbank market in the euro area, this trend should be reversible. But in some measure, the reduction of flows between banks could also be explained by a decrease in the cross-border lending within banking groups, from the parent company to the subsidiary and the other way round. But this is difficult to quantify due to the lack of empirical evidence. In addition, this development is driven not only by the pressure of national supervisors, but also by the willingness of bank managers to get to a closer matching of assets and liabilities in each jurisdiction, reflecting the fact that the sovereign-bank loop has made risks much more country specific than they used to be in the 2000s. The internal compartmentalisation of cross-border groups, which de facto could be described as a "soft" break-up of the integrated group model developed by some banks in the early years of the EMU, may be more difficult to return from, and has a significant impact on the functioning of the Single Market.

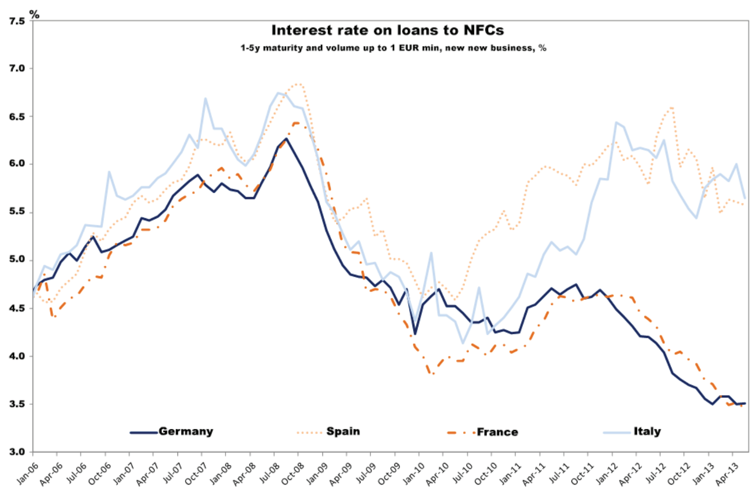
Figure 3. Consolidated foreign claims by sector (ultimate risk basis) of reporting European banks vis-à-vis selected countries, 2010 Q4=100



Source: BIS, Consolidated Banking Data

In fact, the internal capital market of cross-border groups has been an important driver in the integration of retail business, as the remote provision of services or the expansion through branches have proven much less effective in a market that is dominated by information asymmetries and where customers' trust plays a major role. The breaking down of this mechanism implies that the Single Market is impaired in fulfilling its key function, that of recycling savings from countries in surplus to countries in deficits. The divergence of bank lending rates for small and medium enterprises (SMEs) in what are commonly called "core" and "peripheral" countries – a terminology that by itself already signals the splitting up of the market – gives a very vivid representation of the damages being suffered by the Single Market (Fig. 4).

Figure 4



Source: ECB MIR statistics

To restore trust between supervisory authorities and to restore an environment conducive to financial market integration, the EBA is carrying out a great amount of work, which needs to remain behind the scenes to be effective and preserve confidentiality. We have deployed all the instruments in our armoury: we conducted investigations into possible breaches of European law, started mediation processes, triggered dialogue between home and host authorities on specific measures giving rise to conflicting supervisory assessments, called for enhanced cooperation in colleges of supervisors. In several cases, restrictive measures were reviewed and relaxed, conditional on enhancements in the functioning of mechanisms for cooperation and information exchange. But this is a lengthy and difficult process, which could always be put in reverse gear if market conditions were to sharply deteriorate. It is clear that the only way to permanently address the issue is a change in the institutional set up.

3. The Banking Union: a good start, and remaining challenges

The decision of the Council in June 2012 to establish a Banking Union amongst the Member States in the euro area, and to open it to other Member States willing to participate, has been a major step forward in repairing the institutional set up and breaking the link between banks and their sovereign.

The first building block of the new architecture is the Single Supervisory Mechanism (SSM), i.e., the framework for banking supervision, entrusted to the ECB. In this area, European policy makers delivered a positive surprise to market participants accustomed to lengthy decision-making processes leading to half-baked, partial solutions. The legislative package which is in the final stages of approval is a very ambitious one and it has been agreed upon in an extremely compressed time frame.

The ECB is given full responsibility for the prudential supervision of banks. There is no ambiguity here: the ECB will be able to use all the tools any supervisor has at its disposal, from licensing to sanctioning and triggering resolution. Also the scope of responsibilities is wide, as it covers directly all the major banking institutions but is also coupled with a right to receive information on all banks and take them under the ECB's responsibility in case of risks transcending the local markets. This is particularly important, as recent experience has shown that European markets may well be rocked by adverse developments in small and mid-size local banks, such as the Spanish Cajas; moreover, a split regime would have risked triggering volatility in deposits in periods of stress, as savers could have an incentive to move to the banks under the more reliable supervisory scheme, within the same country.

The legislation also requires the ECB to conduct a balance-sheet assessment before taking up its responsibilities. This entails an in-depth asset quality review, which is essential to complete the process of cleaning up banks' balance-sheets to ensure that asset valuations are sufficiently conservative and comparable across banks. The process is already being designed, with a close coordination with the EBA, which has prepared an EU-wide recommendation for asset quality reviews. The EBA stress test, also to be conducted in close cooperation with the ECB, will complete the process, by making sure that banks are in a position to converge towards full compliance with the Basel 3 requirements also under stressed conditions. The completion of the process of bank balance-sheet repair is a pre-condition to kick-start lending again, as shown in most past crises.

The positive assessment of the reform being implemented should not make us blind to the enormous organisational and technical challenge of integrating supervision. Notwithstanding the progress made in convergence of supervisory practices, national authorities are still relying on different approaches – for instance, a different emphasis on off-site surveillance, on-site examinations, external audits, etc. – enshrined in rather diverse administrative frameworks and entailing different ways of interacting with the industry. Unfortunately, and differently from the process that led to the monetary union, the crisis has not helped in identifying a clear blueprint for effective supervision: there is no model that has emerged as the clear benchmark, and all authorities are engaged in a difficult process of reviewing their approaches. At the same time, this also represents a unique opportunity to establish together a sounder and stronger supervisory culture. The EBA will contribute to this process, as the changes to its founding regulation introduced to reflect the establishment of the SSM envisage that we will have to develop a Single Supervisory Handbook, which should ensure that the methodologies for assessing risks and determining the supervisory reactions are integrated at an EU-wide level.

The second building block of the new institutional framework is the establishment of the Single Resolution Mechanism (SRM). This entails different steps, each fraught with a number of technical complexities and political sensitivities.

First, it is necessary to complete the design of a legislative framework for bank recovery and resolution at the EU level. The Bank Recovery and Resolution Directive (BRRD) currently under discussion pursues the ambitious goal of defining a fully harmonised set of tools for resolution authorities, including the possibility to "bail-in" creditors according to a well defined waterfall and thus avoid the need to disburse taxpayers' money in bail-out operations. While this piece of legislation is extremely ambitious, the strong willingness of governments and parliaments to prevent future crises from having a disruptive impact on government finances has created a positive momentum for a quick finalisation of the BRRD. However, in certain areas, there are worrisome calls for leaving certain key aspects to national discretion, a point to which I will come back later.

Second, an effective SRM requires the establishment of a Single Resolution Authority (SRA) and a Single Resolution Fund (SRF). A truly European resolution mechanism cannot be based on a loose network of national authorities. Effective resolution requires clear powers to intervene in property rights of individuals, attributing losses through bail-in, transferring assets to bridge entities, attributing assets to the "good bank" or the "bad bank." The competent authority needs to operate on the basis of a clear and strong legal framework; otherwise the fear of lawsuits would paralyse action and prevent the prompt and decisive intervention which is essential to protect the public interest. Such powers cannot be legally attributed to a committee of independent national bodies. There need to be clear and effective decision making mechanisms able to deliver quick and neat solutions at the European level. I understand the concerns raised by those who argue that a Treaty change would be needed to empower a European Resolution Authority. But this is still based on a rather narrow interpretation of the so-called Meroni jurisprudence, which in my view should be overcome in light of the completely different institutional set up which has been developed since such interpretation was first elaborated, and of the clear real life subsidiarity test that we have experienced in the last phase of the crisis.

Third, effective resolution needs funding and liquidity provision, to ensure continuation of business while resolution measures are put into place and stabilised. A European resolution fund, financed by (possibly risk-based) fees paid by the banking industry, would provide a necessary source of liquidity to temporarily support the ailing bank. This step could meet the resistance of the industry, especially if the fees for the European fund are cumulative to other taxes and fees paid at the national level. But there will also be a need for a public backstop, a facility providing liquidity in case the resolution fund falls short of the resources needed to tackle a systemic crisis. As shown in the case of the Federal Deposit Insurance Corporation (FDIC) in the US, which has access to a special credit line with the Treasury, these loans only provide a temporary support and are normally paid back when resolution proceeds to the next stage. The European Stability Mechanism (ESM) could fulfil this purpose.

Timing is of essence here. Delaying the deployment of ESM resources to directly support bank restructuring could adversely affect the effectiveness of the Balance Sheet Review to be conducted by the ECB, as national authorities would have all the incentives to minimise the restructuring efforts that would exclusively impact already depleted national safety nets. Having effective mechanisms for restructuring and resolution is essential to decisively dealing with the excess capacity that still remains in the banking sector, thus restoring sustainable profitability and releasing the constraints to bank lending.

Does the new institutional set up also require a centralised deposit guarantee scheme? I would argue that as long as the resolution fund is established at the European level and the deposit guarantee scheme is asked to fulfil only a pay-box function, the responsibilities could be left at the national level. This arrangement would be neither optimal nor sustainable in the long term, as it still is susceptible to reactivating the adverse loop between banks and their sovereign, in case a Member State is not considered strong enough to support the local guarantee scheme. However, as long as a credible ESM backstop is in place and there is a credible commitment to bail-in senior creditors in a crisis, the system could be sufficiently strong. In the longer term, one should put in place mechanisms that envisage the creation of an effective European system of deposit guarantees, which respects the willingness of certain categories of predominantly local intermediaries (cooperative and savings banks, in particular) to maintain their mutual insurance mechanisms as it is. For instance, one could build upon the proposal raised by Daniel Gros to have a European deposit guarantee fund, with reinsurance mechanisms for local, mutual schemes.

4. Repairing the Single Market: the interface between the SSM and the EBA

The Banking Union will include all the euro area countries and may well extend to other Member States that decide to participate, but will not embrace the whole EU. Hence, the important measures discussed in the previous sections will not go all the way to restoring the proper functioning of the Single Market. In other words, there is a possibility that some segmentation will remain among Member States in and outside the Banking Union. At the same time, the centralisation of supervision in a core component of the EU banking sector will create pressure for the further strengthening of certain pillars of the Single Market.

This second, potentially more benign force should be visible, first and foremost, in the area of rule-making. It is very difficult to conceive of the ECB conducting its supervisory tasks in a truly unified fashion in the absence of common rules, adopted through EU regulations – including the technical standards prepared by the EBA. Extending the Single Rulebook is a necessary condition for the success of the Banking Union.

We have made a lot of progress towards establishing a Single Rulebook for banking, but differences in national positions have played a major role in the finalisation of important regulatory reforms: significant elements of national discretions have been introduced in the texts of the Capital Requirements Directive and Regulation (CRD4-CRR), and the same is very likely to happen in the BRRD.

The EBA has sent opinions to the Commission, Council and Parliament pointing out several areas in which further efforts were needed to ensure the necessary regulatory consistency. In particular, our attention focused on the definition of capital and on the calculation of Basel 1 floors, pointing out the relevant differences in national approaches and the detrimental impact this has on the Single Rulebook. We quantified the potential impact of a few discretions still remaining in the regulatory framework at 300 basis points for the Core Tier 1 capital ratio of the banks included in our recapitalization exercise. Also some remaining ambiguity in the (very large) margins of flexibility granted to national authorities to set macroprudential requirements could in principle impair the functioning of the Single Market. It is absolutely true that authorities have the power to raise the regulatory requirements in order to pre-emptively deal with a build-up of risks in a specific country or region within the EU. Certainly, we would be in a different place if these instruments were activated when a real estate bubble was building up in Ireland and Spain. At the same time, such discretion needs to be exercised within the boundaries set by clear European guidance, to avoid an abusive use of the instrument to ring fence domestic markets and trap bank capital and liquid assets of subsidiaries of foreign banks.

Similarly, as already mentioned, the negotiations on the BRRD are introducing a number of national discretions on the financial instruments subject to bail-in, on the amount of loss absorbency capacity (i.e. instruments that would be subject to write down or conversion into equity in case of non viability) that banks will need to build up, and on the thresholds for proportionality, which would lead to lighter requirements or outright exemptions of smaller local banks. This would hamper the ability to effectively interconnect resolution procedures for cross-border banks and would also imply that investors buying the same instrument in two different Member States could be subject to a different treatment in a crisis.

The SSM will require a further push in harmonisation of the rules, and could also function as a catalyst for greater convergence in supervisory practices in the whole EU. The EBA's Single Supervisory Handbook will provide a unique window of opportunity to focus on a few core chapters of the manual for examiners and define truly consistent methodologies. This convergence process will have to be accompanied by an expansion of common supervisory definitions, which would also support truly comparable disclosure of information by the banks. The EBA has recently made significant process, by preparing common definitions for non-performing loan, loan forbearance and asset encumbrance.

The likely push for greater harmonisation might lead to a stronger and more extensive Single Rulebook, which would also provide an important safeguard for a level playing field, with banks headquartered in Member States not participating in the Banking Union. However, if the SSM and the authorities of non-participating countries disagree on key issues, there is a potential risk that a greater degree of flexibility will be maintained at the EU level, while the SSM will move to more homogeneous rules and supervisory practices. This could potentially generate a rift within the Single Market. The EBA role in bridging between "ins" and "outs" will be particularly relevant in the coming years.

A potentially trickier issue arises in the area of recovery and resolution. As discussed above, the balkanisation of the Single Market has been driven mainly by the market assessment on the reliability of national safety nets. The integration of supervision and resolution functions at the European level for the Member States joining the SSM would, to a large extent, fix this problem, provided that an ambitious approach is followed in implementing the SRM. But as long as the SRM will cover only a subset of Member States, there is a serious risk that some degree of fragmentation will remain within the Single Market.

Key Single Market principles have already stopped working: the single passport and the application of the home country principle in resolution and in deposit guarantees have been significantly stretched in recent crises. In most cases, foreign establishments have been hurriedly sold in order to deploy the traditional restructuring and resolution instruments at a country level and prevent cross-border spillovers.

How can we repair the functioning of the Single Market?

I believe the Single Market principles need to be strengthened based on experience, possibly distinguishing more clearly between retail and wholesale business. In particular, efforts should be focused on workable recovery and resolution plans for cross-border banks, which would identify an appropriate balance between (i) the need to allow the free flow of resources within banking groups in the Single Market, with a firm-wide view on risks, capital adequacy and liquidity position, and (ii) the reasonable request of host authorities to have sufficient safeguards for local savers in case of a crisis. Hence, it is necessary to think about liabilities structures of the various components of the banking groups, to be discussed, agreed and monitored between home and host authorities. But we also have to consider that agreements between national authorities have not been effective during the crisis and an enhancement of their quality is not likely to dramatically improve their credibility. As a matter of fact, recovery and resolution plans and cooperation agreements are, at best, sort of "incomplete contracts," which will require interpretations and adaptations when faced with a real crisis. It is therefore essential to develop robust legal underpinnings that could make resolution agreements de facto enforceable. A necessary condition for this to happen is that a European authority is entrusted with the responsibility to conduct binding mediation between home and host authorities, thus ensuring the smooth application of the plan and the agreements against the specific features of the crisis. But it would be very helpful also to reconsider the need for a European statute for banking groups, similar to the idea behind the European company statute. This would allow banking groups to ensure a strong responsibility of the parent company for the fulfilment of regulatory requirements, coupled with safeguards for minority shareholders and creditors of the foreign subsidiaries and the possibility for a much more integrated approach in resolution.

5. Conclusions

Great progress is being made in repairing the features of our institutional setup that have generated the adverse feedback loop between banks and their sovereigns, leading to a balkanisation of the Single Market. The establishment of the SSM is proceeding according to plans and will generate a major overhaul in the current system, for the better. However, I believe that we should continue to pay great attention to completing all the elements of the puzzles, to ensure a successful Banking Union and repair the functioning of the Single Market.

In my view, the main challenges ahead of us are:

- avoiding half-baked solutions for the establishment of the SRM: there is a need for a single authority, coupled with a fund generated with pooled resources provided by the industry and a public backstop by the ESM;

- unlocking the direct support of the ESM to banks, so that the forthcoming balance sheet review to be conducted by the SSM can lead to swift progress in cleaning bank balance sheets and in bank restructuring if and where needed;

- working on the development of a multi-tiered deposit guarantee system, which, in the longer run, could complete the architecture – although in the short term the framework would remain sustainable without Europeanisation of deposit guarantees;

- developing a greater commitment to the Single Rulebook, reviewing where necessary national flexibility and discretions that could generate a major impact on the functioning of the Single Market – the EBA could be asked to develop into a guardian of the Single Rulebook, flagging to the lawmakers areas where legislative initiatives are warranted;

- rethinking key Single Market principles, with a view to enhancing them, especially via an effective and enforceable framework for recovery and resolution, based on solid legal underpinnings at the EU-wide level.

I remember clearly that in the years before the crisis those sceptical about the need for greater integration frequently invoked the subsidiarity principle. The burden of proof was always on the side of those advocating the need for a more integrated system at the EU level, and the bar was usually set very high – you had to actually prove that the system was broken ("if it ain't broke, don't fix it" was the leading principle). But we paid a high price for having waited for concrete proof that the system would not have worked in a crisis. Now that there is political awareness of the need for reforms, we should go all the way in repairing the Single Market.

6
Banking Union instead of Fiscal Union?

Daniel Gros

In September of 2012, close to the peak of the euro crisis, the four Presidents of the European Union (the Presidents of the European Commission, the European Council, the Euro Group and the European Central Bank) issued a joint report entitled “Genuine Economic and Monetary Union.”

The report was drafted after the European Council of June 2012 had already decided that, in order to break the negative feedback loop between sovereign debt and bank debt, a single supervisory mechanism (SSM) should be established for large systemic banks – and that moving towards federal supervision would also require additional steps towards a federal resolution mechanism. These elements together came to be called ‘Banking Union.’

The four Presidents argued in essence that the establishment of a Banking Union should also be seen as a first step towards further integration. According to their report, a Fiscal Union would be the next logical step. Moreover, a Fiscal Union was held to imply the need for a political union.

There is surprisingly little analytical argument for the nexus between a banking union and a fiscal union. The key argument is most often simply the observation that the euro area has only a very limited central budget (at least compared with other monetary unions), and that therefore there are almost no fiscal transfers to smooth asymmetric shocks. By contrast, the US, which is of a similar size as the euro area, does have a substantial federal fiscal budget. The US experience is thus usually taken as an example of what is needed for a sustainable monetary union.

It is indeed very true that most existing monetary unions have a much larger federal budget (and constitute federal states, not loose confederations). But this was known when the architecture for EMU was drawn up in the early 1990s. It is often forgotten that there was a wide-ranging debate about this issue during the preparation for Maastricht (and it is surprising that the report of the four Presidents does not contain any reference to this debate). The conclusion then was that the case of a fiscal shock absorber was not very strong even if one looked to the US as a model, and that even if it might be useful in theory, it would be exceedingly difficult to implement in practice. Instead of revisiting the debate of the 1990s that led to the decision to start EMU with only a minimum degree of fiscal integration, in this contribution we would just like draw attention to two aspects of the US experience that are widely misunderstood – but are crucial to the debate about the link between monetary union, banking union and fiscal union.

- First, the federal budget in the US provides very little insurance against shocks although it is an important income redistribution instrument.
- Second, the 'Banking Union' of the US provides a very tangible insurance against local financial shocks.

That said, I take it that the current discussion is about the alleged need to have a separate and additional fiscal shock absorber, where fiscal is understood in a narrow sense (taxes and benefits not related to financial markets).

The Great Recession provides a very important episode with which to assess the importance of shock absorbers. One reason is that the housing boom was very concentrated in the US (as it also was in Europe). The increase in housing prices varied enormously from state to state and only a few states accounted for most of the overbuilding and thus the subsequent economic distress and losses from delinquent mortgages. Moreover, in normal times, it should be possible for most economic actors to use financial markets to smooth consumption in the face of temporary shocks. However, the Great Recession coincided with a profound financial crisis, which froze financial markets for some time and excluded entire groups from access to lending. This implies that fiscal shock absorbers would have been even more important during the Great Recession than during more normal business cycles.

1. What lessons from the US 'fiscal union'?[1]

The argument for the need of fiscal shock absorbers at the euro area level has often been made with reference to the US experience. One mechanism to provide such a shock absorber that is often mentioned is a common (European) unemployment insurance scheme. However, any reference to the US would be misleading in this case.

In the US, the unemployment insurance is financed mainly at the level of states. While there is some de facto reinsurance at the federal level, in practice the federal reinsurance is not used most of the time. It springs into action only in the case of large shocks. The great Recession constituted one of those large shocks; indeed there has been a considerable federal involvement in unemployment benefits over the last few years. But this support was given to all states and thus does not provide those states most affected by the downturn with much more support than the others.

Moreover, unemployment benefits are not as important as often assumed. In most countries they amount to only about 2-3% of GDP, even during a major recession. In the US the supplementary federal

1 The first part of the following is based on chapter 8 of Gros and Thygesen (1992), European Monetary Integration, Longman, London.

expenditure amounted to only about 1% of GDP in recent years. It is thus clear that a euro area unemployment insurance system would never be able to offset major shocks like the ones hitting Ireland or Greece where GDP has fallen by over 10%.

Moreover, one has to take into account the fact that unemployment differences across states in the US tend to be temporary, which is not the case in the EU (or euro area). Any common unemployment insurance system in the EU would thus risk leading to permanent transfers. This persistence in national unemployment rates (and thus the difference between the EU and the US) is understandable given that most of the factors that determine the unemployment rate in the long run are social norms and regulations, which remain national in the EU.

Unemployment insurance is of course not the only way to provide a shock absorber. A 'fiscal capacity' for the eurozone has thus been proposed. The key question is: Against what type of shocks would such a system be intended to insure?

If business cycle shocks were really the key problem, individual member states could first of all 'self-insure' by running a prudent fiscal policy and lower their debt level so that they have the freedom to run temporary deficits in case they face temporary shocks. The 'Fiscal Compact' with its target of approximate balance in cyclically adjusted terms is implicitly based on this idea.

However, the euro crisis has shown that the really important shocks result not from normal business cycle fluctuations, but from financial boom-bust cycles which can put the entire financial system in jeopardy. Such shocks are less frequent than business cycles, but when they arrive, they have a much larger impact. Before the outbreak of the financial crisis of 2007-08, normal business-cycle shocks led to fluctuations in GDP of at most 1-2 percentage points. However, the 2008 crisis led to a fall in GDP several times larger and in the wake of the euro crisis some countries have experienced double-digit falls in GDP and have seen their entire financial system close to collapse. What kind of fiscal system could provide insurance against this type of shock?

Most proposals for a euro area fiscal shock-absorber mechanism are grounded in the perception that in most existing federations, the federal budget redistributes income across regions and thus offsets at least part of the interregional differences in income. While this has been repeatedly documented for the US (for some older references, see MacDougall (Commission of the EC, 1977) and Sachs and Sala-i-Martín (1992)), the inference that redistribution is equivalent to a shock absorber mechanism is wrong.

The research cited above concluded that the US federal budget offsets about 30–40% of the differences in the level of income per capita across states because poorer states contribute on average lower income taxes and receive higher social security payments. However, this does not automatically imply that these mechanisms also provide an insurance against shocks (i.e. changes in income).

My own work (see Gros and Jones, 1995) suggests that evidence of a high degree of stabilisation of income is in reality the result of the joint effect of the (automatic) stabilisation across states at any given point in time and the (at least partly discretionary) changes in the federal fiscal stance, which stabilise income over time for all states together. The automatic stabilisation across states or regions accounts for less than one-half of the overall stabilisation, reducing the variability of personal income by about 15%. The federal fiscal stance turns out to have a stronger stabilising impact, and this has been the case even during the Great Recession.

The degree to which the US federal fiscal system absorbs shocks at the state level cannot be very large for the simple reason that the main federal source of revenues which does react to the business cycle (i.e. the federal income tax) accounts for less than 10% of GDP (as remarked above, unemployment benefits remain in normal times at the state level). This implies that on average only about one-tenth of any shock to state income is automatically absorbed at the federal level.

2. What lessons from the US II: Evidence from the 'Great Recession'

More recently I have looked at the distribution of federal expenditure and taxes by state within the US. To my surprise I found that there was very little relation between the severity of the recession at the level of individual states, measured by the fall in GSP (gross state product) or increase in local unemployment rates, and the amount of net federal transfers received (by residents of the state). (As mentioned above the differences in the shocks to GSP are as large as the difference among EU member states, given the regional concentration of the housing boom in the US.)

The federal deficit has of course increased by several percentage points of GDP, which implies that on average (residents in) most states have received more federal fiscal expenditure than they (or rather their residents) have paid in federal taxes. Yet, it is striking in particular that (the residents of) those states hardest hit by the real estate boom/bust cycle (like Arizona or Nevada, which thus suffered the highest increase in unemployment and large falls in GSP) did not receive more net federal transfers than other states.

These findings reinforce the conclusion that, all in all, it is difficult to rest the case for some euro area shock absorber on the US experience.

I would add that the distinction between transitory and permanent shocks becomes crucial in this area because any permanent shock requires adjustments in real wages and/or migration, rather than permanent financing. Moreover, it is difficult to see how one could provide insurance against permanent country-specific shocks without addressing directly the issue of income redistribution among member states.

3. What lessons from the US 'banking union'?

It is generally agreed that a fully-fledged Banking Union (BU) has three elements:

i. Common supervision (this is now agreed in principle in Europe, with the ECB under the SSM (Single Supervisory

Mechanism) soon ready to take over supervision for most larger banks).

ii. A common mechanism to resolve banks. In Europe agreement on the so-called Single Resolution Mechanism (SRM) has been reached in principle once SSM is working effectively.

iii. Common deposit insurance. No agreement yet in Europe, but at least some reinsurance of national deposit insurers against catastrophic risks will be needed.

The US has had all three elements at least since 1933. The US thus qualifies as a BU – and the consequences could be seen during the financial crisis. A simple comparison of the fate of two different members of a large monetary union when they are hit by a financial crisis provides a powerful illustration of the importance of an integrated banking system. Ireland and Nevada, in fact, provide an almost ideal test case. These two entities share several important characteristics. For example, they both have similar populations as well as GDP and they both experienced an exceptionally strong housing boom. But when the boom turned to bust, the US state did not experience any local financial crisis (nor did the state government have to be bailed out).

The key difference between Nevada and Ireland is that banking problems are taken care of in the US at the federal level (effectively a banking union), whereas in the euro area, responsibility for banking losses remains national.

Local banks in Nevada experienced huge losses and many of them became insolvent, but this did not lead to any disruption of the local banking system as these banks were seized by the Federal Deposit Insurance Corporation (FDIC), which covered the losses and transferred the operations to other, stronger banks. In 2008-09, the FDIC thus closed 11 banks headquartered in the state, with assets of over $40 billion, or about 30% of state GDP. The losses for the FDIC in these rescue/restructuring operations amounted to about $4 billion. Other losses were borne at the federal level when residents of Nevada defaulted in large numbers on their home mortgages. The two federal institutions that re-finance mortgages have lost between them about $8 billion since 2008.

