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MADARIAGA COLLEGE OF EUROPE FOUNDATION

Reconciling Governance and Model

A Five-fold Narrative for Europe

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Contents

Foreword: Federalising or Failing the Euro

Pierre Defraigne[1]

How is it that the euro, which could provide the springboard for Europe to project itself as a robust economy and a global player in the 21st century, is surreptitiously turning into a deadly trap, not only for the eurozone itself, but potentially for the Single Market and therefore the whole EU? It is indeed increasingly obvious that, without a central last resort lender and a central fiscal backstop for sovereigns and banks which only a central budget and a banking union can secure, the eurozone will operate below its growth potential and above a sustainable level of unemployment. The eurozone is today working as a machine for creeping deflation, for divergence between North and South and for growing inequalities within countries. Can intergovernmental incrementalism trace a path back towards growth from the overindebtedness of sovereigns and banks while ensuring the integrity and the cohesion of the eurozone? Or can leapfrogging into a federal monetary union alone consolidate the political construction of Europe in an age of economic stagnation and strategic uncertainty? Could such a move be achieved without a radical reworking of strategic thinking in Europe?

These reflections are building up on a set of original and robust contributions made by five prominent economists and lawyers during the Conference held by the IED and the Madariaga-College of Europe Foundation at the European Parliament on 25 April 2013.

Five narratives for the euro crisis

Agnès Bénassy-Quéré, in a clear and articulate presentation, makes a strong case for a eurozone stabilisation function in Musgrave's taxonomy in order to secure a counter-cyclical fiscal policy alongside the monetary policy and to deal with country-specific (or idiosyncratic) shocks. Since only a budget of 2% of GDP can be reasonably envisaged when there is a risk of eurozone-wide negative shocks of 6% of GDP, she recommends the discretionary issuance of Eurobonds up to 2% of eurozone GDP which would be paid back once the economy recovers. A strict governance would prevent the accumulation of deficits over the cycle and therefore eliminate the possibility of a 'moral hazard'.

Michel Aujean highlights the loss of public sovereignty entailed by harmful tax competition within the EU with two major effects: a shrinking of public resources and a diminution of progressive taxation. He emphasises the cost of BEPS – Base Erosion and Tax Shifting – mainly through transfer pricing and non-consolidation of losses and profits at EU level.

He pleads for two major advances: on the one hand, a CCCTB – Common Consolidated Corporate Tax Base – through enforced cooperation, with the elimination of the necessity of transfer pricing for all intragroup transaction between EU companies registered with members of a CCCTB group, and apportionment of the net profit base to each member state; on the other hand, an automatic exchange

[1] Executive Director of the Madariaga – College of Europe Foundation.

of information between member states and with third countries, regarding any taxable income from a given taxpayer in the country of residence.

Jean-Luc Gaffard addressed real divergence between surplus and deficit countries through a revisited approach to re-industrialisation. He focuses on differences in firms' growth strategies and in member states' industrial policies, mainly between Germany and France. The number of medium-sized companies is 4,000 in France and 16,000 in Germany. The salient feature is total firm turnover (entry + exit rates) which is 3% in Germany, where it reflects a Schumpeterian creative destruction process, and 11% in France, where sector profit shock prevails. **Jean-Luc Gaffard** insists on the relative importance of barriers to growth over barriers to entry, and suggests that industrial policies address obstacles that prevent small firms from reaching a bigger size through innovation. Imperfect information and imperfect competition are better ways of dealing with the situation. Ruling out 'protective' sector-based policies, he recommends horizontal interventions, not geared towards full (perfect) competition but rather oriented towards innovation, and the building of human capital and exporting, generating positive spill-overs for the economy as a whole since they create information. Insistence is on labour market organisation that eases adjustment to technological and market changes, yet preventing segmentation between solid and short-term jobs proves a challenge. The regional dimension both at macro- and micro-levels is also central. **Jean-Luc Gaffard** concludes by highlighting the need for a macroeconomic policy that prevents the destruction of industrial segments in Europe.

In Professor **Eric de Keuleneer's** opinion, it is not the lack of integration of European banks that caused the banking crisis, but the lag between integration and regulation. Commercial banking has seen a reduction in regulation since the late 1970s. Although more competition brought about some benefits to consumers, mergers within countries may have replaced cartels with oligopolies. The gains in size led to limited economies of scale, but reinforced the implicit subsidy associated with the 'too big to fail' moral hazard. Better banking regulation should be the absolute priority. A Vickers model of separation between commercial and investment banks would be the ideal solution. If one sticks to universal banking then banks should grant full collateral cover for the deposits. A recapitalisation of banks should be enforced and the resulting lower profitability could lead to lower remuneration for managers and lower returns for shareholders.

Investment banking would gain from more transparency and competition, so as to limit market domination. The separation between investment and transaction banking would contribute to doing away with the existing massive rents. Trading of derivatives, which are a major source of liquidity and solvency risks, should be flanked by the generalisation of Central Counterparts (CCPs)

Transaction banking would gain from European integration through MIFID and UCITS directives and through the elimination of double taxation. It would thereby contribute to developing capital markets across Europe.

Cinzia Alcidi and **Alessando Giovanini** examine the ECB dilemma: financial stability or independence?

The eurozone has embarked not only without a fiscal policy but without a banking union either. Member states taken by surprise by the financial crisis (2008) and the sovereignty crisis (2010) procrastinated in working out appropriate institutional solutions. Therefore the ECB – risking its independence – had no choice but to take over the responsibility of financial stabilisation, which has long prevailed over its main mandate of ensuring currency stability. The severity of the protracted recession (which can still turn into a Japan-style depression) and the constraints of the eurozone's incomplete and complex governance have forced policy towards more discretionary hands-on action adapted to the specific needs of deficit and overindebted countries. Two jobs under one roof pose severe operational challenges, despite the Chinese wall built up between monetary and supervisory policies, also raising challenges for democratic accountability. The ECB, through the conditionality attached to its OMT (Outright Monetary Transaction) programme, is forcing governments to supplement its partial last-resort lender role with a joint resolution fund which would dispense the ECB from purchasing assets to the point of undermining its independence.

Path dependency and political inconsistencies of the eurozone

Path dependency is central in an empirical political construction like the eurozone. No grand design, no blueprint presides over the enterprise despite its highly political character. The initial move towards a monetary union originated in the microeconomic requirements of the achievement of the Single Market which, in the view of its promoters, was the only workable way towards an ever-tighter political union of Europe. In the late 1980s, three obstacles of a monetary nature were identified as critical for the completion of a borderless internal market: capital controls, transaction costs on goods and services and intra-EU exchange rate fluctuations brought about by the volatility of the dollar. The latter caused severe disruptions in the functioning of the European Monetary System, in particular due to the tensions between the Deutsche Mark (DM) and the French Franc. Two circumstances provided the conditions to opt for a common currency. First, the fall of the Berlin Wall and the subsequent reunification of Germany exposed the Bonn authorities to political pressure from Paris and London. Second, lifting the barriers to capital movements and to the free circulation of financial products and services was deemed essential by the City engaged in a race with New York for financial centre supremacy. This concern caused Margaret Thatcher not to raise objections to a common currency, despite the tentative step it represented in the journey of the European Community towards political integration. Jacques Delors, Helmut Kohl and François Mitterrand were the main architects of the eurozone.

Yet there was a price to pay for substituting the euro for the DM: a very narrow conception of the common currency governance based on the Bundesbank doctrine. Monetary stability had to be the main task for an independent ECB while fiscal discipline would be imposed on member states through a parallel Stability and Growth Pact. The most conspicuous feature of the euro-governance was the lack of tools for real convergence and for solidarity despite the heterogeneous character of the national economies admitted in the eurozone on the basis of narrow nominal convergence criteria focused on inflation. There was to be no eurozone budget, no monetisation of public debt, no bail-out by partners in case of a sovereign default, no banking union, no convergence of social models and no tax harmonisation. Yet, for a while, growth camouflaged these structural flaws. The rapid lowering of interest rates and massive surges of cheap Chinese imports contributed to the 'great moderation' of the late 1990s. Resulting growth was further eased by technological convergence with US-led IT revolution. It secured the success of the euro until the financial crisis of 2008.

Then the initial fault-lines were brutally revealed by the banking and the sovereign debt crises. Meanwhile a growing divergence in terms of wages, fiscal and financial policies and in terms of trade balances between the core (Germany and its industrial partners) and the Southern periphery of the eurozone exposed the intrinsic vulnerability of the euro.

Empiricism prevailed once more. It took the twin form of incrementalism – step by step – and intergovernmentalism, i.e. shared sovereignty among States rather than sovereignty and resources transfers to the EU. New instruments such as financial insurance schemes – EFSF and ESM – and fiscal and macroeconomic discipline and surveillance, both quite intrusive for deficit member states, were hastily put in place under the pressure of the markets. Drastic social conditions were imposed on populations of debtor countries in order to protect the taxpayers of creditor countries from the risk of the formers' default. The process of mending the eurozone governance was mainly led by the twin concern of minimising transfers while avoiding 'moral hazard' behaviour by aided countries.

No serious attempt was ever made to rekindle growth beyond the usual supply-side type recommendations provided by the failed Lisbon Strategy (2000-2010). Yet the most daunting challenge for the survival of the euro lies today in the radical change in growth perspectives for Europe. Two obstacles lie on the road to recovery on the global demand side: first, the debt legacy inherited from the systemic crisis of western capitalism and second, the waning of the growth sources which presided over the 'Glorious Thirty' (until 1973) and over the next three 'satisfactory decades'.

A systemic crisis of Western market capitalism

The systemic character of the crisis of western capitalism stems from three factors which grew in importance over the three last decades, gradually eroding growth: the rise in inequalities brought about by technology and globalisation which resulted in a contraction of aggregate demand; the extravagant hypertrophy of self-serving finance; and, lastly, the accommodating monetary policy first by the FED and then by the ECB and the BoE. The overindebtedness of banks, states and households was the final outcome of this three-pronged systemic crisis. Today the debt overhang inhibits the return to growth. Since inflation is not in view, restructuring of the debt, including some degree of default, is unavoidable: it has already begun in Greece, Cyprus, and even across the pond, in Detroit.

The sources of growth are indeed drying up in Europe and this new trend complicates the exit from the debt constraint: Europe's ageing population is a key factor; there is no technological revolution in the making; the initial drive in plastic credit for households has surpassed sustainable levels as has the continuous rise in public expenditures and social transfers; energy and commodities are getting more expensive; manufacturing jobs are being off-shored and outsourced by global firms through relocalisation of segments of the global chain. The twin rent of well-paid jobs monopolised by the West and cheap commodities is indeed over.

This prospect, if authenticated, sheds new light on the austerity strategy chosen by the eurozone to get out of the debt trap and which is proving to be self-defeating. The recent recommendations from the IMF and those of the G20 Finance Minister on 20 July 2013 to ease austerity policies hint at the possibility that this gloomy perception permeates across the leading circles of the world economy. A Japanese scenario is feared for Europe, but a replication by the eurozone of the aggressive fiscal and monetary policy recently implemented by Prime Minister Abe in order to take Japan out of its lethargic state would be perceived as a 'beggar-thy-neighbour' policy.

The strategic triangle of the eurozone

The eurozone must be considered as the hard core and the pioneering group of the two-speed Europe which is emerging as the new – and hopefully temporary – framework of European integration. Three major issues justify radically upgrading the strategic capacity of the eurozone despite its excessive heterogeneousness, which could lead to the provisional withdrawal of some countries. By strategic capacity, one should understand the institutional and political ability of the eurozone to take advantage of the economic and demographic weight of the EU in order to shape the future of Europe in a 21st century world marked by the rise of China and the other BRICS and by slower growth prospects for the industrialised countries. Strategy is about preserving the singularity of the European society and about acting as an autonomous and global power in the new economic and geopolitical world order. European nation states, whatever their size, are no longer up to the task.

Re-founding market capitalism regulation

The first strategic test for the eurozone as driving force for the EU is to draw the lessons of the systemic crisis of western market capitalism and to re-found the system exploiting Europe's dimension. Only Europe provides a relevant framework for restoring a satisfactory balance between market and politics. The purpose is to provide a solid mode of regulation of market capitalism in Europe in order to shore up a common social model for the eurozone. Such a model must combine innovation, as continuous advances in productivity could help to offset the rapid ageing of the continent, and a fair distribution of income and wealth allowing for a certain degree of equality and social mobility as these remain the underpinning of a truly democratic society in Europe.

Re-founding market capitalism in Europe requires improving the rules of the economic game on different fronts: tackling bigness and rent through effective competition policy, substituting a stakeholder-led corporate governance for one that is shareholder-led, promoting social economy, subordinating finance to the real economy, ensuring an effective taxation of global capital, internalising environmental costs, incentivising unemployed people and players in the healthcare system in order to keep social transfers and expenditures under control.

Restoring the macroeconomic conditions for growth

The second question is the degree to which the eurozone must achieve the two-pronged solidarity necessary for improving the fundamentals for growth and job creation. Two items must be addressed here: the debt legacy and the transfer union. On the one hand, debt must be alleviated with transfers from creditors to debtors since the growth prospects which, so far, were providing the implicit guarantee that debt would be serviced and paid back in full, have drastically plummeted. A significant transfer from *rentiers* to young people in quest of a job is a necessity if we are to avoid severe intergenerational conflicts in Europe. On the other hand, a transfer union is necessary for ensuring the effective recycling of current trade surpluses and of deficits across the monetary union. Such transfers are the logical counterpart of agglomeration effects and the industrial polarisation between the North and South of the eurozone. A common policy for supporting real convergence through the re-industrialisation of the periphery could keep these permanent transfers at a workable level. Moral hazard must be strictly tackled as transnational transfers take place through a central eurozone budget.

Turning the eurozone into a political federation

Thirdly, a simple currency area is not enough to justify the sovereignty transfers and resources pooling required to make it work. This appears paradoxical, but a common currency calls for a level of discipline and solidarity that outweighs the relative micro- and macro-economic benefits attached to the single currency. On the one hand, a narrow economic reasoning does not justify a federal move. On the other, the eurozone confronted with 'the Great Adjustment' ahead will not withstand the centrifugal forces it will entail unless it opts for a federal system.

The degree of federalism the eurozone needs can only be justified by a broader scope of collective action. The eurozone – acting as the core for the larger EU – must be in the condition to interact effectively with the rest of the world both with regard to global economic and ecological governance as well as to the new geopolitical balance of power. There are several strategic challenges which currently fall beyond the capacity of member states. They range from climate change and fair and sustainable access to natural resources to guaranteeing open markets and international monetary stability, from coping with migratory pressures and terrorism to promoting the rule of law in international relations and controlling the nuisance power of rogue States. In order to effectively tackle these challenges, the eurozone must be comprised of both an economic and a political ambition. It therefore needs to work out a common *weltauschaung* so as to build up a level of political and strategic autonomy, including a common defence which should be seen as the logical counterpart to the common currency. What is at stake is the preservation and deepening of our singular social model which ensures an effective balance between market forces and democratic ideals on the European continent, and the ability of Europe to project its influence and power in a multipolar world.

Getting from A to B

How and when will the eurozone overcome these major hurdles and achieve its political unity, a prerequisite for an effective and fair economic policy and a basis for global strategy?

Considering the way that the EU is integrating – by a piecemeal approach – it would be ludicrous to sketch out a timeline, even less a consistent sequencing for definitively predicting the successful outcome of an extremely ambitious and complex historical process. External threats and domestic circumstances will be the decisive forces in making political unity take place. European leadership is indeed doomed to remain weak as long as a major institutional aggiornamento through a Constitutional process does not take place. Yet contrary to eurosceptic views, there is a momentum gathering strength. The 'Big Three' – the UK, Germany and France – are starting to realise that they are not up to the twin challenges looming ahead: an effective regulation of global market capitalism and a strategic capacity to deal with a multipolar world made up of large continental states. France, despite its jealous sovereignty and its preference for intergovernmentalism, is probably closer to admitting its need for more transfers. The UK, which is tentatively exploring a return to 'splendid isolation', will soon discover that its special relationship with the US would not survive its leaving or taking a back seat in the EU. Germany is, by all appearances, successful. Yet it has a rapidly ageing population and it is discovering that imposing fiscal austerity and wages deflation to its eurozone partners is biting into its own growth performance. How much longer will Germany believe that it can walk on an EU economic leg and on a transatlantic strategic one, enjoying US protection through NATO and tapping the American market for sophisticated German exports through the TTIP? The TTIP might prove to be a stretch and its arduous and disappointing negotiation could raise questions in Berlin about the limitations of Germany's schizophrenia.

The key unknown in Europe's strategic equation is China, which no member state could think of influencing except through a multilateral system or as a US dependent. Since the multilateral system badly needs a serious reshuffling and since the US support comes with a heavy (although often ignored) cost, the European unity will eventually prove the best option for any individual member state. But developing a perception of a 'commonality of destiny' across national borders and beyond national identities proves a deep rift for a continent whose success for centuries has been based on diversity and rivalry instead of unity and cooperation. The EU is about combining diversity and unity, but the eurozone calls for a considerable move towards the latter. The European Parliament election next spring will provide a much-needed opportunity to raise these fundamental questions among European citizens across national borders about their collective capability to control their future.

No Euro Budget without Eurobonds

Agnès Bénassy-Quéré[2]

In December 2012, the 'four presidents' of the European Union launched the concept of a fiscal capacity for the euro area.[3] *The idea was to "improve the absorption of country-specific economic shocks, through an insurance system set up at the central level" . They also introduced the concept of contractual agreements whereby "structural reforms would be supported through financial incentives and would result in temporary transfers to Member States with excessive structural weaknesses"" Since then, the project of fiscal integration has seemed to lose traction. However, a proper banking union will inevitably require a common fiscal backstop in order to make bank resolution credible even in the event of a systemic crisis. In this short paper, we try to clarify the purpose of a budget devoted to the euro area, and the various implications.*

1. A Eurozone budget: what for?

In order to clarify the discussion on fiscal union, it is useful to rely on the taxonomy proposed by Musgrave and Musgrave on the purposes of government intervention in the economy: allocation, redistribution, and stabilisation (Musgrave and Musgrave 2013).

