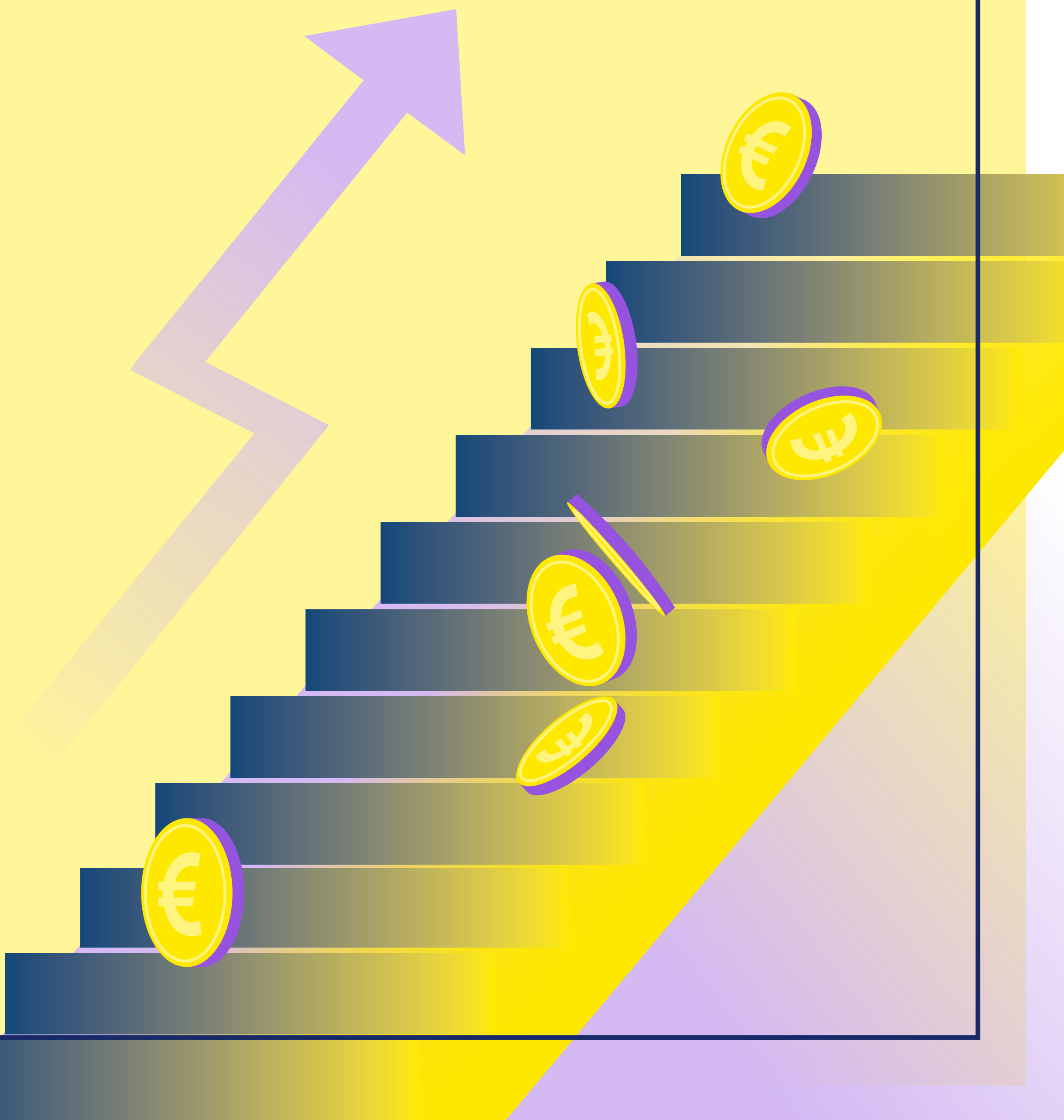
FUTURE EUROPE

ISSUE #02

Inflation Rising

Assessing EU Monetary Policies in a Post-Covid Political Economy



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Issue #02
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June 2022

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PUBLISHER
European Liberal Forum
Rue d'Idalie 11-13, boite 6
1050 Ixelles, Brussels

Co-funded by the European Parliament

ISBN
9 782390 670 391

DOI
10.53121/ELFFEUJ2

ISSN
2790-3354 (Online)
2790-3346 (Printed)

DESIGN
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June 2022

ABOUT

The publishers

The European Liberal Forum (ELF) is the official political foundation of the European Liberal Party, the ALDE Party. Together with 47 member organisations, we work all over Europe to bring new ideas into the political debate, to provide a platform for discussion, and to empower citizens to make their voices heard. Our work is guided by liberal ideals and a belief in the principle of freedom. We stand for a future-oriented Europe that offers opportunities for every citizen. ELF is engaged on all political levels, from the local to the European. We bring together a diverse network of national foundations, think tanks and other experts. In this role, our forum serves as a space for an open and informed exchange of views between a wide range of different EU stakeholders.

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EDITORIAL

Another crisis, another opportunity: inflation as a chance to rethink EU monetary policies

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DANIEL KADDIK
ELF Executive Director

DANIEL KADDIK

The economic integration of EU Member states has proven to be a practicable instrument for ensuring stability on the continent and providing a viable alternative to isolationism. The introduction of the euro as a common currency was an attempt to effect a single market and strengthen economic and political integration. While it is clear that single EU Member States cannot, in the long term, compete alone in international global markets, the single currency project has revealed built in and politically induced flaws. European financial institutions therefore need to be updated and upgraded to ensure the Union's finances are kept safe.

Current attempts to mitigate the effects of the crisis brought about by the COVID-19 pandemic represent an opportunity to assess the resilience of our financial institutions. On the one hand, the crisis has highlighted the long-standing problem of an incomplete banking union, accompanied by political interference in decisions in times of crisis. On the other hand, Member States have used the European Central Bank (ECB) as a source of privileged financing and benefited from historically low interest rates. The ECB's balance sheet has grown to a staggering 9 trillion euros, some 7 trillion more than 2014. Securities purchased under the pandemic emergency purchasing programme (PEPP) and the asset purchase programme (APP) over the pandemic are the latest catalysts for the political role of the ECB.

An expansive monetary policy and purchases of state bonds have kept interest rates and yields on savings at a historic low while encouraging debt for state, business, and private actors. This has disrupted classic banking while encouraging stocks, real estate, and other commodities investments, creating bubbles ready to burst. With actors in the market showing a reduced trust in fiat money and traditional banking business, the emergence of alternative commodities and businesses could represent a way forward and the start of the emergence of a new financial system.

This issue of the Future Europe Journal attempts to add content to the long-standing discussion about the necessary changes in the organisation of the monetary and banking union. Questions about the independence of the ECB during the pandemic vis-à-vis monetary strategy and a comparative analysis of bailout policies may give rise to suggestions for new rules to secure fiscal sustainability in the European Monetary Union.

With crises around us and a persistent expansive monetary policy, we are witnessing daily increases in prices while our purchasing power is rapidly fading, hurting low- and middle-income earners and families in particular. The explosive potential of inflation rates at the beginning of 2022 and the slow realisation of the potential societal fallout is pushing institutions to rethink the principles of monetary union and speed up its completion. The existing endemic crisis in growth rates and inflation in the Euro Area monetary and banking system has created new dynamics affecting the financial and banking system across Europe.

This issue of the Future Europe Journal attempts to add content to the long-standing discussion about the necessary changes in the organisation of the monetary and banking union. Questions about the independence of the ECB during the pandemic vis-à-vis monetary strategy and a comparative analysis of bailout policies may give rise to suggestions for new rules to secure fiscal sustainability in the European Monetary Union. All these topics are brought together by our guest editor, Juan Castañeda, in order to focus the discussion that liberals and democrats have to engage in.

The problem of inflation is far from over and we are moving head-on into the next crisis, exacerbated by the Russian invasion of Ukraine. But, ironically, this may in fact provide a way out of the uncertainty characterising EU monetary and financial integration: the experience of the adverse shock after the war in Ukraine might force the monetary institutions to provide the system with resilient and responsive features, at least in the short term.

SECTION 1

THE POLITICAL ECONOMY CONSEQUENCES OF COVID-19

A More Political Euro?

The 'Displacement Effect' of the Eurozone in Times of Crisis

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Citation suggestion: Juan E. Castañeda, JC (2022). A More Political Euro? The 'Displacement Effect' of the Eurozone in Times of Crisis. *Future Europe*, 2(1), 15–21.

Two different models of monetary integration in times of crisis

No political or economic institution can escape change, either through mutation or adaptation to new conditions. Indeed, sometimes radical change becomes necessary. Ideally an institution should be designed to be flexible enough for change to be easily possible while embedding new information-gathering and knowledge-building in its functionality, so that it allows those in charge of the institution to learn from past mistakes. No institutional setting is perfect, nor can it ever be regarded as complete, and no political project should be taken as permanent or fixed 'once and for all'. The European Union (EU), and the Eurozone in particular, is no exception. When these principles are applied to something such as money, design is critical if its functions are to be preserved as a means of minimising transaction costs in a well-functioning market economy.[1] To achieve this, preservation of the purchasing power of the currency becomes essential. This is the most relevant criterion to assess the functionality of a currency as the universally accepted means of exchange among market participants. This is the benchmark that should be used to assess money and its effectiveness in facilitating transactions, which requires analysis of the legal, political, and economic institutions that affect the creation of money in a given territory.

The euro was envisaged as an essential step in the completion of the European single market and also, let us not forget, as a step forward in the process of enhancing both economic and political integration in the EU. In the language of the Maastricht Treaty, the aim was to achieve an 'ever-closer union among the peoples of Europe' (European Parliament, 2018). As one of the contributors to this issue reminded us some years ago, the euro is also a political project (see Schwartz, 2004) and, I will add, this is particularly apparent and indeed always becomes more relevant during a time of crisis – all the more so in particularly severe or protracted crises. The Global Financial Crisis, the subsequent 'euro crisis', and the COVID-19 crisis have all been accompanied by significant changes within the institutions governing the Eurozone, as well as the political and economic foundations upon which it rests. And this is precisely what this issue intends to address: it will consider how the monetary and fiscal responses to the pandemic have already affected and are likely to affect the 'direction of travel' in the development of the Eurozone, including its main institutions and policies. We will focus on the discussion of the types of economic policies put forward since spring 2020, how they were motivated, and what their main goals were, while paying particular attention to the role(s) played by the European Central Bank (ECB) in driving or financing such policies. Already a key EU institution before 2007, with the last two crises the ECB has effectively developed its functions and transformed itself into the most relevant policy actor in the understanding of recent economic and political events in the Eurozone.

When the last stages in the process of monetary integration in Europe were being discussed, in the 1980s, the most popular model for the adoption of both a common and single currency for all member states was to be found in the so-called Delors report, which featured a very specific vision for monetary integration in Europe. In fact, adopting the definitions used by two of the authors in this issue elsewhere (see Capie and Wood, 2003), what the architects of the euro chose at the time was to create a 'monetary union', which involves the surrendering of the national currencies and the adoption of a single currency for all. The alternative scenario would have been a 'currency union' whereby countries keep their own currencies but adopt a common standard for all in terms of an external or common currency, as well as establishing a rule for determining the value of their national currency against it (under either a floating or a fixed exchange rate system). The latter model was used by the gold standard countries more than a century ago (1870s–1913), where the national currencies could be exchanged for gold at a given (in this case, very firmly fixed) parity. This system was very flexible and decentralised, as it allowed members to enter and leave at will, without the need to seek approval from the other members nor to coordinate their economic policies. All that new members had to do was to announce, commit to, and honour the exchange of their currency for the common currency at a set parity (that is, the convertibility of national bank notes into gold, under the classical gold standard). And indeed, countries could change the parity and even abandon their commitment as desired, again autonomously, because they remained fully sovereign in the making of their own economic decisions.

In sharp contrast with a currency union, under a monetary union such as the Eurozone, there is a single central bank and a single currency and member states join by international treaty and thus by mutual accord. This construct is a more regulated and rigid system. Indeed, it closely resembles the formation of the traditional modern state, which usually has 'one currency, one central bank and one Treasury', though the latter feature was not mentioned in the initial Eurozone constitution in the 1990s. Therefore, a monetary union was established without a fiscal union. Instead, the Maastricht and Lisbon treaties included several provisions (which are still in place) to prevent member states from borrowing from the European System of Central Banks (that is, the ECB plus the EU national central banks) and featured the well-known 'no bailout clause', preventing one member state rescuing another during a time of crisis. This effectively meant that a fiscally errant member state, in the absence of the other member states' support or ECB intervention, would be left to leave the Eurozone if necessary. In addition, following the successful example of the Bundesbank, the ECB was granted independence and was also given a very clear mandate to maintain price stability above other goals in its statutes. All in all, the euro architects opted for a model of a single currency for all, but not a political currency – one which, above all other considerations, should be managed in a way that preserves its purchasing power. However, this model has been revealed once again to be at odds with a fully functioning (modern) central bank able and willing to support the government(s) in times of severe crisis.

Monetary history shows that modern central banks with the monopoly power to issue the national currency were established to support the government's efforts to raise funds more easily. If we take the example of the Bank of England (1694), the newly established Bank was given special privileges by the government, including the exclusive ability to issue paper notes for a certain amount, against the granting of a loan to the government for the same amount (see Smith, 1936). Other privileges and the extension of the monopoly power were granted in the following years, and the amount lent out to the government increased correspondingly. This process results in the establishment and development of a bank (later referred to as the central bank) with a significant advantage in the market against its competitors. At the time, lending to the government was not a routine operation, of course, but in times of crisis the national central bank would be expected to (and actually did) come to the rescue of the government by acquiring its newly issued debt. The central bank helped to alleviate the financial strain on the government by offering lower interest rate payments and thus made the servicing of the debt more affordable. In such critical times, the timely assistance of the national central bank expands the boundaries of the government's budget constraint by providing an additional means to finance spending (that is, the printing of new money to pay for the debt). More recently, in the first decades of the twentieth century, national central banks started to engage in what we now call 'open market operations' on a more regular basis, accepting government bonds as the main form of collateral in the provision of regular credit to commercial banks. This is how modern central banks operate routinely nowadays, thus incentivising the purchase of sovereign bonds by commercial banks, which they will be able to present to the national central bank when requesting both regular and extraordinary lending. Therefore, if only indirectly, the system of money creation in modern economies does favour government financing. In addition to this, particularly since the 2007/2008 crisis, central banks have been willing to purchase sovereign bonds on a massive scale.[2]

The debate on the role and independence of the ECB

One of the key questions discussed in this volume will be whether national central banks, and indeed the ECB as the central bank of the Eurozone, can be truly independent in times of severe crisis. In other words, can they prevent governments using them as a source of privileged finance? This tension has been present since the establishment of the ECB. Should the central bank's main task be the preservation of the purchasing power of the euro, or should the ECB act primarily as a standard 'national central bank', though in this case the central bank of a multi-state monetary union, thus being willing to support the government(s)? The Maastricht Treaty provisions seemed to have established provisions to preserve the ECB from political interference, and yet we have seen how asset purchase programmes, mainly consisting of the acquisition of member states' debt (so-called quantitative easing), were launched after the Global Financial Crisis, albeit only after a long delay, and again, this time in a much more rapid and decisive manner, during the COVID-19 crisis. It seems that the link between the national central bank and the government is so profound and intricate that central bank independence becomes irrelevant as an effective institutional constraint when it matters the most.

The debate on the role of the ECB within the Eurozone is crucial to understand the evolving nature of the Eurozone and the type of economy Eurozone policymakers wish to create. It is far from being just a technical discussion on ECB policies and functions, as it very much involves a conflict between two very different views on the construction of the Eurozone: on the one hand, one that favours a decentralised vision of the Eurozone, with a strong but limited ECB and monetary independence from any political power, as well as member states being in charge of their own fiscal policies; versus, on the other hand, a more centralised vision of the Eurozone, with the ECB willing to support the member states as required, and also featuring increased oversight by the European institutions of member states' fiscal and other economic policies. Whatever the reader's preferred option, it is very apparent that the 'euro crisis' and the COVID-19 crisis have moved the 'political pendulum' quite rapidly towards a more centralised vision of the Eurozone, one where the range of EU institutions and government policies become more prominent and more significant regarding the regulation of the economy. Peacock and Wiseman (1967) showed that if government spending is increased in times of a major event such as a war, it very rarely returns to the pre-crisis level. This phenomenon has been coined the 'displacement effect' of public spending. The same feature seems to apply to the changes made to the EU institutions and policies since the 'euro crisis'. The Eurozone's institutions have been transformed and now have greater control of policy while adopting a more interventionist political and economic stance, which has displaced the consensus and vision for the euro at the time of its launch in 1999. Either vision of the Eurozone, if it had been designed coherently, would have been feasible, although they represent very different ideas on the role of government in a market economy.

Already a key EU institution before 2007, with the last two crises the ECB has effectively developed its functions and transformed itself into the most relevant policy actor in the understanding of recent economic and political events in the Eurozone.

Summary of the content

In the remainder of the Introduction, I will summarise briefly the content of the contributions to the volume. The topics covered are quite diverse, ranging from questions of political economy, such as the analysis of the approach taken by policymakers in addressing the COVID-19 crisis and the legacy of such an approach in the future, as well as the constitutional stance of the Eurozone, on the one hand; to more concrete questions related to the ECB's independence, the recent review of its policy strategy, the assessment of the bailouts in the Eurozone compared with those in the United States, and the current debate on the reform of the Eurozone's fiscal rules and the completion of the so-called European banking union, on the other. What all these contributions have in common is an assessment of how much EU and Eurozone institutions – and their policies – have changed in the light of the impact of the COVID-19 crisis, as well as some proposals regarding the changes needed to improve the functioning of the Eurozone.

The first two articles in the volume are very much focused on how the COVID-19 crisis has affected the underlying political and economic approach taken by policymakers in Europe to address the pandemic and, specifically, the policy design and policies favoured to overcome the crisis. In the first article, Alberto Mingardi (Istituto Bruno Leoni) provides an excellent – though not very optimistic – narrative on the strongly interventionist paradigm and top-down vision adopted by policymakers in addressing the COVID-19 crisis. Mingardi elaborates on the distinction made by the great US economist Thomas Sowell between two opposite visions of society and political matters. The first acknowledges that we are restricted necessarily by limited knowledge and information. Therefore, the outcomes in human society are the result not of an omniscient central planner but rather of cooperation and interaction among individuals pursuing their own goals in the best way they can (thus, the 'constrained vision'). The second presumes that society can be managed to achieve a greater good and that if there is a problem, we will surely be able to identify the solution for it, which can be efficiently implemented by the policymaker (thus, the 'unconstrained vision'). The constrained vision would favour a bottom-up approach in designing economic and political institutions; in sharp contrast, the top-down unconstrained vision calls for those in power who think they know the solution to the problem to intervene. Mingardi evaluates the solutions to the challenges posed by the pandemic since 2020 in the light of these two visions and concludes that they have been very much determined by politicians with a top-down mentality, behaving as if they knew the solution to the problem as well as showing a complete lack of regard for any limitation in their knowledge affecting such policies, in the form of growing public deficits or other effects. In his view, this is a trend that will have lasting consequences for the direction of the economy in the post-COVID-19 world in Europe. In a similar vein, Professor Pedro Schwartz (Universidad Camilo José Cela) continues with a political economy analysis of the reaction of the EU authorities to the COVID-19 crisis, and in particular the 'Recovery Plan for Europe' approved in 2021. This plan includes the 2021–2027 Multiannual Financial Framework and the new 'Next Generation EU' fund. Professor Schwartz identifies the roots of the Plan in the industrial policies of governments in the nineteenth century and after the Second World War in Continental Europe and the United States. In line with these policies, the Next Generation EU plan assumes that governments know how to manage the economy, which justifies the creation of more institutions and a larger bureaucracy to design and implement the plan. This means a stronger Commission with both more powers and new sources of revenue, and thus higher taxes in Europe. As Professor Schwartz puts it, rather than a bottom-up process led by free markets and institutional competition, this is another attempt at further integration of the Eurozone through the creation of a more federal Europe with more powers at the centre. In the author's view, this is another example of economic planning that, as F. Hayek and L. Mises showed a century ago, is by its own design and limitations condemned to fail. Professor Schwartz concludes with a very clear assessment: 'whether this Plan will make Europe freer and more prosperous must be answered with a hesitant No'.

All in all, the euro architects opted for a model of a single currency for all, but not a political currency – one which, above all other considerations, should be managed in a way that preserves its purchasing power.

Professors Forrest Capie (Bayes Business School) and Geoffrey Wood's (University of Buckingham) piece is the first in a series of four articles focused on the ECB and how its roles and policies have been affected and changed, particularly since the outbreak of the COVID-19 pandemic. They explain the origins of the Bank of England in 1694 and the subsequent development of its roles to highlight how the unavoidable connection between the national central bank and the government goes back to its foundation. This makes it impossible to have a truly independent central bank. In fact, we can find abundant historical evidence of the support given by the national central bank to the government, particularly in times of crisis. The ECB is no exception. Even if it was designed as an independent central bank in the Bundesbank tradition, the ECB has acted

Photo by Carlos Pernalete Tua on Pexels

politically, especially during the COVID-19 crisis, with the purchase of government debt from the member states. In their view, this has not been due to any need to improve the monetary transmission mechanism in the Eurozone; rather, it was done to support government finances. Instead of focusing their discussion on central bank independence, they propose that the ECB follows the principles (rules) adopted by successful central banks in the past, such as the provision of liquidity against collateral in times of a bank crisis, thus acting as an effective lender of last resort of the banking system; and as regards the purchase of public debt, a sound rule would consist of ensuring that price stability is preserved, thus essentially limiting the scale of such purchases. In the light of the current inflation episode in the Eurozone and other leading economies, the application of this principle would have resulted in the ECB not buying as much debt as it has done since March 2020.

Professor Alberto Ruiz-Ojeda (Universidad de Málaga) discusses the constitutional arrangements in the Eurozone and suggests a reform which would establish a new constitutional consensus; it would include the addition of meta-rules in the fiscal and monetary realm in order to protect the euro from political interference, which in turn would enhance economic growth and productivity in the Eurozone. As he explains in his article, the current institutional setting of the Eurozone, very much the result of the Maastricht and Lisbon treaties, has proven insufficient to protect the value of the single currency. It is an asymmetrical system that delegates monetary policy to the ECB while keeping fiscal policies at the national level, though subject to some form of fiscal constraints. However, the ECB is lacking in a monetary strategy and a policy rule suitable to assess inflationary trends in the first place and eventually to tackle inflation, while the EU's fiscal rules have proven to be ineffective in keeping member states' public finances in check. This has resulted in tensions among the Eurozone membership, very much exemplified by the dispute between the 2021 ruling of the German Constitutional Court regarding the ECB's policy on asset purchases, and the European Court of Justice. Ruiz-Ojeda advocates the adoption of new fiscal and monetary rules at the EU's constitutional level to overcome the flaws of the current euro architecture. These rules would be binding and could not be altered by policymakers at will.

Professor Tim Congdon (Institute of International Monetary Research) addresses one of the major challenges of the Eurozone. As he puts it, since its establishment the Eurozone has been confronted by a potential 'free rider problem'; all member states benefit from low and stable inflation, but in a multi-state Eurozone each member state will be tempted to overspend and borrow from the ECB, thus contributing to a higher rate of inflation whose costs will be shared by all member states. Describing the problem in some detail, Professor Congdon explains how money is created in modern economies by the banking system when extending new loans, and indeed by the central bank when lending to the government. The author explains how the behaviour of the ECB has changed in the last 20 years. It was initially under the influence of the Bundesbank tradition (1999–2007), but then came three major crises that have dramatically changed the ECB policies and paradigm. As summarised in the article, thanks to these three crises 'the ECB and the nation states have become financially and monetarily irresponsible. Unless these irresponsible tendencies are reversed, the future viability of EMU [Economic and Monetary Union] will come into question.' The 'free rider problem' is yet to be resolved, and the ECB's response to the COVID-19 emergency since March 2020 has resulted in extraordinary growth in the amount of money and in the highest rate of inflation in the Eurozone since 1999. In the author's opinion, since 2007 the ECB has abandoned its adhesion to the Bundesbank tradition and principles and, particularly since 2020, it has entered uncharted territory with an expansion of its asset purchases operations, high monetary growth, and high inflation. The free rider problem has clearly been reflected in the size of the Target-2 system (im)balances, which have grown significantly as a result of the last three crises.

John Greenwood (International Monetary Monitor Ltd) continues with a discussion of the ECB, assessing its 2021 monetary policy strategy review. The focus of his analysis is whether the new strategy will contribute to stability in the rate of growth of (broad) money in order to achieve low and stable inflation in the long term. In his view, with its recent review the ECB has deviated from its previous anti-inflation strategy in favour of policies focused more on the short term. The changes made in the ECB strategy in 2021 resemble those introduced by the US Federal Reserve in 2020. The author shows how both major central banks have moved their strategies in the same direction, very much disregarding the effects of changes in the amount of money on asset prices, consumer prices, and nominal income. In the case of the ECB, the 2021 strategy review has meant the abandonment of the two pillars used by the ECB to make policy decisions (the so-called economic pillar and monetary pillar) in favour of interest rate-based policies that disregard any use of the amount of money as a key indicator of changes in prices in the medium and long terms. This means that the ECB does not consider changes in the amount of money to be the primary determinant of changes in prices in the long term. In his view, as we are already observing with the acceleration of inflation in the US, these changes will not deliver more stable money growth or steady inflation in the Eurozone.

Professor Francisco Cabrillo (Universidad Complutense de Madrid and UNIR) and Dr Rocío Albert (Universidad Complutense de Madrid) address another major issue in the Eurozone – the debate on the reform of fiscal rules after COVID-19, which were suspended during the pandemic. The authors discuss the changes made to the fiscal rules in the Eurozone in the aftermath of the Global Financial Crisis to control member states' public finances, which resulted in 'an excessively complex system, which in practice makes it very difficult to carry out such control. The main variables to monitor are not clearly defined, and their assessment is subject to so many possible interpretations that the application of the preventive and corrective arms of the SGP [Stability and Growth Pact] becomes virtually non-operational, inefficient, and even non-credible.' The article includes the proposal of clear rules – rather than just standards – to contribute to fiscal sustainability in the Eurozone. They support the adoption of a fiscal rule that requires balanced budgets in a multi-year budget period, so that it considers the effects of the business cycle on public revenues and spending. In order to avoid a deficit bias in the rule along the cycle, the rule would require balanced budgets or even a surplus when the economy is growing at an annual rate of 2 per cent or above. As regards the size of the public debt, they suggest a rule that sets up different criteria according to the size of the debt to GDP ratio in each member state, in particular imposing a higher debt reduction when the ratio is higher than 90 per cent. In the application and enforcement of these rules, the authors advocate the establishment of independent fiscal institutions with new powers in all member states, though supervised by the European Commission.

In the final part of this issue, we address two specific questions resulting from the Global Financial Crisis in 2007/2008: the bailouts of European banks along with a proposal for reform, and the completion of so-called European banking union.

Aneta Hryckiewicz (Economic Institute for Empirical Analysis), Natalia Kryg (European Bank for Reconstruction and Development), and Dimitrios P. Tsomocos (Saïd Business School) start by asking a very controversial, and indeed unpopular, question: what should be done about a bank considered to be systemic or 'too big to fail' when it needs to be bailed out? In the absence of a market willing to take the lead, they consider government intervention for distressed banks as inevitable in some cases and focus in their article on what we need to learn from the experience of bailouts in Europe since 2007. They do so by comparing what they consider a more successful bailout experience in the United States during the Global Financial Crisis. In the US, the Treasury acquired preferred stocks which, with some exceptions, did not carry voting rights. As part of their intervention in the banking sector, US authorities focused on making changes in bank governance, without being involved in the day-to-day banking business. In addition, priority was given to the disinvestment of the Treasury holdings at the earliest opportunity. In fact, as the authors underline in the article, this strategy was very successful as the Treasury was able to recover the vast majority of the funds by 2013 and had made a profit by the end of 2018. In contrast, in Europe the rapid deterioration of banks' balances after 2007 resulted in a more significant intervention in those banks by the member states, in the form of partial or total nationalisation of several banks with the acquisition of common stocks which carried voting powers. This effectively meant a much larger involvement of the government in the banking business. The authors conduct an empirical analysis to compare these two bailout systems and conclude that the US system was able to facilitate access to sufficient capital by the distressed bank, as well as enabling changes to be made in the senior management team of the bank along with its restructuring. In the light of this experience, they propose the creation of a unified resolution system in Europe run by the Resolution Authority with an intervention focused on changes in the bank's governance.

What all these contributions have in common is an assessment of how much EU and Eurozone institutions – and their policies – have changed in the light of the impact of the COVID-19 crisis, as well as some proposals regarding the changes needed to improve the functioning of the Eurozone.

The volume ends with Professor Rosa Lastra's (Queen Mary University) contribution, in which she welcomes the centralisation of both the supervision and the resolution of significant credit institutions in the aftermath of the Global Financial Crisis but also identifies a 'missing pillar' in the development of European banking union. This is the lender of last resort function. In her article, she advocates for the ECB to be responsible for the provision of liquidity not only to the market (as is already the case) but also to individual credit institutions in need of liquidity, which at the moment is done by the national central banks in the Euro area. In a crisis scenario, time is of the essence and the ECB is in a better position than member states' authorities to assess contagion risks in the Eurozone; therefore, the ECB should be responsible for the provision of emergency market liquidity as well as individual bank liquidity to illiquid but solvent credit institutions. In addition, Professor Lastra underlines the differences in the management of a crisis by the ECB on the one hand and the Bank of England and the US Fed on the other, as in the Euro area there is no single Treasury able to back the decisions made by the ECB. The article ends with a positive assessment of the response by the ECB and the EU to the COVID-19 crisis, in the form of the provision of extra liquidity to the market, the pandemic emergency purchase programme, and the approval of the Next Generation EU programme.

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COVID-19 and the Triumph of the 'Unconstrained Vision of Humankind'

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Citation suggestion: Alberto Mingardi, AM (2022). COVID-19 and the Triumph of the 'Unconstrained Vision of Humankind'. *Future Europe*, 2(1), 22–27.

Abstract

Genuine emergencies, such as the COVID-19 pandemic, can be used by politics to foster particular policy goals. To avoid 'wasting a crisis' meant inflating the public budget, with no measures immediately related to healthcare or other social spending. In the European Union, this process took the form of the 'Next Generation EU' funds. Increasing public spending and borrowing is consistent with a 'vision' (in the terminology of Thomas Sowell) in which human beings can engineer their own society with a top-down approach and apparatus. While the pandemic was ultimately halted thanks to the automatic reaction of our immune systems, fostered by vaccinations, all the political emphasis was on policies requiring conscious action, such as business shutdowns. The pandemic's legacy will endure in its emphasis on government action, the superior knowledge of experts, and inordinate public budgets. It is a triumph of what Sowell labelled the 'unconstrained vision' of humankind and the demise of the traditional role of economics in highlighting scarcity and trade-offs.

Introduction

During the 2008 financial crisis, Rahm Emanuel, then an advisor to US President Barack Obama and later the mayor of Chicago, famously said that an apt politician 'never let[s] a crisis go to waste'. The catchphrase has been repeated many times since, by leaders of very different kinds. Yet perhaps we fully understood it only during the COVID-19 pandemic.

Faced with a genuine emergency, European leaders acted with resolve. Their resolutions were, however, perhaps better attuned to their own ideological mindsets than the genuine result of coping with the new situation at hand. This is hardly surprising or outrageous: while political leaders constantly claim to be pragmatic, they reason and act within a previously adopted framework of ideas.

The COVID-19 pandemic became the occasion for increasing both public spending and borrowing, in the tacit understanding that monetary policies were to be kept lax and fiscal rules were to be suspended *sine die*.[3] It is telling that such new public spending was targeted not at strengthening healthcare systems but rather at projects aiming to tackle climate policy and foster digital innovation. The healthcare emergency produced an economic stimulus (more than a targeted healthcare response) that aimed at goals with which the European establishments have long been flirting.

While emergencies 'naturally' tend to see a growth in the scope of government activity,[4] this time the crisis was consciously used to 'do more' and to end up with a stronger and bigger government. This process has been fed by the idea that unfettered use of political power and uncompromising public spending were beneficial and had very few side effects.

A crisis not to be wasted

In early 2020, the news that a new coronavirus had appeared in China mutated from a reported event to become a part of the life of all Europeans. Human societies have always struggled with parasites, and such struggles have contributed to shaping them (see McNeill, 1976). But human societies had never been as technologically advanced and prosperous as they were when they met the new coronavirus. Our advancement had consequences of very different kinds. On the one hand, science and applied research allowed us to develop instruments to cope with the new coronavirus in an impressively short time period. On the other hand, the development of faster information technology and, particularly, of social media produced a 'pandemic of information'. With this, I do not mean merely the by now familiar issue of *fake news* (some of which resulted in sanitary mismanagement and bad treatment) but also a sense of emotivity which will shape the memory of the COVID-19 pandemic and which has already shaped the policies that developed during the crisis.

The RNA virus that causes the disease called COVID-19 is SARS-CoV-2. It is only the most recent among many animal viruses that have become parasites of humans over the past millennia. In terms of lethality, SARS-CoV-2 is less dangerous than Marburg, Ebola, and two other coronaviruses in the same family (SARS and MERS). However, while these more lethal viruses that can infect humans currently fail to establish persistent transmission cycles in the host, that is, person-to-person transmission, SARS-CoV-2 has rapidly become, and forever will be, a parasite of our species (with some animal reservoirs among other mammals). To date it has not killed anywhere near as many people as HIV (30 million) nor the 'Spanish flu' (estimates are variable but it may have caused about 50 million deaths in the early twentieth century). As far as we know now, the lethality of COVID-19 is more akin to that of the influenza pandemics of the 1950s (1957–1958) and 1960s (1968–1969), to which about one million deaths (probably an underestimate) have been attributed out of a world population of three billion.

Whatever its origin, SARS-CoV-2 is surprisingly well adapted to the demographic and social setting prevalent in most Western societies: an older population heavily concentrated in cities. Its spread its spread is favoured by the fact that it usually causes severe or lethal infections in the older age cohort, which for the past half a century has represented a conspicuous percentage of the most advanced countries' populations, whereas it only causes relatively mild symptoms in those individuals (younger people) who transmit it more easily.

The ongoing competition between the human species and the virus is leading to some form of dynamic equilibrium, in a time frame that is not entirely predictable, even if vaccines – particularly if they are widely used – will surely be decisive.

Paradoxically, the uncertainties regarding the time required to reach an equilibrium are a consequence of the better health conditions and more advanced healthcare we enjoy in our complex societies. It is a virus, in short, that is particularly dangerous for societies that allow themselves what has historically been a great luxury: growing old.

