Monetary Policy of the European Central Bank and its Relationship to Member State Sovereignty

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In partial fulfillment of the requirements for the degree of Masters of Arts

in Law & Economics

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Budapest, Hungary

2013

Abstract

The euro zone and its ongoing sovereign debt crisis are at the forefront of financial market news and economic debate. The media has even created new terminology, such as Grexit to indicate potential Greek secession, to accompany recent news because surely current vocabulary is not sufficient to describe such unprecedented happenings. To fully comprehend what these happenings entail, one must briefly trace the origins of the euro zone and critically analyze the following components: why the European Union included a monetary union, how the common currency and its operators work in theory and effect, and the conditions that precipitated and surround the debt crisis. Finally, one can then assess the potential outcomes, solutions, or alternatives to monetary union and the current predicament. The status and function of the European Central Bank continually evolves as the currency bloc demands and it gradually assumes increasing powers and responsibility. At the moment, the Bank's primary dilemma is whether or not to create euro bonds, common debt denominated in euros. Euro bonds, as George Soros postulates, seem to be the only feasible solution to the sovereign debt crisis, aside from the complete dissolution of the monetary union.

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Introduction

May 6, 2010 was a memorable day for anyone working in the American stock market. It was a Thursday afternoon with light trading volumes and European markets had already closed for the day. Heading into the final hours of trading in New York City, the Dow Jones Industrial Average looked to close a couple hundred points, or about 2 to 3% lower, which was not an alarming decline, as heightened volatility had become the norm. The usual headlines influenced trading activity, such as uncertainty in the euro zone with respect to the ongoing debt crisis in Greece. Suddenly, the domestic indices plummeted in excess of 6%due in part to Greece passing harsh austerity measures amid violent opposition and European Central Bank inaction. This is a significant drop for the market index, as further declines would have triggered New York Stock Exchange circuit breaker levels and caused the market to close immediately, at least temporarily.Rumors of a malicious market manipulation instantly swirled, though the major indices made a prompt and remarkable recovery before the closing bell even sounded with the Dow ending just about 3% lower. The United States Securities and Exchange Commission later attributed the sharp drop,or 'flash crash,' to high frequency trading and thin volumes, which thereby severely limited liquidity causing fewer trades to have a much more substantial impact on stock prices.

Regardless of the technical factors that contributed to the highly unusual trading activity that afternoon in New York, the relevant subjective factors are irrefutable. Debt concerns in Europe had dominated the headlines for months, consistently exuding negative sentiment, and have continued up to the present day.

It was, and perhaps still is, difficult for the common, American market participant to comprehend how debt issues across the Atlantic could have such a severe impact on the domestic stock market in the United States. Yet since the European Central Bank dictates the monetary policy of the European Union, it influences the value and investment profile of a dominant world currency. As demonstrated on May 6, 2010 and over the past few years, the Bank's policies and actions, or lack thereof, can have a profound effect on the global market.

Meanwhile, some market commentators may have started to feel like broken records: reciting the same scenario and trading drivers every day. To some degree, trading drivers are always repetitive: economic data, corporate earnings, merger and acquisition activity, etc. However, the concept of a currency bloc, consisting of sovereign nations, but bound by monetary and economic union, is wholly new and unprecedented. The concept of a bailout within the European Union is an even more recent phenomenon than the Union itself as earlier versions of the Treaty prohibited the existence of any form of overdraft facility or the obligation of the Union to inherit the burden of Member State debt and vice versa. To effectively address the debt challenges that face the euro zone today, one must first examine the creation of the euro and European Central Bank, the economic and legal implications of monetary union, the Bank's intended functions and actual capacity, and then gauge the viability of this union given current conditions.

The creation of the euro and European Central Bank

TheTreaty on European Union

The concept of a united Europe arose following the Second World War as a way for Europe to eventually regain competitiveness in the global marketplace. Leaders dreamt that a single market would allow the region's economy to rise like a phoenix from the ashes, though in reality it was exceedinglycomplicated and time-consuming to bring this idea to fruition. It was more than 40 years from the end of the war until the signing of the Maastricht Treaty, or The Treaty on European Union, in 1992.

The Treaty on European Union, or TEU, articulates its primary aims and purposes in Article 3. Included in that Article is the intention to create an internal market for the "sustainable development of Europe based on balanced economic growth and price stability" through "an economic and monetary union whose currency is the euro" (TEU, Article 3).

Founding Member States largely commenced monetary integration as early as in 1979 with the European Monetary System, or EMS, which was a resolution of the European Council. This served to "keep most Community currencies in a single exchange rate system" while also producing the European Currency Unit, or ECU, "which was defined as a 'basket' of fixed quantities of the currencies of the Member States" (Scheller 19). In 1987, the adoption of the Single European Act, or SEA, furthered the region's goals of economic union, but also made it apparent that progress would be limited without full monetary union. Two years later, the Delors Report unveiled three stages for complete economic and monetary union: 1) cohesion of economic policies to complete the internal market, 2) build institutional infrastructure, and 3) fix exchange rates and coordinate institutional obligations. The fulfillment of these stages entailed the creation of the Statute of the European System of Central Banks andof the European Central Bank and ultimately concluded with the completion of the euro transition on 1 January 2002.

