Law and the Financial Crisis: Searching for Europe's New Gold Standard

Introduction – The Role of Law in the Economics of the Eurozone

'[T]he European Union is a community of law, subscribed to by the Member States in which *pacta sunt servanda*. This refers to all the pacts, starting from fiscal discipline in the Member States to the commitment of the Member States to pay their debts…The euro…is about respect for the law.'[1]

The role of law in the economic crisis engulfing Europe is ambiguous. In European scholarship, law is often portrayed as having been a crucial driver towards integration, providing powerful individual rights to access markets. The European Union had established a quasi-constitutional legal framework that took traditional inter-state trade politics out of economics to be replaced by the certainty of law and legal procedures. The crowning legal achievement, the single currency, was supposed to operate in a similar manner, with automatic corrective legal procedures ensuring fiscal discipline and a prudent central bank mandated to control inflation. With this solid legal framework, competitive open markets were supposed to deliver stability and growth. Thus, in theory, the crisis should not have happened at all.

During the crisis, the limits of the established legal framework have become a source of contention. Given the cataclysmic implications of failure, it is surprising, even surreal, how often debate has focused upon the issue of whether the EU institutions are acting *unlawfully*.[2] The EU has thus resembled a fire-fighter who, at the scene of a blaze threatening to engulf a neighbourhood, worries she cannot extract water from a nearby house without the owner's permission. The Maastricht treaty has indeed appeared at times to be a suicide pact. In reality, of course, arguments about the proper scope of the Eurozone's legal powers are far from legalistic: underlying them are profound differences over the economic causes and appropriate resolution of the crisis. The question of what the EU *may* legally do has become entangled with that of what it *should* do. This paper explores the role of law in the crisis and its relationship to the underlying economic and political debates.

It is widely agreed now that the crisis has revealed that the legal order of the single currency created unsustainable imbalances. Economic evidence shows that under-regulated capital markets in Europe reflected global trends toward excessive risk-taking. These capital flows were the necessary counter-parts to huge trade imbalances and asset bubbles within Europe from 2000-7

[1] Intervention by Lorenzo Bini Smaghi, Deputy-President, European Central Bank, ECON Committee Hearing on "Improving the economic governance and stability framework of the Union, in particular in the euro area," Brussels, 15 September 2010.

[2] See M Ruffert, 'The European Debt Crisis and European Union Law' (2011) 48 CMLRev 1777-1806 for an analysis which reveals the tension between law and resolving the crisis. He criticises the strategy adopted to tackle the crisis concluding that there 'are good reasons to submit that this policy is in breach of important provision of the TFEU' (785) arguing that this undermines the principle that '[t]the European Union is a Union based on the rule of law, not of power (claimed by whomsoever), and this must also hold in times of distress.' At the same time he offers no plausible alternative economic solutions, either within or without the legal framework of Maastricht, to the crisis that faced the Eurozone in 2010-12. This suggests that Maastricht was indeed a constitutional 'suicide pact'.

that have since dramatically reversed.[3] The subsequent collapse in asset prices, banking sectors and economic activity felt in the deficit countries has created public spending crises there. With the flight to safety, a sovereign debt panic was allowed to spread across Europe in 2010-11. The Maastricht framework was never designed to provide large-scale fiscal support to Member States and the political response of the Eurozone has been piece-meal and confused. Nevertheless, massive amounts of support have been marshaled, particularly through the ECB.[4] This has prompted growing concern about both the economic costs and the legal or political basis for such transfers.

In interpreting these events there is a powerful strand of German economic thinking, derived from the Hayekian and ordo- liberal schools, that argues that law is critical to resolving the crisis, in particular, by reaffirming the rules on fiscal and monetary discipline.[5] Failure by Member States, and latterly the ECB, to adhere to these rules is viewed as both legally illegitimate, a breach of the spirit of the Maastricht treaty and, above all, economically dangerous.[6] A renewed assertion of the Maastricht European economic constitution is thus central to allow market prices to adjust and rebalance the economy.[7]By contrast, Keynesians suggest that fiscal indiscipline was not a key cause of the crisis. Austerity imposed by law is doomed to fail, both politically and economically. The powerful Member States, however, largely share the liberal economic assessment and have been politically unwilling to commit adequate funds. The crisis has thus repeatedly resurfaced, leaving the European System of Central Banks to assume a crucial, but legally and economically contentious, role in preventing a break-up of the single currency.

The ultimate 'grundnorm' of the single currency has been thrown into doubt, both in terms of economic theory and legal design. The original price stability norm, inscribed into the Maastricht design by Germany, was successfully achieved. [8] Liberal economists now argue however that the vast liquidity provided by the ECB to the periphery both creates an illegitimate transfer union and impedes the process of economic adjustment necessary to restore stability. Legal limits upon money creation are necessary to allow price and wage *flexibility* and eliminate moral hazard on the part of governments. On this view, what is needed is more law and less discretion to prop up weak

[3] See S Barnes, 'Resolving and Avoiding Unsustainable Imbalances in the Euro Area' (2010) OECD Economics Department Working Papers, No.827.

[4] The sources of direct support include bilateral aid and pledges to the EFSM, EFSF and the ESM which when combined could reach €800 billion. These have so far been drawn upon by Ireland, Portugal and Greece. More significant are the indirect funds from the ECB which include €1.2 trillion in LTRO funds, €200 billion in SMP funds and the TARGET2 account deficits of around €800 billion.

[5] For a good overview of the development and basis of ordo-liberal thought and see D Gerber, *Law and Competition in Twentieth Century Europe: Protecting Prometheus* (1998) Oxford University Press, Ch.7.

[6] For a good range of influential German economists see the debate in the papers collected in the CESifo Forum 2012. Accesible at http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/30publforum/_PUBLFORUM12

[7] For a detailed discussion of the influence of German ordo-liberalism upon the interpretation of the European treaties see W Sauter, ' The Economic Constitution of the European Union' (1998) 4 Colum. J Eur L 27 at 43-56.

[8] M Herdegen, 'Price Stability and Budgetary Restraints in the Economic and Monetary Union: the Law as Guardian of Economic Wisdom' (1998) 35 CML Rev 19 describes price stability as 'a fundamental norm in a meta-constitutional sense', 21.

economic actors and governments, even if this may involve default or exit from the single currency in some cases. There is as yet no serious consideration of moving closer towards deeper political union as a basic norm

The fear of a financial disaster being triggered by the default or exit of a Eurozone member is however such that powerful Member States have been unwilling to re-commit to a market-based order. Present polices are a compromise in which structural reform and recession are imposed alongside conditional transfers and large amounts of central bank money creation. Political leaders, whilst constrained by domestic concerns, have perhaps also decided that the crisis may be a means of overcoming long-standing obstacles to reform within Europe.[9] Centrifugal forces are however constantly threatening to overwhelm centripetal dynamics: austerity may prompt default, exit and devaluation by debtor nationals, whilst the burden of bail-outs and currency debauchment may prompt creditors to form a breakaway monetary union. The search for a new stable European legal order will entail a period of huge instability in which law is replaced by power politics as creditors, including the ECB, seek to restructure debtor nations outside the legal framework of a full political union. The nations that survive this process may then find themselves part of a group of core countries who are permitted the option of going further with deeper shared fiscal institutions and common debt issuance.

Credibility, Co-operation and the End of Classical Gold Standard

The Eurozone crisis contains strong echoes of the challenges and debates surrounding the gold standard during the period 1928-36. That period also saw strong legal commitments (at national level) towards fixed exchange rates backed by gold that eventually collapsed under political and economic pressure. This epoch also witnessed the first real economic debates between the new Keynesian ideas and those of classical liberalism. The former argued for loosening monetary and fiscal policy to stimulate demand, whilst the liberalism articulated by Hayek and Von Mises contended that normal business cycles must be allowed to adjust prices and wages downwards.[10] Eichengreen, in his classic account of the period, argues that the stability of the gold standard during its pre-World War One heyday rested upon twin props of *credibility* and international *co-operation*.[11] This credibility, whilst based partly on legislation, derived most its force from an unwavering commitment of central banks and governments to impose serious austerity upon the population. The 'rules of the game' entailed that wages and

[9] 'the crisis represents an opportunity....Europe always moved forward in times of crisis. Sometimes you need a little pressure for certain decisions to be taken.' Wolfgang Schäuble, German finance minister, cited in Reuters, 14th December 2011.

[10] See FA Hayek, *Contra Keynes and Cambridge: the Collected Works of FA Hayek* (ed.) B Caldwell, 1995, London, Routledge. Keynes was, of course, not the only critic of classical liberal approaches to the depression. See BJ McCormick, *Hayek and the Keynesian* Avalanche, (1992) New York, Harvester Wheatsheaf for a detailed review of the debates. For a comparison of the links between Hayek and the ordoliberal school see F Bonker and H-J Wagener,'Hayek and Eucken on the State and Market Economy' in A Labrousse and J-D Weisz (eds*.) Institutional Economics in France and Germany: German Ordoliberalism versus the French Regulation Schoo*l, 2001, Springer, Berlin.

[11] B Eichengreen, *Golden Fetters: the Gold Standard and the Great Depression 1919-1939*, (1995) Oxford University Press.

employment be allowed to fall to correct balance of payments deficits. So strong was this political fact that private capital flowed *towards* countries with trade deficits in the knowledge that central banks would raise interest rates. The system was self-correcting. After World War One, this credibility began to erode with the rise of social democracy and its commitment to protect employment and welfare.

This left the second prop of international co-operation as critical: only if major central banks were willing to constantly adjust monetary policy to help struggling countries could imbalances be resolved. Thus surplus countries had to inflate by lowering rates in order to draw in imports from those in deficit. This level of co-operation was rarely achieved after 1918, despite severe trade and capital imbalances arising from European reconstruction. The United States Federal Reserve, increasingly the most important central bank in the system, was focused upon the domestic economy and did not co-operate to secure the gold standard. Instead, trade in real goods and services became unbalanced with the US running large trade surpluses; only continued short-term US capital flows could stop balance of payments crises draining gold from deficit countries in Europe. [12]

The banking crisis in 1929-31 saw this capital dry up, leaving countries with the choice of severe austerity to stay on the gold standard or quitting the system and devaluing their currencies. Gradually countries left gold after serious austerity had failed to attract new capital flows. Countries leaving the gold standard imposed capital controls to stabilize currencies. Some were able thus to increase exports but, more importantly, leaving gold allowed them to relax domestic credit constraints and reduce interest rates. Domestic demand was stimulated. Those staying on gold, particularly France and America retaliated against devaluation with tariffs on cheaper imports. Thus there was a 'beggar-thy-neighbour' spiral leading to a break-down in international co-operation and free trade, which greatly worsened the economic hardships that had originated in a United States' domestic down-turn.

PolyaniPolanyi, in his critique of the period leading to the Great Depression, argued that the end of the gold standard represented the failure of orthodox liberal economics.[13] The gold standard was the final element in a free market system. The central bank's main role was to protect the currency from debasement. Continued confidence in the central bank depended however upon balanced budgets to avoid monetarising debt. The classical liberal view, shared by Hayek, and followed by the ordo-liberals, was that governments should not intervene against the corrective forces of the market. '[Q]uestions of social organisation had to be wholly subordinated to the needs of the restoration of the currency. Deflation was the primary need; domestic institutions had to adjust as best they might.'[14] PolyaniPolanyi argued that far from being self-regulating and stable, gold standard economics imposed such hardships upon the population that they were incompatible with, not just economic and social life, but liberal democracy itself. He criticised the 'stubbornness with which economic liberals…in the service of deflationary

[12] Above at 21.
[13] K PolyaniPolanyi, *The Great Transformation: the Political and Economic Origins of our Time*, (2001) Boston, Beacon Press Books.
[14] 241

policies, supported authoritarian interventionism' during the 1920s.[15] The severe adjustments required of the population in terms of wages and employment were eventually rejected; instead state intervention including credit creation, exchange controls, tariffs, debt default and public spending where used to protect people from the market and gold was abandoned.

Substituting current Northern European trade surplus countries for the role of the United States during the Great Depression, the current crisis in the Eurozone raises similar questions of co-operation and credibility.[16] What was initially seen as a global economic shock driven by private sector excess, has mutated into a European game of recrimination about 'profligate' nations. The Eurozone Member States have thus been unable to co-operate to provide large-scale transfers of funds or growth to mitigate deep recessions in the periphery. Instead, they have simply deepened their legal commitment to austerity in an effort to make it more credible. Countries in recession were on their own aside from access to highly conditional loans. This failed to convince financial markets to re-invest in such countries.

As we shall see, in the absence of adequate action by Eurozone members, the European System of Central Banks, whose Governing Council operates by majority voting on monetary policy, provided the necessary co-operation among central banks. The Eurozone banking systems have therefore had unlimited liquidity to avoid bankruptcy and their governments have not had to underwrite large-scale banking failures yet.[17] Peripheral Member States with trade deficits have still been able to import goods and services. Under the single currency, unlike the gold standard, countries are like regions within a state and cannot be allowed to literally 'run out of money'. This was always implicit in the legal framework of Maastricht but only when the crisis struck did its true significance become clear. Real 'solidarity' within the Eurozone has come in the unlikely shape of the central bankers meeting every month in Frankfurt. These opaque transfers via the ESCB are however being increasingly questioned on legal, political and economic grounds in core countries, just as stringent austerity is questioned as a legal and economic necessity in peripheral countries.

