State Sovereignty Under EU Crisis Management

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Abstract

This thesis is on the relationship between state sovereignty, national democracy, and crisis management in the European Union. The specific question it addresses is "What have recent efforts to manage the financial crisis meant for the sovereignty of EU member states and the democratic legitimacy of the European Union?". By exploring the design of the European Central Bank and the actions of the EU in managing the crisis in Greece and contrasting them with the International Monetary Fund and crisis management in Hungary, I argue that the financial crisis has pushed the Eurozone closer to political union and created an ambiguous and fraught relationship between supra-national authority, national sovereignty, and popular representation. The IMF/Hungary case serves to illustrate that external financing and conditionality do not in themselves cause states to sacrifice their fiscal sovereignty, but the particular handling of the crisis in the EU has created a situation in which sovereignty has indeed been taken out of the hands of national governments and their electorates and been vested in the ECB and ESM.

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Introduction

The role of debt and financial crisis in catalyzing major transfers of sovereignty cannot be overlooked. As Thomas Sargent noted in his Nobel Prize lecture[1], it was the American financial crisis of the 1780s that caused the United States to shift from an essentially confederate system towards the Constitution and federalism. While most of the existing writing on the topic holds that external financing undermines sovereignty and/or democracy[2][3], at least in those countries having received funding with conditionality structures attached, I aim to probe into whether this is in fact true of all conditional financing packages. On the one hand governments lacking sufficient fiscal discipline will ultimately see a breakdown in their capacity to provide public goods to their citizens, including the rule of law, the mechanisms of functioning democracy, and ultimately sovereignty itself. On the other, the demands that the financial crisis have placed on Eurozone countries to support their partners have produced measures that in some ways lack a clear strategy and broad support from democratically elected leaders. They could thus be said to infringe on national sovereignty and/or to deepen Europe's democratic deficit. The thesis will build on writing about the precarious position of the European Union and the European Central Bank in regulating the fiscal policy of the EU member states in the absence of true political and banking union, as well as an older and more

[1] Thomas J. Sargent, "Nobel Lecture: United States Then, Europe Now," *Journal of Political Economy* 120.1 (2012): 3.
[2] Imtiaz Hussain, "Europe After the Greek Default: Widening, Deepening or Splitting?," in *The EU and the Eurozone Crisis*, Ed. Finn Laursen. (Halifax, NS, Canada. Ashgate, 2013). 150-160.
[3] George Kopits, "Can Fiscal Sovereignty be Reconciled with Fiscal Discipline?."*Acta Oeconomica* 62 no. 2 (2012): 141-142.

substantial body of writing about the “democratic deficit” structurally inherent in the mechanisms of the Union.

The country subject to the most attention in this discussion is Greece, as it has seen the most severe economic turmoil in the wake of the financial crisis and has undergone the most restrictive centrally mandated austerity measures and fiscal constraints. It has also seen the most high-profile conflicts between its politicians, its citizenry and the ECB and Brussels. I will compare the situation in Greece with that of Hungary, specifically the impact of its dealings with the International Monetary Fund, an international financial institution working under different constraints and with different tools than the ECB. The Hungarian case is interesting for a number of reasons; Hungary is not part of the monetary union and is thus independent of the political forces and constraints acting on the EU/ECB, and it has enacted fairly stringent fiscal measures but with very different political and financial repercussions.

Theinquiry will begin with an examination of the idea of sovereignty and a defense of one of its many definitions for understanding sovereignty in the EU. An institutional overview of the ECB, the IMF, and the EFSF/ESMwill follow, with particular attention paid to the conflict between the ECB’s original mandate and its actual approach to crisis management, specifically the use of Outright Monetary Transactions and its commitment to unlimited financial support of Eurozone members. We then turn to the case studies of Greece and Hungary to illustrate the difference in how the crisis was managed in the two countries. The closing chapter examines how the management of the crisis in the Eurzone has impacted member state sovereignty, relying on the Hungarian case to illustrate that there is more at work here than the effects of conditionality on sovereignty alone.

Rationale

The notion of sovereignty lies at the innermost core of international relations; indeed, the discipline is essentially predicated upon it. The project of European Union has clearly changed state sovereignty, as its member states are increasingly bound by treaties and by decisions of the Council, Commission, and the Court of Justice. However, not enough inquiry has been made on the effects of financial crisis management on state sovereignty, despite the drastically different political and economic landscape that has emerged in the wake of the crisis. It seems clear that understanding the changing nature of state sovereignty in Europe is critical to evaluating the success and the character of the European integration project.

Statement of Problem

The great bulk of publications on the European financial crisis are focused on describing the causes of and solutions to the crisis. So far unprecedented steps in EU history have been taken to stabilize the currency area and more substantial mechanisms of resolving ongoing fiscal and debt problems remain under serious consideration. Discussion of the crisis centers around the role of institutional efforts at crisis resolution, but little has been made of the potential for these efforts to change the distribution of authority within the

EU. At this point of relative political and financial calm, it is critical to evaluate the effects of what has been done so far and the direction that the EU is heading in.

Objective of Thesis

This thesis aims to use an institutional overview and two case studies to provide a way towards better understanding the relationship between supra-national fiscal regulation and state sovereignty in the EU and to develop a coherent viewpoint on the status of the relationship between the European Union's crisis-management measures, EU member state sovereignty, and the democratic deficit.

Methodology

The thesis will proceed by first defending a particular conception of sovereignty and reviewing the relationship between sovereignty and government financing, as well as a look at the idea of democratic deficit within the European Union. This will be followed by overviews of the ECB, the IMF, and the EFSF/ESM. This will lead into the case studies on Greece and Hungary, where the details of their interactions with the Troika and the key events and implications of crisis-management efforts will be examined. The different actions taken by the Troika in the two countries and the difference in their effects will be of particular focus,allowing for discussion of precisely how and to what degree both debtor and creditor governments have lost sovereignty to international authorities and how this contributes to the notion of EU democratic deficit.

The closing section will build a general outline of the relationship between state sovereignty, supra-national fiscal regulation, and democratic accountability in the Eurozone. The possible directions the currency union can take in the event of a second debt crisis will then be analyzed in terms of member state sovereignty. I will conclude with a succinct review of just what the response to the financial crisis means for EU member state sovereignty and the democratic deficit.

Chapter 1: Sovereignty, Fiscal Sovereignty, and the Democratic Deficit

“There exists perhaps no conception the meaning of which is more controversial than that of sovereignty. It is an indisputable fact that this conception, from the moment when it was introduced into political science until the present day, has never had a meaning which was universally agreed upon.” - Lassa Oppenheim

There is no disputing Oppenheim’s claim that sovereignty will always remain a cumbersome and ill-defined concept. But there is also no doubt that its importance can hardly be overstated. Indeed, it has been said that state sovereignty “has long been the core assumption of the discipline of International Relations”[4]. To arrive at a working conceptualization of sovereignty for the purposes of this thesis, we briefly examine some of the key approaches in the literature surrounding the idea. Proceeding to an examination of the specific notions of fiscal sovereignty and the EU’s democratic deficit, this chapter establishes the conceptual groundwork we will build on in understanding the implications of financial-crisis management for EU member state sovereignty.

[4] Darel E. Paul, "Sovereignty, Survival and the Westphalian Blind Alley in International Relations," *Review of International Studies* 25 no. 2 (1999): 217.

1.1 Sovereignty in the European Union

1.1.1 Conceptualizing Sovereignty

Weber's "monopoly of the legitimate use of physical force within a given territory"[5] definition of the state is heavily relied on by realists. In this view, sovereignty is equated with state existence and survival; only sovereign actors can play a role in the international system and only states can be sovereign. The state is the constitutive unit of the international system, in which anarchy prevails and sovereign states are not beholden to any external authority. In this view, all structures of authority terminate at the state level. And yet there are a number of cases that this view fails to account for. A state may be formally sovereign but not actually be able to exercise its independence, as was the case in the Soviet satellite republics, with some exceptions. This view also fails to characterize the case of the EU, in which significant authority lies with both the member states themselves and with supranational institutions[6], such that neither level of organization could properly be called 'sovereign' in strictly realist terms. Paul argues that "since it is clear that a state can move from sovereign to non-sovereign status without suffering physical destruction or ontological demise, we must separate the interest in survival from the interest in sovereignty or independence."[7]While no EU member currently risks being totally stripped of its status as a state, there are certainly considerations of sovereignty at stake that realist views cannot account for.

[5]Max Weber, *Politik als Beruf*, 11 ed. (Berlin: Duncker & Humboldt GmBH, 2010): 8.
[6] e.g., The Court of Justice of the European Union and the European Central Bank
[7] Paul, "Sovereignty, Survival and the Westphalian Blind Alley in International Relations," 218.

Wendtian constructivism views sovereignty as part of a state's social rather than ontological identity, as an anthropocentric "meta-physical assumption".[8] While this approach would appear to differ starkly from the realist one, in which sovereignty is a defining characteristic of a state, it still implies that the world is composed of groups that have organized themselves into states and that states have uniformly claimed sovereignty. Ruggie's view of the state[9] allows for the consideration of multiple actors within a single structure, allowing us to move beyond conventional conceptualizations of the monolithic sovereign rooted in Hobbe's conception of the Leviathan.[10] However, like realism, constructivist views fails to account for the different levels at which authority is organized within the EU structure. The constructivist framework differs from realism primarily in the view that sovereignty is determined endogenously rather than exogenously. The difference between the schools is much less clear when it comes to what sovereignty actually means, particularly for EU/Eurozone member states.

Krasner's neorealist work on state sovereignty provides an excellent alternative to the realist and constructivist traditions. He relies on three overlapping concepts: international legal sovereignty, tied to the formal recognition of one state by others; domestic sovereignty, involving the actual capacity of a state to govern and exercise its authority; and Westphalian sovereignty, or the absence of any external authority other than the domestic one over the state.[11][12] This three-layered approach is ideal for understanding

[8] Alexander Wendt, and Raymond Duvall, "Sovereignty and the UFO," *Political Theory* 36 no. 4 (2008): 607.
[9] John Gerard Ruggie, "Territoriality and Beyond: Problematizing Modernity in International Relations," *International Organization* 47, no. 1 (1993): 139.
[10] Thomas Hobbes, *Leviathan*, ed. C.B. MacPherson (London, Penguin Books 1985), 12
[11]Stephen Krasner, "Rethinking the Sovereign State Model," *Review of International Studies* 27 (2001): 19.

what sovereignty means for EU member states. While most conceptualizations of functional democracies assume the presence of strict Westphalian sovereignty in terms of popular rule, external influences at the international level will always play a role, and this is especially the case within the EU. Broadly speaking, the member states have invoked their international legal sovereignty to create an authority structure that cedes aspects of Westphalian sovereignty, under the assumption that in doing so their capacity to govern according to the national government's preferences (domestic sovereignty) will be strengthened. Unlike pure Westphalian sovereignty, domestic sovereignty can be compatible with the supranationalization of authority structures. However, Krasner identifies a natural tension between these forms of sovereignty.[13]

1.1.2 The Tension between the Forms of Sovereignty

The international system is characterized by asymmetric powers, varied and conflicting interests, and a lack of any ultimate and final international authority or enforcement mechanism. As a result, deviations from Westphalian sovereignty are to be expected and do in fact occur often, from the present situation of Russian interference in Ukraine to the US backing of "banana republic" regimes in Latin America during the Cold War. Despite the egalitarianism espoused in the EU's legal and institutional framework, strong incentives remain for states to intervene in the affairs of others. The nature of the different forms of sovereignty creates an inescapable tension- states cede some of their

[12] A fourth form, Krasner's interdependence sovereignty (involving state capacity to regulate flows of people, goods, and ideas across its borders) is not considered here because of its virtual irrelevance within the European Union given the Four Freedoms.
[13]Stephen Krasner, *Sovereignty: Organized Hypocrisy* (Princeton University Press: Princeton, 1999), 4.

authority over domestic matters to supranational structures, sacrificing aspects of Westphalian sovereignty under the assumption that the domestic government's capacity to achieve its ends will be enhanced. For these compromises to be legitimate, they must be the product of international legal agreement between democratically accountable governments.

