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PUTTING THE *‘E’* INTO *‘EMU’*

The following consists of three separate notes, written over a three-month period, on the novel issue of so-called *“quantitative easing”* in the context of European economic governance. The first note, “The EMU as lender of first resort” [Dec. 10th, 2008], was written in response to an exceptionally able article by Martin Wolf in the *Financial Times* of the day before [“The Eurozone depends on a strong US recovery”]; to fix ideas, the ‘thought experiment’ proposed here is conducted in its extreme mechanistic version, with qualifications dealt with as necessary in the sequel. The second note, “Euro-Sovereign finance” [Feb. 11th, 2009] continues the line of argument in the light of altogether feeble, kite flying attempts to launch a possible *Eurobond*; this idea is seen as an unstable half-way house between market-dominated anarchy and the market-disciplining device proposed here [the Eurobond trick has since been killed]. A third note on “”Crisis” of Sovereign finance” [Feb. 25th, 2009] displaces the argument to an altogether different plane, far too implicit in the two previous notes and now made explicit – and writ large, perhaps uncongenially too large; it is proposed that, *if* there is ‘politics’ involved in the crisis – and who would deny it? – the problem is to ‘define’ the *relation* between the kind of politics relevant to ‘the’ issue of sovereign finance and, in the limit, *sovereign solvency*, at the precise interface between politics in the form of the sovereign state and the financial markets. A concluding note [March 5th 2009] provides references to the intellectual ancestry and the implicit ‘model’ underlying the exercise.

I. THE *EMU* AS LENDER OF *FIRST* RESORT

[Dec.10th 2008]

The ongoing financial crisis is characterized by twin mutually reinforcing excesses, *too much debt* and *too much liquidity*, locked in positive feedback. The consequence is a crippling flight to safety, exemplified by the near and even below zero yield of US 3-month T-bills, *before* official rates moved to match. Yet while monetary policy is enfeebled, fiscal policy must be financed to an extent calling to question the validity of all money, i.e. sovereign solvency.

A new blend or, perhaps more accurately, *hybrid* monetary-fiscal innovation is the emergence of quantitative and/or qualitative easing. Whether or not as yet perceived, use of this hybrid instrument cannot be indifferent to the threat of sovereign in-solvency. In particular, it is not clear-cut in all cases who the sovereign actually is.

This is pre-eminently the case of the European Economic and Monetary Union. Here the hybrid lies between the hands of the European Central Bank [ECB] and its as yet institutionally *undefined* fiscal twin – there is no European 3-month T-bill etc. as there is as yet nothing like a European T. The EMU as presently constituted must thus contend with just MU and see how far it can get without the E.

Abstracting from all, repeat all legal and whatever other institutional and/or political constraints* [*a serious matter which will be addressed repeatedly below], an E-MU tentative *thought-experiment* in quantitative-qualitative easing targeted at the financial crisis and its real economic consequences could be as follows:

1. The [ECB] mother bank *'lends'* euros to the E-MU-system member banks so that they can purchase EMU member countries' sovereign debt, to serve as *collateral* for the loan, the lending rate being the currently official ECB lending rate – the latter hopefully falling to vanishing point. The system's member banks immediately use this quasi-overdraft window refinancing facility according to a *plan* designed, in the first instance, to contain sovereign member countries' debt, as inter-sovereign spreads ominously increase and, thereafter, to reduce the longer-term deflationary force of servicing excessive sovereign debt until such time as serious recovery is afoot and orthodox *conversion* is ripe for the agenda. Refinancing thus comes first, to immediate effect, restructuring and reducing member countries' sovereign debt comes after.

2. The [ECB] mother bank is explicitly party to the system's member banks' and countries' individually contracted bilateral *economic-financial recovery plans*: each such plan is not just a contractual pair-wise agreement between member

banks and member states but equally and more so a contractual agreement among member banks and the mother bank; for since it is unclear who, in the EMU as now constituted, the true *financial-monetary-economic sovereign* is, it is inescapable that the formally *'as if'* yet truly sovereign authority must be the ECB-System itself, with the [ECB] mother bank as its capping stone.

