Research finding summaries

WP2 Banking Crisis and Financial Stability

Summary of the summary

The establishment of instruments outside the Treaty Framework & EU legitimacy.

- A blurring of the European legal order has consequences for the legitimacy of the entire euro governance structure. This is most clearly visible with the ESM.
- Member States have showed little willingness to open up the Pandora's Box that constitutes treaty change.

Out of the framework, and yet working

- ESM: compliance with the requirements of the conditionality programmes is high since each tranche of financial assistance is conditional upon results. The problem? ESM is overriding national democratic decision-making.
- Fiscal Compact: the results are mixed; in many instances it has been quite easy to break the rules without consequences.

Impact on the EU's economic framework

- For the moment, the economic governance framework in the EU functions relatively well; past weaknesses of the European Semester have been recognized and addressed.
- Flexibility is an important precondition for the framework's success.

Corporate tax avoidance and evasion while implementing a tax system for competitiveness

- The EU is a determined agent in reforming global tax governance. The policy environment for global tax governance mirrors Europe's own internal complexities.
- Combatting tax avoidance and the promotion of competitiveness are complementary rather than opposing goals.

The impact of decisions and programmes put in place to counter the crisis

- The direct consequences are limited; however, this new institutional framework ties member states further into European governance forms and cycles. The effect: a further Europeanization of member states policymaking.

The societal impact of the MIP

- The MIP is not very well known to citizens at large. The procedure is too technocratic to reach a wider audience. There is often a general sense that "Brussels" is focused on government budgets and structural reforms, but that is not mirrored in a more nuanced understanding of the actual functioning of the MIP.

Research finding summaries

The MIP: less coercive and effective than critics and champions say

- The MIP can put pressure on a Member State through monitoring and peer pressure, but in no way represents some type of imposition over national democratic decision-making.
- It is becoming a tool to organise consensus around reform priorities. It should do so primarily with the Member State itself.
- The MIP operates in domains where the EU has very limited “hard” competences.

The effect of the European Semester’s in-built bias towards fast-burning crises

- Addressing immediate fiscal imbalances through budget cuts can sow the seeds of future imbalances that are more structural in nature.
- In the early cycles of the European Semester Member States were often advised to safeguard public investment and increase education quality, but such calls were simply overridden by the recommendation to bring the budget back to sustainability.
- Ideas on excluding public investment from the rules of the SGP or officially safeguarding social institution have not yet been formally introduced.

Instability, policy-making and the crises

- The crisis proved that financial stability risks predominantly come from the *inside*.
- The global financial crisis has triggered a wide range of reforms to make the financial sector more resilient and able to fight systemic risks. One of the most important innovations are macro-prudential policies.

The expert networks at the core of the decisions made in pursuit of financial sustainability

- For the MIP: top officials from DG ECFIN have long wanted a macroeconomic counterpart to the SGP. They act and think in accordance with a small group of insider economists.
- The Council has come with its own assessment of necessary mechanisms at the start of the crisis (the Van Rompuy taskforce). While the German Wolfgang Schäuble has been cautious with the MIP, the French Christine Lagarde has been a big proponent.

The networks’ influence on European modes of governance

- For the MIP, not one network has driven the mode of governance, but several.
- There has been a relatively broad consensus in the institutions (ECB, Commission, Council and EP) that the MIP should have some bite.

The ideas behind the discourse that accompanied decision-making

- The evolution of the MIP has been a process of learning-by-doing.
- If we focus the European Commission, we see that the approach at the start, both in procedural and substantive terms, has had to be amended.
- Procedural changes have contributed to substantive changes in the discourse on reform priorities.

Research finding summaries

ECB fiscal policy ideas inspired self-defeating policies in crisis-stricken countries

- The Trichet ECB's reluctance pushed countries towards fiscal retrenchment across the board. In early 2010 the ECB did not steadfastly commit to repair the damaged collateral function of "peripheral" sovereign bonds. Just as downgrades chipped away at the collateral value of these bonds, the ECB withdrew extraordinary liquidity interventions. In these conditions, governments had to address the disruption of collateral markets for fear that bank runs would wreck their countries' banking systems and take the national economies down with them. European governments and the societies they governed had to pay the price of stabilizing collateral markets via austerity.

The ideational networks behind the rejection of IMF's policies

- Network analysis suggests that the IMF's dominant position (fiscal revisionism) came largely from within its own ranks and so did the ECB's dominant position (fiscal orthodoxy). In both institutions, the most important supplier of orthodox arguments was the Center for Economic Policy Research (CEPR). Outside experts cover a broad spectrum.
- Central banks produce conservative experts while think tanks don't.
- Economists whose professional profile includes stints in academia, government and the private sector are a positively conservative force in the fiscal policy debate.

Research finding summaries

7 Key concepts to understand the European banking crisis and the path to financial stability

European System of Financial Supervision (ESFS)

The development of the European System of Financial Supervision (ESFS) and Banking Union are arguably the most important institutional innovations in the EU's post-crisis financial governance framework. The ESFS essentially aimed at redressing two important shortcomings in the EU's pre-crisis framework, identified in the De Larosière report published in 2009. First, it lacked a supervisory authority that would monitor, warn of, and mitigate systemic risks building up in the financial system. The newly developed European Systemic Risk Board (ESRB) – formally part of the European Central Bank – contributes to this endeavour of macro-prudential supervision. Second, the EU's pre-crisis framework for individual financial institutions (micro-prudential supervision) was too fragmented along national lines: EU member states had much discretion in tailoring rules to national needs. EU officials feared this discretion often amounted to competitive deregulation, where EU rules were tweaked to give national champions a competitive edge over their foreign competitors. The EU thus set up three European supervisory authorities (ESAs) – the European Banking Authority (EBA); the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) – to contribute to the development and enforcement of harmonized micro-prudential rules. The ESRB and the ESAs together form the ESFS.