The EU member states have voluntarily sacrificed domestic control in two main areas: judicial independence under the Court of Justice of the European Union and monetary policy under the ECB (within the Eurozone). While in principle both of these supranational entities enjoy democratic legitimacy as they were endorsed by their various member states, it is fair to say that the authority that has accrued to both actors could hardly have been predicted by anyone agreeing to the institutions' establishment, and their evolution has produced much conflict and debate. But even if a member state doesn't agree with a specific decision, the costs of leaving the Union have always outweighed the costs of accepting the decision.

The EU can thus be viewed in terms of Krasner's "shared sovereignty", which involves "the engagement of external actors in some of the domestic authority structures of the target state for an indefinite period of time".[14] Shared sovereignty has a critical pre-condition: international legal sovereignty and a voluntary agreement to the shared sovereignty system.[15] The compromise is grounded in the assumption that on the basis

[14] Stephen Krasner, *Power, the State, and Sovereignty: Essays on International Relations*,(Routledge: New York, 2009), 247.
[15] Stephen Krasner, "The Hole in the Whole: Sovereignty, Shared Sovereignty, and International Law" *Michigan Journal of International Law* 25 (2003): 1091.

international legal sovereignty, member states enter into agreements expected to enhance domestic sovereignty while sacrificing Westphalian sovereignty. Monetary union is a prime example of this, however, the extent to which this also entails fiscal/political union is not yet fully clear.

1.2 Fiscal Sovereignty and Financial Market Integration

1.2.1 Fiscal Sovereignty and the Pre-Crisis EU

Fiscal sovereignty is best understood as authority over the raising and distribution of government revenues, including decisions whether or not to repay sovereign debts.[16] Fiscal sovereignty is a "right which has been carefully guarded by sovereign states and protected in international law over hundreds of years".[17] It has been the catalyst of important events over the course of history, perhaps nowhere more so than in the colonial "no taxation without representation" rhetoric preceding the American Revolution. However, fiscal sovereignty does not imply that there will not be negative consequences to profligate fiscal policy or defaults on sovereign debt, but rather that governments have the choice to make such choices in the first place.

In his paper on the relationship between fiscal sovereignty and fiscal discipline, Kopits finds that the best way for governments to maintain their long-term fiscal sovereignty is to bind themselves within a permanent rules-based fiscal framework and show

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[16]Jonathan Rodden. "Achieving Fiscal Discipline in Federations: Germany and the EMU," 2-3, (Paper prepared for Fiscal Policy in EMU: New Issues and Challenges, Brussels, Belgium, 12 November 2004.
[17] Rajiv Biswas, ed.,*International Tax Competition: Globalization and Fiscal Sovereignty* (London: Commonwealth Secretariat, 2002), 1.

commitment to it through transparency and consistency. Governments that fail to do so are likely to see their fiscal sovereignty weakened. Kopits identifies four historical cases where states have lost their fiscal sovereignty: The Ottoman Empire's financial collapse in the early 1900s, the League of Nations loan to Hungary in 1924, the Indonesia IMF standby agreement in 1998, and the EU-IMF bailouts of Greece in 2010 and 2012.[18] This short list of cases reveals two key insights for this study: firstly, that instances of compromised fiscal sovereignty are fairly rare, and second, that fiscal sovereignty was viable within the framework of the pre-crisis EU. The primary tool of EU fiscal regulation before the crisis proved insufficient to constrain Greece and others and prevent fiscal derailment and a slide into sovereign debt crisis.

The Stability and Growth Pact came into full force in the EU in 1999 with the goal of preserving the monetary union by establishing member state criteria for government debt-to-GDP ratios and deficit levels as a percentage of GDP, which were to be kept below 60% and 3% respectively.[19] The SGP provided for the monitoring of national fiscal information and mechanisms for sanctioning transgressors. However, the SGP proved a rather toothless instrument for controlling fiscal policy. Fiscal rigor in Europe deteriorated, with large budget deficits becoming increasingly normal. The ECB sent mixed signals to member states, ignoring differences in sovereign bond yields in the run-up to the financial crisis. This implicit guarantee led ratings agencies to grant high credit ratings to member states even where they were not necessarily warranted by economic

[18]Kopits, "Can Fiscal Sovereignty be Reconciled with Fiscal Discipline?", 142.
[19] "Stability and Growth Pact," Economic and Financial Affairs, European Commission, last modified 9 May 2013, accessed 12 May 2014. http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

fundamentals. The non-Eurozone economies also enjoyed the assumption that they would eventually join the currency union, leading to lower than merited yields. Thus the SGP did not serve to infringe on member state fiscal sovereignty prior to the crisis so much as simply distort it. Member states were essentially able to run their budgets according to their will, and the credit ratings they received could be read as indication that investors had strong expectations they would be bailed out by the ECB should they become insolvent. [20] Kopits argues that meeting the standards imposed by the SGP was insufficient for ensuring good outcomes for EU member states in the financial crisis, and that sound domestic policy was ultimately the critical factor.[21]

1.2.2 Does Financial Market Integration Threaten Sovereignty?

The increased degree of financial integration across the world has led some to argue that sovereignty is being weakened by the role of global capital markets. This is an overly narrow view, as it ignores the fact that a high degree of dependence on international capital is neither historically novel nor is it outside the prerogative of national governments. No state is externally compelled to run large deficits and depend heavily on debt financing, and thus the idea that sovereignty is being threatened by global capital confuses authority over state activities (the essence of sovereignty) with state control over capital markets, which has never existed in the age of capitalism.

Claims that globalization is undermining sovereignty ignore many historical cases in which similar forces affected governments without changing the nature of sovereignty.

[20]Rodden. "Achieving Fiscal Discipline in Federations," 13.
[21]Kopits, "Can Fiscal Sovereingty be Reconciled with Fiscal Discipline?", 146.

Governments have had to ensure their competitiveness on international markets to maintain their power ever since the rise of global trade in the early eighteenth century.[22] European rulers of the late 17th century depended far more heavily on international finance than modern ones do. Debt financing accounted for more than 60 percent of government spending in the UK, France and Holland in the 18th century.[23]The idea that the level of cross-border financial flows and economic integration in the EU and the broader global macro-economy poses an unprecedented threat to state authority misses the fact that this is nothing entirely new in the international system.

Cross-border financial flows do not threaten government authority in and of themselves. Even if globalization is changing the way domestic authority systems operate, it does not mean sovereignty as a defining feature of political existence has been substantially altered. Ideas and modes of governance have always flowed across states without changing the essential nature of sovereignty, and modern sovereign debt financing is no exception. Any system involving inalienable rights to private property places some inherent limits on the powers of the state. Indeed, the economy sets the boundaries of modern politics and establishes the issues with which the political actor must concern itself. Even though all politics through history has had to concern itself with the economy to some degree, for most of history the political has basically consisted of the protection of territory. Modern governance has largely been reduced to the creation of benefit for the public, as the modern public has come to regard economic prosperity as a necessary

[22]Istvan Hont, "Free Trade and the Economic Limits to National Politics:Neo-Machiavellian Political Economy Reconsidered," in *The Economic Limits to Modern Politics*, ed. John Dunn (Cambridge: Cambridge University Press, 1990): 44.
[23] John Brewer, *The Sinews of Power: War, Money and the English State*, (Cambridge MA: Harvard University Press, 1990), 115.

though not sufficient condition for decent existence.[24]The integrated global financial market provides a critical mechanism for creating that economic prosperity. Financing the machinery of the state and preserving government authority is made all the more feasible when governments can issue debt beyond their borders. While government profligacy can undermine fiscal sovereignty, this is a matter of government policy and not one of an inherent threat posed by external capital markets.

1.3 The Democratic Deficit of the EU

1.3.1 Standard View

Though definitions of the deficit vary widely, the core criticism underlying most all of them is that the process of integration in the European Union has empowered democratically unaccountable EU executives at the expense of national parliaments. National parliaments hold national executives to account, but in the EU, Council ministers and Commission appointees dominate policy-making and are far less readily controlled by the populace they govern. Follesdal and Hix identify several broad features definitions of the democratic deficit tend to share[25]:

- The European Parliament is too weak compared to the other institutions. At first many saw the European Parliament's authority as directly conflicting with national parliamentary authority; now, it has come to be viewed as conflicting with the

[24] John Dunn, "The Economic Limits to Modern Politics," in *The Economic Limits to Modern Politics*, ed. John Dunn (Cambridge: Cambridge University Press, 1990): 20-25
[25] Andreas Follesdal and Simon Hix, "Why There is a Democratic Deficit in the EU: A Response to Majone and Moravcsik," *JCMS: Journal of Common Market Studies* 44 no. 3 (2006): 534-535.

Commission and the Council's authority. Its power has increased substantially since the mid-80s, but there are still strong arguments that it is relatively weak.

- National politicians often campaign on the basis of domestic rather than EU issues. Thus, voters' decisions at parliamentary elections have only a weak influence on the actual policy choices made regarding EU issues.

- Even with improvements to the legitimacy of EU elections were made and the influence of the Parliament was increased, voters remain detached from the EU. There is little citizen control over the machinations of the Council and the Commission; they are not perceived as instruments for reflecting the citizen's interests. The procedures for appointing the Commissioners are obscure, and council decision-making processes lack transparency.

- The integration process creates a 'policy drift' from the actual preferences of voters. Many policies adopted at the EU level do not have the support of majorities within some or most of the member states, such as the neo-liberal basis of the common market, EMU monetarism, and the distribution of subsidies within the CAP. Highly organized business interests tend to influence decision making more than loosely organized consumer interest groups and trade unions.

1.3.2 Questioning the Deficit

Majoneviews the EU as an essentially regulatory state, in which national governments have deliberately delegated regulatory oversight to the EU level to insulate decision-making from the vagaries of national politics.[26] He argues that too much majoritarianism at the EU level would create shortsighted decisions instead of the more optimal ones an independent EU is able to come up with. Majone sees a 'credibility crisis'[27] rather than a democratic deficit, one that could be remedied by increased transparency and review of decisions, and improved expertise.

Moravcsik holds that democratically elected national governments still dominate in what is an essentially intergovernmental EU.[28] He argues that changes to the Parliament's role have mitigated criticisms of its weakness and that the EU is less opaque than most domestic systems. He also takes issue with the idea that business interests undermine the average center-left voter, citing the EU's system of checks and balances, which requires strong consensus for a decision to move forward.[29] Essentially, Moravcsik's views reflect his liberal-intergovernmental theory of how the EU functions, in which legitimacy is derived from the influence of elected national representatives participating in international agreements. However, intergovernmentalism really only accounts for

[26]GiandomenicoMajone, "The Rise of the Regulatory State in Europe," *West European Politics* 17 no. 3 (1994): 77.
[27]GiandomenicoMajone, "Temporal Consistency and Policy Credibility: Why Democracies Need Non-Majoritarian Institutions," *European University Institute*, Working Paper RSC No 96/57, (1996), 1-2.
[28] Andrew Moravcsik, "Preferences and Power in the European Community: a Liberal Intergovernmentalist Approach," *Journal of Common Market Studies* 31 no. 4 (1993): 480-488.
[29] Andrew Moravcsik, "In Defense of the "Democratic Deficit": Reassessing the Legitimacy of the European Union," *Journal of Common Market Studies,* 40 no. 4, 603-620.

certainintegration processes. A second, supranational force, driven by the ECJ and now increasingly the ECB, has also pushed the EU towards integration without accountability to national governments. Moravcsik's intergovernmentalism is increasingly outmoded in characterizing the actual power structure of the EU after the financial crisis and the standard view of the democratic deficit is made even more credible. We turn to an examination of the ECB as an institution (within the broader Troika crisis-management system) to begin to elucidate why Moravcsik's logic does not hold in the face of the financial crisis.