Protocol 4 to the TEU and the Treaty on the Functioning of the European Union, or TFEU, contains the Statute of the European System of Central Banks, or ESCB, and of the European Central Bank, or ECB. Article 3 defines its primary tasks as "to define and implement the monetary policy of the Union; to conduct foreign-exchange operations; to hold and manage the official foreign reserves of the Member States; and to promote the smooth operation of payment systems."

The Governing Council holds the primary decision-making power of the ECB and it is comprised of an Executive Board and the Governors of the national central banks. The Governing Council dictates monetary policy of the euro zone, while daily, operational tasks and policy implementation is left to the Executive Board. The six Executive Board members are appointed by euro area heads of state on a "recommendation from the EU Council, after consulting the European Parliament and the Governing Council" (Scheller 59). "As [a] member of the Executive Board, the President of the ECB [plays] a prominent role [as:] the chair of all three decision-making bodies of the ECB, the casting vote in the Governing Council and on the Executive Board, [and] the external representation of the ECB (for instance at the international level)" (Scheller 61).

In terms of money creation, the European Central Bank has the "exclusive right to authorize the issue of euro banknotes within the Union" and only these notes "have the status of legal tender" (TFEU, Article 128). Legacy currencies ceased to be of value in the euro area by the end of February 2002.

Economic and legal implications of a common currency

The principle costs of monetary union are immediately apparent: the elimination of Member State monetary sovereignty and thus the severe restriction of economic policy tools. This inhibits or abolishes the ability of nations to independently influence domestic trends in labor, wages, and consumption."Monetary sovereignty has been transferred to the supranational level under the terms and conditions" of the TEU, TFEU and

Protocol No. 4 (Scheller 28). Consequently, exchange rate authority is likewise allotted to the ECB. Member States retain some degree of economic dominion since the Treaties only require Member States' "close coordination" of their fiscal policies," which results in varying tax rates, social security programs, etc. (TFEU, Article 119). However, Member States are encouraged to adhere to the Broad Economic Policy Guidelines. Other principles of the European Union intend to partially mitigate or compensate for the effects of monetary subjugation such as the promotion of the free movement of labor. The current crisis in the euro zone unfortunately reveals the potentially fatal costs of monetary integration. However, as with any new and optimistic enterprise, costs were generally overlooked in favor of the anticipated benefits of currency union.

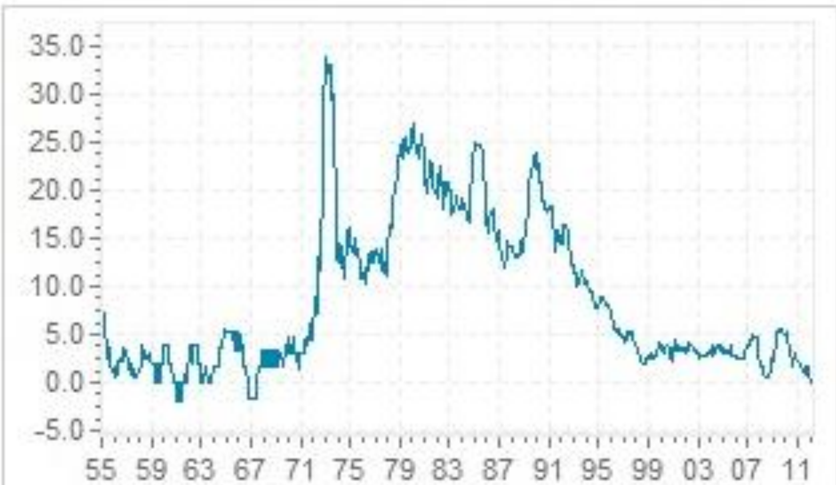
The perceived benefits of a single currency to accompany the Single Market are to increase price stability and transparency, "eliminate exchange rate risks, reduce transaction costs and, as a result, significantly increase economic welfare in the Community" (Scheller 20).

Price stability is a fundamental goal of the European Union and is achieved via monetary union due to the centralization of monetary policy and creation. The most widely accepted gauge of price stability is inflation, while the most common measure of inflation is the consumer price index.

From an economic standpoint, the benefits of controlled inflation are obvious: if the inflation rate remains fairly low, it encourages an efficient level of consumption for goods and capital and thus contributes to economic growth.

The relative success of price stability via inflationary control is apparent through a comparison of historical consumer price data and the present harmonized rate of inflation among euro zone countries.Greece, for example, experienced severe volatility in its inflation[1] with levels exceeding 30% in the early seventies.

