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The various roles of the ECB in the new EMU architecture

NOTE

Abstract

The ECB has emerged as the single most decisive and most successful player among all European institutions during the crisis, but this is not sustainable over the long run. The note shows why this is so and how some flaws in Europe's architecture could be remedied.

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CONTENTS

EXECUTIVE SUMMARY

- During the recent crisis, the European Central Bank (ECB) has emerged as the single most decisive and most successful player among all European institutions. Although this role is perfectly compatible with the Treaty on European Union (TEU), it is not sustainable over the long run for economic and political reasons;
- A whole range of new institutions and procedures have been created and the complexity of the euro area's governance has become more opaque;
- The role of institutions should be derived from their functions. The central bank is the bank of banks. This creates a clear division of tasks: the central bank gives credit to banks and banks give credit to the rest of the economy;
- The central bank must monitor the creditworthiness of banks, and commercial banks have to monitor the creditworthiness of their clients. In this architecture it makes no sense to ask the European Central Bank to grant credit directly to firms, such as Small and Medium Sized Enterprises, or to governments;
- The central bank must guarantee the convertibility of bank deposits into money and therefore act as lender of last resort to the banking system. This does not imply that it also acts as lender of last resort to governments;
- Outright Monetary Transactions (OMT) Program was able to stop the avalanche of fire sales and restored stability in the Euro financial system. However, it is a corrective action which became necessary, because the ECB had no preventive instruments, which could have avoided the debt problems in some member states;
- Macro-prudential supervision should become a preventive instrument to prevent excessive credit booms in specific sectors and regions. Yet, Europe's regulatory gaps create incentives for regulatory arbitrage, which is a manifestation of collective action failures generated by Europe's institutional architecture;
- Many institutional reforms in recent years have re-enforced intergovernmentalism and this tendency to decentralise has augmented the ECB's role as the only "federal" institution;
- The note sets out a clear logical framework for centralisation and decentralisation of policies in the European institutional architecture;
- Democracy has turned into a crucial pillar of the architecture of European monetary union, not because democracy is part of the shared values of Europe, but because democracy is the tool by which collective preferences are defined. Without knowing these preferences, it is impossible to determine which policies are "efficient";
- The Euro crisis could have been an occasion to innovate and build a better house. So far, this opportunity has been missed.

1. INTRODUCTION

During the recent crisis, the European Central Bank (ECB) has emerged as the single most decisive and most successful player among all European institutions. This growing influence, which "new institutionalists" would call "displacement" (Salines, 2011), is, however, not unique to the European case. Robert Pringle (2013) has noted that in the UK, the US and elsewhere "central banks have come out of the global financial crisis with enhanced powers and added responsibilities. Governments look to them not only as the main instruments for keeping economies from slipping back into recession but also for two other crucial tasks: to re-float the financial system - at least in those countries where it has been on crutches - and to take the lead in ensuring the system does not crash again". What is special in Europe is the absence of a unified government at the euro area level, while monetary policy is centralised in the hands of the ECB. This asymmetry has accelerated the institutional displacement in the euro area more than in other economies. Compared to the many small national governments with little impact on policy decisions other than excreting nuisance value, the ECB as the European single institution appears as a giant.

However, I will argue that for economic and political reasons, this role is not sustainable over the long run. Economically, it is well known that monetary policy, although necessary for the foundation of a market economy, is only one among several instruments for achieving the objectives of stable prices, sustainable growth, full employment, external balance, etc. By assigning a privileged role to monetary policy, Europe risks overburdening an institution that has in fact a rather limited and technical role. But if the ECB alone cannot guarantee full employment and sustainable growth, its economic rational will be challenged and this challenge might ultimately prevent it from fulfilling its mandate. Politically, the displacement of policy responsibility to a technical institution is likely to hollow out the democratic sovereignty of European citizens and to generate a legitimacy crisis which could lead to the dismantling of monetary union.

For these reasons, it is useful to reconsider the institutional evolution that has taken place during the crisis and ask whether it may require a new orientation. In this context the image of "architecture" reflects the fact that there are different interconnected policy areas, which through their interactions generate the "European House". A fundamental principle in architecture is that the design of a building should serve the purpose of that building. Along these lines we may ask whether the architecture of EMU is serving the objectives stated in the Treaty on European Union (TEU). However, one difficulty with this metaphor is that there is no architect who has the overall responsibility for a rational design; under the impact of shocks, European institutions seem to evolve primarily as a random walk.[1] Nevertheless, in order to remain sustainable, it is important that institutions fulfil their functions correctly. As in architecture, "form follows function", and the institutional displacement observed by Pringle may reflect how central banks fulfil their function. Within the euro area, the ECB has repeatedly been lauded for its crisis management, but also criticised, even by its own shareholders. Becoming aware of the requirements of a European institutional architecture is an indispensable element for making the euro a sustainable institution and for facilitating political change and improved welfare.

[1] A "random walk" is a concept from econometrics that reflects the evolution of time series data which are subject to random shocks and remember these shocks forever. It is the opposite of a stationary time series, which returns after a shock to the long-run equilibrium. Political scientist call random walk dynamics "path dependency" (Pierson and Skocpol 2002). Efficient institutions create behavioural patterns that converge to a long run expectational equilibrium, i.e. a situation where agents' predictions are not systematically wrong.

2. THE FUNCTIONS OF THE EUROPEAN CENTRAL BANK

European Monetary Union (EMU) has a complex architecture (Hix, 1999), which has grown out of an incessant flow of political compromises. Occasional Treaty revisions were supposed to restore some order in the byzantine system of governing Europe, but the frequent reoccurrences of shocks and crises have regularly pushed the system to its limits and necessitated new arrangements. Since the Euro crisis a whole range of new institutions and procedures have been created and the complexity of the euro area's governance has become even more opaque.

