Abstract

More than five years from the outbreak of the global financial crisis, the paper addresses two issues: how poor regulation has contributed to its origination, and how current regulatory responses to the crisis are (not) differing from the poor regulation that caused it.

In the first part, the paper offers an overview of the most relevant examples of poor regulation that have arguably played a role in determining the crisis, with a focus on the US and the EU: from the institutional design of central banks (that influences the type of monetary policy they implement), to the rules at the basis of fractional reserve banking (a source of great systemic instability, according to the perspective adopted in the paper); from the prescriptions in the Basel Accords I and II (that strongly encouraged banks to invest in the "wrong" assets), to the several policies adopted by the US authorities to encourage the purchase of a house by American

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households (resulted in a bubble whose burst triggered the global financial turmoil); from the regulatory requirements entrenching the oligopoly of credit rating agencies (more competition might have meant improved overall rating abilities), to the deposit insurance schemes (a source of great moral hazard and financial irresponsibility of consumers); from some shortcomings that can be identified in the way the institutions of the EU and of the Eurozone were designed (a major source of the current turmoil in this area), to the policies making the size of government grow, resulting in an increase of spending, taxation, deficit and public debt (something highly unhealthy for the economy from the perspective adopted in the paper), to some features of "regulation" narrowly meant (at best, an obstacle to the proper functioning of the markets). The concluding paragraph explains how all these failures might have led to the crisis, and reflects on what lessons can be derived from the inquiry made, what would be appropriate responses from legislators and regulators, and what mistakes it should be wise to avoid repeating: in particular, it is argued that definitely not more, but less regulation (and government intervention in general) is needed.

In the second part, the lessons summarized in the former one are contrasted with the actual legislative and regulatory responses adopted by the US and the EU: from the changes in central banking (that not only have fallen short of reducing the power of central banks to manipulate money, but have instead entrusted these institutions with even more power), to (non-existent) changes in fractional reserve banking (that unfortunately has not been subject to any rethinking in the mainstream thought);
from the rules of Basel III (that do not seem to be truly capturing what went wrong with its two predecessors), to the still ongoing distortions of the real estate sector (GSEs were eventually bailed out and not surprisingly subprime mortgages seem to have resumed); from the legislative proposals in the field of credit rating agencies (that go as far as proposing the establishment of a public European-wide credit rating agency), to the EU agreement to set up a common deposit-insurance scheme (that will probably encourage consumers' recklessness to an even greater extent than national schemes); from the many attempts to fine-tune the European architecture (that do not seem bound to remedy the identified pre-crisis shortcomings), to the many decisions further increasing spending, taxation, deficit and public debt (thus putting recovery at stake), to the new flood of "regulation" (narrowly meant) that has struck the markets (all but helping them to restore their ordinary functioning). The final paragraph offers some reflections on what is the role that law and regulation should instead play in financial markets, and argues that it should be confined to a set of clear, broad and general principles, giving up the idea of pre-determining the outcome of the competitive game, but simply dictating its rules, in the spirit of Hayek's lesson in the first volume of *Law, Legislation and Liberty*. 
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I. POOR REGULATION IN PLACE WHEN THE CRISIS HIT: ERRARE HUMANUM EST

From a certain respect, this is an impossible article: as was effectively written, "[w]ith the exception of health care, financial services is the most highly regulated industry in America (and, generally speaking, in all developed countries)". Because the forms of regulatory interference with the ordinate flow of financial markets are so incredibly numerous, dealing extensively with all of them would require much more than a paper. Hopefully, a similar endeavour might be attempted in the future.

Our more modest, but more manageable goal in this article is therefore trying to give an overview of the main examples of (poor) financial regulation that, according to the view subscribed to in here, have contributed to originating the crisis, and are now

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3 Essentially, it is the position of the so called Austrian school of economics, that offers a consistent reading of the past crises and the current one, looking at them as the inevitable "busts" that follow a period of artificial "boom" in the economic cycle, generated by different forms of government intervention and stimulus. Among several scholars of the past and present times that hold "Austrian" views, the French economist Pascal Salin is the one to which this work is particularly indebted: see in particular his book Revenir au capitalisme... pour éviter les crises (Odile Jacob, Paris 2009), surprisingly (and unfortunately) not (yet) translated into English (the literal translation of the title is: Coming back to capitalism... in order to avoid crises). Among the books in English, see in particular Harry C. Veryser, It Didn't Have to be This Way: Why Boom and Bust is Unnecessary—and How the Austrian School of Economics Breaks the Cycle (ISI Books, Wilmington 2013); Philipp Bagus, The Tragedy of the Euro (Ludwig von Mises Institute, Auburn 2012 [2010]); David Beckworth (ed.), Boom and Bust Banking. The Causes and Cures of the Great Recession (The Independent Institute, Oakland 2012); Johan Norberg, Financial Fiasco: How America's Infatuation with Home Ownership and Easy Money Created the Economic Crisis (Cato Institute, Washington DC 2012); several essays in Jeffrey Friedman (ed.), What Caused the Financial Crisis? (University of Pennsylvania Press, Philadelphia 2011) and the book by the same Jeffrey Friedman and Wladimir Kraus, Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation...
contributing to making it worse.

Our focus is on the US and on the EU (mostly the Eurozone); because of their typical soft-law nature, regulatory efforts at the global level are generally left out of the analysis, except for some instances (in particular, the Basel Accord rules), that were implemented by national or EU (hard) law or regulation and have had a major impact on our topic.

Our attempt is to provide a unitary reading of the regulatory sources of the crisis: obviously, the areas considered have rather different legal systems, and more importantly, as we shall see, the path that led them to their respective crises was quite different. However, we are persuaded that it is possible to identify an underlying unitary thread in the long series of regulatory failures that has been afflicting both the US and Europe, and that is arguably responsible for the financial turmoil that both

have been experiencing.

In this first Part, we review what we believe are the most significant pre-crisis regulatory failures: from central banking and its paraphernalia to fractional reserve banking, from the Basel Accords to the housing market policies adopted in the US, from the rules governing the activity of credit rating agencies to the ones establishing deposit insurance schemes, from some shortcomings in the European institutional engineering to the policies making the size of government grow (and therefore increasing the amount of spending, taxation, deficit and sovereign debt), to some features of "regulation" narrowly meant.

We conclude by trying to explain how all these failures might have led to the crisis, and what lessons we can derive from this inquiry. Our bottom-line is that too much regulation, not too little, was the problem.

In Part II, we move on to a summary of the most relevant regulatory responses to the crisis in the same areas considered under Part I: in the final paragraph, we then contrast such responses with the lessons drawn in Part I: our conclusion is that legislators and financial regulators all over the US and Europe are persisting in the same mistakes made before the crisis.

We read what they have been doing through the lens of Friedrich von Hayek's reflections on law in Rules and Order, the first volume of his Law, Legislation and Liberty: we find indeed a great predominance of what Hayek termed as the "law of legislation" over what he described as the "law of liberty", and identify this as the
primary explanation of why the conspicuous efforts made by legislators and regulators to constrain the markets have been quite unsuccessful in restoring growth, stability and confidence.

Before starting our analysis, one caveat is needed: in this article, we take the word "regulation" in its broadest meaning, essentially as a synonym of government intervention in the economy. Some would argue that this is too broad a meaning, but in our view every way the government interferes with the market, from taxation to public monopolies, can appropriately be conceptualized and described as a way to direct the market, to steer it, to lead it towards a desired outcome, to limit it, to redress it: in one word, indeed, to regulate it.

I.A. THE MANIPULATION OF MONEY BY PUBLIC AUTHORITIES: CENTRAL BANKING

We believe that all the aspects that we have chosen to consider are crucial in explaining how regulatory interference undermined the creation of a healthy spontaneous order⁴ in the markets. But undoubtedly the most important aspect of all is the role played by central banking and its "manipulation" of money⁵.

By central banking we refer to the existence of government-appointed institutions

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⁴ For an inquiry into the history of this notion, that was elaborated by several authors over the centuries, one of the most prominent of which is Friedrich von Hayek, see Nigel Ashford, Spontaneous Order. Freedom Creates Order in Society, 49(7) The Freeman (1999), available at http://www.thefreemanonline.org/features/spontaneous-order.

that are granted the monopoly over the issuance of money, on its turn sanctioned by the rules forbidding any other private entity to issue its own competing currency\(^6\), and sometimes – as was the case in the US in 1930s\(^7\) – even outlawing gold payment clauses in contracts\(^7\) and gold possession by private individuals\(^8\) (both such policies were discontinued later\(^9\), but their effect could not be undone, and by that time fiduciary money had prevailed). Having the monopoly over money, central banks have the widely discretionary power to decide how much of this money to issue, thus determining the level of the money supply circulating in a certain country (monetary policy). And coherently with the fact that the currency created by central banks is the only form of "legal" money, such money is then typically declared to be legal tender, that is to say creditors cannot lawfully refuse payment in that currency, and taxes

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6 In the US, this is the result of An Act to authorize Payments in Stamps and to prohibit Circulation of Notes of less Denomination than One Dollar (37th Congress, Sess. II, Ch. 196, 12 Stat. 592, July 17, 1862), whose s. 2 stipulated that "no private corporation, banking association, firm or individual shall make, issue, circulate or pay any note, check, memorandum, token or other obligation, for a sum less than $1, intended to circulate as money or to be received or used in lieu of lawful money of the United States".

7 This was done by the Gold Repeal Joint Resolution (Joint Resolution to assure uniform value to the coins and currencies of the United States (73rd Congress, Session I, Ch. 48, Pub. Res. No. 10, 48 Stat. 112, June 5, 1933).

8 This is what was done with the Executive Order 6102, Requiring Gold Coin, Gold Bullion and Gold Certificates to Be Delivered to the Government, issued on the 5th of April 1933 by President Franklin Delano Roosevelt: it "prohibit[ed] the hoarding of gold coin, gold bullion, and gold certificates within the continental United States by individuals, partnerships, associations and corporations". Roosevelt's Executive Order was overcome by the even stricter Gold Reserve Act of 1934 (An Act To protect the currency system of the United States, to provide for the better use of the monetary gold stock of the United States, and for other purposes, Pub.L. 73-87, 48 Stat. 337, January 30, 1934); see Henry Mark Holzer, How Americans Lost Their Right To Own Gold And Became Criminals in the Process, available at http://www.fame.org/pdf/Holzer%20Henry%20Mark%20How%20Americans%20Lost%20Their%20Right%20to%20Own%20Gold.pdf.

9 Respectively by An Act To authorize the Secretary of the Treasury to invest public moneys, and for other purposes (Pub. L. 95-147, 91 Stat. 1227, 1229, Oct. 28, 1977, s. 4(c), originally codified under 31 USC 463, recodified as amended under 31 USC 5118(d)(2)), and by An Act to provide for increased participation by the United States in the International Development Association and to permit United States citizens to purchase, hold, sell, or otherwise deal with gold in the United States or abroad Pub. L.
must be paid using that currency.\textsuperscript{10}

The desirability and legitimacy of a system of central banking has been the subject of considerable debate. In our perspective, monetary policy is an extremely dangerous tool in the hands of those who handle it, and should be rejected – from a theoretical point of view – as should any form of government monopoly. Very simply, the objection to government monopolies derives from the trust in the competitive process to better serve the consumers' needs.

As for any other good – money, indeed, is a good\textsuperscript{11} –, money production should be better left to the cares of different competing issuers, which would likely result in sounder and more stable money, as it happened during the centuries before its progressive corruption\textsuperscript{12} and the rise of central banking\textsuperscript{13}.

\textsuperscript{93-373, 88 Stat. 445, August 14, 1974.}\textsuperscript{10} See for instance, in the US, s. 102 of the Coinage Act of 1965 (An Act To provide for the coinage of the United States, Pub.L. 89-91, 79 Stat. 254, July 23, 1965), a provision now slightly amended and codified in 31 USC 5103, with the following text: "United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) are legal tender for all debts, public charges, taxes, and dues. Foreign gold or silver coins are not legal tender for debts". In the Eurozone, see Article 128 TFEU, and Article 10 of Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro, OJ EC 11.5.98, L 139/1: "As from 1 January 2002, the ECB and the central banks of the participating Member States shall put into circulation banknotes denominated in euro. These banknotes denominated in euro shall be the only banknotes which have the status of legal tender in all these Member States"; Art. 10 is then complemented by national rules establishing the prohibition for creditors to refuse payments in legal tender currency: for instance, in Italy see Art. 1277, § 1 of the civil code ("Pecuniary obligations shall be paid off with currency having legal tender in the State at the time of the payment and at its face value").\textsuperscript{11} Ludwig von Mises, The Theory of Money and Credit (Yale University Press, New Haven 1953 [1912]), especially Part One (The Nature of Money), pp. 29-94, and in particular Chapter V (Money as an Economic Good), pp. 79-90; see also the fundamental studies by Carl Menger, Principles of Economics (Ludwig von Mises Institute, Auburn 2007 [1871]), especially Chapter VIII (The Theory of Money), pp. 257-285.\textsuperscript{12} In this unfortunate process, an important role was played by the Supreme Court, as examined extensively by Richard H. Timberlake, Constitutional Money: A Review of the Supreme Court's Monetary Decisions (Cambridge University Press, New York 2013).\textsuperscript{13} The case against government monopoly on money was most famously made by Friedrich von Hayek in his Denationalisation of Money (Institute of Economic Affairs, London 1990 [1976]); see also, among
In fact, leaving money in the hands of monopolistic institutions affords them the power to debase the currency – by issuing more units of it – any time they wish so, as again history shows they did repeatedly and with no effective restraint. Not only does this inflation impoverish those who hold money and therefore discourage savings, but it also alters the ability of entrepreneurs to evaluate the return of investments: the artificial growth of money makes money cheaper, and cheap money makes investments look more attractive to the entrepreneur than they actually are. However, sooner or later the bubble of only apparently good investments bursts, and such operations reveal themselves as bad investments, or malinvestments.

This is not just an hypothesis: arguably, it is precisely the most credible explanation of what caused the 2008 financial crisis in the US. To the exact opposite of the beliefs he had held in previous years, Alan Greenspan, during his chairmanship at the Federal Reserve, systematically pursued a low interest-rate policy, and – just like Austrian economists, several decades before, had expected it would happen – this...
eventually ended up in a bust.

From this perspective, central banking – an actually failed experiment\(^{20}\) – is the most important form of regulation that should be repealed\(^{21}\). More realistically, and perhaps more interestingly for lawyers, attention can be paid also to the possible ways to constrain the discretion that – as we said – central banks usually enjoy when deciding their monetary policies. Indeed, in spite of the efforts of even some prominent politicians\(^{22}\), the abolition of central banking may be an extremely long way down the road, therefore it seems useful, in the meanwhile, to reflect on the possible ways to limit the potential damages arising from a misguided monetary policy\(^{23}\). In fact, legislators themselves seem aware of the risk that central bankers abuse of their powers, therefore they have taken measures in all countries in an attempt to tie their hands.

The typical path followed has been to pre-determine central banks’ goals and discretionary powers by way of legislation or even constitutional provisions. So, according to s. 2A of the \textit{Federal Reserve Act}\(^{24}\), the Fed has the institutional mandate

\begin{itemize}
\item Friedrich von Hayek, with his \textit{Prices and Production} (Augustus M. Kelley Publishers, New York 1967 [1931]).
\item See the analysis by George Selgin, William D. Lastrapes, Lawrence H. White, \textit{Has the Fed been a failure?}, in 34(3) \textit{Journal of Macroeconomics} (September 2012) 569-596.
\item Following our premise in § I.I, we consider central banking a form of regulation in the sense the monetary policy regulates the amount of circulating money.
\item Most notably US Congressman from Texas Ron Paul, who has been campaigning for many years in order to \textit{End the Fed}, as says the title of his best-selling book (Grand Central Publishing, New York 2009).
\item See the thoughtful analysis on this crucial issue by Peter J. Boettke, Daniel J. Smith, \textit{Monetary Policy and the Quest for Robust Political Economy} (paper presented at the 9th Mises Seminar of the Bruno Leoni Institute, 7 October 2012).
\item 12 USC 225a, added to the \textit{Federal Reserve Act of 1913} by the \textit{Federal Reserve Reform Act of 1977} (Title II of \textit{An Act To extend the authority for the flexible regulation of interest rates on deposits and}}
to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates"; in Europe, in order to reassure the Germans that ordinary legislation would not be enough to amend them, the goals of the ECB were written in primary law, i.e. in the Treaties: Art. 119(2) TFEU (as well as Art. 127(1) TFEU and Art. 2 of Protocol No. 4) stipulates that the "primary objective" of the single monetary policy and of the ESCB "shall be to maintain price stability".

