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From Territorial to Monetary Sovereignty

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State sovereignty is closely intertwined with, but not limited to, control over territory and people. It has long been recognized that control over monetary affairs is a critical part of genuine sovereignty. In this Article, I go a step further and argue that the relevance and importance of territorial versus monetary sovereignty has shifted in favor of the latter. This shift goes hand in hand with the rise of credit-based financial systems. Such systems depend, in the last instance, on backstopping by an entity with control over its own money supply and no binding survival constraints. Only states with monetary sovereignty fit this pattern. All others are de facto more like private entities, which by definition cannot manipulate their own survival constraint. States can surrender their monetary sovereignty directly by adopting another currency or by issuing their own debt in foreign currency and under foreign law. They also compromise their sovereignty by permitting unlimited capital inflows denominated in currencies other than their own. This is because in times of crisis they will not be able to rescue the domestic financial system from its tendency to self-destruct without subjecting itself to a sovereign debt crisis and the implied need to rely on a lifeline from other states or supranational entities.

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Introduction

This Article explores the transformation of sovereignty in the age of globalization. It argues that control over money and finance determines *actual* sovereignty. Viewed in this light, most countries' sovereignty is compromised. International public law treats sovereign states as equal subjects of international law. States may be bigger or smaller, older or younger, democratic or autocratic. None of this matters for sovereignty as construed by public international law. The decisive criterion is effective power over territory and people. Indeed, the most rudimentary definition of a state is the organization of power over territory and people within that territory.[1] Territory determines the boundaries of polities and their jurisdiction over different aspects of economic and social life both within and between states. Public international law, too, is built around the notion that sovereign states are bounded by territory and limits the extraterritorial reach of state power by principles of comity and the international law of war.

The flatness of territorial sovereignty stands in marked contrast to the "inherently" hierarchical nature of money and, by implication, of monetary sovereignty.[2] It goes without saying that only countries that issue their own currencies retain control over their monetary policies, a precondition for "monetary" sovereignty. Countries that adopt a foreign currency (by dollarizing their economies) or join forces with others to adopt a new, common, currency (the euro) give up more than control over interest rate policy. They also relinquish their ability to address financial crises that are endogenous to a financial system built on credit.[3]

States may compromise their financial sovereignty even while keeping their own money. This is because state money is inextricably intertwined with financial assets, or private moneys, that private entities issue, trade, and hold

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1 The so-called "three-element theory." *See* Georg Jellinek, Allgemeine Staatslehre (1905). More precisely, the Montevideo Convention stipulates that a state is a "permanent population with a defined territory, possessing a government that has the capacity to enter into relations with other states." *See* Montevideo Convention on the Rights and Duties of States, art. 1, Dec. 26, 1933, 165 L.N.T.S. 19 (entered into force Dec. 26, 1934).

2 *See* Perry Mehrling, *The Inherent Hierarchy of Money*, *in* Social Fairness and Economics: Economic Essays in the Spirit of Duncan Foley 394 (Lance Taylor, Armon Rezai & Thomas Michl eds., 2013) (developing the "money view," which treats private and public moneys as part of an integrated money system).

3 *See* Hyman P. Minsky, *The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to "Standard" Theory*, *in* Can "It" Happen Again? Essays on Instability and Finance 59 (1982) (originally published in 1977 on the tendencies of a financial system to destabilize endogenously).

— on the assumption that they can convert them into state money on demand. Whether private money can be converted into state money, how fast, and at what price are critical issues especially when doubts arise as to whether claims created in the past will actually perform. Holders of such claims may be forced to write down their value and face a liquidity crunch, if not insolvency, as a consequence. If many holders of private moneys experience similar problems, the stability of the entire financial system will be at risk, and in the extreme it might collapse. At this stage, states and their agents (typically their central banks) have to decide whether they want to intervene and rescue the financial system from collapse or step aside and watch it self-destruct.

States that do not control their own currency have lost power over this critical question, as have states that incur most of their own debt in foreign currency, which they do not control. Similarly, if intermediaries that seek access to state money need foreign rather than domestic currency to meet their obligations, their home state may not be of much help unless it has substantial foreign currency reserves or maintains a currency swap line with the relevant country whose money is in demand.

The key thesis of this Article is that if the question of sovereignty was tied not to effective control over territory and people but to effective control over money, including state and private moneys, most states in this world would fail the test of sovereignty. Given the central importance of finance for the operation of states, this raises the question of how sovereign most states truly are. The only states that may be deemed sovereign in monetary terms are the United States, the United Kingdom, Canada, Japan, Switzerland, Australia, and the People's Republic of China. All other countries have compromised their financial sovereignty. Even as regards countries that have retained their monetary sovereignty, one may call into question their ability to exercise it. As the great financial crisis (GFC) that has engulfed the world since 2007 suggests, monetary sovereignty can be compromised by losing control over the process of *domestic* money creation. When private money expansion has run its course and a crisis threatens the survival of the system, states can, of course, deny liquidity support or bailouts. Yet the political consequences of that decision may well force their hands.

Does this matter? It does if monetary sovereignty is of sufficient import to call into question whether states with compromised monetary sovereignty are truly sovereign.[4] This Article takes the position that it matters hugely. It posits that the changing landscape of monetary sovereignty challenges the very notion of state sovereignty. This is because access to and control over

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4 Daniel Pilpott, *Sovereignty*, *in* STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Edward N. Zalta ed., 2016), http://plato.stanford.edu/entries/sovereignty/.

financial resources is a key source of power in a global economy that has torn down entry barriers for capital, even as it builds new fences and walls for states to guard against people entering their territory.[5] Capital can and does roam the globe, but not all states are equally equipped to deal with the fallout from financial crises, which are an inevitable byproduct of money systems organized around credit.[6]

Lack of access to the money needed to serve sovereign debt can also compromise a state's territorial integrity. A recent example is Ukraine in 2015 when it simultaneously faced a sovereign debt crisis and a threat to its territorial integrity by its eastward neighbor. Indeed, the rapid accumulation of Ukraine's debt since 2009 has been attributed to military spending.[7] At the time, Russian military action may have been still a possibility rather than a reality, but the relation between the two countries had already reached a low point. The fact that access to international lending markets can determine the fate of sovereign states is nothing new. Funding wars has been a major motive for issuing sovereign debt ever since England financed its wars with France by chartering the Bank of England in 1694 and using it to issue sovereign bonds.[8] However, with the growing complexity of domestic finance and increasing interdependence of global financial systems, access to finance has become a central issue not only in times of war. Every severe financial crisis challenges sovereign power in the country where it happens to break out. Every crisis puts to a test the ability of states to rescue the domestic money system without recourse to external help. Some countries can help themselves and others can't. External help always comes with strings attached and constrains autonomous decision making.

These strings may be lifted once countries have repaid their debt or implemented the demanded policies. They may therefore be dismissed as merely temporary. However, what appears to be a temporary measure masks deeper, structural features of the global money system. It is an inherently

5 Waldron in this issue posits the thought-provoking question whether sovereigns have the power to exclude persons that are not acting as agents (troops) of foreign states from their territory. *See* Jeremy Waldron, *Exclusion: Property Analogies in the Immigration Debate*, 18 Theoretical Inquiries L. 469 (2017).

6 *See* Hyman P. Minsky, Stabilizing an Unstable Economy (1986) (discussing capitalist economic systems as financial systems based on credit finance).