This need not be read as some *second-best* institutional situation but rather as a logical-evolutionary step forward. The ECB-System as it now stands is sufficiently recognized as *legitimate* to serve the purpose. Given the reality of the ongoing financial crisis, and certainly in the spirit if not exactly the letter of the constituting treaties, allows the ECB to interpret the goal of *monetary stability* beyond whatever conjunctural necessities – according to the *raison d'etre* of its legal independence. At all events, the System's and particularly the ECB's responsibility is, inescapably, enormous.

3. Euro-member sovereign parties to the *monetary-financial-fiscal hybrid* 'Pan-Euro-pean' to the above containment-of-and-recovery-from-crisis Plan [viz. the immediate Eurosystem-wide containment, then effective reduction of member countries' sovereign debt through non-inflationary soft or 'gradualist' conversion], must integrate with whatever else there is of the 'economic' branch of EMU: in particular, countries participating in the plan must commit to paying the money back – an effectively interest-free loan is still a loan not a grant.

This, given the likely time-scale of events, must refer to a 2 to 5 and in some peripheral cases even up to 10-year period of quantitative and qualitative surveillance of everything that can be surveyed and is pertinent.

Even so, the rake's progress and *past* profligacy must not be confounded. Hopefully, this might be the proper gradualist mode for the construction of credible and effective European economic governance.

The alternative check on unsustainable sovereign debt explosion or, conversely but immediately worse, the inability to finance the fiscal stimulus required to meet the present crisis, is either a severe and severely unthinkable bout of inflation, or an orchestration of at least somewhat unthinkable sovereign default or, worse of all, an abandonment to deep depression, assuredly not a part of the ECB's mandate.

The explicit aim of the exercise is to literally and for a time *'crowd out' the markets*, that is to under-price them and thus <u>keep them out of sovereign debt finance before they can do more harm</u>. So useful in fair weather, the markets have proved inept in turn-rounds. Their potential negative impact on regional and global financial or, even worse, *institutional stability* is only now being tested as they prove unfit to 'rate' sovereign institutions at a time of crisis – if there is even a *soupçon* that Germany has trouble selling its bonds, what, *inter alia*, will be the benchmark on which to read the intra-EMU spreads? And, if Germany, through the Bundesbank, is not allowed to use the ECB's so-called 'window', who else might be allowed to come near it?

Unless it be ever so paradoxically assumed that the window is so constructed that only private fingers may tap on it, so long as they have the purest junk to offer as collateral.

But this would be playing with the mischievous idea of the EMU and its consequent Euro-money as being a passing fad and not an irrevocable anchor for all time.

These, of course, are words of the moment. Once the markets and what remains of the credibility of the rating agencies have sorted out their own concerns by de-leveraging the private sector, which they so cleverly enticed into unsustainable indebtedness, they may once again be trusted to address the issue of sovereign indebtedness and its finances.

The above, merely 'thought' experiment concerning ongoing crisis-management of sovereign debt is perhaps *overly conservative*, certainly more so than similar 'real-time' Central Bank experiments now underway involving private sector debt. It may nonetheless be disliked or mis-interpreted as an excuse or cover-up for governments' past and prospective errant behaviour.

But in the context of actual EMU – and ECB - history this is not so. With adequately practical judgment, sovereign prudence and at least transient financial profligacy can be reconciled while punishing truly errant behaviour. As in the past the mere appearance of the Government Broker dictated the effectiveness of Bank rate, it may be that the *mere announcement* of ECB 'presence' may turn sovereign finance from a risky bet to a positive certainty – serving to educate the markets before 'crowding' them back in.