From Single Market to Single Currency: Learning Only Some Lessons from the Great Depression

In standard discussion about the origins of the Common Market, reference is usually made to the links between this collapse in world trade caused by protectionism in the 1930s and the subsequent world war. Europe was said to have learned the lessons and so the Treaty of Rome contained strong legal prohibitions on tariffs and quotas. These legal commitments have become firmly established over 50 years. [18] The unquestioned 'economic constitution'

[15] 243

[16] For a good summary see European Commission, (2009) 'Economic Crisis in Europe: Causes, Consequences and Responses', European Economy 7/2009, DG Economic and Financial Affairs.

[17] The Irish government was the first Eurozone government to recapitalise its banks on a large scale following their realisation of huge losses on property loans. There remain however grave doubts about the banking sectors in Greece and Spain where property loans have also failed. Private lending to such banks will remain constrained until the losses are realised and banks recapitalised.

[18] They were eventually extended to include prohibitions on capital controls, thus removing a key tool of balance of payments policy. Council Directive 88/361 [1988] OJ L178/5.

of the EU, they form the core of legally enforceable market rights. Whilst the benefits of open markets in goods and services are widely agreed upon by economists, the move to a single currency presented the more challenging problem of regulating trade imbalances, the same challenges that led to the collapse of the gold standard.

Before the Euro, in a world without the gold standard or fixed exchange rates, currency flexibility was a crucial shock absorber. Devaluations enabled countries to eliminate trade deficits by making their goods more competitive but also accommodated inflation. Some of the underlying problems damaging competiveness like interest group rivalry and monetarisation of public debt, were not resolved. Italian and French elites wished to change their internal political economy by creating more credible commitments to curb inflationary expectations. The Bundesbank had the best inflation control in Europe. In 1979, the European Monetary System ('EMS') therefore saw the major economies anchor their currencies to the Deutschmark. Interest rates had to rise to very high levels to maintain parities.[19] Just like the inter-war gold standard, EMS proved unstable because (a) deficit countries would not impose unlimited austerity and (b) surplus countries would not provide unlimited credit. This meant the EMS was a persistent target for speculators. The move to a legally 'irrevocable' single currency was seen as a way of eliminating speculation through establishing greater credibility with markets and internal economic actors. The present crisis has revealed however that, whilst suppressed for a time by 'irrevocable' legal ties, speculation can re-emerge within a single currency in markets for sovereign debts.[20]

In the economic literature, the cost/benefits of moving to a European single currency were in debated in narrow terms relating to which Member States together might make up an 'optimal currency area.' [21] [22] Most economists agreed that only a core group of Northern Member States were

[19] See Mundell's famous impossibility triangle whereby a state can have two out of three of the following: fixed exchange rates, free movement of capital and monetary autonomy. It must surrender one to achieve the other two. RA Mundell (1963). "Capital mobility and Stabilization Policy under Fixed and Flexible exchange rates". *Canadian Journal of Economic and Political Science* **29** (4): 475–485

[20] See PM Garber, 'Notes on the role of Target in a Stage III Crisis' Working Paper 6619, NBER, June 1998 who argued that speculators could seek to test the degree of commitment to the single currency by moving funds out of high-inflation countries to those with low-inflation. This would force surplus country central banks to fund deficit countries in an unlimited sum, a commitment that they might not be prepared to honour.

[21] F Snyder, 'EMU Revisited: Are we making a constitution? What constitution are we making?' in P Craig and G de Burca, The Evolution of EU Law, 1999, Oxford University Press.

[22] Mundell had famously argued that currency union between nations could only be justified on economic grounds when the countries involved shared key characteristics, particularly high levels of cross-border labour mobility. R Mundell, 'A Theory of Optimum Currency Areas' (1961) American Economic Rev 51.Mundell argued that other important factors pointing against currency union were if economic shocks to members tended to be asymmetric, if members were large and if there were no fiscal co-ordination between them. See also J Meade, 'The Balance-of-Payments Problems of a European Free-Trade Area' (1957) Economic Journal 379 who argued that flexible exchanges rates were necessary in the absence of political union. Goodhart however argues that there is no evidence that real nations or federations conform to the theory of optimal currency areas and yet they subsist. CAE Goodhart, 'The Political Economy of Monetary Union' in P Kenen (ed) Understanding Interdependence. The Macroeconomics of the Open Economy. (1995) Princeton University Press.

sufficiently similar in economic terms.[23] It was argued that more inflation-prone peripheral nations of Southern Europe were more suited to a separate currency area with a lower exchange rate. [24] The economists' concern was that, with wages inflexible and migration limited, a wide Eurozone would see competitiveness eroded in the periphery; trade deficits would develop. With fixed currencies, only sudden, and politically difficult, austerity measures to push down wages and consumption could correct such deficits.

Whilst political factors of course dominated in the decision to widen participation in the Euro to include the periphery,[25] the European Commission had argued that capital markets would regulate trade deficits automatically. The single currency would act like a new classical gold standard; with the private sector convinced that exchange rates were locked irreversibly, lending could flow based only credit risk. Integrated and open capital markets could perform the shock-absorber role formerly left to the exchange rate, assuming that markets could price risk properly.[26] In fact, because of the European Central Bank, Eurozone member banks could never run out of liquidity to finance cross-border trade. The balance of payments would become as invisible and irrelevant as transfers between banks in London and Manchester. The Maastricht Treaty therefore only made provision for balance of payments support for non-Eurozone members of the EU.[27]

The First EU 'Gold Standard': the Life and Near-Death of the Original Stability and Growth Pact

Given the current deflationary bias in the world economy, it is easy to forget that it was the inflationary 1970s that really shaped economic thinking around the single currency. Germany, whilst keen to achieve currency stability to protect demand for her exports, had always favoured a deeper form of political union, with direct EU control over economic policy to prevent inflation. [28] As is well known, the Delors report eventually concluded that the single currency could be stable without political union so long as two key elements were adopted - an independent central bank with a strict price stability target

---

[23] B Eichengreen, 'Is Europe an Optimal Currency Area?' B Eichengreen, (1997) *European Monetary Unification: Theory, Practice and Analysis,* MIT Press, Cambridge, Mass.

[24] T Bayoumi and B Eichengreen,'Ever closer to heaven? An Optimum-Currency-Area Index for European Countries' (1997) 41(3-5) European Economic Review 761-70.

[25] See L Tsoukalis, 'EMU: the Primacy of High Politics' in W Wallace and W Walton (eds.) Policymaking in the EU, (3rd ed.) Oxofrd Univesrity Press, 279-99.

[26] European Commission, (1990) 'One money, one market: an evaluation of the potential benefits and costs of forming an economic and monetary union' European Economy 44, 162. 'The conclusion is, therefore, that the complete liberalization of capital flows and the irrevocable fixing of exchange rates or a single currency would imply that the disappearance of the intra-Community external constraint would be at least partially a substitute for nominal exchange rate adjustment in EMU.'

[27] TFEU Art 143.

[28] E R Staal, 'European Monetary Union: the German Political-Economic Trilemma', (1999) ZEI Discussion Paper, C45. The debates had coalesced around 'monetarists' who argued that exchange rate stability would in itself help to reduce inflation in high-inflation countries and the 'economist' school who argued that real economic convergence was necessary first otherwise exchange rate stability would simply lead to inflation being exported from, for example, France to Germany. The debate was resolved by agreement to ensure both price and exchange rate stability under the Euro.

and fiscal convergence. Germany agreed to monetary union on this basis despite its misgivings.[29]

Certainly combatting inflation, not fear of spill-overs from sovereign debt defaults, was the main driver behind the legal limits on public debt agreed at Maastricht. Article 121 TFEU nevertheless made clear that neither the EU nor the Member States would assume legal liability for the debts of any of the other Member States. Before the current crisis of sovereign default risk, the most obvious fear was that Member States might use public deficits to reduce unemployment and thereby raise inflation. The credibility of the ECB might be undermined if interest rates had to rise to intolerable levels to combat inflationary forces.[30] In the run-up to monetary union there was significant progress in achieving convergence in average deficit levels down from 5% to 2% GDP between 1992 to 1998. The average stock of public debt increased to 73.2% but this was sustainable so long as economic growth continued.[31]

Maastricht confirmed this duty: Member States 'shall avoid excessive budget deficits.'[32] It also set out the surveillance procedure whereby the Commission should monitor the budgetary situation in order to identify 'gross errors' in non-compliance with the reference values for the stock of public debt and the annual deficit. These were set at 60% of GDP and 3% of GDP per annum respectively.[33] These commitments towards 'sound public finances' were expressions of the German ordo-liberal design of Maastricht. There was no power to engage in Keynesian-style demand management at EU level.[34] Delinquent Member States were to be reported to the Council by the Commission. [35] In the end the Council had the ultimate power to decide on whether there had been a breach, whether to make private recommendations or to make these public and, ultimately, to impose financial sanctions.[36] The

[29] J Delors, *Report on Economic and Monetary Union in the European Community* (1989) Committee for the Study of Economic and Monetary Union, Luxembourg: Office of Official Publications of the European Communities. J Pisani-Ferry, 'Only One Bed for Two Dreams: A Critical Retrospective on the Debate over the Economic Governance of the Euro Area' (2006) 44(4) JCMS 823-44 for a discussion of the debates.

[30] MJ Artis and B Winkler, 'The Stability Pact: Safeguarding the Credibility of the European Central Bank,' (1998) National Institute Economic Review, January 87-98. MJ Artis and B Winkler, 'The Stability Pact: trading off flexibility for credibility?' in A Hughes-Hallett, MM Hutchinson and SE Hougaard Jensen (eds.), *Fiscal Aspects of European Monetary Integration*, Cambridge University Press, 1999. There were some who argued that only a clear commitment to an independent ECB with a commitment to monetary policy to convince financial markets. T Padoa-Schioppa, *The Road to Monetary Union in Europe: the emperor, the kings and the genies*. 2000, Oxford University Press. 'There are no compelling arguments that a common monetary policy also requires a common fiscal policy or a major shift in decision-making power from national to Community authorities.' 159

[31] See M Larch, P van den Noord, L Jonung, 'The Stability and Growth Pact: Lessons from the Great Recession' European Economy Economic Papers, 429/2010, DG Ecofin, European Commission.

[32] Art 126 Treaty on the Function of the EU

[33] Council Regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. See also TFEU Protocol No. 12 on the excessive deficit procedure.

[34] K Dyson and K Featherstone, *The Road of Maastricht: Negotiating Economic and Monetary Union*, (1999) Oxford University Press, 382.

[35] There was an area of discretion in the Commission such that deviations that were due to temporary emergencies or were moving readily towards the reference values could be ignored.

[36] Art 126(3)-(13)

'automaticity' of procedures and penalties was one German demand that was removed in the final draft.

As is well-known, in practice the legal limits upon deficits were not enforced rigorously. The Commission took annulment proceedings after the Council refused to act against France and Germany. The European Court ruled that there was no power to put the procedure into abeyance and that, in the absence of a new recommendation from the Commission, the Council must take further steps to compel deficit reduction.[37] The Council did not obey the Court's order and instead the procedure itself was modified to allow states with excessive deficits to avoid further legal action where the economic conditions justified this.[38] The amendments mean that the SGP was no longer, even purportedly, a legally-binding rule but rather a politically negotiated and discretionary process.

The original SGP lacked credibility. The target values proved to be too inflexible in the face of recession in the two leading Eurozone powers. Germany, now so successful, had been struggling for years with slow growth and unemployment arising from reunification. Law here proved to be secondary to domestic political and economic concerns.[39] In fact, whilst long-term debt *sustainability* is a critical economic goal, the SGP design did not address this.[40] There was no system for coordinating fiscal policy in the different Member States to ensure each contributed to balanced and sustainable growth. [41] A Member State facing an 'asymmetric' shock could not expect to receive help from other Eurozone countries or the ECB to raise aggregate demand.[42] This lack of true fiscal union meant that 'excessive' budget deficits were inevitable if reasonable growth and employment levels were to be maintained. For some Member States, like Greece, however deficits were an expression of a structural inability to properly resolve economic conflicts and manage its finances.[43]

Trends in the Eurozone Before the Crisis: Single Currency Credibility Drives Risk and Market Imbalances

[37] C-27/04 Commission v Council of the European Union, Judgement of 13 July 2004.

[38] Council Regulation 1056/2005 amending Regulation 1467/97 on speeding up and clarifying the implementation of the excessive debt procedure. See Presidency Conclusions, European Council, 23 March 2005, 7619/1/05 REV 1. The changes allowed 'cyclical' deficits caused by recessions to persist; 'structural' deficits were now the target of legal actions. There was room of huge disagreement upon the meaning of this term.

[39] See W Schelkle, 'EU Fiscal Governance: Hard Law in the Shadow of Soft Law?' [2007] 13 Col. J. Eur Law 705

[40] A basic model of sustainability looks at the growth of nominal GDP less the interest rate on debt and multiplies that by the ratio of debt to GDP. The government must run a primary surplus (spending before interest payments) to cover this amount in order for debt levels to remain static. The SGP references values did not look at this.

[41] WH Buiter, 'The "Sense and Nonsense of Maastricht" revisited: What have we learnt about stabilization in EMU?' (2005) 44 JCMS 687-710.

[42] C Allsop and D Vines, 'Fiscal Policy, Labour Markets and the Difficulties of Inter-country Adjustment within EMU' in D Cobham (ed.) *The Travails of the Eurozone: Economic Policies, Economic Developments*(2007) Palgrave Macmillan, 95-120.