From the earliest beginnings, and largely under the intellectual guidance of the *Bundesbank*, it was clear that EMU had to centralise monetary policy making in a unified European Central Bank. However, there was also little doubt that monetary policy has to be functionally embedded in a broader context of economic policies (Werner Report, 1970). This is why "EMU" was translated as *economic* and monetary union by the Delors Report (1989), which designed the blueprint for monetary union. The founding fathers of the euro, including Chancellor Helmut Kohl, had always believed that monetary union needed to be complemented by political union. However, the Maastricht Treaty did not reproduce the comprehensive architecture envisaged by the Werner or Delors Reports (Dyson and Featherstone, 1999). While Maastricht correctly centralised monetary policy in order to create a credible currency, the broader policy framework remained underdeveloped because national governments were not willing to delegate more power to European institutions and this lack of Political Union has generated many of the policy inconsistencies, which are at the root of the Euro crisis. For example, the Delors Committee had discussed the need to complement monetary policy by a coherent fiscal policy framework, but this idea was reduced during the Maastricht negotiations to the much weaker procedure of "avoiding excessive deficits" and the so-called no-bail-out clause. The first was subsequently tightened by the Stability and Growth Pact, with the consequence that fiscal policy never became a policy "tool" for stabilising the euro area's macroeconomy. The no-bail-out clause (TFEU, art. 125) was meant to use "market pressure" for disciplining governments, but it failed miserably to control sovereign debt dynamics. The clause ignored the implications of fire sales in financial crises for the stability of the euro, and this construction mistake would have been fatal unless the ECB had not set up the OMT program. Thus, experience shows that in the euro area a regulative authority is required to maintain monetary stability.

The embeddedness of monetary policy into the broader policy framework is a consequence of the roles and functions that a central bank fulfils in a monetary economy. I will therefore now discuss these functions.

2.1 The mandate of the ECB

The Treaty on European Union (TEU) gives a clear mandate to the European Central Bank. Article 3of TEU establishes the primary objective of monetary policy, which is repeated in TFEU art. 127:

> The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.

Articles 3 determines the broader context within which monetary policy stands. Monetary policy had little capacity to influence the objectives mentioned there, except by generating necessary but not sufficient conditions for growth through the generous supply of liquidity to the banking system.

In addition to these broad policy objectives, art. 127.2 also mentions the more technical task of promoting "the smooth operation of payment systems". These technical tasks are necessary for the ECB being able to conduct policies in pursuit of its "primary objective" of maintaining price stability. Without the smooth working of the payment system TARGET2 the currency union would instantaneously collapse. When the interbank market dried up during the crisis because banks no longer trusted the solvability of other banks, the ECB had to step in as lender of last resort in order to keep the system liquid. Given the unequal distribution of risks across the euro area, this led to the accumulation of large imbalances between the national components of the Eurosystem. While some scholars have criticised this system (Sinn and Wollmershaeuser, 2011), it must be recognised that the unconditional transfers of money balances are the *conditio sine qua non* of a currency area (Collignon, 2012; 2013). The high levels of lending by the ECB to banks are consistent with by the bank's mandate and the architecture of European monetary union.

The same is true for banking supervision. The malfunctioning of the interbank market during the crisis was a consequence of inadequate regulation and supervision of European financial markets (Liikanen Report. 2012). Member states sought to keep control of financial markets at the national level, often with protectionist motives. However, the spillover effects from excessive bank lending affected the whole banking and financial system of the euro area. These externalities typically generate collective action dilemmas[2], which require a centralised policy institution in order to minimise damage. The European Treaties have forseen the need for centralised banking supervision. TFEU art. 127 paragraphs 5 and 6 stipulate (emphasis added):

5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the *prudential supervision of credit institutions and the stability of the financial system*.

6. The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, *confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions* and other financial institutions with the exception of insurance undertakings.

Hence, the recent move to make the ECB the single supervisor for large banks, limited as it is, fulfills simply the provisions in the Treaty of the European Union. It is less an institutional displacement than the moving into one of the predesigned tracts of the European House.

In September 2012 the ECB announced the creation of a new policy tool, the OMT Programme, by which it will buy sovereign bonds, provided the issuing country has agreed to a fiscal adjustment programme with either the European Financial Stability Facility (EFSF), or its successor, the European Stability Mechanism (ESM). Again, the ECB was criticised for overstepping its role or even of violating its mandate. However, the European Treaty had clearly empowered it to do so in the Protocol (No 18) on the Statute of the European System of Central Banks and of the European Central Bank (1992), which says (emphasis added):

[2] Institutional collective action (ICA) dilemmas arise from the division or partitioning of authority in which decisions by one government in one or more specific functional area impacts other governments and/or other functions. See Feiock, 2013.

> 18.1. In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: — operate in the financial markets by *buying and selling outright* (spot and forward) or under repurchase agreement and by lending or borrowing claims and *marketable instruments*, whether in Community or in non-Community currencies, as well as precious metals; — conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.
>
> 18.2. The ECB shall *establish general principles for open market and credit operations* carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions.

Clearly government bonds are marketable instruments, which the ECB is entitled to buy and sell outright and the OMT Program has established clear principles when the ECB is willing to intervene. The only reasonable question is whether doing so would undermine the achievement of the "primary objective" of price stability. So far, the ECB has always maintained that there is no risk for accelerating inflation. For example, the *ECB Monthly Bulletin 8|2013*:54 says:

> "taking the appropriate medium-term perspective, underlying price pressures are expected to remain subdued, reflecting the broad-based weakness in aggregate demand and a modest pace of recovery. Medium to long-term inflation expectations continue to be firmly anchored in line with price stability. The risks to the outlook for price developments are expected to be still broadly balanced over the medium term".

The credibility of such a statement depends partly on the theoretical approach one adopts. In order to understand why the ECB has made use of "unconventional monetary policies" or assume new responsibility for financial supervision, it is, however, not enough to focus on the ECB's mandate; one has to consider the functions of a central bank in a monetary economy. I will therefore discuss two alternative views in the next section. Nevertheless, we may conclude here that the European Treaties have, rather wisely, designed policy areas where the ECB could and should act if the situation so required. The European House was, so to say, designed larger than what had been occupied.