Starting off with an economically damaging as well as politically dangerous, so immensely prolonged and structurally chronic *deflationary bias* of more than two decades, the payoff of the now past uphill road to confidently enshrined <u>monetary stability</u> did fortunately result in the EMU contractually legal and by now deeply legitimated construct – the ECB-System and the Euro - whose 'sovereign' value is abundantly obvious to outsiders but also, crucially, to insiders – there is a rush to join and an abhorrence to leaving. In the present ongoing financial and economic crisis, it is ultimately the *sovereign value of the EMU achievement* which is at stake and must be carefully, thus <u>proactively</u>, used to be solidly preserved.

II. EURO-SOVEREIGN FINANCE – 3 Scenarios

[Feb. 11, 2009]

The *Financial Times* opened its invitation to the recent *séance* with Nouriel Roubini with the reminder that, aside and beyond the redoubtable problem of bringing the financial system back to life, lies the immediate problem of financing the sovereign entity which is called to supply the necessary fiscal stimulus. As a sequel to my previous note of December 10th '08 ["The EMU as Lender of First Resort"], I pursue the crisis-policy exercise of sovereign finance for the *hybrid* Euro case. As before, I abstract from the politics of the issue as it may confound the economic argument, though inevitably some political slant must again interfere at the margin. The essential background remains: <u>the crisis equals the pair of too much liquidity and too much debt, gridlocked in positive feedback</u>.

<u>Scenario 1 – call this the Pure Market Case</u>

This is the base scenario, the one in effect: the *n* countries of the Euro-system possess no *fiscus* but a powerful monetary authority – the European Central Bank - curiously for one which sets its own rules, self-deprived by constituting treaty from *directly* financing government[s]*[* 'Directly' is the probably correct legal reading of the treaties; yet, even though it is arcane to foresee what the ultimate 'legal' reading may be, it is arguable that 'indirect' financing may be legal enough, e.g. refinancing of 'seasoned' gilt-edged issue if, even for a second, it has been mediated by commercial bank underwriting, even though such may be part-nationalized, to then take recourse to that famous window – the true story behind this most peculiarly constraining treaty provision may best be kept untold for the time being].

Thus while monetary policy is unitary, fiscal policy is plural – the so-called fiscal stability rules are from another age etc., but this is where politics crucially comes in so I shall for now ignore it.

This way, fiscal decentralization amounts to a refinancing free for all or, perhaps, *slave for all*: it is the markets that shall rate the credit-worthiness of the separate *n* member countries and thus determine the spreads, a relative measure, effective only if the base rate is given, call this the German rate – curiously above the Central Bank's rediscount rate, low and predictably falling, perhaps eventually to zero. But for the base rate to be given, German financing and refinancing of sovereign debt must be guaranteed – though by whom? – such a macro-geo-political guarantee is a strange constraint these days, but let us pass on. The markets dispose before governments propose, a reversal of the late C.P. Kindleberger's *dictum*. Is this an <u>equilibrium</u>?

It could be if *deflationary*, fiscally induced, pressure is effective soon enough. And it could well be. For weak finances means weak governments, weakening finances means yet weaker governments, they will submit to the Euro-rules as these are ever reinterpreted by the stronger – whether the juridical agent is the Commission or the Eurogroup – some Euro-member countries may even fall through while some or perhaps most fuddle and muddle through - who indeed should care if the periphery ordains its future downward along the credibility order? But is this a *stable* equilibrium, stable enough, that is, to pull the Euro-project through the crisis and beyond?

That, in the hands of the forex markets, the Euro itself may suffer is a possibility. That in itself will export its problems elsewhere, immediately to the pound sterling, perhaps to the dollar, beyond this by now narrow Atlantic order matters are more obscure. But it is hard to see Euro-group deflation benefiting short or indeed medium term German exports. Besides, but out of bounds for the present exercise, political constraints may start biting.

So: an <u>equilibrium</u>? - perhaps yes, a stable one, strongly less so, a long period one, profoundly questionable. The base Scenario 1 of the exercise is thus where *markets are protected indeed enticed and cajoled but crucially preserved in their speculative actual short-termism*, the *rentier* may now dictate the *euthanasia* of the sovereign on whom he ultimately depends.