There are obviously some considerable differences between the two formulas, and this has given rise to much debate too (in particular, much has been written about the Fed’s dual mandate, comprising also the promotion of full employment, as opposed to the ECB's only goal of maintaining price stability). But what matters here is that both provisions share the intent to limit the respective central banks' powers, trying to ensure that they act to offer stability to the economy, and in particular that they keep prices stable. However, in the years leading up to the crisis, this expectation was not fulfilled, especially in the US, where the Fed acted to boost the economy, eventually putting stability at stake (its dual mandate certainly helped it in justifying this policy). As we shall see, in the post-crisis years the record is even worse, for both the Fed and the ECB, in spite of the fact that the ECB only has a single mandate.

25 For a general analysis of the institutional differences between the ECB and the Fed (and also of the Bank of Japan), see, among many Dieter Gerdesmeier, Francesco Paolo Mongelli, Barbara Roffia, The Eurosystem, the US Federal Reserve and the Bank of Japan. Similarities and Differences (ECB Working Paper Series No 742, March 2007), available at http://www.ecb.int/pub/pdf/scpwps/ecbwp742.pdf; in any case, Philipp Bagus, The Fed and the ECB: Two Paths, One Goal, Mises Daily, 9 September 2011, persuasively argues that the differences between the two institutions eventually had no relevant consequence on their actions (see also Chapter Seven [Differe in the Money Creation of the Fed and
Moving on to consider the institutional architecture of central banks, as was said their high officials are normally appointed by governments: this is true in the US\textsuperscript{26} as well as in the Eurozone\textsuperscript{27}. Once appointed, the heads of central banks are granted a considerable amount of independence from the governments: legislators are usually well aware of the temptation for the latter to exert pressure on the central bankers so that they make money cheaper and thus stimulate the economy for a while (until the next election!). Therefore, typically central banks are devised as independent institutions, that do not receive government instructions.

However, one could also make the case that such a great power should not be removed from the democratic legitimacy circuit: since central banks can make them a lot poorer by the year, people should at least be allowed to directly vote for whom they want to entrust this power to (or, for whom they consider least likely to actually impoverish them).

No system of central banking is devised in this way, though. Here, the underlying problem is the counter-majoritarian paradox\textsuperscript{28}, typical of judicial review of legislation and of constitutionalism more broadly: we need to prevent people from democratically taking decisions that would imperil democracy, or in other words from

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\textit{the ECB} of Bagus's \textit{The Tragedy of the Euro}, pp. 81-89).
\textsuperscript{26} S. 10 of the \textit{Federal Reserve Act of 1913} (\textit{An Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes}, 63rd Congress, Sess. II, Ch. 6, 38 Stat. 251, December 23, 1913).
\textsuperscript{27} Article 283(2) TFEU.
freely taking decisions with which they would harm themselves. As some fundamental principles and rules are subtracted from the democratic game and cannot be amended by ordinary laws, and as some unelected wise men are appointed in order to make sure that the political majority is not able to circumvent this barrier, in the same way some supposedly enlightened economists are appointed by governments in order to determine which "price is right" for money.

The reasons to prevent people from democratically deciding that money should be cheaper and cheaper are quite sound; but also the arguments in favour of letting people decide on a matter of such a great relevance to their wealth should not be underestimated. The conundrum seems to be without solution, so the only possible way out seems to open up the market for money and leave it to the free market to issue currency, de-nationalizing money production, and allowing for several competing currencies to fight in order to win the favour of their users, as advocated by Hayek\textsuperscript{29}.

Clearly, this would require also the repeal of the already mentioned rules establishing a legal tender, i.e. the rules according to which only the currency issued by the central bank is the accepted – the legal – form of money, therefore payments in that specie cannot be legitimately refused, and government taxes must be paid using that specie. Indeed such a rule, driving out all other forms of money (even when they remain legal), allows the government to manipulate money, giving it the power to artificially set its value.

\textsuperscript{29} See above, note 12.
In the past, such power used to be mitigated by the pegging of currencies to gold (or silver), in what is commonly referred to as the gold standard. Under gold standard, the circulating money no longer corresponded to the amount of precious metals stored in the vaults of bankers, as it was at the beginning of banking: circulating money eventually became several times more than the actual gold deposited at central banks, that kept issuing (actually: 'printing') deposit certificates even if they were not backed by actual wealth. However, there was still a link between the two, a standard ratio that pegged paper money to real gold.

But when in 1971 US President Richard Nixon unilaterally abandoned the convertibility of dollar into gold, the road was completely clear for governments to decide with total discretion the value of money. Money became completely "fiat", i.e. dependent on an act of will by the government, that could manipulate it according to its needs.

Obviously, this does not mean that governments (to be sure, monetary authorities, but as we hinted at, the difference is often imperceptible) will necessarily abuse of such a power of theirs: they could decide to be very conservative in this field and adopt a tight monetary policy, defending the value of their currency (and in fact even the Fed pursued a "relatively sound monetary policy" from around 1950 and for

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30 For an in-depth analysis, see for example Joseph T. Salerno, *Money, Sound and Unsound* (Ludwig von Mises Institute 2010), Part Three, pp. 323-419.
31 By way of a simple announcement: it is quite remarkable how a decision of such huge (and devastating) economic consequences was taken *de facto*, without finding its way into a legally binding piece of legislation.
32 In the words of Mark A. Calabria, *Did Glass-Steagall Put a Man on the Moon?*, Cato@Liberty, 29 July 2012.
about two decades). However, loosening the monetary policy typically boosts the economy in the short term, and this helps to win re-election. The public school choice insights\textsuperscript{33} tell us that it is therefore very likely that, sooner or later, governments will not resist pressuring monetary authorities for cheap money, unable to resist the temptation to "buy" their way into re-election, by lowering the cost of credit and thus stimulating the economy.

As we saw, constitutional architects usually try to overcome this problem by entrusting monetary policy to independent entities, but independence seems to be often more apparent than real, because for many reasons central banks end up doing what political bodies ask them to do. This was true in the US before (and after) the crisis. As we shall see, it has proven to be equally true in Europe, especially after the crisis hit.

One last important point to make is that the Federal Reserve System is also responsible for creating the expectation in large financial firms, that they would be bailed out in case they took excessive risks and ran into trouble: indeed, in 1998 the Federal Reserve Bank of New York created a very dangerous precedent with the bailout of the Long-Term Capital Management hedge fund, an operation that must have been very reassuring for investment bankers at Wall Street in the years of the subprime bubble, dramatically increasing the incentives for moral hazard\textsuperscript{34}.

\textsuperscript{33} See in particular the groundbreaking \textit{The Calculus of Consent: Logical Foundations of Constitutional Democracy} by James M. Buchanan and Gordon Tullock (University of Michigan Press, Ann Arbor 1962).

\textsuperscript{34} This argument was made for instance by Tyler Cowen, \textit{Bailout of Long-Term Capital: A Bad Precedent?}, in \textit{The New York Times}, December 26, 2008.
Another source of great systemic instability lies in the way modern banking itself has evolved. Indeed money is manipulated not only by central banks that are allowed to 'print' as much money as they deem appropriate: private banks can do essentially the same. It all started when the bankers, who until then had acted as true depositors of precious metals (i.e. of real money), started lending out more (paper) money – in the form of paper certificates – than the amount of gold or silver they actually held, counting on the fact that depositors would not normally show up to redeem their gold or silver all at the same time.

This amounted to a form of money creation "out of thin air"\(^{35}\), and when it was initially discovered, depositors perceived it as a fraud\(^{36}\): they had handed their gold to bankers because they had stipulated a contract of deposit with them, but in fact bankers treated it as a loan, and started lending out that gold without permission, and even artificially multiplying it by way of paper certificates.

This operation, initially perceived as a fraud, gradually became the normal practice of banking, and was definitively sanctioned by the rise of central banks: while under

\(^{35}\) To use Rothbard's words in his *The Mistery of Banking* (Ludwig von Mises Institute, Auburn 2008 [1983]), p. 98.

the previous system of free banking, a bank inflating its notes would soon go bankrupt, because there was no one out there to bail it out, central banking, with its lender of last resort function, prevented the fraud to be called, and allowed for a contextual creation of money out of thin air by all banks.

So fractional reserve banking became perfectly legal: in some countries, its conditio sine qua non, i.e. that the contract between the depositor and the bank was not to be deemed a deposit but a loan (therefore the bank acquired ownership of the money deposited), was even explicitly written down into the law: for instance, Article 1834 of the Italian civil code stipulates that «in deposits of a sum of money at a bank, the bank acquires ownership of that sum, and shall return it in the same currency».

The legitimacy of fractional reserve banking is debated even among Austrian scholars: some, like Jesús Huerta de Soto, Thorsten Polleit, and Rothbard before
them, are extremely critical of it, while others argue that it would be legitimate if the depositor freely and knowingly decided to conclude a fractional reserve contract with the bank.  

Certainly, fractional reserve banking calls into question the notion of property: can two people own the same good at the same time? In particular: can a depositor dispose of the money he deposited, while at the same time that very money is lent out many times to other people? The fiction of fractional reserve banking as we know it is founded on the assumption that this is possible. It is in fact hard to believe that this is true by way of a simple statute that declares this possible. The question whether two people can freely and knowingly conclude a fractional reserve contract – under a system of free banking – is more difficult.

But even if we concluded that fractional reserve banking would not be a problem under a system of free banking, certainly, when it is coupled with a fiat money system run by central banks, like the one we are used to, it massively magnifies the imbalances of such system, making the castle of cards of fiat money many times bigger and more precarious, and thus amounting to a major ingredient of the global collapse.

Without going into details, it is sufficient to recall that, in the US, "[r]eserve requirements were first established at the national level in 1863 with the passage of

the National Bank Act"⁴⁴, the power to adjust them as an instrument of monetary policy was entrusted to the Fed for the first time in 1935 (even though within certain limits)⁴⁵, the requirements subsequently changed many times, and in particular they started being progressively decreased, especially between 1980 and 1990⁴⁶.

As for the ECB, under art. 19(1) of its Statute, it "may require credit institutions established in Member States to hold minimum reserve on accounts with the ECB and national central banks". Relying on this provision, and on the implementing Council Regulations (EC) No. 2531/98 and 2532/98 of 23 November 1998, respectively concerning the application of minimum reserves by the European Central Bank⁴⁷ and concerning the powers of the European Central Bank to impose sanctions⁴⁸, the ECB issued its Regulation No. 2818/98 of 1 December 1998 on the application of minimum reserves⁴⁹. Art. 4 of this Regulation introduced a 0% reserve ratio on: 

(a) deposits with agreed maturity over two years; (b) deposits redeemable at notice over two years; (c) repos; (d) debt securities issued with an agreed maturity over two years"; for all other liabilities, the reserve requirement was set at the level of 2% (as we shall see, this latter level was cut to 1% since January 2012).

I.C BASEL I AND BASEL II

Not to be confused with the reserve requirements dealt with in the previous paragraph are the capital requirements included in the so called Basel Accords, that concentrate on the amount of capital that investment banks must hold, against the assets in which they invested. Indeed, exactly as they do with loans against deposits, banks that engage in investments do invest much more than the actual capital they hold: just as fractional reserve banking (at least under a non-free banking system), this generates a great systemic risk.

And just like reserve requirements, that, together with deposit insurance schemes (see below, § I.F), are the remedy devised by regulators in order to face the risk of bank runs, capital requirements are introduced in order to make sure that banks always have a sufficient buffer of capital available in case of a sudden deterioration of the value of their assets (corresponding to an increase in the risk to which they are exposed): in particular, Basel I established that such capital reserve should be the 8% of the invested assets.

Clearly, the assets do not all carry the same amount of risk: to take that into account, Basel I stipulated that the assets had to be risk-weighted, namely that some of them – deemed particularly safe – did not require an increase in the capital requirements, while others required the full 8% reserve. In the middle ground, there were other categories50.

50 The text of the Accord, of July 1988, updated to April 1998, can be read at http://www.bis.org/publ/bcbsc111.pdf; it was originally implemented in the US by the Risk-Based Capital...
In this way, investment banks had an extremely high incentive to invest in the securities that enjoyed a preferential treatment from the Basel Accord and whose purchase did not require to set aside capital, while they faced a specular disincentive to invest in the assets classified at the other end of the spectrum. The problem is that the preferred assets were cash and bonds of central banks and governments of OECD countries, deemed to have a 0% risk of credit (i.e. there was supposed to be no risk at all that they would not be repaid), while the riskiest investment, according to Basel I, were corporate bonds, requiring a 100% (of the 8%) reserve.

In retrospect, considering that the current epicentre of the crisis lies with European sovereign bonds, this looks like a spectacular regulatory failure, and quite ironic indeed.

The shortcomings of Basel I were even worsened in the US by the adoption of the so called 'recourse rule'51, i.e. the one that "extended the accord's risk differentiations to asset-backed securities (ABS): bonds backed by credit card debt, or car loans — or mortgages — required a mere 2 percent capital cushion, as long as these bonds were rated AA or AAA or were issued by a government-sponsored enterprise (GSE), such as

Guidelines, in 54 Federal Register 4168, 4177, January 27, 1989 (12 CFR Part 3 appendix A), by the Minimum Capital Ratios, in 55 Federal Register 38797, 38800, September 21, 1990 (12 CFR § 3.6(c)), and most importantly by the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub.L. 102-242, 105 Stat. 2236, 2253, December 19, 1991 (12 USC § 1831o) (see also 12 CFR Part 6) (as for what was then the European Economic Community the EU, the Member States that was also members of the BIS implemented it with national rules).
Fannie or Freddie. Thus, where a well-capitalized commercial bank needed to devote $10 of capital to $100 worth of commercial loans or corporate bonds, or $5 to $100 worth of mortgages, it needed to spend only $2 of capital on a mortgage-backed security (MBS) worth $100. A bank interested in reducing its capital cushion — also known as "leveraging up" — would gain a 60 percent benefit from trading its mortgages for MBSs and an 80 percent benefit for trading its commercial loans and corporate securities for MBSs. This rule, part of a decade-long policy by the US authorities to favour home-ownership by the American citizens, was meant to encourage the purchase of homes. However, it substantially contributed to the tremendous housing bubble whose burst was the outbreak of the financial crisis in the US (see the next paragraph).

Basel II attempted to correct some of the features that had proved to be highly...
unsatisfactory in Basel I. Without going into the details, the greatest problem with this new Accord is its complete reliance on the risk-assessments made by the credit rating agencies. The problem is that, as we shall see in § I.E, the market for credit rating is on its turn highly regulated, and this has led to a notorious oligopoly, which inevitably affects the quality of ratings. Again, in retrospect, entrusting credit rating agencies with such a great power appears to be another huge regulatory mistake, and fairly ironic as well if one considers how much their trustworthiness has come into question in the past few years54.

I.D HOUSING MARKET POLICIES

In the previous paragraph, we mentioned the severe distortions of the housing markets that arose from the policies adopted by several US authorities over the decades: before the 'recourse rule', there had been many other provisions "doping" this market, which, together with the cheap money policy by the Fed55, and with a certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management, and Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management; and Package III, i.e. Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.


55 On this link, see Steven Gjerstad and Vernon L. Smith, Monetary Policy, Credit Extension, and Housing Bubbles, 2008 and 1929, in Friedman (ed.), What Caused the Financial Crisis?, pp. 107-137.
century-long policy favouring home-ownership, generated a combustible mixture. As explained in a 1993 set of recommendations to the banks by the Boston Fed, "the Fair Housing Act prohibits discrimination in the sale or rental of a dwelling on the basis of race, color, religion, handicap, sex, familial status, or national origin. Under the Fair Housing Act, it is unlawful for any person who engages in the business of making or purchasing residential real estate loans, or in the selling, brokering, or appraising of residential real property, to discriminate on the basis of the factors listed above", while "[t]he Equal Credit Opportunity Act (ECOA) was enacted in 1974 to promote the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status, age, receipt of public assistance funds, or the exercise of any right under the Consumer Credit Protection Act. Regulation B, issued under the ECOA, prohibits creditor practices that discriminate on the basis of any of these factors.

