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Eurozone Bank Crisis & Federalism

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Abstract: The laggards of the Eurozone pose a novel economic and legal issue. Whereas the Eurozone sorely needs growth in the PIRGS, neither conventional Keynesian stimulus nor devaluations are likely to be productive. This essay proposes that growth be rekindled by forced over-recapitalization of the laggards' private banks. This will generate local growth while circumventing inefficient national governments and without starting an inflation spiral or additional bureaucracy. The danger is that the proposal leaves open the possibility that member states can take advantage of their banks which implies the Eurozone needs to revisit its approach to federalism, to help which the paper juxtaposes the development of US bank federalism.

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I. INTRODUCTION

The woes of the economically weaker "PIRGS" Eurozone countries—Portugal, Italy, Ireland, Greece, and Spain—bring to the fore a central issue about rekindling growth. Proponents of separate state action, like Paul Krugman, argue that the PIRGS would be better off outside the Eurozone because they could devalue and regain productivity and economic growth.[1] Yet, the majority of the voters in those countries favor staying in the Eurozone.[2] They believe that a future in the euro is better than a future under a new lira, drachma, or peseta. The infrastructure of the euro is justifiably more trustworthy than the infrastructures of their individual currencies with their undisciplined history.[3] This, however, appears to leave a policy void. If a future within Eurozone austerity is bleak and one outside it bleaker, does a mechanism for inducing local growth within the Eurozone exist? This brief paper argues the answer is a forced over-recapitalization of local banks, akin to the forced over-recapitalization by $250 billion in 5% preferred stock of the major US banks by the Treasury Department in late 2008 under the Capital Purchase Program (CPP) of the Troubled Asset Relief Program (TARP).[4]

Part II [EDITORS, *This part is optional because it is addressed to a general audience; it can be considered too easy for a specialized audience.* NLG] describes the predicament of banks in a recession and how the regulation of capital adequacy does not induce lending. Part III describes the operative features of forced over-recapitalization. Part IV discusses the inadequacy of the alternatives, devaluation, conventional Keynesian stimulus, or direct investment. Part V describes the US experience. Part VI concludes.

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1. See *infra* note 19.
2. See, e.g., *Over 80% of Greeks Reject Greek Exit from Euro: Polls*, XINHUANET ENGLISH NEWS, May 31, 2012 (over 80% favoring staying in Eurozone at any cost) available at http://news.xinhuanet.com/english/world/2012-05/31/c_131621436.htm (last visited Oct. 20, 2012).
3. Several of the PIRGS had a history of high inflation. See *infra*, text and figure accompanying note 21.
4. See, generally, UNITED STATES DEPARTMENT OF THE TREASURY OFFICE OF FINANCIAL STABILITY, CITIZEN'S REPORT, http://www.treasury.gov/initiatives/financial-stability/Pages/default.aspx (last visited on Oct. 22, 2012). For the bankers' meeting with the Secretary of the Treasury Henry Paulson and the Chairman of the Federal Reserve Ben Bernanke, see FINANCIAL CRISIS INQUIRY COMMISSION REPORT at 373-74 (2011) (hereinafter "FCIC REPORT"); Henry Paulson, ON THE BRINK (2010), at 360-68, David Wessel, IN FED WE TRUST 237-41 (2009); see also Mark Lander and Eric Dash, *Drama Behind a $250 Billion Banking Deal*, N.Y. TIMES Oct. 14, 2008, available at http://www.nytimes.com/2008/10/15/business/economy/15bailout.html (last visited Oct. 22, 2012).

II. BANK CAPITAL-ADEQUACY + RECESSION = NO LENDING

A sharp recession makes banks stop lending by reducing the value of the loans they have made and the collateral they hold. Rules about capital adequacy do not help banks in this predicament. This part demonstrates this with a simple example.

Capital-adequacy rules limit the amount of debt held by banks and regulate the credit-worthiness of their loans. Firms in most industries do not face such regulation. Unregulated firms are free to operate with immense debt in relation to their assets and to extend reckless credit. Unregulated firms thus take the full risk of insolvency, especially in a recession. A recession reduces income and impairs the repayment ability of creditors, which may lead a firm without capital-adequacy regulation to insolvency. The regulation of capital adequacy limits the risk that banks may take. During economic growth, this limitation on risk also reduces the potential for growth, but that is part of the price of the regulation: the compromise of growth for safety. Regulating bank safety reduces the severity of recessions. Before capital-adequacy rules, recessions led to widespread bank failures, producing a vicious cycle of reduced depositor wealth, reduced spending, and aggravation of the recession.

Even with capital adequacy rules, however, a sufficiently large recession would induce some banks to have to recapitalize. As the economy slides into recession, the likelihood that private banks will be able to collect the loans they have made drops. The recession also causes the value of the collateral securing banks' claims to drop. This reduces the value of bank assets, jeopardizes the banks' compliance with capital-adequacy rules, and makes the banks unwilling to lend even if they can borrow at low cost from their central bank. Recessions cause banks to need recapitalization to restore capital adequacy. However, neither capital-adequacy rules nor the economic environment induce banks to initiate new lending.

Capital-adequacy rules, in essence, require banks to have an excess proportion of financing, in equity and in the form of easily and safely liquidable assets or cash, given each bank's obligations to depositors. For example, the Basel III capital-adequacy requirements, simplified, are that a bank must have common equity equal to 4% of its assets and have 6% of its capital in highly liquid and

highly safe investments or cash (called "Tier 1 capital").[5] This is slightly different than requiring that 6% of deposits be in such assets. Consider the example of forming a new bank by raising some equity and taking deposits. To maintain equity of 4%, for every $40 of equity, the bank must take no more than $960 of deposits. If the bank were to make no loans, the deposits would remain as cash and the bank would more than satisfy the requirement that 6% of its assets be very liquid. As the bank lends more of those deposits, the quality of its assets would erode because lending exchanges the high-quality asset of cash for the low-quality asset of claims against borrowers. The bank must stop lending as the proportion of assets that are in highly liquid form approaches the 6% floor.

With the arrival of a recession, the value of a bank's claims against borrowers dissipates, as does the reassurance from the value of any collateral. Suppose that a recession forces one tenth of firms into insolvency. Then, one tenth of a bank's borrowers, on average, will be unable to repay their loans. Suppose that the bank will be able to recover a quarter of its claims from the insolvent borrowers and that the bank started with assets of $1,000 by means of a $95 equity contribution and deposits of $905, and lent 90% of its assets, or $900. Notice that before the recession, this bank was amply capitalized, having $95 of equity instead of the required 4%, which would be $40, and having $100 of liquid assets instead of the required 6%, which would be $60. The loans to the insolvent firms are one tenth of the $900 of loans, or $90. When their value drops, the bank's assets are the $100 that it did not lend, the claims against solvent firms, or $810, and a quarter of its claims against the insolvent firms, or $22.50. In sum, the bank's assets are $932.50. Since the value of the bank's loans has dropped but it still holds the same $100 of cash, the bank has actually moved farther from breaching the requirement that 6% of assets be highly liquid. However, because equity is equal to assets minus liabilities and the value of the banks assets dropped, the bank violates the requirement to have 4% equity. Since the bank's assets have dropped to $932.50 but it continues to owe depositors $905, the bank only has $27.50 of equity. Equity is less than 4% of its assets which would be $37.30.

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5. Basel Committee on Banking Supervision, Press Release: Group of Governors and Heads of Supervision announces higher global minimum capital standards, Sep. 12, 2010, available at http://www.bis.org/press/p100912.pdf (last visited July 12, 2012).

Thus, the recession has caused the bank to breach capital-adequacy requirements.

The banks' violation of capital-adequacy rules, as a result of the recession, is destructive for business lending. Recall that the bank in our example started well capitalized. Before the recession the bank could make new loans. Capital-adequacy required the bank to keep $60 in high quality assets (6% of $1,000). The bank of the example had $100 in such assets, so it could still lend $40. Thus, before the recession the bank could make new loans with 4% of its assets. After the recession, however, because of losses from loans to now insolvent enterprises, the bank is not able to make any new loans. Thus, the recession in combination with capital-adequacy rules produces a contraction of credit, which further aggravates the recession.