[43] Indeed in 2004 Greece revealed that its budget deficits and debt stock were much higher than had been revealed before and have always exceeded the 3% ceiling rather than been below it as claimed. International Monetary Fund, (2004) Article IV Consultation, Staff Report.

The period from the launch of EMU until 2007 appeared to be a success: there was convergence in incomes between poorer and richer Member States. There was no need for deeper fiscal union after all.[44] The flow of short-term capital around Europe suggested that markets had accepted the credibility of countries' legal commitments to the Euro. Exchange rate risk was removed. Beyond this however, markets seemed to pricing in an implicit commitment by core countries that, regardless of the Maastricht text, no sovereign default would be allowed by any Eurozone member. The most obvious manifestation of this level of belief was the fall in the yield on government debts in Southern Europe: the spread over German bunds (viewed as the benchmark safe asset) fell to historic lows.[45] Countries were able to borrow much more cheaply. Deficits and debts could be bigger. Relative risks between sovereigns however should have remained a concern; the launch of EMU did not see any general convergence in debt/GDP ratios.[46] Economically, the pre-crisis fiscal picture was mixed: fast growing economies, such as Ireland (48.3% GDP to 25% GDP) and Spain (62.3% GDP to 36.1%GDP) used the fruits of growth to lower their stock of debt over the period 1999-2007. Even Greece could support its high level of debt (94% to 107%) and fund persistent deficits. With growth rates over 7% p.a. and historically low interest rates, capital markets lent freely to such countries. Member States with slower growth were vulnerable for different reasons. Portugal (49.6% to 68.3% GDP) had low savings and relied on foreign investors. Italy (113.7% to 103.6% GDP) had high savings but a very high debt burden. Both turned out to be vulnerable financial panic spreading from weaker states.

Trade and capital imbalances were exacerbated by monetary union. Countries with high savings and low wage growth, particularly Germany, Netherlands and Finland ran 5% GDP trade surpluses. Banks, unable to find investment outlets at home, recycled this money towards peripheral countries, particularly Spain, Greece and Portugal, allowing them to run trade deficits of 7% of GDP.[47] There was no 'currency' to defend and so no pressure on the periphery to reduce imports and raise exports. The trade imbalances between countries of the Eurozone were treated as irrelevant. Surplus countries found ready markets and recycled capital flows allowed peripheral consumers to

[44] O Issing, 'The Euro – A Currency without a State' (2006) 23/2006 BIS Review, 1-4 argued that 'over the very long term, strong elements of a political union may (need to) emerge, but for the time being EMU can proceed perfectly well without a political union in the form that we understand today.'(2) He argued however that this was only possible if markets were flexible and the SGP was enforced rigorously.

[45] Astonishingly, with the benefit of hindsight, the spreads for 10-year government bonds above the German Bunds on 4 July 2006 was 0.31% for Greece and 0.30% for Italy. See Buiter above at 11.

[46] The period from 1999 to 2007 saw governments prone to inflation and higher borrowing costs experience rapid convergence in interest rates down towards German levels. Deficits also fell to 0.7%. This freed up resources to cuts taxes and increase spending as well as reduce the stock of public debt. Thus whilst the average level of public debt reduced from 73.2% to 66.8%, it remained well above the 60% criteria in the SGP. Even Germany saw significant increases in public debt levels. Italy initially reduced its debt from over 120% of GDP to around 100%, thereafter matters went into reverse. Similarly Greece, with its bad accounting revealed in 2004, made no real progress towards reductions in the stock of debt.

[47] See S Barnes, 'Resolving and Avoiding Unsustainable Imbalances in the Euro Area' (2010) OECD Economics Department Working Papers, No.827.

enjoy higher wages, consumption and asset windfalls.[48] The Commission had already noted, however, in its pre-EMU assessment of the prospects for the single currency that 'the only remaining limitation in EMU consists in a long-run solvency constraint of companies, households and governments. The current account may for a long time be in disequilibrium as long as there is the expectation that in the end the foreign debt will be repaid…'[49] The private capital markets were thus to be the sole discipline on trade imbalances.

Improving or even sustaining competitiveness in the periphery was not seen as a matter for intervention by the European Commission. Capital, product and service markets were of course subject to further liberalisation efforts during this period. There was however no country specific policy of enforcement to open up the closed professions or attack restrictive practices and inefficient state enterprises. Enforcement remained ostensibly neutral, avoiding any attempt to target rising unit labour cost rises and improve competitiveness in the deficit countries. The developing jurisprudence of the single market regarding 'market access' could have provided a legal basis upon which to remove many of the worst regulatory restrictions and special interest protections that have been put under the spot-light since the crisis erupted.[50] Even then, the surpluses might have persisted and capital markets would have likely recycled these towards bad investments. The Commission's own post-crisis assessment concluded that asset price bubbles in Ireland, Spain and the Baltic helped to raise nominal prices and wages there but did not themselves cause the trade imbalances. They merely were consequence of the capital markets misallocation of resources toward uses that did not improve productivity, above all, into property speculation.[51]

From Private to Sovereign Debt Crisis: Constructing Rescue Funds Amid a Fear of Disorderly Default

When the credit crisis first struck in 2007-8 it was confined to private capital markets. Initially there was thus no existential threat to the Maastricht framework: although the Stability and Growth Pact constraints were breached - as government debt increased to make up for shortfalls in private spending and to recapitalize banks - the sovereign debt market remained stable. The crisis first spread to the fiscal side in early 2010 when Greece failed to convince capital markets that its debt was sustainable after it revealed a much

[48] The Commission had concluded that whilst *private actors* considering lending to countries might look at the current account deficit to see if it suggests a longer-term problem of insolvency and *governments* might do so because it was a sign of inflationary tendencies, the European Union as a whole did not need to consider such imbalances.

[49] See 'One money one market,' above 22, 162.

[50] See the discussion in G Davies, 'Understanding Market Access: Exploring the Economic Rationality of Different Conception of Free Movement Law' (2010) 11(8) German Law Journal 671-703

[51] European Competitiveness Report 2010, European Commission, pp 28-42. In fact real labour productivity grew faster in Greece than Germany during the period. However real unit labour costs fell in Germany compared to Greece because of stringent wage restraint in the former. For an argument that unit labour costs are not a good measure of competitiveness see J Felipe and U Kumar, (2011) 'Unit Labor Costs in the Eurozone: The Competitiveness Debate Again' ,Levy Economics Institute, Working Paper No.651.

higher deficit than previously published. [52] Greece suddenly found that it could only either borrow at prohibitive rates or impose politically impossible levels of cuts in GDP.[53] The fact that even the data provided by a Member State could not be trusted dealt the 'law' on fiscal discipline a body blow. The Eurozone could in principle have left Greece to default: there was no legal prohibition on sovereign default nor did the Treaty give powers or mechanism to support either liquidity or longer-term finance for sovereigns.

Significantly however, despite the apparently totemic status of the 'no bail-out' principle of Maastricht, the Council immediately decided to establish a permanent fund ready to prevent contagion and meet looming problems elsewhere in the Eurozone. Support for general public spending was not directly contemplated by the Treaty: only Article 122 (3) provided some legal basis for transfers where 'a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or *exceptional occurrences beyond its control*.' The creation of the immediate temporary European Financial Stability Mechanism funded with €60 billion, secured against the EU budget, was based upon this provision.[54] The Greek fiscal crisis was clearly a result of Greek economic mismanagement over a long period upon which the general crisis was overlaid. A provision designed to cover earthquakes and hurricanes was a doubtful basis for a permanent stability fund given the clear understanding of the Maastricht settlement. At the same time Eurozone members agreed to create a private company, the European Financial Stability Facility, endowed with guarantees against up to €440 billion in fresh loans.[55] Its funding still had to be approved by national parliaments. The actual funds provided for Greece had to be initially made outside the framework of EU law altogether through bilateral loans.[56] Given the emergency, approval was pushed though at national level but there remained doubts about the legal compatibility of the EFSF and the EFSF with the Maastricht 'no bail-out' rule.[57] If a recipient of loans from EFSF or EFSM defaulted then that would amount to an illegitimate (in terms of Maastricht) fiscal transfer rather than a commercial loan.

Why did the EU arrange the initial Greek bail-out given Greece's dreadful track record on fiscal matters? The answer may seem obvious: to keep the single currency together. This said, it is not certain that a default would have seen Greece choose to leave the single currency. Exit would deny

[52] For the political economy of Greece in the period under the single currency see K Featherstone, 'The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime' (2011) 49(2) JCMS 193-217.

[53] D Gros and C Alcidi, 'Adjustment Difficulties and Debt Overhangs in the Eurozone Periphery' (2011) CEPS Working Document 326/2011 conclude that, because of multiplier effects, the fall in GDP would have had to be 31% to restore Greece to the Maastricht 3% deficit level from 12.4% in 2009.

[54] Council Regulation 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism. 12.5.2010 OJ L 118.

[55] EFSF Framework Agreement (Consolidated Version). The Eurozone states did not have to actually pledge capital upfront to the EFSF.

[56] Greek loans were however transferred to the EFSF subsequently. For a detailed analysis see J-V Louis, 'The no-bailout clause and rescue packages' (2010) 47 CMLRev 971-986

[57] The German constitutional court later ruled that, whilst the initial agreement to bail-out Greece was lawful in constitutional terms, German participation in future bail-outs must be subject to prior approval by the Budget Committee in the German Parliament. The legal powers of the Eurozone were not analysed in depth. See the judgment of 7 Sept 2011, 2 BVerfG, 2 BvR 987, 1099 and 1485/10.

Greek banks access to the ECB and lead to bank failures. The Greek government could have legally written it off its debt as it was mostly governed by Greek law. The real reason arose from fear of sparking another Lehman Brothers-style credit event. With Eurozone banks still fragile, default by even small peripheral country with a fixed stock of debts held in identifiable institutions, was seen as potentially such an event. The financial crisis had shown that capital markets were both too interconnected and too indebted for the Maastricht prohibition on bail-outs to withstand events. The Greek bail-out can thus be put down to Eurozone leaders' fear of financial markets rather than any notion of European solidarity. Since that time, the on-going problem within the Eurozone has been when and how to allow normal market forces to apply again in financial markets. This has been made more complex because the fate of sovereigns and their private banks have become entwined.

The hope that Greece was an isolated and containable case proved unfounded however as in November 2010, Ireland and, subsequently, in May 2011, Portugal, both required support from the European Financial Stability Mechanism acting in conjunction with the ECB and IMF.

The European Central Bank – an Unlikely Saviour?

The European Central Bank has come to be the key actor during the crisis. This is for three reasons: first, it is relatively immune from political or legal challenges to its decisions; second, core Member States, unable to agree openly on large scale transfers to peripheral states, were content to allow the ECB to provide funds that did not feature in their national debt figures and third, its legal remit has turned out to be rather more flexible than previously imagined.

It was not supposed to be this way. The primary duty on the European System of Central Banks (ESCB) comprising the ECB and the national central banks is 'to maintain price stability.'[58] The ESCB's obligation to promote 'the general economic policies in the Community' (including growth) is without prejudice to price stability. From the outset, inflation was considered the primary enemy to be controlled by European monetary policy. The fact that only monetary, not fiscal union, was agreed at Maastricht was made clear by Article 123 TFEU which stated that 'Overdraft facilities or any other type of credit facility with the European Central Bank or the with the central banks of the Member States in favour of ….central governments, regional, local or other public authorities…shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.' This was confirmed in Article 21 of the ECB Statute.[59] This 'no bail-out clause' suggested there was to be no recourse to the independent central banking system by Member States to help them fund their primary debts. The Commission had emphasized this limited role for the ECB in the design of the Euro to ensure fiscal discipline. The markets would have to be convinced that there would be no support: 'Only an absolute "no bail-out" clause, prohibiting financial support not only from [the ECB], but also from the

[58] Article 105(1) TFEU.

[59] Protocol (No. 4) On the Statute of the European System of Central Banks and of the European Centeral Bank C 115/230 OJ

Community as a whole, could persuade the markets that no solidarity measures can be expected.'[60]

The original design of the ESCB reflects the narrow anti-inflationary goals of its designers. The modern sovereign national central bank is typified by in practice being a lender of last resort to both the private and the public sectors. It is able to do this because its ultimate source of funding is the monopoly power of taxation held by its sovereign state. The central bank cannot go bankrupt unless its state does so. It is given a guarantee of the highest kind, namely that of the nation's taxing power. This also works in reverse: a national bank can buy up unlimited amounts of public debt to guarantee solvency and liquidity of its government.[61] The ECB by contrast was not officially a lender of last resort of to either private or public sectors.[62] In fact, it was barred from buying up their public debt. Furthermore, it remained reliant upon capital provided by its shareholders – the Member States - on a proportionate basis: there was no sovereign guarantee backed by Member States' taxation systems to protect it from financial difficulty.[63] This was deliberate; the ECB was not a sovereign institution but rather a servant of its shareholders who had made only limited commitments to its finances. Independent national central banks, well-endowed with gold and other liquid assets, remained in existence as a reminder of Member States' continued existence as independent states.

Initial response to the Crisis: Unlimited Short-term Liquidity to the Private Sector

The lessons of the Great Depression had been well-understood by most central bankers who saw that tight monetary policy to defend the gold standard was a key element in causing a recession to lurch into all-out depression in 1929-31.[64] The fact that the initial burden of the crisis was felt by the private sector left the ECB with greater legal and political flexibility to use new methods to tackle the issue. There was little legal or economic controversy about the tools employed. The aim was to ensure that there was

---

[60] 'One money, one market' above, 111.

