



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT **A**
ECONOMIC AND SCIENTIFIC POLICY



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The various roles of the ECB in the new EMU architecture

Monetary Dialogue September 2013

COMPILATION OF NOTES



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Monetary Dialogue 23 September 2013

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Abstract

The five briefing papers included in this compilation assess and comments on the ECB's new responsibilities as a supervisory authority. The papers examine the overall position of the ECB and the various roles of the ECB in the new institutional framework as well as its relationship with other bodies in terms of institutional design. In the context, the papers assess synergies, overlaps as well as the risks of possible conflicts of interest between ECB's different roles and among institutions, including the positive and negative externalities that the new tasks may generate in relation to ECB's key mandate for price stability.

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CONTENTS

INTRODUCTION	4
1. The ECB in the age of Banking Union: Old and new roles in the EMU architecture by Zsolt DARVAS and Silvia MERLER	5
2. New Roles and Challenges for the ECB by Karl WHELAN	33
3. The various roles of the ECB in the new financial architecture by Anne SIBERT	47
4. The various roles of the ECB in the new EMU architecture by Sylvester C.W. EIJFFINGER	65
5. The various roles of the ECB in the new EMU architecture by Stefan COLLIGNON	77

INTRODUCTION

The ECB key role is to conduct monetary policy with the objective to maintain price stability in the euro area. With the emergence of the economic and financial crisis the ECB has become a key institution in formulating crisis response and its role and tasks have extended remarkably. The ECB plays a leading role in **macro-prudential oversight**. It provides the Secretariat for the ESRB¹ and the ESRB is chaired by the President of the ECB.² The ECB forms part of the so called '**Troika**', together with the EU Commission and the IMF and plays a role in the **design and ongoing assessment of the financial assistance programmes**. The ESM Treaty explicitly enshrines a role to the ECB in the ESM programmes. Within the Single Supervisory Mechanism (SSM), the ECB will become the direct **supervisor of the euro-area's largest banks**.

The five briefing papers included in this compilation assess and comments on the ECB's new responsibilities as a supervisory authority. The papers examine the overall position of the ECB and the various roles of the ECB in the new institutional framework as well as its relationship with other bodies in terms of institutional design. In the context, the papers assess synergies, overlaps as well as the risks of possible conflicts of interest between ECB's different roles and among institutions, including the positive and negative externalities that the new tasks may generate in relation to ECB's key mandate for price stability.

Experts broadly argued in favour of the extension of ECB's tasks and roles beyond standard monetary policy management, as confirmed by the positive reaction by financial markets. In particular, they noted that both the adoption of unconventional monetary measures and design of the new supervisory architecture in EMU have not endangered (at least so far) the ECB's ability to anchor medium-term inflation expectations to ECB's price stability target.

Experts broadly agreed that synergies stemming from ECB new roles are more important than potential conflicts of interest emerging from task overlaps between different institutions. Risks can build up in the financial sector even when the price stability mandate is achieved (i.e. during the pre-crisis period). Thus monetary policy on its own is not able to counterbalance such risks. This is especially true in a heterogeneous monetary union like the EMU. But there is a potential for conflicts of interest too, for example, in a situation when an interest rate increase is needed for monetary policy purposes but such an increase would have a critical impact on the balance sheet of banks. But these risks do not seem to be shared by financial markets. Experts generally admitted the risk that absent a clear institutional separation between monetary policy and supervisory tasks, the ECB would be subject to political influence. At the same time, however, the emergence and evolution of the financial crisis has highlighted the importance of financial stability for monetary policy management.

The roles played by the ECB in financial assistance programmes as a partner of the European Commission and the IMF in the Troika was found to be ambiguous. While the ECB's expertise could bring valuable input into programme design and monitoring, the conflicts of interest may alter the ECB's positions and could be exposed pressures from the other institutions of the Troika. It was claimed that an informal role in the design and monitoring of financial assistance would lessen the possible conflicts of interests.

¹ <http://www.esrb.europa.eu/shared/pdf/ESRB-ECB-en.pdf?80812809956246ea2e478247b0e9a49a>.

² <http://www.esrb.europa.eu/shared/pdf/ESRB-en.pdf?2ff6e0faf8dc9bfdafd177cfcf5200f5>.



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The ECB in the age of Banking Union: Old and new roles in the EMU architecture

Zsolt DARVAS and Silvia MERLER

NOTE

Abstract

After gaining a strong reputation as the guardian of price stability in the euro area, during the crisis the European Central Bank's roles have been greatly extended, taking in monetary policy and other areas. In addition to the primary objective of price stability and the secondary objective of supporting EU economic policies, we identify ten new tasks related to monetary policy and financial stability. We argue that there are three main constraints on monetary policy: fiscal dominance, financial repercussions and regional divergences. By assessing the tasks in light of these constraints, we highlight a number of synergies between these tasks and the ECB's primary mandate of price stability. Furthermore, we outline major conflicts of interest related to the ECB's participation in designing and monitoring financial assistance programmes. We also underline that the ECB's government bond purchasing programmes have introduced the concept of 'monetary policy under conditionality', which involves major dilemmas. A solution to the dilemmas would be an immense change in fiscal integration toward a system like in the US, in which state public debts are small, there are no federal financial bail-outs for states, the central bank does not purchase state debts and banks do not hold state debts. Such a change is unrealistic in the foreseeable future.

CONTENTS

LIST OF ABBREVIATIONS	7
EXECUTIVE SUMMARY	8
INTRODUCTION	10
1. TWELVE TASKS OF THE ECB	11
1.1. Maintaining price stability	11
1.2. Supporting EU economic policies	11
1.3. Lender of last resort for banks	11
1.4. Collateral policy	12
1.5. Quantitative easing: targeted credit easing through asset purchases	12
1.6. Sterilised government bond purchases	12
1.7. Designing, approving and monitoring financial assistance programmes	13
1.8. Micro-prudential supervision	14
1.9. Comprehensive balance-sheet assessment	14
1.10. Macro-prudential supervision	15
1.11. Possible participation in macroeconomic surveillance missions	15
1.12. Agent for the secondary market activities of the ESFS and ESM	16
2. MONETARY POLICY CONSTRAINS	17
2.1. Fiscal dominance	17
2.2. Financial repercussions	17
2.3. Regional divergences	17
3. SYNERGIES AND CONFLICTS BETWEEN THE ECB'S TASKS	19
3.1. Long-term liquidity operations: easy to remedy the dangers	19
3.2. Monetary, micro- and macro-prudential policies: good siblings	20
3.3. Monetary policy and bank supervision: internal separation within the ECB to be reconsidered	21
3.4. Designing and monitoring of financial assistance programmes: a dangerous liaison	23
3.5. Monetary policy with conditionality: major dilemmas	24
4. CONCLUSION	29
REFERENCES	31

LIST OF ABBREVIATIONS

BoE	Bank of England
BoJ	Bank of Japan
CBPP	Covered Bond Purchase Programme
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
ESAs	Joint Committee of the European Supervisory Authorities
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FED	Federal Reserve
IMF	International Monetary Fund
LTRO	Long Term Refinancing Operation
MIP	Macroeconomic Imbalances Procedure
MRO	Main refinancing operations
NAIRU	Non-accelerating inflation rate of unemployment
OMT	Outright Monetary Transaction
SMP	Securities Markets Programme
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union

EXECUTIVE SUMMARY

After gaining a strong reputation as the guardian of price stability in the euro area, the European Central Bank's roles have been greatly extended during the crisis, taking in monetary policy and other areas. The good news is that the new tasks have not endangered (at least so far) the ECB's ability to anchor the inflation expectations of market participants: five-year-ahead expectations continue to be anchored at the two percent target.

Nevertheless, the new tasks pose major challenges for the ECB and give rise to both synergies and conflicts of interests. We have reviewed the new tasks and assessed five major interactions between them.

- First, while liquidity provision to banks at a massive scale can stabilise financial markets in a stress situation, it can keep alive otherwise insolvent banks, encourage excessive risk taking and indirectly finance governments (when banks borrow cheaply from the ECB to purchase government bonds). The new EMU architecture has the potential to limit these adverse side-effects: the ECB can foster bank restructuring by performing in the toughest possible way the comprehensive balance sheet assessment before it takes over the single supervisory role and, after that, micro-prudential supervisory powers can be used to ensure that all banks receiving liquidity support have indeed only a liquidity problem, and not a solvency problem. The architecture could be further extended to dispel all doubts that liquidity provision to banks is backdoor financing of public debt: longer-term ECB financing could be conditional on banks not increasing their net lending to the government and/or increasing their net lending to the real economy.
- Second, there is a potential synergy between monetary, micro-prudential and macro-prudential policies. Risks can build up in the financial sector even when the price stability mandate is achieved; monetary policy, on its own, is not able to counterbalance such risks. This is especially true in a heterogeneous monetary union like the EMU. Micro- and macro-prudential tools can help to limit the build-up of such risks, leading to synergies. But there is a potential for conflicts of interest too, for example, in a situation when an interest rate increase is needed for monetary policy purposes but such an increase would have a critical impact on the balance sheet of banks. Monetary policy credibility may also be undermined by eventual supervisory failures. In our view, these risks are not high and also not shared by markets, because long-term inflationary expectations continue to be anchored. We also note, however, that the limitations on the ECB's macro-prudential tools (e.g. the ECB cannot impose requirements for loan-to-value ratios) may constrain effectiveness.
- Third, the strict organisational separation of monetary policy and bank supervision within the ECB, which was a major goal of SSM regulation, is not so important. On the contrary, because of synergies between monetary policy and financial supervision, an appropriate flow of information would facilitate the achievements of the goals of price and financial stability, even if the transparency and accountability requirements of monetary policy and supervisory decisions are different. Recent organisational changes at the Bank of England also encourage co-operation and co-ordination across the different policy areas.
- Fourth, the roles played by the ECB in financial assistance programmes as a partner of the European Commission and the IMF in the Troika is ambiguous. The ECB's participation in future assistance programmes, which is formalised by the treaty on the European Stability Mechanism, creates potential conflicts of interest with the

other tasks of the ECB, such as price stability, liquidity provision to banks and the new bond purchasing programme, the Outright Monetary Transactions (OMTs). While the ECB's expertise could bring valuable input into programme design and monitoring, the conflicts of interest may alter the ECB's positions and could be exposed pressures from the other institutions of the Troika. An informal role in the design and monitoring of financial assistance would lessen the possible conflicts of interests.

- And fifth, the ECB's government bond purchasing programmes were essential to avoid financial meltdown in the euro area. But this cannot be unconditional, as it would create moral hazard and other risks. The informal conditionality of the Securities Markets Programme did not work and the formal conditionality of the OMTs exposes the ECB to a major dilemma: if the OMT is warranted from a monetary perspective, but the conditionality is not met, the ECB would face the dilemma between (a) interrupting the OMT at the risk of possibly endangering the stability of the euro area, and (b) continuing the OMT at the risk of inflicting a fatal blow to its own credibility. This could also undermine the political support for the euro in creditor countries. On top of this dilemma, the involvement of the ECB in the negotiation of an EFSF/ESM programme within the Troika would make it very difficult for the ECB to conduct a fully independent assessment of conditionality fulfilment and it could expose it to pressure from the other institutions. There is no proper solution to this quandary of 'monetary policy under conditionality' within the euro area's current economic governance framework. The alternative to the OMT would be a complete revision of the framework for euro-area sovereign debt crisis management and an immense increase in fiscal integration, by moving toward a system like in the US, in which state-level public debt is small, there is no federal financial bail-outs for states, the central bank does not purchase state debt and banks do not hold state debt. Unfortunately such an immense change is unrealistic in the foreseeable future.

INTRODUCTION

Before the crisis, the European Central Bank (ECB) focussed on price stability and gained a strong reputation as its guardian in the euro area. The average actual inflation rate was very close to the two percent per year target, and long-term inflationary expectations were anchored at this level. With the start of the global financial and economic crisis in the summer of 2007 and the intensification of the euro crisis in early 2010, the ECB's tasks have been significantly extended, partly at its own initiative, and partly by legislation adopted by EU member states, in relation to monetary policy and beyond.

The ECB adopted wide-ranging measures to support financial stability and repair the monetary transmission mechanism, by providing banks with ample liquidity under revised collateral rules and by launching two government bond purchasing programmes. The latter programmes introduced the concept of 'monetary policy with conditionality'. The ECB conducted two small-scale quantitative easing programmes (purchasing of covered bonds) to promote credit growth. The ECB became a member of the Troika, along with the European Commission and the IMF, and as a consequence it has been actively involved in the design and monitoring of the economic conditionality in the context of EU/IMF macroeconomic adjustment programmes in euro-area countries. Such competences for the ECB have been formalised and broadened by the Treaty on the European Stability Mechanism (ESM), the euro area's permanent rescue fund. The ECB started to take on board macro-prudential roles by becoming a key participant in the European Systemic Risk Board (ESRB). Also, the ECB agreed to act as an agent for the secondary market activities of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), the rescue funds of the euro area, and it can play a role in surveillance missions within the Macroeconomic Imbalances Procedure (MIP).

Most of these tasks and roles will remain permanent and major new tasks are being added because of the development of the Single Supervisory Mechanism (SSM), the first element of the European Banking Union. This will probably be the biggest change in the history of the ECB and will give it both micro-prudential and macro-prudential competences. Before assuming the day-to-day supervisory role, the ECB will have to conduct a comprehensive asset-quality review of those financial institutions that will fall under its umbrella.

Beyond taking stock of the ECB's new tasks, this Briefing Paper assesses the possible synergies and conflicts of interests between these various tasks. It is important to emphasise that our goal is not the evaluation of the ECB's response to the crisis; instead, we take a forward-looking perspective to assess the interaction between various ECB tasks. To this end, we first describe the tasks in the next section. This is followed by a discussion of the three main potential constraints to the effective implementation of monetary policy. After that, we assess the possible synergies and conflicts. The final section offers some conclusions.

1. TWELVE TASKS OF THE ECB

Based on its mandates as defined in the Treaty on the Functioning of the EU (TFEU) and in other European legislation, the ECB has several tasks in the euro area, some of which have implications for non-euro area EU countries. Among the various tasks we highlight the twelve that are the most relevant for monetary policy and financial stability¹.

1.1. Maintaining price stability

The core monetary function of the European System of Central Banks (ESCB), which is governed by the decision-making bodies of the ECB, is laid down in Article 127(1) of the TFEU, according to which: *“The primary objective of the European System of Central Banks [...] shall be to maintain price stability”*. The numerical definition of price stability (*“below but close to 2 percent inflation over the medium-term”*) is not laid down in the Treaty, but was set by the ECB’s Governing Council itself.

In pursuing its task to preserve price stability, the ECB acts in full independence from any EU institutions, bodies, offices and agencies and from member state governments. In normal times, the main tools for achieving price stability are interest rate policy, short-term liquidity management and communication².

1.2. Supporting EU economic policies

Article 127(1) of the TFEU continues by stating that *“Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union.”* The latter are listed in Article 3 of the TFEU and include inter alia *“balanced economic growth”* and *“a highly competitive social market economy, aiming at full employment and social progress”*.

The specific price-stability mandate and these rather broad other Treaty-based mandates paved the way for the ECB to venture into unconventional monetary policy during the global and euro-area crises³. Most of the measures are still operational and could remain in the toolkit for some time.

1.3. Lender of last resort for banks

Unlike the Federal Reserve (Fed), the Bank of England (BOE) and the Bank of Japan (BOJ), which relied extensively on asset purchase interventions, the ECB’s unconventional monetary operations have been mostly concentrated on ensuring the necessary supply of liquidity to euro-area banks (Pisani-Ferry and Wolff, 2012a), at a time when the interbank market had become dysfunctional and several countries in the south of the euro area were undergoing a sudden stop in external financing (Merler and Pisani-Ferry, 2012a). In October 2008, the ECB introduced a policy of 'full allotment', for all ECB liquidity-providing operations. Under this procedure, the control of central bank liquidity is effectively moved from the central bank to the banking system, as banks can access all the central bank liquidity they need at a fixed rate (if they provide sufficient eligible collateral). The maturity

¹ Additional tasks include foreign-exchange operations, foreign reserve management, operation of the payments system, advisory functions, collection of statistical information and international cooperation.

² We note that in July 2013 the ECB added a major new element to its communication strategy: forward guidance, which is a way for central banks to give indications about their future policy intentions, by making it more (like the FED and the BOE) or less (like the ECB) explicitly conditional on the assessment of the current and future economic developments and outlook.

³ For detailed reviews of the ECB crisis responses, see Cour-Thimann and Winkler (2013) and ECB (2011a).

of liquidity operations were initially extended from three months to six and twelve months, and in December 2011 and in February 2012 the ECB also conducted two extraordinary Longer Term Refinancing Operations (LTROs) with maturities of three years, from which banks in the euro area borrowed almost €1 trillion. These operations, along with the collateral policy (see below) allowed liquidity-strained banks to refinance a large portion of their balance sheets through central bank lending, accessible at a low interest rate and available with a long-term maturity. In a heavily bank-based system, such as the euro area's (Darvas, 2013a), these measures were essential to avoid a financial and economic meltdown.

Another crucial element during the crisis was Emergency Liquidity Assistance (ELA), an emergency liquidity line provided by national central banks to solvent banks that exceptionally and temporarily do not have enough (or sufficiently high quality collateral) to access normal Eurosystem operations. The ECB's Governing Council can at any time order an ELA programme to be stopped⁴. The ELA statistics are opaque, yet most likely the central banks of Greece, Ireland and Cyprus have used ELA extensively, while it was used for a few days in Belgium. Recent rumours suggest that Portugal also made use of ELA.

1.4. Collateral policy

Complementing its credit operations, the ECB has changed its collateral framework several times since 2008, expanding and changing assets' eligibility requirements in order to mitigate possible constraints arising from collateral shortage. It is worth mentioning that certain credit claims have been included among eligible collaterals. Also, while initially the ECB denied the need for country-specific collateral rules, credit-rating requirements were completely abolished for government bonds of countries under financial assistance programmes.

1.5. Quantitative easing: targeted credit easing through asset purchases

The ECB introduced two asset purchase programmes – though at a much smaller scale than the Fed, BOE and BOJ. Under the first Covered Bond Purchase Programme (CBPP), launched in 2009 and terminated in June 2010, the Eurosystem committed to buy covered bonds up to €60 billion, while in November 2011 the second CBPP commitment was up to €40 billion until October 2012⁵. The goals of these programmes were “(a) *easing funding conditions for credit institutions and enterprises; and (b) encouraging credit institutions to maintain and expand lending to their clients*”.