The evolutionary history of our species cannot be understood without considering the impact that parasites, including pathogenic ones, have had on it. The COVID-19 pandemic was a Darwinian phenomenon in which 'we' as humans adapted, but SARS-CoV-2 adapted too. In our case, the adaptations are reflective and purposeful. In the case of the virus, they are casual but 'sifted' through natural selection. Yet our adaptations and those of the virus interact in a sort of dance, which can hardly call for comprehensive social reforms. The way in which we could pragmatically adapt to the pandemic would depend on the definition of the targets or values we aim to preserve,[5] but the sort of interventions and rhetoric we have witnessed since March 2020 suggest something different. Path dependence from the way in which the preceding financial crisis was managed, as well as the precise 'vision' of the government and the intellectual establishment, shaped the response and will potentially influence our societies for many years ahead.

The pandemic spread from China and thus the initial Chinese reaction, which consisted in locking down the city of Wuhan and other cities in the region of Hubei, deeply influenced the

Path dependence from the way in which the preceding financial crisis was managed, as well as the precise 'vision' of the government and the intellectual establishment, shaped the response and will potentially influence our societies for many years ahead.

Western response. In early 2020 (up to February), the risks of contagion were downplayed in the West and stock markets behaved as if a pandemic was a remote possibility. But when investors and the chattering classes became alert to the risk, a fair number of them assumed that the Chinese model for tackling the virus was the best approach.[6]

The first European country to be severely impacted was Italy, in particular the area encompassing the cities of Bergamo, Lodi, and Piacenza. In just a few days, the hospitals became overwhelmed. That led the Italian government to opt for a national lockdown. The aim was to avoid replicating the same nightmare situation in the south of the country, where the healthcare system is traditionally more fragile. Ever since that time, restrictions have been with us to different degrees, sometimes becoming stricter, sometimes more relaxed. To a certain extent this response was predictable and inevitable, as we needed to adapt to a new situation. But there was also an ideological twist.

On one level, politicians suggested that people needed to face a trade-off between 'economics' and 'healthcare'. Economic activities were given classifications and some of them, considered trivial, were forced to shut down. Such activities were basically considered important merely as generators of salaries. No attention was paid to the dynamic effects of the shutdowns nor to their psychological downside. Government understood its role as a sort of insurance policy, to be used to support people's falling income in lockdown.

On another level, the way in which we dealt with COVID-19 was an egregious case of path dependence. The last major crisis we had faced previously was that triggered by the sub-prime mortgage collapse in 2007–2008, on top of which the sovereign debt crisis in Europe developed in 2010–2011. How did we deal with those crises? Basically, through monetary policy, through quantitative easing (that is, asset purchase programmes by the central bank). Surreptitiously, the European Central Bank removed the corset of European fiscal rules, gave some oxygen to the member states, and allowed them to make moderately expansive budget laws and to finance their enlarged deficits relatively easily.

How did we deal with the COVID-19 crisis? In a very similar way. From the outset, European elites thought that increasing public spending was the necessary condition to make lockdowns acceptable and sustain the continent's economies.

On a deeper level, such an outcome was necessitated by the fact that we chose to impose a very strict lockdown regime. This naturally produced a need to increase indebtedness, if only to make up for the lower state revenues resulting from the lower level of private sector activity. Yet this approach was somehow strengthened by a vision which thought that a good crisis should not be allowed to go to waste. Some leaders, both in the intellectual field and in the realm of politics (an example is the Italian healthcare minister, Roberto Speranza), clearly thought that the virus had provided them with a chance to overcome 'neoliberalism' or to put a leash on globalisation. In a book published in October 2020, Speranza claimed that the 'war' on the virus was over, although the book was retired from circulation when Italy was hit by the second wave of COVID-19 and its message seemed decidedly too optimistic. In his book Speranza maintained that the pandemic showed us why we should do away with fiscal restraint, austerity, and the almighty power of international markets: the time is finally ripe for radical change (Speranza, 2020).

Visions' and crisis

In his works in political philosophy, which perhaps have not received the attention they deserve, Thomas Sowell suggested that we focus on 'visions' rather than 'theories'. A vision is 'what we sense or feel *before* we have constructed any systematic reasoning that could be called a theory, much less deduced any specific consequences as hypotheses to be tested against evidence'. In short, 'a vision is our sense of how the world works' (Sowell, 2007 [1987]: 4).

Visions are postures: they are not necessarily conscious, or chosen, attitudes towards the world around us but they imply a certain tendency or predisposition to understand it in a particular way. Sowell distinguished between a 'constrained' and an 'unconstrained' vision, each of them being the likely foundation for different nuances of a social theory.

What is or is not 'constrained', in these different frameworks, is the nature and hence the possibilities of human beings. In the constrained vision, 'the moral limitations of man in general' are 'treated as inherent facts of life, the basic constraint ... The fundamental moral and social challenge was to make the best of the possibilities which existed within that constraint, rather than dissipate energies in an attempt to change human nature' (Sowell, 2007 [1987]: 12). In this framework, society and cooperation are not the outcome of the design of a great planner but rather the result of a myriad of interactions into which women and men enter in pursuance of their own goals and not in order to produce a superior social good.

The 'unconstrained vision', on the contrary, assumes that 'man's understanding and disposition were capable of intentionally creating social benefits' (Sowell, 2007 [1987]: 15). The reference to understanding suggests to us that the constrained vision assumes not only the moral but also the cognitive limitations of individuals, whereas the unconstrained visions imply that our cognitive limitations can be overcome too.

Sowell considers Adam Smith to be the champion of the constrained vision and William Godwin to be the patron saint of the unconstrained one. But more than their intellectual ancestry, what matters in the context of our discussion is a fundamental attitude which comes with each vision or mindset. For the unconstrained vision, problems in society call for solutions which can be planned and executed by benevolent social actors, if only they are endowed with enough power to cope with the challenge. For the constrained vision, definitive solutions to social problems are rare occurrences. Those who hold the constrained vision dear tend to think in terms of *trade-offs* rather than solutions.

Sowell writes:

> The great evils of the world – war, poverty, and crime, for example – are seen in completely different terms by those with the constrained and the unconstrained visions. If human options are not inherently constrained, then the presence of such repugnant and disastrous phenomena virtually cries out for explanation – and for solutions. But if the limitations and passions of man himself are at the heart of these painful phenomena, then what requires explanation are the ways in which they have been avoided or minimized. (Sowell, 2007 [1987]: 24)

The idea that 'solutions' to social problems can be manufactured justifies and requires substantial political power. The 'unconstrained vision' tends to imply an unconstrained vision of government: a limited understanding of its enterprise will, by definition, suggest that only *some* problems are within the province of government. But if human beings can be improved and their options enhanced if only the right set of policies is conceived, that translates into a need to unleash the power which may operate to that effect.

The 'unconstrained vision' is, in some version, the prevalent one within our ruling classes. It was epitomised, in the context of COVID-19, by the many who reasoned and acted similarly to the Italian healthcare minister Speranza. In another work, Sowell refers to the 'vision of the anointed': a large chunk of the intellectual class thinks it owns the necessary instruments to save the world from itself, a recurrent need in history. The anointed, explains Sowell, seem to assume '(1) that they have more knowledge than the average member of the benighted and (2) that this is the relevant comparison'.

On the contrary,

> The real comparison, however, is not between the knowledge possessed by the average member of the educated elite versus the average member of the general public but rather the *total* knowledge brought to bear through social processes (the competition of the marketplace, social sorting, etc.) involving millions of people, versus the secondhand knowledge of generalities possessed by a smaller elite group. (Sowell, 1995: 114

Sowell insists that this elitist thinking is predicated upon the substitution of the knowledge produced via bottom-up processes with top-down decision-making. In a sense, this very substitution requires an increase in the power of government institutions. Therefore, the absence of the sort of knowledge which is generated through networks and markets needs to be compensated for by the sort of all-powerfulness which can bend reality to fit a plan. These elites craft their claim to power in terms of a legitimacy founded on their knowledge, but they actually need that power to be able to mould a society which they do not necessarily attempt to comprehend.

In *The Vision of the Anointed*, Sowell classifies 'crisis' among the buzzwords of the 'vocabulary of the anointed' (Sowell, 1995: 183). All sorts of situations are classified as 'crises', regardless of their actual characteristics. The vocabulary of 'crises' per se calls for *solutions*, which can only come from the top.

Understanding the COVID-19 crisis as a Darwinian struggle, as I suggested earlier, would have called for a trial-and-error method, with no pretence of offering a 'solution'. It was instead understood as a crisis which governments could solve and – not by chance – was from the very beginning interpreted as an occurrence akin to war. See, for example, an article by Mario Draghi in the *Financial Times* that supported the approach adopted by most European governments and which contributed to shaping the European Union's future 'Recovery Fund':

> The coronavirus pandemic is a human tragedy of potentially biblical proportions. Many today are living in fear of their lives or mourning their loved ones. The actions being taken by governments to prevent our health systems from being overwhelmed are brave and necessary. They must be supported. (Draghi, 2020)

Notice the use of the war metaphor. The war metaphor had great success in the pandemic and proved rhetorically effective from government viewpoints, as far as stressing the uniqueness of the situation and hence the need for an extraordinary response. But it was ultimately misleading: SARS-CoV-2 was not an army, no foreign general was in charge, no plans to invade were prepared. The virus, in short, lacked purposeful action.

Yet the use of the war metaphor was conducive to preaching a purposeful change of behaviour. Governments, particularly in the first phase of the pandemic, wanted *people* to respond to the virus by changing their lifestyles. The management of the emergency required a personal involvement and a change of behaviour comparable to rationing during wartime. But success in the pandemic came only when vaccines entered the picture, which means when we stopped *consciously* fighting a war and allowed the automatic response of our immune system to take care of us.

The multiplication of the anointed and the triumph of the unconstrained vision

Sowell explains that the 'vision of the anointed' is commonly shared by the most educated few, and legitimates their claim to rule over the unsophisticated many. During the COVID-19 pandemic, however, their attitudes were not different from those of the many.

The educated few can rightly claim to have a deep knowledge of their respective field of expertise, but as a rule this knowledge was unsuited to face the particular threat represented by an emerging virus.The biases of the few were unbridled in this new circumstance, particularly the idea that action should be organised and planned top-down. The many felt more or less the same. No matter how sceptical of expertise 'populist' political parties may have been in the past, virtually everybody trusted a top-down response to be sensible and effective.

With the exception of a handful of fringe intellectuals, the whole of the political and intellectual establishment shared an 'unconstrained' vision. This 'unconstrained' vision was not, interestingly, predicated on bold confidence in medical expertise and scientific progress. Yes, global research and 'Big Pharma' ultimately came to the rescue. But what the unconstrained vision trusted was governmental responses aiming at curbing the virus *before* vaccine deployment.

There are two elements to this, one cultural and one financial, and they are intertwined.

The anointed are, according to Sowell, self-congratulating. Their cement is self-righteousness. The pandemic produced mass self-righteousness: mass self-righteousness, shared not only by that population subset typically styled as 'elites', but virtually everyone who aligned with it and followed certain prescriptions, was gratified with feeling 'on the side of science', as they themselves would say. Social media not only amplified the *influence* of such thoughts but made the self-righteous attitude behind them viral. The anointed are a minority no more.

The 'unconstrained' vision found weak opposition and spread its roots more widely than ever. From the very beginning, the discourse on the pandemic has been filled with moralistic undertones. During the first lockdown, to give only one example, the mayor of Milan urged joggers to stay at home (by law, they were supposed to jog only in the vicinity of their domicile anyway) because 'while you jog and are happy, you have a hundred in the window looking at you and getting angry because they feel confined' (see, among others, Tg-Com24, 2020). Joggers were the first to be scapegoated in the pandemic. Younger people came next, as curfews made it impossible for them to enjoy dining out in the evening. Public health measures were argued to be sacrifices that were needed to prove virtue and exorcise the virus in each case.

This moralist rhetoric reinforced both the sense of a crisis and the narrative of the necessity of ever-growing interventions to cope with it. The way in which, according to the sociologist John Robb, we are 'being mentally rewired by the technologies of social networking' (Robb, 2018) suggests that widespread moral outrage could be a more effective lever for interventionism than ever. Certain policies dear to the 'anointed', to use Sowell's language, were stopped in the past because they coincided with a reduction of freedom of choice on the part of consumers at large. But what if consumers endorse some modernised version of Sabbatarianism, for example, in order to participate in the 'fight for climate justice'? What if people, as political actors, become the first to demand allegiance to elite thinking, thereby sabotaging bottom-up devices such as markets for creating and disseminating information?

The other element is financial. What is now 'unconstrained' is public finance, which is considered the source of solutions to all the potential problems we may face. During the pandemic, the sort of top-down policies we refer to, being based on widespread shutdowns of the economy, clearly necessitated support to small businesses and other categories that lost substantial chunks of their income. But we have gone way beyond that. The pandemic emergency allowed for unprecedented growth of public spending in peacetime, most of which was not healthcare related. The so-called Next Generation EU plan was predicated upon fostering changes that a market economy will not accomplish by itself, or not at that pace. It made use of the vocabulary of the crisis (the current, pandemic one, and the future, climate one) to foster a veritable palingenesis of society and change the way in which factors of production are autonomously associated with economic actors.

In this context, fiscal responsibility or even responsibility towards future generations, in the sense of public debts, are simply out of the picture. They quickly became words of no use in politics, clearly anachronistic in the context of an unprecedented crisis which needed to be met with unprecedented means. Economics used to be 'the science of the postmagical age' as it kept 'telling us that we cannot do it, that magic will not help' (McCloskey, 1992: 40). But nowadays in a sense we are back to the magical age, and the old economist's appeal to the need to cope with scarce resources is a thing of the past. The lesson of the pandemic is that challenges should be met by a determined faith in governments' and experts' ability, supported by whatever resources may be needed – supplied by government, if possible by government borrowing.

The nuances of economic thinking are gone and the thinking of the chattering classes appears, at least to this author, surprisingly homogeneous. The new emergency represented by the war in Ukraine will test the constellation of ideas and proposals that emerged from COVID-19. So far, the impression is that self-congratulatory make-believe is a revolutionary force, destined not to be swayed.

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The EU Recovery Plan as Politics

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Citation suggestion: Pedro Schwartz, PS (2022). The EU Recovery Plan as Politics. *Future Europe*, 2(1), 28–32.

Abstract

The 'Recovery Plan for Europe' launched in 2021 is aimed at setting the EU economy back on its feet after COVID-19 and modernising a society left behind by technological transformation. It is also surreptitiously intended as another step towards making Europe more federal. The Plan consists of a €1.3 trillion seven-year budget paid for by old and new taxes and an €807 billion 'Recovery and Resilience Facility' financed by an issue of European Commission bonds. The total sum is no less than €2.02 trillion. Mutualising EU states' debt is what Hamilton did for the nascent United States. This is an industrial policy plan with increased fiscal pressure and a careful avoidance of the free market. The reservations of Mises and Hayek regarding wholesale planning are gainsaid with a complicated to-and-from mechanism to control waste and adapt to shocks. The resulting centralisation will be another element in the slow creation of a European state.

The 'Next Generation EU' plan

In February 2021 the EU Commission approved a plan originally proposed by then Chancellor Angela Merkel and recently re-elected President Emmanuel Macron.[7] It thus launched a 'Recovery Plan for Europe' with two overt aims: to set the European economy back on its feet after COVID-19 and to modernise Europe and put it on a par with the most advanced economies. Underneath, however, there is a further implied aim: to have the European Union take another step on the path to becoming a national state. This poses the question whether this ambitious Recovery Plan will make Europe freer and more prosperous (European Commission, n.d.).

The Recovery Plan consists of two parts: (1) the Multiannual Financial Framework (MFF) or EU budget covering seven years from 2021 to 2027; and (2) a once and for all fund called 'Next Generation EU' (NGEU) containing a 'Recovery and Resilience Facility' (RRF). In current prices, the total expenditure for the seven years covered by the MFF is set at €1.2109 trillion, financed by old and new taxes. The RRF, also at today's prices, will amount to another €806.9 billion, to be financed by the Commission borrowing on the capital markets on behalf of the EU. If we add this facility to the multi-annual budget,

this Recovery Plan as a whole will come to the mind-boggling sum of €2.018 trillion.
Clearly, the Recovery Plan aspires to be much more than a package of measures to help Europe recover from the effects of the pandemic. In the words of the EU Commission,

> *NextGenerationEU* is more than a recovery plan. … It is a once in a lifetime chance to emerge stronger from the pandemic, transform our economies, create opportunities and jobs for the Europe where we want to live. We have everything to make this happen. (European Commission *The Recovery Plan for Europe,* Introduction)

Obviously, this shower of money is more than economic in intent. No doubt there was a need to provide relief to people hit hard by the pandemic and the restrictive measures taken to fight it. However, as suggested by the political enthusiasm infusing the above declaration, COVID-19 has become an occasion for moving forward towards the eventual creation of a European state. By pandering to the belief that only government can be trusted with the post-COVID-19 reconstruction, the Commission is in fact working towards the goal of having Europeans unwittingly accept the creation of a unified polity capable of claiming a place among the great powers of the world.[8]

Hence, before examining the political dimension of the Commission's plan, we must analyse it as an industrial policy document. The idea that it is a proper goal of government to take a leading role in the industrialisation of the country has its roots in the Continental European and American reactions to the British example of economic progress during the so-called Industrial Revolution, based on private technology and capitalist manufacture rather than state commerce. Continental practice was generally based on Crown privilege and aristocratic custom rather than unregulated innovation and popular consumption, as in Scotland and England, where there was no Colbert or Bismarck. True, the *Encyclopédie* (1751–1772) was presented as a vademecum for aspiring industrialists, as its subtitle promises: *Dictionnaire raisonné des sciences, des arts et des métiers.* On the Continent of Europe and in the United States during the nineteenth century, the weapons used for industrialisation were public initiative and foreign trade barriers, with varied success. After the Great Depression and the Second World War, the policy changed to creating national industries or nationalising existing ones, with dismal results. Then the era of Ronald Reagan and Margaret Thatcher dawned, and industrial policy went out of fashion. At present we are witnessing a return to governmental industrial policy. There is no better example than the post-COVID-19 Recovery Plan of the European Union. European industrial policy has two traits: a belief in the ability of bureaucrats to mark the way of the future for national economies, and a thick undergrowth of institutional and financial arrangements to assuage special interests.

As to macro policy, the general object of the MFF and the NGEU project is 'to make Europe greener, more digital and more resilient'. It is normal for public organisations and private companies to proclaim a mission statement, usually devoid of practical content. But when the organisation is pulled by conflicting interests, the mission statement runs the risk of being reduced to strategic confusion by trying to satisfy everyone.

The NGEU plan is difficult to follow for the variety of institutions, funds, and acronyms it compounds. (See Table 2) What is clear is that it consists in a huge sum of money. This bonanza will finance an abundance of industrial policy projects, some entrusted to the Commission, most to the Member States (MS). Of the Europe-wide projects, the main one is REACT-EU, an accelerated disbursement of cohesion funds totalling €47.5 billion to redress the harm caused by COVID-19. The programmes entrusted to the MS come under the 'Recovery and Resilience Mechanism' (RRM) and are assigned up to €67.5 billion, conditioned on the success of the plans proposed by national governments, with a maximum of 6.8 per cent of each gross national income.

Levying new taxes, no role for the market

The aims of the RRM are summarised in no fewer than six 'pillars'. The two most important ones are (1) 'green transition' and (2) 'digital transformation'. Subordinate aims are (3) intelligent, sustainable, and integrating growth; (4) social and territorial cohesion; (5) health, economic, social, and institutional resilience; and (6) forward-looking education. Most economists accept the old Tinbergen admonition that each policy instrument should be directed at one single policy goal. It will be difficult to combine these six goals, especially because they are set in terms so wide that national proposers of projects and Commission adjudicators and controllers will find it difficult to be sure they are respected in practice. In any case, the Commission off its own bat makes numerous country-specific recommendations semester by semester. There are eight headings under which MS can be admonished: fiscal policies, digital and energy transition, social policies, education, financial markets and banking, labour markets, and taxation.

A stronger Commission with more tasks needs new taxes. Next Generation EU will initially be financed by bonds placed on the world's financial markets. Those bonds must be serviced and refunded.[9] To that end the Commission proposed, and the European Council and Parliament in 2021 approved, three new 'own resources', to be added to the existing sources of revenue of the Commission: (1) 25 per cent of the revenues of emission trading in the EU; (2) 75 per cent of the income enjoyed by MS from the carbon adjustment mechanism; and (3) 5 per cent of the reallocated profits of very large multinationals that were avoiding taxes on local profits.[10] Taxation is clearly too heavy in Europe. This hampers economic growth and reduces the space of individual freedom. Long historical experience shows that new states rely on more taxes because one of the ways to achieve their national ambitions is through expanded public expenditure.

One striking feature of the Recovery Plan for Europe is that the idea of free markets and free competition is absent. There is no mention of the free market as an instrument of recovery and economic transformation. In fact, the market is mentioned only under the label of a 'single market', in the sense of finally turning the EU into a large economic area. The healing powers of market competition and of institutional competition are not understood by the Commission nor more generally in Europe.

This makes the Marshall Plan, often mentioned in this context, an object lesson for the defenders of the present Recovery Plan. The Marshall Plan did signify a profound change in American public opinion in favour helping Europeans recover from the destruction of physical and human capital in the Second World War. It was a generous action that alleviated the balance of payments deficit of countries needing imports from America for which they had no means to pay. However, reconstruction was swifter and more thorough in Germany and Italy than in France and the United Kingdom, where wartime interventions and socialist policies were applied for the rest of the 1940s and even during the 1950s. The German and Italian 'miracles' show the healing power of the free market. Ludwig Erhard and Alcide De Gasperi, by getting rid of officious interventions, put in effect an expansion that eluded the social-democratic governments of the two victor countries, in contrast with the vanquished.

The example of Spain

The Spanish economy is known to be one of the worst managed in Europe. With growing tensions among its autonomous regions, a structural rate of inflation higher than that of most of its Eurozone companions, a persistently high rate of unemployment, a badly managed welfare state, public deficits among the highest in Europe, and a coalition government incapable of reform, it is surprising that Spain should be among the most successful of the suitors under the Recovery Plan. But it is receiving high praise from the Commission.[11] Between 2020 and 2026 Spain is to receive €140 billion under the Recovery and Resilience Facility. The first step is to present a National Recovery and Resilience Plan. Spain was among the first to do so in 2021. It was accepted by the Commission, with some specific recommendations.

For an economist who lives and works in Spain, the document, which was approved with high marks by the Brussels Commission, reads like a fairy tale. The Spanish government has presented it as a coherent plan 'of investments and structural reforms' aiming at recovery in the short term, focusing on 'digitalising and decarbonising the Spanish economy, while reducing the gender gap'. The language is well in harmony with current fashion. The 'adequate mix of monetary and fiscal policy, together with the Next Generation package', have brought about a quick recovery. Perhaps the present situation of increasing inflation is not the best moment for praising monetary policy. And saying that Spain has been applying a reform and investment programme for three years does not accord with facts. The government has chosen no fewer than 110 investment projects and 102 structural reforms of its own. The role of the private sector in this transformation will be assured by the presentation of green, digitalised, and gender equality projects, most of which were in portfolio before COVID-19.

Table 1 Multiannual Financial Framework 2021–2027 and Next Generation EU total allocations

Demand category	MFF	Next Generation EU
1. Single market, innovation and digital	€ 149.5 billion	€ 11.5 billion
2. Cohesion, resilience and values	€ 426.7 billion	€ 776.5 billion
3. National resources and environment	€ 401 billion	€ 18.9 billion
4. Migration and border management	€ 25.7 billion	-
5. Security and defence	€ 14.9 billion	-
6. Neighbourhood and the world	€ 110.6 billion	-
7. European public administration	€ 82.5 billion	-
TOTAL MFF	€ 1 210.9 billion	€ 806.9 billion

Source: Table from the European Commission (see https://ec.europa.eu/info/strategy/recovery-plan-europe_en#figures)

If this is the way the Commission intends to avoid waste, there is reason to worry.

The impossibility of a planned economy

As long ago as the first half of the twentieth century, Ludwig von Mises and Friedrich von Hayek warned of the impossibility of economic planning – literally (Mises, 1975 [1933]).[12] The planners had insufficient information and the planned were led astray by misguided incentives. The price system continuously offers such an abundance of information that no individual can gather or transmit it all. Firstly, all-encompassing blueprints such as the Recovery Plan for Europe turn out to be rigid, as the notion of 'Five-year Plans' indicates. They are especially exposed to unexpected events, given their rigidity. This is so for the managing of a static economy, but more so for a dynamic economy subject to shocks. Aggregate planning adapts with difficulty to new circumstance. The Recovery Plan for Europe was designed as a response to the 2008 financial crisis and as a springboard for the modernisation of Europe. It first encountered inflation brought on by central banks' mistaken monetary policy – a possibility not even mentioned in that programme of fiscal expansion. It was then thrown into further disarray by the mega-shock of war in Ukraine and sanctions against Russia. Speak of uncertainty! The Commission knows from experience that the EU is rigid by design. When trying to foresee and shape the future of the EU, the planners in Brussels were led to commit the 'Khrushchev mistake' (Spufford, 2010),[13] that is, overfunding projects to try to overcome the structural defects of the planned economy, resulting in waste, misinformation, and corruption.

The method by which the Commission tries to sidestep the problems posed by centralised planning in practice is interesting but, in the end, a failure. The steps are the following. Firstly, the planners state general goals, such as those listed in Table 1. Secondly, their practical and concrete definition is passed over to the MS, which present their various national goals. As we saw in the case of Spain, the governments outline a general plan of how these goals are to be achieved in their jurisdiction. Thirdly, private firms of all sizes present their own transformation projects to their government and the Commission. Fourthly, to avoid the 'Khrushchev mistake' the whole process is undergirded with a 'Performance Framework', overseen by a 'Recovery and Resilience Taskforce', so as to follow and control the exact realisation of projects. All this, in a way, is an acknowledgement of the difficulty of attaining such wide-ranging goals as those financed by the RRF.

The Plan as politics

The Recovery Plan for Europe, as I said at the beginning of this article, is another attempt to further the integration of Europe, especially of the Eurozone. Many of the persons in charge of European institutions see as the goal of the European Union its slow transformation into a federal state. This is not the general wish of the citizens of the MS but there is no doubt that the persons employed at the Commission see this as the object of their endeavours. One could even say that a majority of the MEPs at the European Parliament are also federalists at heart.

In the aftermath of the Second World War, the founding fathers of the EU, Konrad Adenauer, Alcide De Gasperi, and Robert Schuman, inspired by Jean Monnet, chose an indirect path to get the former enemies to work together in building a peaceful Europe: rather than politics, it was the economy and the Common Market that opened the way. When I say that the Commission's Plan will further the idea of a federal

Table 2 The Next Generation EU programmes

Recovery and Resilience Facility (RRF)	€ 723.8 billion
of which, loans	€ 385.8 billion
of which, grants	€ 338.0 billion
React-EU	€ 50.6 billion
Horizon Europe	€ 5.4 billion
InvestEU	€ 6.1 billion
Rural Development	€ 8.1 billion
Just Transition Funds (JTF)	€ 10.9 billion
RescEU	€ 2.0 billion
TOTAL NGEU	€ 806 billion

Source: Table from the European Commission (see https://ec.europa.eu/info/strategy/recovery-plan-europe_en#figures)

One striking feature of the Recovery Plan for Europe is that the idea of free markets and free competition is absent. There is no mention of the free market as an instrument of recovery and economic transformation.

Europe, I am not trying to derogate from their achievement, but I am saying that the kind of Europe the Commission's Plan is seeking to construct is not liberal. This is not the first attempt to take a big step to federalise Europe: the constitution proposed by the committee headed by Giscard d'Estaing wrote a document that the citizens of France and the Low Countries rejected. No matter. The failed constitution was transformed into two Directives and applied surreptitiously. The Resilience and Recovery Plan is doing it again.

The authorities at the head of the EU find it impossible to conceive a Union based on free economics and open institutional competition. A Brussels Commission financed by external tariffs and mutualised debt will always choose centralisation over bottom-up spontaneity. The question I set at the beginning, whether this Plan will make Europe freer and more prosperous, must be answered with a concerned No.

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ENDNOTES

Section 1

1 Of course, an alternative paradigm is also possible; rather than designing what money is and how it should be governed, it could be left to the market to do so. This would be a bottom-up approach to monetary integration and monetary creation in Europe that would require no explicit design by anyone. Rather, money (or, to be more precise, different types of money) would be issued in a competitive system guided by the ability of the issuer to provide the best means of payment in the economy (see the seminal work by Hayek (1976) on the 'Denationalisation of Money').

2 Strictly speaking, open market operations are repurchasing operations involving the central bank and commercial banks, whereby a public bond is taken by the central bank temporarily as collateral when a commercial bank borrows from the central bank. Once the maturity of the loan expires, the bond returns to its owner, the commercial bank. The asset purchases operations, or quantitative easing, we have witnessed since 2007/2008 are of a different nature; they involve an outright purchase of (mainly but not only) public bonds by the central bank.

3 At the time of writing, European fiscal rules are bound to be kept 'on ice' up to 2023 (see Smith-Meyer, 2022).

4 In explaining the dynamics of government growth, Higgs (1987) is still unsurpassed.

5 This is what happened in Madrid, where the regional government chose the goal to keep Madrid's society as 'open' as possible and, to that effect, went for a series of policies aiming at realising that goal: from mass testing to a system to monitoring how the virus moved through the region by testing wastewater at some 289 sampling points over time.

6 In part, this was the result of outright Chinese propaganda (see Molter, 2020).

7 Any EU Commission document is difficult to read, let alone criticise. The varied power centres of the EU and their supposedly mnemotechnic acronyms make life difficult for outsiders – and insiders. I have been greatly helped by the article by Alonso et al. (2022).

8 When the euro was launched, I wrote a book titled The Euro as Politics (Schwartz, 2000). I feel no compunction about titling this essay 'The Recovery Plan as Politics'.

9 The proposal by some MS to make those bonds perpetual was rejected. Perpetual bonds undermine the ability to issue more bonds – a practice to which a federal Europe would not be averse.

10 The Commission lacks the power to levy its 'own' taxes. Up to 2021 the Commission's existing 'own' sources of revenue were customs duties, share of national VAT income, national contributions based on gross national product, and taxes on non-recycled plastic packaging waste.

11 Again, the January–February 2022 issue of Información Comercial Española has been useful. In this case, Vazquez de Parga (2022) has clarified for me an involved brief on the effect of Next Generation EU on Spain.

12 The Mises article and the other essays in Hayek (1975 [1933]) point at what was later called the 'Khrushchev' problem: the lack of sufficient information when there are no prices, and the prevalence of disobedience when the managers of nationalised industries are forced to cheat if they are to fulfil their assigned quotas.

13 The hero of Spufford's non-fiction novel Red Plenty (if the contradiction is allowed) is Leonid Kantorovich, the co-discoverer of linear programming with Tjalling Koopmans. This mathematical tool could in principle be applied to reducing waste in production. With its help, attempts were made under Khrushchev to try to mimic the free market in a planned system without private property of factors and resources.

SECTION 2

THE REACTION OF THE ECB: POLICIES AND ROLES

Has Central Bank Independence Suffered from COVID-19?

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Citation suggestion: Forrest Capie and Geoffrey Wood, FC & GW (2022). THas Central Bank Independence Suffered from COVID-19? *Future Europe*, 2(1), 35–41.

Abstract

Central banks have been involved in the financing of governments since the emergence of the Bank of England in the seventeenth century. It has long been recognised that such finance of governments can lead to substantial falls in the value of money and thus in the predictability of its purchasing power and its associated usefulness. A metallic base for money served as a constraint on this until early in the twentieth century, and habit served likewise in many countries until the early 1950s. Habit then broke down. Central bank independence was introduced in part to restore monetary stability. In this article we consider how well that latest attempt has resisted the sharp rise in government spending that followed the COVID-19 pandemic.

Introduction

Many of the commercial government banks that later became central banks were initially both privately owned and given privileges in return for raising funds for the monarch. That is a legacy which has hung over central banks ever since. The fear that they will monetise government debt unless somehow constrained has always been present.

More recent is another fear: that political control of monetary policy will be used for electoral ends and will thus ultimately damage real and monetary economic stability. The second fear meant that towards the end of the twentieth century it became fashionable for countries to give their central banks 'independence' – in New Zealand and in the United Kingdom, to give two examples of many.

Further, it was made obligatory for countries which wished to join the euro to first make their existing central bank independent. This may in part have been motivated by a desire to avoid political manipulation but was also the result of the fear of inflation that the 1920s experience had instilled in much of Europe.

But what is this apparently all-important independence?

Numerous economists have written on the subject, but they have almost always paid attention to how to measure some undefined notion of independence rather than discussing what the term might actually mean. The context was the relationship between degree of independence, somehow measured, and inflation. This was raised in two papers by Barro and Gordon (1983a, 1983b). The pioneers in testing whether there was a relationship between low inflation and independence were Bade and Parkin (1987). Subsequent studies typical of the approach were Masciandaro and Tabellini (1988) and Alesina (1988, 1989). Capie and Wood (1991) reconsidered the issue using a wider range of measures of independence and a longer data period. Broadly speaking, the findings of this work were unanimous: independence did correlate negatively with inflation though, as Capie and Wood (1991) note, in some countries inflation was low regardless of the status of the central bank.[14]

None of these studies spent much time on what independence actually meant. In a much earlier paper, however, one which concluded by recommending not central bank independence but a monetary rule as the best guarantee of price stability, Milton Friedman (1962) devoted some time to considering the meaning of independence.

He wrote, '[t]he device of an independent central bank embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything ... of the current political authorities' (Friedman, 1962. Republished in Friedman,1968, 178 Page references are to the reprint). He went on, 'a first step in discussing this notion critically is to examine the meaning of "independence" of a central bank.

There is a trivial meaning that cannot be the source of any dispute about the desirability of independence. In any kind of bureaucracy, it is desirable to delegate particular functions to particular agencies' (p. 179). What he called a more basic meaning of independence is that 'a central bank should be an independent branch of government coordinate with the legislative, executive, and judicial branches, and with its actions subject to interpretation by the judiciary' (p. 179).

That is the meaning which most writers have implicitly applied to the concept of an independent central bank. Friedman reviewed three proposed solutions for the problem of ensuring that so long as government is responsible for money, it cannot by debasement abuse that responsibility. The solutions were an automatic commodity standard, an independent central bank, and a rule binding the conduct of policy. An automatic standard, such as gold, has tended to develop towards a 'mixed' system with a substantial fiduciary component. Further, it is not now feasible because 'the mythology and beliefs required to make it effective do not exist' (p. 177).