Chart: Long-term Greek CPI

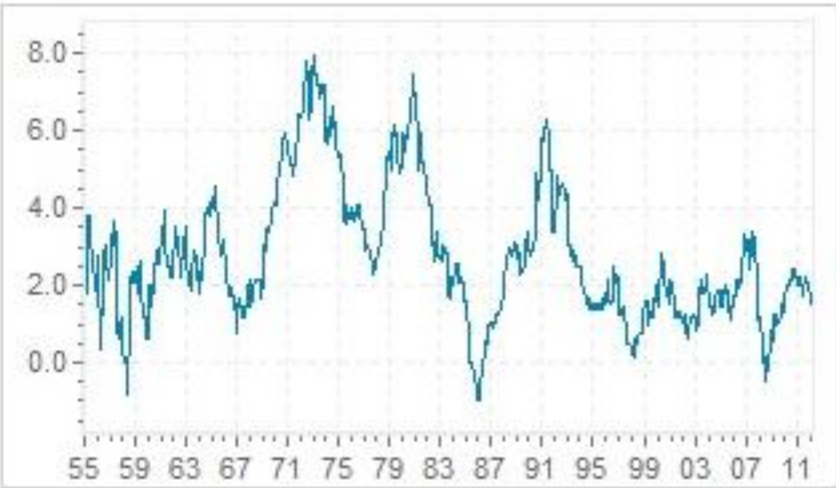


Source: Global-Rates.com[2]

[1] "The Greek CPI shows the change in prices of a standard package of goods and services which Greek households purchase for consumption. In order to measure inflation, an assessment is made of how much the CPI has risen in percentage terms over a give period compared to the CPI in a preceding period" (Global-Rates.com).
[2] "For the current and historic inflation figures we make use of the websites of the central banks of the relevant countries. We also use the websites of the localstatistical offices and a number of international organizations" (Global-Rates.com).

Even Germany, which some may consider the epitome of fiscal restraint, experienced inflation levels above the typical target range of 2 to 3% throughout its history preceding the euro.

Chart: Long-term German CPI



Source: Global-Rates.com

The harmonized consumer price index, or HICP according to Global-Rate's terminology, chart below indicates that monetary union succeeded in maintaining a low inflation rate for most of its duration. There is a downturn at the onset and throughout the escalation of the debt crisis, but inflation nevertheless has stayed within a narrow range.

Chart: Long-term HICP within the euro zone

Source: Global-Rates.com

In addition to price stability, a common currency allows for price transparency. This is directly beneficial to consumers, businesses, and investors and it enhances the competitiveness of the Single Market.Typically considered a prerequisite for a competitive market, full disclosure in price composition creates better-informed consumers and promotes seller honesty.

Finally, the elimination of exchange rate risk is also directly beneficial to consumers, businesses, and investors as it diminishes transaction costs.In this context, a common currency particularly aids the tourism industry within the EU, businesses with international sales and operations, and European investors.

Subjective benefits of monetary union may include the perception that it lends credibility to the EU and visibility to the euro in the global marketplace.

The legal implications of monetary union are less straightforward than an economic cost-benefit analysis and permeate numerous facets of national law. Member States and their central bank charters cannot have conflicting legislation. However, there is not enough precedent or homogeneity in some areas of national financial market regulation,such as mortgage valuation, lending practices, or capital raising techniques, to ensure that Union monetary policy will impact each Member State in relatively similar fashions. The result is that the "way in which the same interest rate increase is transmitted into consumption and investment spending will be very different across Union members" (De Grauwe 22). Case rulings constantly prove that Union law is superior to national law and it seems that the legal implications directly applicable to euro unity remain under development in courtrooms.

Procedural aspects

While the longer-term consequences of monetary integration continue to develop, the immediate requirements for inclusion are explicit. Title VIII of the TFEU outlines the general economic and monetary policy frameworkof the EU and Article 119.3 obliges Member States to comply "with the following guiding principles: stable prices, sound public finances and monetary conditions, and a sustainable balance of payments."Coinciding with the TFEU's guiding principles, there are four economic components, or transitional provisions, for current and future inclusion in the euro area.Protocol No. 4 delineates specificities relating to these provisions and those of the ESCB and ECB.

Price stability is determined by inflation, which is measured by the nation's consumer price index. A state's rate of inflation should be closely aligned to the inflation rates of "the three best-performing Member States in terms of price stability," which is typically between 2 and 3% (TFEU, Article 140).

Secondly, Member States must have a healthy fiscal position thereby avoiding excessive government debt levels. Debt is gauged in proportion to gross domestic product and the Protocol creates a reference value for this ratio, which is a maximum of 60%. Exceptions to the reference value may be given to states with declining or temporarily inflated debt levels. Fiscal position is also measured by the government budget and an annual deficit should not exceed 3% of GDP.

The third component of economic integration is exchange-rate developments. Aspiring euro zone members must adhere to the current exchange rate mechanism for a minimum of two years, which, at present, allows a currency's central rate to fluctuate ±15% against the euro.

The final, general criterion is "the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the long-term interest rate levels" (TFEU, Article 140). Participation in the exchange rate mechanism, or ERM, entails fixing the domestic currency to the euro for a minimum of 2 years. As with inflation, interest rates should be in-line with those of the three best-performing Member States. Interest rates are measured "on the basis of long- term government bonds or comparable securities" (Scheller 37).