The Banking Union

While the ESFS strengthened the EU dimension of micro-prudential and macro-prudential financial regulation, the actual powers to supervise financial institutions and take corrective measures have by and large remained a national prerogative. The rapidly escalating Eurozone crisis buttressed the case for centralizing supervisory responsibilities for the EU banking system. It also showed that mechanisms to deal with failing banks were inadequate. The Banking Union was set up to address these deficiencies. The first pillar – the Single Supervisory Mechanism (SSM) – made the European Central Bank directly responsible for the day-to-day supervision of EU's largest, most significant banks. The supervision of smaller banks remains the responsibility of national competent authorities, although the ECB may at any moment take over direct supervision of any bank. The SSM also entrusts some macro-prudential powers to the ECB, although the main responsibility remains at the national authorities. The second pillar – the Single Resolution Mechanism – ensures the orderly resolution of failing banks. It gives the Single Resolution Board the power to restructure a failing bank or wind-down its activities. Also important in this respect is the Bank Recovery and Resolution Directive, which regulates the different stages and elements of a faltering bank's recovery and resolution process. A particularly salient if contentious element is the bail-in requirement, which holds

that any losses occurring should in principle be absorbed by shareholders and creditors rather than tax-payers.

The Economic Adjustment Programs

The Economic Adjustment Programmes are the programmes that lay out the conditionality attached to bailout packages. In other words, they constitute a series of country-specific targets and measures with the aim of bringing a country back to budgetary sustainability and access to capital markets after the country has sought financial assistance from the EU. The programmes have been introduced for Greece, Portugal, Cyprus and Ireland and in slightly different manner for Spain, Hungary, Latvia and Romania. The financial assistance packages are organised in tranches and the payment of each tranche is conditional upon progress made in the adjustment programme, this gives the programmes considerable weight, as there is clear punishment for insufficient implementation. The content of the programmes is negotiated between the Member States themselves and technocratic institutions (the Commission, often in conjuncture with the ECB and the IMF), but adopted by the Council. Oversight on progress occurs by missions of teams of technocratic officials, such as the famous Troika (Commission, ECB and IMF). This form of governance has been widely criticized as overriding national democratic principles and giving too much power to those Member States in the Council that have contributed most to the financial assistance programmes.

The European Stability Mechanism (ESM)

The ESM is a bailout fund. This means that if European countries find themselves in severe financing problems and cannot borrow on the capital markets in a sustainable manner they can request a loan from the ESM to finance their government bonds. The ESM has a lending capacity of 500 billion euros, guaranteed by the Member States. The financing is organised indirectly, this means that the ESM sells bonds on capital markets, the money then is spent on the financial assistance packages to the state in need. Any loss the ESM may incur has to be made up for by Member States. The argument that “taxpayer money is going to Greece” is in fact incorrect. Taxpayers *guarantee* the bonds issued by the ESM, but the ESM is seen as a very credible institution by financial markets, so interest rates on its bonds are extremely low. It is therefore able to lend to states in financial trouble at rates that are far below the market value. The ESM has grown to be a significant player in bond markets, with outstanding bond volumes comparable to a small country.

The Fiscal Compact

The Fiscal Compact is one of the more curious creatures to come out of the responses to the euro crisis. Officially, it is embedded in the Treaty on Stability, Coordination and Governance, an intergovernmental treaty outside the normal European Treaty framework, signed by most Member States (apart from UK and Croatia). It can be seen as a significant toughening of fiscal discipline since Member States commit themselves to a general government budget in balance

or in surplus. Member States under the Fiscal Compact should meet a country-specific medium-term objective that does not exceed a structural deficit of 0.5% of GDP. The calculation of what constitutes a structural deficit is tremendously complex, full of discretionary decisions and barely understood by most politicians. This is all the more curious because the treaty also commits Member States to introduce an automatic correction mechanism, enshrined in national law, preferably constitutional law, for the enforcement of this rule.

The treaty was adopted by most national parliaments in a surprisingly short period of time. But in certain cases it is questionable whether Member State really meant for these rules ever to be implemented. Under the rules of the fiscal compact Italy for example would have to reduce its debt at 30 billion euros every year for decades, leaving no room for any budget-stimulated growth (Moschella, 2017). The treaty also duplicates and overlaps with the fiscal oversight of the European Semester (see below) and is poorly implemented (see below). Rather this treaty should be interpreted as a sign of the time: EU leaders sought to calm financial markets by committing themselves to the toughest fiscal rules possible. A number of Member States also pushed for access to the funds of the ESM to be conditional upon states signing the Fiscal Compact, as they wanted guarantees of fiscal solidity before they could agree to the financial solidarity of the ESM.

The European Semester

The European Semester is a framework for the coordination of national fiscal and socioeconomic policy. It encompasses several legal frameworks in one: the Stability and Growth Pact (famous for the 3% rule on government budget deficit), the EU 2020 growth strategy outlining economic priorities for the future, and the Macroeconomic Imbalance Procedure (see below). Member States that have been subject to an Economic Adjustment Programme have not been simultaneously subject to monitoring under the Semester. In the early days of the crisis European policymakers felt that oversight over developments in the economies of Member States was insufficient. There had not been sufficient warning mechanisms about the exact size of the Greek budget deficit. The Commission was aware of the risks around foreign money pouring into the Spanish housing market, but it had insufficient means to urge the Spanish government to address this problem. Ireland, in turn, was hailed for its economic growth only a few years before their economy collapsed and needed financial support from the ESM.