7 *See* Elaine Moore, *Explainer: Ukraine Debt Crisis*, Fin. Times, July 23, 2015, https://www.ft.com/content/2d058776-312b-11e5-8873-775ba7c2ea3d?siteedition=intl.

8 For an account of the early history of the Bank of England, see Bruce G. Carruthers, City of Capital: Politics and Markets in the English Financial Revolution (1996); and Stephen Francis Quinn, Banking Before the Bank: London's Unregulated Goldsmith-Bankers, 1660-1694 (1994).

hierarchical system that links assets, intermediaries, and countries in ways that predetermine winners and losers in times of crisis. One has to be at or close to the top to come out of a crisis relatively unscathed; those on the periphery will be the first to absorb the losses.

The rest of this Article is organized as follows. Part I develops the conceptual framework for the argument and relates it to debates in the literature. Part II argues the case that the rise of money and the integration of money systems globally have transformed sovereignty. Part III pitches territorial sovereignty against monetary sovereignty to further sharpen the argument. Part IV discusses the normative implications of compromised monetary sovereignty for the ability of people to self-govern. Part V concludes.

I. Rethinking Monetary Sovereignty

Monetary sovereignty has not been central to debates about sovereignty. To the extent that it has been addressed at all, it is acknowledged that sovereign states have the power to issue their own currency and manage their own financial systems.[9] Once subsumed as a facet of the unified concept of sovereignty, the argument follows familiar steps for explaining sovereignty internally and externally: states may delegate part of their sovereignty by entering into international agreements with other states. They may even relinquish their own currency and transfer monetary policy, as the member states of the European Union, which adopted the euro as their common currency, have done. As long as delegation takes place within existing constitutional mandates, such measures will not compromise sovereignty. Further, in the external realm sovereignty shall not be compromised by other states, but neither shall one state use its sovereign powers in ways that inflict harm on other states.[10]

There are two problems with this account. First, it embraces a very narrow view of sovereignty that is limited to state money and state action. Second and related, it treats money as perfectly analogous to territory. Just as the sovereign's territory can be clearly distinguished from land and ownership of land, so state money, the legal tender, is assumed to be clearly distinguishable from private money, the financial instruments that private entities issue, hold, and trade. The sovereign sets the rules of the game[11] and private parties pursue

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9 See Claus D. Zimmermann, *The Concept of Monetary Sovereignty Revisited*, 24 Eur J. Int'l L. 797 (2013) for a useful summary of the debate.

10 *See id.* at 810.

11 This, of course, is Douglass North's widely followed definition of "institutions." *See* Douglass C. North, Institutions, Institutional Change and Economic Performance (1990).

their own goals within these constraints. However, while control over land and territory have effectively been separated into a world of private property rights on one hand, and public domestic and international law governing territory and territorial borders on the other, money *cannot* be neatly parsed in this fashion. In short, public and private moneys are part of an integrated, hierarchical money system, both domestically and globally.[12]

Entities that can relax their own survival constraint occupy the apex of this system. Only entities that can impose their own liabilities on others can do so. States are paradigmatic examples of such entities, but as discussed below, not the only ones. This quality ensures that state-issued legal tender serves as a reference for all private moneys, which are priced in public money, and as an asset of last resort whenever the risk of holding money issued by private and thus fallible entities becomes too high. The location of private entities in a hierarchical system is determined by their access to state money, the only safe asset in times of crisis.

A state that controls its own currency can produce it in unlimited amounts. That is the source of its backstopping capacity. However, unrestrained use of this power will undermine its credibility as the guardian of public money's safety. States with a track record of sustained high- or even hyper-inflation are a case in point; everyone will flee from their money, exchange it for other currencies or for "real" assets that may not be tradable but promise more lasting value.

To appreciate the interconnectedness of private and public money systems it is useful to conceptualize our domestic and global money systems as sets of interlocking balance sheets.[13] What constitute one person's or entity's assets are another person's or entity's liability. The basic rule in a market economy is that in principle all must balance their assets and liabilities. Those failing to do so will be liquidated and their assets reallocated to more efficient users.[14]

Critically, this auction-block rule does not apply to states. It is sometimes said that states cannot default, because they can always print their own money. Clearly, this can apply only to states that control their own money. Sovereigns with foreign exchange exposure can and often do default; yet a default does

12 This is not how modern finance theory sees it. For a critique of this view and a call to take into account the actual operation of the money system, see Perry Mehrling, *Minsky and Modern Finance: The Case of Long Term Capital Management*, 26 J. Portfolio Mgmt. 81 (2000).

13 Perry Mehrling, The New Lombard Street: How the Fed Became the Dealer of Last Resort (2011); Mehrling, *supra* note 2.

14 This is the basic rationale for liquidation in bankruptcy. *See* Douglas G. Baird, The Elements of Bankruptcy (1993).

not trigger the demise of these states. The principle of state sovereignty and their ability to commit the future productivity of their economies insulates even insolvent states from liquidation. It follows that sovereigns do not operate under a binding survival constraint.[15] In contrast, private entities do, unless they have a direct or indirect lifeline to a sovereign. If the conditions for the lifeline are set ex ante and held firm even in times of crisis, states maintain the upper hand over private entities. If private entities can compel sovereign states to support them ex post, private entities gain the upper hand over states. In short, monetary sovereignty can be impaired not only by acts of other states, but also, and perhaps primarily, by private actors.

The above analysis renders at least two important implications. First, money systems are not flat but hierarchical. Moreover, one's position in this hierarchical system is determined by the relative elasticity of one's survival constraint. Second, law is central to the organization of money systems, domestic and global. Every IOU is a contract, which can be dressed up to enjoy priority rights against the world with the help of property and collateral law and protected from unwanted creditors by employing trust or entity law.[16] Law thereby helps to scale money systems from settings in which mutual monitoring is sufficient to ensure which commitments are made, to national or global markets where anonymity makes mutual monitoring infeasible. Law's scaling power is a function of the coercive powers of states.

Yet, the power of law can also help destabilize the system when it turns out that not all enforceable claims will indeed generate the expected returns. This is the essence of the "Law-Finance Paradox."[17] All claims to future pay entail a speculative element, because nobody can know for sure what the future might hold. Frank Knight has coined the term "fundamental uncertainty" to capture this basic insight.[18] The more market participants rely on credible legal commitments and equate them with predictability of actual returns, the larger but also the more volatile the system becomes. Once defaults mount, and they typically begin to mount on the periphery, every market participant

15 This is the term used by MINSKY, *supra* note 6. In a similar vein, János Kornai uses the term soft and hard budget constraints. States and public entities operate under a soft budget constraint as they can shift liabilities to others, but private entities operate under a hard budget constraint since they are, in principle, not able to do so. *See* JÁNOS KORNAI, THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM (1992); János Kornai et al., *Understanding the Soft Budget Constraint*, 41 J. ECON. LITERATURE 1095 (2003).

16 *See generally* Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMP. ECON. 315 (2013).

17 *See id.*

18 FRANK H. NIGHT, RISK, UNCERTAINTY AND PROFIT (1921).

will necessarily seek to protect itself by calling in claims against others and rebalancing assets that have lost value. If all do so at the same time the system will self-destruct. Retreat from there is possible, but only by compromising the very pillars on which the system rests. It requires the relaxation of the full force of the law by suspending existing commitments or by offering state money (liquidity) where none is owed. Relaxing if not suspending the full force of the law undermines the credibility of legal commitments needed to scale financial systems to size.