1.6. Sterilised government bond purchases

The ECB launched two government bond purchasing programmes: the Securities Market Programme (SMP) on 10 May 2010, which on 6 September 2012 was terminated and replaced by the Outright Monetary Transactions (OMTs). While monetary financing of governments is strictly prohibited, Article 18(1) of the ESCB Statute allows national central banks and the ECB to buy or sell (among others) marketable instruments on the financial markets. Both programmes had similar aims: the SMP's “*objective is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism*” and the OMTs “*aim at safeguarding an appropriate monetary*”

⁴ For a very detailed review of the legal technicalities of the ELA see Boyer and Lemangnen (2013).

⁵ Cour-Thimann and Winkler (2013) estimate that the size of the first programme represented about 2.5 percent of the outstanding covered bonds.

policy transmission and the singleness of the monetary policy." In the framework of the SMP, the Eurosystem bought on the secondary market about €220 billion of the sovereign bonds of Greece, Ireland, Portugal, Italy and Spain. At the end of 2011, the ECB's holding was estimated to amount to about 23 percent of total outstanding in Greece, 16 percent in Ireland, 11 percent in Portugal, 6 percent in Italy and 5 percent in Spain (Merler and Pisani-Ferry 2012b)⁶. All the purchases were sterilised (ie the liquidity provided was re-absorbed by the Eurosystem) to ensure that the monetary stance was not affected. The SMP could not bring definitive relief to markets, while the OMT has to date been more successful (see Darvas, 2012). It is based on explicit conditionality: compliance with a full or precautionary macroeconomic adjustment programme by either the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM). Countries exiting current adjustment programmes could also be considered. ECB intervention will not be automatic, but the Governing Council will decide on a case-by-case basis when and to what extent it will intervene. OMTs will be unlimited in principle; limited only by the outstanding stock of eligible bonds, which should have residual maturity of between one and three years (the relevant horizon for monetary transmission). The ECB will not have any preferential treatment in the case of a credit event (ie *pari passu* treatment with other creditors). Since the programme's inauguration, no country has qualified for OMT.

1.7. Designing, approving and monitoring financial assistance programmes

The Troika of the IMF, the EU and the ECB was inaugurated in spring 2010 to negotiate the Greek financial assistance programme. The participation of the ECB, and of the IMF, was demanded by the heads of state or government in their 25 March 2010 statement⁷. The Troika also negotiated the financial assistance programmes for Ireland, Portugal and Cyprus, and the new programmes for Greece, and concluded joint missions to assess compliance.

The ESM Treaty formalises the ECB's role in covering the whole process of granting and monitoring financial assistance programmes. "*The European Commission, in liaison with the ECB, shall be entrusted with*" several tasks, such as "*Assessing the existence of a risk to the financial stability of the euro area as a whole or of its Member States; Assessing whether public debt is sustainable; Assessing the actual or potential financing needs of the ESM Member concerned.*" (Article 13(1)), "*...the task of negotiating, with the ESM Member concerned, a memorandum of understanding [...] detailing the conditionality attached to the financial assistance facility*" (Article 13(3)), and "*monitoring compliance with the conditionality attached to the financial assistance facility.*" (Article 13(7)). Wherever appropriate and possible, the IMF's involvement will be sought.

When emergency voting is needed, it "*shall be used where the Commission and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance [...] would threaten the economic and financial sustainability of the euro area.*" (Article 4)

The ECB will be also involved in forming an opinion on other aspects of ESM operations, including possible secondary market support: "*decisions on interventions on the secondary market to address contagion shall be taken on the basis of an analysis of the ECB*

⁶ De Sousa and Papadia (2013) estimate that the SMP would have been a profitable operation under mark to market accounting.

⁷ See at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf.

recognising the existence of exceptional financial market circumstances and risks to financial stability” (Article 18).

1.8. Micro-prudential supervision

Arguably, the most significant change to the ECB’s structure has been brought about by the decision to give to it significant supervisory responsibilities in the framework of the Single Supervisory Mechanism (SSM), which is the first element of the European Banking Union. The legal basis is provided by Article 127(6) of the TFEU: *“The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”*

After extensive negotiations between various stakeholders, on 12 September 2013 the European Parliament gave its consent with the amended draft Council Regulation on conferring the aforementioned tasks *“with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the EU and each Member State ...”* (Article 1 of the Regulation).

Starting in Autumn 2014, the ECB will supervise *“significant”* credit institutions (as defined by the regulation; see eg Darvas and Wolff, 2013), and will have exclusive competence for those *“specific supervisory tasks which are crucial to ensure a coherent and effective implementation of the Union’s policy relating to the prudential supervision of credit institutions”*. Such tasks include in particular: authorising (and withdrawing authorisation) of credit institutions; assessing the implications for the acquisition and disposal of qualifying holdings in credit institutions (except in cases of bank resolution); ensuring compliance with the EU rules on own funds requirements, securitisation, large exposure limits, liquidity, leverage, and reporting and public disclosure of information on those matters; ensuring compliance with governance rules, risk management processes, internal control mechanisms, remuneration policies and practices and effective internal capital adequacy assessment processes; carrying out supervisory reviews, including stress tests, on the basis of which to impose on credit institutions specific requirements; carrying out supervisory tasks in relation to recovery plans, and early intervention where a supervised entity does not meet or is likely to breach the applicable prudential requirements.

1.9. Comprehensive balance-sheet assessment

Related to assuming the role of the single supervisor, the ECB should perform *“a comprehensive assessment, including a balance-sheet assessment, of the credit institutions”* (Article 27(4) of the SSM draft regulation), before actually taking on the new supervisory responsibilities. We highlight this role, because this is a major task that will likely have an impact on the reputation of the ECB for its supervisory mandate and beyond.

1.10. Macro-prudential supervision

The ECB's macro-prudential tasks are related to the European Systemic Risk Board (ESRB) and the SSM.

The ESRB was set up in 2010, gathering representatives from national central banks and supervisors from all EU countries. The ESRB became part of the European System of Financial Supervision (ESFS) and it will be required to cooperate closely with the other participants in the ESFS⁸. The ESRB, according to its mandate, "*shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability [...] that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. ...*". The ESRB was not given any direct authority over policy instruments, but it has the power to issue recommendations and warnings about systemic risks to national authorities. The decision-making body of the ESRB, the General Board, is chaired by the president of the ECB. The ESRB Secretariat is located at the ECB.

The SSM Draft Regulation provides a role for both the ECB and national supervisors in macro-prudential policy, under the principle of 'the stronger wins'. While the ECB can express objections to measures proposed by a national authority, the authority concerned only has to "*duly consider the ECB's reasons prior to proceeding with the decision*" (Article 4a(1)). The ECB cannot block such measures. On the other hand, the ECB is given the power to apply higher requirements for capital buffers and more stringent measures than those set by the national authorities, with the aim of addressing systemic or macro-prudential risks. And again the ECB is only obliged to "*duly consider*" the objections of national supervisor, if any, but these objections do not have blocking power.

It is important to highlight that the macro-prudential tools available to the ECB will be more limited than the arsenal available to national supervisors. National supervisors can apply "*any [other] measures aimed at addressing systemic or macro-prudential risks provided for, and subject to the procedures set out, in the Directives 2006/48/EC and 2006/49/EC*", but the ECB can only apply "*higher requirements for capital buffers ... in addition to own funds requirements ... including countercyclical buffer rates*". Therefore, the ECB can apply those tools seeking to influence lenders' behaviour, as categorised by Blanchard, Dell'Ariccia and Mauro (2013), but the ECB cannot apply tools aimed at controlling borrowers' behaviour, such as loan-to-value ratios and debt-to-income ratios.

1.11. Possible participation in macroeconomic surveillance missions

The so-called six-pack, which governs the EU's new Macroeconomic Imbalances Procedure (MIP), foresees a possible role for the ECB in macroeconomic surveillance missions. Article 9 of Regulation No 1176/2011 dealing with "Monitoring of corrective action" says that: "*The Commission may carry out enhanced surveillance missions to the Member State concerned, in order to monitor the implementation of the corrective action plan, in liaison with the ECB when those missions concern Member States whose currency is the euro...*" Article 13(3) clarifies the role of the ECB in these surveillance missions: "*Where the Member State concerned is a Member State whose currency is the euro or is participating in ERM II, the*

⁸ Besides the ESRB, the ESFS comprises: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA), the Joint Committee of the European Supervisory Authorities (ESAs), and the competent or supervisory authorities in the Member States as specified in the legislation establishing the three ESAs.

Commission may, if appropriate, invite representatives of the European Central Bank to participate in surveillance missions."

Therefore, it seems that the ECB will have only a low profile in macroeconomic surveillance missions, but no specific tasks and responsibilities are related to such missions, nor to other elements of the MIP process.

1.12. Agent for the secondary market activities of the ESFS and ESM

In December 2011, the ECB agreed to act as an agent for the secondary market activities of the EFSF and the same role is foreseen for the ESM⁹. The ESCB statute allows such operations (under the prohibition of overdraft or any other kind of credit facilities). In this role, the ECB would merely execute the EFSF/ESM's decisions on secondary market operations.

All in all, beyond the primary objective of price stability, the ECB has a Treaty-based mandate to support the EU's broader goals related to growth, competitiveness, employment, social progress, the soundness of credit institutions and financial stability, while the ESM Treaty broadened the responsibilities of the ECB in financial assistance programmes. The ECB's role in macroeconomic surveillance will have a low profile, while it can also act as the agent of the EFSF and ESM on the secondary government bond markets.

⁹ See question 36 on page 19 of the Frequently Asked Questions on the ESM: <http://www.esm.europa.eu/pdf/FAQ%20ESM%2001072013.pdf>.

2. MONETARY POLICY CONSTRAINS

There are at least three main constraints on monetary policy, which all have a bearing on the assessment of the various tasks of a central bank: fiscal dominance, financial repercussions and regional divergences. We highlight these constraints before assessing the ECB's tasks in the next section.

2.1. Fiscal dominance

Fiscal dominance describes a situation in which there is a threat to fiscal sustainability due to large public debt and budget deficit, potentially endangering financial and macroeconomic stability. This limits the freedom of the central banks (either indirectly by internalising the threat from fiscal unsustainability, or directly by pressure from the government) in pursuing the price-stability goal freely. The central bank can influence government borrowing costs in various ways and under fiscal dominance it may act to help fiscal sustainability, to the detriment of its core mandate of price stability.

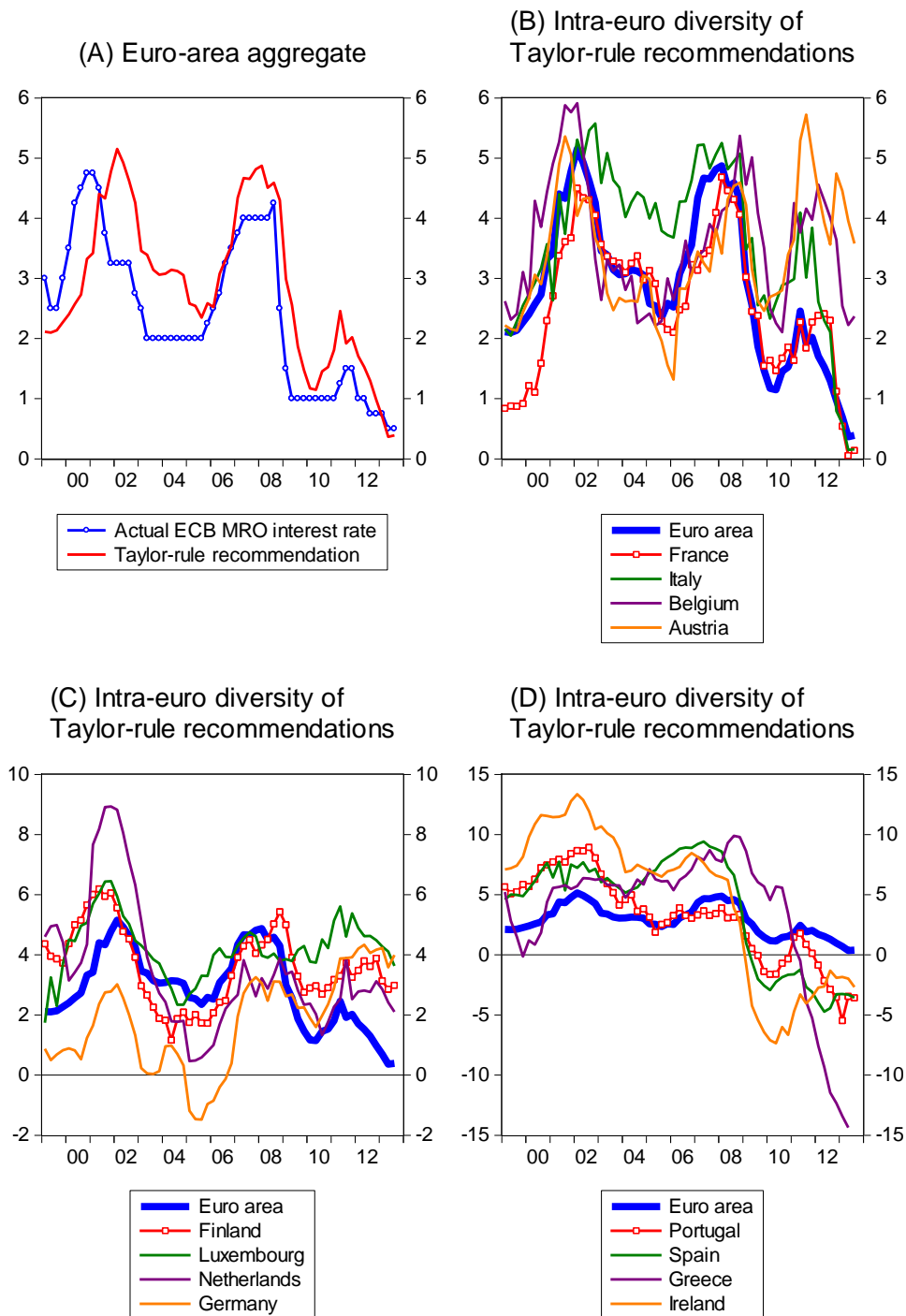
2.2. Financial repercussions

Financial sector vulnerability is a key constraint. The period in the run-up to the global financial and economic crisis has clearly indicated that price stability (defined as low and stable inflation) in itself is insufficient to promote stable and durable economic growth. On both sides of the Atlantic, major financial vulnerabilities were built up, which erupted suddenly, leading to major economic contractions, high unemployment and undershooting of the inflation target during the crisis. In Europe, banking fragility continues to constrain monetary transmission even five years after the demise of Lehman Brothers.

2.3. Regional divergences

Regional divergences, such as the build-up of macroeconomic imbalances (diverging external positions and price competitiveness) were particularly notable in the euro area, where there is no centralised fiscal authority to smooth regional shocks, and where intra-regional adjustment mechanisms work much less effectively than in federal states, like the United States. Particularly weak economic conditions in some regions of a monetary union in the absence of proper adjustment mechanisms in themselves undermine the 'one size fits all' property of monetary policy (Figure 1, panels B, C and D). But the vicious circle between banks and sovereigns (whereby banks hold a large amount of the debt of the government of their home country and are expected to be bailed out by the same government) in some euro-area countries further pushed both banks and governments to the abyss, thereby leading to major differences in the transmission of monetary policy across the members of the euro area. While at the present economic juncture the optimal rates warranted for, e.g. Spain (and also for a number of other euro-area countries), would be much lower than in Germany, actual lending rates are much higher in Spain, partly because of the fragmentation of euro-area financial markets, and partly because of higher risks and weaker economic outlook in Spain, which in turn are related to the build-up of the pre-crisis macroeconomic imbalances. Therefore, macroeconomic imbalances can hamper the proper transmission of the ECB's monetary policy.

Figure 1: Taylor-rule recommendations for the ECB interest rate, 1999Q1-2013Q3



Source: Bruegel using the methodology of Nechio (2011). Notes: Taylor-rule target = $1 + 1.5 \times \text{Inflation} - 1 \times \text{Unemployment gap}$. Similarly to Nechio (2011), we use core inflation (all items HICP excluding volatile food and energy prices) and the deviation of the actual unemployment rate from the estimated non-accelerating inflation rate of unemployment (NAIRU), as estimated by the OECD. MRO = Main refinancing operations. The 2013Q3 recommendation is based on July-August 2013 inflation rate and the July 2013 unemployment rate. The countries are ordered according to the average absolute deviation from the euro-area recommendation in 1999-2013, ie developments in France were the closest to the euro-area average and Ireland was the farthest from the euro-area average. See Darvas and Merler (2013) for a more in-depth discussion of this figure.

3. SYNERGIES AND CONFLICTS BETWEEN THE ECB'S TASKS

The key take-away from the previous section is that the conditions for proper conduct of monetary policy across the regions of a monetary union are sound public finances, sound banks and financial stability and balanced economic development. We assess the various tasks assigned to, or adopted by, the ECB in light of this lesson. There are several interactions between the ECB's task. Here we focus on five issues that we regard as most important, starting with the easiest to solve, and ending with the most difficult.

3.1. Long-term liquidity operations: easy to remedy the dangers

In normal times, central banks did not engage in really long-term liquidity operations (recall that before the crisis, the maturity of ECB's LTROs was three months). A reason for this is related to moral hazard: long-term central bank financing at rates below what banks could get from the market might encourage excessive risk taking. Also, such operations may keep alive otherwise insolvent banks.