56 This is due in particular to the mortgage interest deduction, introduced by the Revenue Act of 1913 (ch. 16, 38 Stat. 114, October 3, 1913).
57 Salin, Revenir au capitalisme... pour éviter les crises, chapter 1, § 3; but see also Arnold Kling, Unchecked and Unbalanced: How the Discrepancy Between Knowledge and Power Caused the Financial Crisis and Threatens Democracy (Rowman & Littlefield, Lanham 2009), in particular pp. 1-10; and Peter J. Wallison, Housing Initiatives and Other Policy Factors, in Friedman (ed.), What Caused the Financial Crisis?, pp. 172-182.
58 Federal Reserve Bank of Boston, Closing the Gap: A Guide to Equal Opportunity Lending (1993), available at http://www.bos.frb.org/comdev/closing-the-gap/closingt.pdf, p. 26. The FHA was Title VIII of the Civil Rights Act of 1968 (An act to prescribe penalties for certain acts of violence or intimidation, and for other purposes), Pub.L. 90-284, 82 Stat. 73, 81, April 11, 1968, 42 USC 3601 et seq.; the ECOA was Title V of An Act To increase deposit insurance from $20,000 to $40,000, to provide full insurance for public unit deposits of $100,000 per account, to establish a National Commission on Electronic Fund Transfers, and for other purposes, Pub.L. 93-495, 88 Stat. 1500, 1521, October 28, 1974, 15 USC 1691 et seq.
After that, the *Community Reinvestment Act of 1977*\(^{59}\) established a scheme to favour access to home ownership by disadvantaged groups; s. 1211 of the *Financial Institutions Reform, Recovery, and Enforcement Act of 1989*\(^{60}\) amended the *Home Mortgage Disclosure Act of 1975*\(^{61}\) by adding a requirement that the banks made public the data on the ethnicity of those requiring and obtaining or not a mortgage from them; another 1992 statute\(^{62}\) imposed the government-sponsored businesses Fannie Mae and Freddie Mac to stimulate universal access to home ownership\(^{63}\).

Then the Federal Reserve of Boston in 1993 published the guidebook for banks mentioned slightly above\(^{64}\), where it recommended them, when dealing with someone requiring a mortgage, to disregard his income, the ratio between his salary and the mortgage required, and her credit record, in order not to discriminate against low-income people and minority members; and finally in 1995, penalties were even introduced for banks refusing to give credit to members of disadvantaged groups\(^{65}\),


\(^{61}\) Title III of *An Act To extend the authority for the flexible regulation of interest rates on deposits and share accounts in depository institutions, to extend the National Commission on Electronic Fund Transfers, and to provide for home mortgage disclosure*, Pub.L. 94-200, 89 Stat. 1124, 1125, 12 U.S.C. § 2801 et seq., December 31, 1975.


\(^{64}\) Above, note 57.

\(^{65}\) Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS), *Community Reinvestment Act Regulations. Final Rule*, in 60 Federal Register 86, 22156 (May 4, 1995) (12 CFR Part 25, 12 CFR Part 228, 12 CFR Part 345, 12 CFR Part 563e, 12 CFR Part 203) (in particular, it was provided that compliance by a bank with the *Community Reinvestment Act* would be taken into account when it was under review for operations of mergers, acquisitions, or opening of new...
but the political pressure to "expand mortgage loans among low and moderate income people" kept growing\textsuperscript{66}.

It is well known how the housing bubble collapse in the US acted as a "detonator" of the global financial crisis, triggering the domino effect that has been threatening to bring the whole global economy to collapse\textsuperscript{67}. At a closer look, such bubble has very clear regulatory causes, both at the federal and at the local level (in particular, local governments' strict regulations on land use and geographical land constraints prevented the supply to quickly adjust to an – artificially – increased demand\textsuperscript{68}).

I.E THE REGULATION OF CREDIT RATING AGENCIES

In § I.C, we also hinted at the regulatory restrictions to the market for credit rating, that are at the origin of the current oligopoly. In particular, "since 1931, the government has required or encouraged certain types of investors to prefer financial instruments that rating agencies rate highly"\textsuperscript{69}.

But the most important barriers to entry were introduced in the US by the SEC with

\footnotesize

\begin{itemize}
\item \textsuperscript{66} As explained Steven A. Holmes, \textit{Fannie Mae Eases Credit To Aid Mortgage Lending}, in \textit{The New York Times}, 30 September 1999.
\item \textsuperscript{67} A comprehensive account can be found in Oonagh McDonald, \textit{Fannie Mae & Freddie Mac: Turning the American Dream into a Nightmare} (London-New York 2012).
\item \textsuperscript{68} This point was made for instance by Randal O'Toole, \textit{How Urban Planners Caused the Housing Bubble}, Cato Institute Policy Analysis No. 646, October 1, 2009; see also Mark A. Calabria, \textit{Local Governments Also To Blame For Housing Crisis}, Cato@Liberty, February 17, 2012, who refers to his own \textit{Supply: A Tale of Two Bubbles}, Cato Journal, Vol. 31, No. 3 (Fall 2011), p. 551, to O'Toole's article, and – for some interesting evidence – to Haifang Huanga, Yao Tang, \textit{Residential land use regulation and the US housing price cycle between 2000 and 2009}, 71(1) Journal of Urban Economics 93 (January 2012).
\end{itemize}
some rules it enacted in 1975\textsuperscript{70}. Under these regulations, it became necessary to be specifically licensed in order to carry on this activity: indeed rating agencies became known as \textit{Nationally Recognized Statistical Rating Organizations}. The licensing requirement, that was quite tough to meet for new-entrants, acted as a barrier to entry, and in the long run was responsible for the concentration of the market, consolidating the oligopoly of the existing companies in the US. On its turn, this concentration spilled over to Europe, where essentially no new entrant was able to challenge the leadership of the incumbents\textsuperscript{71}.

The distortions to this market had particularly relevant consequences, because, as we saw, the ratings issued by CRAs were on their turn central to the Basel II framework, making it necessary to undergo a review by them in order to be able to raise capital on the financial markets\textsuperscript{72}.

\section*{I.F Deposit Insurance Schemes}

Another significant source of alteration of the free-market process is the existence of deposit insurance schemes in all the countries hit by the crisis. The US scheme is the

\textsuperscript{70} 17 CFR 240.15c3-1.
\textsuperscript{71} The lack of competition is arguably the main reason of the underperformance of credit rating agencies observed in recent years: on their "subprime debacle", see Lawrence J. White, \textit{The Credit-Rating Agencies and the Subprime Debacle}, in Friedman (ed.), \textit{What Caused the Financial Crisis?}, pp. 228-237; more generally, see also Siegfried Utzig, \textit{The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective} (ADBI Working Paper Series No. 188, January 2010), available at http://www.adbi.org/files/2010.01.26.wp188.credit.rating.agencies.european.banking.pdf, pp. 7-9.
\textsuperscript{72} A detailed explanation of how the existing regulation of CRAs in the US contributed to the financial crisis, together with some suggested improvements, is offered by Emily McClintock Ekins, Mark A. Calabria, \textit{Regulation, Market Structure, and Role of the Credit Rating Agencies}, \textit{Cato Policy Analysis No. 704}, 1 August 2012.
oldest, dating back to the *Banking Act of 1933*, that established the Federal Deposit Insurance Corporation\(^73\), while a similar mandatory insurance of bank deposits was introduced in Europe only in the 1990s (previously, forms of voluntary schemes already existed in some countries\(^74\)). In particular, *Directive 94/19/CE of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes*\(^75\) established a duty for then EC Member States to introduce a deposit insurance scheme (for instance, Italy complied with such duty at the end of 1996\(^76\), while the UK did it only in 2000\(^77\)).

The problem with deposit insurance schemes is chiefly the great moral hazard they generate, creating the incentive for depositors to seek the highest returns from banks, without taking pain to evaluate how safe their money is with them, counting on the fact that they will not lose it, at least up to a certain threshold\(^78\).

Ironically, deposit schemes would also be nothing more than illusion, at least according to Rothbard's version of them, that is very provocative but seems rather convincing:

\(^73\) The rules were then reformulated by the *Federal Deposit Insurance Act of 1950*, Pub.L. 81-797, 64 Stat. 873, September 21, 1950.


\(^77\) With the *Financial Services and Markets Act 2000*, 2000 c. 8.

\(^78\) For an in-depth analysis (and critique) of deposit insurance, see chapter 6 (*Should Government Play a Role in Banking?*) of Lawrence H. White, *The Theory of Monetary Institutions* (Malden, Blackwell 1999), 121-137.
[T]he FDIC itself has less than one percent of the huge number of deposits it “insures.”

The very idea of “deposit insurance” is a swindle; how does one insure an institution (fractional reserve banking) that is inherently insolvent, and which will fall apart whenever the public finally understands the swindle? Suppose that, tomorrow, the American public suddenly became aware of the banking swindle, and went to the banks tomorrow morning, and, in unison, demanded cash. What would happen? The banks would be instantly insolvent, since they could only muster 10 percent of the cash they owe their befuddled customers. Neither would the enormous tax increase needed to bail everyone out be at all palatable. No: the only thing the Fed could do, and this would be in their power, would be to print enough money to pay off all the bank depositors. Unfortunately, in the present state of the banking system, the result would be an immediate plunge into the horrors of hyperinflation.

Let us suppose that total insured bank deposits are $1,600 billion. Technically, in the case of a run on the banks, the Fed could exercise emergency powers and print $1,600 billion in cash to give to the FDIC to pay off the bank depositors. The problem is that, emboldened at this massive bailout, the depositors would promptly redeposit the new $1,600 billion into the banks, increasing the total bank reserves by $1,600 billion, thus permitting an immediate expansion of the money supply by the banks by tenfold, increasing the total stock of bank money by $16 trillion. Runaway inflation and total destruction of the currency would quickly follow.  

79 Rothbard, *Fractional Reserve Banking: Part II*. 
I.G European Institutional Architecture

As far as Europe and in particular the Eurozone are concerned, it is inevitable to focus also on the shortcomings of their institutional design: the mistakes made in drawing the underpinnings of such projects bear a great responsibility for the current dramatic situation.

Such mistakes have been pointed out by many commentators, that have usually blamed the creation of a single currency without the simultaneous unification of the participating countries' economies and fiscal policies. However, as was explained by Pascal Salin in an op-ed for The Wall Street Journal, the problem was arguably not that one: in the US, when a State threatens to go bankrupt like Greece, Spain, Portugal and Italy are threatening to do in Europe, other States are not supposed to bail it in, unlike it is happening de facto within the Eurozone, so there can actually be a single currency between countries whose economies and fiscal policies are not unitary 80.

Instead, the real problem seems to have been that the requirements that had to be met in order to be admitted to the Euro (the so called Maastricht criteria) 81 were not taken seriously: also thanks to some creative accounting, Greece notoriously hid a substantial amount of its debt from its balance-sheet, by exploiting loopholes in Eurostat accounting rules, in order to falsely appear compliant with such

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81 The Maastricht criteria were contained in Article 121(1) of the EC Treaty (now Article 140(1) of the
requirements, but when the scam was exposed, no punishment whatsoever was
levied, and the ECB even refused to allow public access to the documents on the
issue\(^{82}\).

Similarly, after the EU Member States decided, with the Stability and Growth Pact,
that such criteria should be met also once the euro was launched\(^{83}\), no penalty was
ever imposed on countries that did not meet them\(^{84}\). In fact, the criteria were even
relaxed in 2005\(^{85}\), pursuant to the European Council held in Brussels on 22-23
March\(^{86}\).

Also such betrayal of the Maastricht spirit was arguably a regulatory failure: it is
ture that in this case some rules were in place, and we are advocating here in favour
of their maintenance and respect, while they were blatantly unenforced. But there is
no contradiction here because they were rules trying to make sure that Member
States were fiscally responsible, and therefore to limit their spending. They were

\(^{82}\) Such denial has been challenged before the EU General Court, but the judges sided for the ECB
(Thesing and Bloomberg Finance v. ECB, T-590/10); the appeal case is currently pending before the ECJ
(C-28/13 P).

\(^{83}\) The Stability and Growth Pact consisted of a Resolution of the European Council (Resolution of the
and two Council Regulations (Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening
of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ
L 209, 2.8.1997, p. 1, and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and
clarifying the implementation of the excessive deficit procedure, OJ L 209, 2.8.1997, p. 6).

\(^{84}\) The data is available at http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

the strengthening of the surveillance of budgetary positions and the surveillance and coordination of
amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive

\(^{86}\) The conclusions are available at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2005-03-
therefore good rules from the perspective here adopted, and it was very unwise to
leave them unenforced.

A similar argument can be made with regard to the absence, in the years leading to
the crisis, of a constitutional rule prescribing a balanced budget in all the countries
considered. This is another example of rule that, if in place and enforced, would have
prevented public deficits to grow to such an unsustainable level as they did.

I.H DEFICIT, DEBT, PUBLIC SPENDING AND TAXATION

The very large deficits and public debts of the most troubled countries in Europe,
but also of the US, are indeed another form of simply too much regulation (taking
regulation – as explained in the introducing paragraph – as an equivalent to
government intervention in the economy): after all, all forms of public spending derive
from some legal provision authorizing them. Similarly, also the problem of the high
levels of taxation, particularly serious especially in some countries such as Italy, but
certainly present to some extent in all the countries most involved in the crisis (with
the partial exception of Ireland), is yet another form of regulatory interference with
the free-market process, that is severely impaired by a fiscal burden at the level
reached both in Europe and in the US.

I.I REGULATION IN ITS PROPER MEANING AND THE "TOO BIG TO FAIL" PROBLEM

Finally, we cannot discount also the role played by the piles and piles of regulation
– in its narrow sense – existing in all the countries under consideration. Contrary to popular belief, financial markets before the crisis were all but under-regulated: the amount of rules that existed before the crisis, and that tried to direct their ordinate development (either by setting some prudential standards, or by outright dictating the conduct of business to be followed), is astounding. It is impossible to go into details here, but suffice it to say that the underlying rationale of all these rules is arguably the aspiration to eliminate or at least reduce the systemic risk. However, from the analysis done in the previous paragraphs, it should have emerged that the deep sources of systemic risk lie in regulation itself. If one looks carefully, what conduct of business rules and prudential regulation try to do is to remedy the distortions created by other regulation. The problem is that, in so doing, they end up altering the free-market process even more.

For instance, the existing rules setting the standards of conduct for credit rating agencies operators are arguably necessary only insofar as a government-created oligopoly exists in this market (*see above, § I.E*), and exactly the same is true with regard to the rules requiring government approval to operate as a bank\(^\text{87}\). Arguably, not only do all these rules fall short of guaranteeing an actual immunity from the risks they are trying to avert, but we could go as far as to claim that, without regulatory interference in the first place, the market would spontaneously adjust to

\(^{87}\) In the US, at the federal level such requirement was first introduced by ss. 5 ff. of the *National Bank Act of 1864* (*An Act to provide a National Currency, secured by a Pledge of United States Bonds, and to provide for the Circulation and Redemption thereof*, 38th Congress, Sess. 1, ch. 106, 13 Stat. 99, June 3, 1864).
provide the outcome that such rules try to attain, by rewarding rating agencies issuing the most accurate reports and banks managing to be sound and safe, by ruling out any chance of banks to lend or invest more money that they actually hold, and by making consumers more careful on where they deposit their savings. Instead, we are confronted with rules carefully devised and continuously adjusted to remedy the consequences of other rules.

However, such regulatory flood is not just redundant: it probably even contributes to worsen one of the problems it aims to solve, i.e. the "too big to fail" problem. This phrase famously refers to the existence of some financial institutions that are just so large that their default would make the whole system collapse, due to the great interdependency of financial institutions from each other, something usually described as systemic risk.

The reason why some financial institutions grow so big that their collapse would generate a domino effect and the fall of "faultless" institutions, is debatable. So far, we lack counter-evidence of what would happen in an unregulated system: presumably, the free market would automatically take care of limiting the size of financial institutions, avoiding their growth to such a level where no other market actor can rescue them. Therefore, the reason why "too big to fail" institutions exist is likely to be found in the informal promise by governments to bail such institutions in should they need it, a promise that sometimes is even proudly announced to the
public, as was the case with the infamous Greenspan Put\textsuperscript{88}.

