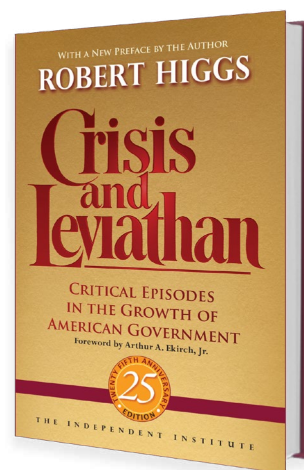
SUBSCRIBE NOW AND RECEIVE *CRISIS AND LEVIATHAN** FREE!

"***The Independent Review*** does not accept pronouncements of government officials nor the conventional wisdom at face value."
—**JOHN R. MACARTHUR**, Publisher, *Harper's*

"***The Independent Review*** is excellent."
—**GARY BECKER**, Noble Laureate in Economic Sciences

Subscribe to ***The Independent Review*** and receive a free book of your choice* such as the 25th Anniversary Edition of ***Crisis and Leviathan: Critical Episodes in the Growth of American Government***, by Founding Editor Robert Higgs. This quarterly journal, guided by co-editors Christopher J. Coyne, and Michael C. Munger, and Robert M. Whaples offers leading-edge insights on today's most critical issues in economics, healthcare, education, law, history, political science, philosophy, and sociology.



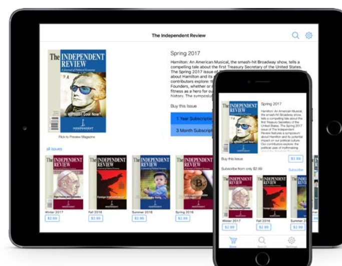
Thought-provoking and educational, ***The Independent Review*** is blazing the way toward informed debate!

Student? Educator? Journalist? Business or civic leader? Engaged citizen? This journal is for YOU!

***Order today for more *FREE* book options**

SUBSCRIBE

Perfect for students or anyone on the go! ***The Independent Review*** is available on mobile devices or tablets: iOS devices, Amazon Kindle Fire, or Android through Magzter.



INDEPENDENT INSTITUTE, 100 SWAN WAY, OAKLAND, CA 94621 • 800-927-8733 • REVIEW@INDEPENDENT.ORG PROMO CODE IRA1703

The Agony of the Euro

Roy C. Smith

Late in 2011, the European Union (EU) convened a meeting of its twenty-seven heads of state to hammer out an unprecedented agreement on fiscal unity that was designed to calm persistent fears of the dissolution of the euro and possibly of the EU itself. Powerful market forces had disabled the remedies put in place by Eurozone leaders over the previous eighteen months by continuously devaluing European sovereign bonds, bank debt, and other securities.

The agreement that followed, presented in Brussels with much fanfare on Friday, December 9, 2011, was a reluctant acknowledgment that the interests of all Europe necessitated that high-cost bailouts of a few countries would require all the rest to accept tight, centrally controlled fiscal and budgetary standards. The agreement was soon called the "Merkozy Plan" after its principal sponsors, German chancellor Angela Merkel and French president Nicholas Sarkozy. Markets appeared to be relieved: the Euro Stoxx 50 index rose 2.8 percent that day.

The plan provided for a "Fiscal Compact" to limit national debt levels of all EU countries, with mandatory fines for those in violation; a "Golden Rule" that each country would pass a balanced-budget amendment to its constitution, which would have to be certified as legally sufficient by the European Court of Justice; "firewalls" to prevent the crisis from spreading to other countries by leveraging and accelerating the deployment of previously agreed €440 billion of European Financial Stability Funds (EFSF); and a new promise to lend €200 billion to the International Monetary Fund (IMF), funds that are to be lent out again, under the IMF's strict controls, to distressed Eurozone member countries. It was intended as a major step

Roy C. Smith is a professor of finance and entrepreneurship at New York University Stern School of Business.

The Independent Review, v. 18, n. 1, Summer 2013, ISSN 1086–1653, Copyright © 2013, pp. 49–76.

in shifting national sovereignty over economic policy to the European Commission, the EU's faceless, central governing body.

For the Merkozy Plan to be applicable to all member countries of the EU, it would have to be ratified by all of them. The United Kingdom did not go along, however, so the compact was redirected to apply only to the seventeen countries that utilized the euro (collectively "the Eurozone"), with the other EU countries participating voluntarily.

By the following Monday, however, the markets had reconsidered its support. Over the next three days, the Euro Stoxx index dropped nearly 6 percent, bringing its 2011 decline to 21.3 percent, as compared to a decline of less than 1 percent for the U.S. S&P 500 index. Bond spreads for Italy and Spain, which had narrowed by more than one hundred basis points in anticipation of the agreement, widened once again.[1] The euro–dollar exchange rate also weakened—it had already declined by 12.8 percent against the dollar since rising to its peak for the year at €1 to U.S. $1.48 in May 2011. The gloom that had spread over European (and American) financial markets since the beginning of the year but then had lifted after the announcement of the Merkozy Plan quickly returned.

Investors in key financial markets evidently did not believe the December agreement went far enough; the EU had made earlier promises to control debt levels, but even Germany and France had regularly ignored them with impunity. Why would this agreement be any different?

Many economists claimed that the Merkozy Plan headed in the wrong direction. The best solution, they said, was to issue "Eurobonds" collectively guaranteed by all the countries of the Eurozone to stem the panic. Instead, the plan offered a long-term effort to improve the credibility of the Eurozone by providing the missing fiscal union that would assure acceptable government debt levels in the future. Neither Germany nor France was prepared to guarantee the rest of Europe's debt without these assurances, so this was the best that could be done for the time being—at least until the Merkozy Plan's commitments were fully and legally put in place.

Italy alone had more than €3 trillion of public debt outstanding, and if it had to sustain this level of debt at then prevailing market rates of 6.5 to 7 percent, its finances would collapse. Italy would also have to be bailed out at a cost far greater than the resources the Merkozy Plan had been able to assemble.

The Economist pointed out that only the European Central Bank (ECB) had the financial capacity to turn markets around ("A Comedy of Euros" 2011), but this idea was anathema to the Germans, who feared that printing enough new money to save Italy would be inflationary, would undermine the euro, and might not be repaid.

The critics' consensus was that the governments of the EU had once again done too little, too late to win the race against market forces that were about to undo the

1. Spreads are the difference in interest rates between these bonds and German government bonds.

thirteen-year experiment with a single European currency, which many academics on both sides of the Atlantic had considered poorly designed and premature.

Origins of the Experiment

Shortly after World War II, the reorganized governments of continental Europe found themselves endangered by three different threats.

One was the urgent need to revive the economies of the war-torn region, which was to be assisted by the formation of the World Bank, the IMF, and the General Agreement on Tariffs and Trade (now the World Trade Organization), as agreed to in 1947. In addition to these new institutions, the U.S. Marshall Plan (1947) was aimed to help Europe especially.

A second concern was over the possible rise of Communist parties within Europe and the threat of hostilities with the Soviet Union, for which the North Atlantic Treaty Organization (NATO) was put in place in 1949.

A third was to prevent the ending of a war with Germany from seeding the beginnings of another. This latter concern would require a different way of thinking from what had emerged after World War I. It would be based on the idea that an economically prosperous Germany, integrated into Europe, would create commercial and financial entanglements that would tie it and the rest of Europe together in such a way as to make war an impracticable solution to cross-border conflicts and therefore unlikely.

Some in Europe sought a set of new European institutions, separate from the global institutions formed after the war, to assure its economic and political integration. German chancellor Konrad Adenauer and French president Charles de Gaulle were early leaders in the this effort, as were three French civil servants—Jean Monnet, Robert Schuman, and Robert Marjolin, who rose to become the principal journeymen tasked with delivering the requisite European institutions. This Franco-German effort, one that continues today, began with the creation of the European Coal and Steel Community (1951), Euratom (1957, for the peaceful use of nuclear energy), and the Treaty of Rome (1958) among six continental countries. This treaty established the European Economic Community (EEC), a form of customs union with an executive body (the European Commission); a Council of Ministers; and a development agency, the European Investment Bank. Britain joined the EEC in 1973, after French objection to U.K. membership was withdrawn. Defense was left to NATO, which encompassed the same countries, although France withdrew from NATO in 1966 and did not rejoin until 2009.