In this chapter we have examined the concepts of sovereignty, fiscal sovereignty, and the democratic deficit. The core arguments are that sovereignty (particularly in the Eurozone) is a concept built on multiple, interlocking components, fiscal sovereignty is not inherently jeopardized by foreign-held sovereign debt, and the existing arguments against the presence of an EU democratic deficit may not hold up against recent developments in the field of financial crisis management.

Chapter 2: Understanding the Troika

Greece is not run through democracy now, it is run through a Troika.

- Nigel Farage

The ECB, IMF and the European Union have collaborated to manage the recent financial crisis in the European Union. We turn to an examination of its constituent parts in order to better understand the forces underlying the Troika's response. While the Troika is often referred to as though it were a unitary entity, each member has a different origin, purpose, and role.

2.1 Overview of the European Central Bank

2.1.1 Purpose and Mandate

The ECB is a historically unprecedented institution in that it is the first central bank to have "the explicit legal power to make monetary policy decisions for multiple independent states"[30]. Currency union under the ECB constitutes a unique situation in which sovereign governments issue money in an essentially "foreign" currency. Thus, they have no way of guaranteeing with certainty that the debt will be payable at maturity, whereas any state with its own currency can inflate its way out of any debt burden (of

[30] Karl Kaltenthaler, *Policymaking in the European Central Bank: The Masters of Europe's Money*, (Plymouth, UK: Rowman& Littlefield, 2006): 61.

course not without consequences)[31]. As a central bank, the ECB controls the Eurozone's money supply and key interest rates. According to its Statute, the Bank's "primary objective shall be to maintain price stability"[32]. This differs from the mandate of the US Federal Reserve, which entails both the maintenance of price stability and the maximization of employment.[33]

In addition to its core mandate, the Statute on the ESCB[34] also spells out four "basic tasks" of the banking system: "to define and implement the monetary policy of the Community*[35]; 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"[36].The Statute does not explicitly mention a commitment to financial stability, but recent events have caused the Bank to expand its prerogative into this realm.

In September 2012 the ECB reported that it would offer unlimited, though conditional, credit to Eurozone member states in the sovereign debt market under the auspices of the 'Outright Monetary Transactions' Program.[37] This is not necessarily consistent with the primary objective of price stability, as unlimited support to sovereign governments in the debt market is liable to create inflationary pressures. Thus the financial crisis has led to a

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[31] Paul de Grauwe, "The European Central Bank as Lender of Last Resort in the Government Bond Markets." *CESifo Economic Studies* 59 No. 3 (2013): 520.
[32] Protocol on the Statute of the European System of Central Banks and of the European Central Bank, *Official Journal of the European Union*, Protocol No. 4 (2008): Article 2.
[33]Full Employment and Balanced Growth Act, H.R.50 (1978), § 2.
[34] European System of Central Banks, including both the ECB itself and the heads of the various member state central banks.
[35] i.e. the Eurozone
[36]Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 3.
[37]deGrauwe, "The European Central Bank as Lender of Last Resort," 520.

potential undermining of the core mandate of the ECB without the adoption of a new EU Treaty to legitimate the change.

2.1.2 Structure and Operations

The ECB is an EU institution with its own distinct legal personality. It is managed by the Executive Board and the Governing Council. The Executive Board consists of the Bank's president and vice-president as well as four other board members appointed by consensus among the heads of the member states, all of whom serve eight year terms. The Board manages the day-to-day operations of the ECB and coordinates the meetings of the Governing Council. The Governing Council is comprised of the heads of the various Eurozonemember's central banks.[38] It determines the monetary policy of the ECB in terms of monetary supply and key interest rates, and may (by two-thirds majority), "decide upon the use of such other operational methods of monetary control as it sees fit…"[39].

The ECB issues Euros into the financial market, which are then purchased by the central banks of the currency union's member states at various risk premiums. The Bank can also operate in financial markets by trading in claims and marketable instruments in all currencies and metals, and "conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral"[40]. However,

[38] Dermot Hodson, "Managing the Euro: the European Central Bank," in *Institutions of the European Union*, ed. John Peterson and Michael Shackleton, (Oxford University Press, Oxford, 2012): 199-208.
[39] Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 20.
[40] Ibid, Article 18.

according to Article 125[41] of the Lisbon Treaty[42], the ECB is forbidden from assuming responsibility for the financial liabilities of member state governments. This has not stopped it from making purchases of sovereign debt via “Outright Monetary Transactions (OMTs)”[43], which have sparked controversy and led to recent questioning of their legality by the German Constitutional Court.[44]\

2.1.3 Independence

Article 7 of its Statute establishes that “neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body”[45]. ECB independence is based in its distinct legal personhood separate from the EU, independence of personnel, budget (from central banks, not EU), and goal setting (except price stability).[46] Scheller argues that ECB independence is critical to it meeting its mandate of maintaining price stability, because otherwise, the bank is liable to become subject to pressure from member state governments and pursue inflationary policies.[47] Weber and Forschner see the ECB’s independence as an effort to add credibility to the bank’s commitment to price stability, preserve central bank policies

[41] The so-called “no-bailout clause”

[42] Treaty of Lisbon, *Official Journal of the European Union*, C 306 50, (2007): Article 125.

[43] European Central Bank, *Press Release- Technical Features of Outright Monetary Transactions,* ECB Europa, last updated 6 September 2012, accessed 12 May 2014, http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

[44] “It isn’t Over,” *The Economist*, 15 February 2014, accessed 17 May, 2014. http://www.economist.com/news/finance-and-economics/21596570-european-monetary-policy-has-not-been-given-reprieve-markets-believe-it-isnt

[45]Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 7.

[46]Christoph Weber and Benedikt Forschner, "ECB: Independence at Risk?," *Intereconomics* 49 no. 1 (2014): 48.

[47]Hanspeter Scheller, *The European Central Bank*, (European Central Bank: Frankfurt, 2006): 123..

from changes in preferences stemming from changes in government, and generally insulate the bank from the often-shortsighted policy preferences of actors in the political sphere.[48] Initially, the ECB was held to be one of the most or the most independent central bank in the world because of the inability of politicians to influence its goal setting and its general lack of oversight by and accountability to the EU.[49] However, of late there have been challenges to its independence by way of the nationality of bank staff members, recent use of OMTs, and the new bank oversight system.[50]

2.1.4 Origins in the Bundesbank

The German Bundesbank was essentially the precursor to the ECB. The Deutschmark served as the hub currency in the European Monetary System of fixed exchange rates that preceded the introduction of the Euro. German monetary policy was set on the basis of German unemployment and inflation figures, and the other EMS central banks had to translate German policy into domestic policy in order to maintain exchange rate requirements[51]. With the introduction of the Euro, decisions have to be based on Eurozone averages rather than German figures.[52]

Dornbusch et al. submit that the character of the ECB mandate can be read as stemming from the Bundesbank's role in the EMS. From its inception the ECB needed to show a

[48] Weber and Forschner, "ECB: Independence at Risk?", 45-46.
[49] Kathleen McNamara, "Rational Fictions: Central Bank Independence and the Social Logic of Delegation." *West European Politics* 25 no. 1 (2002): 66.
[50] Weber and Forschner, "ÉCB: Independence at Risk?", 49-50.
[51]Rudiger Dornbusch, Carlo Favero, and Francesco Giavazzi. "The Immediate Challenges for the European Central Bank,"*National Bureau of Economic Research*, no. w6369 (1998): 6-9.
[52] Emmanuel Apel. *Central Banking Systems Compared: The ECB, the Pre-Euro Bundesbank and the Federal Reserve System*,(Routledge: New York, 2003): 66.

commitment to the Bundesbank's long history of price stability in order to satisfy investors[53]. Any deviation from this path early on could have shocked markets and thrown the monetary union into jeopardy. Instead it "has to tread the narrow path between an institutional revolution and uninterrupted continuity with the Buba."[54][55] The financial crisis meant that the ECB was faced with issues that the Bundesbank never encountered, leaving it with little precedent to follow in managing the current state of the monetary union and unable to rely on a strategy of imitating the Bundesbank to satisfy markets.

One core difference between the Bundesbank and the ECB lies in the idea of monetarism and fixed exchange rates. While the Deutschmark served as the hub currency of the ERM, the currencies pegged to it were able to fluctuate within a defined band. On the other hand, the currency union under the ECB amounts to an irrevocable pegging of currencies across all member states. Friedman argues that floating currencies are absolutely necessary for maintaining, among other things, price stability and fiscal soundness.[56]However, the effective fixing of rates means that the ECB, as an independent, insulated institution can make decisions about the money supply and credit that may be at odds with the fiscal position or business cycle in some of the states affected by its policies.[57] Without the freedom of a floating currency or exchange rate band, national governments have no room to maneuver in this circumstance. Another

[53]Dornbusch, Favero and Giavazzi, "The Immediate Challenges for the European Central Bank," 35-39.
[54] i.e., theBundesbank
[55]Dornbusch, Favero and Giavazzi, "The Immediate Challenges for the European Central Bank," 39.
[56]Milton Friedman, *Essays in Positive Economics*, (The University of Chicago Press: Chicago, 1953): 157-158.
[57]László Csaba, "On the New Economic Philosophy of Crisis Management in the European Union," *Society and Economy* 35 no. 2 (2013): 123.

important difference from the Bundesbank, the ECB's new role in overseeing private banks in the Eurozone, is discussed below.