Article 131 of the TFEU requires all Member States to "ensure that its national legislation including the statutes of its national central bank is compatible with the Treaties and the Statute of the ESCB and of the ECB." Compatibility must particularly be addressed in the areas of national central bank independence, money issuance, foreign reserve holding, and exchange rate policy.

Once these economic and legal admission requirements for transition have been met according to the satisfaction of the ECB and European Commission, the two bodies will consult with the European Parliament, discuss with the European Council, and the Council will vote on the Commission's proposal. Upon Council approval, the currency will be "irrevocably" fixed to the euro ERM and subsequently exchanged.

The Union at present

Motivation and description of bailout legislation and process

After years of planning and preparation, the euro party is in full swing and the currency recently celebrated its 10-year anniversary. While much pomp and circumstance ushered in the euro's birth, the decade milestone passed quietly and the closest thing to fireworks last year was probably a Molotov cocktail at a protest. The drastic change in sentiment can be attributed to the ongoing euro zone sovereign debt crisis, which has dominated worldwide headlines for more than 5 years. Given the present situation, it is quite an interesting and unbelievable fact that initial Treaty legislation explicitly prohibited any form of shared debt burden or accompanying loan procedures.

Article 123 of the TFEU prohibits "overdraft facilities or any other type of credit facility with the ECB" while Article 125 further stipulates that the "Union shall not be liable for or assume the commitments of central governments… of any Member State." This clause was intended to ensure that the "responsibility for repaying public debt remains national [and] thus encourage prudent fiscal policies at the national level" (Scheller 33). Meanwhile, Article 126 again reiterates that Member States must avoid "excessive government deficits." Despite its founding principles, the EU eliminated these bailout prohibitions at the onset of the global financial crisis and established the European Financial Stability Facility, or EFSF, and the European Financial Stability Mechanism, or EFSM. Intended to be temporary, they may be superseded by the European Stability Mechanism, which would be a permanent addition to the Treaties, upon their expiration.

The sovereign debt crisis within the euro zone created the need for these various stability mechanisms. A currency union and the resultant subjugation of a nation's monetary authority made the crisis inevitable because participating states did not simultaneously relinquish budgetary control. Members of the European monetary union "issue debt in a currency over which they have no control" (De Grauwe 7). Meanwhile, fiscal autonomy allows for variances among Member States in terms of taxation and social welfare, which creates a distinct conflict of interest when a State can exhibit blithe generosity towards its constituents without feeling cost restraint. This was an intrinsic flaw in the creation of the European monetary union, which has been exacerbated by ever-evolving and increasingly complex market transactions such as the securitization of longer-term government obligations like pension plans. Market instruments evolve with such rapidity that it is really shortsighted to believe they can be contained by legislation. Furthermore, this "implies that financial markets acquire the power to force default on these countries" (De Grauwe 7). The influence of financial markets is evident every time Moody's, Standard & Poor's, or Fitch downgrades the credit rating of a nation. The issues in the euro zone have been a near constant weight on the financial markets, but one must admire the creativity of market commentators in describing current conditions in the EU. Though it is essentially the same story of spending more than one earns, media outlets contrive new buzzwords such as contagion, market capitulation, and Grexit that typically undermine any fleeting positive sentiment in the market. By nearly forcing default on indebted nations in the euro zone, financial markets also influence political power as the region's crisis has led to numerous leadership changes. This new leadership does not always take kindly to ECB intervention.

To understand how a country's leadership specifically earns the ire of the Troika, another financially fashionable word that refers to the ECB, International Monetary Fund, or IMF, and European Commission, take the example of Cyprus. The small, scenic island was previously renowned for tourism and its tax haven status. Now it is known the world over for its banks taking depositors' money and thereby a cautionary tale that exemplifies the need for the Treaty amendments related to bailout funds.

Case study: Cyprus

Cyprus joined the European Union in 2004 and the common currency area in 2008. The small island was already a prominent investment and corporate center of the world due to its low corporate tax rate and double taxation treaties with a number of other countries – notably with the former Soviet Union and current Russian Federation. Cyprus hoped to further capitalize on its position as an international business center by joining the common currency zone of Europe and it contributed a well-educated workforce with a high concentration of accountants and lawyers (Orphanides 2013).

Shortly following its union with the euro zone, presidential elections resulted in a communist victory with DemetrisChristofias promising political unification of the island. It is important to note that his victory was not related to any economic policy.

The aforementioned rules that regulate admission and membership in the euro zone are not compatible with communist ideology and practice. The new Cypriot government essentially "took a country with excellent fiscal finances, a surplus in fiscal accounts, and a banking system that was in excellent health … [and] started overspending … [on] unproductive government expenditures. … [They also] raised implicit liabilities by raising pension promises and so forth" (Orphanides 2013). These excessive expenditures began to weather on international investor confidence, which culminated when Cyprus lost access to the international capital markets in May 2011 due to prohibitively high premiums on sovereign debt and an inability to borrow or raise capital. The island was in a precarious position because of the dominance of its banking sector and its high exposure to Greek debt. However, communist leadership declined to request aid from the ECB at this time because it did not want to make any accompanying structural adjustments.