Anyway, whatever be the source of the "too big to fail" problem, the whole body of financial regulation seems at least responsible for making it even worse. Indeed, by trying to remove the perspective of bankruptcy\textsuperscript{89}, these rules alter substantially and definitively the functioning of the market process. Business risk is a fundamental component of a functioning market system, so trying to sterilize it already leads to creating a different one, that is no longer a genuine market system, but something else\textsuperscript{90}: once again, blaming the financial turmoil on a lack of regulation looks like a very weak position.

I. J. A REGULATORY FAILURE

The analysis in the previous paragraphs has tried to give an overview of how many examples of regulatory interference were in place in the American and European financial markets and economies in general. As was said, by far the most important form of interference is the one caused by the monopoly of central banks on issuing and determining the value of money. On its own, such power is able to create huge distortions in the market process, altering one of its fundamental elements. Prices are absolutely fundamental signals for market operators, that reflect the amount of

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\textsuperscript{89} The ninth edition (2013) of the Mises Seminar of the Bruno Leoni Institute was precisely devoted to the issue of Failure: Why We Need It. Some of the papers presented there are available at http://www.brunoleoni.it/sitonelsito.aspx?codice=0000002119&padre=0000002113.

\textsuperscript{90} As a saying goes, "capitalism without bankruptcy is like religion without hell".
existing supply and demand for a certain good or service.

Altering the price of money indirectly alters the prices of all goods and services, and a system where prices of goods and services are not freely determined by interactions between market operators, but are severely influenced by external factors, is a highly regulated system, and no longer a truly "free"-market system.

The manipulation of money, already the source of economic cycles terminating in busts, becomes an even more serious problem when coupled with the other form of manipulation that we have briefly described, i.e. the fractional reserve banking, an inherently unstable system in that it is founded on the creation of money out of thin air.

The situation becomes unsustainable because of the existence of the other rules and policies we have briefly reviewed: from the Basel Accords, creating an incentive for banks to invest in certain assets instead of others, thus artificially lowering the price of the former; to the measures implemented in the housing market, that – together with cheap money – artificially boost the value of real estate, until the bubble bursts and the whole economy is severely hit in a domino effect; from the regulatory barriers to entry in the markets for rating and for banking, that decrease competition and entrench oligopolies and incumbents' market shares, to deposit insurance schemes, that alter the risk perception of depositors; from the mistakes in the European institutional engineering, that allowed governments to be fiscally irresponsible without suffering any consequence, until the markets at some point took care of unveiling the illusion, to the excesses in taxation, public spending, and
accumulation of deficits and public debts, that in the current situation are threatening to take Euro countries’ economies down, and finally to regulation in its narrow meaning, unwisely trying to make the failure of "too big to fail" institutions impossible, again altering the risk perception by market operators.

On careful consideration, then, the crisis that the Western world has been experiencing in the past years looks all but a crisis from a deregulated market. Instead, it looks like a crisis from an over-regulated financial sector and economy in general, suffering from misguided incentives and inevitably falling into huge malinvestments, that on their turn must be liquidated at some point. Which is exactly what is happening. If this is true, then the ideal response to the crisis would be to correct the misaligned incentives created by excessive regulation, and let the market operate more freely, taking the principle of responsibility seriously and allowing competition to take care of protecting consumers and investors. Let us now move to contrast such ideal with the line of conduct followed by American and European legislators and regulators in the wake of the crisis.
II. POOR REGULATION IN RESPONSE TO THE CRISIS: \textit{PERSEVERARE DIABOLICUM}

Exactly like in Part I, we are interested here in the big picture: the hundreds of pages of the \textit{Dodd-Frank Act}\textsuperscript{91}, for instance, are beyond the reach of this article. What we would like to inquire into is the underlying approach followed by governments in reaction to the crisis: have they realized that they had systematically interfered with the economy, severely damaging it, or have they claimed that more intervention from their part was needed to redress alleged market failures? The answer is invariably the latter. Let us try to provide an overview of the same areas analysed in Part I, looking at the main courses of action followed\textsuperscript{92}.

\textbf{II. A CENTRAL BANKING}

If the manipulation of money is the issue that we have identified as the most important form of market alteration that accounts for the crisis, probably not by coincidence it is also the sector that shows the worst record also in the post-crisis years.

All the central banks have responded to the crisis by lowering the interest rates to

\textsuperscript{91} \textit{An Act To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes}, Pub.L. 111-203, 124 Stat. 1376, July 21, 2010.

\textsuperscript{92} A comprehensive overview of the initial regulatory responses was done by harles A.E. Goodhart, \textit{The Regulatory Response to the Financial Crisis} (Edward Elgar, Cheltenham 2010).
some historical lows, and getting closer to a zero interest-rate policy. The Federal Reserve soon reacted to the crisis by cutting the benchmark interest rate, gradually slashing it from a 5.25% in September 2007 to a 0.25% in December 2008: since then, the rates have lingered in a region between zero and 0.25%\footnote{The data is available for instance at http://www.tradingeconomics.com/united-states/interest-rate.}

Similarly, the ECB progressively cut its benchmark rate from a 4.25% in September 2008 to a 1% in June 2009, to raise it again to 1.25% in April 2011 and up to 1.5% between July and October 2011, only to slash it again to 1.25% and then to 1% that same month, and then to 0.75% in July 2012, to 0.5% in May 2013, and finally to 0.25% in November 2013, a record low\footnote{The data is available for instance at http://www.tradingeconomics.com/euro-area/interest-rate.} (according to the ECB Governor Mario Draghi, a raise is unlikely for quite some time\footnote{Brian Blackstone, Draghi Says ECB Won't Raise Rates for Foreseeable Future, in The Wall Street Journal online (1 August 2013).}).

But intervention by central banks definitely did not remain confined to making money cheaper by setting the benchmark interest rates: they notoriously resorted to several other measures, including "unconventional" or non-standard measures. In particular, as far as our field of analysis is concerned, both the Fed and the ECB took a highly interventionist stance\footnote{A detailed chronological account is available at http://www.newyorkfed.org/research/global_economy/Crisis_Timeline.pdf and at http://www.newyorkfed.org/research/global_economy/IRCTimelinePublic.pdf.}.

As for the Fed, it engaged in a massive purchase of securities, principally with the goal of providing markets with new liquidity, that was newly-printed for the specific purpose of carrying on the purchases: such programme was characterized by the Fed
Governor Ben Bernanke as "credit easing".

But the most important measure was the quantitative easings, consisting in – so far – three rounds of purchases of securities (mostly US government bonds, or Treasuries, and mortgage-backed securities) with newly-electronically-created money, with the aim to boost the price and reduce the yields of the assets bought, and most of all increase the money supply, in an effort to stimulate the economy\(^7\) (the QEs started respectively in November 2008, November 2010 and September 2012 in the US\(^8\)).

The ECB statute prevented it from engaging in the same operation, because it would have amounted to a direct financing of Member States' public debts, but this is forbidden by Art. 123(1) TFEU (as well as by Art. 21(1) of Protocol No. 4), that stipulates: "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States [...] in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments".

However, between December 2011 and February 2012 the ECB notoriously devised two exceptionally long-term refinancing operations for banks (LTROs), which consisted

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\(^{8}\) The third round of QE, of an open-ended nature, has consisted in a purchase of $85bn assets per month since December 2012, and so far this pace has not slowed down, let alone stopped, in spite of the announcement of the so called tapering by Ben Bernanke, so far not implemented (in fact, chairman Bernanke clarified in July 2013 that the Fed still considered an easy monetary policy necessary for the
in a loan of a virtually unlimited amount of cash to banks\textsuperscript{99}, at a 1\% interest-rate, for 36 months (on top of other refinancing operations with shorter maturities, renewed at least until mid-2014). Banks had to offer collateral in order to obtain the money, but the ECB increased collateral availability\textsuperscript{100}, and Italian banks were even helped by an emergency measure passed by the Italian government, providing special public guarantee of bank bonds, so that they could qualify as safe enough collateral\textsuperscript{101}.

But there were other non-standard measures implemented by the Fed and the ECB\textsuperscript{102}. Fed's interventions began with the establishment of the \textit{Term Auction Facility} and of swap lines with other central banks\textsuperscript{103} in December 2007, in a coordinated attempt to lower the spread between overnight and longer-term interbank loans, that was signalling a decrease in interbank lending confidence\textsuperscript{104}. A few months later, the Fed introduced the \textit{Term Securities Lending Facility} and the \textit{Primary Dealer Credit Facility} to inject liquidity into the markets, and increased the swap lines with other central banks.

But such actions were not enough, and were followed by several similar ones, all aimed at relaxing the rules on collateral against which it would loan money. Later in foreseeable future).

\textsuperscript{99} Which ended up being of more than 1bn euro.
\textsuperscript{100} For the details, see the press release of 8 December announcing the operation, \textit{available at http://www.ecb.int/press/pr/date/2011/html/pr111208_1.en.html}.
\textsuperscript{101} Article 8 (\textit{Misure per la stabilità del sistema creditizio [Measures for the stability of the credit system]}) of Decree-Law 6 December 2011, No. 201, converted into Law 22 December 2011, No. 214.
\textsuperscript{102} For an overall critique of the former, see Lawrence H. White, \textit{The Rule of Law or the Rule of Central Bankers?}, in 30(3) \textit{Cato Journal} 451 (2010).
\textsuperscript{104} After several temporary renewals, this measure was renewed for an indefinite time in October 2013: see Claire Jones, \textit{Central banks agree to retain swap lines}, in \textit{Financial Times}, 31 October 2013.
2008, rules on collateral eligible in both TSLF and PDCF operations were relaxed, and the swap lines further increased. In September 2008, another instrument to fight markets' illiquidity was engineered, the *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility*, and swap lines with the ECB and other central banks were further increased. Only a few weeks later, yet another instrument was established, the *Commercial Paper Funding Facility* (to include commercial paper in the collateral), and after another couple of weeks a new one, the *Money Market Mutual Fund Liquidity Facility*; November 2008 then witnessed the creation of a further one, the *Term Asset-Backed Securities Loan Facility*.

These facilities, that were intended to last for the short time necessary to put markets back on track, were extended for a longer duration than originally provided (they were eventually closed starting from February 2010, after some stability was restored to the markets), and the rules on collateral were further expanded several times, in an unprecedented effort to provide liquidity to the markets.

In April 2009, the Fed also struck foreign currency swap agreements with the ECB, the BoE, the Swiss National Bank and the Bank of Japan, a move that was severely criticized as a covered bailout of the Eurozone\(^{105}\). This facility was later extended on its turn.

Finally, the Fed in September 2011 also engaged in another significant move, the so-called *Operation Twist*, that it presented in the following way: "Under the maturity

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extension program, the Federal Reserve intends to sell or redeem a total of $667 billion of shorter-term Treasury securities by the end of 2012 and use the proceeds to buy longer-term Treasury securities. This will extend the average maturity of the securities in the Federal Reserve’s portfolio. By reducing the supply of longer-term Treasury securities in the market, this action should put downward pressure on longer-term interest rates, including rates on financial assets that investors consider to be close substitutes for longer-term Treasury securities. The reduction in longer-term interest rates, in turn, will contribute to a broad easing in financial market conditions that will provide additional stimulus to support the economic recovery.106

Let us now move on to consider the unconventional measures taken by the ECB, in an effort to provide liquidity to a banking sector under severe stress: besides making available a great amount of liquidity in foreign currencies107, the ECB engaged in the outright purchase of securities. This happened with the Covered Bond Purchase Programmes108 and with the Securities Markets Programme109. While in the latter scheme bond purchases were sterilized (i.e. the liquidity injected into the system was reabsorbed through other operations by the ECB), this was not done with the CBPPs,

106 See http://www.federalreserve.gov/monetarypolicy/maturityextensionprogram.htm; moreover, “[i]n June 2012, the FOMC continued the program through the end of 2012, which will result in the purchase, as well as the sale and redemption, of an additional $267 billion in Treasury securities”: see http://www.federalreserve.gov/monetarypolicy/maturityextensionprogram-faqs.htm.
107 On which see below.
which therefore substantially increased the money base in the Eurozone\textsuperscript{110}. Moreover, by way of all these purchases, the ECB expanded its balance sheet to a higher level than the Fed's ($3.2 trillion against $2.9 trillion at the end of 2011\textsuperscript{111}, although it later decreased substantially), and it also reached an unprecedented level of leverage, with a reported ratio between total assets held and capital and reserves exceeding 30 times\textsuperscript{112}.

But the most impressive move by the ECB was the launch of the \textit{Outright Monetary Transactions} programme, that replaced the SMP. The OMT scheme was anticipated by a famous speech in London in July 2012 by ECB Governor Mario Draghi, where he announced that ECB was ready to do “whatever it takes” to save the Euro; the official announcement came in August 2012, and the details were outlined in a press release of September 2012\textsuperscript{113}, but no official act was ever adopted to support it, and in fact some crucial aspects remained obscure and Mr Draghi had to clarify them.

The OMT consists in the conditional purchase, in the secondary markets, of Euro-area government bonds (without limits, as clarified by Mr Draghi); it has never been actually employed so far, but its announcement was decisive in putting an end (at least temporarily) to the Eurozone sovereign debt crisis started in the summer of 2011. A constitutional challenge was brought against the OMT scheme before the

\textsuperscript{110} As emerges from the \textit{Liquidity analysis} by the ECB itself on its website, at http://www.ecb.int/mopo/liquidity/index.en.html; see also the summary of ECB open market operations at http://www.ecb.europa.eu/mopo/implement/omo/index.en.html.


\textsuperscript{112} Jamie Coleman, \textit{Bloomberg: ECB Leveraged Like Lehman}, in \textit{Forexlive}, 20 December 2011.
German Constitutional Court and it has attracted a vast attention\textsuperscript{114}, but the consensus is that the German judges are very unlikely to take a strong stand against the programme: even though it would only affect Germany, a negative pronouncement would indirectly jeopardise the entire scheme, a step the German court will most likely want to avoid.

Another non-conventional measure was the widening of the collaterals accepted in credit operations by banks, in a parallel move to the one implemented by the Fed with its several facilities described above. This is another important aspect of money manipulation: the wider is the amount of securities that banks can pledge in return for cash, the easier it is for them to obtain such cash, the more cash is injected into the economy.

Art. 18.1 of the ECB Statute stipulates that «In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: [...] — conduct credit operations with credit institutions and other market participants, with lending being based on \textit{adequate} collateral»\textsuperscript{115}. It is therefore up to the ECB itself to decide what qualifies as \textit{adequate} collateral. The ECB did that with its \textit{Guideline on monetary policy instruments and procedures of the Eurosystem}, originally adopted in 2000\textsuperscript{116}, subsequently amended several times, and finally recast in 2011\textsuperscript{117}.

\textsuperscript{114} A summary of the legal issues involved is the case is for instance the one by Helmut Sickmann, Volker Wieland, \textit{The European Central Bank’s Outright Monetary Transactions and the Federal Constitutional Court of Germany}, Institute for Monetary and Financial Stability (Working Paper Series No. 71 (2013)).
\textsuperscript{115} Emphasis added.
Coherently with its overarching policy, the ECB acted repeatedly to loosen the eligibility criteria for collateral in response to the crisis: admittedly, from time to time some restrictions were also introduced, but the overall trend has definitely been towards relaxing the standards for collaterals\textsuperscript{118}.

Moreover, the Guidelines rely on certain \textit{External Credit Assessment Institutions} (ECAIs) for credit risk assessment, which are the usual incumbent rating firms, whose oligopoly is then inevitably reinforced once more.

Finally, the ECB reportedly saved Greece from bankruptcy at least once by increasing the upper limit for Emergency Liquidity Assistance (ELA, a line of credit that national central banks can provide to their banks suffering a crisis of liquidity)\textsuperscript{119}: this was necessary for the Greek National Bank to be able to loan to Greek banks the €3 billion cash needed to repay a maturing bond of the Greek government\textsuperscript{120}. Similarly, it reportedly overlooked the practice by the Bank of France (and possibly other national central banks), under the Short Term European Paper programme, of accepting collateral of poor value in exchange for cash, in order to help national banks in distress, which in turn keep buying French sovereign debt\textsuperscript{121}. The legitimacy of such coordinated actions by the ECB and the national central banks seems really

\textsuperscript{118} See \url{http://www.ecb.europa.eu/paym/coll/html/index.en.html}.
\textsuperscript{119} Jan Hildebrand, Sebastian Jost, \textit{EZB verschafft Griechen Luft} [ECB gives Greece a breather], in \textit{Die Welt}, 4 August 2012. The details on the functioning of the ELA, that was used also for Ireland and Cyprus, were made public by the ECB in October 2013: see their ELA procedures on its website.
\textsuperscript{120} Maria Marquart, \textit{The European Central Bank’s Discreet Help for Greece}, in \textit{Spiegel Online}, 8 August 2012.
questionable in light of the prohibition to finance Member States’ debt clearly set out in the Treaties.