The US Banking Union thus provided Nevada with a 'shock' absorber of about 10% of GDP, not in the form of loans, but in the form of an (ex-post) transfer because losses of this magnitude were borne at the federal level.

Moreover, a lot of the banking business in Nevada was (and still is) done by 'foreign' banks, i.e. by out-of-state banks, which just took the losses from their Nevada operations on their books and could set them against profits made elsewhere. This is another way in which an integrated banking market can provide insurance against local financial shocks. Given that the large banks had a market share of about 50% in Nevada, one can estimate that they provided another loss absorption of 10% of GDP.

The experience of Washington Mutual (WaMu) illustrates this general point. The biggest bank to have failed in US history, a mortgage specialist, WaMu had its headquarters in Nevada (although the name suggests otherwise) and some small operations there. However, its failure did not lead to any local losses as Washington Mutual was seized by the FDIC and its banking operations were sold for a very low sum to another large US bank (JP Morgan Chase) – but without any loss for the FDIC. Moreover, Washington Mutual received about $80 billion in low-cost financing from the US Federal Home Loan Bank. If a bank like WAMU had been headquartered in Ireland, the Irish government might have been held responsible for its losses as well.

In Europe, only the Baltic countries, whose banks are to a large extent in foreign hands, benefited from a similar loss-absorption protection provided by the Scandinavian headquarters of their local banks. Conversely, most of the real estate lending in Ireland had been extended by local banks and the government had to assume their losses. Irish banks received massive amounts of low-cost emergency liquidity assistance from the European Central Bank, but the Central Bank of Ireland had to guarantee these loans, which was not the case for any bank in Nevada.

All in all, it thus appears that losses in Nevada on the order of 20% of the GSP were absorbed at the federal level.[2] If the plans for a euro area Banking Union are completed, the euro area could acquire an extremely effective shock-absorber system.

4. Concluding remarks

The really important and costly shocks are financial boom-bust cycles, followed by a financial crisis. These financial crises are rare and regionally concentrated (even within a 'genuine' monetary union like the US). What arrangement provides the best protection against these shocks?

The US experience seems clear: the shock-absorbing power of explicit federal transfers is rather small, but the US Banking Union provides important support in the case of large shocks to the local financial system.

This has one simple implication: To insure its stability, the euro area needs a strong Banking Union, but not a Fiscal Union. The usual argument that the former needs to be followed by the latter should thus be turned on its head: an area with a well-functioning Banking Union does not need fiscal shock absorbers and thus does not need a Fiscal Union. From the latter observation, it follows that there is also no need for a Political Union. As long as the banking system is stabilised, member states can thus remain responsible for their own fiscal policy. Excessive spending by individual member states could no longer destabilise the entire banking system. This implies that political responsibility for fiscal policy could remain at the national level.

2 See my note on the Nevada Ireland comparison (http://www.ceps.eu/book/banking-union-ireland-vs-nevada-illustration-importance-integrated-banking-system).

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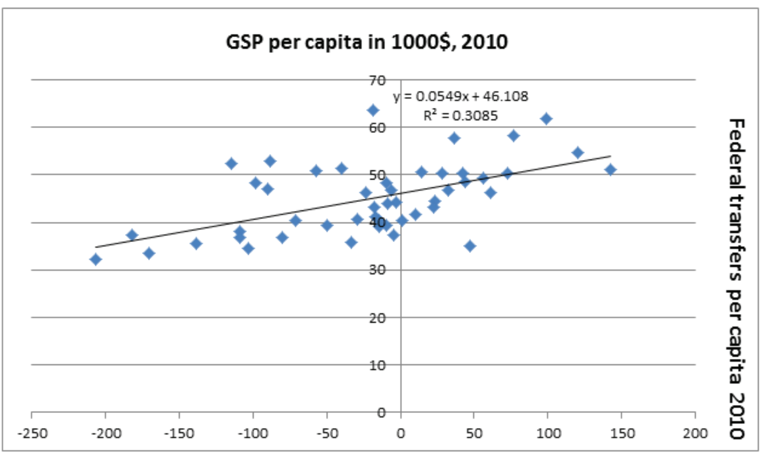
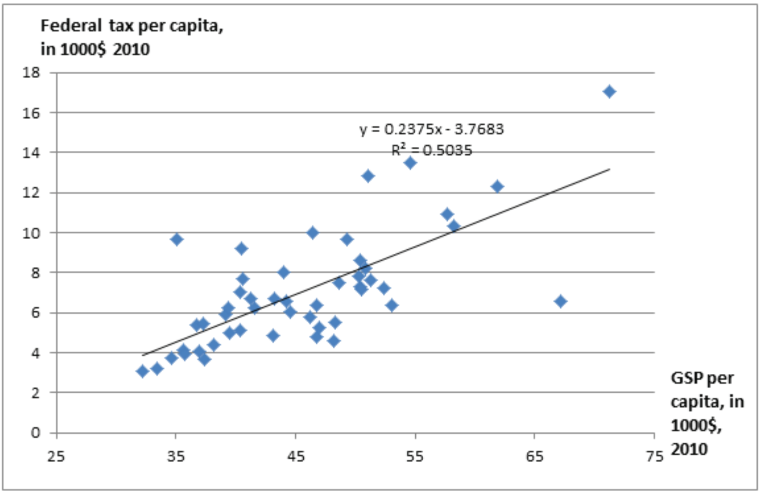
Annex: Federal transfers in the US during the Great Recession.

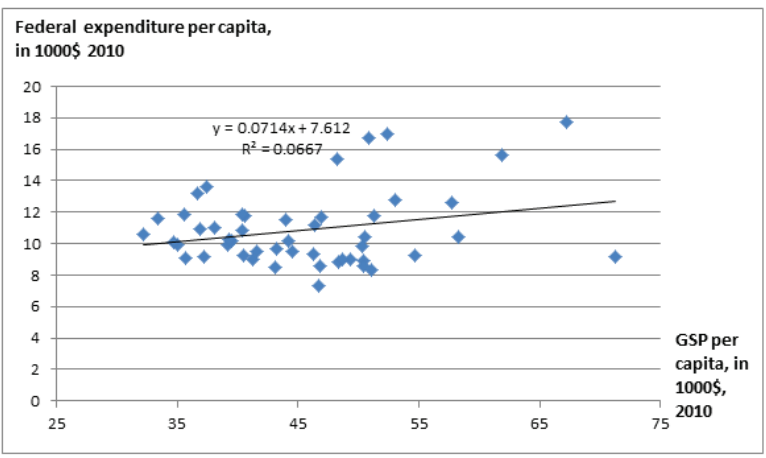
Federal transfers are defined here as the difference between total federal expenditure (for payments to individuals, including wages and salaries, procurement, etc.) and federal taxes paid by residents of the state considered. For more detail of the revenue and expenditure items, see below. The overall difference between federal expenditure and taxes summed over all 50 states corresponds to the US federal primary deficit.

The first point is that there is indeed a strong relationship between the level of GSP (Gross State Product) and the level of federal transfers. The correlation coefficient between the levels of the two variables in the year 2010 is about 30 % as shown in the scatter plot below.



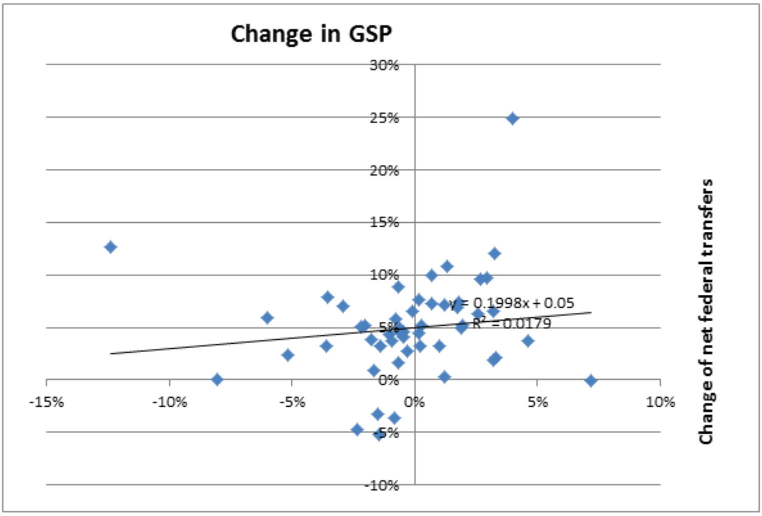
The high correlation of the levels is due mainly to the fact that federal tax receipts are highly correlated with GSP, but this is not the case with federal expenditure as the following two charts shows:



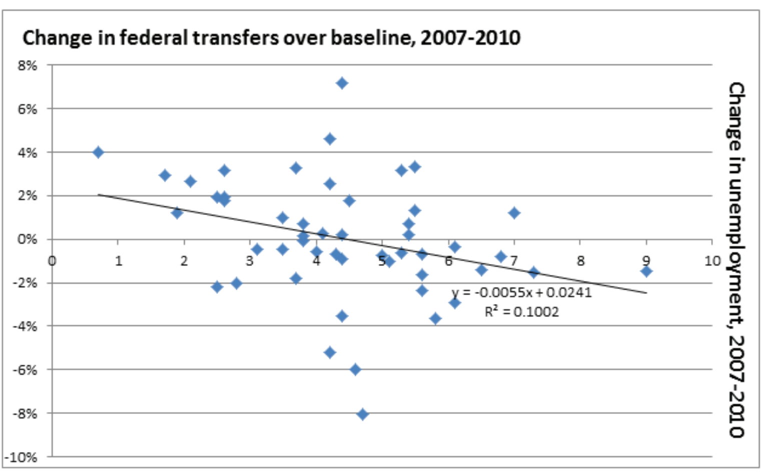


Federal tax and expenditure reaction to shocks

If federal transfers (as defined here) are to be shock absorbing, there would need to be a strong correlation between the initial differences, i.e. changes in unemployment rates by state and the change in the federal transfers received by residents of the states over the same period. However, this is not the case. The correlation between the two is rather low if we take into account the post crisis data, i.e. the change between 2007 and 2010.



The result does not change if we use changes in unemployment by state as the variable indicating state specific shocks as the scatter plot below shows. The correlation between these two variables is only about 10 %.



7
Managing Country Debts in the European Monetary Union: Stronger Rules or Stronger Union?

Robert P. Inman

With the decision to join the European Monetary Union (EMU) beginning in 1999, seventeen European countries took a bold step towards a more complete economic union for their once independent state economies. The promises of the Union are the benefits of more integrated capital, labor, and product markets and, with a common currency, lower currency risk and hopefully increased trade and investment across country borders. While the newly created Monetary Union centralized monetary policy under the direction of the new European Central Bank, union members retained, under the founding principle of subsidiarity, full control over country fiscal policies. From the perspective of economic theory, this institutional arrangement has much to recommend it. Economic institutions should assign the control over a policy to a governing institution that represents the interests of those most affected by the policy, and each level of governance will need the fiscal and regulatory tools necessary to provide its assigned services.[1] These tools include spending and taxing powers and the power to issue public debt.

When assigning spending powers we should seek to match policy control as closely as possible to the economic interests of affected

1 The classic text on theory of assignment for fiscal policies is Oates (1972). A valuable text for the implementation of this theory is Boadway and Shah (2009).

citizens. Services that benefit only local residents should be decided and provided by local governments, but services that display significant economies of scale in production or that involve significant benefit spillovers between communities – services such as higher education, construction and maintenance of public highways, prisons and courts, and the protection of water and air quality – should be funded and provided by a provincial or national government. Assigning taxing powers should be done to most accurately match tax payments to the benefits they finance. Resident, or destination, based taxation will typically be needed to ensure residents pay the full marginal cost of the public services they consume. Resident taxation taxes factors of production by where the factors live, not where they work, and taxes consumption by the location of the consumer. The alternative, known as source-based taxation, allows a share of the tax burden to be shifted onto non-residents. Source-based taxation discourages the efficient location of economic inputs, and because non-residents pay a share of the taxes used to finance the marginal costs of public services, residents or their elected officials may find it advantageous to over-provide the subsidized state services.[2]

Finally, borrowing powers should be used to prevent large increases in taxation when governments are faced with the necessity of large, one-time increases in government spending. Such expenditures might be planned, as for public investment, or unexpected, as in the case of natural disaster relief, war spending, or relief from deep recessions. Without access to public debt, states will be forced to raise taxes significantly resulting in negative effects on investment, savings, and work. The use of government debt to finance such expenditures allows the government to increase tax rates only slightly and to then hold tax rates stable over the period of debt repayment. This fiscal strategy is called “tax-smoothing” and helps to minimize the efficiency losses from the financing of large increases in government expenditures.[3]

These guidelines tell us how public finance should work in principle to achieve the full economic benefits of an economic union. With one important exception, the European Monetary Union has followed these prescriptions with resulting economic success. That one

2 See Gordon (1983) and Inman and Rubinfeld (1996).
3 See Barro (1979).

exception is the management of public debt by its member countries, and this failure has the potential to undo the union.[4]

II. The Problem: Eurozone Public Debts

Governments borrow for two reasons: one is economically valid, one is not. The valid reason is to "smooth" out tax financing for large, lumpy government expenditures. The invalid reason is to borrow money for consumption today in expectation that the country might declare default when that debt falls due, thus shifting the final burden onto resident and non-resident bondholders or, in the case of debt bailout, onto taxpayers outside the debtor country. Valid debt is repaid by the country's citizens and will only be undertaken when the present value of social benefits of current spending exceed the present value social costs of debt repayment. Invalid debt is repaid (or absorbed as a loss) by non-residents outside the borrowing country and will be undertaken even when the social benefits of current spending are less than the, now shared, social costs of debt repayment. When the burden of debt can be so shifted, too much debt and associated government spending will result.

While the majority of the Eurozone countries have borrowed only for valid reasons, three countries – Greece, Portugal, and Italy – have arguably succumbed to the temptation of invalid deficit financing. Two other countries – Ireland and Spain – may have tolerated excessive private sector borrowing for private (housing) consumption with the expectation that public debt and a subsequent public bailout might be forthcoming.[5] Figures 1a and 1b provide background evidence. Figure 1a shows the time path of country interest rates from 1992, the date of the Maastricht Treaty sanctioning a European Monetary Union, to 2012 for all Eurozone members (the solid line) and for each of the five "at-risk" countries tempted by the invalid reason for public borrowing. Figure 1b shows the time path of country deficits as share of GDP over the same period, again averaged for all Eurozone countries (the solid line) and for the five high debt countries. Four conclusions seem evident.

4 See Inman and Rubinfeld (1994) and Lane (2012).
5 See Panetta, et. al. (2009).

First, prior to joining the monetary union, each country faced private market interest rates for their long-term debts that reflected the likely risks of debt repayment. Higher interest rates for riskier country debts, coupled with the incentives to meet Maastricht debt and deficit guidelines required for Union membership, led to moderated and then declining country deficits from 1995 to 1999.

Second, once within the monetary union, the financial markets treated long-term public debt from *all* Eurozone countries as equally risky loans. This equivalence remained in place until the Great Recession of 2007-2010, when the threat of default by each of the five at-risk countries became an economic reality. Prior to the Great Recession, however, the financial markets either thought the five at-risk countries would manage their public finances like the more prudent union members (e.g., Germany) *or* that there would be a good chance of a union bailout if these countries threatened to default on their public debts.

Third, the five at-risk countries did not assume the German mantle of fiscal prudence but rather took advantage of the lower interest costs to increase public borrowing above the Eurozone average and above the Maastricht Treaty's 3 percent guideline for acceptable deficits.

Fourth, once the assumed full bailout by the EMU appeared less certain, interest rates for long-term debt issued by the five at-risk countries rose sharply, reflecting again the underlying probabilities of country repayment, perhaps net of any partial union bailouts.

To understand why there emerged invalid borrowing by the at-risk members of the monetary union, we need to understand why those members, and the financial markets which facilitated excessive borrowing, thought there would be a union bailout if debts could not be repaid. Why did the other members of the monetary union not just say: NO? The answer lies in the incentive for fiscal bailouts in monetary unions. Figure 2 shows when fiscal bailouts are likely to occur, and then what must be true to hold this temptation, and thus invalid borrowing, in check.[6]

6 The analysis presented in Figure 2 motivating central government bailout behavior is from Inman (2003). Conditional upon the likelihood of a central government bailout, states will then over borrow; see Krogstrup and Wyplosz (2010).

Bailouts emerge when the debtor country can impose significant economic hardships on other members of the monetary union if the debtor country were to default. If this is the case, the debtor country can count on a bailout, shift the burden of these local deficits onto citizens of the other union member countries, and finance its own public services at a subsidized rate equal to true costs less the bailout. The incentive is to over-consume deficit financed public services. That the citizens of the at-risk countries understood this (invalid) motivation for public borrowing was made clear at a recent soccer "friendly" between Greece and Germany. Germany easily won the match, but the Greek fans held up a sign saying: "You may beat us in football, but you'll never get your money." To control inefficient public borrowing in a monetary union requires controlling the incentive for union bailouts of country deficits. From the analysis in Figure 2, this means controlling the economic (E), financial (F), and empathy (S) spillover costs that might be imposed on other, fiscally sound union members by a debtor country.[7]

7 The U.S. historical experience is instructive on the importance of each cost for the bailout decision; see Inman (2003). The possibility that the federal government might bail out the debts of U.S. states was established by the Hamilton Compromise. Alexander Hamilton, the first Secretary of the Treasury, argued that it was essential that the new United States assume the revolutionary war debts of the many states as a signal to European credit markets that the new union would be a worthy credit risk going forward. Virginia, which had already repaid its debts, resisted. The compromise had the federal government assume state debts and in return have the U.S. capitol moved from New York City to the border of Virginia, now Washington, D.C. States assumed that this precedent for bailouts might continue, and it did until 1843. In 1843, Congress rejected requests for the bailout of state bonds issued by eight border states to fund railway construction and state banks. State economic development did not generate sufficient profits to repay those loans. The costs of the bailout would have been $200 million or approximately $6.2 billion in today's dollars. By the analysis in Figure 2, the decision by Congress to not provide a bailout was an easy one. The states at risk were a minority of the population, rural, and as frontier states not connected to the export economies of the Eastern seaboard. Thus the economic (E) and empathy (S) costs of a no bailout decision were low. Since most of the debt had been issued by European banks, the financial costs (F) to the U.S. economy were also low. Finally, Congress appreciated the incentive consequences of a bailout. In the words of one commentator at the time: "To establish the policy of federal assumption of State debts would undoubtedly encourage recklessness and extravagance in the States." As the responses to Detroit's fiscal problems and to state pension underfundings make clear, the federal government has continued to today its commitment to a no bailout pledge.

The initial economic costs from a public default arise from two consequences of default within the economy of the defaulting government. First, resident bondholders see their wealth decline leading to less private consumption and private investment. Second, the defaulting government will be denied access to the international capital markets for new government debt. The inability to borrow means higher taxes and less government spending – that is, an austerity budget. Both effects result in lower aggregate demand and less short-term economic growth and lower public and private investment and thus less long-term economic growth. Importantly for the non-debtor countries, these negative effects can spillover to impact their economies to the extent they are a trading partner with the defaulting nation. These are the economic spillover costs (E) of a country default.[8] New evidence on the macro-economic interdependencies among Eurozone members suggests such spillovers can be significant. A 1 percent decline in GDP in the originally affected economy can lead to a 3/10's of 1 percent indirect decline in the economies of important trading partners; see Beetsma, et. al. (2005), Beetsma and Giuliodori (2011), and Hebous and Zimmerman (2013).[9]

As important as these economic spillovers may be, the financial costs (F) of default may be greater and more far reaching. The fall in the value of bank assets following a government default reduces the ability of affected banks to both borrow and lend. If the fall in value is large enough, it may even raise the specter of bank collapse leading to a run on bank demand deposits. Further, if one bank's observed decline is taken as a signal of other banks' possible exposure and decline, there may be a contagion effect constraining the ability of other banks to borrow and perhaps even encouraging runs on other

8 There is a direct economic cost of a default I am ignoring here. Non-residents holding defaulted debt would suffer a decline in wealth, meaning potentially less consumption, less future investment, and less growth for their economies. However, were we to adopt a bailout, then non-residents who pay the bailout will suffer a comparable loss of wealth, consumption, and country growth at the time of the bailout. These non-resident wealth effects occur on both sides of the cost comparison of "bailout" and "no bailout" policies and are therefore ignored for this analysis.

9 Carlino and Inman (2013a) find similar results for the U.S. federal system, where a 1 percent decline in job growth in the largest state within each of the eight "economic regions" implies a 6/10's of 1 percent decline in the aggregate job growth in the other, surrounding states of the region.

banks' demand deposits. The end result of the original public debt default can be significantly reduced liquidity in, and even trust of, the original creditor's banking sector. The costs to the real economy of such a financial market contraction will be lower investment, lower aggregate demand, and lower short-run and long-run economic growth. The impacts will be felt within the defaulting country and may spill over to other Eurozone countries holding significant positions of the defaulting country's debt. Together, the short and long-run declines in growth within neighboring economies define the financial spillover costs of one country's default.

Table 1 shows the exposure of the banking sector in the Eurozone countries not at risk for a public debt default to the book value in euros of their public, bank, and total debt holdings in the five "at-risk" economies: Greece, Ireland, Italy, Portugal and Spain; see Table 1, cols. (1)-(5). Table 1, col. (6) shows the country's total exposure by type of debt summed over the five at-risk countries. Table 1, col. (7) provides an estimate of how important these debts are to the overall risk-weighted value of all bank assets in each of the Eurozone creditor countries.

Though it is likely that the default of sovereign debt in any one of the at-risk countries could be separately managed by banks in the creditor countries, were one default taken as a signal of multiple defaults, the impact on creditor banks could be significant. In Belgium, for example, all at-risk sovereign debt as a share of the country's banks' risk-weighted assets is 3.1 percent, in France 2.7 percent, and in Germany 4.7 percent. Further, a sovereign debt default may also impact banks within the defaulting country, and other Eurozone banks have positions in the defaulting country's banks. This is an additional risk exposure for creditor countries. For example, the share of risk-weighted assets of Belgium banks held as loans to banks in all the at-risk countries is 6.5 percent, of French banks 2.8 percent, and of German banks 7.0 percent. Finally a network of default-induced recessions or reductions in bank lending in the at-risk countries threatens the repayment prospects and thus the market value of all loans, whether public, bank, or private. Table 1, col. (7) shows the total exposure of banks in creditor countries to defaults and recessions in the five at-risk countries. If one suspects one country's default can trigger a sequence of loan devaluations within and across all at-risk countries, then it is easy to see why the financial costs of that default will be significant for the other, creditor countries of the Eurozone. By this logic, German, French, and Belgian support for the ECB bailouts of Greece, Ireland, Portugal, and Spain is understandable.

Finally, and though more difficult to measure but important politically, are the empathy costs (S) following defaults without bailouts. Facing the Samaritan's dilemma, no one country may be able to ignore a neighbor in trouble. To exploit such sympathies, the government in arrears may cut services to its most vulnerable citizens. For example in its current fiscal crisis, Greece allowed international news services to distribute photographs of disabled citizens picketing the Finance Ministry after cuts in the social service budget. Similar strategies have earned fiscal bailouts for poor U.S. cities (Camden, New Jersey) and poor South African provinces (Eastern Cape).

Facing potentially significant economic, financial, and empathy costs of a no bailout decision, it is perhaps not surprising that the fiscally healthy members of the Eurozone have chosen the bailout alternative for Greece, Portugal, Ireland, and Spain. Italy's fiscal future remains to be decided but, when necessary, a bailout here seems likely too. A bailout policy, however, cannot be a long-run equilibrium for an economically successful monetary union. Bailouts inevitably lead to inefficient levels of public debt for all member countries, or alternatively, the withdrawal from the union of the fiscally responsible nations being asked to pay for the bad debts of their irresponsible neighbors.[10]

The long-run future of the European Union may therefore turn on its ability to control member country fiscal bailouts. There are only two approaches: regulate country borrowing with stronger balanced budget rules or get the deficit incentives right through a strengthened monetary and fiscal union.

10 Though a recent Pew Foundation study of attitudes of EU residents towards the fiscal decisions of EU leaders suggest we are not there yet. Support for the EU generally is down from its levels in the spring of 2007 but still at 60 percent in Germany, the main guarantor of bailout funding. See Pew Research Center (2013), Table Q9f.

III. The Regulatory Approach: Stronger Balanced Budget Rules

Balanced budget requirements (BBRs) are commonly imposed in most developed economies and at all levels of government.[11] At a minimum, they are a guideline to state budgets; at a maximum, they are meant as a binding constraint on government fiscal behaviors. Appropriately, most rules allow governments to run deficits to smooth tax payments for large, lumpy expenditures such as capital outlays or disaster relief. What is required to be in balance are current accounts revenues and expenditures for current services and transfers including capital maintenance. Borrowing within a fiscal year is allowed to manage the flow of expenditures and revenues, like households use a credit card. Rolling over short-term debts into the next fiscal year may or may not be allowed. Ideally, each year's non-debt revenues must equal current accounts spending at the end of each fiscal year.[12]

Writing a rule and its enforcement are separate matters, however. Table 2 summarizes the attributes of weak (i.e., unenforceable) and strong (i.e., enforceable) BBR's and then compares the European Union's original (Maastricht) and new ("Fiscal Compact") Stability and Growth Pact BBR's to the two standards.[13] First, enforceable rules require the date of review to be during and at the end of the fiscal year, that is *ex post*, and not just at the beginning (or *ex ante*) of the fiscal year only. If a deficit is discovered during a fiscal year, it must be resolved during that fiscal year, either by raising revenues or reducing expenditures. There can be *no carryover* of deficits from one fiscal year to the next. Second, enforceable rules *are difficult to amend*, and certainly not open to amendment during the fiscal year

11 Schaechter, et. al. (2012) provide a detailed database of fiscal rules for 81 countries for the years 1985-2012.

12 There remains a good deal of flexibility in how a balanced budget rule defines current revenues and spending. Ideally the BBR would prohibit dissavings except for well-specified emergencies. This would mean the sale of government assets could not be counted as revenues, except perhaps for a plausible estimate of interest earned on the proceeds of the sale. Pension spending could be paid in part from interest earned on prior accumulation of fund assets but the market value of pension assets should not be depleted. And maintenance expenditures to cover depreciation in physical assets must be counted as a current period expense. Generally Accepted Accounting Principles (GAAP) should apply. All accounting should be done on a per capita basis.

13 This summary table is based on the analysis in Inman (1997) and the empirical work in Bohn and Inman (1996).

when there is a deficit. Strong BBR's are grounded in a constitution or formal treaty requiring super-majority approval to be changed. BBRs needing only legislative approval can be overturned by the legislature voting for a deficit. Third, a binding rule must define a clear constraint and *not allow overrides* via multiple or vague exceptions. Fourth, the rule must be enforced. To ensure enforcement, those affected by a violation must have *open access* to the enforcement process, the adjudicator must be *independent* of majority-rule politics, and *large penalties* are required to impose sufficient harm to deter deficit financing. Only when all four requirements are met will a BBR successfully constrain invalid deficit financing.