That point is supported by the well-known quotation often attributed to Ramsay McDonald, the prime minister in the government immediately before that which took the decision on Britain's leaving the gold standard in 1931: 'No-one told us we could do that.'[15]

Many advocates of an independent bank recognise the current impossibility of a commodity standard and view an independent bank as an alternative way of attaining price stability. Hence, together with the widespread acceptance that inflation is not desirable, we have central banks given instructions to focus on maintaining some measure of price stability.

That focus does not absolutely preclude any purchases of government debt by the central bank, but it does limit them so that the resulting money growth does not threaten monetary stability. Here we come to the importance of the COVID-19 crisis. The pandemic led, almost worldwide, to pressure on government finances and a consequent surge in government debt. Has that debt been monetised such that it will lead to damaging inflation?

A precedent

The Reserve Bank of New Zealand was the first modern example of an independent central bank. This was part of a complex set of responses to major problems in the New Zealand economy. By mid-1984, a crisis was believed to have arrived. (Knight, then Deputy Governor of the Reserve Bank, wrote of 'a disastrous outcome for the New Zealand economy by the mid-1980s' (1991).) Following a change of government there was widespread acceptance of the need to change both the nature and the direction of economic policy. A sustained programme of reform, affecting the institutions which designed and implemented policy as well as the policies themselves, was launched.

As part of these reforms of policy, the 'mechanics' of the public sector were reformed. Clear objectives were established for public sector organisations; accountability for the attainment

'[T]he device of an independent central bank embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything ... of the current political authorities'
(Friedman, 1962)

of the objectives was assigned; performance-based contracts were given to the chief executives of the organisations; and they were given much increased management and financial freedom within a framework of agreed policies and total budgets. A revision of the Reserve Bank Act was also undertaken. After some detailed study of central banks which had been more successful than average in delivering low and steady inflation, the Act was drafted, passed with bipartisan support in December 1989, and became effective on 1 February 1990.

The Reserve Bank was given a clear statutory objective. The primary function of the Bank was to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices (Reserve Bank Act 1989, s8). That was the primary, not the only, function. But it was the only macroeconomic function. (The Bank retained regulatory and supervisory responsibilities for commercial banks.)

Notably, there are no limits on the central bank's ability to finance the government. It may seem curious that there should be no restrictions on debt monetisation, particularly as New Zealand had in the past experienced inflation because of such monetisation. Legislation against this was, however, thought to be both unnecessary and undesirable: unnecessary in view of the full-funding commitment the government had previously adopted, and undesirable because it could constrain actions undertaken for, say, liquidity management or in the course of a lender of last resort operation.

Insofar as there were lessons learned from this experience, one emerges from a comparison with the UK. Both countries have a majoritarian form of government – that is to say, a majority in parliament gives close to unchecked authority. There are few 'veto points' where a change can be blocked. Hence it is perhaps no surprise that a new government in the UK, which took office in 2010 after the financial crisis, made substantial changes to the structure of regulation and to the relationship of the Bank of England to that structure. But changes to the inflation mandate were not considered, and concerns about the Bank's internal government were essentially ignored. In contrast, no changes took place in New Zealand after the crisis.[16] This reflects several factors. There was of course no widespread financial crisis in New Zealand – there were substantial problems, but in one part of the financial sector only, and that a part outside the remit of the Reserve Bank (see Mayes and Wood, 2012). But it is also worth remarking that the Reserve Bank had a constitution which actually encouraged it to think about financial stability and the role of the Bank as lender of last resort.[17] That was, explicitly, the reason that there were no restrictions on Reserve Bank purchases of government debt. Hence the specification of the Reserve Bank Act had been such as to make the institutions it produced more robust.

A general crisis

Banking crises can be of two types, although they rapidly merge into one another. The classic banking crisis is that which lender of last resort evolved to deal with: a sudden surge in the demand for liquidity by the greater part of – possibly the entire – banking sector.[18] The New Zealand Act was consciously framed both to direct the attention of the Reserve Bank to the possible need for this operation and to allow it to take place.

But there is another type of banking crisis, much rarer in the whole run of recorded banking history but one that has occurred twice in comparatively recent years – one due to a shortage of capital not in one bank but across all or most of a banking system. This was the source of Japan's banking problems and also the original difficulty in the Global Financial Crisis (see, for example, Lastra and Wood, 2010).

There is no provision in the Reserve Bank Act to deal with a 'capital' crisis. There could have been. For while there could be no instruction for the Reserve Bank to provide capital when needed – as with all central banks, its balance sheet is too small to allow that – there could have been formal procedures under which it could approach government to request capital support under certain circumstances. This provision was not there. It was not there because it was thought that such a crisis could never happen, nor was its absence due to a desire to allow banking system failure under such circumstances. Rather it was due to no more than lack of complete foresight, and thus the inability to write a complete contingent contract dealing with all possible states of the world.

And that is the fundamental problem, if it is in fact a problem. It is impossible to design a contract so complete that nothing ever happens to require its being rewritten, thereby letting the government of the day tame or at the least reshape the central bank. That is the basic reason for almost every financial crisis leading central banks into the arms of government for assistance, relaxation of law, or some other form of support or guidance.

This is exactly how the COVID-19 crisis can lead central banks into the arms of government – or, perhaps better put, can lead governments to seize central banks in their arms. A sudden increase in the demand for finance, regardless of the cause, can do it.

Some English historical experience

We next review some historical experience in one of the world's major central banks, the Bank of England. We concentrate on this because it was the model for many other central banks, and because it illustrates many aspects of the problems we discuss.

The Bank of England was founded in 1694 out of the needs of the state to finance war. In return, the Bank was given a charter from the state that gave it a privileged position in banking in the country. The renewal of the charter clearly rested on the Bank's satisfying the state's requirements. And so began a relationship of dependency. The state needed the Bank and the Bank relied on the state for its privileges. When the Bank's charter was renegotiated in 1697, for ten years, it was given protection from competition from rivals; its position was strengthened further in the renewal of 1708 when a fresh loan was required from the Bank. At the renewal of 1715 its privileged position was further enhanced when it was given the job of managing the government's debt. The Bank's position depended on its fiscal usefulness to the state.

In the nineteenth-century age of laissez faire, the Bank's independence was still limited. The Bank's essential function was management of the gold standard and it was constrained by the rules of the standard, particularly after these were redefined in the 1844 Act. The main objective was to maintain convertibility of the currency into gold and the main control instrument was the short-term interest rate. The interest rate was made effective by discounting bills and, increasingly as time passed, by open market operations. These were all things the Bank became expert in and it was left to get on with the job without political interference.

However, a financial crisis that involved a scramble for cash presented a serious problem. In the crisis of 1825 the government instructed the Bank to pay out to the last penny (Feaveryear, p 237.). Instruction was thought to be needed as it was feared the still privately owned bank might otherwise have looked after its immediate profits due to either insufficient attention to the long term or caution over its own survival. The 1844 legislation made it difficult for the Bank to perform its key role in a crisis, that of lender of last resort. The Act needed to be suspended and that required a letter from the Governor to the Chancellor seeking the necessary exemption. That happened in the crisis of 1847 and again in 1857. Then, at the height of the Victorian boom in 1866, crisis struck again in the famous case of Overend Gurney. The Chancellor agreed that it was 'requisite to extend their discounts and advances upon approved securities, so as to require issues of notes beyond the limit allowed by law'. But he continued: 'No such discounts or advance, however, should be granted at a rate of interest less than 10 per cent, and Her Majesty's Government reserve it to themselves to recommend if they should see fit, the imposition of a higher rate' (quoted in Fetter, 1978 [1965]; see also Gregory, 1964 [1929]).

When crisis struck, government dictated how the Bank should behave. Fetter concluded of the nineteenth century, 'the Bank and the Government ... continued the fiction of official independence' (Fetter, 1978 [1965: 280).

4.1 First World War years

That was true again on the outbreak of war in August 1914, when there was a major crisis. The Governor was invited to Downing Street and told to sign a statement and to promise that during the war 'the Bank must in all things act on the direction of the Chancellor of the Exchequer whenever in the opinion of the Chancellor the national interests are concerned and must not take any action likely to affect credit without previous consultation with the Chancellor' (Sayers, 1976: 99–107). Cunliffe, the Governor, initially refused to sign and had the support of the Bank, where, they believed, 'it was impossible for the Bank thus to renounce its functions'. But some face saving was allowed and Cunliffe agreed to comply.

It is impossible to design a contract so complete that nothing ever happens to require its being rewritten, thereby letting the government of the day tame or at the least reshape the central bank.

The Governor throughout the interwar years, Montagu Norman, made it clear that ultimate authority rested with the Treasury. 'I assure Ministers that if they will make known through the appropriate channels what they wish to do in furtherance of their policies they will at all times find us willing with good will and loyalty to do what they direct, as though we were under legal compulsion.'[19] Norman went further than that when he told a meeting of Commonwealth bankers, 'I am an instrument of the Treasury'.

4.2 Post-Second World War

It is often assumed (or asserted) that after the Bank was nationalised by the Labour government in 1946 everything changed and the Bank thenceforth became a subsidiary of the Treasury. But in fact very little changed. While there were complex drafting requirements to specify the functions, powers, and purposes of the new public corporations being formed after the war, in the case of the Bank this was unnecessary because there was 'never any question that it should not continue doing what it had been doing for a very long time' (Chester, 1975: 196).

Throughout the period from the 1950s to 1980 the Bank operated with considerable freedom, with what it liked to think of as independence (see Capie, 2010: 773–780). Its principal function of defending the exchange rate was restored. Things were as they had been in the golden age before the First World War. Many actions were taken but most important was the use of its oldest instrument – Bank Rate. Bank Rate was regarded as primarily of use for external purposes. And movements in Bank Rate were not merely executed but were determined by the Bank. The Bank argued that knowledge of interest rates was a key part of their expertise and they knew better than any other part of government where interest rates should be and when they should be changed. Whenever there was a developing threat to sterling, the Governor would tell the Chancellor that a rate change was proposed on a particular date. The Chancellor's reply was simply a one-line memo of approval. There were only a few isolated cases of resistance or postponement (see Capie, 2010: chapters 4, 5, and 6). The relative freedom began to come under serious pressure in the 1970s following the loss of the explicit exchange-rate target. When monetary targets were in place, monetary policy was increasingly politicised and politicians and civil servants had a simple number which they wanted to see met or to be told why it was not. Further, as these monetary targets were chosen domestically, they could if desired be changed, even to facilitate lending to government.

Thus it can be seen that from the Bank of England's founding a dependent relationship with government was accepted. Since the country was at war more often than it was not between 1688 and 1815 and the state needed funds, it needed the Bank, and the Bank depended on the state for preservation of its privileges. What can be called the 'fiscal threat' was almost always present.

4.3 Post-Global Financial Crisis years

The financial crisis of 2007/2008 exposed weaknesses in the mandate given to the Bank of England, as well as defects in how the Bank (and the Financial Services Authority) responded to the crisis. This inevitably required not only action from the government to deal with the crisis, but also changes in the mandate. The former plainly compromises central bank independence. Does the latter? The changes have concentrated authority in the Bank, but of course a consequence of this is that there is more that can go wrong and affect the Bank's reputation and thus its authority.

There are some similarities with the US Federal Reserve (the 'Fed'). Much of Allan Meltzer's history of the Fed is concerned with its independence. 'The purpose of independence is to prevent government from using the central bank to finance its spending and budget deficit' (2009: 1256). But Meltzer argues, following Friedman, that independence needed to be defined in law. If it were not, its interpretation was left to its Chairmen and Board of Governors. A fundamental problem, according to Meltzer, was the failure of the Fed ever in its history to set out its lender of last resort policy. On some occasions it would respond in one way, and on other occasions in another way, depending on the views being taken at the time by either the Chairman or the Board, thus generating uncertainty. Nowhere was this more evident than in the 2007/2008 financial crisis.

Meltzer argues that in the years 2007–2009 the Fed lost much of the independence it had regained in the 1980s: '[Bernanke] worked closely with the Treasury and yielded to the pressures from the chairs of the House and Senate Banking Committees and others in Congress' (2009: 1243). Further, he states that he 'has acted frequently as a financing arm of the Treasury' (2009: 1256). In 2008 the Fed almost trebled its balance sheet, much of it in illiquid assets. The policy of ignoring inflation and claiming to be concerned solely with unemployment, the other goal of the Fed, continued into 2012. The dual mandate allowed something that was politically convenient but, as Taylor (eg 2011.) argues, far from obviously either effective or even worth trying.

The European Central Bank

If ever a central bank were designed to be independent in the sense of entirely free of political influence, it was the European Central Bank (ECB), with the Bundesbank as its template. It was made quite explicit that political interference would not be tolerated. However, in the context of the banking crisis and subsequently of the COVID-19 crisis, the behaviour of the ECB can surely only be described as political. It has bought government debt not in the conduct of monetary policy but to finance governments. The ECB has denied this but its willingness to buy the debt of governments seen as bad risks must raise doubts. There is a justification given for these purchases – they are intended to make the monetary transmission mechanism work across the whole area, a phrase interpreted by the ECB as keeping rates on the debt of all Eurozone governments

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within a narrow corridor. But that justification is not robust. And that is for the major reason that debt markets and banks in certain countries are shunned over doubts about solvency. Again, independence has not withstood a crisis. Rather, the central bank adopted a politically chosen goal other than the one it was given, under extensive and well-reported pressure.

It has behaved as if all Eurozone government debt is of equal standing. It may seem bizarre to be concerned about debt issued by a sovereign; such governments do not default. That is a lesson often drawn from contrasting the experience of countries which have got into grave financial difficulties after borrowing in another country's currency, with the experience of countries which borrow solely in their own. But to apply that to the Eurozone is to conflate two meanings of 'sovereign'. Eurozone countries have shared and not given up their sovereignty in the European Union – except when joining the Eurozone, when they give up monetary sovereignty, the control over their national monetary policy. They no longer have a national monetary policy. They do retain some influence over the monetary policy of the ECB, but it is dilute influence over a monetary policy not exclusively their own.

Hence there can be legitimate concerns about the ability of the ECB to resist fiscal pressures. Some members may wish to resist them, but others do not. Despite its constitution, the ECB has manifestly had its independence compromised by the COVID-19 crisis. But, as has been argued above, central banks have always been potentially if not always actually subject to the fiscal demands of government.

Conclusion

It may seem tempting to conclude by constructing a counterfactual, so as to consider what a 'truly independent' central bank might have done in the two most recent crises, the banking one and the COVID-19 one. But we resist that temptation, as the whole argument of our article is that such a truly independent central bank cannot exist. There is, however, another and more fruitful way of getting close to the question. What might a central bank guided by and adhering to the principles set out by Thornton, Bagehot, and Hawtrey have done in these circumstances? The answer is clear. They would have provided liquidity until the liquidity aspect of the crisis was over. They would have had nothing to do with the provision of capital to support individual banks – that is not their responsibility, beyond their balance sheet capacity, and it is a contradiction of the principles guiding lender of last resort action. As for buying almost all the debt the government cared to issue, that would certainly not have been done – the harm to price stability that would follow had been abundantly illustrated during the Napoleonic Wars.

An altogether different approach was chosen in most major countries. James Bullard, President of the Federal Reserve Bank of St. Louis, said, 'I am a little – maybe more than a little bit – worried about the future of central banking. We've constantly felt that there would be light at the end of the tunnel and there'd be an opportunity to normalise but it's not really happening so far.' (Bullard, 2012)

That describes very well what has happened to the 'independent' central bank of every major Western economy, not just in the financial crisis James Bullard was discussing, but also in the more recent COVID-19 crisis. The history of central bank dependence on government does not need to be revised.

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Which Constitutional Economics for the Two-Decade-Old Eurozone?

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Citation suggestion: Alberto Ruiz-Ojeda, ARO (2022). Which Constitutional Economics for the Two-Decade-Old Eurozone? *Future Europe*, 2(1), 42–49.

Abstract

The twentieth anniversary of the euro brings to light the feats and flaws of the European integration process and gives occasion to revise its peculiar configuration. This article contains reflections from a legal and economic perspective and is aimed to provide readers with an assembled vision of the monetary, fiscal, and constitutional features of the Eurozone. The critical analysis of the ECB's monetary policies on inflation and quantitative easing, along with comments on the judiciary conflicts that have arisen between the European Court of Justice and the German Constitutional Court, form the core of the article. Some attention is also paid to the Fiscal Union and the role of a European Fiscal Compact to balance the asymmetry of a single currency without a taxation-budget counterpart. A new constitutional consensus for the EU, endowed with sound economic foundations, is considered indispensable to fill the legitimation gap left by current 'fiscal dominance' in the monetary realm.

A 20-year-old euro: from the Great Moderation to times of unrest

Money cannot and never will be immune to the polar effect of the two widespread, contrasting visions of the state and markets.[20] Moreover, as lucidly emphasised by Charles Goodhart (1998), the logic of currency areas – the central topic of this article – requires a profound comprehension of the dialectical game of Metallist versus Cartelist traditions. Moreover, the Eurozone's insertion into the architecture of the European Union is a rarity in the historical and comparative panorama whose survival and development can hardly resist the passing of time and two major crises since 1999. In other words, a construct built on subtleties could become unaffordable and difficult to maintain when the big picture

The ECB is an independent authority, not an independent power. Central banks' autonomy relies on the specific mandate jointly received from the executive and the legislative powers to be in charge of monetary policy; this mandate must be specified and implemented on the grounds of their technical capability and subject to the law.

changes. The euro was devised and launched in a period of unprecedented economic, political, and social amenity, which included the 'Great Moderation' years and coincided with the Eastern European socialist bloc's collapse, along with its Balkan extension. Apparently, this left a vacuum at the disposal of its capitalist, democratic counterpart. Just when Western civilisation, whose crutch was the current EU, was undergoing a process of structural reform as a consequence of the Great Financial Crisis and the pandemic, the Ukrainian war broke out. Whether this event will undermine or foster the European integration process is difficult to predict, but sound reflection is required.

I am going to deal firstly with the up-to-date stance of the Eurozone monetary policymakers on the wider issue of the constitutional shaping of the European Central Bank (ECB) (section 2), then move on to the discussion of some economic misconceptions and wrong projections incurred by the ECB (section 3). I will later tackle the institutional trouble caused by the May 2020 German Constitutional Court decision on the ECB's asset purchase programmes (so-called quantitative easing, or QE) (section 4) and its derived strands. To finish (section 5), I will draw some conclusions and discuss the forthcoming scenario to discern the connection between monetary and fiscal policies and to what extent current EU fiscal rules will usher in the dawn of tighter integration.

Schmittian momentum for a Hamiltonian moment?

Federal criteria must be at play in order to manage any sort of pluri-national structure. Reflection on comparative history is of great use to learn from past experience and to shape specific responses to the problems raised by supra-state schemes. This - reflecting on comparative historical experiences - is what most of the best-endowed European (as well as non-European) brains have done with occasion of the two formidable challenges that the common currency has had to face, the Global Financial Crisis and the COVID-19 pandemic, not to mention the large task ahead: coping with the recent outbreak of the war in Ukraine and its aftermath.

When making the comparison, a milestone in American history comes to mind: the 1790 joint decision by Alexander Hamilton (US Treasury Secretary, promoter of the idea), James Madison (a life-long opponent of central banking), and President Thomas Jefferson (initially reluctant) for the US federal republic to absorb the states' debts after the War of Independence. This is more than scholarly vagary, as a formal statement by ECB President Christine Lagarde (2021) explicitly mentions the need for constitutional mutation in the EU in order to accommodate the big leap implied by the Eurozone member states' public debt mutualisation through a Fiscal Union. In a sophisticated and elegant legal-theory parlance, Lagarde makes additional reference to the American tradition by proposing how that mutation might be carried out, through European Court of Justice (ECJ) case law, in a trial-and-error fashion. Setting aside other implications, her call for activism on the part of European judges might be supported by the favourable precedent of recent ECJ jurisprudence on the ECB's legal stance in EU primary law, mainly in asset purchase programme cases, as we will see below. The ECB President goes further by expanding her creative interpretation of the law to other independent EU entities other than the ECJ, specifically the ECB. Which lawyer has not heard the demand to be more creative from a desperate client? I will return to this shortly after summarising the Hamilton experiment.

The Hamiltonian move had already been evoked, most remarkably by Thomas J. Sargent (2012) in his 2011 Nobel Prize discourse where he made the US–EU comparison. Some other economists labelled this episode as Hamilton's Eurozone tour (James, 2012). Sargent summarises how the experiment came to an end in the US in the early nineteenth century and ultimately with the 1861–1865 Civil War. In a nutshell, the outcome was a surge in public debt, hyperinflation, consequent price instability, economic fragmentation, and a more profound political disaffection which contributed to the armed conflict. The expansion of federal tax revenues as a result of the states' debt mutualisation gave creditors the illusion of a deep pocket that faded away a few decades later when the US Treasury restructured its debt (a sort of repudiation) in 1848.[21] This happened in a context of non-constitutional coverage, insufficient political consensus, and, not surprisingly, the creation of the American central bank prototype in 1811, the First Bank of the United States. To tell the whole story, Hamilton himself had put his finger on the key issue of fostering institutional reforms both to assure the states' fiscal discipline and to avoid their debt appetite at the expense of federal tax pooling. None of these reforms took place. As has historically been the case, institution-shaping procrastination and the neglect of the matrix of incentives for stakeholders are the coincidental features of the Hamiltonian US and the present EU.

However, Lagarde's innuendo regarding the role of the ECB and its position within the architecture of the EU seems much more worrisome to me than the debatable pertinence of the historical comparison. Should the ECB become the EU's constitutional father-reformer, history would be made. Lagarde grasps hold of Justice R.B. Ginsburg's allegation, 'prestige to persuade, but not physical power to enforce', to underpin her intended constitutional rule-making mission of the ECB before the current threats to the Eurozone. Though the accurate discussion of such a proposal is beyond the scope of this article, it leaves a remarkable nuance unattended: the ECB is an independent *authority*, not an independent *power*. Central banks' autonomy relies on the specific mandate jointly received from the executive and the legislative powers to be in charge of monetary policy; this mandate must be specified and implemented on the grounds of their technical capability and subject to the law. Along with administrative accountability and control by the courts of justice, central banks are under the pressure of the reputational opprobrium derived from their mistaken analyses, wrong forecasts, and misled measures.[22] As a branch of the government, giving central banks responsibility for making law, whether of a constitutional nature or not, whether through formal enactment or case-by-case decisions, would convert them into the type of sovereign that Carl Schmitt considered was reserved for one capable of declaring a state of emergency: *Salus populi suprema lex esto*.[23] What would become in the meantime of the Orsian pristine authoritative knowledge of independent bodies such as the central banks?[24] Regarding inflationary trends and price stability, in the case of the ECB, as we will see, these could have been lost due to its Schmittian metamorphosis. The ECB's projections on inflation (that is, the institution's core goal) have been not only wrong but also biased since the very beginning of the Eurozone.

Beyond the 'old monetary malpractice' and 'spaghetti economics': understanding inflation to make sound policy decisions

There is nothing more useful than a good theory, providing it is able to explain reality in causal terms. But this does not mean that wrong theories are useless, at least to policymakers, whether fiscal or monetary. Moreover, politicians at all levels are prone to use wrong theories if they endorse their policies. That is what happens with Modern Monetary Theory (MMT), which has become both the most mistaken theory and the one that best explains both governments' fiscal misbehaviour and central bankers' monetary errors. MMT's holistic scope from taxation to money must not be missed to appraise its appeal.[25] *Necessitas non habet legem* (i.e., 'necessity knows no law'), nor theoretical restrictions.

The *Financial Times* journalist Wolfgang Münchau (2021a) has named this the 'dedicated follower of fashion's syndrome'. But unlike haute couture, in monetary policy fashion followers do not coincide with fashion victims – not even close. Revolving doors show us the trend. They no longer function from the financial industry to central banking/financial regulators, and the other way round, but instead function between the latter and conventional politics. The examples of Mario Draghi, Lagarde, Luis de Guindos, and Janet Yellen need no further comment. A kind of mimesis is taking place between the knowledgeable and the partisan-vested ones. In practice, MMT is receiving robust backing from central banks' monetary measures in the form of a new version of the 'old monetary malpractice', money printing.

The ECB's reaction to the surge in inflation, initially labelled as 'provisional', also shows the same addiction to noble lies, now regarding the other aspect of the ECB's balance sheet operations, QE. As Juan Castañeda (2021: 27–28) has stated, for MMTers, public debt purchasing by central banks is not simply an option but is, in fact, the latter's proper role. And it must be carried out in a way that throws double-entry accounting into oblivion: 'central banks could simply credit the account of the government without any other counterbalancing debit being required'.[26] MMT's simplicity is beyond all doubt. But it converts financial theft into an exercise of banality, as if the mere fact that those who do it may sanctify the practice.

Sergio Leone's followers might gladly accept my denomination of the ECB Executive Board member Fabio Panetta's (2021) explanation of inflation as 'spaghetti economics'. He talks about three kinds of inflation: the 'good', the 'ugly', and the 'bad'. The 'good' inflation is the one that falls inside the ECB's 2 per cent target, when demand is high, the output is potential, and unemployment is high. The 'ugly' inflation is the persistent one. Finally, the 'bad' one is linked to supply shocks. To sum up Panetta's stance, these three kinds of inflation have a common feature: none of them has much to do with the ECB's actual policy measures. 'Good' inflation has occurred sporadically during the ECB mandate. The same happens with the 'ugly' one, because current inflation is not going to be persistent but is transitory, an idea the ECB strongly upholds, though nobody knows how transitory it will be. Ultimately, 'bad' inflation is related to macroeconomic instability caused by exogenous factors outside the control of the ECB: first the pandemic, and then by the Russia–Ukraine engagement.

Isabel Schnabel (2021), another ECB Executive Board member, has recently provided us with a formidable, *digital* analytical tool for inflationary forecast: 'we keep our finger in the wind to determine whether the breeze [of inflation] will turn out to be more long-lived than just a transitory gust'. The effective result of this method has been the ECB's life-long navigation in the dark when it comes to the Eurozone's inflation estimates, its main and founding goal, as has been noted, among others, by F. Canepa (2021).[27] The ECB's projections on inflation are not only wrong but also biased because what lies beneath the discourse is a mistaken theory on inflation.[28] Panetta's 'good' inflation revisits the Keynesian version of the Phillips curve.[29] 'Ugly' inflation is here to stay for a long time, and it has been caused by the unprecedented increase in the amount of money in the economy derived from the ECB's monetary policies, that is, the zero/negative interest rates and the pharaonic asset purchasing programmes. The 'bad' one, simply put, is not inflation, though disruptions of supply chains due to warfare are more harmful in inflationary contexts, as is the case with the current Eurozone. It is more important than ever to recall Milton Friedman's (1970: 24) saying: 'Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.' Ad hoc, cost-based theories of inflation only explain relative price fluctuations, not that of overall prices; thus the control of the quantity of money, which monetary theories of inflation advocate, permits the mastery of overall price levels (see Greenwood and Hanke, 2021). Juan Castañeda and Tim Congdon (2020) have shown how the analysis of the evolution of money aggregates supports an accurate ascertainment of inflation trends and the outline of robust, consistent projections.

Revolving doors show us the trend. They no longer function from the financial industry to central banking/financial regulators, and the other way round, but instead function between the latter and conventional politics. The examples of Mario Draghi, Lagarde, Luis de Guindos, and Janet Yellen need no further comment. A kind of mimesis is taking place between the knowledgeable and the partisan-vested ones. In practice, MMT is receiving robust backing from central banks' monetary measures in the form of a new version of the 'old monetary malpractice', money printing.

The Eurozone's bizarre architecture and the German legacy: taxation through monetary regulation by an ECB without fiscal counterpart

One of the main conclusions of Simon Mee's (2019: 313) formidable book *Central Bank Independence and the Legacy of the German Past* is that the euro is the monument to the deutschmark. Twentieth-century German historical experience of inflation is a swelling soar. But it is much more than that, insofar as it has been engraved in their constitutional framework, the Grundgesetz (GG), along with the explicit enshrinement of a Ricardian fiscal regime that subjects the increase of money supply through budgetary imbalances to severe restrictions.[30] Article 110(1) GG guarantees fiscal equilibrium, and Article 115 sets up explicit quantitative limits to public debt and indebtment, something which might be surprising to any constitutional expert. In short, the 'no taxation without representation' motto has its more solemn recognition in German constitutional law. Certainly, 'monetary dominance' through a sound currency and fiscal austerity is the keystone of that nation's institutional system. Broadly said, we may talk of the prevalence, at least in this realm, of the German, southern Catholic vision over the Prussian, northern Protestant one, in a paradoxical response to the well-known nineteenth-century budgetary conflict finally won by Chancellor von Bismarck.[31] Whether this trend could be reversed to get back to the Prussian style is a question that will remain unanswered here.

In this context, nobody can be struck by the disagreements between Germany and the EU, both as a whole and inside the European comitology, and their conveyance to the ECJ and the German Constitutional Court (the Bundesverfassungsgericht, or BVerfG) level. Since the 2007–2008 Global Financial Crisis, which gave rise to the Eurozone's sovereign debt turmoil a few years later, and and the ECB's reaction by the assets purchase programmes, a line of conflicting case law has emerged. Specific BVerfG requirements of clarification to the ECJ in the form of preliminary ruling procedures are at the root of the latter's decisions on the Gauweiler (2015) and Weiss (2018) cases, preceded by the

Irish-induced Pringle one (2012).[32] However, the bombshell fell on the occasion of the 5 May 2020 BVerfG decision,[33] already known as the ultra vires judgement.[34] At the core of the issue was the ECB itself and its pandemic emergency purchase programme (PEPP). To summarise the dispositive part of the ruling, the BVerfG states that the German Federal Government and the German Bundestag (the German Parliament) violated the German constitution (the principle of democracy) by omitting to take appropriate measures against the ECB not checking and explaining whether the PEPP was in compliance with EU law (the principle of proportionality). The BVerfG concludes that 'the PSPP constitutes an ultra vires act, given the ECB's failure to substantiate that the programme is proportionate, their responsibility with regard to European integration (*Integrationsverantwortung*) requires the Federal Government and the Bundestag to take steps seeking to ensure that the ECB conducts a proportionality assessment in relation to the PSPP' (emphasis intended). The German Constitutional Court settled accounts with the ECB and the ECJ's jurisprudence by considering itself the supreme interpreter of both German constitutional law and EU primary law, as the BVerfG upheld that the preliminary ruling remedy to the ECJ was correctly depleted through Gauweiler and Weiss. The BVerfG gave the ECB a three-month transitional period to adequately justify the PSPP in the following terms:

> [T]he ECB Governing Council adopts a new decision that demonstrates in a comprehensible and substantiated manner that the monetary policy objectives pursued by the ECB are not disproportionate to the economic and fiscal policy effects resulting from the programme. On the same condition, the Bundesbank must ensure that the bonds already purchased under the PSPP and held in its portfolio are sold based on a – possibly long-term – strategy coordinated with the ESCB.

Thus, the Bundesbank may no longer participate in the implementation and execution of the said PEPP.

This BVerfG judgement raises many troublesome issues that cannot all be mentioned here. The European Commission reacted by initiating infringement proceedings against Germany in June 2021, based on the BVerfG's violation of EU primacy and autonomy law. In less than six months, on 2 December, the Commission closed proceedings by way of an extremely brief official announcement declaring that they had received proper assurance from Germany, which 'commits to use all the means at its disposal to avoid, in the future, a repetition of an *ultra vires* finding, and take an active role in that regard'.[35] To go out on a limb, let me say that the BVerfG just asked the ECB for what Paul Tucker (2018: 419) calls the basic demand of the Principles for Delegation on independent authorities such as the ECB; 'that the monetary objective should be observable and central bank's actions comprehensible', nothing more, nothing less. It is hard to find in the ECB's decisions on the asset purchase programmes anything that duly justifies (a) the monetary impact of the measure according to Article 119 of the Treaty of Functioning of the EU (TFEU); (b) adherence to the sovereign debt monetisation ban in accordance with Article 123(1) TFEU; (c) the non-privileged financing of member states rule of Article 124 TFEU; or (d) the prohibition of member states financing by the EU envisaged by Article 125(1) TFEU. Other critical aspects have been left behind the Schmittian-like Mario Draghi's mantra 'whatever it takes', basically the wealth distributional effects of the ECB's asset purchases and the potential losses to be absorbed by its member states shareholders, and consequently by their citizens because of non-performing sovereign bonds (the principle of democracy alleged by the BVerfG).

To shed light on the issue, let me retrieve the proposal by C.M. Reinhart and K.S. Rogoff (2013) for the confiscation of private savings through compulsory haircuts to avoid sovereign debt defaults. Surprisingly, they do not seem to realise that inflation puts into effect the same taking of wealth without any procedure or identifiable decision. Additionally, net sovereign debt balances inside the ECB's books, combined with the rollover practice, produce a result identical to cancellation, in all but name.[36] It is by no means insane to think that the ECB has circumvented constitutional rules and sensible financial standards. Both perpetual public debt and inflation confirm the point made by N. Kocherlakota (2010): one cannot eliminate the costs caused by central banks' intervention but must simply shift them among certain groups in the economy.

Towards the end of the twentieth century, before the euro entered into force, R.A. Musgrave (1999: 175) wisely identified the central issue as the absence of a fiscal central counterpart to the ECB able to be in charge of stabilisation measures: 'The entire responsibility for stabilization is thus left with the common central bank and its monetary policy.' German tradition led to an asymmetrical construction that relies on some sort of competitive, incomplete federalism based on the economic rivalry among member states inside a common framework of deficit and debt limitations that coexist with a single, centrally managed currency. Should this asymmetry be tolerated for a long time? Should it bear the fruit of an integrated, recognisable EU?

Some conclusions: the way forward

Let me conclude and share some conclusions in the following points:

- Monetary policy tools have very limited effect. The same can be said of fiscal ones. A sensible combination of both in a single package is as necessary as it is difficult to achieve, even more so in the case of complex, pluri-national architectures such as that of the EU. The current Maastricht–Lisbon

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framework provides the EU with an asymmetrical, unconventional monetary-fiscal structure that largely relies on the Mundellian optimum currency areas paradigm of perfect mobility of economic factors and member states' rivalry.[37] This has worked reasonably well up to now,[38] but the 20-year-old euro shows clear signs of fatigue after having survived two severe crises that have converted the ECB into the common stabilisation artefact of the EU in the absence of a meaningful centralised fiscal lever. Certainly, the EU's real economy improvement is the issue, and how to shape an institutional framework that fosters productivity and gives shock-absorbing relief without counter-incentives to member states is the hard task ahead. Maintaining a situation of fiscal dominance through monetary policy willing to support government finances constitutes an unsustainable deficit of legitimation that undermines European cohesion and deepens the schizophrenia caused by a dual ('South' vs 'North') Eurozone.[39]

- In the meantime, the ECB's reversal of the monetary policies of the last decade in an effort to address rampant inflation seems to be a forced course of action to return to price stability, rather than the outcome of a rule-based monetary strategy and solid economic analysis.[40] The Eurozone needs prestigious central bankers who care about their professional reputation, not politicians in technicians' clothes. The euro is in jeopardy, and the EU's industrial decline could be the last nail in the coffin.[41] On the fiscal side, the proposal to eventually mute of the Stability and Growth Pact,[42] as well as the EU budget stabilisation measures introduced to address the effects of the pandemic and the war in Ukraine, might be the continuation of the same approach, rent distribution by money printing (see Feás Costilla, 2021).

