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Institutional Responses to the Euro Area Crisis

Tobias Tesche

Thesis submitted for assessment with a view to
obtaining the degree of Doctor of Political and Social Sciences
of the European University Institute

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European University Institute
Department of Political and Social Sciences

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For my family

CHAPTER OVERVIEW

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1. INTRODUCTION

1.1. AN OVERVIEW OF FIVE COMPETING EURO AREA CRISIS NARRATIVES[1]

The euro area crisis shook the foundation of the Maastricht order to its core. Together with the introduction of the single currency twenty years ago and the signing of the Treaty of Rome more than sixty years ago, the euro area crisis has been the event with the single largest impact on the direction of European integration. The drama started in October 2009 when the Greek Prime Minister Papandreou revealed that the actual budget deficit was exceeding the officially reported numbers by a multiple (Featherstone 2011; Zahariadis 2013; Moschella 2016). This announcement anchored the fiscal interpretation as the predominant cause of the crisis. It was only later when the crisis kept dragging on and financial contagion was spreading that the financial narrative featured more prominently among the competing crisis interpretations (Jones 2015). The underlying causes of the euro area crisis were, however, manifold and cannot be traced back to a single origin (Hall 2012; Eichengreen 2012; Hansen and Gordon 2014; Bastasin 2015; Baldwin and Giavazzi 2015; Matthijs and McNamara 2015; Sandbu 2015; Henning 2017). Höing and Kunstein (2018) have undertaken a comprehensive review of peer-reviewed political science journals for the period of 2004 to 2015 and have identified five main crisis narratives: (i) fiscal and economic co-ordination, (ii) the democratic legitimacy of the institutional framework, (iii) questions of trust, (iv) financial regulation, and (v) the construction of EMU. This article-based Ph.D. thesis engages with the main arguments advanced by each of these five crisis narratives. In the following section, I will give a brief overview of the key arguments of each of these five crisis explanations and introduce the contribution that this Ph.D. thesis makes to each of them.

Fiscal and economic co-ordination

The initial response by European policy-makers to the Greek fiscal travails has been to reform the fiscal governance architecture of the EU. The six-pack, two-pack and intergovernmental Fiscal Compact formed the backbone of this new fiscal framework (Buti and Carnot 2012; Begg 2013; Chang 2013; Mabbett and Schelkle 2016; Savage and Verdun 2016). It included a revamped Stability and Growth Pact (SGP) and a tightening of economic surveillance through the European Semester. Sanctions were supposed to become semi-automatic in order to address the compliance gap with the fiscal rules (Heipertz and Verdun 2004; Verdun 2013; Schön-Quinlivan and Scipioni 2017). The accession of the intergovernmental bailout fund – the European Stability Mechanism (ESM) – was made conditional upon signing on to the Fiscal Compact (Schimmelfennig 2015; Schoeller 2016). Stronger ex-ante

[1] The concept of 'narrative' is not used for analytical purposes in this chapter but as a way to structure the chapter and to provide an overview of the differing explanations of the euro area crisis.

coordination was required if ballooning deficits and macroeconomic imbalances were to be detected at an early stage. Additionally, focusing on expenditure growth and the level of sovereign debt was needed to make public finances more sustainable in order to prevent negative spillover effects from unsustainable debt dynamics within EMU. An important recognition was that the fiscal rules lacked the national ownership as they were too often perceived as being imposed on member states. National ownership in the context of the EU fiscal framework means that member states are more deeply involved in the monitoring and enforcement of the fiscal rules through national institutions rather than being mere 'rule-takers'. Stronger involvement of national institutions increases member states' incentives to comply with the rules-based system. One major innovation of the new fiscal framework was therefore the requirement to establish 'functionally-autonomous' fiscal councils at the national level that are tasked with monitoring the compliance with the fiscal rules independently and to assess the macroeconomic and budgetary forecasts of the government (Fasone and Fromage 2017; Fromage 2017; Larch and Braendle 2018; Horvath 2018). A fiscal council is defined as 'a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability, and other official objectives' (Debrun et al. 2013, 8). Such an independent body would build up a reputation for non-partisanship in order to govern fiscal policy indirectly (Beetsma and Debrun 2016b). By disseminating 'unbiased' information to intermediaries such as parliamentarians, credit rating agencies and voters they would sound the 'alarm bell' whenever a government was in danger of succumbing to fiscal profligacy. In doing so, fiscal councils could moderate the chronic 'deficit bias', i.e. a government's persistent tendency to overspend.

Chapter 2 asks how we can explain the heterogeneity in the design features of national fiscal councils in the EU. The theoretical framework builds on a particular strand of rational-choice institutionalism (RCI), namely principal-agent (P-A) theory (McCubbins and Schwartz 1984; Moe 1984; Hall and Taylor 1996; Pollack 1997; Tallberg 2000; Thatcher and Stone Sweet 2002; Hawkins et al. 2006; Dehousse 2008; Abbott et al. forthcoming). P-A theory has been a mainstay of European integration studies (Kassim and Menon 2003; Héritier 2007; Adriaensen and Delreux 2017). It is particularly well-equipped to elucidate the choices of self-interested rational actors that hold stable preferences and are subject to certain external constraints (Scharpf 2000). Abbott et al. (forthcoming) have introduced a new typology that combines different modes of indirect governance. It is used to construct three ideal types of a fiscal council: an agent, a trustee and an orchestrator. In a next step, I show that the troika institutions - the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) - formed a technocratic consensus about the desirability of establishing national fiscal councils in the EU. Considerable disagreement existed, however, with regards to their design features. Each institution promoted a distinct fiscal council model in line with their institutional self-interest. Preference heterogeneity among the troika members ultimately prevented the spread of a one-size-fits-all fiscal council in the EU. In a nutshell, Chapter 2 makes a distinct contribution to the political economy literature on the troika (see Pisani-Ferry, Sapir, and Wolff 2013; Featherstone 2015; Hodson 2015; Moschella 2016; Henning 2017; Heldt 2017; Lütz and Hilgers 2018) by shedding light on how the institutional self-interest has informed policy advice given by the respective troika member.

The democratic legitimacy of the crisis management

The institutional responses to the euro area crisis exacerbated the perceived lack of democratic legitimacy (Schmidt 2015; Scicluna 2017). When liquidity started to retreat behind national borders and the interbank market dried up, the state of financial markets increasingly determined the calendar of the EU Summit meetings. However, European Council meetings failed to have an impact on market sentiment beyond the very short term (Smeets and Zimmermann 2013). The pressure to rapidly solve the crisis led to *ad hoc* institution building efforts in which functionality took precedence over accountability. The democratic legitimacy of the crisis management lagged because it was often not possible to democratically ratify decisions in real time. When parliamentary approval was required, legislation was rushed through parliament and politicians felt they did not have enough preparation time for taking a well-informed decision. Key events were justified on the grounds of a 'supreme emergency' like the ECB's announcement to 'do whatever it takes' to save the euro (Dyson 2013; White 2015; Kreuder-Sonnen 2016; Scicluna 2017). A CJEU ruling found that OMT was not violating the provisions of the European treaties only years after it was announced. The delegation to non-majoritarian institutions was the consequence of European policy-makers' narrowed room for maneuver due to the fact that the 'permissive consensus' morphed into a 'constraining dissensus' (Hooghe and Marks 2009; Schimmelfennig 2014; Genschel and Jachtenfuchs 2016). Crum (2013) cautioned that going further down the path of what Habermas has termed 'executive federalism' will sacrifice democracy to protect monetary integration and national determination. The centralization of more competences at the European level will be based on technocratic surveillance procedures, whereas political control will remain with the creditor countries. Moschella (2017) has shown how the decision to grant financial assistance in the case of Greece has empowered only the parliaments of some creditor countries at the expense of others. Kriesi (2017) points out that declining economic indicators can affect the way in which citizens evaluate the workings of their national democracies, however, it doesn't necessarily undermine their support for democracy itself and can even lead to a strengthening of democratic principles.

Chapter 3 discusses the legitimacy of different fiscal council models. It distinguishes between the three aforementioned ideal types of a fiscal council – the agent, trustee and orchestrator model (Abbott et al. forthcoming). The chapter reviews the arguments that prominent advocates of fiscal councils have put forth from a normative perspective. It finds that the identified cause of the 'deficit bias' determines which model of a fiscal council one prefers. Those who argue that the 'deficit bias' is caused by overoptimistic forecasts prefer the agent model of a fiscal council. Accordingly, a fiscal council has the task to assess and endorse the official macroeconomic and budgetary forecasts of the government. An independent check on the official forecasts reduces the forecasting error. By rendering forecasts more reliable public finances become more sustainable in turn. An agent fiscal council can provide technocratic input legitimacy by reducing the forecasting error and, thereby, making public finances more sustainable. Those who argue, on the other hand, that the government's tendency to overspend is the result of political incentives to reward their voter base with 'pork barrel' programmes producing concentrated benefits but dispersed costs for all taxpayers are likely to favor a fiscal council with strong powers over budgetary politics (trustee model) (von Hagen and Harden 1995; Eichengreen, Hausmann, and Von Hagen 1999). The trustee model relies on superior output legitimacy. The delegation of aspects related to fiscal policy to an independent body would reduce politicians' room for maneuver regarding discretionary spending and increase fiscal discipline. Whereas others identifying asymmetric information as the cause of the 'deficit bias' prefer a fiscal council that disseminates 'unbiased' information to even out existing informational asymmetries (orchestrator model) (Beetsma and Debrun 2016a, 2017; Beetsma, Debrun, and Sloof 2017). The underlying assumption of the latter model is that the electorate suffers from 'fiscal illusion' because public finances lack sufficient transparency (Buchanan and Wagner 1977, 134). A permanent disconnect between expenditures and revenues ensues due to imperfect foresight regarding the future cost of debt-financed increases in government spending. The orchestrator model relies on 'throughput legitimacy' because it tries to engage intermediaries like the electorate in the governance process ('governing *with* the people') (Schmidt 2013). The chapter concludes with a discussion about the contribution of fiscal councils towards strengthening the governance architecture of EMU, enhancing the fiscal literacy of the electorate and weakening populism.

Trust and distrust

Trust, or rather the lack thereof, has been a key parameter throughout the euro area crisis. First, financial markets did not trust that member states could service their debts due to the constraints of operating within a currency union in which monetary policy is delegated to a supranational institution (De Grauwe and Ji 2015). Second, mass publics increasingly distrusted their national political leadership since the onset of the euro area crisis (Foster and Frieden 2017). Third, distrust in the European institutions increased. In particular, distrust in the ECB rose to unprecedented levels (Kaltenthaler, Anderson, and Miller 2010; Wälti 2012; Ehrmann, Soudan, and Stracca 2013; Roth, Gros, and Nowak-Lehmann D. 2014; Hayo and Neuenkirch 2014; Bursian and Fürth 2015; Braun 2016). Nevertheless, the publics' support for the euro as a currency remained at relatively high levels throughout the crisis even in countries receiving financial assistance (Roth, Jonung, and Nowak-Lehmann D. 2016; Kaltenthaler and Anderson 2001). Finally, there was little trust that the institutional architecture was adequate to cope with the crisis in an efficient manner. It had evolved through incremental steps of 'layering' and 'redirection' rather than 'big leaps' forward (Salines, Glöckler, and Truchlewski 2012). This generated the expectation that any reform efforts could not meet the necessary level of ambition.

Chapter 4 deals with the ECB and its role during the euro area crisis. It tries to explain why ECB President Draghi started to visit national parliaments when before the crisis the ECB declared that the European Parliament was the only body to whom it could discharge accountability. To answer this question, I use qualitative text analysis to identify the main topics of Draghi's introductory remarks in front of national parliaments. The chapter assesses the consequences of the ECB's quasi-fiscal unconventional monetary policies and finds that they created three mutually reinforcing threats to its independence. First, it triggered unprecedented levels of public distrust in the ECB. Eurobarometer data is used to trace the level of distrust from 1999 to 2018. Second, it invigorated a fierce debate among academics and central bankers about the appropriateness of the political independence of central banks. Third, it overburdened the central bank in many respects with adverse consequences for its output legitimacy. Given that the demands from creditor and debtor states were diverse, the ECB saw an opportunity to reduce the audience costs of their policies by directly targeting national parliaments. The main advantage of this strategy was that it allowed the ECB to penetrate the national discourse on its unconventional monetary policies and present its own views by generating heightened national media coverage. However, 'exchange of views' with national parliaments called into question that the European Parliament was the only body to which the ECB discharges accountability. Ultimately, the ECB was willing to take this risk in order to consolidate its independence.

Financial regulation and the banking union

The inadequacy of the current financial regulation regime was forcefully revealed when contagion was spreading in the euro area via bank balance sheets. Governments had promoted 'national champions' with the objective to guarantee cheap refinancing conditions (Véron 2015). In order to withstand takeovers from foreign competitors these banks had to be large. However, this meant that they would also be 'too big to fail'. At the same time, capital requirements under Basel III attached a zero risk-weighting to government bond portfolios. Financial repression additionally forced banks to stock up on the sovereign bonds of their home country which gave rise to a significant 'home bias' in their portfolios. When the debt sustainability of a euro area country was put into question due to the absence of a lender of last resort (De Grauwe 2012, 2013) or because financial markets doubted the sovereign's ability to shoulder the costs of a potential bank bailout, the sovereign-bank nexus ensued. It set in motion a vicious circle whereby the value of a bank's sovereign bond portfolio declined and exacerbated the refinancing conditions for the sovereign increasing in turn the likelihood of a bank bailout (Schäfer 2016). The goal of the banking union was precisely to break the sovereign-bank nexus (Tesche 2017). The banking union consists of three key pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and a European Deposit Insurance Scheme (EDIS). The first pillar is hosted within the ECB and supervises large banks in the euro area directly, while the 'non-significant' banks are supervised indirectly via the competent national authorities (Howarth and Quaglia 2013, 2016; Glöckler, Lindner, and Salines 2017). The SRM is the second pillar of the banking union and was a crucial element that lends 'teeth' to the SSM (Howarth and Quaglia 2014; Busch 2015). It was argued that only if the SSM can credibly threaten to close down banks will it be able to supervise banks in a stringent manner. As a complement to the SRM, a Single Resolution Fund (SRF) has been created through an intergovernmental agreement (IGA) to offer financing for failing banks during the resolution process (Brandt and Wohlfahrt 2018). The SRF is gradually built up until the end of 2023 with contributions from the banking sector. By this date it is supposed to reach at least 1% of the amount of covered deposits of all credit institutions within the banking union (approx. €55bn). At the European Council meeting in December 2018 it was decided that in case the SRF would not be sufficient to cover the resolution costs, the European Stability Mechanism (ESM) will provide a backstop. However, funds from the SRF/ESM are only accessible after a certain amount of capital has been bailed in. This 'bail-in cascade' also includes deposits above €100.000 that could be wiped out completely. Finally, the third pillar that would 'complete' the banking union has, thus far, not been established due to resistance from Germany that wants to protect the business model of its savings and cooperative banks (Donnelly 2018; Howarth and Quaglia 2018). The objective of EDIS is to backstop national deposit guarantee schemes to ensure that depositors don't start a bank run and move their savings to a different member state (Gros and Schoenmaker 2014). In sum, the banking union tries to reduce the vulnerability of a currency union with deeply interconnected financial markets. If the sovereign-bank nexus could be broken, it would allow banks to function independently of the fiscal safety net provided by any euro area member state. This would also reduce financial fragmentation and have positive spillover effects for the functioning of the transmission mechanism of the ECB's monetary policy.

Chapter 5 zeros in on the European banking union which enabled the ECB to assume the competence to conduct micro-prudential supervision for large banks in the euro area. The research objective of this chapter is to draw causal inferences from a within case study (Van Evera 1997, 49-88) to explain what caused the decisive shift to supranationalize banking supervisory competences in the euro area. The chapter tests competing theoretical explanations to increase the validity of the findings (George and Bennett 2005, 117-9). Systematic process-tracing is used within the case to increase the number of collected data points (George and Bennett 2005, 205-32; Hall 2003, 391-5) and identify the key episodes that led to the creation of the banking union. The chapter draws on a diverse set of empirical material that ranges from position papers of key bank lobby groups, speeches of key decision-makers, the existing academic literature to press releases and articles from high-quality newspapers. The chapter shows how the banking union project was in the interest of the same banks that massively pushed for it. Large cross-border banks stood to gain from the banking union because it would level the playing field, create regulatory savings and ultimately encroach on the business model of the smaller competitors that had, thus far, been shielded from competition through favorable regulation. We show how the dominant interest coalitions in the German and French banking sector fractured as a result of the deepening of European financial markets. As large banks became less and less dependent on their domestic markets, their loyalty towards their domestic regulator and their smaller competitors ceased to exist (cf. Epstein 2014). Empirically, the chapter shows how the Spanish banking crisis in 2012 was decisive in reordering the German position which then paved the way towards the banking union. The chapter concludes by assessing the first tests of the new framework in Italy and Spain which confirm our view that large banks stand to gain from the banking union.

Completing EMU

The narrative that EMU was fundamentally 'incomplete' and needed to fix its design flaws featured prominently in the discussions about the governance architecture of EMU (De Grauwe 2012; Hall 2012; De Grauwe 2013; Pisani-Ferry 2014; Niemann and Ioannou 2015; Giavazzi and Wyplosz 2015; Jones, Kelemen, and Meunier 2016; Henning 2017; Mody 2018). The original promise of the euro that it would automatically foster economic convergence was left unfulfilled (Eichengreen 2012). This had direct repercussions for the ECB's one-size-fits-all monetary policy. Under economic divergence, it can be even more costly to be a member of a currency union. In the absence of sufficiently large fiscal buffers, member states are deprived of their stabilization tools to smoothen the business cycle and to adequately deal with asymmetric shocks. A macroeconomic stabilization capacity or a budgetary union could address the problem of pro-cyclical fiscal policy (da Costa Cabral 2016). Other proposals such as moving towards debt mutualization through the creation of Eurobonds encountered strong resistance from member states and were not adopted (Matthijs and McNamara 2015). Lessons from the history of US fiscal federalism proved particularly useful in sketching out a future integration path for the EU (Henning and Kessler 2012; Mayer 2012; Gaspar 2015).

Chapter 6 categorizes newly created and proposed EMU institutions according to different modes of indirect governance (Abbott et al. forthcoming). Four empirical cases from the realm of EMU governance are discussed, i.e. the European Stability Mechanism (ESM), the European Central Bank (ECB)/Single Supervisory Mechanism (SSM), the proposed European Minister of Economics and Finance (EMEF) and the European Fiscal Board (EFB). The chapter asks how we can explain that the institutional response to the euro area crisis has produced such diverse governance arrangements. It shows that when credible commitment problems need to be solved, member states tend to delegate competences to a trustee (ECB/SSM). Supranational actors with scarce competences prefer orchestration (EFB). However, when the objective is to minimize 'agency loss', member states prefer to delegate competences to an agent (ESM) that they can tightly control. In contrast, supranational actors rely on cooptation (EMEF) in such cases.

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2. 'THE TROIKA IS DEAD, LONG LIVE THE DOMESTIC TROIKAS?': THE DIFFUSION OF NATIONAL FISCAL COUNCILS IN THE EUROPEAN UNION[2]

2.1. INTRODUCTION

The euro area crisis triggered a reform effort tailored towards fixing dysfunctional fiscal institutions with a focus on addressing the compliance gap that plagued the Stability and Growth Pact (SGP). But how could EMU's fiscal architecture regain its credibility given that the European Commission had proven to be too lenient as a fiscal watchdog? Decentralization of fiscal surveillance by creating expert fiscal councils at the national level was proposed as a potential remedy. The International Monetary Fund (IMF) defines a fiscal council as 'a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability, and other official objectives' (Debrun et al. 2013, 8). If these new technocratic bodies could build up a reputation for 'unbiased' analysis and disseminate their reports to the public, they could govern fiscal discipline indirectly through enabling intermediaries (i.e. voters, media, credit rating agencies or parliamentarians) to adequately judge the government's fiscal competence (Beetsma and Debrun 2017). As a result, the compliance gap would be narrowed and negative externalities for the whole eurozone contained because existing informational asymmetries would be evened out leading to a more prudent fiscal policy.

The first fiscal council in Europe was established in 1945 in the fiscally-hawkish Netherlands, followed by others in Denmark (1962), Austria (1970), Belgium (1989) and Sweden (2007). It was, however, not until the 2008 financial crisis that the number of fiscal councils rose in the European Union (EU) (see Beetsma et al. 2018, 6-7; Debrun et al. 2013, 11). The sovereign debt crisis subsequently accelerated the spread of fiscal councils even more. The diffusion of fiscal councils constitutes the second wave of delegation to technocratic non-majoritarian institutions after the rise of independent central banks and regulatory agencies in the 1990s (McNamara 2002). But, in contrast to the previous wave, it did not result in the spreading of a one-size-fits-all governance model. What explains this variance in the design features of fiscal councils in the EU? An explanation based on coercive pressures exerted by powerful member states attempting to impose constraining institutions on fiscally profligate governments through EU-wide regulations would lead us to find such a one-size-fits-all fiscal council.

[2] This chapter is derived from an article accepted for publication in the *JCMS: Journal of Common Market Studies* on October 25, 2018, © Blackwell Publishing Ltd.; an earlier version of this article was published as a *TARN Working Paper 03/2018* under the title 'The troika is dead, long live the domestic troikas?' Varieties of technocracy and the diffusion of national fiscal councils in the European Union: Agents, trustees or orchestrators of fiscal discipline?, available online: https://ssrn.com/abstract=3202232.

Yet, this is not what we observe empirically. Fiscally hawkish Germany has set up a fiscal council that leaves too much space for political meddling and lacks the financial resources to build up sufficient analytical capacity (Fromage 2017). In contrast, the repeated SGP-violator Portugal has exceeded the minimum legislative requirements and created an effective vanguard fiscal council (von Trapp, Lienert, and Wehner 2016; Horvath 2018). This chapter contends that by focusing on the influence of different international organizations (IOs) in the diffusion of fiscal councils this puzzle can be solved. Broome and Seabrooke (2012) have shown that IOs use 'analytic institutions' to make their member states 'legible', which in turn allows them to construct cognitive authority in certain policy areas. Thus, IOs have the capacity to instigate domestic institutional change indirectly. As this chapter will show, this task becomes harder as different IOs compete in the same policy area to assert their cognitive authority over others. In the case of fiscal councils, IOs have relied on indices to interpret their member states' experience with them and to promote a certain conceptual model that is in line with their own institutional self-interest and policy goals. This type of persuasion through *entrepreneurial benchmarking* constitutes the key mechanism by which member states were nudged to adopt a specific conceptual model. The troika institutions - the European Commission, the European Central Bank (ECB) and the IMF - formed a technocratic consensus about the desirability of establishing a fiscal council to improve fiscal policy-making in the long-term. Their consensus was based on the shared understanding that the status quo of the fiscal governance framework was untenable and that fiscal policy had an important role to play in macroeconomic stabilization despite being subject to the principle of long-term sustainable public financing. Nevertheless, considerable disagreement existed about the desirable fiscal council design features that would promote the particular IO's institutional self-interest. As a result, the respective benchmarking indices proposed by IOs do not focus on the same characteristics or tasks of national fiscal councils and differ markedly with regards to the rankings. The three troika members ultimately undermined each other's persuasion efforts and, thereby, prevented the emergence of a one-size-fits-all fiscal council model.

This chapter will derive three conceptual models of fiscal councils from the literature and categorize them according to a specific mode of indirect governance (i.e. delegation, trusteeship and orchestration). Subsequently, the main transmission mechanism of each model to foster fiscal discipline will be elucidated. The following section shows why each troika institution supported a distinct mode of indirect governance, which ultimately undermined the emergence of a one-size-fits-all conceptual model of a fiscal council. Finally, the chapter concludes with a summary of the main findings.

2.2. THREE CONCEPTUAL MODELS OF FISCAL COUNCILS

The three troika institutions formed a technocratic consensus that propagated fiscal councils as an effective institutional innovation to tackle fiscal profligacy (European Commission 2006; European Central Bank 2010; Debrun and Kumar 2007; Debrun, Hauner, and Kumar 2009; Debrun 2010; Debrun et al. 2013). Their alignment resulted from a shared long-term goal to achieve sound fiscal policies and sustainable public finances. Yet, diverse medium-term objectives also motivated their promotion of fiscal councils: (1) the Commission wanted to improve compliance with the SGP and increase local ownership of the fiscal rules but without endangering its monopoly power as the 'fiscal rule interpreter of last resort' (European Commission 2006, 2014); (2) the ECB wanted to anchor monetary dominance (i.e. a regime in which the central bank's monetary policy stance acts as an effective constraint on fiscal policy) more firmly in EMU's governance architecture and prevent negative spillover-effects from fiscal profligacy (cf. Henning 2016); and (3) the IMF wanted to maintain global financial stability and ensure repayment of their financial assistance by reinforcing EMU's fiscal discipline.