The ECB's 3-year LTROs reduced the risk that solvent banks could become insolvent because of liquidity constraints, and it also contributed, though only temporarily, to the stabilisation of Italian and Spanish government bond markets (see Darvas and Savelin, 2012), which was a major achievement at that time. But they did little to trigger lending to the private sector. To a great extent, banks either deposited the cheap central bank funding at the ECB for rainy days, or purchased higher yielding government bonds. Thereby, the LTROs in effect supported liquidity, ensured stable long-term (3-year) financing, subsidised the banking system and helped to restore profitability, and temporarily supported distressed government bond markets. When the alternative was a potentially escalating financial crisis, these achievements were beneficial. But Belke (2012) and Pill (2013) rightly argue that the LTROs delayed the bank restructuring efforts and prolonged the existence of non-viable banks, with major negative side effects. The remedies for this are obvious: the ECB can foster bank restructuring by performing in the toughest possible way the comprehensive balance-sheet assessment (task 9 in section 2) before it takes over the single supervisory role. After that, the ECB's micro-prudential supervisory powers (task 8) should be used to ensure that all banks receiving liquidity support have indeed only a liquidity problem, and not a solvency problem. This is even more relevant in the context of the ELA, where the dividing line is less clear and where the pressure is the highest, because the impact of a decision for or against the granting of emergency liquidity can have significant financial stability consequences. The case of Cyprus, where the existence of major banking problems was probably known well before the dramatic days in March 2013 (when banks were closed down for several days and uninsured depositors suffered massive losses), but where ELA was provided to banks on a massive scale, is exemplary in this respect. Furthermore, to dispel all doubts that liquidity provision to banks is back-door financing of public debt (whereby banks borrow cheap from the ECB to purchase government bonds), longer-term ECB financing could be conditioned that banks do not increase their net lending to the government and/or increase their net lending to the real economy (see Darvas, 2013b).

3.2. Monetary, micro- and macro-prudential policies: good siblings

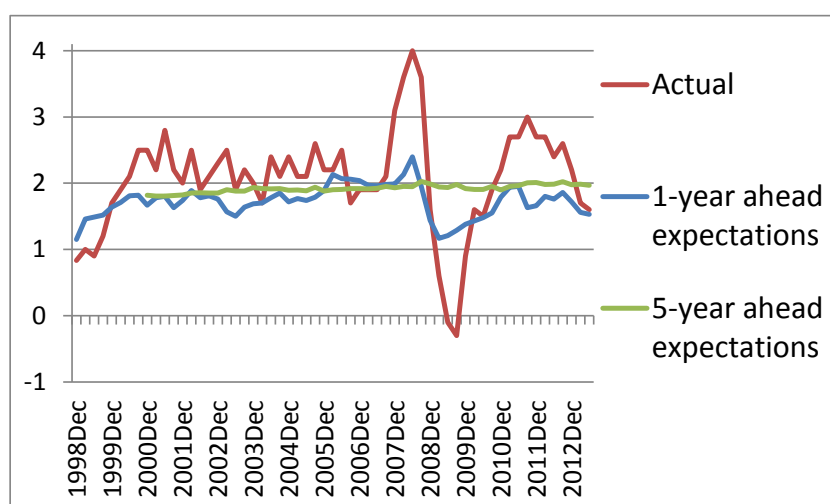
There is a potential synergy between monetary, micro-prudential and macro-prudential policies, i.e. tasks 1, 8 and 10 (section 2). As we argued, risk may be building up in the financial sector and asset prices deviate upward from fundamental levels even without significant movement in CPI inflation. The potential for monetary policy to react would be limited in that case, because monetary policy does not take asset prices into account but generally targets consumer-price inflation. On the other hand, low interest rates, which are needed to stimulate demand in an economic downturn, may encourage excessive risk taking by the financial sector, which could be counteracted by strong micro-prudential supervision and macro-prudential tools (Farhi and Tirole, 2012).

The synergy between these policies can be even stronger in a heterogeneous monetary union, like EMU, in which there are divergences in inflation dynamics at the regional (or country) level. The counteractive role of monetary policy is even more limited in this case, because the central bank targets the average inflation rate. As Blanchard *et al* (2013) argue, in such a heterogeneous union, macro-prudential tools have to contribute to the management of aggregate demand too.

Yet as Blanchard *et al* (2013) highlight, the key question is the organisation of these policies: should they belong to a single institution or independent institutions? We agree with their conclusion that when none of them works perfectly, combining them in the same institution brings more benefits than possible costs.

Certainly, there are associated risks. For example, a main argument against giving the same institution both price and financial stability mandates is that the latter might undermine the former: when monetary policy considerations may necessitate increasing the interest rate, the merged institution may be reluctant to raise interest rates, if it endangers financial stability, and therefore the inflation rate may overshoot the target. At least so far, this risk is not shared by market participants, as the five-year ahead inflationary expectations in the euro area continue to be anchored to the two percent target, even though more recently the ECB's supervisory role became a certainty (Figure 2).

Figure 2: Euro area inflation: actual and expected, December 1998 – June 2013



Source: ECB. Note: percent change compared to the same month of the previous year, using the harmonised index of consumer prices. Expectations: ECB Survey of Professional Forecasters.

Another main risk would be reputational. The possibility of supervisory failures or, more generally, of negative events occurring within the remit of banking supervision, cannot be excluded, and the risk is that any blow to the central bank as supervisor could negatively spill over to the credibility of the central bank as the guardian of price stability (Goodhart, 2000).

An additional risk pointed out by Goodhart (2000) is the possibility that the central bank could lose independence and become politically captured, by taking up a role that is particularly sensitive from a political perspective. It could be argued that the SSM structure can potentially mitigate this risk with respect to a decentralised system, by bringing national supervisors together and subjecting them to a certain degree of peer pressure.

Overall, the risk that the ECB's financial supervisory role may undermine its monetary policy does not seem too high.

There is a synergy between micro-prudential supervision and the assessment of risk to the financial system as a whole, which falls within the macro-prudential remit of the ECB. Information about the financial system – including at the institution-level – is a crucial variable for the effective conduct of macro-prudential policy.

Concerning the macro-prudential tools available to the ECB, their limitations may constrain effectiveness. The ECB cannot impose, for example, limitations on loan-to-value ratios. This is a major shortcoming, because housing is a very important source of macro risk and housing bubbles have frequently been associated with financial crises. The national supervisory authorities will have such tools: it will to be seen if national supervisors will be as vigilant as the ECB in pinpointing housing bubbles. While the housing sector is typically politically sensitive, it would have been better to entrust the ECB with direct tools to include this sector.

One way to circumvent this limitation would be to involve the ECB more in macroeconomic surveillance. As highlighted by task 11 in section 2, the ECB will have negligible role in the Macroeconomic Imbalances Procedure, which is also designed to identify similar vulnerabilities.

More generally, to the extent that the evolution of the financial cycle – which is generally agreed to be the 'target' of macro-prudential policy – can be driven by the development of underlying macroeconomic imbalances in the economy, the involvement of the ECB in the field of macroeconomic surveillance seems complementary to the conduct of macro-prudential competences that it has been assigned.

Overall, we regard it a wise decision to entrust the ECB with micro- and macro-prudential competences, yet the limitations to the ECB's macro-prudential tools may constrain effectiveness.

3.3. Monetary policy and bank supervision: internal separation within the ECB to be reconsidered

The draft SSM Regulation requires as much separation as possible of financial supervision from monetary policy within the ECB. But is this separation needed? We highlighted some points in favour of separation in the previous section and concluded that they are not decisive.

Also, there is not a unanimous agreement in the literature on whether the two functions should be kept separate (see Beck and Gros, 2012, for an overview of the literature). It is not unusual for central banks to be in charge of supervisory responsibility. Fourteen out of the seventeen national central banks in the euro area have a role in supervision and so do several major central banks elsewhere in the world (Draghi, 2012).

There can be significant synergies between monetary policy and supervision. ECB president Draghi himself has stressed that *"it is an established fact that stronger supervision facilitates the conduct of monetary policy"* (Draghi, 2012). One reason for this is that the banking system plays a crucial role in the transmission of monetary policy impulses to the economy and therefore in the achievement of the central bank's goal. This is especially the case in times of crisis, when the banking system comes under heightened stress, the monetary transmission mechanism can be impaired and the standard monetary policy tools (the short-term interest rate) can become powerless. This synergy constitutes a rationale for the central bank to have an interest in the stability of the financial system (Constâncio, 2013) and therefore in its effective supervision, as the latter *"contributes to a stable financial system [and] can only benefit the smooth transmission of monetary policy"* (Draghi, 2012). Therefore, if it is true that in crisis times the line between (unconventional) monetary policy and financial supervision becomes less clear, it is also true that in such a situation output and inflation are subject to downside risks, and financial stability and price stability actions would go in the same direction, making a conflict unlikely.

Also, as we concluded in Section 3.1, using supervisory information will help the ECB in deciding which banks are solvent but illiquid, and which banks are insolvent, which would be essential for its function as the lender of last resort to banks. As pointed out by Whelan (2012), the experience with Northern Rock in 2007 shows how coordination of different authorities can be insufficient to solve the problems associated with the lender of last resort not being involved in supervision. The fact that the removal of banking supervision from the Bank of England – decided in 1997 – is now being reversed, can perhaps be taken as a sign that strictly separating bank supervision and monetary policy may be suboptimal.

A more practical question is if a full organisational separation of the two functions within the ECB is possible. The Supervisory Board will consist of five representatives of the ECB and potentially the representatives of all euro-area central banks. As pointed out by Beck and Gros (2012), it is very difficult to imagine how national central bank representatives could not be in very close contact, especially since one (the governor) would be hierarchically superior to the other (the head of supervision). The final decision will anyway remain with the Governing Council, even though the latter is supposed to operate *"in a completely differentiated manner"* when dealing with monetary policy and with supervision. But it would be the same people deciding and it is hard to see how they would not use all the information at their disposal, when taking a decision.

It is also noteworthy that in the Bank of England, such a separation was not sought:

"The new system ... encourages co-operation and co-ordination across the different policy bodies. [...] There is overlap between the memberships of the FPC, the PRA Board and the MPC, including the Governor and the Deputy Governor for Financial Stability both being members of all three policymaking bodies. This will support the flow of information across the different bodies and an understanding of their approaches and likely reactions to events." (BoE 2013, page 26)

Certainly, the accountability of the ECB regarding monetary policy and financial supervisory decisions is different from each other, and the European Parliament rightly requested more detailed information about supervisory decisions¹⁰. But it would be not too difficult to ensure that supervisory decisions are more transparent for the Parliament even when there is greater information sharing between the two areas within the ECB.

¹⁰ In their final agreement before the 12 September 2013 vote of the European Parliament, EP President Martin Schulz and ECB President Mario Draghi agreed over transparency, under which the ECB will send detailed confidential accounts of the minutes of its bank supervisory board meetings.

We therefore conclude that the efforts made in the draft SSM regulation to separate monetary policy and financial supervision within the ECB may not have been so important.

3.4. Designing and monitoring of financial assistance programmes: a dangerous liaison

The role played by the ECB in the Troika is ambiguous¹¹ and difficult to assess. The local central bank is always included in negotiations on IMF financial assistance programmes, but since the central banks of programme countries in the euro area are part of the Eurosystem, the ECB could not have been left out. However, the ECB sits on the same side of the table with lenders (IMF and the European Commission), while in a typical IMF programme, the central bank of a country with its own currency would sit with the national authorities.

There are three additional reasons for ECB involvement (Pisani-Ferry, Sapir and Wolff, 2013). First, the European leaders trusted the ECB and wanted it to be part of the European negotiation team alongside the Commission. Second, the European leaders feared possible recommendations from the IMF that would have challenged ECB policies and therefore wanted to make it possible for the central bank to participate in the policy discussions. Third, the ECB had a very significant exposure to programme countries (through its liquidity operation with banks) without having any legal hold over the supervisory assessment of its banking system. Participation in the Troika gave to the ECB the possibility to perform a better assessment of potential risks to its balance sheet, and to have a say over decisions that might affect it.

All of these reasons will likely characterise future ESM programmes. But the ECB's participation in the design and monitoring of financial assistance programmes creates potential conflicts of interest with the other mandates of the ECB.

First, there is a potential conflict with the ECB's prime activity of monetary policy, and in particular, price stability. In the implementation phase of programmes, the ECB might be tempted to deviate from its price stability objective in order to help improve fiscal sustainability in a given programme country. *Ex ante*, the fear that fiscal unsustainability in a particular country may result in pressure on the central bank to soften its monetary stance might lead the ECB to overemphasise the need for fiscal consolidation. However, it has to be stressed that this problem is not specific to the participation of the ECB in the Troika, because fiscal dominance coming from non-programme euro-area countries can also undermine the price stability mandate (see section 3). In this context, we note that fiscal sustainability in larger euro-area countries, like Italy and Spain, provides a bigger threat to financial stability than fiscal sustainability in current programme countries (which are all much smaller). Therefore irrespective of the ECB's participation in the Troika, it may be tempted to opt for higher inflation than the target. The experience so far has clearly demonstrated that this is not the case, even though Greek public debt became unsustainable and so far two rounds of public debt restructuring have been implemented. On the contrary, the major risk at the moment is that inflation undershoots the target in the coming years (even the ECB's own forecast for 2013-14 is well below the target), while the ECB does not act to counterbalance it. This will make the adjustment of countries in southern Europe much more difficult, because when average euro-area inflation

¹¹ For an extensive evaluation of the Troika's operate and set-up see Pisani-Ferry, Sapir and Wolff (2013). Preliminary assessments of the specific role played by the ECB and of the potential conflicts of interest for the central bank had been conducted also by Merler, Pisani-Ferry and Wolff (2012). This section is largely based on these two works.

undershoots the two percent target, the conflict between intra-euro relative price adjustment and debt sustainability is more severe (Darvas, 2013c).

Second, there is a potential conflict of interest with the ECB's function of lender of last resort to banks. Banks in programme countries are typically under high stress and may need to rely heavily on ECB liquidity. *Ex ante*, the ECB might seek to minimise liquidity operations that constitute a risk to its own balance sheet, and to label banking problems as solvency problems that would need to be addressed through state bail-out or through bail-in of private shareholders and creditors. *Ex post* however, the ECB might actually be inclined to provide liquidity on soft terms, as would any central bank interested in the success of the programme, by acting on the strictness of its collateral framework or of the ELA provision. Again, this possible conflict is not specific to financial assistance programmes, as the ECB may act similarly with respect to non-programme countries. But the ECB's participation in the design of financial assistance programmes may bias programme conditionality.

Third, there is a potential conflict of interest with the ECB's bond-purchase programmes. By buying bonds of vulnerable countries in the context of the SMP or OMT, the ECB becomes formally a creditor of the governments receiving financial assistance, and this may influence its position in the negotiations. Fear of losses stemming from its bond holdings might lead the ECB to be especially tough on fiscal consolidation or especially timid on debt restructuring – if the latter were needed – to reduce the likelihood of losses on its holdings. The Greek case, in which the ECB loudly rejected debt restructuring even a few weeks before such a decision was made by euro-area heads of state, and then negotiated a special position so that ECB holdings of Greek government bonds were not restructured, clearly underlines this threat. Also, a highly problematic issue with respect to the ECB's OMT is the introduction of an explicit conditionality set-up in the conduct of monetary policy, which is particularly delicate and dangerous, and is dealt with in the next section.

In conclusion, the unclear nature of the ECB's hybrid role in the Troika raises concerns about possible conflicts of interest that the ECB could experience in relation to the conduct of its other functions. This role, which the ECB took on in emergency at the time of the first Greek programme, is now being crystallised into a permanent competence by the ESM Treaty (see task 7 in section 2). The ECB will have a say both *ex ante*, in the preliminary assessment of the decision to grant support, and *ex post*, in the monitoring of conditionality, thus being in the delicate position of having to balance considerations of financial and fiscal stability.

A better option would have been a 'light' participation of the ECB in financial assistance programmes, such as voicing concerns, beyond obtaining information, which is in line with the conclusions of Pisani-Ferry, Sapir and Wolff (2012). However, this option is not feasible without a change to the ESM Treaty.

3.5. Monetary policy with conditionality: major dilemmas

Government bond purchases by the ECB, which reduce the yields and increase the price of government bonds, can help the transmission of monetary policy through three main channels (see ECB, 2012a):

- (1) Price channel: 'excessive' government bond yields increase the yields for the private sector, because government yields are typically taken as a benchmark, and therefore a reduction in the government bond yield reduces the yields for the private sector;
- (2) Balance-sheet channel: government bond purchases can lead to a fall in government bond yields/increase in the price of government bonds, which improves bank balance sheets and thereby the ability of banks to lend to the non-financial sector, since they

hold significant amounts of government bonds in their portfolio;

- (3) Liquidity channel: pressure on the sovereign bond markets makes it substantially more difficult for banks to access liquidity on the interbank market, when government bonds are used in repo markets as collateral and as a benchmark for the haircut applied to other instruments. Government bond purchases by the ECB can lessen such pressures.

While these benefits and their link to monetary policy transmission are straightforward, and it is fair to say that without the SMP and OMT the euro area would have likely been engulfed by a financial meltdown, there are number of concerns with ECB government bond purchases:

- (a) Even if purchases are conducted on the secondary market, they are on the 'borderline' with debt monetisation. There may be investors who purchase bonds on the primary market only because they know that they can sell these bonds to the ECB on the secondary market, thereby they 'intermediate' the ECB's secondary market purchases to the primary market.
- (b) Such an implicit debt monetisation may endanger the ECB's reputation.
- (c) The ECB may suffer losses in the event of sovereign default.
- (d) Moral hazard: by reducing the market pressure on the beneficiary countries, the bond-buying programme would simultaneously reduce the incentives to consolidate and reform.

The ECB itself seems to have anticipated the latter concern and made it very clear in the announcement of the SMP that the Governing Council, in making its decision, had "*taken note of the statement of the euro area governments that they [would] "take all measures needed to meet [their] fiscal targets [that] year and the years ahead in line with excessive deficit procedures" and of the precise additional commitments taken by some euro area governments to accelerate fiscal consolidation and ensure the sustainability of their public finances*"¹².

Certainly, the policies adopted by governments have a bearing on the effectiveness of the actions of central banks. But the fact that the SMP announcement formally refers to governments' fiscal commitments raises important issues. First, it suggests that a decision taken in the remit of monetary policy had been to some extent subject to fiscal considerations – despite the ECB not being a fiscal policy-making institution. Second, although the tone is vague enough not to establish any direct link ("*taken note*"), the statement still seems to convey the message that without such commitments, the ECB might have acted differently. Since the SMP was subject to the full discretion of the Governing Council, the result seems to be a sense of embryonic (and implicit) conditionality: the ECB adopts measures to improve monetary transmission, and thereby achieve its Treaty-based primary objective of price stability, only if governments do their homework.