Granted, one could argue that banks in this predicament would simply raise new equity but the recession makes that onerous. Despite the solvency of our bank, the recessionary environment means that issuing common stock is unappealing and dilutive. Issuing preferred stock is dangerous.

Common stock will appear too cheap to justify new issuances during the recession. Recall that our bank was financed with a $95 equity contribution. The recession has made the equity have a book value of $27.50. The market value of its equity, the price at which the bank's stock trades, must have declined even more. Consider Citigroup, which had a stock price of almost double its book value before the recession but reached a low of less than 20% of book value.[6] If our bank's stock traded at 50% of book value—a ratio much more generous than the worst of Citigroup—then it would have a market capitalization of $13.75, half of its book value of $27.50. The stock trades below its book value during the recession because insolvency is a possibility. Our bank would not want to issue common stock because of its stock's low price.

The bank will also not want to issue common stock because the new investors would dilute existing shareholders. A further twist in the running example illustrates the dilution. Suppose the bank was to issue a number of new shares of common stock equal to those outstanding. Since the outstanding shares, in aggregate, trade for $13.75, that is the amount that new investors would be willing to pay for the new equivalent amount. The contribution of

6. YCHARTS: CITIGROUP CHART (PRICE TO BOOK VALUE), http://tinyurl.com/9corh66 (last visited Sept. 26, 2012).

the initial shareholders, however, corresponds to book value of $27.50. After raising the new contribution of $13.75, book value will increase to $41.25, the old $27.50 plus the new contribution of $13.75. Consider, however, how shareholders perceive their corresponding share of book value. As the original shareholders now hold half the shares, half of the book value corresponds to the contribution of the original shareholders. Notice that whereas before the issuance the book value that corresponded to the original shareholders' investment was the entire $27.50, after the issuance, it is half of $41.25 or $20.63. Therefore, from the perspective of the original shareholders the issuance of new common at a price below book value effectively transfers book value that corresponds to their investment to the new investors.

Issuing preferred stock is not dilutive but risky. Raising new funds by issuing preferred stock does not expose common stockholders to an immediate dilution because when the bank repays the new preferred, all its book value will again correspond to the stake of the old shareholders. However, if the bank's finances deteriorate, then the seniority of the preferred vis-à-vis the common means that the stake of the common is riskier and may become worthless.

The point is that because recapitalizations during recessions are onerous, banks keep the size of refinancings to a minimum. Banks have the incentive to recapitalize only to the extent necessary to satisfy capital adequacy rules, with no margin for new lending.

The recessionary economic environment already deters lending because the recession implies a scarcity of appealing investment opportunities. Neither will borrowers tend to ask the bank for loans nor will the bank tend to want to raise new capital for lending.

It is not surprising that bank regulation does not produce an incentive to lend and, thus, grow the economy. Bank regulation aims for safety, not growth. Capital adequacy ensures that banks are safe for depositors. Conventional wisdom is that other policies will drive economic growth, policies unrelated to bank regulation. For example, the typical Keynesian recipe calls for government spending.[7]

The problem for the EU is that the governments of some PIRGS are inefficient so that the typical Keynesian recipe of having the EU finance projects administered by the governments of the

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7. John Maynard Keynes, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (1936).

member states is ineffective, as Part IVB elaborates. The alternative that circumvents the PIRGs' governments is the forced and costly over-recapitalization of banks.

III. FORCED AND COSTLY OVER-RECAPITALIZATION OF BANKS

Subpart A explains he mechanism of the forced and costly over-recapitalization of banks. Subpart B discusses the related US experience.

A. The Mechanism

Five items explain the process of rekindling growth in the PIRGS. The forced over-recapitalization has four operative features and, fifth, should take the form of preferred stock. The operative features are (1) that the over-recapitalization be excessive and not a mere recapitalization; (2) that it be costly, requiring the recipient banks to pay a substantial return; and (3) that it be forced rather than voluntary. (4) An operative but non-banking feature is necessary in the EU context. The EU must not let national governments take advantage of the over-recapitalized banks by precluding changes in their regulation. Cash-starved national governments can take advantage of over-capitalized banks in a myriad of ways, most obviously by either increasing taxes or forcing the banks to lend to the national government. Finally, (5) issuance of preferred stock best achieves the over-recapitalization.

The *excessive* nature of forced over-recapitalization is necessary because mere recapitalization fails to induce lending. The objective is to induce growth. Merely having the central bank lend at the recipient banks' request is not enough. The refinancing must place recipient banks in the position of having an overabundance of capital. The idea is to replace the recession-driven problem of having too little capital with a new problem, the problem of having too much capital. Only then will the recipient banks feel the need to lend and, thus, rekindle growth.

The *costly* nature of the forced over-recapitalization is necessary because the need to cover that cost pushes recipient banks to find borrowers for the additional capital. The cost of the extra capital is particularly important in the current low-rate environment that lets banks borrow from the central bank at near-zero interest

rates.[8] The forced over-recapitalization must carry a higher cost, a rate closer to those at which recipient banks lend. The greater cost to the recipient banks also matches the risk of the investment as preferred stock.[9] Finally, the cost must not be so high as to push recipient banks to speculative investments.

The *forced* nature of the over-recapitalization follows from the recessionary environment, the reduced opportunities and the reduced demand for credit. The recessionary environment means that businesses tend not to see opportunities for expansion and, therefore, do not seek loans. Consequently, banks tend not to face demand for loans. In the recessionary environment the injection of the additional capital of the over-recapitalization creates tension for the recipient banks. Granted, the new capital makes the bank safer. However, the over-recapitalization places on the recipient banks the burden of finding a way to earn a return that will cover the cost of the new capital. Since that is the very lever that will lead to growth, banks must not have the option of declining the additional funds.

Finally, the EU must exempt banks from national laws. The EU must do so to preclude the temptation that over-recapitalized banks will create for the financially strapped national governments to take advantage of them. For example, the national governments may pass rules requiring the recipient banks to lend to the national government or its central bank. The national governments may impose special taxes or fees on the recipient banks. The national governments may even try to pass to the recipient banks welfare obligations. Such measures would neutralize the inducement for growth. Federalism and banking regulation in the US has not skirted these predicaments, as the historical overview of Part V shows.

The best instrument for achieving the banking goals is *preferred* stock. The recipient banks should issue preferred stock in exchange for the EU's over-recapitalization. Preferred stock is junior to the bank's borrowing. The junior nature of the preferred

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8. As of September 25, 2012, the federal funds rate was 0.15 percent. Since December 2008, the target rate has been 0 to 0.25%. See FEDERAL RESERVE BANK OF NEW YORK: FEDERAL FUNDS DATA, http://www.newyorkfed.org/markets/omo/dmm/fedfundsdata.cfm (last visited Sept. 25, 2012); FEDERAL RESERVE BANK OF NEW YORK: HISTORICAL CHANGES OF THE TARGET FEDERAL FUNDS & DISCOUNT RATES, http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html (last visited Sept. 26, 2012).

9. Preferred stock is junior to debt, i.e., is repaid after debt in a liquidation, but senior to common stock, i.e., must be repaid before common stockholders receive any capital. Being junior to debt implies that this preferred stock is more exposed to insolvency risk and should compensate by offering a higher return. The preferred's seniority over common stock means that preferred need not provide as high an expected return as common stock.

improves rather than aggravates the recipient banks' compliance with capital adequacy rules. If the over-recapitalization took the form of debt, then the recipient bank would be less likely to comply with capital adequacy and, therefore, also less likely to lend, frustrating the objective of the over-recapitalization.