2.2 The functions of a central bank

The central bank is the bank of banks. It issues money (a nominally fixed liability) against assets – gold and silver (bullion) in ancient times, nowadays primarily by granting credit to commercial banks that is backed by securities i.e. financial claims on the real economy. It also guarantees the integrity of the payment system between banks, thereby ensuring their liquidity. Commercial banks grant credit and hold deposits for their clients in savings accounts and provide payment services by transferring money from debtors to creditors. Because, they offer their clients the choice of holding liquid assets, i.e. of holding assets that can be exchanged immediately against any other asset (Goodhart, 1987), they need to hold liquidity reserves with the central bank, and these reserve deposits are central bank money (or money proper, also called high powered money or monetary base).

In this system, there is a clear division of tasks: the central bank gives credit to banks and banks give credit to the rest of the economy. It implies that the central bank has to monitor the creditworthiness of banks, and commercial banks have to monitor the creditworthiness of their clients, which may be households, firms or governments. In this architecture it makes no sense to ask the European Central Bank to grant credit directly to firms, such as Small and Medium Sized Enterprises, or to governments. However, historically central banks were often founded as the government's banker and debt manager and this meant

that central bank money was issued directly to the treasury against claims on future tax revenue. As we saw above, the Treaty on European Union does not allow the ECB to lend directly to governments, but government bonds are certainly an important part of the asset *portfolio against which the ECB lends to banks*.

Which functions are assigned to the central bank in the architecture of EMU depends partly on how one interprets the functions of money. For monetarists money is a means of exchange; the alternative paradigm interprets money as a means of payment that extinguishes debt contracts (Keynes 1971). The distinction is subtle but important, because it throws different lights on the issue of financial stability. If money is a token that facilitates the exchange of goods and services, the stability of the euro area is essentially reduced to price stability, and the function of the central bank is to ensure that not too many tokens are issued as this would cause inflation. The central bank must control the supply of money and it does so by oversighting credit creation. By contrast, if money is a means of payment that extinguishes debt contracts, it has a genuine liquidity function in addition to the transaction function. We can call this second interpretation the liquidity paradigm. Because the nominally fixed liabilities of the central bank serve as money, banks which lend money and hold deposits for their clients need to have access to central bank money at all times. Without this convertibility guarantee bank runs would develop that undermine the stability of the financial system. Central banks must therefore act as *lender of last resort* to the banking system, although this does not imply that they also act as lender of last resort to governments. In fact, if they lent to governments without limits, which frequently happens in non-democratic regimes, it would imply a tax burden rising without limits, which is not sustainable. When governments then default, the central bank's balance sheet is distorted and the resulting macroeconomic imbalance would generate inflation.

Related but distinct is the issue of the origin of money, or rather why people use money. Most monetarist economists since John Locke and Adam Smith have adhered to the exchange paradigm, arguing that money has evolved as a private sector, market-oriented, response to overcome the transactions costs inherent in barter. We may call this the *bottom-up* approach to explaining the origin of money. It implies that the utility of money consists in what it can buy. Against this view, a small minority of economists, but the majority of anthropologists, numismatists and historians, has argued that the State has played a central role in the evolution and the use of money by stipulating what counts as money (Goodhart, 1998). We may call this the *top-down* approach to explaining money. It implies that money has an intrinsic utility as a means of payment which no other asset has. The most prominent thinker of the top-down *Chartalism* was Knapp (1924: 32), who argued that "money is a creature of law". Although economists disagree, as usual, on the proper explanation for the origin of money, the historical evidence shows that the bottom-up and the top-down dynamics of money often intermingle. Early merchants in the Italian city republics created money bottom-up by inventing the letter of credit; sovereign rulers decreed top-down what was the means of payment for tax purposes. However, especially with modern fiat money there is a middle position where the two approaches meet. For if money is a means of payment in a market economy and is created by credit contracts, the establishment of law and order, and therefore government, is a necessary condition for the functioning of markets and money. Markets may be the driver of money creation, but legal recognition of the means of payment is necessary to ensure the security of contracts[3].

[3] This is in fact, how European monetary union came about. The private contract money ECU was not able to replace the old national currencies until monetary union started at the legally fixed date. See Collignon and Schwarzer, 2002.

The euro poses a challenge to Chartist theories as well as for monetarists. For if money is a creation of government, the absence of a European government would then seem to be a serious flaw in the architecture of European monetary union. On the other hand, if money is a market creation, why should one impose an "artificial" political monetary union on the European internal market? In fact, European monetary union was a laboratory experiment to test the two theories. Before the Maastricht Treaty set a legal date for the start of the currency union, there existed private contract money, the ECU, which was not recognised by governments as legal tender. If the exchange paradigm were correct, currency competition would have crowded out national currencies, as some economists and policy makers (including Margaret Thatcher) believed. But the ECU was not able to replace the old national currencies (see Collignon and Schwarzer, 2002). Nevertheless, the exchange paradigm has remained intellectually pre-dominant, especially in the form of Optimum Currency Area theories. As Goodhart (1998: 409) pointed out, "if the origin of money is to be seen in terms of private sector market evolution, whose function is to minimise transactions costs, then the evolution of a number of separate currencies in differing geographical areas should, analogously, be analysed in terms of private sector market evolution, whose function would have been to minimise some set of (micro-level transaction) and (macro-level) adjustment costs". Hence, the optimum currency area has no relation with political sovereignty, and this explains partly why the architecture of monetary union has remained so weak with respect to political union.

If money is a creature of law, the issue of who makes the law and who is the sovereign, becomes crucial. Yet, the remarkable feature of the euro area is that it has laws (and rules) but no government. European laws are made by agreement between many governments. This is precisely how monetary union was created. On 1 January 1999, the euro became legal tender in the participating member states (TEU, art. 3.4) and European central bank liabilities have become money by law. Previously existing monetary laws in member states were abrogated and the European Central Bank (ECB) was set up as the directive organ and head office for the conduct of monetary policy. The existing national central banks (NCB) were merged with the ECB to form the Eurosystem. Hence, money in EMU functions exactly like in any other currency area.