1.1 Allocation: raise social welfare

The first purpose of government intervention is to improve the allocation of resources performed by the market. If markets were perfect, there would be no need for government intervention. However, markets are full of imperfections, including information asymmetries, collusion, natural monopolies, and externalities. For instance, governments generally consider it their duty to produce or fund a number of services (such as police or education) and infrastructures (roads, airports, and telecommunications) that would not be provided in adequate quantity or quality by the private sector alone. These goods, for which the social return exceeds the private return (i.e. the return that can be privatised), are called public goods.

The European Union already contributes to the production of public goods at the EU27 level. These expenditures include programmes for infrastructure building and R&D. The question here is whether it would be appropriate to carry out allocation expenditures at the euro area level. Such a decision would be appropriate in two non-exclusive cases:

- There are euro-specific public goods that need to be funded. An obvious case for a euro-specific public good is financial stability: a bank failure within the monetary union carries more risk for the members of the monetary union than for non-members. This interdependence

[2] Professor at the Paris School of Economics (University Paris 1) and Acting President of the French Council of Economic Analysis

[3] See the report of the President Herman Van Rompuy, in close cooperation with José Manuel Barroso, President of the European Commission, Jean-Claude Juncker, President of the Eurogroup, and Mario Draghi, President of the European Central Bank, "Towards a genuine economic and monetary union", 5 December 2012.

related to the single currency has been well understood. The response has been the banking union, which includes a single supervisory mechanism, a single resolution mechanism, and a bank resolution fund. The funding of non-systemic banking crises can easily be envisaged through national arrangements (for legacy risks) and a common resolution fund financed through a bank levy. For systemic crises, however, there will be a need for a common fiscal backstop in the form of credit lines on the budget of Member States.

- Euro area members are willing to proceed towards further integration by transferring more policies to the federal level. The difficult discussions on the EU multiannual framework 2014-2020 have revealed a reluctance to raise the budget at the EU level. Looking to the future, it is possible to envisage a two-speed union with further integration at the euro area level, the EU itself becoming increasingly limited to a single market.

1.2 Redistribution: raise equity

The second purpose of government intervention is to improve the distribution of income performed by the market, either because market imperfections lead to distortions in income distribution, or because market distribution is considered inequitable.

Some redistribution is already performed at EU level, from rich to poor regions and from industry and services to agriculture. At the euro area level, redistribution may be considered a non-starter. Indeed, since the start of the crisis German leaders have repeatedly stated that they would oppose a "transfer union". Still, redistribution can rely on Article 2 of the Treaty on the European Union: "It [the Union] shall promote economic, social and territorial cohesion, and solidarity among Member States".

The main justification for introducing permanent transfers between members of the euro area would be that the single currency tends to increase inequalities across Member States, because in encourages the agglomeration of activities in the core of the area. In the presence of agglomeration effects, the marginal productivity of labour and of capital does not decrease along the growth process: the more production factors agglomerate, say, in the western part of Germany, the higher the incentive to locate further activities in this region. In such a situation, it is optimal to (i) let activities agglomerate in the 'centre', where there is an initial geographic advantage, and (ii) share the agglomeration economies (i.e. the return derived from agglomeration) with peripheral regions. In practice, this would mean transferring a share of the high productivity workers from central regions to peripheral regions with low productivity workers and inactive populations.

The main problem here is that of perverse incentives arising from a system of permanent transfers: if transfers are regularly flowing to peripheral regions, what will be the incentive for local entrepreneurs to invest, hire workers and compete with the core? Depending on the design of local transfer systems (such as the design of unemployment schemes), this risk may be avoided. Nevertheless, it is not realistic to envisage a transfer system before social benefits have been harmonised across the euro area.

1.3 Stabilisation: reduce instability

The third purpose of government intervention is to improve the stability of income growth compared to what arises from the free play of the market. Due to delays in price and wage adjustments, but also to the severity of some shocks, GDP growth is unstable and needs to be stabilised by macroeconomic (fiscal and monetary) policies.

In a monetary union, the loss of an independent instrument of economic policy (monetary policy) needs to be compensated for with price and wage flexibility, labour mobility, financial integration or a federal budget (Mundell 1961). If one region is hit by a negative shock to GDP, it will pay lower federal taxes and receive more federal transfers, which will cushion the impact of the shock. Hence, in this view, the budget is justified by the needs to stabilise idiosyncratic shocks.

This argument, however, has not been pursued by the founders of the euro area. The idea was that if government debts are kept at reasonable levels, and if the government budget is balanced on average, then there is ample room for stabilising idiosyncratic shocks through national budgets, each government being able to borrow during crises and repay during booms. To justify a euro area budget for the purpose of stabilisation, one needs to appeal to two additional arguments:

- When the euro area as a whole is hit by a large shock (like the collapse of international trade in late 2008-beginning 2009), the common monetary policy may not be sufficient to stabilise the economy, especially when the interest rate hits the zero bound. In such circumstances, individual governments may no longer be able to borrow from international capital markets, for instance due to a self-fulfilling assessment of unsustainable fiscal policy. Hence the capacity of the euro area to absorb the shock may be impeded, as has been observed since the start of the eurozone crisis.

- In case of a systemic banking crisis, the cost incurred for a given government can be so high that it will not be possible to borrow the necessary amount on the international capital markets (Bénassy-Quéré and Roussellet 2013). Then, the only way to control the risk of a systemic banking crisis is to combine single supervision, single resolution and a common fiscal backstop. We are back to the funding of a specific public good – financial stability.[4]

On the whole, stabilisation is probably the most compelling purpose for creating a budget at the euro area level, as it can be viewed as a natural complement to a monetary union. Indeed, the recent evolution of structural fiscal deficits in advanced economies isolates the euro area as an odd case of much pro-cyclical fiscal policy (see Figure 1 and 2).

It must be acknowledged, however, that this view is far from consensual. For instance, Feld and Osterloh (2013) argue that, even when it is substantial, the federal budget fails to significantly smooth consumption in existing federations (Feld and Osterloh 2013). Additionally, it is quite difficult to design a risk-sharing scheme that excludes permanent transfers. Indeed, existing federations combine temporary and permanent transfers. Finally, country-specific shocks cannot be observed, and they can be mixed-up with political shocks.

Pisani-Ferry and Wolff (2012), and Gourinchas et al. (2013) argue that launching a risk-sharing scheme at the euro area level is difficult as long as the distribution across Member States is not unknown. Therefore, most economists would recommend waiting until the banking sector has been cleaned up in all Member States in order to remove a major source of shocks (banking crises).

[4] Another possibility would be to allow national governments to issue Eurobonds under strict conditionality. This alternative, which can be viewed as an extension of the ESM, would allow the question of a euro area budget to be bypassed, but not that of Eurobonds. Additionally, it would fail to break the loop between banking risk and sovereign risk.

Finally, the stabilisation purpose of a euro area budget raises the question of its size, which needs to be limited given the lack of fiscal space, but not too small if some macroeconomic impact is contemplated.

Figure 1. Output gap (%)

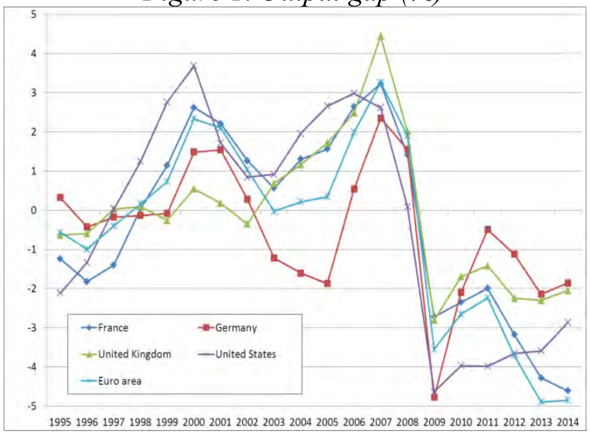
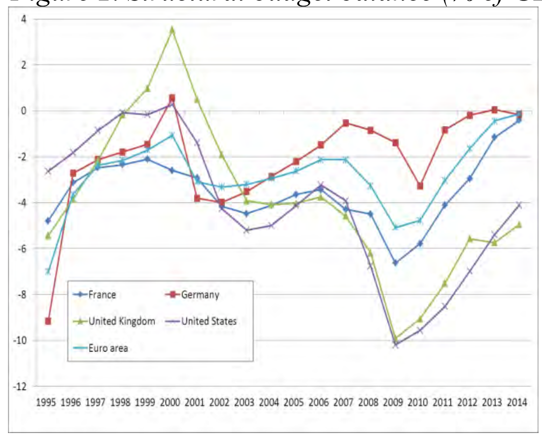


Figure 2. Structural budget balance (% of GDP)



Source: OECD EO92.

2. Stabilisation: a problem of size

In 1977, the MacDougall report already claimed that "a Community fiscal stabilisation policy is a key element in any programme of European monetary integration". It suggested a 5-7% of GDP budget as a first step (EU Commission 1977). More recently, Pisani-Ferry, Vihriälä and Wolff (2013) envisage a budget of 1.8% of GDP (over the cycle). To get orders of magnitude of the stabilising capacity of a small euro-area budget, we retain a 2% of GDP budget here, and rely on two simple assumptions:

- The fiscal multiplier: we assume a fiscal multiplier of unity, meaning that a 1 euro increase in public spending (or a 1 euro cut in taxes) raises GDP by 1 euro.[5]
- The automatic stabiliser (impact of GDP on the fiscal balance): we assume that a 1 percentage point increase in the output gap (the difference between observed GDP and potential GDP, in percentage) raises the budget balance by s% of GDP, where s is 0.01 times the size of the budget (i.e. s=0.02 for a budget of 2% of GDP).[6]

The calculations are provided in the Box. The orders of magnitude obtained suggest that relying on automatic stabilisation would lead to limited stabilisation of asymmetric shocks within the euro area. The only way the euro area budget could have a significant impact on GDP fluctuations would be to allow for discretionary fiscal policy financed by Eurobonds at the euro area level.

Box 1. The stabilising impact of a euro area budget of 2% of GDP

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[5] This corresponds roughly to the upper measures of the Keynesian multiplier in 'normal' times (Spilimbergo, Symansky and Schindler 2009),

[6] This corresponds to the standard rule of thumb: for a European country with a budget a close to 50% of GDP, a 1% increase in GDP raises the budget balance by 0.5% of GDP. Hence, for a budget of 2% of GDP, a 1% in GDP raises the budget balance by 0.5*2/50=0.02%.

Let us denote by Y the level of GDP, G the level of public spending and T the level of taxes. The budget balance is $S=T-G$.

We denote by m the fiscal multiplier: $m = \frac{dY}{dG} = -\frac{dY}{dT} = 1$,

and by a the automatic stabiliser:[7] $a = \frac{dS/Y}{dY/Y} = \frac{(dT - dG)/Y}{dY/Y} = 0.02$

The euro area budget is assumed to be 2% of GDP: over the cycle, we have, for each country: $\frac{G}{Y} = \frac{T}{Y} = 0.02$

To simplify the resolution, let us assume that stabilisation only goes through taxation: $dG=0$. We then have:

$dY = -dT + u$ (where u is an exogenous shock on GDP)

and $dT=0.02\times dY$

Thus, we have: $dY = \frac{u}{1.02}$, or $\frac{dY}{Y} = 0.98 \times \frac{u}{Y}$

The euro area budget stabilises 2% of the shock through automatic stabilisers. For instance, in the case of a negative shock of 6% of GDP in one country, the fall in GDP will only be of 0.98×6%=5.88% ex post. This is to be compared with the extent of national stabilisers. Assuming a 0.5 automatic stabiliser at the national level, the impact of the same negative shock on GDP is a fall of only 4%: 2/3rds of the shock is absorbed.[8]

As for the impact of the shock on the contribution to the budget, we have:

$$dT = 0.02 \times dY = \frac{0.02 \times u}{1.02}, \text{ or } \frac{dT}{Y} = \frac{0.02}{1.02} \times \frac{u}{Y} \approx 0.02 \times \frac{u}{Y}$$

For a negative shock of 6% of GDP, the contribution of the country to the euro area budget falls by 0.12% of GDP. Hence, assuming a perfectly anti-symmetric shock of 6% of GDP in the euro area (meaning that half the area enjoys a positive shock of 6% of GDP, half a negative shock of 6% of GDP), the 'euro+' zone raises its contributions from 2% to 2.12% of GDP, whereas the 'euro-' zone reduces its contribution from 2% to 1.88% of GDP.

These figures are to be compared with what happens to national budgets. With national budgets roughly 50% of GDP, the impact of the shock on the 'euro+' zone is an increase in national budget balance by (0.5/1.5)*6%=2% of GDP, and the impact for the 'euro-' zone is a deterioration in the budget balance by the same amount.

We can conclude that a 2% of GDP euro area budget would have a very limited stabilising impact on idiosyncratic shocks, if only based on automatic stabilisers. Note that even tripling the automatic stabiliser to 0.06 (by focusing the budget on counter-cyclical expenditures, such as unemployment benefits, and pro-cyclical taxes, such as corporate taxes) would only lead to limited stabilisation. For instance, a 6% negative shock on GDP would result in a GDP drop by only 5.64% ex post.

[7] To make it simple, we assume a constant level of potential GDP.

[8] To get this figure, we apply the same methodology as above with a=0.5. We get dT=0.5dY, hence dY/Y=(1/1.5)*(u/Y)=0.66*6%=4%.

Now assume that the euro area as a whole is hit by a 6% negative shock. All Member States reduce their contributions to the common budget by 0.12 (or 0.36) percent of GDP. This leads the euro area GDP to fall by 5.88% (or 5.64%) ex post. The missing budget resources must be recovered by borrowing on the financial market, i.e. by issuing Eurobonds. The 'Finance minister' of the euro area, backed by a euro area sub-committee from the European Parliament, could then vote an additional borrowing of, say, 2% of GDP. Such discretionary fiscal policy would in turn stabilise GDP by 2% of GDP, hence GDP would fall only by 3.88 (or 3.64%) ex post, which becomes substantial. Of course this borrowing would need to be repaid when the economy recovers, which would reduce the pace of recovery. Very strong governance would be needed to avoid accumulating deficits over the cycle.

3. Conclusions: no eurobudget without eurobonds

We conclude from this short analysis that, although stabilisation is probably the most compelling motive for launching a budget at the euro area level, it will not deliver unless the euro area is able to issue Eurobonds backed by an own resource. This is, in fact, the situation in federal countries, where states or regions are generally constrained in terms of borrowing whereas the bulk of fiscal stabilisation is performed at the level of the federal government. This means that the euro area should not try once again to invent something new in the realm of fiscal policy: the idea of designing a small euro area budget that would always be balanced and would only stabilise idiosyncratic shocks based on automatic stabilisers is an idea that will probably never fly.

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Preserving Progressive Taxation through Harmonisation

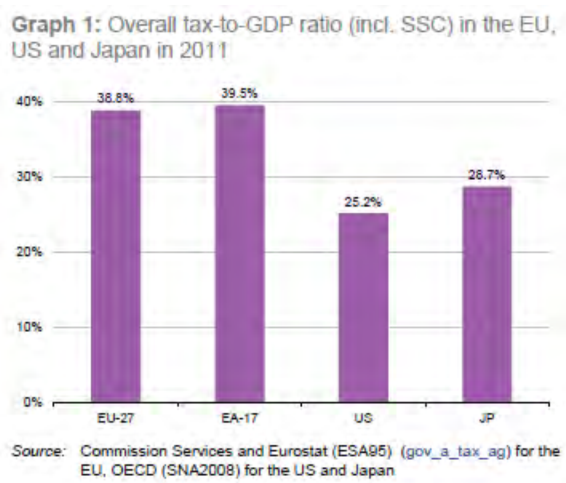
Michel Aujean[9]

While the tax package presented by the Commission and adopted by the Council in 1997 was an essential step in the fight against harmful tax competition, the problem remains and it is seriously affecting the process of European integration. Conducting a reflection on tax policy at the EU level is an absolute necessity. It is notably of great importance to better appreciate the contradiction that exists between the principles of the Single Market, for which the fundamental freedoms are implementing an origin principle, and the tax systems, which are mostly governed by Member States on a principle of destination or residence so as to preserve their sovereignty. This means that only a large degree of harmonisation can provide for a "compatibility" solution completed by some coordination (EU Commission 2006) in areas where harmonisation is either not necessary or not possible.

1. Introduction: The EU as a very diverse and high tax area

Looking at the share of taxation (including all taxes as well as social security contributions) in GDP[10], one can see the large diversity of situations between Member States. But one characteristic is clear: on average, taxes are well above the levels seen in the rest of the world, and well above the levels of Japan and the US in particular (see Figure 1).

Figure 1. Overall tax-to-GDP ratio (incl. SSC[11]) in the EU, US and Japan (2011)



The diversity of structures of tax systems has substantially widened since the accession of the 12 new Member States, whose structures of taxation differed greatly from the 15 existing MS. This is notably due to their different stage of economic development: less mature economies usually choose to base

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[10] We will systematically refer to the figures presented in the latest version of Taxation Trends, Commission Services - 2013. The latest figures available are those from National Accounts 2011.

[11] Social Security Contributions.

their tax system on taxes that are easier to collect, that is, indirect taxes such as VAT and excise duties. Indeed, when one looks at the structure of tax revenues collected in these countries by major type of taxes, the share of indirect taxes is generally much higher in the new MS than in the old ones, with shares above 40% for eleven of them. Reciprocally, the share of direct taxes (Corporate and Personal income taxes), which are more difficult to implement and administer, is much lower in the new than in the old MS (see Figure 2). The various shares of social security contributions do not follow this same model and are more specific to each situation.