[61] D Gros and C Alcidi, 'Adjustment Difficulties and Debt Overhangs in the Eurozone Periphery' (2011) CEPS Working Document 326/2011:'within the euro area, the usual assumption that public debt is risk-free does not hold. The reason is that no individual euro country has access to the printing press. The latter is what makes government debt risk-free in nominal terms in countries with their own currency. In this sense, in the peripheral euro area, public debt has more characteristics of private or perhaps "sub-sovereign" debt than of a risk-free security', 1.

[62] Consider M Bordo and L Jonung, 'The Future of EMU: What does the history of monetary unions tell us?' in FH Capie and GE Wood, *Monetary Unions: Theory, history, public choice*, 2003, Routledge, London and New York.

[63] See Statute of the European System of Central Banks and of the European Central Bank, Article 28 where the original capital was set at a modest €5 billion and Article 33(2) 'In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and…against the monetary income of the relevant financial year…'

[64] The Federal Reserve, no longer on gold, did not make the same mistake again and dramatically cut its main rate in early 2008 alongside providing open-ended liquidity. The ECB, historically more hawkish, remained more concerned about inflation and kept its main refinancing rate at twice that in the United States. Only when credit markets completely shut down following Lehman Brothers collapse in September 2008, did it make dramatic cuts in rates.

no chain reaction of banking failures, including large numbers of Northern European banks under stress. [65]

The ECB thus had no hesitation in supporting private banks facing a frozen credit market throughout 2007-8. It used both standard measures, cutting its main policy rate, and 'non-standard' measures, enhanced credit support in the form of loans of up one year and even outright purchases of bank debt securities. Regardless of the Maastricht Treaty scheme, the ECB can essentially create new money and loan this to banks or even buy assets outright. The only condition is that the assets provided in return be 'eligible.'[66] It is here, in the arcane world of the ECB Guideline on Monetary Policy Instruments that the real power of the Bank to fight the economic crisis has been found. This is also the principal area where the ECB has been subject to accusations of abusing its legal mandate by socialising risk across all Eurozone members. Simply by means of agreeing to accept an asset as eligible, the Governing Council has come to wield the power of life or death over banking systems and thereby nations. As the crisis spread from banks in core countries outwards to the weaker periphery, the ECB has continued to accept collateral from Eurozone members viewed as increasingly insolvent, to back the creation of new money and debt.

Initially this collateral backed long-term refinancing loans of up to one year. [67] This went well beyond the usual overnight or two-week loans that were the core of standard ECB monetary operations. Whilst primarily aimed at supporting private banks, the policy indirectly provided support to sovereign debts markets which were beginning to diverge.[68] There was however no immediate question raised about the legality of the ECB acting as lender of last resort, particularly as core Eurozone members' banks were caught up in the crisis too. The ECB reassured the potential critics that the quality of the assets it had taken onto its balance sheet was sound and that there was little credit risk for its shareholder Member States. Indeed by summer 2009, the ECB President was already promising an exit strategy through winding down of the Bank's liquidity support whilst urging Member States to similarly 'return to sound, sustainable public finances' and 'prepare and communicate ambitious and realistic fiscal exit and consolidation strategies within the framework of the Stability and Growth Pact.'[69] This chimed with the Commission's recommencing procedures to restore the fiscal benchmarks of the Stability and Growth Pact across the Eurozone.

---

[65] See L Quaglia, R Eastwood, P Holmes, 'The Financial Turmoil and EU Policy Co-operation in 2008, (2009) 47 Annual Review JCMS 63-87.

[66] European Central Bank, 'Guidelines of the European Central Bank of 31st August 2000 on monetary policy instruments and procedures of the Eurosystem,' ECB/2000/7, Chapter 6 sets out the guidelines for eligible collateral which 'must meet high credit standards....the ECB takes into account...available ratings by market agencies'(6.2).

[67] See ECB Press Release, 18 October 2008, 'Measures to further expand the collateral framework and enhance liquidity.'

[68] WH Buiter and AC Sibert, 'How the Eurosystem's Open Market Operations Weaken Financial Discipline (and what to do about it)' at http://www.nber.org/~wbuiter/smooth.pdf published by national bank of Poland.

[69] J-C Trichet, 'The ECB's enhanced credit support' Keynote address at the University of Munich, 13 July 2009.

The Rolling Sovereign Debt Crisis – the ECB Crosses the Rubicon and Repents

The fiscal position of the Member States had collapsed in 2008-9. Some Member States, like Greece, started out with very large stocks of public debt which rapidly became unsustainable when growth stopped. By contrast, Ireland began the crisis with a small public debt but this exploded after a steep recession and state underwriting of its vast bad bank debts. In these countries private funding dried up for sovereigns and public debts could not be serviced. In May 2010 when the Greek had government asked for help from the EU and IMF, the ECB had become involved in the negotiations for reasons which were initially unclear; its mandate did not include structural reform packages. The answer came when the ECB revealed that it had agreed to buy Greek sovereign debt (at a large discount) on the secondary market due to 'severe tensions in certain market segments' which were 'hampering the monetary policy transmission mechanism.' Its total purchases amounted to €40 billion. At the same time it announced that it was beginning a 'Securities Market Programme' to buy up securities rather than simply hold them as collateral to support loans to banks. [70]

Were these actions lawful? The debt purchases were still made only on the secondary market, in compliance with the strict text of Article 123. The Governing Council did not however explain how the purchase of one Member State's public debt contributed to the ECB's primary remit of achieving price stability in the Eurozone. Of course, the risk of general depression, causing deflation rather than price stability, would have been a possible basis for such action. The ECB did not however say this: its intention appeared to be to support the Greek sovereign debt market in particular. The voting procedure in the Governing Council on this issue, as on most, is not weighted by capital contribution but rather proceeds by simple majority. [71]Axel Weber and Jurgen Stark, the German members of the Council voted against the decision on the grounds that it was outside the ECB's legal remit. The exact purpose of the purchases remains obscure but it was followed by later interventions to support Ireland and Portugal. In any event, the only method of legally challenging the ECB is through direct annulment proceedings. This is however up to the EU institutions and Member States who have privileged access.[72] Any hint of such a legal challenge would of course bring financial chaos. The ECB also relaxed the collateral rules so that banks could continue to obtain short-term credit by posting Greek (and later Irish and

[70] This was not Quantitative Easing ('printing money') as practiced by the Federal Reserve or the Bank of England because the money created was sterilized by withdrawing liquidity elsewhere.

[71] See Statute of the European System of Central Banks and of the European Central Bank, Article 10. This contrasts with votes relating to the allocation of profits and losses of the ECB in which voting is weighted by capital contributions of the Member States. Gros argues that this creates a conflict of interest whenever the Governing Council is voting on monetary policy that has a particular effect upon their own region. Thus Germany benefited from covered bond programmes in 2009 whilst the periphery did with the SMP programme. The individual members of the Executive Board voting in the Council would have no reason not to vote through monetary policy that might have fiscal effects being shared by the whole EU if it led to losses. D Gros, 'Conflicts of interest in central banking', Vol 22(2) Central Banking 37-39. He argues taxpayers should have a closer say in such votes through institutional change like the closer alliance between the Federal Reserve Board and the US Treasury.

[72] Article 263 TFEU.

Portuguese) sovereign debt even though the debt had been down-graded to junk status by ratings agencies.[73] These steps helped to support the peripheral states public debt market in ways that were hard to reconcile with the ECB's narrow remit, if not directly contrary to the law governing its powers.

Having established the precedent, the ECB took similar steps by participating in bail-out packages in relation to first, Ireland, in November 2010, and then, Portugal, in March 2011. The later resignations of both Stark and Weber from the Board were in protest against these ECB purchases of sovereign bonds. Most seriously, the ECB had itself come to have a big financial interest in collecting the payments due upon its high-risk sovereign debt portfolio which amounted to over €200 billion by end 2011.In addition, the ECB held as collateral large amounts of sovereign debt.[74] The ECB has only limited capital and its own solvency was put at risk.[75] It failed to secure any guarantees from the Member States against losses on these purchases which were not senior debt (unlike IMF loans which always rank first in any default). It had to ask for further capital injections in late 2010. The ECB has become vulnerable to losses on its portfolio and has thus resisted strongly suggestions that debt in peripheral countries be restructured, repeatedly emphasizing the need for countries to honour their debts and to make fiscal cuts. This extended even to the Greek rescue packages, in which the Bank, whilst reluctantly accepting that private sector bond holders must bear losses, refused to accept any losses on its portfolio.

The ECB's growing worry about its own involvement in sovereign debt markets led to it press hard for Member States to put in place a clearer and permanent legal mechanism (beyond the EFSF) to make fiscal transfers to Eurozone members in difficulty. Alongside fears about the German constitutional court rejecting further bail-outs under the pre-existing Maastricht treaty, this drove the European Council to agree in December 2010 to amend the Article 136 TFEU to allow Eurozone members to establish 'a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole.'[76] This allowed for the creation of a permanent

[73] Decision of the European Central Bank of 6 May 2010 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Greek Government. (ECB/2010/3). Article 1 simply states that the 'minimum requirements for credit quality thresholds...shall be suspended.' Article 2 confirms that 'Such assets shall constitute eligible collateral ...irrespective of their external credit rating'. This was also applied to bank loan guaranteed by the government. Similar decisions were made for Irish and Portuguese debt.

[74] See R Ruparel and M Persson,'A House Built on Sand? The ECB and the hidden cost of saving the euro', Open Europe, June 2011.

[75] There is a lively debate about whether a central bank can 'go bust.' The consensus is that it cannot because it holds the monopoly on issuance of new currency. Therefore, commercial banks will always need new reserves which only the central bank can create. In exchange they must give it assets. Therefore, whilst a central bank may have liabilities greater than its assets for a time (if it has to write-off some of its assets), this is just an accounting measure of insolvency. It may also therefore pay out less in dividends to its state shareholders. But it will never have its financial viability in doubt because its monopoly on reserve and note creation means it is a unique business. See W Buiter, (2008) 'Can Central Banks go Bust?', Centre for Economic Policy Research Policy Papers No.24 who argues that unless they hold large volumes of foreign-denominated liabilities, then central banks can always print money to recapitalize because their hidden assets include the net present value of seignourage revenues which they can raise by creating inflation.

[76] Confirmed in European Council Decision 2011/199/EU OJ L 91, 6.4.2011, p.1.

European Stability Mechanism – the transfer fund due to replace the emergency EFSF in 2013.[77] Although the ESM had real capital and a lending capacity of €500 billion it was still perceived by markets as inadequate to actually stabilize sovereign debt yields at low levels for larger Member States. Significantly, the ESM funds could only be accessed 'subject to strict economic policy conditionality under a macro-economic adjustment programme.'[78] There was no power for the ESM to simply buy up debt in the secondary market without strings attached, becoming a lender of last resort.[79] The core countries refused to allow it to be given a banking license so that it could borrow from the ECB to finance such a role.

Eurozone leaders have always said Greece was a special case: its finances were so unsustainable that it needed both a bail-out and debt forgiveness which, although 'voluntary', imposed losses on private bond-holders (ultimately amounting to 53% of their face value). This was the first sovereign default in Europe since 1945. The impossible tension has been that Eurozone rescue funds are designed both to reassure markets whilst also avoiding moral hazard for states seeking to limit austerity packages. The imposition of conditionality immediately suggested that Member States needing support could no longer be trusted to run their own economies in ways compatible with the good of the Eurozone. Rather than being victims of the global financial crisis, such States were to be increasingly being defined as delinquents who had authored their own down-fall. The creation of the ESM thus continued the uncertainty for both the peripheral governments and the ECB: there was to be no knock-out solution to drive down sovereign debt costs and reassure markets. This maintained the market pressure on the ECB to engage in more open-ended, but legally and politically unacceptable, support for public debt markets throughout 2011.

The Eurozone Payments System: a stealth bail-out?

Continuing the critique of the ECB, other commentators from Germany have suggested that a massive hidden bail-out has anyway occurred through the payments system of the Euro.[80] The legality of this is not directly questioned but it is argued that a legal loophole allows peripheral countries access to unlimited funds through loans which pose risks for taxpayers in core countries. To understand the argument one needs to grasp the role of the European System of Central Banks in the ensuring that money flows securely through the European banking system.[81] This obligation, 'to promote the smooth operation of payments systems' is set out in Article 105(2) TFEU. In practice the system requires the ESCB to ensure that payments against any authorised bank located anywhere in the Union clear regardless of the financial position of the host country. Confidence in the banking system

[77] See European Council Conclusions 24/25 March 2011, Annex I.
[78] Article 12
[79] D Gros and T Mayer, 'Refinancing the EFSF via the ECB' (2011) CEPS Commentary argue that this would have been a way of providing liquidity to solvent Eurozone states like Italy.
[80] See H-W Sinn and T Wollmershauser, 'Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility,' CESifo Working Paper No.3500, 24 June 2011. The debate was then fully discussed in the papers collected in the CESifo Forum 2012. Accesible at http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/30publforum/_PUBLFORUM12
[81] See Bundesbank Monthly Bulletin, March 2011, 34-35 for a detailed explanation.

requires that there be no doubt that payments will be settled. This takes places ultimately through the national central banks transferring funds to meet commercial banks private payments obligations

As an example, we can imagine a Greek consumer who buys a German car. The Greek consumer's bank asks the Greek national bank to transfer the funds. The Greek national bank then has a debit with the ECB. The Bundesbank then creates funds in the German seller's bank. The Bundesbank has a credit for the same amount at the ECB. These accounting entries at the ECB are called TARGET2[82] balances. They are recorded as public exports of capital from Germany to Greece in balance of payments data. Before the crisis, such transfers of liquidity from the periphery to the core were largely re-financed by short-term bank loans from core countries. Thus, a current account deficit was matched by a capital account surplus. The TARGET2 accounts then cancelled each other out.