European economic development benefitted from the establishment of these institutions. Several academic studies have demonstrated that the reduction in intra-European tariffs provided significant stimulus to the private sector, but the benefit only went so far (Erixon, Freytag, and Pehnelt 2007). Economic growth within Europe was still uneven.

By the 1970s, politics in Europe had swung to the left, triggering extensive nationalization of private industrial corporations and banks, a rise in the power of labor unions, a surge of Euro communism, and outbreaks of terrorism by radical groups—all while economic output drifted into a state of low growth and high inflation (which some journalists called "Stagflation").

By the end of the 1970s, continued weak economic performance in Europe (a condition that journalists called "Eurosclerosis"), especially in competition with the United States and Japan, was coming to be considered a threat to European standards of living. This concern shifted political sentiment back toward more conservative, market-driven policy ideas. Margaret Thatcher became prime minister of Britain in 1979 and led the way in confronting labor unions, reforming financial markets, privatizing industrial companies that previously had been nationalized, and actively pursuing free-market economics. The resulting economic success in the United Kingdom under Thatcher soon spread her policies to the continent.

The Single Market

In 1985, the European Commission, then presided over by Jacques Delors (another pro-Europe, French civil servant), ordered a study of an "integrated market" for Europe, free of various residual trade and other barriers that had survived the Treaty of Rome. Delors delegated the job to Arthur Cockfield, a market-oriented euro skeptic newly appointed to the commission by Margaret Thatcher. Only a few months after Cockfield arrived in Brussels, he produced a mammoth white paper listing three hundred barriers to intracommunity trade, with a timetable for abolishing them (Cockfield 2007). He engaged Italian economist Paolo Cecchini to conduct a study of the costs of the remaining internal trade barriers and the value to be obtained by their removal. Cecchini's report, published in 1986, declared that the member countries could boost their collective gross domestic product (GDP) by 5 percent by eliminating these barriers (Committee of the European Commission 1998). Soon afterward, the now twelve members of the EEC passed the Single Market Act, which would go into effect in 1992, and renamed the EEC the "European Union."

Although many Europeans were doubtful that this law would change very much, Delors, French president Françoise Mitterrand, and German chancellor Helmut Kohl fully accepted the idea that it would enable Europe, with a population greater than the United States, to develop its integrated economy more rapidly—and, indeed, to overtake the United States as the world's largest marketplace. The French in particular seemed to believe that it would return global economic leadership to Europe. Margaret Thatcher went along but was more cautious—economic integration on the basis of free-market principles was very nice, but not if it came at the price of European political or bureaucratic interference in British life, which she feared would be attempted (Jenkins 1988, 287–88).

Soon after the Single Market Act was agreed upon, European corporations went to work preparing for more opportunity, more competition, and less government obstruction in business. This work helped to ignite a robust period of capital-market activity, mergers and acquisitions, privatization of government-owned businesses, and initial public offerings of shares by European companies—a process that continued until the end of the decade.

During this time, however, other momentous things were happening. The Berlin Wall came down (1989); East and West Germany were reunited (1990); the rest of eastern Europe overturned its Communist governments; and the Soviet Union was dissolved (1991), thus ending the Cold War. Ten former Soviet European satellite countries subsequently joined the EU.

Economic and Monetary Union

Delors, Mitterrand, and Kohl, still maintaining the original Franco-German commitment to keeping the peace in Europe, sensed that political conditions in Europe were right for another large step toward integration. In 1989, they proposed the Economic and Monetary Union (EMU), which would create a common currency (the euro), along with the ECB, which would consolidate the reserves of the participating national central banks and conduct a common monetary policy aimed at protecting the value of the common currency by avoiding inflation. The entire EU approved the proposal (the Maastricht Treaty) in 1993, with Britain, Sweden, and Denmark opting out of adopting the euro. For them, it was too great a concession of economic sovereignty.

The name *euro* was officially adopted on December 16, 1995. The euro was introduced to world financial markets as an accounting currency on January 1, 1999, replacing the former European Currency Unit (ECU) at a ratio of €1 to U.S.$1.17. Euro coins and banknotes entered circulation on January 1, 2002. Although the euro dropped subsequently to U.S.$0.86 within two months, it has traded higher than the U.S. dollar since the end of 2002, peaking at U.S.$1.60 in July 2008 and averaging about U.S.$1.20 since 2000.

There were key flaws in the EMU Treaty, however, which were widely discussed at the time. There was no fiscal union to balance the monetary union, which meant that debt levels and deficits could vary widely within the common currency. There were target ratios for government deficits and debt (budget deficit limit of 3 percent and total indebtedness of 60 percent of GDP), but these targets were unenforceable, and exceeding them involved no penalties. After the Germans and French exceeded them, which both countries did for most of the years after 1999 (European Commission 2012), other countries also ignored them. Moreover, allowing Italy and Greece—both highly indebted and economically mismanaged countries—into the EMU only endangered it. The member countries' economies would sooner or later fall out of alignment with each other and put

strains on the currency. The inability to force them into a common and disciplined fiscal regime made the system inherently unmanageable under the stressful conditions that inevitably would come. In time, many argued, the Eurozone would shake itself apart.

Politicians, however, saw the situation differently. What flaws there were in the imperfect legislation, many politicians believed, could be repaired by future amendments. Helmut Kohl, in particular, seemed to believe that if you really want something, you must act while support is possible, even if the plan has flaws. Kohl, also a strong believer in German unification, ignored the warnings of his economic advisers (that the planned currency exchange rate was wrong and would cause problems, which it did) in order to get the job done (Seiters 2009). Politics often overrides economics.

This was clear in the effort after 2004 to expand the EU to include the former Communist countries of eastern Europe before these countries had developed fully into market economies and to allow Cyprus and Malta, two tiny states with no economic power, to join the EU and be entitled to full voting rights.

Amending Maastricht

Political and economic pressures were developing within the EU sufficient to cause its members to amend some of its earlier treaties to improve the organization's governability.

The EU member states signed the Treaty of Lisbon in December 2007, and it entered into force in 2009. It amends the Maastricht Treaty and the Treaty of Rome by replacing the requirement for unanimity with qualified majority voting in several policy areas, provides for a more powerful European Parliament, and creates two important executive offices—a president of the European Council and a high representative for foreign affairs and security policy. The Treaty of Lisbon also provides a legal mechanism for a member state to exit the EU.

By the beginning of 2012, the EU had grown to include twenty-seven states (it will be twenty-eight after Croatia joins on July 1, 2013) and more than 500 million people; it is now the world's largest common market and trade bloc.

The Flaws Appear

The seventeen Eurozone countries have been heavy borrowers: in 1999, the year the euro was launched, the member countries' average indebtedness was 72 percent of GDP. Even though the target rate to join was 60 percent, it had to be fudged if extreme outliers such as Belgium, Italy, and Greece were to participate. By 2010, that ratio rose to 85 percent—in part due to stimulus efforts to counter recessionary forces after the financial crisis of 2008. By 2010, the most indebted

Eurozone countries in terms of debt to GDP were Greece (145 percent up from 103 percent when it joined the Eurozone in 2000) and Italy (118 percent up from 114 percent in 1999, though this ratio declined to 103 percent in 2007, just before the crisis). Ireland's indebtedness nearly doubled after 1999 to 95 percent of GDP, although it dropped to as low as 25 percent in 2007; Spain's debt ratio was slightly less in 2010 than it was in 1999, at 61 percent.[2]

Monetary union and the euro provided low interest rates and easy access to borrowing for all of its member countries, regardless of their individual sovereign credit ratings. But differences between these sovereign credit ratings should result, as in the U.S. municipal bond market, in different interest rates for sovereign borrowers.[3] However, confidence in the EMU was such that from 2000 until the end of 2009, all seventeen Eurozone members were able to borrow at virtually the same rates as Germany, and, indeed, until 2008 all their budget deficits as a percent of GDP were about the same, with the notable exception of Greece (Smith and Walter 2000, 7). The system, despite its flaws, had worked well enough through one earlier recession (2000–2001), but the real estate–based financial bubble and the Great Recession that followed in 2008 were too much for the more heavily indebted economies. The anticipated stress test of the euro had arrived.

Market Runs and Bailouts

As of December 30, 2010, the global market capitalization of debt securities and tradable bank loans was an extraordinary $150 *trillion* (McKinsey & Company 2011). This massive pool of funds, driven by professional money managers, could move quickly (as it did during the 2007–2008 financial crisis) to avoid holdings that might be subject to rapid losses in value.