Figure 2. Structure of tax revenues by major type of taxes in % of total tax burden (2011)

This difference in structure is also partly the result of a political and economic choice, reflecting these countries' willingness to attract investment and multinational companies by way of a lower level of direct taxation. This choice is most often made by smaller countries who cannot afford the same level of infrastructure, transportation, trained manpower and size of market that large countries can, and is a well-known element of the tax competition debate (Devereux and Lorentz 2012).

2. No model but some common wisdom

Although there is no uniform model of tax policy to recommend to countries or to Members States of the EU, one commonly accepted fact is that low taxes do not translate into better economic performance and that high taxes do not guarantee a more efficient redistribution. Nevertheless, many economists tend to consider that an optimal system must rely on:

- An efficient VAT system (broad base, no reduced rates, few exemptions);
- A fair progressive personal income tax (PIT);
- A broad base/moderate rate corporate income tax (CIT).

Another approach was recently presented by the OECD in its attempt to deal with the relation between taxes and economic growth. The resulting OECD recommendation lists the taxes that least affect economic growth, by order of least to most harmful:

- Recurrent property taxes;
- VAT and excise duties (consumption taxes);
- Personal income tax (PIT);
- Corporate income tax (CIT).

3. Some principles for a Single Market

The EU Single Market is often characterised as a "social market economy" in which competition plays a central role and is therefore regulated by Treaty rules. State aid rules, in particular, contribute substantially to this framework, including those applied to taxation. This is even more evident in a Single Market where citizens and companies have been granted rights (fundamental freedoms) across the EU Single Market and where the ECJ plays a fundamental role in ensuring that no discrimination or obstacles affect the exercise of these fundamental freedoms.

But now, more than ever, there is strong competition for internationally mobile factors with a focus on attracting profits and investments, highly-skilled labour and portfolio investments of households. This competition has increasingly exacerbated the public debate on tax policy by affecting corporate taxation and taxation of income from capital (savings of individuals).

Although tax competition is often seen as a means to discipline the State and protect citizens and companies from excessive taxation (Leviathan model), its negative effects on tax revenues and increased risks for European social models have led to many negative repercussions for the tax system as a whole. A degree of tax competition is useful but when tax competition becomes harmful it results in a negative-sum game: revenue is lost and no growth or jobs are created.

When examining the evolution of tax revenues from corporate taxation, it might seem that despite a decrease in rates by one third between 1995 and 2007 (see Figure 3), no serious decrease in revenues has taken place: the corporate tax revenue collected in the EU has remained stable at around 2.5% of GDP (see Figure 4). But in fact this can be explained by three main factors:

- lower rates have partly been compensated by broader bases;
- this was a period of high profitability (high profits mean high revenue from tax on profits);
- "incorporatisation" has taken place: many individual firms have been transformed into corporate companies.

However, none of these factors will last for very long and at the end of the day corporate tax revenues will be seriously affected.

It is also interesting to note that this downward trend in rates is rather specific and more pronounced in the EU than in the other industrialised economies (main non-EU OECD countries: US, JAP, CDN, AUS, CH), a fact which is usually interpreted as the increased impact of tax competition on tax rates.

Figure 3. Evolution of Corporate tax rates (1995-2007)

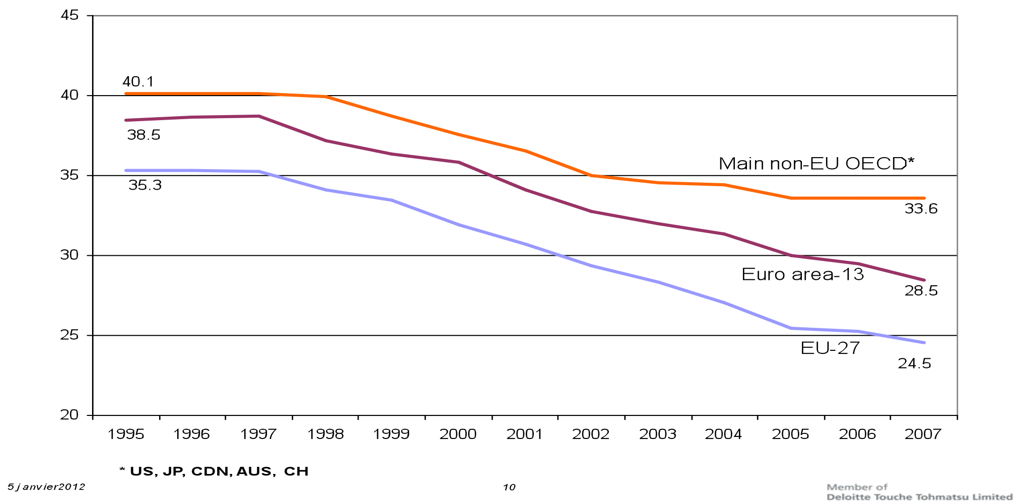
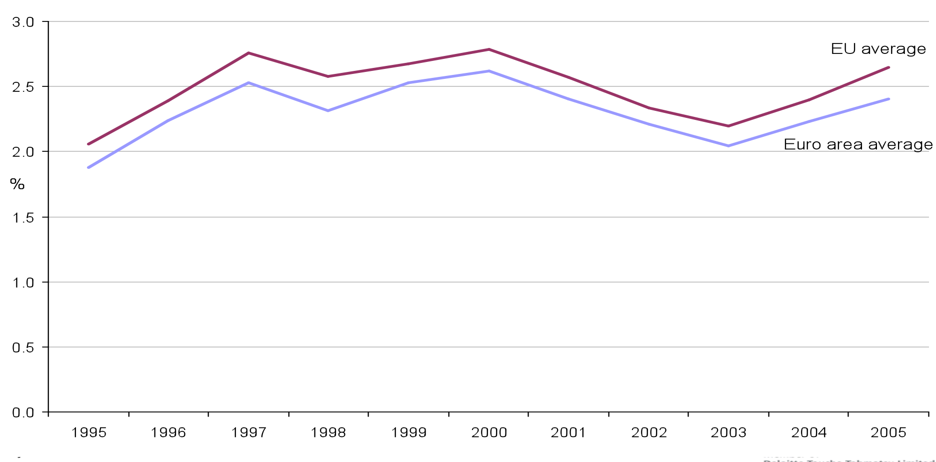


Figure 4. Evolution of tax revenues from corporate taxation in % of GDP



4. A new approach to making tax policy in Europe?

In the mid-nineties, in response to the growing concern over the development of tax competition, the need for international cooperation on direct taxation and the sheer difficulty of meeting that need, the Commission prompted a general discussion of taxation in the EU and proposed a new and comprehensive view of taxation policy when the ECOFIN Council met, informally, in Verona in April 1996.

This new policy aimed to confront three challenges:

1) to restore the tax-raising capacities of Member States faced with the development of harmful tax competition;
2) to complete the realisation of the Single Market, notably by removing tax obstacles;
3) restructure taxation systems by reducing the tax burden on labour.

At that time it was clear to the Commission that tax obstacles could not be eliminated as long as taxation systems or tax authorities were giving rise to harmful forms of tax competition between Member States, which often called for the establishment of new obstacles to protect national tax bases from erosion. A vicious circle and a negative-sum game were in place and an innovative approach was the only way forward.

The adoption of a "Tax Package" in the mid-nineties was new from an institutional point of view (Cattoir 2006). The first "innovation" was the formulation of a package composed of three proposals with the common goal of improving tax neutrality in the functioning of the internal market. The Savings Directive, the Code of Conduct and the Interest and Royalties Directive all aimed at making taxation more neutral, by avoiding double taxation or double non-taxation which both result in an inefficient allocation of resources in a single market.

The main reason for substituting a package with a case-by-case approach was to maximise the possibility of having a political consensus around these proposals. The linkages between tax policy, fiscal policy and economic policy provided the second innovative aspect of the new approach. The point was made that harmful tax competition was dismantling the "economic sovereignty" of Member States, and at the same time acting against the required fiscal consolidation and MS attempts to make their tax systems more employment-friendly.

5. A framework for tax competition: the 1997 Code of Conduct for business taxation

The Code of Conduct, adopted by the Council on 1 December 1997, was undoubtedly a very important step in the fight against harmful tax competition. Both because it was the first time that an agreement was reached at the EU level to regulate business taxation by consensus, but also because it provided a clear and useful definition, at that time, of what could be considered as "harmful tax competition". This is done on the basis of two sets of criteria:

1) Defining its scope: the Code "concerns those measures which affect, or may affect, in a significant way the location of business in the Community". More specifically, "tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this Code."

2) Assessing harmful tax measures, the Code establishes the following criteria: "When assessing whether such measures are harmful, account should be taken of, inter alia:

i. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or

ii. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or

iii. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or

iv. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or

v. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way."

Thus, only specific measures which departed from the application of the standard rules were concerned (sometimes referred to as preferential regimes in the parallel exercise conducted by the OECD) while general measures applicable across the board (like a general low rate of taxation) could not be considered as harmful on the basis of the Code. The rollback of more than 100 harmful tax measures in the 27 Member States (out of more than 400 measures examined) as well as the continuous application of the "standstill clause" (potentially new harmful measures must be notified and assessed by the Code Group) have been particularly effective in eliminating these forms of tax competition.

6. From tax competition to Base Erosion and Profit Shifting (BEPS)

This does not mean that tax competition is no longer a problem – quite the contrary. New forms of tax competition have emerged or have been more intensively exploited and are seriously affecting the Single Market and the EU's process of economic integration.

This particularly concerns some specific areas like the so-called "impatriate regimes" (personal income tax regimes for highly-skilled labour, including football players, who do not fall under the business taxation mandate of the Code), special dividends provisions (like in the Maltese regime where the 35% corporate tax is rebated when dividends are distributed to non-resident shareholders) and the different types of "mismatches" between national legislations (like profit-participating loans which do not receive the same treatment in the various MS resulting in double non-taxation).

Moreover, a general trend of lowering corporate tax rates has taken place at an accelerated pace since the accession of the new Member States and it has progressively extended to most of the old MS. France is the only country that has maintained and – recently – even increased its corporate tax rate. This trend is affecting corporate taxation in the EU to the extent that it tends to increase pressure on the most vulnerable elements of international corporate taxation: transfer pricing and thin capitalisation.

International competition for profits and tax bases is also increasing, notably with the development of the new digital economy. This new dimension is placing strong pressure on corporate tax systems at a moment where the need for fiscal consolidation is putting all tax systems under heavy stress. The threat to tax revenues has become a serious political issue, relayed by most of the press and economic observers through the well-known examples of Amazon or Starbucks[12].

Under the impetus of the G20 Finance Ministers[13], triggered by a joint statement from UK Chancellor George Osborne and German Finance Minister Wolfgang Schaübie, the OECD was asked to report on this issue at their meeting in February 2013.

The debate over base erosion and profit shifting (BEPS) has become an issue well beyond the borders of EU and has reached the highest political level as a high priority on the agendas of several OECD and non-OECD countries. US President Barack Obama, in his Framework for Business Tax Reform, stated that "the empirical evidence suggests that income-shifting behavior by multinational corporations is a significant concern that should be addressed through tax reform".

But as Pascal Saint-Amans, the director of the OECD Centre for Tax Policy and Administration said recently (2013): "It is easier said than done. The first step was to carry out an in-depth analysis of BEPS issues to identify what the problems are and the different factors that have determined them... The OECD published "Addressing Base Erosion and Profit Shifting in February 2013". The report analyses the root causes of BEPS and identifies six key pressure areas: (1) hybrids and mismatches which generate arbitrage opportunities; (2) the residence-source tax balance, in the context in particular of the digital economy; (3) intragroup financing, with companies in high-tax countries being loaded with debt; (4) transfer pricing issues, such as the treatment of group synergies, location savings; (5) the effectiveness of anti-avoidance rules, which are often watered down because of heavy lobbying and competitive pressure; (6) the existence of preferential regimes."

Evidently solutions will not be easy to find, especially if the framework into which they are to be adopted remains, as it is today, inspired by the "arm's length principle", which is the basis of the OECD transfer pricing guidelines, and if more fundamental tax reform cannot be considered.

7. A solution for Europe: the Common Consolidated Corporate Tax Base

This debate is nothing new. From the start, the process of EU integration has been deeply affected by the need for a degree of corporate tax harmonisation, as was already well-perceived in 1962 by the authors of the Neumark report. They explained that "the best method for the creation of a true single market would be the centralisation of the tax base calculation in the state where the company is resident followed by an allocation of the base between the different Member states concerned (like this is the case between German Landers for the "Gewerbesteuer")"(Aujean 2008).

However, no such thing took place, and the EU had to wait until 2001 for an in-depth examination of this type of approach (EU Commission 2001) and then until 2011 for a Commission proposal (EU Commission 2011) to be adopted.

[12] See The Economist, December 2012*, Wake up and smell the coffee: "*'This is an unprecedented commitment,' said Kris Engskov, the boss of Starbucks in Britain and Ireland, on December 6th, announcing that the coffee retailer will volunteer to the British taxman around £10m ($16m) a year more in 2013-14 than it is required to pay by law. It is doing so not under any pressure from the authorities, which had not been party to the firm's decision to donate an extra shot of cash to the exchequer, but to please British consumers furious not, as you might expect, at the high price of a latte, but at how little tax the firm pays in their country."

[13] The G20 leaders' meeting in Los Cabos on 18-19 June 2012 explicitly referred to "the need to prevent base erosion and profit shifting" in their final declaration.

The title of the proposal might not be clear enough for those who would like to understand the concept of CCCTB:

- a common tax base across the EU, which ideally should be a broad base, eliminating most of the tax incentives, preferential regimes and other types of "niches fiscales"[14], dramatically reducing the possibilities of tax competition from this side;
- with a consolidation mechanism within a group of companies, providing both an immediate compensation for profits and losses and taxing only the net profit of the group, and an allocation mechanism (apportionment) attributing the base to each country (MS) using a formula involving three factors: labour (payroll and number of employees), capital (tangible assets) and sales at destination (on the market where delivered);
- a one-stop-shop administration would complete the system;
- and Member States would remain free to fix their tax rates.

The merits of this approach are found in the harmonisation of the base and in the consolidation and apportionment process which would eliminate the necessity of transfer pricing for all intragroup transactions between EU companies who are members of a CCCTB group. It is certainly the best way to fight against base erosion and profit shifting within the EU and some would say this is one main reason for opposing it (Picciotto 2012).

But it is interesting to note that from the beginning of the discussion, the business community has expressed very strong support and has considered that such a solution would bring more certainty and simplicity and would also provide a true economic solution with the single taxation of net profits and the elimination of the difficulties associated with transfer pricing obligations (Monsellato 2013).

Unfortunately, until now the discussion of the proposal at the Council level has been slow and disappointing. At the last meetings under the Irish Presidency, which, for obvious reasons, is the most opposed delegation, a kind of consensus was emerging for a step in the direction of harmonising the base, but consolidation and apportionment were postponed indefinitely.

The OECD discussions on BEPS are taking place under similar circumstances: many tax administrations who prefer to remain in the uncertain world of transfer pricing and arm's length principles consider solutions based on formulary apportionment as going too far. This may well cast serious doubts as to the real willingness to fight base erosion and profit shifting opportunities which lie deep in these very principles.

8. Some operational conclusions in view of preserving progressive taxation

One point is clear: tax competition has resulted in a substantial decrease in marginal rates of personal income tax in most countries, with a broadening of the tax base in many cases. The negative effect on redistribution through progressivity of income tax is evident and in many countries the redistribution effects have increasingly taken place through public expenditure. To a certain extent, the efficiency and fairness of European tax systems has declined.

VAT systems are less efficient as the multiplication of reduced rates have resulted in lower efficiency rates in the collection of tax through VAT while the result of reduced VAT rates on redistribution is

[14] Tax loopholes.

very small. If, in relative terms, reduced VAT rates seem to provide an advantage to poorer families, in absolute terms this is not true as rich families obtain a much bigger advantage from these reduced rates[15]. This means that this is an extremely costly method of redistribution. A direct subsidy would do much better (Institute for Fiscal Studies 2011).

Corporate tax systems are not efficient as they are too complex, too uncertain and they offer too many forms of tax incentives and advantages that can be used and sometimes abused to erode the base and shift the profits. Some base broadening has taken place with the lowering of rates, this is welcome, but the main sources of difficulty lies in the treatment of group taxation at the international level and the new business models of the digital economy. Only a major change of model will help to resolve these difficulties.

Progressive personal income tax is still the most common model in EU countries, although some flat rate systems have been implemented in the new Member States. An efficient implementation of progressive income taxation can only take place if the tax authorities are able to apprehend all the forms of taxable income from a given taxpayer in the country of residence. This is why the development of automatic exchange of information is so important. The EU has been one of the leaders in this domain with the Savings Directive but until now has been unable to get rid of the derogations conceded to Luxembourg and Austria. The US initiative of FATCA is a chance for the EU to finish the job. Ensuring that automatic exchange of information can be effective will be essential for future development: this means harmonising the categories of information, income and flows of funds to be reported in view of an automatic exchange.

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Re-industrialising the Eurozone

Jean-Luc Gaffard[16]

The emergence of real divergences between eurozone countries in terms of economic performance makes it necessary to define an economic policy oriented towards a re-industrialisation of some regions in Europe. Supply-side reforms should consist in establishing a framework aimed at supporting both competition and cooperation between the various players in innovation, thus enabling the successful implementation of firms' strategies. This requires competition policy, labour policy and regional policy to be reconsidered, but industrial policy should also be revised to take the form of large public programmes. However, any change in the industrial landscape in Europe will only be possible if a new macroeconomic policy prevents inappropriate destruction of productive capacities.

1. Introduction: Why and how should the eurozone be re-industrialised?

Advanced economies are confronted with a huge structural change due to the globalisation of the market economy. This change has been accompanied by delocalisation, deindustrialisation, and jobs destruction which, in some countries, has revived calls for industrial policy intervention. Fundamentally, the reason for such a revival is that globalisation, increased international competition, and a strong euro, all reduce the time or the margin firms have to gather the information and mobilise the resources necessary to successfully stay in the market, leading firms to favour public intervention. Industrial policy becomes a fashionable topic whenever market conditions tighten and firms find themselves under stress.