After the sovereign debt crisis took hold, the market for private credit to the periphery stopped amid fear over the safety of peripheral banks. These banks had to raise new reserves through borrowing at very low refinancing rates of around 1% from the ECB. As collateral, banks often provided the lowly-rated assets that the ECB has continued to accept. There was thus no obvious limit to the extent to which peripheral banks, and their citizens, could continue borrowing and lending regardless of their level of solvency.[83] The TARGET2 system, which had previously shown few imbalances, assumed a new dimension. For example, by October 2011 the Bundesbank had €496 billion (up from €25 billion in 2006) of credits at the ECB which largely matched the debits of the Irish, Spanish, Greek and Italian central banks. These vast in-flows were a mixture of capital flight, speculation and funding of current account deficits. The critics argue that these balances represent de facto forced loans to the periphery from Germany, the Netherlands and Luxembourg, backed by nothing more than dubious collateral. This has been strenuously rejected by the ECB and the Bundesbank itself who argue that TARGET2 balances do not take the legal form of loans; rather they are merely accounting entries that reflect the pattern of cross-border private sector bank payments. The profits and losses from the operations of the ESCB are distributed between its Members based upon their capital contributions not their TARGET2 balances.[84]

It is however true that if the ECB lost money because some of the assets it has acquired from the periphery turned bad, then the Eurozone members would have to recapitalize it in proportion to their shareholdings. Germany is the largest shareholder. If a Member State left altogether, the losses could be very large. The system is thus socializing the risk of default across the Eurozone without using the official lending under the ESM.[85]

---

[82] See European Central Bank Guideline on theTrans-European Automated Real-Time Gross Settlement Express Transfer system (TARGET2) ECB/2007/2.

[83] This is of course subject to the peripheral banks continuing to hold assets to put up as collateral. Their stock of their own government debts was however very large and could be added to as governments raised new loans year on year. Thus this is a theoretical limit only.

[84] Speech of Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, International Risk Management Conference 2011, Free University of Amsterdam, 15 June 2011.

[85] See S Homburg, 'Notes on the TARGET2 dispute' CESifo Forum 2012. Accesible at http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/30publforum/_PUBLFORUM12 at who speaks of 'the equivalence of TARGET2,

These sums are not obvious to taxpayers and do not appear on national debt figures. The deeper economic critique is however again that prices and wages were not allowed to adjust in the periphery. 'A bit more courage to let the market processes run their course would have saved the ECB the huge problems posed by the stock of dubious collateral it now has to live with.'[86] The ECB has attempted 'to intervene against market processes in an open-ended fashion.' It thereby prevented the collapse of the banking system but also 'relieved these countries from having to push through the necessary domestic adjustments. Thus, Spain, Portugal and Greece were spared the need to start the necessary real devaluation by reducing wages and prices' so that 'there will be a dozen Mezzogiorni in Europe…permanently on the drip of the stronger regions…who will never get back on their feet again.' [87]

If peripheral central banks had to clear their TARGET2 balances each year at the ECB by providing hard assets such as gold, these payments imbalances would not have been able to continue to grow as their central banks ran out of limited assets. [88] The cheap ESCB finance for their own commercial banks would have dried up and they would have to bear the very high market rate for borrowing. Many would be insolvent. Consumers would no longer be able to borrow at rates similar to those in Germany. The represents the Hayekian idea that loose central bank credit impedes maximal adjustment flexibility through market mechanisms. The classical gold standard adjustment process is being retarded. If this were accepted however then the single currency would cease to exist at all because euros would not all be of the same value as a means of exchange in all Member States.[89] Speculators (along with all other actors) would then have even more incentive to move money out of weak regions anticipating de facto'devaluation.'[90] The design of the single currency had always implied that countries could not run out of money and that re-financing rates in the private sector would be equal across the eurozone. The reassertion of 'national' analyses of the balance of payments has been prompted by the perception in 'creditor' regions that there is an increasing risk of default and exit.

Eurobonds and ESM' and that 'by accepting junk bonds as collateral, the Eurosystem anticipated the establishment of the ESM, created a gigantic liability union, and violated the principle of good central banking according to which monetary policy should not have redistributive effects and should be sharply separated from fiscal policy,' 54.

[86] H-W Sinn and T Wollmershauser above at 36.

[87] H-W Sinn and T Wollmershauser above at 40.

[88] There is a lively debate on this point. Some German commentators contrast the system in Europe contrasts with that in the USA which requires annual settlement between each regional federal reserve bank in gold or other assets of value. However, in practice these transfers are just book-keeping exercises to rebalance asset holdings each year. During the financial crisis the Federal Reserve Board even allowed regions to post increasingly weak forms of assets to settle their annual deficits. See Buiter et al at above who argue that tolerating these imbalances is central to a monetary union.

[89] See S Merler and J Pisani-Ferry, 'Sudden stops in the Euro area' Bruegel Policy Contribution, Issue 2012/06, March 2012, 11 who argue that setting limits on TARGET2 balances would only encourage speculation and the solution lies in resolving the underlying banking and fiscal crises.

[90] P Garber, (2010) 'The Mechanics of Intra-Euro Capital Flight' DB Economics Special Report, 10 December. Garber argues however that TARGET2 is presently enabling capital flight, even by domestic savers who have lost confidence in their own banks, to occur on an open-ended basis which is further weakening the periphery.

The Long-Term Refinancing Operation (LTRO) – the ECB as Long-term Lender of Last Resort but only to the Private Sector

The Greek crisis had continued on through 2011 as the first bail-out package had not restored fiscal sustainability. Greece still could not borrow on the market and faced insolvency in the absence of a second large loan. The ECB had bizarrely begun raising its main policy rate in summer 2011 in the belief that inflation was a risk. This made weak sovereigns weaker still, as investors worried about debt service. With peripheral bond interest rates above nominal GDP growth, debt burdens were rising. By summer 2011 speculation had re-emerged within the single currency: instead of currencies, sovereign debts and banks were now the subject of short-selling and derivatives trading. Capital flight drove up borrowing costs and became a self-fulfilling spiral. The consequence of the Eurozone members having given up their central banks' power to buy debt to control yields was becoming more apparent.[91] The governments of Italy and Spain were put together with the insolvent Greek government in the minds of financial markets. The European Financial Stability Facility was not designed to underpin countries considered too big to save. Even domestic depositors in peripheral private banks began to move their money to safer banks in core countries. In effect a hidden bank run was in progress.

A second credit squeeze was emerging in Europe, putting banks at severe liquidity risk. Whilst very short-term credit from the ECB could be realised, bank could not raise longer-term debt. Throughout this period the ECB came under increased pressure to directly buy Italian and Spanish public debt. Its continued refusal to countenance such action on legal grounds was questioned.[92] When the new governor Mario Draghi took over, expectation increased that a public bond-buying programme would began in order to help governments directly. Draghi however played a careful game: he suggested that further ECB measures might emerge if politicians acted to establish 'a new fiscal compact' that would 'enshrine the essence of fiscal rules and …ensure that the latter become fully credible, individually and collectively.'[93] He argued that 'confidence works backwards: if there is an anchor in the long term, it is easier to maintain trust in the short term.' In fact, there is also some suggestion that he had come to the view that resignations by German members of the ECB, demonstrating underlying German resistance, were serious reasons to limit further sovereign debt purchases.[94]

---

[91] See D Gros, 'Speculative Attacks within or outside a Monetary Union: Default versus Inflation (what to do today)' 16 November 2011, CEPS Policy Brief no.257. He argues that default within monetary union is more serious because it leads to a liquidity shortage and this spills over into a banking crisis. By contrast, countries that retain their own currency can ensure that central bank liquidity is maintained, which helps both banks and the sovereign to remain solvent. Ironically, one key benefit of joining monetary union for a country like Italy was said to be the lower interest rates it could achieve by giving up the right to monetarise its debt.

[92] G Davies, 'Should the ECB buy sovereign debt?' Financial Times, 20th November 2011. P de Grauwe,'Who cares about the survival of the eurozone?' 16 November 2011, CEPS Commentary.

[93] Introductory statement by Mario Draghi, Brussels, 1 December 2011, Hearing before the Plenary of the European Parliament on the occasion of the adoption of the Resolution of the ECB's 2010 Annual Report.

[94] 'We have to act within the Treaty. In general, there must be a system where the citizens will go back to trusting each other and where governments are trusted on fiscal discipline and structural reforms.' See interview with Mario Draghi conducted by the Financial Times, 14 December 2011 in Frankfurt.

A further, perhaps little known reason for urgency was the imbalances caused by the TARGET2 system. German banks had been using the flood of deposits from the periphery to pay off their central bank loans. By October 2011 the Bundesbank only had €21 billion of private securities (down from €224 billion in 2009). It refused to sell its remaining assets of gold and foreign reserves. Instead the Bundesbank had to borrow from banks to drain liquidity from the system and avoid importing inflation. Furthermore, from the ideal of a 'hard' currency backed by solid assets, the Bundesbank had only indefinitely increasing claims on TARGET2. Taxpayers and politicians worried about bearing potentially large losses on this vast indirect funding to the periphery. This threatened the whole Eurozone system and the ECB itself. If the Bundesbank refused to accept TARGET2 inflows, the ECB would itself have to buy up assets from peripheral countries to ensure sufficient liquidity. Its small capital base would be threatened and it would in effect be creating new money in breach of its long-held commitment against such action.[95] But a failure to do so would lead to the end of the Euro as a de facto exchange rate opened between, say, Greek Euros and those held in Germany. There was a need to try stem capital flight by supporting peripheral banks.

In November, Franco-German leaders openly considered if Greece should leave the Eurozone. The ECB President had questioned the ability of the Berlusconi government to institute the necessary austerity in Italy. Subsequently, Greece and Italy saw new technocratic governments appointed with austerity and reform agendas. After the European Council 8-9th December 2011 agreed a new fiscal compact treaty, the ECB acted by granting unlimited cheap loans to the European banking sector.[96] This took a new form of three-year debt at only 1% with a very generous collateral requirement: peripheral government bonds were taken as all equally risk-free. The ECB had become the lender of first and last resort in the Eurozone banking system. Providing this highly unorthodox long-term bank funding skillfully respected the key German demand that there be no direct purchase of government debt. Nevertheless the loans invited domestic banks to buy their sovereign's debts (yielding over 5-6% for Italy or Spain) and rebuild their capital. The LTRO programme was taken up on a vast scale (around €1 trillion) by banks desperate for liquidity. Some of it appears to have gone into short-term sovereign debt purchases, particularly of the stronger Member States like Spain and Italy. This was the first programme launched by the ECB engaging in fresh deposit-creation - true 'money printing'.[97] This drew

[95] A Tornell and F Westermann, 'Eurozone Crisis, Act Two: Has the Bundesbank reached its limit?' at www.vox.org/index.php?q=node/7391. It is not clear that a refusal by the Bundesbank would have been lawful or unlawful. The provision of liquidity to the ESCB is not subject to clear legal rules but arises as a necessary part of the payments system. The other fear for the ECB was that control over monetary policy in Germany would be lost because insufficient assets were held by the Bundesbank to influence inflation any longer. Normally sales of such assets would drain liquidity and reduce inflation.

[96] Decision of the European Central Bank of 14 December 2011 (ECB/2011/25) confirms the arrangement. For a second-hand account of the meeting with Europe's leading bankers before this decision see R Atkins, 'Eurozone crisis: a deft way to buy time' Financial Times, 7 February 2012.

[97] Ironically a further reason for the ECB beginning LTRO was that the Bundesbank was running out of assets to sell to meet its obligations to find funds to contribute to the TARGET2 system as deposits in the periphery ran down and required replacement. The Bundesbank had sold off its portfolio of private debts and refused to sell its gold holdings in order to provide payments liquidity. It had had to borrow money from German banks to meet its obligations under TARGET2.

the Bank far from the Maastricht ideal of a 'responsible' central focused only on price stability.

The ECB rightly continued to deny that these actions amount to illegitimate monetary financing of public debt. [98] They were certainly legally within the ECB's powers. Although its liquidity supply kept solvent governments from having to bail out their banks, the ECB has always refused to make any explicit promise to support sovereigns. This is based not just upon a fear about the legality of such a commitment. The ECB's senior officials appear reluctant to relieve the pressure on deficit governments. The ambiguous stance of the ECB, along with the limited and conditional bail-out funds through the EFSF and EFSM maintained maximum political pressure upon the Member States to instigate serious austerity and structural reform. However, LTRO itself has attracted further criticism from the Bundesbank whose President argued that the relaxation of collateral rules meant that insolvent peripheral banks were being spared bankruptcy and restructuring.[99] The scale of insolvency within the European banking sector remains unclear given the volume of emergency support.[100] The message was clear: in the end, economic pain must be imposed upon the periphery and the ECB should not seek to delay this indefinitely with 'non-standard' measures based upon loose interpretations of adequate collateral.