- Undoubtedly, the euro is a political project whose survival and prosperous development needs political traction, and thus political commitment. A going-Prussian Germany longing to recoup its role as a Central European catalyst and East–West cushion would make possible a shift in the present state of affairs and the creation of a new equilibrium. But a consequential constitutional consensus for the EU will be indispensable, including some sort of Buchanian monetary and fiscal meta-rules.[43] The essence of every tyranny, even that of the benevolent dictator, consists of the enforcement of rules that are not applied to the ruler.[44]

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Assessment of the ECB Monetary Strategy Review, 2021

Does the New Strategy of the ECB Secure the Purchasing Power of the Euro over the Long Term?

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Citation suggestion: John Greenwood, JG (2022). Assessment of the ECB Monetary Strategy Review, 2021: Does the New Strategy of the ECB Secure the Purchasing Power of the Euro over the Long Term? *Future Europe*, 2(1), 50–58.

Abstract

The European Central Bank (ECB)'s Monetary Policy Strategy Review (MPSR) conducted in 2020–2021 provides little certainty as to whether the next few years will be more inflationary than the past decade, when the Eurozone persistently undershot its inflation target. Since the outcome of the MPSR will depend on the average growth rate of M3, the question is whether the MPSR provided any clarity on this issue. Following directly from a similar review conducted by the US Federal Reserve in 2019–2020, we find that exercise was unhelpful in determining a path for the amount of money in the United States or the Eurozone. Moreover, international trends in monetary policy away from 'economic and monetary analysis' – the Bundesbank-based founding principles of the ECB – towards interest rate management or adjusting policy to 'financial conditions' are unhelpful for achieving any target for broad money (M3 in the Eurozone). The original 'reference value' for M3 is shown to have been too low, but the ECB's new reliance on interest rates and 'financial conditions' alone without retaining a quantitative anchor as part of its dashboard is risky. The revised framework of a symmetric inflation target widens the ECB's discretion while retaining its new policy tools without committing to any core principles, resulting in a high degree of uncertainty about future M3 growth and inflation.

Introduction

In the two decades since its creation, the European Central Bank (ECB) has carried out two reviews of its monetary strategy, one in 2003 and one in 2021. The first was conducted against a backdrop of relative stability in economic activity and inflation, and relatively normal interest rates. Its main focus was the emphasis to be placed on the two pillars that took centre stage in the early days of the ECB's foundation: the economic analysis and the monetary analysis (Issing, 2004). Already by 2003 it was becoming clear that the 4.5 per cent 'reference value' for M3 was being exceeded without serious inflationary consequences. Unfortunately, the outcome of the review was that the two pillars – the economic analysis and the monetary analysis – were downgraded for modelling and analytical purposes, although they retained a nominal presence in the ECB President's monthly presentation of policy (Issing, 2004).[45]

The second review of 2020–2021 was conducted against a much less stable economic and political backdrop. Following the Global Financial Crisis (GFC) in 2008–2009 and the Eurozone debt crisis of 2011–2012, Euro area monetary policy had experienced enormous challenges. In the immediate aftermath of the GFC, it was plagued with negative and sub-par M3 growth, weak nominal GDP growth, and near-deflationary conditions. This was followed by the Euro area debt crisis, which required the introduction of a series of 'non-standard policies', notably the Securities Markets Programme (SMP, May 2010–September 2012), long-term refinancing operations (LTROs, 2011), Outright Monetary Transactions (OMT, 2012), and the Asset Purchase Programme (APP, consisting of corporate, asset-backed, and public sector securities purchases from 2015). Finally, as if the early and middle years of the last decade were not problematic enough, the onset of the COVID-19 pandemic in 2020 has required the ECB to embrace a further series of non-standard measures including TLTROs (targeted long-term refinancing operations) and the PEPP (pandemic emergency purchase programme). All these have drastically changed the way the ECB operates, forcing the Governing Council to consider how it should best fulfil its mandate in a dramatically changed environment.

Note that none of these non-standard policies was introduced with the specific aim of raising the amount of money (as measured by the M3 growth rate). After Mario Draghi won the existential battle to preserve the euro (with his declaration of 'whatever it takes' in July 2012), policy shifted to belated adoption of quantitative easing (QE) in 2015, and M3 growth finally accelerated modestly. But money growth has become less and less of a focus for Governing Council members.

The purpose of the current article is to assess whether the conclusions of the 2020–2021 Monetary Policy Strategy Review (MPSR) provide an adequate basis for assuring long-term stability of broad money growth and hence prices and purchasing power in the Euro area. My assessment will be presented in the light of developing trends in central bank policy strategy, particularly in the US, as well as against the gradual divergence from the original medium-term anti-inflation framework devised for the Eurozone but steadily pushed aside in favour of shorter-term goals.

The article is structured in three parts. To set the stage, section 2 summarises the Fed's 2019–2020 review, because the ECB's review cannot be seen independently of the discussions and conclusions comprising the Fed's review and the wider trends in central bank management strategies around the world. In some respects, the ECB review can be seen as a copycat exercise, starting and ending about a year after the Fed's review. In the case of the ECB, the recent MPSR comes after a decade of major monetary policy challenges which, in my view, are best understood in the light of the shift in priorities from the original strong framework of the two pillars to a looser collection of ideas built around the management of interest rates. Section 3 therefore discusses some of the reasons why the strong original framework of the two pillars was maintained in name but not in substance, and how policy was conducted in practice following the downgrade of the two-pillar framework in 2003. Section 4 contains a brief theoretical explanation of why the current interest rate-dominated framework will likely founder. Section 5 summarises the 2020–2021 MPSR and concludes that a return to a better formulated two-pillar framework would serve the people of the Eurozone better than the interest rate/financial conditions-led strategy which ECB policy has progressively adopted during the past decade.

The 2019–2020 review of the US Fed policy

The ECB's 2020–2021 review took place against a background of the US Federal Reserve system having recently conducted the first-ever review of its policy in 2019–2020. The review took the Federal Reserve's statutory mandate of full employment and price stability as given as well as the longer-run inflation objective of 2 per cent. The review process featured three key components (Board of Governors of the Federal Reserve System, n.d.):

- A 'Fed Listens' initiative involving consultation with a broad range of people and groups across the country. This part of the exercise was aimed at reinforcing the Fed's accountability by stressing diversity, inclusiveness, and openness to discussion with all groups. The ECB's MPSR followed a similar format.
- A more technical part of the review featured a flagship research conference hosted by the Federal Reserve Bank of Chicago. This brought policymakers together with leading academics and researchers to hear about research central to the framework review.
- Finally, the Federal Open Market Committee (FOMC) discussed topics associated with the review at five consecutive

FOMC meetings beginning in July 2019. This discussion was informed by analytical work by research staff across the Federal Reserve System and was reported in the minutes of those five meetings.

The results of the Fed's review were announced on 27 August 2020 and rapidly earned the moniker 'Flexible Average Inflation Targeting'. The key product of the review was a revised Statement on Longer-Run Goals and Monetary Policy Strategy, which lays out the goals for monetary policy, articulates the policy framework, and serves as the foundation for the Committee's policy actions.

Among the more significant changes to the framework document were:

- On full employment, the FOMC intends to pursue 'maximum employment' as a broad-based and inclusive goal. The Committee reported that its policy decision will be informed by its 'assessments of the shortfalls of employment from its maximum level'. The motivation derives from the observation, mentioned several times in speeches by Fed governors and others, that lower income groups were benefiting significantly from employment and wage gains late in the cyclical expansion. The implied conclusion was that it was better to reach near-maximum employment as quickly as feasible after recovery so long as inflation was not triggered, rather than proceed with the kind of slow, 'jobless' recoveries that had characterised the three previous business cycle upturns (from March 1991, from November 2001, and from June 2009).
- On price stability, the FOMC adjusted its strategy for achieving its longer-run inflation goal of 2 per cent by noting that it 'seeks to achieve inflation that averages 2 percent over time'. To this end, the revised statement states that 'following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time'. While it is highly unlikely that the Fed has this degree of control over the levers of policy and hence the inflation outcome, nevertheless, following a decade of undershooting on both employment and inflation targets, the Fed was adjusting its priorities to emphasise that it will try hard not to repeat the mistake of undershooting again. However, this worthy objective has already been torpedoed by the surge in consumer price inflation to over 7 per cent in late 2021 and early 2022 since the Fed will be compelled to spend 2023 and 2024 at least ensuring that inflation declines back towards its 2 per cent target zone, rather than maintaining an accommodative stance as they would prefer.

Following a decade of undershooting on both employment and inflation targets, the Fed was adjusting its priorities to emphasise that it will try hard not to repeat the mistake of undershooting again.

Ironically, the Fed came to these conclusions on maximum employment and 2 per cent average inflation just at the time – amid the pandemic – when broad money growth had been excessive, but the consequent inflation had not yet become evident. Therefore, the review concluded that central bank interest rates were more likely to be constrained by their effective lower bound than in the past. However, it has been clear for many months, in the light of the surge of inflation in 2021–2022, that the short-term outlook for policy rates must be for more rapid increases than central banks such as the Fed or the ECB were acknowledging back in 2020 or the first half of 2021. In other words, despite the elaborate façade of policy coherence that central banks have built up over the past two decades, the reality is that their interest rate- based policies have not controlled the mix of medium-term growth (or employment) and inflation anything like as closely as they may have claimed.

Three observations relevant to the ECB review are worthwhile at this stage. Firstly, the FOMC's preferred instrument is interest rate adjustment. (The Bank of England has also made similar statements in recent months.) Secondly, due to the proximity of interest rates to the so-called effective lower bound (ELB), the FOMC stands ready to resort to balance sheet expansion whenever it might be deemed necessary, complementing such policies with forward guidance. A return to orthodox interest rate policies by the Fed and other central banks is clearly preferred but cannot be guaranteed. Thirdly, although unstated in its review, it is a fact that the Fed abandoned any attempt at managing – or even referencing – the quantity of money from the 1990s onwards, with the result that the inclusion of traditional monetary measures or similar quantitative criteria for judging the stance of monetary policy was not even considered in the recent Fed review.

The lack of any reference to a broad money supply aggregate means that the Fed does not have such variables anywhere on their 'dashboard' of key indicators, and the huge growth of money during the early part of the pandemic was ignored by the FOMC. Yet despite many claims about global factors such as supply chain disruptions or energy prices causing the inflation, the true reason for the surge in economic growth and inflation was the egregious increase in the broadly measured stock of money in the US since the onset of the pandemic in March 2020. By contrast, the much lower relative rates of broad money growth in China, Japan, and Switzerland over the two years 2020–2021 explain why inflation in those economies has remained much lower. This is despite these economies experiencing the same type of supply chain disruptions and similar energy price increases (see Greenwood & Hanke, 2021). The conclusion is that the Fed's reliance on interest rate-based policies, as advocated in its review, is not a good formula for ensuring low and stable money growth in the future.

The 2003 Strategy Review and the ECB's shift from the two pillars to interest rate management

Numerous contemporary papers and subsequent memoirs lay out the original philosophy adopted by the ECB at the start of the Eurozone. Confidence in the two-pillar framework derived from the long success of the Bundesbank in managing monetary policy for Germany in the post-war years after its formal creation in 1957. When the euro was formally introduced in January 1999, the expectation was that the new central bank for the Euro area, endowed with full independence from political direction and provided with the same operating philosophy, would operate on the same principles that the Bundesbank had followed so successfully for the previous four decades.

As mentioned in the introduction, the Eurozone's chosen reference rate for M3 growth was 4.5 per cent, but it was not given the status of an intermediate target. Otmar Issing, previously chief economist at the Bundesbank and subsequently the first chief economist of the ECB, explained the ambivalence towards relying on the signal from M3 in a Mais Lecture (2004). He first expressed the desirability of including such information but then admitted that it had not been possible to include monetary aggregates into central bank modelling and therefore the Governing Council would, in a practical manner, look at everything affecting the inflation outlook.

Last but not least, inflation forecast targeting neglects the information stemming from monetary developments. Up to now it has not proved possible to integrate the monetary side into the inflation forecast in a satisfactory manner. Whether this will ever be possible in a convincing way – not least on account of the different horizons involved – remains a matter of conjecture. At any rate, the Governing Council is adhering to its stance of considering all important indicators and of according monetary factors a prominent position in its assessment of the risks to price developments and thus in its monetary policy. (Issing, 2004: 5)

In effect he was saying that 'for good reason the ECB has chosen a strategy which does not focus exclusively on either a single indicator or a single analytical tool – be it money or an inflation forecast'.

The curiosity I wish to explore here is the difference between the chosen reference rate of 4.5 per cent for M3 and the reference rate that would have been appropriate for the newly created monetary union. To calculate the appropriate money growth rates for each economy I have used the Cambridge version of the equation of exchange (MxV = PxY), taking logs of both sides of the equation and differentiating with respect to time, which enables the data to be expressed in rate of change form (thus, m+v = p+y). The data in Table 1, where all the variables are shown as average rates of change over one year, strongly suggest that, for the four largest economies of the monetary union, the appropriate money growth rate – given the common 2 per cent inflation target, the different real GDP growth rates, and the annual change in desired money balances – would have been significantly higher than 4.5 per cent. On a simple average basis, a better rate would have been 5.2 per cent, although this ignores the fact that Italy had been a relatively high-inflation economy and therefore Italian velocity did not exhibit the normal downward trend shown in other economies. Omitting Italy, the appropriate reference rate for M3 would have been 6.0 per cent.

If we now consider what happened subsequent to the launch of the monetary union, the results again suggest that a higher reference rate for M3 would have been appropriate, not only for the four largest economies but also for the Euro area as a whole.

In all Euro area countries the real GDP growth rates slowed in the two decades after 1999, and in the Italian case it did so quite strikingly, from 2.5 per cent per annum to. to 0.5 per cent per annum. However, more than offsetting the declines in real GDP growth, the demand to hold money balances (the inverse of income velocity) increased substantially. This is the kind of result that perhaps should have been expected from creating a monetary union whose prime purpose was to keep inflation low and stable. On a simple average basis, the combination of lower real GDP growth but increased demand for money balances plus the 2 per cent inflation target in these four leading economies translates into an appropriate rate of growth of M3 of 5.7 per cent per annum. It should be noted, however, that this ignores the probability that smaller, faster-growing economies of the Euro area would almost certainly have raised this average even further in two ways – not only through their higher growth rate, but also because lower-income economies tend to see a faster rise in desired money balances relative to income (or a faster decline in velocity).

This naturally leads one to wonder, given that the M3 growth rate considerably exceeded the 4.5 per cent reference rate in the early years – averaging 8.4 per cent growth in 2001 and 6.7 per cent per annum for the five years 1999–2003, without generating inflation significantly above 2 per cent – whether one of the reasons for downgrading the monetary pillar in the 2003 review was that it had been set at too low a rate which was already obsolete by 2003 (European Central Bank, 1998).

'For good reason the ECB has chosen a strategy which does not focus exclusively on either a single indicator or a single analytical tool – be it money or an inflation forecast'.

In addition to problems with the M3 reference value, the other major factor to consider in the ECB's shift away from the two pillars since 2003 is the prevailing intellectual climate surrounding monetary economics. In addition to its continued use of Phillips curves, the output gap, and other Keynesian tools of long standing, the economics profession had started to make extensive use of the so-called Taylor rule (1993), a device linking central bank interest rates to the level of the output gap (or in some versions the degree of tightness in the labour market) and the extent of overshoot or undershoot in inflation. The essence of this idea is that there is a monotonic relationship between central bank nominal policy rates on the one hand and the stance of monetary policy on the other: tighter policy requires higher rates, easier policy requires lower rates.

Although the Taylor rule concept is directly contrary to the teachings of Irving Fisher (in the sense that it assumes nominal interest rates lead inflation, whereas Fisher showed that the opposite was true) and in conflict with Milton Friedman's aphorism that monetary policy is not about interest rates but about the growth of the quantity of money, it nevertheless attracted widespread professional attention. For example, modifications of the Taylor rule have been used to calculate theoretical negative central bank interest rates under QE.
Together with the Phillips curve and a dynamic IS curve (that is, one that incorporates expectations), the Taylor rule has featured in New Keynesian models to analyse monetary policy, culminating in the Clarida, Galí, and Gertler three equation model (1999). The subsequent two decades have seen further development, but although these ideas dominate academic analysis of monetary policy they do not perform well empirically.

For its part the Governing Council of the ECB has not wanted to adopt either a corrected two-pillar philosophy for the Eurozone economy or the prevalent New Keynesian orthodoxy. Its approach in the years preceding the recent review has remained pragmatic, paying lip service to the original two pillars but not actually adjusting policy to conform to the implicit recommendations of either monetarist or New Keynesian schools. Thus the monthly press conferences of the President of the ECB following the meeting of the Governing Council almost invariably contained the following three sentences (or something very close to them):

1. 'Let me now explain our assessment in greater detail, starting with the *economic analysis* ...' [emphasis here and below in the original].
2. 'Turning to the *monetary analysis*, the annual growth rate of broad money (M3) ...'
3. 'To sum up, a *cross-check* of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed ...'

This formulaic presentation appeared to remain true to the original two-pillar design, in part no doubt to placate the conservative, anti-inflation interests on the Governing Council. In practice, however, the wide deviation of monetary growth on either side of the appropriate M3 growth rate – for example, the double-digit growth of M3 in 2007–2008 followed by the collapse to year-on-year declines between October 2009 and May 2011 – showed either that the Governing Council did

Table 1 Calculation of appropriate growth rate for Eurozone M3 based on pre-1999 data

	Data Range	p	y	v	Appropriate M3 (= p+y-v)
West Germany	1970–1998	2	2.9	(-1.8)	6.7% p.a.
France	1971–2000	2	2.7	(-0.9)	5.6% p.a.
Italy	1971–1998	2	2.5	(+1.7)	2.8% p.a.
Spain	1971–2000	2	2.7	(-0.9)	5.6% p.a.
Average	1971–1998	2	2.7	(-0.5)	5.2% p.a.
Average (ex-Italy)	1970–2000	2	2.8	(-1.2)	6.0% p.a.

Table 2 Calculation of appropriate growth rate for Eurozone M3 based on data after 1999

	Data Range	p	y	v	Appropriate M3 (= p+y-v)
Unified Germany	1999–2021	2	1.3	(-2.1)	5.4% p.a.
France	2000–2021	2	1.3	(-3.1)	6.4% p.a.
Italy	1999–2021	2	0.5	(-2.8)	5.3% p.a.
Spain	1999–2021	2	1.8	(-1.9)	5.7% p.a.
Eurozone	1999–2021	2	1.3	(-2.6)	5.9% p.a.

not pay much attention to such deviations from the original reference value, or that the Governing Council felt unable to adjust the monetary growth rates in the short to medium term, even if it had the intention to do so.

Since the announcement of the new monetary policy strategy on 8 July 2021, this formula for presenting Governing Council discussions and decisions has been abandoned. Instead, after some introductory remarks, the President's speech now contains the following sections: Economic Activity, Inflation, Risk Assessment, Financial and Monetary Conditions, and a Conclusion. It is noteworthy that since July 2021 the section on Financial and Monetary Conditions has included regular mention of financing conditions, market interest rates, and bank lending as well as bank balance sheets and profitability, but the narrative has been entirely qualitative, with no specific numbers being mentioned in this section. Reporting on the amount of money (as measured by M3) in the President's remarks has been dropped entirely.

Theoretical and empirical objections to an interest rate-based strategy

At this point it is worthwhile to spell out briefly why purely interest rate-based strategies for managing monetary policy are liable to be unsound. In any diagram of supply and demand in economics there are two axes: typically, a horizontal quantity axis and a vertical price axis, as in the quantity of wheat and the price of wheat. When it comes to money, however, this convention is routinely broken. On the vertical axis teachers and students alike usually show interest rates. This occurs even in widely taught concepts such as IS-LM curves, or in the Keynesian liquidity preference diagram. The problem is that interest rates are not the price of money – they are the price of renting or borrowing money for a specific period, that is, the price of credit per unit of time. The price of money, however, is its opportunity cost – what a certain number of units can purchase, best expressed as the inverse of the price level, or as an exchange rate for another currency.

The problem with these diagrams is that the experience of the world is the exact opposite of what is shown in the supply/demand diagrams. According to the liquidity preference diagram, if the quantity of money is increased, interest rates decline. Yet if we ask, 'In which countries of the world are interest rates lowest?', the answer will be economies such as Japan or Switzerland or the Eurozone. But this is not because they have been increasing the quantity of money rapidly. On the contrary, these economies have been holding down the growth of money. They have low interest rates because there is negligible inflation and economic growth is weak.

Similarly, if one asks the question, 'In which countries of the world are interest rates highest?', the answer will be economies such as Venezuela or Argentina or Turkey. But this is not because they have been holding down the quantity of money. On the contrary, these economies have been increasing the quantity of money rapidly. They have high interest rates because they have inflation.

These phenomena are essentially what Irving Fisher showed: high interest rates tend to reflect a strong economy and high or rising inflation expectations. Conversely, low interest rates tend to reflect a weak economy and low or falling inflation expectations. Later Milton Friedman showed that interest rates go through a two-stage cycle during a business cycle upswing and the opposite two-stage cycle during a business cycle downswing. Initially interest rates tend to fall temporarily during a monetary acceleration, but then as the economy strengthens, as the demand for credit rises and inflation expectations rise, interest rates will tend to rise. Conversely, in a downturn, initially interest rates tend to rise temporarily during a monetary deceleration, but then as the economy weakens, as the demand for credit falls and inflation expectations decline, interest rates will tend to fall. A short-term liquidity effect in one direction is followed by a longer-term inflation (Fisher) effect in the opposite direction. In short, policymakers cannot rely on the level of interest rates to judge the state of the economy or the stance of monetary policy.

Translated into a policy prescription for the ECB, this means that a monetary policy strategy that is led by interest rates alone without regular reference to the growth of the quantity of money can easily become unanchored – much as we have seen with the US Federal Reserve's monetary policy during the pandemic, when the desire to ensure low rates and smoothly functioning credit markets resulted in an increase in the quantity of US M2 in excess of 40 per cent in less than two years. By abandoning the two-pillar strategy, as the ECB did in the 2020–2021 review of its strategy, this is the risk the ECB is taking.

Expressed more robustly, given an inflation target and knowing the real GDP growth potential and the trend of money holding in the economy (the inverse of velocity), we can specify an optimum or appropriate monetary growth rate (for broad money) for any economy. By contrast, there is no equivalent for the short-term policy rate of a central bank – notwithstanding the huge literature on r* (the real interest rate that should pertain when an economy is in equilibrium, meaning that unemployment is at the natural rate and inflation is at the target rate). Depending on the state of the economy and inflation expectations, 6 per cent broad money growth may initially require the central bank's main policy rate to be 0 per cent, 2 per cent, 4 per cent, or 8 per cent, and even then, it may require further adjustment. This is the essence of the argument here – priority should be given to money growth, not to interest rates. But sadly, or unwisely, the ECB appears to have taken M3 off its dashboard.

The ECB's 2020–2021 Monetary Policy Strategy Review and prospects for the future

In January 2020, the ECB announced a Monetary Policy Strategy Review with the aim of 'making sure our monetary policy strategy is fit for purpose, both today and in the future'. Since the 2003 review, the ECB had stressed that declining economic growth linked to slower productivity growth and demographic factors implied lower 'equilibrium real interest rates'. In turn, this had reduced the scope for the ECB to achieve its inflation mandate by relying on changes in policy interest rates alone. This interest rate-driven framework has dominated monetary policy in the Euro area – and elsewhere – for the past two decades, with any changes in monetary aggregates at best a secondary consideration, but more often largely ignored. In the ECB's case I showed how the President's regular press statement after each meeting of the Governing Council paid lip service to the growth of monetary aggregates. With this backdrop in mind, the ECB sought – on the basis of consultations with private financial institutions, governments, and private citizens – to consider whether it could develop a new approach to monetary policy in the face of persistently below-target inflation.

When the ECB's new strategy was announced on 8 July 2021, the reactions both in the financial markets and in the financial media were relatively muted, suggesting that there were no significant or substantive changes in the way the ECB will conduct monetary policy in the future. Initially a 12-point summary of the ECB's review was released, and later, a more complete 'Overview of the ECB's Monetary Policy Strategy' was published. Item 9 of the 12-point release provides a convenient summary of some of the key issues relating the old, two-pillar framework to the proposed, new decision-making and operating procedures of the ECB in the future:

> The Governing Council bases its monetary policy decisions, including the evaluation of the proportionality of its decisions and potential side effects, on an integrated assessment of all relevant factors. This assessment builds on two interdependent analyses: *the economic analysis and the monetary and financial analysis*. Within this framework, the economic analysis focuses on real and nominal economic developments, whereas the monetary and financial analysis examines monetary and financial indicators, with a focus on the operation of the monetary transmission mechanism and the possible risks to medium-term price stability from financial imbalances and monetary factors. The pervasive role of macro-financial

> linkages in economic, monetary and financial developments requires that the interdependencies across the two analyses are fully incorporated. *This framework reflects the changes that the ECB's economic analysis and monetary analysis have undergone since 2003*, the importance of monitoring the transmission mechanism in calibrating monetary policy instruments and the recognition that financial stability is a precondition for price stability [emphasis added]. (European Central Bank, 2021b)

The ECB has shifted further away from the Bundesbank tradition of focus on monetary factors as the primary driver of inflation towards the prevailing consensus of interest rate-led monetary policy among major central banks.

The wording of the above paragraph pays tribute to the former two-pillar formula while building in 'financial indicators' (to allow more attention to interest rates and yield spreads), 'the monetary transmission mechanism' (code for how interest rate and yield changes impact the wider Euro area financial system), 'the possible risks to medium-term price stability from financial imbalances', and 'the recognition that financial stability is a precondition for price stability'. In short, the new formula insists – perhaps understandably from a political accountability perspective – that the members of the Governing Council will now look at everything in coming to their decisions on monetary policy and will not be bound by the strictures of the old, two-pillar framework. Crucially, they will be more concerned with shorter-term market considerations than medium-term inflation forecasts based on M3.

Part 4 of the ECB's Overview document (2021a) is headed 'ECB's Integrated Analytical Framework' and makes the case for further downgrading the role of monetary aggregates in future analysis. The claim is made that '[t]he monetary analysis has shifted from its main role of detecting risks to price stability over medium to longer-term horizons towards a stronger emphasis on providing information for assessing monetary policy transmission'. The authors justify this change with three arguments: (1) a weakening of the empirical link between monetary aggregates and inflation – a claim that could surely be challenged; (2) impairments in monetary policy transmission during the global financial crisis; and (3) the broadening of the ECB's monetary policy toolkit.

After stating that 'the new framework will replace the previous two-pillar framework and discontinue the cross-checking of the information derived from the monetary analysis with the information from the economic analysis', there is a judicious amount of back-pedalling. Although 'the integrated analytical framework will continue to consider the information from monetary and credit aggregates', the emphasis will move to various parts of the transmission mechanism such as 'the credit, bank lending, risk-taking and asset pricing channels'. The claim is that 'such assessments facilitate the identification of possible changes in transmission (for example related to structural factors such as the rise in non-bank financial intermediation) or impairments in transmission, for example owing to fragmentation or market stress'.

In summary, based on its review, the ECB has shifted further away from the Bundesbank tradition of focus on monetary factors as the primary driver of inflation towards the prevailing consensus of interest rate-led monetary policy among major central banks. That consensus largely discounts the lagged relationships between broad money aggregates (such as M3 in the Eurozone) and their impact on asset prices, spending, and inflation in favour of an analysis that relies more on the short-term transmission of monetary policy via interest rates, other 'macro-financial linkages', and their effects on the stability of the financial system. As we have seen with the Fed's recent experience, success in ensuring price stability based on this modus operandi is far from guaranteed.

Conclusion

The majority of the proposals from the ECB's Monetary Policy Strategy Review are cosmetic at best and mainly serve to entrench the new paradigm of interest rate-based central bank policies adopted across advanced economies. There are three key concepts:

- A 2 per cent average or symmetric inflation targeting mandate related to the Fed's flexible average inflation targeting scheme.
- Further movement away from reliance on monetary aggregates towards reliance on discretionary judgements about the appropriate level of interest rates or financial conditions, supposedly with a view to monitoring the transmission of monetary policy.
- A stress on inflation expectations rather than actual inflation or money and credit growth as the ultimate guide to monetary conditions (that is, whether monetary growth is too slow or too rapid).

Whether this combination of policies will produce a better record of stable money growth and steady inflation in future seems highly unlikely. More probably, once the current episode of inflation has been brought under control, balance sheet ratios and capital requirements imposed on commercial banks by Basel III and other regulations will again lead to sub-par growth of bank balance sheets and hence deposit money or M3. In turn, this will bring low inflation and low rates, followed by another crisis which will require the ECB to create money directly from its balance sheet using non-standard measures instead of relying on the commercial banks.

If the ECB wishes to raise inflation sustainably to the 2 per cent target, it will need to raise the average growth rate of the broad money supply (M3), perhaps to 6–7 per cent per annum. The ECB could easily achieve this by adjusting its QE asset purchase programme to include non-bank counterparties, or by reducing capital and liquidity requirements imposed on the commercial banking sector. In the absence of such reforms, the new MPSR paradigm summarised by the three concepts above will have little material effect on the growth in money and bank credit, meaning any extended impact on inflation will also be minimal.

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ENDNOTES

Section 2

14 In a novel study Posen (1993) reversed the argument and maintained that central bank independence was an endogenous consequence of a low-inflation-desiring system. Independence came with rather than led to low inflation.

15 McDonald's saying was subsequently rejected by him and by some of his acquaintances. The remark was then passed around several of the ministers of his government, but the parcel has not yet found a definite home.

16 Nonetheless, towards the end of 2012 the opposition parties in the New Zealand parliament tabled a bill to add further objectives in the US style to the Reserve Bank of New Zealand's inflation mandate. It failed by one vote, with voting along party lines.

17 Nonetheless, New Zealand mimicked Australia by introducing two temporary measures in October 2008. The first was a wholesale funding guarantee and the second a crown deposit guarantee scheme. In Australia this latter scheme has become permanent while in New Zealand it lasted two years, dragged on for a further year for half a dozen non-banks, and ended in 2011.

18 See Wood (2000) for a detailed description of the evolution of lender of last resort.

19 Nevin, p. 111, quoting report in the Time. The Times, 7 October 1936.

20 On this point, an insightful book comes to mind that recounts the dialogue between two great economists and thinkers, J.M. Buchanan and R.A. Musgrave (1999).

21 On this widely forgotten episode in American history, see Reinhart and Rogoff (2011: 111–116).

22 Tucker (2018: 421ff.) offers outstanding reflections on this.

23 In Schmitt's own words: 'The sovereign is he who decides on the exception' (2005: 5). A translation could be also given: "Let the welfare of the people be the supreme law"

24 Mention is made of the remarkable contributions about the meaning of auctoritas by the Spanish Roman Law Professor Álvaro D'Ors Pérez-Peix; on this matter, see the summary and comments in Vanney (2016).

25 Among others, Castañeda (2021) offers an insightful critique of the MMT. An MMTer's view can be found in Bernal (2021).

26 These kinds of rude tricks for book-cooking are explained well in Dowd (2018).

27 This source includes graphs that show the deviations. Canepa states: 'The ECB has a dismal track record at predicting inflation, having mostly overestimated price pressures in the last decade after underestimating them between 2009 and 2011.' The most illustrative graph is the same one that appears in Schnabel (2021). For a more detailed analysis of the ECB's projection deviations, see Demertzis and Domínguez-Jiménez (2021), especially 137–138. The entire Yearbook is accessible at https://www.fundacionico.es/wp-content/uploads/2021/03/ANUARIO-EU-RO-2021_EN-1.pdf. Another interesting survey is offered by Darvas (2018).

28 As noted by Münchau (2021b): 'The intellectually lazy central banker relies on models that explain a world of unknown unknowns with known knowns.'

29 John B. Hearn (2015) has brought attention to the manipulation of the Phillips curve by the Keynesians.

30 Even though it is a crucial issue, the study of Ricardian/non-Ricardian fiscal regimes supersedes the scope of this article. For further details, see the already classic Sargent and Wallace (1981). António Afonso (2005) gives attention to the matter and its developments in the EU Member States.

31 Stacie E. Goddard (2008) recounts the Prussian budgetary conflict.

32 I have addressed the constitutional implications of all this in Ruiz-Ojeda (2020).

33 Case No. 2 BvR 859/15. Official English version available on the BVerfG's webpage: http://www.bverfg.de/e/rs20200505_2bvr085915en.html.

34 See the article by Franz C. Mayer (2020), one of the most dedicated legal scholars on the troubles that stem from the conflict between Germany and the EU on the issue. Another useful study is by Rodríguez de Santiago (2021). I have already dealt with this issue in two previous articles (Ruiz-Ojeda, 2021a, 2021b).

35 Access to the Notice of the closure (emphasis added) at https://ec.europa.eu/commission/presscorner/detail/en/inf_21_6201?fbclid=IwAR1w6wbHhdcA5vxlqXTohUjxcgF7mJbpS-BxTXjxaNWXpMJ0MIzb9Zyuwv7I.

36 Among MMTers, one of the most tenacious advocates of sovereign debt cancellation in the Eurozone is B. Mitchell (2021).

37 I would refer to Paul Krugman for a formidable summary of Robert Mundell's ideas and his intellectual fathership of the euro, more specifically to Krugman's (2021) article on the occasion of Mundell's recent passing.

38 As has been demonstrated by J.E. Castañeda and J.L. Cendejas (2021). A more general analysis is offered in Castañeda, Damrich, and Schwartz (2020).

39 In the very vein of Ernst Fraenkel (2017).

40 Castañeda (2020) makes a number of suggestions.

41 Current data show a worrisome scenario, as noted by Matthew Lynn (2022).

42 One of the most remarkable advocates of this solution is A. Estella de Noriega (2021). See also Fazi and Iodice (2016).