For example, consider the previous example of the bank that is subject to the 4% equity capital-adequacy standard of Basel III and has $905 of deposits and, after the recession, equity with a book value of $27.50. If it were to issue a large quantity of preferred, say $200, which by its terms had sufficient flexibility for capital adequacy rules to treat it as equity, then the total equity of the bank becomes $227.50 (the new $200 added to the existing $27.50). While the bank did not have the 4% equity that Basel III standards required before the over-recapitalization (equity of $27.50 and debt of $905 produce an equity-to-assets ratio of $27.50-to-$932.50 or 2.9%), after the over-recapitalization it has equity of 20.09% (from equity of $227.50 to assets of $1132.50, the old assets plus $200) and can lend the money it receives and usually more.[10]

Moreover, the seniority of the over-recapitalization claim over common stock avoids the problem of dilution at the cost of risk for the common. If the recipient bank repays the preferred, then the common stockholders will not face dilution, otherwise the commons will suffer loss. Preferred stock offers two more flexibilities: (1) the accounting flexibility that its return is not an expense, being dividend rather than interest which lets the recipient banks report greater profits than if it were debt; and (2) the practical flexibility that the recipient bank can postpone declaring dividends for the preferred.

The preferred that the US used in its forced bank recapitalization had some additional desirable features: (1) its rate went up after five years from 5% to 9%, thus inducing fast repayment although its term was perpetual; (2) the recipient banks did not have the right to repay or repurchase the preferred for the first three years but could repay it at any time after that with their regulator's approval; (3) for financial institutions to strengthen their balance sheet, the US agreed to exchange the preferred for the

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10. Given that the recipient bank meets the equity component of the capital-adequacy test, the limiting factor in lending is maintaining asset quality, Basel III's requirement that 6% of assets be in highly liquid, tier-I capital. Our example bank already had ample tier-I capital, $100. The 6% of its new level of assets is $67.95. Since the bank needs less liquid capital than the amount of liquid capital the bank already has, the bank can lend more than the amount the bank received in the over-recapitalization.

institution's common stock in some cases, most notably Citygroup; (4) the US also received 10-year warrants to acquire common shares of the publicly-traded recipient banks at their current price in an aggregate amount equal to 15% of the value of the preferred;[11] (5) if the recipient banks missed six dividends to the preferred, although the preferred was non-voting, the US obtained the right to appoint two directors on the recipient banks' board. In sum, the terms of the US over-recapitalization were not light and the program was quite sizable. Financial institutions accepted those terms because of the depth of the crisis. European financial institutions may face smaller pressures, that may be reflected in different terms.

B. The US Example

The US offers a striking example of forced and costly recapitalization of banks. The context is the "Great Recession," the global financial crisis that started in December of 2007.

By the September 2008 the crisis was raging. Two once venerable investment banking firms and two large banks no longer existed.[12] The government had rescued the quasi-governmental enterprises that supported the home mortgage market[13] and had announced a massive guarantee in favor of all parties having claims against the giant insurance company AIG.[14] Borrowing was so dysfunctional that debtors as credible as General Electric and

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11. Recipient banks that were not publicly traded but privately held had to give the government 10-year warrants to acquire common shares at their current price in an aggregate amount equal to 5% of the value of the preferred. *See* DECEMBER 8TH CPP DEADLINE FOR PRIVATE BANKS QUICKLY APPROACHING, http://www.foley.com/intelligence/detail.aspx?int=-9285 (last visited Sept. 26, 2012).

12. Investment bank Bear Stearns collapsed in March 2008, and Lehman Brothers on September 15, 2008. Banks Washington Mutual and Wachovia followed on Sep. 25 and Sep. 28 to Oct. 3. For details, see generally FCIC REPORT, *supra* note 4, at 280-91 (Bear), 324-42 (Lehman), 365-71 (WaMu and Wachovia) ; Henry Paulson, *supra* note 4, 90-121, 171-221; David Wessel, *supra* note 4, at 154-72 (Bear), 10-25 (Lehman), and 218-26 (WaMu and Wachovia).

13. FCIC REPORT, *supra* note 4, at 309-23; Paulson, *supra* note 4, at 125-70; Wessel, *supra* note 4, at 176-87.

14. FCIC REPORT, *supra* note 4, at 344-51; Paulson, *supra* note 4, at 222-41; Wessel, *supra* note 4, 193-97; Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Secured Credit Facility Authorized for American International Group, Inc. on September 16, 2008, http://www.federalreserve.gov/monetarypolicy/files/129aigseccreditfacility.pdf (last visited on Oct. 5, 2012).

Goldman Sachs had to receive financing from Warren Buffet's Berkshire Hathaway at exorbitant interest rates.[15]

The Secretary of the Treasury Henry Paulson, previously head of Goldman Sachs, summoned the heads of the largest US banks to a meeting on Monday October 13, 2008, with the Chairman of the Federal Reserve, Princeton Economics Professor Ben Bernanke, a scholar of the great depression.[16] Paulson and Bernanke had new firepower in the form of the appropriation of the Troubled Asset Relief Program by Congress.[17] The chair of the FDIC, Sheila Bair, also attended, to explain that if the banks accepted the over-recapitalization, then the FDIC would expand its insurance to cover all the banks' obligations.[18] At a time when the dominoes of the financial system were falling one after the other, the deal was irresistible.

Paulson and Bernanke effectively forced the banks to accept $250 billion in the form of 5% preferred. The eight banks received in total $144 billion. Another $85 billion would go to smaller banks.

This forced and costly over-recapitalization was a game changer. Until that moment, in the recessionary panic, banks sought to protect themselves from failures in a sinking economy where everybody's credit was deteriorating. This was a self-aggravating vicious cycle because part of the reason for the deterioration of credit was unwillingness to lend. Afterwards, banks not only had ample credit—dispelling concerns—but they even had the opposite problem of needing protection against failing borrowers. Now the problem was to find borrowers for their excess funds in a way that would cover their 5% cost. The vicious cycle of fear to lend was replaced by a virtuous cycle of need to lend.

The graph of the amount of outstanding nonfinancial commercial paper (very short term business loans) illustrates the crisis and the changes in the aftermath of the meeting. This lending drops by over 35% in October 2008 and quickly recovers after the Paulson-Bernanke gambit.

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15. Tom Petruno, *Buffett's Berkshire Hathaway invests $5 billion in Goldman Sachs*, BALTIMORE SUN, Sept. 24, 2008, http://articles.baltimoresun.com/2008-09-24/news/080-9230187_1_buffett-billion-in-goldman-goldman-sachs (last visited Oct. 5 2012); Steve Lohr, *Buffett's Bet on G.E.: Almost as Good as a Bailout*, N.Y. TIMES, Oct. 1, 2008, http://www.nytimes.com/2008/10/02/business/02electric.html?_r=0 (last visited Oct. 5, 2012).

16. See, e.g., Ben S. Bernanke, ESSAYS ON THE GREAT DEPRESSION (2004).

17. 12 U.S.C. §§ 5211-41 (Supp. V 2011).

18. See FCIC REPORT, *supra* note 4, above; PAULSON, *supra* note 4; WESSEL, *supra* note 4. Also in attendance was the then President of the New York Federal Reserve Bank, Tim Geithner, later Secretary of the Treasury.

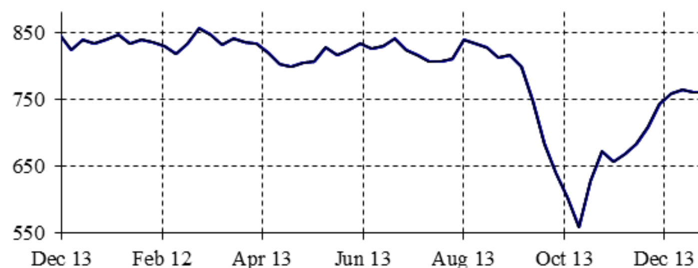

Figure 1: Outstanding Commercial Paper from December 2007 to December 2008, nonfinancial, seasonally adjusted, all maturities, weekly data, in billions of US dollars, showing the October 13 date of the meeting. Source: http://www.federalreserve.gov/datadownload/.

Saying that the forced over-recapitalization ended the crisis would be an overstatement. The recovery has been slow and unsteady. Yet, the relief of the crisis, however unsure, started at that meeting. Europe needs its equivalent for the PIRGS. The legislatures of the PIRGS countries should enact a forcible over-recapitalization of their banks and the European Central Bank should fund it.