In fact, if the Fed, in order to pursue its very activist policies, could rely on its emergency powers under the Federal Reserve Act of 1913, things are more complicated as regards the ECB, that has no equivalent emergency powers and whose mandate limits (or should limit) its ability to rein in distressed markets. For that matter, an action such as the one just described, implemented in order to rescue Greece from imminent bankruptcy, is almost certainly in breach of the Treaties; again, though, no remedy seems to be available, also considering that the German Constitutional Court rejected the request for a preliminary injunction in a proceeding challenging the legality of the ESM, and is very unlikely to reverse its stance on the merits (see below, § II.G).

Similarly, no remedy, even in theory, is available against the decisions of the central banks on monetary policies, and not even to have them at least comply with their inflation target, in case they miss it. Even worse, in the US it is the monetary system itself that is arguably incompatible with the original constitutional design \(^{122}\), but no remedy seems actually available either.

II.B FRACTIONAL RESERVE BANKING

Unfortunately, fractional reserve banking was all but called into question by

mainstream economic thought and subsequently by policy reform proposals. As was mentioned, the legitimacy of this practice is debated even among Austrian scholars, and the controversy was revamped in the wake of the crisis. However, such debate did not cross the borders of intra-Austrian discussions, and in fact both the Fed (with a decision effective 29 December 2011)\textsuperscript{123} and the ECB (starting from 18 January 2012)\textsuperscript{124} went as far as lowering the reserve requirements imposed on deposit institutions as a response to the crisis, in this way further increasing the power of banks to create money "out of thin air".

\textbf{II.C BASEL III}

Contrary to its proponents' expectations, also the Basel II Accord fell short of providing the desired stability to the global financial markets. In fact, as we saw, it arguably contributed to the severe imbalances that eventually ended up in the markets collapse.

However, global financial regulators opined that the problem did not lie in the very fact that financial institutions leverage their capital, investing many times more assets than they actually hold, counting on the fact that they will be bailed out in case something goes wrong. Instead, they thought the problem was again – as with Basel I – only with the details of the Accord, and kept trusting their ability to definitively

\textsuperscript{123} See \url{http://www.federalreserve.gov/monetarypolicy/reservereq.htm}.

\textsuperscript{124} As can be derived from the \textit{Instruments} section on ECB website, at \url{https://www.ecb.europa.eu/mopo/implement/mr/html/calc_en.html}; in particular, the reserve ratio for "all other liabilities", not included in the list of Article 4 of Regulation (EC) No 2818/98 of the European
remedy the previous shortcomings by simply adjusting such details.

This fine-tuning effort was done with the new round of Basel Accords, the so called Basel III\textsuperscript{125}. This new set of rules tries to make financial institutions more resilient and improve risk management. Without going into the details, suffice it to say that the changes are mainly related to leverage ratios and capital requirements: while, in the wake of the crisis, financial regulators had relaxed capital definitions in order to help banks face an emergency situation\textsuperscript{126}, it became clear that in the long run such rules had instead to be tightened, in order to make banks stronger and better prepared to face shocks and systemic contagion. Unfortunately, Basel III rules are currently set to be fully implemented only in 2019, and came out less stringent than originally anticipated\textsuperscript{127}.

But even though Basel III is a step towards a sounder financial system, the changes brought about remain anyway anchored to the paradigm followed by Basel I and Basel II: some shocks may be averted by the new rules, but the rationale behind them is the same as the one behind the rules in Basel I and Basel II that proved spectacularly

\begin{flushright}
Central Bank of 1 December 1998 on the application of minimum reserves, was cut down to 1\% from the previous 2\%.
\textsuperscript{125} Basel Committee on Banking Supervision, \textit{Basel III: A global regulatory framework for more resilient banks and banking systems} (December 2010, rev June 2011), available at \url{http://www.bis.org/publ/bcbs189.pdf}; the implementation process is still ongoing, both in the US (the latest proposed rulemaking is available at \url{http://www.fdic.gov/news/board/2012/2012-06-12_notice_disb.pdf}), and in the EU, where the Commission on 20 July 2011 adopted a proposal for a CRD IV package, that would replace the current directives 2006/48 and 2006/49 with a regulation and a directive (see \url{http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm}).
\end{flushright}
Inadequate to prevent the crisis\textsuperscript{128}.

In particular, government bonds rated AA- or higher keep being considered risk free, with the consequence that there is still a great (distorted) incentive to purchase them, because no capital needs to be set aside against these bonds\textsuperscript{129}: by contrast, corporate bonds with the same rating require a 20 per cent risk weighting (the unequal treatment is the same with bonds rated A+ to A-, that require a 20 per cent risk weighting for sovereign bonds and a 50 per cent one for corporate bonds; for bonds rated BBB+ to BBB-, that require a 50 per cent risk weighting in case of sovereign bonds and a 100 per cent in case of corporate ones; and for bonds rated B+ to B-, that require a 100 per cent risk weighting if it is sovereign bonds, while a 150 per

\textsuperscript{128} Similar reasons for scepticism were raised by the Free Exchange blog of The Economist, in a rather convincing post of 13 September 2010, Third time’s the charm?, where the author observed, quite presciently: "More important, the new regulatory scheme could fail in several ways. The most serious failure in Basel III is that it doesn't address the principal contribution of Basel II to the last financial crisis, namely, the calculation of risk-weights. One of the key components of Basel II was to increase the amount of capital banks had to hold against riskier assets. Extremely low-risk assets, meanwhile, could be held with very little or even no capital. Risk, moreover, was calculated primarily by reference to the rating assigned by one of the recognised ratings agencies. The consequence of this Basel II reform was to discourage banks from lending to risky enterprises, and to encourage the accumulation of apparently risk-free assets. This was a primary contributor to the structured finance craze, as securitisation was a way to "manufacture" apparently risk-free assets out of risky pools. What brought banks like Citigroup and Bank of America to their knees wasn't direct exposure to sub-prime loans, but exposure to triple-A-rated debt backed by pools of such loans, debt which turned out not to be risk-free at all. Since it did not change this risk-weighting, Basel III effectively doubles down on Basel II. Banks will need to hold more common equity than ever—against their risk-weighted assets. That massively increases the incentive to find low-risk-weight assets with some return, since these assets can be leveraged much more highly than risky assets. Unless I've missed something, lending to AA-rated sovereigns still carries a risk-weight of zero. So one result of Basel III could be to encourage banks to increase their lending to sovereigns at the margins of zero-risk-weight status. If that happens, anyone want to guess where the next crisis will crop up?".

\textsuperscript{129} This adds to another regulatory preferential treatment for government bonds, consisting in the fact that “While bank exposures to a single counterparty are limited, in principle, to a quarter of their eligible capital, exposures to sovereigns are exempted from that large exposures regime”, as explained by Deutsche Bundesbank President Jens Weidmann, Stop encouraging banks to buy government debt, in Financial Times, 30 September 2013. Not surprisingly, bank exposure to government bonds in the EU has been further increasing, as reported by Christopher Thompson, Patrick Jenkins, Bank exposure to EU states’ bonds on rise, in Financial Times, 13 October 2013.
cent one if it is corporate bonds\textsuperscript{130}).

The only positive innovation from our perspective was a joint memorandum by the Fed, the Office of the Comptroller of the Currency of the Department of the Treasury and the Federal Deposit Insurance Corporation\textsuperscript{131} proposing a regulatory turnaround: changing the current risk weight applied to gold bullion (that now has a 50 per cent risk weighting), and applying a zero risk weight. If this change were implemented, it would be a historical acknowledgement of the fact that gold is money, something that has been denied ever since President Nixon discontinued the pegging of dollar to gold\textsuperscript{132}; however, as was easily predictable, such proposal was never followed-up.

II.D HOUSING MARKET POLICIES

As is well known, in the US the housing market sector was the first and most severely hit by the crisis, the one that experienced the worst bubble. We will now focus on the regulatory responses by American legislators and regulators in this sector. It is a highly instructive analysis, because it allows us to observe the typical approach followed by US authorities to fight the crisis, the one that we have been criticizing over the course of this article and that EU authorities have predominantly followed as well. Again, a full analysis would require a self-standing work, so we will be


\textsuperscript{132} Alasdair Macleod, \textit{Gold reentering the monetary system}, Cobden Centre, 2 July 2012.
content with sketching the big picture, avoiding the technicalities.

The first actions were a coordinated plan by the Treasury and the Fed to tackle the demise of the housing values and the severe stress on government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. The business of these two enterprises was to back home mortgages; they were formally privately-owned, but in fact they received substantial sponsorship from the federal government. When the subprime home mortgages burst, Fannie and Freddie were severely hit, so intervention was focused primarily on them.

On July 13, 2008, the Fed announced it had "granted the Federal Reserve Bank of New York the authority to lend to Fannie Mae and Freddie Mac should such lending prove necessary. Any lending would be at the primary credit rate and collateralized by U.S. government and federal agency securities. This authorization is intended to supplement the Treasury's existing lending authority and to help ensure the ability of Fannie Mae and Freddie Mac to promote the availability of home mortgage credit during a period of stress in financial markets"133.

On the same day, the Secretary of the Treasury announced a three-pronged plan of his own: "First, as a liquidity backstop, the plan includes a temporary increase in the line of credit the GSEs have with Treasury. Treasury would determine the terms and conditions for accessing the line of credit and the amount to be drawn. Second, to ensure the GSEs have access to sufficient capital to continue to serve their mission,

the plan includes temporary authority for Treasury to purchase equity in either of the two GSEs if needed. Use of either the line of credit or the equity investment would carry terms and conditions necessary to protect the taxpayer. Third, to protect the financial system from systemic risk going forward, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by giving the Federal Reserve a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards.\textsuperscript{134}

But the main form of intervention came a few days later, on 26 July 2008, when the Congress, with bipartisan support, passed the 694-page \textit{Housing and Economic Recovery Act of 2008} (HERA), signed into law by President Bush on 30 July 2008.\textsuperscript{135} This comprehensive piece of legislation consisted of several different acts, each of them tackling a different aspect. The most important provisions were the following: a new tax credit for home purchases; an offer of emergency help to local governments to buy and renovate abandoned and foreclosed homes; an increase (up to $300 billion) in the limit for the refinance mortgages that the \textit{Federal Housing Administration} was authorized to insure in order to avoid potential foreclosures; an increase in the dollar limit of the loans that the GSEs are allowed to purchase; an authorization to states to refinance subprime loans; the merger of the Office of Federal Housing Enterprise Oversight and of the Federal Housing Finance Board into a newly-established regulator, the Federal Housing Finance Agency (FHFA), with the

\textsuperscript{134} U.S. Department of the Treasury, \textit{Paulson Announces GSE Initiatives}, 13 July 2008, \textit{available at}
power to oversee GSEs and Federal Home Loan Banks; an enhancement of the mortgage disclosure requirements; a new mandatory licensing and registration system for mortgage loan originators; and finally, the authorization to the Treasury to refinance Fannie Mae or Freddie Mac and purchase agency-guaranteed mortgage-backed securities, coupled with the increase of the Treasury's debt ceiling by $800 billion.

Relying on the provisions of the HERA, on 7 September 2008 the FHFA announced it had put Fannie Mae and Freddie Mac under its conservatorship\(^{136}\). On its turn, this lied the basis for an agreement of both GSEs with the Treasury, under which the Treasury committed to invest up to 100 billion dollars in each of them, in return for a certain amount of senior preferred capital\(^{137}\). Between October and 2008 and December 2009, the Treasury also enacted its agency MBS purchase program\(^{138}\).

The Fed followed suit: on 25 November 2008, it announced the creation of the already mentioned TALF\(^{139}\) and the intention to purchase up to $100 billion of "the direct obligations of housing-related government-sponsored enterprises (GSEs)-Fannie

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Mae, Freddie Mac, and the Federal Home Loan Banks—and mortgage-backed securities (MBS) backed by Fannie Mae, Freddie Mac, and Ginnie Mae\textsuperscript{140}.

Such actions substantially amounted to a bailout of Fannie and Freddie out of taxpayers' money, and eventually were not even included in the federal budget\textsuperscript{141}. They managed to partially stabilize the housing market (socializing the cost of the \textit{de facto} bailout), but in the medium run they did not prove particularly effective in ending the easy credit to subprime borrowers: a \textit{New York Times} reportage of April 2012 already showed that there were signs that subprime mortgages were resuming\textsuperscript{142}. This is quite disappointing, if one looks at the cost so far of the nationalization of Fannie and Freddie: according to the Office of Management and Budget, "Treasury currently has a net investment of $151b in Fannie Mae and Freddie Mac [...]. OMB projects the eventual cost to fall to $28b by fiscal year 2022"\textsuperscript{143}.

And nonetheless, as admits the same Office of Management and Budget report, "the housing market remains a challenge"\textsuperscript{144}: moreover, a plan by the Obama administration to reduce "principal on mortgages worth more than the underlying

\textsuperscript{144} See also this column in the \textit{Financial Times} of 27 February 2012 by Robert Reich, \textit{Housing is the rotting core of the US recovery}. According to Mark A. Calabria, some role in slowing the recovery might also be played by the rules governing the foreclosure procedure: in particular, judicial foreclosures might be slower and therefore worse than simply administrative ones: \textit{see} his \textit{Cato@Liberty} post of March 8, 2012.
home”[^145] was blocked by the FHFA (on the grounds that it might determine further costs for the taxpayers and create a perverse incentive for borrowers currently paying off their debts to stop doing that in order to take advantage of the plan), leaving the administration with not many other policy options to keep artificially sustaining the troubled housing market[^146]. Unfortunately from our perspective, the only "healthy" choice, i.e. simply letting malinvestments to be liquidated, as painful as that may be, is not even taken into consideration; nor have unwise policy choices such as the interest mortgage deduction been discontinued yet; in fact, the Obama administration seems to be trying all they can to keep alimenting the bubble[^147], and it is hardly surprising that this approach is not proving particularly satisfactory.

To conclude, "the Treasury [...] amended its agreements with Fannie and Freddie so that the companies no longer have to pay a fixed dividend to the U.S. taxpayer, but


[^146]: After such decision by the FHFA, a US Senator, Jeff Merley, came up with a plan for a mass mortgage refinancing, at the expense of a government-financed trust: this plan was praised by Joseph E. Stiglitz and Mark Zandi in a *New York Times* op-ed, *The One Housing Solution Left: Mass Mortgage Refinancing*, 13 August 2012, p. A17, and criticized by Mark A. Calabria in a post on the same day in *Cato@Liberty, Ricardo and Mass Mortgage Refinancing*.

instead “every dollar of profit” from the companies to the taxpayer”\textsuperscript{148}. In spite of the misleading announcement by the Treasury\textsuperscript{149}, “[t]he problem is that the Government Sponsored Enterprises (GSE) have never had a year where their profits would have covered the dividend payments, so while we can debate if the taxpayer will recover \textit{anything} from the GSEs, shifting to just collecting profits definitely means the taxpayer’s potential recoupment is lower”\textsuperscript{150}.

\section*{II. E THE REGULATION OF CREDIT RATING AGENCIES}

Credit rating agencies came under harsh criticism and regulatory scrutiny due to their quite remarkable shortcomings in timely and accurately registering the credit risks of both companies and sovereign states. As we saw, in this field as in all the other ones we have considered, there was all but a lack of regulation in place before the crisis, and in fact the government-entrenched oligopoly and the barriers to entry existing in the US are arguably responsible for the unsatisfactory outcomes. With the outbreak of European sovereign bond crisis, many European leaders reacted furiously against the multiple downgrades inflicted to their countries by CRAs, in their view unjustified. In Italy, some prosecutors even alleged that some top managers of S&P

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\item \textsuperscript{148} Mark A. Calabria, \textit{Geithner Favors Fannie Mae Debtholders over Taxpayers ... Again}, in \textit{Cato@Liberty}, 17 August 2012.
\item \textsuperscript{149} Department of the Treasury, \textit{Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac}, 17 August 2012.
\item \textsuperscript{150} Mark A. Calabria, \textit{Geithner Favors Fannie Mae Debtholders over Taxpayers ... Again}. Explains the author: “How does the change protect debtholders over taxpayers? It reduces the ability of FHFA to place Fannie or Freddie into a receivership, under which FHFA could impose losses on creditors. Under Section \textsuperscript{1145} of the \textit{Housing and Economic Recovery Act} [http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf], FHFA has the discretion of appointing a receiver if one the
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conspired with the purpose of destabilizing the Italian government, and downgraded on purpose Italian bonds contrary to the much better data on the credit-worthiness of the Italian government that would have been available to them – a truly far-fetched accusation. Other litigation was brought against CRAs in several other countries, including in the US (see in particular the fraud lawsuit brought by the US government against Standard & Poor’s, that the latter publicly accused of being a form of retaliation for downgrading the US government debt a few days earlier).