The specification of the European Union's BBRs shows its deficit rule to be deficient on two of the four dimensions, most importantly, on the dimension of enforcement. The Maastricht Treaty's Stability and Growth Pact, implemented on January 1, 1999, required that all members of the European Union maintain an annual budget with deficits no greater than 3 percent of GDP and an aggregate ratio of government debt to GDP no greater than 60 percent.[14] Member country budgets were to be reviewed at the end of each fiscal year, but there was no ability to intervene during the fiscal year to force adjustments in spending or revenues if a country appeared likely to violate either the 3 percent or 60 percent rules. For this reason, the original Maastricht rule is viewed as an ex ante requirement enforcing only the promise of a balanced budget with deficit *carryovers* allowed from one budget to the next. In its favor, the Maastricht BBR was treaty-based and therefore cannot be easily changed; thus "amendment" was *difficult.* Nor did the original specification of the BBR allow for vaguely specified exceptions to the 3 percent deficit or the 60 percent debt rules. Thus as stated, the Maastricht rule did *not allow overrides*.

It was on the dimension of enforcement that the original Maastricht BBR was most lacking. Only the European Commission could bring a formal complaint; in effect, the enforcement process was *closed*.

14 Historically, public infrastructure investment by Union governments had averaged about 3 percent of GDP, so the 3 percent deficit rule was seen as valid approximation to a rule requiring a balanced current accounts budget; see Buiter, et. al. (1993). The enforcement of the 3 percent rule allows for exceptions when there are large public sector investments during a fiscal year; Maastricht Treaty, Article 104.c.3.

The adjudicator of any complaint was to be the Council of Finance Ministers with decisions made by weighted majority rule of Union members (excluding the violating country). Since possible future violators were to sit in judgment of current violators, such decisions were likely to be *partisan.* Finally, the penalty for a violation was *small*. A deposit of no more than 1/4 of one percent of GDP for each percentage point in excess of the 3 percent rule was required, and the funds would be returned when the country returned to compliance. As specified by Maastricht, enforcement of the Union's BBR must therefore be considered weak.

This proved to be the case just two years after the implementation of the Maastricht BBR. Both Germany and France violated the 3 percent deficit guideline. The European Commission brought a complaint, but in November 2003, the Council of Ministers decided not to follow the recommendation of the European Commission to impose the required penalties on Germany and France. An appeal by the Commission to the European Court of Justice led to the decision not to intervene in such matters, confirming the importance of the partisan Council as the enforcer of the Union's fiscal rules. The observed explosion of deficit financing in Greece, Italy, and Portugal confirms the analysis in Table 2, that the Maastricht specified BBR was indeed a weak regulator of Union member deficits.

In response to the poor performance of the Maastricht specification for an EU BBR, members adopted the *Treaty on Stability, Coordination and Governance in the European and Monetary Union* now commonly known as the "Fiscal Compact." The new treaty was signed by all members of the European Union on March 2, 2012, except for the Czech Republic and the United Kingdom. The treaty entered into force on January 1, 2013 for the sixteen countries which have ratified the treaty. Importantly, this includes Greece, Ireland, Italy, Portugal, and Spain. The new treaty seeks to strengthen the Union's BBR on each of the four dimensions in Table 2. It is unlikely to succeed.

First, and to its credit, the new treaty and associated guidelines for enforcement do improve the details of budget review by specifying a precise five year budget planning and oversight process called the

Medium Term Budgetary Objective (MTO).[15] For countries in violation of the 3 percent deficit and/or the 60 percent debt guidelines, the European Commission may hold the violating country responsible for a five year budgetary plan designed to hold deficit spending to no greater than ½ of one percent of GDP and to bring the aggregate debt to GDP ratio to 60 percent or lower over time. Unfortunately, monitoring the planned budget depends upon data provided by member countries. There is evidence that Eurozone countries often use favorable revenue forecasts and creative accounting to bring their budgets into line with proposed guidelines.[16] Further, even with accurate fiscal accounts, any deficits incurred in a fiscal year may still be carried over into the next year's budget. The fact remains that the new BBR will remain an *ex ante/carryover* review.

Also to its credit, the Fiscal Compact's BBR remains a treaty based rule and will therefore remain *difficult* to amend. Regarding overrides, however, the unambiguous 3 percent, 60 percent requirements of the original, Maastricht BBR are now relaxed to allow a variety of exceptions. The required ½ of one percent deficit target can be dropped if there is (i) a period of significant economic hardship for the Eurozone as a whole; or (ii) an unusual event outside the control of the member state affecting the state's deficit; or (iii) any other factors that in the opinion of the member state and the supervising European Commission and Council of Finance Ministers requires the deficit target to be relaxed. In the Guidelines for enforcing the new BBR, these "other factors" may include a within-country financial crisis or contributions "fostering international solidarity and (working towards) achieving Union policy goals" (European Commission (2013, p. 10). The intent for allowing rule overrides is to give the rule more flexibility in times of deep recessions or within country crises or to pursue other EU wide objectives. While laudable, the fact remains that *allowing overrides* weakens deficit enforcement.

Finally, while the new BBR sought to strengthen enforcement, the treaty's changes are likely to have little effect. The Fiscal Compact's

15 See European Commission (2012b).

16 See Frankel and Schreger (2012). Historically, the favorable forecast errors have been largest for Greece, Portugal, and Ireland, while those for Spain and Italy are better but still significantly above average errors.

Article 8 now allows not just the Commission to bring a deficit or debt complaint against an EU member country but for any other country signer to the treaty to bring a complaint. As before, that complaint would then be reviewed by the Commission. If the Commission did not act on the complaint, the complainant could then go directly to the Court of Justice of the European Union. The Court of Justice, however, has been reluctant to review matters of fiscal policy. True open access to enforcement allows, as in the United States, private parties potentially harmed by excessive state deficits to bring a complaint directly to the Court. That is not permitted here. Enforcement must still be considered *closed*. In addition, the initial adjudicator of any complaint remains the partisan Council of Ministers, but now with the possibility of appealing to the Court of Justice if Council does not enforce the rule.[17] It is hard to see the members of the Court as politically independent appointees, however. Each is appointed to represent one of the twenty-seven EU members. In 2011, one of the principal candidates to be Prime Minister of Greece was the then President of the Court. Enforcement remains *partisan*. Third, penalties for continued deficit violations remain *small*, either non-interest bearing "loans" returned when the violation is corrected or a fine not to exceed 1/10 of 1 percent of GDP (which might be paid by the deficit in excess of ½ of 1 percent of GDP!).[18]

17 The Fiscal Compact introduces the novel idea of changing the status quo point for Council voting in hopes of controlling the tendency for a qualified majority of Council members to defer to deficits in hopes of comparable treatment if they were ever to violate the 3 percent rule. Under Maastricht, the status quo was the deficit violation and the Council needed to vote to discipline the violating country. Under the Fiscal Compact, the status quo point becomes the discipline outcome with the Council needing to vote to allow deficit behavior. As a strict matter of voting theory, however, this will make no difference. There are only two outcomes along a single dimension – allow a deficit or not – and the qualified majority will choose its preferred option independent of the status quo.

18 It is hoped by some European fiscal scholars that the Fiscal Compact's requirement for a five year budget plan will provide an independent metric against which a country's fiscal performance can be evaluated and monitored. Enforcement of the five year budget guidelines would turn on the quality and independence of the analysis and on moral suasion of the general electorate within member countries; see, for example, Hallerberg, Strauch, and von Hagen (2009), Chapter 7. From the U.S. experience, only those oversight authorities that impose significant fiscal penalties when there is a violation of the budget target seem to succeed, however. For example, the Pennsylvania Intergovernmental Cooperation Authority (PICA), charged with ensuring balanced budgets over five year horizons for the city of Philadelphia, has the power to withhold all or a portion of state aid to the city, where such assistance accounts for 40 percent of city revenues.

It seems safe to conclude that the Fiscal Compact's BBR is no stronger than the original Maastricht BBR, and is arguably slightly weaker because of efforts to make the rule more flexible in the face of special circumstances. Maastricht's BBR's failure to control excessive country borrowing does not bode well for the Fiscal Compact's ability to constrain such excesses. The EU needs to consider a second strategy therefore, one directed at getting the borrowing incentives right.

IV. The Incentive Approach: A Stronger Union

The central weakness of the current fiscal union is its inability to control excessive country borrowing for current public spending in anticipation of a full or partial bailout. The incentive to overborrow comes from the willingness of other Eurozone countries to offer bailouts rather than bear the economic, financial, or empathy costs of the deficit country's default; see Figure 2. Controlling these spillover costs is the key to controlling inefficient country borrowing. To do so will require a stronger banking union to control financial spillovers and a stronger fiscal union to control economic and empathy spillovers following a country's default.

Control of financial spillovers will require a banking union with the ability to regulate major banks' holdings of any one country's debt to a small fraction of a diversified portfolio of bank assets.[19] The asset constraint for government debt can be specified by individual country, or for a group of countries if there is thought to be a risk of contagion among country risks. The objective of the regulation is to ensure that a country's default of its debt will not threaten the long-run economic viability of another country's banks or the banks' short-run ability to offer credit to the private sector.

19 At the time (1975) of New York City's fiscal crisis, the book value of New York's short and long-term debt outstanding was \$13.5 billion; the value of all bank assets was \$705 billion. In contrast to the sovereign debt exposures in Table 1, New York City debt equaled only 1.9 percent of all U.S. bank assets. Further, there was a clear appreciation at the time for the uniqueness of the New York City fiscal crisis by the financial markets. There was no concern that a New York City default signaled a wider risk of default by other public credits; see Gramlich (1976). Thus the financial spillover costs of a New York City default were seen as small and manageable. By the logic outlined in Figure 2, it was no surprise that President Gerald Ford denied the bailout request from city officials.

The same institutional requirements needed for an effective BBR must apply as well for an effective bank asset requirement. A regulation limiting bank holdings of a country debt's must be monitored on a regular, say quarterly, basis, must be clear and without override provisions, not easily amended by EU legislation, and enforced by an independent agent with open access to the bank's balance sheet and with ability to impose significant penalties for violations.

The proposal by the EU Finance Ministers agreed to on December 14, 2012 is sensitive to these requirements; see Goyal, et. al. (2013). First, the proposal places the major banks (assets greater than €30 billion or 20 percent of the country's GDP) of each Eurozone member state under the direct regulation of the politically independent European Central Bank managing a Single Supervisory Mechanism (SSM). Regulation of a country's smaller banks will remain the responsibility of current national banking authorities, but the ECB may take over the supervision of any Eurozone bank at any time; see Huertas (2013). Second, clear and transparent portfolio requirements are to be developed by the (again, independent) European Banking Authority, perhaps along the lines of the Basel III recommendations. Third, proposed penalties for violating bank regulations will include the possibility of temporary or permanent supervision of bank activities by the ECB. Temporary supervision may be coupled with temporary financial assistance to ease liquidity constraints on bank activities. In the case of permanent supervision, the bank would fall under the governance of a Single Resolution Mechanism (SRM). In either case, and as required for the effective enforcement of any regulation, the affected bank's management will suffer significant penalties either in lost discretion or termination. Finally, the EU proposal also includes a recommendation for deposit insurance for small creditors. Though not essential for effective regulation of bank borrowing, separately financed bank deposit insurance has a potentially important role to play in controlling country or bank bailouts. Specifically, it reduces one important source of the empathy costs of sovereign defaults. By controlling the adverse financial and empathy spillover costs from sovereign debt, a successful banking union becomes a first, and necessary, step towards an efficient economic union.

To effectively control the economic and empathy costs of a country's default, a fiscal union will be required to ease the adverse economic consequences of default for the citizens of the defaulting country. To the extent a fiscal default precipitates a country recession, a transfer from the fiscally stable, economically growing countries should be paid to the newly unemployed residents of the defaulting country.[20] Transfers should be paid directly to affected households, not to the government in default (*that* would be a bailout). Eligible households will be those with a family member unemployed because of the default induced recession. Importantly, the transfer should be for temporary unemployment lasting perhaps no longer than one year and paid to workers residing and working within the depressed economy. Benefits should be indexed to country-specific rates of inflation. To avoid discouraging structural reforms of country labor markets, it is essential that the policy be triggered by a temporary downturn in the country's economy and that it have a clear limit for eligibility. Recent research shows such household specific transfers can have a strong stimulus effect on the aggregate economy and facilitate an economic recovery.[21]

The proposed EU social insurance program would be approved and administered by existing EU institutions, though each country would be free to supplement the EU transfers at their own expense without penalty. The EU-wide insurance policy would set a floor for temporary household assistance. The initial design of the policy might come from the European Commission in consultation with the Council of Ministers and the European Parliament and then subject to final approval by a qualified majority of the Council. The policy would be limited to contributions and transfers clearly stated in the enabling legislation. The policy would be supervised as a trust fund by the politically independent European Commission. A new administrative division of the EU would be needed to collect revenues and disburse checks to qualified households. To avoid problems of moral hazard, contributions to the EU fund would (i) be collected directly from firms and employees within each country, (ii)

20 The logic for such transfer policies to control adverse economic spillovers is developed formally in Farhi and Werning (2012).

21 For European economies, see Gali and Perotti (2003), and for the U.S. economy, see Romer and Romer (2009) and Carlino and Inman (2013b).

be experience rated by industry and country, and (iii) be held in a clearly earmarked "country account." Any additional payments to support a country's supplemental insurance fund could be collected by the country and locally administered, or perhaps for administrative efficiency, by the EU itself.

Such a constrained income insurance policy is all EMU members need to contain the temptation for fiscal bailouts for country debt. There is no need to expand EU fiscal powers to include general taxation and spending. A fully empowered fiscal union managed by the Council of Ministers, and inevitably the European Parliament, is likely to create more problems than solutions. Central government legislatures requiring agreement among coalitions of local interests, as is likely for the European Parliament, have shown a propensity to tap the collective tax base for spending on projects with only local benefits; see Inman (2003). The result is an incentive to use the common tax base to overspend on country-specific public goods. To ensure efficient debt policies by EMU member countries then, one need go no further than a treaty specified and Commission administered policy of temporary income insurance.

V. Conclusion

At its core, the European Economic Union is not about economics but rather, as the 2012 Nobel Peace Prize recognized, ensuring the long-run peace for central Europe. The Union's prime movers, German Chancellor Helmut Kohl and French President Francois Mitterrand, realized shared economic fortunes created the strongest incentives for peaceful co-existence. To this end, the Monetary Union was an important first step. The current economic crisis has made it clear it cannot be the last. The fiscal incentives within a Monetary Union led to excessive borrowing and fiscal bailouts. As now designed and enforced, EU fiscal rules – an appeal for sinners to heal themselves – will not work. Rather than a regulatory strategy, the preferred alternative is to get the incentives right.

For that, additional EU institutions will be needed to control the propensity to offer fiscal bailouts when a member country borrows excessively for current consumption. That means controlling the financial, economic, and empathy costs that a country's default can impose upon its neighbors. To control financial spillovers, a banking union managed by the European Central Bank and capable of credibly regulating large banks' holdings of sovereign debt is required. To control economic and empathy spillovers, an expanded, but limited by treaty, fiscal union to provide income insurance to residents of member countries facing a temporary economic downturn will be needed.

While expanding EU economic powers, both the proposed banking and fiscal unions are prudent extensions of the EU institutional architecture. They will be treaty-based with clear responsibilities administered by existing EU institutions. Both find their intellectual foundation within the guiding principle of subsidiarity. Since country, and thus citizen, approval is required for the new institutions to have force, there is no adding to the "democratic deficit." As specified here, neither union creates new, open-ended powers centralized in the hands of EU political institutions. Together with the current monetary union, they offer the best hope for a stable economic union and its original promise of a peaceful, economically integrated Europe.

Figure 1


(a) Euro Zone Interest Rates
Interest Rate (%)
25
20
15
10
5
1990
1995
2000
2005
2008
2010
Year
(b) Euro Zone Deficits as % of GDP
Deficit as % of GDP
30
20
10
0
-10
1990
1995
2000
2005
2008
2010
Year
Greece
Spain
Portugal
Ireland
Italy
Euro Zone Avg.

Figure 2: Union Bailouts and Inefficient Public Debt

The decision by a higher tier of government (here the EMU) to offer a bailout for debt incurred by a lower tier of government (here, an EMU member) is the result of a sequential policy game played between the upper and lower tiers of government. The first move in the policy game belongs to the member country. They can either deficit finance current service expenditures (policy, D) or tax finance those services (policy, T). If the member country sees a chance to successfully repudiate their debt, thereby shifting the costs for current services onto non-resident bondholders if they default or onto non-resident taxpayers if there is a bailout, then deficit financed current services will be subsidized by non-residents. In this case, inefficiently excessive public services will be purchased by the member country. If the member country tax finances its current services, then there will be no subsidy from non-residents and current services will be efficiently provided. Whether the member country adopts inefficient D or efficient T will depend on how the upper tier government, the monetary union, responds to the threat of a default by a member country. This response is the second move in the policy game.

When facing a default on D, the monetary union can either provide a bailout of B (= D) or choose to not provide a bailout. Choosing to not make a bailout may not be costless, however. There are three possible costs on other union members if the union does not bail out the debts of its defaulting member.

1. *Economic Spillover Costs (E)*: If the deficit country were to default and there was no bailout, two negative shocks would impact the deficit country's own economy. First, the resulting depreciation in value of country debt held by country banks could trigger a financial crisis within the deficit country. Second, the deficit country would be denied access to the international bond market until those original debts were repaid. The first shock limits private investment; the second discourages public investment. The result may be a significant decline in the deficit country's near-term and long-run economic growth, both of which may adversely affect the economies of the deficit country's trading neighbors. These adverse spillovers define the economic costs (E) of the union's no bailout decision.

2. *Financial Spillover Costs (F)*: The defaulting member's debts may be in the portfolios of financial institutions of other union members. Default will weaken the financial position of these institutions, leading to fewer loans and investments (in the best case) or financial collapse (in the worst case). These lost economic activities and lost wealth borne by residents of the other member countries will define the financial costs (F) of the union's no bailout decision.

3. *Empathy Spillover Costs (S)*: Default with no bailout denies the deficit country access to debt for valid public investments and deficit financing for current period services and transfers. Both lead to lower economic growth and lower incomes for residents of the deficit country. The burden of low growth and/or recession is likely to fall disproportionally on the less well educated, on minorities, and on the very young and elderly. Residents of other union countries may wish to reduce these burdens as they engender empathy: *But for the grace of God, go I.* Failure to offer a bailout means citizens in other countries bear an empathy, or good Samaritan, cost (S).

The bailout decision by the monetary union reduces to a comparison of the costs of the bailout choice (B = D) to the spillover costs of the no bailout choice (= E + F + S). If B > [F + E + S], then bailouts are more expensive than no bailouts, and the union will not offer a bailout. Conversely, if B < [F + E + S], then the no bailout alternative is more expensive to union members, and the bailout will be forthcoming. We conclude:

> *If B < [F + E + S] and a bailout is forthcoming, then the at-risk member countries have an incentive to borrow for the invalid reason of funding current consumption. However, if B > [F + E + S] and no bailout is offered, then at-risk member countries have an incentive to only borrow for valid, tax smoothing reasons.*

Table 1: Eurozone Bank Exposure* December 2011 Millions of Euros

Reporting Country	Type of Exposure	At-Risk Countries: Greece (1)	Ireland (2)	Italy (3)	Portugal (4)	Spain (5)	Total Exposure (6)	Total Exposure as Percent of Bank Risk-Weighted Assets (7)
Austria	Public Debt	18.9	38.0	613.9	4.3	144.2	819.4	0.4 %
	Bank Debt	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	Total Debt	3,391.8	1,763.9	1,491.1	14,092.5	788.1	21527.4	10.0 %
Belgium	Public Debt	175.2	357.3	1,333.6	65.8	1,328.2	3260.2	3.1 %
	Bank Debt	10.6	620.2	2,750.4	510.0	2,965.5	6856.6	6.5 %
	Total Debt	9,973.3	548.7	16,614.1	9,414.7	2,101.4	38652.3	36.4 %
Finland	Public Debt	0.3	0.0	0.1	0.0	48.5	49.0	0.1 %
	Bank Debt	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	Total Debt	913.5	19.8	391.4	400.5	186.2	1911.4	5.6 %
France	Public Debt	6,879.3	1,313.7	32,455.7	2,983.3	6,194.4	49826.3	2.7 %
	Bank Debt	169.5	6,057.9	23,846.2	3,390.3	19,735.4	53199.2	2.8 %
	Total Debt	87,176.8	33,707.8	20,870.8	252,578.5	16,537.4	410871.3	21.9 %
Germany	Public Debt	5,586.6	802.0	30,236.4	3,638.0	18,089.3	58352.3	4.7 %
	Bank Debt	576.8	13,590.9	24,144.9	8,009.5	40,377.5	86699.5	7.0 %
	Total Debt	111,031.4	10,149.7	72,449.0	101,803.6	22,957.7	318391.3	25.9 %
Netherlands	Public Debt	810.9	225.7	3,019.1	562.5	941.6	5559.8	0.8 %
	Bank Debt	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	Total Debt	51,500.7	2,648.6	9,932.3	26,153.5	3,689.7	93924.8	13.6 %
Other	Public Debt	5,347.7	382.5	1,255.9	139.5	178.3	7,303.8	8.6 %

*Columns (1) to (5) list the holdings of select Eurozone banks ("Other" includes Cyprus, Luxembourg, Malta, and Slovenia) in Greek, Irish, Italian, Portuguese, and Spanish debt. Debt is measured at face value. "Public debt" includes sovereign debt exposure, while "bank debt" refers to bank-to-bank lending where the counterparties' banks are incorporated in the at-risk countries. "Total" includes all public and private claims in the at-risk countries. Source: Bank debt and total exposure are from the Bank for International Settlements, Consolidated Banking Statistics, Table 9E. Public debt holdings are from the European Banking Authority, 2011 EU Capital Exercise. Column (6) lists total holdings as the sum of cols. (1)-(5). Column (7) estimates the percent of risk weighted bank assets that are held as at-risk debt, where total risk-weighted bank assets are from the European Banking Authority. N/A indicates data were not available.

Table 2: Specification of Balanced Budget Rules

SPECIFICATION	WEAK BBR	STRONG BBR	MAASTRICHT BBR	"FISCAL COMPACT" BBR
Date of Review	Ex Ante/Carryover	Ex Post/No Carryover	Ex Ante/Carryover	Ex Ante/Carryover
Ease of Amendment	Easy	Difficult	Difficult	Difficult
Overrides	Allowed	Not Allowed	Not Allowed	Allowed
Enforcement				
Access	Closed	Open	Closed	Closed
Adjudicator	Partisan	Independent	Partisan	Partisan
Penalty	Small	Large	Small	Small

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8
No to a Transfer Union, yes to an Economic Justice Union

Mattias Kumm

One thing that economists agree on is that in order to move out of the crisis rather than have it continue indefinitely, losses have to be allocated sooner rather than later. Only once this politically painful step has been taken, can Europe move on. But who should pay for the mess? If the crisis were the result of profligate spending of some states, then it seems logical that these states should bear the burden of their actions before they can count on European support, and that this support should come with strict conditions. This, in effect, is what the ESM and Fiscal Compact are meant to ensure. But if, as is considerably more plausible, the sovereign debt crisis is, to a large extent, the result of a banking crisis, the answer may turn out to be very different. There is something arbitrary about burdening the states in whose jurisdictions the banks requiring bail-outs happen to be domiciled. The banking crisis would not have had the same intensity and structure if it were not for the European common currency and European freedom of capital guarantees. The EU has exercised its concurrent competencies over the area of banking and financial markets and is in the process of deepening its involvement in the sector by the establishment of a Banking Union. Furthermore the bank-bailouts themselves have considerable cross-border positive externalities. Given the interdependence of the banking sector, the failure of major banks in one state would have had difficult-to-control contagion effects across Europe. Under such circumstances, it seems more plausible to allocate financial public sector risks resulting from financial sector failings at the European level. The costs of bank-bailouts are, to a significant extent, the result of genuinely European risks, for which it would be appropriate to hold the European Union, as a whole, accountable.

But if the European Union as a whole, rather than individual states like Spain, Ireland or Slovenia, is to be held accountable for the costs of the bank-bailouts, inter-state transfer mechanisms, such as those foreseen by the ESM, should not be used. These costs should be paid for by genuinely European funds, raised by European taxes or levies. The way money is raised and spent comes with its own political presumptions and burdens of justification. It should not be seen as just a neutral technical device. There is something deeply incongruous and misleading in first having individual states bail out banks, and then transferring money from one state to another, so that stronger states end up supporting weaker states. This mechanism misguidedly creates the impression that stronger states have to bail out weaker ones because the weaker ones cannot handle their responsibilities, even when the original responsibility belongs to the European Union. Inter-state transfer mechanisms corrode solidarity in Europe, because they give the misleading impression that one state has to ultimately pay for the failures of another.

Note how interstate transfers harm solidarity even in established federal systems, while in other contexts policies can rely on national solidarity. Take the example of Germany's Länderfinanzausgleich, which can be roughly described as follows[1]: Rules of fiscal federalism in Germany allocate most federal taxes to the federal government, which spends its money in accordance with federal policies. Here the question of how much money has flown from one state to another is generally not a high profile political issue: federal taxes for federal policies help create and sustain a federal political community and its policies. A portion of the taxes, however, is allocated to states according to the amount that was generated locally (örtliches Aufkommen). A small portion of these taxes allocated to states is

1 For details see Art. 107 German Basic Law.

again redistributed between states according to certain legislatively established need-based criteria. As of last year, the Bavarians had to pay 3 billion Euros of the money originally allocated to them in the distributive pot, while the happy-go-lucky "poor but sexy" city-state of Berlin received 3 billion. The nifty Baden-Württembergers support the socially generous and undisciplined Bremeners, etc. There is a lot of political theatre and a great deal of animosity on parade in the annual process of re-allocation. This inter-state reallocation creates significant resentment and effectively undermines solidarity. The reason for this is, at least in part, that Bavarians assume that the money originally allocated to them is what is rightly theirs, and they don't want to to help other states who cannot seem to get their act together.

Whether or not the Bavarians and Baden-Württembergers have a point is not the issue here. The point here is that the way money is distributed is linked with assumptions about whose money is distributed. Once money originally allocated to A flows from A to B, A assumes the money transferred is its money and what needs to be justified is B's need for it. If money is distributed to all those living in A and B following criteria that were jointly decided and then followed by C, and money is raised using general criteria related to policy benefits then the question of how much money flows from A to B becomes moot or at least secondary. Then the question changes: is this a policy that C (rather than A and B) should decide upon, does C have competencies in this area and should those competencies be exercised? If so, is it a good policy, worth the money that is spent on it? And is the money raised according to appropriate criteria? The way flows of money are channelled determines the nature of the debate.

Moreover, it is not a good argument to insist that a sufficiently strong identity – an identity that Europeans may be argued to lack - is a prerequisite to allowing the EU to raise its own resources. Identity may well be relevant for the allocation of competencies and the definition of policies. But once it is decided and accepted that competencies should be allocated and policies defined on a European level with regard to a particular set of issues, then it is unlikely that funding these policies in line with criteria that are meaningfully connected to the economic benefits bestowed would be considered unacceptable. Genuinely European resources, best raised from taxes or levies that burden actors and transactions that are profiting financially from the internal market (e.g. shareholders, corporations, transactions with strong cross-border dimensions like certain financial transactions), appropriately connect regulatory responsibility with financial accountability. Furthermore, taxing actors and transactions that have profited from regulatory competition would be in line with the European Union's promise to fairly distribute burdens in the globalization context. The European Union should not become a Transfer Union (this is not about transfers from one state to another), it should become an Economic Justice Union, in which the European Union accepts financial liability for the consequences of its regulatory responsibilities and is able to raise its own resources to do so.