<u>Scenario 2 – call this the Euro-Bond case</u>

It is decided amongst the Euro-Group's *n* countries that 'it' shall issue a new sovereign bond, called the *Eurobond* - leaving again to one side the politically disturbing issue of who the sovereign issuing the same may be, with perhaps a new Treaty lurking away in the mists of future time.

This is again a fundamentally *market* scenario, but one significant step away from the previous one. The market again disposes but now the 'sovereign government' [hybridly both existent and non-existent] proposes not on account of its identity, whereof it lacks, but of its sheer displacement – one for all and all for one, and/or conversely yet altogether not quite – but crucially, *provided that* the shares of power-sharing otherwise *rents* or, perhaps better, newly rediscovered *seigneurage*, are predetermined – which they clearly at present are not. It is nonetheless still the market which decides the level of benchmark-rate, curiously, as already noted, yet again above the Central Bank rate for *private* sector refinancing – God only knows covered by what *value* of collateral security.

But the relative 'spreads' from market-constrained EuroBond-benchmark rate must be now somehow determined. Who is the, now formally excluded, 'market' or at best 'quasi-market' *agent* to do this – in haste - when there is only one Euro-Bond? Will the issuing authority conduct *n*-country auctions or will the 1^{st} country be the intermediating auctioneer for the *n*-1 others? An at least *quasi-political* agency must be substituted for the ever-greedy markets, an inevitably political-administrative *game* must be sufficiently market-like or at least seemingly so [for the markets are watching], to determine the market-like yield from remarketing unique Euro-Bond proceeds to the several *n*-1-country Euro-group sovereign members. Thus, while the base rate is market-determined, the spreads must be somehow negotiated amongst the strong and the weak, otherwise the strong will not play – so back to Scenario 1, though a bit worse, as confidence will meanwhile have shifted for the worse, including for the 1^{st}-country base rate. Failed markets, when whipped to desperation, are vengeful – not just the *n*-th country but severally and together all, including the 1^{st}, will suffer.

It is not beyond even *cameralist* mentality – which is the best currently available - to rise to the challenge. Euro-Bond based inter-country Euro-System countries' fiscal *sovereigns* may be agreeably self-decreed wilful and willing *subjects* of ever higher spreads, on the merit or demerit of market-like or admistratively determined, yet at sovereign level agreed, 'objective' and, worse, prospective criteria of credit worthiness, at the penalty of ever sharper tutelage. The chief *rentier*, Germany, may exact its well earned *seigneurage* through paying the issuing [who?] Eurobond authority *less* than the market-determined Eurobond rate issue. The *n*-1 other Euro-member countries must then obviously pay ever more to make the new Eurobond *market-worthy* [the ever wonderful accountants' logical boundary] to the issuing [who?] Eurobond authority so that while, e.g., the ECB official refinancing 'window' rate is, as it now [then] is 2% p.a. [and predictably set to fall – as it has], spreads may be an ever opening *eventail* extending to more than 300 basis points from top to bottom – but with sovereign finance 'guaranteed' and thus sovereign insolvency ruled out – the cost to the Europroject is unclear. The sovereign *seigneur* must claim his *prima nox*, the *villains* must pay for their sovereign financial survival. Both *seigneur* and *villains* have thereby surrendered to the market. It figures that a difficult <u>political</u> negotiation lies ahead, is it worth it?

Negotiation and compromise are obviously the order of the day, *a-noia* rather than *para-noia* is not. The Euro-Bond project is borne-dead because it does not start at the right place, as there is to begin with no right place given this framing of the sovereign finance question. <u>Either</u> the 'market' is allowed to rationalize its crimes by clemency or pittance - <u>or</u> it is to be tamed by alternative games where it is put on the defensive, until a new equilibrium [between who?] is reached.