Anyway CRAs were subject to some new regulations by the Dodd-Frank Act (see below, § II.1), essentially in an effort to correct the misguided over-reliance on CRAs typical of the existing regulation.

As for Europe, CRAs were subject to a particularly intense new round of legislation, and initiatives were taken there to regulate such market even more than it had already been, rather than trying to remove barriers to entry and encourage competition. Some far-reaching changes, like the implementation of a public European CRA, have so far been turned down, but other important innovations

GSEs displays an “inability to meet obligations,” which would include dividend payments. By essentially taking away that lever from FHFA, Treasury has greatly reduced any chance of a receivership”.

151 Italy prosecutors wind up S&P market abuse probe: source, in Reuters, 31 May 2012; also Moody’s and Fitch are being probed by the same magistrates, and so far a criminal case has been sought by them also against two of the latter’s top managers: Ambrose Evans-Pritchard Fitch is targeted by Italian magistrate, in The Telegraph, 23 August 2012.

152 Mark A. Calabria, in his Cato Policy Analysis written together with Emily McClintock Ekins (see above, note 71), and in a more recent blog post, convincingly argues that Liability Is ’Wrong’ Solution for Rating Agencies, Cato@Liberty, 13 November 2012.

153 The same approach can be said to characterize the reforms brought about by the Dodd-Frank Act in the US: for an analysis of the shortcomings of these reforms, even though from a different perspective, see Hill, Limits of Dodd-Frank’s Rating Agency Reform.

154 Other rules, limiting inter alia the ability of CRAs to issue unsolicited sovereign debt ratings, were approved by the European Parliament on first reading on 16 January 2013.
were brought about by Regulation (EC) No 1060/2009\textsuperscript{155}, subsequently amended by Regulation (EU) No 513/2011\textsuperscript{156} and Regulation (EU) No 462/2013\textsuperscript{157}, and implemented by Commission Delegated Regulations (EU) Nos 272\textsuperscript{158}, 446\textsuperscript{159}, 447\textsuperscript{160}, 448\textsuperscript{161}, 449\textsuperscript{162} and 946/2012\textsuperscript{163}.

It is beyond our reach to consider such new rules in detail\textsuperscript{164}: suffice it to say that,

\textsuperscript{161} Commission Delegated Regulation (EU) No 448/2012 of 21 March 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority.
as Article 1 of Regulation No 1060/2009 (as amended) explains, they try to «la[y]
down conditions for the issuing of credit ratings and rules on the organisation and
conduct of credit rating agencies, including their shareholders and members, to
promote credit rating agencies’ independence, the avoidance of conflicts of interest,
and the enhancement of consumer and investor protection». Article 4, then, as
amended by Regulation No 513/2011, makes it very clear that financial institutions
«may use credit ratings for regulatory purposes only if they are issued by credit rating
agencies established in the Union and registered in accordance with this Regulation»,
while the following articles are dedicated to outlining the criteria that a credit rating
agency must comply with in order to qualify as an accepted one.\footnote{In fact, an updated list of registered and certified CRAs was published by ESMA on 20 March 2013. A few months earlier, on 5 October 2012, the Commission had adopted three Decisions declaring respectively the US, the Canadian and the Australian «the US legal and supervisory framework for credit rating agencies shall be considered as equivalent to the requirements of Regulation (EC) No 1060/2009», thus contributing to entrenching the existing oligopoly on a global scale.}

Finally, title III of Regulation No 1060/2009 outlines the details of the registration
procedure mentioned in Article 4, and regulates supervision on the respect of the new
rules, entrusted principally – after Regulation No 513/2011 – with the ESMA, which
«shall charge CRAs fees» for these activities, according to Article 19\footnote{The details are outlined in the mentioned Regulation No 272/2012.}; Title IV deals
mainly with the penalties for non-compliance.

As should be evident, the approach followed by European legislators is completely
ad odds with the one advocated for here: instead of encouraging competition and
trusting the free market to deliver better ratings, some new powerful barriers to entry

\textit{Perspective (ADBI Working Paper Series No. 188, January 2010).}
were raised, and then a remarkable regulatory effort was made in order to try to force CRAs to "behave". Something which is particularly critical to the stability of the market, given the importance that Basel rules, including Basel III, place on ratings.

The regulators' approach looks quite contradictory: first they trust CRAs' judgments to an extremely great extent, and impose investors to rely on their assessment, but then they lose confidence in them, and feel the need to regulate every aspect of their conduct and approve of their very ability to operate\(^{167}\). No wonder, again, from our perspective, that the new rules are not working as hoped, and that still new ones keep being invoked, in the illusion that adding regulation to regulation would finally make the market work\(^{168}\).

II.F DEPOSIT INSURANCE SCHEMES

In order to avoid panic from spreading and turning into bank runs, both the US\(^{169}\)
and the EU\textsuperscript{170} raised the threshold covered by their respective deposit insurance schemes. However, some differences emerged: "In the US, the crucial action took place at federal level. The Federal Deposit Insurance Corporation (FDIC) wound up insolvent banks when it could (450 have been liquidated since 2008, including large-ish entities like Washington Mutual). Institutions considered too systemic to fail were recapitalised by a federal instrument, the Troubled Asset Relief Programme (TARP). And depositors were backed by a US-wide protection scheme administered by the FDIC. [...] In the eurozone, by contrast, almost all the action took place at national level. Several consequences followed. Governments were slower to recognise (and spent a lot of time trying to conceal) the weakness of 'their' national banks. Fewer of these were wound up (a reflection of their crucial importance in local politics). When banks were recapitalised, individual states (like Ireland) were pushed into a sovereign debt crisis. And national deposit protection schemes could not prevent depositor purchase and insure certain types of troubled assets for the purposes of providing stability to and preventing disruption in the economy and financial system and protecting taxpayers, to amend the Internal Revenue Code of 1986 to provide incentives for energy production and conservation, to extend certain expiring provisions, to provide individual income tax relief, and for other purposes, Pub.L. 110-343, 122 Stat. 3765, October 3, 2008) raised that limit to 250,000 dollars until 31 December 2009; s. 204 of the Helping Families Save Their Homes Act of 2009 (Division A of An Act To prevent mortgage foreclosures and enhance mortgage credit availability, Pub.L. 111-22, 123 Stat. 1632, May 20, 2009) extended the deadline to 31 December 2013; and then s. 343 of the Dodd-Frank Act made the increase to the 250,000 dollar-limit permanent. Under this latter section, the FDIC on 9 November 2010 provided for unlimited guarantee of noninterest-bearing transaction accounts between 31 December 2010 and 31 December 2012 (with a Final Rule, available at http://www.fdic.gov/news/news/financial/2010/fil100076.pdf), however, according to Mark A. Calabria, \textit{Will Congress extend the 'TAG' Bank Bailout?}, Cato@Liberty, 27 July 2012, the FDIC lacked any statutory authority to implement such a programme.

\textsuperscript{170} Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay mandated an increase of the minimum amount covered from the previous 20,000 euro to 50,000 and then 100,000 by 31 December 2010.
flight from countries with weak sovereigns such as Greece\textsuperscript{171}.

As for the EU, the proposal of establishing a EU-wide common deposit insurance scheme was brought forward in many policy discussions, for instance in a common report issued by the Presidents of the European Council, of the Commission, of the Eurogroup, and of the ECB\textsuperscript{172}, that was the basis for discussion at the European Council of 28-29 June 2012\textsuperscript{173}. Also due to continuing German opposition to such a scheme, so far the European Commission has only proposed to harmonize the existing rules, as part of the more comprehensive framework for banking resolution currently being negotiated, although a proposal they made provides for the establishment of a Fund that would effectively «serv[e] as a Euro area-wide insurance mechanism»\textsuperscript{174}.

Clearly, from the perspective advocated for in Part I, a common deposit insurance scheme is but a greater mistake: deposit guarantees are a great source of moral hazard, and it is also likely that they could never deliver to the expectations they raise into bank depositors, so they should arguably be abolished. A significant test of the

\begin{thebibliography}{99}

171 Philip Whyte, \textit{A banking union - it is necessary, but is it likely?}, Centre for European Reform, 27 July 2012.


effectiveness of deposit schemes, and of how much they can actually be relied on, was
offered by the financial crisis in Cyprus, culminated in the March 2013 bailout. As
explained Detlev Schlichter, «events in Cyprus did not mark the death of democracy or
the end of the euro but potentially the beginning of the end of deposit ‘insurance’»: 175
indeed, even though the final agreement eventually ruled out haircuts on deposits
below the insured threshold, the first version of the EU-IMF agreement provided a
6.7% haircut also on insured deposits, and it was just thanks to the failure by the
Cypriot Parliament to ratify it (under pressure from street demonstrations in Nicosia
and Russian government anger) that such blatant disregard of the deposit insurance
was avoided. In spite of the above-mentioned attempts by the EU to establish a
framework whereby bank resolutions are regulated in advance and do not need to be
negotiated in the midst of a banking crisis, it might easily happen that a very serious
crisis like the Cyprus one, but on a much larger scale, would lead to a significant
haircut of deposits also below the insured threshold 176.

175 Detlev Schlichter, _Good riddance to deposit 'insurance'_ , 27 March 2013, on detlevschlichter.com.
176 There is also another point made by Frank Hollenbeck, _Insuring Deposits, Ensuring Insolvency_,
Mises Daily, 24 July 2013: in case of a sovereign default of a Euro member, like Italy or Spain, the value
of its debt «will drop significantly as Greek debt did back in 2010»: national banks holding great amounts
of that debt «will go bankrupt instantly, and the Italian or Spanish governments will be on the hook for the
deposits that served as funds to purchase their bonds since these deposits are insured! These governments
will then have to print their way out of the problem. However, this would go against the ECB’s mandate
and would probably face a German veto. A breakup of the Euro would then be inevitable. An official rate
would then be set between Euros and liras or pesetas. This rate, however, would have nothing to do with
the market rate. Depositors holding less than 100,000 euros would get their money back in liras or pesetas.
However, this new currency would not be able to buy much. Deposit insurance guarantees the nominal
value of deposits, not its real value: hence, the illusion of protection». 

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II.G European Institutional Architecture

The enterprise of establishing a new institutional and regulatory framework in Europe, on the assumption that a more integrated economic and fiscal governance would make crises less likely, is a huge work-in-progress.

Several pieces of legislation have been enacted, while many others have been proposed and are currently under examination by EU legislators. The underlying design seems to be the adoption of a series of steps towards a political and fiscal unification of Europe, an objective certainly not shared unanimously all over Europe, but strongly supported by European top bureaucrats and many prominent national European politicians. While the resistance by Northern European leaders has so far prevented the achievement of full integration, the measures already taken or agreed arguably try to pave the way towards such an outcome. Let us try to quickly review them, considering first some strictly institutional arrangements, then the mechanisms devised to provide financial support to troubled governments, and finally the new agreements concerning the surveillance of public finances and the fostering of economic growth across the EU.

a) First of all, some important innovations were brought about by the Lisbon Treaty: some "provisions specific to Member States whose currency is the euro" were introduced in the TFEU (Articles 136 to 138), empowering the Council to adopt measures "(a) to strengthen the coordination and surveillance of their budgetary
discipline; (b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance”; and a new Protocol to the TFEU was added (Protocol No. 14 on the Euro Group), stipulating that "The Ministers of the Member States whose currency is the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currency is the euro and of the Commission".

Another innovation was brought about by the Ecofin, that on 7 September 2010 established the so called “European Semester”\(^\text{177}\), an institutionalized mechanism to enhance coordination and supervision among EU members in the field of economic policy, aimed at helping the convergence among them and at "strengthen[ing] budgetary discipline, macroeconomic stability and growth\(^\text{178}\). In the framework of the European Semester, both the Euro-plus Pact and the "six-pack" were agreed (on which see below). The European Semester was institutionalized by Regulation No. 1175/2011\(^\text{179}\).

On the institutional level, we shall also mention the European System of Financial


\(^{178}\) Ibidem.

Supervisors, the new framework of authorities entrusted with the supervision of financial markets, that became operational between the end of 2010 and the beginning of 2011: it comprises the European Systemic Risk Board\(^{180}\); the three new European Supervisory Authorities\(^{181}\), i.e. the European Banking Authority\(^{182}\) (which replaced the Committee of Banking Supervisors), the European Insurance and Occupational Pensions Authority\(^{183}\) (which replaced the Committee of European Insurance and Occupational Pensions Supervisors), and the European Securities and Markets Authority\(^{184}\) (which replaced the Committee of European Securities

\(^{180}\) Established by Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board; Article 3 explains that the ESRB "shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth". See also Council Regulation (EU) No 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.


Regulators); the Joint Committee of European Supervisory Authorities\textsuperscript{185}, and the competent supervisory authorities in the Member States.

Finally, the European Council of 28-29 June 2012, based on the already mentioned Report by the Presidents of the European Council, European Commission, Eurogroup and ECB, set the stage for a single European banking supervision, possibly to be entrusted to the ECB under Article 127(6) TFEU; work is still ongoing in this direction.

b) With the progressive deterioration of public budgets in some eurozone countries, the need arose to set up a mechanism to provide assistance to these troubled governments\textsuperscript{186}. As for Greece, a first round of help was provided via the Greek Loan Facility, a joint programme of the Euro area Member States and the IMF, respectively contributing 80 billion and 30 billion euro, whose coordination and management was entrusted to the European Commission. The details of the plan were outlined in a Council Decision of 10 May 2010\textsuperscript{187} and in a Memorandum of Understanding between the Greek government, the IMF and the Commission on behalf of euro area Member States.

But in order to help Ireland and Portugal, much stronger intervention was needed.

\textsuperscript{185} Established by Articles 54 and ff. of Regulations No 1093/2012, 1094/2010 and 1095/2010.
\textsuperscript{187} Council Decision of 10 May 2010 addressed to Greece with a view to reinforcing and deepening
In May 2010, two new coordinated instruments were created: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Mechanism (EFSF). The former was "based on Art. 122.2 of the Treaty and an intergovernmental agreement of euro area Member States" and implemented with Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism. Under EFSM, the Commission is allowed to borrow up to a total of €60 billion in financial markets on behalf of the Union under an implicit EU budget guarantee. The Commission then on-lends the proceeds to the beneficiary Member State. This particular lending arrangement implies that there is no debt-servicing cost for the Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission. The EU budget guarantees the repayment of the bonds through a p.m. line in case of default by the borrower.

As for the well-known EFSF, "the representatives of the governments of the euro area member states adopted a decision to commit to provide assistance through a Special Purpose Vehicle that is guaranteed on a pro rata basis by participating member states in a coordinated manner and that will expire after three years, up to EUR 440 billion, in accordance with their share in the paid-up capital of the European Central Fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit (2010/320/EU).

189 OJ EU L 118/1, 12.5.2010.
The EFSF was created with the task of raising money, through the issuance of debt instruments (backed by a guarantee from euro-Member States proportionally to their shared of ECB paid-in capital), and then lending such money to governments of the eurozone in need of financial assistance, or using it to recapitalize banks or to purchase sovereign bonds.