Moreover, the eurozone is confronted with an unexpected difficulty: the increasing divergence in real terms within the European Union between surplus and deficit countries, while industry represents more than 75% of R&D and more than 75% of exports. This situation feeds the obsession with competitiveness justifying calls for supply-side reforms, while the real sources of competitiveness are not really identified.

Before considering what kind of policy firms need, it is necessary to identify the nature of the difficulties that emerge between countries belonging to the eurozone, why industry is at the heart of these difficulties, and which are the strategic and policy differences between countries that explain them. A new analytical framework will then be contemplated, aimed at showing that, in a world characterised by irreversibility of investment and imperfection of market information, only restrictive practices – that is to say cooperative agreements – will allow firms' growth strategies to be successful. This makes it possible to revisit both the objectives and the channels of industrial policies. This paper will conclude by considering the European challenge that implies the need to reconcile the goals and instruments of macroeconomic policy with the re-industrialisation of the eurozone.

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2. Real divergences

The main point that should be stressed at the European level is the real divergence in terms of economic performance (growth rate, unemployment, trade balance) between the two major players, France and Germany. This divergence is taking place in a context characterised by a sluggish final demand, involving a more intense struggle for market shares among firms, particularly in the manufacturing sector. It reveals the existence of strategic and policy differences that may provide information about the good and bad practices.

2.1 Cost issues

Germany is characterised by a dense and stable group of medium-sized firms (16,000 firms with between 500 and 5,000 employees). Production segments are outsourced to low-cost countries with highly qualified employees, so that real wage costs (taking into account the labour costs of countries in Eastern Europe) are about 20% lower than those of other countries in the euro area. Furthermore, as many industrial jobs are created as outsourced jobs.

In France, large firms that specialise in a specific area – aeronautics, energy, environment, luxury goods, etc. – perform exceptionally well on global markets. When they relocate some part of their business, it is to less-developed countries most often characterised by low wages and low skills. On the other hand, there are too few medium-sized firms (4,000 firms between 500 and 5,000 employees), and successful SMEs are rapidly sold and acquired by large firms when they should instead be allowed to grow without losing their identity. The consequence is that firms belonging to large segments of industry are more sensitive to price competition.

Over the past decade unit labour costs rose much faster than average in credit boom countries like Greece and Spain. In France and Italy, unit labour costs rose when wages grew faster than productivity. In Germany, outsourcing to foreign countries, weak domestic demand, and wage restraint meant that costs remained more or less flat. The resulting loss of competitiveness of peripheral countries is among the causes of the crisis.

The internal devaluation triggered by the crisis has stopped the divergence process, and in some cases reversed it. For example, in Spain, unemployment and fiscal consolidation led to a drop in real wages. This drop and the substantial increase in productivity have made Spain more competitive in comparison to its European partners, particularly France. The country's trade deficit has been substantially reduced due to the decreased imports as a result of the drop in economic activity but also due to rising exports.

2.2 Strategic oppositions

Differences between France and Germany in terms of firms' turnover and performance on the export market can be explained by the differences between firms' strategies and the divergent industrial policies characterising both countries.

During the 1990s, in manufacturing sector, the total firm turnover (entry plus exit rates) was about 3% in Germany, while it was around 11% in France. Moreover, firm exit (6.5%) outpaced firm entry (4.5%) in France, while Germany experienced a more balanced pattern (Bartelsman et al. 2004). Entry and exit rates are positively correlated in Germany, while they are negatively correlated in France.

This can be interpreted as meaning that the creative destruction process is predominant in Germany, while sector profit shock is predominant in France. However, another interpretation is possible: that in Germany market structures are more or less stabilised and investment behaviours are more or less co-ordinated, while more turbulences persist in France, revealing a weaker degree of co-ordination within industries which affect firms' performance. In the German case, as a result of better coordination between the various players of innovation processes (firms, banks, and workers), the restructuring process boosts productivity and employment. An analysis that puts investment behaviour and coordination at the centre of the industrial dynamic process will be further developed, this being consistent with the patterns observed in France and in Germany.

The export participation rate (44% against 72%) and mean export intensity (40% against 21%) are further differences between Germany and France. It indicates that in France there are lower barriers to entry, but stronger barriers to growth in export markets.

When it comes to the orientation of industrial policies in each country, strong differences can be observed. State aid as a percentage of GDP is much higher in Germany than in France (horizontal objectives: 54.4% against 33.5%; total: 90.5% against 56.4%); it is more oriented towards the environment (31.7% against 0.6%), and regional aid (11.8% against 6.3%), and less towards employment (0.6% against 6.7%), R&D (6.7% against 8.0%), and SMEs (2.0% against 7.9%). In fact, both environmental and regional aids are aimed at creating market information and market conditions that help firms to invest by reducing uncertainty. Whereas France spends four times as much as Germany on policies supporting SMEs and ten times as much on supporting employment, net job creation has remained significantly lower in France. However, it should also be noted that Germany's performance in terms of job creation has not yet reached that of the US and the UK.

It is worth mentioning the real impact of labour market reform in Germany. A recent study (Carlin and Soskice 2007) argues that the long period of high unemployment in Germany could be largely an aggregate demand phenomenon. It also shows that the German model of employee representation and protection, the apprenticeship system and the collective bargaining continue to operate most strongly in the export sectors. These reforms have not been oriented in the direction of a more flexible labour market as is usually understood in the contemporary debate. The most notable change has been the extent to which chairs of works councils (elected by employees) have been brought into the *de facto* co-management of large companies. It has largely been obtained by direct negotiation between business associations and labour unions.

In contrast to Germany, France has not elaborated a fully coherent industrial policy framework. Only a recent policy aimed at sustaining the development of local clusters may appear as a step in the right direction insofar as it promotes cooperation between small and large firms, and between firms and research groups. What differentiates the two countries are both the channels and the level of public intervention. The divergence between France and Germany developed against the background of a wider process of divergence between the centre and the periphery of the eurozone.

2.3 Barriers to entry and barriers to growth

Recent literature focuses on the incentives to innovate, which would be determined by the nature and the strength of the barriers to entry. Contrary to common wisdom, available data do not reveal any problems with entrepreneurship in countries like France. The turnover rate in France is relatively high, mainly in manufacturing (Bartelsman et al. 2005).

Rather, it is likely that the main problem faced by French firms lies not in the existence of barriers to entry, but in the existence of barriers to growth.

The observed patterns of firm demographics and survival may help in clarifying the debate. Firm size distribution has both a sector and a country component, with the latter playing a more prominent role in explaining cross-country differences in overall size. There are no large differences in firm turnover across countries, once differences in sector composition of the economy are taking into account, and there are no large differences in firm rate of survival 7 years after birth. But post-entry growth of survivors is much stronger in some countries, like the US, than in others (Bartelsman et al. 2005).

In the case of France, for example, the percentage deviation from average sized firms with more than 20 employees as a function of sector specialisation is -0.22%. France's specialisation should lead to larger firms (+0.06% in sectors with large volumes of production), however its firms remain small (-0.21%).

These findings suggest that barriers to growth are much more significant than barriers to entry in explaining differences in performance across countries. These barriers could be attributed to the existence of sunk costs, and to the difficulty of coping with them. Therefore, there are reasons to believe that enhancing the ability of new and old firms to invest and grow would be much more decisive than incentives for the creation of new firms and for these to enter the market.

According to recent studies, the size distribution for a given group of firms exhibits a significant skew to the right, suggesting the presence of a large mass of small firms. Thus, the combination of sunk costs in setting-up a new business and of high uncertainty leads firms to start small and to expand once they are established on the market. In other words, some firms are small because they are financially constrained, while in a later phase, financial constraints cease to be binding and these firms will grow to their optimal size (Cabral and Mata 2003). Differences between countries in terms of firms' size distribution would then be revealed in conditions of financial growth.

Thus, as is the case for French manufacturing firms, financial constraints significantly increase the probability of exiting the market; access to external financial resources has a positive effect on firms' growth in terms of sales, capital stock, and employment; and financial constraints are positively correlated with productivity growth in the short run (Musso and Schiavo 2008).

Nevertheless, the productivity path is U shaped for French manufacturing firms entering export markets – in fact, total factor productivity decreases prior to entry. This suggests that time to build constraints that generate sunk costs is responsible for this decrease in the productivity of new exporters. The difficulty of coping with these constraints could explain the low export intensity in the case of French exporters (Bellone et al. 2007).

The role of financial constraints is puzzling. On the one hand, they must not be too tight and should allow firms to grow. On the other hand, they discipline competition between firms by preventing them from excessive investment with respect to the size of the market. In any case, the main challenge being faced by firms is the reduction of the barriers to growth, such as the barriers to converge towards a sort of natural market structure, which allows firms to capture productivity gains.

3. Innovation and competition

Re-industrialising the eurozone and re-establishing the trade equilibrium require the real sources of firms' competitiveness to be identified. While most of the discussion around industrial policy consists in determining the outcomes, which correspond to different information structures, and results in directing policy-makers to liberalise all markets, this paper intends to explore how firms may gain access to the relevant market information and will reveal what really are the market forces.

3.1 Information and co-ordination

Barriers to growth cannot be assimilated to barriers to entry. Firms are not only concerned with incentives issues in industries that are meant to be fully co-ordinated on a good or a bad equilibrium. They have to face co-ordination failures, as market imbalances and financial constraints hamper their ability to grow.

For a process of growth to take place, investments must be planned and carried to completion. After a phase of construction, this will result in a new productive capacity, to be matched by a corresponding demand for final output. As Richardson put it (1960), the profitability of firms' investment, and hence its growth rate, will depend on how it will obtain sufficient information on which to base its investment decision. A specific problem of co-ordination is then involved, due to the existence of two delays: the delay of gestation of investment and the delay of transmission of market information. On the one hand, investment represents a firm commitment, and this commitment will give rise to an additional output only after a certain interval of time has elapsed. On the other hand, entrepreneurs will learn about the commitments of others and also about the needs of customers only after a certain period of time. Concretely, the marketing of a new product will take time and, of course, money. As demand for it grows, productive capacity will have to be enlarged. In general, manufactured products will gain in market share only gradually, as their merits become apparent and as the capacity to produce them is developed. During this period, rival offerings (and old products) will still be on the market and their lifespan may be prolonged somewhat by price reductions which help to offset their disadvantages. Meanwhile, a new product will be in development, ready to challenge the one that is gaining ground. Although a new product may be superior to an old one in all respects, the process of replacement is rarely immediate. Heterogeneity of products appears as a critical aspect of industrial dynamics.

Then, being confronted with the irreversibility of investment decisions and the lack of market information, firms will engage in new activities only if they are confident about the degree of coordination between competitors.

Imperfect information and imperfect mobility of resources are at the heart of competition, which is the better device for dealing with these natural imperfections. But, co-ordination through market transactions is only possible by virtue of the existence of circumstances which establish the boundaries, particularly for investment decisions. As Richardson (1960) describes, these enabling circumstances exist naturally (such as differential capabilities or asymmetries of information) or may be contrived through collective action (such as market sharing arrangements). The basic idea is that *"entrepreneurs would have access to the market information they require only if there exist a variety* *of restraints, of different strength and durability, to which their freedom of action would frequently be subject"* (G.B. Richardson 1960 p. 56). In order to take informed investment decisions, firms require some stability in their environment, and this is provided by these restraints or agreements, of different nature, which permit the industry to converge towards a state of dynamic equilibrium.

All these restraints can be qualified as market failures and may appear to be incompatible with market discipline, which prevents entrepreneurs from reducing both production and investment and from maintaining a rate of profit in excess of the normal level. This is true only from a static viewpoint. From a dynamic viewpoint, it is worth distinguishing between those restraints that help firms to invest and innovate and those that are really harmful and penalise customers, such as attempts to destroy competitors by deliberately operating at a loss or to exclude new entrants by monopolising the supply of an essential factor.

Therefore, the simultaneous co-existence of a number of competing firms, each innovating and producing with increasing returns, depends not on the intensity of competition as measured by the number of firms or by the level of the mark-up, but on the existence of so-called market connections, that is, to some extent, on imperfections that are in the nature of the competition process.

Contrived restraints mainly correspond to agreements that exist in a great variety of forms. Agreements made between firms and their customers. Those that firms make with each other – among them, R&D agreements play an essential role. Of course, they allow firms to share heavy costs of development but, more fundamentally, they allow firms to share market information, which is made available only step-by-step, with the effect of avoiding an excess of competitive investment.

3.2 Firms' competitiveness and market equilibrium

Firms' growth depends on the behaviour of their competitors as well as their suppliers and customers. Thus, firms' growth (and innovation) strategies are successful when investments are well co-ordinated, that is, when a sort of natural market structure is stabilised.

Successful innovation requires a breaking up of the market structure in an early phase, followed in the later phase by a stabilisation of this structure (Amendola, Gaffard 2006, Amendola, Gaffard, Musso 2006). The problem then is not so much to define a given market structure that is assumed optimal and considered as a benchmark, but to put in place a stabilisation process that can lead to different market structures, depending on the evolution of the process itself. Stabilisation means that several firms coexist on the market, market imbalances are progressively dampened, and both competitive and complementary investments are made compatible with each other. This latter situation can be defined as a dynamic equilibrium (Richardson 1998). This is a situation in which competition causes the rate of investment in product development to rise or fall towards the level at which this investment yields only a normal return. It is also a situation in which the prices charged by the firms reflect decreasing average costs so that the benefits from innovation can also be distributed to customers. Finally, this is a situation in which the stability of market shares obtains an average: entries and exits do not change the market structure and appear as a purely random phenomenon. In short, this situation corresponds to dynamic efficiency, and a well-managed process of creative destruction.

Dynamic equilibrium is consistent with the co-existence of a number of competing firms, all of them supplying products for the same general market in conditions of increasing returns. This market supports several firms that remain differentiated not so much because they supply differentiated goods, but because they are each one at a different stage of the life cycle of the innovation process. Several firms live on the market, not only because they cater to different needs, but also because it takes time for new products to gain ground and for old ones to be driven from the field. The so-called natural structure, which is the more efficient one, will depend on the properties of technologies and preferences. What is important is that a dynamic equilibrium may be consistent with the rise and decline of firms within the industry. Furthermore, the rates of entry and exit are positively correlated, which means that there is no significant excess of demand or supply on the market.

These considerations not only qualify a dynamic equilibrium, but also what should be the competitive conditions consistent with the effective gains from innovation and hence with increasing returns. As we have seen, these conditions often come down to market connections (monopolist practices) and new forms of regulation commanding the new inter-industry relationships, that is, imperfect competition. This, however, must be carefully distinguished from market failures. Market failures are generally defined with respect to the conditions of perfect competition. This implies that they must be corrected by means of specific incentive rules, without any consideration for the fact that the economic process is a time-dependent process. On the contrary, this paper maintains that imperfect competition is a characteristic of any market process and cannot be removed nor systematically corrected. It is a normal state quite often associated with the persistence of rivalry.

Two points must be stressed here. First, the maintenance of a plurality of firms that compete with each other is, in this framework, the best situation both for firms and customers. But, it might be argued that the dynamic equilibrium has nothing to do with perfect or full competition (Richardson 1998). In fact, it corresponds to a natural market structure in the sense that it allows firms to capture all potential gains of productivity. Moreover, innovative firms' competitiveness can go hand-in-hand with stability of market shares. Second, the characteristics of the dynamic equilibrium are unknown before the evolution has taken place. They will be the result of the rivalry between firms under specific restraints. Consequently, policy cannot be devoted to reducing the gap between the existing market structure and this entirely unknown structure. It must be aimed at establishing those conditions that favour the convergence towards the so-called dynamic equilibrium, which are not, in any way, the conditions for full competition.

4. Industrial policy revisited

It is common to oppose sector-based and horizontal policies. Sector-based policies are above all protective policies: these aim at protecting firms in specific sectors exposed to foreign competition from market forces, and therefore to grant them more time to look for and acquire competitive advantages. These are 'traditional' industrial policies that are not very successful in the medium to long run since they do not address the root of the problem. This family might include all kinds of protectionist policies which are increasingly advocated nowadays: entry barriers, trade barriers, currency devaluations, government subsidies, and even import-substitution policies implemented in many countries in the past. Horizontal policies correspond to a broader interpretation of industrial policy. They are aimed at supporting firms engaged in free markets and at favouring market selection. They include antitrust, regulation, and export policies, but also supply-side policies that are concerned with the working of labour and financial markets.

4.1 Usual deficiencies

The main issue with industrial policy is regarding the information that is available to policy-makers. According to the standard economic theory, increasing returns to scale, asymmetries of information, and externalities lead to these so-called market failures that pave the way for public intervention. However, how government ought to intervene depends on the characteristics of the industry. These characteristics – technology, preferences, and information asymmetries – are not really known by policy-makers. As a result, many subsidies can be inefficient and may introduce distortions in competition, harming customers' welfare. This is the main argument against sector-based policies. The problem is that horizontal policies face the same limitations. They are not targeted towards specific sectors, and are aimed at changing the environment for a large group of firms in many sectors. Nevertheless, their efficiency also depends on the ability of policy-makers to know the nature of market failures to be dealt with. In order to fix R&D subsidies, policy-makers have to know the real content of knowledge spillovers, and the potential imperfections in the capital markets' funding of R&D. In order to sustain the accumulation of human capital, they have to know what sorts of market failures are affecting the training of human capital. In order to reduce the gap between the existing market structure and the optimal one, they have to identify the characteristics of the former. Indeed, they do not have access to this kind of information. Finally, from this perspective, the only eligible policy would be the policy that would focus on the working of the different markets, enhancing their liberalisation. In other words, there is no place for an active industrial policy. Competition and regulation policies, supply-side reforms, which are defined with respect to full competition as a benchmark, are instead applied to industrial policy in the narrow sense.

4.2 A new view

This paper's perspective is a little bit different, and would like to suggest that industrial policy makes sense not only because there are market failures or market imperfections, but also because believing in full competition as a benchmark is a dangerous obsession, which may turn into waste. As will be explored, industrial policy can (and should) facilitate the working of market forces, but market forces have nothing to do with full competition assimilated to an optimal state of affairs.