An obvious response to the two points made previously is to say that sovereigns can and should constrain private parties. They should restrict their moneymaking activities and not allow them to become too dangerous to the stability of the system. Indeed, many states have done so in the past and every crisis brings about another effort to do so. The form these constraints take varies and may include limitations on issuing notes, the rules governing the composition of balance sheets, or constraints on the size of financial regulation or the scope of their operations in terms of both geography and subject matter.[19] Notably, none of these constraints has been immune to erosion.

It is virtually impossible to write complete laws.[20] Every legal constraint therefore necessarily leaves gaps that can and will be exploited for gain. The forces of competition push every system of private moneys towards greater risk-taking and more imaginative exploitation of gaps in the regulatory scaffolding.[21] Hyman Minsky has described this trend as follows.[22] Financial systems may start out funding predominantly projects that are highly likely to generate the expected returns at a certain future date. Competitive pressure, however, will lead more and more market participants to relax the conditions

19 For a comprehensive overview of the legal constraints that existed in the United States after the new deal, but were lifted over time, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. Ill. L. Rev. 215. For historical comparisons of banking in the United States and in Germany, see Charles W. Calomiris, *The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870-1914*, *in* Coordination and Information: Historical Perspectives on the Organization of Enterprise 257 (Naomi R. Lamoreaux & Daniel M.G. Raff eds., 1995). More generally, on different models of banking and finance in modern Europe, see Richard Tilly, *Universal Banking in Historical Perspective*, 154 J. Inst. & Theoretical Econ. 7 (1998).

20 *See* Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 J. Int'l L. & Pol. 931 (2003).

21 See Minsky, *supra* note 6, for a comprehensive treatment of endogenous destabilization of money systems.

22 *Id.* at 225-26.

for lending. They will also invest in projects that have a substantially high probability of requiring a rollover of debt, as they won't be able to deliver when debts become due. That he calls "speculative" finance. For the most aggressive lenders, speculative finance is not enough. They are willing to fund projects that almost certainly will need refinancing and charge higher interests for them. This he calls "Ponzi" finance — after the famous Ponzi scheme, where investors are duped into committing funds, which are used to pay back others who have done so earlier — with no investments ever made.[23]

In theory, sovereigns might respond to this by filling gaps left in the regulatory scaffolding as they observe the gradual destabilization of the system. In practice, they rarely do so. One reason is that governments need to fund themselves. Debt finance often seems more palatable than tax finance, especially in democracies where electorates frequently demand both social benefits and low taxes, and punish governments that do not deliver. Moreover, governments benefit from growth, and credit helps fuel growth. Reliance on public and private debt finance appears to have increased after inflationary practices have been curtailed.[24] Insulating the making of money from direct state control, however, is only part of the story. The other part is ensuring that the production of money is not taken over by the private sector, which invariably will seek full conversion into public money.[25]

Last but not least, unlike land, the most immobile of all assets, money is not confined to territory. States can impose capital controls for inbound or outbound capital flows, but they are difficult to police and have been largely abandoned when fixed exchange regimes were replaced by floating ones. Capital controls were put in place after World War II to complement a global monetary system that was anchored once more in the gold standard. Under the Bretton Woods system, the U.S. dollar was pegged to gold and all other major currencies were pegged to the dollar.[26] However, this system hardly ever operated in its pure form. Private parties sought to sidestep capital controls

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23 The closest to this in recent times has been the Madoff phenomenon.

24 Inflation rates increased in most developed economies over the 1970s, leading to concerted efforts to impose rigid inflation targets.

25 Greta A. Krippner, Capitalizing on Crisis (2011) makes this point for the United States, showing that the imposition of high interest rates under chairman Volcker to contain inflation went hand in hand with the lowering of capital controls and the influx of foreign capital to fund the government.

26 See Barry Eichengreen, Globalizing Capital: A History of the International Monetary System (2d ed. 2008) for a historical exploration of different monetary and currency regimes.

by using currency swaps and similar legal devices.[27] Governments too found it difficult to operate under the constraints it imposed. The United States in particular found it impossible to pursue its overseas military strategies while facing increasing demands for gold conversion by European allies after their economies had regained their footing in the postwar period. In 1971 the United States abandoned the gold standard and allowed the currency to float.

The demise of Bretton Woods ushered in an era not only of floating exchange rates, but also of free capital flows. There was no need for governments to control the flow of capital if the benchmark money, the currencies, was priced effectively by the market. The regime shift created a new arena for private moneys. Private entities began to create and disseminate assets that were deemed as safe as state money but offered higher yields. The trick was to use asset backing rather than liquidity backstopping to ensure their safety, at least so the argument went to thwart regulatory interventions.[28] Asset-backed securities (ABS) became prominent in the United States in the early 1970s as a way to stimulate home ownership.

At first, only government-sponsored entities (GSEs) created and lent credibility to them.[29] The next step was to use ABS to back another class of assets derived from them, such as collateralized debt obligations (CDOs) and their squared and cubed variations, or credit default swaps (CDSs) that were used to insure the value of the underlying claims. These assets were created and funded for the most part outside the formal banking system, although banks were deeply involved in them.[30] They did this through off-balance sheet structures (the so-called special purpose vehicles, or SPVs) that insulated them from regulatory oversight and protected investors in these structures against the credit risk associated with banks.[31] The proliferation of these assets

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27 The origins of capital swaps as a means to circumvent capital controls are mentioned in MEHRLING, *supra* note 13.

28 *See* GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET AND UNLEASHED A CATASTROPHE (2009) (discussing the negotiations between JP Morgan and regulators about regulatory oversight over CDOs).

29 For an excellent summary of the role of Fannie Mae and Freddie Mac in residential mortgage-backed securities, see W. Scott Frame et al., *The Rescue of Fannie Mae and Freddie Mac*, 29 J. ECON. PERSP. 25 (2015).

30 The best evidence for this is that issuance of derivatives was concentrated in the hands of five major banks. *See* Bruce G. Carruthers, *Diverging Derivatives: Law, Governance and Modern Financial Markets*, 41 J. COMP. ECON. 386 (2013).

31 The keyword here is "bankruptcy remoteness." This was achieved by placing assets into trusts, which in turn issued certificates or notes to investors. For an overview of these securitization practices, see Steven L. Schwarcz, *The Alchemy*

escaped regulatory oversight for two reasons: They were exempted from such oversight in the United States by the famous 1974 "Treasury Amendment" to the act that established the Commodity Futures Trading Commission (CFTC) — the agency in charge of overseeing commodities and futures markets. Moreover, the assets thus created were marketable in foreign jurisdictions, because they had opened their borders and legal systems to assets created under foreign law.[32]

In short, the shift from the gold standard to fiat money in the realm of state moneys had its complement in the private sector in the shift from formal banking to parallel banking: the expansion of structured finance and the organization of off-balance sheet structures to shift risk and avoid regulatory charges.[33] In a world freed from capital controls, these instruments too can travel freely — and they did. On the downside, the diffusion of ABS and credit derivatives (CDOs and CDSs) also helped spread contagion when the crisis hit. It is certainly the case that "banks live globally but die nationally,"[34] as the former Bank of England governor Mervyn King has quipped. But equally important, financial assets, or moneys, produced under the laws of one sovereign can wreak havoc on the territory of another. If and when they do, that sovereign faces the challenge of stabilizing its financial system. This is when it turns out that some can, and others cannot. Private money let loose globally thus can bring sovereigns to their knees. They need not have delegated sovereignty consciously; all they have to do is to open their borders to free capital flows.