The existence – and the risks – of such informal conditionality became clear in August/September 2011, when the ECB started to buy Italian bonds. It was not publicly disclosed at the time, but before engaging in the Italian bond market the ECB had sent a dry letter to Rome, listing a number of measures that the ECB considered "*essential*" for Italy at that juncture. No explicit reference was obviously made to the SMP and the actions listed in the letter were not described as conditions for its activation. But the possibility that

¹² ECB press release: <http://www.ecb.int/press/pr/date/2010/html/pr100510.en.html>.

the ECB could intervene to ease the escalating tensions on the Italian bond market had been extensively discussed over the summer and the ECB started buying Italian government bonds a few days after the letter was sent.

The intervention was successful in easing the pressure on Italian sovereign bonds (at least in the short-term), but by the end of the month the Italian government publicly announced the intention to scrap a previously proposed 'solidarity tax'. For those critics of the SMP who had been warning against the risk of moral hazard, this was a nightmare coming true: the ECB had provided relief from market pressure to a country whose government was now backtracking on its commitments.

The OMT framework marks a shift to an entirely different level, in two respects. First, it introduces explicit conditionality for the bond buying, which is made subject to the activation of an ESM/EFSF programme. Second, and most important, it assigns to the ECB an equally explicit and active role in the monitoring and assessment of compliance with such conditionality, thus blurring even more the thin red line between monetary and fiscal policy and increasing the potential for conflicts of interests.

This setting puts the ECB in an extremely delicate position. In the words of ECB president Mario Draghi, the objective of the OMT is to "*safeguard the monetary policy transmission mechanism in all countries of the euro area. [...] to preserve the singleness of [...] monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the area*". As such, it qualifies as a tool fully within the ECB's monetary policy scope. At the same time, however, it is a monetary policy instrument, the activation and use of which is made subject to considerations that would not strictly pertain to a central bank in the exercise of its monetary policy competences. The ECB explicitly commits to terminate the OMT not only – as would be logical – in case the latter is no longer warranted from a *monetary policy perspective*, but also in case the beneficiary country fails to comply with the required conditionality.

It therefore introduces an idea of monetary policy with conditionality. As Nielsen (2012) points out, this idea is quite unheard of and not easily justifiable from a theoretical perspective, not to mention that it creates confusion about the ECB action. The specific way in which this conditionality is structured is indeed problematic not just for the ECB's independence, but also for the survival of the euro.

1. First, it is not clear how compliance with the conditionality would be assessed. The ECB will be involved, with the European Commission and possibly the IMF, in future ESM-funded financial assistance programmes, according to the ESM Treaty (see task 7 in section 2). This would make it very difficult for the ECB to conduct a fully independent assessment of conditionality fulfilment and it could expose it to pressure from the other institutions, even if the Governing Council will decide "*in full discretion*"¹³.
2. Second, in a case in which the OMT was warranted from a monetary perspective, but the conditionality was not met, the ECB would face the dilemma between (a) interrupting the OMT at the risk of possibly endangering the stability of the euro area, and (b) continuing the OMT at the risk of inflicting a fatal blow to its own credibility.

¹³ The technical features of the OMT regulate the assessment the following way: "*The Governing Council will consider Outright Monetary Transactions to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme. Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate.*" (source: ECB, 2012).

The latter could also undermine the political support for the euro in creditor countries. The choice would be a very tough one, and consequences could be dismal in either case.

There are no easy solutions to this quandary and, in our view, this is the most problematic dilemma that the ECB faces.

A possible – though imperfect – solution could be to remove the ECB's own assessment of the fulfilment of the conditionality, and also to remove the ECB's contribution to the ESM's assessment. In turn, the latter would require changes to the ESM Treaty, as we discussed in the previous section. Therefore, the decision on compliance with the conditionality would be based solely on the ESM Board of Directors, and the ECB would need to assess only if the OMT is warranted from a monetary policy perspective, if the ESM Board of Directors gives the green light. In such a system, the responsibility for starting, and once started, stopping or continuing the OMT when compliance is either not met or at the borderline, would lie with the Governors of the ESM Board, ie the representatives of euro-area governments, who have, in the first place, created a financial assistance system in the euro area. This is because in uncertain situations when compliance is at question, markets will likely behave nervously and therefore there would be a need for an OMT from a monetary policy perspective.

On the other hand, such a system would undermine the ECB's monetary policy independence, as it would set a pre-condition for monetary policy actions on the decisions of a body other than the Governing Council. Also, leaving the decision on compliance entirely to a more political body is not without risks. The ECB is in a privileged position to assess the financial risks facing member states and the euro area. ESM Governors would not be able to have the same information on their own, and if they receive this information from the ECB in an informal way, they may not take it sufficiently into account when making decisions that can have political repercussions. ECB involvement in the assessment of compliance is therefore problematic and valuable at the same time. Excluding it entirely from the process of evaluating financial assistance programmes may not be the best way to square the circle.

Consequently, there is no correct solution to the aforementioned dilemmas. When members of a monetary union have large public debts, a lender of last resort for governments is necessary to avoid a bad equilibrium in which financial markets force an otherwise solvent country into default (De Grauwe, 2011). This cannot be unconditional, as it would create moral hazard. But as the experience of the SMP indicates, informal conditionality does not work, while formal conditionality exposes the ECB to the major dilemmas discussed in the two points above. The best we can hope is that the OMT will never need to be used, but if used, the country in question will comply with the conditionality.

The alternative to the OMT would be to revise completely the framework for euro-area sovereign-debt crisis management, by moving toward a US-style system, in which state-level public debt is small, there is no federal financial bail-out for states, the central bank does not purchase state debt and banks do not hold state debt. Under such conditions, markets would discipline state public finances well and an eventual default of a state government would not undermine financial stability. Since public debts in most euro-area countries are high, steps toward such a system should involve a much higher level of fiscal integration, including the mutualisation of a significant share of public debt (like the 'Blue bonds' of von Weizsäcker and Delpla, 2010). Holding the remaining national debt ('Red Bonds') could be prohibited for banks, or at least higher capital requirements could apply. This would reduce the impact of a sovereign default on the country itself and reduce contagion fears (Darvas, 2011). However, by drawing a parallel with US history, O'Rourke and Taylor (2013) remind us that even after the US political integration, it took a very long

and painful process to reach a high level of fiscal integration. It is unfortunately unrealistic for the euro-area to embark on such an immense change in the foreseeable future.

4. CONCLUSION

After gaining a strong reputation as the guardian of price stability in the euro area, the European Central Bank's roles have been greatly extended during the crisis, taking in monetary policy and other areas. The good news is that the new tasks have not endangered (at least so far) the ECB's ability to anchor the inflation expectations of market participants: five-year-ahead expectations continue to be anchored at the two percent target.

Nevertheless, the new tasks pose major challenges for the ECB and give rise to both synergies and conflicts of interests. We have reviewed the new tasks and assessed five major interactions between them.

First, while liquidity provision to banks at a massive scale can stabilise financial markets in a stress situation, it can keep alive otherwise insolvent banks, encourage excessive risk taking and indirectly finance governments (when banks borrow cheaply from the ECB to purchase government bonds). The new EMU architecture has the potential to limit these adverse side-effects: the ECB can foster bank restructuring by performing in the toughest possible way the comprehensive balance sheet assessment before it takes over the single supervisory role and, after that, micro-prudential supervisory powers can be used to ensure that all banks receiving liquidity support have indeed only a liquidity problem, and not a solvency problem. The architecture could be further extended to dispel all doubts that liquidity provision to banks is backdoor financing of public debt: longer-term ECB financing could be conditional on banks not increasing their net lending to the government and/or increasing their net lending to the real economy.

Second, there is a potential synergy between monetary, micro-prudential and macro-prudential policies. Risks can build up in the financial sector even when the price stability mandate is achieved; monetary policy, on its own, is not able to counterbalance such risks. This is especially true in a heterogeneous monetary union like the EMU. Micro- and macro-prudential tools can help to limit the build-up of such risks, leading to synergies. But there is a potential for conflicts of interest too, for example, in a situation when an interest rate increase is needed for monetary policy purposes but such an increase would have a critical impact on the balance sheet of banks. Monetary policy credibility may also be undermined by eventual supervisory failures. In our view, these risks are not high and also not shared by markets, because long-term inflationary expectations continue to be anchored. We also note, however, that the limitations on the ECB's macro-prudential tools (eg the ECB cannot impose requirements for loan-to-value ratios) may constrain effectiveness.

Third, the strict organisational separation of monetary policy and bank supervision within the ECB, which was a major goal of SSM regulation, is not so important. On the contrary, because of synergies between monetary policy and financial supervision, an appropriate flow of information would facilitate the achievements of the goals of price and financial stability, even if the transparency and accountability requirements of monetary policy and supervisory decisions are different. Recent organisational changes at the Bank of England also encourage co-operation and co-ordination across the different policy areas.

Fourth, the roles played by the ECB in financial assistance programmes as a partner of the European Commission and the IMF in the Troika is ambiguous. The ECB's participation in future assistance programmes, which is formalised by the treaty on the European Stability Mechanism, creates potential conflicts of interest with the other tasks of the ECB, such as price stability, liquidity provision to banks and the new bond purchasing programme, the Outright Monetary Transactions (OMTs). While the ECB's expertise could bring valuable input into programme design and monitoring, the conflicts of interest may alter the ECB's

positions and could be exposed pressures from the other institutions of the Troika. An informal role in the design and monitoring of financial assistance would lessen the possible conflicts of interests.

And fifth, the ECB's government bond purchasing programmes were essential to avoid financial meltdown in the euro area. But this cannot be unconditional, as it would create moral hazard and other risks. The informal conditionality of the Securities Markets Programme did not work and the formal conditionality of the OMTs exposes the ECB to a major dilemma: if the OMT is warranted from a monetary perspective, but the conditionality is not met, the ECB would face the dilemma between (a) interrupting the OMT at the risk of possibly endangering the stability of the euro area, and (b) continuing the OMT at the risk of inflicting a fatal blow to its own credibility. This could also undermine the political support for the euro in creditor countries. On top of this dilemma, the involvement of the ECB in the negotiation of an EFSF/ESM programme within the Troika would make it very difficult for the ECB to conduct a fully independent assessment of conditionality fulfilment and it could expose it to pressure from the other institutions. There is no proper solution to this quandary of 'monetary policy under conditionality' within the euro area's current economic governance framework. The alternative to the OMT would be a complete revision of the framework for euro-area sovereign debt crisis management and an immense increase in fiscal integration, by moving toward a system like in the US, in which state-level public debt is small, there is no federal financial bail-outs for states, the central bank does not purchase state debt and banks do not hold state debt. Unfortunately such an immense change is unrealistic in the foreseeable future.

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New Roles and Challenges for the ECB

Karl WHELAN

NOTE

Abstract

The ECB's new role of banking supervisor for the euro area greatly complicates the work of the organisation both in terms of its internal structures and its relationships with various other organisations. In this paper, I review the arguments relating to synergies and conflicts of interest between monetary policy and bank supervision. I argue that the synergies are much more important than the conflicts of interest. While the new structures proposed for bank supervision at the ECB are cumbersome and somewhat unnecessary, they should still allow for important synergies in the coming years. The ECB will need to hit the ground running in its supervisory role and co-ordinate fully with national governments and the ESRB to make the upcoming stress tests a success. One task the ECB should give up, however, is designing and monitoring structural adjustment programmes.

CONTENTS

1. INTRODUCTION	35
2. SYNERGIES VERSUS CONFLICTS OF INTEREST	36
2.1. Synergies between Banking Supervision and Monetary Policy	36
2.2. Conflicts of Interest?	37
2.3. The New Structures for Monetary Policy and Bank Supervision	39
3. NEW STRUCTURES AND NEW RELATIONSHIPS	40
3.1. Relationships with National Supervisors	40
3.2. Relationships with Parliaments	41
3.3. The ECB, Bank Resolution and Financial Stability	41
4. THE ECB AND FINANCIAL ADJUSTMENT PROGRAMMES	43
REFERENCES	45

1. INTRODUCTION

While commentators regularly express frustration at what is perceived as the slow pace of policy changes in response to the ongoing European economic crisis, it is also the case that, viewed from a longer historical perspective, recent years have seen a series of unprecedented policy actions and enormous shifts in economic policy structures of the EU and the euro area. Four different countries have received financial assistance from euro area governments as part of adjustment programmes and a new permanent sovereign bailout has been put in place; a new fiscal compact treaty has been agreed as well as enhanced macroeconomic surveillance procedures. Most recently, events in Cyprus have seen depositors experiencing large losses and the imposition of capital controls inside the euro area. These are changes that could not have been imagined as recently as six years ago.

For the ECB in particular, the last few years have seen huge changes. New monetary policy tools such as the Outright Monetary Transactions (OMT) programme have been put in place and the ECB is now playing a key role in macro-prudential policy by providing the secretariat for the European Systemic Risk Board (ESRB). The ECB has participated in designing and monitoring adjustment programs as part of the so-called "troika" with the IMF and European Commission.

Most importantly, the ECB is in the process of taking on the role of the Single Supervisory Mechanism (SSM) for banks in the euro area. Taking on the SSM task represents a major organisational challenge for the ECB and will clearly involve a significant increase in staff numbers. Even with the decisions to limit direct supervision to roughly 150 larger banks and to leave "non-essential" supervisory tasks (such as payments, regulating markets in financial instruments and consumer protection) some reports have indicated that perhaps up to two thousand new staff may be required.

As an increase of this size would more than double staff numbers and cause significant adjustment problems, not least in relation to long-standing plans to move all ECB staff to a new premises. With a host of tasks being transferred to the ECB but many still remaining with national regulators, the new regime will require a wide range of new relationships to be established between the ECB and bodies such as national regulators, national parliaments, the European Parliament and the ESRB. These will take time to work out.

In this paper, I discuss a number of issues related to the ECB's new roles. In light of the influence that concerns about conflicts of interest between monetary policy and banking supervision had in the new structures being put in place, I first review the arguments for and against combining these two policy functions in one institution and then discuss the new structures for banking supervision that are being put in place at the ECB.

I then discuss some of the new relationships and challenges for the ECB due to its new role as banking supervisor. New relationships with national regulators, parliaments and governments will need to be established. In particular, the ECB will be playing a number of roles in the upcoming stress tests (supervisor, provider of emergency liquidity, guardian of financial stability) and it will be hugely important that it co-ordinates well with other bodies to maintain stability in the European banking system through this process.

Finally, I discuss the ECB's role in designing and monitoring adjustment programmes. I recommend that this role should not be continued.

2. SYNERGIES VERSUS CONFLICTS OF INTEREST

Over the past few decades, there has been plenty of debate in policy circles about whether central banks should be involved in bank supervision. In the years before the global financial crisis, international practice was moving somewhat towards the practice of having separate bank regulators.¹ In this section, I review the arguments for why there are significant synergies between banking supervision and monetary policy and also discuss the question of conflicts of interests that may arise from pursuing these goals.

2.1. Synergies between Banking Supervision and Monetary Policy

A good starting point for understanding the relationship between banking supervision and monetary policy is the special role that banks play in monetary policy. In the modern era, central banks implement monetary policy by setting a target for short-term money market interest rates and meeting this target generally requires monitoring of the short-run liquidity needs of banks.

More generally, however, the banking sector plays a crucial role in transmitting changes in monetary policy to the macro-economy. Relative to the total economy, very little money is borrowed in the Euribor or Federal Funds markets. The key interest rates that influence the economy are the rates at which households and businesses borrow to fund purchases of houses, consumer durables and business equipment and the institutions that determine these interest rates are banks. Indeed, banks play an even more crucial role in these areas in Europe than in the United States.

The idea that the health of the banking sector plays a key role in the transmission of monetary policy has become a standard part of macroeconomic theory and practice. Banks that are under-capitalised or facing liquidity funding pressures will seek to cut back on lending, so banking sector problems tend to make credit expensive or difficult to access even if the central bank is targeting a low money market interest rate. For these reasons, central banks collect a range of hard and soft information on current bank lending conditions as well as future lending plans.

The most obvious external signs of this monitoring of banks' lending conditions are surveys such as the ECB's Bank Lending Survey and the Fed's Senior Loan Officer Survey. However, there is evidence to suggest that more qualitative information obtained from the supervisory process is useful for monetary policy purposes. Federal Reserve economists Peek, Rosengren and Tootell (1999) showed that confidential information from supervisors can improve forecasts of inflation and unemployment. They argued that this information was actively used by members of the Federal Open Market Committee (FOMC) and that the information is best accessed directly by the central bank rather than indirectly through a separate regulator.

These arguments suggest that supervisory information is useful for monetary policy purposes even during normal business cycles. However, current conditions in the euro area are anything but normal. The crisis in the euro area has led to a breakdown in European interbank markets as well as the longer-term bank funding markets. This has left much of the banking system heavily dependent on the ECB for its funding.

The weakness in the banking system has led to fundamental change in how the ECB implements its monetary policy. Instead of auctioning off fixed amounts of credit, the Eurosystem now provides as much credit to banks as they request, provided they can pledge sufficient amounts of eligible collateral. While the large expansion in base money

¹ See Goodhart and Schoemaker (1995) and Peek, Rosengren and Tootell (1999) for two pre-EMU examples of papers that debated this question.

associated with this change in lending policies has yet to translate into a fast growth rate of broader measures of the money supply (such as M3) or into inflationary pressures, concerns that they could yet do so cannot be dismissed as irrelevant. This makes monitoring of the factors that influence banks' balance sheets important for achieving the ECB's key policy goal of price stability. These connections all point to strong synergies between the monetary policy and banking supervisory tasks.

The lender of last resort role is another important element of monetary policy. Given the dependence of many banks on ECB borrowing at present and the huge influence that this borrowing has on the supply of base money, there is now a clear connection between monetary policy and lender of last resort policy in the euro area. And it is in the public interest for lenders of last resort to have as much useful information as possible about the banks they are assisting.

The problems with Northern Rock in 2007 provide a good example of the problems that can arise when the lender of last resort is distant from the supervisory process. Co-ordination difficulties between the UK Treasury, the Financial Services Authority and the Bank of England lead to slow decision-making that ended up producing a retail bank run that was damaging to the banking sector around the world. That the 1997 removal of banking supervision from the Bank of England is now being reversed is a telling sign that the "Chinese Walls" approach to monetary policy and banking supervision is increasingly viewed as a failure.