What are the implications of these two competing paradigms for the EMU architecture? From a monetarist perspective, the central bank's principal function is to issue money. If it "prints" or issues too much money, this will cause inflation, which impedes its function as a means of exchange and undermines the function of money as a store of value. The Treaty on European Union reflects this in TFEU art. 128.1,[4] and therefore stipulates "maintaining price stability" as the "primary objective". As policy makers, monetarists concentrate on the liability side of banks and the central bank in order to restrain money supply and keep it in line with potential economic growth. The ECB gives some consideration to this approach when it conducts its monetary analysis and formulates benchmarks for money growth in the two pillar strategy. In this model money is neutral in the long run; the "real" drivers of the economy are labour productivity and technology, which can be affected by "structural reforms" and not by monetary policy. Banks are (frictionless) intermediaries which collect savings and channel it to investment, while the central bank "prints" money which gives it the status of a benevolent dictator as long as it keeps prices stable.

From the point of view of the liquidity paradigm, however, this explanation is not really wrong, but too narrow. If money is an asset, i.e. a *claim* on real goods and resources, the transfer of which extinguishes debt contracts, it is more than a piece of paper that

[4] TFEU, art. 128.1. says: "The ECB shall have the exclusive right to authorise the issue of banknotes within the Union. The ECB and the national central banks may issue such notes. The banknotes issued by the ECB and the national central banks shall be the only such notes to have the status of legal tender within the Union".

represents the value of goods and services[5]. Each asset claim has as its counterpart the liability by someone to fulfil the promise to pay. In other words, money is created by credit and banks are the supplier of money in this broad sense. But the asset that extinguishes debt is the central bank liability which is legal tender. Hence, in order to make payments on behalf of their clients, banks must be able to convert deposits into central bank money. In a liquidity crisis, they are unable to do so because the central bank does not provide sufficient credit to them, either because it mistakenly keeps monetary policy too restrictive or because the banks have inadequate collateral. This means that the asset side of banks and the central bank may constrain (or inflate) the process of money creation. In this case, monetary stability may not only be threatened by inflation (or deflation), i.e. by the *liability* of the central bank's balance sheet, but also by shocks to the value of *assets* in the balance sheet of financial institutions.

This explains the rational for unconventional monetary policies: given the uncertainty of the economic environment after 2008, banks, firms and households all had high preferences for holding liquid assets. Had central banks all over the world not accommodated this liquidity preference by increasing their balance sheets, they would have deepened the crisis because banks would have been forced to sell less liquid assets at dislocated prices. Maintaining monetary stability requires then not only price stability, but also to stabilise financial markets by avoiding excessive price volatility for securities which serve as collateral for banks obtaining central bank money. This assigns a larger responsibility to the central bank and justifies the macro-prudential supervision by the central bank.

2.3 Financial supervision

By definition, promises and credit are uncertain. If promises to pay are broken and debtors default, creditors may themselves become unable to make payments and default avalanches will follow, causing serious disturbances in the real economy. In principle, one may distinguish two reasons why a debtor may not be able to make a payment: insolvency and illiquidity.

Insolvency is understood as the failure to make a payment due to a lack of profitability, or rather due to the fact that liabilities exceed the value of assets. Liquidating the available assets and distributing the returns to creditors will cause losses to the latter. In small proportions such losses may be absorbable, but if the shocks to asset values are large and generalised in the economy, they can generate cascades of defaults. Illiquidity means a debtor is solvent (assets exceed liabilities), but unable to convert these assets into money at fair prices. A banking crisis occurs when banks do not have sufficient access to central bank money in order to transform deposits into cash.

Monitoring the risk of insolvency of debtors by gathering specialised information on the default probabilities for firms and households is one of the prime functions of banks. However, if banks fail in their monitoring function, they may themselves become insolvent. Before the financial crisis, it was widely believed that the self-interest of shareholders and managers would ensure that banks will not lend excessively. Yet, there is now a growing literature which shows that if banks can move liabilities from their own balance sheet to unregulated financial institutions and securitisation, loosely termed the "shadow banking system", then banks will want to gamble and risk failure, rather than take precautions to prevent failure (Diamond and Rajan, 2011; Kashyap et alt, 2011). In other words, individual banks may not properly internalise the costs their behaviour could generate for the financial system's stability. It is the prime purpose of micro-prudential supervision to prevent the costly failure of individual financial institutions, but macroprudential regulation

[5] The distinction between the exchange and the liquidity paradigm can therefore be understood as exchanging goods against goods (barter) in the first case and goods against claims on goods in the second.

is needed to deal with the externalities of systemic risk. Both supervisory regimes should be extended to cover also shadow banking (ESRB, 2013).

Insolvencies may not only be caused by reckless borrowing and lending; lack of liquidity can also turn into insolvency. This is particularly dangerous in the case of fire sales. Shleifer and Vishny (2011) define a fire sale as

> "essentially a forced sale of an asset at a dislocated price. A sale is forced in the sense that the seller cannot wait to raise cash, usually because he owes that cash to someone else. The price is dislocated because the highest potential bidders are typically involved in a similar activity as the seller, and are therefore themselves in a similar financial position. Rather than bidding for the asset, they might be selling similar assets themselves."

In this case, the fire sale reduces the value of the bank's assets and impairs its net worth, because the liabilities are nominally fixed. If the shocks are large, a large number of banks may become insolvent, which again may cause significant systemic risks. The asset shrinkage will also force banks to deleverage, which will reduce bank lending and cause a significant slowdown in economic activity. Micro-prudential regulation cannot prevent such downward spiral; instead a macroprudential approach that recognises the importance of general-equilibrium effects must safeguard the financial system as a whole (Hanson et alt. 2011).

Fire sales have been an important cause for the Euro crisis or at least for its persistence. The political uncertainty around the Greek sovereign debt position, which then spilled over into Ireland, Portugal, Spain and Italy, generated excessive sales of government securities by financial market operators with the consequence of a rapid reduction of the prices for government bonds in the southern crisis states (Collignon et alt, 2013). The assurance by the ECB that it will buy government securities in unlimited amounts under the terms of the OMT Program was able to stop the avalanche of fire sales and restored stability in the Euro financial system. The simple announcement was sufficient to put a floor on panic sales because banks and other market participants recognised that the ECB was accepting its role as lender of last resort to banks, so that they could obtain liquidity without having to sell and bid down the price of their assets.