IV. THE ALTERNATIVES

The proposal for forced over-recapitalizations is not the only path to rekindling growth. Likely, however, it is more effective than the three alternatives: devaluation, Keynesian governmental stimulus, and direct investment.

A. Devaluation's Pointlessness, Permanence, and Spiral

Several commentators, most prominently Paul Krugman and the Economist magazine, advocate that Greece exit the Eurozone.[19] By implication, this applies to all the PIRGS countries. The argument is that outside the Eurozone, each country would have the

19. See, e.g., Ben Chu, Interview with economist Paul Krugman: 'Greece will leave eurozone within 12 months', THE INDEPENDENT, May 30, 2012, available at *http://www.independent.co.uk/news/world/politics/interview-with-economist-paul-krugman-greece-will-leave-eurozone-within-12-months-7804753.html* (last visited Oct. 8, 2012); Paul Krugman on Euro Rescue Efforts: 'Right Now, We Need Expansion,' SPIEGEL, May 23, 2012, available at *http://www.greekcrisis.net/2012/05/paul-krugman-on-euro-rescue-efforts.html* (last visited Oct. 8, 2012); Charlemagne, Germany and the future of the euro(1): Is Grexit good for the euro? THE ECONOMIST, June 16, 2012, available at *http://www.economist.com/blogs/charlemagne/2012/06/germany-and-future-euro-1* (last visited Oct. 8, 2012).

capacity to induce orderly devaluation, regain competitiveness and thus mobilize its economy again.

While this may seem sound, the analysis has three major drawbacks: (1) exit splits the Eurozone, (2) devaluation perpetuates the inefficiency of the PIRGS' public sectors and (3) devaluation initiates a spiral toward hyperinflation.

The promise of the Eurozone is much larger than a common currency. The movement of people, goods, and services produces value in many ways beyond mere economics. Moreover, the less efficient PIRGS countries will have a very difficult task in attaining the standards for reentering the Eurozone. Therefore, the EU must not sacrifice unity while alternative paths toward growth exist.

Devaluation would not contribute at all to reducing the inefficiency of the PIRGS' public sectors. Essentially, devaluation is effective only for countries with well-functioning public sectors. Well-functioning public sectors may exist in the PIRGS, but they are a rarity. Greece and Italy are at the bottom of the integrity rankings, both those authored by the EU and independent ones.[20] Before entering the Eurozone, the PIRGS states functioned under higher inflation equivalent than the rest of the Eurozone, equivalent to significant annual devaluations of their currency, as figure 2 shows.[21] In the seventies and eighties, the PIRGS average inflation was over 14% for 11 years with peaks of 21% in 1974 and about 20% in 1978, 1981, and 1982, significantly greater than the rest of the Eurozone which never exceeded 12%.[22]

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20. See, e.g., *European Commission, Citizens' Perceptions of Fraud and the Fight Against Fraud in the EU27* p. 7 (Oct. 2008) available at http://ec.europa.eu/public_opinion/flash/fl_236-_en.pdf, visited April 10, 2012 (91% of the Greeks surveyed considered that the extent to which the state budget was being defrauded was "rather frequent"); Transparency International computes a corruption perception index and ranks Greece 80th in the world in 2011, tied with Peru, Morocco, El Salvador, Colombia, and Thailand with a Corruption Perceptions Index of 3.4. That makes Greece the laggard of the Eurozone and penultimate in the European Union. The next worst showing of the Eurozone is Italy, which scores 3.9 tying for 69th place in the World, then Slovakia with 4.0 tying for 66th, while the rest of the Eurozone countries have indices of 5.5 or greater. Only one PIRGS country has a better corruption idex than only one other Eurozone member, Ireland with 7.5 beats France's 7.0 but also ties Belgium, that also has 7.5. See Corruption Perception Index, Wikipedia; see also www.transparency.org.

21. Data extracted on Oct. 25, 2012, from inflation statistics found at OECD.StatExtracts, http://stats.oecd.org/ (last visited Nov. 6, 2012).

22. Statistical comparisons using the t-test of the inflations of the PIRGS to those of the rest from 1973 to 1983 indicate differences with statistical significances better than 99% (probability values smaller than 1%).

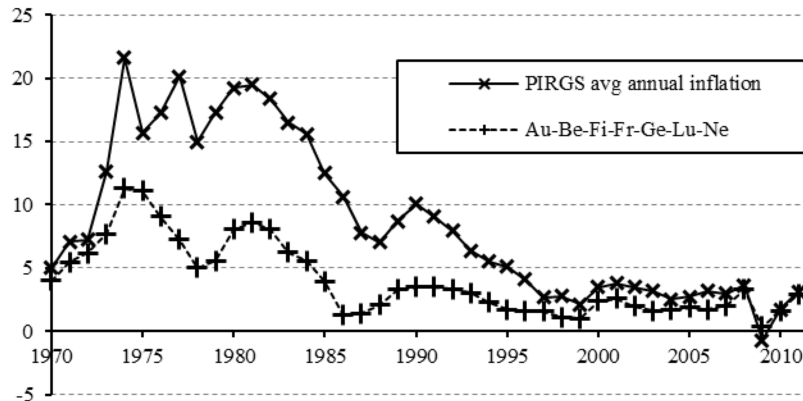

Figure 2: Annual inflation, 1970-2012. Average of PIRGS and average of Austria, Belgium, Finland, France, Germany, Luxembourg, and the Netherlands. Data for Ireland begin in 1976. Germany is only West Germany before reunification.

In that environment, they were able to maintain exports and economic viability despite the inefficiency of their public sector. Allowing them to exit the Eurozone means a return to large annual devaluations which relieve the pressure to reform the public sector. Exit and devaluation perpetuates the inefficiency.

Finally, the inefficiency of the PIRGS' public sectors indicates that they will not have the discipline to maintain the single devaluation that these proposals suggest. Rather, the initial devaluations will produce an inflation spiral that will lead to devastating hyperinflation.

Consider an example of a stylized PIRGS country consisting of ten individuals, five working for the bloated public sector stamping licenses, one being the financial sector and four working in industry, service, and agriculture (if you will, a builder, a driver, a farmer, and a refiner). While an efficient public sector would mean that only one person suffices for security and licensing compliance, the public sector's inefficiency makes this economy have five. The taxes produced by the five persons in the private sector cannot pay the salaries of the five in the public sector. Exiting the euro offers a solution for this country only once and without solving its structural problem. By devaluing, the private sector's product will be cheaper in the international markets. This makes the private sector busier for one year and brings more taxes. The increased tax revenue will suffice to pay the public sector that year, in their depreciated salaries. But the employees of the public sector will demand raises to maintain their living standard. The ineffective public sector will not be able to resist them. The next

year, the taxes will again not suffice, requiring a new devaluation. Anticipating devaluation, employees demand raises more often, inducing more frequent devaluations, starting the inflationary spiral that leads to hyperinflation.

Breaking the Eurozone relieves the tension once, but perpetuates inefficiency and begins an inflation spiral. In other words, the sacrifice of the Eurozone would only bring short-term relief, significant harm, and no long-term benefit.

B. The Capture of Keynesianism by the Inefficient States

Keynes' recipe for ending recessions calls for public spending that will spur economic activity.[23] Potential but contested examples of its success are the US highway system and the Marshall plan in Europe.[24] Opponents point to significant drawbacks of Keynesianism, largely stemming from the anticipation of higher taxes or inflation in reaction to government spending, and from lack of empirical validation.[25] Even for its proponents, however, the application of Keynesian stimulus to the PIRGS economies has two problems. First, the inefficiency of PIRGS public sectors dilutes the gains from Keynesian stimulus. Second, Keynesian stimulus may even aggravate the PIRGS bureaucracies.

The mobilization of a government-led stimulus requires action of both the legislature in adopting it and the executive in implementing it. Any benefits of Keynesian stimulus will be diluted by the inefficiencies of the PIRGS bureaucracies. Inefficiency can arise at every step. The states may not chose the most effective projects for kindling growth. One of the projects that Greece chose to fund before the great recession was the new Acropolis Museum. As great as the result is, one can easily argue that the abundance of museums and antiquities suggests other projects would have had a more stimulating effect on the Greek economy. Regardless of the

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23. *See* Keynes, *supra* note 7.