Policies oriented to ameliorate industry performances should be aimed at improving market information to firms, creating a more stable environment, and should then help industries to converge towards a dynamic equilibrium. Of course, governments have no more information than the firms do about markets and technologies. But they have the devices that should allow firms to acquire more information about market conditions, helping them to innovate and grow. In other words, even if the government and firms share the same issues with information, the government has different constraints and objectives.

From this perspective, industrial policy, rather than being targeted at sectors or technology, must be an array of horizontal interventions that concern the relations between firms, between firms and their employees, between firms and financial intermediaries, or between firms and public research institutions. This final option is preferable to any other since such intervention does not shield any particular firm or sector, but rather increases the quality of incentives, which are strongly dependent on conditions of co-ordination. Subsidies must not be devoted at supporting national champions or high tech sectors *per se*, but at encouraging cooperation between firms, including, of course, the firms that compete with each other.

Industrial policies should be horizontal. But instead of replicating or re-establishing the conditions of full (perfect) competition as required by those calling for supply-side reforms, they should be aimed at validating restraints that allow firms acquiring market information.

Therefore, policies oriented at innovation, the building of human capital, and exporting, can be designed in terms of helping firms to make choices that might not be immediately profit-maximizing for the single entity, but have positive spillovers for the economic system as a whole since they create information.

4.3 Good market policies

Competition plays a central role in the co-ordination process, as it determines the way in which the market information relevant for co-ordination is being made available step-by-step, so that the required adjustments in productive capacity can actually take place. Thus it helps to make this process viable and to obtain the productivity gains deriving from it. In this light, competition is not only aimed at equalising supply and demand in a given market and technological environment, but also has to *"adapt both structure and technology to the fresh opportunities created by expanding markets"* (Richardson 1975, p. 353). Therefore, competition policy cannot be conducted in isolation without considering the distortions that are in the nature of the growth process and the necessity of having some market connections. Instead of targeting any optimal market structure, it must be aimed at enforcing viability (and growth) conditions.

However, policy-makers may be faced with a real dilemma. On the one hand, contrived arrangements help firms to invest and innovate. On the other hand, it is sometimes in the nature of these arrangements that they can be used to shelter inefficiency or extract undue profits. Metcalfe (1998) distinguishes good and bad market imperfections: *"The imperfections identified in the market failure approach, therefore, can be viewed in a different perspective, as integral and necessary aspects of the production and the dissemination of knowledge in a market economy. In this perspective it is surely perverse to call them imperfections. This is, of course, not a new point; for those who have studied Schumpeter they are the natural features of an economic process driven by creative destruction"* (Metcalfe 1998, p. 114). To rule that all imperfections are against the public interest *per se,* denies the existence of the dilemma faced by policy-makers. It is necessary and possible to offer them some practical guidance by seeking to specify the circumstances in which these practices may or may not justified. The dilemma faced, for example, by anti-trust authorities is that market imperfections are, on the one hand, necessary in order to convince firms to launch innovative investment and, as such, they are not something to be systematically condemned; on the other hand, these imperfections reveal real market failures as they hamper the viability of the innovation process. Fundamentally, competition and regulation policies have to take into account the possible divorce between static and dynamic efficiency, and support restrictive practices that enhance the medium-term efficiency at the expense of the short-term one. As industrial policies, they must be discretionary policies rather than be reduced to the enforcement of given rules.

4.4 Labour market policies

The prevailing view in the literature and in most political circles is that the possibility of hiring and firing freely, and of offering wages at a freely-chosen level, is an incentive to invest and hence favours innovation and growth. As such, labour market policies could figure in an industrial policy.

A theoretical basis to this view focuses on the effect of labour market rigidities, identified by high firing costs, and on long-run productivity and growth (through the effect on the 'structure of innovation'). The argument is that, given that higher levels of productivity are obtained by the firms operating in high tech sectors, and that these firms (and sectors) are characterised by strong turnover and a pronounced creation and destruction of employment, dismissal costs (employment protection) reduce the incentive for investment, technical change and productivity increases, and help to retain human resources in low productivity sectors. This tends to reduce the average rate of productivity in the economy as a whole.

However, the fundamental aspect of a thorough process of innovation is the creation of skills. And, because it increases job tenure and, through this channel, favours on-the-job training, employment protection affects not only employment but also human capital accumulation, and hence productivity and welfare. Then, labour market policies, far from being oriented to the dismantlement of the welfare state, should promote labour market organisation and forms of bargaining between employers and employees that help with adjustment to technological and market changes. It would be more appropriate to reinforce bargaining procedures between employers and employees, and to revise the working of internal labour markets rather than suppress them.

Therefore, the effect of employment security regulation and of the partial reforms recently carried out, which extend to the use of temporary contracts for newly-hired workers leaving employment protection unchanged for permanent workers, and hence make the labour market more flexible, have only favoured a segmentation of this market and the appearance of a new category of workers, namely the 'short-term' workers. This segmentation might even be an obstacle to workers' mobility and growth by preventing voluntary quits from 'solid' jobs. Labour market policies should be designed in order to avoid such segmentation.

4.5 Regional policy

Industrial policies have a territorial dimension insofar as there are local learning processes. But, there is no evidence that local or regional governments are better informed than the national government, have a higher degree of competence, or are less easily captured by lobbyists. Moreover, due to information imperfections and political interests, there is no evidence that competition between countries induces firms to be located wherever they add more value since a government will offer more than another only if the external benefits are larger in the first region than in the second. Competition between regional governments could even be globally inefficient if its main consequence is to ameliorate the performance of a small number of regions at the detriment of all others. Such inequalities would negatively affect global efficiency. The conjecture can be made that the smaller the regions, the more wasteful competition between them will be. This might be so because small regions are more inclined to compete with each other by promoting generic advantages such as tax reductions or set-up subsidies, which reduce the sunk costs that firms have to bear and make setting-up more instable. Larger regions, on the other hand, would be more inclined to promote cooperation between firms within and outside its territory, and to pay subsidies aimed at sustaining large public programmes such as environmental programmes. This might be the reason why there is a tendency towards cooperation between larger regions. The issues to deal with are to build on critical mass, to allow diversification or differentiation, and most of all, to facilitate adjustments to changes affecting technologies and preferences.

Clusters as well as technologies are the result of the innovation process rather than a precondition of it. So policy-makers are faced a dilemma, which concerns both the appropriate level of decision-making and the relevant geographical area of public intervention. There are local externalities, mainly in the form of learning processes, which require defining a relevant geographical perimeter of public intervention. This inevitably interferes with local political interests. So the real issue to be dealt with is about the nature of relations that prevail between regions, and the size of each of them.

5. Conclusions: The European challenge

The main objective of any policy in Europe should be re-establishing the conditions of a convergence in real terms, which means re-establishing a balanced trade between the large European countries, and, thus, re-industrialising some parts of the eurozone. This requires reconsidering both national and European policies that are growth-enhancing, that is, competition policy, labour policy, regional policy, but also industrial policy *stricto sensu*.

First of all, it would be worthwhile to abandon the idea that supply-side reforms making the labour market more flexible in each country would reinforce the competitiveness of each one without damaging global demand and growth at the European level. Instead, supply-side reforms should consist in establishing a policy framework aimed at supporting both competition and cooperation between the various players of innovation processes. This is largely the case in Germany, but not in France and not at the European level. Therefore, other countries in Europe should take advantage of the German experience and revisit their national policies. At the same time, a new European initiative should take the form of large public programmes defined at appropriate geographic levels, that is, levels that permit avoiding the destructive competition between regions or countries, typically technological programmes in the field of the environment, energy and applied research. The main reason for developing such programmes is that they are transversal both in terms of activities, firms and countries, and they aim at improving market information for firms, creating a more stable environment, making it credible and relevant for these firms to invest. Moreover, each country should be able to benefit from such programmes in terms of development of some segment of industry.

However, any change in the industrial landscape in Europe will only be possible if a new macroeconomic policy is under way. In fact, generalised austerity is going to destroy large segments of industry in Europe. Therefore, even if fiscal consolidation is a necessary part of a rebalancing strategy, it is vital that countries with large surpluses take action to stimulate their domestic demand.

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What Integration for the Banking System in Europe?

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Banking integration in Europe can be presented as a logical step forward in the single market project that should one day bless Europe with its benefits; it has lately also been proposed as a way, or even a necessary precondition, to cure the problems that have appeared within the eurozone since the 2008 banking crisis and the 2010 sovereign financing crisis. In order to analyse the type of integration that is required and the best way to get there, it is first necessary to make sure this is not another case of political objectives being set with insufficient concern for economic reality. European banks of all sizes were hit by the banking crisis that began in 2008These banking problems originated in many banks' unwise, even speculative, financial risk-taking in international markets, and in many others' dabbling in speculative real estate. Regulatory regimes that were too lax or 'nationalistic' either did not help or only compounded the problems, but there is no indication that any 'lack of European integration' had any responsibility in those banking problems. Looking at what level and what type of integration would make economic and financial sense for banks in Europe, we propose to first look at the objectives that this integration is supposed to achieve, then analyse the main components of banking, and look at the issues and impact of integration on each of them, and on the banking system in general.

1. Introduction: Defining objectives of integration

The general aim of a banking system can be one of two broad categories. Should it be a service sector that provides financing to the economy, individuals and businesses, or should it be seen as an end in itself, that should be judged solely on the basis of the profits it generates? Banking systems routinely enjoy privilege and protection, therefore we think the former should be retained, together with a fair profitability for banks, when they do their job correctly.

There can be several economic objectives of an increased European integration of banks.

<u>Efficiency</u> would be an important objective. The allocation efficiency of capital, through the flows of credit and other sources of funding, is a key objective. Then the operational efficiency of banks themselves can be another objective, though towards which cost and revenue efficiency must be assessed in light of the supposed economies of scale and other synergies, as well as enhanced risk management that European integration could bring.

<u>Competition</u> is an obvious objective for a sector that has often enjoyed protected national markets and oligopolistic arrangements inside those markets. Thus what matters is competition that would reduce market power and reduce or delete rents.

<u>Risk reduction</u> and <u>improved regulation</u>, thanks to the spreading of best practices among banks and a strict regulation without the nationalistic protectionism that often weakens it.

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Innovation, and the quality of innovation, thanks to the creation of a larger and more demanding market, could also be seen as an objective of further financial integration.

We could define two main components, namely commercial banking and investment banking. This is, however, a rather theoretical and very US-oriented subdivision, well understood in the UK for historical reasons, but which presents its own dangers. The situation on the European continent is slightly more confusing as many large banks have long been active in all components, under what is called 'universal banking'.

We propose to look at the three main components of present-day universal banking in Europe:

- Commercial banking, which engages in deposit-taking and credit activities;

- Transaction banking, which engages in distribution, brokerage and custody of securities and other investment products like investment funds;

- Investment banking, where corporate finance and primary market risks are managed, and where during the last decennia a 'trading' activity has developed, namely market risks that are taken, managed, amplified or hedged; securities market risks, but also other risks that have been absorbed in the financial sphere, namely the currency markets, most commodity markets, etc.

To conclude we will argue that commercial banking does not need to be more integrated but made more responsible and safer, which to a large extent is a matter of better management and governance – and the incentives to get there – and better regulation. We will also argue that investment banking is already integrated in practice, around London-based banks, and that it needs more competition and transparency but that operational integration is not a real issue. Above all, those two components need better and more adapted regulation, implemented with impartiality, which could improve under international oversight. Transaction banking is a domain where many structural changes have been taking place over the last decennia in a rather haphazard way, and where some further integration would bring substantial benefits to European markets and users of capital markets. Hence this integration should be a priority. Capital markets remain undeveloped in (continental) Europe on many counts, which is intertwined with the very high 'bancarisation' of the economic activity and financing in general. Making transaction banking more independent from universal/commercial banking on the continent (and, ideally, from investment banking in the US and even in the UK) would also be very welcome in the interest of eurozone capital markets and their customers.

2. Commercial banking in Europe during the last decennia, between illusion and disillusion

2.1 From protected national markets to oligopolies

So far, the integration of commercial banking has been an important objective within the EU, with the justification that it would bring about more competition and a freeing of capital movements. In the decennia prior to the 1970s, the conviction emerged that national regulation, protectionism, and lack of competition in commercial banking had allowed the existence of rents in the sector, prevented the benefits of economies of scale, and hampered financial innovation; the absence of a financial crisis between the 1940s and the late 1970s was taken for granted, with a dwindling number of observers making the link between tight regulation and financial stability. Since the late 1970s, regulation was regularly reduced or deleted.

Since then, European directives in relation to the sector were largely aimed at increasing competition by forcing the opening of national barriers and outlawing conventional tariffs which, in many countries, were established on a cartel-like basis. These directives have had a mixture of positive and negative effects. Some aspects of banking have become easier and less expensive for customers, occasionally because of competition, sometimes because of economies of scale, but also because of appropriate national or EU regulations, for example on money transfers and on consumer protection.

In many countries however, there is hardly any more competition in commercial banking in 2013 than there was before the 1980s. This is because cross-border banking grew only modestly and many bank mergers took place, mostly within borders, which made the sector much more concentrated nationally (and in many concentrated countries, much more profitable). Due to this concentration, tariffs for many services have risen after their deregulation and the sector lost much of its diversity – many small banks, mutual, cooperative, and state-owned banks, were merged into larger banks, for the sake of achieving 'the necessary size', and for the supposed benefits of privatisation.

The barriers to entry for newcomers in a banking market remain high because of information and credit selection issues; cross-border banking increased between the 1980s and 2008, but mostly in some specific fields like (large) corporate lending, cash pooling, some Institutional securities activities and, to a small extent, mortgage lending. This trend has reversed since 2008, as most banks reduced – sometimes drastically – their cross-border banking ambitions, or at least their cross-border lending activities.

So, should we hope and encourage a new push for integration of commercial banking activities in Europe, and for which reason?

2.2 What could greater European integration bring to commercial banking in Europe?

Greater efficiency due to size? It is quite dubious that a larger size would bring better operational efficiency to commercial banks in Europe. Independent studies converge and show that revenue efficiency does not increase with size, and that cost efficiency thanks to size stagnates at a pretty small size (30 to 40 billion euro balance sheet, or a medium-sized bank). The only area where size brings 'efficiency' is, or rather has been so far, in funding; larger banks having been allowed to function with lower equity ratios and having enjoyed the benefit of a free insurance by the name of 'too big to fail', which is in fact a public subsidy. The advantage brought by size in Investment Banking is another matter, which we revert to a bit later.

Economies of scope? No evidence of economies of scope have appeared in banking (again, beyond a certain, rather modest level). Banks operating in various European countries do not show superior efficiency; some have used cheap domestic funding in one country to help finance their operations in another country, but that looks more like a transfer of profits and/or risk from one part of a group to another rather than a gain in efficiency and does not appear sustainable. International networks are neither needed nor even best for providing the vast majority of banking services. Local banks with a good network of correspondents often offer better services than banks offering – or attempting to offer – continent-wide services.

Superior allocation of capital? There is little indication that internationally integrated banks would offer superior credit allocation efficiency. On the contrary, studies tend to show that in many cases local decision-making brings better credit selection. As to the fact that interest rates are different in various eurozone countries, this problem stems from the dysfunctionality of the eurozone and from the lack of integration of European capital markets and transaction banking, which will be discussed below.

Competition? The (limited) cross-border banking activity that developed from the 1980s to 2008 brought some competition, but often not enough to compensate for the competition reduction resulting from domestic mergers and concentration. Since 2008, cross-border competition has somewhat diminished, and it is doubtful that 'integration' would bring enough competition where it is lacking. The protections and subsidies are enormous, and even the regulatory measures taken to offset some of the subsidies and State aid sometimes further reduce competition.

Innovation? Nothing indicates that an integrated market would bring more, or better, innovations. Recent experiences indicate that financial innovation has to be better monitored by the Board of Directors of banks themselves, and their regulators. Reckless financial innovation in badly regulated markets can be very dangerous for clients, banks, and the taxpayers who have to bail them out. Useful financial innovation can certainly be adopted by banks worldwide regardless of their size, affiliation or integration. Internet banking and various 'crowd-funding' types of financing can probably develop across Europe – if their business model justifies it – within the existing banking framework, but so far the successful experiences have been local.

Better risk management? No evidence of this either. Operational controls do not seem to improve with size or with international integration. Some banks achieved constructive risk diversification by internationalising their operations, but they were exceptions. Some banks have been able to stay out of trouble even when concentrated in countries affected by major economic or real estate problems, proving that in banking, like in many other sectors, the critical variable is good management, which is not linked either with size or with European integration.

As a matter of fact, risk management and regulation are areas where major issues were created by the European integration of banks in the last 30-odd years, because controls have lagged behind. Due to operational issues and bad risk assessment, many mergers and acquisitions undertaken with the declared objective of achieving size or cross-border integration have led to problems. Size and lack of controls over international operations created problems for many European banks during the 2008 crisis.

Better banking regulation should be an absolute priority. Since the 1990s, many promises of integrated banking regulation have been made, but little has actually been achieved. So far, the integration of banks has preceded the integration of regulation, often making it less effective.

2.3 How do we get safer commercial banks, and how do we get a better financing of the European economy?

The Banking Union that is currently envisaged consists of plans for a regulation and supervision framework, a common resolution mechanism and a common deposit-guarantee system at European level. Whether this Banking Union is attempted beginning with an integrated regulation and supervision or with an integrated deposit-guarantee system, the very concept will be difficult to achieve satisfactorily if certain priorities are not correctly placed, one being the prime responsibility of banks towards depositors.

Better protected deposits

We are frequently told that it is the duty of governments to protect bank's depositors, which is true to some extent, but should not mean as it (surprisingly) does today that banks should not view the protection of depositors as their own duty. Thanks to the public guarantee on deposits, given with very little control and requirements, many banks are directly or indirectly using these cheap deposits to engage in very risky activities, thus putting depositors and taxpayers at great risk.