2.1.5 Private Bank Oversight

In November of 2014, the ECB is set to take on a supervisory role over about 130 credit institutions across the Eurozone under the Single Supervisory Mechanism. The assets of these banks constitute approximately 85% of all Eurozone banking assets.[58]"The main aims of the SSM will be to ensure the safety and soundness of the European banking system and to increase financial integration and stability in Europe".[59] The Bank reserves the right to expand the scope of its oversight to any Eurozone credit institution.[60]While the specifics of its role remain under negotiation, the SSM will essentially entail the issuing of regular reports by the credit institutions involved and further information as requested to the ECB. The ECB will monitor their balance sheets and activity and make decisions about regulation, bank recapitalization actions, and other efforts at maintaining stability and solvency on this basis.[61]

The SSM has been met with criticism on two fronts: it expands the role of the ECB in a way that has the potential to undermine its independence, and it transfers a great deal of authority over banking regulation from national bodies to a single supranational one. Weber and Forschnerhold that the ECB's dual role as a central bank and a regulatory

[58] "Banking Supervision," *European Central Bank*, updated 12 May 2014, accessed 31 May 2014, http://www.ecb.europa.eu/ssm/html/index.en.html
[59] Ibid.
[60] Ibid.
[61] Dorothea Schäfer, "Banking Supervision in the Eurozone." *Intereconomics* 48 no. 1 (2013): 2-3.

authority will likely lead to threats to its instrument independence. If the needs of specific banks within its purview should come to influence its monetary policy, it can no longer really be thought of as an independent institution. It is not truly possible for a single institution to manage two different competencies entirely independently of one another; therefore, Weber and Forschner argue that a separate monitoring entity should be created.[62] A second criticism revolves around the transfer of regulatory authority that the SSM implies. Csaba argues that if controls over cross-border banking, gaps between national and EU regulation, and the management of hundreds of billions of Euros "were to vested with the second leg of the ECB and empowered by the exceptional jurisdiction of the ECJ, allowing for immediate validity without proper instances to appeal against them, *these steps would transfer an exceptional degree of sovereignty to un-elected supranational organs* [emphasis original]".[63]

2.1.6 Controversy Surrounding the ECB

2.1.6.1 The Democratic Deficit of the ECB

In the years after the establishment of European Monetary Union, a number of scholars argued that the ECB was a democratically deficient institution on the grounds that it had an overly high level of independence for a central bank. Its independence has raised questions about its democratic accountability.[64] It is generally assumed that central banks require a high level of independence in addition to an inflation-restraint mandate to

[62] Weber and Forschner, "ECB: Independence at Risk?," 49-50.
[63] Csaba, "On the New Philosophy of Crisis Management," 130-131.
[64] Willem Buiter, "Alice in Euroland," *Journal of Common Market Studies* 37 no. 2 (1999): 185.

ensure price stability. Otherwise, politicians may steer the bank toward inflationary policy for short-term political gains. According to Begg and Green, the democratic deficit of the bank lies in the fact that it has autonomy over both its goals and the means for meeting them.[65] They see the bank as being too independent of the political sphere, and argue that in the end monetary policy must lie in the hands of democratically elected politicians. De Haan and Eijffinger find that the ECB is more independent than its counterparts in the US, UK, Japan and Canada. They argue that goal independence undermines the democratic accountability of a central bank and that the ultimate responsibility for monetary policy should lie with elected politicians by way of an override mechanism.[66]

In the wake of the financial crisis, much of the criticism of the ECB has taken an about-face and begun to focus on the lack of central bank independence.[67] The process of crisis-management has been fraught with political turmoil and controversy, and few issues have weighed higher on the EU political agenda. However, this shift in views about the ECB's independence does not undermine previous characterizations of it as a democratically deficient institution. A political rift has developed between a predominantly northern camp set on preserving the price stability mandate and a predominantly southern camp in favor of expansionary policy, and politicians from the two sides are competing for influence on monetary policy. Hussain sees Germany at the core of crisis management rather than the ECB's officials, and argues that Angela Merkel has positioned herself as

[65] Iain Begg and David Green, "Political Economy of the European Central Bank", in *The Political Economy of Central Banking*, ed. P. Arestis and M.C. Sawyer, (Cheltenham: Edwar Elgar, 1998): 122-130.
[66]Jakob de Haan and Sylvester Eijffinger. "The Democratic Accountability of the European Central Bank: A Comment on Two Fairy-Tales," *Journal of Common Market Studies* 38 no. 3 (2000): 402-406.
[67]Csaba, "On the New Economic Philosophy of Crisis Management in the European Union," 136.

the anchor of fiscal stringency in order to secure domestic political support rather than based on any conviction about what is best for the Union.[68] Another key aspect of ECB's democratic deficit is that its decisions affect countries both within and outside of the Eurozone without full representation for the latter. As a supra-national institution, it is insulated from the preferences of the EU public at large.

Though influence has shifted to democratically elected politicians, it has not done so in a way that equally favors the various member states. By extension, ECB goal-setting is still not determined by aggregate voter preferences among EU citizens. The ECB's nominal focus on a single objective (price stability) means the management of the crisis has been largely *ad hoc* and not based on well-established objectives or a clear democratic mandate. The lack of a clear end-goal in regulating the crisis has left EU citizens confused and provoked negative speculation on financial markets, especially during the period preceding the Greek bailouts.

2.1.6.2 The ECB as Lender of Last Resort

In addition to concerns about the democratic legitimacy of the ECB, a new debate has started about the idea of the Bank as a lender of last resort for the Eurozone. While central banks do generally act as guarantors of a single nation's currency, the ECB would seem to be implicitly forbidden from doing so by the "no-bailout clause". The Bank issued a declaration in September of 2012 that it would in fact provide the Eurozone

[68]Imtiaz Hussain, "Europe After the Greek Default: Widening, Deepening or Splitting?," 150-160.

states with unlimited support by way of Outright Monetary Transactions[69], essentially purchases of government debt in the secondary market. This declaration has yet be set down in any amendment to the Bank's Statute nor any piece of EU legislation, but the idea of the Bank as a lender of last resort has provoked controversy both before and after the statement.

Many have argued against expanding the role of the ECB towards becoming a lender of last resort because of the inflationary pressures increased liquidity would create.[70][71]This could put controlling price stability outside of the ECB's power. There is also the obvious problem of moral hazard; in an international monetary union with guaranteed central bank support, member states have lessened incentive to maintain balanced budgets and avoid insolvency. More stringent states would become victim to the profligacy of others with little room to control them in the absence of hard budget constraints, which the SGP has hardly provided. Alesina and Grilli find that for the currency union to function harmoniously, central bank policy needs to be at least as monetarily stringent as they are in the country with the most stringent preferences. This premise is reflected in the sole focus on price-stability in the ECB's statute, which reflects the law of the Bundesbank and by extension German desires for stringency rather than other state's preferences for stability and employment-oriented policy. The most conservative government in the

[69]European Central Bank, *Press Release- Technical Features of Outright Monetary Transactions.*
[70]OtmarIssing, "Moral Hazard will Result from ECB Bond Buying," *Financial Times*, 30 November, 2011, accessed May 15, 2014. http://www.ft.com/cms/s/0/41640740-1a7a-11e1-ae4e-00144feabdc0.html#axzz337DXoeGN
[71] Rainer Buergin, "Schaeuble Rejects ECB as Lender of Last Resort, Joint European Bond Sales," *Bloomberg*, 15 January 2012, accessed May 15, 2014. http://www.bloomberg.com/news/2012-01-15/schaeuble-rejects-ecb-as-lender-of-last-resort-joint-european-bond-sales.html

union (presumably Germany) may encounter strong incentives to leave if less stringent preferences prevail.[72]

On the other hand, the crisis has prompted a number of academics to support lender of last resort status for the ECB. De Grauwe argues that in times of liquidity crisis banks tend to become highly risk averse and therefore increased ECB support would create solvency without leading to a large increase in loan activity that would cause inflation. Even after the crisis had subsided, the accumulated liquidity could be prevented by the ECB sale of its holdings of government bonds (in a presumably more stable market that would not see major yield increases) or by increasing bank reserve requirements, preventing them from heating up the economy with their accumulated liquidity.[73]Buiter and Rahbari emphasize the importance of a lender of last resort for preventing sovereign states from getting trapped in a bad equilibrium, in which the possibility of sovereign debt default increases speculation and drives up bond yields, further increasing the likelihood of default in a vicious cycle.[74]

Its declaration to provide unlimited support to the Eurozone without any accompanying push for legislation has calmed markets while avoiding some of the public debate likely to arise out of an explicit adoption of lender of last resort status. The Bank has nevertheless exposed itself to criticism of its new approach. The guarantee of support for the Euro effectively implies a second core goal for the ECB which is likely to directly conflict with price stability. Weber and Forschner see an acute need to clarify the

[72]Alberto Alesinaand Vittorio Grilli. “The European Central Bank: Reshaping Monetary Politics in Europe,”*National Bureau of Economic Research*, no. W3860, (1991), 2-15.
[73] Paul de Grauwe, “The European Central Bank as Lender of Last Resort,” 5-6.
[74] Willem Buiter and EbrahimRahbari, "The European Central Bank as Lender of Last Resort for Sovereigns in the Eurozone," *Journal of Common Market Studies* 50 no. s2 (2012): 18.

ambiguity if legitimacy can be maintained in the Eurozone, arguing, “The ECB cannot simply expand its own mandate; this requires a stipulation by law through an amendment of the Treaty… otherwise, democratic legitimacy as a main trait of the “European idea” is lost”[75]. In the absence of a clear public endorsement of unlimited support across the various Eurozone governments, the ECB is charting a new course while ignoring the commitment of credit it implies for every state in the currency union.

2.2 Overview of the International Monetary Fund

2.2.1 Purpose and Role

The espoused purposes of the IMF are to “Promote international monetary cooperation through a permanent institution”; to foster international trade, high employment, exchange rate stability, and high real income; and “to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards”[76]. In other words, the institution exists to foster economic growth and stability across the globe by acting as a lender of last resort to countries in states of economic crisis.[77]

[75] Weber and Forschner, “ECB: Independence at Risk?”, 50.
[76] “Articles of Agreement of the International Monetary Fund,” *International Monetary Fund*, Article I, document last modified 3 March 2011, accessed May 18, 2014. http://www.imf.org/External/Pubs/FT/AA/index.htm#art4
[77] DeveshKapur, "The IMF: a Cure or a Curse?," *Foreign Policy* no. 111 (1998): 118.

Demand for IMF funds hit a low after the Asian financial crisis, but after 2008 the IMF has been restored to its place as "first responder to financial distress"[78]. The G20 has done much to move the IMF into its current role in the financial crisis, committing $740 billion to the fund in a 2009 meeting. Grabel notes that beyond its role in stabilizing the global macro-economy, "the re-emergence of the IMF at the heart of the global financial system is significant since the IMF has played a central role in driving thinking about policy and circumscribing the actual policy space available to developing and transitional countries over the last three decades"[79]. According to its Articles of Agreement, IMF members are expected to pursue policies with the aim of creating sustainable economic growth, economic and financial stability, and non-manipulation of exchange rates.[80]

2.2.2 Management and Operations of the Fund

"Each member shall be assigned a quota" that it is required to pay into the fund in order to have access to its resources.[81]Quotas are determined based on member's GDP, reserve holdings, and current account receipts and payments (and their variability).[82]The aggregation of these quotas forms the pool of funds from which the IMF conducts its operations.

[78] Ilene Grabel, "Not your Grandfather's IMF: Global Crisis,'Productive Incoherence' and Developmental Policy Space," *Cambridge Journal of Economics* 35 no. 5 (2011): 808.
[79] Ibid, 809.
[80] "The Articles of Agreement of the IMF", Article IV.
[81] Ibid, Article III.
[82] Richard Cooper and Edwin Truman, "The IMF Quota Formula: Linchpin of Fund Reform," *Policy Briefs in International Economics*, Peter G. Peterson Institute for International Economics, (1997): 3.