9
Fiscal Union in the Eurozone?

Hélène Rey[1]

1. Optimum currency areas

Since the creation of the euro was contemplated in the Werner report of 1970, its desirability was assessed from an economic point of view through the lenses of the optimum currency area theory (OCA) - developed by Mundell in 1961 and later refined and extended by McKinnon (1963) and Kenen (1969). The 1961 Mundell paper laid out the tradeoffs between the benefits, chiefly the reduction in transaction costs following the adoption of a common medium of exchange, and the costs of losing the exchange rate as an adjustment mechanism. The loss of monetary independence was rightly diagnosed as being particularly problematic in the presence of large asymmetric real shocks, whether on the demand or on the supply side. When asymmetric shocks hit, in the absence of a nominal exchange rate, adjustment is eased if there is high labour mobility (Mundell) or fiscal transfers (Kenen).

Subsequently, Frankel and Rose (1998) pointed out that part of the divergence between countries' business cycles was endogenous and due to the prevailing exchange rate regime. Monetary union by boosting intra-industry trade in response to lower transaction costs would deepen financial and trade integration and therefore reduce

1 I am grateful to Richard Portes for comments.

regional cyclical asymmetry and increase income convergence. Thus asymmetries were bound to decline with the birth of the euro so that countries which would join EMU would satisfy OCA properties ex-post even if they did not ex-ante: the "endogeneity of OCA" paradigm was born. On the other side of the debate, Krugman (1993) had discussed the possibility that increased regional specialization (due to increasing returns to scale and integration) could lead to more divergence across country cycles.

As far as the gains of a common currency were concerned, Rose (2000) estimated huge potential increases in international trade coming from the adoption of a single currency. But his analysis relied on the rather special sample of countries that historically had adopted a currency union – i.e., mainly small territories. The potential for the euro to rival the dollar as an important international currency was also seen as a positive factor, as it would go in parallel with an enhancement of the liquidity in financial markets for all euro assets and a decrease in the cost of capital in the area (Portes and Rey 1998). Financial integration would be a partial substitute for fiscal integration. On the other hand, there were concerns that the institutional design of monetary union left it vulnerable to financial instability (Begg et al. 1998).

On balance, the assessment was that the euro project was viable, though more political and fiscal integration would be desirable. But they were thought likely to come down the road. The European project had always progressed by leaps of faith, subsequently consolidated by economic necessities and political pragmatism. The discussion at the time was sensible.

2. Banking crises as asymmetric shocks

a) Unbridled financial sector growth

What was not envisaged was the threat to the common currency that would arise from the unchecked growth of bank balance sheets within the euro area in the context of a global financial crisis. The idea that a financial meltdown and large banking failures could lead to the bankruptcy of sovereigns and loss of market access had not been contemplated. Yet, this was potentially the biggest of all possible asymmetric shocks that could hit the euro area.

Financial integration did proceed rapidly, in some dimensions. Fed by massive cross-border financial flows in the euro area, the banking sector assets in many euro area countries swelled to being a multiple of countries' GDPs, as banks took on unprecedented leverage. In 2012 Q2, Ireland's bank assets were still 8 times the Irish GDP, for example, and the Spanish bank assets about 3 and a half times Spanish GDP. Credit growth to the private sector was particularly rapid during the 2003–07 period. The fall of interest rates in most countries of the euro area, as currency risk disappeared in 1999 (in 2001 for Greece), led to increases in borrowing for consumption and purchases of real estate. The decrease in risk aversion in global markets from 2003 onwards, as well as the securitization boom, sustained credit growth in the period immediately before the crisis. In Ireland and Spain, cross-border credit flows interacting with domestic distortions helped fuel real estate investment booms. Neither monetary policy nor fiscal policy were used to offset private credit growth, nor "macroprudential" measures. In Ireland, property prices increased by about 30 percent between March 2005 and March 2007. As Figure 1 shows, net claims of German and French banks on Greece, Ireland, Portugal, and Spain amounted to large fractions of GDP in the borrowing countries. For example, in 2008, net claims of German banks were about 50 percent of Spanish GDP, while those of French banks amounted to about 40 percent, helping fuel real estate bubbles (see Rey 2012).

As the returns to real estate–related activities increased while the bubbles were inflating, more resources shifted into the nontraded sectors at the expense of the manufacturing sector. Thus resources were drawn away from industries that may have more scope for productivity growth and human capital development, endangering the future potential of the economy. Unit labour costs in the periphery increased relative to those of Germany, eroding competitiveness and widening intra-European imbalances. As shown in Figure 2, in 2007 Q4, Spain had a current account deficit of about €28 billion (about

11 percent of GDP), while Germany had a current account surplus of about €54 billion (about 9 percent of its GDP).

Figure 1a,b: Net Consolidated Claims of German and French Banks on Countries in the Euro-Area Periphery, March 1999–September 2011. (Percent of peripheral-country GDP)

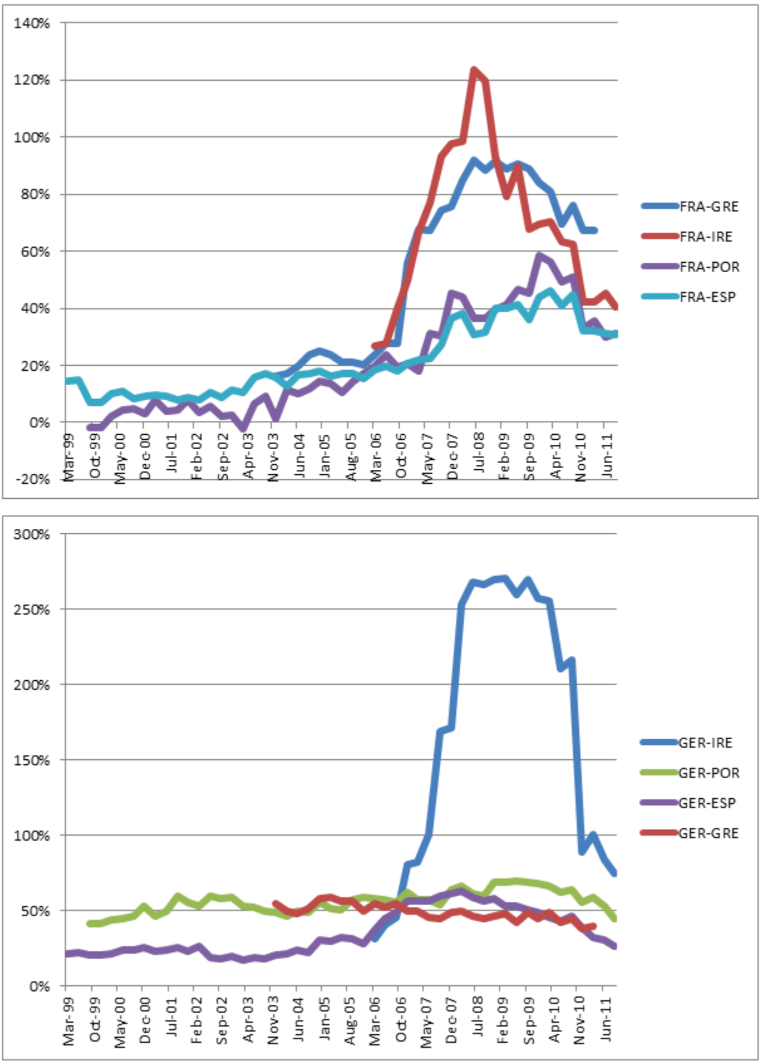
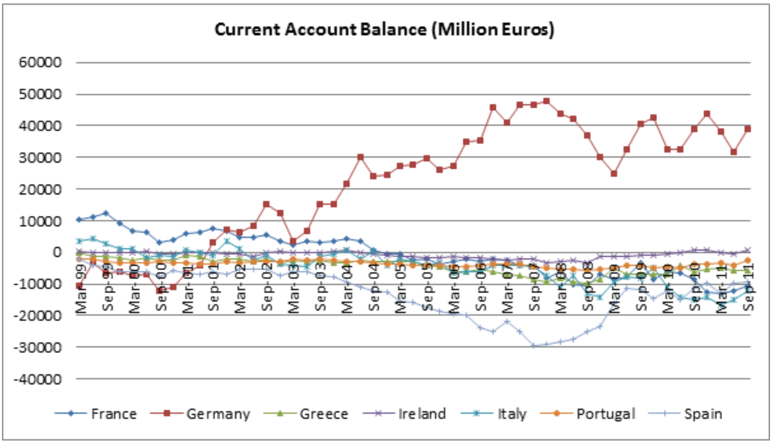


Figure 2



b) The policy responses: more asymmetry!

The Lehman failure in the fall of 2008 led to a major reassessment of risks, asset prices, and growth forecasts worldwide. For the periphery countries, the shock was brutal. The bursting of the real estate bubbles led to major failures in their banking sectors and to a massive downturn in real economic activity. Given the large size of the banks' balance sheets, the insolvency of the banks threatened the solvency of the sovereigns themselves. The shock, which had already hit the euro area countries asymmetrically depending on their exposures to toxic assets, the size of their banks and the severity of their real estate bubbles, was made even more asymmetric by the policy responses. In the Irish crisis case, for example, Irish taxpayers ended up bailing out foreign banks for the most part. This was not only detrimental from a moral hazard point of view, as reckless investors did not have to bear the consequences of their excess lending, but this also meant that most of the adjustment to the shock was shouldered by the debtor countries. There was effectively very little burden sharing. Similarly, as restrictive fiscal policies were adopted everywhere at the same time, including in the countries with market access, this meant that debtor countries were forced into a deflationary adjustment process with high unemployment. Hence the euro area was faced by a very large financial shock which hit countries' financial systems asymmetrically and whose asymmetric effect was reinforced by the policy responses adopted. Such large asymmetric shocks are precisely of the sort that a currency union cannot cope with in the absence of more fiscal integration.

3. Banking Union as a substitute for a Fiscal Union

When in 1989, the Report on economic and monetary union in the European Community was presented to the European Council, it was judged that a fiscal union was politically beyond reach despite multiple mentions of the necessity of more fiscal integration in previous reports, including the Werner report of 1970 (Vallée 2013). Thus, the Delors consensus was built around the establishment of a minimalist monetary union with no fiscal backbone. There are no reasons to believe that the political willingness to establish a fiscal union is any greater now than it was then. In fact, due to aversion to loss sharing after a crisis, it is likely to be even weaker. The current crisis has, however, established beyond doubt that existing euro area institutions were not strong enough to weather banking meltdowns. A legitimate question to ask is therefore what would be the minimal institutional reforms that would help ensure the survival of the common currency?

A fully fledged banking union might provide such a necessary step. Such a banking union would rest on three pillars: a common resolution fund (to close or restructure any euro area bank), a single supervisory mechanism, and a common deposit guarantee. This would fall short of a full fiscal union but would require some pooling of resources. It would take off the table the most destabilizing asymmetric shocks for the euro (the banking shocks). To work, however, a banking union does need some common fiscal backing ready to be used in the case, for example, where ultimately the emergency recapitalisation of large banks by the official sector is needed. It is indeed clear that the current constraint of raising recapitalisation funds from individual national budgets, some of them already overstretched, seriously hinders the process of restructuring of the euro area economies and economic growth. As the GDP costs of banking crises are high (Laeven and Valencia 2012) and the European banking sector oversized, the magnitude of a reasonable fiscal backing for the banking union is likely to be larger than the current European Stability Mechanism (5% of euro area GDP). A banking union without a common resolution fund would be useless, as the power of a supervisor is mostly linked to its ability to put banks, even large ones, in resolution. The ability of supervisors to perform credible stress tests is also intimately linked to the availability of a fiscal backstop.

A well designed banking union would therefore be a partial substitute for fiscal integration. It would deal with the most serious asymmetric shocks (banking crises) which can engulf the currency area as a whole in a deadly crisis. It is the minimum additional set of institutions to keep the euro area together. At the same time, it would not deal with more standard asymmetric real shocks to the cycle (demand, supply) and would therefore fall far short of a full fiscal union. It remains an open question whether even this minimalist reform, however, is politically feasible.

4. Gradualist approach to fiscal integration

While a meaningful banking union is essential for the survival of the euro, this does not mean that deeper fiscal ties in the euro area would not be desirable. They could substantially improve the workings of the currency union by facilitating risk sharing. The key issue is to design them in a way that a) keeps moral hazard under control and, b) if possible, uses the process of fiscal integration to improve existing institutions at the euro area level.

a) On the issue of moral hazard, there is a choice to be made between having ever more external monitoring by the European Commission and/or by other member states, or going down the American route and increasing gradually the euro area budget, while having credible no-bail-out rules for national budgets. The external monitoring can be made ex ante with veto powers on national budgets, for example, strict budgetary rules endorsed at the euro area level, or ex post via sanctions. The ex post approach has clearly demonstrated its limits with the serial violation of budgetary rules by Germany and France in particular, and no corresponding sanctions. It is important to note that the very fact of centralizing more budget capacity and providing more smoothing devices at the euro area level increases the credibility of no-bail-out rules at the national level. As usual, if really catastrophic events are insured at the federal levels, it becomes doable, and therefore credible, to let nations default under the strain of smaller shocks or mismanagement.

b) On the issue of euro area institutions, it would be a missed opportunity not to link any enlargement of the euro area fiscal capacity to reforms in member states. One possibility would be to give flesh to the idea of "contracts for reforms," whereby loans would be made conditional on the realization of certain reforms by member states. Another concrete and more ambitious example of how this could be done is provided by the April 2013 Report of the French Conseil d'Analyse Economique. It proposes linking a new European unemployment insurance topping the national one to voluntary adoption of a European employment contract. Workers would be given the choice between the national contract or the European one. The unemployment insurance would take into account structural unemployment levels and differences in compensation (reflected in different levels of contributions), so that countries with low unemployment would not be penalised. The new European employment contract would be designed to have better properties than the prevailing employment contracts in several euro area countries (in which dual labour markets effectively deny jobs to young and long-term unemployed workers). Linking fiscal deepening at the euro area level to desirable euro wide structural reforms would also stand a chance to reconcile euro area citizens with the purpose of European integration. After all, since its origins, the goal of European integration has been to maintain peace and to increase prosperity for all.

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10
The Evolution of Euro Area Sovereign Debt Contracts: A Preliminary Inquiry

Mitu Gulati*

I. Introduction

The euro area sovereign debt crisis is now over three years old and reforms are being instituted in an attempt to correct some of the problems that caused the crisis. In this essay, we investigate a key assumption that underlies one of the major policy reforms that has been put in place as a result of the crisis: the mandate that all euro area sovereign bonds, starting on January 1, 2013, begin using a set of contract terms aimed at solving collective action problems (CACs) among bondholders. That reform is supposed to make bailouts less likely and make private sector involvement (PSI) in future restructurings more likely. The hope is that the result of the reform will be that the weaker members of the Eurozone will no longer be tempted

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to over-borrow (and their creditors will no longer be tempted to over-lend) by the expectation of a bailout.

The important question here is: Why are these contract terms, the CACs, being mandated? Contract theory tells us that, as a rule, when a state mandates contract terms, this tends to reduce welfare. Sophisticated parties are thought to be better able to decide on the terms that best suit them than is the state. The exception is where the parties to the contract have the ability, through their contracts, to impose externalities on third parties. Hence, to understand why it made sense for the euro area governments to mandate contract terms for the debt contracts issued by all of their members, there has to be a story about how, in the absence of this mandate, these parties have an incentive to enter into contracts that produce negative externalities on their fellow EMU members.

What is that externality? There has been little explicit discussion of this question in the recent policy debates. The answer, we believe, has to do with a frequently articulated narrative regarding the causes of the euro area sovereign debt crisis. According to this narrative, certain entrants to the monetary union, recognizing that the markets perceived them differently upon their gaining entry to the union, began to behave irresponsibly with respect to their borrowing. Given the strong economic interdependencies that the monetary union was sure to create, if an economic crisis hit one member of the euro area, its effects would necessarily be felt strongly by other members of the union as well. That meant that any nation that got into financial trouble would have a higher likelihood of receiving external assistance from its fellow nations in the euro area, than it would have had prior to joining the monetary union. Understanding the increase in likelihood of a bailout that arose out of the formation of a monetary union, certain members of the union might have been tempted to go on a borrowing spree.[1]

1 For an articulation of this dynamic, *see* Thushyanthan Baskaran & Zohal Hessami, *A Tale of Five PIIGS: Soft Budget Constraints and the EU Sovereign Debt Crises*, University of Konstanz Working Paper # 2011-45 (available at http://www.uni-konstanz.de/FuF/wiwi/workingpaperseries/WP_45-Baskaran-Hessami-11.pdf); *see also* Paul De Grauwe, The Governance of a Fragile Eurozone, CEPS Working Paper Number 346 (2011) (referring to the views of 189 German economists opposing the ESM).

A monetary union and the resulting close economic ties do not, however, make bailouts inevitable. The richer nations in the union are typically going to be reluctant to provide bailouts to their weaker brethren, especially if the latter have acted irresponsibly in getting themselves into trouble in the first place. More practically, history teaches us that the use of public funds to provide bailouts to private creditors tends to generate taxpayer ire. Politicians in the richer nations will therefore prefer that weaker nations settle their debt problems by asking for "bail ins" from private creditors rather than asking for taxpayer subsidies from the citizens of the richer countries in the union. Recognizing this, however, the weaker sovereigns and their creditors have an incentive to use the types of contract provisions in their debt instruments that make it difficult for PSI to occur. The classic example of such a contract provision is a requirement in a multi-creditor sovereign bond (with thousands of dispersed bondholders) that does not allow for the payment terms of the bond to be modified unless every single bondholder agrees to the modification.[2]

The particular form of the moral hazard we have articulated above, where countries choose to utilize harder-to-restructure provisions so as to raise the likelihood of a bailout, may strike some as so implausible as to not be worth even testing. But a version of this argument is likely the basis for CACs having been <u>mandated</u> for the euro area. To see why that is so, it helps to go back to a prior incarnation of CAC initiatives, from roughly a decade earlier and on a different continent.

During the period 1995-2002, a number of emerging market nations suffered debt crises and received bailouts from the Official Sector (primarily the IMF). Policy makers perceived there to be a problem of excessive bailouts.[3] The dominant narrative was one of moral hazard; that emerging market debtors were able to borrow excessively because their creditors were confident that there would be bailouts

2 *See* Anna Gelpern & Mitu Gulati, *The Wonder-Clause*, 41 J. Comp. Econ. 311 (2013) (reporting on interviews with officials and market participants regarding the perceived reasons for the Euro CAC initiative).
3 *E.g.*, John B. Taylor, Global Financial Warriors 100 (2007); Ross P. Buckley, *Sovereign Bankruptcy*, 15 Bond L. Rev. 95-110 (2003).

in the event of a crisis.[4] And part of the reason for the confidence regarding bailouts was that the debt contracts underlying the debt were such that forcing restructurings would have been extremely difficult.[5] Inevitably, the bailouts of the mid 1990s upset taxpayers who demanded a solution -- one that would replace bailouts with PSI. Policy makers decided that one of the key barriers to PSI was the unanimity provision that was standard fare in sovereign bonds issued under New York law. After much debate, the solution that emerged was for the Official Sector to persuade emerging market sovereign debtors and their creditors to shift from using unanimity provisions to what are now known as collective action clauses or CACs.[6] These CACs, in key part, are clauses that allow for modification of a bond's payment terms with significantly less than unanimity among the bondholders (typically 75%).

The proposals for CACs to be adopted were not initially received with enthusiasm by emerging market issuers, and particularly not so by the large issuers like Brazil and Mexico. And for a number of years after the CAC proposals first emerged (roughly in 1995), the major emerging market issuers showed little willingness to experiment with using CACs. Policy makers and academics, therefore, had

4 A number of scholars have attempted to test, with ambiguous results, the extent to which moral hazard resulted from IMF lending. *See e.g.*, Giovanni Dell'Ariccia, Isabel Schnabel, & Jeromin Zettelmeyer, *How do Official Bailouts Affect the Risk of Investing in Emerging Markets*, 38 J. Money Credit & Banking 1689 (2006); Andrew Haldane & Ashley Taylor, *Moral Hazard: How Does IMF Lending Affect Debtor and Creditor Incentives?*, Financial Stability Review, June (2003); Prasanna Gai & Ashley Taylor, *International Financial Rescues and Debtor Moral Hazard,* 7 Int'l Fin. 391 (2004).

5 For models of these dynamics, *see* Michael P. Dooley, *Can Output Losses Following International Crises be Avoided?,* NBER Working Paper 7531 (2000); Michael P. Dooley & Sujata Verma, *Rescue Packages and Output Losses Following Crises,* Chapter 5, in Managing Currency Crises In Emerging Markets (Jacob Frankel & Michael P. Dooley eds. 2003). For further discussion of the bailout dynamics as related to contract clauses, *see* Barry Eichengreen & Ashoka Mody, *Bail-Ins, Bailouts, and Borrowing Costs,* 47 Imf Staff Papers 155 (2001); Barry Eichengreen & Ashoka Mody, *Do Collective Action Clauses Raise Borrowing Costs?,* 114 Econ. J. 247 (2004).

6 *See e.g.*, Barry Eichengreen & Richard Portes, Crisis? What Crisis: Orderly Workouts For Sovereign Debtors (1995). For a description of the events leading up to the adoption of CACs in New York law sovereign bonds in 2003, see Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract*, 84 Wash U. L. Q. 1627 (2007).

to wrestle with the question of why nations were not shifting to these new clauses and what needed to be done to push them in that direction. Among the answers that were given was that nations simply did not have the individual incentives to move to CACs because they and their creditors preferred a regime in which bailouts would be provided.[7] In essence, this is a moral hazard story. That is, that countries seeking bailouts have an incentive to utilize tougher-to-restructure contract provisions than they would otherwise. Given this assumption, there was discussion of the need to mandate a CAC-like solution, since nations did not look like they would choose one voluntarily.

The effort to urge the big emerging market issuers to move (many of whom issued bonds under New York law) finally got off the ground in early 2003 when Mexico and Brazil finally began using CACs. This only happened, though, in the shadow of the threat of mandate via the IMF's proposal for a sovereign debt bankruptcy mechanism. By 2004, close to 90% of all new sovereign bonds issued under New York law contained CACs.[8] That there were few bailouts of emerging market sovereign debtors in subsequent years is seen by some as evidence of the success of the New York CACs.[9]

Fast forward roughly a decade, and we have the euro area sovereign debt crisis. This crisis hit sovereign issuers who were primarily issuing their debt in the European market and who were members of EMU. Greece was hit first and the hardest. Ireland, Portugal, Spain, Italy and Cyprus followed. The reaction of the euro area policy makers during the first few years of the crisis was much the same as it had been in the mid 1990s with respect to emerging market debtors such as Mexico and Argentina – bailouts were given to Greece, Portugal, Ireland, and Cyprus. Italy and Spain sat in the hot seat. Taxpayer

7 *See* Barry Eichengreen, *Restructuring Sovereign Debt*, 17 J. Econ. Persp. 75 (2003); *see also* Sonke Haseler, *Collective Action Clauses in International Sovereign Bond Contracts – Whence the Opposition*, 23 J. Econ. Surveys 882 (2009).
8 Michael Bradley & Mitu Gulati, *Collective Action Clauses for the Eurozone: An Empirical Analysis* (2013 draft, available at
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948534).
9 *See e.g.*, John B. Taylor, *Why Did Macro Policy in Emerging Market Countries Improve*?, Economics One, March 2, 2010, available at http://johnbtaylorsblog.blogspot.com.ar/2010/03/why-did-macro-policy-in-emerging-market.html

anger followed, rising in decibel level with every bailout-type action, especially among citizens of nations who believed that their countries were providing the bailouts. In reaction to the anger over perceived subsidies and the "moral hazard" concerns, policy makers chose the solution that had worked a decade earlier with respect to emerging market sovereign issuers, CACs.[10] Starting on January 1, 2013, all new sovereign bonds issued by members of the Eurozone were to have a standard set of CACs resembling the ones that had been prescribed in New York a decade prior (albeit, with some enhancements). Policy makers were clear about the message of this Euro CAC initiative: In the future, there would be no automatic bailouts; PSI would be part of the package.[11]

To reiterate, what interests us in the foregoing is the assumption in both the New York initiative of the previous decade and in the current euro area initiative, that the weaker sovereign issuers need to be constrained in terms of the contract terms they utilize. As noted, as an economic matter, mandatory contract terms rarely make sense.[12] The exception is where the terms being chosen produce negative externalities impacting third parties. In this case, the externality story – had it been explicitly articulated, as it often was in the emerging market context a decade prior – was that the weaker issuers in the euro area had an incentive to use tough-to-restructure provisions so as to increase the likelihood of bailouts from the richer nations.

A decade ago, when there was heated debate over the need to impose CACs on emerging market issuers issuing under New York law, there had been no straightforward way to test the foregoing story. Was it really plausible to think that weaker nations, recognizing that their rich brethren were worried about contagion and would pay a high price to avoid it, would move to using tougher-to-restructure

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10 *See* Gelpern & Gulati, *Wonder Clause, supra* note 2; *see also* Arturo C. Porzecanski, *Behind the Greek Default and Restructuring of 2012*, in Sovereign Debt And Debt Restructuring: Legal, Financial And Regulatory Aspects (Eugenio A. Bruno ed. 2013) (describing the concern with moral hazard that led to the Merkel-Sarkozy pronouncement in Deauville in October 2010 that then led directly to the CAC initiative in November 2010).

11 *See* Gelpern & Gulati, *Wonder Clause*, *supra* note 2.

12 *See* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds,* 89 Northwestern U. L. Rev. 566 (1995).

provisions? The formation of the EMU provides us with a natural experiment that should enable testing of this contract version of the debtor moral hazard story ("DMH"). If the DMH story holds, we should find that member nations – and particularly the weaker ones – reacted to their admission to the union by using contract terms that made restructurings more difficult and bailouts more likely.

There is a twist in the story here, that makes it different from the New York story from the previous decade: the euro area had an explicit "no bailout clause" under the Lisbon Treaty.[13] This clause had been put in place as a constraint, because the architects of the monetary union had been worried about precisely the problem of individual nations failing to act in a fiscally responsible fashion and then seeking bailouts.[14] For the DMH story to hold, therefore, the assumption also has to be that the relevant euro area debtors and their creditors did not take the "no bailout" seriously, knowing that when push came to shove politicians would not stick to it. A counter-narrative is that nations in fact took the "no bailout" condition prohibition on bailouts seriously. If they had taken it seriously, one would not expect new members of the EMU to have reacted to their entry by using tougher-to-restructure contract terms in their bonds.

Using a dataset of sovereign bonds issued in the decades both before and after the formation of EMU, we test the assumption that the weaker entrants to the EMU disbelieved the Lisbon Treaty and entered into tougher-to-negotiate contracts so as to increase the likelihood of bailouts. Our test does reveal clear differences in the types of contract terms used by EMU members and their creditors before and after their entry to the EMU. However, the differences do not move in the direction that the DMH story predicts; they move in the opposite direction. Entrance into the EMU corresponds to an *increased* use of easy-to-restructure provisions, not a reduced use. Rejecting

13 The relevant provision is Article 125 of the Treaty governing the formation of the European Union or T/FEU. The original provision comes from the Maastricht Treaty and was subsequently incorporated into the Lisbon Treaty.

14 In addition to the prohibition on bailouts, the Stability and Growth Pact, by setting limits on budget deficits and debt/GDP rations, was also supposed to help deter overborrowing by EMU member states. *See* Philip R. Lane, *The European Sovereign Debt Crisis,* 26 J. Econ. Persp. 49 (2012). In hindsight, we know that that didn't work either.

the version of the DMH theory we test does not necessarily show that EMU members and their creditors took the "no bailout" clause seriously. It may simply mean that the DMH was operating through some other channel. The rejection does, however, raise the question of why the mandatory CACs were thought necessary.