The EFSF (together with the EFSM, and also with the IMF) was soon employed essentially to bail out Ireland and Portugal, respectively in January and June 2011. This consumed part of the capital guarantee, but it was clear that the emergency was not over, with Greece looming on the verge of bankruptcy and investors starting to seriously worry for Spain and Italy too. Eurozone governments responded to this fresh emergency by increasing the EFSF guarantee commitments from the previous 440 billion euro to around 780 billion, an amount corresponding to an effective lending capacity of 440 billion. The enlargement was agreed upon with an international treaty, that required ratification by all signatory countries. Such process was particularly controversial in Slovakia, where the question was raised that the EFSF violated Art. 125(1) of the TFEU, i.e. the so called no-bailout clause introduced in the Treaties by the Maastricht Treaty. However, ratification was eventually accomplished in Slovakia too and the amended EFSF Framework came into force on 18 October

191 Council of the EU, Economic and financial affairs, Extraordinary Council meeting Economic and Financial Affairs, Brussels, 9/10 May 2010, Press release, p. 7 (the EFSF was agreed with a Decision of the Representatives of the Governments of the Euro Area countries of 10 May 2010 to set up the European Financial Stability Facility (EFSF) as a private company with euro states as shareholders).
2011. Soon after that, the EFSF was then used for a second bailout of Greece. Meanwhile, discussions had started to establish a permanent stabilisation mechanism: the EFSF and EFSM had indeed been established as temporary vehicles. In order to do that, an amendment to the Treaties was necessary: this was implemented by the European Council on 25 March 2011, under a simplified Treaty amendment procedure. The amendment (whose ratification was completed only on 23 April 2013) set the stage for a permanent stabilisation mechanism by adding a new paragraph to Article 136 TFEU, which stipulates that “The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality”.

Based on such provision, on 1 February 2012 the governments of euro-Member States signed the Treaty establishing the European Stability Mechanism (ESM). The ESM “will perform the same activities as the amended EFSF: - issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries in financial difficulties; - intervene in the primary and secondary debt markets; - act on the basis of a precautionary programme; - finance recapitalisations

of financial institutions through loans to governments including in non-programme countries. At the euro area summit on 29 June 2012, it was proposed that once an effective supervisory mechanism is established for banks in the euro area, involving the ECB, the ESM could, following a regular decision, have the possibility to recapitalise banks directly"¹⁹⁶.

After the German Constitutional Court’s ruling on 12 September 2012 dismissing a request for a preliminary injunction against its ratification¹⁹⁷, Germany ratified (with reservations) the ESM Treaty on 27 September 2012 (followed on 4 October 2012 by Estonia, the only remaining State that had not ratified it yet), so now euro-Member States have in place a permanent system for assisting those financially troubled among them¹⁹⁸ (the case on the merits has not been decided yet, but has lost relevance, now that ratification is completed).

The ESM has a total subscribed capital of 700 billion euro, and an effective lending capacity of 500 billion; but its paid-in capital will be of 80 billion, provided by euro-Member States in proportion to their ECB paid-in capital. As was explained by Bocconi Professor Roberto Perotti in an op-ed in the Italian financial daily Il Sole 24 Ore¹⁹⁹, there is a crucial difference between the EFSF and the ESM: while they can loan a similar amount of money, around 500 billion euro, for Eurostat rules the EFSF loans

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¹⁹⁷ For some comments on this decision, see the Special Section The ESM Before the Court of the German Law Journal, vol. 14, No. 1, pp. 1-190.
¹⁹⁸ To be sure, a preliminary reference procedure from Ireland is pending before the Court of Justice of the EU, but the ECJ is highly unlikely to unsettle the ratification process.
qualify as public debt\textsuperscript{200}, while the great majority of the ESM capital is just callable, so it only has to be paid-in contingently on needs, and is not required to be included in the calculation of the public debt. In this way, the commitment for the Member-States taxpayers is exactly the same, but the ESM allows governments to hide it to them, thanks to a loophole in Eurostat accounting rules. Currently, the ESM Chief has declared he is convinced that Greece will very likely need a third bailout\textsuperscript{201}.

In June 2013, the Eurogroup decided that the ESM will be given the power to directly recapitalise banks\textsuperscript{202}; this innovation, clearly unhealthy for the financial system from the perspective of this article, will be one of the building blocks of the banking union, together with the Single Supervisory Mechanism (on which see below, § II.I), the Single Resolution Mechanism (currently under a drafting process, but whose key elements were agreed in the Council of 27 June 2013\textsuperscript{203}), and possibly, in the future, a common deposit insurance scheme.

c) Measures were also taken in the field of economic and fiscal governance of the EU, aimed at consolidating sovereign budgets and stimulating European ailing growth.

In particular, on 25 March 2011, the 17 euro-Member States plus Bulgaria, Denmark,

\textsuperscript{199} Roberto Perotti, Quei debiti «fuori bilancio», in Il Sole 24 Ore, 24 luglio 2012.
\textsuperscript{201} Stability Fund Chief Expects Third Greek Bailout, Spiegel Online International, 4 October 2013.
Latvia, Lithuania, Poland and Romania signed (under the EU Open Method of Coordination, and integrated in the European Semester) the so called Euro Plus Pact. "The Pact commits signatories to even stronger economic coordination for competitiveness and convergence, also in areas of national competence, with concrete goals agreed on and reviewed on a yearly basis by Heads of State or Government." An important line of action is the commitment to implement a "common base" for corporate taxation.

At the end of 2011, the EU also enacted the so called "six-pack", a set of five Regulations and one Directive – entered into force on 13 December 2011 – that cover fiscal surveillance, but also macroeconomic surveillance under the new Macroeconomic Imbalance Procedure. In the fiscal field, the six-pack strengthens the Stability and Growth Pact (SGP). According to the SGP Member States' budgetary

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balance shall converge towards the country-specific medium-term objective (MTO) – so-called preventive arm – and the general government deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP (or at least diminish sufficiently towards the 60% threshold). The six-pack reinforces both the preventive and the corrective arm of the Pact, i.e. the Excessive Deficit Procedure (EDP), which applies to Member States that have breached either the deficit or the debt criterion.\textsuperscript{207}

Slightly after the approval of the "six-pack", the Commission already tried to supplement it with the proposal of two additional Regulations (the so called "two-pack")\textsuperscript{208}, "aimed at strengthening the surveillance mechanisms and promoting further economic integration and convergence in the euro area".\textsuperscript{209} After the approval by the European Parliament\textsuperscript{210}, the "two-pack" entered into force on 30 May 2013. But the most relevant piece of legislation so far was the adoption on 2 March 2012 by all EU Member States except for the UK and the Czech Republic of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union\textsuperscript{211}. As was mentioned, the ESM Treaty entered into force on 27 September 2012 (and on 4

\textsuperscript{207} European Commission, \textit{Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance}, 14 March 2012. It is worth noting that under the Macroeconomic Imbalance Procedure, the Commission has ruled that not only account deficits, but also account surpluses need to be reduced (at least if they exceed the 6\% of GDP threshold), a view that is highly questionable though.\textsuperscript{208} Proposal for a Regulation of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, COM(2011) 821 final; Proposal for a Regulation of the European Parliament and of the Council on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area, COM(2011) 819 final.\textsuperscript{209} European Commission, \textit{Economic governance: Commission proposes two new Regulations to further strengthen budgetary surveillance in the euro area}, 23 November 2011.\textsuperscript{210} \textit{EU Parliament Approves Two-Pack Fiscal Rules but Sets Conditions}, in \textit{The Wall Street Journal}, 13 June 2012.
October 2012 for Estonia).  

The fiscal part of this Treaty is the so called Fiscal Compact. As explained by the European Commission, it “[r]equires contracting parties to respect/ensure convergence towards the country-specific medium-term objective (MTO), as defined in the SGP, with a lower limit of a structural deficit (cyclical effects and one-off measures are not taken into account) of 0.5% of GDP; (1.0% of GDP for Member States with a debt ratio significantly below 60% of GDP). Correction mechanisms should ensure automatic action to be undertaken in case of deviation from the MTO or the adjustment path towards it, with escape clauses for exceptional circumstances. Compliance with the rule should be monitored by independent institutions. These budget rules shall be implemented in national law through provisions of "binding force and permanent character, preferably constitutional". European Court of Justice (CoJ) may impose financial sanction (0.1% of GDP) if a country does not properly implement the new budget rules in national law and fails to comply with a CoJ ruling that requires it to do so. In the case of "euro-area Member States", sanctions would be channelled to the ESM, in the case of "non-euro-area Member States", the money would be attributed to the EU budget. Compliance with the rule implementing the MTO in national law will also be monitored at the national level by independent institutions. Other provisions aim at reinforcing the implementation of the Stability and Growth

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212 "TSCG will only be binding for all "euro-area Member States", while other contracting parties will be bound once they adopt the euro or earlier if they wish (they are allowed to choose provisions they wish to comply with)”. European Commission, Six-pack? Two-pack? Fiscal compact? A short guide to the new
Pact: re-statement of the debt rule set up by the six-pack, behavioural commitment reproducing RQMV among "euro-area Member States" when the Commission considers that an excessive deficit exists (formal modification of the voting rules would require a Treaty change). Finally, the TSCG sets stones for a reinforced surveillance and coordination of economic policies, with ex ante coordination of debt issuance plans among Contracting Parties and economic partnership programmes for Member States in EDP, which detail the structural reforms needed for an effective and durable correction of their excessive deficit. TSCG also includes a part on economic governance in the euro area, e. g.: Euro Summits at least twice a year; reinforced economic cooperation.213

Finally, in order to try to revive the struggling European economies, the European Council of 28-29 June 2012 also undertook a commitment of a 120 billion euro-worth "compact for growth and jobs".

Overall, the actions by the EU and the Eurozone Member States in the area of fiscal and economic governance offer a mixed picture from the perspective shared here. Indeed the attempt to finally take the neglected Maastricht criteria more seriously and keep the public budget under control is surely to be praised, as is the push towards the adoption of constitutional rules mandating a balanced budget. However, it remains to be seen whether such rules will be taken seriously, and in fact the EU has already agreed to extend some countries' deadline for the reduction of their excessive deficit.
deficits, indicating that the old habits are not lost.

Moreover, what seems utterly misguided in terms of policy is the decision to spend enormous amounts of (other countries') taxpayers' money in order to try to bail out bankrupt governments. Not only is this highly questionable from a moral point of view, but it does not even seem to be an effective approach, if one considers for instance how much Greece is struggling and how little it has accomplished in terms of the promised economic reforms, in spite of the hundreds of billions in bailout funds it has received.

The other aspect to consider is that both the bailouts and the other actions taken by the European States seem to go down the road of the definitive fiscal and political unification of the continent: indeed the bailout funds tend to be granted in return for progressive withdrawal of sovereign powers\textsuperscript{214}, and as we saw the European institutions also worked explicitly in the direction of tax policy harmonization\textsuperscript{215}.

The combined effect of these two trends is the coming closer of the political unification of the countries that will not decide to opt out: the current middle-way unification, where monetary policy is shared but fiscal and economic policies are not, and that – as we explained in § I.G – many consider to be one of the reasons of the

\textsuperscript{214} The redemption pact being discussed by EU authorities under proposal of the German Council of Economic Experts is another huge step in this direction (details are available at http://www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?&L=1)

\textsuperscript{215} Bagus, in the introduction to his The Tragedy of the Euro, pp. XVIII-XIX, goes as far as to argue that "[t]he project of the Euro has been pushed by European socialists to enhance their dream of a central European state" And he adds: "[b]ut the project is about to fail. The collapse is far from being a coincidence. It is already implied in the institutional setup of the EMU [...]. The story is one of intrigue, and economic and political interests. It is fascinating story in which politicians fight for power, influence
current turmoil, seems bound to be eventually overcome: either by a (maybe partial) break-up, or by closer unification.

At first sight, the latter choice seems preferable for non-virtuous countries because foreign impositions currently appear to be the only realistic ways for them to achieve some fiscal discipline. From this perspective, even some prominent Austrian scholars – chiefly Huerta de Soto – have argued in *defense of the euro*\(^\text{216}\), praising it for its rigidity and for preventing undisciplined countries like Greece, Italy, Portugal or Spain to try to respond to the crisis by devaluing their currency, a false solution to their problems in which they have engaged for too long.

However, the price to be paid for this advantage cannot be overlooked. That price is a further, at this point potentially irreversible, loss of sovereignty, given the massive transfer of power from the periphery to the centre, and from elected representatives to unelected, sometimes quasi-self-appointed bureaucrats. From this perspective, Gary North's severe critique of the euro (and of de Soto's defense of it)\(^\text{217}\) seems to be very much in point: in particular, such critique sounds persuasive when it exposes the highly constructivist nature of this enterprise and the great loss of self-determination powers that it has determined, and the even greater to come if one wants to keep the whole project alive, in order to avoid a painful return to national currencies, with the subsequent tremendous debasement that this would mean for essentially bankrupt countries like the so called 'PIGS'.

and their own egos". 
II.H MORE TAXATION, DEFICIT, DEBT, PUBLIC SPENDING... TO FINANCE BAILOUTS

As should be fairly easy to predict from the analysis of the previous paragraphs, the actions taken by the US government and by most European countries determined a general increase of the tax rate, public deficits and debts, and public spending in general\textsuperscript{218}: the frequent cries against an alleged austerity wave\textsuperscript{219} seem therefore highly overstated\textsuperscript{220}; in fact, austerity is only partial and much smaller than what is often claimed\textsuperscript{221}.

A great amount of money was used for the bailouts, chiefly of Fannie and Freddie\textsuperscript{222} and of the financial\textsuperscript{223} and auto sectors\textsuperscript{224}, in the US, and of banks and troubled governments, in the EU\textsuperscript{225}.

But especially in the US, a huge amount of money was spent also on a massive

\textsuperscript{216} Jesús Huerta de Soto, An Austrian Defense of the Euro, Mises Daily, 22 June 2012.
\textsuperscript{217} Gary North, Let the Euro Die... Soon, on Gary North's personal website (27 June 2012).
\textsuperscript{219} See the debate between Veronique de Rugy (Show Me the 'Savage' Spending Cuts in Europe, Please in National Review Online, 7 May 2012, and The Debate over Austerity Continues, 8 May 2012) and Ryan Avent, Yes, there is austerity, in The Economist, 8 May 2012. A major source of misunderstanding is that the word 'austerity' is used to refer both to spending cuts and to tax increases, but the two are conceptually opposite types of measures: to be sure, three types of austerity can be identified: see Frank Hollenbeck, The Three Types of Austerity, Mises Daily, 4 September 2013.
\textsuperscript{220} See for instance Martin Masse, Is “Austerity” Responsible for the Crisis in Europe?, Mises Daily, 11 June 2013.
\textsuperscript{221} See the series of posts by Juan Carlos Hidalgo for Cato@Liberty, respectively Looking at Austerity in Britain (9 May 2012), France (10 May 2012), Greece (14 May 2012), Italy (16 May 2012), Spain (31 May 2012), and Portugal (2 July 2012).
\textsuperscript{222} See § II.D.
\textsuperscript{223} The Troubled Assets Relief Program implemented under the Emergency Economic Stabilization Act of 2008.
\textsuperscript{224} David Shepardson, Treasury: U.S. to lose $25 billion on auto bailout, in The Detroit News, 13 August 2012.
Keynesian stimulus plan to jump-start the economy, the $831 billion-worth *American Recovery and Reinvestment Act of 2009* (ARRA)*226*. Clearly, such policies were completely unwise from a free-market perspective, because they inevitably perpetuated the distortions of the markets and created new formidable sources of malinvestment, rather than allowing the past malinvestments to simply liquidate and the economy to re-start on a sounder basis, without artificial stimuli. Not surprisingly, a 2012 study found compelling evidence that rescued banks were riskier than non-rescued ones both before and after the crisis and the subsequent rescue programmes*227*; in general, a very convincing argument can be made that, even when bailouts seem to have been harmless or even advantageous to taxpayers, this is just the appearance, but what is not seen – to use the famous Bastiat’s words – is that bailouts inevitably consist in “the undermining of the rule of law, ... property confiscations, ... politically driven decisions and the distortion of market signals”*228*.

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225 See the previous paragraph.
II.I Regulation

A final issue for consideration is the actual flood of regulation, in its narrow sense, that has submerged financial markets in the wake of the crisis. In the US, this happened especially with the very well-known 848-page long Dodd Frank Act. It is a huge set of new regulatory prescriptions, pushing business offshore, of dubious constitutionality, on its turn giving rise to an even larger flow of implementing regulations, whose underlying rationale is an attempt to regulate the financial sector in great detail, ending the alleged deregulation that in the legislators' view would have characterized the pre-crisis era, and would bear responsibility for originating the crisis.

The view advocated here is the opposite one: the markets (and financial ones in particular) were already highly regulated, with severe regulatory barriers to entry hindering competition, which prevented competitors from challenging the

Money Corrupted Wall Street and Shook the World Economy (Wiley, Hoboken 2010).