But which fiscal council design would best achieve these diverse policy goals? After all, eurozone member states were in charge of implementing EU legislation that mandated the creation of a 'functionally autonomous' fiscal council (Jankovics and Sherwood 2017, 10; Fromage 2017, 111)[3]. Especially the ECB and the IMF favored a more independent fiscal council because they had less leverage over member states but were also less constrained by European politics than the Commission. Thus, a fiscal council managed in a non-hierarchical fashion and insulated from governmental pressures would be more likely to achieve their policy goals. However, the Commission was adamant that a fiscal council's mandate should be limited to the monitoring of compliance with the fiscal rules and the assessment of macroeconomic forecasts tightly controlled by the government (agent model). The Commission's pivotal role in the legislative process requires its proposals to be adopted towards the preferences of the member states as expressed in the Council of the EU. The ECB argued in favor of a highly independent fiscal council that would possess the competence to set a certain budgetary target (trustee model). Such a fiscal council would act as an active constraint on discretionary spending but would fall short of a complete delegation of fiscal policy like handing over the direct control over fiscal instruments to set specific taxation levels. Like the ECB, the IMF favored a highly independent fiscal council. The IMF argued that fiscal councils should indirectly govern fiscal policy by providing ideational support to intermediaries (voters, media, rating agencies or parliament) that would then be empowered to adequately judge the fiscal competence of the government (orchestrator model). These

[3] In the intergovernmental Treaty on Stability, Coordination and Governance in the EMU (TSCG), which entails the so-called Fiscal Compact, it was the amendment to the preventive arm of the SGP (EU Regulation 1466/97), the 'Six-pack' (EU Directive 2011/85) and the 'Two-pack' (EU Regulation 473/2013) that instructed eurozone members to create a fiscal council (Fromage 2017, 111).

heterogeneous views on fiscal councils rendered it more difficult for any of the troika institutions to impose its preferred model.

In each case the policy goal of the respective IO determines the preferred institutional design of the fiscal council. A principal initiating a new indirect governance relationship has to make two fundamental choices. First, she has to decide whether to grant authority to a new institution or to enlist a pre-existing one. Second, she has to decide whether to manage this relationship through hierarchical or non-hierarchical controls (Abbott et al. forthcoming). As a result, Abbott et al. (forthcoming) distinguish four modes of indirect governance[4].

Figure 4: Modes of indirect governance

	MANAGEMENT (EX POST)	
INITIATION (EX ANTE)	Hierarchical	Non-hierarchical
Granting authority	*Delegation*	*Trusteeship*
Enlisting authority	*Cooptation*	*Orchestration*

Source: Abbott et al. (forthcoming)

Delegation constitutes the dominant mode of indirect governance. It describes a situation in which a principal grants authority to an agent that is subject to ex ante and ex post controls (Hawkins et al. 2006). The principal can write a detailed delegation contract and assign certain tasks to the agent. If the agent acts outside of his mandate, he will be sanctioned under the ultimate threat of revoking the granted authority. A fiscal council that is supposed to give an impartial assessment of the government's fiscal policy might find it hard to build up a reputation if it is obvious that any confrontation with the government would trigger immediate sanctioning. This hierarchical type of ex post control stands in marked contrast to a non-hierarchical relationship. The latter gives the agent more degrees of freedom and, thus, reaps the benefits of relative policy autonomy. In a trusteeship, a trustor (principal) grants authority to a trustee (agent) who has considerable discretion in interpreting its mandate (Abbott et al. forthcoming; Majone 2001). As a consequence, the initial authority relationship might be inverted ex post (Abbott et al. forthcoming; Thatcher and Stone Sweet 2002). A government that creates a trustee fiscal council might find that it will gradually loose its ability to conduct fiscal policy. Finally,

[4] Co-optation refers to the co-optor (principal) enlisting a co-optee (agent) with the goal to reverse pre-existing authority relationships (Abbott et al. forthcoming). The Orbán government's co-optation of its fiscal council is a good example (Kopits and Romhanyi 2013). Beyond the Hungarian case no empirical evidence exists, which is why this mode of indirect governance will not be further explored here.

orchestration describes ‘the mobilization of an intermediary by an orchestrator on a voluntary basis in pursuit of a joint governance goal’ (Abbott et al. 2015, 722). Orchestrating fiscal councils rely on intermediaries to disseminate their assessments about the true state of the government’s public finances to govern fiscal policy choices (target). It is important to note that one rarely observes any of the three models in their pure form. Rather, national fiscal councils (like the Dutch CPB) often exhibit mixed features that combine various aspects of the three models. The OECD’s principles for independent fiscal institutions reconcile design features of all three models (von Trapp, Lienert, and Wehner 2016). For the sake of clarity, this section presents the key features of the three ideal types of fiscal councils.

Fiscal councils as agents: fiscal rule monitoring and forecast assessment

A stripped-down version of a fiscal council acting as an agent on behalf of a principal would limit its role to the monitoring of the fiscal rules and/or assessing macroeconomic and budgetary forecasts. Such a minimalist version would have several benefits for the principal. First, an agent would operate hierarchically under the control of elected representatives. Second, it would not be in direct control of any fiscal instruments, which would increase its democratic legitimacy. Third, the principal would have the right to sanction the agent if it overstretched its mandate (hard control). Herein lies a major risk for the credibility of a fiscal council acting on behalf of a political principal. Even though agents can pursue strategies to enhance their autonomy, it is harder when the costs of revoking delegated competences are low for the principal (Hawkins et al. 2006, 199-228). A hawkish fiscal rule monitor that does not shy away from publicly criticizing a government’s fiscal policy stance could face budgetary starvation. Fiscal councils require relatively little financial resources to operate but are still susceptible to budget cuts. If the financial and operational independence is not sufficiently guaranteed, a credible monitoring of the fiscal rules is not achievable. It would also make it harder to reduce the forecasting error in the government’s macroeconomic and budgetary projections. Furthermore, the increased complexity of the fiscal rules has turned monitoring them into a discretionary task. Regulating this discretion in a P-A contract is neither feasible nor desirable. The credibility and reputation of the fiscal council would suffer. In sum, an agent fiscal council is likely to be characterized by the following observable implications: a low level of independence, a mandate limited to fiscal rule-monitoring and forecast assessment excluding the possibility to make binding fiscal policy choices, and low public awareness. An agent fiscal council usually has only weak ties to other actors like the parliament because it interacts predominantly with the government. In practice, the German fiscal council – the Advisory Board to the Stability Council – follows the agent model. It performs only a narrow range of tasks and is subordinated to the Stability Council which is a joint political body of the federal level and its constituent parts that monitor the budgets of all levels of government (Fromage 2017, 125).

The independent trustee model: conducting fiscal policy

The trustee fiscal council is inspired by the independent central bank model (Wyplosz 2005; European Central Bank 2010; Coeuré 2016). It suggests that an independent fiscal council should mimic the success of inflation-targeting central banks (Wyplosz 2005; Blinder 1997). Importantly, it puts a premium on political insulation over reputation building to enhance the credible commitment of the government to fiscal prudence. Accordingly, fiscal policy like monetary policy needs to be insulated from political pressures to overcome the time-inconsistency problem. Politicians facing short-term incentives will deviate from the optimal fiscal policy path (Alesina and Tabellini 1990; Persson and Svensson 1989; Wyplosz 2008). To address the inherent deficit bias, politicians can credibly commit to fiscal prudence by delegating authority in the realm of fiscal policy to independent technocrats (Majone 2001). The trustee could, then, set the overall long-term objectives - for example, debt targets - and determine the short-term fiscal balance that is compatible with them (von Hagen and Harden 1995; Eichengreen, Hausmann, and Von Hagen 1999; Calmfors 2003). In an extreme case, a trustee fiscal council could even make binding fiscal policy choices like setting the level of taxation and expenditures to achieve long-term debt sustainability. Existing proposals regarding a mandate differ with respect to the optimal combination of control over targets and policy instruments (see Debrun, Hauner, and Kumar 2009). According to Wyplosz (2005, 72):

> 'the proposal's main advantage in comparison with budget rules is to replace mechanical limits with judgement, exactly as inflation targeting does in comparison with monetary aggregate rules. The demonstrated success of MPCs [Monetary Policy Committees] to balance their *long-term* objective against shorter-run output stabilization can be replicated in the case of FPCs [Fiscal Policy Committees]. What seems to be squaring the circle, combining short-run flexibility with long-run discipline, can be achieved in the area of fiscal policy in the same way as it has been achieved in the area of monetary policy'.

A trustee fiscal council would exhibit the following observable characteristics: a high level of political, financial and personal independence, and a mandate that goes beyond merely fiscal rule-monitoring and forecasting explicitly allowing for the possibility to make binding fiscal policy choices with high distributive consequences, thus, raising the level of public awareness (European Central Bank 2014, 96; Coeuré 2016). However, the trustee model would need to overcome serious obstacles to be implemented in practice (Wyplosz 2008, 186-90). First, time-inconsistency as the sole origin of the deficit bias in fiscal policy might be misleading. The political economy literature on the deficit bias points to a panoply of potential origins (Debrun et al. 2013, 43; Larch and Braendle 2018) but no straightforward methodology exists to correctly identify them. Second, the trustee model leaves the control of certain fiscal policy instruments in the hands of un-elected technocrats. The right to tax and spend is a sovereign prerogative of elected representatives and cannot be easily delegated without constitutional amendments ('no taxation without representation') (Wren-Lewis 2013). The fine distinction between the budget balance and the broader role of fiscal policy can be deliberately blurred by opponents of the trustee model (Wyplosz 2008, 190). Third, there is no proven track record of a fiscal council conducting fiscal policy instead of the government (Wren-Lewis 2013). This is not surprising given the lack of consensus regarding the goals of fiscal policy (Ódor 2014, 7; Leeper 2010). While monetary policy theory has steadily evolved, a trend towards the 'scientization' of fiscal policy has emerged only recently. Fourth, politicians prefer not to fully lose control over fiscal policy because redistribution allows them to build winning coalitions of voters to boost their reelection prospects (Alesina and Tabellini 2007). Fifth, a trustee fiscal council that constraints the government too tightly runs the risk of being dissolved completely (Wyplosz 2008, 188). Thus far, these hurdles have prohibited the implementation of the trustee model in its pure form. Nevertheless, one can observe fiscal councils with trustee-like features. The UK's Office for Budget Responsibility (OBR), for instance, is tasked with producing the bi-annual five-year economic and fiscal forecasts that are used by the government (Chote and Wren-Lewis 2013; von Trapp, Lienert, and Wehner 2016, 241-56). This bestows a degree of budgetary authority upon the OBR at an early stage of the budgetary process and distinguishes it from other fiscal councils that merely assess the government's forecasts.

Fiscal councils as orchestrators: pushing governments towards fiscal discipline

Orchestration perfectly illustrates the transmission mechanism of a fiscal council. First, orchestrating fiscal councils lack hard control over the targets they want to govern (Abbott et al. 2015, 720). They neither possess decision-making authority nor do they have legally-binding enforcement powers (Kopits 2011; Hemming and Joyce 2013). A fiscal council might want to reduce the budget deficit to meet the Maastricht criteria but has no direct control over the fiscal instruments to achieve this goal. This allows other actors to easily dismiss the orchestrator's recommendations unless it is politically costly to do so because the latter possesses a high reputation and a degree of focality in budgetary politics. Second, an orchestrator enlists a voluntary intermediary whose goals are aligned (Abbott et al. 2015, 722). Fiscal councils (orchestrator) can enlist voters, the media, credit rating agencies or parliamentarians with a strong preference for fiscal discipline (intermediaries) by providing ideational support, such as nonpartisan budgetary forecasts, normative assessments and recommendations or costing of specific fiscal policy measures (soft inducements) to influence the fiscal policy choices of the government (target) indirectly. Informational asymmetry often hinders voters and opposition parties from fulfilling their role in a system based on checks and balances. The average voter struggles to verify whether a fiscal policy measure will be budgetary neutral (Calmfors and Wren-Lewis 2011). Thus, the electorate may not be able to observe the 'true' fiscal position of the government. In the absence of a sufficient understanding of the intertemporal budget constraint ('fiscal illusion'), voters might be prone to succumb to over-optimism regarding the 'true' state of public finances (Calmfors 2010, 2015). If governments exploit this informational asymmetry for electoral gain, the well-known political business cycle will ensue and create persistently high budget deficits ('deficit bias'). Fiscal councils can break this vicious circle by sending a credible signal to voters about the 'true' fiscal stance of a government. The credibility of the signal will be stronger if the fiscal council enjoys a reputation for non-partisanship. Like the trustee model, the orchestrator model, therefore, presupposes strong institutional independence. The main difference between the two is, then, that the trustee can make binding fiscal policy decisions, whereas the orchestrator cannot. Third, by enhancing fiscal transparency, better informed citizens will make better decisions when judging the government's fiscal competence (Beetsma and Debrun 2017). Governments target individual groups through increased spending to reward the loyalty of their constituency (Weingast, Shepsle, and Johnsen 1981; Calmfors 2010; Calmfors and Wren-Lewis 2011; von Hagen 2013). 'Unbiased' information might reinforce the *ex-ante* and *ex-post* public scrutiny on budgetary matters and, thereby, influence fiscal policy indirectly. In sum, an orchestrating fiscal council is characterized by the following observable implications: high public awareness due to a well-developed network of intermediaries and an effective communication strategy, sufficient access to information and a high level of independence. The Portuguese fiscal council, the *Conselho das Finanças Públicas* (CFP), closely adheres to the orchestration model. The CFP is not merely in charge of conducting assessments of the compliance with the fiscal rules but, crucially, assesses the government's overall fiscal strategy (von Trapp, Lienert, and Wehner 2016, 189-203). The use of various media channels ensures that the CFP sends credible signals to the public. In doing so, it multiplies its impact and lives up to its full orchestration potential.

2.3. THE DIFFUSION OF HETEROGENEOUS MODELS OF FISCAL COUNCILS IN THE EU

IOs can play an important role in domestic institutional change. They can rely on 'analytic institutions' to interpret the experience of their member states, which allows them to construct cognitive authority in a wide array of policy fields (Broome and Seabrooke 2012). However, IOs are not neutral observers but self-interested players that try to advocate institutional change in line with their own agenda. They often use their 'analytic institutions', such as different indices, to promote their preferred conceptual model. This *entrepreneurial benchmarking* is defined here as the indexing of institutional models according to selected criteria to persuade actors of the benefits of a specific conceptual model preferred by the respective organization. The IMF often makes use of 'associational templates' that compares the experiences of a regional peer group like the EU to make its advice to member states more palatable (Broome and Seabrooke 2007). If different IOs simultaneously promote heterogenous conceptual models, member states have more wiggle room to 'pick and choose' from the available menu options.

Other factors contributing to the heterogeneity of fiscal councils include: the timing of their creation, historical path dependencies, party preferences, the political system and economic and financial crisis. First, fiscal councils created after 2004 are more likely to harness their full orchestration potential through regular hearings in parliament (Debrun et al. 2013, 17). Second, country-specific historical path dependencies can condition the institutional adaptation. In France and Finland the fiscal councils are located within their country's Court of Audit (Debrun et al. 2013, 24), whereas in other countries an institutional clean slate made it necessary to build new fiscal institutions from scratch. Third, the preferences of political parties matter for the creation of fiscal councils but their advocates do not stem from a particular corner of the political spectrum. In Sweden, the liberal-conservative government established a fiscal council but later formed a cross-party consensus with the left-leaning opposition (Calmfors 2013). Fourth, in presidential systems with a powerful executive, fiscal councils are often attached to the parliament. The US Congressional Budget Office was formed in 1974 in an attempt to regain congressional control over the federal budget by counterbalancing President Nixon (Steuerle and Rennane 2013). In parliamentary systems with strict party discipline, on the other hand, a fiscal council should ideally be a stand-alone body separated from both branches of government (Kopits 2013, 9). Finally, the origins of fiscal councils can often be traced back to economic and financial crises (Kopits 2013, 3).

Before the 2008 global financial crisis only five fiscal councils existed in the EU. When Hungary became the first country to ask for financial assistance in November 2008, it provided a window of opportunity for the Commission and the IMF to put pressure on the Hungarian government to install a fiscal council. A loan agreement with the IMF allowed the country to tap the EU's balance-of-payment facility for non-euro area countries, which gave the IMF and the Commission additional leverage to enforce its conditionality. However, even under maximum external pressure it was not clear which conceptual model of a fiscal council should be adopted (Kopits and Romhanyi 2013, 216). Ultimately, the Hungarian parliament passed the Fiscal Responsibility Law that foresaw the creation of an orchestrating fiscal council that would have sufficient 'dissuasive authority' to put pressure on the government in case of fiscal profligacy (Kopits and Romhanyi 2013). During the Romanian bailout programme in 2010, the IMF also explicitly demanded the creation of a fiscal council and staged a public intervention in support of the latter when the Romanian government was about to co-opt the new fiscal watchdog's authority (Ban 2016, 224-5). Thus, early adopters were small open economies like Romania, Hungary, Ireland, Greece and Portugal that were particularly vulnerable after the financial crisis and depended on external financial assistance. Especially for the latter three countries the creation of a fiscal council was an iron-clad provision of the memoranda of understanding negotiated by the troika (Fromage 2017, 121).

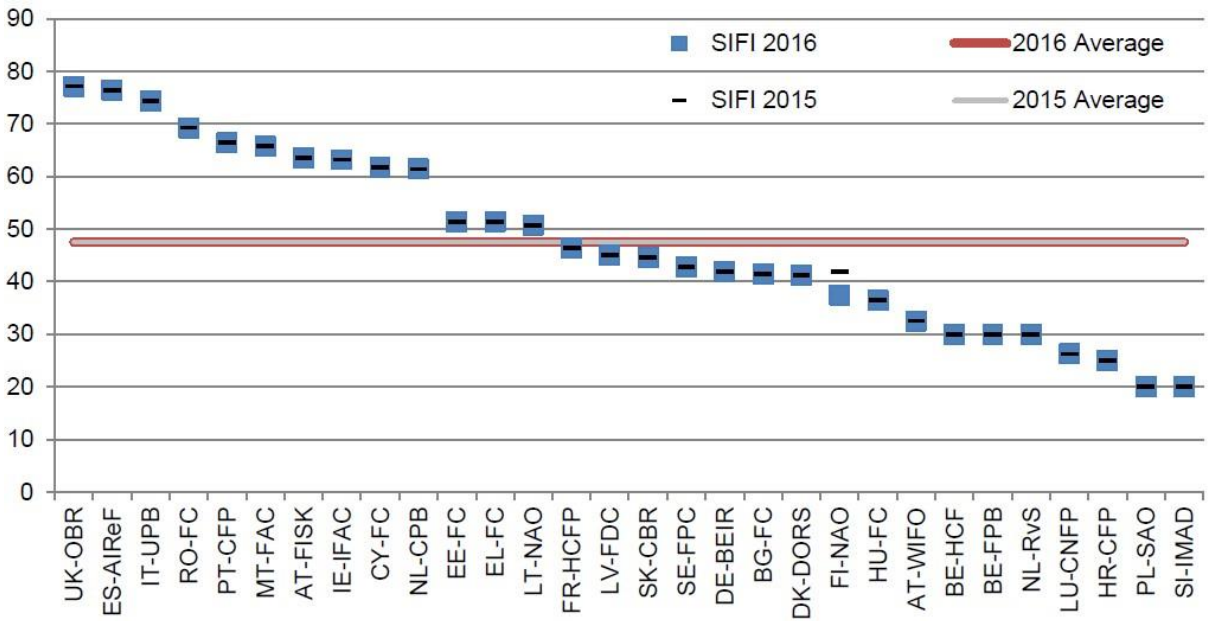
A power-based explanation of the diffusion of fiscal councils in the EU would emphasize external coercion as the main independent variable. Member states experiencing fiscal stress turned to the troika for financial assistance which imposed a fiscal council on them as part of its conditionality. While the troika format provided an important enforcement vehicle to create fiscal councils in the first place, it fails to explain the variance in the design features. Some member states without a troika presence imposed a fiscal council on themselves overshooting the EU's legislative requirements, whereas other countries with a troika programme reluctantly implemented the minimum requirements. A functional rational choice institutionalist (RCI) explanation would argue that fiscally stressed member states were eager to credibly commit to fiscal prudence to avoid having to implement the politically costly conditionality of a financial assistance programme. Fiscally profligate countries with clientelistic regimes could promote fiscal transparency through setting up fiscal councils (Wyplosz 2008). When the troika comes knocking on your door and confronts you with the prospect of having to implement tough austerity measures, political parties face strong incentives to quickly form a cross-party consensus to create an independent fiscal council to reaffirm their commitment to fiscal discipline. Under these circumstances, it might be politically expedient to delegate some fiscal policy tasks to technocrats for future blame avoidance. Even if these watchdogs would turn out to be mere smokescreens, it would be worth to set them up to receive a short-term boost in fiscal credibility until financial markets would call the bluff. A constructivist explanation would explain the fiscal council variance with the role of ideas. Especially, ordo-liberal ideas have constituted an important driver behind the new EMU fiscal architecture (Nedergaard and Snaith 2015). However, this explanation would lead us to expect the German fiscal council to be particularly hawkish, which doesn't hold. In sum, the above listed explanations shed light on contributing factors to the rise of heterogeneous fiscal councils. The following section will elaborate on the rationale behind the support for a particular fiscal council model by the respective troika member and will show how each member promoted its preferred model.

2.4. THE ACTORS AND THEIR INTERESTS BEHIND THE CREATION OF FISCAL COUNCILS

The European Commission: closing the compliance gap and increasing local ownership

The European Commission had been an advocate of fiscal councils ever since member states started to dilute the SGP (European Commission 2006, 2014). First, it wanted to improve the compliance record with the fiscal rules. Second, many member states concluded that a 'political' Commission lacked the credibility to fulfil its role as the 'guardian of the treaties'. Partially outsourcing a task that had become too politicized was the attempt to reestablish its own credibility. But it also meant creating potential challengers to the Commission's monopoly power as the 'fiscal rule interpreter of last resort'. Competing compliance assessments by the national fiscal councils and the Commission could lead to conflicting interpretations of the rules (Jankovics and Sherwood 2017, 29). To avoid such conflicts the Commission would have ideally preferred to set up a 'European System of Fiscal Councils' in which the supranational European Fiscal Board (EFB) as its agent would have coordinated the work of independent national fiscal councils (Asatryan and Heinemann 2018). However, member states and their national fiscal councils opposed such a system. The Commission's second-best solution was then to advocate for a narrow mandate for national fiscal councils so that its discretion in interpreting the various flexibility clauses under the SGP would not be endangered. To persuade member states of the benefits of the agent model of a fiscal council the Commission constructed its SIFI Index (Figure 2), which puts a disproportionate weight on the monitoring of the fiscal rules under the SGP *and macroeconomic/budgetary forecast assessment*. This *entrepreneurial benchmarking* leads to a considerably different ranking of fiscal councils compared to the IMF's ranking (Figure 3). It rewards those fiscal councils that have adopted the agent model, whereas it punishes orchestrating fiscal councils. An index can provide a soft incentive for member states to undertake institutional change in order to avoid being labeled as the laggard. The political costs of this public shaming can be minimized by adopting the model that would catapult the national fiscal council to the upper ranks.

Figure 5: Scope Index of Fiscal Institutions (SIFI)



Source: European Commission (2018)

The eurozone crisis has demonstrated that negative fiscal spill-over effects can bring a monetary union to the brink of collapse. Strengthening the fiscal governance framework was a core task to make EMU more sustainable. This would require a higher degree of local ownership of the fiscal rules, which would in turn make the fiscal measures appear more nationally rooted. It explains why the Commission provided enough leeway in its legislative proposal to account for national idiosyncrasies. In its 2017 report on the implementation of their obligations contained in the Fiscal Compact, the Commission found that all euro area member states were compliant with the TSCG and the common principles (European Commission 2017b). In its stock-taking exercise it pointed out that:

> 'The framework set by the TSCG and the accompanying common principles is one of relatively broad requirements that are principles-based, reflecting compromises needed when negotiating the TSCG and the common principles. In addition, to raise national ownership, margin was given to customise national provisions to the specific institutional budgetary setting' (European Commission 2017a, 3).

The Commission's pivotal role in the legislative process renders it sensitive to EU member states' preferences as expressed in the Council of the EU. This political interplay might have tipped the balance towards the Commission's support for a leaner (advisory) fiscal council mandate.

The ECB: ensuring monetary dominance

In light of the repeated SGP violations, the ECB had been struggling to ensure monetary dominance (Henning 2016). Fiscal profligacy in one member state could put pressure on the ECB to soften its monetary policy stance and, in a worst-case scenario, lead to monetary financing. If local ownership of the fiscal rules could be increased, it would allow the ECB to step back from the politicized role as 'policeman and judge' of the SGP (Howarth and Loedel 2004). Fiscal councils acting as a permanent 'domestic troika' would provide an additional prevention mechanism against negative externalities arising from low compliance with the fiscal rules. Thus, they indirectly help to maintain the quality of the ECB's sovereign bond portfolio. The ECB's preference for the creation of trustee fiscal councils is most evident in the central bank's comprehensive blueprint for a deepened EMU entitled 'Reinforcing Economic Governance in the Euro Area' (European Central Bank 2010). The report did not only call for an independent EU fiscal agency acting as a watchdog for the fiscal surveillance framework but also strongly encouraged the creation of 'independent fiscal monitoring institutions' (European Central Bank 2010, 8). In its legal opinion on economic governance reform in the EU, the ECB proposes 'introducing a top-down approach, meaning a prior agreement on the total spending level that is then allocated in spending allotments for different ministries or government agencies' (European Central Bank 2011, 6). While this proposal falls short of the full-fledged trustee model, it would constitute a first step towards 'institutions-based fiscal decision-making' (Coeuré 2016). While the ECB expressed concerns about the limited leverage to force the government to pay attention to fiscal councils' policy recommendations *(European Central Bank 2014, 99)*, it contends that:

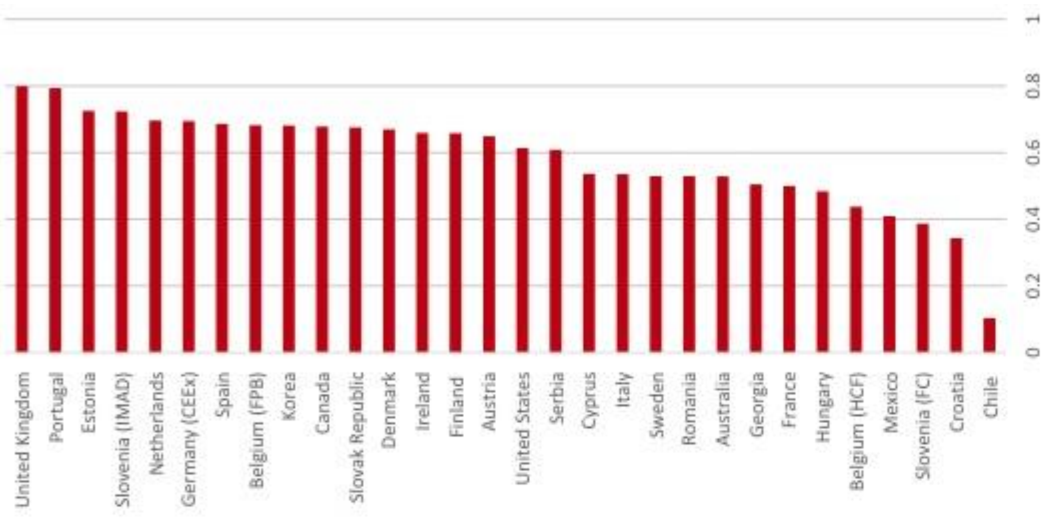
> 'the effectiveness of fiscal councils will largely depend on whether they are independent from political interference and whether they have functional autonomy. A fully independent and credible fiscal council increases the political cost for the government to deviate from its commitments. It is thus important that political interference is legally prohibited and that the council members are appointed based on competence and experience rather than political preference' (European Central Bank 2014, 99).