However, the OMT Program is a corrective action created in the midst of the crisis. It became necessary, because the ECB had no *preventive instruments*, which could have avoided the emergency. In fact, it has been argued that the global financial crisis occurred because of insufficient financial markets regulation – in the USfor ideological reasons, in Europe for nationalist reasons – while, for example, Canada had a better supervisory system that made it more robust to shocks. It is true that both Europe and the United States have complex regulatory frameworks in which agencies have overlapping jurisdiction, and in which there are regulatory gaps. However, the major difference between Canadian banks and banks in other OECD countries was their funding source. Canadian banks generally relied less on wholesale funding, or borrowing from short-term from money markets, and more on depository funding, much of which came from such retail sources as households (Jackson, 2013). The relative stability of banks in some Euro member states, such as Italy, may have a similar explanation.

Supervising the structure of banks' balance sheets and imposing rules and regulations for their funding is the core of financial regulation. Because banks need to have access to high powered money from the central bank, the central bank should have responsibility to supervise to whom it is lending money individually and collectively[6]. It also needs an

[6] See Goodhart (2011) for a discussion of this proposition and possible alternatives.

appropriate tool kit to do so. It must be able to impose restrictions on capital and liquidity requirements for banks and non-bank financial institutions (NBFI), but it should also be able to constrain banks' desire to securitise and sell off their loans to NBFI by setting differentiated safety margins for collateral lending (Kashyap et alt. 2011).

In the end, the purpose must be to prevent excessive credit booms in specific sectors and regions. Yet, Europe's regulatory gaps create incentives for regulatory arbitrage, which is a manifestation of collective action failures generated by Europe's institutional architecture. Because member states retain political sovereignty and governments depend on local elites, which have an interest in seeking regulatory rents, pareto-improvements in European welfare are blocked. The purpose of centralising macro-prudential financial supervision at the ECB must be to overcome the distortion created by Europe's institutional architecture.

By creating the new OMT program, the ECB has fully assumed its role as lender of last resort to the banking system without becoming a lender to governments. Once crisis countries lost access to financial markets, the function of lending to governments was correctly assumed by the newly established European Stabilisation Mechanism (ESM), which is funded by governments and not by money creation. From the perspective of the liquidity paradigm, this is the correct assignment of roles in the architecture of monetary union: the central bank is the bank of banks. However, there are still two unsolved issues in this institutional setup. One is related to the quality of assets in the central bank's balance sheet, the other to the precarious solvency of public debtors.

To maintain its reputation as a credible actor, a central bank must provide liquidity against assets with low default risks. Traditionally, it is assumes that government bonds have this quality, but during the crisis this was clearly no longer the case for the southern crisis states. The ECB could have refused to accept down-graded government bonds as collateral for liquidity operations in order to maintain the quality of its balance sheet. But this would have put banks in the crisis countries into difficulty because, as is well-known, banks have a *home bias*, whereby they act as banker to their governments and keep a disproportional share of their own government's debt in their portfolio (Collignon, 2012b), and this would have generated fire sales and bank runs. In the end the ECB rightly valued financial stability of the system higher than the reputational damage from a weaker balance sheet. But the crisis revealed an important weakness in the euro area's architecture: the no-bail-out clause and the resistance to fund a comprehensive ESM by member states has undermined the ECB's reputation and made it more dependent on national fiscal policies. A solution to this problem would be the issuance of Eurobonds and the mutualisation of a portion of outstanding public debt in a redemption fund (Doluca et alt. 2012). Similar to US Treasury Bonds, Eurobonds would provide a deep market and a safe benchmark for monetary policy operations.

The other problem is related to the distribution of potential losses from sovereign defaults. If public debt carries high insolvency risks and governments are losing access to financial markets, member states' capacity to make payments is not a liquidity issue. Because public debt is serviced out of taxes, the risk of insolvency must be borne by tax payers. The problem in the euro area is that in most cases national debt is so important that a sovereign default could threaten the stability of the financial system, so that the costs of defaults are generalized, while the benefits of debt-financed expenditure are largely, but not exclusively, national. Stabilizing the financial system is then subject to collective action dilemmas, the dangers of which have been more than evident in the Euro crisis. These collective action dilemmas are setting the limit to what the European Central Bank can do. Policy externalities must be dealt with in the framework of a political union. I will therefore,

now discuss how the creation of the euro has transformed the governance of the euro area and what this implies for the institutional architecture.

3. FORM FOLLOWS FUNCTION - OR DESIGNING AN EFFICIENT ARCHITECTURE FOR EMU

Remarkable changes have been made to the architecture of the euro area since 2008. Here is not the place to evaluate all the important institutional additions made to the European House. The most important steps were[7]:

- Setting up the "European semester" of integrated multilateral economic and budgetary surveillance;
- Reform of the Stability and Growth Pact (as part of the "Six-Pack" set of legislation);
- Setting up a stabilisation mechanism consisting of the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Facility (EFSF), both of which were supplanted by a permanent rescue mechanism for euro area Member States - the European Stability Mechanism (ESM);
- Introducing a new procedure for macroeconomic surveillance, the Macroeconomic Imbalance Procedure (as part of the "Six-Pack" set of legislation);
- Two regulations to enhance economic surveillance, coordination, integration and convergence amongst euro area Member States (Two-Pack);
- The Treaty for Stability, Coordination and Governance and the Euro Plus Pact to strengthen budgetary discipline and the economic governance among 25 Member States.

All these reforms were done *ad hoc* rather than by design. Some may be useful, some harmful, but all are making Europe's economic architecture more complex. One principle inspires them all: more rules, less discretion.[8] This translates into: more nationalism, less Europeanisation. Europe's political architecture has become more intergovernmental. Yet, during the crisis, many voices were heard calling for a "federalist leap"; they were ignored. Thus, Europe's institutional form does not follow function.