24. See, e.g., J. Bradford de Long and Barry Eichengreen, *The Marshall Plan: History's Most Successful Structural Adjustment Program* at 3-4 (NBER Working Paper 3899, Nov. 1991).

25. See, e.g., John B. Taylor, *An Empirical Analysis of the Revival of Fiscal Activism in the 2000s*, 49 J. ECON. LIT. 686-702 (2011) (finding no increase in individual spending or in municipal spending in reaction to federal tax cuts and transfers; "the three countercyclical stimulus packages of the 2000s … did not have a positive effect on consumption and government purchases, and thus did not counter the decline in investment … as the basic Keynesian … model would suggest." at 701; with further citations).

effectiveness of the projects as economic stimulants, the states may also execute them in a wasteful fashion. For example, before the Great Recession, Greece funded the 2004 Olympiad. Allegations have been made that the auctioning of the projects was late and had irregularities.[26] Some have also claimed that Greece did not plan adequately for the use of the facilities after the games.[27] The point is that a given amount of stimulus spending in an efficient government can be enormously more effective than the same spending at an inefficient state.

Even disregarding inefficiencies, Keynesian stimulus is also not appropriate for the PIRGS because it may aggravate the public sector's inefficiency. Return to the above example of a state of ten individuals with a bloated public sector of five rather than the optimal one. If the EU finances a project, besides some of the financing leading to more economic activity, a significant fraction of it will tend to be absorbed by the public sector, fostering its inefficiency. Rather than helping the transition toward the public sector with only one employee, it may lead the public sector to expand. To wit, the new financing requires more stamping of licenses and a larger bureaucracy!

C. The Desirability of Direct Investment

Professor Varoufakis of Athens University has advocated that the EU produce growth in the PIRGS by directly funding entrepreneurial projects.[28] The EU would create an investment agency that would invest directly in enterprises in the ailing PIRGS member states. This would create business activity in the ailing states and help them exit the recession.

In principle this proposal is in harmony with forced over-recapitalization. Both the proposal to forcibly over-recapitalize

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26. John Drayton, *Samaranch orders Greeks to sort out Olympic shambles*, DAILY MAIL, Apr. 21, 2000, at 89; Mike Gorrell, *2004 Games in a Muddle: Poor planning, red tape plague Athens; IOC Says Athens is Ill-Prepared for 2004 Games*, SALT LAKE TRIBUNE, Apr. 21, 2000, at A1; *Athens denies Olympic turmoil*, DESERT NEWS, Sept. 30, 1999, at A11.

27. See Elena Becatoros, *Athens Olympics Venues in Decay 8 Years After 2004 Games*, HUFFINGTON POST (Aug. 3, 2012), http://www.huffingtonpost.com/2012/08/03/athens-olympics-venues-photos-abandoned_n_1739264.html#slide=more242797; *In the Olympic Race, Athens Fell Short of the Line*, INSIDE GREECE: NEWS AND OPINION (Aug. 21, 2012), http://insidegreece.wordpress.com/2012/08/21/in-the-olympic-race-athens-fell-short-of-the-line/.

28. See Yanis Varoufakis and Stuart Holland, *A Modest Proposal for Resolving the Eurozone Crisis, Version 3.0*, http://varoufakis.files.wordpress.com/2010/11/modest-proposal-3-0-may-2012-without-rebalancing-mechanism.pdf (last visited Nov. 2, 2012).

PIRGS' banks and the proposal to have the EU make direct investments in private enterprises in the PIRGS' economies would help rekindle growth. Advocating over-capitalization in no way suggests that direct investment should not occur. Better yet, the EU should do both, direct investment and forced over-recapitalizations. However, if the EU had to select one fix, direct investment is less appealing. It requires the establishment of a new bureaucracy, the investment agency. This implies delay and inefficiency compared with over-capitalizing private banks.

V. THE US REGULATORY EXPERIENCE: CONTESTED FEDERALISM AND MULTIPLICITY OF REGULATORS

The danger that the PIRGS governments may try to take advantage of over-recapitalized banks requires a transition to EU regulation of banks. The meandering path of the United States toward federal bank regulation illustrates the potential complexities. This part discusses the history of bank federalism issues in the US. The conclusion extrapolates about issues that the Eurozone may face.

The history of US bank regulation is an illustration of the astonishingly strong political current against regulation in the United States compared to Europe. Merely the creation of a central bank took over 120 years. Although the Great Depression resulted in tight regulation, that was politically excessive and regulatory burden has retreated. Finally, the gradual nature of the enactment of regulation combined with political resistance to federal authority produced a multiplicity of regulators which still failed to prevent the Great Recession that started the December of 2007.

A. The Arduous Path to a Central Bank

Immediately after independence, the dispute was merely about the creation of a national bank rather than the regulation of banks with an eye to safety—prudential regulation.[29] The first bank lasted three years until the Pennsylvania legislature repealed its state license in 1785.[30] Then, Congress established the first Bank of

29. The government was to own a minority stake in the banks, with a majority owned by private investors. This was intended to replicate the structure of the British central bank but made the proposal vulnerable to political attacks of favoritism to foreign investors.

30. Acts of the General Assembly of PA (9th), Chapter CCXXV, at 358 (1785).

the United States in 1791 with a twenty-year duration. When, in 1811, the time came to renew the bank's charter, the opposition prevailed. After the fiscal disaster of the war of 1812, the Federalists managed to establish a national bank in 1816, the second Bank of the United States, again with a twenty year term. Its establishment was challenged before the Supreme Court as exceeding the enumerated powers of the federal legislature but, in a historic Chief Justice Marshall opinion, it was upheld.[31]

Despite the legal victory of federalism, and despite that Congress authorized the renewal of the bank charter, southern anti-federalist president Andrew Jackson vetoed its renewal.[32] This left no federal bank or regulation till 1863, defining the 1836 to 1863 period as one of "free banking." State banks proliferated but often failed. Their private currency was risky and discounted depending on each issuing bank's credit. Crises were frequent and deep, with alternating inflationary and deflationary periods. For example, the six-year period from 1837 to 1843 saw deflation of -33%.[33] The five-year period from 1843 to 1847 saw inflation of 11%.[34]

The next evolutionary steps were regulatory and came as part of the Civil War and brought major changes: (i) prevented parties from refusing to accept payment in paper currency; (ii) enabled the chartering of national banks with higher standards than existing state banks; (iii) required banks to hold treasury securities, facilitating the financing of the civil war.[35] The acts also created the first agency with authority over banking, the Office of the Comptroller of the Currency to supervise a national unified (and newly paper) currency. That this level of regulation was politically sustai-

31. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819); see generally Gerard N. Magliocca, *A New Approach to Congressional Power: Revisiting the Legal Tender Cases*, 95 GEO. L.J. 119 (2006) (discussing the different interpretations of federal power stemming from *McCulloch* over time).

32. Veto Message, July 10, 1832, 3 COMP. MESSAGES AND PAPERS PRES. 1139-54 (1896) (lengthy discussion of lack of necessity of allowing foreign ownership of the bank's stock and the unconstitutional nature of its exemption from state taxing power: "Whatever interest or influence … has given rise to this act, it can not be found in either the wishes or necessities of the executive department, by which present action is deemed premature, and … not only unnecessary, but dangerous …" at 1153).

33. See *Robert C. Sahr, Inflation Conversion Factors from Year 1774 to estimated 2018* at 2 (2008) (reporting the deflator of the Bureau of Labor Statistics in 1982-82 dollars going from 0.096 in 1837 to 0.074 in 1843, a 33% drop), http://oregonstate.edu/cla/polisci/faculty-research/sahr/infcf17742007.pdf (visited Nov. 7, 2012).