Every member state has a Governor on the Board of Governors in the IMF. There is also an Executive Board of Directors, with one Director from each of the large-quota countries and the rest representing multiple states. There is also a Managing Director chosen by the Executive Board who conducts the "ordinary business of the Fund".[83] (Article XII) Each member state is granted voting rights based on their quotas, as well as a small number of automatic votes given to all members, giving a slight voting bias to low-quota countries.[84]

Borrowers exchange domestic currency for the currencies of other IMF members to resolve balance of payments and/or currency reserves issues. Borrowers can repurchase their currency from the Fund at any time.[85]IMF funding is tied to explicit policy reforms, a process known as conditionality. Conditionality has two components: ensuring the changes necessary in the borrowing country's macroeconomy to allow it to repay its debts, and promoting its broader economic in accordance with IMF economic logic. From the 1980s the IMF built on its original conditionality methods to include a variety of structural measures, and the overall number of structural conditions bound up with the average IMF program increasing substantially, as did the average number of conditions in general.[86]Since 2000, the fund has moved towards reducing the complexity of programs to focus more closely on the terms most critical to success.[87]

[83] "The Articles of Agreement of the IMF", Article XII
[84]Brock Blomberg and J. Lawrence Broz, "The Political Economy of IMF Voting Power." *California: Claremont McKenna College, University of California* (2006): 4.
[85] "Articles of Agreement of the IMF", Article V.
[86]Morris Goldstein, "IMF Structural Conditionality: How Much is too Much?," *Peterson Institute for International Economics*, no. 1, (2001): 106-107.
[87] "Guidelines on Conditionality," *International Monetary Fund*, 25 September 2002, accessed May 19, 2014. https://www.imf.org/external/np/pdr/cond/2002/eng/guid/092302.pdf

2.2.3 IMF Conditionality

Criticisms of the IMF are wide-ranging, from controversy over its macroeconomic approach to debates on whether it should assist countries with poor human rights records. The diversity of the economic and political regimes of its members creates natural conflicts over how the Fund ought to operate. We focus here on the idea that IMF conditionality undermines sovereignty in borrowing states by imposing a rigid neoliberal platform that often does more harm than good.

"If a government finds itself in a deep financial crisis, it must sacrifice the country's sovereignty and submit to the IMF's conditions to get a loan. The government must change its 'bad' policies to what the IMF views as 'good' ones".[88] Vreeland captures the spirit of the view that the IMF preys on weak states in order to impose its agenda. Dominated by wealthy countries with a strong interest in maintaining the global capitalist order, the IMF forces less developed ones to accept its ideology in exchange for funding destitute governments.

According to Mussa and Savastano, this strain of criticism towards IMF conditionality is largely fueled by the inability of its programs to create positive outcomes across all

[88]James Vreeland, "The IMF: Lender of Last Resort or Scapegoat?"*Midwest Political Science Association Meeting, Chicago, IL*. 15-17 April 1999: 5.

aspects of an economy at once (e.g. inflation, unemployment, economic growth).[89] Because countries generally seek IMF support amidst crisis or impending crisis, the structural reforms they go through often create large numbers of economic losers, for instance in the mass unemployment in Southeast Asia following the currency crisis there in the late 1990s.[90]The use of conditionality has been criticized for putting in place policies that governments would not implement out of their own self-interest. [91][92] However, the more structurally complex that a program is, the more room there is for a state to deviate from it enough to lose access to funds. On balance, it appears that the usefulness of conditionality (especially structural conditions) may be limited in actually shaping policy in borrowing states.[93]

2.3 The European Union in Crisis-Management

2.3.1 The European Financial Stability Facility

In May of 2010 the finance ministers of the twenty-seven states of the EU agreed to form the European Financial Stability Facility, a special purpose vehicle for managing the debt

[89]Michael Mussa and Miguel Savastano, "The IMF Approach to Economic Stabilization," *NBER Macroeconomics Annual 1999, Volume 14*. MIT, 2000:103.
[90]Nicola Bullard, Walden Bello, and Kamal Mallhotra, "Taming the Tigers: the IMF and the Asian Crisis." *Third World Quarterly* 19 no. 3 (1998): 519-528.
[91] Mary Tsai "Globalization and Conditionality: Two Sides of the Sovereignty Coin." *Law & Policy in International Business,* 31 (1999): 1326.
[92] Catherine Lee, "To Thine Ownself be True: IMF Conditionality and Erosion of Economic Sovereignty in the Asian Financial Crisis," *University of Pennsylvania Journal of International Economic Law* 24 (2003): 877.
[93]Mussa and Savastano, "The IMF Approach to Economic Stabilization," 123.

crisis.[94]"The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to euro area Member States within the framework of a macro-economic adjustment program", according to its website.[95] It was initially granted the right borrow up to €440 billion from the Eurozone's members, and in 2011 this was expanded to €780 billion.[96]

The EFSF is authorized to issue bonds to raise funds for loans to governments, intervene directly in the primary and secondary debt markets, and recapitalize private financial institutions via loans to governments, insofar as these activities are "linked to appropriate conditionality".[97]The EFSF was approved in the national parliaments of its contributors. In 2012 the operations of the EFSF were transferred to the European Stability Mechanism.

2.3.2 The European Stability Mechanism

On October 8 2012 the treaty establishing the ESM was ratified by the seventeen states of the Eurozone, as a "permanent crisis resolution mechanism for the countries of the Euro

[94] "Press Release: Extraordinary Council Meeting," *Council of the European Union*, 9-10 May 2010, accessed 30 May 2014.
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf
[95] "About EFSF," *European Financial Stability Facility*, accessed May 30 2014.
http://www.efsf.europa.eu/about/index.htm
[96] "European Financial Stability Facility," *European Financial Stability Facility*, updated 21 January 2013, accessed 30 May 2014. http://www.efsf.europa.eu/attachments/faq_en.pdf
[97] Ibid.

area", with a lending capacity of €500 billion.[98] It is an international institution governed by international law rather that EU law. It is authorized to perform the same loan and market operations as the EFSF.[99]After the transfer of the EFSF's assets, the ESM manages a total of over €750 billion in assets.[100]

The ESM is managed by a Board of Governors, consisting of the various Eurozone member's Ministers of Finance. Decisions are taken on the basis of qualified majority (80%), with votes weighted according to the contributions of each Governor's member state. There is also a subordinate Board of Directors, with one director per member state, which manages areas delegated to it by the Board of Governors.[101]It has no direct accountability to the European Parliament.

The ESM has faced criticism for both its operational structure and its implications for national sovereignty. Christova notes the lack of an automatic mechanism for waiving obligations to fund fiscally troubled governments. This implies that creditors will generally assume full ESM bailouts of Eurozone governments no matter the condition of their balance sheet, meaning defaults have to be handled on an *ad hoc* basis. Furthermore, the ESM does nothing to alleviate the core problem of excessive debt in extending further credit to insolvent states, and risks taxpayer money in the process.[102] It has also been noted that the ESM was essentially born of path-dependence; while the EFSF proved a

[98] "Frequently Asked Questions on the European Stability Mechanism," *European Stability Mechanism*, updated 8 October 2012, accessed 30 May 2014.
http://www.esm.europa.eu/pdf/FAQ%20ESM%2008102012.pdf
[99] Ibid.
[100] Csaba, "On the New Economic Philosophy of Crisis Management in the European Union," 122.
[101] "Frequently Asked Questions on the European Stability Mechanism."
[102] Alina Christova, "The European Stability Mechanism: Progress or Missed Opportunity?," *Baltic Journal of European Studies,* 1 no. 10, (2011): 55-57.

sub-optimal force for dealing with the worse than expected debt crisis, its institutional design was essentially copied for the ESM because of the immense politically difficulty of gathering support for any alternative.[103]Lastly, the ESM's budget is about five times larger than the total 2014 operating budget of the European Union.[104] This fact, combined with the right of the ESM to capitalize private banks, implies a massive transfer of financial authority to the supranational level of the EU.[105] Small-contribution member states lack control over decisions that could commit their tax-payers to risky funding of insolvent member states. This implies nothing less than a substantial transfer of sovereignty to the ESM.

2.4 Key Differences between the Troika Members

The ECB is a central bank, and the IMF and ESM are international financial institutions,but to some extent their functions in the global economy have overlapped during the financial crisis. Nonetheless, the ECB is a fundamentally different institution from the other two. While they are all potential agents of crisis management and can both operate on capital markets aiming to provide funds to governments lacking other sources of financing, they are working from very different positions. These differences begin to reveal why it may be the nature of the ECB's role in crisis management rather than international sovereign debt financing in itself that may be impinging on the sovereignty of the EU's member states.

[103]Ledina Gocaj and Sophie Meunier, "Time will Tell: the EFSF, the ESM, and the Euro Crisis." *Journal of European Integration*, 35 no. 3, (2013): 248-250.
[104]"Budget 2014 in Figures", *European Commission*, updated 19 February 2014, accessed 31 May 2014. http://ec.europa.eu/budget/figures/2014/2014_en.cfm
[105] László Csaba, "On the New Economic Philosophy of Crisis Management in the European Union," 131.

Firstly, the IMF works from a defined pool of resources. It cannot lend more than it collectsfrom its members and cannot collect funds beyond those generated by their quota systems.The ESM is able to issue debt, but also works from a defined pool of collateral and is thereby limited in its capacity to do so by its need to maintain high ratings on its bonds. The ECB can issue Euros at will and is now ostensibly committed to unlimited support for Eurozone members, meaning it can potentially take steps towards maintaining the currency union at significant expense for the Euro's exchange value. This quasi-lender of last resort status is a critical shift towards an even deeper European economic union.

The second key difference between the institutions lies in the difference between intergovernmentalism and supranationalism. The IMFrelies on a cooperative model with proportional voting based on contributions and "cannot, in broad terms and over a sustained period, pursue policies which the members do not generally approve"[106], and especially cannot ignore the countries providing it with the most substantial portions of its pool of funds. It must be responsive to its members and take their preferences into account to maintain its role as a desirable partner; otherwise members will withdraw from the Fund. The ESM also relies on voting proportional to member state contributions and cannot act against the preferences of the Governors contributing the most in terms of resources. It requires intergovernmental cooperation among the representatives of the member states in order to function, but its operations are nonetheless relatively unaffected by the influence of democratically elected leaders. On the other hand the ECB

[106] Mussa and Savastano, "The IMF Approach to Economic Stabilization," 84.

isat its core a self-governing supranational institution. The Eurozone member states are not proportionately represented nor are representatives expected to pursue the interests of their state. The Bank can pursue and implement policies at odds with national regimes, as the recent case in Karlsruhe indicated. Eurozone member states are not able to exit the currency union without leaving the European Union altogether, meaning the ESM and ECB are able to deviate substantially from national preferences without fear of provoking an exit by any member because of the enormous political and economic costs it would entail.[107]

Lastly, there is a difference in the nature of the agreements underlying the various entities. The IMF isgrounded in the idea of international legal sovereignty; by accepting its Articles of Agreement and paying the quota, a state presumes it will gain from membership and enhance its capacity for economic growth. Likewise, when a state enters into a program with the Fund, it is permitted to negotiate the terms of the agreement and reject them if it is unsatisfied without withdrawing from the Fund altogether. In both cases, sovereignty is maintained via international agreement. The ESM is also grounded in international agreement among representatives of the contributing states and was legitimized by approval in their national parliaments.However, the lack of accountability to the national or European Parliaments means that the ESM still lacks oversight. Despite the intergovernmental character of its origins, it is still an essentially supranational institution run by unelected executives.Its €750 billion in managed assets greatly outweighs the EU's annual budget and constitutes a major shift from the national to the

[107] "Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community (2007): Article 50.

supranational in terms of the distribution of financial authority in the EU. Finally, the ECB has moved away from what was envisioned in Maastricht and expanded its mandate and the scope of its oversight without any new legitimating agreement to justify this[108]. While the Bank's Statute does allow for a high level of independence from the preferences of member state politicians, the fact that the ECB seems to have changed the character of its mandate via its OMT programs renders the original agreement that granted it that independence dubious in terms of validity in the absence of amendment or a new Treaty.

In this chapter, we have examined the Troika's constituent parts. While they have all faced criticism, the European Central Bank is the most exposed to accusations of not operating in a democratically legitimated fashion because of both its statutory independence and its recent moves to expand its mandate. However, the tremendous transfer of financial authority to the ESM means that it has also been vested with a great deal of power over sovereign governments without being fully accountable to them.

[108]Weber and Forschner, "ECB Independence at Risk?," 50.