43 Let me recommend Boettke, Salter, and Smith (2018).

44 Llewellyn (2021: 4ff.) calls attention to the danger entailed by the risk-averse regulators in the monetary and banking contexts.

45 The economic analysis focuses mainly on the assessment of current economic and financial developments from the perspective of the interplay between supply and demand in the goods, services, and factor markets. The monetary analysis serves as a means of cross-checking, from a medium- to long-term perspective, the short- to medium-term indications arising from the economic analysis. In October 1998 the Governing Council assigned a prominent role to money in recognition of the fact that, in the medium to long run, monetary growth and inflation are closely related. This provides the Governing Council with key information at time horizons stretching beyond those usually adopted for the construction of central bank inflation projections. The prominent role assigned to money in the ECB's strategy is signalled by the announcement of a reference value for monetary growth. However, the monetary analysis seeks to provide a comprehensive survey of the liquidity situation, thereby going far beyond an assessment of monetary growth in relation to the reference value.

SECTION 3

THE LONG-TERM CHALLENGES FOR THE EUROZONE ARCHITECTURE

Can the Eurozone Manage Its Free Rider Problem?

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Citation suggestion: Tim Congdon, TC (2022). Can the Eurozone Manage Its Free Rider Problem? *Future Europe*, 2(1), 61–71.

Abstract

European monetary integration has from the outset faced a potential 'free rider problem'. The essence of the problem is that one or more member states may be tempted to borrow heavily from the European Central Bank (ECB) regardless of the impact on inflation for the entire Eurozone. Inflation for the whole area depends of course on the behaviour of all member states. The 1992 Maastricht Treaty – which reflected the monetary orthodoxy of the German Bundesbank – tried to pre-empt the free rider problem, with the key clauses 121 to 126 including both a prohibition on overdraft finance to national governments and a no bailout provision. The article shows how the ECB's responses to three crises – the Great Financial Crisis of 2007 and 2008, the recession of the early 2010s, and the COVID-19 medical emergency – have led to enormous expansion of its balance sheet. The Bundesbank's monetary orthodoxy has been abandoned and the constraints on the ECB balance sheet in the Maastricht Treaty have been disregarded, while inflation has risen to the highest levels since the introduction of the single currency.

Introduction: the free rider problem in a multi-government monetary union

European monetary integration has, from its outset, had to confront a 'free rider' problem. This problem has been variously defined, but its essence is that agents can secure a benefit without paying anything towards it.[46] The danger is that, without a pre-emptive agreement between all the parties affected, the benefit will be under-provided or not provided at all. The argument of this article can be quickly stated: in its early years the key players in European economic and monetary union (EMU) – that is, its member nation states and the European Central Bank (ECB) – respected the free rider problem and behaved prudently, but more recently they have either forgotten about it or decided to disregard it. Already the annual increase in the consumer price index at the time of writing (March 2022) has reached 5.1 per cent, the highest figure since the European single currency was introduced in 1999. In important respects, the ECB and the nation states have become financially and monetarily irresponsible. Unless these irresponsible tendencies are reversed, the future viability of EMU will come into question.

In a multi-government monetary union such as the Eurozone, a special difficulty arises. All the Eurozone member nations may benefit from price stability, but the link between the fiscal and monetary conduct of any one nation and the desired area-wide price stability may be elusive and unclear.

In the single currency context, the free rider problem is readily described.[47] The objectives of EMU have been to provide the European Union not just with a shared currency and medium of exchange, but also with a money that is stable in value, and hence a reliable unit of account and standard of deferred payment. As is well known, excessive growth of the quantity of money – a rate of money growth far above the rate of growth of output – leads to inflation and undermines currency stability. Since money growth is determined by banks' extension of new credit to the private sector and the state, restrictions of some sort are needed on the state's ability to borrow from the banking system. A traditional monetary jurisdiction has only one government and one central bank, which together constitute the monetary authorities. In such a jurisdiction, which is normally a sovereign nation state, the blame for inflation mistakes falls unequivocally on the nation's monetary authorities.[48] But, in a multi-government monetary union such as the Eurozone, a special difficulty arises. All the Eurozone member nations may benefit from price stability, but the link between the fiscal and monetary conduct of any one nation and the desired area-wide price stability may be elusive and unclear.

Indeed, the lack of clarity may be such that one government comes to believe that it can borrow, with impunity, on an enormous scale from the banks. If so, it may be tempted to act as a free rider at the expense of other nations. The perverse incentive is most obvious for small nations. The Eurozone contains, for example, Portugal and Greece, which both produce under 2 per cent of Eurozone gross domestic product (GDP). (In 2019 they accounted respectively for 1.8 per cent and 1.6 per cent of Eurozone GDP, according to the International Monetary Fund's database.) If they run large budget deficits relative to GDP and finance these deficits entirely from banks, the impact on the Eurozone's aggregate growth of credit and money is likely to be minor. The impact should be small enough that it does not endanger price stability for the Eurozone as a whole. But the outcome would be patently unfair on other larger Eurozone member states, if they maintained strong public finances with the associated high taxation and incurred debt in the capital markets at consequent extra cost (relative to bank finance).

Institutional safeguards against free riders

The discussion so far is not original. It was well understood by EMU's architects in the late 1980s and 1990s, and the founding documents tried to anticipate the free rider problem by specific provisions. The Maastricht Treaty of 1992 contained the 'no bailout clause' (Article 125) and a prohibition on overdraft finance from the Euro system (that is, the Eurozone's central banks, under the aegis of the ECB) to national governments (Article 123).[49] Moreover, Articles 121 and 126 envisaged a newly centralised role for the European Commission and the Council of Ministers. The Commission and Council were to monitor member nations' fiscal imbalances and assess their compatibility with the integrity of EMU.

Meetings of the Council of Ministers in 1997 resulted in further regulations based particularly on Articles 121 and 126. These amounted to a 'Stability and Growth Pact' (SGP), which laid down limits on the maximum permitted levels of a member nation's budget deficit and public debt relative to its GDP. The SGP also specified an 'excessive deficits procedure' whereby governments that breached the limits would be subject to fines. In the first decade of the single currency the Maastricht Treaty provisions and the SGP were thought to be a sufficient remedy for the free rider problem. In a 2010 analysis by Wyplosz, the no bailout clause, the prohibition on overdraft finance, and the excessive deficits procedure were identified as three vital 'safeguards' of the single currency's long-run sustainability.[50]

However, the three safeguards identified by Wyplosz had two serious weaknesses. Firstly, the Maastricht Treaty allowed large-scale transactions in government securities by central banks as part of monetary policy. It was understood that substantial asset purchases might be needed to boost the quantity of money and thereby to halt a recession (Issing, 2008: 124). The inconsistency here was definitely an issue, even if its implications were only latent. Government finance from the Eurozone's national central banks by means of overdraft is unacceptable in normal conditions, according to an international treaty. But government finance from those central banks by means of open market purchases of government securities, in order to forestall recessions, is quite alright in practice. Is the distinction robust? Crucially, who is to decide when a recession is imminent? The point cannot be escaped: open market purchases of securities issued by governments – just like overdraft finance to them – expand the central bank balance sheet. Indeed, when the central bank finances its open market purchases from commercial banks (by the emission of cash reserves to them) and makes the purchases from non-banks, the effects are to increase both the monetary base and the quantity of money.[51]

Secondly, an acknowledged task for any central bank is to help commercial banks in the management of their cash. According to a well-recognised argument dating back at least to Bagehot's 1873 classic text on *Lombard Street*, the central bank should provide 'lender-of-last-resort' loans to solvent banks when they are subject to a run on their deposits. This task can be problematic in a traditional one-government monetary jurisdiction, as the central bank can be criticised for being too soft on badly managed banks. It may be accused of 'bailing out' profit-seeking organisations in private ownership with highly paid senior executives.[52] But the central bank's job is much harder in a multi-government monetary union such as the Eurozone. Most banks have their headquarters in a particular nation where they are registered and supervised, while their shareholders, depositors, and other stakeholders are mostly located in and belong to that nation.[53] The risk in the Eurozone is that runs on banks' cash are concentrated in certain member states, while most member states are unaffected. Last-resort loans may then be extended, on a differential basis, to particular countries. Of course, last-resort loans have in one respect the same result as asset purchases: they expand the central bank balance sheet.

The three institutional safeguards noticed by Wyplosz in his 2010 analysis were important, not least because they put down a marker for central bank strategy. All the same, from the start of the single currency the understood constraints on the ECB's asset acquisition could be bypassed by the methods outlined in the last two paragraphs. The size of the ECB balance sheet, and the monetary consequences of its operations, might prove far more elastic – and potentially more inflationary – than envisaged when the Maastricht Treaty was signed.

Evolution of the ECB's balance sheet: the early years, 1999–2007

In its early years the ECB's behaviour could be said to resemble that of the Bundesbank. Since its establishment in 1957 the German central bank had forged a reputation as a staunch fighter of inflation. The ECB's first two chief economists – Otmar Issing and Jurgen Stark – had Bundesbank backgrounds. Part of their thinking was that the quantity of money was influenced by the monetary base, a concept usually understood to include *both* notes and coin held by the public, *and* commercial banks' cash reserves with the central bank. The monetary base does not constitute all of a central bank's liabilities, but it normally moves in tandem with the central bank balance sheet as a whole. A familiar claim in thinking of this sort –commonly associated with the University of Chicago's monetarism, but also blessed in numerous textbooks – was that the quantity of money could be viewed as a stable multiple of the base. Even if they did not believe in a rigid connection between the base and money, Bundesbank officials were concerned to limit the growth of the ECB's own balance sheet; they tended to see rapid increases in the size of that balance sheet as potentially inflationary. One well-regarded book on monetarism said that 'monetarists favour some measure of [banks' cash] reserves' as the best indicator of monetary policy, because they are 'clearly under the control of the central bank' and 'have a powerful effect on the money stock, the monetarists' target variable' (Mayer, 1978: 26–27). The argument that central bank expansion was unwise because of its inflationary repercussions was important in its own right, but it also acted as a bulwark against free riding – with undue monetary financing of budget deficits – by Eurozone member states.

A prohibition on overdraft finance to the government had been spelt out in the national legislation that founded the Bundesbank in 1957. German hostility to such finance stemmed from the catastrophe of the Weimar hyperinflation in 1923, when the printing of new notes had been on an inordinate scale to cover the expenditure of the German state.[54] Although some national central banks under the ECB umbrella did hold government securities from the introduction of the euro in 1999, these were very small relative to the Eurozone's economy.[55] More fundamentally, changes in its holdings were modest from month to month, and even from year to year, and allowed no scope for free riding by insubordinate member states.

Until the Great Financial Crisis, which began in 2007, the ECB's most important activity was setting the short-term interest rate by repurchase operations. As implied by their name, repurchase operations involved the sale (or purchase) of securities, which would be followed at a later date by a matching purchase (or sale). They mattered because the terms of the repo set a price (that is, an interest rate), not because any change in the size of the ECB balance sheet was intended. Meanwhile, the opening years of the single currency were ones of reasonable prosperity, with banks generally profitable or very profitable and readily able to fund their assets in the wholesale markets. Lender-of-last-resort assistance was not needed anywhere in the Eurozone. With ECB holdings of government securities stable, and no last-resort lending, the ECB's balance sheet was insignificant relative to that of the entire European banking system. In this period European monetary integration seemed to be going well, and worries about the free rider problem were not only unjustified but appeared to be hypothetical and remote from reality.

During and after the Great Financial Crisis, 2007–2011

The situation changed radically from the start of the Great Financial Crisis, usually dated as 9 August 2007, when BNP Paribas blocked withdrawals from three of its money market funds, citing such 'a complete evaporation of liquidity' in the wholesale money markets that the valuation of the assets inside the funds had become impossible. All banks which owed money on a short-term basis to other banks (and to some extent even to non-bank financial institutions) might find themselves unable to finance their assets. The strains symptomised a modern form of the cash run discussed by Bagehot in the late nineteenth century. Lender-of-last-resort lending – or 'emergency liquidity assistance', as it tended to be labelled in the early twenty-first century – was needed.

On 3 August 2007, just before the crisis, the ECB's 'lending to Euro area credit institutions related to monetary policy operations' came to €448 billion. The ECB made borrowing facilities available on a potentially immense scale to its member banks, with the amounts at stake – by means of so-called fine-tuning operations – being €95 billion on 9 August, €110 billion on 10 August, and €310 billion on 13 August. Happily, the speed and scale with which the facilities were granted had the effect of restoring confidence, and for much of the following year the Eurozone seemed unaffected by the much worse banking crises in the United States and the United Kingdom. The ECB's assets in August 2008 (at the 29 August make-up day, to be precise) were €1,451 billion, up on the immediate pre-crisis figure (on 3 August 2007) of €1,195 billion, but not dramatically so. 'Lending to Euro area credit institutions' on the same date was €467 billion.

However, in September 2008 the difficulties in the wholesale markets intensified and regulatory officialdom let it be known that banks would in future have to maintain much higher capital to asset ratios. Under the planned Basel III regulatory regime, equity capital per unit of risk assets would rise by over 60 per cent.[56] By now banks in several Euro area countries were having trouble rolling over liabilities in the inter-bank market. The ECB helped them by its willingness to extend loans with what it termed 'non-standard measures'. By the last make-up day that year (on 19 December), 'lending to Euro area credit institutions' was €843 billion and the ECB's total assets were €2,022 billion. The loans were probably mostly to non-German banks, although data on the destination of the loans are not readily available.

As chief economist, Jurgen Stark was unhappy about the non-standard measures and believed that the resulting expansion of the ECB's balance sheet might cause upward pressures on inflation. On 15 April 2010, he gave a speech in Washington which warned that 'keeping our non-standard measures in place for longer than necessary would entail the danger of harmful distortions'. He noted, moreover, that 'we have started gradually to phase out some of them' (Stark, 2010). Unfortunately, as banks lost their ECB funding, they were obliged to sell assets, and the easiest assets to sell included government securities issued by the less creditworthy Eurozone governments. The prices of these securities declined and yields rose sharply. For example, the yield of ten-year Greek government bonds, which had been under 5 per cent in November 2009, had climbed to almost 8 per cent by April 2010. Further increases in bond yields implied ever-mounting interest bills on Greek government debt and, ultimately, might result in state bankruptcy. Over the weekend of 8–9 May 2010, European leaders agreed that the ECB should buy nation states' government securities in sufficient volume to keep yields down to levels consistent with long-run fiscal solvency. On 10 May the ECB announced the Securities Markets Programme, which gave it authority to buy large quantities of government bonds. Purchase of Greek government paper came first.

On the ECB Governing Council, Stark and Axel Weber, the latter attending as the President of the Bundesbank, voted against the Securities Markets Programme, but they were outmanoeuvred and outvoted (Sinn, 2014: 261–265). So the attempt to limit the ECB's balance sheet (and hence the monetary base) by reducing loans to banks was frustrated by the consequent pressure on the ECB to increase holdings of government securities. The ECB was split between, on the one hand, representatives of Bundesbank analysis and the German sound money tradition, and, on the other, representatives from most of the other countries with more pragmatic and flexible views. The tensions between the two kinds of thinking increased during 2010 and 2011, while in the background many Eurozone government bonds suffered from severe selling and large yield increases. (The yield on the ten-year Greek government bond went through 10 per cent in July 2010 and continued to rise in the following months, despite the ECB purchases.)

As Stark was perhaps the most prominent advocate of the Bundesbank position, his statements became increasingly important. In a contribution to the 13th Euro Finance Week event in Frankfurt on 16 November 2010, he emphasised in his concluding line that the 'non-standard measures were the exceptional response to exceptional circumstances'. On 21 February 2011 Reuters reported that, in remarks again given in Frankfurt, Stark had expressed concern that 'risks to the medium-term outlook for price developments ... could move to the upside' (Master and Jones, 2011). In a speech on 10 June 2011, also given in Frankfurt, he reiterated that 'we see risks to price stability on the upside', which demanded 'strong vigilance', including 'further steps to phase out the non-standard measures' (Stark, 2011). In this speech he also referred to the ECB's 'two-pillar' framework for forecasting inflation, in which analysis of money and credit (the monetary pillar) accompanied analysis of the economy (the economic pillar). The mention of the two pillars was surprising, as the

ECB Governing Council had decided over eight years earlier – in May 2003 – to stop publishing a reference value for M3 broad money. Many observers thought that the ECB could no longer defend the focus on money and inflation that had been such a feature of the Bundesbank's intellectual framework in the late twentieth century.[57]

Unfortunately, as banks lost their ECB funding, they were obliged to sell assets, and the easiest assets to sell included government securities issued by the less creditworthy Eurozone governments.

Stark's grumbling about rising inflation may have made sense relative to a long-standing and successful approach to monetary policymaking in his own country. However, in the circumstances of late 2011 it had an overriding defect as far as the Eurozone was concerned. In forecasting terms, it was totally wrong. True enough, the annual increase in the Eurozone consumer price index did reach 3.0 per cent in October 2011. But from then on inflation declined relentlessly in depressed economic conditions. Eurozone real GDP fell for six consecutive quarters from the final quarter of 2011. Indeed, the prevalent concern in 2012 and 2013 became not inflation, but deflation. On 9 September 2011, Reuters reported that Stark would leave the ECB due to disagreement with the Securities Markets Programme, although the official announcement was that his resignation was for 'personal reasons' (Framke and Hübner, 2011).[58] (Stark's term had been due to end in May 2014.)

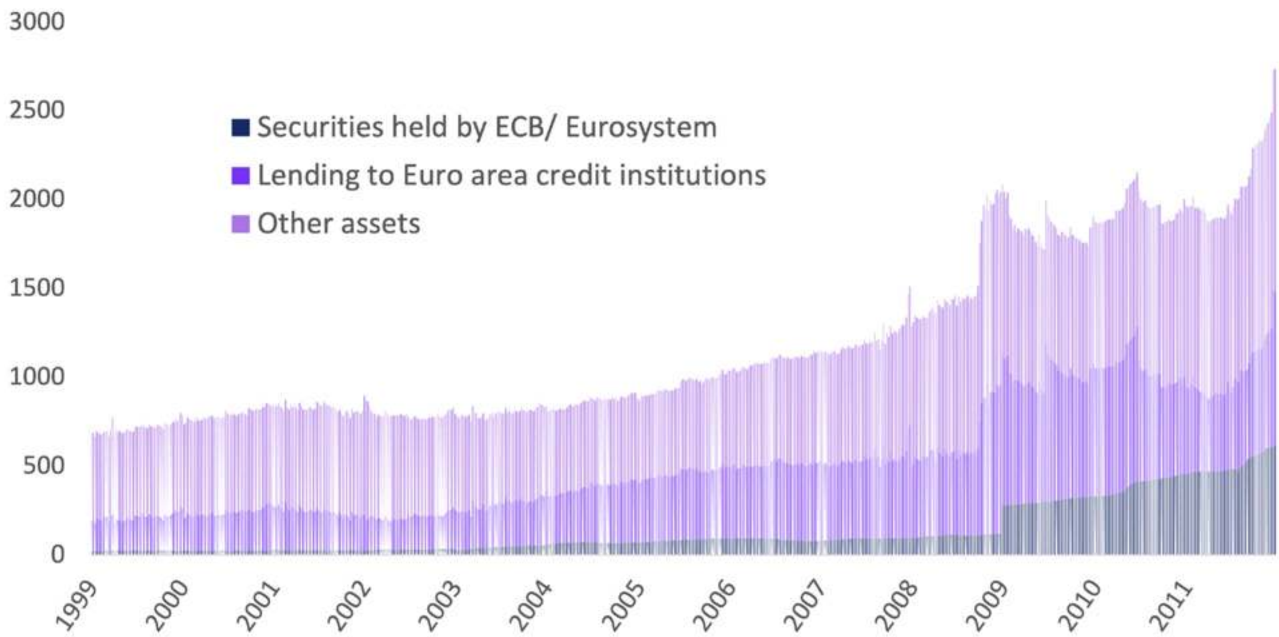
Stark's resignation marked the end of German monetary orthodoxy as a powerful conceptual influence on ECB policymaking. While this orthodoxy prevailed, monetary and fiscal free riding faced a strong obstacle. Quite simply, because any expansion of the central bank balance sheet was regarded as suspect, debt and deficit monetisation by high-spending countries could not be tolerated, and cash-deficient banks were deterred from seeking emergency liquidity assistance. But in truth Stark had lost the argument. During 2010 and 2011 his pronouncements reflected concern that the Eurozone would suffer rising inflation over the medium term. Even within the Bundesbank framework, this was strange. In the two years from December 2009 M3 growth was negligible, a mere 1.5 per cent. (In other words, the annual rate of increase was under 1 per cent.) Anyhow, the recession of 2012 made his forecasts look ridiculous and discredited his position.

Figure 1 shows the size and composition of the ECB's assets from the start of 1999 to the end of 2011. At the start of the single currency the ECB's assets were dominated by 'other assets', mostly gold and foreign exchange, with tiny holdings of securities and only modest lending to credit institutions. This pattern continued to hold until the Great Financial Crisis, when in late 2008 lending to credit institutions (that is, banks) jumped sharply in a few weeks. Such lending then *fell*, particularly in 2011, in line with Stark's comments. A key message of the chart is that, even at the end of this period, in December 2011, the ECB's 'other assets' were much larger than either securities held or lending to credit institutions.

The Draghi presidency, 2011–2019

Soon after Stark's resignation, another crucial change occurred in the ECB's top management. Mario Draghi of Italy took over from the French Jean-Claude Trichet as President of the ECB. Draghi's interpretation of the Eurozone's problems was utterly different from Stark's. In Draghi's view, the closure of the inter-bank market in 2007 had crippled the banking systems of several Eurozone member states, particularly where these systems had become reliant on the international wholesale markets for financing their expansion. These states included not just small members such as Greece, Portugal, and Ireland, but also Spain and to a lesser degree Italy.[59] Banks in these countries were under pressure to shrink their loan portfolios, largely because of the Basel III capital regime, but also to some extent because of heavy loan losses. Economic analysis argued that the shrinkage of banks would have adverse repercussions on economic activity.[60] Here indeed was a persuasive explanation of the deflationary forces which seemed to have become entrenched in the Eurozone. Further, the less robust banks were sometimes forced sellers of government securities, which pushed up yields. When Draghi assumed the ECB presidency, the yield on Greek ten-year government bonds was approaching 20 per cent. It was at these levels even though the previous months had seen a large default by Greece, in which private holders of Greek government bonds had been forced to accept a write-down of over 50 per cent on the supposed redemption value.[61]

Figure 1 Size and composition of ECB assets, 1999 - 2011
Data are weekly and values are in billions of euros



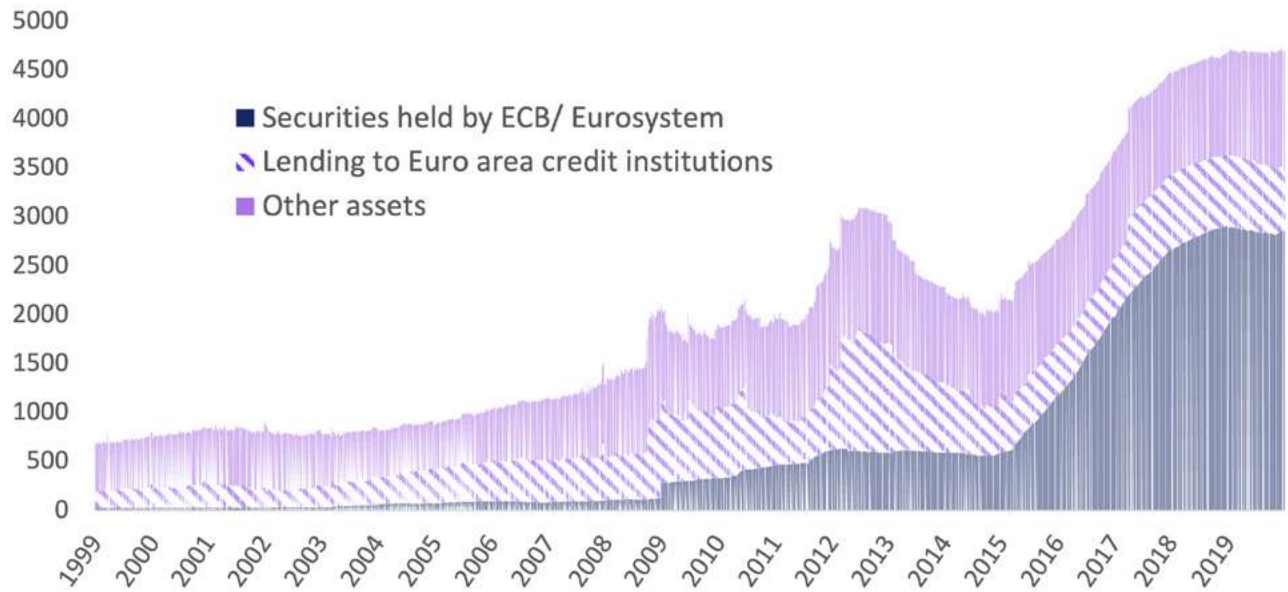
Draghi and his colleagues decided that the answer was not to limit the non-standard measures, but to expand them enormously. In December he announced that €500 billion of new low-cost financing facilities would be made available to banks, with a term of up to three years. In February the figure was doubled to over €1,000 billion. The programme was called the 'Draghi bazooka' by the media, but in fact it was just a revamped and much enlarged version of the non-standard measures.[62] The ECB's lending to credit institutions touched a low of €580 billion on 4 November 2011, just as Draghi took over. Three months later the number had climbed to €795 billion and three months after that to €1,117 billion. (The peak for this episode, of €1,261 billion, was on 29 June 2012.)

The Draghi bazooka saved the Eurozone banking system and in that respect helped the economy. The pressures on banks to shrink their balance sheets eased, as they had time to make new capital issues and to retain operating profits, and so to rebuild equity. They no longer had to sell government bonds on such a large scale, and most Eurozone government bond yields fell in 2012 and 2013. However, money growth remained low. Cash-strained banks could take advantage of the borrowing facilities for a generous period of three years, but that still meant that the loans had to be repaid within the deadline. In the years to December 2012 and 2013 M3 broad money increased by 3.0 per cent and 1.0 per cent respectively. In 2014 consumer inflation dropped to negligible levels. By December 2014 the annual increase in the consumer price index fell into negative territory and it stayed there in the opening months of 2015.

In these circumstances another upheaval in Eurozone policymaking was discussed and endorsed. In both the United States and the United Kingdom, the central banks had reacted to the Great Recession by purchasing assets from the non-bank private sector in operations usually labelled 'quantitative easing' (QE). Given the apparent success of QE in boosting demand, output, and employment, a case could be made that a similar approach should be adopted in the Eurozone. Admittedly, open market purchases of government securities might be construed as government finance from the ECB, which would be contrary to the spirit of Article 123 of the Maastricht Treaty. But – as discussed earlier – stimulatory open market operations had always been regarded as a legitimate response to recession. By early 2015 the ECB's Governing Council was committed to a major programme of asset purchases. According to a Reuters story in December 2018:

> The asset purchase program, a monetary experiment known as quantitative easing (QE), was launched in March 2015 to prevent sub-zero inflation from further

Figure 2 Size and composition of ECB assets, 1999 - 2019
Data are weekly and values are in billions of euros



> hitting an economy still reeling from the euro zone debt crisis. The ECB has spent €2.6 trillion euros (€2,600 billion) over almost four years, buying up mostly government but also corporate debt, asset-backed securities and covered bonds – at a pace of €1.3 million a minute. That equates to roughly €7,600 for every person in the currency bloc. As intended, QE has lifted economic growth while wages and lending have risen. (Carvalho, Ranasinghe, and Wilkes, 2018)

The benign effects of QE were inescapable and impressive, with the Eurozone recording positive growth of real GDP in all five years to 2019, while inflation stayed down. However, the ECB had moved far from the Bundesbank philosophy of restricting central bank assets. To recall, the Bundesbank's approach to central banking was intended both to counter inflation and to curb the free rider problem. The increase in the ECB's holdings of government securities in the four years to end-2018 was enormous relative to the amounts involved in the Securities Markets Programme that had caused so much friction between Stark and other ECB officials in 2010 and 2011. By the end of 2018 these holdings had exceeded €2,900 billion. They levelled out in 2019, with the ECB's leadership increasingly hopeful that the Eurozone banking system was again in good shape and that the economy could move forward without the artificial support of its asset purchases.

Draghi stood down from the ECB presidency at the end of October 2019. He was widely admired as having 'saved the euro' by his astute decisions and, especially, by a speech on 26 July 2012 where he said that the authorities would do 'whatever it takes' to keep the Eurozone in being. However, one assessment was that the intellectual debates on European economic policy had become confused and fractious, and that Draghi left the ECB 'more divided than ever' (Amaro, 2019). Many economists had started to prescribe actively expansionary fiscal policy to boost demand, even though the implied large budget deficits would breach the SGP.[63]

An analyst at the consultancy firm TS Lombard, Constantine Fraser, judged that '[i]t's hard to overstate just how important Draghi's tenure has been, even if you're generally sceptical about individuals' ability to shape historical events. Not only did he play the single most important role in – essentially – saving the euro zone, but since autumn 2011 he has de-facto rewritten the ECB's mandate' (Amaro, 2019). The significance of this rewriting is evident in Figure 2, which again shows the size and composition of the ECB's balance sheet, but now from the inception of the single currency until Draghi's departure. A salient feature of Figure 2 is the dramatic surge in the ECB's holdings of securities – meaning mostly government securities – beginning particularly in 2015.

The COVID-19 emergency, 2019

Christine Lagarde assumed the presidency of the ECB in November 2019. She had worked for over 20 years as a lawyer at Baker & McKenzie, a large Chicago-based international law firm. Unlike her predecessor, she had no serious background as an economist. Her speeches did not indicate deep knowledge of monetary economics, and she had no meaningful scholarly papers on economics to her name. The academic counterweight to Lagarde at the ECB since 2019 has been Philip Lane, an Irish economist who has specialised in international monetary economics. From 1 January 2020 the most senior German figure on the ECB Executive Board – apart from the Bundesbank's own representative (Jens Weidman) – was Isabel Schnabel, who was seen as a 'moderate' in the various doctrinal disputes that afflict modern macroeconomics (Arnold and Buck, 2019).

Very early in the Lagarde presidency, concern was expressed about the economic implications of COVID-19. The global pandemic was announced in March 2020. Restrictions on personal contact were imposed, with devastating negative impacts on the travel and hospitality sectors everywhere, and a loss of output that year of up to 10 per cent in major economies. This loss of output was viewed by economists as 'a recession', a word which usually denotes a reduction in output and employment due to a deficiency of aggregate demand. The policy response in the leading Western economies was therefore to boost demand, both by widening budget deficits and by resuming central bank asset purchases (or QE). The return of QE was justified – according to Lane, Schnabel, and others – by the very low level of central bank interest rates, which meant that stimulus could not come from a big cut in such rates. The effect of the asset purchases on the quantity of money was a matter of little or no interest at the ECB, as at other top central banks, because the quantity of money was not believed to matter to the determination of any important macroeconomic variables. In the four months to June 2020 the M3 measure of broad money increased by 5.6 per cent or at an annualised rate of 17.8 per cent. This was the fastest M3 increase in a four-month period in the history of the single currency. The annual rate of increase reached 12.5 per cent in January 2021, again the fastest pace of expansion in a period of this length since the euro had come into existence.

A case can be made that attributing 2020's output loss to demand deficiency was a serious misinterpretation. The output loss could instead be understood as an interruption of supply, imposed for medical reasons, and hence as an adverse supply-side shock. If so, increasing aggregate demand by deliberate policy would lead to excess demand and rising inflation. This line of discussion could proceed in the sort of framework set out in naïve Keynesian textbooks, without any reference to money aggregates. In the event the short-term impact of the collapse of output was particularly on energy prices since oil was of course used particularly in travel and transport. The fall in oil prices was so large as to prompt forecasts of persistent deflation. On 2 July 2020, as the money explosion was at its peak, Schnabel gave a presentation to the Berlin Economic Roundtable which described the ECB's response to the medical emergency as 'necessary, suitable and proportionate'. One slide was titled 'Marked weakening of inflation over the medium term' and envisaged that the annual increase in Eurozone consumer prices would be close to 1.0 per cent at the end of 2021 and to 1.2 per cent at the end of 2022.

Given the intellectual background of the ECB's executives, it is perhaps unsurprising that the size of the ECB's balance sheet ballooned. Early in the pandemic the ECB embarked on a new pandemic emergency purchase programme (PEPP). At the time of writing (March 2022) this is described on the ECB's website as 'a non-standard monetary policy measure ... to counter the serious risks to the monetary policy transmission mechanism and the [economic] outlook for the euro area. The PEPP is a temporary asset purchase programme of private and public sector securities.' The initial setting was for a '€750 billion envelope for the PEPP', but the Governing Council decided to enlarge this 'by €600 billion on 4 June 2020 and by €500 billion on 10 December, for a new total of €1,850 billion'. In 2019 the ECB's holdings of government securities had been stable. From 13 March 2020 to 4 March 2022 holdings of all securities – with government bonds preponderant – rose from €2,879 billion to €5,018 billion. (So the increase in the period was €2,139 billion, somewhat above the €1,850 billion 'envelope'. The explanation is that the PEPP complemented an existing and ongoing asset purchase scheme.)

Some Eurozone banks had trouble funding their assets in the COVID-19 period, but media reports did not suggest these were particularly serious after mid-2020, once the hubbub about COVID-19 had begun to abate. Nevertheless, the ECB made available immense borrowing facilities to the banks under the label 'targeted long-term refinancing operations', where the word 'targeted' made the exercise more respectable. The ECB's loans to credit institutions were €618 billion on 13 March 2020, but no less than €2,201 billion on 4 March 2022. According to Lagarde, in a statement to the ECON committee of the European Parliament on 19 November 2020, '[t]he key role of monetary policy in [the current] situation is to preserve favourable financing conditions for all sectors and jurisdictions ... [P]reserving favourable conditions for as long as needed is key to support people's spending, to keep credit flowing and to discourage mass lay-offs.'