The market began to fear that Greece in particular would be unable to service its debt and would default unless massively bailed out, an action specifically prohibited in the Maastricht Treaty and contrary to political will in the solvent Eurozone countries.

However, a sovereign default might cause Greece to be expelled from the euro and cause a market run on the next most likely countries thought to be in similar trouble—Portugal, Ireland, Italy, and Spain (which journalists collectively sometimes refer to as the "PIIGS," with Greece included).

The Germans immediately recognized that the cost of rescuing so many countries would fall disproportionately on it, Europe's largest and richest economy. The realization returned memories of the hugely expensive, decade-long effort to support and subsidize the states of East Germany during unification in the 1990s,

2. Data from European Commission's Statistic Database; epp.eurostat.ec.europa.eu.

3. This result was predicted in Smith and Walter 2000 7.

a process that brought on large federal deficits, government debt, and inflation. Chancellor Merkel, a former East German herself, recognized her countrymen's reluctance to support all of the rest of Europe, but she also knew that Germany's future was closely tied to the continuation of the EU and the Eurozone, which absorbed most of Germany's exports. She had to tread carefully down a very narrow path.

In May 2010, the first of a series of European summit meetings was called to allay market fears. A rescue plan for Greece, Ireland, and Portugal, in which the IMF also participated, totaled €750 billion. An EFSF would be created to make loans to distressed countries in exchange for promises to implement reforms and austerity programs. The plan was to assure the market that no Eurozone country would be permitted to default on its outstanding debt.

No Big Bazooka?

However big and bold the May 2010 proposals seemed to the European politicians, the market was not happy with them and demanded more. If the euro were to be successfully defended, each country in the Eurozone had to be protected from defaulting, and doing so would mean offering to buy back any distressed country's bonds until the market was convinced than none would in fact default.

To gain assurance of the markets, the Eurozone countries might have to raise as much as €2 trillion, even if the funds were never used. Only by having such a large facility available would Eurozone governments possess what former U.S. Treasury secretary Henry Paulson called the "big bazooka" needed to satisfy the markets that the politicians had the means to back up their no-default commitment.

The €750 billion rescue plan, as large as that was, was not close to €2 trillion. But the Eurozone governments had gone as far as they could politically; the May 2010 rescue commitment was hugely controversial in Germany, where it was challenged in the Federal Constitutional Court, and in other Eurozone countries. There was little political support for a "big bazooka."

The idea of issuing jointly guaranteed Eurobonds (or "Stability Bonds") to purchase or support distressed sovereign debt also surfaced. The European Commission, in producing its own recommendations for such bonds in November 2011 (European Commission 2011b), proposed various ways in which the joint government guarantors could be protected by requiring credible collateral and priority in repayment. And to increase the size of the safety net the Eurobonds would supply, the guarantees could be leveraged to cover larger principal amounts by using them to back only "first losses" of from 25 percent to 40 percent. But Merkel remained steadfastly opposed to the idea—any form of taxing the frugal to bail out the irresponsible was anathema to her political party and others in Germany.

A properly credible plan for sound fiscal management with suitable enforcement machinery may be enough for the Germans and other reluctant EU members

to agree to a more robust program of Eurozone debt assumption. According to one such proposal, the debt pool eligible for Eurozone guarantees would be limited to debt of member countries only up to 60 percent of their GDP. Such Eurobonds would be called "blue bonds" (Delpla and von Weizsacker 2010).

Blue bonds could create a massive new, very liquid, high-grade, integrated Eurozone bond market worth €5.6 trillion, or five times the German bond market and nearly as large as the $8.3 trillion U.S. Treasury bond market (Delpla and von Weizsacker 2010). Sovereign debt in excess of the 60 percent of GDP ratio, called "red bonds," would trade as sovereign risk only and thus would be subject to credit ratings and market pricing based on the red bonds' own merits. They would trade at a discount to blue bonds.

The most feasible alternative to Eurobonds or guarantees was the ECB, which can act without legislative approval, has lots of reserves (including substantial gold reserves), and can also print money. But both ECB head Jean-Claude Trichet and then his November 2011 replacement, Mario Draghi, maintained that bailing out sovereign governments is not part of the ECB's legal mandate. Nevertheless, the ECB did maintain a modest, low-profile support effort in the European sovereign-debt market, accumulating about €200 billion of distressed sovereign bonds in an effort to "maintain stable monetary policy," which is within its mandate (Atkins and Barber 2011). Some German officials and ECB board members opposed even the limited support the ECB did provide because they believed that trying to extinguish a debt crisis by issuing more debt could only end in devaluation of the currency.

Moral Hazard

Merkel and many others in Europe feared the moral hazard that would develop if distressed peripheral countries were guaranteed by the rest of the Eurozone governments. The guarantees would solve their immediate financing problems but would leave it to those that were bailed out to change the weak or irresponsible financial practices that had gotten them into trouble in the first place. Making such changes, however, would almost always require drastic budget reductions and tax increases that would surely be resisted by the general public and could result in changes of government. The changes might also force the countries into severe recessions, from which it would be even more difficult to service outstanding debt.

This had already happened in Greece, which received its first EFSF loan in the summer of 2010. The austerity measures required by the lenders were the cause of rioting, general strikes, and violence that substantially destabilized the country. The government of George Papandreou struggled to meet the lenders' expectations (the aid was to be doled out quarterly against benchmarks, which were often not met), while attempting to pacify a Greek population inflamed by the harsh terms of the rescue, which forced layoffs while also reducing social benefits.

Meanwhile, Greek GDP dropped by 4.5 percent in 2010 and was projected to fall a further 3.8 percent in 2011 (European Commission 2011a). In November 2011, the Greek government fell and was replaced by a unity government of "technocrats" led by Lucas Papademos, a former head of the Bank of Greece. Similar, though nonviolent, demonstrations took place in Ireland, Portugal, Spain, and Italy—all of which by the end of 2011 experienced changes of government.

Banks Compound Sovereign Risks

European banks have long held large amounts of their home governments' securities as well as sovereign bonds issued by other Eurozone government. The banks were encouraged by international banking rules that exempted all sovereign debt from capital requirements. They also believed, as did many institutional investors, that Eurozone sovereign debt would never be allowed to default.

Both of these assumptions were called into question: revised banking rules would require capital against sovereign debt, and Greece's desperate condition (and the Eurozone reaction to it) made its default seem possible, if not likely. As a consequence, banks began to sell sovereign loans. As economists should have expected, nonbank "speculators" were quietly accumulating Eurozone sovereign bonds as the banks sold them, betting that whatever bailout terms eventually emerged would improve upon the price they had paid in the distressed market.

Indeed, nonbank holders of Eurozone sovereign debt soon began to dominate the market. A February 2011 study by the Bruegel Institute reported that of €1.1 trillion of privately held debt of Greece, Ireland, Portugal and Spain, €627 billion (57 percent) was held by domestic and foreign nonbank institutional investors (Darvas, Pisani-Ferry, and Sapir 2011, 4).

Investors were tested, however, and the bond prices continued to drop below levels at which arbitrage purchases could be expected. For example, ten-year Greek debt traded around 70 percent of par value in May 2011, but by August it traded around 50 percent, and in December 2011 at 22 percent.

Investors also believed that the banks still owned many of the sovereign bonds and that they had not fully marked these bonds to their market values. They also understood that the European banks were heavily exposed to each other. So the markets began to develop concerns about securities issued by European banks, as well as the risk of lending to them.

In early 2011, U.S. money-market funds began to stop buying certificates of deposit and other securities issued by European banks; by December, these banks were experiencing significant difficulty rolling over their maturing obligations in Europe as well. As a result, European bank stock prices declined sharply: the shares of Deutsche Bank and BNP-Paribas, among Europe's largest and most prestigious banks, were down 25 percent and 37 percent, respectively, for the year. Other large European banks suffered similar declines.

Seeking to reassure both debt and equity investors of the relative stability of the European banks, the European Banking Authority (EBA) issued a requirement in October 2011 that the seventy-one largest European banks achieve "tier-one" capital-to-risk-weighted-assets ratios[4] of 9 percent by July 1, 2012, after marking their sovereign-debt holdings to market values. This requirement would result, the EBA announced, in the affected banks' having to raise an additional €115 billion of new capital over the ensuing eight months, a very large amount, but one that nevertheless was doable (Jennings 2012).

The banks alternatively could attempt to shrink themselves into compliance by selling risk-weighted assets, which many banks did during 2011. Nevertheless, the EBA announcement made European banks appear to be significantly undercapitalized, so pressures on the banks' funding sources continued to intensify.