A number of structural measures could be envisaged to improve this situation. Ideally, the banking entity that collects deposits could be separated into a purely deposit and credit institution, and ring-fenced according to the model of the Vickers proposal in the UK. If that cannot be done (mainly because European politicians accept the argument that the universal banking model is 'too successful' and 'too specific' to be broken up), banks that collect deposits should at least be prevented from giving priority status or collateral to other creditors for substantial amounts; they should in fact simply respect a 'negative pledge', something they are keen to impose when they themselves lend money. Otherwise, they should be requested to give a full collateral cover, like for covered bonds; in fact a kind of *pari passu*, which they also like to request when they lend money. This collateral should consist of diversified loans to the economy at large, excluding however loans to financial activities, risky real estate development, etc., and be defined and controlled by the regulators and/or a kind of Deposit Insurance Company (the eligible assets would be about the same as those inside the 'ring-fence' of the Vickers model). This should not be a deterrent to lending to the economy, quite the contrary. These types of measures would be fairly easy to define and implement. They would make it easy to implement a resolution mechanism and a deposit guarantee scheme that would not be a further subsidy to the sector.

Safer banks in general

The Banking Union should also aim at the advent of strict norms defined and controlled by the ECB, including higher capital levels and an end to the fallacy of defining solvency on the basis of Risk Weighted Assets, where sovereign bonds are considered to be zero risk – which encourages banks to hold far too many sovereign bonds –, and where models are used to judge credit risk and, in practice, are used for credit selection with very negative effects, both on lending activities and actual risk control. Credit committees with real experience are much more effective and flexible than models.

Anyway, stricter capital requirements and thus lower leveraging of banks might somehow reduce banks profitability, but this should be mitigated by a combination of a cap on excessive remunerations, and lower required returns on equity (due to lower risks); it should certainly go together with measures to encourage the financing of sovereign debt, but also of loans in general through capital markets and alternative financing mechanisms, so as to enable an easy reduction of banks' balance sheets. These kinds of capital market financing, and alternative financing in general, are sometimes presented as a dangerous activity included in a dark cloud called shadow banking. Undoubtedly, some off-balance sheet activities and capital market activities can be destabilising, and some banks are taking too much risk by financing them, but labelling all capital market and alternative financing as diabolic shadow banking activities is at least a mistake and at worst propaganda encouraging the 'business as usual' attitude that some lobbies are promoting.

Banks in Europe and their universal model have not favoured the development of capital markets until now, which might therefore be another good reason to envisage a separation of their capital market activities at large, not only of investment banking and the risks associated with this activity, but also transaction banking which is the main facilitator of capital market financing.

3. Transaction Banking: brokerage, advice and distribution deserve better

The activities that we will call transaction banking include the distribution of securities, mutual funds, etc., as well as any other related activities, such as the financial analysis (or 'research') leading to advice given to investors and the execution of client orders, either on stock exchanges or over-the-counter (OTC). On the European continent, this activity is traditionally performed by commercial/universal banks, who deal with most of the financial savings of individuals (retail clients). It is difficult to establish absolute causality, but on the continent, a very big part of those savings are oriented towards bank deposits and other forms of bank financing; companies are also largely financed through banks. Capital markets are somewhat underdeveloped. Even investment funds on the European continent are often managed by and distributed through commercial/universal banks. There are few independent brokers who distribute securities to retail clients. In the UK and the US, the tradition had long been – certainly until the 1980s – that this activity was conducted by brokers and other specialised intermediaries, and it has remained to some extent separated from commercial banking. Capital markets are much more developed, and bank intermediation has a smaller share of financial intermediation. European integration of this activity has evolved together with commercial banking, with some cross-border opening and substantial national concentration and increase in market power by a few players. Tax discrepancies remain quite high and make the very concept of a single market an illusion.

The European Commission has produced important pieces of legislation bringing European harmonisation in the distribution of securities, as well as in the management and distribution of investment funds, mainly through directives aiming at giving them 'European passports'. Two directives in particular made the biggest impact: the Markets in Financial Instrument Directive (MiFID), which brought the framework for new exchanges and rules on brokerage of Financial Instruments; and the various Directives on Undertakings of Collective Investment in Transferable Securities (UCITS). There have been several of these, UCITS 4 being presently applied. UCITS has brought about some useful standardisation of investment funds at European level and has been used by various other countries in the world, making it the only truly international standard for investment funds.

Nevertheless, the fact that commercial banks are by far the main producers and distributors of UCITS on the continent means that the sector remains quite fragmented. In this field economies of scale seem substantial, and so are the benefits of open competition by a sufficient number of large independent players: the management fees and related costs charged to European retail investors of investment funds are very much higher than those charged to US retail clients for comparable products. Since in this activity of asset and fund management, after the choice of category of investment, the costs are the main determinants of performance in the long run, this is a very important issue for the benefit of citizens.

MiFID rules foresee that bank's retail clients have to benefit from 'best execution', but curiously UCITS are not included in MiFID rules so far. Concerning the cost of buying or selling securities, the same problem appears. Retail clients tend to pay quite high commissions on investments in securities or UCITS. The link between commercial banking and brokerage is thus globally costly for retail investors in the eurozone.

In the Anglo-Saxon tradition that has been generalised in Europe, brokers are the main producers of advice on shares, and consequently exert a significant influence on their valuation, and especially on their price movement in the short and medium term. Since the market abuses of the late 1990s and early 2000s, it is known how detrimental the influence of merging and concentrating Investment Banking and Brokering can be to investors, because the banks originating securities issues are also the main advisors to investors. On the continent, this is further aggravated by the even larger control that universal banks exert on the system.

European integration and the abovementioned directives on European passports have brought some positive results in the Institutional Securities market. Increased competition has lowered the costs for securities transactions by Institutional Investors. Further steps should be taken, such as measures about the tax treatment of securities and evidently the independence of advice. Securities lending is an area where institutional investors and asset managers are taking risks that are often unreported and accepting remunerations that are often opaque, skewed in favour of asset managers and against the best interest of end investors. Some regulation at European level has been attempted, but with little success so far.

To sum up, progress is needed at European level in transaction banking. First and foremost, a European saver should not be discouraged from investing in another European country, double taxation should be deleted. Second, MiFID-type regulation should be strengthened (and better applied), brokerage services should be made independent from fund managers (thus banks should decide whether they want to be brokers or fund managers) and their costs made more transparent. Globally, a separation of brokerage services from commercial/universal banking would be useful for the promotion of capital market activities in the eurozone.

Market infrastructures have been improved for some, and remain challenging for many others. Historical stock markets have merged in Europe during the last decennia, and their concentration is probably not a real issue since alternative exchanges have appeared after the MiFID directives and legislation, but these new exchanges can lack transparency.

The custody of securities has been rationalised in Europe, and the clearing and settlement of securities transactions as well.

For capital market activities at large, many problems exist in Europe. These are not so much linked to European specificities but to the worldwide problems of the lack of price transparency and market abuse, mostly because the activities in many critical areas are dominated by a few large investment banks or universal banks with unresolved conflicts of interest and dominant market positions, as will be discussed below.

4. Investment Banking: quite integrated, but for the benefit of clients?

First of all, the investment banking activities described in this section refer to investment banking *sensu stricto*, also called corporate finance, meaning the activities most specific to investment banking as it was defined in the 1930s in the US, namely advice on and underwriting of security issues, Initial Public Offerings (IPOs) and securities (shares and bonds) issuance in general, as well as advice on Mergers & Acquisitions and long-term financing in general. Today, investment banking also includes the activities that can be called risk-taking or trading', and consists of various kinds of arbitrage, warehousing, market making and speculating on securities and financial instruments in general.

Corporate finance services in Europe for sovereign clients (governments issuing marketable debt) and for large corporate clients (issuing bonds or shares, or engaging in Mergers & Acquisitions) are offered on quite an integrated basis, mostly out of London. It is quite concentrated and there is probably little need for further European integration in this activity, since it does not seem it would increase operational efficiency.

However, there are important problems arising from the cohabitation of this activity with trading, transaction banking and commercial banking.

For banks with a large investment banking activity (the big New York banks and some others), size seems to bring an advantage but rather in the form of a capacity to dominate markets and an impunity concerning dubious market practices, but not so much an advantage of efficiency. Superior profitability of large Investment Banks can be seen when profitability is measured before bonuses, which is a major justification for these bonuses. This in itself creates problems not only within the banking sphere – bonuses encourage risky behaviour that is often detrimental to the stability of capital markets and banks – but in the economy at large, since the mercenary attitude induced by bonuses has contaminated other sectors and since the ultimate costs of exaggerated risks are borne by taxpayers.

The marriage of investment banking (including trading) and transaction banking has been an important development of the 1980s. Until then, investment banking remained specific to corporate finance, and the distribution of securities and their trading in the secondary markets remained the domain of brokers, whose main franchise was the investors they were advising and dealing with. There has always been a risk of creating conflicts of interest by mixing investment banking *sensu stricto* (corporate finance, thus advising corporations) with brokerage (the advice to investors). Allowing these banks to trade for their own account made matters worse; when banks have their own interests to capitalise on in transactions with clients they can hardly still be called intermediaries, even less advisors.

To alleviate the concerns of clients and regulators, banks then promised to put internal separation – 'Chinese Walls' – into place but most of it remained quite formal and ineffective. Large investment banks are indeed using the synergies brought about by this cohabitation to various effects, amongst others to gain the loyalty of large investors, who appreciate privileged access to primary market transactions and to useful information.

Large investment banks have had a real influence, though never readily admitted, on those investment advisers named rating agencies on the one hand and share analysts on the other, further consolidating the placement power which large banks enjoy thanks to the loyalty of large fund managers.

Banks use this placement power to try and cartelise securities issues transactions and consolidate their market domination. By linking origination and distribution of financial products through in-house brokers, investment banks have created an integrate model in which 'placement power' and size bring a competitive advantage that is very profitable for banks – but of dubious interest for clients and markets – and which reduces the capacity of markets to discriminate between the quality of Financial Instruments.

The trading of derivatives is a problem in Europe as in other parts of the world, because it lacks transparency and competition and is not well-regulated. Moreover, it creates substantial counterparty risks and is for many banks, and their depositors, a major source of liquidity risk and solvency risk. The generalisation of Central Counterparties (CCPs) for all financial transactions and in particular for derivatives transactions would go a long way towards reducing those risks, making greater transparency possible. But this has to be done in a way that does not give the main banks (that already dominate the markets) control over these CCPs, but reduces the systemic risk via simple rules and high capitalisation. Most banks have been hostile to such changes, although some large banks seem now to be supporting it.

5. Conclusions: a view on the European integration of banks

Thus European banking should be better integrated in some areas, but in many others the aim should be to make banks safer for their depositors, and the whole system should be made more conducive to the financing of the economy, more favourable to capital market financing and more cost-efficient in asset management.

We need better regulation that is less sensitive to the protecting of national champions and more concerned with the safety and efficiency of the system. Regulation and supervision at European level might be more successful than the national regulators have been so far.

The universal banking model survives today thanks to massive subsidies in the form of guarantees on deposits with little or no counterpart. Ideally, rules should impose the separation of commercial banking from investment banking so as to help isolate deposits from excessive risk-taking. If that is not possible, this system should be fed fewer subsidies through a number of simple rules. First, an end should be put to the quasi-subordination of depositors. Depositors should be treated by banks as senior creditors at the highest level, enjoying negative pledge and *pari passu*, and banks that give more than 5% of their assets in collateral should give depositors their best assets in collateral. It would then be much easier to achieve a deposit guarantee and resolution mechanism based on national Deposit Insurance Companies, under the umbrella of a European one that only intervenes if the national DICs have correctly applied the rules (for instance, checking the quality of the assets in the collateral). The cost of insuring deposits should be defined in function of the risk specific to each bank, and charged by the DIC. Moreover, for deposit-taking banks that have trading activities, the capital requirements should be much higher than they are today. The risks associated with Trading activities are largely underestimated when it comes to regulatory and capital adequacy, because the models that calculate risks in those activities are inappropriate and the top management and boards of many banks (particularly the large commercial/universal banks) often do not adequately control those activities.

Investment banking in Europe, but also in general, suffers from some major flaws. The challenge is to make it more open to transparency and competition, thus more receptive to what Adam Smith described as the major characteristics of well-functioning markets. It is ironic that various changes in banking and in capital markets overall, of which many have destabilising effects on the financial system and do not really serve the client's interests, have been promoted by banks and accepted by regulators and politicians for the sake of 'liquidity'. These market innovations were meant to provide us with a superior level of liquidity, but when a major financial problem appears – like in 1998 in New York, or in 2007-2008 worldwide – liquidity disappears from the markets and only Central Banks are there to provide it. Another great economist, John Maynard Keynes, did explain (in Chapter 12 of his

'General Theory'), that there is no such thing as liquidity for society as a whole, and that liquidity is an illusionary, even dangerous, objective to follow. But that was in the 1930s, and we are much wiser today.

A welcome consequence of a separation between investment banking and commercial/universal banking would be that the regulation of investment banking could be made much simpler. Investment banks should be regulated on their market practices but their risk management should largely be their own concern, as long as they are obliged to transact through CCPs and they are prevented from lending clients' securities. The prudential regulation of banks (which is extremely difficult) would be much less necessary because the bankruptcy of investment banks should then be much less of a problem: they would not have retail depositors and the side effects that were so substantial in the Lehman case, namely the counterparty risks and disappearance of securities in long chains of lending and relending, could be better controlled and prevented.

Separating investment banking from Brokerage would also be very beneficial for the markets and for clients. It has been attempted in the US after the many scandals that had led to the internet bubble in the early 2000s, but the banking lobby was able to resist the separation projects. A first step, at least, would be to set a rule preventing conflicts of interest of professional investors and asset managers and making them more responsible through increased transparency in the remuneration of the advice they are taking.

It is not an increase in the integration of banks, but better and more integrated regulation that will give us safer and more functional Commercial Banks in Europe. It should leave aside the political and chauvinistic concerns that have too often got in the way of defining correct objectives for banking regulation, and it must resist the permanent call from unrepentant bankers and some politicians for ever-more public guarantees and transfers that may be called 'solidarity', but are in fact little more than increasing subsidies to unreformed, oversized and badly-regulated banks.

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The ECB Dilemma: Financial Stability or Independence?
Past, Present and Future Challenges

Cinzia Alcidi[18] and Alessandro Giovannini[19]

From the mid-1980s on, inflation targeting emerged as the golden rule of monetary policy and this tool has delivered successfully in the ensuing years. The ECB's design, modelled on that of the Bundesbank, replicates this view without making of the ECB a formal inflation-targeting bank. First the 2007 crisis, and then the euro area crisis have raised fundamental questions about its original structure. This paper retraces how the ECB has devised its monetary policies since 2007 in order to respond to the risks posed by financial instability. The authors argue that in the past the ECB response was a result, not only of the specific economic conditions of the euro area, but also of the unique institutional characteristics of the Monetary Union and its governance. In order to understand how the role of ECB will evolve, one should take into account the risks emerging from challenges related to poor economic performance and falling inflation, as well as to little change to euro area fiscal governance, which may undermine the bank's independence and credibility.

1. Introduction

August 2007, when the first cracks in the US sub-prime market started to appear, marked the end of the so-called Great Moderation and the beginning of a challenging era for central banks across the world.

Before then, the inflation-targeting framework was considered as the golden standard of monetary policy. Such a paradigm emerged as the result of the post-high inflationary 1970s and the poor economic performance that characterised that decade, as well as a new consensus emerging among academics. Low and stable inflation was recognised as a prerequisite for growth, and a tool to keep inflation under control had to be found in the central bank's commitment to a quantitative monetary objective. Moreover, theory suggested that because inflation expectations are crucial in determining actual and future inflation, anchoring expectations around a fixed target is of central importance, and for this reason the credibility of the central bank is key. This emerging consensus was strongly influenced by empirical analysis of the relationship between central bank independence and macroeconomic performance. Among advanced economies, central bank independence was found to be negative correlated with average inflation.[20] Based on this, the 1990s saw many countries adopting reforms that increased central bank independence.

It is on these principles that the European Central Bank was established and its mandate was defined. Even if the ECB cannot be formally defined as an inflation 'targeter' (its original design was largely

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[20] See among others, Alesina & Summers (1993) and Svensson (2007).

modelled on the Bundesbank paradigm), it adhered to the main pillars of the inflation targeting framework: price stability defines the ECB's objective and its political independence is considered conducive to maintaining price stability.

The financial crisis created an enormous challenge to this consensus[21] on central banking and has proved that price stability can neither be considered in isolation nor as the mother of financial stability.[22]

It also showed the limits of standard monetary policy tools in times of crisis, when the interest rate hits the zero lower bound. Unconventional monetary policy tools do not represent a direct threat to inflation targeting *per se* but require a shift of strategy, as occurred in many countries. An increasing number of central banks (including the ECB) have expanded their monetary policy toolkit to ensure adequate response to the crisis and to assure financial stability in their economies.

The following sections will retrace the actions of the ECB since the onset of the crisis, showing how the changes imposed by the latter have profoundly altered the conduct of monetary policy and have posed serious and far-reaching questions about the essence of Central Banks' role in modern economies.

There is no doubt that narrow inflation targeting failed to deliver financial stability, but this implies that financial stability needs to become an explicit policy objective. As "monetary policy and financial stability policy are intrinsically linked, given the powerful interactions between financial and economic conditions",[23] central banks are called to pursue both objectives simultaneously. While this makes perfect sense, it also poses considerable challenges.

On the one hand, what instruments are assigned to each objective should be specified, on the other hand, it should be assessed in advance whether financial stability and price stability are potentially conflicting and how the decision-making process adopted for the resolution of such a trade-off influences the independence of the central bank.

It is not by chance that a big debate emerged after the 2008 crisis about the correct design of a new central bank financial stability role without undermining political independence. A BIS study analysing the final output of this design activity finds that no new arrangement overturns the respective central bank's independent authority over monetary policy, or makes monetary policy objectives subservient to financial stability ones.