The ECB's view on a fiscal council's design features is strongly affected by its own experience with the time-inconsistency problem, which provided the rationale for its high level of independence. Thus, it does not come as a surprise that the ECB tries to promote its own institutional design as a template for other technocratic institutions. While the ECB tried to persuade member states of the benefits of the trustee model, the main reason for the ECB's unsuccessful persuasion attempt was the relative unattractiveness of the trustee model to elected politicians. The ECB only engaged half-heartedly in *entrepreneurial benchmarking* because it shied away from ranking countries. Instead, the ECB chose to rely predominantly on the persuasive power of its legal opinion, conferences and its Economic Bulletin in which it published a qualitative fiscal council index (see European Central Bank 2014, 97).

The IMF: creating a sustainable EMU and ensuring loan repayment

The IMF sees the transferal of knowledge and diffusion of best practices as a core part of its technical assistance missions. The eurozone crisis opened a window of opportunity for the IMF to persuade the EU member states of the benefits of the orchestration model of a fiscal council. In the post global financial crisis period the EU has increasingly relied on the IMF with regards to loan provisioning and economic surveillance turning it into a *de facto* EU institution (Hodson 2015). As a result of the diminished confidence in the Commission, the IMF gained access to various indirect channels of influencing EU policy-making (Henning 2017) and became almost indistinguishable from the traditional 'engines' of deeper integration (Hodson 2015, 586-9). Former IMF Managing Director Strauss-Kahn pushed the idea of establishing a 'more credible judge of fiscal behavior in the euro area' in Brussels (Strauss-Kahn 2010). An IMF Staff report explicitly called for establishing fiscal councils in the euro area (Allard et al. 2013, 17). As a bail-out monitor and as a creditor, the IMF had a stake in enforcing fiscal discipline in the EMU. Permanently institutionalizing fiscal discipline at the national level would increase the chances that the IMF loans would be repaid. The beneficial side effect would be that the IMF could claim credit for its research directly contributing to sound fiscal policies. The IMF had set up a fiscal council dataset to demonstrate the benefits of its preferred model and also published a comprehensive study on the global population of fiscal councils (see Debrun et al. 2013). Four design features were key to orchestrating fiscal councils: (1) a high level of operational independence, (2) the independent assessment of budgetary forecasts, (3) a high media profile (i.e. presence in the public debate), and (4) the monitoring of fiscal rules. According to the IMF's orchestration model, a fiscal council 'should be equipped to ensure that public information about the budget sends a clear signal of politicians' genuine intent and actions' (Beetsma and Debrun 2016). Thus, the IMF's SEC Index strongly emphasizes the ability to communicate with the public. Countries that have adopted the orchestration model of a fiscal council will therefore be ranked higher in the IMF's evaluation (Figure 3). This soft incentive has been very successful in promoting the IMF's orchestration model. It reflects the IMF's deep knowledge of their member states' experience with their domestic institutions. To interpret and to distil lessons from this that can be used to persuade others of the superiority of a certain conceptual model is a skill that the IMF has also used in other issue areas. The frequent exchange with its member states through Article IV Consultations is indispensable in this regard. Even though the IMF has no formal rule-making powers in the EU as such, it was able to act as a major driver of institutional change.

Figure 6: Signal-Enhancing Capacity Index (SEC)



Source: Beetsma and Debrun (2016)

2.5. CONCLUSION

This chapter has shown that the conceptual models developed by the troika institutions were heterogeneous and provided enough wiggle room for member states to make their fiscal councils compatible with their domestic institutions. The empirical evidence shows that the orchestrator and the agent model make up the largest part of the population, whereas only a few EU member states like the Netherlands and the UK have created fiscal councils with trustee-like features (Horvath 2018). In the latter cases the government has entrusted them with the production of the official forecasts, which bestows a degree of budgetary authority upon them. IOs employed tailor-made indices to persuade others of the superiority of their preferred conceptual model. Persuasion through *entrepreneurial benchmarking* constitutes an important mechanism by which IOs construct their cognitive authority over member states (cf. Broome and Seabrooke 2012). Yet, when different IOs propose different indices this task becomes considerably harder because they undermine each other's persuasive power. While this does not explain the entire observed variance in the design features of fiscal councils, it certainly is a condition which has hindered the development of a one-size-fits-all model.

As the euro area crisis' overshooting effects recede, fragile 'regime complexes' like the troika that were born out of necessity (Henning 2017) are being gradually substituted by more permanent institutions. When compared to the diffusion of central bank independence, it becomes clear that 'institutional isomorphism' – i.e. the spread of a uniform institutional design across different settings of social interaction (McNamara 2002, 62) – is rather exceptional as it requires all actors to converge around a single conceptual model and then collectively enforce its implementation. At the current juncture, fiscal councils resemble 'neglected siblings of independent central banks' (Larch and Braendle 2018) but definitely not twins given their institutional heterogeneity. However, convergence towards a more homogeneous fiscal council model might ensue after an initial stage of institutional experimentation. A network of EU independent fiscal institutions has already formed with the goal to 'exchange views, expertise and pool resources in areas of common concern'. But the absence of a one-size-fits-all model doesn't have to be detrimental because a degree of heterogeneity enables institutional learning and allows national fiscal councils to be embedded in the overarching domestic economic framework. If national fiscal councils and the supranational EFB would gradually intensify their cooperation, it could lay the foundation for an emerging 'technocratic federalism' in fiscal policy (Sánchez-Cuenca 2017). This would facilitate a timelier transfer of best practices, while leaving the door open for institutional innovation.

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3. THE LEGITIMACY OF FISCAL COUNCILS IN THE EUROPEAN UNION[5]

3.1. INTRODUCTION

In the literature on fiscal councils two opposing views have emerged with regards to their democratic legitimacy. The first sees the rise of fiscal councils as compatible with and even democracy enhancing (Fasone and Griglio 2013; European Commission 2014; Fasone and Fromage 2017). The second argues that it reveals 'increasing technocratic tendencies, where experts no longer inform decision making but become the decision-makers' (Connor 2017, 6) depriving democratically elected representatives of their policy tools. This chapter argues that these detrimentally opposed views aim at conceptually distinct models of a fiscal council. The fully-fledged trustee model of a fiscal council with direct control over fiscal policy instruments (i.e. setting the level of taxation) certainly runs counter to democratic principles (Majone 2001; Basso and Costain 2018). Such a fiscal council would make distributive choices without elected representatives. Advocates of this model point to the superior output legitimacy measured in terms of the boost in fiscal discipline. They emphasize that more independent fiscal councils possess a higher fiscal scrutiny capacity and will lead to more sustainable public finances (von Trapp and Nicol 2018). Orchestrating fiscal councils, on the other hand, rely on intermediaries (i.e. parliaments, voters and the media) to influence fiscal policy indirectly. They lack any direct policy instruments that could adjust the fiscal path, so they try to force the hand of a fiscally profligate government through their orchestration capabilities, i.e. the dissemination of non-partisan analyses of fiscal policy choices. Better informed citizens and parliamentarians with a greater 'fiscal literacy' are likely to improve the quality of democracy and will be able to cast their ballot for a party in line with their own fiscal preferences. An orchestrator can, thus, generate 'throughput legitimacy' by 'governing with the people' (Schmidt 2013). An agent fiscal council that acts under the hierarchical control of the government can, in a similar vein, be democracy-enhancing. It can generate technocratic input legitimacy by assessing and/or endorsing the macroeconomic and budgetary projections. This, in turn, can correct the overoptimistic governmental forecasts that often lie at the heart of the problem.

The chapter is structured as follows. First, an overview of the origins of the 'deficit bias', i.e. a government's tendency to run persistently high budget deficits, is given. It is argued that the identified root cause of the deficit bias determines which conceptual model of a fiscal council one prefers. If the forecasting problem dominates, the agent model of a fiscal council should prevail. If the common pool problem causes the deficit bias, one should prefer the trustee model. But if asymmetric information has been identified as the cause of the deficit bias, then the orchestration model seems more

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appropriate to eliminate the deficit bias. An empirical example is provided of each fiscal council model and its legitimacy is assessed using the familiar concepts of input, output and throughput legitimacy (Scharpf 1999; Schmidt 2013). The chapter concludes with a discussion about the contribution of fiscal councils towards strengthening market discipline and fiscal literacy of the electorate and the role they can play in actively weakening populism.

3.2. THE ORIGINS OF THE DEFICIT BIAS

The literature on the deficit bias has identified a host of reasons for the persistence of budget deficits. The specific cause of the deficit bias should inform the design features of the fiscal council so that the root cause can be effectively eliminated (von Hagen 2013). However, correctly identifying the underlying cause of the deficit bias is not straightforward. The advocates of the agent model argue that the deficit bias is caused by political meddling with the official macroeconomic and budgetary forecasts (Jonung and Larch 2006). The advocates of the trustee model argue that the origin of the deficit bias lies in the common pool problem (i.e. concentrated benefits but dispersed societal costs of spending choices) (von Hagen 2018), whereas the proponents of the orchestration model suggest that the deficit bias is nourished by asymmetric information and fiscal opaqueness (Beetsma and Debrun 2017). These diverging opinions on the origins of the deficit bias have important downstream consequences for the preferred fiscal council model. If you assume that overoptimistic forecasts cause the deficit bias, then, an agent fiscal council will suffice to eliminate the forecasting bias by producing and/or assessing the official forecasts. If you assume that the common pool problem causes the deficit bias, then a politically independent fiscal council should have direct control over fiscal policy instruments that would enable it to undertake across the board spending cuts (von Hagen and Harden 1995). In essence, a trustee fiscal council would have to possess the capacity to decisively intervene in the government's budget making process. If, on the other hand, the deficit bias is caused because voters, parliamentarians and other actors, such as credit rating agencies, hold asymmetric information vis-à-vis the government, then it would be sensible to instill an orchestrating fiscal council with a mandate that disseminates impartial information about the 'true' fiscal policy stance of the government. Relying on third party intermediaries allows the orchestrator (the fiscal council) to enlist certain capabilities that it does not possess itself (Abbott et al. 2015). Thus, it can indirectly govern fiscal policy choices of the government by flattening the asymmetrical information between the government and other actors.

The Forecasting Problem

Fiscal policy is the most important tool to build winning coalitions in electoral competitions. Politicians have no incentive to limit their own fiscal room for maneuver (Alesina and Tabellini 2007). However, they face strong political incentives to make overoptimistic revenue forecasts that will allow them to overspend and leave the bill to successive governments (Jonung and Larch 2006). At the same time, they will try to deflate their spending estimates. 'Creative accounting' is often used to circumvent the fiscal rules (Debrun et al. 2013, 43). A persistent bias in the official macroeconomic and budgetary forecasts can therefore have a severe impact on fiscal policy outcomes. It will result in non-compliance with the fiscal rules and in the long run will only increase the debt burden. An advisory fiscal council that acts as an agent of the government could receive a mandate to independently assess and/or endorse the official macroeconomic and budgetary forecasts. This would delegate a task to the fiscal council that has no direct distributive implications but is often subject to political meddling.

The Common Pool Problem

Governments often target individual groups of society through increased spending (financed by all taxpayers) to reward the loyalty of their constituency (Weingast, Shepsle, and Johnsen 1981; Calmfors 2010; Calmfors and Wren-Lewis 2011; von Hagen 2013). If the state fails to internalize this externality, for example, through coordinated spending decisions in a structured budget process, it will lead to concentrated benefits with dispersed costs resulting in excessive debts, deficits and spending (von Hagen 2013). A dynamic version of the problem is the 'war of attrition' over fiscal consolidation. In the presence of an unsustainable budget deficit various groups in society can holdout in the hope that the burden of adjustment will be shifted to another group. This 'waiting game' will delay the inevitable consolidation and, simultaneously, raise its general costs. Eventually, fiscal consolidation will be more painful due to the high level of accumulated debts (von Hagen 2013). Again, the negative externality could be internalized by a coordinated approach decided upon by a trustee fiscal council that would evenly split the costs of fiscal consolidation between the groups. Nevertheless, it is doubtful whether these trade-offs should be solved through delegation to independent technocrats. Rather, democratic and open deliberation among the different societal groups affected by a certain fiscal policy should guide the decision-making process. Politicians with short time horizons can shift the burden of adjustment into the future. In older societies the electoral pay-off for 'kicking the can down the road' is particularly high but with detrimental consequences for inter-generational justice because future generations will face exploitation through higher taxes (Calmfors and Wren-Lewis 2011). Streeck (2014) has pointed out that the politics of the consolidation state entails pitting the younger versus the older generation. This inter-generational cleavage inevitably creates difficult trade-offs. Delegation to fiscal councils is an attempt to paper over these by suggesting that they could be resolved in a purely technocratic manner. This is indicative of a broader trend towards 'governing by the rules and ruling by the numbers' (Schmidt 2015).

Asymmetric Information

Well-functioning democracies require all parties to be fully informed. However, this condition is often unfulfilled because informational asymmetries exist between the government on the one hand and the voters and opposition parties on the other. Thus, the electorate may not be able to observe the 'true' fiscal position of the government. In the absence of a sufficient understanding of the intertemporal budget constraint - that postulates that future primary surpluses need to be equal or greater than the outstanding net government debt - voters might be prone to succumb to over-optimism regarding the 'true' state of public finances ('fiscal illusion') (Calmfors 2010, 2015). A government claiming that a fiscal policy measure will be budgetary neutral, leaves the average voter struggling to verify this information (Calmfors and Wren-Lewis 2011). If governments exploit this informational asymmetry for electoral gain, the well-known political business cycle will ensue creating persistently high budget deficits. Thus, disseminating non-partisan assessments of fiscal policy can foster a shared understanding of the underlying fiscal policy trade-offs and even out informational asymmetries (Bos and Teulings 2013).

3.3. THREE CONCEPTUAL MODELS OF A FISCAL COUNCIL

The agent model of an advisory fiscal council

An agent fiscal council is characterized by a low level of independence, a mandate limited to fiscal rule-monitoring and forecast assessment excluding the possibility to make binding fiscal policy choices, and low public awareness (see Chapter 2.2.). An agent fiscal council usually has only weak ties to other actors like the parliament because it interacts predominantly with the government. The narrow mandate allows it to build up its technocratic credibility with regards to the accuracy of its forecasts. This will raise the reputational costs to the government if its forecasts are not endorsed by the advisory fiscal council.

The (technocratic) input legitimacy of an agent fiscal council

A fiscal council that is mandated by the government to assess and endorse the macroeconomic and budgetary forecasts is providing technocratic input into the policy-making system. This input is supposed to be 'unbiased' and impartial and should not be influenced by political considerations. Given that the government can dismiss or completely ignore the technocratic advice, it is questionable whether this will lead to more fiscal prudence. However, it is fully in line with democratic principles because the technocratic input is mediated by elected officials that have the final say on whether they will revise the forecasts in line with the advice provided by the fiscal council or whether they will dismiss it and use their own forecasts. In sum, an agent fiscal council is fully compatible with democratic principles because it is subject to hierarchical controls and because its mandate has been bestowed upon it by elected representatives.

Empirical Case: The Advisory Board to the German Stability Council (ABGSC)

As part of a major overhaul of its federal system, Germany created the Stability Council in 2010 - a joint body of the federal level and its constituent parts (the *Länder*) anchored in its Basic Law (Art. 109a) with the goal to monitor the budgets of all levels of government (Fromage 2017, 125). The underlying logic resembles that of the preventive arm of the SGP. The idea is to anticipate impending budgetary imbalances and to use appropriate counter-measures in a timely manner to avoid a fiscal emergency. The Stability Council also monitors compliance with the European fiscal governance framework and the constitutionally devised 'debt brake' to ensure compliance with the upper limit for the general government structural deficit of 0.5 percent of GDP. The Stability Council consists of the Federal Minister for Finance, the *Länder* Finance Ministers and the Federal Minister for Economic Affairs and Energy. This executive formation would not have complied with the legislative guidelines of the 'Two-pack'. Thus, Section 7 of the Stability Council Act provides for the establishment of an independent expert body that assists the Stability Council in its monitoring task of the upper limit of the general government structural deficit. The main task of the independent Advisory Board to the German Stability Council (ABGSC) is to produce statements and recommendations that provide the basis for the ensuing discussion in the Stability Council. The chair of the ABGSC participates in the meetings of the Stability Council and communicates the opinion of the Advisory Board. Generally, the members of the ABGSC consist of: one representative from the Bundesbank and the German Council of Economic Experts respectively; one representative from the research institutes involved in preparing the joint economic forecast; four experts appointed for a period of five years by representatives of the Federation and *Länder* in the Stability Council; and two experts appointed for a period of five years by the national associations of local authorities and the national organizations of the social security funds. Beyond these rules, it remains opaque what constitutes merit and technical competence in the appointment procedure.

A closer look at the composition of the advisory board reveals that the watchdog closely follows a structure that is deeply engrained in German corporatism. While the structure of the ABGSC is compatible with the coordinated German market economy, it could create certain conflict of interests for its members. The cardinal design flaw of 'sinners judging sinners' is likely going to propel the deficit bias. The local authorities and social security funds might have a conflict of interest because they can potentially be large contributors to the budget deficit. In the 7th ABGSC statement the interests of the latter feature prominently. The ABGSC recommends that 'it would be sensible for plans and reports on the debt brake of the federal government to regularly contain an accompanying report of expected deficits of the social security funds in order to identify potential dangers to compliance at an early stage' (Advisory Board of the Stability Council 2017, 16-7). Because social security funds are barred from issuing debt they are lobbying to include any potential funding shortfalls in the assessment of the debt brake. This means that the fiscal rules are deliberately used for self-serving purposes, i.e. to secure stable funding for the social security funds.

The ABGSC publishes its statements and recommendations on the website but is not forced to make all of them accessible for the public. The ABGSC meeting minutes can only be published with a two-thirds majority according to the rules of procedure (Section 4(6)). An essential feature of any effective fiscal council should be its ability to send a credible signal to the wider public about the 'true' fiscal competence of a government. The institutional set up confines any disagreements to the Stability Council. Access to information is not legally guaranteed and forces the ABGSC to rely on publicly available information (Wolff 2012). It lacks any parliamentary channels to indirectly influence the budget making process even though a minimum of operational and financial independence is safeguarded. Its members don't participate in parliamentary hearings and are, thus, unlikely to capture public attention. In the absence of a 'comply-or-explain' rule, the ABGSC's legally non-binding recommendations won't have any media impact either. In sum, Germany has poorly complied with the minimum legal requirements for fiscal councils stipulated in the 'Two-pack', 'Six-pack' and Fiscal Compact.

The trustee model of an independent fiscal council

A fully-fledged trustee fiscal council could determine a long-term debt target and outline the short-term fiscal balance required to achieve it (von Hagen and Harden 1995; Eichengreen, Hausmann, and Von Hagen 1999; Calmfors 2003). Existing proposals diverge regarding the optimal mix between objectives and the necessary policy instruments (see Debrun, Hauner, and Kumar 2009). Advocates of the trustee fiscal council argue that it could mimic the success of inflation-targeting central banks (Wyplosz 2005; Blinder 1997). According to Wyplosz (2005, 72), 'combining short-run flexibility with long-run discipline, can be achieved in the area of fiscal policy in the same way as it has been achieved in the area of monetary policy'. In sum, a trustee fiscal council possesses a high degree of political independence and a strong mandate to make binding fiscal policy choices (see Chapter 2.2.).

The output legitimacy of a trustee fiscal council

The trustee model raises a host of democratic legitimacy issues which renders its implementation doubtful. Insulating fiscal policy from politics is contestable because it would mean giving up a degree of democratic control. Decision-making on taxing and spending, however, is a sovereign prerogative of elected representatives and should not be delegated ('no taxation without representation') (Wren-Lewis 2013). Thus, the redistributive implications of fiscal policy and the lack of clearly measurable objectives are an obstacle for entrusting it with independent experts (Alesina and Tabellini 2007, 2008). A trustee fiscal council could suffer from a democratic legitimacy deficit unless a strong societal consensus existed about its objectives. But society's preferences on fiscal policy do not seem to be stable and public opinion regarding budget deficits is highly susceptible to media and elite framing (Barnes and Hicks 2018). While there is no trustee fiscal council conducting fiscal policy instead of a government (Wren-Lewis 2013), fiscal councils with trustee-like features do exist.

One way of measuring the impact on the conduct of fiscal policy making could be to measure the variation in the sovereign risk premium demanded by financial markets. Trustee-like fiscal councils that raise the credibility of a government's fiscal policy by promoting fiscal transparency might see the spreads of government bonds declining. Alternatively, the output legitimacy of trustee fiscal councils could be measured by assessing whether the fiscal council has increased the compliance with the fiscal rules or whether the forecasting error of the government's macroeconomic and budgetary forecasts has been reduced. Furthermore, fiscal council's output legitimacy could be assessed by measuring the fiscal literacy of mass publics, i.e. the publics' skills and knowledge enabling them to take an informed stance on fiscal policy matters. Regardless of which measure one ultimately uses, it would be already an improvement if fiscal councils could enhance the parliamentary debate about fiscal policy by forcing parliamentarians to be transparent about the distributional impact of their policy proposals.

Empirical case: The failure of the Hungarian Fiscal Council of 2008 – a cautious tale of a quasi-trustee

Hungary experienced a prolonged period of rising debts and deficits in the early 2000s due to a rampant common pool problem which culminated in a financial assistance programme jointly monitored by the EU and the IMF. In 2008, the Hungarian parliament passed the fiscal responsibility law which created a fiscal council (Kopits and Romhanyi 2013). Even though the parliament ultimately decided against bestowing any legally binding instruments of enforcement upon the fiscal council, the latter operated in many respects as a quasi-trustee with a high level of political and operational independence. Its wide mandate enabled it to intervene in parliamentary debates and steer fiscal expectations to reduce the sovereign risk premium. For example, the fiscal council prepared its own 'macro-fiscal projections, conducted real-time evaluation of the effects of each fiscal proposal prior to parliamentary debate, and monitored fiscal rules' (Kopits and Romhanyi 2013, 212). Three fiscal rules were of particular importance (Kopits and Romhanyi 2013, 223): (1) prevention of any legislation proposal to produce a net deficit in the current and subsequent year (pay-go rule); (2) cap on primary expenditure growth; (3) limit on the real stock of central government debt. During the 2010 budget bill debate, the fiscal council scrutinized numerous MP proposals to assess whether they were in line with the pay-go rule (Kopits and Romhanyi 2013, 223). However, shortly after the 2010 general election MPs of the ruling Fidesz party proposed significant budget cuts and later disbanded the fiscal council completely to narrow its mandate. Stripped off its responsibilities, the fiscal council is now merely 'a part-time deliberative body without remuneration' (Kopits and Romhanyi 2013, 227). In sum, the Hungarian fiscal council fell prey to its own success as a highly independent expert body with trustee-like features. A less powerful fiscal council might have survived the populist onslaught with some minor budget cuts without being coopted. But a fiscal council with such a high capacity for fiscal scrutiny compelled the Hungarian government to dismantle its core.

Fiscal councils as orchestrators of fiscal discipline

Fiscal councils (orchestrators) can enlist voters, the media, credit rating agencies or parliamentarians (intermediaries) with a strong preference for fiscal discipline (target) by providing ideational support, such as independent budgetary forecasts, normative assessments and recommendations or costing of specific fiscal policy measures (soft inducements) (see Chapter 2.2.). If the electorate cannot check and balance the government on fiscal issues due to informational asymmetries, fiscal councils can send a credible signal to voters about the 'true' fiscal stance of a government (Beetsma and Debrun 2017). This signal will be the stronger, the higher the reputation of the fiscal council for non-partisanship. Third, by enhancing fiscal transparency better informed citizens will make better decisions when judging the government's fiscal competence (Beetsma, Debrun, and Sloof 2017). Hence, the ideational support provided by the orchestrator is crucial in flattening out any existing informational imbalances. In sum, fiscal councils as 'producers of reliable information' can harness the benefits of expertise without having formal decision-making powers (Tucker 2018, 94-5).