Shortly after the Merkozy Plan was introduced in December 2011, ECB head Mario Draghi made the striking announcement that the ECB would make "unlimited funds" available to European banks for periods of up to three years, under a new "Long-Term Refinancing Operation." Within weeks of this announcement, on February 29, 2012, the ECB said that it had bought nearly €500 billion of three-year notes from 523 European banks (Fairless 2011). The intervention was seen as powerful and determined, and it worked. The market pressure on the banks eased substantially.

Indeed, the U.S. Federal Reserve had quietly done the same in its effort to support U.S. banks in the fourth quarter of 2008 after the financial panic over the failure of Lehman Brothers had begun. The Fed, a subsequent revelation has shown, extended $7.8 trillion in lending limits and guarantees to support the U.S. financial system in 2008 and 2009. Doing so more than doubled the liabilities on the Fed's balance sheet (Ivey, Keoun, and Kuntz 2011). The American experience demonstrated that the amount of resources necessary to turn back a market run was far greater than previously thought. Europe was now finding itself the object of the lesson.

As necessary as this intervention may have been to support the banks, the irony of the effort was that the banks that were being supported continued to be large holders of sovereign debt that the ECB had refused to support.

Defending the Euro

By early 2012, the future of the euro had become unclear. The series of summits of European heads of state during the prior year and a half was not able to convince markets that the leaders were willing or able to commit the funds necessary to assure markets that, wisely or not, the euro experiment would be fully defended.

4. The more stringent of two tiers of capital required under the twenty-seven-country Basel Accord, calling for minimum-risk-adjusted capital adequacy for banks.

The leaders were seen as engaging in a continuing series of reluctant and inadequate steps toward the goal, without ever being able to achieve it. The markets had in fact extracted far more in concessions than might have been imagined when the crisis began, but those concessions were still not enough, and the big bazooka was still missing.

The underlying problem was that the Eurozone lacked even minimal collective political authority. It was set up that way because individual countries were unwilling to cede any more sovereignty than absolutely necessary to a new, unproven central body. This position rendered the Eurozone powerless (which was fine with most of its members) and indefensible against market forces with the power to destroy it.

Recognizing this situation for what it was, Merkel and Sarkozy decided to try a different tactic with their December 2011 plan. They would essentially "federalize" EU fiscal and budgetary affairs and thereby provide the missing link for the centralization of economic management. The European Commission would work in concert with the ECB, the EBA, and the other EU financial regulators (all established in 2010) to manage and control Eurozone economic and financial affairs. Sovereignty over economic matters thus would be yielded to the EU, but political issues would remain the province of independent nations. Of course, a great deal of modern economics is politics, which can cast doubt on the outcome of government actions.

It was a strange concoction. The plan still did not create a federal system because there was no federally elected executive or constitution—only economic policy was federalized. Moreover, it was unclear how the arrangement would be managed or enforced and whether it could work outside established national political systems. To most of its supporters, the Merkozy Plan was seen as a pragmatic concession to the moment sufficient to deal with the ongoing market crisis. But, of course, it might not work at all. Many other observers considered the plan a disappointment, but nonetheless an important step in the direction of federalization that must progress further if the flawed euro system were to survive.

Federalizing

This is not the first time a confederation of independent states has striven to gain the advantages of federalism while avoiding its disadvantages. History presents many other examples, but perhaps the most relevant is the American experience during the thirteen years in which the new independent states operated under the Continental Congress and after 1783 under the Articles of Confederation.

At this point, the states retained their sovereignty. There was no central government to constrain them. A continental legislature existed, but it had no power to enforce its own laws. The economy was inert, and conflicts between states dominated political life. After a few years, it became clear that this system would

have to be replaced and that the replacement would have to convey authority to a workable federal system. The constitution that was ratified in 1789 involved many compromises, but federal authority was established and utilized to solidify the states into a coherent economic and political union.

A major issue, fiercely debated at the time, was the federal government's assumption of all states' pre-1789 debts. Most of this debt had been incurred during the war of independence from Britain, so it had a common purpose. But different states had different amounts of debt outstanding, and some had been frugal, whereas others had not. There was controversy over the taxpayers of some states having to service the large debts of other states, especially if the former had conscientiously repaid their own debts. Treasury secretary Alexander Hamilton was the orchestrator of this important concession to the centralization of credit. In the end, he was successful: sound American creditworthiness was established soon thereafter, and economic development proceeded at a rapid pace (Brookhiser 1999, 82–90).

About fifty years later, amidst a serious recession, nine states that had borrowed extensively at rates reflecting investors' assumption that the federal government would protect them defaulted on their obligations. Contrary to expectations, the U.S. government did not assist the defaulting states. They were on their own and had to adopt austerity measures and restructure their debt so as to regain access to the markets (Grinath, Wallis, and Sylla 1997). To make this process easier, most of them passed balanced-budget amendments to their constitutions that are still in force today; forty-nine of the fifty states have such "balanced-budget amendments" (Snell [1996] 2004) similar to those now required in the Merkozy Plan for EU members.

A United States of Europe has never been a popular notion with Europeans. Indeed, even the idea of a constitution for the EU was defeated in 2004 after years of preparation. In effect, it has been assumed that Europe does not need or prefer federalization and can get along without it, but the recent market-driven crisis in the Eurozone has challenged this assumption. Merkozy did receive twenty-six out of twenty-seven votes, and the British might have gone along if they had been allowed the regulatory concessions they sought for the City of London, the United Kingdom's financial marketplace.

Should Greece Abandon the Euro?

Many observers questioned why Greece should remain in the Eurozone, given the dubious conditions of its initial membership, its questionable financial management as a member, and the difficulty it would now have in meeting the austerity measures necessary to avert default. Why not abandon the euro, reestablish the drachma and let the currency float, default on the remaining debt, and then restructure it—as Argentina did in 2005—at 30 percent of its bond's face value? With a realistically valued currency and reduced debt overhang, Greece

would have a chance to earn its way out of trouble. If Greece were to rise to the challenge, this argument goes, the ultimate economic cost would be lower than if Greece were to remain permanently lashed to the euro.

Exiting the euro would involve a sharp, immediate shock to the Greek economy as it rebased itself on a new drachma, forcing conversion losses on all Greek savers and institutions. A cheaper currency, however, would promote agricultural and other exports and tourism, although the main advantage would be in escaping a system that would impose austerity or penalties for years to come on an economy not suited to be aligned with the group of more advanced and developed European economies.

The Greek government has been reluctant to abandon the euro. Greece's prestigious reputation as a developed country, affirmed by its status as a Eurozone member, would be lost and might not be recoverable for generations. Its membership in the Eurozone and the EU has provided many economic benefits, not to mention the bailout assistance already received and promised. Leaving the euro would end this assistance.

Greek political leaders know that the country will have to face hardship either inside or outside the Eurozone. The austerity programs being imposed on Greece by the other Eurozone countries were considered arduous—and politically very unpopular—but they may not be worse than those that would result from leaving the euro. So why give up their prestigious membership if they don't have to, especially if the Eurozone members are offering incentives for them to stay in out of fear of triggering exits by other member countries?

Markets pondered Greece's continuation in the Eurozone for some time. Concerned about its future in the euro, investors in Greece (and in other distressed Eurozone countries) began selling bonds and withdrawing deposits from banks in order to redeploy their assets outside the Eurozone—in Swiss, British, or U.S. banks, gold, and even London residential property. The Bank of Greece reported that €60 billion, or 25 percent of all deposits, were withdrawn from Greek banks from the beginning of 2009 through the end of 2011, much of it being transferred abroad (Ball, Cohen, and Bouras 2011). After indecisive Greek elections in May 2012, bank deposit withdrawals accelerated considerably.

After a second round of elections in June, Antonis Samaras, the center–right party leader, became prime minister of Greece and began to assemble an austerity program acceptable to the European Commission, the ECB, and the IMF. Inside Greece, support for leaving the euro was becoming more vocal, but Samaras made a plea to the Germans that Greece be granted more breathing room, which gained enough local support to pass the $23 billion austerity measures he needed. But the support was still very tenuous as 2012 came to a close (Tzortzinis 2012).

Should the Eurozone Expel Greece?