In order to address such issues EU leaders decided to give the Commission more competences for scrutiny of economic developments in the Member States. In practice this means that every year the Commission assesses the draft budgetary plans of Member States, the potential for economic imbalances and progress on reform priorities on the basis of a National Reform Programme. Based on such assessments the Commission issues recommendations to Member States on their budgetary path and socioeconomic reform priorities. These recommendations

are discussed in Council Committees of Member State representatives and adopted by the Member States in the Council. (For more information, see: Verdun and Zeitlin, 2017)

The Macroeconomic Imbalance Procedure (MIP)

At the start of each annual European Semester cycle the Commission carries out an assessment to detect imbalances or potential imbalances in the economies of the EU states. Imbalances in the economies of Member States can have significant negative effects for other states, such as the previously mentioned Spanish housing sector, which caused losses in banks all over Europe. To prevent imbalances from becoming so deep that a country loses investors' trust and is required to seek financial assistance, the Commission monitors the economies of Member States under the MIP. It is a type of early-warning tool. The Commission does this monitoring through a scoreboard of indicators, annexed to the so-called Alert Mechanism Report. If the scoreboard indicates that a country might be experiencing imbalances it is subject to a deeper review of the economic situation to determine whether indeed there are imbalances. This is called the In-Depth Review and the conclusions can be that a country is experiencing no imbalances, imbalances that require policy action, excessive imbalances that require policy action and specific monitoring or excessive imbalances that requires the opening of the Excessive Imbalance Procedure.

In practice, when a country is seen as experiencing imbalances, such as too high private debt levels, consistent loss of competitiveness or too many troubled loans in the banking sector, some of the recommendations that it receives from the Semester are linked to the MIP. When a recommendation is linked to the MIP it signals that Member States should take them more seriously. Especially if a Member State is seen as experiencing excessive imbalances this signals that the situation is worrisome and therefore the Commission will organise extra missions to oversee whether a Member State is putting in enough effort to address the imbalances. If a Member State is seen as lacking in effort whilst imbalances are becoming more severe, the Commission can propose to the Council to open up the Excessive Imbalance Procedure, which introduces a more coercive approach and could ultimately lead to financial sanctions.

The European Stability Mechanism (ESM) and the Fiscal Compact: obstacles for EU legitimacy?

The establishment of instruments such as the ESM or Fiscal Compact outside the Treaty Framework has posed challenges to the EU's legitimacy.

The work done in WP2 does not include any assessment of the legal implications of the establishment of treaties outside the legal framework of the EU Treaties, so there are no empirical findings on this issue. Having said that, it is clear that a blurring of the European legal order has consequences for the legitimacy of the entire euro governance structure. This is most clearly visible with the ESM. The ESM could not be established within the Treaty framework, because the Treaty explicitly rules out the possibility of a bailout (Art. 125 TFEU). During the crisis years the predecessor of the ESM, the EFSF was established as a public company under Luxembourg law. But it was clear from the start that a more sustainable solution was necessary to balancing the need for a bailout mechanism with the legal constraints of the Treaty. A paragraph was added to the Treaty to allow euro area states to establish a stability mechanism (Art. 136(3) TFEU). The ESM as we know it now is an intergovernmental institution under public international law.

Due to this legal creativity the governance structure of the ESM is peculiar, conditionality packages linked to financial assistance are negotiated by the Commission, in liaison with the ECB, monitored by the Commission, ECB, IMF and ESM and approved by the euro group which does not have any formal legal status and whose finance ministers also act as Board of Governors. This institutional design is first of all confusing to the wider public as to whom is in charge of the highly contentious conditionality requirements linked to financial assistance. In other words, whom should we hold accountable for overly strict requirements to Greek public finance? The perception, not fully unjustified, is that a small number of actors within the euro group practically have veto-power over the budgets of Member States under financial assistance. This is damaging for the legitimacy of the entire enterprise. Furthermore, it does not allow for any oversight of the European Parliament and legal safeguards of EU law, such as information rights, integrity provisions or the EU's fundamental rights charter do not apply. For more information, see: Ban and Seabrook, 2017.

Created to palliate the crises, mechanisms stand strong

For both the ESM and the Fiscal Compact it is not clear at this stage whether they are sustainable or just transitional. Article 16 of the Fiscal Compact stipulates that the substance of the Treaty is to be incorporated into the EU legal framework within five years (1 January 2018). Some – especially within the European Parliament – have therefore thought in the past that this would open up the possibility for treaty change in 2017. But Member States have showed little willingness to open up the Pandora's box that constitutes treaty change. In the Five Presidents Report – a report setting out future steps to deepen EMU – again reference is

made to incorporating the substance of the Fiscal Compact into the Treaty framework, but no such step has been taken to date. The status of the Fiscal Compact is therefore ambiguous, the predominant mode of governance for fiscal policy in the EU is the European Semester, rather than the Fiscal Treaty, but the Commission continues to make additional assessments within the framework of the Fiscal Compact. Many have called for a more fundamental overhaul of the entire fiscal framework, because it has gotten too complex, but politically this is not so easy. The ESM seems more sustainable, but the Five Presidents Report also speaks of incorporating the ESM into the Treaty framework to increase accountability and simplify decision-making. No steps have been taken in this direction to date. At the same time, there are continuous discussions on the future policy aim of the ESM, some have argued for broadening the mandate of the ESM to allow for more stimulating fiscal policy, others have suggested transforming the ESM into a European Monetary Fund, equal to the IMF, but it is unclear as of yet what this would entail precisely.