The throughput legitimacy of an orchestrating fiscal council

An in-built incentive of orchestrating fiscal councils is to be as transparent, inclusive and open as possible. Even if a larger share of the public will be enabled to adequately judge the fiscal competence of the government, this does not necessarily lead to lower deficits. Hence, the traditional concept of output legitimacy might fail to capture the contribution of orchestrating fiscal councils. Given that fiscal councils have only indirect means of influencing fiscal policy it would be difficult to measure their impact on fiscal policy outcomes. Against this backdrop, a more process-oriented, 'real-time' measure of legitimacy is 'throughput' legitimacy or 'governing *with* the people' (Schmidt 2013). Located in-between input and output, 'throughput' legitimacy relates to the quality of the decision-making process (Torres 2013, 291-2) and, thus, is key to the work of orchestrators. 'Throughput legitimacy demands institutional and constructive governance processes that work with efficacy, accountability, transparency, inclusiveness and openness' with an emphasis on consultations *with* the people (Schmidt 2013, 7-8).

A major advantage of the orchestration model is that it is democracy-compatible. Fiscal councils can function as 'accountability multipliers' and enhance the role of national parliaments due to its improved fiscal scrutiny capacity (Fasone and Griglio 2013; European Commission 2014; Fasone and Fromage 2017). Importantly, a fiscal council can 'nudge the intermediary toward governance goals that are compatible with its own goals' (Abbott et al. 2015, 722). However, the legitimacy of an orchestrating fiscal council will ultimately depend on the public´s support for its goals (i.e. the degree of local ownership). In many European countries orchestrating fiscal councils have become highly reputable bodies which makes it harder for parties to ignore their recommendations (Horvath 2018). But it is often a balancing act for an orchestrating fiscal council to preserve its aura of nonpartisanship and to critically assesses the government´s fiscal policy at the same time.

Empirical case: The Portuguese fiscal council Conselho das Finanças Públicas (CFP)

The case of the Portuguese fiscal council shows that well-designed fiscal councils can reconcile accountability with democratic legitimacy when a broad political compromise provides the foundation for strong national ownership. The mandate of the Portuguese CFP explicitly mentions the enhancement of the quality of democracy as one of its core tasks. The *Conselho das Finanças Públicas (CFP)* was set up in May 2011 as part of the fifth amendment to the 2001 Budget Framework Law (Law 22/2011) and became operational at the beginning of 2012. Several beneficial circumstances have facilitated the CFP's high effectiveness. First, already in 2010 (before the arrival of the troika) a cross-party consensus to set up a fiscal council between the Socialist government and the largest opposition party (the Social Democrats) emerged (von Trapp, Lienert, and Wehner 2016, 190). An independent working group was tasked with drawing up the CFP's statues, which cumulated in the signing of law 54/2011. The resulting high level of local ownership has proven beneficial for the CFP's democratic legitimacy. Second, the CFP has a broad mandate that covers eight different tasks. Among them are assessing macroeconomic and fiscal projections, public debt sustainability, compliance with the budget balance rules and the rules on expenditure by the central government, autonomous regions and local governments. In sum, the CFP is not merely in charge of conducting assessments of the compliance with the fiscal rules but, crucially, assesses the government's overall fiscal strategy. Third, the CFP's financial independence is guaranteed through state budget appropriations which can only be modified under 'exceptional circumstances'. The CFP's budget of €2.53 million (in 2014) accounts for the breath of its mandate and allowed it to hire a sufficient number of qualified research staff (von Trapp, Lienert, and Wehner 2016, 189-203). Fourth, the CFP is supposed to have access to all information that it needs to perform its tasks. Fifth, the CFP's strong commitment to transparency and democratic accountability requires it to publish all its reports on the its website. They are sent to the President of the Republic, the government, the parliament, the Court of Auditors and the Central Bank. The use of social media and media outreach ensure that the CFP sends credible signals to the public at large as foreseen in the orchestration model. In doing so, the CFP multiplies its impact and lives up to its full orchestration potential.

3.4. FISCAL COUNCILS AND THEIR TOOLKIT

Macroeconomic indicators and forecasting

Macroeconomic forecasting is based on economic formulae that make distributional choices by default. This is because macroeconomic indicators such as public deficits are calculated on the basis of deeply political formulae engrained with significant distributive implications (Mügge 2016). Powerful neoliberal ideas linger in the background and govern these indicators. If one follows this line of argument, it would mean that even a fiscal council with a narrow mandate to only produce macroeconomic or budgetary forecasts inevitably makes deeply distributional choices. Accordingly, these forecasts can never be completely 'unbiased' because a specific measurement will always lead to an advantage for some societal groups over others (Mügge 2016). However, the mere production of 'unbiased' macroeconomic projections can improve the conduct of fiscal policy significantly (Jonung and Larch 2006).

Beckert (2016, 231) argues that 'forecasting should be considered as an instrument for the construction of fictional expectations'. Orphanides and van Norden (2002) have shown that using measures such as the output gap will lead to persistent measurement errors due to the unreliability of real-time data. This raises doubts about the capacity of fiscal councils to produce accurate forecasts. Beckert, however, cautions that it is not the actual accuracy that is important but the 'credible claim for correctness' (Beckert 2016, 231). Given that future contingencies cannot be foreseen, forecasts turn into focal points around which actors' expectations converge (Beckert 2016, 234). Macroeconomic and budgetary forecasts have a special responsibility because they influence the economic behavior of domestic households. Overoptimistic governmental forecasts that falsely predict a balanced budget might incentivize households to reduce savings when they should have created saving buffers for future consumption smoothing. These 'fiscal fictions' will ultimately lead to coordination failure. Fiscal councils have, thus, an important role to play in 'de-politicizing' forecasting and in creating a reliable coordination device for households' economic activities.

Fiscal rules

In the EMU the fiscal rules devised by the SGP have often been criticized as arbitrary and overly intrusive to the point that some have advocated a complete renationalization of fiscal policy (Eichengreen and Wyplosz 2016). The rule-based approach to fiscal policy has aimed at constraining discretionary fiscal policy. This might be successful in creating long run debt sustainability but comes at the expense of short-term output stabilization. It bears the risk that fiscal policy becomes pro-cyclical as tax revenues decline and automatic stabilizers kick in during economic downturns (Wyplosz 2005). Because fiscal rules are either too lax or too tight they should be substituted with an independent fiscal council that does not exhibit a deficit bias and can use its discretion to engage in deficit targeting (Wyplosz 2005, 2008). The practical reality is that most fiscal councils function as complements to the existing fiscal rules (Debrun et al. 2013; Calmfors 2015). This is due to the *rule complexity trade-off*. The more complex a fiscal rule is, the more difficult it is to monitor and the more likely that its implementation will be outsourced to experts (Calmfors 2015). Vice versa, the simpler the fiscal rule, the easier it is to monitor without the need for an independent fiscal council. However, a simple fiscal rule like a cap on the annual budget deficit can provide for inadequate fiscal policy for a given state of the business cycle. In this regard, it is important to understand the role of fiscal councils in fiscal regimes that exhibit permanent budget surpluses like Sweden. The Swedish fiscal council, for example, criticized the government that clinging to an expenditure ceiling irrespective of the general economic developments can be costly (Haffert and Mehrtens 2015, 138). The example shows that fiscal councils can also turn into champions of Keynesian stimulus spending if governments leave their fiscal space unexploited.

The ‘scientization’ of fiscal policy

Leeper (2010, 2) has observed that ‘monetary policy tends to employ systematic analytics, while fiscal policy relies on unsystematic speculation’ or what he terms ‘fiscal alchemy’. He advocates for a ‘fiscal science’ that would anchor the fiscal expectations of households in order to improve economic decision-making. In the current regime of ‘fiscal alchemy’ uncertainty about entitlement reform might incentivize individuals to hold savings above the optimal level. Unanchored fiscal expectations are likely to create negative spill-over effects on the ability of central banks to curb inflation. Leeper (2010, 4) cautions further that ‘in the coming era of fiscal stress with no credible government plans to confront the growing fiscal strains, unanchored fiscal expectations become a certainty’. Thus, if fiscal policy would be subject to the same scrutiny as monetary policy by independent fiscal councils, it would offer more reliable guidance for private households. For this purpose, the ‘less political’ aspects of fiscal policy that are ‘more amendable to science’ should be separated and a societal consensus should be formed on them. Among these aspects Leeper (2010, 6) lists the debt target, the adjustment path of tax rates and spending to ensure debt sustainability and specific circumstances under which a change in the debt target is permissible. Larch and Braendle (2018) argue that the Musgravian stabilization function of fiscal policy should be entrusted with independent technocrats. An independent fiscal council would then set the ceiling for the nominal budget deficit for a certain period.

The fiscal rules enshrined in the SGP have set tight limits on the debt-to-GDP ratio and the permissible budget deficits but have become increasingly complex and flexible over time. Yet, they have contributed to the 'scientization' of fiscal policy that has pervaded monetary policy (see Marcussen 2009). As political deliberations about the redistributive implications of fiscal policy are gradually 'crowded out' by technocratic discourses, fiscal policy is being 'apoliticized'. Technocrats that are nominated to serve on fiscal councils on the basis of their expertise and knowledge gain in legitimacy and expert authority. At the same time, this increases the likelihood that more and more tasks related to fiscal policy will be subject to delegation as fiscal policy becomes ridden of ideological debates. Schmidt (2015) has described this process as 'governing by the rules and ruling by the numbers'. Since a complete contract anticipating all future contingencies can never be written, the question remains what the reaction function of a fiscal council would be during an emergency situation when fiscal stress renders its forecasts obsolete. What can a fiscal council do if the central bank engages in fiscal policy by stealth? Does the national statistics office collect the type of data that allows to measure a government's hidden off-balance sheet debts? The UK's Independent Office for Budget Responsibility (OBR) has started to issue so-called Fiscal Risk Reports to provide answers to some of these questions. Inspired by the banking sector stress test, the OBR even conducts fiscal stress tests in which it quantifies the impact of large tail risk events on the country's public finances.

3.5. DISCUSSION: FISCAL COUNCILS AND THE FUTURE OF EMU

Strengthening market discipline and fiscal literacy, weakening populists

Fiscal councils can contribute to a stable EMU governance architecture in various ways. First, fiscal councils can strengthen market discipline. Financial markets have repeatedly been criticized for not being able to adequately fulfill their watchdog function because they tend to overreact during bad times. Thus, market discipline only works ex post and fails to exert sufficient ex ante pressures for fiscal discipline during good times. Fiscal opaqueness of governments contributes to the failure of market discipline because credit rating agencies do not possess the adequate information to assess a government's fiscal stance correctly which results in rapid downgrading cascades during a crisis. A fiscal council that manages to rebalance the informational asymmetries in favor of third parties will decisively contribute to more accurate credit ratings. If the fiscal council enjoys a high reputation and credibility, it will contribute to faster upgrades of ratings after an asymmetric shock has hit the economy. In 2014, Moody's referred extensively to the CFP's assessments in its decision to upgrade

Portugal's government bond rating (Moody's 2014). As credit rating agencies benefit from better information, financial markets will move closer to perfect discrimination between euro area sovereign bonds. Fiscal councils encourage a government to undertake counter-cyclical fiscal policy and remain committed to long-term debt sustainability. By avoiding stirring negative market sentiments and bringing sovereign bond ratings in line with economic fundamentals positive spill-over effects for the stability of the euro area as a whole are likely to ensue.

Second, fiscal councils can help to contain populism. The populist governments across the EU have rattled the financial markets and led to a spike in sovereign bond rates. They show disdain of fiscal rules and a tendency to politicize them for electoral gain. Their policy prescriptions are characterized by an excessive short-term bias resulting in a neglect for future-oriented investments. The longer time horizon of fiscal councils could provide an effective remedy against populist myopia. Jacobs (2016, 442) has argued that to cope with the political problem of the long term, institutions need to (i) 'enhance the relative quality of information about the long-run consequences', (ii) 'stabilize political commitments over time', and (iii) 'minimize distributive opportunism by organized groups'. Fiscal councils make a strong contribution to each of these dimensions. In the Netherlands, for example, all parties submit their economic proposals to the Dutch fiscal council (CPB) for an independent assessment of their policy proposals to facilitate a better understanding of the fiscal consequences of different electoral platforms (Bos and Teulings 2013; European Fiscal Board 2017, 36). This allows voters to take an informed vote that is more aligned with voters' own fiscal preferences. Interestingly, all parties voluntarily participate in this exercise even though the fiscal council has no legal means of enforcing their participation (Bos and Teulings 2013). The example of the CPB shows that fiscal councils can govern effectively even with a thin legal and political basis because it is reputationally costly for parties to withdraw from the process (especially, shortly before a general election). Thus, the Dutch model facilitates the stabilization of the political commitments over time by providing an effective check on excessive spending promises of populist parties. Moreover, the costing of policy proposals contributes to minimizing distributive opportunism by stating explicitly which societal groups will bear the brunt of the adjustment burden. In a nutshell, fiscal councils have an important role to play in preventing the rise of populism by continuously fact checking the fiscal policy debate. Even in countries in which fiscal councils have been weakened through budget cuts (like in Hungary) their tasks can be taken over by private initiatives like the Fiscal Responsibility Institute Budapest (Kopits and Romhanyi 2013, 228). These bottom-up initiatives could also help to regain trust in the work of experts. Promoting fiscal transparency could broaden political participation and build trust in the reliability of information. This would increase the overall quality of democratic decision-making.

Third, a policy proposal by 14 French and German economists called for ‘more independent fiscal watchdogs at both national and European levels’ (Bénassy-Quéré et al. 2018, 5). The authors advocate to delegate the fiscal and macroeconomic watchdog role to the European Fiscal Board (EFB), which is an independent advisory body of the Commission. They sketch out a scenario in which fully independent national fiscal councils propose a rolling 5-year medium term debt reduction target (subject to approval by the euro area fiscal watchdog) and forecast nominal growth projections. In a second step, national fiscal councils would determine the nominal expenditure ceiling compatible with the debt reduction target. This proposal would mirror the European System of Central Banks and pave the way towards a European System of Fiscal Councils (ESFC) (Asatryan et al. 2017). Given that national fiscal councils have been careful to avoid deepened cooperation with the EFB in order not to tarnish their institutional independence (Asatryan et al. 2017), it is unlikely that an ESFC will emerge. In December 2017, the European Commission has proposed a directive that would enhance the enforcement capacity of national fiscal councils (European Commission 2017). According to the proposed directive, national fiscal councils should command more tools to ratchet up compliance with the fiscal rule framework. Yet, unless governments are willing to guarantee a minimum level of operational independence, fiscal councils would merely function as ineffective ‘smokescreens’ (Debrun and Kumar 2007). Strengthening the operational independence of fiscal councils would make rapid strides towards improving the general ‘fiscal literacy’ of the electorate. In other words, increased throughput legitimacy can generate various positive spill-over effects despite the fact that governments might still be able to simply ignore the fiscal council’s recommendation and get off scot-free.

3.6. CONCLUSION

This chapter has argued that the underlying assumptions about the causes of the deficit bias have led to three distinct conceptual models of fiscal councils. Advocates of the agent model of a fiscal council argue that the forecasting problem is the root cause of the deficit bias, while proponents of the trustee model argue that the common pool problem causes the deficit bias. Others championing the orchestrator model point to asymmetric information as the main culprit. The agent model relies on (technocratic) input legitimacy because it checks the accuracy of the official government forecasts. In contrast, the trustee model relies on output legitimacy, while the orchestrator relies on throughput legitimacy. The German fiscal council provides an example of an advisory body that is closely linked to the political process. The short-lived experience of the Hungarian trustee fiscal council points to the challenges that powerful fiscal councils face. The Portuguese CFP shows that an orchestrating fiscal council can be even democracy enhancing. In addition, this chapter has argued that fiscal councils are likely to foster market discipline and fiscal literacy in the EU and can even contribute towards tackling the rising populist threat to liberal democracy.

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4. THE ECB PRESIDENT IN NATIONAL PARLIAMENTS: TOWARDS CEREMONIALIZED ACCOUNTABILITY?[6]

4.1. INTRODUCTION

One of the most frequently leveled criticisms against the European Central Bank (ECB) is that it is an unaccountable and opaque institution (De Haan, Amtenbrink, and Waller 2004; Buiter 2014; Curtin 2017). Given its treaty-enshrined political independence, the ECB has the normative obligation to communicate and explain its monetary policy decisions to the wider public. The euro area crisis increased the pressure on the ECB to become more accountable and transparent (Fraccaroli, Giovannini, and Jamet 2018). Key drivers were the ECB's controversial role in the troika (Beukers 2013; Chang 2016; Braun 2017) and its unprecedented use of unconventional monetary policies (UMPs) with quasi-fiscal implications (Torres 2013; Schelkle 2014; Lombardi and Moschella 2015; Krampf 2016; Orphanides 2017).

A major sticking point has always been the ECB's reluctance to publish the minutes of the Governing Council's monetary policy deliberations (Buiter 1999; Issing 1999). Under the tutelage of Mario Draghi the ECB reversed course and started to publish its first 'meaningful account' of the Governing Councils deliberations without any voting records in early 2015 (Giavazzi and Wyplosz 2015; Verdun 2017). But, more importantly, Draghi embarked on a tour of national parliaments to explain the ECB's monetary policy decisions and to engage in an 'exchange of views' with elected representatives (Bovens and Curtin 2016; Jančić 2017). Why does the ECB President appear in front of national parliaments when the pre-crisis ECB insisted that the European Parliament's ECON Committee was the only proper body to exercise democratic oversight? Draghi's accountability stunt is puzzling because the ECB had, thus far, jealously guarded its political independence avoiding any impression that could suggest it is listening to elected parliamentarians. Visits to national parliaments are risky because they could further politicize the role of the ECB and undermine the 'Monetary Dialogue' (MD) with the EP. On the other hand, they allow the central bank to appear responsive and accountable.

This chapter makes an empirical contribution to the burgeoning literature which analyzes the ECB's actions through the lens of the principal-agent framework (Elgie 2002; Amtenbrink and de Haan 2002; Torres 2013; Högenauer and Howarth 2016; Pollack 1997; Thatcher and Stone Sweet 2002). In particular, it tries to shed additional light on the important question 'how agents matter' (Hawkins and Jacoby 2006). It argues that as long as monetary policy was perceived as a technocratic rules-based

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exercise with limited distributional implications, the EP appeared to be the appropriate oversight body. But the 'new normal' in which monetary policy is 'more distributive and targetable' (Fernández-Albertos 2015, 230) demanded renewed democratic legitimacy from the euro area sovereigns. Faced with this diverse set of challenges, the ECB decided to go beyond its conventional accountability measures and to speak to national parliaments directly. *Conventional* accountability measures like the exchanges with the EP are *formal* (i.e. they follow a standardized procedure) and *permanent* (i.e. they reoccur in pre-set intervals). In contrast, *unconventional* accountability measures are *informal* (i.e. they are based upon negotiated terms and do not follow one template) and *ad hoc* (i.e. they are tailored towards a particular actor). Paradoxically, EMU's democratic deficit manifest in the absence of sufficiently formalized accountability channels enabled the ECB to instrumentalize national parliaments to thwart arising threats to its independence.

The chapter will proceed as follows. The next section recaps the ECB's actions during the euro area crisis. The subsequent section zeros in on the fiscal repercussions of UMPs and on the ECB's membership in the troika. The following section shows how these have triggered three threats to its independence. The penultimate section demonstrates empirically how the ECB expanded its 'accountability toolkit' to include unconventional measures to bolster its institutional position. It also discusses the risks involved in visiting parliaments for the ECB. The chapter concludes with a summary of the main findings.

4.2. THE ECB DURING THE EUROZONE CRISIS

In the pre-crisis era, the borders of the ECB's remit were clearly defined by its (allegedly) narrow legal mandate. The extension of the mandate was ruled out by default. Heisenberg and Richmond (2002, 206) concluded that 'the Treaty does not leave open the possibility of accreting more powers to the central bank like fiscal policy or banking supervision. Without a treaty amendment, any possibility for increasing its competences, in the way the Court has, is virtually non-existent.' The euro area crisis has fundamentally transformed the perception of the ECB as a reluctant institution. It shifted its 'approach from (simply) critically assessing, suggesting and recommending to (also) strongly pressuring a specific course of action' (Beukers 2013, 1604). As a troika member the ECB prescribed tough austerity measures to countries with a financial assistance programme (Chang 2016). ECB officials repeatedly threatened to cut off emergency liquidity assistance (ELA) to ensure compliance with troika conditionality (Beukers 2013; Steinbach 2016; Braun 2017). As a result of its willingness to engage in an iterative game of chicken with the eurozone's fiscal authorities (Henning 2016), the ECB has been described as a strategic, even shrewd, political actor (Torres 2013, 279; Menz and Smith 2013, 203). Others perceived the ECB's actions as the sum of policy-makers' omissions that failed to step up to the plate (Eichengreen 2012; Orphanides 2014; Glencross 2014; El-Erian 2016, 94). Because member states preferred to take the path of least resistance, the ECB was forced to serve a triple purpose as 'government of last resort' (Streeck 2014), 'supranational fiscal authority' (King 2016, 235) and 'garbage truck of integration' (Genschel and Jachtenfuchs 2016b, 54) enabling the collective principal to achieve the survival of the euro and deeper European integration at a minimal audience cost (Genschel and Jachtenfuchs 2016a).

Its first bond buying scheme - the Securities Market Programme (SMP) – was initiated in May 2010 to restore the proper functioning of the monetary transmission mechanism that was hampered by financial fragmentation (Niemann and Ioannou 2015, 211). It was the first cautious attempt by the ECB to intervene in the sovereign bond markets, however, with limited success. The Governing Council had to realize that anything short of a 'big bazooka' would not return confidence to jittery markets. This would require not only extending its balance sheet but also to send a clear signal that it stood ready to act as a lender of last resort. Ultimately, Draghi's London speech prevented a eurozone break-up (De Grauwe and Ji 2015; Chang and Leblond 2015). It was an act of successful 'leadership by default' because the central bank possessed the right positional resources (i.e. decision-making competences and financial resources) enabling it to act without having to face political veto players (Héritier and Prakash 2015, 250; Schoeller 2018). A side-effect of OMT was that it paved the way for fiscal integration through the 'monetary backdoor' (Schelkle 2014; 2017, 214-8). The ECB also adopted 'forward guidance', a new communication instrument by which the central bank conveys its future inflation expectations and reassures markets that cheap money will flow for an 'extended period'. When the traditional interest rate instrument hit the zero-lower bound, negative interest rates and other UMPs were supposed to remove deflationary risks (Lombardi and Moschella 2015; Krampf 2016).

In 2012, European policy-makers decided to turn the ECB into the eurozone's chief banking supervisor for significant banks (De Rynck 2016; Howarth and Quaglia 2013; Epstein and Rhodes 2016). The ECB had a long-standing interest in acquiring competences in banking supervision (Padoa-Schioppa 1999; European Central Bank 2001). Supranationalized micro-prudential supervision provided access to data that eliminated informational asymmetries and enabled central bankers to extend liquidity to solvent banks only. In addition, the ECB acquired responsibilities related to macro-prudential supervision under the umbrella of the European Systemic Risk Board (Hodson 2011; Salines, Glöckler, and Truchlewski 2012; McPhilemy 2016; Lombardi and Moschella 2016). Last but not least, the ECB showed 'ideational leadership' (Dyson 2000, 262) as part of the Van Rompuy Task Force and by sketching out a path towards a 'deep and genuine EMU' in the Four and Five Presidents' Report (Niemann and Ioannou 2015). In a nutshell, the ECB extended its remit beyond the realm of regulation into stabilization through liquidity provision and even allocation (Caporaso et al. 2015; Fontan, Claveau, and Dietsch 2016). The extension and transgression of its mandate left it politically exposed to an unprecedented degree with adverse consequences for its legitimacy and its political independence (Högenauer and Howarth 2016; Balls, Howat, and Stansbury 2016; Schoeller 2018).

4.3. THE FISCAL REPERCUSSIONS OF UNCONVENTIONAL MONETARY POLICY

On 22 January 2015, Draghi announced that the ECB would embark on their own version of quantitative easing (QE) termed the Public Sector Purchasing Programme (PSPP). QE aims at pushing down yields at the long end of the maturity curve to ease credit conditions when short-term interest rates hit the zero-lower bound. By buying large amounts of long term debt, the central bank creates incentives for investors to rebalance their portfolios towards riskier assets. This might put downward pressure on the exchange rate and thereby lead to a depreciation of the currency which will boost inflation. In addition, QE might have a direct effect on long-term inflation expectations because the central bank demonstrates its willingness to act (Brunnermeier, James, and Landau 2016, 362). Yet, considerable uncertainty remains about the exact channels through which QE functions. This is nicely captured in a quote ascribed to former FED chairman Ben Bernanke that 'the problem with QE is it works in practice, but it doesn't work in theory'.