In October 2011, the European Union Council decided to decrease the value of Greek bonds held by the private sector. All banks operating, and therefore holding debt, in Greece suffered. “For Cyprus, the write-down of Greek debt was between 4.5 and 5 billion euros,” which is substantial given that the entire country’s GDP in 2011 was $24.7 billion according to World Bank data (Orphanides 2013). Simultaneously, the European Banking Authority raised capital requirements. This caused severe liquidity issues, but again, Cypriot leadership declined ECB intervention in an attempt to avoid compromising its structural sovereignty. Furthermore, Cyprus still had no access to capital markets so the government could not raise public debt to compensate for the banks’ losses. Instead of attempting to aid the banks, leadership chose to attack the banks and blame them for the nation’s economic woes ahead of another election in 2013.

AthanasiosOrphanides, governor of the Central Bank of Cyprus from 2007 to 2012, said propaganda ahead of the 2013 election claimed Cypriot banks needed as much as 10 billion euros. Though he believed this figure to be inflated, it nonetheless raised substantial concerns over Cyprus's debt sustainability. The growing amount of debt led all three, major ratings agencies to downgrade Cypriot sovereign debt below investment grade in June 2012, which, according to ECB rules, "made the government debt not eligible as collateral for borrowing from the euro system, unless the ECB suspended the rules, as it had done for the cases of Greece, Portugal and Ireland" (Orphanides 2013).

Theoretically, the ECB could have simply suspended the eligibility rules again, but it chose instead to press the government into negotiations to determine a debt reduction program. Yet again, the stubborn communists refused to adopt outside influence so it took 9 months and another change in Cypriot leadership for the ECB and the island government to finally reach an agreement. Here, the Cyprus saga really starts to sound like a soap opera.At this point, the island had started to implement some of the required structural adjustments such as the privatization of wholly or partially state-owned enterprises and limiting public spending. However, as previously noted, Russian capital comprised a substantial portion of the deposits in Cypriot banks so negotiations with the ECB turned highly political. In Orphanides view, Germany's leadership was motivated by upcoming elections and no politician wanted to be associated with an ECB bailout of the "Russian oligarchs" (Orphanides 2013).Consequently, Cyprus was essentially threatened or bullied into accepting the depositor 'haircut' that subsequently garnered so much media attention and sparked social upheaval on the island.

Cyprus sheds light on the numerous, inherent flaws in a monetary union comprised of sovereign nations. First and foremost is the misalignment of monetary and budgetary policy and the inevitable conflict of interest produced by this separation of powers. From an economic theory standpoint, the evolving bailout process of the euro zone has also allowed two troubling issues to develop: 1) moral hazard due to the failure of regulation, and 2) the principle of the tragedy of the commons.

Moral hazard is a byproduct of the bailout system as the ECB can be viewed as a lender of last resort. This has parallels to the banking crisis in the United States as the large banks came to be considered as 'too big to fail.' When the banks have the comfort of knowing that the Federal Reserve will not allow them to become insolvent and shut their doors, it creates an environment that encourages them to take on additional risks in their investment. There is a common saying that one must 'risk big, to win big' and of course an investment bank would do just that if it has nothing to lose in terms of capital or its ability to continue operations. As in communist

Cyprus's case, the conditionality of IMF and ECB loans is probably the only factor mitigating the moral hazard of the indebted nations in the euro zone.

Secondly, the tragedy of the commons is an economic scenario in which free access to a resource will inevitably and rather quickly lead to its depletion. When multiple parties have access to a shared resource, each acts in their best interest and thus maximizes their share of the resource with disregard for the resource's efficient and sustainable allocation. In a way, this inadvertently occurs with ECB capital available for lending and exacerbates any notions of voracity an indebted Member State may possess. The ECB previously suspended its eligibility rules for Greece, Ireland, and Portugal, so it would almost be reasonable for Cyprus to expect similar treatment. Orphanides noted in his interview that Spain requested additional capital from the ECB on the same day that Cyprus finally asked for Troika assistance in June of 2012. With so many hands in the cookie jar, one is bound to come out hungry.

Related to these two concepts, is the fundamental economic assumption that an individual or entity always acts in its best interest. Every sovereign, democratic nation has the implicit obligation to serve its constituents to the best of its ability. For an example, a German politician elected by the German people obviously has the duty to serve Germany's interests.

Therefore, a successful union of any sort must be accompanied by a transition in mentality.Until said politician considers himself European first and German second, there is absolutely no chance for objective management of the European monetary union. Regardless of the complex system concocted for voting in the ECB's Governing Council, it always boils down to the money in a capitalistic mentality. These tensions are evident in, and likely exacerbated by, media reports, which, for example, may depict a fat Greek relaxing on a beach while the dedicated automaker in Germany slaves away to support his lazy counterpart. Understandably, there was a plethora of economic analysis surrounding the creation of the euro zone, but perhaps analyses drastically underestimated the psychological impact of independent nations sharing a single currency. Nevertheless, currency union obviously happened and the only direction to move is to find a way forward.