Out of the framework, and yet working

In the case of ESM compliance with the requirements of the conditionality programmes is high (the Greek case should perhaps be considered an outlier in every sense), given that each tranche of financial assistance is indeed conditional upon delivery of results. **The problem is that this compliance mechanism is overriding national democratic decision-making**. With the Fiscal Compact the results are more mixed, a strict analysis of annual compliance with the requirements will show that in many states it is actually quite easy to break the rules without consequences. Multiple states have not brought back their deficit and debt in the pace that is required by the pact, never has the automatic correction mechanism been triggered. Some researchers have therefore concluded that the entire pact had little impact on actual policy-making (Gros and Alcidi, 2014). But this does not make the Fiscal Compact an innocent creature per se. While it is hard to link fiscal outcomes to one mechanism, national rules and politics, the Excessive Deficit Procedure of the European Semester, European fiscal standards as benchmarks or the Fiscal Compact, it is clear that all in all budgetary sustainability has been at the forefront of European politics. EU leaders have opted for a ‘stability culture’, with all sorts of national and European institutions and regulations in place and the results of this policy orientation have been clear: Europe has exited the crisis via a much more fiscally austere path than other parts of the world.

Impact on the EU’s economic framework

Intellectual honesty demands care when making predictions about the future of political institutions. It is fair to say that for the moment, the economic governance framework in the EU functions relatively well; past weaknesses of the European Semester have been recognized and addressed. That said, it would be a misconception to think that this governance framework constitutes a strict set of rules that are followed independently of the specific context in which they become relevant. As is true for other forms of European governance, their flexibility is an important precondition for their success. Put differently, their relative weakness in terms of

automatic enforcement allows the acceptance of for example the MIP by member states. To what degree the recommendations emerging from the MIP actually shape member state policy varies from case to case.

Considering other elements of contemporary European governance, the record is mixed – as should be expected in a fast-moving environment. The ESM has substantially updated euro-area governance and thereby changed the course of the common currency at a time when it was under significant pressure. Other innovations, such as the Fiscal Compact or the Euro Plus pact, have had less direct impact, and it remains to be seen whether they remain important pillars of European economic governance in the decade to come.

The EU's endeavour to reduce corporate tax avoidance and evasion while implementing a tax system that contributes to European competitiveness

The European Union is a determined agent in pushing forward important reforms in global tax governance. In recent years, the EU and its agencies have developed policies to increase reporting transparency for large financial institutions and multinational corporations that are active in Europe. The most ambitious of these agendas, Country-by-Country Reporting, has been heavily promoted by expert activists in a manner that aligns with the EU's goals to combat fiscal leaks. The political and economic consequences of these proposals are serious for EU member states and the European Economic Area, leading to a series of compromise positions on what kinds of institutions should be subject to more stringent transparency regulations.

The policy environment for global tax governance mirrors Europe's own internal complexities. Key policy agents, such as the Organisation for Economic Co-Operation and Development are arenas for European and transnational interests from the private, public and civil society sectors to battles over the content of tax reforms. Hot topics there include transfer pricing and financial secrecy. Assertive and unilateralist actions from both the United States of America also shadow over the direction of global tax governance.

In practice, we find that combatting tax avoidance and the promotion of competitiveness complementary rather than opposing goals. By closing fiscal loopholes European member states raise additional legitimate revenue that bolsters their economic position and enables them, if they so choose, to implement policies that actually further their economic standing, for example through investment in education or infrastructure. Policies against tax avoidance are not breaks on economic growth but in fact important tools to balance economic models.

The impact on member states and the EU as a whole of decisions and programmes put in place to counter the crisis

The instruments devised in the EU in response to the crisis have had a range of general aims and effects: formalizing mechanisms for mutual assistance, clarifying the conditions for such assistance, and a centralization of monitoring to get a comprehensive overview of economic developments (also for financial stability) and avoid collective action problems. An example is competitive deregulation or weak enforcement of financial regulation.

Even though the adjustment programmes have only been applied to countries in severe difficulties, the framework now applies to all member states. In consequence, they too submit to the European Semester and the MIP. The direct consequences for them are limited; indirectly, however, these new institutional framework tie member states further into European governance forms and cycles, for example concerning the instruments used to assess policy and its effectiveness. The effect of the new programmes and decisions has therefore been a further Europeanization of member states policymaking. How sustainable that will prove to be, and whether member states at some point change the role of these tools – either by upgrading or by downgrading them – remains to be seen.

The societal impact of the MIP

The MIP is not very well known outside a relatively small circle of academics and civil servants, the procedure is simply too technocratic to reach a wider audience. The number of parliamentarians in Italy or France that are aware of the specific message that their country has been labelled as experiencing excessive imbalances and receive additional monitoring, is perhaps not more than a couple of hands full. But this is also not directly necessary for the MIP to be effective. There is often a general sense that Brussels looks at government budgets and structural reforms.

The MIP: less coercive and effective than critics and champions say

The study on the MIP assesses the hierarchical character of the policy tool, rather than its coerciveness. Hierarchy in governance frameworks is a multidimensional concept. This means that different aspects of a framework can contribute to a possible hierarchical character.