II. Predictions

Assuming that EMU members, and particularly the weaker among them, did not believe the dictates of the Lisbon treaty and realized that tougher-to-restructure provisions would help induce bailouts, we should see the following two patterns in the data:

<u>Prediction One</u>: Entry to the EMU will result in a move to tougher-to-restructure contract provisions in their bonds.

<u>Prediction Two</u>: Prediction One is more likely to hold for the economically weaker EMU entrants (the ones likely to be receiving bailouts) than the stronger ones (the ones likely to be providing bailouts).

III. The Contract Terms

Sovereign bond contracts tend to be heavily documented and contain a wide array of terms. A full contract can run, on occasion, to between fifty and a hundred pages. Our interest is in a subset of contract terms. Specifically, the terms whose presence makes it more or less likely that the sovereign debtor in question will immediately face a crisis unless a bailout is provided. A simple example is the contract term specifying the grace period. Sovereign debtors, when issuing their bonds, can negotiate for shorter or longer grace periods from their creditors. What the grace period does is give the debtor a certain amount of time (that can range between 0 and 90 days) to cure any inability it might have had to make payments on the pre-specified dates of payment. The longer the grace period, the more time that the sovereign has to try a obtain new funding or negotiate new terms with the existing creditors without an "event of default" being declared, all of its debt being accelerated, credit default swaps being triggered, and litigation against it beginning. We are interested in whether nations are contracting for terms that make bailouts more or less likely. To that end, sovereigns with longer grace periods have more time to work out their debt problems on their own and are less likely to need bailouts to stave off a full blown crisis that might impact their partner nations in the union. The DMH model would predict, other things being equal, a reduction in grace periods as a function of entry to the EMU.

Along the lines described above, we report results on seven key contract terms that impact whether a sovereign in crisis is likely to have the space to work its way out of that crisis or not (less space = bailout more likely). As a general matter, the contract terms in a sovereign bond divide into three groups that map roughly onto the three stages of a sovereign debt crisis.

Stage One is when the crisis hits. At this stage, creditors have not pulled the plug yet and the sovereign might be able to find interim financing from private sources to stave off the need for the default. Whether the sovereign is able to find interim financing, though, depends on what kinds of contract terms it has agreed to. We call the terms that either give or take away the sovereign's flexibility in the pre-default stage the *Flexibility Terms*.

Stage Two is where the sovereign has failed to find bridge financing and has to request that its creditors renegotiate the terms of its debt. Certain contract terms, particularly as a function of their ability to solve the collective action problem across a large number of dispersed creditors, help determine whether a debt restructuring can occur easily. We call these the *Restructuring Terms*.

Stage Three is where the sovereign has been unable to persuade all of its creditors to restructure and faces litigation from unhappy creditors. Such litigation can hold up the restructuring process and make it difficult for the sovereign to access the capital markets for fresh financing. A third subset of contract terms determines how difficult litigating against a sovereign is. These are the *Litigation Terms*.

The combination of these three types of terms will determine how easy it will be for a sovereign debtor to maneuver its way out of a crisis without needing a bailout.

In this version of the article, we report only (a) on a subset of contract terms (the flexibility provisions) and (b) on simple before-and-after entry to the EMU comparisons. In the fuller version of the article, we report on restructuring and litigation terms as well.[15] The basic story does not, however, change. Before getting to the results, we describe the flexibility terms.

Flexibility Terms

i. Grace Period. The grace period is the time that a debtor has to cure what are called "technical defaults." If the technical default – which range from a failure to pay coupon amounts on time (serious) to a failure to fulfill a promise to list the bonds on a particular exchange (not as serious) – occurs, the debtor has the grace period to remedy the breach. Sovereigns with longer grace periods are better able to weather problems because they have a longer period of time before the creditors initiate litigation or accelerate the other obligations under the bond. Sovereigns with longer grace periods are less likely to need bailouts; and particularly so in the event of short-term liquidity crises. We code two grace period variables; one for principal and the other for interest.[16]

ii. Negative Pledge. Debtors in trouble find it difficult to get creditors to lend to them. One way for a troubled debtor to buy time is to grant security interests in its key assets to creditors. In other words, the ability to grant security interests helps debtors to weather sudden storms (just like a longer grace period does). A negative pledge clause is a promise by the sovereign not to borrow on a secured basis unless

15 Some of the basic results on these other contract terms (albeit from a significantly smaller dataset) are also reported in Stephen J. Choi et al., *The Evolution of Contractual Terms in Sovereign Bonds,* J. Legal Anal. (forthcoming 2012), available at http://jla.oxfordjournals.org/content/early/2012/05/31/jla.las004.full.pdf+html.
16 Most contracts have a third grace period variable as well; the grace period for violation of other contract provisions than the interest and principal payment obligations. The grace periods for this third variable tend to be highly correlated with those for the two we report (in terms of whether they are high or low).

the security interest being granted to the new creditor has the same rank as the debt with the negative pledge. Effectively, though, if everyone has a negative pledge clause, it ceases to have value. After all, no one wants a security interest if everyone else is going to be given the same one – that would be the same as having no security interest. In sum, the negative pledge clause constrains debtors from bailing themselves out during times of distress. We code the negative pledge clause in terms of its presence or absence.

iii. *Pari Passu.* The *pari passu* clause is similar to the negative pledge clause. The traditional meaning of the clause was that it protected creditors against debtors showing preferential treatment to creditors by granting them informal preferences (quasi security interests in a sovereign's tax revenues, for example). The more modern interpretation of the clause that certain courts have given it is to bar preferential payments to one creditor over another in the event that the sovereign is in default.[17] This second meaning of the clause would impose a significant constraint on a debtor in crisis who wishes to preferentially pay certain important creditors crucial to its functioning and delay payments to others who might be less crucial. We code the *pari passu* clause for whether the version used is one vulnerable to the second interpretation or not.

iv. Cross Default. The cross-default clause also constrains troubled debtors in terms of the options they have when faced with a crisis. As noted above, a debtor in financial difficulties seeking to keep afloat typically wants to be able to choose which creditors to default on and which ones to keep paying. The cross-default clause constrains this ability in that it links the various debts instruments of the debtor together by saying that a default on one instrument will constitute a default on the others. We code the contracts for the presence or absence of a cross-default clause.

17 As of this writing, there is uncertainty regarding the meaning of the *pari passu* clause. The second meaning of the clause that we describe in the text, however, has been adopted by the Second Circuit Court of Appeals in New York. For discussion of this case, *NML v. Republic of Argentina, see* Theresa Monteleone, *A Vulture's Gamble: High Stakes Interpretation of Sovereign Debt Contracts in NML Capital, Ltd. v. Republic of Argentina,* Cap. Mkts. L. J. (forthcoming 2013).

At bottom, a sovereign debtor who agrees to a small grace period and concedes to having negative pledge, *pari passu* and cross default-clauses in its contracts, gives itself less leeway in the event of a financial crisis. Assuming that these contract provisions cannot be easily bargained around in the typical sovereign bond context with thousands of dispersed bondholders, a sovereign with the foregoing contract provisions is more likely to need a bailout from external sources. Under the predictions of the DMH model, the weaker entrants to the Eurozone, other things equal, should have adopted shorter grace periods and more negative pledge, *pari passu* and cross-default clauses.

<u>v. Acceleration.</u> An acceleration provision works in a similar fashion to the cross-default provision; it speeds up a debt crisis and constrains the debtor's ability to work its way out of problems. The provision gives the creditor, under certain conditions (for example, where the debtor has not paid its required coupon payments), the right to declare that all of the future payments it is due be accelerated to the current date. That means that the debtor's bill that is due at the current date suddenly becomes much larger. As a result, the debtor's ability to get out of the crisis diminishes. Sovereign bonds vary in terms of their acceleration provisions. At one extreme, some lack them altogether, which puts the debtor in a strong position. At the other extreme, individual creditors have the right to accelerate. In between these two extremes, acceleration typically requires a vote of something between 10 and 25 percent of the bonds. Creditors have the most power and debtors the least where each creditor has the individual right to accelerate the debt. We code the acceleration provision in terms of whether it gives creditors the individual right to accelerate or not.

<u>vi. Reverse Acceleration.</u> The power that an acceleration provision puts in the hands of a minority of holdout creditors can be limited somewhat by a feature that allows the effects of the acceleration to be reversed. Typically, if a reverse acceleration provision is present, it specifies that the initial acceleration can be reversed if a majority of creditors agrees. We code reverse acceleration in terms of its presence or absence.

vii. Tax Gross Up. Sovereigns, by definition, have the power to tax. That, in theory, includes the power to tax bond payments that the sovereign makes to bondholders. For a sovereign in a debt crisis, taxing payments owed to bondholders would be an easy way to reduce its obligations. A tax gross-up clause, however, promises that the sovereign debtor will make the creditors holding a tax gross-up clause whole by reimbursing them the amount of the tax. We code the tax gross-up in terms of absence or presence.

IV. Data

Our dataset covers contract terms in sovereign bonds over the period January 1, 1990 - January 1, 2011. We chose that period of time because it captures the era of the modern sovereign bond market. There was a robust sovereign bond market at various points during the 1800s and then particularly in the early 1900s. However, things went awry during the depression in the 1930s and 1940s, with nearly half of the issuers in the market defaulting. The bond market did not get resuscitated until the end of the Latin American debt crisis of the 1980s. For the period 1990 - 2011, we have over 1,300 bonds issued by over 75 sovereign issuers. Of these, there are roughly 600 bonds for the euro area sovereigns specifically.

Our dataset contains information on all of the bonds that were available from the three primary commercial sources of prospectuses and offering circulars for sovereign issuances: Thomson One Banker, Perfect Information and Dealogic. There is considerable overlap among these data sources. Our coding focused on the documents available from Thomson One Banker. We then supplemented gaps in this data with what was available from Perfect Information and Dealogic.[18] A key aspect of this data we have put together is that it represents information about bond contracts that international investors are willing to pay for. All three of the companies producing the data earn fees as a function of the contracts that their customers

18 We used Dealogic only to supplement our collection of EMU bonds, the primary focus of our analysis. There is a fourth commercial source, Bloomberg, that also has bond documents available. However, we were unable to find any on Bloomberg that we had not already obtained from the other data sources.

download. Our understanding is that the presence of contracts on these databases is demand driven; contracts show up in the database if customers ask for them. That means that our dataset is weakest for those nations for whom investors are so confident that they are not interested in the details of the contracts – countries like the United States and Germany. The dataset also undersamples locally issued bonds. Presumably, the local population either has easy access to the information or the contract terms are largely irrelevant when one is contracting with one's own sovereign. Hence, what we have is a dataset largely comprised of the bonds that foreign investors are interested in purchasing or have purchased.

In constructing the database, we downloaded every prospectus, prospectus supplement or offering circular that was available on the databases mentioned. From those documents, we hand-coded the contract terms. The documents are not the contracts themselves but the sales documents that provide investors with descriptions of the key terms of the contracts.

In what follows, we report a set of before-and-after comparisons of the incidence of key contract terms that relate to the ability of a sovereign to extricate itself from financial crisis. To map onto our two predictions, we report our comparisons in three separate tables. First, we examine all of the original entrants to the EMU, plus Greece (that joined shortly thereafter). Second, to focus in on the effects on the weaker EMU members, we eliminate the AAA rated nations from the analysis. Third, to guard against the possibility that our results are being driven by a couple of larger issuers, we eliminate the two largest issuers. Finally, so as to be able to control for global trends in contract drafting practices in all three tables, we report in each case a comparison table for the rest of the world (excluding the AAA issuers). We are unable to report data for the very strongest issuers though – nations like France, the Netherlands and Germany – because their contracts do not appear in our databases. That said, our information from market actors is that there were no changes in the contracts for these types of issuers over the period we examine.[19]

19 There is a second set of EMU members whom we also exclude and this is the set of more recent entrants (nations like Estonia, Slovakia, Slovenia, and Cyprus). These nations entered the EMU too recently for us to have a meaningful set of data to analyze for them.

We use 1999 as the breakpoint in our analysis even though the EMU was officially formed in 2000 because, as of 1999, it was fairly certain that the EMU would be formed and practices and expectations were likely already changing.

V. Results and Analysis

a. Flexibility Terms

We examine seven different contract terms that can impact the amount of flexibility the sovereign has to maneuver its way out of a crisis (one of the contract terms, the grace period, has two aspects – so we have eight variables that we measure). Sovereigns who, by contract, have restricted their own ability to do things like grant preferred status to new lenders or to tax bond payments that they owe, have necessarily restricted the amount of flexibility they have to deal with a financial crisis. The prediction, under the DMH story, would be for the weaker and systemically important nations to respond to their entry to the EMU by utilizing tighter (less flexible) terms. By contrast, we should expect to see less of this effect for the richer nations.

Tables 1A, B, and C report the results for the eight flexibility terms for different groupings of countries in accordance with our hypotheses. Table 1A begins with the eight original EMU entrants plus Greece.

Column two in each table reports the direction of the shift one would expect under the DMH model for each variable. As an example, take the grace period that sovereigns have for making delayed payments of principal (Table 1A). Under the DMH model, one would expect nations and their creditors to seek reduced grace periods. Hence, the prediction in column two is "Decrease." Then, moving to columns three and four, we can see whether entry to the EMU correlated with downward shifts in the grace period. What we see is an upwards shift in the grace period instead of the predicted decrease. Columns five and six report the shift that occurred over the same period for the rest of the sovereign debt market for which we have data (excluding the

EMU members). For the grace period variable, we see that there was a significant increase in grace periods there as well. That is, for the grace period for principal payments, the shift for the EMU members looks very similar to the shift in the global market.

Table 1A. Flexibility Provisions: Original Members Plus Greece

	DMH Predictions	Eight Original Plus Greece		General Market Practice (Excluding the super-safe issuers)	
		1988-1998 (n=307)	1999-2011 (n=329)	1988-1998 (n=185)	1999-2011 (n=565)
Grace Period for Principal	Decrease	15	19***	17	21** ǂǂǂ
Grace Period for Interest	Decrease	18	22***	19	22**
Acceleration (individual right or	Increase	94%	69%***	51%	33%*** ǂǂǂ
Reverse Acceleration Clause	Decrease	0%	16%***	19%	46%*** ǂǂǂ
Negative Pledge Clause	Increase	84%	66%***	95%	95% ǂǂǂ
Strong *Pari Passu* Clause	Increase	2%	11%***	46%	61%*** ǂǂǂ
Cross Default Clause	Increase	60%	45%***	78%	88%** ǂǂǂ
Tax Gross-Up Clause	Increase	65%	64%	100%	99% ǂǂǂ

***p<0.001 **p<0.01 *p<0.05, two-tailed tests for bonds issued during 1988–1998 and 1999-2011
ǂǂǂp<0.001 ǂǂp<0.01 ǂp<0.05, two-tailed tests for 9 Eurozone Member Countries and the "general market"

Going down the rows of Table 1A, we see the same pattern for the next three variables. Those are, grace period for interest payments, the acceleration rights of creditors (whether individual or collective), and the reverse acceleration rights of creditors (whether collective). For all three variables, column two has the DMH model's predictions and columns three and four have the actual shift that took place. We see significant shifts in the opposite direction predicted by the DMH model. From columns five and six we also see that these shifts mirror the general shifts in the market. In sum, for the first four provisions, the DMH model fares abysmally. Not only do its predictions not hold up, but the shifts are in the opposite direction.

While we find little evidence of any DMH effect as a result of entry to the EMU though, we cannot reject the presence of a DMH effect altogether because there appears to have been, at the same time, a general market shift. In other words, what we may be seeing is that the strength of that general market shift overwhelms the DMH effect. We know from other research that the global market was hit by significant shocks over the same period of time (the Asian crisis of 1997-98 and the Argentine crisis of 2000-01) that did produce general shifts towards more flexible contract terms for sovereign debt instruments.[20] From the results on the first four variables then, all we can say is that the DMH effect, if it was there, was not strong enough to counter the general trends in the market.

20 *See e.g.*, Choi et al., *supra* note 15.

The next four variables are the negative pledge, *pari passu*, cross default, and tax gross-up clauses. These are arguably the four most important flexibility provisions in the contract.[21] At first cut, we see a similar picture to what we saw with the first four provisions. First, we see from columns three, four and five, that for three of the four variables, we have shifts in directions different from the DMH predictions. For two of the variables (negative pledge and cross-default) the shifts are significant and in the opposite direction from predicted. And for the third (tax gross-up) there is no change, whereas the DMH prediction is for a downward shift. For only one variable of all eight of the variables examined so far (whether there is a strong *pari passu* clause), is the shift in the predicted direction of flexibility reduction. It is even clearer now that there is little support for the DMH story, at least in terms of the flexibility terms.

When we look at the last two columns in Table 1A for these last four variables though, we get a more interesting story than we had for the first four (and less important) variables. Here, for three of the four variables (negative pledge, cross-default and tax gross-up) there is no change in the general market patterns.[22] However, when we look back at the EMU entrants, we see significant changes, towards flexibility, for two of the four variables, negative pledge and cross-default. The relevance of this is that the shift cannot be explained by a general market trend towards more flexible contract terms. The general market, over this period, had no trend. The shift towards greater flexibility for these two important terms was only for EMU entrants. Now, therefore, we have a stronger rejection of the DMH model because we see that, absent any general market trend, the EMU entrants are still moving towards greater flexibility.

Table 1A reported numbers for the nine original members of the EMU. The predictions of the DMH story though, should work differently for countries of different size and strength. We consider first, therefore, the case of the strongest credits – the AAA credits. These nations are the ones who, if there is a crisis, are likely to be in the po-

21 For a discussion of the key provisions in a sovereign debt instrument, including a sense of their relative importance, *see* Lee C. Buchheit, How To Negotiate Eurocurrency Loan Agreements (2d ed. 2002).

22 For the fourth variable, *pari passu*, we see that the EMU trend is in the same direction as the market trend.

sition of having to provide a bailout rather than receiving it. In other words, their contract terms are unlikely to be affected by EMU entry. So, in Table 1B, we report results after having excluded the AAA nations among the first nine. Luxembourg, Austria and Finland are the three that get excluded, leaving us with the nations that were at the center of the Eurozone crisis in 2011-12 – Greece, Italy, Ireland, Spain, Portugal and Belgium.

Table 1B. Flexibility Provisions: Excluding the AAA Countries

	DMH Predictions	Minus the AAA		General Market Practice (Excluding the super-safe issuers)	
		1988-1998 (n=209)	1999-2011 (n=248)	1988-1998 (n=185)	1999-2011 (n=565)
Grace Period for Principal	Decrease	13	19***	17	21** ⧻
Grace Period for Interest	Decrease	17	22***	19	22**
Acceleration (individual right o	Increase	96%	68%***	51%	33%*** ⧻
Reverse Acceleration Clause	Decrease	0%	16%***	19%	46%*** ⧻
Negative Pledge Clause	Increase	94%	67%***	95%	95% ⧻
Strong *Pari Passu* Clause	Increase	2%	15%***	46%	61%*** ⧻
Cross Default Clause	Increase	93%	61%***	78%	88%** ⧻
Tax Gross-Up Clause	Increase	98%	85%***	100%	99% ⧻

***p<0.001 **p<0.01 *p<0.05, two-tailed tests for bonds issued during 1988–1998 and 1999-2011
⧻p<0.001 ⧺p<0.01 ⧺p<0.05, two-tailed tests for Euro Periphery and the “general market"

The patterns observed in Table 1A in terms of rejecting the DMH model get stronger once we take out the AAA rated nations. For seven of the eight variables in Table 1B, the direction of the shift is in the opposite direction, as predicted. If we then eliminate the variables for which the direction of the shift is the same as that for the general market, we are left with three contract provisions – the negative pledge, the tax gross-up and the cross-default clauses. With all three, the size of the shift is now bigger than in Table 1A (and toward flexibility; instead of toward constraint as DMH would predict). Further, whereas the tax gross-up clause did not show a significant shift towards greater flexibility in Table 1A, the removal of the AAA countries in Table 1B now shows a significant shift. In effect, the rejection of the DMH story is stronger when we move towards the nations that are supposed to be at the heart of that DMH story.

Table 1C. Flexibility Creating Provisions: Excluding Spain and Italy

	DMH Predictions	Minus Spain and Italy		General Market Practice (Excluding the super-safe issuers)	
		1988-1998 (n=143)	1999-2011 (n=126)	1988-1998 (n=185)	1999-2011 (n=565)
Grace Period for Principal	**Decrease**	14	17	17	21** ǂǂǂ
Grace Period for Interest	**Decrease**	18	21	19	22** ǂ
Acceleration (individual right o	**Increase**	95%	72%***	51%	33%*** ǂǂǂ
Reverse Acceleration Clause	**Decrease**	0%	15%***	19%	46%*** ǂǂǂ
Negative Pledge Clause	**Increase**	96%	41%***	95%	95% ǂǂǂ
Strong *Pari Passu* Clause	**Increase**	0%	0%	46%	61%*** ǂǂǂ
Cross Default Clause	**Increase**	91%	38%***	78%	88%** ǂǂǂ
Tax Gross-Up Clause	**Increase**	97%	79%***	100%	99% ǂǂǂ

***p<0.001 **p<0.01 *p<0.05, two-tailed tests for bonds issued during 1988–1998 and 1999-2011
ǂǂǂp<0.001 ǂǂp<0.01 ǂp<0.05, two-tailed tests for Poorer Europe and the "general market"

Finally, in Table 1C, we remove the two nations that formed the biggest part of our initial set, Italy and Spain. We remove them because of their sheer size; the data on them has the potential to dwarf the rest of the data. The conclusions from Table 1A and 1B remain; if anything, they get stronger. The strongest members, the AAA countries, were already using highly flexible terms. So, nothing changed for them. But the weaker members that had earlier been borrowing from external investors under contracts resembling the wider market (and particularly, the emerging markets), now began to borrow under more flexible contracts. In other words, EMU entry correlated with a convergence in the types of borrowing terms towards the practices of the strongest credits.

VI. Implications

One understanding of the Euro CAC initiative is that it was aimed at solving the debtor moral hazard problem. That is, its goal was to push the system toward making sovereign restructurings easier and, therefore, reducing the need for Official Sector bailouts.[23] Indeed, the foregoing (and reasonable) understanding has led at least some to conclude that the announcement of the PSI/CAC initiative in late

23 *E.g.,* Gelpern & Gulati, *supra* note 2 (reporting on interviews with policy makers who blamed the Deauville announcement and the subsequent CAC initiative for the widening of spread in the euro area); Jean Tirole, *The Euro Crisis: Some Reflexions on Institutional Reform*, 16 Financial Stability Review (Banque de France) 225, 234 ("[CACs] definitely improve the countries' ability to restructure"); Elena Carletti, *Euro Defaults Need to be Carried Out Quickly,* Bloomberg.net, December 10, 2010 ("[CACs] make debt restructuring faster by forcing minority bondholders to accept the terms agreed to by a majority of creditors"), available at http://www.bloomberg.com/news/2010-12-17/euro-defaults-need-to-be-carried-out-quickly-commentary-by-elena-carletti.html

2010 was responsible for the widening in spreads for many euro area sovereigns.[24] The data, however, reveal scant support for the DMH story, at least not the version of it that might justify the Euro CAC initiative. Reality is that many of the most vulnerable euro area sovereigns had shifted a long time ago to bond contracts that were remarkably easy to restructure. The ease with which the Greek 2012 restructuring occurred illustrates this. By mandating CACs in all euro area sovereign bonds, these sovereigns are going to find it harder to conduct PSI operations in the future, not easier. And, to extend that logic, CACs may have made bailouts more, not less, likely. At this point though, it is worth reminding readers that the data used here is likely but a subset of the overall debt stock of the nations in question. It is the data that was available from the public databases (in other words, the contracts that someone was willing to pay for). We see no obvious reason why our results should not generalize. However, we are working with only a subset of the overall data.

Assuming that our findings are generalizable though, one implication is that the effort that has been exerted over the past few years in designing and executing the Euro CAC initiative has been a waste of effort in terms of solving a problem that did not exist. Further, this initiative, by making restructurings more difficult and bailouts more likely, might help create the very problem that it was supposed to solve. Even worse, if one believes that it was the announcement of

24 For example, Barry Eichengreen has explained:

> The extension of EFSF and ECB [to Greece in mid 2010] support occurred against the backdrop of objections . . . about how far and under what conditions stronger European countries would be prepared to aid their weaker brethren.
>
> The answer to this last question came into focus at the end of October, when German Chancellor Angela Merkel's governing coalition . . . endorsed the idea that bondholders should be forced to take losses in any future rescue of a European sovereign. The position may have been expedient politically and admirable economically . . . [b]ut coming at this point in the crisis it was destabilizing. Bondholders fearing that they would be first to be sacrificed in the event of additional difficulties rushed to dump the bonds of other potential crisis countries.
>
> Ireland, already in the throes of a property market collapse and incipient banking crisis, was affected most immediately, with Irish spreads rising to a 600 point premium over German bunds. No longer able to tap the markets, Dublin was forced into talks with the EU, the ECB and the IMF (the so-called Troika).

Barry Eichengreen, Euro Area (Mis)Management, Working Paper (2013).

the PSI/CAC in late 2010 that caused the dramatic spike in euro area yields for the economically weaker nations and subsequently necessitated the bailout for Ireland, then the irony of what our results show is particularly cruel. It means that the worsening of the crisis that occurred in late 2010 resulted from politicians misunderstanding the import of the policy reforms they were advocating and markets believing that misunderstanding.

There is a more optimistic narrative that one might tell though. euro area policy makers were under public pressure in 2010, after the first Greek bailout, to do something to protect against future bailouts of the type. So, they reached for what, at the time, seemed a simple solution. That was to borrow the technique from the U.S. context (CACs) that had worked to tackle what must have seemed to be precisely the same problem a decade earlier. Perhaps what European policy makers did not realize in late 2010, when the CAC initiative was announced, was how easy the local law aspect of most euro area debt made it to restructure. Or perhaps they did realize it, but they did not want the markets to realize that they were contemplating using the local law advantage that they had. After all, most investors had purchased euro area government debt assuming it was inviolable. Realizing that certain euro area nations were contemplating passing domestic legislation to eliminate large portions of the debt could well have caused a much worse panic than the one that did occur in late 2010. Take the following statement by former ECB board member, Lorenzo Bini Smaghi:

> The only way to protect taxpayers in 'virtuous' countries is to avoid over-indebted countries from easily getting away with not paying their debts; the payment of debts should be enforced, through sanctions if need be.[25]

By late 2011 though, with the Greek debt situation having spiraled out of control, policy makers had no option but to recognize that using the local law aspect of the Greek bonds might become necessary (and it did in March 2012). Under this alternative narrative then,

25 Lorenzo Bini Smaghi, *Private Sector Involvement, From Good (Theory) to Bad (Practice)*, 6 June, 2011 Speech, available at
http://www.ecb.int/press/key/date/2011/html/sp110606.en.html

the problem faced by euro area policy makers was not one of forcing individual members of the euro area to restructure their debts, but rather one of constraining them from rushing towards a restructuring via legislative fiat. Under this alternative story, mandatory CACs for the euro area make sense because the real fear of policy makers is that issuers, tempted by the example of Greece, will reach too easily for the solution of restructuring. The mandatory CACs force nations needing to do a restructuring to do it in consultation with their creditors.[26]

VII. Conclusion

Our rejection of one channel through which the DMH problem may have worked does not mean that it might not have operated through alternate channels. One possible channel that nations seeking to induce bailouts might use is the strengthening of the tie between the stability of its local banking sector and its sovereign debt. The story here would be that nations who present the risk of not only going into a sovereign debt crisis, but also producing a domestic banking crisis, have a much higher likelihood of causing contagion than a country that just has a "plain vanilla" sovereign debt crisis. Therefore, these types of nations have effectively ensured a higher likelihood of receiving a bailout for themselves. Even if we were to find that this was the DMH dynamic at play though, that still would not explain the mandatory CACs. That is, not unless one turned to some ex post justification as we did in the prior section.