The design of QE considered debt instruments issued by all levels of euro area governments in addition to eurozone-based public sector agencies and European institutions as eligible (Micossi 2015; Claeys and Leandro 2016). The purchases of bonds were gradually increased peaking at a total monthly amount of €80bn in March 2016, only to be subsequently tapered off. The PSPP was repeatedly extended with modified settings to counter the perception that the ECB could run out of eligible securities to purchase. For example, the remaining maturity of bonds was to include a broader range between 1 and 30 years and could include yields below the ECB's deposit rate facility (Van Riet 2017). In addition, the securities purchases were limited to one-third of a country's complete debt issuance and to 25 percent of any given issue (which was later increased to 33 percent for debt securities not containing collective action clauses (CACs)) (Claeys and Leandro 2016). Like the SMP and OMT before, the design of QE was strongly influenced by legal (over the monetary financing prohibition) and political considerations (over moral hazard concerns by Germany) (Lombardi and Moschella 2015). When the PSPP started, the final OMT ruling by the CJEU was not yet released; only the opinion of the Advocate General had been published. Consequently, the design of QE largely reflects the legal considerations as put forth in the opinion, namely, that bond purchases are within the mandate of a central bank but have to be carried out in a manner that prevents any market distortions (i.e. there must be a real price difference between the primary and the secondary market grounded in economic fundamentals) (Micossi 2015, 31). Furthermore, the self-restraint regarding the issue limits on QE purchases had the purpose to keep the ECB out of debt restructuring politics because it avoided to have a blocking vote to activate a CAC (Micossi 2015, 31). These legal precautions did not prevent the opening of proceedings in front of the German Constitutional Court, which referred the QE case to the CJEU. In December 2018, the CJEU ruled that QE did not violate the prohibition of monetary financing and is in line with the treaty provisions because it constitutes monetary policy.

All assets are purchased according to the ECB's capital key and 80% of the purchases are bought by NCBs (therefore not subject to profit- and loss-sharing) (Brunnermeier, James, and Landau 2016, 361). The remaining purchases (10% of sovereigns and 10% of securities of European institutions) will be held on the ECB balance sheet and are subject to full risk-sharing. In the case of a counterparty default, this could wipe out the capital of an NCB and leave the burden squarely on the respective sovereign, which could give rise to a new type of negative feedback loop between national central banks and their sovereigns (Micossi 2015, 30). Despite Greek bonds being exempted from QE purchases for the duration of its financial assistance programme, German observers cautioned that QE was tantamount to fiscal transfers through the backdoor fueling moral hazard (Brunnermeier, James, and Landau 2016, 365). Orphanides (2017) argues that by deviating from its conventional loss-sharing regime the ECB implicitly taxed fiscally weak countries and subsidized fiscally strong ones. He criticizes that the decision increased the risk of a partial eurozone break-up and illegitimately empowered the ECB to shield its balance sheet from the consequences of moral hazard inspired actions by elected governments. It is also conceivable that the ECB wanted to avoid any political conflicts with Finance Ministers over sharing potential QE profits. The former Greek Finance Minister Varoufakis had repeatedly demanded the release of the approx. €1.9bn profits from the SMP purchases of Greek bonds (Varoufakis 2017, 332-33). According to the established procedure, the proceeds first had to be distributed to the NCBs according to the ECB's capital key and then to the national governments, which could decide in the Eurogroup to transfer them back to Greece. By reverting to purely national profit- and loss-sharing the ECB would shield itself from any accusations that it retained profits for strategic purposes.

Already in 2010 there was a growing realization within the Governing Council that embarking into unchartered monetary territory would require the 'fiscal backing' of the eurozone fiscal authorities. During an emergency, the quality of the collateral that a central bank accepts in its liquidity operations inevitably declines even if adequate haircuts are applied (Giavazzi and Wyplosz 2015, 730). The looser the requirements for the assets that the central bank can load upon its balance sheet, the higher the risk that its capital could be wiped out in an adverse scenario. ELA provision by NCBs posed an additional risk because any loss would have to be absorbed by their own capital base. Even though a central bank can operate with negative capital (Buiter and Rahbari 2012), out of fear for its credibility and financial independence the ECB tries to avoid a scenario in which it would have to call upon the member states to replenish its capital. For this reason the ECB quietly increased its subscribed capital by €5bn between 2010 and 2012 up to €10.76bn (European Central Bank 2010). Furthermore, it might be politically more palatable for a government to replenish the capital of its NCB rather than that of the ECB directly. However, this option might not be available either in case of sovereign default. Thus, an 'accounting solution' would be to carry the losses forward and then gradually recapitalize the central bank through future seigniorage revenues (Van Riet 2017). While the ECB's net profits and losses are shared with the member states according to its capital key (Art. 33 ESCB Statute), the NCBs' own arrangements exhibit a greater variance (Ingram 2010). NCBs possess discretion regarding the size of the provisions for potential losses emanating from the common monetary policy. The Bundesbank, for instance, increased their provisions in 2016 by €1.8bn to a total of €15.4bn due to risks related to QE and negative interest rates (Bundesbank 2017), which is €7.4bn higher compared to the Banque de France's Fund for General Risks (FRG). Withholding profits for 'rainy day' funds signals that the NCB anticipates risks to taxpayers and might thus be used as a strategic tool to delegitimize UMPs in the eyes of the public. However, not all NCBs exhibit the same conservative approach to risk management and instead have maintained their seigniorage payments. When push comes to shove, these NCBs will have no adequate capital buffer to cover their losses.

Fiscal dominance - a central banker's worst nightmare - is to be avoided at all cost. The deep aversion is demonstrated by the fact that all the ECB's UMPs have been designed in a such a way as to bolster monetary dominance (Lombardi and Moschella 2015; Henning 2016). Bond purchases under the SMP were only forthcoming in exchange for structural reforms of the member states, OMT would only be activated if a structural adjustment programme was agreed *ex ante* with the ESM and QE pushed most of the fiscal risks onto the balance sheets of the NCBs. A 'whatever it takes' counterfactual in which the member states would have *ex ante* clearly signaled to the ECB that they would not comply with any capital call to offset any potential losses under an OMT-type programme would have likely led to the demise of EMU (Sims 2017). However, such a collective 'fiscal un-backing' did not happen because Germany and others had an overriding interest in preventing a eurozone break-up. The alternative scenario, in which a fiscal authority hands its central bank *ex ante* a carte blanche that indemnifies it against any crisis-related risk exposure, is likely to cause moral hazard. Berlin's implicit backing of Draghi's London speech lend his words the credibility they need to have an impact on the markets (Brunnermeier, James, and Landau 2016, 354-57). But unless elected officials have formal transparent channels through which any potential fiscal commitment can be expressed, EMU's democratic deficit will only widen.

4.4. MISSION CREEP IN THE TROIKA

Since the eurozone crisis erupted, mission creep, i.e. the expansion of powers by claiming competence over policy fields that are functionally related but formally beyond the mandate, spread within the ECB (Menz and Smith 2013; Buiter 2014; Gros 2015; Braun 2017; Chang 2018). The ECB's participation in the troika results from the high priority it has attached to its role as a 'technical advisor' to governments (Jabko 2003, 725) and its willingness to enhance its competences when they are compatible with its commitment to price stability and the bureaucratic self-interest of the NCBs (Hodson 2015). However, many policy fields indirectly affect price stability opening a Pandora's box to unlimited creeping competences. Even before the troika was launched, the ECB had sent informal letters to the Spanish, Irish and Italian government in which bond purchases were implicitly offered as a *quid pro quo* for structural reforms (Henning 2017, 133-4). To be sure, under different circumstances the ECB would have probably preferred to stay out of the troika all together. For the most part, it was dragged in reluctantly. The longer the financial assistance programmes lasted, the higher were the associated political costs for the ECB. President Draghi and other ECB officials became increasingly uncomfortable with their role in the troika (Henning 2017, 252). Draghi even hinted at the possibility of exiting the troika arrangement. The pressure increased when the Advocate General of the CJEU Cruz Villalón argued in his opinion on OMT that the ECB should not be directly involved in any financial assistance programmes. In the European Parliament Draghi later stated that: 'The ECB is not going to stay in the Troika forever, that is for sure. Now it is a time of crisis, but basically the ECB is complying with existing legislation. It is not up to the ECB to decide whether to leave the Troika or not; it is actually up to you' (Draghi 2015d).

To conceal its mission creep, the ECB made frequent reference to its core mandate. In response to an EP questionnaire on the troika, the European Central Bank (2013) replied that it 'gives advice as part of the troika in full respect of its primary mandate to maintain price stability. It is in the best interest of both the euro area as a whole and of the respective Member State that the ECB conducts sound monetary policy operations to be able to deliver on its mandate.' Furthermore, legally ambiguous language ('*in liaison* with the ECB') helped to obscure the ECB's responsibilities in the troika. While the Eurogroup formally approved the financial assistance programmes, the ECB played a crucial advisory role in shaping the conditionality (Gros 2015). Given its balance sheet exposure, this allowed the ECB to gather first-hand information about the quality of the Eurosystem's collateral (Pisani-Ferry, Sapir, and Wolff 2013, 123). Juggling these dual roles created a deep conflict of interest for the ECB. Gros (2015, 6) criticized that:

> 'Today the ECB argues that it only gave 'advice' and that Finance Ministers took all the decisions, but during the time the programmes were running, the ECB has seldom emphasized this aspect in public. Members in the Governing Council were usually careful to use the term advice in describing the activities of the ECB, but the overall impression they were giving was that the ECB played a full part in the process and had developed views on all aspects of the overall programme design'.

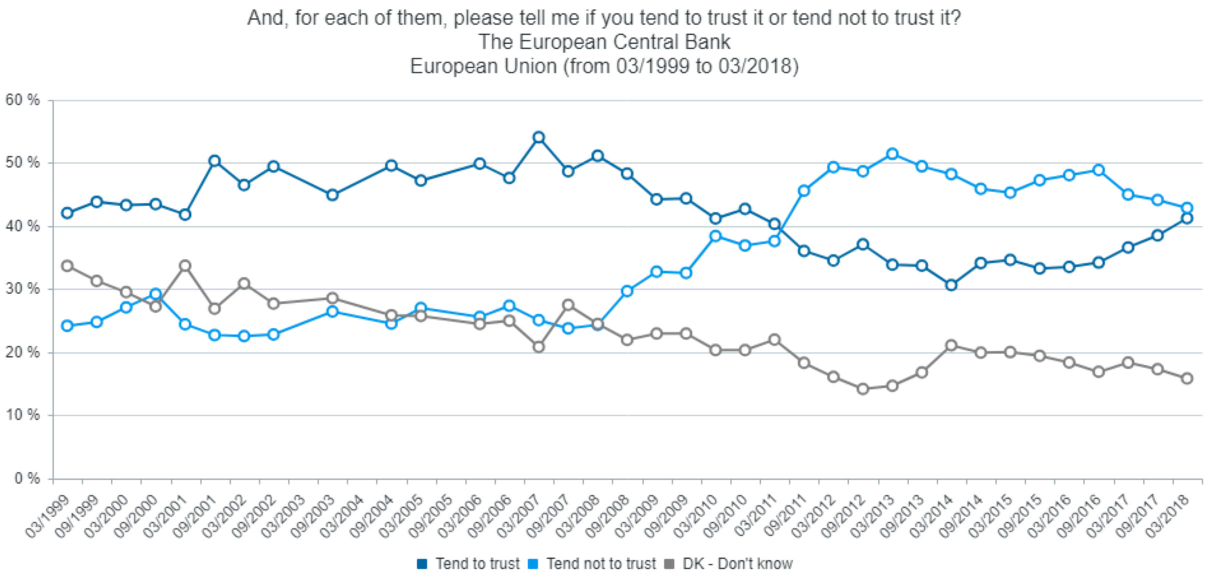
Highlighting one's 'politically impartial expertise' is an indicator for mission creep. This framing helps to extend the 'sphere of expertise and to play down the political dimension of its recommendations' (Jabko 2003, 722). Even though Draghi protested that it was not the ECB's task to coerce governments into action, his track record suggested otherwise (Beukers 2013; Braun 2017; Curtin 2017). Ultimately, the troika membership only deepened the ECB's legitimacy dilemma with detrimental consequences for its political independence.

4.5. THREATS TO CENTRAL BANK INDEPENDENCE

The ECB's UMPs and its troika participation created three mutually reinforcing threats to its political independence. If trust in an institution declines, it negatively affects its capacity to fulfill its mandate resulting in declining output legitimacy. For instance, long-term inflation expectations are particularly susceptible to declining institutional trust. A central bank that derives its legitimacy from its ability to guarantee price stability might suddenly find that the pre-crisis elite consensus on the desirability of political independence morphs into an elite dissensus, which can set in motion a vicious circle of declining independence further eroding its output legitimacy and trust. Once these negative feedback effects are at work, it is hard to reverse them. The following section discusses these three threats to the ECB's political independence in more detail.

First, the ECB's UMPs and its troika membership led to the highest level of distrust in the ECB (51 percent) ever measured within the EU since the birth of the euro (see Figure 4). However, we need to assess trust in the ECB by dividing the eurozone up into creditor and debtor countries. In the creditor countries distrust increased mostly due to the concern that the ECB's UMPs are outside of its mandate, whereas in the debtor countries distrust rose because of its participation in the troika. Vice versa, UMPs were positively assessed in debtor countries and the ECB's troika membership was welcomed in creditor countries. The aggregated EU level data show a rising level of distrust with the onset of the Lehman crisis. The second spike in distrust coincides with its participation in troika missions and the launching of the SMP in May 2010 triggering the resignations of two hawkish members of the Governing Council.

Figure 4: Trust in the European Central Bank (1999 - 2018)



Source: Eurobarometer (2018)

Albinowski, Ciżkowicz, and Rzońca (2014) found that lowering nominal interest rates at the zero-lower bound can fuel distrust if households have pessimistic consumer expectations. Also QE nourishes distrust because it contradicts the monetarist folk theory that the central bank strictly controls the quantity of money (Braun 2016). In November 2016, an alarming 55 percent of German respondents distrusted the ECB, while only 33 percent still trusted it (Eurobarometer 2016, T80). In the same year, only Greece (80%), Spain (66%), Cyprus (65%) and Slovenia (57%) exceeded the German level of ECB distrust. Roth, Gros, and Nowak-Lehmann D. (2014) find rising unemployment decreases trust in the ECB in times of crisis, while other factors might be at play in normal times. However, national idiosyncrasies (i.e. troika presence, high debt-to-GDP ratio, blame-shifting) can all give rise to increasing distrust in the ECB. In the largest creditor country, Germany, economic variables such as the level of unemployment fail to explain the high levels of distrust as the unemployment rate was failing while distrust was rising (Roth, Gros, and Nowak-Lehmann D. 2014, endnote 19). Furthermore, the mere fact of being a country with an EFSF/ESM financial assistance programme has reduced trust in the ECB (Kalbhenn and Stracca 2015). By the beginning of 2017, distrust had declined slightly due to the fact that most countries had exited their structural adjustment programmes and a fragile economic recovery had set in.

Second, the ECB's actions during the crisis have ignited an elite debate about the appropriateness of central bank independence (Buiter 2014; Tucker 2014; Issing 2016; De Haan and Eijffinger 2016; Braun 2017; Orphanides 2017; Papadia and Välimäki 2018). The rock-solid pre-crisis consensus about its desirability suddenly appeared fragile. The functional benefits of delegating monetary policy to independent central banks have been questioned in the past (McNamara 2002). Now, it was argued that giving up political independence would not curb a central bank's ability to keep inflation in check as long as operational independence was guaranteed (Balls, Howat, and Stansbury 2016). Lohmann (1999, 26) had presciently cautioned that 'because of its apolitical design, the ECB will have difficulties attracting political protection. It would be preferably by far for the designers of the ECB to accept the idea that a central bank, with its vast powers over the wealth and well-being of millions of voters, is fundamentally a political animal.' In essence, a central bank that is too independent will run into practical difficulties because its institutional design is in denial of the underlying distributional conflict inherent in its policies. Even if the general support for the euro remains high (Roth, Jonung, and Nowak-Lehmann D 2016), institutional distrust will incentivize political entrepreneurs to support the erosion of central bank independence for electoral gain (Kaltenthaler, Anderson, and Miller 2010). The Italian populist party *M5S* has called for a referendum on euro membership. But blame-shifting is not an exclusive feature of populist parties in debtor countries. Increasingly, creditor countries' parties blame national distress on ECB's policies and call for exiting EMU (Frieden and Walter 2017). Former German Finance Minister Schäuble blamed the ECB for the rise of the right-wing party *AfD* (Wagstyl and Jones 2016). The elite dissensus on central bank independence enabled these statements and reinforced public distrust in the ECB. In turn, this convinced the ECB that a communication strategy tailored towards national monetary discourses was urgently needed.

Third, central banks took on a host of new competences that were not always conducive to enhancing their output legitimacy because they clashed with their existing mandates (Buiter 2014). They are now expected to preserve financial stability through their involvement in micro- and macro-prudential supervision, while providing liquidity to keep struggling banks afloat. Former ECB chief economist Issing warned that 'being seen as the only game in town demonstrates an existential disequilibrium in the distribution of political power in the EMU. It signals an extreme case of overburdening of the central bank in almost every respect – creating expectations, assigning a political role for which a central bank has not and must not have a mandate' (Issing 2016, 7). Furthermore, since the 2008 financial crisis the ECB had not achieved its self-defined goal of an inflation rate 'below but close to 2 percent'. The persistent undershooting of its inflation target placed a premium on reinforcing its input legitimacy through visits to national parliaments. Inevitably, the ECB had to shield itself against accusations of incompetence by engaging with national representatives directly.

4.6. THE ECB'S CONVENTIONAL AND UNCONVENTIONAL ACCOUNTABILITY MEASURES

Accountability has been defined by Bovens (2007, 107) as a 'relationship between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgment, and the actor may face consequences'[7]. Applied to the ECB, we can see that the latter element of the definition conflicts with its treaty-based independence (Fromage and Ibrido 2018, 298). Nevertheless, to keep up the pretense that the ECB could face consequences, it tries to create the impression *as if* by ceremonializing accountability. Ceremonialism describes the 'superficial reporting of an organization's activities designed to satisfy monitors without revealing too much information' (Hawkins and Jacoby 2006, 210). Ceremonializing accountability means that the agent gets the principal to accept incomplete or symbolic information (Hawkins and Jacoby 2006, 210) and, thereby, manages to preserve its current level of independence. Highly independent agents even rely on 'structured self-reporting, which might permit the principal's desire for reassurance, but attenuate any potentially intrusive aspects' (Hawkins and Jacoby 2006, 211). Whether an actor can deploy ceremonialism depends on its degree of independence. Less autonomous agents whose accountability regime is tightly governed by their principal might find it harder. This section presents empirical evidence how the ECB deployed conventional and unconventional accountability to bolster its institutional position.

Conventional Accountability Measures: Monetary Dialogue and Minutes

Since its inception, the ECB understood the need to keep principals at bay to preserve its political independence. Consequently, the ECB's first President Duisenberg agreed to appear in front of the EP's ECON Committee for a quarterly MD. This accountability stunt went beyond the formal treaty requirements. However, the EP can neither dismiss ECB Executive Board members for inadequate performance nor does it have a say in their appointment procedure (Howarth 2009, 83). Jabko (2003, 721) has shown that 'the ECB tried to utilize the European Parliament in order to consolidate its independence, while the European Parliament accepted to play the game in return for its privileged oversight role.' The ECB's meddling with fiscal policy tipped off this fragile equilibrium. As a result, it became more challenging for the ECB to use the EP as a platform for independence consolidation also due to the launch of an own-initiative report on the troika. This led to a structural break in the inter-institutional relationship between the EP and the ECB.

First, the euro area crisis has raised the salience of the EP-ECB exchanges even though they still generate less media attention compared to the ECB press conferences (Claeys, Hallerberg, and Tschekassin 2014). Second, it has given MEPs a strong incentive to attend the MD and to take an

[7] For an alternative definition of accountability and different modes of accountability mechanisms, see Grant and Keohane (2005, 29).

informed and critical stance on ECB policies. This also explains the disproportionate increase of written MEP questions to the ECB President (Braun 2017, 44; Jančić 2017, 149; Fraccaroli, Giovannini, and Jamet 2018). Recent research covering the period 2009-2014 shows that a core group of active MEPs (i.e. mostly full members of the ECON Committee) felt 'well informed and prepared' for the MD (Collignon and Diessner 2016, 1310). Third, the technical nature of the relevant policy problems moved to the center stage of the exchanges. Overall, MEPs managed to gradually assert themselves over the ECB leading to a more balanced working relationship characterized by a higher degree of operationality and technicality under Draghi (Collignon and Diessner 2016, 1305). Fourth, new competences related to the accountability of the Single Supervisory Mechanism (SSM) reaffirmed the EP's privileged oversight role. While it roughly mirrors the ECB's accountability regarding monetary policy, it provides for the possibility of additional ad hoc exchanges of views and for confidential meetings in which market-sensitive information can be discussed between the Chair of the Supervisory Board and selected MEPs behind closed doors (Amtenbrink and Markakis 2017; Maricut-Akbik 2018). The EP also has a say in the appointment procedure of the SSM Chair and Vice-Chair.

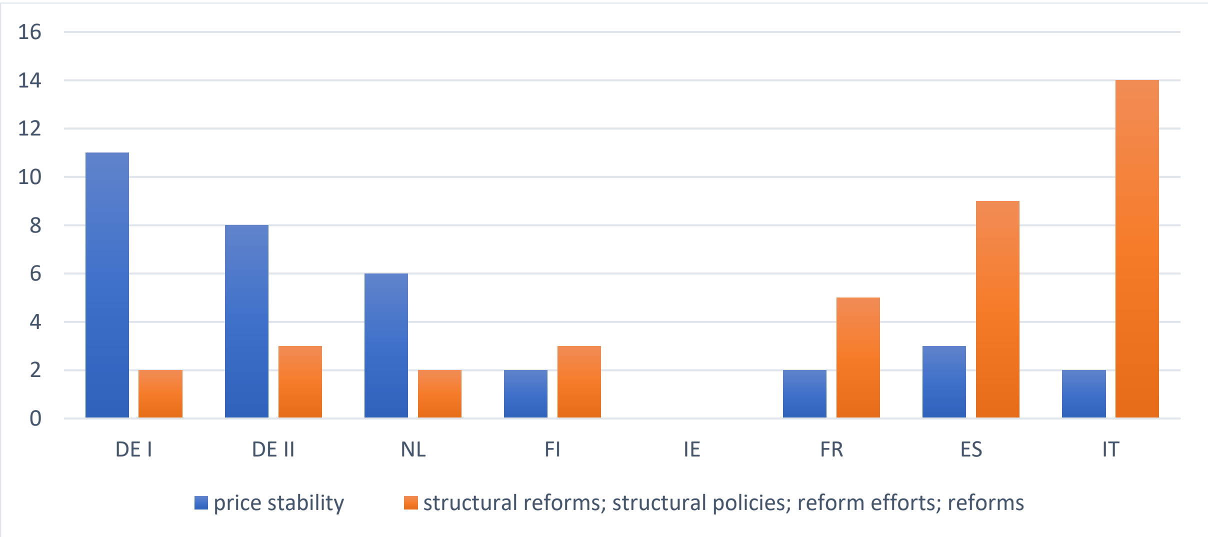
While the SSM accountability regime added another layer of complexity to the ECB's inter-institutional relations, it did not alleviate the pressure on the ECB to increase the democratic legitimacy of its quasi-fiscal policies. As a result, the ECB undertook a host of measures to boost the 'procedural transparency' of its monetary policy decision-making process (Geraats 2002, F540). By superficially reporting the Governing Council's deliberations - through the publication of a 'meaningful account' of the minutes – the ECB satisfied monitors without revealing individual voting records (Giavazzi and Wyplosz 2015, 732)[8]. It also functioned as a disciplining device for dissenting NCB governors by mitigating double-talk (Verdun 2017) and as a communication tool for steering expectations. A repeated pattern emerged by which the ECB would make strides towards greater transparency only after external pressure had reached a critical point. The ECB would then present its decision as emblematic for its commitment towards transparency. This was the case for additional information regarding the TARGET2 balances, the Irish bail-out letters, the ELA procedures, the Executive Board members' meeting calendars, the agreement on net financial assets with NCBs and the credit ratings of its holdings of corporate debt. But this 'stop-and-go transparency' failed to instill trust in the ECB. This left the ECB with the sole option to engage in a direct 'exchange of views' with national parliamentarians.

Unconventional Accountability Measures: visiting national parliaments

[8] Additional information about the voting behavior is often revealed during the press conference after the Governing Council meetings. A modicum of transparency is provided on important monetary policy decisions such as QE. However, it is only acknowledged whether a decision was unanimous or whether it was supported by a large majority. The voting records of individual governors are not disclosed publicly.

Since taking office Draghi has visited the German, French, Spanish, Finish, Italian, Dutch and Irish parliament to explain and to listen to the concerns of parliamentarians (Bovens and Curtin 2016; Jančić 2017). The ECB is the only supranational central bank that faces the challenge of having to communicate to multiple national audiences that sometimes produce conflicting demands. Thus, visiting national parliaments provides an opportunity to deliver a message tailored towards the concerns of a specific national public sphere, thereby, contributing to increasing 'throughput legitimacy' (Torres 2013). Interestingly, Draghi has visited national parliaments of creditor countries in which the legitimacy costs of OMT were the highest[9]. These were countries whose support for its independence was considered vital for the ECB also because they are some of the largest subscribers of the ECB capital key (Tesche 2018). Regaining lost trust and steering their domestic policy debates in the right direction was thus crucial. Due to the diverging assessments of the ECB's UMPs and its troika membership in the creditor and debtor countries, one would expect Draghi to counter the perception that the ECB acted outside of its mandate by reaffirming its commitment to the ECB's primary mandate in the creditor parliaments and to convince debtor parliaments of the benefits of the troika's reform agenda.