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of Asset Securitization, 1 Stan. J.L. Bus. & Fin. 133 (1994). *But see* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 Cardozo L. Rev. 1553 (2008) (offering a critique of securitization from the perspective of legal doctrine and black letter law).

32 The legal changes required went beyond simply lifting capital controls. Countries had to recognize the creation of assets under foreign law, which they had been reluctant to do in the past out of sovereignty considerations. A detailed analysis of the "choice of law" principles and how they changed over time would go beyond the scope of this Article.

33 For an excellent account on the expansion and operation of the shadow banking system, see Tobias Adrian & Hyun Song Shin, *The Shadow Banking System: Implications for Financial Regulation* (Staff Report, Fed. Reserve Bank of N.Y., Working Paper No. 382, 2009).

34 *See* Mervyn King, Governor of the Bank of England, Banking: From Bagheot to Basel and Back Again, The Second Bagehot Lecture Buttonwood Gathering (Oct. 25, 2010), http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech455.pdf.

II. Sovereignty Transformed

The globalization of money, in particular private money, is transforming sovereignty. Territorial sovereignty still matters. Yet even states that exert effective control over territory and people may find themselves on the periphery of a global money system that is not flat, but hierarchical. This has serious repercussions for their ability to act with the autonomy and authority to self-govern that sovereignty is meant to convey.

At the heart of the problem lies the fact that the world has embraced the free flow of capital but has not created mechanisms for sharing the costs of crises that will inevitably erupt from time to time. Instead of cost sharing, countries where a crisis happens to erupt are saddled with its fallout. It is often assumed that only countries with "bad" institutions, that is, countries that do not effectively protect private property rights and enforce contracts, are prone to crisis.[35] Viewed in this light, there is nothing wrong with forcing them to shoulder the costs. These countries should simply learn the lesson and build better institutions for the future. However, the GFC has turned this argument on its head. The eye of the storm was in the countries that had been heralded as models for best practice governance of finance, the United States and the United Kingdom.

In hierarchically organized systems, crises tend to erupt on the periphery and work their way up to the core of the system. Ordinary households and entities without access to credit lines from major banks or the government will find that at some point they can no longer roll over their debt. They will have no choice but to exit through liquidation, because their balance sheets are too small to absorb a serious downward adjustment of the value of their assets.[36] Intermediaries and dealers further up in the hierarchy may still believe they are safe, but not safe enough to help those below. They will discover that they too have a binding survival constraint when they can no longer roll over their debt; and so forth.

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35 This, certainly, has been the perspective of the International Monetary Fund in the aftermath of the East Asian Financial crisis, when it created its "Financial Sector Assessment Programs" that were used to assess the quality of legal and regulatory institutions in member countries. These efforts continue today. For details, see *Financial Sector Assessment Program (FSAP)*, Int'l Monetary Fund, https://www.imf.org/external/np/fsap/fsap.aspx (last updated Apr. 3, 2017).

36 *See, e.g.*, Matthew P. Dreannan, *Income Inequality: Not Your Usual Suspect in Understanding the Financial Crash and Great Recession*, 18 Theoretical Inquiries L. 97 (2017) (showing that inequality among households was a major cause of the GFC, and that a major part of households' debt was caused by elementary expenses and necessities).

When self-preservation becomes the order of the day, the system will contract from the periphery towards the center, leaving defaults and entities scrambling for another lifeline in its wake. Once the flight to safety, as it is commonly called — that is, the attempt to exchange assets that no longer promise the expected returns and may even default for others that do — engulfs the core of the system, we have a full-blown crisis. At this point, the only safe asset is the state money, and only few have access to it on demand: regulated banks with access to reserves held at central banks, the discount window or emergency lending facilities made available to them, and, of course, the state itself.

This model of a hierarchical money system describes not only domestic, but also the global financial system. Recall that stress began to build in 2006 as housing prices flattened out, putting an end to house flipping and easy refinancing.[37] By the summer of 2007, the stress that had built on the periphery claimed its first victims among financial intermediaries: the French bank BNP Paribas, the German IKB, and the English Northern Rock were rescued from the brink by a government bailout. The first two had entered the credit derivatives markets late in the game, and aggressively so, and neither had a capital base sufficiently large to sustain the losses they never expected to incur. The latter had funded mortgages by refinancing liabilities on interbank lending markets, which began to dry up in the summer of 2007.[38] In the fall of 2007 even the largest financial intermediaries had realized that they needed fresh capital. Finding it difficult to raise capital on private markets, they went, hat in hand, to the sovereign wealth funds sponsored by governments with substantial foreign currency revenue from oil or exports, which they invested in global markets: Qatar, Singapore, China, as well as Kuwait, Saudi Arabia, and South Korea.[39]

Even well capitalized sovereign wealth funds, however, were not willing to put too much of their capital at risk to save the global financial system. When

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37 The New York Fed has put together a crisis timeline. *See Financial Turmoil Timeline (June 2007 - November 2007)*, Fed. Reserve Bank of N.Y., https://www.newyorkfed.org/medialibrary/media/research/global_economy/Crisis_Timeline.pdf (last visited Feb. 21, 2017). Note, however, that IKB's failure is not included. For a more comprehensive timeline, see *Credit Crisis Timeline*, Credit Writedown, https://www.creditwritedowns.com/credit-crisis-timeline/ (last visited Feb. 21, 2017).

38 For a comprehensive analysis of the failure of Northern Rock, see House of Commons, Treasury Committee, The Run on the Rock: Fifth Report of Session 2007-08 (2008).

39 For a detailed account of the investment patterns and their rationale, see Katharina Pistor, *Global Network Finance*, 37 J. Comp. Econ. 552 (2009).

Bear Stearns failed in March of 2008, the New York Fed brokered a deal that had JP Morgan Chase take over the smaller investment bank with financial help from the Fed. In August, Fannie Mae and Freddie Mac, the two privately owned but government-sponsored entities that had promoted the market for securitized mortgages were taken into conservatorship.[40] In September, the attempt to arrange another shotgun marriage for a failing investment bank, Lehman Brothers, failed and the bank was forced into bankruptcy when no willing suitor was found.[41] What followed was a full-blown run on the assets and entities as every entity in the system took a fresh look at its balance sheets, enforced outstanding claims and collateral calls against counter parties, and shed assets that were declining in value. Left to its own, such a downward spiral in asset prices can bring down an entire financial system. We cannot know for sure whether it would have done so in 2008, but the threat of an imminent collapse triggered responses from central banks and governments around the world.

Central banks extended liquidity programs, first to primary dealers and regulated banks and then to ever more entities, including money market funds and other intermediaries that previously had enjoyed a special status as entities that offered de facto banking services without being regulated as banks or paying upfront deposit insurance. Legislatures passed bailout packages for financial intermediaries. When the United Kingdom came out with its decision to bail out its major banks, many other countries followed suit. They feared that failing to do so would trigger a run on their banks, as they would be deemed less safe than competitors with full government backing.