In summary, the Lagarde presidency has so far been accompanied by an extraordinary indifference to the constraints on the ECB balance sheet – the three safeguards noticed by Wyplosz in 2010 – that were discussed and formulated in the 1990s. When she took over from Draghi, the ECB's total assets were €4,676 billion, whereas on 4 March 2022 (the latest numbers at the time of writing) they were over 85 per cent higher at

Figure 3 Size and composition of ECB assets, 1999 - 2021
Data are weekly and values are in billions of euros

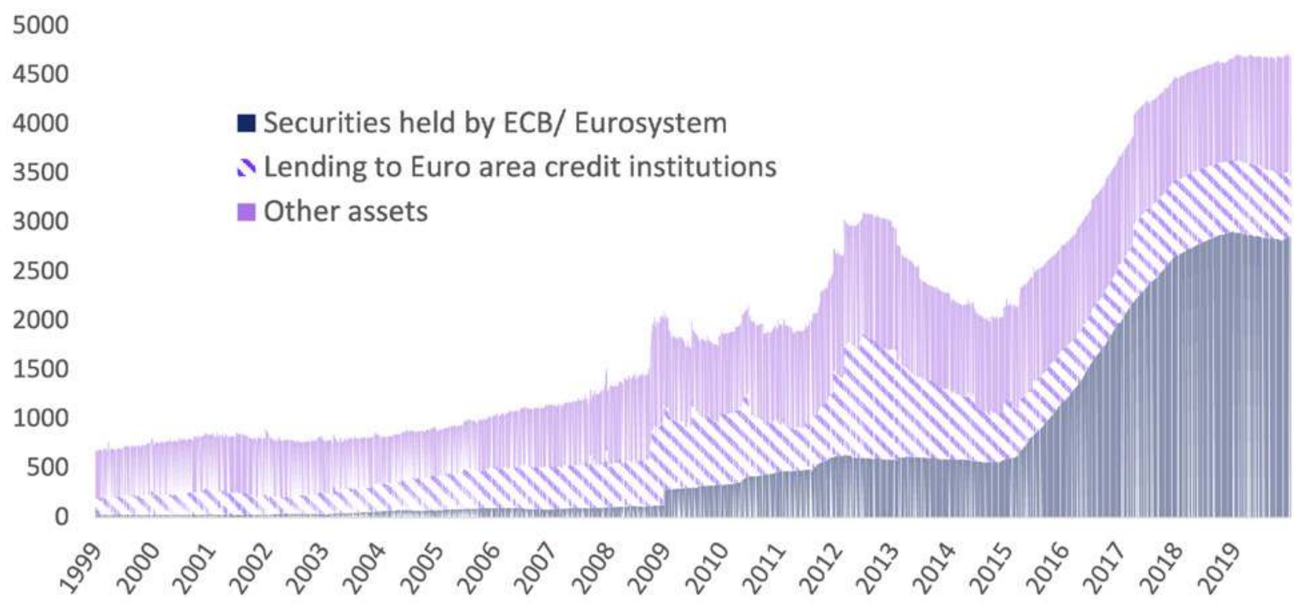
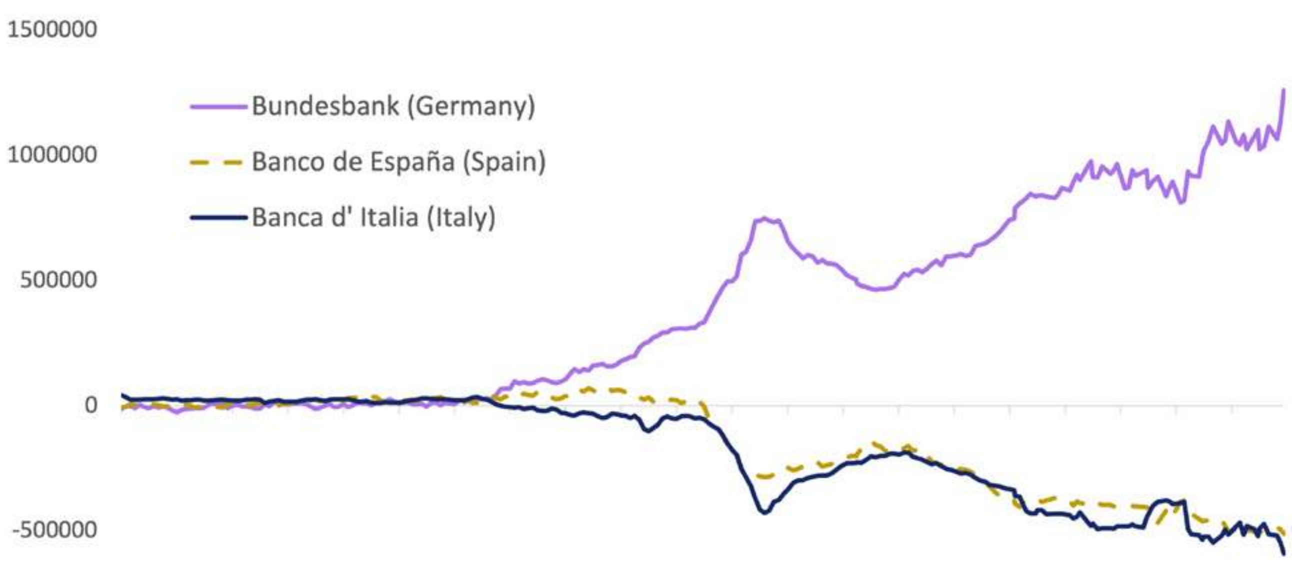


Figure 4 Credit/debit positions of the Eurozone's central banks in its Target2 settlement system, 2001 - 21
Data are monthly and in m. of euros, with final figures at December 2021



€8,673 billion. The increase in this period of less than two and a half years was therefore almost exactly €4,000 billion. By contrast, in the first eight years of the euro's existence, when the constraints in the Maastricht Treaty still meant something, the ECB's assets rose by less than €500 billion and the assets that expanded most were the ECB's claims on the rest of the world. In a remarkable speech called 'Escaping Low Inflation' on 3 July 2021, Schnabel nevertheless worried that 'medium-term inflation' would be 'likely to remain below the Governing Council's aim'. She wanted the ECB's monetary policy decisions, in concert with active fiscal support from Eurozone governments, 'to set in motion a virtuous circle of rising underlying inflation and wages' (Schnabel, 2021). In other words, Schnabel supported more inflation.

Conclusion: the free rider problem remains

In the early years of the European single currency the ECB's approach to monetary control owed much to the example of the Bundesbank. The aversion to both monetary financing of budget deficits and loan assistance to the commercial banking industry anticipated the free rider problem. As intended by Articles 121 to 126 of the Maastricht Treaty, there was limited scope for individual member nation states to run large budget deficits or for their banks to secure cheap central bank finance.

But since 2007 the Bundesbank model has been abandoned. Good reasons could be provided from 2007, when the global inter-bank market closed to new business, for the ample borrowing facilities (or 'non-standard measures') made available to banks to enable them to fund their assets. Moreover, an argument can be made that the two Draghi bazookas (of much expanded 'non-standard measures' from late 2011 and large-scale asset purchases from early 2015) were essential to keeping the single currency in being. All the same, certain nations benefited from the ECB's actions in the Draghi presidency, while others lost out. The ECB's purchases of government securities from the 2010 crisis were particularly of debt issued by the Greek, Portuguese, and Irish governments, while there can be little doubt that the loans to banks were directed mostly to banks with high levels of non-performing loans and hence little credibility in the inter-bank market. Many of these banks were – and still are – in Italy, Spain, Greece, and Portugal. Draghi may have saved the euro, but he had indeed rewritten the rule book.

Respect for the Maastricht Treaty's constraints on central bank balance sheet expansion vanished, almost completely, during the COVID-19 medical emergency. The ECB lent freely and on an enormous scale to Eurozone banks. Although the destination by country of these loans is not publicly disclosed, the remarks in the previous paragraph are still relevant. The banks with questionable solvency are predominantly in Italy, Spain, Greece, and Portugal. Further, the ECB's purchases

In the early years of the European single currency the ECB's approach to monetary control owed much to the example of the Bundesbank.

of government securities have been particularly helpful for countries with large budget deficits which might otherwise have had difficulty selling bonds in capital markets. By contrast, countries with budget surpluses have gained next to nothing from QE. One symptom of the unfairness of the ECB's conduct is the large imbalance in the Eurozone's Target2 settlement system. Germany (that is, the Bundesbank) has for several years had a large positive balance, on which it receives hardly any meaningful return. Meanwhile, Italy and Spain (via their central banks) have – again for several years – had large negative balances, in effect borrowed money on which they have to pay next to zero interest.[64]

So far the risk inherent in the Eurozone's free rider problem – that all nations try to borrow heavily from the ECB and so cause excessive money growth – has not been unmanageable. Nevertheless, the highest rates of broad money growth in the Eurozone's history – recorded, as shown above, in 2020 and early 2021 – have been followed by the highest inflation rates. Recent analysis of this topic by the ECB's research department has to be characterised as short-sighted and inadequate. Far into 2021 the ECB's leaders articulated concern about too low inflation, when the prospect was already for inflation far above desired levels. Sure enough, other central banks – notably the Federal Reserve and the Bank of England – also failed to anticipate the inflation dangers in the high money growth they had orchestrated from spring 2020. But the ECB had received a special intellectual legacy of sound-money ideas from the Bundesbank – and it might have been expected that this legacy would have checked undue ECB expansionism even in the stressful COVID-19 period.

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New Rules to Secure Fiscal Sustainability in the European Monetary Union

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Citation suggestion: Francisco Cabrillo and Rocío Albert, FC & RA (2022). New Rules to Secure Fiscal Sustainability in the European Monetary Union. *Future Europe*, 2(1), 72–80.

Abstract

In this article, after a brief introduction to the evolution and enforcement problems of the fiscal rules set up so far to achieve stability and growth of the Euro area, new fiscal rules are proposed to avoid the successive breaches of the current ones. We argue that the adoption of clear and detailed new rules would be more efficient than mere standards. These new fiscal rules are complemented by a reference to what the functions of the European Central Bank should be, returning to its original purpose. Finally, we suggest an organisational structure and the role that independent fiscal authorities should play to guarantee compliance with the new rules.

The problem

When the first steps were taken in the design of the European Economic and Monetary Union (EMU), there was debate around the convergence criteria required of the countries that wanted to be part of the union. While the monetary criteria – referring to inflation rates, interest rates, and exchange rates – were not the subject of much discussion, since their relevance to a unified currency area was clear, the same was not true of the fiscal criteria, which required public deficits to be lower than 3 per cent of GDP and a level of public debt not exceeding 60 per cent of GDP. The question as it was put at the time was: is it necessary to control these variables in a monetary union, when its rules expressly prevent financing public spending through borrowing from the central bank? Some economists pointed out that such fiscal rules were not necessary, since fiscal policy was the responsibility of the member states and they could not influence the balance sheets of the European Central Bank (ECB) and, therefore, the creation of money supply (Vaubel et al., 1989). A sustained budget deficit or a very high public debt to GDP ratio in a member state of the monetary union would be equivalent to the financial imbalances of a region or province in a member state with its own central bank. These imbalances could have important effects on the real economy but not on price stability, the main objective of the ECB, according to the Treaty on the European Union.

This idea was rejected, however, on the grounds that the existence of serious fiscal imbalances in a member state could cause problems for the monetary union because they would threaten the stability of the single currency. As the Greek financial crisis later showed, the systematic breach of the principles of fiscal stability by a member state – even by one whose GDP represented only a small percentage of the GDP of the Eurozone – could well create serious problems for the whole monetary area. If default and partial cancellation of the debt are not considered an acceptable solution for a member state of the monetary union, it is then necessary to impose rules to avoid unwise fiscal policies.

The initial fiscal stability rules were consolidated in the Stability and Growth Pact (SGP). These were later modified on several occasions, with regard to both its 'preventive arm' and its 'corrective arm'. The first reform was made in 2005, while changes were also introduced in 2011 and 2013. These reforms were intended to deal with the specific problems that the application of the SGP posed to some member states, especially in the aftermath of the 2007–2008 Global Financial Crisis. The most important changes were the following: emphasis was placed on country-specific medium-term objectives and procedures to set and revise them; furthermore, it was considered convenient to take into consideration the possible existence of 'severe economic downturns' and the role of other relevant factors to establish what comprises an 'excessive deficit'. A complex expenditure benchmark was introduced as an indicator to assess compliance with the adjustment paths towards the medium-term objectives; a 'significant deviations procedure' and a 'corrective mechanism' with possible sanctions were created; and members states were required to submit to the Commission and to the Council their budgetary plans in the autumn of each year, ahead of the discussion of the budget in their own national parliaments. These reforms, aimed at better controlling each member state's public finances with fiscal imbalances, had, however, the negative effect of creating an excessively complex system, which in practice makes it very difficult to carry out such control. The main variables to monitor are not clearly defined, and their assessment is subject to so many possible interpretations that the application of the preventive and corrective arms of the SGP becomes virtually non-operational, inefficient, and even non-credible. For example, the new fiscal regulations that were approved also contemplated the possibility of establishing sanctions for fiscally errant member states, but this was never implemented.

Despite all these problems, the fiscal rules established in the EMU have had positive effects insofar as they have created incentives for the governments of some member states – especially in Southern Europe – to improve their public finances since the end of the so-called euro crisis (2010–2013). Although some economists and politicians thought that the introduction of fiscal reforms would be very difficult to implement when the European Monetary Union was launched (for example in Italy, Greece, or Spain), the data show that they could be carried out. It can be argued that the Union's policy has been excessively tolerant of non-fiscal compliance by member states. But even so, the mere existence of rules draws public attention to the fiscal policies of those governments more prone to fiscal imbalances, and the awareness that the fiscal goals were not being achieved eventually contributed to the correction of too lax fiscal policies.[65] This does not mean, of course, that the mere existence of rules guarantees that fiscal discipline will be met. For example, the way in which some countries interpreted the fiscal deficit rule under the SGP is especially striking, even before its modifications in later years. It seems that some governments have considered that the 3 per cent deficit limit was the rule to follow both in years of low GDP growth and in years of expansion. And this was obviously not the objective of the rule. In a model designed to achieve a balanced budget in the medium term, or along the business cycle, a 3 per cent fiscal deficit is acceptable in years of low economic growth as it can be compensated with budget surpluses in the expansionary years, therefore resulting in balanced budgets over the cycle. But some countries, with no real desire to reduce their structural deficits, used their compliance – or near compliance – with the 3 per cent rule as an excuse to accumulate excessive deficits for a long time, and hence cumulative growth in public debt over the long term. The COVID-19 pandemic significantly worsened the already existing fiscal imbalances in some EMU member states. But the problem existed before, as shown by the budget deficit data of some member states even when they were benefiting from reasonable economic growth rates in the years prior to 2020.

Data from pre-pandemic years show substantial differences between fiscal policies and performance across EMU member states. Tables 1 and 2 show data of net lending or borrowing and of GDP rates of growth in the five biggest economies of the EMU in 2017, 2018, and 2019. While countries such as Germany and the Netherlands closed their budgets with

Table 1 General government net lending (+) or borrowing (-) (% of the national GDP)

	2017	2018	2019
Germany	1.3	1.9	1.5
France	-3.0	-2.3	-3.1
Italy	-2.4	-2.2	-1.5
Spain	-3.0	-2.5	-2.9
Netherlands	1.3	1.4	1.7

Source: Eurostat

Table 2 Real GDP growth rates (annual rate of growth, %)

	2017	2018	2019
Germany	2.7	1.1	1.1
France	2.3	1.9	1.8
Italy	1.7	0.9	0.4
Spain	3.0	2.3	2.1
Netherlands	2.9	2.4	2.0

Source: Eurostat

sustained surpluses between 2017 and 2019, France, Spain, and Italy ran high deficits.

The comparison between budget deficits and GDP growth rates in these countries is interesting for the study of fiscal stability rules because it shows that the deficits of France, Spain, and Italy cannot be explained as a result of experiencing low economic growth rates. Conversely, Spain was the country with the higher rate of growth in this group and France had a higher rate of GDP growth than Germany in these years. Despite this, France and Spain were both unable to balance their budgets and ran fiscal deficits in the range of -2.3 per cent, -3.1 per cent of GDP. This result has implications when thinking about the reform of budget stability rules because data show that these imbalances were not created by 'severe economic downturns' and thus were not motivated by the action of the so-called fiscal automatic stabilisers, which result in higher government spending and lower tax receipts when the economy is contracting. This deficit drift in some of the member states' fiscal policies would inevitably produce ever-increasing public debt levels.

Rules versus standards

Since the return to the fiscal stability rules was proposed after being put on hold due to the COVID-19 pandemic, numerous reports and articles have been published on how the new fiscal stability framework should be designed (see, for example, Blanchard, Leandro, & Zettelmeyer, 2021; Darvas, Martin, & Ragot, 2018; Delivorias, 2021; Ilzetzki, 2021; Leiner-Killinger & Nertlich, 2019). Opinions on the direction to take are very different regarding both the role of the European Union and the EMU in designing stabilisation policies and the type of rules that should be imposed on member states to ensure a more sound fiscal position in the Eurozone.

The debate on the best norms for a specific regulation has a long tradition in law and economics. It focuses on the choice of either norms that determine *ex ante* the expected behaviour in a detailed way (that is, rules) or norms that formulate general principles of behaviour to achieve a certain objective *ex post*, without going into much detail about how to achieve it (that is, standards). Article 126 of the European Union Treaty, which establishes that 'Member States shall avoid excessive government deficits', is a good example of a standard with which member countries must comply. At the same time, the norms which set a limit of 3 per cent for the budget deficit and a limit of 60 per cent for the public debt to GDP ratio are examples of rules with a much more precise content and detailed formulation.

It is not surprising that in the current debate on fiscal sustainability in the European Monetary Union the issue of rules versus standards has emerged again. For instance, Blanchard, Leandro, and Zettelmeyer (2021) support the idea that designing the new fiscal sustainability regulation as a set of rules makes no sense because of the existence of a number of uncertain economic and political factors. Given such conditions, 'rules are bound to lead to mistakes, constraining fiscal policy either too much or too little'. This is why they suggest the adoption of a guideline that would explain, for instance, that deficits are excessive when debt does not appear to be sustainable with high probability.

Such an argument, however, seems to us flawed and, more importantly, of little use when designing an efficient system of regulations to preserve fiscal sustainability. In his well-known article Kaplow (1992) accepts the idea that the construction of *ex ante* rules requires effort, whether in analysing the problem, resolving value conflicts, or acquiring the relevant empirical knowledge. For this reason, it is necessary to carry out a cost–benefit analysis, taking into consideration whether the costs of adopting a detailed rule are offset by the significant cost savings of lower costs of application. In cases in which it is to be expected that enforcement problems will not be frequent, then we can say that the lower costs of applying the rules will not compensate for the greater difficulties encountered in their design. But if problems are expected to be frequent, the use of standards can be much less efficient, since the lower design costs will not compensate for the conflicts that will arise in their application. But should we expect frequent conflicts in the application of fiscal sustainability rules? According to the experience available, it is reasonable to say that the answer to this question has to be yes. The history of the European Monetary Union shows that non-compliance with the rules has happened many times; furthermore, we have good reason to think that, if clear and precise rules are not established, non-compliance will also be very frequent in the future.

A public choice argument can also be used in favour of rules over standards. Given that politicians are short-term maximisers of their utility functions, and that their main objective, when in government, is to remain in power, they can reasonably think that the application of the norms aimed at avoiding non-compliance regarding fiscal sustainability could eventually lead to poorer electoral performance in later elections. Therefore, they will have clear incentives to try not to apply them. And such a strategy will be easier and more successful when dealing with fiscal standards, which they can interpret at their own convenience, as compared with more precise rules, which are more difficult to interpret vaguely.

A proposal of new fiscal rules: a public spending rule

The next task is to determine what type of rules should be applied in the light of the impact of the COVID-19 crisis on public finances in order to achieve fiscal sustainability, as well as how to encourage compliance with the rules. It may be useful to review the evolution of the two main fiscal criteria set up in the SGP in the period between the two main economic crises of the twenty-first century: the Global Financial Crisis that began in 2007–2008 and the COVID-19 crisis from 2020.

These reforms, aimed at better controlling each member state's public finances with fiscal imbalances, had, however, the negative effect of creating an excessively complex system, which in practice makes it very difficult to carry out such control.

Despite a relatively good performance in the first years of the launch of the euro, these crises revealed some of its weaknesses and the asymmetries in fiscal performance across member countries. The 2007–2008 crisis and the macroeconomic policies that were applied to try to reduce the macroeconomic imbalances that it created produced a recessive cycle in the Eurozone, and the GDP of the Euro area fell in 2012 and 2013. But, from 2014 to 2020, the GDP of the Euro area grew steadily with average rates of around 2 per cent, as shown in Table 3. It is interesting to see how the two main fiscal variables discussed in this article evolved in this period. The figures are presented in Table 4.

The budget deficit was reduced from -2.5 per cent in 2014 to -0.6 per cent in 2019. Yet we should note that the sum of the budget balances of Euro area members was a negative figure for every year in this period. Two further points should be noted: firstly, given the recurrence of GDP growth rates in this period, the Euro area was in a position to achieve a balanced budget in the medium term or along the cycle, or even a slight budget surplus.

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Table 3 Real GDP growth rate, Euro area 2014–2019 (annual growth rates, %)

2014	1.4
2015	2.0
2016	1.9
2017	2.6
2018	1.8
2019	1.6

Source: Eurostat

Table 4 Government deficit and government gross debt as a percentage of GDP, Euro area 2014–2019

	GOVERNMENT DEFICIT (%)	GOVERNMENT DEBT (%)
2014	-2.5	92.7
2015	-2.0	90.8
2016	-1.5	90
2017	-0.9	87.5
2018	-0.4	85.5
2019	-0.6	83.6

Source: Eurostat

Secondly, as we have seen previously, the behaviour of the different countries in terms of their fiscal performance was very diverse. While some applied sound fiscal policies and contained their deficit, others did not. Moreover, it is precisely in the latter countries where it is more important to establish new rules to secure fiscal sustainability. Regarding public debt ratios, the data show a sustained reduction from 92.7 per cent of GDP in 2014 to 83.6 per cent of GDP in 2019; that is a reduction of 9.1 percentage points, which must be attributed more to GDP growth than to fiscal policies aimed at reducing imbalances.

Multiple formulas can be used to achieve fiscal stability goals. The two criteria used by the European Monetary Union from its origins – limits on the annual budget deficit and limits on the ratio of public debt to GDP – are related to each other since the public debt to GDP ratio is a stock variable that will be reduced over time depending on the size of the deficit in each country. The Maastricht Treaty and the SGP opted for a combination of both fiscal criteria. But given the experience of these years, it seems more relevant to put the emphasis on controlling budget deficits. Public debt is a stock generated by the long-term accumulation of budget deficits, and it is not easy to control in the short term. Alternatively, it is more effective to focus on controlling the budget deficit every year. As noted above, some countries considered that the limit of 3 per cent was a maximum for budget deficits, even when experiencing sound rates of GDP growth. New fiscal stability rules should prevent this from happening. Two steps in this direction can be adopted. The first is to design a fiscal rule that requires governments to balance their expenses and revenue in a multi-year budget period. This formula seems the most suitable to control the deficit within a certain degree of flexibility because it would require governments to adjust their spending and income to the situation of their economies each year, thus guaranteeing medium-term budgetary stability while at the same time allowing for expansionary public policies in the years with lower – or negative – rates of growth. These deficits should be offset by surplus budgets in the years of higher growth along the business cycle. The rule should also set the maximum level of deficit that a government could reach in a specific year – it could remain at 3 per cent of GDP – with the sole exception of years of a severe recession (which would be specified in terms of a fall in the GDP), in which the European Union could authorise higher deficits if such policies were supported by independent national and European fiscal authorities. The problem with using multi-year budget balances as a rule would be that it might be more difficult to control governments' policies until the budget cycle is over. For this reason, the rule should be complemented with an additional requirement, such as for balanced budgets – or even surplus budgets – in years of substantial rates of GDP growth, such as 2 per cent or higher. This rule would prevent a country with such a growth rate from having a budget deficit in that year.

At the same time, if the public debt limit rule were kept, it would not make sense to establish a specific debt ratio for all countries, be it 60 per cent of GDP or any other. The data presented in Table 5 show that the public debt of the Euro area represented, at the end of 2020, 97.3 per cent of its GDP, with large differences between countries. Below the limit of 60 per cent of GDP we have countries such as Ireland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, and Slovakia; between 60 and 70 per cent we have Germany and Finland; and above 100 per cent we have Belgium, Spain, France, Italy, Cyprus, Portugal, and Greece (the latter with a public debt ratio greater than 200 per cent of its GDP).

Trying to set a common ceiling for all these countries would make little sense today, in the post-COVID-19 economy, when public debt performance among member states is so asymmetric. It would be better to establish criteria for a gradual reduction of these ratios for each member state to be applied each year, except in the case of deep recession that simultaneously generated high budget deficits and growth in the debt to GDP ratio due to the reduction of the GDP. Higher rates of reduction of the public debt to GDP ratio should be applied to countries with a higher ratio, that is, over 90 or 100 per cent. And countries in which this rate was below a certain level – 60 per cent or a similar ratio – would not be required to reduce their debt.

The possibility of introducing a rule to control the growth of public spending in the member countries is also on the discussion table. Already in 2011, with 'six-pack' legislation, an expenditure benchmark rule was established which relates the annual growth of government expenditure, net of discretionary revenue measures, with medium-rate term of potential GDP growth.[66] This rule could be improved by setting a ceiling on government spending growth conditioned by the rate of potential output growth, which would be reviewed by an independent fiscal control institution, as we will see in the next section. A spending rule has some important advantages over a deficit rule. While changes in public revenue are determined, in the short term, mainly by the evolution of GDP, public spending can be determined by governments with a much greater degree of discretion. This means that governments can use it to achieve short-term political goals that, in many cases, may make it difficult to improve fiscal sustainability over the medium and long term. It could be objected that this rule would prevent a government from increasing the public spending to GDP ratio when it desired and its parliament so approved, thus effectively curtailing the fiscal sovereignty of member states. However, this type of rule would apply to countries with fiscal imbalances. Once fiscal balance was restored, voters could again determine what public spending to GDP ratio they wanted in their country.

The independence of the IFIs should be reaffirmed and their functions extended, which should consist of contributing to the design of fiscal scenarios that allow compliance with clear fiscal rules, especially regarding the deficit.

We should also refer to the role played, especially after 2020, by the European Central Bank. At the end of that year, the ECB accumulated 20.8 per cent of the total stock of government debt of the Euro area as a whole. This policy, articulated by the adoption of a new asset purchase scheme in 2020 (the pandemic emergency purchase programme, or PEPP), accompanied by its expansionary monetary policy, has allowed the countries of the Euro zone to finance their increased expenditures and deficits during the pandemic with almost no restrictions and at an extraordinarily low cost. The positive effect of this policy has been to help finance member states in a very difficult economic situation. Nevertheless, it has also had the negative effect of reducing to a minimum the incentives that a more open financial market would have imposed on governments to limit their indebtedness. If in the future we want to halt the growth of public debt, it would be important for the ECB to focus on its primary function of maintaining price and financial stability and to stop financing the deficits of member countries. Before 2020, it was argued that what the ECB was doing when purchasing government debt was to carry out open market operations to raise an inflation rate that was below its objective of 2 per cent. However, this argument does not make sense now, in 2022, with an inflation rate in the Eurozone above 5 per cent. We should avoid the potential conflict between different goals given to (or adopted by) the ECB, as the main policy actor focused on returning to price and financial stability on the one hand, while on the other hand making it easier for member states to finance their deficits without the discipline imposed by financial markets.

Independent fiscal institutions to monitor and enforce the rules

As we have shown, the history of the Stability and Growth Pact in the European Union has been characterised by alternating periods, first of greater demands for compliance with budgetary stability, and second, in the face of persistent non-compliance by the member states with the SGP rules, the adoption of much more flexible norms. Effectively, this led to non-compliance, made possible by the adoption of short-term compliance plans and varied instruments or institutions that gave the appearance of achieving objectives that were spread out over time.[67]

The independent fiscal institutions (IFIs) appear for the first time in Directive 2011/85, establishing that compliance with the quantitative budgetary rules should be monitored by a body independent of the budgetary authorities. Then, with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union in 2012, the preventive part was reinforced to compel member states to have an automatic correction mechanism in the event of deviations from the medium-term objective. In this way, the IFIs are assigned the role of monitoring this correction mechanism. This gives the IFIs a new role, in addition to *ex ante* control, and subsequent monitoring of the correction measures, which is much more difficult for national governments to rigorously carry out.

Finally, Regulation 473/2013 goes a step further by attributing to the IFIs greater organisational independence and facilitating access to resources and information to endorse or point out deficiencies in budget forecasts by member states; but at no time does it grant them true autonomy. This would require the IFIs of the different countries to depend on the European

Table 5 General government gross debt 2021 in Q3 as percentage of GDP (%)

Euro area	97.7
Belgium	111.4
Germany	69.4
Estonia	19.6
Ireland	57.6
Greece	200.7
Spain	121.8
France	116.0
Italy	155.3
Cyprus	109.6
Lithuania	45.1
Luxembourg	25.3
Malta	57.2
Netherlands	52.6
Austria	84.1
Portugal	130.5
Slovenia	79.6
Slovakia	61.1
Finland	68.7

Source: Eurostat

Commission, or any other European body that was chosen, and all IFIs would need to have a homogeneous structure with the same set of functions and operational autonomy to allow them to fulfil their objective. That is, in addition to serving as an independent control mechanism for compliance with the budgetary rules of economic convergence in the European Union, they would actively participate in the design and debate of the fiscal policy of each country, both in the preparation of the budgets and in their subsequent execution, and in the decisions on fiscal reforms in each country.

However, the structure, degree of independence, available resources, functions, and other aspects of the organisation of these institutions very much varies across the EU member states, which makes it very difficult to compare them. In most cases their main roles continue to be extremely normative and focused on the supervision of both national and EU fiscal rules; however, it would be desirable to strengthen their contribution to the discussion of the fiscal policy of each country.

In our view, within this reform, the independence of the IFIs should be reaffirmed and their functions extended, which should consist of contributing to the design of fiscal scenarios that allow compliance with clear fiscal rules, especially regarding the deficit. In other words, these institutions should play an active role in preparing the macroeconomic forecasts that serve as the basis for drafting the budget to avoid the recurrence of persistent annual deficits, except in cases of severe crisis. In fact, if we want IFIs to have a meaningful role in preventing further deviations of the deficit in the future, they should even have veto power in cases where the government's budget draft included significant differences with respect to the macroeconomic forecasts marked by the IFIs.

Furthermore, these organisations should have the power to propose changes to enable their countries to comply with the rule of reducing the gross public debt ratio in the medium term, establishing the conditions to be met by member countries, as well as the timetable for this compliance plan. Moreover, the independent fiscal authorities should also be the real controllers of the government's fiscal position, so they can comply with the setting of a ceiling on its spending growth, as conditioned by the rate of potential output growth. In order to achieve these new roles, our proposal involves the creation of a new European system of national fiscal institutions that are both organically and functionally independent of their countries' governments and accountable to the European Commission.

Conclusions

The data shown throughout this article demonstrate that the existing fiscal rules have not created an effective system to contribute to fiscal stability in the Euro area. Specifically, the experience of the last two decades illustrates that fiscal imbalances in several member states were not the result of 'severe economic downturns' and that these states have actually interpreted the 3 per cent deficit rule as a limit to their budget deficits, regardless of the growth rate of their economies at the time. Similarly, the data indicate that different countries have responded very differently with respect to the commitment to reduce public debt. Indeed, there is a high degree of dispersion as regards fiscal performance among the Eurozone member states.

For these reasons, in this article we present a new proposal for fiscal rules to achieve the desired fiscal stability, after analysing the advantages of establishing specific fiscal rules instead of standards. Thus, we start from the fact that non-compliance with the prevailing rules has happened repeatedly; and we have good reason to think that, if clearer and more precise rules are not established, non-compliance will also be very frequent in the future.

We propose a new budget rule that should have two essential requirements: firstly, it should require governments to balance their expenses and revenues in a multi-year budget period. This formula seems the most suitable because it would force governments to adjust their spending and income to the situation of their economies each year, thus guaranteeing budgetary stability and allowing, at the same time, expansionary public policies during a downside phase in the cycle or even negative growth rates. Secondly, it should establish the obligation to present balanced budgets – or even surplus budgets – in years of high levels of GDP growth, so that a country with a growth rate of 2 per cent or higher could not present a budget deficit in that year. This is to avoid the tendency of governments to defer compliance with the deficit rule until the end of the multi-year budget period, which makes it more difficult to correct for excessive deficits in previous years.

With regard to the public debt rule, it seems more reasonable to implement, instead of a single public debt ratio of below 60 per cent for all, criteria for a gradual reduction of these ratios to be applied each year, except in the case of a severe recession that generated high budget deficits and then a rapid acceleration in the debt to GDP ratio. Similarly, we believe that if we want to contain the growth of public debt in the long term, it is important for the European Central Bank to focus on its primary functions (that is, to maintain price and financial stability) and stop financing the deficits of member countries. Moreover, it is essential to introduce a rule to control the growth of public spending in the member states; this rule could be improved by setting a ceiling on government spending growth conditioned by the rate of potential output growth.

Finally, so that compliance with these new fiscal rules does not become a dead letter, we propose the creation of IFIs under the supervision of the European Commission, with homogeneous functions in all countries. IFIs would play an important role in drawing up the macroeconomic scenarios for the preparation of annual budgets, preventing governments from altering their forecasts of expenses and income as driven by the political cycle. In addition, these institutions should establish and supervise compliance with gradual public debt reduction programmes. Finally, they should be responsible for the observance of the spending ceiling rule of national governments.

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An Assessment of the Europeans' Bank Bailout Policies since the Global Financial Crisis and a Proposal for Reforms

A Comparison with the US Experience

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Citation suggestion: Aneta Hryckiewicz, Natalia Kryg, and Dimitrios P. Tsomocos, AH, NK & DT (2022). An Assessment of the Europeans' Bank Bailout Policies since the Global Financial Crisis and a Proposal for Reforms: A Comparison with the US Experience. *Future Europe*, 2(1), 81–93.

Abstract

Europe still has a lot to learn from the events of the Global Financial Crisis (GFC) of 2008 as it continues with reforms of its bank resolution ecosystem. Through a comparison of the bailout mechanisms used in Europe and the United States during the GFC, we show that the US bank bailout approach appears to have been much more successful than the European one. The separation of governance functions from management functions and the nature of voting rights have incentivised the US Treasury to actively intervene in the distressed banks by imposing critical changes, for example a change of CEO or affecting the board compensation. In addition, such US Treasury behaviour has also disciplined other banks to implement the necessary restructuring changes to avoid government intervention. In turn,

the European bailout approach has supported government passiveness in the governance functions and its greater involvement in bank business. As a result, we have noticed a significant increase in board compensation at nationalised banks, and no significant restructuring changes. Our findings call for bailout mechanisms incentivising the resolution authority playing an active role in the governance functions at distressed banks without significant involvement in bank business. We also opt for time-constrained intervention.