There is a reason for this. Policy makers are torn between European centralisation and national autonomy. The French Prime Minister Pierre Bérégovoy had proposed in the early 1990s setting up a *gouvernement économique* for the euro area; he was blocked by his President Mitterrand and resisted by the German government. Yet, a decade later the German Foreign Minister Joschka Fischer (2000) in his Humboldt University speech, came to a similar conclusion. He pointed out that the old Monnet method of governments delegating power to Brussels was no longer efficient and lacked democratic legitimacy. This started the constitutional process, which failed miserably in national referenda.[9] During the Euro crisis, it became even clearer that the survival of the euro required more and deeper *political* integration. In June 2010, ECB President Jean-Claude Trichet called for a "quantum leap" on Eurozone economic governance.[10] Yet, a few months later, the German Chancellor Merkel went in the opposite direction, declaring the Monnet method dead und resurrecting intergovernmentalism under the new name of "Union Method"[11].

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7 See: http://ec.europa.eu/economy_finance/focuson/crisis/index_en.htm.

8 For an explicit statement of this philosophy see ECB 2011.

9 It is, however, remarkable that out of the total number of votes expressed in the referenda in Spain, Luxemburg, France and the Netherlands, the yes-vote was in majority.

10 http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20100621IPR76407.

11 Speech by Mrs. Angela Merkel , Chancellor of the Federal Republic of Germany at the opening of the 2010/2011 academic year at the College of Europe, Bruges campus , 2 November 2010; https://www.coleurope.eu/speeches.

Two years later, European Commission President Barroso (2012) called

> "for a federation of nation states. Not a superstate. A democratic federation of nation states that can tackle our common problems, through the sharing of sovereignty in a way that each country and each citizen are better equipped to control their own destiny. This is about the Union with the Member States, not against the Member States. In the age of globalisation pooled sovereignty means more power, not less."

Similarly, The Van Rompuy Task Force (2010) reflected the ambivalence between centralisation and national autonomy when it stated:

> "The recommendations in the Task Force Report address the high degree of economic interdependence, particularly in the euro area, while preserving national responsibilities on fiscal and economic policies."

Why do we find such widespread hesitation to create a unified political institution for economic policies in the euro area, given that most observers agree that Europe's governance is not functioning satisfactorily? In a remarkably candid speech, President Barroso (2013) gave the answer:

> "One of the reasons why the term federalism is so sensitive is of course the idea or the suspicion that countries would be overshadowed by a unified, centralised federal state. For European countries, most of which have fought long and hard to become united and/or independent, the thought of being a mere sub-federal entity is unbearable. This aversion to centralisation is both understandable and unsurprising."

Nevertheless, it is worthwhile to ask whether muddling through confusion with ad hoc political compromises is likely to build an efficient architecture that can solve economic problems in the euro area's. In recent years, institutional reforms have followed the path of least resistance, which means policy outcomes have emerged as Nash equilibrium in a non-cooperative game where each government is making the best decision it can, taking into account the decisions of all the others. As is well known, such Nash equilibria are not Pareto optimal because of collective action dilemmas and free riding incentives. This means that at least some member states, or rather citizens in them, could be made better off by a different set of policies. But which policies? The answer is crucial for the rational design of Europe's institutional architecture and depends on the nature of policy externalities and public goods.

3.1 Externalities and public goods

The divorce between monetary centralisation and political decentralisation at the level of the nation state is an obvious source of potential tensions. It is not difficult to see that intergovernmental policy making has prevented the pursuit of optimal policies because the partial interests of national interests have dominated the common interest of European citizens. Political economy theories have developed a number of models to explain the dilemmas of collective action. For our purposes, it is useful to start with the concept of public goods.

The economic literature distinguishes between private goods, pure public goods, club goods, and common resource goods (Collignon 2011). Because *private goods* are defined by exclusive property rights, they can be efficiently provided by the invisible hand of the decentralised market mechanism. This logic was the underlying rational for the creation of the European internal market, which has generated welfare benefits because larger markets allow economies of scale for producers and more choice for consumers. By contrast, *pure public goods* are characterised by free access and unlimited benefit. They are relatively rare. More frequent are impure public goods. For *club goods*, access can be restricted, while benefits are unrestricted for club members. Because members share

mutual benefits, which are not available for non-members, membership in clubs is voluntary. Of course, the desire to join the EU can be interpreted in terms of club good logic. By contrast, *common resource goods* are openly accessible but limited in supply and benefit. Under certain circumstances such open access regime can impose severe social costs by overexploiting limited resources and the distribution of these costs poses important questions of social justice. I will argue below that the creation of the euro has generated a whole new range of public goods that requires new forms of economic governance and the transformation of the institutional architecture of EMU.

The appropriate governance regime for public goods depends on the underlying incentive structure. It is well known that public goods are not efficiently provided by markets, because with free access individuals could free-ride on others who are willing to pay for them. If every individual behaved this way, the public good would not be supplied at all. This is why political economists since David Hume have emphasised the need of setting up a government to ensure that public goods are supplied. However, modern theories have qualified this claim. Club goods may be provided by voluntary cooperation of decentralised agents. Common resource goods may be transformed into quasi-private goods if the open access can be restricted. In the context of European resource goods such access restrictions lead to the renationalisation of policies that creates new externality problems. Overcoming such externalities may necessitate a centralised decision maker which could improve welfare provided there is a mechanism to ensure that the supply of public goods coincides with the collective demand of the people concerned. Democracy is this mechanism.

In the economic literature public goods used to be identified with particular goods and services shared by many. Lighthouses, bridges etc. were the classical examples. They were defined by externalities, which occur when the originator of the externality would only incorporate his or her own costs and benefits into their economic calculus and would ignore incidental costs and benefits experienced by others. From this perspective, public goods are defined by positive and negative externalities and their character is given by specific incentive structures. Governments are viewed as outside agents, who through the imposition of taxes and subsidies could induce the externality generator to limit or increase his or her activity, so as to achieve efficiency (Cornes and Sandler, 1996:6).