The reality is that the ECB was faced with a second liquidity crisis and a sovereign debt crisis which were mutually reinforcing. The LTRO sought to stem the banking crisis, whilst the fiscal compact was supposed to provide assurances that a long-term path to debt sustainability was in hand. This was nothing like a true lender of last resort commitment and it is clear that a crucial collapse in the market for sovereign debt in Europe can be dated to this period. Foreign investors were faced with default and exit risks that were no longer negligible. Furthermore, the holders of Greek public debt had been twice forced into large write-downs in order to protect official lenders like the ECB and EFSF from any losses on their loans. This precedent suggested that future bail-outs might lead to further heavy private sector losses on other

---

[98] See interview with Mario Draghi conducted by the Financial Times, 14 December 2011 in Frankfurt where he said that this is 'obviously not equivalent to the ECB stepping-up bond buying.'

[99] J Wilson, 'Bundesbank squares up to ECB's Draghi' Financial Times, 1 March 2012.

[100] The origins of the present crisis remain central to resolving it: the failure of private credit markets and a loss of confidence in banks. Solvency fears began due to bursting of bubbles in asset markets. Lenders would not lend to any banks and limited concerns about solvency developed into a general liquidity crisis. The textbook role of the central bank here is to provide unlimited liquidity to *solvent* borrowers, not to bail out the insolvent (and hence imprudent). Traditionally, central banks would lend at penal interest rates in order to flush out insolvent banks and force them towards insolvency (See W Bagehot, *Lombard Street: A description of the money market* available at http://www.econlib.org/library/Bagehot/bagLom.html) As part of a bank resolution scheme, governments and banking regulators force the disclosure of bad assets. These are then written-off or sold to a bad bank. In this manner, shareholders and bank bond-holders bear the losses of their bad investment decisions. The taxpayer only guarantees depositors' assets. The government then decides if the bank should remain as an on-going concern by recapitalisation or allowed to fail with its good assets being sold off. Banks failed in the past without systemic effects. Post-Lehman however regulators and governments have become afraid to allow significant financial institution to fail due to fear of contagion. In the Eurozone, sovereign debt default has also become unacceptable for similar reasons. For the latest European Banking Authority stress tests on banks see http://stress-test.eba.europa.eu/pdf/EBA_ST_2011_Summary_Report_v6.pdf.

sovereign debts.[101] The risk-free assets in Europe had narrowed to the government bonds of Northern surplus countries. Ironically, the failure by the ECB or the Eurozone members, on legal and political grounds, to cap sovereign debt costs explicitly for Italy and Spain raises the cost of future rescue packages and deepens the austerity needed to pay interest bills. [102]

The Increased Political Power of the ECB as an Agent of Restructuring Programmes and Fiscal Discipline

The ambiguous nature of its legal powers and intentions has allowed the ECB to play a complex game of economic bluff with other EU actors and Member States. Following the LTRO programme and the TARGET2 loans, the ECB has been emerging as the most important creditor in the Eurozone. Thus, even though it has not directly provided funds to Member States, the ECB has become heavily involved in approving and monitoring the fiscal and socio-economic restructuring of debtor countries. This occurs through its membership, along with the Commission and the IMF, of the so-called 'Troika', an ad hoc grouping that is not known to European law and has no institutional basis, democratic transparency nor legal framework. This process has been entwined with the EU's broader economic governance moving towards a tougher legal enforcement of the fiscal compact. The ECB has persistently told the Eurozone members that it considers only strong fiscal discipline can bring an end to the crisis.[103]

On the broader question of economic governance, the ECB has pushed hard for strict new legal procedures to enforce budgetary control. Thus in response to the EU Council's proposed new regulation on the excessive deficit procedure, in February 2011, the ECB argued for a tougher regime saying that 'the current crisis has demonstrated very clearly that ambitious reform to the economic governance framework is in the profound and overwhelming interest of the European Union.' This would entail a 'quantum leap in the surveillance of the euro area, which the ECB deems necessary to ensure its stability and smooth functioning.' The Commission proposal was attacked because penalties were insufficiency automatic and there were too many escape clauses. At that time, the ECB recommended a further Treaty to strengthen economic governance.[104] Important actors at the ECB have repeatedly asserted, without much evidence, that weak legal powers to enforce public debt rules had been an important cause of the crisis. It was argued that merely continuing with modified tools set up under the Stability and Growth Pact would not ensure 'a credible institutional framework

[101] The ESM treaty did not mandate 'private sector involvement' but does require an assessment of debt sustainability and write-offs where this is considered appropriate. Article 14.

[102] See W Buiter and E Rahbari,'Why Does the ECB not put its mouth where its money is? The ECB as lender of last resort for Euro area sovereigns and banks' 27 February 2012, Global Economics View, Citibank which argues that this studied ambiguity has meant that the cost to the ECB of improving the bond market in Europe has been higher than an explicit commitment would have been.

[103] In launching its first sovereign debt purchases, the ECB expressly relied upon the Member States' commitment to meet their fiscal targets in accordance with the excessive deficit procedures. Decision of the European Central Bank of 14 May 2010 establishing a securities market programme. (ECB/2010/5) at Recital 4.

[104] Opinion of the European Central Bank of 16 February 2011 on economic governance reform in the European Union (CON/2011/13).

for both a return to sound public finances and the smooth functioning of EMU.'[105] This would entail that countries 'must agree to give up sovereignty over macro-fiscal objectives (notably as regards governments deficits and debts)' but that Member States remain responsible for their own financial obligations. The changes to national law could include the introduction of balanced budget laws requiring overspends to be paid in the following year into an account. The ECB has thereby increased its influence over the shape of the EU economy as a whole but has compromised its independence and legal mandate as a tool of price stability.[106] Such interventions however 'bring the bank on to political ground, very far from its traditional technocratic set-up.'[107]

Budgetary Discipline not Fiscal Union as the New Eurozone Constitution

The death of the Stability and Growth Pact in 2005 had appeared to be inevitable: it recognised that to impose a rigid budgetary system on a diverse group of countries without fiscal co-ordination and a uniform interest rate was neither economically sensible nor politically possible. There was a final flourish in which the EU, along with the G20, approved a co-ordinated deficit-led fiscal stimulus in late 2008. Since then sovereign debt problems have pushed the SGP back into a central position in EU legal order. The EU has set out on a course of ever greater legal control over Member States' budgets. Indeed fiscal discipline was already back on the agenda as early as March 2009 when the Commission began excessive deficit procedures against most Member States. [108] These procedures currently will remain until 2013 and set demanding targets deficit reductions in order to meet the 3% target by then.[109] By September 2010 the Commission had proposed toughening the SGP.[110] These proposals were eventually passed in September 2011. They reinforce the original Stability and Growth Pact in a recast 'six pack' of Regulations on economic governance.[111] The most significant change was to set binding

[105] L Schuknecht, P Moutot, P Rother and J Stark, 'The Stability and Growth Pact: Crisis and Reform,' ECB, Occasional Paper Series, No.129, September 2011, 17.
[106] This included action outside formal bail-out procedures including writing to the Italian prime minister in August 2011 to request action to balance the budget and reform the economy.
[107] L Niedermayer, 'The gathering storm' (2011) Vol 22(2) Central banking 81-4, 83.
[108] This was strange given that the fiscal stimulus package had been agreed by the European Council only in November 2008 which actually endorsed counter-cyclical deficits to combat the crisis but it was the Commission's assumption that the worst of the crisis was past and that a four-year plan to move back towards the SGP reference values was needed.
[109] See Communication for the Commission to the Council assessing action taken in response to Council Resolution of 2nd December 2009, 15.6.2010, COM (2010) 329.
[110] COM (2010) 522 final on amending Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.
[111] Regulation No. 1173/2011 of the European Parliament and of the Council of 16 November on the effective enforcement of budgetary surveillance in the euro area; Regulation No. 1174/2011 of the European Parliament and of the Council of 16 November on enforcement measures to correct excessive marcroeconomic imbalances in the euro area; Regulation No. 1175/2011 of the European Parliament and of the Council of 16 November amending Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies;. Regulation No. 1176/2011 of the European Parliament and of the Council of 16 November on the prevention and correction of macroeconomic imbalances; Regulation No. 1177/2011 of the European Parliament and of the Council of 16 November amending Regulation (EC) 1467/97 on

annual adjustments downward of at least 0.5% in the deficit and 1/20th of amount the stock of debt exceeding 60%.[112] Where the Commission recommends fines, these are automatically imposed unless the Council rejects them by a qualified majority.[113]

Despite these attempts to reassure markets that binding fiscal laws were being re-established, as we saw, the crisis intensified in summer 2011 as contagion spread to the crucial market for Italian and Spanish sovereign debts. The ECB had hinted that further action by it was dependent upon even deeper legal guarantees of fiscal discipline. The core countries in the Eurozone felt that the commitment to fiscal discipline needed to be enshrined in higher law, through a fresh treaty. Germany had always wanted there to be greater 'automaticity' of sanctions in the original SGP and a debt-brake enshrined in national law.[114] As we saw above, the European Council agreed to sign this new 'fiscal compact' in December 2011.

Regardless of the great publicity and value attached to it, the Fiscal Compact is largely devoid of legal or practical importance; it does not significantly change the key targets already set out in the 'six-pack.' The main new feature is that it 'constitutionalizes' fiscal commitments in Treaty-form and requires them to be given similar status in national law. The most important additional economic rule is that the 'budgetary position of the general government shall be balanced or in surplus.'(Art 3) This is the new 'golden rule', defined as a 'structural' deficit of less than 0.5%. This represents the underlying deficit when the economy is adjusted for its position on the business cycle. There is however no definitive understanding amongst economists of what this figure is. It will be negotiated for each country with the Commission. For States whose stock of public debt is below 60%, a structural deficit of 1% is allowed. The 0.5% limit is an ultimate target, beyond each Member States' existing medium term objectives under the SGP and the 3% Maastricht target. Thus Eurozone members will in principle have to remove their present structural deficits which average about 4% of GDP, although the present depressed conditions will justify delay.[115]

The deeper integration of fiscal discipline into national democratic life is required as the pact must be implemented in national law 'through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be respected throughout the national budgetary processes.' (Art 3(2)) The aim is to avoid any domestic distributional disputes derailing the facts of fiscal adjustment. Parliamentary processes must be ultimately made subject to the balanced budget commitment. The European Court has jurisdiction to ensure this measure is correctly implemented. Where

---

speeding up and clarifying the implementation of the excessive deficit procedure; Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

[112] Art 5(1) and 1(a) Regulation No. 1177/2011 of the European Parliament and of the Council of 16 November amending Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure

[113] Art 11 and 12 above.

[114] H Hahn, 'The Stability Pact for European Monetary Union: Compliance with Deficit Limit as a Constant Legal Duty' (1998) 35 CML Rev 77-108, 82-3 shows how the Waigel plan of 1995 ran into difficulty because it was stricter than the more discretionary approach set out in Article 104C EC Treaty at Maastricht. It would have required a further treaty to implement as the fiscal compact has indeed now done.

[115] European Commission AMECO database.

any significant deviation from the path towards the medium term objective occurs 'a correction mechanism shall be triggered automatically.' (Art 3(1)(e))

This is an attempt to get back to the classical gold standard mechanism of automatic ex-ante budgetary constriction by governments. To this extent it largely ignores the reality of modern social democracy in Europe. The Commission is already finding it impossible to get Member States to implement the adjustment programmes that were agreed in 2009 given the recession in the Eurozone.[116] To cut the stock of debt to 60% requires running budget surpluses for perhaps two decades.[117] Debt levels are presently rising towards an average 90% of GDP. Countries like Italy and Spain, with interest rates at 5-6% and no growth must run government surpluses of 4-5% to stop debt escalating. It is difficult to see when progress along the path laid down in the Fiscal Compact might begin.[118] Only the small Baltic republics have achieved such dramatic cuts since the crisis began.[119] The Eurozone began falling back into recession in 2012 and even conservative economic opinion from ratings agencies to international bodies questioned whether further deficit cuts might be difficult to implement.[120] Unemployment rose across the Eurozone from 7% in 2007 to 10.8% in 2012 but this concealed big variations: Spain (23.6%), Greece (21%) and Ireland (14.7%) reached record highs whilst Germany saw its rate fall to 5.7%.[121]

Much economic opinion on the new Treaty thus suggests that adherence to the Fiscal Compact will lead to a prolonged period of recession in much of the Eurozone.[122] There will be on-going and bitter negotiations with DG Economic and Financial Affairs as to the pace and nature of fiscal

---

[116] See the negotiations with the new right-wing Spanish government over the pace of its fiscal consolidation which saw the Commission agree to reduce the deficit target in March 2012 from 4.9% up to 5.3% of GDP.

[117] N Heinen, 'Debt Brakes for Euroland' Deutsche Bank Research, July 2010, which calculated that Italy would take until 2041 to reach the 60% public debt ratio by balancing the budget every year.

[118] European Commission, (2011) 'Public Finances in EMU', European Economy 3/2011. Even Germany has an unsustainable debt level on some of the Commission's models. T

[119] Their unique position can be explained by the fact that they achieved record growth in the years before the crisis which made cuts more politically acceptable. They were outside the Euro but chose to maintain parity with the single currency and had to institute huge reductions in consumption to correct the balance of payments. Their unemployment tripled to over 20% and GDP fell by a similar amount. Mass migration and nominal wage cuts followed. The current account returned to surplus in 2010 on the basis of export growth and import cuts.