34. Id. (going from .074 to .082, an 11% increase).

35. Legal Tender Act of 1862 § 1, 12 Stat. 345 (1862) ("[S]uch notes . . . shall also be lawful money and a legal tender in payment of all debts, public and private, within the United States . . ."); National Bank Act of 1863, 12 Stat. 665 (1863); National Bank Act of 1864, 13 Stat. 99 (1864).

nable was evidenced because it did not produce a one sided effort either for more or less regulation. Rather it was followed by regulatory ping-pong against private initiative that sought to avoid costs. Entrepreneurs likely tended to avoid the cost of establishing federal banks, and traders likely tended to prefer paying using the riskier banknotes of state banks while hoarding those of federal banks. The federal government responded by taxing the banknotes of state banks. State banks circumvented the tax by creating checking accounts. Checking accounts substituted the circulation of checks for that of banknotes.[36]

The frequent and deep financial crises continued and eventually led to the creation of today's central bank, the Federal Reserve, in 1913 after a six-year negotiation. Its initial shape was to be fully private, as envisioned by its primarily Republican advocates. It was, however, enacted under a Democratic Congress as a nominally private entity with a Board of Governors appointed by Congress.

B. *Political Sustainability: From Glass-Steagall to Dodd Frank*

The stock market crash of 1929 led to a bank crisis that hampered business activity and financing, and led to the Great Depression. The legislative response was the passage of numerous measures of regulation including the Banking Act of 1933 known as the Glass-Steagall Act,[37] which (i) separated commercial banking from securities and insurance,[38] (ii) submitted commercial banks to a stricter regulatory regime,[39] and (iii) established bank insurance through the FDIC.[40] Other New Deal legislation established the Securities and Exchange Commission[41] and the Commodity Futures Trading Commission.[42] Regulation of the financial system would be

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36. Richard Sylla, *The US Banking System: Origin, Development, and Regulation*, The Gilder Lehrman Institute of American History, http://www.gilderlehrman.org/history-by-era/economics/essays/us-banking-system-origin-development-and-regulation (last visited Nov. 2, 2012); Stephen Quinn and William Roberds, *The Evolution of the Check as a Means of Payment: A Historical Survey*, 93 Fed. Res. Bank of Atlanta: Econ. Rev. , no. 4, 2008 at 9-14.
37. Pub.L. 73-66, 48 Stat. 162 (June 16, 1933).
38. §§ 16, 20, 48 Stat. at 184-85, 188-89.
39. See generally §§ 9-33, 48 Stat. 180-95.
40. § 8, 48 Stat. at 168-80.
41. Securities Exchange Act of 1934, § 4, 48 Stat. 885 (June 6, 1934), 15 U.S.C. § 78d (2012).
42. Commodity Exchange Act of 1936, Pub. L. 74-675, 49 Stat. 1491 (June 15, 1936) (establishing Commodity Exchange Commission); Commodity Futures Trading Commission Act of 1974 § 101, Pub. L. 93–463, 88 Stat 1389 (Oct. 23, 1974) (establishing Commodity Futures Trading Commission).

apportioned in this increasing number of regulators. The New Deal also completed a reversal of political tendencies about regulation, making the Democratic Party favor regulation and federalism and the Republican Party to oppose regulation and, eventually, favor states' rights.[43]

The banks of 1934 were so severely restricted that they bore little relation to today's banking conglomerates. They could have more than a single location (branch banking) only if state law allowed that, they could not offer interest on checking accounts, faced restrictions in making variable-rate mortgage loans, and they could not be affiliated with a brokerage or insurance business.[44] This exacting regulatory environment eliminated financial crises but exceeded the political taste for regulation. The regulatory ping-pong was replaced by single-sided efforts to erode the Glass-Steagall monolith. Restrictions were gradually relaxed, either through legislation, administrative rulemaking, or private arrangements that circumvented banks, and financial crises started reappearing.

The crises culminated in the Great Recession that started in December of 2007. At its gravest point, financing froze. The pinnacle of the panic was the market's refusal to lend to the world's safest borrower, General Electric, which had to get financing from Warren Buffet's Berkshire Hathaway at the exorbitant rate of 10%.[45] The expected depression made the Great Depression look like a walk in the park.[46] Vigorous stimulation of the economy by the Treasury, the Federal Reserve and the legislature averted the catastrophe.

The legislative attempt to prevent a repetition of the causes of the crisis was the Dodd-Frank Act, which delegates its implementation to administrative agencies, restarting the regulatory ping-pong.[47] The two measures of the many of Dodd-Frank that have the

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43. See, e.g., Gary Miller and Norman Schofield, *The Transformation of the Republican and Democratic Party Coalitions in the U.S.*, 6 Perspectives on Politics, Sep. 2008, at 433, 437-38.
44. Banking Act of 1933, 48 Stat. §§23, 11(b), 20, 21.
45. See *G.E. Will Pay Back $3 Billion to Buffett*, N.Y. TIMES DEALB%K (Sept. 13, 2011, http://dealbook.nytimes.com/2011/09/13/general-electric-to-pay-back-warren-buffett/, (last visited Aug. 24, 2012); *Buffet to Invest $3 Billion in GE*, N.Y. TIMES DEALB%K (Oct. 1, 2008, http://dealbook.nytimes.com/2008/10/01/buffett-to-invest-3-billion-in-ge/, (last visited Aug. 24, 2012).
46. Ambrose-Evans Pritchard, *Crisis may make 1929 look a 'walk in the park,'* THE TELEGRAPH, Dec. 22, 2007, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2821629/Crisis-may-make-1929-look-a-walk-in-the-park.html (last visited Oct. 5, 2012).
47. Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§ 5301-5641 (Supp. V 2011).

potentially greatest prudential effect are (a) that it seeks to increase the safety of banks by preventing them from speculating (through the Volker rule[48]) and (b) that it seeks to reduce the shock of failures by facilitating emergency liquidations and restructurings of institutions that would cause a cascade of failures (through its emergency liquidation authority over systemically important institutions[49]). The idea is that entities that perform banking functions will have some safety and the failure of any institution with the potential to destabilize the financial system will not endanger other sectors of the economy. The reality that money market funds operate as substitutes of banks justifiably draws regulatory attention.[50]

C. Multiple Regulators: Chaos or Synergy?

A striking feature of the broader image of financial regulation in the US is its multiplicity, that regulation comes from multiple administrative agencies. Banks are subject to the Federal Reserve,[51] the Federal Deposit Insurance Corporation (FDIC),[52] and the Office of the Comptroller of the Currency (OCC)[53] (and that is a simplification, as before Dodd-Frank some banks were subject to yet another agency, the Office of Thrift Supervision[54]). Insurance companies are subject to the fifty state insurance commissioners (but some topics, such as credit default swaps[55] and health and pension insurance through employment[56] get the benefit of federal exemptions from state regulation) and, after Dodd-Frank, also to the Federal Insurance Office, a new department of the Federal Reserve.[57] The securities business (but not commodities) is subject to the Securities and Exchange Commission (SEC).[58] The commodities business (which is mostly financial because of the dominant

48. Id. at § 1851.
49. Id. at § 5381-94.
50. See, e.g., *Peter Eavis, A Third Option for Regulators in the Money Market Fund Fight*, N.Y. TIMES DEALB%K (Aug. 30, 2012), available at http://dealbook.nytimes.com/2012/08/30/a-third-option-for-regulators-in-the-money-market-fund-fight, last visited September 2, 2012.
51. 12 U.S.C. §§ 222, 330 (2006).
52. 12 U.S.C. § 1811 (2006).
53. 12 U.S.C. § 1 (2006).
54. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 §301, Pub. L. 101–73, 103 Stat 183 (August 9, 1989) (repealed by the Dodd-Frank Wall Street Reform and Consumer Protection Act § 312, as codified at 12 U.S.C. § 5412 (Supp. V 2011)).
55. Commodity Futures Modernization Act of 2000 § 408, Pub. L. 106-554, 114 Stat. 2763, 2763A–365 (Dec. 21, 2000).
56. 29 U.S.C. § 1144 (2006).
57. 31 U.S.C. § 313, 12 U.S.C. § 5365 (Supp. V 2011).
58. See note 41, above.

volume of trading in financial commodities such as interest rates and index futures[59]) is subject to the Commodity Futures Trading Commission (CFTC).[60] Before Dodd-Frank, coordination was absent. Dodd-Frank established some general oversight through the Financial Stability Oversight Council.[61] Dodd-Frank also established an additional regulator, within the Federal Reserve, the Bureau of Consumer Financial Protection.[62] Thus, the US has seven federal financial regulators, fifty state insurance regulators, and most states also have securities regulators.