Bailouts were politically contentious wherever they occurred. However, not in all countries did a bailout of banks morph into a sovereign debt crisis. It happened in Portugal, Ireland, Italy, Greece, and Spain (also known as the PIIGS), but not in Austria or Germany. They all belong to the Eurozone, but only some had to ask for outside help when the financial crisis got out of control. Two factors help explain the difference: a credit boom fueled by capital flows from some countries and into others,[42] and the lack of an effective backstopping mechanism for refinancing sovereign debt in the Eurozone. In

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40 For details, see Frame et al., *supra* note 29. *See also* Robert C. Hockett & Saule T. Omarova, *"Private" Means to "Public" Ends: Governments as Market Actors*, 15 Theoretical Inquiries L. 53, 60 (2014).

41 *See Financial Turmoil Timeline*, *supra* note 37.

42 Dirk Schoenmaker, Stabilising and Healing the Irish Banking System: Policy Lessons, Paper Prepared for the CBI-CEPR-IMF Conference (Jan. 12, 2015), https://www.imf.org/external/np/seminars/eng/2014/ireland/pdf/Schoenmaker_IrishBanking.pdf (providing data on the financial boom that preceded the crisis).

theory, even a country without its own currency can keep its financial system afloat as long as it can refinance its own debt. For Ireland, this task fell on the European Central Bank (ECB), which refused to offer a helping hand. To the contrary, it threatened to cut back emergency loans in the fall of 2010 should Ireland fail to assume all of the debt of its banks.[43]

Ireland found itself caught in a web of legal constraints that eroded its monetary sovereignty. Relevant treaty law of the European Union prohibits member states from constraining inward or outward capital flows.[44] Ireland therefore could not have possibly stopped the inflow of capital that saw the size of assets held by Irish banks triple in only six years, from 2002 to 2008.[45] It is not clear that Irish regulators perceived the expansion as a potential threat or that it had wanted to take measures to stem the inflow. The point is that it would not have been allowed to do so had it tried.

One might think that a system that collectively subscribes to free capital flows would also create mechanisms to share the costs of such a system. Not so in the EU. Prior to the GFC, no mechanisms were in place to mitigate costs for countries where such a crisis might erupt. Moreover, the role of the ECB as a potential backstop for the system was unclear as a matter of law.[46] While this issue has now been settled largely in favor of the ECB's power to offer backstopping and thus emergency lending, this came too late for Ireland. Interestingly, it did not change the role of the ECB when it faced the decision whether to continue emergency loans to Greece in the summer of 2015 when the country was trying to renegotiate its debt with the Troika.[47] In sum, Ireland (along with other members of the Eurozone) lost

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43 *See* Martin Hellwig, *Notstand oder Erpressung?* [*State of Emergency or Blackmail?*], Das Handelsblatt, July 3, 2015, at 64 (drawing parallels between the role of the ECB in the case of Ireland in the fall of 2010 and in Greece in the summer of 2015. In the latter case the ECB did indeed withdraw emergency loans, forcing the closure of the country's banking system.).

44 Consolidated Version of the Treaty on the Functioning of the European Union art. 63, May 9, 2008, 2008 O.J. (C 115) 47 [hereinafter TFEU].

45 Schoenmaker, *supra* note 42, at 6 tbl. 1 and accompanying text (suggesting that the bulk of the asset expansion was funded from capital coming in from the EU).

46 *See* TFEU, *supra* note 44, arts. 119, 123(1), 127(1)-(2); Protocol (No. 4) on the Statute of the European System of Central Banks and of the European Central Bank, arts. 17-24, Oct. 26, 2012, C 326/230 (preventing the ECB from engaging in outright fiscal financing).

47 *See* Case C-62/14, Gauweiler v. Deutscher Bundestag, 2014 E.C.R. I, http://curia.europa.eu/juris/liste.jsf?num=C-62/14; Press Release, Court of Justice of the European Union, The OMT Programme Announced by the ECB in September

sovereignty on two counts: it had no means of defending its financial system against capital inflows; and it had no viable backstopping (much less cost sharing) mechanism to mitigate a crisis once it erupted. The major difference between these countries and other members of the Eurozone was that they were recipients of foreign capital flows, whereas others (Germany, France, and Austria) housed the intermediaries that exported them. This allowed the latter to externalize the costs of their financing model.[48]

The case illustrates the circumstances of countries that find themselves on the periphery of the global financial system. But Ireland or the "PIIGs" are not alone. The list of financial crises in emerging markets is long. As in the Irish case, these countries faltered when first their intermediaries and then the sovereigns themselves found themselves unable to refinance their debt. There is, of course, no legal right to be rescued when bets made in the past do not work out. However, these bets take place in a context where different sovereign nations have highly uneven access to refinancing opportunities. Access to safe assets is controlled by the issuer of such assets, the central banks at the core of the financial system. How they use these powers is nicely illustrated by the currency swap lines they have created. At first, these were ad hoc measures among the central banks that control the world's leading currencies: dollar, euro, frank, pound, and yen.[49] Some other countries also received an ad hoc swap line — but only if their pain posed a potential threat to the issuer of a leading currency.[50]

After the GFC had subsided, the leading central banks (augmented by Canada whose former central bank governor had become governor of the Bank of England) declared that they would make these swap lines permanent. Remarkably, these six central banks took this decision by invoking their powers to ensure price stability in accordance with their own domestic legislation. No one challenged their power to decide who should be able to join the club and who should be left out. In taking this politically charged decision, they

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2012 Is Compatible with EU Law (June 16, 2015), http://curia.europa.eu/jcms/upload/docs/application/pdf/2015-06/cp150070en.pdf.

48 *See also* Hellwig, *supra* note 43 (arguing that Irish taxpayers effectively paid the claims German banks had against Irish banks).

49 *See* Maurice Obstfeld et al., *Financial Instability, Reserves, and Central Bank Swap Lines in the Panic of 2008*, 99 Am. Econ. Rev. 480 (2009) (lauding the swap lines as evidence of enhanced cooperation among major central banks).

50 *See* Brad Sester, *Where Is My Swap Line? And Will the Diffusion of Financial Power Balkanize the Global Response to a Broadening Crisis?*, Follow the Money Blog (Oct. 18, 2008), http://blogs.cfr.org/setser/2008/10/18/where-is-my-swap-line-and-will-the-diffusion-of-financial-power-balkanize-the-global-response-to-the-broadening-crises/.

further entrenched the global hierarchy of moneys. Entities with access to one of these central banks will also have guaranteed access to the currencies the other five central banks issue. Entities without access can only plead for help in the middle of a crisis.[51]

III. The Political Economy of Money

Territorial sovereignty is based on control over land and the people residing on it. How exactly control is organized is irrelevant for the recognition of territorial sovereignty. It may vary internally, but in the external relation to other states sovereignty is flat. Territorial sovereignty is compatible with feudalistic, autocratic, republican, and democratic orders. The locus of "the sovereign" might shift from the King to parliament, even to "we the people" or the demos, without affecting the status of territorially bounded sovereignty. Sovereignty with its roots in the territorial nation-states can even engage in extraterritorial or supranational governance, provided that they are sufficiently legitimated under existing constitutional law.[52] Territorial sovereignty is also compatible with different forms of land ownership. Land may be owned by the state, leased out, or owned privately. This has no effect on the public claim to territorial sovereignty directed against intruders from the outside. Clearly, states can use their powers to respond to internal challengers and alter the rules that govern their ownership. The simple point is that private ownership and public sovereignty are distinct and can coexist as such.