Nonetheless, given the here and now of the evolving crisis, the project is not to be despised. *Le plus ca bouge c'est moins la meme chose.* As for the question of equilibrium, it is better shelved [for fear that authoritarian *cameralist* memory be invoked] – still best to leave the politics of the issue beyond the arguable margin*.

[* Since writing this, the EuroBond 'kite' project has been formally proposed, discussed and rejected, by guess whom – on March 1st, AD 2009. This is perhaps the just fate of trying to slip in a *politically* trivial idea on the sly.]

<u>Scenario 3 – call this the Sovereign Monetary Authority case</u>

This seeks to *discover*, in the 'Austrian' sense, the eternally befogged equilibrium between the sovereign authority and the market. In crisis, *mehr licht* must sharpen up. *If*, a big 'if' in its modality though thoroughly inescapable 'if', *fiscal stimulus is 'necessary'*, then 'fiscalist' sovereign finance must be secured no matter.

This starts from the fact that market sovereign finance is presently not merely paranoiac but deeply wounded [too much liquidity chasing 'ultimate' security of placement leads to such *rocambolesque* extremes as the Chinese Central Bank's quasi-official signal: China is effectively underwriting America's sovereign debt, see the *FT* of February 12th] – for even extreme *liquidity must 'be' somewhere* - the task is to bring it to shape.

This turns the focus of the argument toward the *institution* of a Central Bank with its famously-infamous yet by now 'logical' predicate of *lender of last resort* - now to become its inverse, the *market maker thus lender of first resort* – moreover <u>a lender necessary to the one and only borrower who craves for money to spend</u> – *the sovereign*.

One perhaps here treads over soft theoretical toes. The exercise proposed in my earlier note is in essence a *hybrid* lying or perhaps travelling between the Scylla of 'ultimate' confidence and the Harybdis of 'functionality' of financial performance.

'Confidence' in the value of sovereign money, like all confidence, is a *marginal* thing, what now needs rebuilding is the <u>overall threshold</u> still confidently given - it is *that* beyond which lies the subliminal fear of *inflation* and the destruction of the monetary standard. For this confidence threshold to be ever reconfirmed is needed the <u>certainty</u> of *sovereign solvency*. <u>For the Euro this means that Euro-confidence is and must be greater than German-confidence, indeed, that it is Euro-confidence that is the guarantor of German-confidence</u>.

The underlying rationale of the scheme is that the present crisis situation may lead to multiple equilibria, say two, a low-level one reached through all variety of deflationary packages of policy *versus* a high-level one reached through all variety of reflationary packages of policy – the latter ever so Pareto superior to the former.

The latter mix must contain a powerful fiscal stimulus. For this to be secured, sovereign solvency must be reinstated in its logical primacy as the ultimate guarantor of the monetary standard which is the inescapable pillar of the market economy. The potential of creditor and debtor *positions* [a presently 'fragile' set] must be logically disconnected from the potential of surplus and deficit *agents* [a 'rigid' set] in *'political'* economics – the sovereign agent is and must be the unique agent with potential for surplus.

A point of departure for Keynes' 1941 original proposal for a global *currency union*, the Pareto superior equilibrium for a crisis-ridden economy may be approached if surplus units – at the least - *share* the burden of adjustment and deficit units are not compelled to exclusively shoulder it, thus dragging all to a profoundly inferior Pareto equilibrium state.

It would appear that the Anglosaxons and perhaps the Chinese are bent on the superior path, the Europeans not so. The US treasurer calls for 'exceptional and complementary measures by all', the subsequent G7 finance summit [13-14 February] formally promise to use the 'full range of policy tools' [FT-14.02.09], yet the Europeans cannot do so unless the European Central Bank shoulders the burden of the Treasury that the EU does not now possess.

III. "CRISIS" OF SOVEREIGN FINANCE – or *crisis of the sovereign*? [25.02.09]

In two previous notes [last December 10th and this February 11th] I attempted to deploy a 'strictly' economic [*sic*] argument in favour of European Central Bank finance of Euro-Government's fiscal policy, using the hybrid arrangement of the European Monetary Union as empirical background - more or less implicitly taking into account the hybrid's self-imposed Treaty constraint [viz. using, by perhaps liberal legal interpretation, formally indirect rather than formally direct finance, through the secondary market, perhaps even using the part-nationalized banking system as obedient intermediary between the sovereign and the market].