Conversely, some have asked why it wouldn't be better for the Germans and the other Eurozone countries to force Greece to exit the zone rather than put together

a disproportionately expensive guarantee program the Greeks might never repay? Letting Greece into the Eurozone was a mistake, this argument maintains, so why not recognize it as such and start over? Such a message would be heard clearly as a warning to all the other distressed Eurozone member counties.

Greek expulsion would satisfy some in the Eurozone, but it might lead to an even greater problem that no one has sought.

If Greece were expelled, it would surely default, causing losses for banks and other investors that would be amplified by the change in currency to the drachma. Realizing that the Eurozone lacked the will to defend even its smallest member economy against a financial run, markets would likely also turn against the larger sources of potential losses, Spain and Italy, and force the battle to be refought on a much larger scale. If that battle against the market were lost, the euro would be indefensible and would surely collapse. The possibility of this happening was reflected in the lowered prices of virtually all European debt and equity securities, except German government bonds, and in the euro–dollar exchange rate at the end of 2011. An actual departure from the euro would increase these unrealized losses, just as a credible commitment to defend the euro would reverse them.

But the economic consequences of dissolution of the euro might exceed any securities losses, however large these losses may be estimated to be. Exchange rates would have to be reset, with many countries suffering exit losses similar to Greece's; trade patterns would be redirected; and national economies would most likely go into recession for some extended time.

And all of this would undermine the EU's economic integrity, which is largely centered on the Single Market Act (1986), which removed economic borders within Europe. If investors in the weaker Eurozone countries decided to withdraw funds from financial institutions to protect those funds from devaluation by investing them abroad, the governments involved would be under great pressure to impose foreign-exchange controls in direct opposition to the Single Market Act. If economic integrity goes, the rest of the EU is of little value.

The combined loss in asset values and economic output would be very large indeed. Germany would have the most to lose: 71 percent of its €1 trillion of annual exports in 2011 were to European countries (25 percent more than before the euro was formed).

As a consequence, many European economists have concluded that being a joint guarantor of eurobonds for Eurozone countries—until the zone gets on its feet again and even at far greater cost than has so far been estimated—would be much cheaper than letting it all go up in smoke.

Grinding It Out

The Eurozone crisis began in May 2010, and through January 1, 2012, assistance was rendered to Greece, Ireland, and Portugal; €440 billion was pledged for a joint

EFSF to be replaced in 2012 by a €500 billion European Stability Mechanism (ESM); a €200 billion loan to the IMF was agreed; and the Fiscal Compact and Golden Rule were agreed to in principle by all but two countries in the EU.[5] The ECB was being given additional powers; a Eurozone banking supervisory effort was agreed upon, along with tougher rules on forcing nondeposit holders of those banks being required to share in losses. Moreover, new and more technically competent governments promising to impose reforms and austerity were elected in all of the distressed Eurozone countries. In November 2011, technocratic administrations led by distinguished academics and former civil servants replaced both the Greek and Italian governments.

Despite all of these actions, markets remained unconvinced that the heavily indebted Eurozone countries would be rescued from default and the future of the euro fully safeguarded.

In January 2012, at a meeting of the G20, Christine Lagarde, the IMF's new head, requested U.S.$600 billion of new capital—to be subscribed by member countries—to provide a "war chest" for assistance to countries affected by the Eurozone crisis. This amount would include the €200 billion addition agreed by the Eurozone countries in December but would expand a new role for the IMF—that is, to assist developed countries in financial reorganization. The United States and other G20 countries opposed this new role, so it is unlikely to be approved.

By early March 2012, it had become clear that one consequence of the ECB's large Long-Term Refinancing Operation lending program had been to enable European banks to borrow at low costs in order to invest in European sovereign debt, which was purchased in the markets. This indirect support for sovereign debt raised the prices of Spanish and Italian bonds, despite other economic pressures in those countries that questioned their creditworthiness. Once the support for the bonds became known, the banks appeared to back away, and prices dropped again, pushing Spanish yields above 6 percent in mid-April. At these levels, fears began to develop again that Spain and Italy might have to be bailed out with programs similar to those used in Greece and Portugal.

These concerns led the Eurozone countries to question again the size of their "firewall" to check the spread of credit fears within Europe. In late March 2012, Merkel said she would support the new ESM running in parallel with the EFSF, at least until the expiration of the latter in July 2013. If there were considerable support for the ESM, she would not be required to return to the German Parliament to approve an increase in its commitment, but the commitment would be there, at least for another fifteen months.

The EFSF agreed in March 2012 to support a cram-down €263 billion private-creditor bond swap for outstanding Greek debt that would enable Greece to reduce public debt by approximately €177 billion. In April 2012, the Greek

5. The United Kingdom and the Czech Republic dissenting.

government announced that 97 percent of holders of old debt worth €100 agreed to exchange that debt for thirty-year low-interest-rate bonds worth €31.5 plus a two-year bond from the EFSF worth €15, resulting in a net "haircut" to bondholders of 53.5 percent (Turner 2012). Just before the exchange, the Greek legislature passed a law adding a retroactive Collective Action Clause (CAC) to outstanding debt that bound all holders if 50 percent tendered their debt for the exchange. The CAC turned the exchange offer into an involuntary event, triggering default clauses under Greek's outstanding credit default swaps and forcing these insurance policies to be paid. However, these swaps had been sufficiently offset so that only about €3 billion of net payments were made after the CAC was approved.[6]

In June 2012, a €19 billion Spanish government rescue of Bankia, a large savings bank (formed by merging several troubled smaller banks into one), raised questions in the market as to how the government would raise the funds required. These questions caused Spanish sovereign-debt spreads to spike and a rush by depositors to withdraw funds from banks. As a result, the Spanish government was forced against its wishes to request a €100 billion loan from the EFSF.

This facility was granted, but existing EU rules required that it be funneled through loans to the Spanish government, which would redirect them to the banks as necessary. Because the repayment of EFSF (or ESM) loans was required to have priority over other debt holders, the move effectively downgraded Spanish debt held by market investors, causing prices to drop to levels that reflected yields to maturity of approximately 7 percent, a borrowing cost thought to be unsustainable.

As a result, Spain has become subject to a "vicious cycle" in which efforts to aid the banks injure the sovereign credit, which makes it more difficult for the latter to assist the banks. Markets understand that a bank's creditworthiness is tied directly to its sovereign credit, which is diminished by assisting the banks. Fears soon developed of a run on deposits from the Spanish banks, as occurred in Greece.

In a July 2012 surprise announcement, the EBA reported that twenty-seven banks had raised €94 billion and that €240 billion had been or would be injected into banks by various means in 2011 and 2012. Thus, the fears of undercapitalization of European banks could be abated, though it was also understood that some of the capital had been added by releasing reserves as a result of shrinking the bank assets. European syndicated bank loans for 2012 were reported to be at a fifteen-year low.

---

6. A number of bondholders whose bonds were issued under foreign (not Greek) law abstained from exchanging their bonds during the March offer. These bondholders were largely hedge funds that bet, despite Greece's assurances to the contrary, that Greece would repay those bonds at maturity to avoid a protracted international legal dispute that would block future access to credit markets. On May 15, 2012, Greece announced that it would fully repay €435 million of maturing international law bonds, after its May 2012 election failed to produce a new government. Further maturities of international law bonds are coming due in the future, but no commitment was made regarding these bonds.

Finally, a Bazooka

On September 6, 2012, after a summer of apparent inactivity following the June summit of Eurozone leaders, the ECB announced a comprehensive plan—called "Outright Monetary Transactions" (OMT)—to deploy an "unlimited" amount of resources to purchase one- to three-year bonds of distressed Eurozone countries in the secondary sovereign-debt markets. The plan is to work in tandem with the ESM, which is to purchase sovereign bonds directly from the governments—that is, in the primary market—relieving the governments of the pressure to roll over maturing debt by sales of new issues. Both plans require the governments being assisted to formally request aid from the ESM and to abide by fiscal and other restraints to be set by the ESM and the IMF.

Spain and Italy had not previously requested assistance from the ESM for their sovereign debt. The governments of both countries were reluctant to do so, not only because of the humiliation associated with such a request, but also because of the harsh economic conditions set by the IMF, which would only add to their domestic economic difficulties. Spain, however, had approximately €180 billion of debt that would be maturing within the next year, €20 billion of which was due in October 2012. The Spanish government, under conservative Mariano Rajoy who was elected Prime Minister in December 2011, refrained from making a request for sovereign assistance for domestic political reasons, and instead shifted its appeal to the bank recapitalization fund.