To specify the concept further, one can identify at least three dimensions: prescriptiveness of the recommendations, the degree of flexibility with which European actors deal with national reservations and the mechanisms for implementation enforcement, which can take the form of legal coercion, threatening with sanctions or stepping up the procedure, peer pressure or open dialogue and debunking of nationally held policy beliefs.

The hierarchical character of the MIP is studied by assessing its design, broader evolution over time, and practical application through case studies by means of process tracing. Effectiveness can be studied by assessing whether the recommendation and its follow-up processes contribute to inducing a Member State to adopt the policy approach that is prescribed. So far the MIP has only been studied by horizontal analysis across all recommendations in a quantitative manner. While such studies give an impression of the MIP, they by no means unravel through what causal pathways the MIP tries to influence national decision-making and which elements of the MIP contribute to possible effectiveness, this requires in-depth case studies and cross-case comparison.

In the years following the conception of the MIP, several scholars have studied the legal design of the MIP and argued that the MIP represents some type of hierarchical imposition of policies on Member States, suffering from severe lack of legitimacy. The case studies show that much of this early criticism of the MIP can be seen as either ill-informed or outdated. The MIP can indeed put pressure on a Member State through monitoring and peer pressure, but its strength should not be exaggerated and in no way represents some type of imposition over national democratic decision-making. At the same time the study shows that there is no clear evidence that adding hierarchical elements to the MIP would make the procedure more effective. This should caution some of the policy makers and scholars who have argued that the MIP should be made more binding in order to better induce Member States to conduct structural reforms. The hypothesis has thus largely been confirmed.

Trusting the Member States to “work towards their fulfilment in their own terms”?

The question here of course is, what is the alternative? Member States cannot be forced to work towards the fulfilment of policy goals, nor should we want them to. It is not a question of trusting Member States, increasingly the MIP is becoming a tool that tries to organise consensus around reform priorities and consensus should primarily be with the Member State itself. By way of constant monitoring of the economic situation and associated policy responses (or lack thereof), the MIP puts pressure on a Member State to deliver on these challenges and priorities. But it has to be remembered that the MIP operates in domains where the EU has very low competences, think of health care policy or wages. Many of the MIP recommendations touch on welfare policies and labour market institutions, where the role of social partners is protected by the Treaty. This requires an approach of the EU institutions that does not significantly disturb the national social and political equilibrium. The EU – through the MIP – can push and persuade by means of analysis, argument, constant monitoring and obliging Member State governments to come with a unified response to questions. In this way the MIP disseminates a particular policy message throughout an administration. But in practice it can do very little if Member States choose another reform path or when parliaments decide to lag or postpone implementation. Sanctions in the MIP can be issued in case of a lack of effort on the side of the government, not a lack of result. Of course, there are cases where Member

States and the Commission are not aligned at all, neither on the analysis, nor on the solution. This has been most prominent in the attempts of the Commission to persuade countries with a surplus in their current account balance to increase fiscal spending. In such cases the MIP acts as a monitoring tool, but also as a tool that can organise consensus around whether or not such phenomena are indeed problematic, by having the Council adopt their proposed recommendation. This can be a powerful message. But not necessarily one that can by automatic means easily override national democratic decision-making. Because, at the end of the day, there is not one agreed-upon path for building resilient and healthy economies.

The effect of the European Semester's in-built bias towards fast-burning crises in detriment of slow-burning ones

Addressing immediate fiscal imbalances through budget cuts can sow the seeds of future imbalances that are more structural in nature. If a country is to meet its budget target of 3 percent budget in deficit, but does so by slashing funding for Research & Development, education or childcare facilities this is simply penny wise and pound-foolish. In high debt countries public investment and education spending has been significantly reduced. As a result birth rates have dropped and disparities in educational quality have been widened. In the early cycles of the European Semester Member States were often recommended to safeguard public investment and increase education quality, but such calls were simply overridden by the recommendation to bring the budget back to sustainability. In part this is inherent in the design of the Semester, the rules on the budget are more pronounced and the procedures for when budgetary norms are exceeded are more stringent, as such there is an in-built bias towards fast-burning ones. Over the years in the evolution of the Semester one can notice a change of orientation of the Commission as described before. The Commission has treated budget deficits with more leniency, has tried to rebalance towards a focus on quality of public expenditure and has introduced more space for investment at the European level. However, ideas on excluding public investment from the rules of the SGP or officially safeguarding social institution have not yet been formally introduced.

Instability, policy-making and the crises

Before the global financial crisis, most policymakers treated financial instability as the result of an *exogenous* event – coming from outside of the financial system – that would first hit an individual institution before spreading out to others. The crisis proved otherwise: financial stability risks predominantly come from the *inside*; they are inherent to the financial system. At the risk of oversimplifying, it showed that individually sensible behaviour may in the aggregate lead to undesirable outcomes; a so-called micro-macro paradox. So while for every financial institution it makes sense to expand lending and increase leverage when markets are booming, in the aggregate this increases financial fragility. Imbalances can build-up for quite some time before they unwind, often sparked by a relatively minor event such as an interest

rate increase or a firms' failure. This can be the breaking point turning boom into bust. Far from operating in a neat, incremental contagious way, systemic risks can materialize suddenly and violently – as many market participants simultaneously become distressed. In the bust the micro-macro paradox also operates, but now in reverse and in a much more violent manner: as individual market participants scramble to improve their financial positions, the system as a whole collapses, leaving most actors worse off.