If we focus on externalities, public policies must be seen as a variant of public goods, not only because governments provide services for many, but, more importantly, because government choices generate externalities in fragmented polity systems. Only in unified closed systems are all cost and benefits integrated into the decision making process. Fragmented governmental jurisdictions have generated institutional collective action (ICA) dilemmas, because the decisions by one government or institution impact on other governments and institutions (Feiock, 2013). In that case, there is no longer an outside agent capable of internalising the externalities. The way out of the collective action dilemma could then be setting up rules that prevent the emergence of negative externalities, provided these rules can be enforced. Matching the scale and coerciveness of policy intervention to the specific scale and nature of policy objectives is the purpose of policy design, but in practice this match is complicated because the fragmentation of policy responsibility is not efficient. Fragmentation creates incentives for choices where the optimal decisions of a partial jurisdiction do not necessarily coincide with the Pareto-optimal welfare of the collectivity[12].

In principle, it is possible for many decentralised actors to provide public goods voluntarily by agreeing to cooperate, if (and only if) compliance to the agreement can be guaranteed

[12] For the theoretical details behind this statement see Collignon, 2003.

(Ostrom 1990). However, the incentive structure to cooperate voluntarily is very different in the case of club goods and common resource goods. With *club goods*, cooperation yields potential benefits for everyone who contributes to the supply of the public good, so that the interaction is a positive-sum game. Cooper and John (1988) call the incentives to cooperate *strategic complementarities*. Voluntary cooperation is, however, not automatic because informational asymmetries may prevent individual actors from doing what it takes to generate the common benefits. For example, if country A cannot be sure that country B will lift trade restrictions, it may not venture to do the first move. Setting up an external agency, Jean Monnet called it a High Authority, could then be an institutional device to avoid shirking from either party. This institution does not need far-reaching powers. All it has to do is ensure the free and symmetric flow of information because the self-interest of reaping the benefits from cooperation will be a strong incentive to cooperate. Some soft procedural rules and standard may support such behaviour. The creation of the European Semester is such a procedure; it implicitly assumes that member states have failed to implement the Stability and Growth Pact because they did not know what their partners did, but would be happy do do so if they could coordinate in advance. However, this assumption seems naïve. It implies that fiscal policy follows the logic of club goods and that is far from true.

Alternatively, *common resource goods* are defined by *strategic substitutabilities*, which means the utility augmenting action of one actor will lower the benefits for another. This is a zero-sum game. It describes a Hobbesian world of either you *or* me. Every actor in this game has an incentive to do the opposite of what all the others do. Those who are able to impose their will, by power or guile, will benefit at the expense of all others. In this case, voluntary cooperation will fail and strong binding rules are necessary to prevent negative externalities. Public debt is a typical example: access to the capital market is open to all, but the loanable funds are limited by the availability of central bank liquidity. If aggregate credit demand exceeds available funds, interest rates will go up which has negative consequences for borrowing anywhere in the monetary union. The rules of the Stability and Growth pact are meant to prevent such externalities.

The two different incentive structures generate very different distributional results. In a positive-sum game, it is always possible to compensate a potential loser out of synergetic gains from cooperation; for common resource goods this is not possible. Furthermore, if the costs of some action are widely shared over many shoulders, while the benefits are concentrated on some specific beneficiaries or regions, the distributional distortions generated by strategic substitutabilities can last a long time and undermine the efficiency of the economic system (Weingast et alt, 1981).

This analysis gives us a tool to understand why European monetary union can no longer be governed by an architecture that was appropriate for the EU before monetary union. In its early stages, European integration was characterised by the creation of *European club goods*. Policy cooperation was successful because European integration appeared as a positive sum game, which was dominated by strategic complementarities for each member state. The Commission, as a custodian of common interests, had the task of ensuring that the governments of the Member States cooperated with one another. This logic still applies to important policy domains in the EU of 27 member states and explains the attractiveness for new members to join.

Yet, with the creation of the Euro, the dynamics of European integration have changed. Money is the general budget constraint of an economy, which means that the supply of money by the central bank is limited under the mandate to maintain price stability. But hard budget constraints necessitate making choices and generate winners and losers. Hence, public goods which are subject to the monetary budget constraint are effectively

following the logic of *common resource goods* and strategic substitutabilities. In this case, soft rules and "open" methods of coordination are insufficient to produce the benefits European policy makers claim. This incentive structure is the reason for the persistent and reoccurring shortcomings in the implementation of European policy rules. When the welfare losses become significant, governments seeking re-election will shirk. Hard, binding rules linked to penalties may then be imposed as an instrument for enforcing compliance. But hard rules break on the rock of member state sovereignty. Politicians who are afraid of centralisation and therefore propose a Europe of "projects" and "results" are likely to raise hopes and expectations which they cannot fulfil. They discredit European integration as a welfare augmenting project. For this reason, hard and binding rules for policy coordination are also not necessarily the solution to policy inefficiencies.

3.2 Time consistency: rules versus discretion

The application of a rule means repeating an action over time, conditional on a set of circumstances. But when circumstances change, actions may change as well. Taking actions in view of present circumstances is called discretion. Since the famous paper by Kydland and Prescott (1977), policy rules are seen as a form of commitment, i.e. as a binding contract, which specifies in advance what actions someone will take in a given context. Rules can incorporate some flexibility if they are made contingent on some exogenous variable that everyone can observe; but they do not allow a decision maker the judgement whether to apply them or not. Under discretion, an actor promises only to take those future actions that will best further his interest later on (Barro, 1986). Pure discretional behaviour would make it difficult for several actors to agree on common future actions, as one cannot rely on what an actor says today. For this reason, binding rules have become popular for the formulation of coherent policies, especially in an intergovernmental context. They are often written into formal treaties or laws, such as the Stability and Growth Pact (SGP) or the new Fiscal compact. The literature has clearly established the conditions under which binding rules are welfare augmenting.

However, the contingency clauses of such contracts are rarely very detailed. For example, the SGP is formally suspended in case of severe recessions[13], but the room for discretion is narrow. This fact makes a system run by binding rule rigid. Alan Blinder (1987) has therefore reminded us that if the economy's self-correcting mechanism is ineffective, then well-conceived discretionary policies offer the prospect of genuine welfare improvement.