Too big not to fail, in The Economist, 18 February 2012.


A first case filed to challenge several titles of it (State National Bank of Big Spring Texas v. Geithner) was dismissed for lack of standing by the US District Court for the District of Columbia, but constitutional litigation was also brought still in the same court by several states in the US and by the Competitive Enterprise Institute: see details on their website, at http://cei.org/doddfrank. See also below, note 255.

This is the convincing opinion of Roger Koppl, The Dodd-Frank Act versus the Rule of Law (NCPA Brief Analysis No. 775, October 2012).


A very interesting book on the misguided narrative about the crisis and how it led to this law is
incumbents’ positions. The greatly misaligned incentives sent to the incumbents and encouraging a huge moral hazard from their part made it convenient to them to take on too much risk, relying on the fact that in any case they would not be allowed to fail.\(^{236}\)

Regulation tried to reduce this systemic risk that other forms of market interference had created, but in fact ended up making the situation worse, by reducing competition. The huge increase in regulatory burdens originating from *Dodd-Frank* is therefore in our opinion a great mistake, a step in the opposite direction than the one that should have been followed. The record a few years into its adoption does not indeed seem satisfactory at all.\(^{237}\)

A typical example is the so called *Volcker Rule*, a regulation still being implemented based on s. 619 of the *Dodd-Frank Act*: such provision brings about *Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds*, and is usually described as an attempt to restore the regulatory framework in place between 1933 and 1999, respectively the dates when the separation between commercial and investment banks was mandated by the *Glass-Steagall Act*.\(^{238}\)

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\(^{236}\) An interesting publication making such arguments is Vol. 32(3) of *Economic Affairs*, entitled *Financial Regulation: The Need for a Revolution* (Institute of Economic Affairs, London 2012).


\(^{238}\) *Glass-Steagall Act* is the colloquial designation for the *Banking Act of 1933* when such measure is referred to (An Act to provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes, Pub. L. 73-66, 48 Stat. 162, June 16, 1933).
such mandatory separation was formally repealed by the Gramm–Leach–Bliley Act\textsuperscript{239}. Again, in the absence of all the rules on deposit guarantees, and of the unwritten bailout promises, that we have seen, the market would arguably take care of keeping banks' size to a manageable dimension, so that they would not grow too big to fail. Therefore also the very complicated Volcker Rule appears at best redundant\textsuperscript{240}.

The trend does not seem very different in Europe. To be sure, the EU has not passed a single piece of legislation as incredibly long and detailed as \textit{Dodd-Frank}, but rather fragmented its intervention into a very high number of legislative and regulatory acts (some of which were discussed in § II.G). Perhaps the most striking example are the short selling bans and restrictions that many EU Member States quickly passed (and repeatedly renewed) in the moments of worse panic on the markets\textsuperscript{241}. On top of the single Member States' on-the-spot regulations, a comprehensive set of restrictions on uncovered short sales and sovereign bonds was enacted by the EU with the Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit

\footnotesize{239} Or \textit{Financial Services Modernization Act of 1999}, (\textit{An Act to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers, and for other purposes}, Pub.L. 106-102, 113 Stat. 1338, November 12, 1999).


\footnotesize{241} See, among the most recent works on the subject, Greg N. Gregoriou (ed.), \textit{Handbook of Short Selling} (Elsevier 2012); Imad Moosa, \textit{The regulation of short selling: A pragmatic view}, 13 \textit{J. Banking Reg.} 211 (2012).
default swaps\textsuperscript{242}.

From our perspective, trying to restrict short selling and CDSs amounts exactly to outlawing a thermometer in order to conceal a fever: not only is this completely ineffective in curing the disease, it actually contributes to underestimating it, thus making it worse and increasing the danger. Along these lines were also the conclusions of a paper published in a certainly not Austrian-lining venue, the \textit{Federal Reserve Bank of New York Current Issues in Economics and Finance}\textsuperscript{243}.

But several other new sets of rules were passed over the last few years, such as the new regulations of the over-the-counter derivatives\textsuperscript{244}, the new rules on short selling\textsuperscript{245}, or the ones on the bankers' bonus cap\textsuperscript{246}.

The most important pieces of legislation so far are probably the ones constituting

\textsuperscript{242} OJ EU L 86/1, 24.3.2012. \textit{See also} the drafts of two Commission Delegate Regulations (EU), respectively supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events, and supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to regulatory technical standards for the method of calculation of the fall in value for liquid shares and other financial instruments.


\textsuperscript{246} \textit{See} in particular Article 94 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. Text with EEA relevance; but the regulatory framework is much more complex, resulting from intertwining national and EU subsequent rounds of provisions, started in 2010. The UK is anyway fighting the cap on before the ECJ.
the Single Supervisory Package: in September 2012, the European Commission proposed indeed a Single Supervisory Mechanism, and in July 2013 it coupled it with the proposal of a Single Resolution Mechanism: such steps were meant to achieve the so called banking union, i.e. a legal framework whereby the rules on the supervision and the resolution of banks are written and implemented at the EU level, rather than at the Member State level. Between September and October 2013, the Parliament and the Council definitively approved the Single Supervisory Mechanism package\(^{247}\), that is set to become fully operational in November 2014, entrusting the most important supervisory tasks on the banking sector to the ECB. As all the attempts to centralize regulation, this one too does not seem a wise policy option: it would arguably be much better to disentangle the very strong relationship between banks and their respective sovereign states, a given that supporters of the banking union seem to take for granted, and then use as one of the main arguments in favour of a common supervisory scheme\(^{248}\).

A new regulatory framework was also passed with the so called *Capital Requirements Directive IV package*, i.e. a Directive and a Regulation\(^{249}\), entered into


\(^{248}\) See a clear example of this way of reasoning in an FT op-ed by Unicredit global chief economist Erik F. Nielsen, *Banking union is critical for eurozone*, in *Financial Times*, 4 September 2012.

force on 17 July 2013, implementing the Basel III standards and including other rules on banking regulation, the most remarkable of which is a new cap on bankers’ bonuses, effective since 2014.

II.J A PERSISTENT FAILURE

In Part I, we argued that the pre-crisis regulatory picture was a highly regulated scenario, and that this vast amount of regulation in place before the crisis was not helpful at all in preventing it; to be sure, it even made it worse, when it did not outright contribute to originating it. Arguably, the lesson to draw from the crisis was therefore to massively reduce the amount of interference with the markets and of regulation in its narrow sense, and let the markets more free to achieve their "spontaneous order".  

Unfortunately from our perspective, the view that has prevailed both within academic and intellectual circles, and in the political and regulatory environment, is quite the opposite: the crisis was allowed, if not directly caused, by a lack of sufficient reigning of the markets, that have demonstrated to cause disasters when left unabridged.

Consistently with this analysis, the clear trend both in the US and in the EU, that we have observed in Part II, has been towards a substantial increase in the amount of


250 See above, note 3.
"regulation" (both in its broad and narrow meaning), even though the general consensus among politicians, bureaucrats, economists and commentators seems to be that all this is still largely insufficient.

But what should have been instead, in concreto, the approach to follow in a more free-market oriented perspective? Even without going as far as advocating for a complete deregulation of financial markets, as well as of any other economic field, a tremendous step forward would have been the choice to follow Friedrich von Hayek's lesson in his Rules and Order, the first volume of his Law, Legislation and Liberty.

The regulatory framework existing before the crisis, and even more so the one built as a response to it, are indeed expressions of what Hayek identified as a “made order or taxis”\(^{251}\), as opposed to the cosmos, a spontaneous order arising from the multiple free interactions of individuals and firms. Taxis corresponds to thesis, namely "the law of legislation", while cosmos corresponds to nomos, namely "the law of liberty", the law originating from society, from facts, from custom, and not from a legislator's (or a regulator's) command.

Financial markets regulation was indeed dominated by the "law of legislation", a law that predetermines the goals and desired outcomes of the market process (e.g., avoiding the bankruptcy of too big too fail firms) and tries to influence the behaviour of economic and social actors in order to achieve them.

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On the wave of economic emergency\textsuperscript{252}, such "law of legislation" has completely marginalized spontaneous law, the one that includes among its fundamental principles the one of responsibility, according to which it is necessary that the negative consequences of any action (such as buying stocks or bonds of a bank or lending it money in the form of bank "deposits" or purchasing sovereign bonds or taking up a big mortgage or granting that mortgage) are borne by the one(s) who committed it.

From this perspective, a desirable law is therefore one that outlines a framework of general and abstract rules, without predetermining the outcome to achieve, and let the "game" be played freely, relying on the benefits of competition. Instead legislators, regulators and central banks pose very specific objectives: economic growth, full employment, "moderate" price inflation, prevention of bankruptcies, and so forth. But by doing this, even when such objectives can be agreed with (which is in no way necessarily so), they do not realize that they often produce an opposite outcome to their desired one: the typical example are regulations meant to prevent bankruptcies, that create the incentives for moral hazard and end up increasing the likelihood of such events.

In such a picture, originally tainted by the "fatal conceit"\textsuperscript{253} of knowing which are the right goals to pursue and of possessing the ability to adequately plan human behaviour so as to achieve them, even repealing some regulations – something that

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\item \textsuperscript{252} On this aspect, see Todd J. Zywicki, Economic Uncertainty, the Courts, and the Rule of Law, 35(1) Harvard Journal of Law and Public Policy 1 (2011).
\item \textsuperscript{253} The Fatal Conceit is the title of Hayek's work of 1988 (edited by William W. Bartley III) (University of Chicago Press, Chicago 1988).
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would be *per se* highly desirable from the perspective here advocated – can in fact have very negative consequences.

For instance, let us consider what happened with the repeal of the mandatory separation between commercial and investment banks, that had been imposed by the so called *Glass-Steagall Act*: such regulation had a very clear benefit in a system where banks were *de facto* prevented from going bankrupt and where a deposit insurance scheme was in place, and it was therefore necessary to limit the incentive, arising from such elements, to undertake risky behaviours that could threaten systemic stability. Repealing such command, while at the same time maintaining the promise of bailout and deposit guarantees has not been a wise choice of policy, and can in fact be considered one of the reasons of the crisis. However, the real problem was not deregulation *per se*, yet deregulation *under the existence of other rules* (typically expression of the “law of legislation”) that induce moral hazard and opportunistic behaviours.

Therefore a closer look reveals that the truly desirable medium-to-long-run solution would not be to reinstate a similar regulation (or anyway move towards that direction, as is being done with the implementation of the so called *Volcker rule*), while maintaining the other rules (obstacles to bankruptcy and deposit insurance), because in this way the business model of banks is predetermined, falling into the law-with-a-goal, i.e. into the thesis. Instead, it is preferable to eliminate also those other rules, so as to re-establish a proper functioning of the market.

On a different but linked level, the timid and partial shift from the heavy
manipulation of the markets described in the first part, that is being implemented as a result of Basel III rules and the subsequent deleveraging, can have negative short-term consequences on real economy. However, the responsibility for the shocks on the real economy does not lie with the decision to start reducing slightly the manipulation, but with manipulating (too much) in the past. As with any drug, monetary "drug", as soon as one stops taking it, produces an abstinence syndrome, that can be extremely painful: but blaming it on the fact that the addicting substance is no longer taken is a mistake, because it looks only at the last stage, overlooking that the problem was in fact the previous prolonged taking of the drug.

And exactly the same holds true for the austerity policies, on which controversies infuriate both in academia and on the press. Even though one can actually find a push towards austerity in the crisis-hit countries – which is debatable\(^{254}\) –, it is plausible that this might have partially recessive consequences in the short-run: but also in this case, this does not seem a good reason to procrastinate with policies that have made public debts sky-rocket, and to give up discontinuing them.

A final point to be made is that repealing the regulations that we have criticized – both pre-dating and following the crisis – would not at all create a framework without rules or even law, or that legendary "far west" scenario, arguably a rather disparaging and oversimplifying picture. In fact, deregulating, and in particular repealing regulations establishing or legalizing central banking, legal tender, deposit guarantees, fractional reserve banking, as well as those distorting investment choices of banks or
the whole markets for credit rating and housing, as well as those responsible for the huge existing public debts of crisis-hit countries and the great amount of regulations in the narrow sense\textsuperscript{255}, would actually lead to a scenario where rules and law regain the leading role they deserve in a functioning free-market, taking the form of \textit{nomos} in the hayekian meaning. In other words, slashing the "law of legislation" by no means implies cutting down on law \textit{tout-court}: in fact, it restores law in its highest and historically predominant meaning, the "law of liberty".

The challenge for law in the face of the crisis seems therefore to be to renounce to pre-determine the goal and the outcome of the economic process, whose evolutions (including reactions to alterations of \textit{cosmos} by \textit{taxis}) it is impossible to predict and plan, and rather concentrate on ensuring the respect of the essential principles of the \textit{nomos}, among which the principle of responsibility and the principle of unhindered competition are particularly relevant.

In this enterprise, constitutional law has a crucial role to play\textsuperscript{256}, in its original meaning of an instrument to constrain the power, to limit the government's aspiration to determine at its own will the outcome of spontaneous social interactions. On its turn, constitutional adjudication and in particular the judicial review of legislation are

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\item[254] See above, notes 218 to 220.
\end{footnotes}
called to quickly remedy the violations of such limits, without bowing to pressures from governments on the grounds of *Realpolitik*: for instance, the German Constitutional Court was right to make it very clear, in its famous *Maastricht Urteil*, that the EMU had to be meant normatively as a "stability community"\(^{257}\), with the consequence that Germany could leave it in case that goal were not achieved\(^{258}\). It would be equally appreciable if the *Bundesverfassungsgericht*, in its upcoming decisions on the merits on the legitimacy of the ESM Treaty, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, and the OMT programme, were again so brave to halt or at least impose strict conditions on the ratification, especially as regards the aspects concerning the breach of the property rights arising from the strong inflationary threats posed by the ESM.

Admittedly, constitutional justices do not always have the remedies necessary to guarantee the enforcement of fundamental principles, whose violations risk to go unpunished. The analysis touched upon several examples of this kind: let us think of the Maastricht-Stability and Growth Pact criteria, whose violation was never punished; or of the Fiscal Compact, that does not seem to include credible mechanisms to make the difference from this point of view; or of the prohibition for the ECB to finance Member States' public debts, substantially violated with the *Securities Markets Programme*, and yet met with a general relief and praise from troubled governments.

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(see also above, note 231).

257 BVerfGE 89, 155, 2 BvR 2134/92, 2159/92, 12 October 1993, §§ 138 ff.

and their public opinions, due to the exceptional emergency of the situation\textsuperscript{259}.

But let us consider also the enumerated powers in Article I, section 8 of the American Constitution: under the Tenth Amendment, Congress's powers should not go beyond such list, and yet only very few authors and political figures argue that the very existence of the Fed and of its monopoly over money – since they exorbitate from that list (something\textit{per se} impossible to deny) – are illegitimate\textsuperscript{260}.

It would be urgent to face this problem and look for possible solutions. Unfortunately, as we saw the governments and the monetary authorities have been going in the opposite direction. On the one hand, some fundamental principles are reaffirmed, as with the \textit{Fiscal Compact}, though again without taking care of establishing adequate mechanisms for their enforcement; on the other, financial markets are flooded with a new tsunami of \textit{thesis}, from \textit{Dodd-Frank} to Basel III reforms to the new Eurozone and EU regulations, thus going all the more farther from a legal order sufficiently clear and enduring, namely from the \textit{cosmos}.

Our concern is that this lays the foundations for new unbalances, new crises that on their turn result in even more \textit{thesis} and \textit{taxis}, in a spiral very difficult to break and potentially fatal to the very survival of the market and of an economic system based on freedom. Facing such a scenario, the only option for scholars and all individuals concerned with the protection of freedom seems to be to denounce the great risks

\textsuperscript{259} Another observation by Hayek looks quite prescient here: "'[e]mergencies' have always been pretext on which the safeguards of individual liberty have been eroded" (\textit{The Political Order of a Free People} [volume III of \textit{Law, Legislation and Liberty}], The University of Chicago Press, Chicago 1979, p. 124).
involved in the approach currently dominating, demand a rethinking of it, and resolutely defend the reasons of nomos and cosmos, i.e. the reasons of "law" in its noblest meaning.

260 The Tenth Amendment Center is the most active group on this issue (http://tenthamendmentcenter.com/).