Figure 5: Word count of Draghi's opening statements to national parliaments (2012 - 2018)



Source: author's own analysis

A comprehensive content analysis of Draghi's introductory remarks in all parliaments shows that the tone of his speeches varied depending on his audience. While he listened to the concerns of the parliamentarians from creditor countries, he tried to convince the debtor countries' parliaments about the benefits of structural reforms. A simple word count shows that Draghi used the words 'price

[9] Schoeller (2018, 84) identifies those countries to be Germany, Finland and the Netherlands.

stability' 27 times in total during his opening statements to German, Dutch and Finish parliamentarians and only 7 times during his visits to France, Spain, Italy and Ireland (see Figure 5). On the other hand, he mentioned 'structural reforms' 28 times in the latter three parliaments but only 10 times when speaking to members of the creditor countries' parliaments.

The ECB has argued that it uses visits to national parliaments to explain its monetary policy decisions in greater detail. However, this is only one rationale for its willingness to engage with national parliaments. Table 1 provides an overview of Draghi's speeches in national parliaments. It shows that topics like EMU governance reforms, central bank accountability, financial stability and the benefits of structural reforms featured prominently.

Table 2: Overview of the introductory remarks of the ECB President to national parliaments (2012 - 2018)

Date	**National Parliament**	**Topics of the introductory remarks**
October 24, 2012	**German Bundestag**	Causes of the euro area crisis; the monetary policy transmission mechanism; defense of OMT
February 12, 2013	**Spanish Congreso de los Diputados de España**	Economic adjustments in the euro area; UMPs impact on Spanish banking system; financial assistance programme and structural reforms; long-term vision of EMU ('reform contracts')
June 26, 2013	**French Asemblée Nationale**	Overview of UMPs (LTROs, OMT); adjustments in the euro area (fiscal consolidation and structural reforms); limits of central bank's capacity to create growth; EMU long-term vision and banking union
November 27, 2014	**Finish Suomen eduskunta**	Overview of UMPs; the ECB's accountability framework and transparency; EMU governance (reinforced SGP)
March 26, 2015	**Parlamento Italiano** (publicly available)	Overview of UMPs; the beneficial effects of structural reforms; economic convergence through institutional convergence
September 28, 2016	**German Bundestag**	Impact of ECB's actions on price stability; the distributional effects of UMPs (implications for households, savers, pensioners and bank profitability); need for structural reforms (closing the investment gap)

May 10, 2017	**Dutch Tweede Kamer der Staten-Generaal** (publicly available)	Distributional effects of UMPs; implications for households, savers, pensioners and bank profitability; financial stability risk (high household indebtedness and low level of mortgage collateralisation); need for structural reforms and prudent fiscal policies; EMU governance reforms (EDIS, SRF backstop, Capital Markets Union)
November 8, 2018	**Irish Oireachtas**	Euro area economic outlook; reiteration of commitment to discontinue net asset purchases by end 2018 and reinvest the proceeds of maturing bonds; risks to financial stability from the non-bank financial sector and Brexit; completion of banking union (SRF backstop, EDIS) and capital markets union; support for the euro and the EU

Source: author's own compilation

The first visit to the Bundestag was a closed-door meeting that played out against the backdrop of the OMT announcement which triggered fears by some German MPs that it would violate the treaties. In his opening speech Draghi embarked on a defense of OMT rebutting the critics' arguments point by point. He claimed that the risk of moral hazard was reduced through linking any bond purchases in the secondary market to ESM conditionality (Jančić 2017, 152). Furthermore, Draghi reaffirmed the ECB's commitment to guarantee price stability. By tailoring his speech to specific German concerns, Draghi managed to reduce the audience costs of OMT. However, additional UMPs created demand for more accountability towards the Bundestag. Only four years later, Draghi was back to launch a defense of QE and its negative interest rate policy. This time concerns about the distributional effects of UMPs on German depositors and pensioners were at the heart of the debate. The term 'price stability' was only invoked eight times as public attention had shifted compared to 2012 (see Figure 5). Draghi acknowledged that real interest rates were low but were required to support the fragile economic recovery. He pointed out that 'what a household may lose in terms of little interest on their bank account, it might save in lower mortgage payments for their home' (Draghi 2016). Yet, his appearance did not have the anticipated effect on parliamentarians. The *FT* titled that Draghi had faced the MPs 'wrath over ECB policies' (Jones and Chazan 2016). One MP lamented that 'the measures the ECB has taken are good for the eurozone as a whole but not for Germany', whereas another highlighted the failure to increase trust in the ECB (Jones and Chazan 2016). The negative backlash continued during a visit to the Dutch House of Representatives, where Draghi was 'riled by Dutch MPs in a rare public grilling' (Jones and Khan 2017). The focus of Draghi's speech resembled in large parts the one he had given in the Bundestag in the previous year as the creditor countries' concerns broadly overlapped.

Draghi defended the UMPs and their distributional implications (Draghi 2017). In addition, he argued that structural reforms and prudent fiscal policies were required and supported by the ECB's accommodative monetary policy stance (Draghi 2017). In the Finnish parliament, Draghi provided a comprehensive overview of the monetary policy measures and reaffirmed the Governing Council's commitment 'to using additional unconventional instruments within its mandate' (Draghi 2014). The remainder of the remarks distinguished the ECB's accountability regime from that of the NCBs which are accountable to their respective national parliament. Draghi explicitly acknowledged the connection between enhanced procedural transparency and UMPs when he stated that 'transparency is key, especially in times where unconventional measures are being taken' (Draghi 2014). Finally, the ECB President called for more 'shared sovereignty' when he argued that 'in the euro area, economic policy choices are so interdependent that, ultimately, sovereignty over economic policy-making should be exercised jointly' (Draghi 2014).

In contrast, in the French Assemblée Nationale Draghi's focus notably shifted towards emphasizing structural reforms rather than price stability. In particular, Draghi singled out the importance of the interplay between fiscal consolidation and other reforms to raise competitiveness and productivity. At the same time, he moderated heightened expectations about the effects of monetary policy when he stated that 'monetary policy cannot create real growth. If growth is stalling because the economy is not producing enough or because firms have lost competitiveness, this is beyond the power of the central bank to fix' (Draghi 2013a). The last part of his address sketched out the key pillars of a closer economic union, namely, the delegation of additional sovereign competences to the European level and sticking to the fiscal rules to increase trust in mutual solidarity. When Draghi addressed the Spanish and the Italian Parliament his emphasis on structural reforms became even more pronounced. In Spain, which was still under an ESM adjustment programme at the time, the ECB President explained that structural reforms would take time to bear fruits (Draghi 2013b). He highlighted the extensive liquidity provision to the Spanish banking sector that was instrumental in averting a credit crunch. Finally, Draghi reiterated how the design features of its UMPs minimized moral hazard risks by linking them to strict conditionality. He stated that 'our interventions are conceivable only if the risk of fiscal dominance is firmly excluded. This requires certainty that governments will maintain fiscal discipline and that continuous reforms will correct underlying weaknesses' (Draghi 2013b). In the Italian Parliament Draghi outlined a comprehensive structural reform agenda with detailed policy prescriptions ranging from administrative and tax reform to skill training of the work force and the reduction of non-performing loans (Draghi 2015c). He cautioned that a lack of institutional convergence could have negative spill-over effects for the euro area as a whole. As a result, he concluded that the 'long-term goal must be to move from a rules-based system to one based on stronger European institutions' (Draghi 2015c).

Risks of unconventional accountability: a slippery slope into parliamentary inquiries?

Giving national parliamentarians an opportunity to voice their apprehension creates a precedent that might lead to a permanent institutionalization of an unconventional accountability arrangement that was supposed to be informal and *ad hoc*. The ECB will likely receive more invitations to visit other euro area based parliaments. If the ECB declines them, it will be accused of pandering to the interests of a selected group of countries. The ECB has not clearly indicated whether it regards the visits as a temporary or permanent feature of its accountability structure. In the Finnish Parliament the ECB President argued that 'our accountability towards the European Parliament does not exclude that there are also a number ad hoc interactions with national parliaments' (Draghi 2014). It is conceivable that the demand for visits might recede automatically. Nevertheless, the visits set an important precedent that cannot be easily reversed by future ECB Presidents. Exchanges of views with national parliaments regarding the micro-prudential supervision of credit institutions have already been formalized in the SSM Regulation. Article 21 states that a national parliament can invite the Chair or a member of the Supervisory Board for an exchange of views concerning credit institutions in the respective country. The same article also gives national parliaments the right to pose written questions related to the ECB's micro-prudential tasks and to receive its annual report (Jančić 2017, 156). Zilioli (2016, 177) argues that 'the rationale for these exchanges of views is the need to involve parties which may be responsible for recapitalizing an ailing credit institution'. It shows that when the fiscal repercussions of the ECB's actions become more identifiable the demand for the involvement of national parliaments grows.

The Irish parliament proved to be a particularly challenging case for the ECB. Like his predecessor, Draghi declined an invitation to testify in front of the Irish Joint Committee of Inquiry in the banking crisis arguing that 'owing to the ECB's accountability to European institutions and primarily to the European Parliament, the ECB is not in a position to participate in inquiries conducted by national parliaments. […] The ECB stands ready, in due course and in liaison with the Irish parliament, to determine how best to interact on an informal basis, outside the context of the banking inquiry' (Draghi 2015b). Later, Vice-President Constâncio was supposed to attend an informal exchange of views according to pre-negotiated terms. However, when it appeared that this exchange of views might be used in the inquiry, the ECB withdrew its offer immediately. Draghi argued that 'statements made by the Chairman of the Joint Committee of Inquiry, suggested that the necessary clear separation between an exchange of views and the work of the committee of inquiry could not be guaranteed.

Under these circumstances, accepting the invitation would have amounted to the ECB de facto participating in the inquiry and hence discharging accountability to the Oireachtas. However, this is the prerogative of the European Parliament' (Draghi 2015a; European Parliament 2014, 18). Only after Ireland had formally exited its adjustment programme and the inquiry committee had published its final report did Draghi signal his willingness to appear in front of the Oireachtas if he was invited again. In November 2018, Draghi made an appearance in the Oireachtas alongside the governor of the Central Bank of Ireland Philip Lane (Draghi 2018). During the exchange of views, the ECB was accused of sending 'ransom notes' and 'diktats' to eurozone governments (Jones and Beesley 2018). The hearing showed a deep anti-ECB sentiment even eight years after Ireland had requested a bailout. Parliamentarians questioned the ECB's assessment that an economic recovery had set in and Draghi was pressed to defend the ECB's involvement in the Irish financial assistance programme. In sum, the course of the hearing demonstrated why the ECB had tried to avoid it for so long.

Despite Draghi's assurances that the ECB is solely accountable to the EP, his appearances have challenged the EP's monopoly as the exclusive interlocutor for the ECB to discharge accountability. First, the co-optation of national parliaments created a rivalling accountability structure even if they are referred to as 'exchanges of views'. De facto the EP now shares its oversight rights with national parliaments. Second, it serves as a reminder that, ultimately, only national parliaments can provide credible fiscal backstops. Third, Draghi's move signals that outside options existed if the EP would become increasingly assertive. In sum, ceremonialism proved to be a useful strategy to address the fundamental trade-off inherent in visits to national parliaments, namely, to show responsiveness to specific national concerns, while not appearing to neglect the interests of the euro area as a whole. The mere symbolism of Draghi reaffirming the ECB's commitment to price stability in the Bundestag might affect public trust through positive national media coverage. Thus, the ECB co-opts national parliaments to penetrate the national public sphere, thereby, causing a virtuous cycle of revived support for central bank independence and increasing output legitimacy. Even though the ECB doesn't reveal any new information, other positive externalities like a reduced risk of future sanctioning through legal challenges can arise.

4.7. CONCLUSION

This chapter has demonstrated that the ECB's UMPs and its troika membership created three mutually reinforcing threats to its political independence. It led to a high level of distrust in the ECB, an elite dissensus on central bank independence and declining output legitimacy. Faced with this diverse set of challenges and in the absence of a fully-fledged eurozone parliament, the ECB tried to contain these threats through conventional and unconventional accountability measures. Its immediate response was to turn to its conventional accountability channels. However, the EP lacked the command of fiscal resources that could bestow the necessary democratic legitimacy upon the ECB's quasi-fiscal operations. To boost its procedural transparency the ECB Governing Council decided to publish a 'meaningful account' of its deliberations. But these measures could not sufficiently halt the onslaught on its independence. The challenge was to address the differing concerns of the ECB's actions in creditor and debtor countries. Thus, the ECB took the unprecedented step to rely on unconventional accountability measures. ECB officials decided that the ECB President should visit national parliaments to reduce distrust by delivering tailor-made messages to national audiences. In sum, the ECB shrewdly instrumentalized EMU's democratic deficit for its own independence consolidation.

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5. DEATH IN VENETO? EUROPEAN BANKING UNION AND THE STRUCTURAL POWER OF LARGE BANKS[10]

5.1. INTRODUCTION

It was only a matter of time before the nascent European Banking Union framework would face its first major test. That reckoning came earlier than expected, in June 2017. The Venetian medium-sized lenders Banca Popolare di Vicenza (BPVI) and Veneto Banca as well as the Spanish Banco Popular were resolved after the Single Supervisory Mechanism (SSM) deemed them 'failing or likely to fail.' In both cases, the resolution of these banks redounded to the benefit of large cross-border banks (Intesa Sanpaolo and Santander), which took over substantial parts of the business or even the whole entity. In contrast, the struggling Tuscan lender Monte dei Paschi di Siena has been nationalized. This outcome of the first real operation of the European Banking Union highlights its central political characteristic, which political scientists have until now underemphasized: the decisive role of large banks in the shift to banking union.

The banking union framework resulted from a gradual shift in the interests of key actors and a crisis moment in 2012 that opened the way for the adoption of significant new institutions. Observers writing from different theoretical perspectives concur that the banking union became possible when Germany, the most powerful member-state in the eurozone, agreed to the adoption of a series of institutional measures to oversee bank functioning and possible resolution (Howarth and Quaglia 2013, 2014, 2016; Schimmelfennig 2015; Schäfer 2016; Glöckler, Lindner, and Salines 2017). This chapter makes a distinctive contribution to understanding the inception of the banking union and the downstream consequences of its design.

Liberal intergovernmentalists tend to emphasize Germany's change of position as a response to the possible costs of break-up of the eurozone (Schimmelfennig 2015), with German interests dictated by the structure of its particular banking sector, notably the network of politically influential private savings banks (Howarth and Quaglia 2014). Those scholars drawing on neo-functional theory emphasize how spillover dynamics stemming from the eurozone crisis strengthened supranational authorities, in particular, the European Central Bank and the Commission, and simultaneously weakened German reluctance to create a banking union (Epstein and Rhodes 2014, 2016, 2018; Niemann and Ioannou 2015; De Rynck 2016; Nielsen and Smeets 2018). Jones, Kelemen, and Meunier (2016) even combine the two modes of explanation into what they characterize as a policy mode of

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‘falling forward,’ in which lowest common denominator intergovernmental deals between powerful states give way to further neo-functionally inspired pressures for integration, which in turn result in new, incomplete intergovernmental deals.

It is clear that intergovernmental deals have been the normal modus operandi for banking union, as in previous stages of integration. It is likewise clear that the eurozone crisis created a strong set of functional pressures that enabled supranational actors to push integration forward. In this sense, we agree with accounts in the existing literature. However, these conventional stories are incomplete. Their theoretical focus, anchored in older debates about European integration, draws attention away from what we view as the most consequential changes that contributed to the emergence of banking union.

As intergovernmental accounts have stressed, national governments are responsive to dominant interest coalitions. What we observe, however, is that the power resources of the different members of national coalitions in finance in key countries has changed over time, and as a result the sort of influence they wield over government has altered. A shift in power resources within a sector – such as finance – can lead to a shift in national preferences over interstate bargaining. That, we argue, was the decisive change that led to the adoption of the institutions of the banking union. Across Europe, the deepening of financial integration led to a break-up of the coalition among large and small banks, as large, cross-border private banks based in the eurozone moved from a business model based on what Epstein (2014a) has called a regime of banking nationalism to one of banking Europeanism. This certainly does not mean that banks ceased to exercise influence at the national level. But the increasing market dominance and international exposure of large banks changed their relationship with national regulators and with smaller banks in their home country. Mügge (2010) has shown that ‘competition politics’ can be a driver of institutional change, as large firms with cross-border operations push for the supranationalization of regulation to gain a competitive advantage over their domestic competitors. The euro area crisis did not change the preferences of large banks for supranationalizing regulation, but it provided an opening for them to deliver a deathblow to their smaller competitors.

To elucidate this transformation within the financial coalition, we draw on the distinction between instrumental and structural power (Lindblom 1977; Culpepper 2015; Fairfield 2015). Instrumental power refers to the means, not necessarily related to business, through which firms exercise political power, such as lobbying and privileged access to senior policymakers. Structural power refers to the exercise of political influence by banks through their core economic functions as employers, investors, and providers of capital to the private sector (Culpepper and Reinke 2014; Young and Pagliari 2017). The euro area crisis has highlighted a neglected aspect of banks’ structural power as a provider of capital to sovereigns. By holding large amounts of domestic sovereign bonds on their balance sheets the fate of 'too big to fail' banks and their sovereigns became closely intertwined.

Over time, the structural power of large banks acting in the eurozone has overtaken the instrumental power exercised by coalitions of small and large banks at the national level. Having structural power does not mean large banks are all-powerful – far from it. What it means instead is that both national and European Union policymakers have shifted their emphasis from a strategy aimed at satisfying the expressed political demands of (often small) banks to a strategy that is consistent with the economic imperatives of large banks, partly because those imperatives have become closely intertwined with the economic well-being of states. We observe this concretely in the break-up of the German coalition between large and small banks, but it is also visible in the French government's volte-face on the banking union, which was initially opposed to the banking union, but which later came around to support it in line with the preference of its systemically-important banks (Epstein and Rhodes 2016, 430; Epstein 2014a).

In the next section we summarize scholarship explaining the emergence of the banking union and show how the literature on power makes a distinctive theoretical contribution. We then show how the rising interest of large banks in pursuing banking union led to a conflict of interests between large and small banks, even as it increased the structural power of large banks. The interpretation of the sovereign-bank nexus as a policy problem was in part a product of the increased structural power of large financial institutions in the Eurozone. The subsequent empirical section demonstrates how the general divergence of interests between large and small banks played out in the Spanish bank crisis, affecting the coalition among German banks, and how that reordering influenced the German position in intergovernmental bargaining. The final section reviews the first bank resolutions that have taken place in Italy and Spain within the banking union framework and shows how their outcome supports an argument that emphasizes the way in which large banks stand to gain from banking union.

5.2. THE BANKING UNION AND STRUCTURAL POWER

Conventional liberal intergovernmental (LI) theory derives national preference from the dominant interest coalition in countries, and the outcome of national bargaining to the power of states with the best negotiating leverage. Applying this model to the case of banking union, Schimmelfennig (2015, 181) predicts 'a common interest in the survival of the euro (area) based on perceptions of interdependence and potential net losses and conflicting preferences on the distribution of the burdens of adjustment depending on their fiscal position.' LI theory predicts that euro area reforms will reflect the preferences of Germany, which was in a strong bargaining position due to its enhanced fiscal space (Schimmelfennig 2015, 188).

Howarth and Quaglia have been at the forefront of recent scholarship on the evolution of the banking union, and their perspective too is fundamentally intergovernmentalist, deriving national preferences for the banking union based on the constraints of belonging to a currency union. They build on the work of Schoenmaker (2011), who argued that a *financial trilemma* exists because the three objectives of free capital movement, financial stability, and national financial supervision autonomy cannot be achieved simultaneously in a currency union. Howarth and Quaglia (2014) add euro membership as an additional building block to the financial dilemma. This '*financial inconsistent quartet*' forms the basis of Howarth and Quaglia's intellectual platform to explain national choices (Howarth and Quaglia 2014, 2016). Their conclusions broadly concur with those of Spendzharova (2014), who finds that low levels of foreign bank penetration combined with highly internationalized domestic banks favour supranational banking supervision, whereas states with high levels of foreign bank penetration and low domestic bank internationalization want to retain domestic regulatory capacity.

These predictions from conventional LI theory run into two empirical puzzles. First, the outcome of the negotiations over the SSM and the SRM do not reflect the preferences of creditor countries to the extent one would have expected, given the LI prediction that fiscally sound countries such as Germany should determine the institutional outcome (Schäfer 2016). Indeed, Germany and other northern European countries created a Single Resolution Fund (SRF) that will be gradually mutualized over eight years. Schimmelfennig (2015, 192) concedes that his LI explanation does not account for large German concessions during the banking union legislative process. Second, the elegant accounts of Howarth and Quaglia fail to provide a convincing rationale for the shift of the German and the French position during 2012.

We argue that the 2012 agreement that jumpstarted the process towards a fully-fledged banking union results from the evolving preferences and power resources of systemically important large cross-border banks. Howarth and Quaglia (2014, 131) claim that

> 'German government concerns over the fate of the *Sparkassen* determined the contours of the banking union agreed between December 2012 and March 2014 and dictated the reach of ECB direct supervision, which ended up covering only one of the more than 420 savings banks'.

We posit that what looks like a product of intergovernmental muddling through in response to small bank pressure in fact reflects the changing interests of large private banks. The ECB indirectly supervises all non-significant banks in the euro area and can take charge of supervision over any credit institution if it deems it necessary to do so. This 'face-saving' compromise allowed the German government to claim that it successfully defended the interests of its savings banks.

We share with conventional LI analysis the perspective that domestic interest coalitions often play a decisive role in determining national positions. Where we propose a theoretical innovation to LI analysis is in not equating national positions with national bank structure (which is generally stable over time), but instead in locating the taking of national positions in a dynamic process of interest representation. Following Epstein (2014a), we contend that it was the changing orientations, loyalties, and business strategies of large banks that eased the path to a European banking union. By promoting national bank champions through banking nationalism (Véron 2015), especially in the larger member states, the largest banks in the eurozone became 'too big to fail'. As the revenue base of these banks in their home countries shrank in relative terms, their loyalty towards their national supervisors decreased in equal measure. At the same time, this growth put their future policy preferences in direct conflict with those of their erstwhile small banking allies. Large cross-border banks benefit from the supranationalization of supervision through reduced compliance costs related to idiosyncratic capital and liquidity requirements that previously tied up resources and through takeovers of weaker competitors. In contrast, (mainly small) banks operating in a single national environment expected neither cost saving nor competitive advantage from centralized supervision (Hennessy 2014; Howarth and Quaglia 2013; Epstein 2014a).

The distinction between structural and instrumental power provides a useful way to summarize the salient political consequences of the expansion of 'too big to fail' banks. Banks such as Deutsche Bank increased so drastically Germany became simply one market among others for them. By 2007, Deutsche Bank generated only 27 percent of its revenue within Germany (Culpepper and Reinke 2014). This reduced dependence on the German market enabled Deutsche to defy German regulators with impunity. This represents an increase in their structural power, because it is bargaining power that results entirely from their economic profile. The increased structural power accruing to Deutsche Bank contrasts with more conventional strategies of influence peddling and lobbying – which are known as instrumental power – because that lobbying depends on the resources expended to exert influence, rather than on economic structural change alone (Culpepper 2015).

Small bank networks, which depend on political protection through instrumental power, witnessed the decrease of their structural power in recent years. The number of employees of the savings banks alone has declined from 251.400 in 2008 to 224.671 in 2016, and their market share by business volume in Germany dropped was 16.8% at the end of 2016, slightly below the 18.5% of big banks (Savings Banks Finance Group 2017, 33). While they often lobby together with large banks on issues of common concern, small banks – such as the German savings and cooperative banks – are highly dependent on their relationship with regulators. This relationship is their sole protection against adverse regulation – one that they were not shy to draw upon once banking union was put on the political agenda. This explains why these banks fought adamantly to safeguard the involvement of the national authorities in the supervision of small banks (Steen, Wilson, and Barker 2012). Georg Fahrenschon, former head of the politically powerful German savings banks association, mobilized immediately against plans for a European deposit insurance scheme through inside lobbying, for which he could draw on close ties to local politicians who often sit on the supervisory board of savings banks. In their lobbying effort, the savings banks benefit from their ability to 'portray themselves […] as small and systemically irrelevant where it suits – but enjoy large benefits from being considered in other circumstances as part of large, closely linked network. "Sometimes they are one of the biggest financial groups in the world and sometimes they are just 400 simple little banks"' (Wilson, Wiesmann, and Barker 2012). Thus, the savings and cooperative bank's instrumental power was effectively deployed in the short run to obstruct the creation of eurozone-wide deposit scheme and ensure the involvement of the national supervisory authorities. At the time of writing, a European Deposit Insurance Scheme has still not been implemented (Donnelly 2018).

As the interests of large banks in banking union grew and their structural power was bolstered by the sovereign-bank nexus, this divergence in the position of large international banks and small national ones eventually caused a rupture in the German banking coalition. It is this rupture, we maintain, that partially accounts for the German change of position during intergovernmental bargaining in 2012. The Spanish bank crisis created a window of opportunity for large banks within Germany to undermine the narrative of the powerful German savings banks and to impose further costs on them, which then paved the way towards banking union. Similarly, the French government aligned its position on banking union with that of its large systemically-important banks. We acknowledge that the high politics quid-pro-quo (SSM in exchange for ESM direct bank recapitalization) was decisive for the shift towards banking union. However, we maintain that this outcome would have been unattainable in the absence of the relative empowerment of large cross-border banks.