In contrast, in credit-based financial systems public and private moneys are necessarily intertwined. This follows from the inherent hierarchical structure of money systems.[53] History is full of examples of systems with private money that lacked public backstopping. Such systems often thrived for a while, but the logic of competition drives them towards instability. Consider only the era of "free" banking in the United States, when state-chartered banks freely issued notes that were convertible into dollars pegged to gold – and yet, neither the banks nor the states who chartered them controlled the ultimate money supply. The end result was that banks frequently collapsed.[54] Private

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51 *See* Katharina Pistor, *Central Banking's New Club Class*, Project Syndicate (Dec. 2, 2013), https://www.project-syndicate.org/columnist/katharina-pistor.

52 For a powerful argument on how to sustain constitutional sovereignty in the age of globalization, see Jean L. Cohen, Globalization and Sovereignty: Rethinking Legality and Constitutionalism (2012). Note, however, that she does not address the question of monetary sovereignty.

53 *See* Mehrling, *supra* note 2.

54 Richard Sylla, *Monetary Innovation in America*, 42 J. Econ. Hist. 20 (1982).

money makes bets on a future that is inherently unknown and unknowable. If and when that future turns out to differ significantly from the assumptions that underlie the bets made in the past, even the most credible commitments will unravel — and with them the entities that made them and the money in which they were coined.

Large-scale financial systems evolved only with the rise of nation-states and the explicit or implicit guarantees they afforded these systems.[55] They are invariably born out of sin: an implicit pact between rulers and financiers to stand in for one another.[56] Financiers fund rulers and in return rulers help refinance their financiers. In recent years, countries like Greece, Spain, or Italy have been singled out as examples of this original sin and attempts have been made to sever the umbilical cord between states and banks by shifting the supervision of banks from the nation-state to the European level.[57] Perhaps these countries have allowed too cozy a relation to develop between their governments and their banks. Yet large-scale financial systems develop only in the presence of effective backstopping. And for reasons explained above, effective backstopping can come only from public entities, or states. Indeed, countries without the bargain between rulers and financiers ("merchants and kings" in the language of Fernand Braudel[58]) have failed to develop a major financial system.[59]

It is widely held that England's advance since the eighteenth century rests in large parts on the Crown's commitment to respect the property rights of its subjects, including the rights of its own creditors.[60] Indeed, as Christine Desan has shown, English rulers were limited in using a common trick to

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55 *See also* Minsky, *supra* note 6 (discussing at length the phenomenon of "big government").

56 For an early example of foreign financiers funding the Spanish empire and relaxing the repayment obligations to ensure future business, see Martti Koskenniemi, *Empire and International Law: The Real Spanish Contribution*, 61 U. Toronto L.J. 1 (2011).

57 For a summary of the design and operation of the European Banking Union, see *Single Supervisory Mechanism*, Eur. Cen. Bank, https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html (last visited Nov. 22, 2016).

58 Fernand Braudel, Sozialgeschichte Des 15.-18. Jahrhunderts: Der Handel [Social History of the 15th-18th Centuries: Trade] (1991).

59 *See* Abhishek Chatterjee, Financial Property Rights Under Colonialism: Some Counterfactual Possibilities (2014) (developing this argument for colonial India).

60 Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. Econ. Hist. 803 (1989).

deal with financial constraints by debasing their metallic currencies. English landlords depended on the value derived from rents paid on land they had leased; and they had a say in matters of money and taxation.[61] This, however, did not prevent the Crown and its financiers from exploring other avenues for dealing with funding shortages.

Expanding the source of moneys rather than debasement became the preferred strategy. This practice predates the creation of the Bank of England in 1694 and involved tax collectors, goldsmiths, and record keepers at the accountants at the Treasury.[62] In principle, tax obligations were owed in the official coinage, also referred to as the means of *final* settlement. Yet for periods of time, bookkeepers accepted sovereign debt (wooden tallies) to extinguish tax obligations. The scheme was intermediated by goldsmiths who bought sovereign debt and used these assets to back their own notes that were issued to investors and widely used as means of pay. Tax collectors accepted the goldsmith notes from merchants, traders, and others who held them as safe investments and as means of pay in their own right. After all, they were easier to carry around than heavy metallic coinage. The tax collectors then presented the notes to goldsmiths, who exchanged them for the tallies that represented state debt. The tax collector could wait until the debt matured and could be exchanged into coins. However, the promise of full convertibility frequently proved good enough for accountants to extinguish the debt.[63]

The scheme was a win-win for all concerned. The sovereign found willing takers for its debt. The goldsmiths enhanced their asset base against which they issued their own notes. The high quality of public debt with designated income streams made the goldsmiths' notes all the more desirable. The takers of the goldsmiths' notes also benefited. The availability of more moneys lubricated the credit market and facilitated payments. But there was a downside. The scheme had to collapse if either the Crown or a significant number of goldsmiths defaulted. The investors on the periphery of the system were the first ones to fall when tax collectors would impose a "coins only" rule when faced with the risk that their debt (collected in lieu of coins) was no longer convertible.

The Bank of England, established in 1694, institutionalized this scheme of multiple moneys used to back one another's credibility. The Bank was chartered by the Crown as a legal entity with the power to own assets and contract in

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61 Christine Desan, Making Money: Coin, Currency, and the Coming of Capitalism (2015).

62 Stephen Francis Quinn, Banking Before the Bank: London's Unregulated Goldsmith-Bankers, 1660-1694 (1994) (unpublished Ph.D. dissertation, Univ. of Ill.), http://hdl.handle.net/2142/20001.

63 *See id.* at 111.

its own name.[64] The goldsmiths became the Bank's private shareholders with limited liability, which created a buffer between them and the Crown. They could convert their shares into cash by selling them on the secondary market, if they needed liquidity to meet their own obligations. If the Crown did not meet its obligations, the Bank, not the individual goldsmiths, was the first in line to suffer. Clearly, the Crown had an incentive to ensure that the Bank would survive any turmoil.

The role of the Bank of England was further strengthened when it was given the monopoly for issuing notes deemed legal tender, which was tied to gold, and the power to manage the country's gold reserves.[65] The Bank presided over the remarkable feat of maintaining the gold standard even as the stock of private money in circulation proliferated.[66] The promise to redeem notes for cash *upon maturity* was sufficient to make notes appealing. It also gave the Bank some breathing space, because it did not have to pay on demand as deposit-taking banks do. Prussia (later Germany) and France, the traditional currency debasers, took a much more conservative position when it came to private money. Notes and bills had to be fully covered by assets to be acceptable in lieu of pay. Clearly this restricted the expansion of the (private) monetary base, and by implication, economic growth.[67]

The United States followed more closely England's path, qualified by its organization as a federal state and the lack of central banking until 1913. Prior to independence, all states borrowed against the future by issuing paper money to fund the government, collect taxes, and extend loans to worthy individuals or institutions.[68] The expenses of the War of Independence left most states deeply indebted. Upon integrating the confederate states into

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64 These are, of course, the core features of a corporate entity as they had evolved with the large chartered trading corporations, especially the English and Dutch East Indian Companies. For the legal history of the Dutch East Indian Company in particular, see Guiseppe Dari-Matiacci et al., The Emergence of the Corporate Form (2016) (unpublished manuscript) (on file with author). On the English East India Company, see Ron Harris, *The Private Origins of the Private Company: Britain 1862-1907*, 33 Oxford J. Legal Stud. 339 (2013).

65 Samuel Knafo, *The Gold Standard and the Origins of the Modern International Monetary System*, 13 Rev. Pol. Econ. 78 (2006) [hereinafter Knafo, *Gold*]; Samuel Knafo, *The State and the Rise of Speculative Finance in England*, 37 Econ. & Soc'y 172 (2008).