The ECB (2011|3:99) has established criteria for "an enhanced economic governance framework", of which the most important are:

> i) more "automaticity" and less room for discretion in the operation of the preventive and corrective arms of the fiscal and macroeconomic surveillance framework; ii) strict deadlines to avoid lengthy procedures, and the elimination of "escape clauses"; iii) the creation of a macroeconomic surveillance framework with a clear focus on euro area countries that are less competitive, have sustained current account deficits or have high levels of public and private debt; iv) the introduction of additional political and reputational measures for compliance with the rules of the governance framework; v) the early and gradual application of financial sanctions under the proposed macroeconomic surveillance framework; vi) more ambitious benchmarks for establishing the existence of an excessive deficit; vii) more ambitious requirements as regards the adjustment path towards a country's medium-term budgetary objective; viii) guaranteed quality and independence of fiscal and economic analysis; ix) a commitment on the part of the euro area countries to swiftly enhance their national budgetary frameworks; …"

[13] Council Regulation (EC) No 1467/97.

Many of these demands have now been met. It is too early to judge results, but it is interesting that the US has succeeded better in overcoming the financial crisis than the euro area. One explanation is that the US was able to follow discretionary fiscal policies, while Europe was tied down by "strict" fiscal rules which prevented a rapid recovery (CER, 2013). In an economic crisis, discretionary policies are often needed to respond to unforeseen shocks. Discretion is the opposite of rules. This raises two questions: When should policies be rule-bound, and when should they be discretionary? Who should decide what discretionary measures to take?

The answer to the first question depends on two dimensions: *preference consistency between actors* and *time consistency between actions* (Collignon, 2008). Combining these two dimensions yields four cases. See Figure 1. (1) If policy preferences converge over time because incentives are set by strategic complementarities, and if circumstances do not change in fundamental ways, then no rules are necessary at all, because voluntary cooperation will be self-regulating. This is the most benign case of policy making. (2) If actors' preferences converge, but circumstances change, optimal policies require consistency over time, and soft coordination rules are useful. Adherence to these rules is in the interest of all actors. (3) However, for common resource goods, this is not the case. When preferences diverge because of strategic substitutabilities and consistency of policy action is required over time, "hard" regimes of legally binding policy rules must be enforced. (4) On the other hand, if policy decisions need to be re-valued frequently in the light of changing circumstances and actors have diverging preferences, they may be better off by delegating policy-making to a centralised institution that acts as the agent of a larger constituency.

Figure 1.: Policy Coordination Regimes

		Time consistency	
		Discretionary	Rule-based
Preference consistency	diverging	I. *Delegation to unified actor* ECB, economic government	II. *Hard coordination with sanctions* Stability and Growth Pact, Excessive Deficit Procedure
	converging	III. *Voluntary coordination* Open Method of Coordination	IV. *Soft coordination by guiding rules* BEPG; European Semester

Source: adopted from Collignon, 2004.

The matrix in Figure 1 shows that the random walk of policy reforms followed since 2008 has created an amalgam of policy coordination regimes which are not likely to produce efficient policy outcomes because the form of the governance are not following the functions polices are to serve. For example, the European Semester will not avoid fiscal crises, because the preferences between member states are not converging but follow the logic of strategic substitutabilities. On the other hand, fiscal policy reforms have tightened compliance with the Stability and Growth Pact, but this prevents discretionary fiscal stimuli in case of severe crises. The consequence of this mismatch is high unemployment and growing Euro-scepticism.

3.3 The political embeddedness of monetary union

Our matrix points to an old gap in EMU's new architecture: there is no European economic government. Yet, contrary to the hopes and dreams of European federalists, efficient governance for the euro area does not require "an integrated single national unit at the European level" (Barroso, 2013). It does, however, require a European Economic Government for a clearly identifiable niche of public policies: namely the management of common resource goods where optimal policies need to be adapted to changing circumstances. But who should have the power to decide on discretionary policy measures, and how should such a power be authorised?

During the Euro crisis, the Troika was established to introduce a small degree of discretionary control into the application of stabilisation policies in crisis countries. The troika is a subcommittee formed by ECB, IMF and European Commission. It has therefore only limited legitimacy which is derived from these institutions. This has generated waves of public discontent, especially in member states where the Troika has imposed strict austerity. This is comprehensible, for it is one of the gretest achivements of European history that only democratic governments must act with discretion on behalf of the citizens they represent. The euro area's governance needs, therefore, more than just a set of (binding) rules to ensure sustainable debt, balanced growth and low unemployment. It needs a government and European democracy.

Democracy has turned into a crucial pillar of the architecture of European monetary union. This is not due to the fact that democracy is part of the fundamental shared values of Europe. Democracy fulfils a function in the public economy because it is the tool by which collective preferences are defined. Without knowing these preferences, it is impossible to determine which policies are "efficient".

One may argue that defining the EU's preferences is the task of the European Council. TEU art. 15.1 says:

> "The European Council shall provide the Union with the necessary impetus for its development and shall define the general political guidelines thereof."

As we have seen, this is unproblematic for the fairly wide range of European club goods, because their incentive structure is dominated by strategic complementarities, which will allow cooperation between member states. However, for public goods subject to strategic substitutabilities under the euro budget constraint, cooperation attempts are likely to end in failure, so that a centralised European economic government must ensure their provision. While it may be defendable to assume that collective preferences are exogenously given in the short run, this is unrealistic over the longer run. Appointing a benign social planer (which is the same as strict, unchangeable policy rules), is then likely to generate political conflicts, which cannot be solved unless the citizens who are concerned and affected by these policies are involved in decision making. Democracy, i.e. public deliberation about public choices and voting to decide which one to adopt, is therefore a necessary condition to sustain monetary union in the long run.

4. CONCLUSION

Our discussion has shown the famous principle “form follows function”, professed by the American architect Louis Sullivan and his assistant Frank Lloyd Wright, could inspire Europe’s institutional architecture and the design of the European House. We should remember, however, that "form follows function" was opposed to "form follows precedent". The Euro crisis could have been an occasion to innovate and build a better house. So far, this opportunity was missed.

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