Perhaps unsuccessfully, I tried to keep the politics out of the argument, merely indicating the margin where the economic does not make sense unless the politics of the case is set out. The issue is practical from the moment the notion of quantitative and/or qualitative easing appeared under the heading of 'monetary' policy: the question is when monetary policy begins to be 'like' fiscal policy, thus 'who' is the *ultimate* guarantor of the Central Bank's liabilities and suchlike.

This 'partial' hybrid at the abstract plane is compounded by the crisis-emerging though already known so-ever hybrid essence of the 'real' European economic scheme. On the issue and content of 'economic governance' there is deeply held, *negative* conviction behind European governments but also European institutions as presently intended, the fudgy term 'ideology' is too weak to be useful, the politics of the matter lie much deeper than rhetoric and, in crisis, the politics are useful as part of the logical argument rather than as tactical substitute.

The fundamental political issue is the *relation*, hopefully the 'balance' between state and market – this can never be for ever resolved, it must ever be argued and somehow settled for the here and now until such time as it is necessary to reopen it. But for now it is wide open and it is market failure because of governance failure which opened it – the causality is important. This is the first *political statement* of this note.

Yet nothing substantive follows from this statement. The 'political' motive force of the argument is what is to be done rather than what and why 'it' has failed. The fundamentals of the moment are not the market[s] but the political underpinning of society, the sovereign agent holding the whole thing together. Obviously, the matter of the essential 'nature' of the *value standard* is not a subject for a note such as this. Yet - related to the market crisis - *the fundamental relation between state and market* must be at least teased out of its implicit oblivion – as Kindleberger put it, the state <u>proposes</u>, the market <u>disposes</u> - yes. What 'state'?

I argue that the prevailing *contractarian state notion* is at the bottom of present political confusion, which is in itself a <u>conservative political position</u> – the second *political statement* of this note.

The alternative to the contractarian state notion I shall leave undefined, in concordance with the undefined Hebraic deity. The matter is perhaps best expressed in French - negatively, thus: *Est souverain celui qui decide de la situation exceptionelle* – the German original being: *Souveraen ist, wer ueber den Ausnahmenzustand entscheidet* – as expressed in Carl Schmitt's *Theologie Politique* (1922) [*Politische Theologie – Vier Kapitel zur Lehre von der Souveraenitaet*], Gallimard 1988].

This – 'sovereignty' - comes into [logical] being just 'before' the contractarian *moment* when "Hobbes'" human agents pass from the savage state to that of civilization.

Since politics became more like economics, the vanished moment of becoming-before-being is at the root of current contractarian-conservative confusion: the *sacred* must be wholly absorbed by what *is*, the 'is' is thus predetermined politically, having unknowingly become sacred it *is* forever, thus *property* as the consecration of what is must be the moral and political sovereign of what may be – the 'sovereign' is just one other 'market' agent.

Until, that is, the 'normal' rules of property are no longer tenable because their failure has come to threaten not just the state of vanishing *value* of property but the basis of the rules for the definition and redefinition of *the permanent value of property*.

'Finance' is the Janus-like self-immolated victim of the shaking of the rules, the agent which tested them by profiting from them is now the *hybris* but also, absurdly, the judge of their proper restitution.

It is curious how the political system reacted differentially to financial socio-political crime as compared with common or garden-like crime as manifested in the sequel of the dot.com and subsequent accounting frauds etc. But this comment is <u>not</u>, at least not yet, other than rhetorically, a *third political statement* of this note. The matter is theoretically too serious for 'hanging-judges' moralistic treatment – and is left aside.