The multiplicity of US regulators is hotly debated in the aftermath of the crisis.[63] The glaring weakness is that the multiple regulators can produce chaotic rules and a nightmare for compliance but somehow that fate has been avoided, perhaps with the help of the power that US courts have to invalidate agency rules.[64] A strength is that some of the multiple regulators may identify a new danger and try to address it through regulation.[65] A corresponding weakness is that the acquiescence of a few key regulators may create a loophole through which a new danger may grow to a threat for the financial system. For example, credit default swaps and collateralized mortgage obligations, the new financial products at the heart of the cause of the Great Recession could have been addressed by regulation if they were concerns for Congress, which

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59. See, e.g., DON M. CHANCE, AN INTRODUCTION TO DERIVATIVES at 236 fig. 7.1, at 261 tbl. 7.6 (3d ed. 1995).

60. See note 42, above.

61. 12 U.S.C.A. §§ 5321-33 (2011).

62. 12 U.S.C.A. §§ 5491-97 (2011).

63. See, e.g., Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 Geo.Wash. L. Rev. 39 (2009); Elizabeth F. Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom, and Australia*, 55 Vill. L. Rev. 509 (2010); Eric J. Pan, *Structural Reform of Financial Regulation*, 19 Transnat'l L. & Contemp. Probs. 796 (2011); Dan Awrey, *Regulating Financial Innovation: A More Principles-Based Proposal?*, 5 Brook. J. Corp. Fin. & Com. L. 273 (2011); Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. Rev. 1629 (2011). The dissenting reports in the FCIC Report point out that since the cause of the crisis was housing policy, changes in financial regulation were unwarranted, *supra* note 4 at 411-533, 533 ("If the crisis could have been prevented simply by eliminating or changing the government policies and programs that were primarily responsible for the financial crisis, then there was no need for the Dodd-Frank … Act")

64. See, e.g., *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (invalidating SEC rule allowing large long term shareholders to propose candidates for director positions).

65. In 1998 the CFTC proposed eliminating its exemption for over-the-counter derivatives dealers and subject them to regulation but its attempt to regulate them was attached by several other governmental actors, including the SEC, the Federal Reserve, and the Treasury, and regulation was eventually prohibited by the Commodity Futures Modernization Act of 2000, see FCIC REPORT, *supra* note 4, at 47-48.

ensured swaps remained unregulated,[66] or for the Office of Thrift Supervision. The Office of Thrift Supervision had authority over AIG, the main issuer of credit default swaps.[67] Also, Fannie Mae could have maintained the rules that prevented risky mortgage financing from being considered "conforming," enabling its easy sale to Fannie Mae from the initial "originator" lender.[68] The acquiescence of these regulators enabled the vortex that almost sank the world economic system.

In sum, the US constructed federal bank regulation very gradually and with multiple regulators. More generally, financial regulation is still strongly contested. Despite the multiplicity (and sophistication) of regulators and the quantity of regulation, the US regulatory system was swept by the mass euphoria that preceded the Great Recession and did not prevent its causes.

VI. CONCLUSION: FORCED OVER-RECAPITALIZATIONS AND EUROZONE BANK FEDERALISM

In the Eurozone banking's transition toward federalism three principal differences from the US are worth exploring. First, political resistance against financial regulation may be different and likely less than in the US, perhaps favoring a plan such as over-recapitalizations. Second, the Eurozone faces the challenge of having inherited the seventeen central banks and regulatory structures of its member states (and twenty-seven if the focus is on the entire EU) raising the question of the political plausibility of adopting an over-recapitalization plan. Third, the issue arises of the extent to which the different function of the European Court of Justice compared to the US Supreme Court may influence the adoption of measures against the Great Recession generally and over-recapitalization in particular.

First, resistance to regulation appears to be much weaker in Europe compared to the US. Granted, some political resistance to

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66. Id.
67. See FCIC REPORT, *supra* note 4, at 352 ("The OTS failed to effectively exercise its authority over AIG and its affiliates: it lacked the capability to supervise an institution of the size and complexity of AIG, did not recognize the risks inherent in AIG's sales of credit default swaps, and did not understand its responsibility to oversee the entire company, including AIG Financial Products. Furthermore, because of the deregulation of OTC derivatives, state insurance supervisors were barred from regulating AIG's sale of credit default swaps even though they were similar in effect to insurance contracts. If they had been regulated as insurance contracts, AIG would have been required to maintain adequate capital reserves").
68. See, generally, FCIC REPORT, *supra* note 4, at 38 *et seq.*

EU financial regulation does arise, mostly from the UK and Germany. For example, the UK has resisted safeguards on pension funds,[69] a tax on financial transactions,[70] and an attempt to curb high frequency trading.[71] Germany has resisted attempts to give the EU increased power over trade policy[72] and, more recently, greater centralized control over banks.[73] The nature of these nations' opposition to financial regulation, however, is different from the US. US opposition to regulation tends to be sweeping whereas the opposition within the EU tends to target specific rules. The EU does not have the deregulatory spirit of the US. Indeed, the consolidation of banking regulation appears to be progressing.[74]

Second, central banking, is the comparison of the governance of the European Central Bank ("ECB") to that of the Federal Reserve or actually, its committee that decides monetary policy, the Federal Open Market Committee ("FOMC"). Monetary policy in the Eurozone is set by the Governing Council of the ECB. The heads of the seventeen central banks of the Eurozone are members of the Governing Council. The Governing Council is rounded out with six members of the ECB's Executive Board.[75] This produces a 23-member body where the PIRGS' central banks are outnumbered. Also, indirectly, disproportionate voting power accrues to citizens of the smaller countries.[76] The ECB has, thus, a much more decen-

69. *UK Pensions: Britain continues to resist EU solvency rules for pensions*, INFORMATION DAILY.COM, June 23, 2012, http://www.theinformationdaily.com/2012/06/23/uk-pensions-britain-continues-to-resist-eu-solvency-rules-for-pensions (last visited Oct. 9, 2012).

70. *European Commission financial tax opposed by UK*, BBC NEWS: BUSINESS, Sept. 28, 2011 http://www.bbc.co.uk/news/business-15090761 (last visited Oct. 9, 2012).

71. Alice K. Ross, Will Fitzgibbon & Nick Mathiason, *Britain Opposes MEPs Seeking Ban on High-Frequency Trading*, THE GUARDIAN, Sept. 16, 2012, available at http://www.guardian.co.uk/business/2012/sep/16/meps-ban-high-frequency-trading?INTCMP=SRCH (last visited Oct. 9, 2012).

72. *UK, Germany resist attempted EU power grab on trade*, EURACTIV, Nov. 5, 2010, http://www.euractiv.com/future-eu/uk-germany-resist-attempted-eu-p-news-499463 (last visited Oct. 10, 2012).

73. James Kanter & Stephen Castle, *Weary of Crisis, but Wary of Change*, N.Y. TIMES, Sept. 13, 2012, at B1 (available at http://www.nytimes.com/2012/09/13/business/global/13iht-banks13.html?pagewanted=all&_r=0) (last visited Oct. 10, 2012); Andreas Rinke, *ECB may not supervise all banks: Merkel ally*, REUTERS, Sept. 22, 2012, http://www.reuters.com/article/2012/09/22/us-germany-banking-supervision-idUSBRE88L04S20120922 (last visited Oct. 10, 2012).

74. See, e.g., *Matthew Dalton, William Horobin and Vanessa Mock, European Leaders Agree on Euro-Zone Banking Supervisor*, WALL ST. J. (Oct. 19, 2012) p. A7 and http://online.wsj.com/article/SB10000872396390444868204578064681942715480.html, visited Oct. 21, 2012.