The current institutional arrangements are not well-designed for the ECB to get the best possible information about the euro area banks. Some of the affiliated national central banks act as banking supervisors but some do not. Among those that act as supervisors, the underlying supervisory cultures may differ, including the amount of information about troubled banks that is relayed to the ECB. Because bank failures often end up costing national governments money and because disclosure of problems with these banks can undermine financial stability, national supervisors may be reluctant to share information about these banks with other European bodies. This has perhaps led the Eurosystem to adopting inappropriate lending policies in the past: For example, would the ECB Governing Council have approved the provision of over EUR 40 billion in Emergency Liquidity Assistance to Anglo Irish Bank if they had been acting as its supervisor and better understood the scale of the bank's solvency problem?

2.2. Conflicts of Interest?

The most commonly cited argument against central banks being bank supervisor is that there is a potential conflict of interest between the goals of monetary policy and banking supervision. Banks tend to benefit from low short-term interest rates and an upward-sloping yield curve as it allows them to pay low short-term rates on liabilities and earn higher long-term rates on their assets. Thus, as documented by Goodhart (2000), the claim is often made that monetary policy decisions can be distorted by a central bank having close involvement with the banking sector because it sometimes leads to central banks setting low interest to assist weak banks.

Despite the frequency with which the "conflict of interest" argument is aired, I find it hard to see much merit in it as an argument for separation. A number of points are worth making about the potential conflict of interest.

First, the fact that central banks have been observed keeping policy rates low when banking sectors are weak does not mean there has been a conflict of interest. As noted above, a weak banking sector tends to increase the cost of credit to the private sector and to reduce the supply of such credit. A central bank focused on reaching a medium-term

inflation target will have to take such weakness into account when setting monetary policy. Even if a central bank has no explicit supervisory role, it may react to banking weakness by adopting looser policy as well as specific measures aimed at combating weakness in the banking sector. So removing bank supervision from the central bank is unlikely to end the linkage between monetary policy and financial sector health that apparently bothers those who wish to see a separation. Conversely, access to the information obtained in the supervisory process can only help with calibrating monetary policy during periods of banking weakness.

Second, there are arguments against the common presumption that the involvement of central banks means a less stringent approach to banking supervision (and thus an increased risk of moral hazard). As Andrew Crockett (2000) outlined in his well-known description of macro-prudential policy, a central bank that is monitoring the financial system during a lending boom should be able to detect weaknesses that may not be obvious to individual supervisors. When asset prices are high and default rates are low, standard supervisory diagnostics can suggest that all the institutions in the financial system are well capitalised. Indeed, as pointed out by Danielsson et al (2001), the reliance of the Basle capital adequacy regulations on credit agency ratings and on Value-at-risk calculations that use short samples introduces a pro-cyclicality into risk-weighted capital ratios that can leave banks surprisingly short of capital when a boom turns into a recession.

An examination of the risks at a macroeconomic level can reveal fragilities not picked up by measuring the capital position of individual banks. While macro-prudential policies have not featured heavily in central bank thinking in the past, there are good reasons to hope that the involvement in banking supervision of central banks that have a wider view of the economy and the financial system will, in future, result in tighter supervision of banks during booms.

These arguments suggest that, rather than representing a conflict of interest, monetary policy and banking supervision are largely compatible tasks and that their joint execution by a single agency can improve both monetary policy outcomes. Monetary policy is improved by access to supervisory data and the use of micro-prudential tools to prevent damaging financial crises. Bank supervision is improved by the use of aggregate data and macro-prudential analysis.

Still, let's assume that, on occasion, there is a conflict of interest between the goals of monetary policy and the supervisory goal of maintaining the long-run soundness of banks. How does separating the central bank from supervision solve this problem? Is having two different government agencies pursuing contradictory policies necessarily the best solution to this tension? Former Fed Vice-Chairman Alan Blinder (2010) has argued that it is not.

what some people see as a worrisome conflict of interest between bank supervision and monetary policy might be viewed instead as the rational balancing of two competing objectives. If so, shouldn't a single agency do the balancing? And who can balance those competing objectives better than the central bank

Economic policy formulation is undoubtedly a difficult business because various goals need to be balanced against each when taking policy decisions. However, separating off related areas of policy formulation into "silo organisations" that pursue their own goals independently is unlikely to provide the best outcome.

2.3. The New Structures for Monetary Policy and Bank Supervision

Despite little in the way of concrete explanation of their importance in the preparatory work done for the SSM agreement, concerns about conflicts of interests had a significant role on the new supervisory arrangements approved by the European Council.

The new structures will see monetary policy and banking supervision *“carried out in full separation, in order to avoid conflicts of interests and to ensure that each function is exercised in accordance with the applicable objectives.”*

The key body carrying out the work on supervisory tasks given to the ECB will be a Supervisory Board featuring representatives from each national supervisory body, four representatives of the ECB, a Chair and a vice-Chair. While the Vice-Chair of the Supervisory Board will be a member of the ECB Executive Board, the four representatives of the ECB will not have any duties related to monetary policy and the Chair will be a full-time position with no involvement in other work performed by the ECB. The Governing Council must hold separate meetings to discuss monetary policy and banking supervisory issues and its involvement in the decision-making process will be limited to either approving or objecting to decisions recommended by the Supervisory Board.

My assessment is that these structures are cumbersome and unnecessary and may limit the beneficial synergies that can be obtained from combining monetary policy and banking supervision. Given the strong inter-relationships that I discussed above, it is hard to see why involvement in monetary policy should disbar an ECB representative from taking a place on the Supervisory Board. Indeed, a “macro” perspective may prove crucial when considering some of the recommendations that the Supervisory Board can make such as imposing macro-prudential-style capital buffers in countries where there are concerns about a boom-bust cycle.

In the same way, the requirement that the Governing Council operate in “a completely differentiated manner” in relation to monetary policy and banking supervision including “strictly separated meetings and agendas” could also be considered a barrier to effective macro-prudential policy making. For example, these requirements could restrict discussions about the range of options available to the Council to control the flow of credit, e.g. the relative impact of raising interest rates versus imposing high capital requirements.

That said, I still believe the new structures will be a significant improvement and should provide some of the advantages that I listed above. With a harmonised approach to supervision and assessment of asset quality, the ECB Governing Council should have a much clearer idea about the scale of banking problems in Member States than it has had up to now. This should help with the formulation of monetary policy. Similarly, the Governing Council will have direct access to information on banks in distress before approving emergency lending programmes and will not have to rely on potentially compromised local regulators.

Over time, I suspect the concerns about conflicts of interest between monetary policy and banking supervision may fade and the ECB can move towards structures that get the best out of each of the different types of information that it receives, using all of it in the formulation of monetary policy, macro-prudential policy and banking supervision.

3. NEW STRUCTURES AND NEW RELATIONSHIPS

In this section, I discuss the new structures that are being put in place with at the ECB due to its designation as SSM and some of the implications this will have for its relationships with other organisations.

3.1. Relationships with National Supervisors

The first, and perhaps most complex, set of relationships will be between the ECB and the current national supervisors. Two types of relationships will have to be sorted out: Those for the approximately 150 banks that are going to be directly supervised by the ECB and those for the rest of the euro area's approximately 6000 banks that are not going to be directly supervised.

In relation to banks that will meet the criteria for being directly supervised by the ECB, the new supervisors have to work out the correct balance of staffing and responsibilities between the new staff in Frankfurt and the current supervisors in the national regulators. The agreed proposal contains lots of sections on co-operation and information sharing but it is unclear how this will work in practice.

One possibility is a structure in which almost all the staff involved in direct supervision remains at the national regulator with a very small number of staff at the ECB involved in overseeing supervision and making policy decisions. However, from the very start of the SSM, with the asset quality review and stress tests, the ECB need to be in a position to make assessments that could be very different from those of existing staff. Getting the balance right in these relationships will likely be very tricky and may work better with some countries than others. Ongoing co-operation with existing staff at national supervisory staff will be crucially important but so will the ability to question past assessments by these staff members and adopt new approaches. In the opening few years, ECB staff will need to maintain good relationships with existing supervisory staff but this cannot come at the expense of an honest assessment of asset quality.

In relation to banks that are not being directly supervised by the ECB, the nature of the ECB's involvement is not clear to me at this stage. The early discussions on the SSM suggested simply that some banks would be supervised by the ECB and others would not. The final agreement is somewhat more complex. Some banks will be directly supervised by the ECB. And the rest? We are told that

Safety and soundness of large banks is essential to ensure the stability of the financial system. However, recent experience shows that smaller banks can also pose a threat to financial stability. Therefore, the ECB should be able to exercise supervisory tasks in relation to all credit institutions authorised in, and branches established in, participating Member States.

It is unclear what exactly this means but it suggests that the ECB can choose to supervise smaller banks if it wishes. However, what is perhaps more important than the ability to intervene at specific small banks, is that ECB staff monitor overall banking developments in each country. Collections of small banks with similar characteristics can often act in the same way so that the sector as a whole can occasionally presents a threat. This has been a familiar story running from small bank failures during the Great Depression to the Savings and Loans debacle of the 1980s. While none of the individual institutions may matter much, the ECB needs to be able to assess the full scale of problems with Spanish Cajas and German Landesbanks and be able to intervene across these sectors.

3.2. Relationships with Parliaments

The ECB will be publicly accountable in its role as bank supervisor with the proposals containing a complex set of relationships with the European Parliament, the Eurogroup, European Council and national parliaments. I have two concerns about the proposed plans.

The first relates to oversight by the European Parliament. The Monetary Dialogue with the ECB President likely provides a template for how the European Parliament's monitoring of the ECB's banking supervisory role will operate. If so, this does not provide much encouragement. The Dialogue sessions often feature the ECB President avoiding answering the questions and the limited time and large number of questions generally rule out follow-up questions. I would hope that a committee interrogating the Chair of the Supervisory Board on the complex questions relating to banking supervision would perhaps have a small number of members, be given a relatively large amount of time for questioning and allow for follow-up questions. (For example, each member of the committee could be allowed up to fifteen minutes for questioning.)

The second concern relates to the role of national parliaments. Parliaments will be allowed to address questions to the ECB in relation to its SSM role and also to request that relevant ECB officials appear before parliamentary committees. However, my reading of the plans is that the ECB is under no obligation to accept. In the case where a bank is in severe financial difficulties, the ECB will now be involved in supervisory decisions that can have major implications for investors, depositors and taxpayers in the country where that bank is located. Given this, I would have hoped for a stronger right for national parliaments to be involved in questioning the ECB's actions as a bank supervisor.

3.3. The ECB, Bank Resolution and Financial Stability

The ECB will not have much time before its ability to juggle all its roles will be severely tested. The upcoming asset quality review and stress tests will require the ECB to coordinate its roles as banking supervisor, provider of emergency liquidity and protector of financial stability.

Senior ECB officials, including President Draghi, are to be commended for their honesty in publicly admitting that previous rounds of stress tests have been unsatisfactory and have failed to convince financial market participants of the soundness of the European banking system. Executive Board member Joerg Asmussen has been quoted as saying that the upcoming stress tests are "our third and last chance" to restore confidence in the system.²

Accepting that previous stress tests were not tough enough in terms of their assessments of asset quality or riskiness, these comments suggest that the new ECB-overseen stress tests will be tougher than previous exercises. If this is the case, however, it is likely that the outcome will see a large number of banks fail the tests with outcomes ranging from a requirement to raise capital to a requirement to implement haircuts on bank liabilities.

If this process works well, it could set in a number of positive processes that would help to get bank credit flowing again in Europe. Banks that have passed the tests and are seen as well-capitalised may find it easier to raise long-term funds in the bond market and thus make progress towards the Basel III targets on stable funding without having to cut down on lending. Equity funds may also be more willing to invest in European banks after these banks have been through a realistic process of asset write-offs and this may help banks move towards the Basel III capital goals without shrinking their balance sheets.

² <http://www.bloomberg.com/news/2013-09-04/asmussen-says-ecb-stress-tests-last-chance-for-confidence.html>.

However, it will be difficult for this process to go smoothly. Ideally, the announcements would come with a set of steps from the ECB and national governments that will reassure investors and depositors about the stability of the banking system. However, previous rounds have generally announced results and left a waiting period in which banks are required to raise capital, so one could also imagine a period of damaging uncertainty.

A post-results period in which the public knows that many leading banks are under-capitalised and possibly may end up imposing haircuts on liabilities (perhaps including deposits) would be a recipe for instability. If deposits flowed out of banks perceived as particularly weak in light of the stress tests results, the ECB would come under pressure to provide replacement funding, possibly in the form of ELA. The precedents set by Anglo Irish Bank and Bank of Cyprus have shown this tends to produce very poor outcomes for citizens of the country in which the receiving bank resides.

Given the risks involved, it is important that the ECB conduct extensive discussions with national governments and also uses its role in the European Systemic Risk Board to see that everything that is possible is done to maintain financial stability both before and after the stress tests.

4. THE ECB AND FINANCIAL ADJUSTMENT PROGRAMMES

The “Troika” as the combination of European Commission, ECB and IMF has come to be known, was born during the negotiations for the Irish adjustment package in 2010. While everyone is now used to the idea of this Troika being involved in monitoring financial assistance programmes, it is worth noting that the involvement of the ECB in negotiating and monitoring of such a deal is actually something of an anomaly.

Ireland’s EU-IMF programme involved borrowing of EUR 45 billion from the EU (in the form of the EFSF and EFSM) and EUR 22.5 billion from the IMF. For these reasons, it was clear that the programme should be monitored by the IMF and also by the EU, in the form of the European Commission.

What was less clear was why the ECB is involved in programme design and monitoring. The ECB did not lend money to the Irish government as part of the programme; as such loans would be illegal. Instead, the Eurosystem lends money to Irish banks. The terms and conditions for such loans come from the Eurosystem’s common monetary policy guidelines and so, at first glance, it is unclear what role the ECB should have had in monitoring an adjustment programme.

In practice, the ECB appears to have been willing to use its risk control framework to cut off lending to Irish banks and appears to have made compliance with the adjustment programme a condition for its continued willingness to provide liquidity to Irish banks. Given the importance of this liquidity, the ECB ended up playing a large role in designing and monitoring the Irish programme.

I believe this level of involvement for the ECB was a mistake for a number of reasons. First, the involvement of the ECB in monitoring adjustment packages gave it a role in monitoring the fiscal policies that was not envisaged as part of the European Treaties. As an indication of how various lines were blurred due to the ECB’s involvement in programme design and monitoring, consider the following quote from Klaus Masuch, former head of the European Central Bank mission to Ireland, as spoken to the BBC:³

People in Ireland were not aware of the enormous support that they get from the Eurosystem. This is a privilege, of course. The partners in the Eurozone also expect that every partner – every government in the Eurozone – is doing its own homework. This means keeping public finances stable and, of course, keeping the banking sector stable.

It is hard to imagine a representative of the Federal Reserve telling the citizens of Texas they should realise that it is a privilege that their banks can borrow from the Fed so one might ask why ECB officials believe there is a good reason to lecture Irish citizens in this manner. These officials publicly linking the provision of liquidity to certain banks to the performance of the public finances in that country was a development that was inconsistent with the operational policies that the ECB is supposed to be pursuing.

Second, the involvement of the ECB in the Irish programme led to considerable confusion in Ireland and elsewhere about the conditionality associated with the EU-IMF programme. It is well known that the ECB insisted on all senior bond creditors of the Irish banks being repaid in full as a condition of continuing to supply funds to these banks. Given its involvement in monitoring the programme, many people believed that repayment of these private bank debts was an explicit condition of the programme.

³ See <http://www.thejournal.ie/the-bbc-bailout-documentary-some-choice-quotes-126048-Apr2011/>.

In fact, the Irish programme documents made no reference to the requirement that private unguaranteed bondholders be repaid. Indeed, such a clause would be unprecedented in an IMF programme document. However, this perception significantly undermined the popularity and legitimacy of the programme.

Given the unsatisfactory nature of the ECB's involvement in the Irish programme, I recommend that the ECB explicitly stay out of designing and monitoring any future adjustment programmes. Lending to banks should be assessed on a bank-by-bank basis as determined by the usual guidelines relating to collateral and risk control and should not be tied to fiscal adjustment programmes. While the ECB is free to comment on national fiscal policies, it is not lending money directly to these countries and should not get involved in areas outside its mandate.

Future adjustment programmes should be agreed purely with the European Commission and the ESM and be monitored by staff from those institutions. It is my understanding that a shortage of well-trained economists at the European Commission in the macroeconomic, financial and banking fields was one reason for the involvement of the ECB, with the Bank supplying much of the staff to do the analytic work for the European element of the programme monitoring. This, however, is not an argument for the ECB to be a formal member of programme monitoring team. It is an argument for more economics staff at the Commission or perhaps a system of secondments from the ECB to the Commission.

With so many new challenges facing the ECB due to its new role as bank supervisor, its leadership should be happy to stay away from the additional problems associated with monitoring structural adjustment programmes.

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NOTES



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The various roles of the ECB in the new financial architecture

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NOTE

Abstract

Since the eruption of the recent financial crisis, financial stability roles have been taken on or assigned to the ECB. They were not envisioned by the writers of the Treaty and some of these new roles are to be permanent. This essay describes the ECB's new responsibilities. It considers the positive and negative externalities that these roles have for each other and for the central bank's role as a conventional and narrowly defined monetary policymaker; it discusses whether the ECB is the right institution for these tasks. It also considers where the new roles leave conventional monetary policy and what institutional changes to the ECB and the Eurosystem might enhance the new financial architecture.