Reassuring results may be deceptive, however. The concept of 'financial stability' is a tricky one. The ECB provides a definition[24] of it, but in practice there is no easy indicator to target, as in the case of

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[21] For an overview of how the crisis has affected the inflation targeting framework see Reichlin and Baldwin (2013).

[22] The position that maintaining price stability through interest rate setting or money supply control is an appropriate and sufficient mandate for conducting monetary policy rests on two key underlying assumptions: price stability leads to financial stability (if supported by financial regulation and supervision) and that the framework of monetary policy can deal with cross-border capital flows.

[23] Peter Praet in "The (changing) role of central banks in financial stability policies", 14th Annual Internal Banking Conference, Chicago, 10 November 2011.

[24] The ECB defines financial stability as "the condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair

inflation. This implies that a 'judgement' (as opposed to a number-based rule) is unavoidable when deciding for interventions aiming at the reduction or prevention of financial instability. Moreover such interventions usually require asset purchases, which make the distinction between monetary and fiscal policy blurred and put independence at risk.

Moreover, in times of protracted recession and high debt, combined with an increased risk of deflation (i.e. the current one) the temptation to resort to central banks' facilities becomes irresistible. In the name of economic growth, the recourse to the printing press may be seen as the only solution to overcome the short-term impasse. The fundamental problem is the long-term cost associated with it: inflation is a tax on the purchasing power and the loss of independence implies a profound effect on the design of a political institution.

Like other central banks in advanced economies, the ECB faced huge dilemmas in finding a way out of the crisis. But in contrast to other central banks, the ECB had major constraints deriving from the complex governance of the monetary union and from the existence of diverging financial and economic conditions within the union.

Against this background, the purpose of this paper is to look at the past behaviour of the ECB, the current framework of its activity and its future challenges. In this perspective, section 2 presents a short overview of the pre-crisis period, and shows how the latter has profoundly altered the standard monetary policy approach, not only in the euro area. Section 3 assesses the ECB's response to the sovereign debt crisis, while section 4 attempts an evaluation of its implications for political independence. The picture that emerges suggests that the challenges that the ECB has already faced and will face in the coming years are different and particularly serious, not only as a result of the underlying economic factors in the euro area, but also as a result of the peculiarity of the economic and political governance of the euro area. Section 5 identifies future challenges for the ECB, by focusing on two aspects: the governance framework related to the Banking Union and the risk coming from the real economy. Section 6 concludes.

2. The illusion of 'great moderation' and the rude awakening of the financial crisis

When the ECB was set up its primary objective was identified as price stability, defined as the medium-term inflation rate not exceeding, but close to 2%. As shown in Figure 1, the target was fully achieved between 1999 and 2008, and then with the onset of the crisis a large swing followed but over the longer term the actual inflation rate has remained in line with the objective. Several factors can explain such a good performance, not only by the ECB but in general by all advanced economies during the later years of the so-called 'great moderation': central bank independence, economic stabilisation and a measure of good luck.

Until 2007, the role of financial stability in the euro area was confined to ensuring the smooth functioning of the euro area internal payments system.[25] The TARGET system was specifically

the allocation of savings to profitable investment opportunities" (see http://www.ecb.europa.eu/pub/fsr/html/index.en.html).

[25] See, among others, Garry J. Schinasi (2003), "Responsibility of Central Banks for Stability in Financial Markets", IMF Working Paper No. 03/121.

established for this reason, and its correct operation before 2007 fostered the rapid integration of the euro area money market, assuring the stability of the system and the good functioning of monetary policy transmission mechanisms.

Figure 1. HICP[26] and inflation target

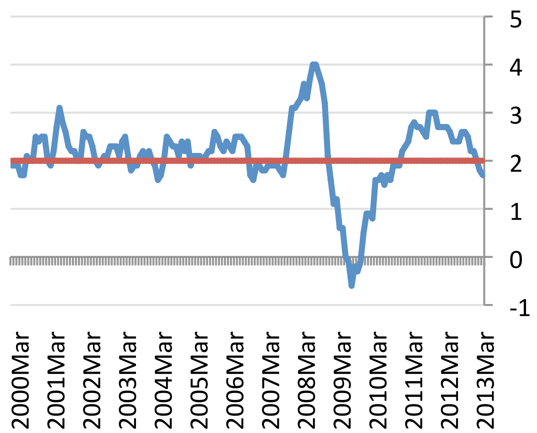
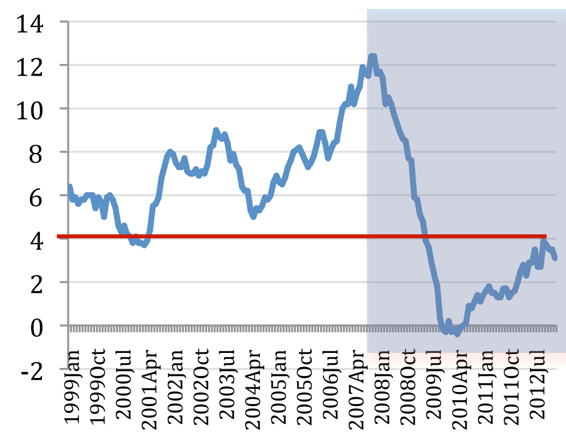


Figure 2. ECB money supply (M3) growth rate (annual basis)



Source: ECB statistical Data warehouse.

One aspect that tends to remain obscure when assessing ECB performance is that the ECB has another reference rate (other than the inflation rate) in its monetary policy setting: according to its 'monetary pillar',[27] money supply (M3) growth should not exceed the reference rate of 4.5% per annum. The rationale for this was that such a rate is consistent with the definition of price stability[28] and deviations from such a rate should lead to inflationary or deflationary pressures in the medium-long term. As shown in Figure 2, the ECB has missed its M3 benchmark since its inception and just before the crisis it was running at around 12%. It then started to decline and fell into negative territory for the first time since the creation of the euro, in 2009. As it emerged from the comparison of figures 1 and 2, the systematic deviation of M3 from the benchmark did not result in inflationary pressures in CPI inflation. What was overlooked was the emergence of inflation in prices other than goods, mostly houses and other assets across the Union, and the huge increase of leverage inside the euro area banking sector (see Alcidi, Gros & Giovannini, 2011).

2.1 The first response to the crisis: a country comparison[29]

When the global financial crisis started in late August 2007, the large Western central banks (the European Central Bank, the Federal Reserve and the Bank of England) responded promptly by cutting interest rates down close to zero and adopted a large raft of unconventional policy measures. On both sides of the Atlantic, these included the extension of the scope of existing facilities, most notably the

[26] Harmonised Index of Consumer Prices.
[27] The other pillar is the economic one and refers to price developments.
[28] This is true under the assumption that the long-run economy growth rate is at around 2% and velocity of money declines every year by about 0.5% (see, among others, De Grauwe, 2008).
[29] For a more detailed analysis of the comparison, see Alcidi et al. (2012).

duration of the usual refinancing operations and lowering the standards for eligibility of collateral applied to banks. But central banks also engineered new mechanisms. For instance, the Bank of England (BoE) swapped high-quality illiquid assets from banks in return for Treasuries. The Federal Reserve (FED) broadened the set of counterparties for liquidity operations but also opened a series of swap facilities to allow other central banks to provide banks locally with dollars as the USD is widely used in inter-bank transactions outside the US.

Despite the scale of the response, the financial crisis intensified in autumn 2008, following the collapse of Lehman Brothers. The most harmful consequence of this event was the loss of confidence in the interbank system. Faced with the reluctance of banks to lend to each other, the primary objective of monetary authorities became to unblock the interbank markets by substantially easing access of the financial system to official liquidity. In order to achieve this objective, central banks intervened more directly to improve credit conditions in particular markets segments. Those measures included further expanding the availability of credit to financial institutions, further reduction in main interest rates and asset purchases financed by central bank money; the so-called 'quantitative easing' (QE). While the Bank of England privileged the purchase of medium- and long-term government bonds (GBP 200 billion of gilts between March 2009 and January 2010), the Federal Reserve purchased commercial papers, asset-backed securities and other private assets containing credit risk, for about USD 1000 billion during the year 2009. At this stage of the crisis, the FED was thus taking on credit risk (for instance through the so-called TALF, the Term Asset-Backed Securities Loan Facility)[30] only later the emphasis shifted to sustaining the economy via lower interest rates.

The ECB also adopted a similar policy response in an attempt to reassure financial markets and re-establish a stable financial system. The main instrument, however, was not the direct purchase of assets in open market operations. Compared to the over one-thousand billions of USD of asset purchases by the FED, the ECB's Covered Bond Purchase Programme (CBPP, which started in July 2009) of EUR 60 billion was paltry. Instead the ECB put in place a series of other equally unconventional measures for about EUR 300 billion focusing on expanding the provision of credit to banks in the framework of the so-called 'enhanced credit support programme', in order to assure the good functioning of the credit mechanism in the euro area:

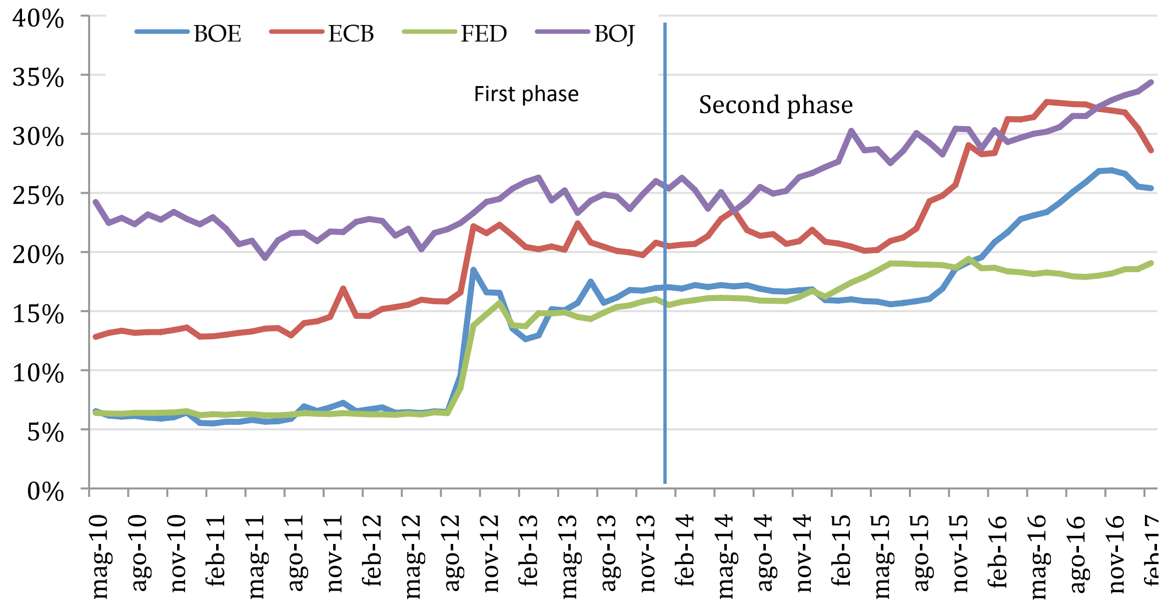
- switching from a variable rate tender to a fixed-rate full allotment tender procedure in all refinancing operations;
- extensions of the list of assets accepted as eligible collateral for refinancing operations to further ease access to Eurosystem operations in an attempt to reduce asset-side constraints on banks' balance sheets;
- setting up of additional longer-term refinancing operations for financial institutions with a maturity of up to six months;
- providing liquidity in foreign currency from time to time, through the swap line provided by the FED.

The common effect of these operations was an unprecedented expansion of central banks' balance sheets: Figure 3 shows that the increase has been particularly important in the UK, where it reached 300% between May 2006 and May 2012. In relative terms, the increase in the ECB balance sheet

[30] "The TALF is intended to assist financial markets in accommodating the credit needs of consumers and businesses by facilitating the issuance of asset-backed securities collateralised by a variety of consumer and business loans. The loans provided through the TALF to eligible borrowers are non-recourse, meaning that the obligation of the borrower can be discharged by surrendering the collateral to the FRBNY" (http://www.federalreserve.gov/releases/h41/current/h41.htm#h41tab1).

looks small at ‘only’ 170% over the same period, while the Fed expansion has been of the order of 230%.

Figure 3. Total Assets & Liabilities as % of GDP



Source: Authors’ elaboration on central banks’ data.

3. The ECB’s responses to the euro area crisis: independence under threat?

Until 2007, financial stability was considered neither an explicit component of the mandate nor a concrete challenge for the ECB. The ECB’s political independence was assured, not only by the strong institutional design of the Treaty on the Functioning of the European Union (TFEU), but also by a complete practical isolation from non-monetary issues of the euro area.

The global financial crisis, and even more the euro area sovereign crisis, however, changed everything and for the first time certain decisions to avert the worst-case scenario clearly undermined the granitic block of the bank’s ‘political independence’.

When national cornerstone sovereign bond markets tumbled with cascade effect on the entire financial sector, the ECB was forced to switch its focus from price stability to financial stability, adopting policies that were increasingly audacious and even unthinkable a few years earlier. While this was accepted as necessary by many, several commentators underlined the conflict they entailed with the statutory obligations of the ECB.

This section critically analyses the ECB’s activity over recent years in order to assess how the task of assuring financial stability has challenged its independence: first, by comparing its policies since 2010 to that of other major central banks, then by applying a game theory approach to describe the behaviour of ECB and fiscal authorities during the same period to see if the final output is consistent, or not, with sound political autonomy.

3.1 Monetary stimulus versus crisis management

The second stage of the crisis, which started in 2010, is unique to the euro area. The degree of financial stress and risk perception in the financial markets was not the same across the two sides of the Atlantic.

In the US, the main concern was about the economic cycle. As the economy was not growing robustly and labour market not recovering, a more intense stimulus through monetary policy was considered necessary. Since interest rates were already at the lower bound, an unconventional and powerful instrument had to be found and quantitative easing (QE) seemed to be fitting for the job. In August 2010, the US Federal Reserve Bank decided to implement further[31] asset purchases through open market operations, buying USD 30 billion of short-term Treasury Notes between August and September. In November 2010, a second wave of 'quantitative easing' was announced leading the amount of Treasuries in its balance sheet to USD 1.6 trillion. A third programme started on 13 September 2012, when the Fed announced the purchase of around USD 40 billion, each month, of agency mortgage-backed securities without a definite end. On 12 December 2012, given the persistent weakness of economic conditions, the Federal Open Market Committee (FOMC) claimed it would increase the amount of open-ended purchases from $40 billion to $85 billion per month (this measure is still in place at the time of writing). As Bernanke puts it, the last two programmes are not pure quantitative easing, but rather 'credit easing' as the approach focuses on private sector assets and the action aims at affecting credit conditions rather than interest rates.

On the other side of the Atlantic, the situation was completely different. In the spring of 2010 the euro area became the epicentre of the worst crisis since World War II. Accordingly, the ECB's response shifted to another level and the financial stability of the monetary union became the major concern of the ECB. The Greek crisis marked the beginning of a set of new policy tools used by the Bank to address severe tensions in the European financial markets: i) the Securities Markets Programme (SMP), based on the purchase of country-specific sovereign bonds in the secondary market; ii) the decision to change the eligibility of debt instruments issued or guaranteed by the governments of the most troubled countries, in order to accept them as collateral in monetary policy operations; iii) two Long-Term Refinancing Operations (LTROs) through which the ECB lent money for about 1 trillion euro at a very low interest rate and with longer maturity to euro area banks; iv) the Outright Monetary Transactions (OMT) programme, under which the ECB has committed to intervene in member states' sovereign bond markets under financial stress against the respect of the conditionality attached to an European stability (ESM) programme.

The result of all these combined measures is that, relative to GDP, the ECB balance sheet is now larger than that of the FED (see again Figure 3, above). Besides the size effect, such measures have had a significant impact on the average quality of the assets held. The Federal Reserve has focused its action on the purchase of almost exclusively risk-free assets, either US government bonds or securities issued by government-sponsored enterprises, which carry the same guarantee (and hence risk) of a government bond.

On the contrary, since 2010 the ECB has bought (much smaller quantities of) risky assets for which the market was drying up, but has lent massive amounts to weak banks (those which could not obtain funding from the market). In short, while the FED action does not entail any additional credit risk, as a consequence of the ECB's interventions, not only the size of the balance sheet has increased but also

[31] Relative to the purchases started in 2007.

the average quality of the assets has changed – shifting towards riskier (both default and credit risk) private assets (mostly loans to banks)

The two different approaches reflect two different targets: while the objective of quantitative easing is to lower long-term interest rates (when short rates are already very low), the main objective of the ECB's action was to contain the negative effect of financial fragmentation within the euro area.

The credit risk the ECB is accepting is of course mitigated by the collateral required in the refinancing operations and the fact that the ECB's claims enjoy senior creditor status. But the ECB has also provided substantial lending, outside its main refinancing mechanism, to banks lacking collateral of adequate quality, through the emergency liquidity assistance (ELA). This lending is guaranteed by the central bank of the member country in question, the banks needing ELA are usually located in countries where the sovereign itself is under financial stress, thus weakening the real values of the guarantee.

This ECB activism has raised several concerns over time. The first is that a large increase in the balance sheet of the ECB might be a way of stoking future inflation. However, since the ECB has not provided much net lending to the euro area banking system but simply acted as central counterparty to a banking system that has *de facto* become segmented along national lines (by offering the deposits it receives from some banks to other banks in quest of funding for about the same amount), the danger of inflation seems minor. Indeed, the ECB is not creating any substantial new purchasing power for the banking system taken as a whole.

The real issue for the ECB is whether it is properly protected against the credit risk it is taking. The very small difference between deposit and lending rates (yielding €7.5 billion per annum) does not provide much protection against losses.[32]

In fact, the success or failure of the ECB interventions to restore financial stability depends on highly political issues in the hands of national governments and their willingness to implement certain policies, over which it has very little control. Against this background, the next section attempts to illustrate the dilemma faced by the ECB in the summer of 2012.