The OMT is seen as providing details to back up Draghi's announcement in late July 2012 that the ECB would do everything required to "save the euro," and "believe me, it will be enough" (qtd. in Plumer 2012). Anticipation of the plan drove two-year Spanish and Italian bonds prices up to reflect yields of 2.8 and 2.3 percent, respectively—down from 6.5 and 5.0 percent in early July.

The plan, supported by Merkel and approved by the ECB board (with a sole dissent from the German representative), foregoes any right that the ECB might claim to priority of repayment relative to private-sector creditors. It also requires, as a measure to reduce the inflationary effect of the bond purchases in the market, that the ECB withdraw from the financial system an equivalent amount of funds that it invests in purchasing sovereign bonds.

The plan, reflecting Mr. Draghi's increasing political skills, accomplishes three important objectives that have otherwise been unachievable since the crisis began.

First, it is large enough to constitute a real bazooka by applying the ECB's vast resources (including its ability to print money).

Second, by using the ECB as a substitute for a federalized fiscal mechanism (such as issuing Eurobonds) to support the Eurozone's sovereign debt, Draghi has accomplished an end run around most of the European resistance to sovereign bailouts (including the limits set by the Maastricht Treaty). Though Mr. Draghi would argue that the move is necessary for the management of Eurozone "monetary policy" (the one and only chartered mandate of the ECB), he had to persuade

the member countries that monetary policy has to be interpreted to include preventing a market run on Spanish and Italian sovereign bonds, which might break up the euro (a consequence that Europeans now call "convertibility risk"). Even so, he also had to tie the OMT to the "conditionality" requirement that the supported countries accept fiscal disciplines established by the IMF to get the votes he needed.

And, third, the application of the federal guaranteed mechanism that the OMT represented is very limited, being restricted only to secondary market transactions and only in instances selected by the ECB to intervene to place a ceiling on market rates for medium-term bonds. It would not necessarily intervene continuously or often, but just enough to move the markets when it needed to. Once such a ceiling for Spanish and Italian bonds has become credible, the ECB would not need to use the bazooka. So the amount of market "manipulation" occasioned by the support effort would be minimal compared to most other alternatives.

In December 2012, Greece offered €10 billion, or 34 percent of face value, to buy back government bonds issued earlier in the year. Holders of the bonds, who would receive six-month EFSF bills, were Greek banks and pension funds. The effort was part of continuing plans to reduce Greek debt to 124 percent of GDP by 2020 from a projected 190 percent in 2014 (Petrakis and Charlton 2012). A number of hedge funds bought the new Greek bonds issued in the March exchange offer at market prices of 14 percent to 20 percent of face value, only to tender them in the second offer in December. One fund reported a profit of U.S.$500 million from the investment (Jones and McCrum 2012).

As negotiations over these steps proceeded, Angela Merkel opened the possibility that Germany may accept that its and other governments' holdings of Greek bonds would have to be written off entirely in order to meet the 2020 target. The EU, the ECB, and the IMF had firmly resisted this action for political reasons until this time.

Elections Intervene in the Unification Effort

During the early months of 2012, economic hardship was spreading within Europe. Spanish unemployment rose to more than 20 percent as the country reentered recession. The United Kingdom and much of the rest of Europe reentered recession, and popular resistance to austerity campaigns and slow growth was becoming widespread.

In April 2012, the coalition Dutch government led by Mark Rutte, a Merkel ally, fell in opposition to the austerity measures. An election was held in September in which no party received a majority. After forty-nine days of negotiations, a new government, also led by Mark Rutte as prime minister, was formed.

In May 2012, the French chose Socialist François Hollande over Nicholas Sarkozy as president in a sharply contested election, and a month later parliamentary elections provided the new president with a majority. Hollande immediately

began to circulate proposals for lightening the austerity programs previously adopted by the Eurozone countries in favor of a more growth-oriented effort.

Also in May, the recently approved technocratic Greek government fell as broad opposition to the austerity measures imposed by the Eurozone countries developed. In elections that followed, no single party received a majority, and efforts to form a coalition government failed, forcing a new round of elections in June that would serve as a referendum on Greece's remaining in the Eurozone. This election was won by the center–right New Democracy Party, with 30 percent of the votes, which would require it to form a moderate coalition government that would keep Greece within the zone. The Greek economy, however, had fallen into a desperate downward spiral: austerity to reduce public spending and debt drove GDP down by 7 percent in 2012, forcing unemployment to rise to 40 percent and driving consumption and future GDP down as well.

In late December 2012, Mario Monti, a respected university president and former EU minister who had been recruited to replace a discredited Sergio Berlusconi in November 2011 as Italy's prime minister, resigned in advance of an election. Monti installed a technocratic administration, with himself as economics minister, to guide Italy throughthe financial crisis. Monti initiated several austerity moves, and was generally seen by the Eurozone establishment to be stabilizing the Italian government and policy actions. But his moves did not make him popular with the people who had to bear the consequences, and before long Sergio Berlusconi, withdrew his support, forcing a new election in February 2013 in which Monti would be a candidate representing a new reform party. Monti was opposed by Berlusconi's right wing party, by a left-wing party and by an anti-government party led by a former comedian, Beppe Grillo, who captured 25 percent of the votes (Monti only got 11 percent). Grillo would not agree to a coalition with any of the others, so a new election had to be held.

European Banking Union

Throughout Europe, the markets became uncertain about banks' exposures to sovereigns and to each other, and funding mechanisms for banks came under intense pressure. Banks' ability to fund themselves in the interbank market and other financial markets was sharply reduced during 2011 and 2012.

Indeed, the ECB and European officials had pointed to this difficulty the preceding March when they began calling for an integrated European Banking Union. Such a union would be a major step toward federalization by providing for centralized bank supervision, regulatory control, and intervention, and, as such, it would be a tall order.

Many European officials believed that the time had come—after a long effort to avoid it—when federalizing at least the major, cross-border European banks was necessary to reverse the vicious cycle. They feared in particular the growing flow of funds from bank deposits in peripheral countries into investments in government securities of Germany, Switzerland, and the United States.

A banking union, however, was fraught with difficulty. Giving such controls to the ECB would cause it to become overly powerful, some feared; giving them to the

EBA, only recently established, might overtax this organization's capabilities. Deciding how much authority to pass from national to central hands was also difficult.

A banking union would also have to be equipped with a deposit insurance scheme—to convince depositors that their money was safe—and that would mean a federal guarantee of a deposit insurance fund.[7] Providing such an unlimited federal guarantee, however, was beyond where the German government was willing to go (Barker and Parker 2012). To insure €5 trillion of Eurozone household deposits would require an insurance fund (using the 1.35 percent reserve ratio set by Dodd-Frank in the United States) of €67.5 billion, which presumably would have to be set aside from the ESM.

Deposit insurance within a banking union raised another issue as well. What was to happen if a bank were found to be insolvent? Would euro officials be able to override national ones in the finding? If the bank had to be closed, what would happen to nondeposit liabilities? The German view was that holders of any such liabilities should be required to share in the losses, using the reorganization of Spanish banks then occurring with Eurozone assistance as an example. Others thought that such a policy would kill the market for bank securities, upon which many large banks relied to support investment banking and some other activities.

In September 2012, the European Commission proposed unified banking supervision in the Eurozone under the auspices of the ECB, with the rest of the EU participating countries (the United Kingdom, the Czech Republic, and Sweden opted out) to be supervised by the EBA. In December, at an EU summit meeting, the European leaders approved a mechanism in which two hundred large banks in the Eurozone would be supervised by the ECB, which would also retain the right to intervene under appropriate circumstances in the affairs of the other Eurozone banks. The new arrangement, which must be approved by national parliaments, is to become effective in March 2014.

There is still much to be done to put a banking union into effect and to sort out divisions of powers between it and the EBA. There is also the question of providing a uniform deposit insurance fund, the mechanisms for intervention, and some other aspects of banking regulation designed to limit systemic risk.

Ringfencing

During 2011, the United Kingdom appointed a commission headed by Sir John Vickers to recommend a mechanism for limiting systemic risk, and his group came up with the idea of "ringfencing" the domestic, nonwholesale banking business, with the wholesale and investment banking activities being outside the fence. Each unit would have to have a separate management and board of directors. The unit

7. In the United States, the Federal Deposit Insurance Corporation (FDIC, established in 1933) provides deposit insurance up to $250,000 per account through an insurance fund into which banks pay annual premiums. If the fund should be exhausted by the requirements to guarantee deposits (which occurred in the early 1990s), it may borrow from the U.S. Treasury, to be repaid from future insurance premiums.

inside the fence would have to maintain a Basel III Tier-1 ratio of 10 percent and not allow capital to be transferred outside the fence, unless this ratio would still be met after doing so. If the ringfenced unit of the bank met these requirements, it would be able to look to government assistance if it needed such assistance, but the unit outside the fence would not. The British Parliament is expected to pass legislation incorporating the Vickers proposals in 2013, to be implemented in 2015.