CONTENTS

EXECUTIVE SUMMARY	49
1. INTRODUCTION: THE NEW ROLES OF THE ECB	50
2. SYNERGIES AND POSSIBLE CONFLICTS OF INTEREST	52
2.1. The ECB and the ESRB	52
2.2. The ECB and the Troika	53
2.3. The ECB and the Single Supervisory Mechanism	54
2.4. Unconventional monetary policy	55
3. THE POSITION OF THE MONETARY POLICYMAKER IN THE NEW EMU ARCHITECTURE	57
4. HOW MUST THE EUROSISTEM ADAPT	60
4.1. Get rid of the NCBs	60
4.2. Move to a system of regional central banks	61
REFERENCES	62

EXECUTIVE SUMMARY

- The financial crises have necessitated the ECB taking on financial stability roles that probably would have horrified the writers of the Treaty. In addition to its roles as lender of last resort and market maker of last resort the ECB is to have three permanent financial stability roles in a post-crisis financial architecture.
- The ECB is to have a macro-prudential supervisory role through its participation in the European Systemic Risk Board. This is unfortunate: supervisors, regulators and monetary policy makers are precisely the people who should *not* populate a systemic risk board.
- The ECB is to have a permanent role in the provision of financial assistance to fiscally troubled euro area Member States as a member of the Troika. This is perhaps unavoidable, but it gives too much power to the ECB and it damages its reputation.
- The ECB is to have a permanent role as supervisor and possibly as a member of the resolution regime in a Banking Union. This is good news: the positive informational impact of the ECB's banking supervisor role on its lender of last resort and market maker of last resort functions outweighs any downsides of this new role.
- The ECB will continue to be the market maker of last resort and the lender of last resort to both financial firms and sovereigns. This is a proper role for a central bank but it requires a *vastly* different amount of accountability than the institution now has.
- The belated realisation that the ECB should have financial stability concerns should not cause policy makers to forget that the overriding mandate of a monetary policy committee should be the provision of low and stable inflation.
- In the new architecture the ECB is a political institution with multiple goals besides monetary policy. Monetary policymakers need to be shielded from the opportunism of external policy makers and from that of policy makers *within* the ECB. The ECB should farm out monetary policy – defined as the choice of policy rates and the amount of quantitative easing – to an independent and small committee of experts.
- Doing away with the national central banks and moving to a system of regional central banks would help the ECB to adapt to its new architecture.

1. INTRODUCTION: THE NEW ROLES OF THE ECB

In 2004 the ECB stated that “The ECB ... is the embodiment of modern central banking: the overriding objective of its monetary policy is price stability; it is independent with a clear and precise mandate.”¹ Indeed, the parts of the Treaty dealing with central banking focus almost entirely on monetary policy. Without ambiguity it sets out the provision of price stability as the primary objective of the ECB; it says little that is concrete about the provision of financial stability. It also gives the ECB extraordinary operational and functional independence that is intended to shield it from political pressure.

Until the emergence of the North Atlantic credit crisis on 9 Aug 2007 the ECB presided over a benign economic environment, maintaining stable if slightly above target inflation; it played no important role in the provision of financial stability. Article 105(5) of the Treaty states, “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.” [Italics mine] The writers of the Treaty intended the role of the ECB/ESCB as a solely supportive one; the competent national authorities were envisioned as the primary caretakers of financial stability.

During the past six years, however, necessity has caused the ECB to depart from its originally intended narrowly defined monetary policy role. Conducting blatantly quasi-fiscal policies via the National Central Banks (NCBs), it has acted in a fashion that, if they were unaware of the circumstances, would have appalled the writers of the Treaty. It has deliberately subsidised financial institutions with its lending operations and it has purchased highly risky euro area government bonds outright in secondary markets as part of financial support schemes for fiscally endangered sovereigns.²

The ECB was forced to act – taking on tasks that it was not assigned and doing things that it was not supposed to do – because no other European or national institution had the necessary funds and the willingness and ability to act at the speed of crises. However, this necessity-driven enhancement of the scope and scale of the ECB’s roles and powers was never approved by the European Parliament or by other legitimate stakeholders, such as the national parliaments. This is costly to the democratic legitimacy of the ECB. Therefore, it is sensible that the role of the ECB in a post-crisis financial architecture is being specified more carefully. It appears that the ECB will have at least three official permanent financial stability responsibilities. It will also continue to be the lender and market maker of last resort, but it is to be hoped that its new official roles will decrease the scale of these operations. In addition, by making it easier to distinguish illiquid but solvent from insolvent institutions, it should make them less quasi-fiscal in nature.

The first new permanent official role of the ECB in the area of financial stability is in the provision of macro-prudential oversight through its participation in the European Systemic Risk Board (ESRB). The ESRB, established by legislation of 16 Dec 2010, is a component of the European System of Financial Supervision (ESFS), the EU’s financial supervisory framework that was set up as a response to the financial crisis. Its task is to identify sources of systemic risk to the EU financial system and to provide warnings with the intent of preventing or mitigating such risks. The President and the Vice-President of the ECB and the heads of the NCBs of all EU Member States are all members of the ESRB’s General Board. The Secretariat is provided by the ECB and is located in Frankfurt. For the first five years the ESRB is to be chaired by the President of the ECB.³

¹ Scheller (2004), p. 12.

² See Vaughan and Finch (2013) for a discussion of the LTROs in this context.

³ See the ESRB’s website: <http://www.esrb.europa.eu/home/html/index.en.html>.

Second, the ECB is to have a permanent role in the provision of financial assistance to fiscally troubled euro area Member States as a member of the Troika (the IMF, the European Commission (EC) and the ECB) component of the European Stability Mechanism (ESM). The ESM, established by treaty on 2 February 2012, is a permanent rescue facility, set up to provide financial assistance programs to euro area Member States that are in severe financial difficulty or whose financial sectors pose a stability risk.⁴ After a request for assistance is received by the ESM, the Troika evaluates the threat to the euro area, decides whether a macroeconomic reform program can realistically be expected to restore fiscal sustainability and considers the amount of financing that is required. On the basis of the Troika's analysis, the Board of Governors of the ESM can mandate the Troika to negotiate a Memorandum of Understanding, outlining a reform program. The Board of Governors will decide the terms and conditions of the program and the Troika will monitor compliance.⁵

Third, the ECB is to have a permanent role as supervisor and possibly as a member of the resolution regime in a Banking Union. The first component of a Banking Union is a Single Supervisory Mechanism (SSM). The European Parliament and the Member States of the euro area agreed upon the specifics of the SSM on 19 Mar 2013 and it is set to become operational in late 2014.⁶ Under the SSM, the important banks of Member States of the euro area and of any other Member States of the EU that choose to participate in the Banking Union are to be supervised by the ECB. Less important banks are to be supervised by national authorities with the ECB having ultimate authority. This task gives the ECB enormous power, as it will be able to license and authorise credit institutions.

A fourth possible role that the ECB may play is as member of a resolution regime in a Banking Union. It is currently unclear what this regime might look like or the exact nature of the ECB's role. On 10 July 2013 the Commission proposed the details of a possible Single Resolution Authority (SRA).⁷ The ECB is to be involved in this mechanism as the banking supervisor and as advisor. Under the proposed SRA, when a bank in a country that is a member of the Banking Union gets into severe difficulty this is to be communicated by the ECB. Then the Single Resolution Board of the SRA is to prepare the recovery or resolution of the bank. This board is to be made up of representatives from the ECB, the EC and the national authorities. On the basis of this, or on its own initiative, the EC is to decide whether and when to place a bank into recovery or resolution and to set out a framework. The national authorities are to be in charge of the execution of the plan with the Board playing an oversight role. A Single Bank Resolution Fund is to be set up under the control of the Board to ensure medium-term funding support. Policy makers hope to reach agreement on the SRA by the end of 2013 so that it might come into force by 2015. This is somewhat heroic, however, as it is hard to imagine the national authorities agreeing to grant such sweeping powers to the EC.

⁴ Once a single supervisory mechanism is in place, the ESM will be able to recapitalise financial institutions directly.

⁵ See the ESM's website: <http://www.esm.europa.eu/>.

⁶ See Barnier (2013).

⁷ See European Commission (2013).

2. SYNERGIES AND POSSIBLE CONFLICTS OF INTEREST

This section considers the synergies and possible conflicts of interest associated with the new roles of the ECB, its crisis roles of lender of last resort and market maker of last resort and its original role of monetary policy maker within a narrow price stability mandate.

2.1. The ECB and the ESRB

Predicting even the incidence of financial crises has proved difficult for economists; predicting the timing is impossible. A more practical alternative is to measure the vulnerability of the system to systemic risk. That is, to assess how vulnerable is the financial system as a whole, should one or more financial institutions fail for idiosyncratic reasons. Measuring the early warning symptoms of systemic risk is a difficult and expensive but important task. If the causes of the systemic vulnerability can be addressed, a financial crisis might be averted.⁸

Collecting and storing the necessary data to measure systemic risk is a monumental task, meriting an agency of its own. Interpreting the data requires an array of talent: macroeconomists to determine whether a capital adequacy requirement is pro-cyclical; experts in money and banking with an understanding of incentives to point out that although securitisation improves risk, unrestricted securitisation destroys the incentive to evaluate and monitor borrowers; microeconomic general equilibrium theorists and game theorists to develop an understanding of how systemic risk might propagate; accountants to realising that implementing a particular accounting standard could force banks to understate the fair value of their assets in a crisis; practitioners who know how their latest clever regulatory or tax arbitrage is adding to balance sheet risk. In addition to needing different types of talent, the board needs people who think creatively and are not afraid to espouse novel ideas.

There is one type of person who should not serve on a systemic risk board: a member of a body that has some responsibility for supervision, regulation or monetary policy. There are four reasons for this. First, there is a clear conflict of interest. Systemic risk is typically to a great extent the result of supervisory and regulatory failures and it might be worsened by monetary policy failures. These failures are more likely to be spotted and reported by independent observers than by the perpetrators. Second, supervisors (and regulators) are famously easy for those who are supervised to capture – not just through outright corruption or through the supervisor's hope of future profitable in the industry that he is supposed to be supervising, but through cognitive capture induced by regular contact and interaction among the supervisors and the supervised. Third, career concerns may stifle members of bureaucratic institutions from voicing unconventional and possibly unpopular ideas. Fourth, if measuring and warning of systemic risk system is important – and it is – the EU should find people who are not otherwise employed to do it; it should be a full-time job. The President of the ECB is the head of a large institution. He is responsible for interactions with home and foreign governments and foreign central banks. He is a monetary policy maker and a supervisor and possibly involved in a resolution regime. How much time is left for him to ponder systemic risk?

The EU's response to the need for a systemic risk early warning system is not entirely what one might have hoped for. Its assigned tasks are sensible enough. It is supposed to determine what the relevant data are, collect them and analyse them with the intent of identifying and prioritising systemic risks. It is to issue public warnings of systemic risks and to make public recommendations of remedies.

⁸ See Sibert (2010b) for a discussion of systemic risk boards.

If it determines that an emergency might arise it is to issue a confidential warning and assessment of the situation to the European Council. It is to follow up on and to monitor the response to its warnings and recommendations, cooperating with other parties to the ESFS if appropriate. The design of its governing body, the General Board, is less satisfactory.

The General Board of the ESRB is made up the following voting members: the President and Vice President of the ECB, the Governors of the NCBs of the EU Member States, one member of the European Commission, the Chairman of the European Banking Authority, the Chairperson of the European Insurance and Occupational Pensions Authority, the Chairperson of the European Securities and Markets Authority, the Chair and two Vice Chairs of the Advisory Scientific Committee and the Chair of the Advisory Technical Committee. There are also the following non-voting members: a representative from each of the Member States' national supervisory authorities and the President of the Economic and Financial Committee. This group is made up almost entirely of members from central banks and other supervisory and regulatory agencies. There is too much overlap in its expertise. The members are already employed elsewhere. The ludicrously large size of the group means that there is a lot of human capital, even if it is too homogeneous. But, it is also likely to ensure that there will be overwhelming process losses due to coordination problems, free riding and poor information sharing. It would be better if the ECB/Eurosystem had been left out of this venture altogether, rather than providing the majority of the voting members.

2.2. The ECB and the Troika

The need to bailout Greece in 2010 led to the creation of the Troika. The ECB needed to be involved both to ensure that the bailout was consistent with European norms and because of its financing capacity. Once the ECB was involved it was necessary to add the EC to ensure legal compliance. The northern European countries were insistent that the IMF be involved because neither the EC or the ECB has any experience with systemic crises, sovereign default or the design of fiscal-financial adjustment programmes, because the IMF would be more likely to insist that funding came with tough conditionality, and to share the cost. A second bailout for Greece and bailouts for Portugal, Ireland and Cyprus followed the initial Greek bailout.

There are a number of difficulties and potential difficulties associated with the ECB's involvement in the Troika. First, giving the power to make both conventional and unconventional monetary policy, supervisory and possibly resolution authority, and a role in design and monitoring financial assistance programs to a single institution makes that institution way too powerful. Second, it may stifle useful dissent within the ECB on other issues. A NCB president might be less willing to express an unpopular idea about, say, monetary policy if his country needs or might need a financial assistance program.

Third, membership in the Troika has created animosity towards the ECB. The Troika is heartily disliked in Greece; it is believed that the Troika's insistence on austerity has exacerbated the recession. This belief has been bolstered by a recent IMF report admitting that it had underestimated the costs to Greece of the austerity.⁹ The Troika's approval of the harsh terms of the initial proposal for Cyprus, which called for even small and insured bank depositors to lose money, and its later back tracking also caused the Troika to appear bumbling as well as ruthless. Dislike for the Troika might in the extreme translate into dislike for the euro and viewing the Troika as incompetent is not good for the ECB's credibility in monetary policy.

⁹ IMF (2013).

Both the accumulation of too much power and the hostility toward the ECB, resulting from its perceived severity and ineptness, are damaging to its legitimacy in all of its roles.

IMF reports tend to be characterised by polite restraint and, especially in this light, the tone of the June 2013 report on the 2010 Greek bailout is damning of the Troika arrangement.¹⁰ The Fund appears to have found the Troika arrangement to be one involving too many cooks: it had to negotiate first with the ECB and the EC and then with Greece. It says that coordination was good “under the circumstances”, but the program documentation was “voluminous, overlapping and subject to varying degrees of secrecy. The Fund also expressed irritation at the two European Troika members’ initial refusal to even consider debt restructuring.

The IMF seems to feel that the EC and the ECB added little in the way of expertise. It noted the ECB’s current lack of expertise in banking supervision, but saved its more scathing remarks for the EC. It noted that the EC had expertise in structural reform, but was more concerned about compliance with EU norms than fostering growth and “was unable to contribute much to identifying growth-enhancing structural reforms.” (p. 31) It added that the EC tended to draw up policy positions by consensus and “had enjoyed limited success with implementing conditionality under the Stability and Growth Pact” (p. 31). It had, the report said, no experience with crisis management.

The ECB’s involvement in financial assistance programs was unavoidable. It is not obvious what the Troika should be replaced with, however, the excess of power it concentrates in the ECB, the cost to the ECB’s reputation, the need to involve the EC, the European component’s refusal to consider obvious possible solutions, the difficulties associated with too many policy makers having responsibility and the superior expertise of the IMF staff all suggest that it would be better if the Troika were rethought after the current bailout programs come to an end.

2.3. The ECB and the Single Supervisory Mechanism

As noted, the first step toward Banking Union involves the ECB taking on the role of single supervisor of most of the euro area banking system and being ultimately responsible for the supervision of the rest of the banking system. This should be of great benefit to the central bank in its lender of last resort and market maker of last resort roles. Financial crises can happen in an instant and if the ECB is also the supervisor of the euro area’s banks, then its detailed knowledge of the key banking institutions will be invaluable in determining whether a bank is insolvent or merely illiquid, and in assessing the liquidity needs of illiquid institutions.¹¹

There are other interactions between the central bank’s role of supervisor, its role of monetary policy maker and its role as protector of financial stability. Some are good and some are bad, but on the whole they are less important than the beneficial effect of the ECB’s banking supervisor role on its lender of last resort and market maker of last resort roles. On the positive side, supervisors that are regularly in contact with bankers will learn useful information about financial markets and systemic risk. The existence of credit default swaps, collateralised debt obligations, and equity tranches of mortgage-backed securities would have come as less of a shock to many central bankers if they had spent more time talking to practitioners. Practitioners may not always like talking to central bankers, but if the central bank is a supervisor they will. There are fewer obvious synergies for conventional monetary policy but some central bankers report that local information they gain from their banking contacts is useful for monetary policy.

¹⁰ IMF (2013).

¹¹ See Sibert (2012) for a discussion of this.

In addition, it is possible that the central banks' improved ability to disseminate information to bankers could make it easier to communicate their monetary policy strategy and thus to improve the central bank's credibility.

There are some harmful side effects of the monetary policy maker being the supervisor. First, it has been argued that if the central bank is concerned about the financial health of the banking sector – and indeed of individual banks – it will be tempted to sacrifice its monetary policy mandate to improve conditions in that sector, say by not tightening monetary conditions enough when price stability considerations mandate it because of concerns for the viability, or even the profitability, of the banks it supervises. Central bankers as supervisors are no more immune to regulatory capture by the banks they supervise than any other supervisors. Second, it has also been argued that supervisory failures will be seen as general incompetence of the central bank and that this could diminish its credibility even in the area of monetary policy. Third, it can also put pressure on monetary policy makers. If the supervisor can close down a country's banks (by suspending or withdrawing its banking license), then an NCB head who cares about his country's banks may be less likely to oppose members of the Executive Board on monetary policy matters, even when NCB's governor's independent judgment (based on Euro-Area-wide price stability considerations) would call for such an opposing stance. Fourth, combining both supervisory and monetary policy functions in one institution might make that institution overly powerful. Finally, there is little overlap between the expertise that is necessary for supervision and the expertise that is necessary for monetary policy.

The governance structure of the ECB when it takes on its supervisory role will involve a separate Supervisor Board. This is helpful in reducing the harmful interactions between supervision and monetary policy. However, as long as the same people are over both functions, the EC's claim that, "Clear separation between the ECB's monetary tasks and supervisory tasks is fully ensured" seems a bit hard to believe.¹²

As a result of the temptation for politicians to use monetary policy for opportunistic reasons and because the provision of low and stable inflation is a technical and primarily apolitical task, the ECB was given an extraordinary amount of both operational and functional independence over monetary policy. However, even if the sole role of the institution were the relatively technical and apolitical one of making monetary policy aimed at a narrow macroeconomic objective – price stability – the substantive accountability void of the ECB – an unelected body in a supposedly democratic society – is somewhat distasteful. Given its unconventional monetary policy roles and given its imminent new powerful and deeply political roles as head of the supervisory mechanism, dominant player in the ESRB and likely key participant in the bank recovery and resolution mechanism, the ECB needs a standard of accountability *vastly* different from the one that now prevails.

2.4. Unconventional monetary policy

In response to the exigencies of the crisis the ECB has made deeply political (including redistributive) decisions and undertaken blatantly quasi-fiscal lending and asset purchase operations. After the current round of crises, it will continue to stand ready to act as market maker of last resort and lender of last resort, both to financial firms and sovereigns. This is a proper role for a central bank but it requires far more *formal* accountability (the provision of information to those to whom the ECB is accountable – the European Parliament and the citizens of the Eurozone) as well as *substantive* accountability (the imposition of sanctions on the ECB by the European Parliament (or some other suitable designated body acting on the behalf of the European Parliament) in case of incompetent or in other ways inappropriate actions by the ECB) than is currently the case.