Introduction

The approach towards and extent of government interventions in respect of distressed banks have been debated for many years. Government interventions can create moral hazard leading to wrong incentives for banks to engage in risky lending (see, for example, Demirgüç-Kunt and Kane, 2002; Demirgüç-Kunt, Kane, and Laeven, 2008). Government interventions can also provide banks with perverse lending incentives on which they exert forbearance, which can result in misallocation of capital to 'zombie' firms (see Acharya et al., 2021; Goodhart, Wang, and Tsomocos, 2020). Moreover, they come with a high fiscal bill and hence are often disliked by the public, particularly in Europe since the Global Financial Crisis (GFC) of 2008. At that time, the costs of recapitalisation of European banks were much higher than in the United States.

However, government interventions remain inevitable in the event of an extreme systemic crisis and/or in cases of distressed banks that are 'too big to fail'. Thus, the debate continues as to what scheme of bank bailouts should be adopted so that the fiscal injection achieves the highest productivity in a short period of time. Government participation in a bank bailout may potentially lead to positive results. For instance, if restricted, it could initiate the restructuring of distressed banks, which otherwise might not have happened. It can also play an important role in the governance process by having the required power to influence management changes. In addition, under certain circumstances, it may also have a positive effect on market discipline by limiting moral hazard behaviour often associated with bank bailouts.

Other stakeholders such as debtholders might not have the right incentive to do so. Since the debtholders have a priority on claims over other shareholders, the incentives to sufficiently monitor and incorporate necessary changes at distressed banks might not matter for them (Landier and Ueda, 2009). Moreover, since the debtholders do not benefit from any bank restructuring programmes, the bank shareholders will not have incentives to implement any restructuring changes at such banks, as found in Tanaka and Hoggarth (2006).

At the same time, there is a high risk that government misuse of public money and its lack of experience might exacerbate mismanagement and risk-taking activities (see Tahoun and van Lent, 2010; Duchin and Sosyura, 2014). Thus, it is crucial that the design of the bank bailout reduces any risk of governmental misuse and provides the appropriate incentives for governments to facilitate the necessary changes at distressed banks.

In the context of the Eurozone countries, an important debate arose on how to create a unified model of banking resolution so that the banking sector recovery could be homogeneous across member countries. Such unified banking resolution model could help to reduce the negative transmission effects across countries (Allen and Gu, 2018) as well as to facilitate more equal growth within the European region.

In this article we argue that the bailout approach used in the US has been more effective than that used in Europe. The US bailouts provided the correct incentives for the US Treasury to actively participate in the governance process and monitor the rescued banks. In addition, the cumulative dividends and restricted involvement of the government successfully increased banks returns.[68] Importantly, the nature of Treasury ownership has incentivised the US Treasury to play an active role in corporate governance while at the same time preventing it from participating in the daily management of the bank. Moreover, the US bailout process left some discretion to bank managers in running bank restructuring activities under the governmental 'sanction' to fire the CEO or to make personnel changes in the management. This kind of 'sanction' has created discipline among the distressed banks to improve their performance due to the possibility of governmental changes in the corporate structure (Muecke et al., 2021).

In contrast, European governments intervened as ordinary shareholders with majority voting rights. This created incentives for them to misuse their power in bank management. Moreover, it precipitated a conflict of interest between governance and management functions within the rescued bank. In the academic literature, government as an ordinary shareholder has been evidenced as an untrustful and inexperienced shareholder, mainly aimed at realising its own political incentives (Caballero, Hoshi, and Kashyap, 2008).

We analyse the effect of different bailout approaches on the governance structure of the bailed-out banks. More specifically, we investigate how different bailout schemes and their mechanisms have incentivised governments to implement the necessary changes in the distressed banks. We use bank-level data on multiple governance proxies such as CEO change, changes in management board, compensation levels of the CEO and other executives, and compensation schemes in the management board. We assess how those variables change depending on the bailout mechanisms for a sample of American and European banks between 2007 and 2018.

We identify four weaknesses of the European bailout approach during the Global Financial Crisis of 2008:

1. Heterogeneous fiscal approaches used in the European countries resulted in wide divergence in the levels of bank recapitalisation among the member states. This left many banks severely undercapitalised and encouraged so-called zombie lending.
2. Ordinary stockholding has created a conflict of interest between the government role in bank governance and management, which caused forbearance in bank efforts on re-structuring.
3. The lack of a unified European approach towards the resolution of distressed banks left many banks in government hands. In countries with poor government performance, many banks are still operating under adverse conditions.
4. Discretion given to banks to run the restructuring process without any monitoring has resulted in the forbearance of restructuring.

In this article we argue that the bailout approach used in the US has been more effective than that used in Europe. The US bailouts provided the correct incentives for the US Treasury to actively participate in the governance process and monitor the rescued banks.

Different bailout approaches: American versus European

There are several fundamental differences between the bailout approach used in the United States and the one used in European countries. The bank bailouts in the US occurred mostly through the Troubled Asset Relief Program (TARP). It was established in October 2008 when Congress passed the Emergency Economic Stabilization Act (EESA). Within the TARP framework, the Treasury launched several equity injection programmes. In total, the US Treasury invested around $205 billion into 707 financial institutions, including Bank of America (BoA), Citigroup, JP Morgan, Wells Fargo, Goldman Sachs, and Morgan Stanley. It is important to note that the initial rationale under TARP was to purchase toxic assets from the troubled banks. However, TARP was eventually transferred into a programme of investing directly into the troubled banks (Sorkin, 2009).

Importantly, the US Treasury often invested either in the form of preferred stock with warrants, which did not involve voting power except in specific situations, or decided to keep the voting rights but with some restrictions. For instance, the Treasury could not interfere in the day-to-day management decisions in the bailed-out banks, and it was expected to dispose of its investment at the earliest possible time. In addition, it could exercise its voting rights as a common shareholder only in respect of core shareholder matters, such as board membership, amendments to corporate charters or bylaws, mergers, liquidations, substantial asset sales, and significant common stock issuances (see Yang, 2019). In addition, the vast majority of Capital Purchase Program (CPP) shares were preferred shares (93 per cent of banks selected this option) involving cumulative dividend payments (87 per cent of those banks that selected the preferred shares option). In addition to dividend payments, the US Treasury included additional covenant related to the appointment of directors. If the bank misses five quarterly dividend payments to preferred shareholders, then the Treasury could ask for permission to send a (non-voting) observer to board meetings. However, CPP institutions had the option to reject Treasury observers, which they did in several cases. If the institution missed six quarterly dividend payments, the Treasury had the right to appoint up to two board members. Finally, any bank that missed a dividend payment was not allowed to distribute dividends to common shareholders until all the missed preferred dividend payments were fulfilled. In a similar vein, the right of the Treasury to appoint board members could be removed only after all missed dividend payments had been realised (Muecke et al., 2021).

There were three models of bailouts that the US Treasury applied during the GFC:

- The first model was pursued in the case of BoA, where the Treasury held a low non-voting position via preferred stock with warrants. The Treasury only held 0.04 per cent of BoA's total outstanding shares without voting rights (Barnes, 2010). Even with exercising the warrants, the Treasury could have held only 5.2 per cent of BoA's shares.
- The second model assumed the minority though major shareholding ownership. Such a model has been pursued by Citigroup, where Treasury

The problem with the European banks' bailout was that decisions and money transfers into the distressed banks were left in the hands of national governments, subject to the approval of the European Commission.

held 34 per cent of Citigroup's outstanding common stocks. The Treasury, however, reduced its voting power to the same proportions as other common stockholders except in major corporate matters.

- AIG was the only institution where the government had majority ownership and could exercise its voting right. It managed its shares via a special trust vehicle. Instead of holding them, it established the AIG Credit Facility Trust to hold AIG shares for the sole benefit of the Federal Reserve Bank of New York (FRBNY).[69] The purpose was to prevent potential conflicts between the government's role as a regulator and as an investor. Although the government could not influence the voting rights vested by the stocks, it decided to use its right to appoint two directors to the board of AIG. The Trust then left the daily management of AIG to its management without the interference of the Treasury (Kahan and Rock, 2011).

Nearly all funds for recapitalisation provided under TARP were repaid as early as 2013. As of 31 December 2018, the Treasury had collected $226.8 billion in proceeds as opposed to the $205 billion original investment and retained holdings in only three banks, as opposed to the 707 in which it invested (Yang, 2019).

The bank bailouts in Europe only partially resembled those in the US. Although in the initial stages of the GFC European governments were taking only minority stakes in banks, the need for recapitalisations combined with limited interest from the private sector to support the distressed banks led European governments to step in and take the majority share in many banks. The cost of the bailout programmes was much higher in Europe than it was the case in the US, particularly in Germany, Ireland, Spain, and the United Kingdom.

The European governments initially sought to follow the American approach to bailouts by playing a more passive role in nationalised banks. Therefore, many capital injections occurred through preferred stocks or hybrid instruments. With the deterioration of the situation in the European banking sector, however, the European Commission gave a 'green light' for nationalisation of the distressed banks to prevent the collapse of key financial institutions (European Commission, 2009). Following this announcement, the European governments were eager to step into the distressed banks. The greater the problems of banks were, the more frequently the governments decided to exercise their power by either acquiring the common stock ownership with voting rights or converting their hybrid instruments into the common stocks.

As a result, many European countries ended up with nationalised banks, where governments had the controlling stakes with significant voting power. Noticeable examples include the following:

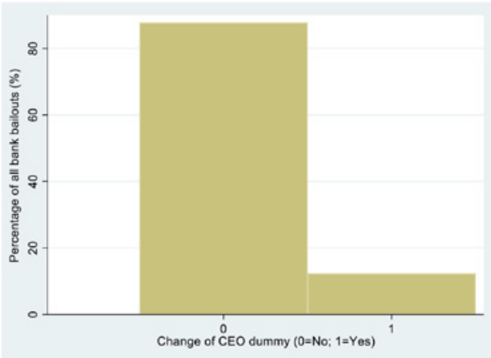
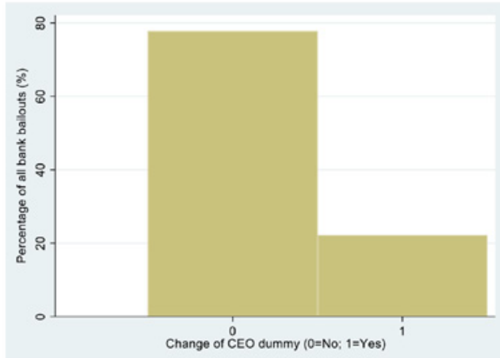
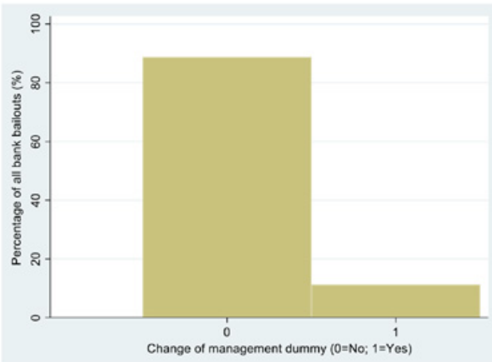
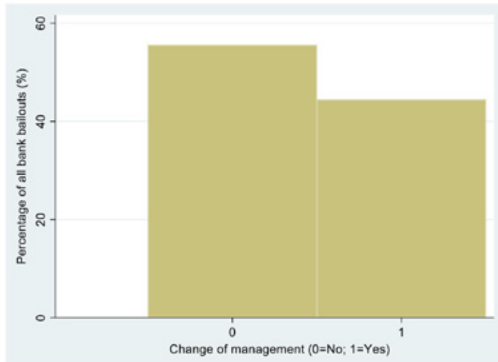
- In Ireland, the government initially injected capital to the Allied Irish Bank (AIB) in ordinary non-voting shares, which after the conversion into ordinary stocks and additional injections reached 92.8 per cent government ownership. However, the Anglo Irish Bank (Anglo) was nationalised on 15 January 2009 and recapitalised later in 2009 with €4 billion in ordinary stock (Igan et al., 2019).
- In Cyprus, the government recapitalised Cyprus Popular Bank as well as Cooperative Central Bank by taking its ordinary stakes to 84 per cent and 9 per cent, respectively.
- In the UK, the Bank of England and the Financial Services Authority (FSA) decided to inject £500 billion ($750 billion) into the country's eight largest banks and building societies. In 2008, the government invested £107.6 billion to acquire a controlling equity stake (84 per cent but only 68 per cent of the voting rights) in Royal Bank of Scotland (RBS) and a 43 per cent stake in Lloyds Banking Group (Lloyds). In 2010, it acquired the whole of Northern Rock and Bradford & Bingley (NAO, 2015).
- Germany nationalised its Hypo Real Estate Holding (HRE) through SoFFin (Sonderfonds Finanzmarktstabilisierung, or the Special Financial Market Stabilisation Fund),[70] which owned 90 per cent in 2009 via capital injections.

Empirical comparison of the American and European approaches to banking bailouts

Side-by-side assessment of the bailout approaches in the US versus Europe displayed several weaknesses of the European approach. This could help to explain the deficient recovery of the banking sectors in Europe and consequently could be a contributing factor to explain the slower overall economic growth on the European continent compared with the US.

Firstly, the problem with the European banks' bailout was that decisions and money transfers into the distressed banks were left in the hands of national governments, subject to the approval of the European Commission, and were dependent on the fiscal situation of the European countries. Many undercapitalised banks did not receive sufficient recapitalisation because of the fiscal constraints of individual countries (see Acharya et al., 2021). This left many undercapitalised banks in

Figure 1 Changes occurring in the management structure at the bailed-out banks in

	European banks	US banks
Change of CEO		
Change of Management		

Source: Authors (2022)

distress and therefore encouraged 'zombie lending'. Moreover, it has exacerbated disparities in the recovery of the banking sectors across the European countries (e.g., Andrews and Petroulakis, 2019).

Secondly, there has been no unified European policy towards the bank resolution process. European bank bailouts occurred at the national level, but European countries differ in terms of bankruptcy codes, power of resolution authorities, and more importantly the quality of the government. This institutional infrastructure has differentiated the restructuring path across the member states of the EU. This problem intensified as the European bailout approach assumed ordinary government participation with major voting rights. Figure 1 shows the differences between the US and Europe in terms of role of government in facilitating restructuring changes at the bailed-out banks.

As can be observed, government participation has not facilitated changes in the European banks to the same extent as in the US. Nearly 20 per cent of bailed-out banks in the US have experienced CEO change, while in Europe this ratio is less than 10 per cent. Similarly, government intervention has caused management changes in more than 40 per cent of the US banks whereas this rate was only 20 per cent in Europe. These data point towards a passive role of government in the corporate governance of bailed-out banks compared with the US, where the government has responded more often.

The passive role of government in the governance of bailed-out banks can be also empirically supported. Table 1 summarises the regression results on the assessment of the impact of government participation on CEO change. The voting rights variable indicates a statistical positive and highly significant effect in the US, while in the Europe sample the effect is negative and even not statistically significant. This shows that the nature of the voting rights as well as the market discipline might matter for how government facilitates its governance role. Our regression results support our hypothesis on the

Table 1 The effect of bailout mechanisms on CEO change in European and US banks

Variables	(1) CEO Change in Europe	(2) CEO Change in Europe	(3) CEO Change in US	(4) CEO Change in US
Duration	-0.0735*** (0.0200)		0.0448*** (0.00593)	
L1.Voting Rights		-0.117 (0.123)		0.335*** (0.00209)
Constant	1.937*** (0.279)	1.299*** (0.136)	0.384 (0.398)	-0.00249 (0.00317)
Observations	138	316	36	369
R-squared	0.559	0.675	0.595	0.342
Bank FE	YES	YES	YES	YES
Year FE	YES	YES	YES	YES
Clustered SE	YES	YES	YES	YES

Note: *The sample covers bailed-out banks as well as their non-bailed-out peers in specific countries. The sample period covers the years between 2007 and 2018.

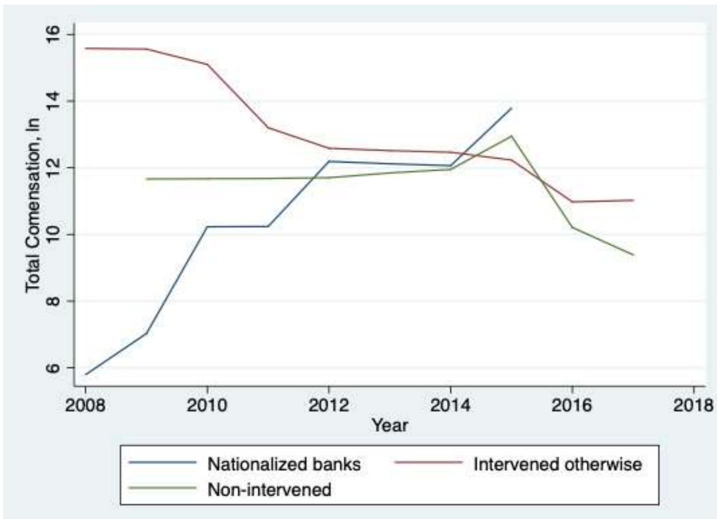
Source: Authors' calculations (2022)

passiveness of the European governments in facilitating management changes at distressed institutions, and consequently they prove their weak role in bank governance. Interestingly, the results show that the longer the duration of the US government at the distressed banks, the more positive changes have occurred. In contrast, the effect is negative in the case of the European banks, where extended government participation reduced the number of changes in the bailed-out banks. Those results indicate that these differences might be a result of additional covenants in the bailout process and consequent expectations regarding governmental role in the governance process.

We can especially notice in Figure 2 the conflicting role of European governments. The institutions with major government ownership have experienced an increase in compensation in the consequent years after the government intervention, while in other banks the compensation level has either decreased (in the case of other bailed-out banks) or stayed stable (in the case of non-bailed-out banks).

We also prove our previous findings on the passiveness of European governments and their potential conflicting role at the bailed-out banks compared with the US using bank compensation data (see detailed regression results in Annex 2). Our regression results also indicate a differential role played by government in the governed in-stitutions in different countries. In general, our

Figure 2 Development of compensation across different European banks



Notes: Bank groups include banks controlled by government (nationalised banks) versus other bailed-out banks including minor government participation as well as their non-bailed-out periods. We account for government participation at a bailed-out bank for a maximum of four years.

Source: Authors (2022)

Photo by Christian Lue on Unsplash

empirical results in Table A1 covering US and European bank compensation data document a positive role of government governance over the distressed banks over the period 2008–2018. In other words, the compensation level has decreased at banks governed by government. However, when the US banks are excluded the regression results change.[71] Interestingly, we notice a positive trend in the compensation level at the European bailed-out banks. This confirms the observations from Figure 2 that European governments did not actively supervise the distressed banks, potentially even using their power to create benefits for their representatives. This could also explain the increasing trend in the compensation level at the bailed-out banks.

Europe should create a unified resolution system, which would allow for a homogeneous response across the member states of the EU during a banking crisis.

Finally, when we control for individual country characteristics, the government effect disappears (Table A2). The effect only remains for total compensation. Almost all country 'dummy variables' are statistically significant, and some coefficients exert different negative signs, which is welcomed. They indicate that those countries' policies could have a positive impact on compensation change at distressed banks in those countries. However, as we could expect, the country dummy does not exert any effect in Spain, while in Iceland we notice a positive and statistically significant effect on compensation. Our sample does not include the compensation schemes in Greece and Italy due to missing data for their banks, but we would expect that the effect would probably be similar to the one observed in Spain. Our regression results indicate that the effect of bailout policies and government participation in this process has been very heterogeneous across European countries, which explains in part the European banking sector's slow recovery the from the GFC of 2008.

Finally, the lack of government activism in terms of restructuring activities and weak governance of distressed banks in Europe gave bank managers discretion in bank restructuring activities. Such a situation has led to moral hazard and incentivised zombie lending in Europe (Andrews and Petroulakis, 2019). It has also not incentivised bank managers to implement restructuring changes. The opposite situation occurred in the US bailouts. The bailout mechanism, mostly in preferred cumulative shares, included covenants which instituted constant government monitoring but also incentivised bank managers to implement restructuring changes aimed at bank recovery to avoid potential appointment of government officials to the board. As mentioned, five missed quarterly dividend payments by the bank would give the Treasury the option to ask for permission to send a (non-voting) observer to board meetings. If the institution missed six quarterly dividend payments, the Treasury had the right to appoint up to two board members (Muecke et al., 2021). The authors document that this kind of mechanism has not only incentivised the distressed banks to implement the necessary restructuring changes but has also created market discipline at other banks by limiting, both ex ante and ex post, the moral hazard. Muecke et al. (2021) namely document that after Vikram Pandit, CEO of Citigroup, was fired, there was a rapid increase in bank exit from the CPP due to the redemption of shares owned by the US Treasury.

Concluding remarks and policy recommendations

Our empirical assessment of the bailout approaches in the US and Europe delivered several important policy recommendations. Firstly, Europe should create a unified resolution system, which would allow for a homogeneous response across the member states of the EU during a banking crisis. This would prevent banks being left in distress due to the poor quality of their respective government. Secondly, the Resolution Authority should have a control of the funds. This would allow sufficient recapitalisation of the distressed banks in the Eurozone, independently from the fiscal situation of each individual country. Thirdly, there should be a clear demarcation on the role of the Resolution Authority between the management and governance functions. Our results strongly suggest that an active role of the Resolution Authority in corporate governance functions at distressed banks would enable it to intervene in crucial matters.

The US experience lends credence to this argument. For example, the Resolution Authority should have the power to appoint representatives, to influence the management structure of a bank, and to affect bank compensation. However, it should not be actively involved in the bank management activities or restructuring changes. Nevertheless, it should undertake a continuous monitoring role under the 'sanction' of preserving the responsibility of appointing its own representatives. This would enhance market discipline as banks might attempt any such development. Finally, the governance role of the Resolution Authority over the distressed banks should be time constrained. In the end, the Resolution Authority should have the opportunity to become a more active participant in management activity, as was in case in the US during the Global Financial Crisis.

ACKNOWLEDGEMENTS: The authors will soon release a paper in which the results outlined in this article are described and discussed in more detail.

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ANNEX 1. DEFINITIONS OF VARIABLES

Duration – the duration of government ownership defined as the difference between the date of government withdrawal and its entry into a bank. The variable is expressed in years

Voting Rights – a variable indicating 1 if a government has taken voting rights in a bailed out-bank, 0 otherwise. The stakeholding is treated for the subsequent four years

Nationalised – a dummy variable indicating 1 if a government has taken majority stake in a bailed-out bank, 0 otherwise. The stakeholding is treated for the subsequent four years

Non-intervened – a dummy variable indicating 1 if a bank has not experienced any type of government intervention. The stakeholding is treated for the subsequent four years

Nationalised otherwise – a dummy variable indicating 1 if a government has taken minority stake in a bailed-out bank. The stakeholding is treated for the subsequent four years

Gov. participation – a dummy variable indicating 1 if a government has taken any stake in a bailed-out bank, 0 otherwise. The stakeholding is treated for the subsequent four years

Unempl. Rate – unemployment rate (%)

Inflation – change in the consumer price index (CPI) (%)

GDP – GDP growth (%)

Capital Ratio – bank's total capital in relation to bank-weighted asset

ROAA – return on average asset

Size (ln asset) – a variable indicating the size of a bank expressed in natural logarithm

mngmt_change – a variable indicating 1 if there was a management change in the year of government intervention, 0 otherwise

CEO change – a variable indicating 1 if there was a management change in the year of government intervention, 0 otherwise

Other benefits paid to CEO – cash compensation plus the stock and option gains realised (including received perks) paid to CEO expressed in natural logarithm; source: S&P

Current and future reserves on employee compensation – salaries, wages, bonuses, commissions, changes in reserve for future stock option expense, and other employee benefit costs covering any expenses related to employment or retirement benefits, whether paid or deferred, recognised during the period expressed in natural logarithm; source: S&P

Total compensation paid to CEO or equivalent – total compensation paid to a bank CEO expressed in natural logarithm; mln USD; source: Bloomberg or S&P.

Total compensation paid to executives – total compensation paid to bank executives expressed in natural logarithm; source: Bloomberg

Total salaries and bonus amount paid to CEO – total salaries and bonuses paid to a bank CEO expressed in natural logarithm; source: Bloomberg

Total salaries and bonus amount paid to executives – total salaries and bonuses paid to bank executives expressed in natural logarithm; source: Bloomberg

Total salary and bonus paid to executives/number of executives – average salary plus bonus portion of executive compensation paid to executives calculated as total salary and bonus paid to executives/number of executives; source: Bloomberg

Source: Authors (2022)

ANNEX 2. DETAILED REGRESSION RESULTS

Table A1 The effect of government participation on compensation structure at European and US banks in the period 2007- 2018
The regression results include the time-fixed effect model with lagged bank control variables and macro variables on compensation schemes at banks. The compensation data come from Bloomberg. The government participation is a dummy variable if a government has been involved in the bailout of a bank. The government participation holds for the four-year period since the intervention. The control sample involves both otherwise bailed-out and non-bailed-out peer banks.

Variables	(1) Total compensation paid to CEO	(2) Other benefits paid to CEO	(3) Current and future reserves on employee compensation	(4) Total compensation paid to CEO or equivalent	(5) Total compensation paid to executives	(6) Total salaries and bonus amount paid to CEO or equivalent	(7) Total salaries and bonus amount paid to executives	(8) Total salary and bonus paid to executives/ number of executives
L1.Gov. participation	0.0291 (0.176)	-0.521** (0.213)	0.445** (0.145)	-0.465*** (0.112)	-0.199 (0.120)	0.0803 (0.161)	-0.309 (0.217)	-0.417** (0.169)
Unempl. rate	-0.0215 (0.0187)	0.0230 (0.0322)	0.0308 (0.0213)	-0.000913 (0.0114)	0.00584 (0.00977)	0.0391*** (0.00999)	0.0102 (0.00769)	0.0122* (0.00575)
inflation	0.148*** (0.0280)	0.0494 (0.108)	0.00607 (0.0724)	0.252** (0.0786)	0.409*** (0.0963)	0.149*** (0.0375)	0.399*** (0.0796)	0.0382 (0.0456)
GDP	0.310** (0.104)	0.407*** (0.0851)	0.199** (0.0718)	0.0829 (0.105)	0.0445 (0.0900)	0.0430 (0.0454)	0.0400 (0.0656)	0.0172 (0.0398)
L1.Capital Ratio	0.00784 (0.00460)	0.00778 (0.00500)	-0.0104*** (0.00216)	0.0142* (0.00600)	-0.00417 (0.00612)	0.0199*** (0.00209)	-0.00398 (0.00308)	0.00827*** (0.00117)
L1.ROAA	0.191** (0.0756)	0.199** (0.0678)	0.0389*** (0.0107)	0.236** (0.0736)	0.241** (0.0755)	0.163** (0.0572)	0.192** (0.0685)	0.158** (0.0506)
L1.Size (ln asset)	0.397*** (0.0217)	0.428*** (0.0208)	0.850*** (0.00942)			0.196*** (0.0229)	0.280*** (0.0174)	0.283*** (0.0124)
Constant	9.084*** (0.476)	8.199*** (0.361)	2.993*** (0.309)	9.865*** (0.446)	11.25*** (0.421)	10.08*** (0.232)	11.06*** (0.299)	10.04*** (0.244)
Observations	642	558	1,648	639	706	667	704	704
R-squared	0.536	0.613	0.951	0.308	0.279	0.157	0.325	0.353
Year FE	YES	YES	YES	YES	YES	YES	YES	YES
Clustered SE	YES	YES	YES	YES	YES	YES	YES	YES

Note: *The sample covers bailed-out banks as well as their non-bailed-out peers in specific countries. The sample period covers the years between 2007 and 2018.
Source: Authors' calculations (2022)

Table A2 The effect of government participation on compensation structure at European banks in the period 2007-2018

The regression results include the country- and time-fixed effect model with lagged bank control variables and macro variables on different compensation schemes at banks. The compensation data come from Bloomberg. The government participation is a dummy variable if a government has been involved in the bailout of a bank. The government participation holds for the four-year period since the intervention. The sample involves both otherwise bailed-out and non-bailed-out peer banks. The missing variables for some country dummies indicate a lack of compensation data for banks from these countries.

Variables	(1) Total compensation paid to CEO	(2) Other benefits paid to CEO	(3) Current and future reserves on employee compensation	(4) Total compensation paid to CEO or equivalent	(5) Total compensation paid to executives	(6) Total salaries and bonus amount paid to CEO or equivalent	(7) Total salaries and bonus amount paid to executives	(8) Total salary and bonus paid to executives/ number of executives
L1.Gov. participation	0.489*** (0.132)	0.108 (0.602)	0.207 (0.613)	-0.148 (0.477)	0.497 (0.385)	0.197 (0.763)	0.305 (0.401)	-0.00596 (0.387)
Unempl. rate	-0.0168 (0.0547)	0.142 (0.0802)	-0.0462 (0.0310)	-0.119 (0.0922)	-0.0282 (0.0465)	-0.193 (0.136)	0.0189 (0.0260)	-0.0159 (0.0280)
Inflation rate	-0.0843* (0.0452)	-0.0555 (0.0727)	-8.89e-05 (0.0384)	-0.293 (0.193)	-0.340* (0.168)	-0.177 (0.254)	-0.221* (0.109)	-0.160 (0.106)
GDP	-0.0284 (0.0381)	0.0514*** (0.00844)	-0.00638 (0.0158)	-0.0574 (0.0399)	-0.0413 (0.0304)	-0.101 (0.0851)	-0.0225 (0.0197)	-0.0291 (0.0199)
L1.Capital Ratio	0.0134 (0.0121)	0.0152 (0.0171)	0.00812 (0.0175)	0.0504 (0.0317)	-0.0528 (0.0327)	0.136* (0.0740)	-0.0454 (0.0357)	-0.0181 (0.0288)
L1.ROAA	0.0815 (0.0466)	0.120 (0.0816)	-0.00439 (0.0303)	0.182 (0.452)	0.266 (0.254)	-0.138 (0.160)	0.179 (0.195)	0.0721 (0.178)
L1.Size (ln asset)	0.328*** (0.0469)	0.309* (0.118)	0.955*** (0.0818)	0.481* (0.254)	0.436** (0.168)	0.228 (0.317)	0.363** (0.128)	0.266** (0.118)
Belgium	-0.199 (0.166)			-0.757*** (0.222)	-2.318*** (0.205)	-0.392 (0.419)	-2.433*** (0.213)	-1.099*** (0.178)
Denmark	2.620*** (0.133)			-2.294*** (0.333)	-2.316*** (0.180)	-3.014*** (0.469)	-1.727*** (0.158)	-1.484*** (0.142)
France	-0.0216 (0.271)			-0.724** (0.267)	-1.963*** (0.163)	0.0456 (0.425)	-1.794*** (0.134)	-0.546*** (0.143)
Germany	0.380*** (0.0407)			-0.624* (0.281)	-0.745*** (0.230)	-2.680*** (0.348)	-0.830*** (0.232)	-0.530** (0.207)
Iceland	4.501*** (0.199)			4.414*** (1.292)	3.745*** (0.762)	3.863* (1.781)	3.484*** (0.542)	4.889*** (0.510)
Netherlands	0.649*** (0.131)				-1.266*** (0.327)	-0.274 (0.784)	-1.240*** (0.250)	-0.608** (0.232)
Slovenia	-0.459** (0.206)	-0.901 (0.497)	0.362* (0.132)	-1.558* (0.803)	-1.803*** (0.493)	-2.900** (1.086)		
Spain	0.531 (1.013)	-2.100 (1.525)	1.070 (0.627)	1.947 (1.562)	-0.221 (0.814)	3.450 (2.302)	-1.152* (0.517)	0.443 (0.525)
Switzerland	0.794*** (0.0953)	0.987* (0.366)	0.288*** (0.0568)	-0.582 (0.357)	-1.480*** (0.365)	-1.147* (0.564)	-1.630*** (0.297)	0.0608 (0.283)

Variables	**(1) Total compensation paid to CEO**	**(2) Other benefits paid to CEO**	**(3) Current and future reserves on employee compensation**	**(4) Total compensation paid to CEO or equivalent**	**(5) Total compensation paid to executives**	**(6) Total salaries and bonus amount paid to CEO or equivalent**	**(7) Total salaries and bonus amount paid to executives**	**(8) Total salary and bonus paid to executives/ number of executives**
United Kingdom	0.674*** (0.135)	0.364 (0.342)	-0.0779 (0.189)	0.625 (0.350)	0.165 (0.315)	-0.0738 (0.544)	-0.265 (0.257)	0.487* (0.236)
Ireland				0.194 (1.021)	-1.380* (0.635)	0.933 (1.540)	-1.765*** (0.527)	-0.404 (0.500)
Constant	9.706*** (0.754)	8.686*** (1.655)	2.160 (1.165)	9.407*** (2.512)	12.24*** (2.002)	10.98*** (2.873)	12.35*** (1.540)	11.36*** (1.412)
Observations	167	83	460	175	216	203	213	213
R-squared	0.823	0.675	0.893	0.378	0.391	0.346	0.394	0.373
Country FE	YES	YES	YES	YES	YES	YES	YES	YES
Clustered SE	YES	YES	YES	YES	YES	YES	YES	YES


CAUTION

Banking Union: An Incomplete Building

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Citation suggestion: Rosa M. Lastra, RL (2022). Banking Union: An Incomplete Building . *Future Europe*, 2(1), 95–103.

Abstract

Banking union is the most fundamental change in the institutional design of the European Union since the advent of monetary union. The centralisation of responsibilities for the supervision and resolution of significant credit institutions is a 'game changer' in the history of European integration. This contribution considers several gaps in the governance of banking union with emphasis on the 'missing pillar': lender of last resort. It argues that the European Central Bank should be the ultimate provider of liquidity in the Euro area, both in cases of market liquidity (where it already has competence) and in cases of individual emergency liquidity assistance (where the competence is national, albeit seriously constrained by a normative framework) at least for significant credit institutions. The future of Europe depends on its ability to build a green, digital, and inclusive economy that fosters intergenerational equity. This requires the completion of both banking union and capital markets union.

Introduction

In contrast to the construct of European monetary union (EMU) – a long and protracted journey that commenced with the establishment of the European Monetary System in 1978–1979 and only became a reality when the Maastricht Treaty was signed in 1992 – the formation of European banking union (EBU) was a much quicker process. Although the intellectual foundations for centralised supervision were advocated by some from the very start of EMU, the urgency with which the actual banking union plan was conceived in 2012 and subsequently executed was made possible by the political consensus that surrounded the need to provide European supervision and crisis management of Euro area credit institutions lest the Euro area disintegrate. The advent of EBU took place at a time in which the vicious link between bank debt and sovereign debt was engulfing the Euro area.

However, like any project adopted under such tense and tight circumstances, there are gaps in the resulting governance structure. Banking union is an incomplete building.