The Bank for International Settlements (BIS) played a pioneering role in translating this new perspective on financial stability into actual policy reforms. They argued it necessitated developing a macro-prudential approach to financial regulation. In contrast to the pre-crisis dominant focus on individual institutions' safety (the micro-prudential approach), the macro-prudential approach explicitly looks at the system as a whole. Financial regulations would need to be reassessed in terms of their contribution to systemic stability rather than only firms' stability. From the BIS these ideas travelled to other key international regulatory agencies – such as the International Monetary Fund – and to European and national agencies.

The crisis thus boosted the case for a macro-prudential regulatory approach to mitigate systemic risks, which essentially encompassed two things. First, it involved the development of macro-prudential policies at the national and European levels. These policies aim to mitigate the boom-bust nature of financial markets – increasing policy stringency when systemic risks build-up, while becoming more lenient when they turn into financial distress – and to mitigate systemic risks that exist at any particular point-in-time, as a result of firms' common exposures or from them being systemically important. In practice, this encompassed institutional innovations – the birth of the European Systemic Risk Board and the designation of national macro-prudential authorities – and regulatory reforms, most notably the inclusion of macro-prudential elements in the EUs most important banking rules (the Capital Requirements Directive IV and the Capital Requirements Regulation). Macro-prudential authorities can impose additional *capital requirements* on banks if they deem them systemically important or if they signal systemic risks are building up. Many countries also introduced *borrower-based restrictions*, maximizing the amount people can borrow relative to their income or the collateral value. In short, it means specifically designated authorities have the opportunity to impose requirements to mitigate systemic risks.

Second, it involved reforming micro-prudential financial regulations to limit their pro-cyclical effects. Most notably, it implied reconsidering regulatory reliance on financial firms' valuation and risk-assessment practices. Whereas before the crisis policymakers generally assumed that increased regulatory reliance on market signals would buttress 'market discipline' and as a consequence would contribute to stability, the crisis showed a darker side: it had contributed to 'hardwired' pro-cyclicality. High valuations and low risk estimates had led to excessive optimism, while during the turmoil it operated in reverse. In response, policymakers reformed international accounting standards to reduce reliance on market prices. They revised banking rules to limit firms' risk models' pro-cyclical effects, particularly by requiring firms to take into account longer time-intervals and 'worst-case scenarios'. And policymakers reconsidered

regulatory reliance on credit ratings – requiring firms to not rely solely or mechanistically and by removing some rating references from financial regulations. While these measures will not remove financial market pro-cyclicality as such, they to a certain extent mitigate regulatory induced pro-cyclicality.

The global financial crisis has triggered a wide range of reforms, aimed at making the financial sector more resilient and fighting the build-up and materialization of systemic risks. One of the most important innovations, as mentioned above, is the development of macro-prudential policies. Their greatest benefit lies in the institutionalization of a systemic risk perspective in the supervisory architecture, in combination with a formalization of supervisors' ability to intervene if they deem particular market developments unsustainable. Instruments such as loan-to-value limits, capital surcharges for systemically important institutions, and the countercyclical capital buffer that can be activated in case of abnormal credit growth may certainly limit financial fragility, even if they will not prevent all problems.

Yet we should not overstate the significance of these reforms. Macro-prudential policy is largely confined to bank capital requirements. To the extent that we see macro-prudential elements in other relevant domains – such as liquidity rules, margining requirements, and credit extension – they take the form of leniently calibrated backstops: limits on market participants' room for manoeuvre that do not vary over the cycle. The macro-prudential components of the capital requirement framework are configured as add-ons rather than a full-blown transformation of the framework itself. Moreover, there is lack of clarity regarding the governance framework, leaving considerable uncertainty over the question who decides under what circumstances to tweak macro-prudential policy-settings. This problem is evident at the EU level, where the ESRB and the ECB are now both involved in macro-prudential policy. The ESRB has to monitor financial stability risks and give advice on macro-prudential policy; but the ECB (in the SSM framework) has formal competences in this domain. As the ESRB is part of the ECB and falls under the responsibility of ECB-President Draghi, this begs the question whether it has sufficient influence on systemic risk mitigation. This lack of clarity also operates between the EU authorities and national authorities: each macro-prudential element in EU capital requirements contains specific and complicated procedures before national authorities can activate it. While such governance problems will be unavoidable to a certain extent, they are worrying nonetheless. As the De Larosière Report had signalled shortly after the crisis, the lack of clarity on responsibilities for the mitigation of systemic risks was one of the core failings of pre-crisis financial governance.

While some of these shortcomings may be repaired over time, we should also acknowledge certain inherent limitations of the macro-prudential policy endeavour. First, it is unlikely that regulators will ever develop a fool-proof way to identify the build-up of systemic risks. Systemic risk is a multifaceted and to a certain extent intractable concept, and 'measuring' it is far from straightforward. As the financial system is a complex, dynamic, and reflexive system, macro-prudential supervisors rightly guard against overly optimistic assessments of their ability to spot problems in time. Supervisors will have to fly by sight, rather than on auto-pilot. Second,

macro-prudential policy interventions may have unintended consequences. The fuzziness of systemic risk measurement introduces a significant amount of unpredictability in countercyclical policy. But an ill-timed, forceful intervention – whether it is through tightening or loosening requirements – can be interpreted as a signal that trouble is underway, triggering the stress that supervisors want to avoid. Such inherent shortcomings show that striving for a situation where macro-prudential supervisors will be able to fully prevent financial instability in a top-down manner will prove futile.