Thus, the unit outside the fence would have limited access to holding company funds and no access to government funds. It would have to fund its activities in capital markets under borrowing conditions that reflect this "stand-alone" status. Capital-market subsidiaries outside the fence are therefore likely to receive lower credit ratings and will have to borrow at higher rates than banks not subject to this provision.

In October 2012, a report was published by a group appointed by the European Commission and chaired by Erkki Liikanen, governor of the Bank of Finland, that also recommended ringfencing, but of trading and the riskier parts of the banking business so as to isolate them from the basic bread-and-butter banking business. The trading division would have to have its own capital, which would have to be raised on a stand-alone basis, including by the issuance of "bail-in-able" contingent debt capital that would convert to equity or be written off if capital ratios fell below a minimum level.

The Liikanen idea quickly gained support. In December 2012, French Finance Minister Pierre Moscovici said he would present a banking plan based on the Liikanen proposals, but one that was "more practical to distinguish between speculation and what's useful for the economy" (Deen 2012). In January 2013, the German government tabled what the Deutsche Bank called a "Liikanen-light" proposal that exemplifies the role of financial regulation in the German election campaign scheduled for the fall (Deutsche Bank 2013).

Discord and Delay

Twelve months after the Merkozy Plan was agreed upon, little of the original accord had been implemented. The banking union, too, like all the other Eurozone initiatives, was slow in becoming a reality.

As joblessness, sovereign-credit questions, and concerns about banks' exposures persisted into 2013, bank lending declined and did little to help pull Europe out of its Great Recession. Political changes had weakened resolve to carry out some reform measures in the hard hit areas, and fears of a Europe retreating from unity to defend national economic borders were kindled.

At the heart of this fear lay a strong, fundamental German concern that it would be dragged into becoming the financial guarantor of Europe without being able to exercise any control over it. As pressure on the euro system from markets and political directions grew, German taxpayers became increasingly concerned that they would be left with a disproportionate share of the cost to return the system to normal. In June, Merkel warned, "Germany's strength is not unlimited" (Peel 2012).

Though Merkel was in the awkward position of having to concede more than her supporters wanted, on June 29, 2012, she was nonetheless able to persuade the German Parliament to approve by a clear two-thirds majority both the Merkozy commitments and Germany's $27 billion share of the ESM.

These commitments were due to take effect on July 1, but they were immediately blocked by a challenge brought to the German Constitutional Court by a group of dissenting lawmakers who argued that German law precluded using state funds to assist other governments. The judges had ruled earlier that the government had kept the German Parliament inadequately informed about its negotiations with the Eurozone over the ESM.

On March 16, 2013, the European Commission, the ECB and the IMF agreed to a €10 billion deal with Cyprus, making it the fifth country to receive money from the EFSF/EDM. As part of the deal, a hugely controversial one-off bank deposit tax of 6.7% for insured deposits up to €100,000 and 9.9% for larger deposits was announced. Wealthy Russians who found Cyprus to be a convenient tax haven held a significant portion of the large deposits. This was the first time a tax had been levied on depositors in any European country and it met with great resistance. The Cypriot parliament rejected the plan, leaving it to the government to negotiate something else or face default.

The following week, a new plan was announced in which all insured deposits (i.e., those of €100,000 or less) would not be taxed, but all uninsured deposits (those above €100,000) would be exchanged for shares in restructured Cypriot banks, in a measure that some estimated would cost the depositors about 50% of their investments. Further, the government imposed capital controls on withdrawals and overseas transfers of funds, in direct contraction to the EU's essential Single Market Act. The capital controls were to be in effect for only a week, but could be renewed if necessary.

The initial Cyprus refinancing effort was generally regarded as a European blunder, mainly because it taxed the insured deposits of the country, raising fears of massive bank runs in other distressed Eurozone countries – quite the opposite of what the Eurozone officials were trying to achieve. The revised plan was seen as the best that could be done and markets accepted it, but the action sent a clear message to investors in deposits above €100,000 elsewhere in Europe, and the capital controls drove a wedge between the single currency of the north and that of the more distressed south. Tiny Cyprus (representing only 0.2 percent of the EU's GDP) had proven to be potentially more harmful to the integrity and credibility of the EU and the EMU than all of its efforts to date had been (Economist 2013).

In October 2012, the court finally ruled in favor of the Merkel government's position that the Germany could ratify the ESM. The court also ruled, however, that any effort to increase Germany's commitment to the ESM would first have to be approved by the German legislature.

Swings in the Value of the Euro

Overall, financial markets remained skeptical of a quick or tidy solution to the European debt problems, in part because the European leaders attempting to manage the crisis were not in agreement with each other and therefore did not appear to be in control of events. And because the toolkit they had to work with was so limited, the actions agreed upon were slow in being implemented.

After the 2012 French and Greek elections, the markets became even more concerned. The Stoxx 50 index fell 18.4 percent between March 1 and June 1, and the euro–dollar exchange rate, which reached a high of U.S.$1.32 per euro in February for the year, dropped 8 percent to U.S.$1.21 in July, its low point for the year. But after the OMT action taken by the ECB in support of banks and sovereign debt, the mood changed. The Stoxx 50 rose 30 percent, and the euro–dollar rate rose to U.S.$1.32 by the end of the year. The Cyprus refinancing affair, however, brought the rate down again to 1.28 by March 30, 2013.

Seeking Normality

Investors, confused by contradictory options of innumerable experts and pundits, have not had a clear idea of what might be done to bring the weakened EMU back to some sort of normality. Yet all seemed to agree that "normal" could not be what it was before the crisis. Most of the commitments and improvements offered during 2011 and 2012 will stick, but so will the realization that enormous market forces, focused on the flaws in the EU and the Eurozone, can bring them down. Any future system will have to be much more robust than the old one, but in the meantime the market forces must be dealt with.

Stability First

Whereas it may be a good and necessary idea to federalize Europe's fiscal system, offering only a tentative version of such a plan to be executed over a long period of time by numerous countries, each with veto power, is not likely to influence an aggressive trader with a short position. Something more immediate needs to be in sight. Investors would like to see eurobonds or sovereign-debt guarantees, which they have not had so far, and they react to what they see in the market.

What they have been looking for is an assurance of abundant liquidity to support rollovers of bank and government debt. The ECB has now largely assured investors that the liquidity to meet bank rollovers will be available even if the amounts involved are in the trillions of euros.

Nevertheless, the Eurozone countries must also insist on debt reduction, particularly by Greece and Italy, through exchange offers at market value and/or the sale of state-held properties, corporations, and other assets suitable for privatization.

Greece was finally able to carry out its debt exchange for private-sector-held debt after almost a year's delay. For Spain and Italy, a similar exchange offer may be useful in extending the maturing of its sovereign debt, but it would not produce nearly as much debt reduction as in Greece because long-term Italian sovereign debt traded in December 2011 at much higher prices, 80–85 percent of face value.

Greece needs to accelerate the privatization of government-owned assets. This has been difficult to do because most of these assets have been hard to separate out into viable economic entities capable of being sold to investors. Greece should look to the experience of the Treuhandanstalt agency in privatizing essentially uneconomic enterprises in East Germany in the 1990s.

Italy has a much larger potential for privatization as a means to sovereign-debt reduction. But the pace at which these efforts have moved has been far too slow. A necessary sense of crisis urgency is lacking at the government levels throughout the system.

The Future of the Euro

Economists on both sides of the Atlantic Ocean have pondered and debated the future of the euro and of the European Union since the financial crisis began in 2008 and introduced market forces into the mechanism that had balanced economic and political factors since 1945. The balance was struck, amidst the many threats of the Cold War and economic dominance of the United States, Japan, or China, by combining welfare-state values with economic collectivization to generate a competitive but humane society that would preserve national identities and cultures. This balance has been shown to be very difficult to maintain, especially in light of such powerful market forces as have been generated in the modern era of globalized trade and finance.