What lies ahead for the euro zone?

The extent to which current legislation allows for ECB influence

Adopting the bailout legislation put the ECB in a hamster wheel, in some respects, as it established groundwork for the perpetual cycle of debt and borrowing to exist in the EU. It also allowed for the further subjugation of national authority because of the structural conditions attached to the bailout money. In this way, the ECB harnesses more power. The TEU somewhat limits ECB authority via the EU's founding principle of subsidiarity, but the inherent vagueness of subsidiarity may also leave room for ECB manipulation via its independence, legal personality, ability to create other monetary instruments, and its control over foreign reserve assets.

One of the most important aspects of the Protocol is Article 7, which establishes and protects the ECB's independence from other EU institutions. The ECB's independence is a strength that it could manipulate because the Treaties allow the ECB to comment on any Union matters relevant to its practices, but the same privilege is not extended towards Union institutions. The Treaties even say explicitly that Union institutions shall not influence the bank in any way. The power lies in the money and every facet of society and the economy can be intrinsically or theoretically linked to monetary policy. The ECB's independence is thus susceptible to manipulation in its external affairs should the ECB overexert its influence.

On the other hand, the Bank's independence is also vulnerable to internal division as previously analyzed in the Cyprus case study. The structure of subscribed capital creates an imbalance of national influence. Unless there is a transition in mentality within the euro zone, the Bank's supposed independence can easily self-destruct.

The ECB has legal personality, privileges, and immunities. "For the ECB, legal independence includes the right to bring actions before the European Court of Justice in order to uphold its prerogatives if they are impaired by a Community institution or Member State" (Scheller 122). There is an entire working paper published by the ECB that enumerates its legal benefits, though it concludes with the remark "that privileges and immunities are not favors granted to the ECB, but are efficient instruments to ensure the proper functioning of the ECB and its independence vis-à-vis the Member States" (Gruber andBenisch 42). Though these benefits only apply to individuals working in an official capacity, the ECB is partially exempt from national law and immune to national jurisdiction. This leaves a fair amount of flexibility with which the ECB can exercise or abuse its power.

The open-endedness of Article 20 of the Protocolalso gives the ECB nearly unrestricted power in creating other instruments of monetary control. The Article states that, "The Governing Council may, by a majority of two thirds of the votes cast, decide upon the use of such other operational methods of monetary control as it sees fit, respecting Article 2." Article 2 is the objective of the ESCB and ECB in maintaining price stability, etc. The complexity and continued evolution of securitization can severely hinder market and financial transparency, as the euro zone experienced with the securitization of long-term government obligations preceding the sovereign debt crisis. With consideration to the seeming lack of internal, political independence, it is possible that ECB leadership could take advantage of this piece of legislation to further the objectives of select individuals or nations in the same way that Germany seemingly lobbied against the Cypriot bailout.

The final aspect of ESCB and ECB legislation that seems vulnerable to potential manipulation is Article 30, which discusses the transfer of foreign reserve assets from national central banks to the ECB.Foreign reserves are a means of international investment, external trade, and a form of savings. "The contributions of each national central bank [are] fixed in proportion to its share in the subscribed capital of the ECB" so they retain a portion of foreign reserves for their own disposal (Protocol No. 4 to the TEU and TFEU, Article 30.2). However, Article 31 stipulates that the ECB must approve such transactions to "ensure consistency with the exchange rate and monetary policies of the Union." Additionally, the ECB credits

Member States "with a claim equivalent to its contribution," though the "Governing Council … determine[s] the denomination and remuneration of such claims" (Protocol No. 4 to the TEU and TFEU, Article 30.3). To some degree, it is just another way the national central banks relinquish monetary control when they become part of the common currency, but it shows the extent to which the nations are truly limited and the breadth of ECB authority. Lastly, the points of Article 30 that reference IMF reserve positions seem contradictory: 30.1 exempts these funds from transferal while 30.5 says the "ECB may hold and manage IMF reserve positions and SDRs and provide for the pooling of such assets." This legislation can theoretically leave room for collusion between the ECB and IMF, which are supposed to be independent and objective entities.

These potential manipulations of course rely on the assumption that the euro zone and ECB will continue to exist in their current form, which seems unlikely. The most oft cited solution to the euro zone sovereign debt crisis is secession. There is also the possibility for fiscal union, which may follow secession, or the issuance of euro-denominated bonds. On the other end of the spectrum, is the possibility for the dissolution of the euro zone.

Potential solutions to debt crisis

Secession

Most, if not all, of the reasons for a country wanting to leave the euro zone are apparent from media coverage surrounding the troubles in Greece, Cyprus, etc. The strongest motivation to secede from currency union is the ability to regain monetary policy sovereignty.