At the end of the day, there is a practical reason for why there is a need to know what the relevant rationale for the Euro CAC initiative is. The Euro CAC initiative is already in place and countries have been issuing bonds with the new CACs for some months now. There are, however, open questions regarding implementation and interpretation of these new provisions – the answers to which will require an understanding of the underlying rationale for the CAC initiative.

26 There are other stories that one can tell for the mandatory CACs, such as the positive network externalities that might occur from having uniformity in contract terms and the need to solve a first-mover problem and so on. The problem with these alternative explanations, though, is that there is no indication that they were anywhere at play when the idea of CACs for the euro area was thought up in late 2010. *See* Gelpern & Gulati, *supra* note 2.

11
Political, Fiscal and Banking Union in the Eurozone

Edmond Alphandéry*

Political union in the eurozone

I have been asked to talk about the Franco-German relationship, how it has been evolving with the euro crisis, and whether any new alliances are taking place in the euro area.

When we discuss Franco-German axis, it is essential to put it in its historical perspective. This is what I will do first, before giving my own views on the present situation and about what we can expect from it in the future.

For my presentation, I will divide the role and the place of the Franco-German relationship into three stages: first, before the creation of the Euro; then, the first ten years of the European currency; and finally, the period since the beginning of the euro crisis to the present. I am not planning to provide an extensive analysis of this relationship, but will instead share my ideas with you about what is necessary to understand the current situation.

Just a couple of facts to start with: the Maastricht treaty dates from February 1992. At that time, the European Economic Community was made up of only twelve states: the six founding members

*Professor Emeritus, University of Paris II

(France, Germany, the Benelux and Italy), Spain, Greece and Portugal, Ireland and two countries that had negotiated an opting out -- the UK and Denmark. In terms of monetary arrangements, we were then living with the EMS (European Monetary System) which had two characteristics: it was asymmetric, the Deutsche Mark playing the role of the system's anchor and, due mainly to liberalization of capital flows, it had become more and more unstable, leading to the exit of the UK in 1992 and to the enlargement of the band of exchange rates fluctuation in August 1993.

At that time, the Franco-German relationship was the cornerstone of the European construction. Not only thanks to heritage of history: the construction of Europe has been a long journey where, following the footsteps of the founding fathers, General de Gaulle and Konrad Adenauer, then Valery Giscard d'Estaing and Helmut Schmidt, and later on François Mitterrand and Helmut Kohl, played a leading role. But in the Europe at 12 which I have had the privilege to observe from the inside, nothing important could have been decided which would not have emerged from the Franco-German couple. The German reunification (October 1990) which came just before the negotiation of the Maastricht Treaty had, in my opinion, a significant impact on EMU. The European Currency was certainly justified on technical grounds: due to its instability and its asymmetry, the EMS was doomed to disappear in a more or less near future. There was also a need for a unique currency to complete the simple market. But the European currency should have taken root and gained its true significance (and EMU should probably have found a better balance between its monetary and economic branches), in the simultaneous deepening of European political integration. And I remember the time when two prominent German politicians, Karl Lammers and Wolfgang Schäuble, came to Paris in 1994 to present a roadmap for European political integration...without any success! At that time, the French were not ready for such a bold step. With hindsight, knowing now what we do about the current Eurocrisis, we cannot but regret it.

But in the minds of certain people in France, the equilibrium which dated back to the post war period, based on a distribution of roles where France was supposed to lead politically and Germany had the stronger economy, was being destabilized by German reunification. And in this period of so called "cohabition" in France, when power was shared, at least on foreign affairs issues, between another couple (the socialists led by François Mitterrand and the Gaullists which were still the more powerful political force in the UDF-RPR coalition government led by Edouard Balladur), France was not in the best political position to welcome this Lammers - Schäuble initiative.

The discussions between the French and the Germans on the future European currency focused on the status of the European Central Bank: if the Germans were to agree to abandon the Deutsche Mark, there would clearly have to be a bottom line: the European Central Bank would have to be totally independent and have a unique mandate which was to secure monetary stability. In France, where the independence of Banque de France was a prerequisite to an independent European Central Bank, when it came down to its vote, there was huge resistance in Parliament. When, as Finance Minister, I presented the bill to the Parliament, I faced huge resistance from the left (Mitterrand himself attacked the law in front of the Conseil Constitutionne for not conforming to the constitution), but from the Gaullists as well who, despite belonging to the Governing coalition, fiercely fought against the law. There was no majority at that time in France in support of an independent European Central Bank.

We therefore ended up with a monetary construction (in which each member of the couple believed that it had made major concessions to the other) which led to a European monetary union where the economic dimension remained wanting: the French called for a "Governement économique européen" which the Germans refused to support because they viewed it as a Trojan horse against the European Central Bank independence; while the Germans called for deeper political integration, for which the French were reluctant because of their fear of destabilization of the balance of power in the Franco-German relationship.

I move now to the second period: during the first ten years of its existence (1999-2009), the eurozone seemed to function to the satisfaction of both partners: the Germans, since the ECB was really independent and was staying the course of price stability, and the French as well since they could pursue their demand push policies painlessly.

No wonder, therefore, that the Franco-German couple appeared to function smoothly, well enough for the two members to jointly decide to violate the Stability and Growth Pact they had solemnly put in place together in 1997.

The problems we can observe now in the Franco-German relationship are deeply rooted in the different ways the two countries managed their economies during this decade.

The Germans, who entered this new monetary era with an overvalued currency and a lack of competitiveness (they posted a current account deficit at the time) undertook the necessary structural reform steps (in the first place on the cost of labor) needed to return to a competitive economy. And they succeeded remarkably well.

The French realized that, thanks to the euro, they would not have to worry about the consequences of any current account deficit which, in the pre-Euro period, would have led to dramatic currency crises. They therefore embarked upon policies aimed at increasing consumption as a means of fostering economic growth. They did not focus enough on fiscal discipline and they delayed significant structural reforms.

When the Euro crisis struck, position of the two countries had changed: while in the 90's, the French economy was the more competitive (it had a current account surplus as opposed to Germany), ten years after the inception of the Euro, Germany had become stronger: in economic terms, but also at the political level where the gap in favour of France had dwindled, certainly because of the enhanced credibility of the German economic policy, but also because the German government had become more and more assertive in the international arena.

With the election of François Hollande, slippage between the two countries came to light: it appeared both in their different views about the types of economic policies needed to fight the crisis, as well as in the divergent paths of their economies. Concerning economic policies, there is no monolithic bloc: neither in France, nor in Germany. So we should be careful not to simplify a situation which is complex and in flux. Nevertheless, everyone can see that there are major differences between the approaches of the current leaders of Germany and France. The Germans have a culture based on stability and discipline and view the economy in a long term perspective, and they are therefore reluctant to engage in any active anticyclical economic policies. The French (at least the current government) are more Keynesian. They believe that fiscal and monetary authorities are capable of influencing the course of economic activity, thus leading to Francois Hollande's policy of trying to provide stimulus to foster economic growth: "refusal of austerity and fight for economic growth" has been the motto of the current French Government in the European Arena.

Furthermore, the Germans do not hide their commitment to a market economy in which the decision-making process is economically and socially decentralized (the social market economy), while in France there is a tradition of faith in the State for solving economic and social issues. These discrepancies appear in the relative weight of public expenditures in the GDP of the two countries and in the role given to Unions in the firms governance.

In this context, it is no surprise that when the French Government was choosing a demand push approach to stimulate economic growth policy, the Germans adopted an export-led growth policy. And current account imbalances between the two countries are still increasing, with Germany currently posting annual surplus of about 170 Billion euros, while France has a deficit of about 60 Billion euros.

Considering this situation, should we conclude that the Franco-German axis is doomed and that the euro is therefore in danger? I do not think so. On the contrary, I do think that there are good reasons to remain optimistic.

The Germans are well aware that they need France -- they do not have an alternative. A weak France is neither in their interest nor in the interest of the eurozone. And since the euro is here to stay in the interest of all parties, and especially Germany, the Franco-German couple has to remain the backbone of the euro area. This is why, despite all these differences, the couple is still alive and remains solid.

Furthermore, the Germans understand that, despite their need for discipline, they have to make concessions; it is worth noting that Finance Minister Schäuble openly admitted that wages in Germany should increase at a faster pace, and has recently agreed to try to boost consumption by a reduction in pension contributions. The Germans, although reluctantly, accepted the implementation of a European Banking union which will certainly involve fiscal transfers among member States. They did not object to the principle OMT operations by the ECB and they feel more and more concerned about the social consequences of austerity policies in peripheral countries. The Germans therefore do not seem to be totally deaf to the arguments put forward by the French authorities.

As for the French, they are perfectly aware that nothing can replace the Franco-German couple. They know that if they tried to form a bloc with the southern member States of the euro area, the euro would be in great danger. Splitting the eurozone into two parts that have two different approaches and hold diverging economic perspectives would be suicidal not only for the euro, but for the Mediterranean member States as well.

Furthermore, little by little, French authorities are starting to understand that they have to embark upon deep structural reforms, however painful they may be, not for the sake of the eurozone, but for their own sake.

For the future of the eurozone, the main issue is not so much the strength of the Franco-German axis, which I do not believe to be in danger, but the impetus that the alliance should give to the European construction. In this respect, and this will be my final remark, I think that under its leadership we still have to formulate the foundations of a European political platform which, through increasing European integration, is the step we need to take in order to put a final end to the euro crisis.

12
The Eurozone Crisis, Institutional Change, and "Political Union"

Peter L. Lindseth

The conference organizers have given me three tasks. First, they asked me to reflect on various possible meanings of "political union" in the EU. Second, and more specifically, they wanted me to consider whether there might be a tension between "de jure" and "de facto" dimensions of the concept. Finally, they asked me to highlight any "barriers to real political union within the Eurozone and what the sources of those barriers might be." I'll do my best to answer these three queries in sequence, although they obviously overlap.

Of the three tasks, I suppose I am least comfortable with the first, on the various possible meanings of "political union." We all know the concept is slippery, with a meaning that differs depending on the person you ask.

We know, for example, that Angela Merkel has expressed support for eventual "political union."[1] Upon closer scrutiny, however, her conception is notoriously limited, at least for the present. She usually speaks more vaguely of the need for "more Europe"[2] and of

1 "Germany's Chancellor Merkel Urges EU Political Union," *BBC*, June 7, 2012, http://www.bbc.co.uk/news/world-europe-18350977.
2 "Merkel Demands 'More Europe!'," *Deutsche Welle*, June 7, 2012, http://www.dw.de/merkel-demands-more-europe/a-16007150.

member states "ceding sovereignty" (as she did in the week leading up to this conference).[3] Encompassed within these slogans are certainly notions of a "fiscal union."[4] But her real aim appears to be increased supranational discipline over national budgets—the "six pack," the "two-pack," etc.[5] —but not any significant fiscal transfer mechanisms, debt-mutualization, or the supranationalization of taxing, spending, or borrowing power under the authority of some kind of European federal "government."[6] If she contemplates any of these steps, they are for the distant future, after a process of political and structural reform in the peripheral countries of the Eurozone.

Also included in Merkel's idea of "more Europe" is some kind of "banking union,"[7] again in recognition of one of the principal functional challenges that the current crisis has revealed. By banking union, however, she apparently means primarily a single supervisory mechanism for a segment of European banks (the very largest), as well as perhaps some kind of coordinated network of European bank-resolution authorities operating according to shared principles, although funded nationally.[8] Merkel's vision of banking union, however, does not at this point include any kind of jointly financed deposit-guarantee scheme or common resolution mechanism.[9] These latter steps would again raise the unacceptable specter of an open-ended transfer mechanism or financial commitments that Germany

3 Noah Barkin, "Merkel Says Euro Members Must Be Prepared to Cede Sovereignty," *Reuters*, April 22, 2013, http://www.reuters.com/article/2013/04/22/us-eurozone-merkel-idUSBRE93L0GO20130422.

4 Derek Scally, "Merkel Urges Greater Fiscal and Political Union," *Irish Times*, June 8, 2012, http://www.irishtimes.com/news/merkel-urges-greater-fiscal-and-political-union-1.1064682.

5 See generally Marco Buti and Nicolas Carnot, "The EMU Debt Crisis: Early Lessons and Reforms," *Journal of Common Market Studies* 50, no. 6 (2012): 899–911.

6 "Merkel Insists on Fiscal Union Before Debt Sharing," *EurActiv.com*, June 28, 2012, http://www.euractiv.com/euro-finance/merkel-insists-fiscal-union-debt-news-513613.

7 "Merkel Warms up to EU Banking Union," *EurActiv.com*, June 5, 2012, http://www.euractiv.com/euro-finance/merkel-warms-eu-banking-union-news-513122.

8 Alex Barker and Peter Ehrlich, "EU Split over Plans for Bank Resolution," *Financial Times*, April 29, 2013, http://www.ft.com/intl/cms/s/0/463e53e8-b0e1-11e2-80f9-00144feabdc0.html#axzz2S29T3uIi.

9 Patrick Donahue, "Merkel Rejects Part of Euro Banking Union, Defends Austerity," *Bloomberg*, April 25, 2013, http://www.bloomberg.com/news/2013-04-25/merkel-rejects-part-of-euro-banking-union-defends-austerity.html.

is currently unwilling to accept (and indeed, which might cause significant legal problems at home in light of prior rulings of the German Federal Constitutional Court).[10]

There is, of course, an alternative vision of "more Europe," one that aims for a "political union" in the most robust sense of the term, in which true political power and legitimacy would be shifted beyond the confines of the member states to supranational institutions. I am thinking here of positions advanced by a whole array of committed European federalists, for example, Jürgen Habermas,[11] the German philosopher and sociologist, or more prosaically, Andrew Duff,[12] the Lib-Dem MEP and President of the Union of European Federalists. Federalists like Habermas and Duff would include in their notion of political union a greatly augmented taxing, spending, and borrowing capacity at the EU level, something that Angela Merkel clearly now rejects. Moreover, federalists call for a deep legal and political transformation of the European Parliament and European Commission into an autonomous legislature and government of the Eurozone, in order to legitimize the expanded fiscal authority of the EU, which they see as a crucial necessity.

From the federalist perspective, in other words, European institutions must become the embodiment or expression of a new kind of democracy transcending national borders, whose legitimacy flows from a single political community ("Europe") rather than from the various national political communities. In the words of Habermas, "the steering capacities which are lacking at present, though they are functionally necessary for any monetary union, could and should be

10 See, e.g., Peter L. Lindseth, "Understanding the German Constitutional Fault Lines in the Eurozone Crisis: Der Spiegel's Interview with Udo Di Fabio," *EUtopialaw.com*, January 12, 2012, http://eutopialaw.com/2012/01/12/understanding-the-german-constitutional-fault-lines-in-the-eurozone-crisis-der-spiegels-interview-with-udo-di-fabio/. See also the cases cited infra, note 32.

11 See, most recently, Jürgen Habermas, "Democracy, Solidarity and the European Crisis" (KU Leuven, Belgium, April 26, 2013), http://www.kuleuven.be/communicatie/evenementen/evenementen/jurgen-habermas/en/democracy-solidarity-and-the-european-crisis.

12 See, e.g., Andrew Duff, "Federal Union Now," September 5, 2011, http://andrewduff.eu/en/article/2011/509160/federal-union-now-new-publication-by-andrew-duff.

centralized only within the framework of an equally supranational and democratic political community."[13] Only then can Europe rise to the challenges confronting it, according to the federalists. As Joschka Fischer, himself a federalist, has put it "It has become common knowledge in Europe that the ongoing crisis will either destroy the EU or bring about a political union" and that there is "[n]o alternative [to the latter] – and certainly not the *status quo*."[14]

Perhaps. But as several speakers at this conference—people with much greater technical expertise than myself—suggested at numerous points in our discussion, there are a number of policy options adequate to stabilizing the EMU in the near or intermediate term that fall well short of "political union" (indeed, well short of "fiscal union").[15] I lack the technical expertise to judge whether that is in fact the case. But what is important here is not technical details of policy but the fact that these options exist at all. Precisely because they exist, they will be tried, certainly before any steps are taken toward full-blown political union on the model advocated by European federalists.

This is true not just because, as leader of Europe's ultimate paymaster, Angela Merkel has a bit more political power than your average philosopher or MEP. Rather, to bring the discussion back to my own area of expertise—the history of modern governance—it is true because Merkel's vision is much more consistent with the overall process of institutional change in integration since its inception. This process has been characterized by the increasing delegation of regulatory power to the supranational level to meet certain pressing functional demands, but the retention of democratic and constitutional legitimacy, for better or worse, within the member states.

13 Habermas, "Democracy, Solidarity and the European Crisis," *supra* note 11.
14 Joschka Fischer, "The Erosion of Europe," *Project Syndicate*, April 30, 2013, http://www.project-syndicate.org/commentary/the-european-union-s-crumbling-foundations-by-joschka-fischer.
15 I am recalling in particular the contributions of Daniel Gros and Hélène Rey, but those of several other economists on the program would likely fit the description as well.

I trace this process in my most recent book, Power and Legitimacy: Reconciling Europe and the Nation-State (2010). "To capture [its] full import," I write:

> one must undertake an examination that is sensitive to change along three interrelated historical dimensions: first, the "functional," in which existing institutional structures and legal categories are brought under pressure and even transformed as a consequence of objective social and economic demands (e.g., international competition, the extension of markets beyond national borders, transnational environmental challenges [or, one might add for our purposes, the exigencies of the Eurozone crisis]); second, the "political," in which divergent interests struggle over the allocation of scarce institutional and legal advantages in responding to these structural-functional pressures; and third and finally, the "cultural," or the ways in which competing conceptions of legitimate governance (often legally expressed) are mobilized to justify or resist these changes in institutional and legal categories or structures.[16]

It is important to add, however, that these dimensions of change are not hermetically sealed; their separation is in some sense simply an analytical heuristic. As I elaborate in *Power and Legitimacy*:

> Of course, the various dimensions of institutional change overlap and the causal relationship among them is varied and multidirectional. Functional change is often seen as the prime mover …. But functional change should not be understood as the "independent variable" in a social-scientific sense—if that were the case, then we would observe much greater evolutionary change in legal and political institutions instead of their notorious "stickiness." Such stickiness can be explained by the fact that structural shifts in the functional dimension (e.g., the extension of markets beyond national borders) are promoted and resisted in the political dimension (e.g., the creation of, or opposition to, transnational forms of governance to regulate those

16 Peter L. Lindseth, *Power and Legitimacy: Reconciling Europe and the Nation-State* (Oxford; New York: Oxford University Press, 2010), 13.

> markets), and then are aided by justifications and interpretations mobilized in the cultural dimension (e.g., theories of constitutionalism or democracy "beyond the state," or invocations of "sovereignty" to define the true locus of legitimate governance as "national").[17]

The approach defined in *Power and Legitimacy* provides insight not merely into the process of institutional *change*, but also, I would maintain, into the likely form of institutional *settlement* that can emerge out of a crisis. I take such settlement to be the central aim of this conference: to understand and predict various possible forms of institutional transformation that might lead to a banking, fiscal, and/or political union as a consequence of the Eurozone crisis. With that focus in mind, I would assert:

> A durable institutional settlement can only emerge … if the processes of change along these various dimensions are somehow "reconciled" in some roughly stable way—that is, if structural-functional and political demands are satisfied but the outcome is still recognizable from the perspective of persistent, though evolving, cultural conceptions of legitimacy.[18]

I would assert that Merkel's conception of "more Europe" comes much closer to the sort of reconciliation between the functional, political, and cultural dimensions of institutional change that has animated the process of European integration for more than a half-century. Despite the fervent hopes of federalists stretching back sixty years, European integration has remained a process of largely instrumentalized rather than idealized supranationalism. Regulatory powers have been transferred to achieve certain defined functional demands of interdependence, but the locus of political legitimacy for those powers has never been properly supranationalized (i.e., rendered autonomous of the members states, as in a genuinely federal system). This tension between supranational regulatory power and national democratic and constitutional legitimacy has shaped the deeper grammar of European governance for nearly a half century, and it will likely continue to do so in this crisis.

17 Ibid., 13, n.37.
18 Ibid., 14.

Federalists may well be right that, today, the optimal solution to the Eurozone crisis is the shift of full-blown fiscal capacity to a strongly legitimated European political "government"—a "political union." But history (not just of European integration but of the modern administrative state upon which it builds)[19] strongly suggests that institutional change is never simply a consequence of functional demands. It also entails a complex process of political and cultural contestation, in which functional demands are satisfied to the greatest extent possible, but the outcome remains recognizable in light of conceptions of legitimacy inherited from the past. And in the case of integration, those conceptions of legitimacy continue to pull toward national institutions, even as functional demands of interdependence—and the resolution of the Eurozone crisis—continue to demand the shift of regulatory power to the supranational level. This is the challenge of "reconciliation" currently facing Europe. And, I would dare to say, *sic semper erat*.

These preliminary thoughts bring me, then, to the second and third questions posed by the conference organizers: the tension between "de jure" and "de facto" political union, as well as what might be the possible "barriers to real political union."

As *Power and Legitimacy* argues in some detail, integration history suggests that there are real limits to what legal and institutional engineering can achieve (what we might call "de jure" integration), particularly in the face of political and cultural resistance (or "de facto" integration). The political union advocated by European federalists is undoubtedly "de jure." It reflects what we might call the *Field of Dreams* theory of integration: "If you build it (legally), then they will come (politically and culturally)." That is: If you just transform the European Commission into a genuine European "government" … if you just make the Commission accountable to an increasingly more powerful European Parliament … ; if you just give the EP authority over a genuine European budget worthy of the name … if, in other words, you just transform European governance into an autonomously "democratic" system beyond the nation-state … , then eventually (but inexorably) democratic loyalty will shift to the Euro-

19 Ibid., 16.

pean level, where it rightly belongs given the scope of authority now exercised by supranational institutions.[20]

This faith in the capacity of legal and institutional engineering, however, reflects a fundamental misreading of European integration history. It confuses regulatory *power* on the supranational level (which is significant) with the shift in democratic and constitutional *legitimacy*—which again, despite the fervent hopes of many ardent European federalists, simply has not occurred.

No doubt, the individual member states have committed themselves to a system of supranational discipline across a whole range of domains, enforced by a European technocracy and court system. This "pre-commitment" is the very essence of European integration and governance. In this regard, the fiscal discipline reflected in the six-pack and two-pack, or in the future system of banking supervision within the ECB, is simply the latest and perhaps most demanding of these supranational commitment mechanisms (although that is debatable). But the key point is this: Even as these commitments shift legal constraints to the supranational level, the democratic legitimation of those constraints remains fundamentally national. In short, these constraints would have no validity without that national affirmation, through ratification of supranational policy goals defined in the various European treaties. The new mechanisms of fiscal surveillance in European public law, which have become the cornerstone of the response to the Eurozone crisis, are in this respect different *only in degree*, but not in kind, from the sort of commitment mechanisms that have been the foundation of European integration and governance in the past.[21] The democratic and constitutional foundations of these commitments have remained national, even if the instrumentalities of these commitments are clearly supranational.

20 See generally Peter L. Lindseth, "Thoughts on the Maduro Report: Saving the Euro Through European Democratization?," *EUtopialaw.com,* November 13, 2012, http://eutopialaw.com/2012/11/13/1608/; see also, e.g., Mattias Kumm, "Democratic Governance of the Euro: Two Practical Suggestions," *Verfassungsblog*, May 23, 2012, http://www.verfassungsblog.de/en/democratic-governance-of-the-euro-two-practical-suggestions/.

21 Lindseth, Power and Legitimacy, *supra* note 16, 110–11.

This brings me, then, to the third and final question, which focuses on the "barriers to real political union within the Eurozone" and what their sources might be. To answer this question, I need to venture a bit into the realm of political and democratic theory, a terrain that economists might find a bit wooly. To make the point about the significant barriers to "real political union," allow me to invoke Lincoln's classic formulation from *The Gettysburg Address*—democracy is "government of the people, by the people, [and] for the people."[22]

The effort to "democratize" the EU commensurate with the vast scope of its regulatory power has over the last several decades made significant achievements along the final two of Lincoln's dimensions. "Government by the people" refers to what academics call "input legitimacy"; that is, popular participation, most importantly via elections (the European Parliament clearly meets this criterion, as do other features of the EU, like the new citizens' initiative in the Treaty of Lisbon). And, despite the many woes of the current crisis, my sense is the EU deserves significant credit in terms of "government for the people," or what the German political scientist Fritz Scharpf has famously called "output legitimacy."[23] This can be measured not merely in additional points added to net GDP as a consequence of market integration (if not of the common currency). But it also includes such things as the removal of border controls; the broadly shared respect for human rights and the rule of law; as well as, perhaps most importantly, the overall sense of peaceful co-existence that integration has brought to this historically troubled continent. (Peace, after all, was the stated aim the Schuman Declaration in 1950.) This "output legitimacy" has given the aspiration of European integration a great deal of power.

So what, then, is the problem with the EU's democratic legitimacy and what sort of barrier does this pose for the creation of an eventual political union? I would say the problem lies precisely in Lincoln's threshold criterion: "government of the people." This refers to the

22 The following discussion is drawn from Peter L. Lindseth, "Of the People: Democracy, the Eurozone, and Lincoln's Threshold Criterion," *Berlin Journal* no. 22 (2012): 4–7, http://www.americanacademy.de/sites/default/files/Lindseth.pdf.
23 Fritz W. Scharpf, *Governing in Europe : Effective and Democratic?* (Oxford; New York: Oxford University Press, 1999).

historical identity between a population and a set of governing institutions; that is, to the political-cultural perception that the institutions of government are genuinely the people's own, which they have historically constituted for the purpose of self-government over time. Europeans may favor integration for all sorts of instrumental and indeed even deeply emotional reasons (certainly the latter is true among federalists). But Europeans, by and large, do not yet experience the institutions of integration as their "own" in the sense of democratic self-government.

Take, for example, the European Parliament, which federalists usually posit as the cornerstone of a future political union.[24] To my mind, despite the effort to replicate a strongly-legitimated legislative assembly on the supranational level, there is no better example of the disconnect between power and legitimacy in European integration than the EP. This body participates in the exercise of real legislative power; it is isomorphically structured along the lines of a national legislative assembly; and yet it does not represent, as yet, a historically coherent political community capable of legitimizing the EP in an autonomously "democratic" and "constitutional" sense. The persistent legitimacy difficulties of the EP demonstrate the limitations of what, since 1999, I have called the "parliamentary democratization strategy."[25] The EP's legitimacy, like the legitimacy of the EU as a whole, is derivative of the legal commitments made by the member states in the treaties. The EP serves a critically important functional and political purpose in integration, no doubt. But the citizens of Europe do not see it, culturally, as an embodiment or expression of the capacity of a new European political community to rule itself in autonomously constitutional terms.