Similar problems hamper attempts to limit micro-prudential rules' pro-cyclical effects. While regulatory reliance on firms' risk management and valuation approaches has obvious undesirable effects, it is not obvious whether the opposite approach – *not* relying on them – is necessarily better. At the very least we have to acknowledge that both approaches have significant shortcomings. For example, even if mark-to-market accounting reinforced market pro-cyclicality, its alternative (historical cost accounting) may allow firms to hide mounting problems; especially if it is applied to financial instruments whose value fluctuates significantly over time. And while regulatory reliance on credit ratings is problematic, there are no obvious candidates to replace them with. As the Eurozone debt crisis showed: *not* relying on credit ratings in regulations may be worse. Moreover, there are also shortcomings in publicly prescribed valuation and risk-management approaches: to the extent that they force all market participants in the same direction, they may contribute to systemic risks rather than mitigate them. So while the crisis demonstrated great flaws in pre-crisis micro-prudential rules, it proved difficult to find better alternatives. Policymakers therefore often opted for cautious and incremental modifications instead of sweeping reforms.

These considerations are sobering, as they point to inherent limits of financial market governance. The implications are twofold. For micro-prudential regulation, it implies that we should not aim for the perfect approach without significant shortcomings, but instead opt for a pragmatic approach where regulatory instruments and their settings can be frequently reassessed in light of market developments. It remains unpredictable how financial actors will react to rule changes, so we cannot map out those courses in advance. This plea for continuously adaptable rules may irk financial firms who complain about regulatory fatigue and prefer a predictable rule-framework. But we must expect rules and instruments to shape financial markets in unpredictable ways and often with undesirable consequences. This implies that dynamic regulation is without alternative.

Second, the limits of micro- and macro-prudential regulation highlight implications that go beyond regulatory policy itself. Instability is inherent to financial markets. When we strive to curb the damage it can do, the more effective, if more difficult, route forward is to diminish the vulnerability of our economy and society to the vagaries of financial markets. For decades on end, finance has become increasingly dominant – for firms, households, and governments alike. Relegating finance to a less central role in society will have to be part of a quest to crisis-proof our economies. The core challenge is to build a less credit-intensive society. The loan-to-value limits that many EU countries introduced are a step in the right direction. Similarly, the

current bias in tax regimes to favour debt finance over equity should over time be eliminated. While these measures surely have distributional consequences in the short run – and policy-makers should address these – fighting our debt-addiction has the potential of both reducing the potential severity of financial turmoil as well as protecting society from a debt-overhang when markets inevitably turn.

Research finding summaries

Decision-making and ideas in the context of the Banking Crisis and the pursuit of Financial Stability – the findings

The expert networks at the core of the decisions made in pursuit of financial sustainability

For the MIP there have been multiple drivers to establish this particular governance mechanism: top officials from DG ECFIN have long wanted a macroeconomic counterpart to the SGP. They act and think in accordance with a small group of insider economists, such as Andre Sapir and Jean Pisani-Ferry who have been writing in the years before the crisis that compliance with European macroeconomic instruments was lacking. The Council has come with its own assessment of necessary mechanisms at the start of the crisis in the so-called Van Rompuy taskforce. Within the Council a number of key finance ministers have been responsible for getting sufficient approval: while the German Wolfgang Schäuble has been cautious with the MIP (it could potentially weaken fiscal norms), the French Christine Lagarde has been a big proponent (euro area governance should be about more than fiscal rules).

The networks' influence on European modes of governance

For the MIP there is not one particular network that has driven the mode of governance, there was a general sense that there should be a procedure for coordination of macroeconomic policy, due to oversight having clearly been insufficient in the case of Ireland and Spain. And, there has been a relatively large consensus in the institutions (ECB, Commission, Council and EP) that the new procedure – the MIP – should have some bite, so a corrective arm with sanctions.

The ideas behind the discourse that accompanied decision-making

The evolution of the MIP throughout the years has been a process of learning-by-doing. If we focus on the key player in the MIP, the European Commission, we see that the approach at the start, both in procedural and substantive terms, have not been resilient. A wide range of interviews shows that the Commission in its first years interpreted its mandate as rigorous as possible. The Commission wanted to significantly increase pressure on Member States to deliver on the MIP recommendations and refused any substantive discussion on the content of the recommendations. This led to counterproductive dynamics and annoyance among Member State officials. Soon the Council started protesting and the Commission took a more conciliatory stance. This has resulted in the Commission nowadays defining reform priorities largely in coordination with the Member States and taking a more neutral stance on politically sensitive topics. Procedural changes have also contributed to substantive changes in the discourse on reform priorities, social actors have been placed on a more equal footing with DG ECFIN, resulting in nuancing the competitiveness frame to a certain extent with social goals receiving more attention in the priorities.

Research finding summaries

ECB fiscal policy ideas inspired self-defeating policies in crisis-stricken countries

During crises the supply of lender-of-last resort liquidity is assumed to have no macroeconomic consequences beyond mitigating tensions in the interbank market. The Fed or the Bank of England's outright asset purchases (unconventional monetary policies) are then just a continuation of the traditional accommodative stance in liberal economies, while the European Central Bank's (ECB) reluctance to intervene in sovereign bond markets reflect the conservative views of (German) central bankers in coordinated economies. Fiscal policy formulation, in this view, remains a process shaped exclusively by domestic non-financial actors, a view paradoxically silent on one key constraint for governments during crisis: the sovereign bond market.