The Eurozone is being tested in ways never imagined in its relatively short history, and the EU's reputation as a "model of enlightened regional integration" as well as "competent economic policy management" is consequently at stake (economist Michael Emerson, Center for European Policy Studies, qtd. in Barber 2012). Politicians know this, but they resist solutions that are unpopular with their national bases or contrary to fundamental values that require preservation of national resources for homeland use or solutions that impose "colonial" restraints on those in difficulty who are seeking to share the resources.

The crisis has brought many issues affecting the sustainability of the euro to broad public attention. The fact that twenty-six EU countries voted in favor of Merkozy suggests that there is a broad consensus for some degree of federalization of fiscal policies, with meaningful penalties for noncompliance. However, the details of these arrangements, including the need to persuade the United Kingdom to participate, cannot be worked out in the bright and urgent glare of a market crisis.

Political support for full federalization, however, still seems weak today. More likely is yet another plan or partial plan or majority-accepted plan that gradually extends EU or Eurozone financial centralization until a de facto federalization sufficient to pacify markets on an ongoing basis has occurred.

José Manuel Barroso, president of the EU, moved toward such a plan in his September 2012 "state of the union" address. He proposed unified banking supervision for the EU (not just the Eurozone countries, but the entire twenty-seven-member union) under the auspices of the ECB. He acknowledged that the plan would reduce national banking supervision and control but claimed that Europe must "evolve to a democratic federation of nation states that can tackle our common problems through a sharing of sovereignty" (qtd. in Chaffin and Spiegel 2012).

However, the price for providing such federalizing assurance will undoubtedly be higher than European leaders have so far been prepared to pay, and, conversely, the price to be paid by distressed countries in order to remain in the euro may also be quite high. The later-eighteenth-century American experience suggests that these countries themselves will have to get along on their own financially and follow policies that consistently reassure the markets and maintain financial access to them. That probably means retreating from the social policies that protected jobs and markets, which have been characteristic of European economies since World War II.

Dealing with uncontrollable market forces is not something the framers of the Maastricht Treaty ever expected to have to face. Markets were not as large then as they have become, but today's markets are quick to exploit flaws, recognize loose promises, and evaluate political tradeoffs as no financial watchdog has ever done before. And, as we now know, these market forces are strong enough to destroy the entire Eurozone experiment and end the hope of a strong and durable united European economy.

The Eurozone has had to deal with the markets as best it can, and doing so has been agony. The markets have required more than the politicians have wanted to give, and perhaps for the first time in Europe's long history the markets' power has enabled them to dictate policy measures to the politicians. The dictates will take the politicians beyond where they feel safe, but if these dictates lead, "as if by an invisible hand," to a better and more durable system than was present before, the agony will have been worth it.

Adam Smith, Europe's first champion of markets over politicians, would be pleased.

References

Atkins, Ralph, and Lionel Barber. 2011. Draghi Warns on Eurozone Break-up. *Financial Times*, December 18.

Ball, Deborah, Sabrina Cohen, and Stelios Bouras. 2011. Beyond Borders: Europeans Stash Money Elsewhere. *Wall Street Journal,* December 19.

Barber, Tony. 2012. On to a Smaller Canvas. *Financial Times,* June 14.

Barker, Alex, and George Parker. 2012. A Union to Bank On. *Financial Times,* June 19.

Brookhiser, Richard. 1999. *Alexander Hamilton—American.* New York: Free Press.

Chaffin, Joshua, and Peter Spiegel. 2012. Barroso Calls for EY Federation. *Financial Times,* September 13.

Cockfield, Baron Arthur. 2007. Obituary. *London Times,* January 10.

A Comedy of Euros. 2011. *The Economist,* December 17.

Committee of the European Commission. 1998. *Europe 1992–the Overall Challenge*. The Cecchini Report. Brussels: Committee of the European Commission, April.

Darvas, Zsolt, Jean Pisani-Ferry, and Andre Sapir. 2011. *A Comprehensive Approach to the Euro-Area Debt Crisis.* Brussels: Bruegel Policy Brief, February.

Deen, Mark. 2012. French Bank Law to be More Pragmatic than Liikanen Plan. *Bloomberg News*, December 3.

Delpla, Jacques, and Jakob von Weizsacker. 2010. *The Blue Bond Proposal.* Brussels: Bruegel Policy Brief, May.

Erixon, Fredrik, Andreas Freytag, and Gernot Pehnelt. 2007. *The Rome Treaty at 50.* Policy Brief no. 4. Brussels: European Centre for International Political Economy.

European Commission. Government Finance Statistics, October 2012.

European Commission. 2011a. *The Economic Adjustment Programme for Greece: Fourth Review, Spring 2011.* European Economy Occasional Papers no. 82. Brussels: European Commission, July.

————. 2011b. *Green Paper on the Feasibility of Introducing Stability Bonds.* Brussels: European Commission, November 23.

Fairless, Tom. 2011. ECB Sees Record Refinancing Demand. *Wall Street Journal,* December 21.

German Policy Watch. 2013. *DB Research,* Deutsche Bank. February 6.

Grinath, Arthur, III, John Joseph Wallis, and Richard Sylla. 1997. *Debt, Default, and Revenue Structure: The American State Debt Crisis in the Early 1840s.* National Bureau of Economic Research (NBER) Historical Working Paper no. 97. Cambridge, Mass.: NBER, March.

Ivey, Bob, Bradley Keoun, and Phil Kuntz. 2011. Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress. *Bloomberg Markets Magazine,* November 27.

Jenkins, Peter. 1988. *Mrs. Thatcher's Revolution*. Cambridge, Mass.: Harvard University Press.

Jennings, Patrick. 2012. Europe's Banks Face Tougher Demands. *Financial Times,* July 15.

Jones, Sam, and Dan McCrum. 2012. Hedge Fund Trades That Made Top Grade. *Financial Times,* December 18.

McKinsey & Company. 2011. *Mapping Global Capital Markets 2011.* Boston: McKinsey & Company, August.

Peel, Quentin. 2012. Merkel Warns of Limited Resources, June 14. Available at: http://www.ft.com/intl/cms/s/0/6a8307be-b60d-11e1-a511-00144feabdc0.html#axzz2RDPeaKPF.

Petrakis, Maria, and Emma Charlton. 2012. Greece Makes Buyback Offer as Merkel Floats Writeoffs. *Bloomberg News,* December 3.

Plumer, Brad. 2012. Mario Draghi's Promise to Save the Euro Could Prove Hard to Keep, *The Washington Post*, July 30.

Seiters, Rudolf. 2009. Interview. *Speigel Online,* November 3.

Smith, Roy C., and Ingo Walter. 2000. *High Finance in the Euro-Zone*. London: FT-Prentice Hall.

Snell, Ronald K. [1996] 2004. *State Balanced Budget Requirements: Provisions and Practice*. Denver: National Conference of State Legislatures.

This Septic Isle. 2013. *The Economist*, March 30.

Turner, Matt. 2012. Giant Greek Deal Masks Slow Restructuring Market. *Financial News,* October 9.

Tzortzinis, Angelos. 2012. Update on Greece. *New York Times,* December 3.

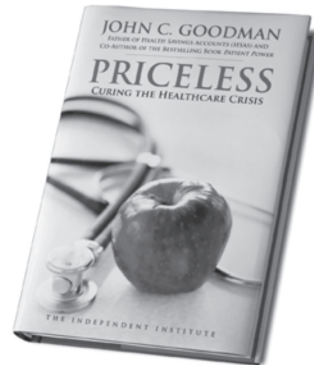
Acknowledgments: I am grateful to Ingo Walter for many useful comments.

Repeal & Replace Obamacare!

Patients, providers, employers, and employees are all trapped in a dysfunctional healthcare system fraught with perverse incentives that raise costs, reduce quality, and make care less accessible. Now ***Priceless*** cuts through the politics and proposes dozens of bold reforms that would free patients and caregivers to chart their own lives with low-cost, portable, high-quality healthcare.

"John Goodman has long been the most insightful healthcare thinker we have.... It's time we acted on his common sense, fact-based wisdom."
—**Mitch Daniels**, Governor of Indiana

"John Goodman is as provocative and controversial as ever in his timely and important, new book, ***Priceless***. Essential reading!"
—**Gail R. Wilensky**, former Head, Centers for Medicare and Medicaid Services



25 figures • 10 tables • index
392 pages • $24.95 • hardcover
Available in all eBook formats

independent.org/priceless
800-927-8733