[120] OECD Economic Surveys, Euro Area, March 2012 argues that whilst 'the experience of the crisis may have increased the determination to impose necessary discipline on other countries, the difficult situations of many countries for the foreseeable future may make it harder for the Council to pass appropriate restrictions', 18. They concede that cuts will depress demand but assert that there is little alternative for countries with no access to finance and that 'it is unlikely that consolidation of the budget balance would be self-defeating', 13. By contrast, Standard and Poors noted that the fiscal compact was 'predicated on only a partial recognition of the source of the crisis: that the current financial turmoil stems primarily from fiscal profligacy at the periphery of the eurozone...however, the financial problems...are as much a consequence of rising external imbalances and divergence in competitiveness....' As such fiscal cuts alone as the basis for reform 'risk becoming self-defeating , as domestic demand falls in line with consumers' rising concerns about security and disposable income, eroding national tax revenues.' Press release, 13th January 2012 lowering rating on Italian sovereign debt.

[121] Eurostat.

[122] P Boone and S Johnson, 'The European Crisis Deepens' Policy Brief 12-4, Peterson Institute for International Economics, January 2012 and M Wolf, 'Merkozy failed to save the eurozone' Financial Times, 6th December 2011 for examples.

contraction. Breaches may see automatic penalties unless several larger states block them. The process will be extremely damaging politically. Larger states may be reluctantly forced to use the European Stability Mechanism with the attendant loss of sovereignty measured in compulsory spending cuts, tax rises, privatisation and liberalization being imposed.

The economic arguments of principle for some fiscal transfers within a single currency area are well-understood. [123] There is however no prospect of even shared debt issuance alongside a more democratic and open process of Eurozone-wide budget setting. This would represent a move towards political union. Instead, the funding mechanism and conditionality under the EFSF and the ESM will continue to be controlled by small numbers of officials and politicians drawn from creditor states, the Commission and the ECB. The European Commission has floated the idea of 'stability' bonds.[124] The German Council of Economic Experts has itself spoken of the need for longer-term debt refinancing at lower rates that presently on offer. It suggested the idea of 'redemption bonds' that would be temporary but spread over 25 years and cover up to 60% of debt to GDP. These ideas have been rejected by creditor nations.

Officials at the ECB have suggested that sequencing matters: the establishing of strict fiscal discipline might lead to consideration of further political integration. Certainly the few remaining triple-A rated Northern European nations will be very reluctant to endanger this status. It is clear that there no contemplation of moving to shared fiscal burdens without taking direct controls over national budget-setting. As Jurgen Stark put it 'only with a fundamental shift in our structures of in the European Union – towards a real political union – could one conceivably create incentive and governance conditions that are commensurate with the issuance of common bonds.'[125] There is however no sense in which a true political union is seen as essential: 'There is no need to have a single budgetary policy in the euro area. No need for a so-called transfer union.'[126] For Eurozone members facing an uncertain period of austerity however, the possibility of default whilst remaining within or

[123] P Krugman, ' Lessons of Massachusetts for EMU' in F Torres and F Giavazzi, *Adjustment and Growth in the European Monetary Union*, 1993, Cambridge University Press who argues that regional specialisation increases in monetary union and renders regions vulnerable to asymmetric shocks that require fiscal assistance to counteract. C Goodhart, 'European Monetary Integration' (1996) 40 European Economic Review 1083-90. 'One must ask the larger question whether countries which do not feel sufficient cohesion to agree to a larger transfer of fiscal competences to the federal centre are sufficiently cohesive to maintain a single currency.' (1089) But he concludes that it is a 'chicken and egg problem. Once we do have a single currency, and no balance of payments data, it will, happily, become considerably harder to estimate net costs, or benefits, to any constituent nation of any fiscal measure.' The hidden nature would allow a transfer of power to the centre but during the early years it will be fragile before selfish attitudes cease. Until then those affected by crises will advocate 'revoking the irrevocable' as they can blame EMU for their problems. 'Within a single currency area, the loss of a region's competitiveness does not become evidenced in worsening regional balance of payment data…but more directly in measures of regional depression, falling output and employment.' (1088)

[124] European Commission Green Paper, 'Feasibility of introducing Stability Bonds' COM(2011) 818 final.

[125] Introductory statement by Jurgen Stark, Member of the Executive Board of the ECB, Brussels, 17 October 2011, Hearing at the Committee on Economic and Monetary Affairs of the European Parliament.

[126] Intervention by Lorenzo Bini Smaghi, Deputy-President, European Central Bank, ECON Committee Hearing on "Improving the economic governance and stability framework of the Union, in particular in the euro area," Brussels, 15 September 2010.

of exiting the single currency will begin to be considered.[127] Indeed, perhaps the most pressing unresolved issue remains that of devising a legal framework to allow a Member State to leave the Eurozone.[128]

The Evolving Policy Framework: From the Instability of Law to the Instability of Politics

During the first period of the crisis 2007-9, when the problems were most acute in the *private* debt markets, the Eurozone system apparently managed well. The ECB was able to act flexibility to make credit available to banks. Since 2010, attention has focused upon *public* debt markets. Driven by fear, rather than a desire for closer union, the Eurozone eventually created highly discretionary funds with strict conditions and high interest rates. These funds will be dispensed, in an opaque manner, by the European Stability Mechanism in conjunction with the ECB. Throughout this period the ECB has provided large volumes of liquidity and shifted private assets onto the public balance sheet without democratic approval.

Thus far in fact, the crisis has produced a shift away from law and legal systems, embodying the equality of Member States, towards national politics and fear as the driving force within the Eurozone. The more powerful Member States and the European Central Bank, supported by the International Monetary Fund, have begun to direct economic reform programmes in faltering Member States largely *outside the legal framework* of the EU Treaties. The single market system enforced by the European Commission and private actors has been judged to have failed to deliver stability. This new system of power politics at the heart of the Eurozone represents a significant shift away from the rule of law that has dominated the single market hitherto.[129] Thus democratic debate in the Council and Parliament on liberalisation, enforcement of single market rules by the Commission or private actors before the Court of Justice, the doctrines of proportionality and careful balancing of social and economic objectives will no longer apply to weaker states faced with severe budgetary problems; instead, structural reform, regardless of its necessity or appropriateness under EU law, will be imposed by creditors.

A new kind of discretionary *political* architecture has replaced aspects of the old *legal* order. The weaker Member States will continue on, not as equal sovereigns, but as dependents. This was neither legally nor economically inevitable. Clearly Maastricht did not create an EU fiscal funding mechanism, but the European Central Bank's legal remit was not without a

---

[127] For Greece, for example, the primary deficit in government spending meant that it needed foreign money to continue to provide public services. Its banking sector would also have been insolvent with a default. Once it has achieved primary balance, default and exit from the Euro might enable it to recapitalize banks and pay its bills without generating massive inflation. For other countries, a debt restructuring within the Euro would be more attractive because it would not lead to the same scale of capital flight and banking crisis.

[128] For a detailed exposition of the legal and economic mechanics of exit see A Das, 'A How to Manual for an Amicable EZ Divorce'(2012) Roubini International Economics, accessible at www.policyexchange.org.uk.

[129] See M Ruffert, 'The European Debt Crisis and European Union Law' (2011) 48 CMLRev 1777-1806 'the intergovernmental and coordinating quality of the mechanisms established …calls into question their democratic legitimacy' at 1801.

flexibility that could have been employed to support solvent Member States, particularly Spain and Italy, facing liquidity problems. It could have made commitments to buy up debt in the secondary market without breaching any explicit provision of the Treaty. Indeed the prospect of this has been constantly hinted at as a *deus ex machina* that could be employed in extremis. Whilst citing legal limitations on bond purchases, senior ECB officials have repeatedly endorsed the economic model of austerity, probably to reassure Northern European leaders but also because they genuinely support it on ideological grounds.

The Gold Standard Debate Replayed: Law, Politics and Market Mechanisms

The search for solutions to the crisis repeats many of the debates that were seen during the 1930s around the gold standard and Great Depression. The debate between Keynes and Hayek is well-documented. The former argued that, unlike in a standard business cycle, general deflation led to worsening indebtedness and real wage cuts were very difficult to achieve in social democracies. The latter argued that loose central bank credit had created a boom/bust and that only liquidation and deflation could correct this.[130] Modern-day liberal thinking finds echoes in the EU treaty's legal framework: there should be no bail-out of insolvent sovereigns or banks by the Eurozone members or the ECB. This underpins a modern-day gold standard philosophy about the way the single market can and should operate. The legal rules of the game are set in advance by (a) adherence to free trade as embodied in the four fundamental freedoms allied to (b) a stable currency which is underpinned by strict fiscal discipline. If legal and currency stability is maintained this way, then markets will clear through adjustments in the prices for credit, labour, goods and services. On this view, resolution of the crisis lies in reaffirming the rules of the game. This reflects strong liberal strands in German economic thought.[131] Both social market economists and the more

[130] For a good statement of the Hayekian position on the origins and correct response see L Robbins, *The Great Depression*, (1935) London, Macmillan: 'But this brings us back to our main contention, the necessity for the elimination of all kinds of inflexibility. In order that the recovery should be restored and future dislocations minimised, it is necessary not only that flexibility should be restored to the prices of different kinds of labour but that flexibility should also be restored in other markets.' He advocated a return to the gold standard and a reduction in wages and prices to clear markets. For a Keynesian view see R Hawtrey, *Trade Depression and the Way Out*, (1933) London, Longmans who advocated inducing inflation: 'Revival means the resuscitation of demand. Demand in any country is expressed in terms of the country's own currency unit. It is a matter within a country's own control, and does not require international co-operation. Each country separately can find the way out of the trade depression by so adjusting the purchasing power of its currency unit as to secure equilibrium between prices, wages and debts.'(171) As regards money wage cuts he said: 'Those who contend that wages should be adjusted to prices rather than prices to wages are like Grock moving the piano up to the music stool instead of the music stool to the piano.'(124)

[131] For a detailed history showing why supply-side social market economics has been so strong in Germany see CS Allen, 'The Underdevelopment of Keynesianism in the Federal Republic of Germany' 263-290 in PA Hall, *The Political Power of Economic Ideas: Keynesianism across Nations*, (1989), Princeton University Press. For a more recent view see S Dullina and U Guerot, 'The Long Shadow of Ordo-liberalism: Germany's approach to the Euro Crisis' European Council on Foreign Relations, Policy Brief No.49, February 2012. For a summary of position see S Razeen, 'Ordoliberalism and the social market: Classical political economy from Germany' (1996) 1(2) New Political Economy 233-257. W Moschel, 'The Proper Scope of Government viewed from an Ordoliberal perspective: the example of competition policy' (2001) 157(1) J Institutional and Theoretical Economics 3-13. The two

laissez-faire ordo-liberal school focus upon legal certainty as a crucial to capitalism. Whilst the social market perspective goes further and see supply-side reforms as important to growth, neither perspective sees a significant role for demand management.

At first glance, in political terms, this view seems to lead to the conclusion that the original design of the Maastricht treaty was largely adequate. There should be no need for any closer political union within the Eurozone, for example, to allow for the issue of common public debt or direct welfare transfers to governments.[132] At a more populist level, this has been fed by an understandable narrative that Northern Europe's surplus countries should not be 'punished' for their success by permanently supporting the indebted South. 'Moral hazard' in the economic sphere must be avoided; bail-outs only encourage further misbehaviour and higher costs in the future. In short: the EU is not a sovereign country, but it does not need such closer political union to have a stable functioning economy with a single currency. However there are still strong strands within German thinking that argue that closer control over economic policy is actually essential for monetary union to really work. This was the original view of the Bundesbank and Helmut Kohl in the period before Maastricht. In short, the longer-term German vision may be that of a political union with a joint treasury and joint liability but only after budgets have been brought into balance by countries that can be trusted.

In the Keynesian view, there was over-reliance upon markets to correct all imbalances and an under-regulated market for capital and credit. The role of excessive public debt is viewed as less significant, apart from in the case of Greece. [133] On this account, the single currency locked in and increased trade imbalances in the Eurozone which arose from excessive savings from Northern European being recycled into trade deficits in the periphery in a kind of vendor finance scheme. The largely unregulated single market in finance, rather than leading to stability, created a ticking time-bomb at the heart of the EU. Capital flight from the periphery then took hold in both private and public debt-markets. This created a balance of payments problem (now seen through TARGET2) and a recession. A sensible path for adjustment is

---

perspectives, liberal and Keynesian, reflect profoundly different roots and philosophies. For Germany, tight monetary policy and an emphasis on export-led growth driven by training, wage-control, competition and long-term investment has been a key to post-war success. The artificial raising of demand by spending or loose credit is only likely to produce inflation. More deeply, there is a belief that the real economy cannot be manipulated by monetary means. This is very close to the long-standing agenda of the European Union in many respects with its emphasis on supply-side reform, technical progress and inflation-control. Keynesians by contrast, whilst not denying that supply-side factors are critical to long-term growth, argue that there are situations when demand imbalances can be behind unemployment and that government intervention to stimulate demand can affect the real economy. In the end, most of the Keynesian tools such as public spending, devaluation or cheap money entail higher inflation but this is seen as a price worth paying if the trade-off with employment is strong enough. For economic elites in Italy and France, for example, the single currency had been more about resolving domestic political impasse. Devaluation and loose money were seen as political compromises born of a failure between classes, groups and regions to agree on fundamental supply-side and tax reforms. In the end, as central bankers like Mario Draghi have repeatedly stated, a single currency may force countries to finally confront their underlying economic problems.