What the experience of the EP to date demonstrates is that the democratic legitimacy necessary to support political union in the deepest

24 See, e.g., European Commission, *A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate*, COM/2012/0777 Final, 35, accessed May 28, 2013, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0777:FIN:EN:PDF

25 Peter L. Lindseth, "Democratic Legitimacy and the Administrative Character of Supranationalism: The Example of the European Community," *Columbia Law Review* 99, no. 3 (1999): 672–83.

sense depends not merely on democracy's inputs or outputs. Rather, it ultimately depends on whether there exists this crucial sense of historical identity between governing institutions and a political community self-conscious of itself as such—what we might call "demos-legitimacy." As is well known today, the EU is riddled with multiple "demoi" across its various member states. This creates a great deal of democratic and constitutional legitimacy, unfortunately not for the EU, but for national constitutional bodies. (There are exceptions, of course, such as in Belgium, Spain, or even the UK, where the coherence of the national demos is deeply contested, thus undermining the legitimacy of national institutions.) Regardless, the persistent "polycentric" character of Europe is something "deeply rooted in the history of [the] continent."[26] Thus, as is broadly recognized throughout Europe, the EU, as yet, lacks any single, overarching European demos. And without such demos-legitimacy—that is, without the sense that European institutions are genuinely the people's own, rather than some distant bureaucratic or juristocratic construct—Europe will always have a great deal of difficulty overcoming its democratic deficit, no matter how much input and output legitimacy otherwise exists.

Given the lack of demos-legitimacy in the EU, the very idea of a "democratic deficit" may itself reflect an elite misapprehension of the nature of the problem. The problem in the EU is not a democratic deficit, in the sense of needing increased input legitimacy, but rather a democratic disconnect:

> The notion of a democratic deficit focuses our attention exclusively on the [supranational] level and implies that democratization of supranational norm-production can take place through changes made largely if not entirely within the confines of supranational institutions (e.g., an augmented role of the European Parliament) …. The notion of a democratic disconnect, by contrast, focuses our attention on the relationship between supranational institutions and national oversight and control. It does not deny the need for greater transparency and participation in

26 Giandomenico Majone, *Dilemmas of European Integration: the Ambiguities and Pitfalls of Integration by Stealth* (Oxford; New York: Oxford University Press, 2005), 173.

> the [supranational] regulatory system, but it suggests that any democratization strategy must, at least in part, include a rethinking of the linkages between supranational norm-production and democratic legitimation derived from the national level.[27]

Indeed, as I have written previously with regard to banking union,[28] it is very likely that the German Federal Constitutional Court (Bundesverfassungsgericht) will insist on heightened national parliamentary scrutiny of the single supervisory mechanism under the auspices of the ECB,[29] or the use of the ESM for bank recapitalization. And the same will certainly be true of any expanded resolution authority on the supranational level. In addressing these institutional innovations, the Court will need to reconcile, as it always struggled to do, the functional demands of the Eurozone crisis with the constitutional imperative of preserving the democratic character of the German state in a culturally and historically recognizable sense.[30]

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27 Peter L. Lindseth, "Delegation Is Dead, Long Live Delegation: Managing the Democratic Disconnect in the European Market-Polity," in *Good Governance in Europe's Integrated Market*, ed. Christian Joerges and Renaud Dehousse (Oxford: Oxford University Press, 2002), 151.

28 Peter L. Lindseth, "'Dual Legitimation', Banking Union, and the *Demokratieprinzip* in Germany: Initial Thoughts After the Recent European Summit," *EUtopialaw.com*, July 9, 2012, http://eutopialaw.com/2012/07/09/dual-legitimation-banking-union-and-the-demokratieprinzip-in-germany-initial-thoughts-after-the-recent-european-summit/.

29 The current compromise proposal on SSM includes some provision for national parliamentary scrutiny, but it gives the bulk of the scrutiny rights to the European Parliament. Moreover, the language relating to national parliamentary scrutiny is precatory while the corresponding language for the EP is mandatory and much more detailed. Compare Articles 17 and 17aa, Council of the European Union, "Proposal for a COUNCIL REGULATION conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions," April 16, 2013, http://register.consilium.europa.eu/pdf/en/13/st07/st07776-re01.en13.pdf. Whether such a compromise will prove satisfactory to the German Federal Constitutional Court remains to be seen.

30 Peter L. Lindseth, "National Parliaments in European Integration: Europeanization, Renationalization, or Reconciliation?," *EUtopialaw.com*, March 1, 2012, http://eutopialaw.com/2012/03/01/national-parliaments-in-european-integration-europeanization-renationalization-or-reconciliation/.

Even in calmer circumstances, this was not an easy balance to strike.[31] In the current crisis atmosphere, it has been especially difficult.[32]

However, precisely because this challenge of reconciliation has been and continues to be so difficult, there is inevitably downward pressure on the scope of authority that supranational bodies can legitimately exercise, given their lack of autonomous democratic and constitutional legitimacy. As Stefano Bartolini presciently warned in his 2005 book *Restructuring Europe*, "the risk of miscalculating the extent to which true legitimacy surrounds the European institutions and their decisions . . . may lead to the overestimating of the capacity of the EU to overcome major economic and security crises."[33] In other words, overestimating the legitimacy of European institutions is not merely an error of academic analysis; rather, it can lead to even more profound and dangerous errors of institutional or policy design.

The events of the last three years suggest that the EMU, in its original conception, was built on just such an overestimation of supranational capacity. The common currency was not just flawed economically (although economists never tire of pointing out that the countries of the Eurozone—and certainly Germany and Greece—do not constitute what they call an "optimal currency area"). Rather, it was also flawed constitutionally, in terms of its lack of a foundation in demos-legitimacy and therefore ultimately in the necessary degree of solidarity to support a genuine political union. Given the downside

31 See, e.g., BVerfG, German Lisbon Decision, 2 BvE 2/08, June 30, 2009, http://www.bundesverfassungsgericht.de/entscheidungen/es20090630_2bve000208en.html (2009).

32 See, e.g., BVerfG, Greak Bailout Decision, 2 BvR 987/10, 2 BvR 1485/10, 2 BvR 1099/10, September 7, 2011, http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg11-055en.html (2011); BVerfG, Bundestag Right of Participation/EFSF, 2 BvE 8/11, February 28, 2012, http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg12-014en.html (2012); BVerfG, Bundestag Right of Information ESM/Euro Plus Pact, 2 BvE 4/11, June 19, 2012, http://www.bundesverfassungsgericht.de/en/press/bvg12-042en.html (2012); BVerfG, Rejection of Temporary Injunctions ESM/Fiscal Compact, 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvE 6/12, September 12, 2012,

33 Stefano Bartolini, *Restructuring Europe: Centre Formation, System Building, and Political Structuring Between the Nation State and the European Union* (Oxford: Oxford University Press, 2005), 175.

risks that the Eurozone crisis is now revealing, the adoption of the euro presupposed a degree of centralized political power and legitimacy—most importantly relating to shared taxing and borrowing authority—that the EU, or rather the Eurozone countries collectively, simply lack and are not about to gain any time soon.

So why not just solve the problem by creating the long-sought "political union" to match the currency union? The answer is simply stated, even if its manifestations are complex: "no demos," or rather, "no sense of European solidarity commensurate with the functional demands of the Eurozone crisis." Within a demos-based polity, it is "we" who are governing "ourselves" rather than being governed by "others." And when it comes to taxation, borrowing, and spending, the existence of a demos is crucial to formulating policies on a scale with real macro-economic significance (not the measly 1% of European GDP that is the current EU budget).[34] Within a demos-based polity, these fiscal actions involve moving money "among ourselves." But in a polity not based on a demos (alas, the EU, as well as the Eurozone), those actions are often perceived as giving money away to "others."[35]

European federalists cannot simply wave the political-cultural magic wand and create the necessary sense of democratic and constitutional self-consciousness across national borders that constructing such solidarity (and hence political union) would demand.[36] To do so without the requisite demos-legitimacy—the sense of "government of the people"—would be the institutional equivalent of pouring good money after bad. At this point in Europe's history, it cannot get from here to there.

Nevertheless, the Eurozone crisis may yet force Europeans into a fundamental constitutional choice, particularly if the functional de-

34 See, e.g., Paul Krugman, "What A Real External Bank Bailout Looks Like," *Conscience of a Liberal*, July 17, 2012, http://krugman.blogs.nytimes.com/2012/06/17/what-a-real-external-bank-bailout-looks-like/.

35 See generally Peter L. Lindseth, "Cyprus … or Why the 'No-Demos Problem' Defines the Policy Response to the Eurozone Crisis," *EUtopialaw.com*, March 27, 2013, http://eutopialaw.com/2013/03/27/cyprus-or-why-the-no-demos-problem-defines-the-policy-response-to-the-eurozone-crisis/.

36 See, e.g., Habermas, "Democracy, Solidarity and the European Crisis," *supra* note 11.

mands of this crisis compel them to confer real fiscal capacity on an autonomous and strongly-legitimated European "political union." No prior step in the integration process has really presented this choice—not the Treaty of Maastricht, not the failed Constitutional Treaty, not the Treaty of Lisbon, indeed not even the Fiscal Compact. Each of those treaties was built on a "pre-commitment" theory of European integration, in which only the power to enforce prior member-state policy commitments migrated to the supranational level, but actual democratic and constitutional legitimacy for those commitments necessarily remained national.

My sense, however, is that it is still unlikely that Europeans will, via the Eurozone crisis, finally cross the political-cultural Rubicon—what Habermas has called "the red line of the classical understanding of sovereignty"[37] — and attempt to create an autonomous European government with a political and constitutional legitimacy (and concomitant fiscal capacity) of its own. I may well be proven wrong on this point, particularly if the crisis deepens. But what is certainly true is that, no matter how much European federalists may attempt to legally engineer the result, the resulting "political union" will be tenuous unless and until Europeans "change fundamentally their understanding of what democratic self-government means, or where it is located."[38]

37 Ibid.

38 Peter L. Lindseth, "Author's Reply: 'Outstripping,' or the Question of 'Legitimate for What?' in EU Governance," *European Constitutional Law Review (EuConst)* 8, no. 01 (2012): 160.

13
The Crises in Which the Euro-Crisis Resides

Richard Parker

I first came to Florence in November, 1966. The Arno had flooded and the city's irreplaceable treasures seemed about to be lost forever. I was nineteen, an American in my third year of college, on my first trip abroad, and I'd flown to Europe in late August to spend the fall at the Universite de Montpellier, two hours southwest of Marseilles. By early October, I had a French girlfriend and a Japanese motorcycle, and to celebrate my twentieth birthday on November 5th, we'd decided to go to Florence.

By November 3rd, Florence was no place to celebrate anything. Europe by then was transfixed by the almost minute-by-minute radio and TV reports from Tuscany: the Arno, swollen by unprecedented rains in the Apennines and rechanneled by poorly-planned growth that had destroyed much of its natural floodplains, was rising relentlessly. By November 4th, beautiful Florence, bisected by the Arno, was drowning in a turbulent, unrelenting Noahtic nightmare of mud and debris.

The city's mayor called for volunteers to come help—Florentine and Tuscan government capacities were being overwhelmed. With two of my classmates, I caught the train to Tuscany the morning of my birthday. By evening, we were nearly there, after changing trains in

Marseilles and Milan. Then shortly after leaving Milan, a conductor came down the aisles telling everyone that the station in Florence had been closed, that our train would be stopping shortly, and we'd all have to get off.

That stirred a hurried (and rather anxious) little conversation among the three of us. We had no idea what to do, but when the train stopped, it was at a little station where a small convoy of trucks from the local municipality was about to depart for Florence. Fortified by the bottle of cheap red wine we'd purchased in Milan, in a broken Franco-Italian-American patois, we talked our way into the back of one of the trucks.

Our convoy reached Florence six hours later, just after dawn; within half an hour, we were working, industriously but rather haphazardly, alongside the men who'd driven us here.

For four days, we toiled in what seemed a dedicated but disorganized rescue effort. We filled sandbags, shoveled mud out of churches and shops, and hauled debris of all sorts—chairs, boxes, refrigerators, TVs, baby strollers, mattresses, magazines and books and kitchenware and clothes—to massive piles. We slept little, when we did crawling into the damp sleeping bags we'd brought with us, curling up on empty church pews or a restaurant table or the back of a flatbed truck. Coffee, pasta, apples and cheap red wine made its way among the rescuers, staving off hunger.

On the fifth day we left. By then it seemed thousands had arrived to help—and with our abominable Italian and lack of construction skills, we were surely among the least efficient or useful of the foreigners there. By then, our clothes were filthy, our hair matted, our sleeping bags soaked. A couple of passengers quickly moved a few seats away when we boarded one of the few trains allowed to leave Santa Maria Novella.

As we headed to Milan, and from there to Marseilles and Montpellier, we told ourselves that even though we'd not done that much, we'd been stout-hearted and thick-armed (and perhaps a bit crazy for coming in the first place)—but we also felt a certain amount of pride in the little we'd contributed: we'd helped save Florence.

Back in Montpellier when we told about our adventure, people bought us drinks, clapped us on the back, and several French girls were especially kind.

In the fall of 2007, forty years later, another flood—an extraordinary flood—suddenly started sweeping over not just Florence or Italy but all of Europe and indeed the world, as relentless torrential waves of debt, default, distrust, and dismay poured out. This time the flood rose not from the Arno but from the Hudson and the Thames, and soon enough the Rhine and the Seine. And this time it fell to frightened central bankers to fill sandbags and anxious prime ministers and exasperated finance ministers to wade into the mess and begin clearing the debris—and as of today, I'm not sure they can claim more credit for what they've achieved than my friends and I did for what we accomplished in 1966. It's something—but it's not been enough.

In November 2009, in the midst of this sodden, turbid, and broken landscape, as the first wave of what the press calls The Great Recession (but I prefer to call The Great Anglo-American Flood) seemed to be cresting, I came back to Europe—but not to Florence.

This time it would be Athens, where my friend George Papandreou had just become prime minister. I was by now a macroeconomist teaching at Harvard, and we'd known each other for years. In a phone call shortly after the election, he told me he'd discovered that his predecessor had passed on to him a budget that wasn't just 6% in deficit as the government had insisted weeks before the elections; it was twice that—over 12% (and very likely even worse). If he admitted this publically, his finance people were telling him it could start a second wave of financial flooding that might very well overwhelm Greece—and perhaps worse, Europe. Would I come over and help?

And so, I found myself heading off to Europe again. This time, though, I stayed longer: Greece would prove to be the start of the second wave of the Anglo-American flood, Europe's own version of "The Lehman Moment"—and so I ended up commuting back and forth between my Harvard teaching and Maximou, the Greek White House, for more than two years. At the end, in January 2012, when Papandreou resigned and a caretaker technocrat (a Harvard economist colleague, as it happened, who'd recently left the ECB) took his place, I left feeling unsure whether I'd been able to do much more than I'd done in 1966, which was help clear away debris, contributing some small amount to diminishing the consequences of this new disaster.

This time, however, I came away understanding far better how this quite manmade Anglo-American Flood had come about—in both its first 2007 Lehman-AIG and then its second, Greco-Lehman, forms. I also carried away a determined and very clear set of convictions about how not only to resolve the flood's ongoing damage but prevent it from happening again.

To explain what I learned, let me execute what may seem a rather odd shift, by discussing dolls instead of floods. This is because I now see the second financial flood that seemed to spring from the Greco-Lehman moment—what is habitually now called "The Euro-Crisis" — as better understood as a middle-sized figure in one of those curious Russian *matryoshka*, in which a series of smaller wooden dolls nest consecutively inside larger ones.

The smallest doll in this *matryoshka* was (and is) little Greece and its initially little fiscal crisis—the country, after all, is barely 2% of Europe's GDP and its "enormous" budget deficit a tenth of that. The next larger doll is the gigantic European Union (the world's largest economy) with its monetary union woes—broadly "the Euro-Crisis doll." But the Euro-Crisis doll sits inside a third and much larger doll in turn: the three-decade-long American- and British-originated re-drawing of financial market rules and their underlying intellectual legitimation.

This Anglo-American Finance doll in turn fits inside the fourth doll, representing a yet larger conservative global re-crafting of public regulations governing the economy in a number of ways. (By the way, I don't consider this "re-crafting" the same as "deregulation," but that is for another lecture.)

The fifth—and largest— doll by far is the one that concerns me the most because it represents this: the question of what 21st-century Western democracy will become as the East, with its enormous population, low wages, and economic potential, rises over the West. I'm in particular concerned about what lies ahead for the Democracy doll in terms of the scope, shape, and balance between democratic governments' visible hand and their economies, domestic and international, that have never operated—East or West—with quite the invisibility that the more ardent followers of Adam Smith (unlike Smith himself) have seen as its beauty. That also means I'm also consequently deeply concerned about who will lead those debates about allocations of wealth among and within nations, and for whom and what values they will speak (more on that momentarily).

Let me now execute a quick second shift, from my *matryoshkas*, to say more about why the future of democracy so concerns me. It lies first in the recency of the democratic experiment itself, and the thinness of the cultural-historic soil in which it is planted. Early in my Oxford graduate work, I was powerfully influenced by three quite legendary books: Barrington Moore's magisterial *Social Origins of Dictatorship and Democracy,* C.B. MacPherson's rather neo-Hegelian *Political Theory of Possessive Individualism*, and Karl Polanyi's enduring *The Great Transformation*. (Training in economics forty years ago required a somewhat broader knowledge than today.)

Drawing on them in years since, I've come to see modern democratic republicanism as evolving through five distinct stages since 1776. I count the American colonists and the French intellectuals and s*ans-culottes* as initiating Stage I, by throwing off colonialism in one case and monarchy in the other. Both were dramatically original at the time, and begun only a decade apart, each initially fed hopes and practices in the other, and both have ever since been over-claimed (by later metrics) for the democratic scope of their original "democratic" achievement, not least because one maintained slavery while the other plunged into tyranny, empire, and squalid reaction.

Stage II emerged after Waterloo as a two-fold revolutionary struggle, and would last more than a century. One contest was between monarchy and rising parliamentary democracy; the other was over who would choose the members of parliament, and both struggles were waged recurrently across Europe and Latin America—and in nascent ways in some parts of Asia. By 1914, this twin political struggle had established the fundamental idea of elected rulers in many countries, chosen regularly by varying (but by today's standards, severely limited) franchise; the era of inherited—even divine—right to govern without the advice and consent of the governed—was ending after nearly 10,000 years.

However, as we all well understand, this had become by the early 20th century the popularly-preferred but not institutionally fully-realized form. Thus from the defeat of Napoleon to the the assassination of Archduke Francis Ferdinand, it produced a combustible string of uneasy monarchic/parliamentary franchises that left open how broadly suffrage would extend and over which societal institutions the rules of democracy would reign.

Stage III started and ran later, roughly from 1848 to 1945—and laid political-economic claim in its socialist and social democratic theories to both universal suffrage <u>and</u> to extensive (in some variants even near-total) public control of the new and rapidly-rising institutions of capitalism, in particular the corporation and finance. To the extent this was a "revolution from below" against the rising dominant economic form of capitalism in the name of the rising dominant political form of democracy, it would prove more successful because those "below" aristocracy cut a broad swath in all societies; to the degree Stage III augured victory for a newly-created industrial working class—rather than the competing urban middle class—it was not a success and in the thirty fraught years between Sarajevo in 1914 and Yalta in 1945, spawned fascist and communist experiments and the two bloodiest wars in human history.

Stage IV began (at least in Europe) in 1945, lasted 30 years, and is what I call the Bretton Woods era of democracy. That is, it was a stage formed to a great degree by the particular internationalist dreams of the United States and acceded to by Europeans because Europe after World War II had no other choice save Moscow's suzerainty (or worse, a return to the brutality of the interwar and war years). The dream that evolved over the 70 years after Bretton Woods convened—and then the break induced in that system by Richard Nixon in 1971, with the rise of the Reagan/Thatcher democratic era that followed— have brought us here.

The democratic political institutions that spread steadily after World War II across Western Europe (and then Central Europe in a leap after 1989), have affixed both the political mechanics of parliamentary power and a near-universal franchise. In both regards, Stage IV has completed the Stage II process, and moreover is part of a wider achievement that has done the same across Europe, North and South America, a substantial part of Asia (and to a lesser degree, Africa).

But the issues of Stage III—the questions of the scope of political democracy in relation to economic power—remain complex and nowhere simply resolved. For Europe, the Monnet-Schuman process, and the original Common Market that emerged from the Treaty of Rome, fit Bretton Woods goals and assumptions by focusing on increasing production (and jobs) through trade, lowering tariffs and (while maintaining fixed currencies) loosening capital controls—all treated as instruments to strengthen democracy first, and capitalism secondarily. When Richard Nixon destroyed Bretton Woods in 1971, and OPEC followed suit by quadrupling oil prices to recover lost purchasing power two years later, a new era began—a Stage V "Bretton Woods redux" era emerged in which the dollar still reigned supreme internationally but was tied more closely to oil (and from the 1990s onward, through trade-for-Treasuries, with China) than gold.

Europe has repeatedly found itself in international economic quandaries in Stage V: member countries had recovered from World War II's devastation, thanks to Bretton Woods' fixed currency relations, Washington's benignly indulgent interpretation of "free markets" that allowed European capital controls to remain in place well into the 1960s in exchange for American multinationals' freedom to enter Europe's consumer markets, and cheap energy—first indigenous coal, and then as Europe became a "car culture" like America in the late 1960s, Arab oil. After 1973, however, Europe faced stagflation, much more expensive oil, and unstable currencies and interest rates that made smooth growth (especially trade-led, high-wage, high-employment growth) far more complicated, a difficulty that compounded as America and Japan turned toward much more rigorous competition internationally.

Floating currencies exacerbated that competition—and led both Bonn and Paris (and for a time London) in the late 1970s to seek ways to recreate something like the stability of Bretton Woods' fixed exchange era—at least inside Europe. (Given the volume of intra-European trade and its constant growth after World War II—and its centrality in maintaining a peaceful prosperity for most—that was a shrewd, albeit straightforward enough, idea.)

But as Europe moved toward creating its own multinational version of America's deeply-integrated continent-sized markets, America, OPEC, and Asia—one after the other—intervened to destabilize Europe's half-moves toward integration. First had been President Nixon's float in 1971—done without warning or consultation. A decade later, the EMS (and the pound) fell to chairman Volcker's policy-induced recession that was meant to crush the inflation that grew from OPEC's second great price hike in 1979. With Ronald Reagan in the White House, and Prime Minister Thatcher at Downing Street, the US, Great Britain, and their capital markets then quickly humbled Francois Mitterand's *dirigiste* plans for massive nationalizations and wage increases through hour reductions—a national plan that French Socialists had somehow thought could be exported, more or less harmoniously, across the continent. Starting in 1985, the Plaza Accord dramatically lowered the dollar's exchange rate in a show of America's continued hegemonic strength that was supported in starkly bipartisan fashion, embraced by the nation's "free market" right as much as by (what then remained of) the Keynesian left.

Washington may have aimed the Accord mainly at Tokyo but it was felt across Europe (and especially in Germany) as a shock to both European nations' growth and sovereignty. Jacque Delors quickly parlayed Franco-German dismay into passage of the Single European Act a year later. From there to creating the Euro was a small step technically and would finally be politically achieved in exchange for not blocking Helmut Kohl's unilateral move to unify the two Germanys after the Wall fell.

Bretton Woods democracy in its heyday from 1946 to 1971 had worked well when governments and goods economies led, and financial markets were small and hemmed in by the legacy of Depression-era controls. That wasn't the case by the 1990s. As innumerable critics warned time and again (though often for widely divergent political reasons), Europe's construction of a common monetary union without a parallel fiscal union or an EU central bank with lender-of-last-resort powers would not go well.

What few of the Euro's planners (or critics) recognized was that far more than those two inherently internal structural design flaws, the much larger and very real danger lay with the Anglo-American-led redrawing of financial regulation, the spread of high-speed IT to globalize the consequences of those decisions, and the eager mimesis of New York and London across Europe.

Trying to make the Euro work was never going to be easy in an era of high-volume, high-velocity global financial markets, with opaque actors and products, flaccid credit agency oversight, and inconsistent, weak public regulation (weak everywhere and inconsistent between nations—and even sectors of financial markets themselves; I think here, as one example, of rules and oversight for banks but not for hedge funds).

Exiting this Stage V for a more stable and equitable Stage VI is going to be tricky. Politically, it requires universalizing democracy, moving it from the political institution under which less than half the world lives now to one under which nearly all live (in this it resembles the domestic fight of Stage II to expand suffrage in the late 19th/early 20th centuries.)

Yet, at the very moment democracy should be universalizing, in its European and American heartlands, public confidence in public leaders and public institutions is at disastrous lows. Well before either the Lehman-AIG crash of 2007 or the Greco-Lehman collapse of 2010, Europeans had lost confidence in Brussels' leadership class, and in the project itself. That class— "la bruxelloisie," as a journalist friend of mine calls it—has shown itself (like most national politician classes) so far incapable of even beginning to confront the large challenges that lie ahead for Europeans and Americans alike, and why the old power configurations (including the West's overarching five-century-long global hegemonic reach) are no more durable going forward than monarchy's chances were a century ago—though few in European elites fully understood that (apart from an over-optimistic left).

But universalizing suffrage and establishing fundamental democratic institutions and norms in the political sphere isn't the end of the problems ahead. We desperately need now global democratic rules to govern cross-border, multi-state activity of all kinds—from ocean fishing to migration to security against non-state terrorism. Even more we need new lines between markets' invisible hand and governments' visible ones in the domestic economies of the democratic world. We no less need new boundaries and rules framed in an international scale, not a national one that encompass corporations, trade, finance, labor, the environment, etc.

The global political problem is that the global East and South are large, getting larger, and hungry to produce and consume at Western levels—but in many cases have political institutions (parties as well as government) that are at best only weakly democratic. Universal suffrage in one-party states is not democracy.

At the moment, Washington is turning more and more toward Asia and away from Europe. Europe and North America encompass the richest and most democratic democracies and yet in Stage V—in an almost perfect reversal of the trends of Stage IV—their economies were austere and increasingly inegalitarian even before the recent austerity adopted in the wake of the Great Recession. Popular support for politics in general is eroding in Europe—certainly for Euro-politics. Center-right parties have no imaginative solution save austerity—and left-of-center parties offer no plausible solutions save defending the status quo and Keynesian stimulation. None of this is forward-looking, only place-holding—and place-holding, given the monumental shift of power from West to East that is underway, is not a viable option.

Western intellectuals have failed since expanding and elevating human rights and environmental claims 40-50 years ago to synthesize a description of Stage VI democracy, or their roles in it. "A little more of the same" is not a political program, but a sentiment—whether voiced by conservatives in defending austerity or the left in defending nationalist Keynesianism in a globalizing world. In the most banal terms, Europe and the Euro, I'm afraid, are doomed to survive. Whether they survive as somewhere and something important in the 22nd century—or merely as historical theme parks—remains quite open.

14
Speech to the European University institute

Tony Barber

The crisis consists precisely in the fact that the old is dying and the new cannot be born; in this interregnum a great variety of morbid symptoms appear.
Antonio Gramsci, The Prison Notebooks

These famous words of Gramsci, written as he languished in one of Mussolini's prison cells in the 1930s, strike me as apt when one considers today's Europe. Since the eruption of the western world's financial crisis in 2008, we have been stuck in Europe between a pre-crisis past remembered, rightly or wrongly, as comfortably prosperous and stable and a future whose contours are defined by insecurity and unpredictability. As for morbid symptoms, we have them in abundance: prolonged economic stagnation or recession, mass unemployment, demographic decline, squeezed middle classes and malfunctioning welfare states, tensions over immigration, corruption scandals in our political systems, the spread of organised crime, rising political populism and, if we are to believe the results of opinion surveys conducted for the European Commission[1], a yawning gap between what happens at an institutional level in Europe and what citizens regard as relevant to their lives.