In contrast, the Trichet ECB's reluctance pushed countries towards fiscal retrenchment across the board. Building on earlier work (Gabor and Ban 2015), in early 2010 the ECB did not steadfastly commit to repair the damaged collateral function of "peripheral" sovereign bonds, as it did in 2009. Just as downgrades chipped away at the collateral value of these bonds, making investors increasingly disloyal, the ECB withdrew extraordinary liquidity interventions. In these conditions, the governments of liberal and mixed governments had to address the disruption of collateral markets for fear that bank runs would wreck their countries' banking systems and take the national economies down with them. Since in these conditions the attempt to absorb these costs through expansionary fiscal policy could only make the problem worse by leading to further downgrades, the onus was on European governments and the societies they governed to pay the price of stabilizing collateral markets via austerity.

The ideational networks behind the rejection of IMF's policies

The chapter's network analysis suggests that the IMF's dominant position (fiscal revisionism) came largely from within its own ranks and so did the ECB's dominant position (fiscal orthodoxy). Interestingly, most of the ECB's revisionist citations also came from the research done by IMF economists from the Fiscal Affairs Department. In both institutions, the most important supplier of orthodox arguments was by far the transatlantic think-tank Center for Economic Policy Research (CEPR), which since 1983 has been perhaps the most prestigious platform for policy-relevant academic work that brought together high-profile policy academics in shared research projects that would be cited by EU officials as authoritative sources for policy stability and change.

Outside experts cover a broad spectrum that does not conform to the conventional wisdom about Ivy League professorial hegemony. In addition to CEPR, for the IMF, the network analysis suggests that the providers of orthodox economists come largely from central banks and universities. Chief amongst these were the central bank of Chile, the Bocconi University of Milan and, unsurprisingly, the University of Chicago. A couple of regional Federal Reserve Banks, a number of European central banks (from Germany, Spain, France) and a mix of top

academic departments (Yale, Rochester, LSE, UC Davis, Pompeu Fabra, University of Pennsylvania) provided exclusively orthodox economists.

Although the IMF's Research Department and the National Bureau for Economic Research (NBER) supplied both reformist and orthodox citations to the IMF, they contributed most to the revisionist camp (in contrast, the IMF's Fiscal Affairs Department supported mostly the orthodox camp). The inner circle of exclusive supporters of revisionism came from three elite US academic departments (UC Berkeley, UC San Diego, Northwestern University), plus INET, the Paris School of Economics and, contrary to conventional wisdom, from several central banks (the Board of Governors of the Fed and the central banks of Denmark, Iceland and England). A number of elite universities (NYU, Harvard, Stanford, Princeton) appear split between orthodox and revisionist positions. A mix of revisionist and orthodox research comes from Oxford, OECD, the Dutch central bank and academia and from University College of Dublin.

For the ECB's epistemic network, the results presented suggest that ECB economists were the main providers of orthodox research, followed by the IMF's Fiscal Affairs Department, the Bank of International Settlements, the OECD and the transatlantic think-tank Center for Economic Policy Research. In addition to an assortment of regional Fed economists, a number of top academic institutions (Harvard, Columbia, Princeton, the Bocconi University of Milan, Carnegie Mellon) threw into battle exclusively orthodox economists.

The institutional providers of revisionist arguments were two: IMF's European Department and the National Bureau for Economic Research. The exclusive providers of revisionist thinking included three central banks (the Fed Board plus the Austrian, the Portuguese and the Dutch central banks), alongside a medley of medium and low tier universities (Bates College, Carleton College, Lund University, Stockholm University, INSEAD, Norwegian School of Economics, University of Konstanz). Finally, the European Commission supplied the bulk of mixed opinion research. A number of institutions were equally split between the revisionists and the orthodox (IMF Research, MIT, Berkeley, World Bank), the orthodox and the mixed (European University Institute) or among all three (Stanford).

Quantitative analysis reveals that professional experience in international organizations – other than the IMF – tends to polarize views on fiscal policy. Specifically, no matter what subset of economists one considers, whether they are cited in IMF *World Economic Outlook Reports*, the ECB *Monthly Bulletins,* or both, the more time they spend working in an international organization the cited economists are always more likely to exhibit extreme points of view. Specifically an economist is more likely to become either more orthodox or more revisionist toward fiscal policy the longer he or she remains at a non-IMF international organization such as the European Commission, the World Bank, the OECD, or the Bank for International Settlements.

The second finding is that central banks produce conservative experts while think tanks don't. When considering both the IMF and ECB cited economists, it is clear that ever having worked

at a think tank contributes to more revisionist views on fiscal policy as opposed to mixed or orthodox. In contrast, ever having worked in a central bank or in the private sector contribute to more orthodox views. Being newly hired by the IMF also contributes significantly toward having more revisionist, as opposed to orthodox or mixed views toward fiscal policy.

Third, economists whose professional profile includes stints in academia, government and the private are a positively conservative force in the fiscal policy debate that took place in the public documents of these key international organizations. Having ever worked in academia or the public sector contributes toward more orthodox views, yet having remained there for a longer period of time generally contributes toward more mixed views toward fiscal policy. For economists cited only in ECB *Monthly Bulletins* and not in the IMF *World Economic Outlook Reports*, having spent any time at all in academia seems to lead toward having a more mixed perspective on fiscal policy as opposed to either orthodox or revisionist views. There are no such wrinkles in the argument when it comes to private sector experiences. Indeed, having ever worked in the private sector contributes toward more orthodox views on fiscal policy.

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