¹² Barnier (2013).

A system where the central bank can buy or sell a security at any price and value the collateral any way it wants, where it can choose any euro area financial firm as counterparty (without offering similar terms to all other eligible counterparties); where the central bank never has to say what the prices paid or received were or how they were decided; where it never has to reveal what haircut on collateral is applied or how it was decided; where the central bank never has to say who its counterparties for particular transactions were or how they were chosen; and where the central bank can even refuse to divulge who is making these decisions is, at best, open to the suspicion of either favouritism or corruption. This is harmful to the legitimacy of the ECB and to the legitimacy of all other EU institutions, including the European Parliament and the European Court of Justice.

A few examples of why more accountability is in order come to mind. One is the NCB of Luxembourg's policy of allowing subsidiaries of Icelandic banks to borrow from it using each other's debt – known as *love letters* – as collateral.¹³ This appears to be a result of extraordinary incompetency or worse, but perhaps there was some good reason for the central bank's actions. In either case, the public should be told the details of the transactions. If the central bank was incompetent or if corrupt practices were involved, the public should be reassured that staff and procedural changes have been instituted to improve matters. If there was some good reason for the actions of the central bank then it should divulge them: the perception of incompetency or graft harms the legitimacy of the Eurosystem as a whole. Another example was the unlimited one-year fixed rate provision of June 2009, which may have transferred EUR 1 billion from taxpayers to delighted banks.¹⁴ Tax payers might wonder if the ECB was playing reverse Robin Hood and since the tax payers are the ones footing the bill, they have a right to know whom they are subsidising and to what extent. A third example is the ECB's Greek sovereign debt purchases. It seems to be widely believed that the ECB's purchases were at far above market value. And, miraculously, over the life of the SMP, French exposure to Greece, the largest in the euro area at USD 86 billion in 2008, has plummeted.¹⁵ Apparently the NCBs selected and sought out the fortunate counterparties whose Greek sovereign debt holdings they offered to acquire under the SMP at more-than-fair prices. One does not have to have too active an imagination to suspect that euro area taxpayers were – without their knowledge or consent – helping to recapitalise the French banks.

The ECB's continued extraordinary secrecy can be contrasted with what is now required of the Federal Reserve System. Section 1109(c) of the Dodd-Frank Act required the Fed to publicly reveal the details of its emergency lending between December 2007 and July 2010 and requires it to publish details of loans made after July 2010 with a two-year lag. In December 2010 the Fed put this information on its website, including the identity of the counterparty, the size of the transaction and the terms. The Dodd-Frank Act exempted discount window borrowing during the crisis but in March 2010 the Supreme Court ordered the Fed to disclose the details of these transactions as well.

¹³ See Sibert (2010a) for a discussion of this.

¹⁴ See Buiter (2009).

¹⁵ See Reuter (2010) and Steil and Walker (2013).

3. THE POSITION OF THE MONETARY POLICYMAKER IN THE NEW EMU ARCHITECTURE

The financial crisis has reminded us that a central bank has a financial stability role but this should not cause policy makers to forget that the overriding mandate of a monetary policy committee should be the provision of low and stable inflation and that, subject to that and without prejudice to that, to support real economic activity. It is vital that policy makers remember the economic, social and human costs of high, unstable and unpredictable inflation and not take the reasonably good inflation performance of the last three decades for granted. This good performance was the result of revolutionary changes in central bank design and a strong commitment to toughness on inflation. It should not be compromised as a by-product of renewed concern for financial stability.

Monetary policy presents two challenges to institution designers. First, the monetary policy-making committee (MPC) must both be designed in a way and given a mandate that ensures that the monetary policy is likely to be designed and implemented well. Second, an oddity of monetary policy as a technical task is that current outcomes depend upon expectations of what policy makers will do in the future. As a consequence it is desirable for monetary policy makers to be able to credibly commit themselves to an optimal (contingent or conditional) path or rule, and this means shielding them from even benevolent political influence that would undermine their credibility.

An MPC should be told to achieve a single and easy to measure outcome and this outcome should be an inflation target of, say, two percent. Monetary policy makers cannot systematically influence real variables and smoothing the path of real variables, while perhaps sometimes possible, is difficult. Thus, an inflation target is the only natural overriding goal for a monetary policy committee.

The policy rate should be decided by a vote and the votes should be made public with little delay. A clear and readily observable goal and published votes make it relatively easy to evaluate the competency of individual group members. This is especially beneficial when committee members have career concerns or otherwise care about how competent they are perceived to be. It is an empirical result that group members are likely to exert the most effort when their individual efforts can be readily observed and evaluated.¹⁶ Published votes may also enhance credibility. The desire to appear competent by meeting the mandate may dampen any incentive to inflate too much for opportunistic reason. Finally, monetary policy committees deliberate for only a few hours. It is probably better – and less conducive to acrimony that might impede cooperation – to focus on how best to achieve a two percent inflation target than to spend the time debating over what inflation rate is the best outcome.

The argument that voting and publication of individual votes of the Governing Council would expose members, especially NCB governments, to pressures from their national political policy makers to vote the national interest instead of the euro area as a whole's interest is risible. It is secret voting or the lack of any formal voting that provides the anonymity and lack of verifiability that permits and encourages NCB governors to act as national delegates rather than as trustees for the euro area as a whole.

The size of an MPC matters for its performance. A group that is assigned a technical task should probably have five to nine members. Fewer members might mean that there is too little human capital. More members that there is free riding, there are coordination

¹⁶ See, for example, Williams et al (1989).

problems and the group does not share information well. The ridiculously large Governing Council has 23 members and will have 24 after Latvia joins on 1 Jan 2014.

If each member gets a ten-minute opening statement four hours would pass before any actual debate would begin. It is no wonder that an unknown subset of the Council, probably the Executive Board, makes a decision prior to the meeting and presents it as a fait accompli.

The introduction of forward guidance makes the need for a small group even more important and urgent. On 4 July 2013 the Governing Council announced that they expected their policy rates to remain at current or lower levels for an extended period of time. This type of *forward guidance*, promising to pursue an expansionary policy longer than they might otherwise be expected to do with the intent of protecting or promoting a fledgling recovery, was also employed by the Federal Reserve in December 2012 and the Bank of England in August 2013. Although some forward guidance can be educational, meant to instruct the market on monetary policy makers' views and understanding, the recent forward guidance has and is intended to have a commitment element.¹⁷ Inflationary expectations and medium- and long-term nominal interest rates depend upon what market participants expect central banks to do in the future. In the absence of a large and unanticipated change in economic conditions, if central bankers deviate from a firm statement about their future plans they may call into question their competency and credibility. If deviating from the interest path implied by forward guidance is costly to monetary policymakers' reputations, this may cause market participants to regard such statements as more than cheap talk. However, this useful form of commitment is likely to be something that works better for small groups where votes are taken and publicly announced than for large and anonymous groups. If Bank of England Governor Mark Carney reneges on his public commitment in the absence of a compelling change in circumstances, he will appear a fool; if individual members of a 23-member Governing Council vote for a change in course of action in private, they can deny either their dissent or their ever being in favor of the original statement of plan. In short, they lack credibility.

Making monetary policy – narrowly defined as choosing a policy rate or quantitative easing – is a specialised technical task. Monetary policy involves a group observing current fundamentals and forming a judgment about future fundamentals and then choosing the policy interest rates that are the most consistent with a stable path of inflation that is close to the target; it is a task best done by research economists with a specialty in macroeconomics. One does not hire career bankers or editors or politicians to fly passenger jets or perform neurosurgery and they should not be making monetary policy.

Nationality should not be a criterion for appointment. It is not consistent to argue that members should not take their own country's interests into consideration above those of the Euro area as a whole and to also claim that national interests need to be represented on the committee. Having the Presidents of the NCBs as automatic members of the Governing Council is a historically understandable anomaly, but one that should be eliminated. The UK and Iceland have appointed non-citizens to their Monetary Policy Committee (including as the Governor or acting Governor); the ECB should be willing to do this, too.

The head of the MPC and the head of a central bank need not be the same person. The head of the MPC should be highly qualified as a research economist and he (or she) should have the ability to run a meeting; making sure that all members participate and share information and that the decision reached by the group is perceived by members to be a fair reflection of their collected individual beliefs. However, the head need not know how to

¹⁷ See Praet (2013).

run a large organisation or how to interact with home and foreign political leaders. He need not have expertise in bank supervision.

Being the head of the ECB requires a different set of skills, including some expertise in supervision and regulation and political and management abilities. Looking for one person who has the talent to make monetary policy and run a large, complex and deeply political organisation has caused the United Kingdom to conclude that no available British citizen is up to the job, the European Council to conclude that no available euro area woman is suitable for the ECB's Executive Board and it is creating great consternation in the United States over the appointment of the next FOMC chairman.

Where do the needs of monetary policy fit into a new EMU architecture? The monetary policy makers need to be protected from political pressure; consistent with this the ECB enjoys extraordinary independence. But it is not elected and it plays an important role: it needs to be formally accountable. It gets some legitimacy from the Treaty. It should not take on tasks that it was not assigned as the ECB was forced to do. It must demonstrate its competency through greater formal accountability and by introducing substantive accountability for the first time. Votes should be taken and recorded. Although transcripts are likely to hinder the sharing of information and ideas, minutes should be produced, recording individual votes and key views and opinions, possibly attributed.

In the new architecture the ECB is a political institution with multiple goals besides monetary policy. Individual policy makers have their own career concerns and political interests. Just as the monetary policymakers need to be shielded from the opportunism of external policy makers, they must be protected from policy makers *within* the ECB. The ECB should farm out monetary policy – defined as the choice of policy rates and the amount of quantitative easing – to an independent and small committee of expert research economists.¹⁸

¹⁸ The five-person Icelandic MPC is peripheral to the Icelandic central bank and aside from an advisory role it is charged solely with choosing policy rates.

4. HOW MUST THE EUROSISTEM ADAPT

Three things would help the ECB to adapt to its new architecture. First, as described in the previous section, the monetary policy role of the central bank should be separated from its other roles. Second, as described in Section 2, the ECB must become more accountable if it is to retain its legitimacy. Third, while politically challenging, it would be desirable to do away with the NCBs and move to a system with a single Euro-Area-wide central bank, the ECB, and a number of regional central banks. Although these regional central banks could be mere branches of the ECB, a better design would be a system of regional central banks with separate legal personalities and real power, similar to US Federal Reserve System.

4.1. Get rid of the NCBs

The Eurosystem should be redesigned, eliminating the NCBs and replacing them with a few regional central banks.¹⁹ There are several reasons for this. First, it would make the Governing Council more effective. It would reduce it to a manageable size. It would eliminate the undesirable feature that, at least in principle, in the monetary policy decisions the Malta NCB has the same weight as the German NCB. Fewer Governing Council members who each have more power is also less likely to lead to enforced consensus and to more transparency in decision making.

Second, a system of regional banks would end the contradictory idea that each country, through its NCB, must have a seat on the Governing Council while at the same time no NCB policy maker is supposed to seek or take instruction from his own government and his own government must not seek to influence him (Article 130 of the Treaty). It would also reduce the likelihood that any government would be able to bring explicit or implicit pressure to bear on a Governing Council Member.²⁰

Third, having regional, rather than national, central banks would reduce the importance of the negative externality associating with the current lending rules. euro area banks and their subsidiaries borrow from the Eurosystem through the NCB of the country in which they are located while losses from Eurosystem operations undertaken for monetary policy purposes are shared across the Eurosystem according to ECB capital shares.²¹ This has undoubtedly led to overly lax lending standards in some countries. Loan operations are subject to guidelines laid down by the ECB, but it appears that there is some (perhaps considerable) flexibility and NCB discretion. While the ECB's penchant for opacity makes it difficult to be certain, concerns have been expressed that some NCBs have been more lax than others in evaluating the collateral offered by their own banks. The Spanish central bank is sometimes suggested as an example of this.

Fourth, regional banks would remove the requirement that small countries have their own NCBs. It is difficult for small countries to support an adequately staffed central bank. The German Bundesbank employed 9,543 people (in all of its offices) in 2013; the Central Bank of Malta employed just 321.²² Even if the staff of a small central bank are highly qualified, there may be just too few of them to be able to adequately brief the President on both monetary policy and supervisory issues and to carry out the bank's lending activities in a competent fashion.

¹⁹ A recent article advocating this is Burda (2013).

²⁰ It is less clear that it would reduce Governing Council Members voting for their local interests; Meade and Sheets (2005) find that regional policy makers in the United States take into account regional unemployment when choosing interest rates.

²¹ An exception is the Emergency Liquidity Assistance, under which approved NCBs can offer support in exceptional circumstances and on a case-by-case basis, typically against lower quality collateral than is accepted by the ECB. Losses for these loans are born by the lending NCB.

²² Central Bank of Malta (2013) and Deutsche Bundesbank (2013).

One wonders, for example, whether the subsidiaries of the large Icelandic banks could have borrowed from the Bundesbank using each other's debt as collateral if they had had subsidiaries in Germany. Regional banks covering large regions would have the staff necessary to carry out lending operations efficiently.

Fifth, it is possible for a NCB to become insolvent. If this were to happen its national government would be expected to recapitalise it. However, if the sovereign itself were insolvent this might not be possible. Under the current rules, resident banks and resident subsidiaries of banks that are headquartered elsewhere would not be able to borrow from the Eurosystem if their home or host country NCB were insolvent. This would leave ECB policy makers with the unpleasant choice of allowing a national banking system to fail or having the rest of the Eurosystem take on the recapitalisation of the insolvent NCB. Regional banks would be more diversified and probably less prone to making risky loans for nationalistic reasons than would national banks; hence they are probably less likely to become insolvent.

4.2. Move to a system of regional central banks

If the national central banks could be eliminated they should be replaced by a system of a small number of regional banks. The heads of these regional banks should form a large part of the membership of the Governing Council of the ECB. There are several reasons why it is important to have regional banks with independent power, rather than to have only the ECB or the ECB and a system of branch offices.

One reason is that decentralising the Governing Council improves the structure of the MPC.²³ A large body of empirical social psychology research demonstrates that groups tend to make decisions that are more extreme than the initial inclination of their members.²⁴ This raises the specter of an MPC composed of members who were wondering if tightening policy might be a good idea being transformed into a group convinced that sizable tightening is in order. If all members are employed by the ECB or, worse, if everyone is located in Frankfurt, then it is likely that there will be too much interaction and bonding that would be conducive to group polarisation.

It can be argued that specialised and anecdotal regional information is useful for interpreting trends in aggregate data and for conducting monetary policy. Regional central banks make it easier to gather such information. For monetary policy makers to be credible, it is important that market participants and observers understand how the monetary policy committee views the economy. Local members can assist in disseminating this information. It might be argued that branch offices of the ECB could do these information gathering and providing activities. However, local market participants and market observers are more likely to be interested in listening to and willing to talk to policy makers and people with inside knowledge and real power.

The ECB has a great devotion to consensus. While it has a demonstrated ability to embrace new ideas in the face of overwhelming necessity, it is probably not its nature to welcome changes in thinking. This is partially a reflection of the real responsibility that it bears. Regional banks bear less responsibility and may be more encouraging of diversity in research and policy ideas.

²³ See Goodfriend (2000) for a discussion of the benefits of a system of regional banks.

²⁴ See Sunstein (1999).

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NOTES



DIRECTORATE GENERAL FOR INTERNAL POLICIES
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The various roles of the ECB in the new EMU architecture

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NOTE

Abstract

The ECB is becoming a central element in the New EMU architecture, emerging as an institution with a strong influence in a variety of supervisory roles and tasks, on top of its key mandate of price stability. This evolution in itself is natural. The ECB is well suited for these new roles which require expertise on monetary issues and at the same time overlap with monetary policy tasks and tools. Most of the time this overlap brings positive outcomes. However, risks related to conflicts of interest, moral hazard or time inconsistencies may arise, in particular during deep economic-financial crises. Such risks shall be minimised. The various roles should be designed so as to grant institutions operational independence with an institutional framework and a decision making process shielded from political influence. Political independence necessarily implies strong accountability. Independence may prove difficult to achieve in practice as a result of the many interdependencies between the different roles. Large institutions are slowly evolving bodies and changes rarely come from inside. We would be surprised to see such a self-correcting mechanism at work for some of the EU supervisory authorities. For that reason, aiming at lean decision making bodies is a desirable path to be followed in the future.

CONTENTS

INTRODUCTION	67
1. A PERSPECTIVE ON THE ROLE OF THE ECB	68
2. CHINESE WALLS	70
3. POLICY INSTRUMENTS	72
4. FUTURE DEVELOPMENTS	73
5. CONCLUSION	74
REFERENCES	75

INTRODUCTION

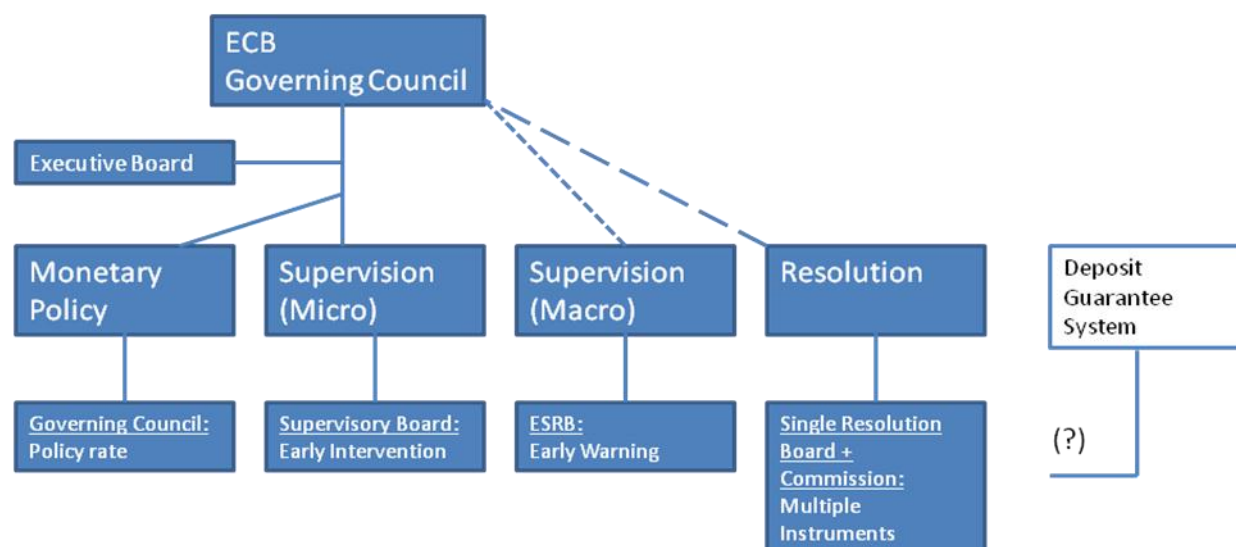
The Monetary Dialogue of September 2013 deals with the various roles of the ECB within the New EMU architecture. The agenda lists a number of interesting issues related to the design of ECB supervisory tasks. In this briefing paper we focus on a subset of questions we find most pressing. In particular we will discuss the current roles the ECB within the EMU architecture, the roles likely to be added in the near future and those which we deem necessary. We do not dwell with the interesting debate concerning the ECB role within the Troika and related issues of financial assistance programmes. Our discussion is very much in line with previous briefing papers we prepared for the Monetary Dialogue. In particular we argue that it is the key for the new institutional architecture to preserve the ECB as an independent and accountable player. At the same time conflicts of interest should be avoided as much as possible. These guidelines sound trivial but they are hard to realise in practice given that the various roles are often related in subtle ways and the policy instruments are interlinked. At the end of this briefing paper we argue in favour of transparent structures of limited size. Tasks should be streamlined without hampering the quality of decision making.