It is also curious how 'the market', <u>the most powerful impersonal instrument of all time</u>, is also the most delicate in the face of misfortune. Market sentiment, for an institution so profoundly based on contract, is curiously animistic, the unknown holds more sway than the known – by contract. Verbally, moral hazard is perhaps the perfect misnomer for a-moral hazard – once individual responsibility is grafted onto to systemic herd a-moral irresponsibility.

But such tangents to the argument are best left to chaotic mathematicians. The humdrum *political* concern is – where does the *logic* of the market end because it can do no better? – but immediately note that this is <u>not</u> the symmetrically obverse question to the obvious transcript, where does the logic of the state end because it can do no better?

For there is no symmetry because there is no pre-defined *whole* whose part-shares are neutral as to its substance. 'One' can be shared between a third and two thirds, or one half and another, or two thirds and one third, etc., but not if 'one' is *variable* and indeed a <u>function</u> of the shares it may be composed of. The *relation* between the shares is the determining factor of what 'one' shall be – to be shared.

The so-called <u>logical</u> 'fallacy of composition' lies subliminally under all political-economic argument, especially in crisis. The static contractarian view of the relation between the state and the market takes 'one' as given – resulting in political confusion. Inquiry must discover the clue for the construction of a <u>new</u> contract: for in any here and now there must be a contract – crisis and its resolution must reconstruct the contract.

It would presently seem that the lynchpin of the sought-for *recontract* is the guarantee of the use of nominal value, the solid effectiveness of the monetary standard – as seen by all sides. For this the money unit must be freely able and willing to buy and, conversely, it must equally be able and willing to sell - itself. What if it – anywhere - does not?

This is the precise 'moment' where the non-contractarian notion of *monetary-financial sovereignty* comes into play: the 'what if it does not' is, in 'sovereign' terms, a logically impossible question. It shall because it must. Like Mercutio taming the Shrew, money will do what it must otherwise it shall not money be. The reader [if he still exists along this narrative] may express this turn of the argument in purely erotic terms: Eros is the other side of sacred Divinity, perhaps the Keynesian side. I otherwise refrain from enraging ideological contractarians and driving them from sarcasm to fury except for a reminder: what does it mean for 'money' to be '*legal* tender'? It is, merely, a matter of the stroke of the pen.

What does it mean to define the present crisis [as I did at the beginning of my first Note], as *the gridlock of excessive liquidity and excessive debt* ?

'Excessive' liquidity is when there is money which does not know what to do with itself but must be put somewhere, therefore seeks an ultimate safe haven, in non-contractarian terms a metaphysical impossibility, thus it must construct for itself an impossibly self-validating *convention*; while 'excessive' debt is when there is desperate need for money to spend but there is none to hand on any terms that it may be offered. In such gridlock both borrowers' and lenders' risk are conjoined - who is to break the spell but the sovereign, the one agent that may guarantee the *validity* of the convention.

The exorcist must be a *non-market*, thus a political agent. Credible exorcism must be made such as much by fear as by hope – faith to restore 'confidence' needs both. Curiously, or perhaps not, there is still at present - where it matters - much less fear than necessary and much more hope than is warranted.

The debonair attitude of the gilded guilty party [the 'markets'] is perhaps aesthetically penitent but still possessed of the politically crucial minority blocking vote in the present, so powerfully conventional, almost contractually defined political-oeconomic environment. In the present here and now, the paralytic political *weakness* of the sovereign state remains remarkable, given the extent and depth of the economic crisis. This is the *third political statement* of the present note.

This schizoid, quasi-postmodernist decoupling of the intellectual *travail* between the possible and the necessary has never since the dark interwar days been so complete, rhetoric and good manners apart. This is in itself an interesting topic. But on the more serious matter enough has been said: when enough is not enough.