1 European Commission, 'Special Eurobarometer 379: Future of Europe' (Brussels, April 2012).

It is on this last point that I propose this evening to make some observations, for nothing in the end will be more dangerous to the European Union, and the eurozone, than the erosion of the bonds of trust that have allowed citizens to place at least some confidence in these still relatively young experiments in multinational co-operation. Of course, the gap between European institutions and peoples is matched, at national level, by declining allegiance to traditional political parties and declining faith that politicians hold the answers to the modern world's most pressing challenges. This process owes something, too, to the steady disappearance of the class, religious and clan loyalties that shaped how people voted in the 20th century.

But in the societies worst hit by the crisis, the perception has gained ground that the solutions devised by Europe's political leaders and bureaucratic experts are actually making matters worse, by requiring the imposition of synchronised austerity on depressed economies – a policy course that seems never to change even when a nation's voters, in a free election, throw out one lot of politicians and throw in another.

This is most noticeable in Greece and, more lately, Cyprus, in both of which countries, I might add, the European consciousness that has accompanied the emergence of younger generations is a rather recent phenomenon and by no means an indelible feature of national identity. But Greece and Cyprus are not the only examples of alienation from the European establishment. Arguably, a more disturbing case is Portugal, where political elites and the broad mass of citizens – people who once embraced Europe as the guarantor of a dignified and modern way of life – have swallowed the anti-crisis medicine prescribed for them by their European peers, only to discover that the cure is little closer than at the start of their treatment. Portugal's present government is still, of course, trying to hold the fort, but the constitutional court's recent rejection of a batch of austerity measures shows that resistance to Europe's prescriptions has spread from society to the guardians of the legal and democratic order established after the 1974 revolution.

For me, the court's ruling was a terribly important statement, because in effect it was saying that 1974 was a foundational moment for Portugal, a moment when a new national social contract was written, and no one – least of all, foreigners – has the right to tear up this social contract, because it expresses our modern identity.

The frustration of the powerless is all the stronger because, contrary to what is imagined in some eurozone creditor states, large numbers of citizens in the bailed-out countries – and I include Ireland here as well – proved perfectly willing in 2010 and 2011 to criticise themselves for their pre-crisis recklessness. They accepted the trade-off between sacrifices at home and solidarity from abroad. But external solidarity turned out to be a cake with a poison plum inside. And the capacity of human nature to engage in indefinite self-criticism is no stronger than it is to endure indefinite stomach disorders. No sinner, whether well-fed or hungry, jobless or employed, will tolerate a lecture in economic morality for the rest of his days. Apathy, pride, resentment and revolt will breed in his heart in close proportion to the self-righteousness of the lecturer. So if this is what is stirring in the relatively small eurozone states that have been bailed out over the past three years, I leave it to your imagination what furious passions would be unleashed if the same potions and homilies turn out to deliver the same lack of success to relatively large states such as Italy and Spain.

Hesitant crisis management of this kind is sowing divisions across the European financial, economic, social and political landscape. The long-term borrowing costs of states, and of private companies within those states, diverge sharply between what in loose geographical terms we call northern and southern Europe. Competitive advantages pile up on one side to the detriment of the other. Private sector capital flees troubled states and redoubles the distress already inflicted on their citizens by fiscal austerity. Once solid banks are dragged towards the abyss by the weakness of sovereign bond issuers. The superficial integration of financial markets achieved in the euro's first decade is no more[2]. I see that David Lipton at the IMF summed up Europe's condition this week as one of "weak growth, fragmented markets, impaired balance sheets and half-completed reforms."

2 Philip Whyte, 'Alice in Wonderland: What Political Union for the Single Currency?' (Centre for European Reform: (London, 9 October 2012).

You might say, as some do in Brussels, well, it was much worse 12 or 18 months ago, and some imbalances are in the process of being redressed. Yet I find it hard to avoid the conclusion that the turbulence of the past three years, though clearly originating in misbehaviour and policy errors going back all the way to and beyond the euro's launch in 1999, owes a great deal also to the misjudged attempts at recovery from crisis. It is, you could say, an architectural problem – by which I mean that, if a tornado damages the roof and walls of your house, there are good ways and bad ways of repairing them. As several Brazilian and Chinese friends have reminded me, Europe is a wealthy place and it owns all the materials required to strengthen the roof and walls. But the architects, bricklayers and roofers are going about their work in laborious and sometimes contradictory fashion, because they cannot agree among themselves on how to insure themselves against future tornados and how to cover the cost of the first tornado.

The consequences of this indecision are not only that Europe's citizens feel cut off from Europe's power centres, but that the political and technocratic elites of certain countries find themselves handcuffed to a project in which idealism is giving way to fear that it is delivering precisely the opposite results to those anticipated in the 1990s. I will confine my remarks here to three countries. First, I regard it as inconceivable that any Italian politician would have argued 15 years ago that the benefits of sharing a monetary union with France and Germany were worth the price of an almost complete absence of economic growth since entry into the eurozone, bond yields permanently higher than those of Germany and sometimes at dangerous levels, a financial sector gasping for capital, and the seemingly permanent threat of entering an international life support ward next to Greece and Cyprus.

Secondly, I would recall that, in French eyes, the entire point of going ahead with the euro was to establish equality in a European dimension with an inevitably more powerful post-unification Germany, to regain a modicum of control from the Bundesbank over Europe-wide monetary policy, and in this way to continue the rather successful post-second world war strategy of using Europe to protect and advance French national interests[3]. The crisis has torn these ambitions to shreds, and it is far from clear what Paris plans to do about it. Less than a decade and a half after the euro's launch, Germany's economic supremacy over its partners in the monetary union is more pronounced than ever. Moreover, it has become increasingly apparent during François Hollande's presidency – though the signs were there in Nicolas Sarkozy's 2007-2012 spell at the Elysée as well – that the Germans regard French efforts at fiscal and economic reform as inadequate to the challenges that lie ahead. In short, the crisis is exposing as somewhat hollow the pre-euro notion of a Franco-German couple operating in balance and in mutual confidence.

As for Germany itself, the unshakeable self-belief that characterises German attitudes at EU and eurozone sessions on economic policy masks a feeling, similar to that in Rome and Paris, that monetary union is turning into a creature very different from the tame, house-trained pet they thought they were getting in 1999. This one bites, scratches, costs money and never says thank you. To put it in more concrete terms, Germany did not expect that giving up the Deutschemark might require propping up weaker nations for eternity by means of a banking union, fiscal transfers or what are loosely known as common eurozone bonds. Germany did not expect that the European Central Bank, modelled quite deliberately on the Bundesbank, would one day cast aside core Bundesbank principles. Still less did the Germans expect their democratically elected leaders to be labelled arrogant representatives of a Fourth Reich, as in bailed-out Greece, or even to be dismissed as "stubborn," as Jacques Delors branded Angela Merkel in March 2012[4].

If truth be told, Germany's political classes have shown considerable patience in coming to the rescue of one embattled country after another, and much resilience in holding together a consensus among the main political parties for pursuing this course. I, for one, believe that Germany is ready to do much more. Yet it is only a belief, based on more than 30 years of living in, working in and visiting

3 Simon Tilford, 'It's the Politics, Stupid!' (Centre for European Reform: London, April/May 2013).

4 EurActiv.fr, 'Jacques Delors flingue l'Union européenne de Merkozy' (Brussels, 30 March 2012).

Germany. I cannot state with confidence what Germany's end vision of European integration is and how it proposes to get there. I appreciate all the domestic social and political constraints that slow down German action, but I worry that this slowness is giving time and space for the political and social fabric in other countries to wear down, and for a loss of faith in the European idea to spread further across the continent than at any time since the second world war.

I am talking here about one vital element in the quadruple identity of citizens: the element that is not local, not regional, not national, but European. People in the most economically stricken countries are questioning this fourth, European element of their identities.

It is what Mario Monti, not long after taking up Italy's premiership, called the "psychological dissolution" of Europe. We are not yet there, but we are on the road and we may be closer to it today than many of us dare to admit.

POSTSCRIPT
Monologic Thinking and the Eurozone Crisis

Patrick O'Callaghan

1. Introduction

We use the word "crisis" to describe the quandary in which the eurozone now finds itself. A crisis, according to the Oxford English Dictionary (OED), is a "vitally important or decisive stage in the progress of anything." The OED adds that the word is applied especially to "times of difficulty, insecurity, and suspense in politics or commerce." That the eurozone's present difficulties represent a decisive stage in the progress of European integration is clear. We are witnessing not just financial and economic crises, but a political crisis of unprecedented proportions in the history of the European Union. But more controversial are questions of what caused the crisis and how we can resolve it. The uncertainty about the viability of the single currency (and, thus, the very future of the "European project") means that these are also times of "insecurity" and "suspense."

In this paper, I will argue that narratives have emerged in Europe about how the financial and sovereign debt crises were caused and the best ways to resolve the accompanying economic and political crises. I contend that these narratives are the product of monologic thinking on the part of many policy-makers and opinion-formers. By "monologic thinking," I mean path-dependent behaviour in the manner described by the Russian literary theorist, Mikhail Bakhtin. Bakhtin understood monologue as a wholly negative and destructive exercise. This is because the monologist always has the "ultimate word," his monologue attempting to "materialize all reality." Counter-arguments or alternative narratives fail to register because, to the monologist, they do not have any "decisive force."[1] This would be concerning enough on its own, but in the context of the eurozone crisis, monologic thinking poses distinct risks not only to a successful resolution of the crisis but also to the democratic legitimacy of the EU. In what follows, I identify three narratives on the causes of the crisis and solutions to it that have attempted to "materialize all reality" in the destructive manner envisaged by Bakhtin.

2. The First Example: "This time is different"

The unbridled optimism about the euro in the years before and after its introduction was, in itself, an example of monologic thinking. The original decision to allow Greece, the birthplace of democracy, to join the monetary union was quite clearly a political one, intended to be deeply symbolic. The euro itself was to be permanent. Indeed, while Article 50 of the Treaty on European Union (TEU) allows for Member State withdrawal from the EU, no such arrangement was made in the Treaty framework for exiting the euro. Warnings about deficiencies in the euro project (e.g., the lack of an optimum currency area) were ignored. This is because the monologic thinking of the time was that the euro project would achieve its four goals, as described by Fernández-Villaverde, Garicano and Santos:[2]

"The first was to build a unified European identity. The second was to eliminate nominal exchange rate fluctuations and the large imbalances that those could create. Of special concern was channelling the export dynamism that Germany had displayed since the 1960s. Third, it would create a monetary authority isolated from political pressures. This was particularly welcomed by countries with poor inflation records such as

1 M. Bakhtin, *Problems of Dostoevsky's Poetics* (C. Emerson, ed. and trans., Minneapolis: University of Minnesota Press, 1984), pp. 292-293.

2 J. Fernández-Villaverde, L. Garicano and T. Santos, "Political Credit Cycles: The Case of the Euro Zone" (2013) Working Paper, available at http://economics.sas.upenn.edu/~jesusfv/Political_Credit_Cycles.pdf

Italy or Portugal. The fourth goal ... was to broaden support for structural, supply-side reforms to improve Europe's growth rate. The main channel through which a monetary union was thought to affect the political economy of reform was by imposing additional constraints on monetary and fiscal policy. Without their own monetary authority and with fiscal policy limited by the Maastricht Treaty, national governments would have few options but to implement structural reforms they had previously been reluctant to undertake." [3]

But the Maastricht Treaty did not restrain Member States in the way many had anticipated it would. Rather, the lure of suddenly low interest rates in the periphery countries (compared to traditional levels) was too much to resist. What all of this meant was that alongside entry to the euro, the countries of the periphery experienced a "gigantic credit inflow."[4]

Monologic thinking also proved to be a feature of the resulting credit bubbles, as becomes clear when we consider the work of Fernández-Villaverde, Garicano and Santos. The general exuberance that emerges during a bubble, when people perceive that their wealth is increasing, masks what is really going on in the economy. In other words, it becomes more difficult to extract accurate information about the performances of financial institutions or government. This leads to a general deterioration in governance. So, "[w]hen all banks are delivering great profits, all managers look competent and when all countries are delivering the public goods demanded by voters, all governments look efficient."[5] But added to this is the phenomenon of "self-attribution bias," the idea that:

"it is hard to convince agents that the good things that are happening are not a result of their own outstanding decisions. As they become more overconfident, they are increasingly likely to overreach." [6]

Here we find the classic elements of monologue in Bakhtin's sense. The monologue weaves a specific narrative: one of success, in

3 Ibid at 4. See also H. James, *Making the European Monetary Union* (Cambridge: Belknap Press, 2012)

4 Fernández-Villaverde, Garicano and Santos, n 2 above, at 5.

5 Ibid at 8.

6 Ibid at 9

this case. It is a monologue that "materializes all reality" as all of the perceived success is presented as a product of the monologist's policies and decisions. But the monologist also has the "ultimate word." Those who criticise policy by pointing to the existence of a bubble are dismissed as naysayers.[7] This is monologue in its most destructive sense, because the larger the bubble grows (fuelled by cheap credit), the bigger the ambitions become.[8] Consider, for example, the then Irish Prime Minister's (Bertie Ahern's) plan to build a massive stadium, pejoratively known as the "Bertie Bowl," when two other large stadia already existed in Dublin.[9] Such "grandiose investments," as Fernández-Villaverde, Garicano and Santos put it, "create persistently lower growth, since they involved multi-year commitments that must be funded through future taxation."[10] Alongside general deterioration in governance, the most obvious destructive effect of the monologic thinking during the bubbles in Spain and Ireland was the rapid house price inflation. Large numbers of households in these countries are now unable to meet mortgage repayments and, in many cases, in significant negative equity.

3. The Second Example: "The PIIGS caused the crisis"

It is clear, then, that there were significant problems in the periphery in the period leading up to the eurozone crisis. But this only goes so far in explaining the origins of the crisis. Yet, in the meantime,

7 During the Irish property bubble, Bertie Ahern, the then Irish Prime Minister, made the following controversial remarks, for which he later apologised: "Sitting on the sidelines, cribbing and moaning is a lost opportunity. I don't know how people who engage in that don't commit suicide because frankly the only thing that motivates me is being able to actively change something." See RTE News (4th July 2007) http://www.rte.ie/news/2007/0704/90808-economy/

8 Fernández-Villaverde, Garicano and Santos point to other destructive effects of bubbles, including what they call a "variant of the 'Dutch disease.'" During a credit bubble, we find that capital (including human) is reallocated from the production of goods that can be traded to other activities, e.g., construction investment. Among other things, this means that once the bubble bursts, large numbers of people are "unprepared for more sustainable activities." Fernandez Villaverde, Garicano and Santos, n 2 above.

9 See RTE News (1st February 2002) http://www.rte.ie/news/2002/0201/22769-stadium/

10 Fernández-Villaverde, Garicano and Santos, n 2 above, at 10.

this has become a monologic explanation for the cause of the crisis. The problem with this narrative is not only that it is wrong, but it distracts our attention from the fundamental deficiencies in the euro project itself, most especially the absence of a system of fiscal transfers.

Monologic thinking about problems in the periphery as the root cause of the crisis downplays the role of private credit bubbles in which core banks were heavily implicated. Before the onset of the financial crisis, Ireland's and Spain's debt to GDP ratios were lower than those of many core countries. We cannot simply attribute blame to some and exonerate others. As de Grauwe has argued:

"The truth is that the responsibility for the euro crisis is shared. For every reckless debtor there was a reckless creditor. The northern countries were all too ready to provide loans to southerners so as to be able to accumulate export surpluses. The northern countries' banks involved in these lending operations managed to shift the loan losses to their respective governments."[11]

Like our first example, this second example of monologic thinking has been destructive because it has provided a justification for the policy response of austerity, which we will consider in more detail below. But it has also resulted in other mistakes. Early on, for instance, there was a failure to distinguish between States that were insolvent and those that were solvent but suffering from illiquidity.[12] This delayed the inevitable, namely the restructuring of Greek debt and the ECB acting as a de facto lender of last resort in the government bond markets through the mechanism of outright monetary transactions (OMTs). The persistent tendency to understand "fiscal extravagance" on the part of the so-called PIIGS as the cause of the eurozone crisis has ensured that legal arrangements for the future of the monetary union are structured in a way that makes it even more difficult for the economies in the periphery to recover. So, as Petch

11 See P. de Grauwe, "The New Bail-in Doctrine: A Recipe for Banking Crises and Depression in the Eurozone," CEPS Commentary (4th April 2013), p. 3, available at www.ceps.eu/ceps/dld/7914/pdf

12 On this point, see T. Petch, *Legal Aspects of the Eurozone Crisis* (London: Slaughter and May, 2012), p. 59.

points out, the restrictive rules in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (e.g., Article 3 (1) which requires a cap on annual structural deficits of 0.5% of GDP) will limit the ability of States to deal with future recessions in an effective way.[13] Those most affected, of course, will be those States that are already in the deepest political and economic difficulties.

4. The Third Example: "Austerity is the only solution"

The third example of monologic thinking concerns the means of dealing with the crisis, namely through the politics of austerity.[14] This is commonly justified as an absolute necessity. Because they no longer have the option of currency devaluation, periphery governments, so the narrative goes, must introduce austerity measures in order to "get their houses in order." The austerity politics try to imitate pre-crisis German labour and welfare reforms that supported export-led growth based on price competition.[15] While these policies may have proved successful in Germany, it does not follow that they should be adopted as a general strategy for the eurozone.[16] Those who support a "one size fits all" solution seem determined to ignore the fact that the eurozone crisis had multiple complex causes, that Greece's problems are not necessarily similar to Spain's or Ireland's. For this reason, Boyer argues "if the sources of the crisis differ, so should the economic policies."[17] Understood in this way, we might regard the drive towards imposing austerity measures as an aspect of a "pre-Keynesian fallacy" that if all countries "repeat the strategy that has proven to be efficient for an individual country the world economy will recover."[18]

This monologic thinking has its roots in ordo-liberalism, a theory that has had a profound influence on successive German govern-

13 Ibid at 60.
14 This section draws on P. O'Callaghan (2012), "Collective Memory in Law and Policy," *Legal Studies* 32(4), 642.
15 R. Boyer (2012), "The Four Fallacies of Contemporary Austerity Policies: The Lost Keynesian Legacy," *Cambridge Journal of Economics* 36(1), 283-312.
16 Ibid at 300.
17 Ibid at 301.
18 Ibid at 306.

ments and the Bundesbank.[19] Inevitably, perhaps, it has also shaped EU law and policy.[20] The need to maintain price stability through low inflation, for example, is a pillar of the ordo-liberal *Verkehrswirtschaft* (*transaction economy*).[21] Of fundamental importance in the EU Treaty framework is the idea of a monetary union as a *Stabilitätsgemeinschaft* (*community based on stability*). Consider, in this context, the ECB's legal obligation to maintain price stability (Article 127 TFEU), the euro convergence criteria (Article 140 TFEU) and the "no-bailout clause" (Article 125 TFEU).

The policy of austerity, inspired, at least in part, by ordo-liberal theory, remains the dominant paradigm at a policy level in the eurozone. It explains the opposition on the part of many Germans to the ECB's recent decision to act as a de facto lender of last resort in the government bond markets. Consider, for instance, Jürgen Stark's (the former chief economist of the ECB) resignation in September 2011 in the wake of the ECB's purchase of Italian and Spanish bonds. Stark had once said that Walter Eucken's (the father of ordo-liberalism) seminal work was "a constant source of inspiration throughout [his] career."[22]

Like the other two examples of monologic thinking, this example has also had destructive effects in Bakhtin's sense. The austerity measures have weakened domestic demand in individual economies leading to a contraction in GDP and high unemployment, especially among the under-30s. Youth unemployment in Greece is now over 60%. In Spain, Ireland, Portugal and Italy we find a similarly worrying trend. But what is significant here is not just the higher numbers (concern-

19 Key ordo-liberal texts include W. Eucken, The Foundations of Economics (London: William Hodge, 1950); E.W. Dürr, *Wesen und Ziele des Ordo-Liberalismus* (Winterthur: Keller, 1954); F. Böhm, Reden und Schriften (Karlsruhe: C.F. Müller, 1960).

20 See C. Joerges (2005), "What is left of the European Economic Constitution? A Melancholic Eulogy," *European Law Review* 461.

21 See D.J. Gerber (1994), "Constitutionalizing the Economy: German Neo-liberalism, Competition Law and the 'New' Europe," 42 *American Journal of Comparative Law* 25, at 47-48.

22 "Monetary, fiscal and financial stability in Europe," Speech by Jürgen Stark, Member of the Executive Board of the ECB, 11th Euro Finance Week in Frankfurt (18th November 2008), available at
http://www.ecb.int/press/key/date/2008/html/sp081118_1.en.html

ing as they are) but the fact that there has been an upward trend since the onset of the crisis, Greece's overall unemployment rate almost tripling in that period. So-called structural reforms have been ongoing for several years but unemployment continues to rise. This is surely evidence enough of the destructive nature of the monologic thinking about austerity.

5. Conclusions: Monologic Thinking and Democratic Legitimacy

The prospect of a "lost generation" of young people who have not had the opportunity to contribute to the workforce and society in the same way that the previous generation did is deeply concerning. But equally important are the implications for democratic legitimacy. What do these developments mean for the future of European integration? The work of the political scientist Fritz Scharpf is particularly instructive here.[23] Scharpf argues that up until the eurozone crisis, the European polity was "beyond the horizon of citizens' expectations."[24] What this means is that:

"[u]ntil recently … the moderating influence of national governments on EU legislation, and their continuing accountability for its implementation, has shielded the Union against the legitimacy crises which authors and politicians castigating its democratic deficit should have expected. In the present euro crisis, however, the shield of legitimacy intermediation has been pushed aside as citizens are directly confronted with the massive impact of European policies – and with their manifest lack of democratic legitimacy."[25]

Understood in this way, there is a general loss of autonomy. This is the case in debtor countries where citizens experience the agonies of austerity policies and creditor countries where politicians talk about defending the euro at all costs and citizens feel like they are "carrying the burden" for the rest of Europe.[26]

23 F.W. Scharpf (2012), "Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis," *MPIfG Discussion Paper 12/6*, available at http://www.mpifg.de/pu/mpifg_dp/dp12-6.pdf
24 Ibid at 17.
25 Ibid at 19.
26 Ibid at 27.

While some see the eurozone crisis as an opportunity for further political integration, Scharpf thinks that the prospect of a federal Europe with a centralised budget is further away now than before and the crisis risks "destroy[ing] the past achievements of European integration as well."[27] This is because:

"the euro crisis, its dominant framing as a consequence of fiscal irresponsibility, and the disastrous impact of rescue policies designed by creditor governments on the basis of this frame have provoked conflicts of interest and identity, mutual distrust and recrimination, and widely diverging public discourses in national politics."[28]

It is always useful to remind ourselves why European integration was pursued in the first place. Quite simply, the EU evolved because the people of Europe "live unavoidably side by side," as Kant would have put it.[29] But European integration demands more than a mere political structure or a set of institutions. If the EU is to constitute anything meaningful, its citizens need to have a "sense of political community" and trust between citizens is surely a prerequisite.[30] Indeed politics, as Waldron writes, "always requires us to put our lives into the hands of others. It is a question of which hands we are trusting enough to deliver ourselves into."[31] Rather than continue to engage in monologic thinking, policy-makers must seek imaginative ways to regenerate trust among the citizens of the EU. Of critical importance here is tackling the plight of the young unemployed by any means possible. While many criticised the "fiscal extravagance" of periphery countries before the onset of the crisis, perhaps now is the time for

27 Ibid at 30.
28 Ibid at 29-30.
29 J. Waldron (2011), "The Principle of Proximity," *New York University, School of Law, Public Law & Legal Theory Research Paper Series,* Working Paper no. 11-08 (January).
30 Scharpf emphasises the importance of what David Easton called a "sense of political community." Scharpf quotes Easton: a "sense of political community" is "… the feeling of belonging together as a group which, because it shares a political structure, also shares a political fate … [T]o the extent there is a feeling of political community, the members will possess mutual sympathy and loyalty with respect to their participation in a common political unit." Scharpf, n 23 above, at 13, quoting D. Easton, *A Systems Analysis of Political Life* (New York: Wiley, 1965) pp. 184-189.
31 Waldron, n 29 above, at 24.

some form of stimulus in the eurozone with the aim of achieving full employment. Only in this way do we engender the trust that is necessary for the EU to survive and thrive as a political community.

Political, Fiscal and Banking Union in the Eurozone?

Workshop organized by Profs. **Franklin Allen**, **Elena Carletti** and **Joanna Gray**

Co-organized by
Pierre Werner Chair Programme
Wharton Financial Institutions Center
Department of Economics,
Robert Schuman Centre for Advanced Studies

Sala Europa, Villa Schifanoia
Via Boccaccio 121, 50133 Firenze

Programme **April 25, 2013**

9.30 - 10.15	Registration and coffee
10.15 – 10.30	Welcome by EUI President
10:30 – 12:00	**Panel 1: Banking Union in the Eurozone?**
	Chair: **Elena Carletti** (European University Institute)
Participants:	**Luis Garicano** (London School of Economics) **Richard Herring** (University of Pennsylvania) **Jan Pieter Krahnen** (Goethe University of Frankfurt) **Philip Wood** (Allen&Overy)
12:00 – 13:00	Keynote Lecture: **Andrea Enria** (European Banking Authority)
13:00 – 14:30	Lunch at Villa Schifanoia

14:30 – 16:30	**Panel 2: Fiscal Union in the Eurozone?**
	Chair: **Franklin Allen** (Wharton School, University of Pennsylvania)
Participants:	**Daniel Gros** (CEPS) **Robert Inman** (University of Pennsylvania) **Mattias Kumm** (NYU, Social Science Research Center Berlin and Humboldt University) **Hélène Rey** (London Business School)
16:30-17:00	Coffee break
17:00 – 18:30	**Panel 3: Political Union in the Eurozone?**
	Chair: **Joanna Gray** (Newcastle University)
Participants:	**Mitu Gulati** (Duke University) **Edmond Alphandéry** (Nomura) **Peter L. Lindseth** (University of Connecticut) **Richard Parker** (Harvard Kennedy School)
18:30	Reception and Dinner at Villa Schifanoia
Dinner speaker:	**Tony Barber** (Financial Times)

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This book contains the proceedings of the conference "Political, Fiscal and Banking Union in the Eurozone?" that was held at the European University Institute in Florence on 25 April 2013.

EDITED BY
Franklin Allen (Wharton School, University of Pennsylvania)
Elena Carletti (European University Institute and CEPR)
Joanna Gray (University of Newcastle)

AUTHORS
Edmond Alphandéry (Nomura)
Tony Barber (Financial Times)
Andrea Enria (European Banking Authority)
Luis Garicano (London School of Economics)
Daniel Gros (Centre for European Policy Studies (CEPS))
Mitu Gulati (Duke University School of Law)
Richard J. Herring (University of Pennsylvania)
Robert P. Inman (University of Pennsylvania)
Jan Pieter Krahnen (Goethe University)
Mattias Kumm (New York University)
Peter L. Lindseth (University of Connecticut)
Patrick O'Callaghan (Newcastle University)
Richard Parker (Harvard Kennedy School)
Hélène Rey (London Business School)
Philip Wood (Allen & Overy)

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