3.2 Is the financial stability target compatible with central bank independence?

In recent years, many have tried to push the ECB into playing a more active role in assuring financial stability in the euro area, including the acceptance of the function of lender of last resort, both for banks and governments. Such a role, typical of central banks, is crucial in times of high financial instability, but the ECB was never assigned it explicitly. It was considered that, since being a lender of last resort essentially entails assets purchase, it could undermine its independence.

When the global financial crisis erupted the ECB did not hesitate to act resolutely as lender of last resort to banks, but when the problems moved to governments, it remained very reluctant to undertake comparable action.

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[32] In the case of Greece, the ECB was protected against losses on its own holdings of Greek Government Bonds by its senior creditor status and the fact that the repayment was directly financed by the ESM, and indirectly by other, private bond holders whose losses were higher than they would have been if the ECB had also taken a haircut.

The amount of government bonds bought under the SMP was meagre relative to the interventions of other central banks as well as to the scale of unconventional liquidity provided by the ECB to the banks. The announcement of the OMT has been perceived as a shift in the ECB position towards a more active role vis-à-vis the government bonds, but the conditionality of the intervention clearly represents a serious limitation relative to the usual role of lender of last resort to governments.

While the previous sections have highlighted the economic reasons that led the ECB to act in a different manner from the other Western central banks, this section aims at shedding light on if and how the ECB approach has been shaped by the priority to defend its political independence.

In this perspective, what follows takes a closer look at the conditions in place at the time the ECB announced the OMT programme and focuses on the dilemma posed by pursuing the financial stability target at the same time as defending full independence.

The narrative around the launch of the SMP in 2010 suggests that the programme never enjoyed full support within the ECB Council; the action was non-transparent, discontinuous and limited in size and hence was perceived as unconvinced and unconvincing. By contrast, the announcement of the OMT in August 2012 and the pursuit of the 'whatever it takes' policy have been seen as a new ECB step towards a more decisive role in assuring financial stability. This was the case, although the OMT is a very different programme from the policies pursued by the BoE, the FED or the Bank of Japan. Indeed the OMT is a tool designed only for financially-assisted member states and therefore fundamentally has a limited scope. What are the reasons that have led to this approach?

A first reason, often discussed, is the fear of inflation that is fed by the monetary financing of government debt in profligate member states. The commitment of the ECB to full sterilisation of the purchases is definitely motivated by the will to reject such a contention.

A second reason relates to the following: when the BoE or the FED conducts QE, they typically acquire bonds issued by their own treasuries, which presumably have no credit risk attached, or they buy other assets where the treasuries underwrite possible future losses. That is not the case when the ECB buys Italian, Spanish or other bonds issued by sovereigns under pressure.

A third reason is that the SMP had to be launched in response to severe conditions in financial markets and the inaction of the member states in the fiscal policy and reform areas. In other words, it was forced by major events rather than driven by a policy choice.

From this perspective, the ECB had the difficult task of striking the right balance between the potential power to print money and its narrow legal mandate to maintain price stability; between the interests of creditor and debtor countries; and between maintaining market pressure on countries to reform and preventing them from being pushed into insolvency.

In order to get a better understanding of these dilemmas, a simple game theory exercise could help to illustrating the ECB choice.

1.3 The ECB dilemma behind the OMT: A game theory approach

Since the euro area crisis started, two broad policy options have been considered, according to opposing points of view, as key to resolving the crisis at large (not only temporary quick fixes): a massive intervention of the ECB in the sovereign bonds markets, comparable to the FED action, and a significant step towards a real fiscal union at euro area level, implying both a Banking Union and a common fiscal budget. Put rather simplistically, the first move is in the hands of the ECB while the other is in the hands of national fiscal authorities.

This section aims at illustrating the behaviour of the ECB and national fiscal authorities in defining their strategic approach to the crisis response.

The following game describes the euro area situation, assuming that there are two players, the ECB and the fiscal authorities of member states (MS), each of them can choose from among two alternative strategies, one of which is always associated with a large political cost while the other is neutral:

- National fiscal authorities (MS) can choose between moving towards a fiscal union or keeping the status quo;
- The ECB can choose between either a massive intervention in debt markets (obviating the need for fiscal union at least in the short term) or no intervention.

For MS, moving towards a fiscal union implies a loss of sovereignty and hence a high political cost (-2) while for the ECB, the cost kicks in if it decides to intervene massively in the sovereign bond markets as it would risk political independence (-2).

It is also assumed that both MS and the ECB are collectively better off if they continue to support the existence of the euro. The problem, however, is that the fiscal authorities are better off if the ECB intervenes, obviating the need for fiscal union; likewise the ECB is better off if governments agree to a real fiscal union, thus obviating the risk of losing political independence.

Assuming that the two players move simultaneously – like in a simple prisoner dilemma –, the game does not deliver any equilibrium: there is no outcome that is strategically superior for both players at the same time (see Table 1).

Table 1. A simple coordination game

		ECB	
		Massive intervention	No intervention
MS	Fiscal Union	0 ; 0	-2 ; 2
	Status quo	2; -2	-3 ; -3

However, if the objective of this exercise is to illustrate the dilemma faced by the ECB over its independence before the announcement of the OMT, a sequential game is more suitable. A key characteristic of a sequential, two-stage game is that the first mover enjoys a sizeable advantage over the other player.

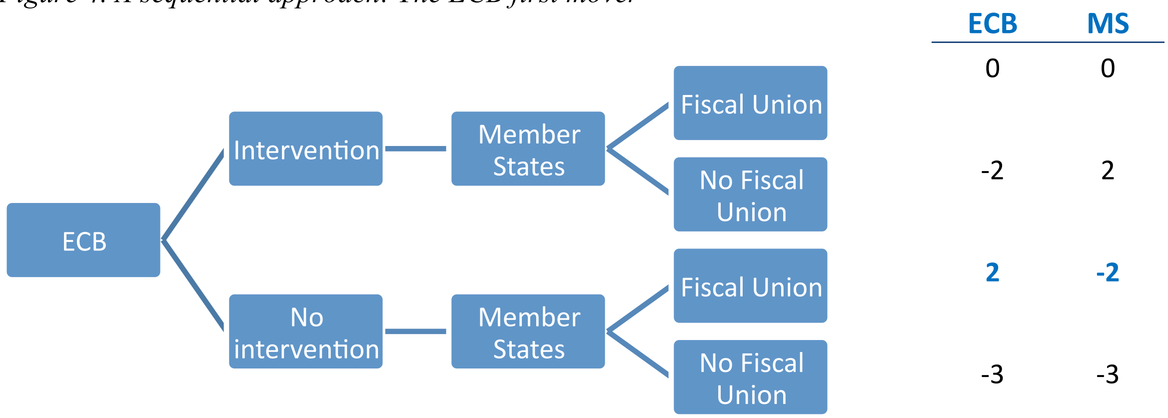
In this specific context, the ECB acting as the first player is equivalent to being independent. The interaction between fiscal and monetary actors in the EMU, and its nature, has been widely analysed in the economic literature. The main, general findings suggest that conflicts among the two arise because policymakers are primarily interested in solving the policy issues of their own branch, potentially damaging the commitment of the other actor to pursue its own targets. [33]

[33] Existing game theory literature underlines how in order to keep its credibility, independence and obtain the best results in terms of economic performance, the ECB should not decide its policies according to what fiscal

Against this background, in what follows we will highlight the different outcomes associated with the alternative hypothesis that either the ECB or the MS is a first mover, respectively.

As illustrated in Figure 4, if the ECB plays first, it will choose not to intervene, forcing the MS to be proactive and move towards a fiscal union.

Figure 4. A sequential approach: The ECB first mover



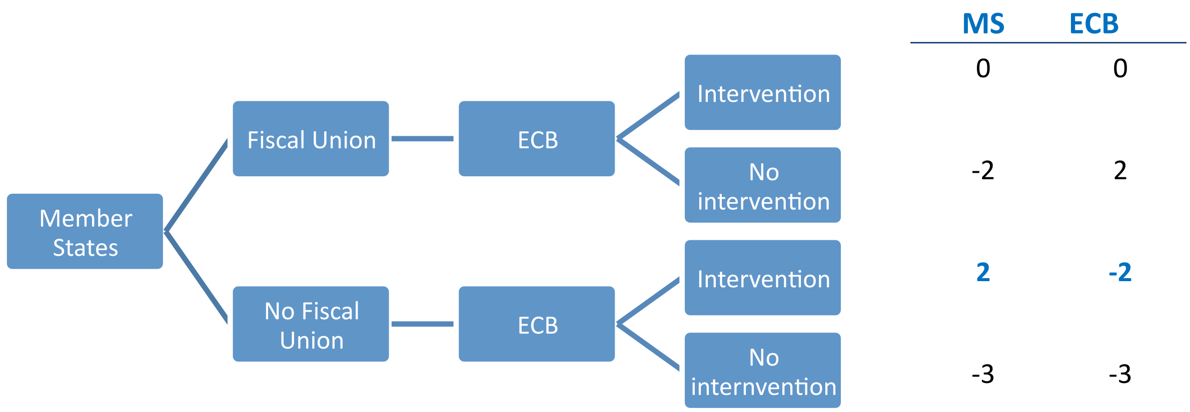
By contrast, as illustrated in Figure 5, if MS move first, the EBC will have to adapt its choice to the strategy imposed by the fiscal authorities and in order to avert the collapse of the EMU will have to intervene massively in the bond market.

The outcome of the two games seems to suggest that the launch of the SMP could have worked as disincentive for the MS to commit to any concrete progress on fiscal union and that the ECB was forced to react in response to the (in)action of the member states. From the point of view of the ECB, this outcome is clearly sub-optimal.

This exercise shows how pursuing the financial stability objective could pose a huge challenge to the ECB and a well-designed policy strategy is required. If one considers the conditionality attached to the bond purchase, as foreseen in the OMT, it becomes clear that the intention of the ECB has been to change the structure of the game and with it its outcome and move towards what would be a cooperative solution in the simple prisoner dilemma, whereby both players follow a proactive strategy.

authorities do and in general it is always better off if it acts as Stackelberg leader (Gatti & van Wijnbergen, 2002). Also when this is desirable from an economic point of view, this coordination could not be optimal, as the Central Banks would potentially be reluctant to engage in co-ordination due to the 'suspicion' about the real objectives of fiscal authorities (Balboni et al., 2007).

Figure 5. A sequential approach: MS as the first mover



4. Challenges ahead for the ECB

While the first ten years of the euro went rather smoothly and the ECB had quite an easy task to perform, the eruption of the financial crisis first and the euro area sovereign debt crisis afterwards, produced a much more complex context in which the monetary policy exercise had to be put in place. In fact, not only was monetary policy in question but financial stability took priority in the Bank's agenda as a necessary response to the European banking sector's dramatic fragility. This pushed the ECB into unchartered waters.

One of the most important responses to the crisis has been the decision to move towards a European Banking Union. A full Banking Union requires three components: a supervisory authority, a deposit insurance scheme and a resolution mechanism. Only the first step has been agreed upon for the moment and the ECB has been recognised as the European actor to play the role of supervisor. This decision has raised many concerns, including the risk of a possible trade-off between monetary policy and surveillance objectives and doubts about the practical feasibility. This is already proving to be a challenging task for the ECB.

Another serious challenge for the ECB may come from the real economy. Until now, one of the main problems in the monetary policy setting is related to the existence of a two-speed Europe and the divergence in terms of macro fundamentals, and economic performance in general, between the core and the periphery. The ECB has striven to find the right policy approach that could fit all, with the core region performing quite well (Germany, in particular) and the periphery in deep recession. While a process of convergence is finally taking place, the gap in growth rates is now shrinking. Yet, this is not because the periphery is catching up with the core, indeed recovery is not taking place, but because the core is slowing down. This poses a serious risk: the entire euro area may enter into a difficult phase of economic stagnation or even long recession raising difficult challenges for the ECB. The question for the future will be: is the future of the euro area economy turning into a Japan-style scenario?

Both challenges will be addressed in the following two sections, respectively.

4.1 Monetary policy and banking supervision under one roof: operational challenges[34]

The June 2012 European Council decided that the legal basis for the European 'Single Supervisory Mechanism' should be Article 127(6) of the Treaty, and that the SSM should 'involve' the ECB. This implies only that supervision should be concentrated within the ECB. In the policy discussion it is generally taken for granted that there should be 'Chinese walls' between the supervisory and monetary policy arms of the ECB and the current legislative proposal is explicit on this account.

Supervision and monetary policy are completely different functions in many respects, e.g. the nature of the decisions that are taken, the background information needed, their implementation, the qualifications of the necessary staff, etc.

Monetary policy, at least in normal times, required only relatively infrequent decisions about one variable, namely the interest rate that the ECB sets on its main refinancing operations. This decision is then implemented uniformly throughout the system by the National Central Banks (NCBs), which all essentially change one element in their computer code. The NCBs thus have no discretion as to how to implement monetary policy decisions. Moreover, central banks change their interest rates with monthly frequency, at most. Monetary policy can thus be decided by a body that does not need to manage 'hands on', but that meets only every second week and then basically has one big decision to take (whether or not to change rates).

The staff of the ECB naturally has a key role in preparing the material to take monetary policy decisions (inflation and general economic outlook), but it does not have to manage the actual implementation on a daily basis, which is left to the NCBs. The latter have no leeway in this matter in any event.

With the crisis, the nature of monetary policy has of course somewhat changed. For example, collateral requirements had to be adapted regularly and the use of new collateral has to be monitored. But even here there is little need to take frequent decisions on specific cases as the collateral rules are set in such a way (mainly ratings requirements) that the staff of the ECB only has to check the fulfilment of the formal requirements.

Supervision is totally different from monetary policy in these practical aspects. It is by nature an activity that requires hands-on management with a vast amount of detailed information to be collected. During normal times, when the financial system is stable, few decisions have to be taken as supervisors try not to interfere with the daily business of their banks. But during a crisis major decisions on individual banks have to be taken much more frequently. This requires more than broad rules and guidelines. Interpretation of the rules and the way they are applied then become crucial. It follows that the Supervisory Board (SB) will have little influence if it meets with the same frequency as the Governing Council (once every second week). Supervision can be said to be exercised by the ECB only if it is done directly by ECB personnel: very little will change if the SB simply elaborates general guidelines for national supervisors.

Finally, it is usually argued that supervision can have immediate fiscal implications. While also monetary policy can have fiscal effects, these are much more diffused and arise throughout the euro area as a by-product of standard monetary policy operations, whereas the fiscal implications of supervision are much more direct and concentrated in individual member states (e.g. the decision to close down a bank or the failure to detect excessive lending). By doing so, supervision affects a wide

[34] For a more detailed analysis of the issue, see Beck & Gros (2012).

variety of interests much more directly than monetary policy operations, whose impact is generally dispersed. This also raises the issue of whether the ECB has the necessary democratic accountability to take such decisions.

Overall, while the banking union project is a critical one for the future of the monetary union, the ECB will have to take the burden and the responsibility that this entails, trying to overcome at the same time the problem of lack of a democratic accountability and the risk of losing political independence.

4.2 The real economy challenge: what if the euro area turns into Japan?

The response to the crisis first and then the inability to completely put an end to the crisis is changing monetary policy across the world. Most notably, Japan is illustrating this mood. The Central Bank of Japan has engaged in a massive monetary policy shift that aims to achieve a 2% inflation target over the next two years through an aggressive mix of quantitative easing and long-term sovereign bonds.

While the idea that monetary policy can only deal with monetary issues, i.e. prices, and at best can have a temporary effect on the real economy, has broadly prevailed since the 1980s (since the end of the inflationary years in advanced economies), the prolonged crisis that is afflicting Europe and the inability of other advanced economies to generate healthy growth rates is putting monetary policy under pressure. As public finances are facing tight constraints across the world, monetary policy is again seen as a possible weapon.

This has been the case in Europe only to a marginal extent, while the argument has strong advocates in the US. Besides the institutional diversity, the reason behind this difference is that the economic recession has been uneven in the euro area and only the most affected countries have tried to push in this direction. The question is, what if the recession extends to the whole region? Will the ECB have to face additional challenges? Including taking bold actions to stimulate the economy of the entire region?

In this debate the most disturbing element is the list of similarities that the euro area of today shares with Japan of the 1990s, from the weak banking sector, growing sovereign debt and an ageing population. If signals that a Japan-style scenario could materialise, the ECB may be called to face another source of pressure, which could seriously put its independence at risk.

5. Concluding remarks

Since the onset of the financial crisis central banking has undergone a transformation. Due first to the crisis and then the prolonged recession in an environment where governments have little room for manoeuvre, central banks were pushed to face significant challenges. This has been the case particularly for the ECB, mostly because of the severity of the crisis within the euro area but also because of the institutional complexity that characterises the Monetary Union.

This paper retraces how the ECB has set up its monetary policies since 2007 in order to respond to the risks posed by financial instability. The authors argue that the ECB's past response has resulted not only from the specific economic conditions of the euro area, but also from the unique institutional characteristics of the Monetary Union and its governance.

Our game theory analysis suggests that since 2010 some of the measures aiming at restoring financial stability undertaken by the ECB have been forced, at least to some extent, by the incapacity of action of governments rather than being the result of policy choice. The reason for this is that such actions carry a risk for the political independence of the ECB.

In the design of the OMT, the inclusion of conditionality, while it cannot take the risk of loss of independence away, can be interpreted as the attempt to force member states towards an outcome that is more desirable for the ECB, as well as collectively.

When it comes to the future, in order to understand how the role of ECB will evolve, two main challenges could emerge: the poor economic performance and falling inflation in the EMU could be sources of pressure for a proactive role of the bank to sustain the economy, combined with little change in euro area fiscal governance, thus potentially undermining the bank's independence and credibility. Were the Banking Union, the supervisory power and other additional powers to be assigned to the ECB, it would become an overcharged central bank. Can a central bank keep its promise to maintain price stability, ensure financial stability (supervision plus lender of last resort for banks and governments), stimulate the economy and remain politically independent?

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