By way of conclusion [March 5th, 2009]

The, perhaps, occasionally Jacobin style of argument in these notes may have put off the non-ideologically even though contractarianist informed reader, if he exists. I can only apologize and refer to my only two intellectual sources, viz. Keynes' early [1941] diagnosis and policy for the world economic problem and his earlier [1932] theory of 'liquid capital' and the forward markets. First:

"It is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is in the *debtor* position of the international balance of payments, - that is on the country which is (in this context) by hypothesis the *weaker* and above all the *smaller* in comparison with the other side of the scales which (for this purpose) is the rest of the world" – viz. the '*sovereign'* – the rest of the analogy should be obvious.

This statement [emphasis supplied] is on p. 27 of the original International Clearing Union proposal, dated 8.9.41 [with the Battle of Britain just over], in Ch.1 of JMK Collected Works, vol. XXV.

Keynes subsequently tells his Whitehall and academic interlocutors that, tactically, an idea is, in the first instance, best argued in the most general terms lest debate be deflected to precise yet variable detail concerning its practical implementation. The precise modality of ECB quantitative easing intervention is better discussed nearer to where the action and, trustfully, the knowledge is – not 'here'.

Yet, as an indicator for this search, what, for example, would the ECB's response be if a good and solid market sector bank turns up at the window offering a bundle of collateral which, other than the usual junk, crucially includes a batch of euro-sovereign bonds, or euro-area bonds, or even beyond, from any, or several, or all euro-member countries and beyond – to somewhere – or if a less solid and/or somewhat 'nationalized' banking entity does the same? Is this a matter that can be resolved on the sly and for how long? Is there potential benefit to announcing a, perhaps temporally and so to say geographically distributed, quantitative upper limit or is it better to let the markets guess and try out the so-called central bank's resolve? What educational thus market disciplining *regime* would in all such multifarious cases be thereby *intended*, even if implicitly – to serve as confidence-building signal to the market? Or, at the unhelpful extreme, will the ECB, in its open/secret or whatever policy of accepting collateral at the window, formally or implicitly accept the ratings of the market-rating agencies – thus defining itself as yet another 'market-thing'? Or is it still best to keep it all mum? as now seems the case.

Secondly, the prescient and subtle Chapter 29 of Vol. II of the *Treatise on Money* [somewhat absurdly subtitled by Keynes *The Applied Theory of Money*] entitled 'Fluctuations in the rate of investment – iii. Liquid Capital' – wherein [section V] the beautiful theory of the 'forward market' – thus to concentrate minds wonderfully: markets *abhor* unsold output, the cost of yield-less carrying stock brings the lot down in a flight to liquidity.

With obvious humility, the usual disclaimer holds. Yet, as principal source of my 'database', the *Financial Times* cannot escape. In the here and now as now constituted, can the *FT* be wrong? I venture to think not. For the *FT* is committed to the 'system' as it might yet be - with an eye to its social consequences. In our second best world I would rather have the *FT* run it in *lieu* of the most godawful alternatives – not zombie banks, rather zombie Europe. This is an acknowledgment of logical though not political gratitude.

P.S.: In today's [March 5th] *FT*, 'European interest rates cut to new lows', I read:

"The BoE *conceded* it had run out of ammunition with *conventional policy* and started a large programme of *quantitative easing* – creating money to buy assets [N.B. as if this were two separate things] – in an effort to prevent deflation. The Bank will from the middle of next week *create money and purchase* [N.B. ditto] UK *government bonds in a 75 billion pound sterling programme that represents 5 per cent of national income* … predominantly of medium and long-dated gilts … [The ECB's] President signalled eurozone costs [?!] could drop further … *Eurozone governments had not been contacted about a possible 'quantitative easing' programme, he said*. But [private economists] argued that by providing *unlimited liquidity*, the ECB was putting banks in a stronger position to buy government bonds – which *could* have a *similar effect to quantitative easing*"[emphasis supplied]

At a time when Eurozone *opportunity cost* is precisely **zero –** even **cameralist zero**.

Thus thank you, *FT* – it is clear that, since starting off on the sovereign finance issue three months ago, <u>the defenders of the indefensible are on the retreat</u> – there is still plenty of road to go.

GKr – March 5th, 2009