The loans of the ECB and IMF are accompanied by significant policy reform and structural adjustment demands, as the communist Cypriot regime clearly aimed to avoid. Once the IMF becomes involved, the loan recipient is subject to severe conditionality requirements, which may include: austerity, emphasizing exports possibly via resource extraction, eliminating subsidies, and promoting the rights of foreign investors. The conditionality of IMF loans drastically undermines domestic authority in the recipient country and may not take into consideration the social consequences of austerity or local economic conditions. Furthermore, the United States, Japan, Germany, France, and the United Kingdom dominate the IMF due to the composition of its voting structure by contribution, or quota, to the Special Drawing Rights pool. The United States is by far the largest contributor, accounting for approximately 17.69% of the total quota, which is almost as much as the combined contributions of Japan (6.56%), Germany (6.12%), France (4.51%) and the United Kingdom (4.51%). The express aim of the IMF is to oversee the international monetary system and promote exchange stability so it is easy to understand critics who perceive the IMF as a thin cover for the promotion of U.S. interests. Compare these contributions to those of Greece (0.46%) and Cyprus (0.07%) and it is easy to understand these small nations' aversion to implementing American and Westernized policies when they have little or essentially no voice in the matter.

The protests in Greece, Cyprus, and other places demonstrate the unpopularity of structural adjustments that disproportionately burden taxpayers, pensioners, and public workers. Protests and strikes tend to exacerbate the situation because it contracts the government's revenue stream even further. The media contributes fuel to the fire by conveying the image of a domineering Troika imposing its Western ideology and mercilessly applying standardized reforms regardless of the contextual situation. This has ignited nationalistic sentiment across Europe – even in countries such as Hungary, which is not on the euro, but contains political factions that are strongly against EU integration.

The motivations for secession are clear, but the actual process for it is nonexistent. While Article 50 of the TEU consents to a Member leaving the EU, the Treaties are devoid of any procedure surrounding a Member State's exit from the euro zone so the topic continues to be at the forefront of economic discussion and debate.

Thankfully, the world has the English to show their trademark pomp and circumstance, even when it comes to solving the puzzle of the euro zone sovereign debt crisis. Only a man with seven words in his official name and title could pose such a daring question to the world: how could the euro zone be safely dismantled? Simon Adam Wolfson, Baron Wolfson of Aspley Guise offered a £250,000 reward to the best respondent. The Financial Times summarized the winner's findings:

> Along with the vast majority of economists who have looked at the issue, Capital Economics said a country, such as Greece, contemplating leaving the euro would have to keep its plans secret until the last minute, introduce capital controls, start printing a new currency only after formal exit, seek a large depreciation, default on its debts, recapitalize bust banks and seek close co-operation with remaining euro members (Giles, Financial Times 2012).

The thrill lies in the secrecy… it will be interesting to see the success of the pact of silence among all parties involved in money creation: leaders of the country in question, the Governing Council, the IMF representatives, the chief executive at the printer's office, etc. Surely none of the aforementioned souls have friends in the financial market… Nonetheless, at least Capital Economics contributes an idea for a solution. Though potential secession from the monetary union of the EU will tend to be very case specific, the Treaties should be amended to include some sort of standardized process parameters or recommendations like the above.

Fiscal union

An alternative or accompaniment to secession would be further integration through fiscal union. This would bring both monetary and fiscal policy under the centralized authority of the ECB indicating the elimination of budgetary discrepancies. Consistency in taxation and expenditures would alleviate in part the disagreements between nations over structural adjustments. Centralized fiscal policy would also be enforceable, unlike the current regime of suggested guidelines.

Euro bonds

Moving from loan recipients to 'the hand that feeds,' a German exit from the euro area is another option postulated by George Soros in an argument in favor of euro bonds. Germany's leader, Angela Merkel, remains opposed to euro bonds because she views the debt collectivization as removing incentive for fiscal prudency. Soros says that Germany should accept the issuance of euro-denominated bonds or leave the Union. He elaborates in an open editorial in the German publication, Der Spiegel:

If countries that abide by the EU's new Fiscal Compact were allowed, but not required, to convert their entire stock of government debt into euro bonds, the positive impact would be little short of miraculous. The danger of default would disappear, as would risk premiums. Banks' balance sheets would receive an immediate boost, as would the heavily indebted countries' budgets. …

Germany has the right to reject eurobonds. But it has no right to prevent the heavily indebted countries from escaping their misery by banding together and issuing them. …

Since all the accumulated debt is denominated in euros, it makes all the difference which country leaves the euro. If Germany left, the euro would depreciate. The debtor countries would regain their competitiveness. Their debt would diminish in real terms and, if they issued eurobonds, the threat of default would disappear. Their debt would suddenly become sustainable.

Dissolution

Germany's secession or the dissolution of the euro zone altogether may have a similar effect. Germany's export-driven economy received an initial boost from the elimination of trade restrictions within the euro area.