Chapter 3: Crisis Management in Greece and Hungary

"The sovereign debt crisis in Greece represents a very interesting case in which the Greek government succeeded in transforming domestic fiscal deficit problems, overspending and fear of free market reforms into a European challenge consistent with justifiable concerns about the sustainability of the euro-project and its likely future".[109]

- Anna Visvizi

Greece and Hungary both faced severe economic fallout as a result of the financial crisis. This chapter will examine why this was the case, how the Troika managed the crisis and interacted with the governments, the results of the two rescue programs, and where each of the countries stands today economically.

3.1 Greece

3.1.1 Factors Underlying the Crisis

Despite the frequent linkage of the Greek sovereign debt crisis to the broader financial crisis beginning in 2008, Greece had minimal exposure to the toxic assets that were responsible for the financial turmoil elsewhere.[110] While the broader economic upheaval did play a role in catalyzing Greece's slide into debt crisis, this was also attributable to

[109]Anna Visvizi, "The Crisis in Greece and the EU-IMF Rescue Package: Determinants and Pitfalls," *Acta Oeconomica* 62 no. 1 (2012): 15.
[110] Ibid, 16

weaknesses in the fundamentals of the Greek economy. The government violated the terms of the EU's Stability and Growth Pact every year after 1999, with deficits rising from four to peak at sixteen percent of GDP and debt levels from 94 to 175 percent of GDP and still rising.[111] The EU opened an Excessive Deficit Procedure against Greece in 2004 and then again in 2009 but was unable to compel the government to reign in its spending.[112]Greek sovereign debt continued to mount with increasing rapidity after 2008, and by 2010 the government had virtually lost access to funds in the sovereign debt market, with yields climbing above 20%.[113] Greece's credit rating fell to junk status, and speculation about a potential default spread to the rest of the Eurozone, driving up yield spreads against the German Bund in most of the member states.[114] Greece became the subject of global media attention and criticism of its policy. It faced the worst of the European sovereign default speculation and it ultimately became clear that the government would be forced to actually default or to ask for external assistance.

We also must note the role of Greek political turmoil in driving speculation about its insolvency. PASOK was elected in October 2009 amidst deteriorating economic circumstances and revealed the 2009 deficit was higher than what the previous ND government had claimed. Though the real figure was seen by some as common

[111] "Greece Government Debt to GDP," *Trading Economics*, accessed 21 May, 2014. http://www.tradingeconomics.com/greece/government-debt-to-gdp
[112] "Country Specific Procedures- Greece," *Economic and Financial Affairs*, European Commission. Last updated 17 February, 2014, accessed 21 May, 2014. http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/greece_en.htm
[113] "Greece Government Bond 10Y," *Trading Economics*, accessed 21 May, 2014. http://www.tradingeconomics.com/greece/government-bond-yield
[114] Roberto de Santis, Carlo A. Favero, and Barbara Roffia. "Euro Area Money Demand and International Portfolio Allocation: A Contribution to Assessing Risks to Price Stability." *Journal of International Money and Finance* 32 (2013): 378.

knowledge before the new government took power[115], PASOK's efforts to discredit the previous conservative government brought about an abrupt negative reaction on financial markets and on the part of other Eurozone governments. Greece responded with calls for increased financial regulation to stop speculation rather than addressing its core structural problems. The economic reforms in the updated Hellenic Stability and Growth Program (SP10), involving reduction of the deficit to 3% by 2012 and a general reduction in government debt and approved by Ecofin left markets and rating agencies unconvinced that Greece was moving towards creditworthiness[116]. Speculation about default began to grow beyond what was merited by economic fundamentals, and Greece became trapped in the bad equilibrium described by Buiter and Rahbari[117], forcing it to seek external funding.

3.1.2 The Bailout Packages

Public discussion of an EU rescue plan for Greece began in April of 2010, with Germany insisting that any funding would be contingent upon Greece accepting an austerity package. After some resistance the Greek government accepted the terms and in May the EU, ECB, and IMF accepted a €110 billion rescue package, with €30 billion coming from the IMF in the form of a standby agreement and the rest from a pool of funds collected

[115] Visvizi, "The Crisis in Greece and the EU-IMF Rescue Package," 25.
[116] Ibid, 20-21.
[117] Willem Buiter and Ebrahim Rahbari, "The European Central Bank as Lender of Last Resort for Sovereigns in the Eurozone," 18.

from the other Eurozone states[118]. Fiscal consolidation involved increased VAT and luxury taxes, fuel, cigarettes, alcohol, levies on profitable firms and increased real estate taxes.[119] Expenditure cuts came in the form on pension reductions and cuts to bonuses, and a general decrease in public investment.[120] Structural reforms involved “public administration reforms, labor market and wages reform, pension system reform, healthcare system reform, business environment reform, reforms aimed at promoting investment and exports, as well as reforms aimed at increasing the levels of absorption of structural and cohesion funds”[121]. The package sparked popular unrest across Greece and left many wondering whether austerity was a viable method of overcoming the crisis, particularly given a rapid increase in unemployment and continued declines in production and investment. In the weeks before the agreement, large numbers of citizens in other European countries, especially Germany, voiced opposition to the bailout, with several studies indicating substantial majorities of the German population opposed to supporting Greece.[122][123]Despite the size of the bailout package, investors were largely unconvinced that the funding and assurances of reform would be enough to stabilize the Greek economy, and as bond yields continued to increase in the sovereign debt market, the IMF

[118] Except Slovakia; this was done independently of the EFSF/ESM
[119] “Europe and IMF Agree €110 Billion Financing Plan with Greece,” *IMF Survey Magazine*, 2 May 2010, accessed May 22, 2014. http://www.imf.org/external/pubs/ft/survey/so/2010/car050210a.htm
[120] Manos Matsaganis, "The Welfare State and the Crisis: the Case of Greece,"*Journal of European Social Policy* 21 no.5 (2011): 506.
[121]Visvizi, “The Crisis in Greece and the EU-IMF Rescue Package,” 28.
[122] Nicholas Kulish, ”Opposition Grows in Germany to Bailout in Greece,” *New York Times*, 15 February 2010, accessed 21 May 2014. http://www.nytimes.com/2010/02/16/world/europe/16germany.html?_r=0
[123] Erik Kirschbaum, “Germans Overwhelmingly Oppose Greek Bailout: Poll,” *Reuters*, 26 February 2010, accessed 21 May 2014. http://www.reuters.com/article/2012/02/26/us-eurozone-germany-poll-idUSTRE81P0BW20120226

assumption that Greece would be able to finance its own debt by 2012 became untenable.[124]

In July of 2011 EU leaders met to discuss a second bailout package, acknowledging that the first was insufficient to avoid Greek default. The IMF admitted that the initial program had failed to achieve several of its aims, citing the need for "refining the Fund's lending policy and framework to better accommodate the circumstances of monetary unions"[125] and the unexpected depth of the crisis, but defending its conditions and describing the recession as unavoidable. The Fund found particular difficulty in translating "promises of conditional assistance from partner countries into formal program agreements."[126]In other words, the ambiguity of the commitment Eurozone membership implied proved a hurdle that slowed down the process at the expense of Greece. After further lengthy and tense debates, a new round of funding was agreed to, totaling €130 billion with an IMF contribution of€28 billion. The package also included a reduction in the loan's interest rate to 3.5% from the original 5.5%.[127] A new set of reforms was attached to the funding, with an emphasis on privatization and the sale of government assets rather than the more controversial areas of wage and benefit cuts. The second bailout package was also contingent upon the acceptance of a partial sovereign default for holders of Greek government debt. The vast majority (95.7%) of bondholders accepted the restructuring, reducing the debt obligations of the Greek state by

[124] Visvizi, "The Crisis in Greece and the EU-IMF Rescue Package," 27.
[125] "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-by Arrangement," *International Monetary Fund*, IMF Country Report no. 13/156, June 2013: 2, accessed 22 May, 2014. http://www.imf.org/external/pubs/ft/scr/2013/cr13156.pdf
[126] Ibid, 2.
[127] "Eurozone Finance Ministers Agree Deal on Greece Bailout," *BBC World News*, 27 November 2012, accessed 22 May. http://www.bbc.com/news/business-20506251

approximately €100 billion[128]in the largest default in history.[129] Initially political turmoil within Greece left many fearing that a Greek exit from the Eurozone was imminent and markets remained tumultuous, but by the end of 2012 (after the ECB commitment to unlimited assistance) bond yields had fallen significantly.[130]

3.1.3 The Situation Today

Today the fiscal situation in Greece has begun to stabilize, but Greece retains debt over 170% of GDP.[131]Bond yields have stabilized around six percent, and speculation about a second default or Greek exit from the Euro has dissipated.[132] However, the Eurozone still faces two enormous liabilities: Firstly, the Greek economy remains a shambles. It is unclear how it will reduce its outstanding debt to sustainable levels without a long period of robust growth, which remains a distant prospect in the current EU economic environment. While a recession in Greece was unavoidable given the tremendous structural reforms the economy needed, a prolonged depression willjeopardize provision of healthcare, police services, and other public goods critical to maintaining the standard of living achieved there. Without further reform it could well remain a chronic

[128]JerominZettelmeyer, ChristophTrebesch, and Mitu Gulati, "The Greek Debt Restructuring: an Autopsy." *Economic Policy* 28 no. 75 (2013): 516-517.
[129] Arturo Porzecanski, "Behind the Greek Default and Restructuring of 2012." *Munich Personal RePEc Archive* (2012): 1.
[130] “Greece Government Bond 10Y,” *Trading Economics*, accessed 21 May, 2014. http://www.tradingeconomics.com/greece/government-bond-yield
[131]“Greece Government Debt to GDP,” *Trading Economics*, accessed 21 May, 2014. http://www.tradingeconomics.com/greece/government-debt-to-gdp
[132] “Greece Government Bond 10Y,” *Trading Economics*, accessed 21 May, 2014. http://www.tradingeconomics.com/greece/government-bond-yield

underperformer in the Eurozone indefinitely, dependent on some or all members of the Troika for assistance and unable to regain its competitiveness.

Second, and even more importantly, the EU/ECB have established a precedent that will shape expectations about the handling of future crises. While the sovereign debt market has stabilized across the Eurozone over the last two years, there have not been significant enough changes in EU fiscal regulation to prevent the large deficits that preceded the debt crisis from recurring in the future, nor have austerity measures created a trend towards surplus in any of the major economies. The ECB is likely to see its commitment to unlimited support for Eurozone members tested eventually, possibly with drastic consequences for the value of the currency if one of the larger economies (i.e. Italy) should encounter a similar scenario as what played out in Greece. While the ECB is now ostensibly committed to unbounded funding of the governments of the Eurozone, it is unclear to what extent it can do so before investors lose faith in the solvency of the currency union as a whole. The precedent set in Greece has shown markets that the EU and ECB are committed to maintaining the union, but none of the factors contributing to the onset of crisis in the first place have been sufficiently dealt with to avoid similar crises in the future.