5.3. THE INTERESTS OF LARGE BANKS IN BANKING UNION: COMPETITIVE ADVANTAGE, REGULATORY SAVINGS

Large banks compete both in an international market, against other large banks, and in a home market, against other small banks. Centralized banking supervision and resolution – which lies at the core of European banking union – helps the strongest large banks on both these fronts. Internationally, it provides incentives for the further consolidation of large banks by creating a single set of supervisory practices that will make it more difficult for national governments to protect weak banks from market pressures. At the same time, the existence of a single set of rules provides a further weapon for large banks to use in their long-running fight against what they view as the politically protected position of small cooperative and savings banks (Lütz 2005). The latter banks, which are well-connected in domestic politics, lose influence when the question of banking supervision shifts to the European level. By serving these two objectives, the banking union kills two birds with one stone for the eurozone's strongest big banks.

Thus, banking union should be understood as 'competition politics' (Mügge 2010, 25) because more stringent supervision will inevitably crowd the weakest players out of the market, making them more susceptible to takeover. The take-over of Banco Popular by Santander and the partial take-over of BPVI and Veneto Banca by Intesa Sanpaolo are cases-in-point. As large cross-border banks benefit from bank consolidation through an increased market share, their smaller competitors are ultimately left without political protection. A first wave of competitive consolidation took place under the rubric of banking nationalism (Véron 2015, 39). Notable attempts at cross-border mergers, such as by the Spanish BBVA of the Italian UniCredit, failed due to the intervention of domestic regulators (Vives 2001). If banking union significantly transformed the ownership structure of large banks, this would introduce an additional element of cross-border risk-sharing into EMU and, thereby, enhance resilience towards idiosyncratic financial shocks.

> 'The installation of supranational bodies is therefore more than just adding an extra layer of governance that otherwise leaves patterns of governance unaltered. It is the formalization of political authority at a level of aggregation that matches the interests and market structures subject to these institutions. It is, in short, a transnationalisation of the state in the face of altered competitive dynamics in the market place' (Mügge 2010, 27).

In a regime of decentralized banking supervision, national regulators can distort competition either because the rules are not uniform or because uniform rules are interpreted or implemented differently across countries, as banking organizations have repeatedly pointed out to regulators (European Financial Services Round Table 2013, 13; Deutsche Bank Research 2000, 4; UniCredit Group 2009). In addition, competition can be adversely affected because regulators react at varying speeds or because regulations enter into force with a considerable time lag. 'Competitive neutrality' – the elimination of regulatory arbitrage based on the principle of 'same risk, same regulation' – has long been a prime concern among large cross-border banks (Deutsche Bank Research 2001, 2). The single supervisory mechanism of the banking union is more likely to achieve a level playing field than would a fragmented supervisory system. Thus, it further limits a state's capacity to shield its savings and cooperative banks from unwanted liberalization (Deeg and Donnelly 2016).

In the scramble for capital to satisfy the more stringent requirements entailed by banking union, the strongest large banking groups enjoy a clear comparative advantage over their weaker competitors. The head of the large French bank BNP Paribas, Jean-Laurent Bonnafé, revealed the strategic interest behind the banking union project. When asked about its consolidation effects, he replied that

> ‘the strongest part of the banking system could be part of some form of consolidation — either through an acquisition or through organic development plans. In the end, consolidation will just take out the weaker players who were unable to strengthen their positions either because of their own situation or because of their jurisdiction’ (Fildes 2013).

From now on the SSM will be in charge of granting and withdrawing bank licenses and will also be in charge of mergers and acquisitions. Banks with expansionary ambitions therefore stand to gain from banking union. Emilio Botín, former chairman of Santander, opined that ‘banking union is an ambitious, complex and difficult process, both operationally and politically, but we cannot afford to postpone it’ (Botín 2012). He pleaded for a maximum harmonization of regulatory rules and standards, the creation of a European Deposit Insurance Scheme (EDIS) and establishing a Single Resolution Mechanism (SRM). Five years later his daughter and successor Ana Botín declared, after having snatched up Banco Popular for a symbolic €1, that this deal is ‘good for Spain and good for Europe’ (Buck 2017). Santander’s domestic rival BBVA also strongly supported a fully-fledged banking union (BBVA Research 2013, 2014).

Large banks had long lamented that the liquidity controls imposed on foreign branches by the host country’s supervisory entity contradicted the principle of home country supervision, because it often served as a pretext for the host supervisor to extend *de facto* surveillance (Deutsche Bank Research 2000, 6; European Financial Services Round Table 2013, 4). Another oft-used strategy by host supervisors was to demand that the foreign bank sets up an independent subsidiary, which would then fall under its own supervisory remit (Association for Financial Markets in Europe 2013). In this way the supervisor could effectively ‘quarantine’ the subsidiary of a foreign bank from any contagious effects caused by failure of its parent company. More importantly, it empowered itself to prevent the recapitalization of a parent company by its subsidiary (as attempted by Santander UK in May 2012) through ring-fencing the funds (Donnelly 2014, 995).

Prior to the banking union, large banking groups were not in the position to reap the full benefits of cross-border expansion due to national variations in capital and liquidity requirements. For example, the *Financial Times* reported that a Single Supervisory Mechanism would free up €7bn of capital for Italian UniCredit from its German subsidiary HVB. The ring-fencing measure by the German competent supervisory authority requiring UniCredit to hold an additional capital buffer was grounded in a lack of trust (Mackintosh, Ross, and Sanderson 2013). Thus, it is not surprising that UniCredit's chief economist strongly supported the banking union (Nielsen 2012). Austrian banks with operations in central and Eastern Europe faced a similar problem from the national regulator, which imposed lending targets on these banks (Epstein 2014b). Instead of relying on traditional capital controls during periods of intense financial stress, regulators often overreacted with macro-prudential oversight or restrictions on the operation of foreign banks (BBVA Research 2013, 2014).

The harmonization of banking supervision entailed by the banking union was therefore expected to liberate excess capital for banks with substantial cross-border operations (Jenkins 2012). The additional capital could then be moved from over-capitalized to less well-capitalized markets, thereby improving a bank's overall capital efficiency. Moreover, working under the surveillance of national regulators created pressures on capital allocation, either from lending targets imposed by a national supervisor during periods of stagnant growth or due to implicit pressures to stock up on the home country's sovereign bonds. In short, the move to a Single Supervisory Mechanism meant that capital that had previously been tied up could flow into higher yielding activities (Epstein 2014a, 5).

Even as it removed regulatory impediments to reaping economies of scale, the move to banking union also offered big banks a regulatory means to establish a level playing field that would allow them finally to crack down on the business model of the cooperative and savings banks. Already in the early 1990s, the German association of private banks (BDB) tried to limit the competitive advantage of the latter. When they failed to resolve the issue at the national level, they turned to the European Commission for additional support (Smith 2001, 529). In 1999 large European banks attacked the business model of the German Sparkassen and Landesbanken by filing a case with DG COMP in which they alleged unfair state aid (Grossman 2006; Smith 2001). The banking lobby group, the European Banking Federation (EBF), took issue with the fact that the Sparkassen benefited from public guarantees. The EBF argued that this special treatment led to a distorted competition, because Sparkassen were able to refinance themselves more cheaply than other banks that were not backed by an implicit state guarantee. The conflict ended in 2005 with a first victory of the large private banks. The agreement between the German government and the Commission phased out local and state government guarantees by 2015 for Sparkassen and Landesbanken that were teetering on the brink of insolvency (Deeg and Donnelly 2016, 592).

Despite this defeat, during the negotiations of the Capital Requirements Directive (CRD) in 2005, the German cooperative and savings banks succeeded in achieving a zero risk-weighting for the treatment of intra-group exposure, which allowed them to operate with lower capital requirements than other competitors (Christopoulos and Quaglia 2009, 187). The IMF has argued that this special treatment might lead to 'a de facto underestimation of capital requirements' and could encourage excessive risk-taking that might endanger financial stability (IMF 2011, 11). Unless specifically required by the national supervisory authority, savings and cooperative banks remain exempted from the statutory national deposit insurance scheme (Howarth and Quaglia 2016, 150). However, a harmonization of the various German deposit insurance schemes has thus far been prevented through the use of instrumental power facilitated by the 'unwavering support of German politicians' (Deeg and Donnelly 2016, 587).

5.4. STRUCTURAL POWER AT THE HEART OF THE SOVEREIGN-BANK NEXUS

The logic of the sovereign-bank nexus posits that any failure of a large cross-border bank in any euro area country could set in motion a doom loop that would eventually drive a country into default, because the failing bank's balance sheet might hold a multiple of assets in comparison to the country's GDP (IMF 2013). The breaking of the nexus became the overarching goal that justified the move towards banking union and the yardstick against which to measure its success. The positive correlation between sovereign and bank funding costs reflected the so-called 'home bias', which describes the large exposure of banks to the sovereign debt of their home country. Arguably, this was the main driver of the negative feedback loop between rising borrowing costs of sovereigns and their banks.

As such, the sovereign-bank nexus that emerged in the sovereign debt crisis is the clearest expression of the newly reinforced structural power of the eurozone's large cross-border banks. By holding large amounts of their home country's sovereign debts on their balance sheets, large banks intertwined their interests with that of the government, effectively insuring themselves against resolution. Large banks did not have to say anything to remind governments of their shared interests; merely watching the moves of markets made such a link manifest. During the height of the Spanish banking crisis in 2012 when peripheral sovereigns and banks saw their funding costs move in lockstep, governmental room for maneuver was hamstrung by these structural conditions. Earlier attempts by the ECB in December 2011 to sever the sovereign-bank nexus with its two Long-term Refinancing Operations (LTRO) had failed because large cross-border banks used the cheap liquidity for what some termed 'the greatest carry-trade ever made'. Instead of lending the money to the real economy, the banks used the cheap liquidity to buy more high yielding sovereign bonds, which turned a nice profit for them but only provided temporary relief for the distressed sovereign bond markets.

Moreover, the banking union had an additional noteworthy feature that appealed to both large banks and member-state governments: it redefined the denominator of 'too big to fail' by moving the issue of bailouts to the eurozone level. During the financial crisis, many large banks had been deemed 'too big to fail'. Thus, the size of the balance sheets of these banks looked huge as a multiple of member state GDP: in 2011, the ratio of total assets to domestic GDP was 84.8% for Deutsche Bank, 99.8% for BNP Paribas and 118.2% for Santander (Liikanen et al. 2012, 39). Post-crisis, euro area member states faced a stark choice between 'cutting banks down to size' through enacting bank structural reform, which would have reduced the power of banks, and between further pushing financial market integration by creating a banking and capital markets union. Instead of cutting banks down to size, banking union meant deeper integration of European financial markets and thus served the interests of large European banks. As a result, the size of a bank's balance sheet would not be measured in terms of its home country's GDP, but would be compared to the pooled resources of the eurozone member states. Large banks can as a result operate completely insulated from the legal, political, and fiscal environment of their home countries – and potentially dangerous doom loops – while at the same time the European taxpayer backs up their balance sheets.

5.5. THE 2012 SPANISH CRISIS AND THE FRANCO-GERMAN BANKING COALITION

Liberal intergovernmental accounts of the eurozone crisis typically stress the Spanish crisis of the summer of 2012 as the critical juncture that led Germany to recalculate its preferences and opened the way for a European Council agreement on the banking union (Krampf 2014; Schimmelfennig 2015; Glöckler, Lindner, and Salines 2017). According to this narrative, as the crisis threatened to tear the eurozone apart, Germany and France altered their preferences because Spain was 'too big to fail', and German and French banks were highly exposed to Spanish and Italian banks (Krampf 2014). The direct recapitalization of Spanish banks via the ESM could occur under the condition that national regulatory forbearance would be eliminated in the future through the supranationalization of banking supervision (Glöckler, Lindner, and Salines 2017). At the European Council in June 2012, euro area countries confirmed that they would move forward with the banking union project. Shortly thereafter on July 26th, ECB President Draghi spoke the infamous words 'whatever it takes,' which then had a game-changing impact on the course of the crisis (Van Rompuy 2014).

The explanation for the preference shift advanced in this chapter is compatible with standard accounts rooted in liberal intergovernmental reasoning. We argue that the Spanish banking crisis had political reverberations in Germany and France. Namely, it decided the 'battle of the German banks' over banking union in favor of the position held by the large cross-border banks. Similarly, the French government that had been reluctant to fully embrace the banking union (Epstein and Rhodes 2016, 430; Epstein 2014a; Schild 2018) aligned itself with the interests of its highly concentrated banking sector that consists of a number of 'too big to fail' banks.

The French reversal on centralizing EU-level supervision was driven by the large financial conglomerates represented by the French Banking Federation (FBF). French banks are among the most internationalized entities and stood to gain from the competitive advantage and regulatory savings (Tibi 2016, 79). In addition, the troubles in the Spanish banking sector shifted market scrutiny towards France's fragile public finances. With rating agencies threatening to downgrade French bonds, the government faced strong incentives to swiftly regain market confidence and endorse a fully-fledged banking union, including direct bank recapitalizations. The ironclad ties among public and private actors in the French financial establishment - best described as an 'informal consortium' (Jabko and Massoc 2012, 566) – helped to convince the government that a European banking union was in its interest. Ultimately, France was at the forefront of the banking union advocates strongly supporting a fully-fledged banking union based on a coherent position formed by its 'too big to fail' banks.

In the German banking sector, a long-standing split frequently rendered the German government's negotiation position ambivalent (Lütz 2005). This split was evident in the financial governance reforms triggered by the 2008 Financial Crisis. 'The large German commercial banks believed that there was no long-term alternative to a European supranational supervisory authority, at least for cross-border institutions. […] By contrast the LB [Landesbanks], savings banks and co-operatives were more reluctant to accept a single European supervisor, although they softened their previously strong opposition' (Buckley and Howarth 2010, 126). Ultimately, Germany's endorsement of the de Larosière reforms was contingent on the UK's guaranteed veto of any European banking supervisor (Buckley and Howarth 2010, 128). The two financial sector poles in Germany were also pulling in entirely different directions during the banking union negotiations (Hennessy 2014).

However, prior to June 2012 the position of the German cooperative and savings banks – which are closely tied to local and regional politicians in Germany through instrumental power – had proved politically decisive. In the case of the banking union, large private banks came to dominate the discourse, aided by their structural power and the unfolding events in Spain at the height of the eurozone crisis. A particularly potent aspect of their structural power lay in their capacity to refinance the sovereign by holding large amounts of domestic bonds on their balance sheets. This then additionally supported the change in Germany's position regarding the question whether to go ahead with the SSM or to maintain the status quo. In other words, theoretical accounts that derive national preferences simply from the dominant interest coalition can be misleading, because interest coalitions are not stable over time. Intra-sectoral alliances can break down, which is what happened in the case of the German banks.

At the beginning of the banking union process, there was an alliance of convenience between the large banks, which wanted elements of banking union to go forward, and the savings and co-operative banks, which wanted to defeat the proposal of a European deposit insurance guarantee scheme

(German Banking Industry Committee 2012). From the large bank perspective, the intra-sectoral alliance had to remain stable – at least temporarily – in order to persuade the national government to follow through and create a banking union. Once this was achieved and the exit option for large banks had been created – through the adoption of the SSM and the SRM – the incentives to cooperate ceased to exist, and the strategic intra-sectoral alliance of German banks split. The incentives for large private banks to support the cooperative and savings banks in their endeavor to prevent a single European deposit insurance had vanished, and those large banks reacted accordingly.

As a result, the Sparkassen and Landesbanken were on the defensive, having to fend off attacks by Deutsche Bank, which invoked the Spanish *cajas* analogy and the case of Bankia, formed from the fusion of seven *cajas* in 2010, to make its case for a broad supervision coverage (Wilson 2012; Mallet and Johnson 2012; Fahrenschon 2012; German Savings Banks Association 2012). The Spanish savings banks played a pivotal role in fueling a devastating housing bubble that brought Spain to the brink of default, whereas Santander and BBVA emerged unscathed from the crisis due to their internationally diversified assets (Otero-Iglesias, Royo, and Steinberg 2016, 32). Like their German counterparts, the *cajas* maintained strong political ties to local politicians and were deemed to be systemically unimportant until they collapsed. Their demise and the sovereign-bank nexus put Santander and BBVA in the driving seat to determine the Spanish government's position on banking union. The former head of Deutsche, Jürgen Fitschen, pressed the case in public shortly before the German decision (Taylor and Gould 2012):

> 'Fitschen said it was illusory to believe problems could be avoided by monitoring only big banks like Deutsche, noting that Bankia had become a national problem for Spain and the broader euro zone, though it was not considered systemically important by international regulators. "No one had Bankia on the list to trigger a crisis," he said…. Fitschen rejected the argument of smaller German savings and cooperative banks, which want to continue to be regulated at a national level. "If we in Germany argue that we are different, we invite other countries to also argue for exemptions," he said.'

The position of Germany nicely emphasizes a fundamental analytical point for understanding banking union politics: national governments have been torn between the competing interests of their large and small banks. The latter pulled towards banking nationalism, while the former pushed for banking Europeanism. Does the German government protect the interests of Deutsche Bank or of the Sparkassen? The answer of the German chancellor would of course be 'both.' Yet the diverging interests and power resources of Germany's banking sector would render this stance increasingly difficult as the banks pushed the government in opposite directions. In France, large systemically-important banks received a boost to their structural power through the sovereign-bank nexus that was starting to affect France's sovereign bond ratings. In contrast to Germany, the French government had to deal with a less fragmented coalition of influential cross-border banks, which led to a more coherent position of all aspects of the banking union.

5.6. BANKING UNION'S PREMATURE DEATH IN VENETO?

The resolution of the Spanish Banco Popular and of two smaller Italian lenders, Veneto Banca and Banca Popolare di Vicenza (BPVI), provided a first credibility test for the European Banking Union. A mixed picture has emerged from these bank closures. While some pundits argued that the banking union's credibility has been severely damaged because loopholes in the BRRD were exploited to avoid a fully-fledged bail-in (Reichlin 2017), others are more optimistic, highlighting the progress that has been achieved compared to the pre-banking union era (Sandbu 2017; Merler 2017). Despite the use of Italian taxpayers' money to smoothen the economic impact of the failure of Veneto Banca and BPVI, shareholders and junior debt were subject to bail-in.

In the case of Veneto Banca and BPVI, toxic assets were separated from good ones, with Italian taxpayers indirectly shouldering a substantial part of the burden through the private sector-funded *Atlante* bailout fund. Intesa Sanpaolo snatched up the high quality assets and the retail business of these banks at a deep discount of a symbolic €1. Prior to agreeing to the deal, Italy's second biggest bank had secured conditions that would insulate it from any negative contagion of non-performing loans (NPLs) on its balance sheet. For that purpose, the Italian state offered Intesa a sweetener of €12 billion in guarantees against any potential losses from the takeover on top of a €4.8 billon cash injection to shore up its capital ratio and to fund restructuring operations.

Contrary to the spirit of the BRRD, the bailout controversially allowed senior creditors to get away scot-free. The SRB's decision that the Single Resolution Fund (SRF) would not be involved in the resolution allowed the Italian government to evade the more stringent bail-in rules enshrined in the BRRD. Even though the Italian government's first-best solution – a precautionary re-capitalization – was not feasible due to the lack of private sector willingness to contribute funds, Prime Minister Gentiloni's interim government avoided the full 'bail-in cascade' that would have resulted in a bail-in of 8% of eligible liabilities, including senior bondholders and deposits above €100,000.

At the Euro Area Summit in the summer of 2012, Europe's leaders declared that it was of paramount importance 'to break the link between banks and their sovereign.' The Venetian saga demonstrates that, at least in Italy, the sovereign-bank nexus is alive and well. If push comes to shove, the government has to step in and mobilize the necessary resources. Private sector involvement (PSI) can quickly run into a political quicksand that will swallow the economic rationale behind it, leaving no trace in the eventual policy solution. Italian banks have mis-sold large amounts of junior debt to retail depositors that have become (often unknowingly) subject to the new bail-in framework. These retail depositors are also voters. Any additional liquidation that would burn this constituency financially would fuel the Italian populist backlash. In order to respect the state aid rules and to avoid angering voters, the Italian government established a scheme that would allow holders of subordinated debts to receive reimbursements under certain restrictive conditions.

The first test cases of the European banking union provide confirmatory evidence for our claim that large banks had a strategic interest in the new regulatory framework and will continue to benefit from it. The acquisition of Banco Popular turned Santander, one of the most-outspoken advocates of banking union, into Spain's largest bank with an overall market share of approximately 20 percent. It also bolstered its competitive position in the Portuguese banking sector. The liquidation of Veneto Banca and BPVI and the ensuing take-over of their good assets and retail business by Intesa Sanpaolo will likewise bolster its market share in Italy. In all cases, the take-overs will lead to a higher concentration in the Italian, Spanish and Portuguese banking sectors, to the benefit of the largest banks.

5.7. CONCLUSION

The effects of the banking union on the playing field can already be felt. It has ratcheted up the pressure on Europe's banks to finally come to terms with their 'legacy assets.' At the same time, it has further limited, but not fully eliminated, national policy-makers' wiggle room for forbearance. National champions (Santander in Spain and Intesa in Italy) are snatching up high quality assets of their struggling rivals at bargain prices and, thereby, further increase their structural power. Thus far, the promise to break the sovereign-bank nexus has not been fulfilled.

Many of the most compelling theoretical accounts of the Single Market Act and European Monetary Union have stressed the causal primacy of the governments of the most powerful countries that chose to create new supranational institutions to govern a single market and single currency. As a way of modelling the underlying politics of inter-state negotiation in the EU, which once again came into play in the birth of the European banking union, this approach has much to recommend it. The weak point of such analysis has long been its static portrayal of the character of domestic interest coalitions that drive policy change. Our discussion of the politics of banking union has emphasized the way in which banking interests have diverged between small and large banks, and the corresponding change in how those banks exercise political influence, between instrumental and structural power. Incorporating such insights about how domestic coalitions evolve over time can add to the dynamic capacity of interest-based accounts to explain the changing institutional architecture in Europe and beyond.

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6. SUPRANATIONAL AGENCY AND INDIRECT GOVERNANCE AFTER THE EURO CRISIS: ESM, ECB, EMEF AND EFB[11]

6.1. INTRODUCTION

The euro area crisis has led to the creation of new institutions like the European Stability Mechanism (ESM) (Gocaj and Meunier 2013; Jones, Kelemen, and Meunier 2016; Ban and Seabrooke 2017; Seikel 2018) and the empowerment of existing ones like the European Central Bank (ECB) that took over the responsibility for micro-prudential supervision of large banks (Howarth and Quaglia 2013; Epstein and Rhodes 2016; De Rynck 2016). Remarkable about this institutional change is that it played out against the backdrop of member states' unwillingness to delegate more sovereign competences to the European level due to increasingly eurosceptic mass publics (Hooghe and Marks 2009; Genschel and Jachtenfuchs 2016). Supranational actors managed to expand their authority in various issue areas (Schimmelfennig 2014; Bauer and Becker 2014; Dehousse 2016). The Commission's proposal for a 'double-hatted' European Minister of Economics and Finance (EMEF) and the newly created European Fiscal Board (EFB) are indicative of a broader trend whereby supranational non-majoritarian actors 'bypass' states to deepen European integration by enlisting existing authority. While the EMEF proposal tried to co-opt the existing authority of the Eurogroup President by making him a Vice-President of the Commission and giving him control over budgetary instruments, the EFB - an advisory board of the Commission - could enlist national fiscal councils to govern fiscal policy choices of governments indirectly. In each case it is supranational agency trying to bypass potential veto players by enlisting existing authority (Abbott et al. 2015a, 6). The new intergovernmentalists predict that in the post-Maastricht era competences are primarily delegated to *de novo* bodies like the ESM or the ECB 'that often enjoy considerable autonomy by way of executive or legislative power and have a degree of control over their own resources' (Bickerton, Hodson, and Puetter 2015, 705). Accordingly, these bodies 'fulfil functions that could have been delegated to the Commission' and their governance structure is often controlled by member states (Bickerton, Hodson, and Puetter 2015, 705). While the ESM and the ECB tend to substantiate these claims, the EMEF and the EFB examples illustrate a counter-strategy to circumvent the constraints imposed by the new intergovernmental dynamics on supranational agency. 'Bypassing states' through enlisting existing authority could pose an alternative to the conventional strategies of deepening European integration (cf. Abbott et al. 2015a, 6).

The chapter's empirical focus lies on institutions operating in the realm of EMU governance, i.e. the European Stability Mechanism (ESM), the European Central Bank (ECB), the proposed European

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Minister of Economics and Finance (EMEF) and the European Fiscal Board (EFB). These four institutions are categorized according to the typology by Abbott et al. (forthcoming) introduced in Chapter 1, which distinguishes between agents, trustees, co-optors and orchestrators. They differ in terms of the level of independence, mandate, legal enforcement tools and decision-making structure. The chapter seeks to explain how the institutional response to the euro area crisis has produced such diverse governance arrangements and what its downstream consequences are for the future of EMU. The aforementioned typology enables us to delineate the scope conditions under which different modes of indirect governance emerge.

The chapter is structured as follows. The following section introduces the four distinct modes of indirect governance and shows how they are intertwined with supranational agency. The third section provides two empirical examples of member states granting authority to an agent (ESM) and a trustee (ECB/SSM). The fourth section illustrates how supranational actors attempt to enlist existing authority to 'bypass' states. The Commission's failed proposal for a European Minister of Economics and Finance (EMEF) and the Commission's decision to set up a European Fiscal Board (EFB) are given as examples. Finally, the chapter concludes with a summary of the main findings and its broader implications for European integration in the post-euro crisis era.