However, recession in other Member States has decreased the foreign population's ability to make major purchases, such as automobiles. If the euro zone were to break up altogether, it would end the cycle of perpetual indebtedness and lending. There would definitely be growing pains and initial difficulties, but the economics of Europe would eventually stabilize. Then there could be independent growth without the constraints of IMF conditionality. There is a surprising lack of literature regarding the logistics of potential euro zone dissolution. Maybe if we don't speak about it, it will not happen. Dissolution and a return to legacy currencies would wreak temporary havoc on the foreign exchange market, but like any major market crisis, the healing begins after the devastating shock. The post-apocalyptic environment would give way to a second-generation phoenix to rise among the ashes and create a new exchange regime. However, less dramatic alternatives could also exist such as in the case of the EU's Scandinavian and neutral neighbors.

Alternatives to monetary union

Advocates of monetary union contend that ECB monetary policy sovereignty is a necessity to ensure the smooth operation of a single currency area. This point is rather inarguable since monetary integration is not an irresolute achievement. However, there can be varying degrees of successful economic cooperation and integration devoid of a common currency, which begets the question of why a nation would unnecessarily subjugate its monetary authority. Monetary and fiscal policy is one of the strongest tools in controlling or influencing a national economy. Members of the common currency subjugate their economies and lose independent decision-making abilities.

Denmark

Denmark and the United Kingdom are examples of EU economic integration outside the confines of monetary integration. Both countries have officially opted-out of the single currency.

Denmark avoided full monetary union through what is referred to as the Edinburgh Agreement, or Denmark and the Treaty on European Union. According to Section B of this Treaty, Denmark will not participate in the third stage of monetary union, whereby the krone would be irrevocably fixed to the euro and then exchanged. This allows Denmark to retain its currency and full monetary policy autonomy. Congruently, however, Denmark "will participate fully in the second stage of Economic and Monetary Union and will continue to participate in exchange-rate cooperation within the European Monetary System" (Section B, Article 3). Therefore, the "Danish central bank's sole mandate is to adjust interest rates and currency reserves to defend the krone's peg to the euro" (Levring, Bloomberg). Though participation in the exchange rate mechanism limits Denmark's fiscal autonomy, it is not irreversible and can be detached at any time.

Occasionally, the prospect of Denmark taking the final step towards joining the euro was put to popular referendum and rejected. Current leadership, Prime Minister HelleThorning-Schmidt, says the existing regime of a fixed exchange rate without monetary union is proving to be the best situation for Denmark and, given the seemingly endless bailout parade, will not change in the near-term future.

Likewise in the United Kingdom, the British population is largely averse to joining the euro area and the government negotiated an opt-out from the Treaty's common currency obligation. Many view the currency union in nationalistic terms and prefer to maintain this aspect of their British identity: rugby shirts, porter, imperialism,and the pound-mother-of-sterling. In contrast to Denmark, however, the United Kingdom does not meet the economic standards previously enumerated and the pound sterling is not pegged to the euro. Therefore, although it remains a popular political debate, it is not a near-term issue.

Switzerland

Switzerland provides another example of economic integration outside the confines of the EU. Switzerland has never shown interest in joining the Union, but has gained accessed to the Single Market through a series of bilateral trade agreements in which it adopts certain aspects of EU legislation.

Though Switzerland enjoys the benefits of economic integration, as the EU is its largest trading partner, it is not without its vulnerabilities either. In 2011, the Swiss National Bank took an unprecedented move by pegging the Swiss franc to the euro. The SNB pledged to maintain a roughly 1.2:1 ratio between the currencies. The appreciation of the franc against the euro prompted – or forced – the bank to make this move so Switzerland could remain competitive in the international market. Previously perceived and hoarded as a safe haven currency, Switzerland's exports were becoming too expensive to buy: white collar watches ascended to starch collar timepieces. Furthermore, the bank had to avoid an influx of cheap imports from disrupting the domestic market. Finally, the relationship between the EU and Switzerland is governed by a plethora of treaties, bilateral arrangements, and joint committees. The costs of economic union can only really be measured in the blood, sweat, and tears or time and effort of politicians and other economic leaders of the two entities.

Upon examination of the unique cases of Denmark, the United Kingdom, and Switzerland, it seems the likelihood of similar arrangements in the future is slim. If every Member State had wanted to retain monetary sovereignty, then the full economic goals of the European Union could not come to fruition. Exchange rate risks and price convolutions would be prevalent despite economic cooperation.

Conclusion

To a certain extent, the global market has already priced in the possibility of Greek or Cypriot secession from the euro zone. It would primarily impact the new currency as it experiences devaluation and volatility at the onset of its circulation and during bank recapitalization. Fiscal union would theoretically harmonize the budgets, but ultimately be the elusive Moby Dick of political and societal cooperation and homogeneity. The Danes can hold their heads high and snort, "I told you so." The Brits can express themselves through the art of song at the local pub whilst spending pound sterlings. The Swiss can make their chocolate and eat it too. Unfortunately, it's too late for me and you. The proverbial grace period has expired for the tolerance of economic integration without monetary union. It seems the European Union and its common currency are left with two choices: 1) follow Alice down the rabbit hole and print euro bonds like there is no tomorrow – after all, it is not a bottomless pit if you can adjust the floor – or 2) face the wrath of dissolution, pray for financial market mercy, and hope to rise like a phoenix in the new monetary world order.

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