1. A PERSPECTIVE ON THE ROLE OF THE ECB

As a consequence of the financial and economic crisis, the ECB has acquired additional roles and tasks. In addition of being responsible for price stability, the ECB will also play a key role in ensuring financial stability. As discussed in our previous Briefing Papers (2009, 2012)¹, a stable financial system is necessary for the transmission of monetary policy.

Figure 1 provides a sketch of the different tasks attributed to the ECB. On the left side of the Figure we see that the ECB is responsible for monetary policy and micro-prudential policy. The latter role is attributed to the ECB by the Single Supervisory Mechanism (SSM), which is expected to be operational in late 2014. Central in the Figure we see macro-prudential supervision. This task falls under the European Systemic Risk Board (ESRB). The ESRB is an independent body, but is intimately related to the ECB as it is hosted by the ECB and chaired by the ECB president. This is indicated in the Figure by a dotted line. To the right of the ESRB we see the Single Resolution Mechanism (SRM). The current proposal envisages a Single Resolution Board with representatives from the ECB, the European Commission and other relevant (national) authorities. Under the current proposal, the Single Resolution Board would make recommendations and oversee resolutions, but the decision to place a bank into resolution would lie with the European Commission. Given that the ECB would have its representatives within the Single Resolution Board, it also has some influence on resolution. In the Figure this is indicated by a long dotted line.

Figure 1: Distribution of supervisory tasks: current, future, proposed and hypothetical



Source: Author's elaboration.

Finally, on the right hand side of the picture we put the Deposit Guarantee System. In the Briefing Paper of July 2013, we outlined our idea of a Common Deposit Guarantee System.² While a Common Deposit Guarantee Scheme is unlikely to be implemented in the near future, we feel that this will ultimately be a milestone in the ongoing process towards a fully-fledged Banking Union. Since this part of the Figure is hypothetical we have put this in a different colour.

¹ Eijffinger, Sylvester C.W. (2009), *What role for the ECB on financial market supervision?*, Briefing Paper for the Monetary Dialogue of March 2009. Eijffinger, Sylvester C.W. (2012), *Banking Union and a Single Banking Supervisory Mechanism*, Briefing Paper for the Monetary Dialogue of October 2012.

² Eijffinger, Sylvester C.W. (2013), *Deposit Guarantee Schemes*, Briefing Paper for the Monetary Dialogue of July 2013.

With this distribution of tasks in mind, we can briefly go through the different roles of the ECB. We skip the basic tasks of the ECB (foreign exchange operations, definition and execution of monetary policy) and first consider macro-prudential supervision.

Macro-prudential supervision deals with financial stability at the systemic level. It aims at preventing the impact of big crises before these unfold or “to take the punchbowl away as the party gets going” (Borio (2011)).³ It is a necessary complement to price stability, the primary mandate of the ECB. Indeed, the recent crisis highlighted that price stability is not sufficient for macroeconomic stability.⁴

Under the SSM the ECB will supervise euro area banks and banks of EU Member States which decide to join the Banking Union. One advantage of having micro-prudential supervision in the ECB premises is related to the informational synergies with other tasks of the ECB such as the oversight of payment systems.⁵ In addition, the ECB has a lot of expertise on the financial sector stemming from other ECB duties.

Despite the nontrivial advantages, the combination of supervision with monetary policy has also raised concerns among policy makers. For instance, Jörg Asmussen, member of the Executive Board of the ECB, expressed the concern that the ECB primary mandate needs to be maintained.⁶ This suggests a separation of banking supervision from monetary policy, an issue which we revisit in the next section.

From the above description of tasks where the ECB is involved, it should be clear that the ECB has become a central bank with (increasingly) important and complex responsibilities in the euro area financial landscape. In previous briefing papers related to this topic we emphasised (1) the importance of ensuring that the ECB can fulfil its primary mandate in an independent way, (2) the importance of providing sufficient and proper tools to all institutions involved in the emerging supervisory landscape, (3) the importance of avoiding conflicts of interests. The success of the ECB in combining the different responsibilities will depend to a large extent on how well the tasks (as presented in Figure 1) are separated from each other. This is the topic of the next section.

³ Borio, Claudio (2011), *Central Banking Post-Crisis: What compass for uncharted waters?*, BIS working paper No 353, Bank for International Settlements.

⁴ International Monetary Fund (2013), *The interactions of Monetary and Macroprudential Policies*, January 29.

⁵ Eijffinger, Sylvester C.W. (2012), *Banking Union and a Single Banking Supervisory Mechanism*, Briefing Paper for the Monetary Dialogue of October 2012.

⁶ Asmussen, Jörg (2012), *Die Finanzmarktunion als Element einer stabilen Währungsunion?* Speech delivered at Handelsblatt, Frankfurt am Main, 4 September 2012.

2. CHINESE WALLS

There are four tasks which involve the ECB to some extent: monetary policy, micro-prudential supervision, macro-prudential supervision and resolution. The last task has not yet been agreed upon, but it is safe to assume that the ECB will bear non-trivial responsibilities in the Single Resolution Board. In what follows we do not discuss the Common Deposit Guarantee scheme as it is unlikely to be adopted any time soon.

Currently, the relationship between macro-prudential supervision and monetary policy is a topic of intense debate and analysis.^{7,8} The key problems faced by macro-economic policy in the implementation of macro-prudential policy are well known: time inconsistency, imperfect institutions and political influence. In dealing with these issues, policy coordination and macro-prudential supervision by the ECB (as is the case in the current institutional setup) are both warranted. However, multiple mandates require a careful institutional design as accountability becomes a key issue and credibility may be hampered.⁹

The IMF report on the interaction of monetary policy and macro-prudential policy suggests that both policy functions should be distinguished, through separate decision-making, accountable and communicating structures. This issue was clearly recognised with the setup of the ESRB as an independent EU body, responsible for macro-prudential supervision. Although the ESRB is an institution separated from the ECB, the two institutions are "functionally" linked (Figure 1). Most important, the ECB president is also chairman of the ESRB as "Chinese Walls" would be detrimental to the efficiency of macro-economic supervision and would, therefore, make little sense.¹⁰ At the same time, as the same person is responsible for both monetary policy and macro-prudential supervision, he/she may give priority to one objective (price stability or financial stability) if the two were to clash. This is undesirable. A solution could be to formulate priorities. Another solution is to appoint somebody else instead of the ECB President (possibly from inside the ECB) as ESRB chair.

As mentioned in the previous section, separating monetary policy from micro-prudential supervision is necessary as well. However, just as in the case of macro-prudential supervision, this may be hard to achieve. While in theory the ECB could well be in charge of both micro-prudential supervision and monetary policy, in practice the two tasks/responsibilities overlap. There is therefore the risk of mixing up goals and responsibilities of policy makers. To deal with this tension, one needs to be vigilant against political interference and, perhaps, to separate the two tasks.

Micro- and macro-prudential supervision need to be singled out as well. While we may think that these supervisory tasks are mostly complementary, they may conflict at times. This could be because the mandates overlap or because of conflicting views on appropriate policy measures. Tensions between the micro-prudential and macro-prudential supervisor are expected to occur mainly during downturns (IMF, 2013). Collaboration between both supervisors may produce important synergies through the sharing of information and learning about potential risks affecting the financial system at different levels. A dialogue between these authorities may also help their mutual understanding and reduce differences

⁷ Angelini, Paolo and Neri, Stefano and Panetta, Fabio (2012), *Monetary and Macroprudential Policies*, ECB working paper series No1449 July 2012.

⁸ Suh, Hyunook (2012), *Dichotomy between macroprudential policy and monetary policy on credit and inflation*, working paper Federal Reserve Bank of Philadelphia wp 13-6.

⁹ International Monetary Fund (2013), *The interactions of Monetary and Macroprudential Policies*, January 29

¹⁰ Eijffinger, Sylvester C.W. (2012), *Monetary Policy and Banking Supervision*, Briefing Paper for the Monetary Dialogue of December 2012.

of opinion. At the same time there is a need to define clear policy objectives and to clarify responsibilities. The idea is that these supervisors should be complementary, yet distinct. As discussed in the next section, it is unlikely that each supervisor can draw on a truly independent toolbox. A delineation of responsibilities and tasks is a key issue. Osinski, Seal and Hoogduin (2013)¹¹ identify three areas of potential overlap between micro- and macro-prudential supervision. First, an overlap concerning objectives, not clearly assigned to each supervisor. Second, an overlap concerning the assessment of risks, not adequately incorporated in the reaction function of each supervisor. An example is the assessment of the health of an individual institution in the context of Pillar 2 (supervisory review process) of the Basel framework: supervision must take into account the risks arising from the environment in which the institution operates (macro-prudential supervision) and, at the same time, reviewing the individual institution (micro-prudential supervision). Third, an overlap concerning the institutional perimeter (IMF, 2013). This refers to the fact that micro- and macro-prudential supervision may overlap as a result of externalities (i.e. the presence of systemic risks).

The previous discussion illustrates that setting up an institutional framework, whereby micro-prudential and macro-prudential supervision cooperate yet remain separate, is a delicate task requiring careful assessment of mandates, functions and tools.

Another "Chinese Wall" to be discussed concerns the functional separation of the resolution authorities from the other authorities. The current proposal by the European Commission¹² envisages a Single Resolution Board which would prepare the resolution of a bank. In the preliminary as well as in the implementation stage of a bank resolution, the Single Supervisory Board is expected to work closely with national resolution authorities.

In our view (Eijffinger, 2013), a resolution authority needs to be able to work independently and free from political capture. On the basis of the current proposal it is hard to judge whether these conditions are fulfilled. We fear the risks of political "intrusion" in different phases of a resolution task as, for example, the Single Resolution Board will consist of representatives who may come under political pressure. Additionally, the final decision about resolving an institution is going to be taken by the European Commission, a situation we consider to be suboptimal (but we prefer not to dwell with this issue here).

¹¹ Osinski, Jacek and Seal, Katharine and Hoogduin, Lex (2013), *Macroprudential and Microprudential Policies: Toward Cohabitation*, IMF Staff Discussion Note June 2013.

¹² European Commission (2013), *Proposal for a regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European parliament and Council* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52013PC0520:EN:NOT>.

3. POLICY INSTRUMENTS

In the previous section we considered the importance of separating certain roles in the design of supervisory bodies. Each of these roles involved the ECB, to some extent. In this section we return to the policy instruments which are related to these different tasks. We consider whether the policy instruments have implications for the "Chinese Walls" discussed in the previous section.

Let us start with the key mandate of the ECB: price stability. The ECB has a liquidity instrument in the form of the policy interest rate to pursue price stability. As emphasised in a previous paper¹³, monetary policy has been largely successful in maintaining financial stability as well. However, when the ECB is empowered also with the task of protecting the financial system, a conflict of interest may arise. For instance, there might be situations where financial stability and price stability require a different use of the liquidity instrument. In an earlier briefing paper we pointed out that this is likely to be one of the big challenges that current ECB president Draghi will face during his term.¹⁴ Part of the solution to the problem lies in additional policy instruments made available for macro-prudential supervision. Yet, the risk remains that combining monetary policy and macro-prudential supervision may engender price stability (Valencia and Ueda, 2012). Similarly, Cecchetti and Li (2008) show that higher capital reserve ratios for banks could hinder the conduct of monetary policy if monetary policy does not take these capital reserve ratios sufficiently into account. Overall, there is a significant overlap between micro- and macro-prudential supervision. Osinski, Seal and Hoogduin (2013)¹⁵ present a comprehensive list of monetary policy instruments which are used in practice by supervisors' tasks: out of thirteen policy instruments used by micro-prudential supervisors and eleven policy instruments used by macro-prudential supervisors, nine policy instruments overlap. This large overlap suggests that both supervisory tasks are linked. It also underlines the difficulty in separating them in practice.

Conflicts between supervisory roles should be minimised. At the same time, institutional arrangements should be set up in such a way to allow the concerned institutions to deal easily and swiftly with conflict situations when and where they arise. To do so, these arrangements have to ensure clarity on responsibility and accountability. Note that regulation of the financial sector is related to macro-prudential supervision in its broadest sense. Regulation and innovation in the financial sector ensures that supervision is not static. This also implies that the arrangements between the micro-prudential and the macro-prudential supervisor should periodically be revised to assure that they are in line with the current state of the financial system.

¹³ Eijffinger, Sylvester C.W. (2012), *Banking Union and a Single Banking Supervisory Mechanism*, Briefing Paper for the Monetary Dialogue of October 2012.

¹⁴ Eijffinger, Sylvester C.W. (2012), *Banking Union and a Single Banking Supervisory Mechanism*, Briefing Paper for the Monetary Dialogue of October 2012.

¹⁵ Osinski, Jacek and Seal, Katharine and Hoogduin, Lex (2013), *Macroprudential and Microprudential Policies: Toward Cohabitation*, IMF Staff Discussion Note June 2013.

4. FUTURE DEVELOPMENTS

A key conclusion from the above discussion is that in order to avoid or minimise issues such as moral hazard or political influence, the different authorities must be able to work independently: independent from each other and shielded from political influences. Two additional remarks may be warranted.

First, the decision making process of supervisory institutions must be efficient, as financial crisis may need to be resolved very quickly. The functional design of some institutions worries us on this front. For example, the ESRB general board comprises 35 voting members and about 55 non-voting members. It is not easy to see how such a large body can swiftly react in an emergency situation. Second, it looks as if each task or role within the EMU architecture has its own intricate organisational structure. Would it not be more transparent if all entities had a somewhat similar structure?

Large institutional are typically slow to adapt. That is why the Monetary Dialogue could be well suited for a comprehensive discussion of both remarks.

5. CONCLUSION

The ECB is becoming a central element in the New EMU architecture, emerging as an institution with a strong influence in a variety of supervisory roles and tasks on top of its initial mandate, i.e. the conduct of monetary policy with the aim of price stability. This evolution is in itself natural. The ECB is well suited for these roles as they require specialised expertise and overlap with traditional monetary policy issues. The economic literature has a long tradition in addressing such issues as conflicts of interests, time inconsistencies and moral hazard. In the majority of cases, combining different roles in one institution or in several linked institutions works well. However, one should also be aware that, especially during deep economic downturns, the institutional framework and the decision making process may not be easily shielded from political influence. We have emphasised that policy makers need to continue to strive for independent institutions. It should also be clear that such an independency requires strong accountability. While positive steps are being taken in favour of a Banking Union, it is important to be vigilant in the policy design of institutions so as to protect their independence. Institutions are slowly evolving bodies and rarely changes come from inside, in particular when they are big. We would be surprised to see such a self-correcting mechanism at work for some of the EU supervisory authorities.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The various roles of the ECB in the new EMU architecture

Stefan COLLIGNON

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.

CONTENTS

EXECUTIVE SUMMARY	79
1. INTRODUCTION	80
2. THE FUNCTIONS OF THE EUROPEAN CENTRAL BANK	81
2.1 The mandate of the ECB	81
2.2 The functions of a central bank	83
2.3 Financial supervision	86
3. FORM FOLLOWS FUNCTION - OR DESIGNING AN EFFICIENT ARCHITECTURE FOR EMU	89
3.1 Externalities and public goods	90
3.2 Time consistency: rules versus discretion	93
3.3 The political embeddedness of monetary union	95
4. CONCLUSION	96
REFERENCES	97

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 rationale 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 scientists 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 fulfills 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 3 of 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.

Article 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 dilemmas², which require a centralised policy institution in order to minimise damage. The European Treaties have foreseen 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

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

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.

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 represents the value of goods and services⁵. Each asset claim has as its counterpart the

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”.

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.

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 rationale 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 al., 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 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 al. 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 al., 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 US for 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 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 collectively⁶. It also needs an 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

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

able to constrain banks' desire to securitise and sell off their loans to NBFIs by setting differentiated safety margins for collateral lending (Kashyap et al. 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 assumed 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 al. 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 generalised, while the benefits of debt-financed expenditure are largely, but not exclusively, national. Stabilising 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 were⁷:

- 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 and resurrecting intergovernmentalism under the new name of "Union Method"¹¹.

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 rationale 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

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

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 (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 to 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 al, 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 discretionary 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 recessions¹³, 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

¹³ Council Regulation (EC) No 1467/97.

commitment on the part of the euro area countries to swiftly enhance their national budgetary frameworks; ...”

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. <u>Delegation to unified actor</u> ECB, economic government	II. <u>Hard coordination with sanctions</u> Stability and Growth Pact, Excessive Deficit Procedure
	converging	III. <u>Voluntary coordination</u> Open Method of Coordination	IV. <u>Soft coordination by guiding rules</u> 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 greatest achievements 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 defensible to assume that collective preferences are exogenously given in the short run, this is unrealistic over the longer run. Appointing a benign social planner (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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NOTES

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