75. See European Central Bank, The Governing Council, http://www.ecb.int/ecb/orga/decisions/govc/html/index.en.html, last visited Oct. 22, 2012.

76. The four Eurozone countries with the smallest population are Malta, Luxembourg, Cyprus, and Estonia with respective populations of 0.4, 0.5, 0.8, and 1.3 million. The four

tralized regime than that of the FOMC. The FOMC has twelve members, the seven governors of the Federal Reserve System, the New York Fed president, and four of the remaining regional Federal Reserve Banks on a one year term ensuring regional representation but on a curiously outdated basis.[77] Thus in the US, the central entity has majority with seven representatives in the twelve-member body, whereas in the Eurozone the central entity has a minority of six in the twenty-three member body.

In the context of the Great Recession, the more centralized decisionmaking of the Federal Reserve seems to have allowed it to operate more forcefully than the European Central Bank—although its decisiveness can easily be attributed to other factors, such as the greater severity of the crisis in the US than in the Eurozone or the political will represented by Congressional approval of the TARP.[78] The over-recapitalization of US banks was achieved at a meeting of the bank chiefs with four officials.[79] Extension of FDIC insurance to all bank creditors (rather than only depositors) was a crucial component of that deal. The European Central Bank could replicate this scheme if it were financed and if the six-member Executive Board were to decide it, provided it had the support of each recipient country's bank insurer, usually its central bank and provided each had the legal authority under national law for extending insurance beyond depositors.

Third, the European Court of Justice functions differently than national constitutional courts and the US Supreme Court. The US Supreme Court has repeatedly addressed issues of banking law, starting with the constitutionality of the creation of a central bank in *McCoulloch*,[80] and addressing almost every major financial regula-

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largest are Germany, France, Italy, and Spain, with respective populations of 82, 65, 60, and 47 million. The remaining Eurozone countries have populations between 2 and 16 million. See Eurozone, Wikipedia, last visited Oct. 22, 2012.

77. See Federal Reserve, The Federal Open Market Committee, available at http://www.federalreserve.gov/monetarypolicy/fomc.htm, last visited Oct. 22, 2012. The four are allocated as follows: one of the FR Banks of Boston, Philadelphia and Richmond, one of Cleveland and Chicago, one of Atlanta, St. Louis and Dallas, and one of Minneapolis, Kansas City and San Francisco. Besides that the Western populations seem underrepresented, the state of Missouri is overrepresented, through St. Louis and Kansas City.

78. See *supra*, note 17 and accompanying text.

79. The four officials were the Secretary of the Treasury Hank Paulson, the President of the Federal Reserve Ben Bernanke, the President of the New York Fed Tim Geithner, and the President of the FDIC Sheila Bair. See *supra* text accompanying notes 16-18.

80. See *supra*, note 31.

tory reform thereafter. Although most reforms were upheld, this was by no means a foregone conclusion.[81]

In the Eurozone context, the European Court of Justice ("ECJ") has the role of the final constitutional court. However, the ECJ has weak versions of two important powers compared to strong constitutional courts.

First, the ECJ has weak authority to hear disputes challenging rules promulgated by member states. Rather, the ECJ must either rely on governmental bodies or national courts to bring issues to the ECJ (cases attacking rules promulgated by member states are brought not by the harmed individuals but by European Commission[82] or are referred to the ECJ by state courts[83]) or is limited to private complaints against EU rules.[84]

Also (and consequently), the ECJ has weak authority to direct national courts how do decide. Granted, national courts must follow EU law and national courts that refer a question to the ECJ, must follow the ECJ's answer. However, legal reasoning allows some flexibility; courts may decide a case on an alternative legal theory.[85]

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81. For example, the court invalidated the original attempt to require payment with paper money instead of gold, invalidated the income tax, limited the scope of antitrust law, and found certain limitations on bankruptcy repossessions to be unconstitutional. See e.g., Hepburn v. Griswold, 75 U.S. (8 Wall.) 603 (1870) (invalidating the requirement that payees accept paper currency for obligations incurred before the civil war, see also *supra* note 31); Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 15 S. Ct. 673, 39 L. Ed. 759 (1895) (income tax); United States v. E. C. Knight Co., 156 U.S. 1, 15 S. Ct. 249, 39 L. Ed. 325 (1895) (antitrust); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 55 S. Ct. 854, 79 L. Ed. 1593 (1935) (bankrupt farm repossessions).

82. See, e.g., *Commission v. Belgium*, Case C-65/03, [2004] E.C.R. I-6427; *Commission v. Austria*, Case C-147/03, [2005] E.C.R. I-5969 (about admission standards in Universities that discriminate against members of other states).

83. See, e.g., *Garcia Avello v. Belgium*, Case C-148/02, [2003] E.C.R. I-11,613 (Ruling that Belgian rules forcing a single surname must not prevent Spanish national in Belgium from giving child two surnames according to Spanish law and custom; Belgian court referred issue to the ECJ). Similarly, see also *Grunkin-Paul v. Standesamt Niebüll*, Case C-353/06, [2008] E.C.R. I-7639.

84. See, e.g., Joined Cases C-402 & 415/05P, Kadi & Al Barakaat Int'l Found. v. Council & Comm'n, 2008 E.C.R I-6351 (private litigants challenging EU rules implementing asset-freezes). See, generally, P. Takis Tridimas & Jose A. Gutierrez-Fons, *EU Law, International Law and Economic Sanctions Against Terrorism: The Judiciary in Distress?*, 32 Fordham Int'l L.J. 660 (2009) ("skeptik[al] as to whether the Community has competence to adopt economic sanctions against non-state actors" at 727).

85. An example of such maneuvering appears in *Epstein v. MCA*, 50 F.3d 644 (9th Cir. 1995) rev'd sub nom. *Matsushita Elec. Indus. Co., Ltd. v. Epstein*, 516 U.S. 367, 116 S. Ct. 873, 134 L. Ed. 2d 6 (1996)(refusing to follow US Supreme Court direction to give full faith and credit to state law settlement of federal securities claims; deciding on new issue of adequacy of representation); see also William T. Allen, *Finality of Judgments in Class Actions: A Comment on Epstein v. MCA, Inc.*, 73 N.Y.U. L. REV. 1149 (1998); Marcel Kahan & Linda Silberman,

The ECJ's powers are weaker than those of strong constitutional courts. As a result, the ECJ tends not to be the major legal hurdle for new Eurozone banking policies. Rather, the national constitutional courts retain much authority to impede new Eurozone policies. No guarantee exists that they will continue to decide in as pro Eurozone a manner as they have. For example, the German constitutional court approved the European Stability Mechanism, allowing Germany to join the treaty and incur liability of €190 billion ($245 b.) in the context of rescues related to the Great Recession.[86] Effectively, the Eurozone is exposed to some risk that national constitutional courts may block changes but it also faces a reduced risk that a strong central constitutional court would block them.

It is impossible to predict possible legal arguments against a Eurozone over-recapitalization project. However, especially interesting may be an evaluation of a claim based on the guarantee of free movement in the EU. Consider a non-PIRGS bank that would claim that the EU support for the over-recapitalization of the banks of a PIRGS state discriminates against that bank. How would the ECJ treat this bank's demand that the offer also be made to itself? Would a state court receiving such a claim refer it to the ECJ or would it find other grounds to dismiss it? Because the over-recapitalization is a one-time, emergency measure it should be treated akin to other regional economic projects of the EU and not give rise to a claim.

The EU may not be in as precarious a financial position as the US was in the fall of 2008. Nevertheless, the US example of forcibly over-recapitalizing banks shows the solution to its predicament of low growth in the PIRGS.

The Inadequate Search for "Adequacy" in Class Actions: A Critique of Epstein v. MCA, Inc., 73 N.Y.U. L. REV. 765 (1998).

86. See, e.g., *German High Court OKs Permanent Bailout Fund with Reservations*, SPIEGEL ONLINE, Sep. 12 2012, available at http://www.spiegel.de/international/germany/german-high-court-oks-permanent-bailout-fund-with-reservations-a-855338.html, last visited Oct 23, 2012.