3.2 Hungary

3.2.1 The Hungarian Debt Crisis

Hungary has long been at odds with the EU over its public finances. It is unusual among the Eastern Expansion countries for its very large state sector and high welfare spending, as well as its (closely related) high levels of sovereign debt.[133] In 2007, it held public debt equivalent to 65.7% of GDP[134], substantially less than in Greece but not by enough to be considered categorically different[135]. Benczes attributes Hungary's weak fiscal position to strong public expectations of compensation for its economic losers after its transition from communism, making structural reform of the economy impossible from a political standpoint.[136] Similar to the case in Greece, Hungary provoked the corrective arm of the SGP and spent nine years (2004-2013) under an Excessive Deficit Procedure, and politicians failed to institute more stringent policy in the run-up to the crisis.[137]

Hungary saw the yields on its government debt and its total debt holdings spike after the financial crisis began in 2008, further sapping its already weak public finances.[138][139] This was due in part to increased speculation about default but was also exacerbated by Hungary's position as a very open economy[140] dependent on foreign financing and

[133] István Benczes, "Market Reform and Fiscal Laxity in Communist and Post-Communist Hungary: A Path-Dependent Approach," *International Journal of Emerging Markets* 6 no. 2 (2011): 119-120.
[134] "Hungary Government Bond 10Y," *Trading Economics*, accessed May 31, 2014. http://www.tradingeconomics.com/hungary/government-bond-yield
[135] "Greece Government Debt to GDP," *Trading Economics*, accessed 21 May, 2014. http://www.tradingeconomics.com/greece/government-debt-to-gdp

[136] Benczes, "Market Reform and Fiscal Laxity in Communist and Post-Communist Hungary: A Path-Dependent Approach,"128.
[137] "Country Specific Procedures- Hungary," *Economic and Financial Affairs*, European Commission. Last updated 17 February, 2014, accessed 23 May, 2014. http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/hungary_en.htm
[138] "Hungary Government Debt to GDP," *Trading Economics*, accessed May 31, 2014. http://www.tradingeconomics.com/hungary/government-debt-to-gdp
[139] "Hungary Government Bond 10Y," *Trading Economics*, accessed May 31, 2014. http://www.tradingeconomics.com/hungary/government-bond-yield
[140] "Share of International Trade in GDP," *OECD Factbook 2014*: *Economic, Environmental and Social Statistics*, OECD Publishing. http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-factbook-2014/share-of-international-trade-in-gdp_factbook-2014-29-en#page4

markets[141], making it highly vulnerable to turmoil in the global macroeconomy. In its report on the necessity of IMF intervention, the Fund noted that "with the decline in global liquidity and increase in risk aversion, financial markets in Hungary came under intense pressure, given Hungary's high debt levels and significant balance sheet mismatches. Several government bond auctions failed, liquidity in the secondary bond market dried up, and bond yields rose sharply".[142] The forint was also subject to speculative attacks and lost substantial value against the Euro, worsening Hungary's financial position.[143] The government was left nearly bankrupt and was forced to seek external assistance.

3.2.2 IMF/EU Loan

In November of 2008, the Hungarian government quickly negotiated[144] a loan with the IMF for €12.3 billion, in combination with €6.5 billion in EU funding and a further €1 billion from the World Bank.[145] The IMF took the lead in the Troika because of its experience with conditionality and ability to work much faster than the EU.[146] The primary goals of the IMF were to push Hungary towards fast and substantial consolidation of its fiscal position in order to restore market confidence and liquidity

[141] Andreas Nölke and Arjan Vliegenthart, "Enlarging the Varieties of capitalism: the Emergence of Dependent Market Economies in East Central Europe." *World Politics* 61 no. 4 (2009): 673-685.
[142] "IMF Executive Board Approves €12.3 Billion Stand-By Arrangement for Hungary," *International Monetary Fund*, Press Release no. 08/275, 6 November 2008, accessed 23 May 2014. http://www.imf.org/external/np/sec/pr/2008/pr08275.htm
[143] László Csaba, "Growth, Crisis Management and the EU: The Hungarian Trilemma." *Südosteuropa Mitteilungen* 03-04 (2013): 162-163.
[144] The process taking only five days
[145][145] "IMF Executive Board Approves €12.3 Billion Stand-By Arrangement for Hungary," *International Monetary Fund.*
[146] Péter Ákos Bod, "The IMF, the EU and the Sovereign Borrower: the Case of Hungary 2008-2010." *Club of Economics in Miskolc TMP*, 6, no. 2, (2010): 4.

support and recapitalization of its banks to prevent internal bankruptcy during the crisis.[147] The IMF program envisioned a structural fiscal adjustment of 2.5% of GDP, emphasizing the broad reduction of government expenditure and the scaling back of the large state sector. The program also emphasized adherence to the EU's fiscal framework to create long-term positive change in government spending.[148][149] Markets reacted positively to the news at first, but as it became clear that 2009 would be a year of much sharper economic contraction than initially expected, Hungary was forced to ask the IMF for a waiver on its deficit commitments.[150]

3.2.3 Post-Election Period

After the 2010 elections and the installation of the Orban government, Hungary ignored the fiscal framework and sent mixed signals to the market on its budgetary discipline. It scrapped structural reform measures and imposed some new taxes but these did little to decrease the debt level. The government also took steps to limit the power of some of its institutions, sacking the Fiscal Council's staff and effectively ridding it of its independence.Bond yields increased and the government's debt was downgraded.[151] In its review of the loan's effectiveness, the IMF noted that "although the program was able to deliver a considerable fiscal adjustment, much of the structural fiscal adjustment has

[147]"Hungary: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement," *International Monetary Fund*, Country Report no. 11/145, June 2011, accessed 23 May 2014. http://www.imf.org/external/pubs/ft/scr/2011/cr11145.pdf
[148]Ibid, 3.
[149] Kopits, "Can Fiscal Sovereignty be Reconciled with Fiscal Discipline?," 158.
[150] "Hungary: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement," 19.
[151] Kopits, "Can Fiscal Sovereignty be Reconciled with Fiscal Discipline?," 155-158.

since been reversed".[152] In June of 2010 the Orban government expelled the IMF from Hungary and suspended its SBA over disagreement about additional fiscal measures.[153] With the withdrawal of external support and the further deterioration of the situation in Greece, speculation about weakness on the European periphery mounted and Hungary saw its economic position worsen, with capital flight and a devaluation of the forint taking a toll on the economy. The Orban government resumed negotiations with the IMF in November of 2011, calming investors despite the lack of a clear strategy. Though negotiations failed to come together into anything of real substance, over the next several months this became essentially irrelevant as Hungarian bonds began to command higher prices than for a number of the Eurozone countries.[154] The incentive to seek external financing diminished, and the IMF withdrew from negotiations in July of 2012, with Hungary capable of fulfilling its own needs despite continued breakdowns elsewhere. The Hungarian balance sheet has continued to improve, with debt-to-GDP and deficit levels below EU averages.[155] Despite the ECB's pledge of unlimited support for the Eurozone, Hungarian bonds continue to trade under their Greek counterparts.[156] The EU finally withdrew its Excessive Debt Procedure against Hungary in 2013.[157]

While the core economic problems precipitating crisis in Greece and Hungary (debt, deficits, overdue structural reforms) differed only to a certain degree, and both countries saw new governments elected partly on efforts to discredit the fiscal policy of the ones

[152] "Hungary: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement," 3.
[153] Ibid, 3
[154] Csaba, "Growth, Crisis Management, and the EU," 163.
[155]Ibid, 163.
[156] Ibid, 163.
[157] "Country Specific Procedures- Hungary," European Commission.

preceding them, the crisis had dramatically different effects.Part of the success of the Hungarian package and failure of the Greek bailouts was the relative speed and efficiency at which an IMF-led program can operate in comparison to an EU-led one. Hungary has essentially re-stabilized despite receiving only a fraction of the funding Greece did, while it remains unclear in Athens how Greece will ever regain its economic vitality.

Chapter 4: Implications for Sovereignty and the Democratic Deficit

Having examined the idea of sovereignty itself, the architecture of the ECB and IMF, and their actions in Greece and Hungary, we now turn to the implications of crisis management for national sovereignty in the Eurozone. Understanding the effects of crisis management on sovereignty is critical to understanding the shape of the Eurozone as both an economic and political entity, and for assessing its direction and viability on both fronts. Without strong crisis-management actions, the currency union may well have not survived the last financial crisis, and may not survive the next. On the other hand, the rebalancing of authority at the supranational level that has occurred has the potential to undermine the democratic legitimacy of the entire project. Beginning with an argument about why it is not external financing itself that jeopardizes sovereignty, we turn to a dilemma of sovereignty that will inevitably present itself in the event of a second major debt crisis and close with a position on why the ECB's commitment to unlimited support has infringed on national sovereignty and deepened the democratic deficit,

4.1 Conditionality, Sovereignty, and the ECB

The relationship between conditionality and sovereignty has been explored by a number of academics, particularly in the wake of IMF intervention in the Latin American and Southeast Asian financial crises. Critics of the IMF programs there hold that state sovereignty was compromised by the IMF and that it did not achieve its objectives, citing the Fund's ineffectiveness in preventing protracted depression in several states involved in the crises.[158] Lee insists that the IMF is dominated by industrialized states that are insensitive to the needs of the third world and have used it to undermine state authority for their own ends.[159]

However, this line of reasoning misses an important point about the structure of the Fund. As Galano finds in his paper on IMF conditionality and Brazilian sovereignty, "the IMF is not only authorized to, but it must impose specific macroeconomic targets, through its austerity programs and resulting conditionality policies".[160] As long as it does not violate its Articles of Agreement, the Fund cannot be said to have violated the sovereignty of its members.[161] In fact, the reverse situation of making funds available to governments without any conditions attached could itself be seen as a violation of sovereignty in this sense, as it would jeopardize the contributions of the IMF's members beyond the terms they had agreed to. As Fischer argues in his work supporting IMF crisis management methods, "there is neither point nor excuse for the international community to provide

[158] Tsai "Globalization and Conditionality," 1326.
[159] Lee, "To Thine Ownself be True," 878.
[160] Anthony Galano, "International Monetary Fund Response to the Brazilian Debt Crisis: Whether the Effects of Conditionality Have Undermined Brazil's National Sovereignty," *Pace International Law Review*, 6 (1994): 347.
[161] Relying on Krasner's conception of international legal sovereignty

financial assistance to a country unless that country takes measures to prevent future such crises. That is the fundamental reason for the inclusion of structural measures in Fund-supported programs".[162] The IMF cannot guarantee the success of its actions, but it does offer a clear set of principles guiding its actions and a defined commitment from its members (the quota system).

The Hungarian case illustrates that the IMF cannot force its conditions on a state unable or unwilling to meet them, reaffirming Mussa and Savastano's finding that the extent to which the Fund can actually create lasting policy change in creditor countries is limited.[163] While structural reforms and lower deficits were agreed to early on, the unexpected severity of the crisis meant that the IMF had to remain flexible in its expectations for 2009, allowing the Hungarian deficit to expand substantially without seeking countermeasures. After the Orban government came to power in 2010, the fiscal framework that had been agreed to was ignored. While this did produce consequences in terms of Hungary's bond yields and credit rating, the government was not constrained from exercising its authority. After some time, it has managed to move towards a more sustainable fiscal position through its own measures, independent of the IMF. Taking this information into consideration, it cannot be argued that there is an inherent compromise of state sovereignty bound up with conditionality. Though conditionality does by nature reduce state authority, in cases in which conditions are agreed to and implemented in accordance with principles that the parties involved have agreed to, under the assumption

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[162]Stanley Fischer, "The IMF and the Asian crisis." *International Monetary Fund*, 1998, accessed May 24, 2014:
pg. 12. http://www.petersoninstitute.org/fischer/pdf/Fischer136.pdf
[163]Mussa and Savastano, "The IMF Approach to Economic Stabilization," 123.

that the borrowing state's economic situation will be enhanced, (and thus its domestic sovereignty) there can be no violation of sovereignty, regardless of the actual economic outcomes. Thus it is not the idea of conditionality in itself that creates potential for infringement on national sovereign authority in the Eurozone. It is how the European Central Bank has handled the financial crisis.