In the ensuing paragraphs I elaborate briefly upon the gaps, inconsistencies, and missing components in the construct of EBU.

Firstly, EMU suffers from a congenitally flawed institutional design; in the words of Alexandre Lamfalussy, EMU rests upon a strong 'M' (the monetary pillar with the euro as the single currency and the European Central Bank (ECB) as the monetary authority) and a weak 'E' (the economic pillar, where economic – fiscal – union is in fact a misnomer, and what we have is economic co-ordination).

> 'The great weakness of EMU is the E. The M part is institutionally well organized. We have a solid framework. We don't have that for economic policy.'[72]

The weakness of the 'E' and by extension the weakness of the supervisory pillar became apparent during the twin financial and sovereign debt crises in the Eurozone.

The ECB's role in the pursuit of financial stability must take into account the interconnection between banking markets and other markets (sovereign debt, securities, derivatives, etc) and the designation of systemically important financial institutions.

Secondly, there is divergence in the actual construction of the three pillars upon which banking union rests, given their different legal bases (Art. 127.6 of the Treaty on the Functioning of the EU (TFEU) in the case of the Single Supervisory Mechanism (SSM), Art. 114 TFEU in the case of the Single Resolution Mechanism (SRM)), their governance structure, and the actual degree of centralisation achieved so far.

Thirdly, as discussed in some detail in this article, there is the 'missing pillar', a fourth necessary pillar for a working banking union, namely lender of last resort.

Fourthly, in the absence of a true fiscal union, there is a limited fiscal backstop in the form of the European Stability Mechanism (ESM). The EU recovery fund and the so-called Corona bonds are steps in the right direction.

Fifthly, the ECB faces fundamental challenges in the pursuit of multiple goals (monetary stability, financial stability, climate change mitigation, and sustainability) in line with its primary and secondary mandates according to Art. 127 (1) TFEU.

Sixthly, there are the problems of jurisdictional domain, with the single market on the one hand and EBU on the other hand, plus the related issues of complexity, coordination, legitimacy, and accountability.

Seventhly, since the contours between supervision, early intervention, recovery, and resolution are porous and since there are multiple authorities involved in what effectively is a seamless process, gaps in coordination can arise. Time is of the essence in any crisis situation! There is also a need for EU harmonisation of bank insolvency rules (UNIDROIT has launched a Working Group of which I am a part on the subject of harmonisation of bank insolvency rules).[73]

Eighthly, there is incompleteness in the pursuit of systemic risk control and financial stability, since banking union (and centralised supervision) only extends to credit institutions, while responsibility for the supervision of securities and insurance remains mostly at the national level. The European financial architecture for the single market, with the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA), is an example of increasing federalisation of financial supervision but does not constitute centralisation of supervisory responsibilities. The 'financial trilemma' conceived by Niels Thygesen and developed by Dirk Schoenmaker[74] looms in the background: you cannot have financial stability, integrated markets, and national supervision. The latter has to go – and not just for banks.

Ninthly, gaps can arise from the exercise of macro-prudential supervision since responsibility for it is divided between the ECB, the European Systemic Risk Board (ESRB), and national authorities.

Finally, there is the question of what constitutes 'adequate supervision' given the need to adopt a comprehensive approach that assesses – as the acronym CAMELS indicates – the different elements that determine bank soundness.

The pillars of banking union

European banking union is based upon three pillars.[75] The first pillar, 'single supervision', has already been completed with the establishment of the SSM. The second pillar, 'single resolution', with the SRM and a Single Resolution Fund, is aligned with the EU Bank Recovery and Resolution Directive (BRRD).[76] The third pillar, 'common deposit protection', is yet to be constructed (though a proposal was published in November 2015).[77] As indicated in the introduction, there is a missing pillar: a clear lender of last resort role (LOLR) for the ECB (see Lastra, 2015b, 2015c).[78]

Challenges for the ECB with the advent of banking union

The ECB is no longer just a price stability-oriented monetary authority.[79] Since November 2014, with the entry into force of the SSM Regulation, the ECB has exclusive supervisory responsibilities for the significant credit institutions in the Eurozone (according to Art. 4(1) of the SSM Regulation, as confirmed by the European Court of Justice in Berlusconi and Fininvest and other cases).[80]

A price stability-oriented independent central bank was a basic tenet in the early 1990s, supported by economic theory and empirical evidence, which became embedded in the Maastricht Treaty and widely accepted in the developed and developing world. This explains why price stability is unambiguously mentioned in Art. 127(1) TFEU as the primary objective of the European System of Central Banks (ESCB) while the tenuous reference to financial stability in Art. 127(5) TFEU indicates the hesitant tone of the treaty drafters in giving this goal equal footing to the goal of price stability ('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'). The enabling clause advocated by Tommaso Padoa-Schioppa auspiciously found its way into the final text of the Treaty – Art. 127(6), thus providing a Treaty basis for the SSM. Times have changed since the Global Financial Crisis and though in practice the primary objective of central banking has become financial stability (also for the ECB) (Buiter, 2015; Lastra and Psaroudakis, 2020), the Treaty remains unaltered.

Functionally, when it was created the ECB resembled the 'Bundesbank model' of one agency (the central bank), one primary objective (price stability), and one main instrument (monetary policy), in line with the Tinbergen rule. This relative simplicity (one goal, one instrument, one authority) in the pursuit of monetary stability contrasts with the multiplicity and complexity that characterise the pursuit of financial stability and the conduct of central banking in the aftermath of the Global Financial Crisis.

Financial stability coexists with other goals; there are multiple instruments to achieve this goal (supervision, regulation, lender of last resort/emergency liquidity assistance (ELA), resolution and crisis management, monetary policy, fiscal policy, and others) and the central bank shares responsibility for maintaining financial stability with other authorities at different levels of governance (national, European, and international).[81] Financial stability (systemic risk control) is a goal that transcends geographic boundaries and institutional mandates. But the very definition of financial stability remains a matter of controversy.

The Dodd–Frank Act of 2010 in the United States reinforced the financial stability mandate of the Federal Reserve System (the overriding objective), and the law governing the Bank of England in the United Kingdom has also been revised to reflect the twin mandate of monetary stability and financial stability. At the EU level, while the hierarchy of objectives remains (price stability reigns supreme in the Treaty), the mandate of the ECB has been substantially expanded via secondary legislation (the SSM regulation and ensuing normative) into the field of prudential supervision.

The ECB also has some macro-prudential powers, according to Art. 5 of the SSM Regulation. And the ECB is also involved in the pre-insolvency phase in resolution. Early intervention (in the context of the SSM regulation) comprises actions taken before the threshold conditions for resolution are met, and before the institution is insolvent or likely to become insolvent. The boundaries between supervision at the 'end of the supervisory spectrum', early intervention/prompt corrective action (PCA), recovery, and resolution are not always clear. Given its powers for early intervention and that the ECB is empowered to 'pull the trigger' for resolution with the declaration of 'failing or likely to fail' (Art. 18 SRM Regulation), the ECB plays a significant role in the commencement of resolution proceedings.[82]

Supervision and crisis management are part of a seamless process which requires timely communication and coordination between the competent authorities, as well as judgement in the exercise of discretion. Supervision is also a thankless task, prone to litigation. The ECB's role in the pursuit of financial stability must take into account the interconnection between banking markets and other markets (sovereign debt, securities, derivatives, etc) and the designation of systemically important financial institutions.

The financial architecture of Europe is now rather complex both jurisdictionally and structurally. The jurisdictional domain of the European Supervisory Authorities and European Systemic Risk Board is the whole EU/single market, while the jurisdictional domain of the SSM is restricted to the Eurozone and those countries that adopt close cooperation agreements with the ECB. The structure of supervision is now divided between centralisation of powers in banking on the one hand and de-centralisation and segmentation in other areas of the financial sector on the other. This will require the ECB/SSM to cooperate very closely with national securities and insurance regulators.

The missing pillar of banking union: lender of last resort

Though LOLR is not included as a pillar of the current banking union plan, in my opinion it is clearly the fourth, 'missing pillar'. Central banks provide liquidity when no other sources of liquidity are readily available (or at least when they are not available at 'reasonable market prices').

The decision to serve as lender of last resort can be taken either to support a single bank suffering from a liquidity crisis (individual bank liquidity) or to preserve the stability of the banking system as a whole, by supplying extra reserves to all banks suffering from large cash withdrawals (market liquidity).

LOLR therefore comes in two forms. The first form is the traditional Thornton–Bagehot 'LOLR model' of collateralised lines of credit to individual illiquid but solvent banks (Wood, 2000; Lastra, 2015a: chapter 10);[83] the second form is the provision of 'market liquidity assistance' via ordinary open market operations and via extraordinary or unconventional measures.

The ECB has clear competence – a competence which it has exercised widely – when it comes to the second form, while, due to its own restrictive interpretation of the ESCB Statute, it does not yet have competence with regard to the first form. In 1998, the ECB adopted a restrictive reading of the ECB competences, concluding that the provision of LOLR assistance (ELA) to specific illiquid individual institutions was a national task of the national central banks (NCBs) in line with Art. 14.4 of the ESCB Statute (a provision which allows NCBs to perform non-ESCB tasks on their own responsibility and liability).[84] Therefore the classic collateralised lines of credit to individual institutions remain the responsibility of the NCBs, at their own cost, but with the fiat of the ECB and constrained by a normative framework at the EU and national level. The risks and costs arising from such ELA provision are incurred by the relevant NCB, although a number of procedures ought to be followed (see Goodhart, 2000; Kremers, Schoenmaker, and Wierts, 2001: chapters 4, 5; Padoa-Schioppa, 2004: chapters 7, 8; Freixas, 2003: 110).[85] This interpretation was reaffirmed in a resolution of the Governing Council of 17 October 2013.[86]

When prudential supervision was at the national level, it was perhaps logical to assume that the national authorities had the adequate expertise and information to assess the problems of banks within their jurisdictions (assistance on a rainy day, supervision on a sunny day). But now that supervision is European, the ECB should at all events be LOLR for all those institutions it now supervises.

Granting the ECB a clear LOLR does not require a Treaty change. The ECB is already competent to provide liquidity assistance to 'financially sound' banks. All that is needed in my opinion is a reinterpretation of Art. 14.4 of the ESCB Statute in the light of new circumstances (banking union) and in accordance with Art. 18 and the principle of subsidiarity; at the very least, such an interpretation is required for significant institutions (see Dietz, 2019).

Since the SSM became operational on 4 November 2014, the ECB should formally be the ultimate provider of liquidity in the Euro area, both in cases of market liquidity and in cases of individual liquidity assistance, as a necessary consequence of the transfer of supervisory powers from the national to the European level.[87] The national competent authority (NCA) is neither the monetary policy authority nor the supervisor. The only advantage of continuing with the current interpretation is that any eventual loss is not shared (but it would have an impact on the whole Euro area).

The ECB has always been competent to act as LOLR if the crisis originates in the payments system, according to Art. 127(2) TFEU, which states that the ESCB is entrusted with the 'smooth operation of payment systems'. The ECB is also competent in the case of a general liquidity dry-up to provide market liquidity according to Art. 18 of the ESCB Statute, and the ECB has amply used this competence during the crisis, even leading to legal questioning of whether it has exceeded its mandate. Indeed, even before banking union, Art. 18 provided a perfectly valid legal basis for the ECB to provide the two forms of ELA/LOLR. And, according to Art. 5.3 TEU (principle of subsidiarity):

> In areas which do not fall within its exclusive competence, the Union shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

In a crisis, action by the ECB is more effective than action by a national central bank or national authority. National supervisory authorities do not have the ability, authority, or inclination to deal effectively with externalities with cross-border effects. The ECB is able to better judge the risk of contagion.

As I wrote in an article with Luis Garicano in 2010: 'The lender of last resort function can only be undertaken by a central bank. The involvement of central banks in financial stability originates in their role as monopolist suppliers of fiat money and in their role as bankers' bank' (Garicano and Lastra, 2010, p.609; see also Lastra, 2015a: chapters 7, 10; Lastra, 2013; Lastra et al., 2014).

While the US Fed and the Bank of England have emphasised the complementarity between monetary policy, macro-prudential policy, LOLR, and micro-prudential supervision,[88] the ECB has highlighted the separation between monetary policy and banking supervision in a Decision of 17 September 2014, in accordance with Article 25(2) of the SSM Regulation.[89]

Conflicts of interest between monetary policy and banking supervision are of course possible, but there are ways to solve or mitigate them. The SSM Regulation establishes a mediation panel to deal with such conflicts.[90]

LOLR/ELA links monetary policy and supervision. Only the ultimate supplier of money can provide the necessary stabilising function in a nationwide scramble for liquidity, as the financial crisis amply demonstrated, with conventional and non-conventional monetary policy measures (quantitative easing (QE) and others).

Fiscal assistance and state aid rules

The problem with having the ECB as LOLR is, of course, the 'fiscal backstop' if the institution receiving the assistance is no longer illiquid but is insolvent. The only way to deal with this effectively is to stick to the 'true nature' of LOLR (assisting illiquid but solvent institutions), combined with a clear and strict application of the EU state aid rules, the prohibition of monetary financing of Article 123 TFEU, and other provisions in the Treaty.

As Goodhart points out, 'a central bank can create liquidity, but it cannot provide for new injections of equity capital. Only the fiscal authority can do that' (2004: xvii). The central bank should not lend over an extended period of time, committing taxpayers' money, without the explicit approval of the fiscal authority. Any extended lending becomes the responsibility of the fiscal authority.

A limited fiscal backstop in Europe is provided via the ESM.[91] The ESM is modelled upon the International Monetary Fund (but with more limited funding, with lending capacity of €500 billion, backed up by an authorised capital of €700 billion), though it also has a direct recapitalisation instrument.[92]

In the US and the UK the central bank (Bank of England in the UK and Federal Reserve System in the US) and the Treasury have worked together in bank crisis management. The problem at the EU level – as the Global Financial Crisis amply demonstrated – is that the relevant fiscal authorities are by definition national. Fiscal policy in the Euro area remains decentralised and the member states are competent, albeit subject to increasing coordination, conditionality, and stringent rules. Thus, while the Bank of England is ultimately backed by the fiscal resources of the UK Treasury and the Federal Reserve System is ultimately backed by the fiscal resources of the US Treasury,

The involvement of central banks in financial stability originates in their role as monopolist suppliers of fiat money and in their role as bankers' bank'.

the ECB does not yet have a European fiscal counterpart. In the US, while the Federal Reserve System provided ample liquidity assistance (both market liquidity and individual liquidity assistance), the Treasury provided the necessary capital with the Troubled Asset Relief Programme (TARP).

A further twist is provided by the need to comply with EU rules on state aid. Because an inherent subsidy exists whenever the central bank lends to an insolvent institution, under the EU rules on state aid, the granting of emergency aid to banking institutions can be considered illegal in some cases. The Luxembourg Court of Justice recognised, in a ground-breaking decision in the Züchner case, that EU competition rules are also applicable to the banking sector.[93]

On 5 December 2007, the EU Commission in its approval of the rescue aid package for Northern Rock concluded 'that the emergency liquidity assistance provided by the Bank of England on 14th September 2007, which was secured by sufficient collateral and was interest-bearing, did not constitute state aid'.[94] The Commission Communication of 13 October 2008 further reiterated this point: 'In establishing a single market in financial services, it is important that the Treaty's state aid rules are applied consistently and equally to the banking sector, though with a regard to the peculiarities and sensitivities of the financial markets.'[95]

In August 2013 the Commission published another Communication extending the 'crisis rules' for banks.[96] According to paragraph 53 of this August 2013 communication:

> Liquidity support and guarantees on liabilities temporarily stabilise the liability side of a bank's balance sheet. Therefore, unlike recapitalisation or impaired asset measures which in principle must be preceded by the notification of a restructuring plan by the Member State concerned and approval by the Commission before they can be granted, the Commission can accept that Member States notify guarantees and liquidity support to be granted after approval on a temporary basis as rescue aid before a restructuring plan is approved.

Paragraph 62 further clarifies:

> The ordinary activities of central banks related to monetary policy, such as open market operations

and standing facilities, do not fall within the scope of the State aid rules. Dedicated support to a specific credit institution (commonly referred to as ELA) may constitute aid unless the following cumulative conditions are met:

1. the credit institution is temporarily illiquid but solvent at the moment of the liquidity provision and is not part of a larger aid package;
2. the facility is fully secured by collateral to which appropriate haircuts are applied, in function of its quality and market value;
3. the central bank charges a penal interest rate to the beneficiary;
4. the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

It is interesting that the Thornton–Bagehot doctrinal principles find their way into a legal text. Paragraph 63 of this 2013 Communication further specifies that 'interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee scheme do not constitute state aid'.

The European Commission launched consultations in 2021 (a targeted consultation and a public consultation) on the review of the bank crisis management and deposit insurance framework and focused on three EU legislative texts: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR), and the Deposit Guarantee Schemes Directive (DGSD). The consultations sought to gather stakeholders' views on the revision of the framework, which is part of the debate on the completion of the banking union and in particular its third pillar, the European Deposit Insurance Scheme or EDIS.[97]

Responses to the COVID-19 pandemic and steps ahead

Robert Schuman famously argued that 'Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity.' (Schuman declaration 1950).[98] This was as much a prediction as it was a challenge. One of the most important characteristics of any effective policy is its ability to adapt to unexpected circumstances and redefine what solidarity means. In its response to the COVID-19 pandemic, arguably Europe has passed the test.

COVID-19 delivered the largest shock to the European economy since the Second World War. An overriding imperative was to prevent a wave of bankruptcies and job losses that would have caused untold harm to the lives of Europeans. The priority for national authorities was to 'freeze' the economy to temporarily absorb the losses arising from lockdown measures. In parallel, monetary policy was called on to be supportive, with further QE measures and new lending facilities.

The adoption of the Next Generation EU (NGEU) is a commendable exercise in EU solidarity in response to the pandemic. NGEU is an exceptional temporary recovery instrument included in the EU's Multiannual Financial Framework (MFF) 2021–2027. The NGEU funding programme for the development of Europe is designed to boost recovery post-COVID-19 (€2.018 trillion). It aims to build a greener, more digital, and more resilient Europe. Coupled with the EU's long-term budget it will increase flexibility mechanisms to guarantee it has the capacity to address unforeseen needs.

> ***'The absence of a well developed market for EMU wide common safe assets (securities issued by the EU with a guarantee from all member states)', is one reason for the stagnation of the euro's development in the international arena.***
> *Will Boonstra*

NGEU is under way and is being supplemented by both local funds and private investments.[99] As part of the flexibility embedded in the programme, and in response to the Russian war of aggression on Ukraine, the EU recovery fund can be repurposed. Countries such as Poland have welcomed over two million Ukrainian refugees. It is an exercise in solidarity to offer help in these exceptional circumstances.[100]

With the EU's fiscal rules suspended due to the extraordinary situation, EU Member States have pushed through unprecedented programmes of fiscal support. Loose monetary and fiscal policies have reinforced each other, while two features of the Euro area economy – the reliance on bank-based financing and a desire to protect jobs through furlough schemes – have become cornerstones of the EU response to the COVID-19 crisis.

In addition to the ECB facilities designed for the pandemic, in particular the pandemic emergency purchase programme (PEPP),[101] the ECB has also facilitated access to euro liquidity outside the Euro area by setting up a series of bilateral swap and repo lines with other central banks and launching a Euro system repo facility. This has helped in stabilising financial markets, especially in countries where the euro is used extensively, and has contributed to fostering the euro's international role.

According to Will Boonstra, the incomplete banking and capital markets union, in particular 'the absence of a well developed market for EMU wide common safe assets (securities issued by the EU with a guarantee from all member states)', is one reason for the stagnation of the euro's development in the international arena. However, as Boonstra notes, '[t]he first serious steps in this area were taken in 2020 with the issuance of the so-called "corona bonds" by the European Commission'.[102] 'In times of turmoil, many investors still take into account the so-called "redenomination risk", i.e., the risk that the eurozone will ultimately break and the euro will cease to exist' (Boonstra, 2022: 3).

European banking union (though incomplete) has contributed to a more robust and resilient banking sector. However, progress is needed in the area of capital markets union (CMU),[103] and this should be a priority for France while holding the presidency of the European Council. A CMU will be needed to restore growth and investment and to diversify sources of funding as well as to improve the efficiency of our financial system.

> The capital markets union (CMU) is a plan to create a single market for capital. The aim is to get money – investments and savings – flowing across the EU so that it can benefit consumers, investors and companies, regardless of where they are located. A capital markets union will:
>
> - provide businesses with a greater choice of funding at lower costs and provide SMEs [small and medium-sized enterprises] in particular with the financing they need
> - support the economic recovery post-Covid-19 and create jobs
> - offer new opportunities for savers and investors
> - create a more inclusive and resilient economy
> - help Europe deliver its new green deal and digital agenda
> - reinforce the EU's global competitiveness and autonomy
> - make the financial system more resilient so it can better adapt to the UK's departure from the EU.[104]

Concluding observations

This article considered several gaps in the governance of European banking union with emphasis on the missing pillar of banking union, namely LOLR/ELA.

In the United States, federalisation of liquidity assistance and supervision took place in 1913 with the establishment of the Federal Reserve System, while federalisation of bank insolvency (today resolution) and deposit insurance took place in 1933 with the establishment of the Federal Deposit Insurance Corporation (FDIC). In EU supervision, just as we went from Lamfalussy to De Larosière to the SSM, when it comes to crisis management, the SRM is a significant first step, while EDIS is needed to complete the framework. With the advent of banking union, the ECB should be the ultimate provider of liquidity in the Euro area, both in cases of market liquidity (already an ECB competence) and in cases of individual liquidity assistance (in accordance with Art. 18 of the ESCB Statute, Art. 127 of TFEU, and the principle of subsidiarity).
The future of Europe depends on its ability to regenerate its economies after the COVID-19 pandemic and to establish a competitive position in the global arena, one built on a green, digital, and inclusive agenda that fosters intergenerational equity.

I would like to give thanks to Ana Maria Fagetan and Andrea Miglionico for research assistance.

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ENDNOTES

Section 3

46 The literature is large. See, for example, EU-Chicago Research Team (2016). The problem of burden sharing in military alliances is similar.

47 See also Congdon (1997), particularly p. 93.

48 For a discussion of the relationship between the budget position and money growth, using the credit counterparts identity, see Congdon (1992).

49 The term 'the Euro system' is taken, for current purposes, to be equivalent to the European Central Bank.

50 In this note Wyplosz (2010) said that the Stability and Growth Pact 'never worked', while the two remaining of the three safeguards had 'been blown away'.

51 The implications of different open market operations for the monetary base and the quantity of money are discussed in Congdon (2011), essay 4, particularly pp. 80–81.

52 Numerous books in a bank-bashing vein have been published. In the American case, all loans made in the Great Financial Crisis by the Federal Reserve to the commercial banking system have been repaid. See Bernanke (2015: 469). Indeed, the federal government has made a profit on its GFC interventions in the banking system.

53 People belong to a nation by some combination of birth, citizenship, and residence.

54 The classic reference is Bresciani-Turroni (1953).

55 The securities held by the ECB on the first make-up day in January 1999 were worth less than €21 billion, compared with a Eurozone GDP of over €6,000 billion.

56 The new rules had several dimensions, but the summary in the text captures the gist of the changes. The changes required banks to shrink assets as demand and output were already weakening and arguably caused an intensification of the recession. See chapters 1 and 2 of Tim Congdon (2017: chapter 1–2) for further discussion.

57 For more on the ECB's disillusionment with the monetary pillar see Castañeda and Congdon (2017).

58 In the ECB internal debates of 2011 the Securities Markets Programme was likely to be replaced by a programme of Outright Monetary Transactions, which was even more unattractive to Stark and like-minded German economists.

59 The offending nations were sometimes grouped as the 'GIPSIC' nations (Greece, Italy, Portugal, Spain, Ireland, and Cyprus) and sometimes as the 'PIGS' (Portugal, Ireland, Greece, and Spain).

60 Normally the repayment of bank loans results in the disappearance of money balances. Many discussions of the period focus on the credit side of the story, without mentioning money.

61 The Wikipedia entry on the crisis is the most useful known to the author.

62 The media use of the phrase 'Draghi bazooka' has been erratic. Sometimes it is used to refer to the programme of long-term refinancing loans from December 2011 and sometimes to the ECB's purchases of government securities from early 2015.

63 The shift in policy fashion to a rather crude Keynesian fiscalism was not confined to Europe. See Cukierman (2021).

64 Sinn (2020), in chapter 9, discusses the interest rates paid on Target2 balances. There is no question that Germany has been disadvantaged by the negligible return on its credit balance.

65 An earlier reform of the SGP in the mid-2000s, following infringements by Germany and France, made the rules more countercyclical but was deemed unenforceable because it set targets in the form of the (unobserved) 'structural fiscal balance' (Ilzetzki, 2021).

66 Darvas, Martin, & Ragot (2018) argue that one of the advantages of a rule based on the growth rate of public spending would be that its basic principle is easy to describe: nominal public spending should not grow faster than long-term nominal income, and they should grow at a slower pace in countries with excessive debt levels. Public spending is observable in real time and can be directly controlled by the government. See also Bénassy-Quéré et al. (2018).

67 Some economists explained this short-term compliance as what they call 'deficit bias', impatience in particular. The idea is simple: agents have hyperbolic discount functions rather than conventional exponential discount functions (Laibson, 1997). This makes individuals impatient in the short term, but more patient over medium- to long-term horizons, implying time-inconsistent preferences, and it can work at the level of individuals or governments (Calmfors & Wren-Lewis, 2011).

68 The cumulative dividends measure enhanced market discipline. It was applied in a fixed amount format.

69 Investment in AIG: Program Status, U.S. DEP'T OF THE TREASURY, www.treasury.gov/initiatives/financial-stability/TARP-Programs/aig/Pages / status.aspx

70 SoFFin is an agency of the Bundesbank placed under the supervision of the Federal Ministry of Finance, and later the newly minted Federal Agency for Financial Market Stabilization, whose purpose was to help the distressed banks by providing liquidity and strengthening their equity capital.

71 Regression results available upon request.

72 Alexandre Lamfalussy, interview with The Guardian, 16 August 2003.

73 https://www.unidroit.org/work-in-progress/bank-insolvency/.

74 Schoenmaker, Dirk, The Financial Trilemma (February 10, 2011). Economics Letters, Vol. 111, 2011, p. 57-59; Duisenberg School of Finance - Tinbergen Institute Discussion Papers No. TI 11-019 / DSF 7, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1340395

75 Underpinning these three pillars is the concept of a common supervisory rule book, laying down uniform terms for the authorisation and withdrawal of credit institutions, for the conduct of micro-prudential supervision over credit institutions, for the resolution of non-viable credit institutions, and for the operation of deposit guarantee schemes.

76 The BRRD was published in the Official Journal of the European Union in June 2014. See Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU, and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12/06/2014, pp. 190–348. See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0190.01.ENG.

77 The rationale for a common deposit insurance scheme is clear: with perfect capital mobility, in order to prevent a flight of deposits from troubled countries to countries perceived to be 'safe', one needs to convince ordinary citizens that a euro in a bank account in one Euro area member state is worth the same and is as secure as a euro in a bank account in another Euro area member state. This is a real challenge, as the experience in Cyprus evidenced.

78 For a recent comparative analysis on lender of last resort in a number of jurisdictions, see Lastra (forthcoming)

79 This section draws on the Report on 'The Interaction between Monetary Policy and Bank Regulation' co-written by Charles Goodhart at the request of the European Parliament in 2015. Monetary policy has entered uncharted territory following the Great Financial Crisis. While prior to the crisis it had broadly converged towards one with a price stability (inflation) target and a short-term interest rate as a policy tool, there is now a second variant of monetary policy, which involves varying both the size and, perhaps, the composition of a central bank's balance sheet, with implications for monetary policy and also for financial stability.

80 Berlusconi and Fininvest, https://curia.europa.eu/juris/liste.jsf?language=en&num=C-219/17.

81 The Financial Stability Oversight Council (FSOC) in the US is a good example of the multiple authorities involved in the pursuit of financial stability. The FSOC is made up of ten voting members under the chairmanship of the Secretary of the Treasury (the other nine member are the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chair of the SEC, the Chair of the Commodity Future Trading Commission, the Chair of FDIC, the Chair of the Federal Housing Finance Agency, the chair of the National Credit Union Administration, and an independent member with insurance expertise) and five non-voting members.

82 According to Art 4.1 (i) of the SSM Regulation the ECB is empowered: '[t] "To carry out supervisory tasks in relation to recovery plans, and early intervention where a credit institution or group in relation to which the ECB is the consolidating supervisor, does not meet or is likely to breach the applicable prudential requirements, and, only in the cases explicitly stipulated by relevant Union law for competent authorities, structural changes required from credit institutions to prevent financial stress or failure, excluding any resolution powers'."

83 The theoretical foundations of the lender of last resort doctrine were first set by Thornton in 1802 and then by Bagehot in 1873, who further elaborated and refined them. See Thornton (1991 [1802]) and Bagehot (1999 [1873]). Recent studies of the work of Thornton and Bagehot on the LOLR are found in Humphrey (1975).

84 Article 14.4 reads as follows: 'National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.'

85 For a critique of the ECB's interpretation of its powers in respect of ELA see Smits (2010: 310–311).

86 See ELA Decision by the ECB of 18 October 2013, at http://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf. The ELA procedures, first published by this 2013 Decision, were revised in 2017 https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf (Agreement on ELA) and then again in 2020 https://www.ecb.europa.eu/pub/pdf/other/ecb.agreementemergencyliquidityassistance202012~ba7c45c170.en.pdf (Agreement on ELA). ELA means the provision by a Euro system national central bank (NCB) of (a) central bank money and/or (b) any other assistance that may lead to an increase in central bank money to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such operation being part of the single monetary policy. Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB.

87 Notwithstanding the ECB Decision of 18 October 2013 on ELA (ELA Procedures) at http://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf, which assigns 'responsibility for the provision of ELA' to the 'NCB(s) concerned', further specifying that 'This means that any cost of, and the risks arising from, the provision of ELA are incurred by the relevant NCB'.

88 The Fed conceives of its monetary policy as having been largely grafted onto its stabilisation and supervisory functions, and it regards such functions as a prerequisite and complement of its monetary policy responsibilities. In the UK, the Bank of England launched its One Bank – One Mission strategic plan in March 2015 stressing the links between the 3Ms: monetary policy, macro-prudential, and micro-prudential supervision.

89 Article 25(2) SSM Regulation: 'The ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy. The tasks conferred on the ECB by this Regulation shall moreover not interfere with its tasks in relation to the ESRB or any other tasks.'

90 Article 25(5) of the SSM Regulation: 'With a view to ensuring separation between monetary policy and supervisory tasks, the ECB shall create a mediation panel. This panel shall resolve differences of views expressed by the competent authorities of participating Member States concerned regarding an objection of the Governing Council to a draft decision by the Supervisory Board.'

91 The European Stability Mechanism Treaty, concluded in Brussels on 2 February 2012, entered into force on 27 September 2012. The ESM was inaugurated on 8 October 2012 following the ratification by all the Euro area members. The Pringle ruling confirmed the legality of the ESM in 2012. See Case C370/12, REFERENCE for a preliminary ruling under Article 267 TFEU from the Supreme Court (Ireland), made by decision of 31 July 2012, received at the Court on 3 August 2012, in the proceedings Thomas Pringle v Government of Ireland. http://curia.europa.eu/juris/document/document.jsf?text=&docid=130381&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=37623 Pringle v. Ir., [2012] IESC 47, para. 5 (S.C.) (Ir.), at http://www.courts.ie/__80256F2B00356A6B.nsf/0/E7504392B159245080257A4C00517D6A?Open&Highlight=0,pringle,~language_en~.

92 The ESM raises funds by issuing money market instruments and medium- and long-term debt with maturities of up to 30 years, which are backed by a paid-in capital of €80 billion and the irrevocable and unconditional obligation of ESM member states to provide their contribution to ESM's authorised capital stock.

93 See Case 172/80 Züchner v Bayerische Vereinsbank [1981] ECR 2021.

94 http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1859&format=HTML&aged=1&language=EN&guiLanguage=en. 'However, the guarantee on deposits granted by the Treasury on 17th September, as well as the measures granted on 9th October, which provided further liquidity and guarantees to Northern Rock and were secured by a Treasury indemnity, do constitute state aid.' On 17 March 2008, six months after the first state aid measures ('rescue aid') took place, the UK authorities submitted to the Commission a restructuring plan. The Commission then launched an in-depth investigation into this 'restructuring aid'. See http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/489.

95 Official Journal C 270, 25.10.2008, paragraph 51: '[T]he Commission considers for instance that activities of central banks related to monetary policy, such as open market operations and standing facilities, are not caught by the State aid rules. Dedicated support to a specific financial institution may also be found not to constitute aid in specific circumstances. The Commission considers that the provision of central banks' funds to the financial institution in such a case may be found not to constitute aid when a number of conditions are met, such as: the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package; the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value; the central bank charges a penal interest rate to the beneficiary; the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.' From the beginning of the Global Financial Crisis in the autumn of 2008 up to December 2010, the Commission issued four communications which provided detailed guidance on the criteria for the compatibility of state support to financial institutions with the requirements of Article 107(3)(b) of TFEU: (1) Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (Banking Communication); (2) Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (Recapitalisation Communication); (3) Communication from the Commission on the treatment of impaired assets in the Community banking sector (Impaired Assets Communication); and (4) Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (Restructuring Communication). See http://ec.europa.eu/competition/state_aid/legislation/temporary.html.

96 Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), 2013/C 216/01, at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730(01).

97 https://ec.europa.eu/info/consultations/finance-2021-crisis-management-deposit-insurance-review-targeted_en and https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12737-Banking-Union-Review-of-the-bank-crisis-management-and-deposit-insurance-framework-DGSD-review-/public-consultation_en.

98 https://european-union.europa.eu/principles-countries-history/history-eu/1945-59/schuman-declaration-may-1950_en

99 https://ec.europa.eu/info/strategy/recovery-plan-europe_en. See also Deloitte (2022).

100 German Finance Minister Christian Lindner was quoted on 26 March 2022 supporting the repurposing of this fund in the light of the war in Ukraine. See Reuters (2022).

101 The study of these monetary facilities is beyond the scope of this article, which focuses on banking union. For a summary of the ECB responses to the pandemic see https://www.ecb.europa.eu/home/search/coronavirus/html/index.en.html.

102 See https://ec.europa.eu/commission/presscorner/detail/en/statement_22_144.

103 See https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union_en. For a list of the legislative measures adopted so far to build a CMU see https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/legislative-measures-taken-so-far-build-cmu_en.

104 See https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/what-capital-markets-union_en.

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