[132] See the comments by 189 German economists locating the problem in excessive public debts at Plenum der Okonomen (2011) Stellungnahme zur EU-Schuldenkrise (http://www.wiso.uni-hamburg.de/lucke/?p=581).

[133] P de Grauwe,'Balanced budget fundamentalism', 5 September 2011, CEPS Commentary.

primarily through the periphery increasing exports and reducing imports. [134] Using austerity alone to drive down wages is very difficult. Sharing the burden by raising demand and inflation in surplus countries is key. The reason why the gold standard collapsed was because this adjustment was imposed on debtor/deficit countries rather than shared with creditor/surplus countries. The ECB has co-ordinated continued liquidity but the process of trade adjustment has barely begun.

Restructuring or Rebalancing the European Economy?

Thus from a Keynesian perspective, a *balance of payments* compact is needed rather more than a fiscal compact. The Euro appeared to abolish the balance of payments as an issue for Eurozone members. Now however it is clear that imbalances were simply masked.[135] What in the past would have been adjusted by currency realignment, is instead being imposed by legally binding fiscal tightening. A legal system to balance trade was first proposed on a global scale by Keynes in his 1943 suggestion to create an International Clearing Union.[136] Mindful of the problems of the gold standard, he noted the lack of symmetry between countries faced with trade imbalances: surplus countries could stockpile reserves indefinitely whilst deficit countries had to bear the whole burden of adjustment by austerity. One answer was to *legally require* both surplus and deficit countries to adjust by a system of pressure and fines.

The European Union already has the basis for such a system through TARGET2 payments. However under the current rules do not prevent either infinite excess deficits or surpluses.[137] The reason Keynes' plan was rejected by the United States was that under his system countries were *obliged* to fund deficit countries to a considerable extent and also to inflate their economies to raise imports. As we have seen, Northern European surplus countries have now come to see TARGET2 as a forced loan of nearly €800 billion to the periphery. Their trade surplus is seen as a virtue derived from superior skills, thrift, efficiency, wage-restraint on so forth, whilst the periphery's deficit is viewed as indicative of vice, profligacy, debt-driven consumption, lack of wage discipline and poor governance. Given this political and moral characterisation, it is clear why public funds have been given reluctantly and are tied to supply-side reforms.[138]

The question raised for Europe now is similar to that put in response to Keynes: is Europe in a 1945 moment or a 1929 moment? The former was a time of reconstruction when the surplus country, the United States, was happy

[134] P de Grauwe,'Governance of a Fragile Eurozone' 4 May 2011, CEPS Working Document argues that in lieu of full fiscal union, the introduction of cheap loans via the ESM, Eurobonds and greater credit controls to prevent bubbles would help to reduce the costs of adjustment.
[135] M Wolf, 'Can One have Balance of Payments Crises in a Currency Union?' 16 February 2012, Financial Times who argues that the adjustment mechanism within a single currency is through the credit channel so that a deficit country (and its banks) suffer capital flight and increased borrowing costs.
[136] I de Vegh, 'The international clearing union' (1943) 33(3) American Economic Review 534-556
[137] L Paus and A Troost, 'A European Clearing Union – the Monetary Union 2.0,' March 2011, available at www.guengl.eu/upload/A European Clearing Union March 2011.pdf.
[138] The fact that massive volumes of ECB funding have gone to the periphery to fund capital flight and general consumption is a problem.

to fund long-term development in Europe through the Marshall Plan, but only if it had control over the process. The latter was a time of general economic depression which government could alleviate through raising demand.[139] The situation amongst contemporary European countries displays elements of both problems. Greece is clearly in need of fundamental restructuring in important respects if it is to be part of the single currency.[140] The Eurogroup suggestion of a 'reconstruction commissioner' for Greece is indicative of the break-down in governance and trust. Ireland by contrast is seen as a very open and flexible economy which always followed the liberal market approach advocated by the Commission. It required a bail-out because it guaranteed its banking sector's debts. Despite faithful implementation of its adjustment programme, it may need further support.[141] Italy and Spain exhibit a confusing mixture of both elements: they have some dynamic export sectors but now depend upon capital funding from Northern Europe through the ECB to keep their banks from insolvency. They also exhibit, to varying degrees, long-standing structural problems that impede growth and competitiveness. Expansion of demand in surplus countries would help all Eurozone members to develop exports and grow.

Taking the opportunity to use their capacity as creditors, the surplus countries, Commission and the ECB are seeking to push through long-cherished reforms aimed at liberalisation and restructuring that go back to the Lisbon agenda and before.[142] These reforms could not be pushed through using EU single market harmonisation nor through soft law and domestic democratic processes. Now the reforms will emerge through conditionality and excessive deficit procedures. It is hinted that, once adequate progress is made, then wider political union may be considered. But long-term austerity is the very opposite of a reconstruction plan. It is doubtful whether such a

[139] See I de Vegh, 'The international clearing union' (1943) 33(3) American Economic Review 534-556 who argued that the United States would have had to contribute huge funds through the clearing union to support European reconstruction without any control over its use. The clearing union could only be 'established in the last stages of economic reconstruction, after economic and political stability has been established.' Otherwise the clearing union would become a 'minor Dracula' exposing the United States to 'periodic bloodletting without any tangible benefits in return.' (553).

[140] For an example of how ambitious this is note: 'The adjustment programme contains a very wide-ranging programme of reforms covering practically all spheres of the economy. In addition to measures that directly contribute to fiscal consolidation, including public administration reform, the fight against tax evasion, healthcare and pensions reforms, there has been some progress in increasing labour market flexibility, the liberalisation and deregulation of professions and services, including utilities, the simplification of investment licensing and the deregulation of the business environment. However the pace at which these reforms have been legislated and implemented has by far not been commensurate to the needs of the Greek economy. A decisive implementation of structural reforms and confrontation of vested interests requires committed action not only by the whole Greek government, but also via a consensus of the main political parties.' European Commission, 'The Economic Adjustment Programme for Greece', Fifth Review, October 2011.

[141] See European Commission, European Economy, Occasional Papers 93, March 2012, Economic Adjustment Programme for Ireland – Winter 2011 Review which notes that growth returned and the current account returned to balance in 2011. Despite government earmarking further cut-backs 'confirming their commitment to do "whatever it takes" to ensure that the deficit-reduction path' is achieved, the continued burdens on the government of resolving the banking crisis meant that capital flight was continuing and unemployment rising with a peak of 15% expected in 2014.

[142] See L Tsoulakis, 'The JCMS Lecture: Managing Diversity and Change in the European Union' (2006) 44(1) JCMS 1-15. European Commission, (2004) 'EMU after 5 years' European Economy, Special Report argued that supply-side problems were the key to poor economic performance so far under the single currency.

programme can be sustained for long.[143] It is not even certain that structural reforms will actually deliver adequate growth because not all Eurozone members can have trade surpluses with each other. The German model of export-led growth arithmetically requires other countries to be in trade deficit.

In the end, the economics suggest that rebalancing must come from both higher growth and inflation in trade surplus countries alongside socially containable austerity in deficit countries.[144] A pan-European bank resolution system and funding for recapitalization will also be required.[145] The level of austerity required should be made bearable by restructuring debt where it is not sustainable (cases of de facto insolvency) and capping bond yields by using the ESM as a true lender of last resort to support countries that are solvent but facing loss of market confidence.[146] None of this is however likely to come in the form of new formal legal commitments but rather will emerge from necessary political compromises.[147]

Conclusions

The legal structure set up at Maastricht has clearly failed. The designers of the Maastricht treaty sought to legally insulate themselves against both inflation and fiscal transfers. In the end this proved impossible. The problem developed in bank credit markets that funded trade imbalances which were not corrected by fiscal or other governance measures. It was believed that capital markets would discipline countries and banks. In fact, markets seemed to have found the single currency too credible: it was assumed (correctly as it turned out) there was an implicit commitment to prevent any sovereign default or exit. The levels of public debt only rose dramatically as a consequence of the collapse in the private sector. Fiscal policy was not the immediate cause of the crisis. Since the sovereign debt markets began to fail in 2010, fear of a second financial disaster has led to improvised legal and quasi-legal action to prevent sovereign default. The longer-term solution lies in resolving which legal and economic model the Eurozone wishes to follow.

---

[143] D Valiante,'The Eurozone Debt Crisis: From its origins to a way forward' (2011) CEPS Policy Brief No.251 who argues that reconstruction is a longer-term project that must follow after sovereign debt markets have been calmed by ECB quantitative easing. Peripheral countries can then be pressured using the ECB interest rate cap to make cuts and reforms.

[144] See T Mayer, 'Euroland's hidden balance-of-payments crisis' (2011) Deutsche Bank Research: 'From the deficit countries' point of view, a policy that overheats the surplus countries is the best outcome as it spares them the costs of deflation. The adjustment costs would be shifted to the creditor countries in the form of ...inflation....these costs are intransparent (sic) and distributed over a long period of time...',7.

[145] European Parliament, (2012) DG General for Internal Policies, Policy Department A: Economic and Scientific Polices, Economic and Monetary Affairs, 'Bank Recapitalisation and Sovereign Debt Restructuring' Briefing Note, IP/A/ECON/NT/2011-01. At the time of writing, Spain has begun the process of forcing banks to increase their provisions against bad debts and the European Commission appears to be considering a relaxation of the Spanish deficit reduction target in light of the cost of recapitalisation.

[146] D Gros and T Mayer, 'Refinancing the EFSF via the ECB' (2011) CEPS Commentary.

[147] The recent election of Francois Hollande as a French president committed to a 'growth' agenda will force a compromise with Germany but this is unlikely to be seen in any change to the Fiscal Compact but rather in joint funding for infrastructure projects and some tolerance of higher inflation in Germany.

We can return to the problems of credibility and co-operation identified by Eichengreen in relation to the gold standard. On one side, we can see the liberal school, who argue that whilst private markets prompted the crisis, the use of large-scale public debt and cheap ECB liquidity has worsened the problems and delayed painful reforms. Credibility must be restored through the fiscal and monetary discipline of a stronger legal framework. The Eurozone can then rebalance through market adjustments in wages and prices in weaker regions. The ECB must be stopped from printing money backed by poor assets and move closer to a gold-standard adjustment system. This might entail default and exit for some. On the other side, are the new Keynesians who argue that the solution lies in closer fiscal co-operation through increasing growth in surplus countries to reverse trade imbalances. This must involve higher inflation in core countries. The difficulty of achieving internal devaluations within the periphery is too great. The risk of years of austerity leading to further defaults and possible exits from the Euro is real. PolyaniPolanyi's point that social democracy is largely incompatible with fully flexible markets is still true. Political leaders will struggle to overcome serious social unrest to radically restructure social democracies.[148]

The politics and power balance have so far seen Northern European states follow the liberal economic approach. They have refused to create a lender of last resort to restore market confidence in Eurozone sovereigns. Rather, strict conditionality and modest fresh loans have been offered. Crisis has come to be seen as an instrumental part of the unfinished liberalization process. This approach aims: first, to allow as much capital repatriation by Northern banks as possible, second, to convince debt markets that core Eurozone members will be solvent in the longer term; third, to convince electorates in the stronger states that they will not have to bail-out or subsidize the public spending of other EU states indefinitely; fourth, to facilitate more direct control over the economic and social decisions of weaker Member States and; fifth, if possible, to produce the real wage reductions necessary to eliminate trade deficits.

The most important EU player in the crisis has been the ECB. It has been able to use the legal ambiguity of its remit to maintain the single currency whilst imposing its own liberal political and economic agenda. The Bank has drawn a sharp distinction between states and private actors. It has maintained adherence to the German view of the Maastricht settlement by not funding public deficits. Its direct public debt purchases were limited and then stopped. It successfully advocated for two broader objectives: the re-establishing of a truly constitutional commitment to 'sound public finances' and the establishment of a bail-out fund with strict conditionality. It has thus refused to be a lender of last resort to sovereigns, who can therefore only meet losses in market confidence with fiscal tightening. For private actors, by contrast, the ECB has however avoided the tight money policy of the gold standard by providing vast liquidity. Critics argue that this distinction between sovereigns and private debtors is not tenable. For liberal gold standard advocates, private liquidity provision has merely delayed bank insolvencies, impeded adjustment in the periphery and indirectly exposed Northern

[148] J Ponticelli and H-J Voth, 'Austerity and anarchy: Budget Cuts and Social Unrest in Europe, 1919-2009' (2011) CEPR Discussion Paper Series No.8513.

European taxpayers to risky assets. On the other side, Keynesian critics say that the failure to cap sovereign debt yields for solvent Member States weakens peripheral banks and necessitates levels of austerity that lack credibility with markets.

The question remains: will this any of this ultimately lead to full fiscal union? Certainly fear of default by peripheral states is not a good basis for deeper union. The lack of trust on all sides is great. The willingness to pool sovereignty further in a common treasury and debt issuance seems very limited. To avoid a financial disaster - which would undoubtedly spread to core countries - the short-term palliative of bail-out funds, whether directly through the ESM or indirectly through the ECB, will continue along with longer-term structural reform. The loss of fiscal, social and economic policy autonomy will be large. This may become intolerable, prompting further debt restructuring and even exit from the Euro in some cases. It is possible also that core countries may choose to leave if the burden of transfers is seen to be too large. The Eurozone has yet to find a stable legal and economic framework that will guarantee the future of the single currency in its present form.