The fact that the ECB has started buying sovereign debt to bring down bond yields, taken over as bank supervisor for the Eurozone's core banks, and given a guarantee to provide unlimited support to governments to preserve the currency unionhave led to serious questioning of whether it can still be called independent. Furthermore, personnel independence has been jeopardized by Nikolas Sarkozy's push for a French person to sit on the Executive Board[164], and by the general politicization of the ECB along north-south lines. The politicization of the bailouts and the general rift between creditor and debtor economies has created has weakened the legitimacy of all crisis management efforts. The often-shortsighted objectives of EU politicians and the long-run view of central bankers have collided to create a muddled and conflicted policy approach. Additionally, the second mandate of unlimited support is difficult to reconcile with the original one of price stability, and it is unclear which goal will receive priority or what that will mean for troubled national economies in the future. There have also been a number of national objections raised during the crisis, most importantly Germany's refusal to countenance OMTs. Thus, the ECB and its operations enjoy little of the validation in terms of international legal agreement that an institution like the IMF does. Krasner's shared sovereignty does not extend to situations in which the legitimacy of the agreement

[164] Weber and Forschner, "ECB Independence at Risk?," 49.

underlying sovereignty's transfer is in question. While all Eurozone members did agree to the founding of the Bank in the Maastricht Treaty it is becoming unclear how much more change, if any, that the Bank can make before these agreements lose their legitimating power. The ECB has empowered itself in such a way that decreases the actual scope of national sovereignty.

The ESM has also been vested with a tremendous amount of authority without a clear framework to guide its operations. While it does enjoy more legitimacy in terms of international agreement than the ECB's crisis-resolution efforts have, a second crisis will create a dilemma for the ESM and ECB which will inevitably infringe further on state sovereignty.

4.2 The Sovereign's Dilemma in a Second Crisis

A second sovereign debt crisis remains a strong possibility for the Eurozone. The collective balance sheet of the currency union remains weaker than before 2008, and growth sufficient to reverse this remains a distant prospect for the time being. While bond yields across the Eurozone have fallen and begun to re-converge on the German Bund, substantial differentials persist, particularly in heavily indebted Greece, Portugal, Italy, and Ireland.[165] These differentials indicate that investors have not interpreted the ECB's statement on its "unlimited support" as indicating true total Eurozone commitment to member state solvency, as default risk remains unevenly distributed. If investors should

[165] "Bonds and Yields," *Financial Times,* last updated May 30, 2014, accessed May 30, 2014. http://markets.ft.com/RESEARCH/Markets/Government-Bond-Spreads

again become panicked about a potential default and spreads should start to widen again, as in the previous debt crisis, the EU will be placed in a difficult position. The IMF alone will not be able to provide enough resources to overcome a crisis comparable to the last one, meaning the ECB and the ESM will have to either coordinate a response together or act alone to prevent deepening turmoil. The ECB could rely on Outright Monetary Transactions to assist troubled states, and/or the European Stability Mechanism could be used to provide liquidity and support. Both options have powerful implications for national fiscal sovereignty in the currency union.

Action by the ECB in the form of OMTs could manage to prevent another protracted debt crisis if markets reacted well. As an independent institution, the ECB would be able to act fairly quickly to suppress an impending crisis. Assuming whatever conditions the Bank expected of the beneficiary state(s) could be negotiated expediently, OMTs might prove a far more effective tool for preventing full-scale crisis than large, slowly negotiated bailout package(s). However, if the ECB were to begin to act totally independently of the EU's heads of state to manage the Eurozone sovereign debt market, it would imply a significant transfer of fiscal authority to the supranational level, beyond that which has already occurred. While the ECB has already engaged in bond buying, it was an *ad hoc* solution arrived at mid-crisis. Without the backing of a new EU Treaty to legitimize the ECB's commitment and to specify the point at which it should start to intervene in debt markets again and what sort of conditionality should be attached to OMTs, the national governments of the Eurozone will not be in charge of their own fates in terms of how the currency union functions. It is only at this point of relative calm that an accord might be reached with the legitimizing force of international legal sovereignty to validate the transfer of authority. After the German objection to the use of OMTs, it is unclear how much they and the other creditor economies would be willing to tolerate in terms of support without a significant political or popular backlash.

On the other hand, if debt crisis should begin to reappear and the EU handles it through the ESM, proceeding in the same fashion as the Greek and other bailouts and seeking the consensus of national representatives before moving forward, it is unlikely to be able to agree on a solution fast enough to circumvent a severe economic fallout in the debtor country or countries. The inability of the EU to reach a quick decision in the Greek case clearly took its toll on the Greek economy, fomented further speculation, and meant that by the time the first bailout package was agreed to, it was insufficient to serve its purpose. It took nearly two more years for a second package to be negotiated, by which point the Greek economy had again deteriorated further, as had the government's capacity to provide public goods. It is clear that real negotiation at the intergovernmental level could not possibly move fast enough to circumvent a breakdown in Greece's domestic sovereignty. Of course, the substantial decline in the Greek state's capacity to govern is attributable to bothits own fiscal profligacy and the slowly negotiated response to speculation about a default, but the ambiguity and slowness of crisis management (and the resulting costs due to speculation) seems to have done more damage than its economic fundamentals themselves, as the very different results in the Hungarian case indicated. In the end Greece gave up far more in terms of its fiscal sovereignty than did

Hungary, with a worse economic outcome.[166] Extended intergovernmental negotiations in a financial crisis will inevitably lead to a worsening of the situation and mean more is demanded of both creditor and debtor countries in terms of funds and conditions, respectively. It is clear from the Greek case that slow, politicized decision making about managing crisis in the currency union cannot prevent loss of domestic sovereignty in states receiving bailout funding. The very ambiguity of the respective roles of the ECB and the ESM and their willingness to assist troubled Eurozone members in the event of the next crisis will only feed speculation should the prospect of default appear on the horizon again. Without a clear operating framework to guide when it issues liquidity support or bank recapitalization credit, the ESM's behavior will remain unpredictable and subject to speculation that will damage national government's operating capacity and domestic sovereignty.

Therefore, there is an inevitable dilemma of sovereignty lurking in the next Eurozone financial crisis. Either the ECB must be relied on to calm markets from the supranational level without a clear political mandate to do so from national governments, or an intergovernmental ESM solution must be reached at the likely expense of the governing capacity of the recipient government(s). Without a clear agreement on the respective roles of the ECB OMT program and ESM, member state sovereignty will remain caught between two powerful forces of crisis management, the use of either of which will have critical implications for the authority of the currency union's member states. The essential pact on which the EU rests in terms of sovereignty, the sacrifice of Westphalian

[166] Indeed, the Greek case is one of only four in modern history which Kopits judges to constitute a true loss of fiscal sovereignty (Kopits, 143).

sovereignty in exchange for a presumed improvement in domestic sovereignty, legitimated by international agreement, could be undermined.

4.3 OMTs, the ESM, and the Democratic Deficit

The ECB's new role as a quasi-lender of last has come without the clear endorsement of national leaders and lacks the force of international legal agreement. It also lacks the legitimacy of democratic support, even though the decision could potentially have major economic repercussions for every single user of the Euro. Likewise, the tremendous amount of financial authority vested in the ESM rests in the hands of unelected executives with the capacity to commit taxpayer money to risky operations in an unaccountable fashion.

Even as the Eurozone slowly moves towards recovery, it is clear that Euroskepticism is far from a minor fringe ideology in the European Union, as recent EU Parliamentary elections have indicated. If OMTs should create inflationary pressures or another enormous bailout package be required of a profligate government through the ESM, it could readily provoke a powerful democratic backlash, jeopardizing the legitimacy of the entire currency union. Majone's argument that the authority of an institution like the ECB is legitimized by delegation of powers by national politicians falls short in the face of a new and unforeseen approach to crisis management by way of the OMT. An institution that does not operate within a clearly defined and endorsed legal framework can hardly be called a regulatory entity.

Likewise, Moravcsik's intergovernmentalist argument against the democratic deficit's existence does not account for the modern ECB. While it was the product of intergovernmental consensus, its role in crisis-management has changed the Bank significantly enough that it can no longer be considered an institution identical to the one conceived of at Maastricht. Furthermore, the idea that the EU's system of checks and balances is enough to keep its institutions democratically accountable also falls short in reference to both the ESM and ECB, which have left themselves significant scope for taking autonomous action, particularly through vague statements on when, how and to what extent they will take action. The ECB's pledge of unlimited support has the potential to expose the various nations of Europe to losses in the bond market or inflationary pressures, or both, without the consensus among elected state representatives that intergovernmentalism implies.

While it is natural for a central bank to maintain substantial distance from voters in the currency area it is responsible for, the European Central Bank has contributed to the democratic deficit in Europe. By expanding its mandate to become a quasi-lender of last resort without the clear consensus-based endorsement of democratically elected national leaders in an open setting, it has become a qualitatively different institution. Without an agreement validating them as an instrument or a clear framework guiding their employment, it is hard to see how OMTs can be used in either an accountable or a predictable fashion. ECB bond buying could help to avoid a second debt crisis, but also may overextend the currency union's money supply, creating inflationary pressures across the Eurozone and generating price instability, which the Bank is very clearly statutorily bound to avoid. While the ESM has more of Moravcsik's intergovernmental legitimation, its presence nonetheless constitutes a transfer of power further away from the Eurozone's electorate. As a result of the transfer of tremendous national resources to the supranational level, Eurozone citizens are even further removed from control over where their tax contributions are sent. This constitutes an undeniable contribution to the EU's democratic deficit.

Conclusion

Crisis-management efforts to maintain the currency union have undermined national sovereignty and contributed to the democratic deficit. Working from Krasner's three-part conception of sovereignty, we find that the authority assumed by supranational structures in managing the crisis is not fully legitimized by the force of international legal agreement and thus does not constitute any sort of shared sovereignty compact. This is most true of the ECB's expanding scope of operations, namely OMTs and bank oversight, which lack a basis in its founding agreement and have arguably undermined the original terms of its statute, particularly its commitment to price stability and independence. The ESM has a deeper basis in international agreement but has nonetheless been vested with a vast amount of resources without being fully accountable to the states and taxpayers contributing them, limiting the power of Eurozone nations to control their own economic fates. Its inability to fully define the framework guiding its operations will likely lead to protracted debate and controversy in the event of another crisis at the further expense of national sovereignty. The IMF's capacity to infringe on national sovereignty is much more limited, as the Hungarian case reveals. This is due to both its compatibility with international legal sovereignty and its capacity to conduct its operations in a relatively forthright and expedient fashion. On the other hand the loss of fiscal sovereignty in Greece despite the scale of rescue operations there and the restrictive burden this imposed on the rest of the Eurozone's national governments implies that EU-led crisis management efforts are unable to guarantee sovereignty's security in their operations, for either creditor or debtor economies.

The ECB and ESM have both also contributed to the EU's democratic deficit. The financial crisis has greatly increased the power of the ECB and led to the creation of the ESM, both of which entities lie far removed from the control of Europe's voters. The ECB's commitment to unlimited member state support could have tremendous impact on everyone using the Euro in terms of purchasing power, and the ESM's operations require the commitment of taxpayer money to an unaccountable supranational body. The question of whether or not the Eurozone is a currency union involving the full commitment of its member states to one another's solvency is still yet to be clearly answered; however, it appears as though that answer is increasingly likely to come not from citizens or even their national governments but from unelected, unaccountable executives in the ECB and ESM. The democratic legitimacy of the European integration project has taken a major step back as a result of the way in which the first major financial crisis the currency union has faced has been handled.

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