66 Knafo, *Gold*, *supra* note 65, at 88.

67 Richard Tilly, *Banking in the Early Stages of Industrialization*, *in* Banking in the Early States of Industrialization 151 (Rondo Cameron et al. eds., 1967).

68 Richard Sylla et al., *Banks and State Public Finance in the New Republic: The United States, 1790-1860*, 47 J. Econ. Hist. 391 (1987).

the United States of America, the federation assumed all state debt on the condition that states would relinquish their note-issuing authority, which they did. States, however, needed to fund themselves. So they turned around and authorized state-chartered banks to issue notes. The scheme worked so well that many states stopped collecting real estate taxes, because they could fund themselves from the business of banking. They either owned shares in these banks and collected dividends, or charged them with franchise taxes. In some states, revenue from banks amounted to one half, if not more, of total state revenue.[69] The downside of this scheme, of course, was that the failure of banks imposed hardship not only on depositors, other creditors, and shareholders, but also on state revenue. Moreover, having relinquished their own note-issuing authority, states did not have the power to bail out their banks — and so they often crashed.

Employing banks to help fund fiscal expenditures became increasingly attractive to the federal government, especially in times of extraordinary expenditures. It is no accident that the system of nationally chartered banks was established during the Civil War and that under the relevant legislation national banks were required to invest a portion of their capital in federal government bonds.[70] For this to work, state-chartered banks had to be lured into adopting a national charter. The carrot offered was lower reserve requirements as compared to state law. When this proved insufficient to increase the number of nationally chartered banks, a stick was thrown into the mix in the form of a ten percent tax on state bank notes.[71] National banks, because of their size and status, could pose threats to the stability of the national financial system. This ultimately led to the establishment of the Federal Reserve System in 1913.

States on their part responded to the threat that the national chartering of state banks posed to their own state finances by lowering reserve requirements and by chartering new forms of financial intermediaries, including investment trusts. The stage was set for both funding and regulatory competition between the federation and the states on one hand, and among different federal regulators on the other. This has been a core feature of the U.S. financial system ever

69 *Id.* at 394 (Massachusetts); *id.* at 395 (Rhode Island); *id.* at 396 (New York, prior to 1830, New Jersey, Pennsylvania); *id.* at 397 (Delaware); *id.* at 399 (Georgia). For other states the share of revenue was lower, but still significant, with the exception of Vermont, which hardly derived any income from banks. For a comparison of all states, see *id.* at 401 tbl. 1.

70 Richard Sylla, *Federal Policy, Banking Market Structure, and Capital Mobilization in the United States, 1863-1913*, 29 J. Econ. Hist. 657 (1969); *see also* Charles W. Calomiris & Stephen H. Haber, Fragile by Design: The Political Origins of Banking Crises and Scarce Credit (2014).

71 Sylla, *supra* note 70, at 663.

since. It has also shaped the development of the global financial system, which opened an entirely new field for regulatory arbitrage.

If all states are beholden to financiers, who in turn rely on states to relax their own survival constraints, why are some states better able to assert their monetary sovereignty than others? As we have seen in the context of the Eurozone crisis, not even all countries that have relinquished their national currencies are equal; some are more equal than others. In that context, what mattered to secure a position higher up in the hierarchy was the direction of capital flows and interest alignment with the monetary authority, the ECB. Countries with financial sectors that fueled capital to intermediaries in other states did better than those on the receiving end. The same countries also benefited from the conservative stance of the ECB with regard to its role as a backstop of the integrated financial system. On the other end, countries that had been the beneficiaries of capital inflows found themselves in the nonviable position of having to absorb losses without benefiting from effective backstopping. They had little choice but to impose much of the burden on their own people. The ability to do so confirms their territorial sovereignty. In this context, it served primarily the monetary interests beyond their shores, and not their own people.

As these examples suggest, monetary sovereignty is not absolute, but relative. All depends on where one is located in the global hierarchy of moneys. This is not so much a matter of formal agreements among states, but of how private money and the entities that issue it relate to the ultimate monetary sovereign(s). Once financial stress builds within a nation-state, the question arises whether the sovereign has the legal power, and the financial as well as political capacity, to step in. If not, then there are two options left on the table: external help or internal austerity — and more often than not a combination of both, as external help typically comes with strings attached. It also means that recovery will be slow and protracted and will entrench the country's position on the periphery of the system.

This raises the question of how the monetary sovereign at the apex of the global system sustains itself. The GFC has demonstrated that the U.S. Fed was able to more than double its balance sheet after the onset of the crisis without any repercussions for the value of the dollar, inflationary pressures, or uptake of U.S. debt. To the contrary, the U.S. dollar was widely regarded as the safest asset around, and the Fed responded to the demand by making state money available to many more. Yet whenever the Fed tries to cut back, market volatility increases.

We have thus come to a point where the credibility of the Fed at the apex of the system is maintained by ensuring dollar liquidity. This is not very different from the much admonished scheme in Greece where banks fund bad government debt and governments keep banks afloat, only that this scheme involves more moneys and more actors and has been scaled to the globe. Private moneys depend on state money, and states have become ever more reliant on private money not only to fund the state, but to help fuel economic growth. The credibility of state money, however, is contingent. The Fed may not be able to politically sustain its policies of quantitative easing for long stretches of time. The powers of the central bank have been scaled back somewhat by the Dodd Frank Act, although these reforms may not stand in the long term.[72] The irony of such a move would be that political, territorially bounded sovereignty would be used to cut the global financial sovereign down to size. From the perspective of democratic self-governance, this only makes sense. After all, the global monetary sovereign commits the future productivity of its country to sustain the system. This comes at huge costs internally, because it extends an implicit guarantee to the financial sector.

In the end, we are back in history where it all started. Think of the Fed as the Crown, the primary dealers that interact with the Fed as the goldsmiths, and the various financial intermediaries as additional layers of goldsmiths that issue their own money in the expectation that it can be converted on demand into either sovereign debt or dollars. It is a win-win scheme on the upside. The problem is that if any of the key players default or retreat, the system will invariably destabilize. At that stage, there may not be another backstop big enough to stabilize it and, if true, the downward spiral suggested by the Law-Finance Paradox would run its full course, bringing down the global monetary sovereign with it.

IV. Money's Challenge to Democratic Self-Governance

Monetary sovereignty faces challenges from different directions and not all pose a threat to democratic self-governance. Sovereign states may delegate monetary powers to supranational organizations or multilevel governance entities. As long as this is done within existing constitutional constraints and does not preempt self-governance about core issues of statehood, it is perfectly compatible with self-governance by the demos, the source of sovereignty in constitutional democracies.[73] Thus, sovereign states may join externally

72 The official title is the Dodd-Frank Wall Street Reform and Consumer Protection Act, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

73 *See* Cohen, *supra* note 52.

managed governance regimes such as the Bretton Woods or the European Monetary system[74] or swap their own for a common currency, such as the euro.

As the discussion in this Article suggests, the greatest challenge to monetary sovereignty does not emanate from other sovereigns. Rather, the challenge to sovereignty emanates from private money issuers, both domestic and foreign. The irony (and further proof of the Law-Finance Paradox) is that neither modern-day money issuers nor their money would exist absent laws and legal institutions that are recognized and enforced by states. Every money private entities issue is rooted in legal institutions, such as contract law, property, and collateral law. Moreover, the issuers themselves are typically organized as corporations or trusts, that is, as creatures of law. These institutions help structure rights, giving greater weight to some, and thereby determine the enforcement of these rights ex post. Stronger rights trump weaker rights; and senior are first in line as compared to junior rights. This works even in relation to parties who never participated in the deals that created these moneys, because the formal legal devices they employ are backed by coercive state power. The enforcing state need not have authorized the entity or the issuance of certain assets; all it has to do is to commit that it will recognize such entities and assets even if created under foreign law, and will enforce them. The shadow of coercive law enforcement by states around the globe lends credibility to global money privately.[75]

Enforceability allows private parties to trade assets among strangers and to scale markets to size. Credible enforcement as such, however, is not a guarantee that the promised future pay will be forthcoming or that the assets that are used to secure claims will retain their value. In fact, legal protections can exacerbate the mismatch between expected and real returns.

Suppose the making of law, intermediaries and their moneys structured in law all happens within a single state. The simple and sensible decisions to allow private agents to engage in credit finance and issue their own notes will, unless restrained, over time destabilize the financial system.[76] To avoid a meltdown, the government (directly or through its agents) may be forced to intervene by relaxing the full force of the law or offering liquidity where no

74 A big puzzle about the case law of the German constitutional court is why Germany's participation in these arrangements was never questioned on grounds of democratic self-governance. For a critical review of this line of case law, see Franz C. Mayer, *Rashomon in Karlsruhe: A Reflection on Identity and Democracy in the European Union*, 9 Int'l J. Const. L. 757 (2011).

75 For a discussion of the shadow of the law and its implications for the distinction between law and "non-law," see Katharina Pistor, Comment, *The Law and the Non-Law*, 27 Mich. J. Int'l L. 973 (2005).

76 *See* Minsky, *supra* note 6.

liquidity is owed. It is within its sovereign powers not to act, but abstention is at its own peril.

Financial meltdowns can topple governments and have done so in the past. Consider the relatively recent example of the Suharto regime in Indonesia in the context of the East Asian financial crisis, but also the implications of Germany's financial distress in the early 1930s, which helped pave the way for the victory and takeover of the state in 1933 by the Nazis.[77] Such outcomes are not inevitable. One thing, however, is certain: the outcome of a meltdown is unpredictable.

Once the decision to intervene has been made, a sovereign state can still decide how resources shall be allocated; who should benefit and who should lose. Still, in the end, the desire to protect the core of the financial system and the state's own prospects of refinancing its debt will most likely determine the outcome. This typically means that the perpetrators of financial instability are more likely to win over others. This implies that even within single systems, the inherent instability of finance poses a threat to democratic self-governance. This threat is built into a system that is an offspring of the original sin of large-scale financial systems backed by sovereign states. The best the demos can do is to ensure that it never verges towards the abyss. Prevention thus appears the best recipe for ensuring democratic control.

Now assume a transnational money system. It, too, is sustained by law and legal institutions, but not of a transnational or global nature. Rather, the legal institutions of one or two states can be used to stitch together a global money system, as long as other sovereign states recognize the legal rights and entities created under those laws.

Further, suppose that the money issuers sanctioned by one sovereign state create havoc in another. Under the Basel Accords and Concordats, which are international "soft" law agreements, states owe liquidity protection to entities incorporated and licensed under their law. This includes foreign branches, but not foreign subsidiaries, which are incorporated in the host state. It is therefore possible that a parent bank in country A operates a subsidiary in country B, for which country B has to offer liquidity protection. Suppose further that country B has no control over capital flowing into or out of the country. This is the perfect setup for externalizing the costs of excess money creation under the laws of country A while leaving the costs of dealing with a crisis to country B. If country B lacks the capacity to stabilize an unstable

77 For a recollection of this episode, see Ulrich Bindseil & Adalbert Winkler, *Dual Liquidity Crises Under Alternative Monetary Frameworks — A Financial Accounts Perspective* (Eur. Cen. Bank, Working Paper No. 1478, 2012).

system — as in the case of Ireland discussed earlier — it must rely on outside help or apply draconian austerity measures.

The financial crisis itself is only the final stage of a dynamic that unfolds hidden from view. Its structural features include a combination of recognition and enforcement of foreign law,[78] the opening of borders to foreign intermediaries, and no restrictions on free capital flow. Only countries that house intermediaries in the business of exporting money can maintain basic principles of democratic self-governance, although even these systems are challenged when a crisis forces the hand of the sovereign or its agent, the central bank. Countries on the receiving end of capital flows, the private moneys issued and disseminated under laws they don't control, are largely helpless. They surrender democratic self-governance much earlier than in a crisis situation when they are forced to seek outside help.

In fact, the very operation of the money system is anathema to democratic self-governance. Deliberation based on shared normative commitments enshrined in constitutional law is at the heart of democratic decision making. Money operates according to different rules: competition, hierarchy, and power. Money and finance may be made "in" law,[79] but their scale and survival depends in the last instance on discretionary backstopping. This follows from the Law-Finance Paradox, which suggests that binding rules can exacerbate a downturn under conditions of fundamental uncertainty.

It is not impossible to break the spell, but it would take a heroic political effort to do so. Two strategies are feasible. One is to let the system crash when it reaches the abyss, even at the risk of an economic depression and political turmoil, and to rely on the powers of learning and reconstruction. The problem with this strategy is that nobody knows what lies ahead at the other side of a financial meltdown, the cost of which will undoubtedly be borne not by those who benefited most from the system's upswing, but those on the periphery of the system.

The alternative strategy is to backstop the system and protect it from self-destruction, but reform it ex post. This is what Minsky advocated[80]: provide liquidity in times of financial turmoil, but invalidate all practices that caused it once the crisis has subsided. However, experience shows that the very act of "stabilizing an unstable economy" (as suggested by Minsky) destroys the political consensus for reform — especially in countries with the greatest backstopping capacity. Indeed, regaining stability will be interpreted as evidence for the strength of the system, not a sign of necessary reforms.

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78 The technical term is "conflict of law rules" or "private international law."

79 Katharina Pistor, *Law in Finance*, 41 J. Comp. Econ. (2013).

80 *See* Minsky, *supra* note 6, at 219.

V. Concluding Comments

This, then, is the predicament of sovereignty in a world ruled by money. Money and monetary sovereignty are not flat, but hierarchical. Countries that lack their own currency or access international lending markets only by issuing sovereign debt in foreign currencies find themselves at the bottom of the hierarchy. Among the handful of countries that retain monetary sovereignty, those that come out at the top are the ones ablest and willing to offer a helping hand to private money in times of crisis. Countries on the periphery are beholden to private money and can at most hope for a helping hand from countries at the apex of the system. Yet only those whose stability may pose a threat for monetary sovereigns can rely on this help.

In sum, the scope of monetary sovereignty is largely the making of others. It thus sits uneasily in a concept of "supreme authority." Even the country at the apex of a global money system is dependent on how much credibility others vest in it. This may but need not be the result of specific policy measures a country has taken. The greatest challenge to sovereignty and to democratic self-governance comes from the fact that countries can lose it without any fault on their part, and they lose it first to private actors over which they have no or little control and then to their home countries or the multilateral organizations they largely control. The best safeguard against such a predicament is to practice monetary autarchy, an isolationist stance that is not very attractive. Neither, however, is the perspective to be pushed to the periphery of a system controlled by others who will further entrench their position at the top with every future crisis.