6.2. SUPRANATIONAL AGENCY AND INDIRECT GOVERNANCE

The following section theorizes under which conditions a certain mode of indirect governance is likely to emerge. Abbott et al. (forthcoming) have expanded principal-agent theory to include different modes of indirect governance (see Figure 6). They argue that a principal has to make two fundamental choices. First, the principal needs to decide whether to grant authority to an agent or whether to enlist existing authority. This chapter conjectures that the latter option presents an effective strategy for supranational actors with scarce formal authority to deepen European integration. Enlisting existing authority allows supranational non-majoritarian actors to govern without facing potential veto points. Second, principals need to choose between managing their indirect governance relationship in a hierarchical or non-hierarchical manner (Abbott et al. forthcoming). This choice is subject to a 'competence-control' trade-off (Abbott et al. forthcoming). A principal can grant an agent significant autonomy to develop her competence which might make it more difficult to control the latter. Thus, when it is particularly important to minimize agency loss, the principal should opt for *delegation* or *cooptation* as the preferred mode of indirect governance. Agency loss occurs when the agent opportunistically capitalizes on asymmetric information at the expense of the principal (Kassim and Menon 2003, 122) or when the delegation contract provides perverse incentives for the agent to permanently be at odds with the principal's preferences (Pollack 1997, 108). Agents that engage in capacity-building or take decisions with large distributional implications will either (1) be tightly controlled by the principal (the case of the ESM) or (2) attract co-optors that want to have more influence on the co-optee's decision-making process (the case of the EMEF proposal). However, when credible commitment problems need to be solved, the principal is more likely to prefer a non-hierarchical mode of indirect governance that emphasizes competence over control such as *trusteeship* or *orchestration*. The conventional view is that member states make credible commitments through delegation to independent trustees like the supranational ECB whose mandate is enshrined in the EU treaties. However, it is not clear what commitment devices supranational actors have in their toolkit if they need to overcome second-order problems of credible commitment. An increasingly 'political' Commission has been struggling to act as a credible enforcer of EMU's fiscal rule framework. Given that it cannot grant authority itself, renewing the credibility of its commitment was achieved by setting up the EFB as an orchestrator that could rely on the existing authority of the national fiscal councils at the local level. Orchestrators mobilize a voluntary intermediary 'in pursuit of a joint governance goal' (Abbott et al. 2015b, 722). *Orchestration* can, thus, serve a dual purpose. It can be used to 'bypass' states (i.e. avoid veto points) and to reaffirm credible commitments at the supranational level.

Figure 6: Supply and demand conditions of four modes of indirect governance

	DEMAND CONDITION	
SUPPLY CONDITION	Minimize agency loss	Credible commitment
Member states granting authority	**Delegation** *(ESM)*	**Trusteeship** *(ECB/SSM)*
Supranational actors enlisting authority	**Cooptation** *(EMEF)*	**Orchestration** *(EFB)*

Source: adopted from Abbott et al. (forthcoming)

The conventional mode of *delegation* has been the conditional grant of authority by a principal to an agent (Pollack 1997; Thatcher and Stone Sweet 2002). The advantage of a P-A relationship is that the principal maintains a degree of control because it can sanction the agent if it strays beyond its mandate (McCubbins and Schwartz 1984). Thus, this relationship is managed hierarchically *ex post*. Maintaining a tight grip on the agent's decision-making procedures has allowed member states to transfer considerable amounts of paid-in capital to the ESM. By pooling financial resources member states can achieve substantial economies of scale and scope that would not be attainable in the absence of delegation. Ultimately, the ESM's financial fire-power will be larger than the sum of its parts due to its superior credit rating that lowers the average borrowing costs. Linking the dispersal of financial assistance to conditionality allows creditor countries to minimize the risk of moral hazard.

In a *trusteeship*, ‘a trustor (governor) grants authority to a trustee (intermediary)’ (Abbott et al. forthcoming, 5). In contrast to a P-A relationship, it is not managed hierarchically because the trustee usually is bound by a narrow mandate and, therefore, the trustor does not rely on hard means of controlling the trustee (Majone 2001; Alter 2008). This can cause an inversion of the authority relationship *ex post* (Abbott et al. forthcoming, 5). During the euro area crisis, member states came to realize that they were issuing debt in a currency they had no control over anymore (De Grauwe 2012, 2013). They had delegated the conduct of monetary policy to an independent trustee only to find that *ex post* the ECB could use its authority to act as a lender of last resort in order to impose conditionality on its trustors. Nevertheless, the initial grant of authority was necessary to credibly commit to price stability. Only if the trustor delegates the full authority over decision-making and enforcement in a given policy area to an independent trustee can the time-inconsistency problem be overcome (Majone 2001). This was also a crucial motivation for entrusting the Single Supervisory Mechanism (SSM) with the task of micro-prudential supervision of significant banks in the euro area (Howarth and Quaglia 2015). Dehousse (2016, 626) argues that ‘north-south mistrust had reached such high levels that creditor countries insisted on a depoliticisation of enforcement mechanisms’. However, overcoming national supervisory forbearance and the breaking of the sovereign-bank nexus could only be credibly achieved if the new arrangement was acting completely independent of any political interference. Thus, the solution was made to entrust the ECB with this task and not the European Banking Authority (EBA).

There are several reasons why enlisting authority is an effective strategy deployed by supranational actors to deepen integration. First, granting authority is an unattractive option for supranational actors because authority is a scarce resource for them and its delegation is legally constrained (i.e. by the Meroni doctrine). Second, enlisting existing authority allows them to deepen integration without facing potential veto points controlled by member states. Third, it neither entails the mobilization of large financial resources nor does it require comprehensive monitoring. Fourth, under *cooptation* ‘a co-optor (governor) enlists a co-optee (intermediary) with preexisting authority over particular targets; once enlisted, however, the co-optee is subject to the co-optor’s hierarchical control’ (Abbott et al. forthcoming, 5). In order to enlist the co-optee’s authority the co-opter lures the former into the relationship by promising to boost its standing and wealth (Abbott et al. forthcoming, 5). After the co-optor ‘got a foot in the door’ she can increase her authority over time. The European Commission’s failed attempt to make the Eurogroup President a Vice-President of the Commission (‘a double-hatted EMEF’) followed the *cooptation* pattern. By supporting the Eurogroup President (co-optee) with additional competences (such as a future euro area budget) the Commission (co-optor) tried to enlist its existing authority. Over time, however, the Eurogroup President's dependence on the Commission would have grown and the authority relationship could have been inversed. Thus far, the Eurogroup President is chosen intergovernmentally among the Finance Ministers of the euro area. *Cooptation* could have turned this into an office that gradually shifted its loyalty towards the supranational level as the dependence on the Commission would have grown.

The fourth mode of indirect governance is *orchestration*. Orchestrators mobilize a voluntary intermediary 'in pursuit of a joint governance goal' (Abbott et al. 2015b, 722). Like the co-optor, the orchestrator lacks hard policy instruments to govern a target directly (Abbott et al. 2015b, 720). It can govern effectively without the need for a massive transfer of competences and financial resources. It relies entirely on soft (ideational) inducements and the voluntary cooperation of intermediaries that are intrinsically motivated (Abbott et al. 2015b, 724). Thus, it is more likely to receive public endorsement. A thin legal and political basis - such as a Commission Decision - is sufficient to establish an orchestrating expert body. This allows a supranational actor to 'bypass' member states to pursue deeper integration in policy areas in which member states are loath to delegate competences because it would encroach on their own 'core state powers' (Genschel and Jachtenfuchs 2014). Fiscal policy is such a core state power that has traditionally been insulated from the reach of supranational agency. To improve the compliance with the fiscal rules the Commission set up the EFB whose task is to monitor the compliance with EMU's fiscal framework and to cooperate with national fiscal councils (Asatryan et al. 2017). However, the EFB has no enforcement capacity on its own that could coerce member states into respecting the fiscal rules. It neither possesses strong executive nor legislative powers. But it can try to enlist the existing authority of 'functionally-autonomous' national fiscal councils to govern the fiscal policy choices of governments indirectly. Thus, the Commission's EFB (orchestrator) could govern fiscal policy by relying on national fiscal councils (intermediaries) whose governance goals partially overlap with those of the orchestrator.

6.3. MEMBER STATES GRANTING AUTHORITY

The European Stability Mechanism (ESM) as an agent

On the 27th of September 2012, the ESM became fully operational with a maximum lending capacity of €500bn (Gocaj and Meunier 2013; Verdun 2015; Jones, Kelemen, and Meunier 2016; Ban and Seabrooke 2017; Seikel 2018). It possesses an authorized capital stock of €704.8bn (€80.5bn paid-in + €624.3 callable capital). The main ESM decision-making body – the Board of Governors - consists of the Finance ministers of the euro area and is equivalent to the Eurogroup. Germany, France and Italy obtained a *de facto* veto in the ESM Board of Governors that allows them to individually block any decision that would lead to further risk-sharing (Henning 2017, 172). Making the Eurogroup the principal of the ESM allowed creditor countries to keep a tight control over the disbursement of financial assistance. Weighted voting rights in line with the share of subscribed ESM capital further bolstered the influence of the larger shareholders.

Several political economy considerations played a role during the ESM's creation. First, a permanent bailout mechanism would put a higher financial burden on European taxpayers due to the increased financial commitments. While the EFSF had only been backed up by guarantees of the euro area member states, a permanent bailout fund would require upfront paid-in capital (Ban and Seabrooke 2017, 12). Second, there was uncertainty about whether a limited treaty change (Art. 136 TFEU) under the fast track treaty amending procedure (Art. 48(6) TEU) was sufficient to pass the hurdle of the German Constitutional Court which later ruled that any fiscal transfers to the ESM needed parliamentary approval. Third, the new intergovernmental ESM treaty required a fresh round of parliamentary ratification, which had already proven to be politically costly in the case of its predecessor the European Financial Stability Facility (EFSF). The ability to tap the ESM was made conditional upon the prior ratification of the Fiscal Compact (Schimmelfennig 2014). Fourth, compared to the EFSF, the ESM was equipped with an expanded toolkit that entailed the ability to intervene in debt markets and to recapitalize banks directly. Both instruments were politically highly contested. At the December 2018 Euro Summit, it was decided to substitute the direct bank recapitalization instrument by a revolving credit line providing a common backstop for the intergovernmental Single Resolution Fund (SRF).

Why was *delegation* preferred over alternative modes of indirect governance? To answer this question, it is helpful to briefly review the Commission's proposal to turn the ESM into a trustee - a European Monetary Fund (EMF)[12] (European Commission 2017a). The transition to a fully-fledged EMF would have entailed the transferal of new competences at the expense of a loss of control for member states if it were to be integrated into the EU Treaty framework (Henning 2017, 251). The ESM had *de facto* become increasingly involved in the monitoring of conditionality and is well equipped to fulfil the same function the IMF had played in the troika (Ban and Seabrooke 2017). The division of labor between the Commission and the ESM has been regulated in detail in a dedicated MoU (European Commission and European Stability Mechanism 2018). It clearly demarcates the respective competences with regards to areas such as the preparation of financial assistance, the negotiation of conditionality and the monitoring of compliance during and after a programme. Delegating more competences to the ESM pertaining to the development and monitoring of financial assistance

[12] The idea had already surfaced during the onset of the eurozone crisis (Mayer 2009; Gros and Mayer 2010).

programmes was a key demand by the 'New Hanseatic League', a mix of fiscally hawkish eurozone and non-eurozone member states under the tutelage of the Netherlands that closely coordinated their position on EMU governance reforms (New Hanseatic League 2018). The 'Hansa' succeeded in shaping the final outcome at the December 2018 Euro Summit and in blocking some of the maximalist positions outlined in the Franco-German 'Meseberg declaration' (Federal Government of Germany 2018).

The Euro Summit on 14 December 2018 decided that the ESM will provide a common backstop to the Single Resolution Fund (SRF) in the form of a revolving credit line (European Council 2018). Furthermore, it provided clarity on the *ex ante* eligibility criteria for countries that want to access a precautionary conditioned credit line (PCCL) to overcome temporary liquidity shortages due to intense market pressures. Only member states that are in full compliance with the fiscal rule framework in the two preceding years are eligible to make use of the instrument (Eurogroup 2018)[13]. These restrictive criteria narrow down the set of member states that could access a PCCL significantly and raises doubts whether countries in need could actually use the instrument (Claeys and Collin 2018). In case of non-compliance, a member state can still transition from the PCCL to an enhanced conditions credit line (ECCL). The outcome of the December 2018 Euro Summit leaves the existing ESM voting procedure essentially untouched. The 'New Hanseatic League' had stressed the importance of preserving the status quo of the ESM voting procedures (New Hanseatic League 2018). The Commission's EMF proposal had envisioned a streamlined decision-making procedures, i.e. 'reinforced' qualified majority voting (QMV) should apply to all decisions concerning stability support, the disbursements of funds and the deployment of the backstop. A reformed voting procedure would have turned the ESM into an independent trustee because it would have limited member states' control over the disbursements of funds. However, the ESM's main purpose was to harness the benefits of pooling financial resources and, thereby, to lower the borrowing costs for stressed member states. For these benefits to materialize, it was not necessary to enlist independent expertise. Ban and Seabrooke (2017, 10) observed that 'institutionally, the ESM is a 'Catch-22': it is a policy instrument intended to provide 'bail-outs', in the context of the EU founding treaties that prevent bail-outs.' The only way to reconcile this institutional arrangement with the demands of mass publics in creditor countries was to demonstrate that governments are in charge of any disbursement decisions and that they will be linked to strict conditionality, i.e. compliance with the fiscal rule framework. The involvement of national parliaments was key in minimizing the risk of future agency loss for large contributing member states. Henning (2017, 173) pointed out that 'through domestic ratification of European decisions on financial

[13] According to the ESM term sheet, 'Member States need to meet quantitative benchmarks (i.e. the debt benchmark, the minimum benchmark and a deficit below 3% of GDP) and to comply with qualitative conditions related to EU surveillance (i.e. not experiencing Excessive Imbalances and not being subject to the Excessive Deficit Procedure)' (Eurogroup 2018).

assistance by unanimity, Germany ensured maximum control over the use of common financial facilities, fiscal exposure through them, and equally importantly, the conditions to which borrowers were required to adhere'. Seikel (2018) showed that where new instruments encompassed risk-sharing and market-correcting elements member states maintained firm control. To further reduce the risk of moral hazard and fiscal exposure, a revamped ESM treaty will include a commitment to introduce single limb collective action clauses (CACs) which is supposed to render possible debt restructurings easier in the future. In addition, the ESM may on a voluntary and informal basis provide a forum for dialogue between its members and the private sector broadly similar to the Paris Club. In sum, *delegation* turned out to be the preferred mode because it provides an insurance mechanism against the agent behaving inimical to the principal's preferences. The final outcome of the ESM negotiations corroborates the finding by Degner and Leuffen (2018) that the Franco-German alliance cannot simply impose its preferred policy solution like a *directoire* on other member states. But it also undergirds a key claim by the new intergovernmentalists that the so-called '*de novo* bodies' like the ESM often 'fulfil functions that could have been delegated to the Commission' (Bickerton, Hodson, and Puetter 2015, 705).

The European Central Bank (ECB) as a trustee

Majone (2001) has convincingly argued that non-majoritarian institutions such as independent central banks do not follow the conventional P-A logic. He contends that their theoretical features are best captured by the *trusteeship* model (see also Grant and Keohane (2005); Alter (2008); Abbott et al. (forthcoming)). According to the Anglo-American legal tradition, 'a trust is a situation where the owner of some property […] transfers it to a "trustee" with the stipulation that the trustee should not treat it as her own but manage it for the benefit of the "beneficiary"' (Majone 2001, 113). The transferal of such far-reaching competences requires a high level of trust that the trustee will refrain from acting outside of her mandate. This is why this type of interaction is often described as a 'fiduciary relationship' (Hadfield 1997, 142).

With the creation of the ECB the euro area member states have relinquished their monetary sovereignty. By delegating authority in the realm of monetary policy to an independent central bank, a government can enhance its credible commitment to pursue anti-inflationary policies (Kydland and Prescott 1977). A central bank that functions as the agent of the government would lack the credibility to firmly anchor long-term inflation expectations due to the time-inconsistency problem. The euro area crisis has bolstered Majone's conceptualization of the ECB as a trustee. First, it has confirmed that the Maastricht treaty is an incomplete contract that entails open-ended commitments such as the broad objective to 'maintain price stability' (Torres 2013, 293; Leblond 2004). But it has also forcefully revealed unanticipated future contingencies that this incomplete contract failed to take into account like the threat of financial dominance, i.e. the ability of the financial industry to shift the costs of bailouts onto either the central bank or the fiscal authorities (Brunnermeier, James, and Landau 2016, 206). Second, to safeguard the viability of the currency union the ECB used its full discretion to reinterpret what constitutes monetary policy (Schmidt 2016). Draghi's London speech 'to do whatever it takes' illustrates that a less independent, hierarchically-managed central bank would not have been able to deal with the eurozone crisis in such a competent manner. On the other hand, it demonstrated that member states have few means of *ex post* sanctioning if they find that the trustee has acted outside of its mandate (Brunnermeier, James, and Landau 2016, 122-4). After granting authority to a trustee, the trustor's initial authority might gradually be inverted (Abbott et al. forthcoming, 5). Even though the CJEU ruled that OMT and QE have not violated the treaties (Zilioli 2016; Kreuder-Sonnen 2016; Schoeller 2018), the typical *ex post* controls that principals usually deploy to sanction the agent if it strays beyond its mandate are less effective because a trusteeship is managed in a non-hierarchical fashion. This is the drawback of a strong commitment to price stability. Eurozone member states realized that they had become dependent on the ECB willingness to exercise its lender of last resort function. They had issued debt in a currency over which they had relinquished control (De Grauwe 2013). As the eurozone crisis proceeded, the ECB demanded structural reforms from governments in exchange for overcoming its reluctance to act as a lender of last resort (Henning 2016). This strategic interaction between the ECB and the governments took the shape of a 'game of chicken' (Henning 2016; 2017, 49). Conditionality was a means by which the ECB tried to insulate itself from the specter of fiscal dominance but this strategy came at a reputational cost for the institution (Henning 2016, 180-5).

The unanimous decision by the European Council to activate the 'enabling clause' (Art.127(6)) that allowed it to entrust the ECB with micro-prudential supervision arose out of the need for a credible commitment to 'break the sovereign-bank nexus' (Véron 2015). The ECB was adamant that a Single Supervisory Mechanism (SSM) was essential for the viability of EMU. The central bank's policy entrepreneurship led to the convergence of member states' preferences and decisively contributed to its entrustment (De Rynck 2016). Two reasons explain why member states were willing to forego the control associated with *delegation* and instead opted for competence-based *trusteeship*. First, the only other existing institution that had the capacity to do the job – the EBA - had suffered from a severe loss of credibility during the failed bank stress tests of 2011 (Glöckler, Lindner, and Salines 2017, 1147). Moreover, the EBA was less independent and lacked the powerful executive and legislative decision-making powers of the ECB. Second, national banking supervisors had lost credibility due to national regulatory forbearance vis-à-vis their 'national champions' (Epstein and Rhodes 2016). The SSM provided a credible commitment to end this practice by supervising significant banks directly and less significant banks indirectly from Frankfurt (Gren, Howarth, and Quaglia 2015). The downstream consequence of further empowering an already competent trustee will increase the likelihood of authority inversion. Like in the realm of monetary policy, the member states national supervisory authority might gradually be absorbed by the SSM trustee. Banking union *de facto* equates to a marketization of the traditionally strong bank-state ties and will, thus, reduce national economic policy discretion further (Epstein 2017, 182). As the long-term consequences of *trusteeship* fully emerge and banks become even less responsive to governmental preferences, member states might be increasingly inclined towards 'taking back control'. For a governor it can often be politically expedient to turn trustees into agents by bringing them under the shadow of hierarchy to minimize agency loss at the expense of endangering a credible commitment[14]. This might explain why central banks jealously guard their independence because they are acutely aware of the political dynamics that can quickly trigger an erosion of their authority if governors want to have a say in their decision-making.

6.4. SUPRANATIONAL ACTORS ENLISTING AUTHORITY

The European Minister of Economy and Finance (EMEF) as a co-optor

As part of its comprehensive reform package 'further steps towards the completion of Europe's EMU: a roadmap' the Commission proposed to establish a European Minister of Economy and Finance (EMEF) (European Commission 2017a). Such a 'double-hatted' EMEF would be a Vice-President of the Commission and at the same time the President of the Eurogroup. 'The European Minister would also oversee the use of EU and euro area budgetary instruments and seek to maximise the impact in support of shared priorities' (European Commission 2017a, 10). By bundling and repackaging existing competences, the Commission could enlist the authority of the Eurogroup President. For a supranational actor with limited authority it is rational to pursue such a strategy because it allows her to govern beyond the formal scope of her authority.

The Commission's EMEF proposal demonstrates the advantages of *cooptation* in the context of European integration. First, a EMEF would have drawn on existing competences that would have been bundled under its new chairmanship. Second, the Eurogroup has become a key informal intergovernmental decision-making body operating at arm's length from the influence of the Commission (Puetter 2012; Hodson 2011). The 'double-hatting' would have increased the co-optee's (Eurogroup President's) standing by giving it more fiscal instruments and power but also by increasing its dependence on the co-optor (European Commission). This would have allowed the Commission to

[14] Vice versa, this relationship might not hold as the case of the ESM shows. If a governor has created an agent with the objective to minimize agency loss, the governor is likely to double down on control mechanisms rather than turning it into an independent trustee.

gradually invert the authority with the objective to indirectly govern the agenda of the Eurogroup meetings of the Finance ministers. However, member states had no intention of giving up their control over the Eurogroup Presidency. A 'double-hatted' EMEF would have also pressured the Eurogroup to clarify its legal status and might have had positive spillover effects for its democratic legitimacy. In addition, the permanent Eurogroup President serves as the chair of the Board of Governors of the ESM. Thus, a EMEF would have given the Commission also more influence in the governance of the ESM.

Cooptation attempts to counter the new intergovernmental dynamics that give member states a firm intergovernmental grip on key decision-making fora such as the Eurogroup. It features prominently in the supranational integration toolkit because it allows actors (1) to escape the straight-jacket of their own capability deficits (Abbott et al. forthcoming), (2) to buffer the intergovernmental encroachment on their authority via the delegation of competences to *de novo* bodies and (3) to minimize potential agency loss. The Commission's desire to bring the Eurogroup President under its hierarchical control results from the latter's goals that have diverged from those of the Commission. Goal divergence became more pronounced during key episodes of the euro area crisis, for example, when former Eurogroup President Dijsselbloem criticized the Commission for its laxness on the interpretation of the Stability and Growth Pact (SGP) (Reuters 2016). As a consequence, co-opting the Eurogroup President became an increasingly attractive goal. Abbott et al. (forthcoming, 5) point out that 'like trusteeship, cooptation inverts authority over time, but in reverse: ex ante the co-optee is superior, as the co-optor must bid for its favor; ex post the co-optor is superior, as the co-optee must comply with its directives'. An EMEF would have gradually diverted agenda setting powers away from the member states towards the European level. However, member states have anticipated the consequences of the cooptation strategy behind the EMEF proposal and it is highly unlikely that it will ever be implemented. Many practical hurdles would have to be cleared with regards to the EMEF's legal status, political accountability and mandate (see Xanthoulis 2018). Nevertheless, the EMEF proposal neatly illustrates how *cooptation* as an integration strategy could allow a supranational actor to broaden its reach beyond the boundaries of its formal authority.

The Commission's European Fiscal Board (EFB) as an orchestrator

The European Commission as the 'guardian of the treaties' is supposed to monitor the compliance with EMU's fiscal framework, however, it possesses only weak enforcement powers to govern effectively in the realm of 'core state power' like fiscal policy (Genschel and Jachtenfuchs 2016). To foster local ownership of the fiscal rules, the six-pack, two-pack and the Fiscal Compact mandated all euro area countries to establish 'functionally autonomous' fiscal councils at the national level (Fasone and Griglio

2013; Fromage 2017). The rationale of member states to set up fiscal councils was straightforward. The euro area crisis increased the demand for credible commitment devices that held out the promise to allay financial markets' debt sustainability concerns and to help lowering sovereign borrowing costs. An independent body of fiscal experts is supposed to produce unbiased assessments, recommendations and reports of a government's fiscal stance and macroeconomic projections (see Chapter 2). In contrast to independent central banks, fiscal councils lack the hard control over policy instruments to govern a target directly (Larch and Braendle 2018). By providing impartial fiscal assessments of the 'true' fiscal stance of a government to parliamentarians, voters, the media and other intermediaries such as credit rating agencies, a fiscal council can indirectly orchestrate fiscal discipline and, thereby, improve the compliance with the fiscal rules (Beetsma and Debrun 2017). In some euro area countries, national fiscal councils already function as reputable watchdogs with a heightened public profile that can increase the political costs for governments pursuing fiscally profligate policies (Horvath 2018).

The diffusion of fiscal councils across the EU posed a challenge for the Commission because it threatened to lead to inconsistent rule interpretations further eroding compliance (Jankovics and Sherwood 2017, 29). The Commission's commitment to strict rule enforcement had suffered severely due to its discretionary interpretations of the various escape clauses in the SGP. To regain its lost credibility it was necessary to set up a 'watchdog for another watchdog' (Asatryan et al. 2017). Naturally, the Commission wanted to guard its role as the 'fiscal rule interpreter of last resort' (see Chapter 2). Hence, a new body was needed to cooperate with national fiscal councils, exchange best practice, and produce common knowledge about the fiscal rules. The idea to set up a European Fiscal Board (EFB) was first proposed in the Five Presidents' Report (Juncker et al. 2015, Annex 3). The EFB was formally established on 1 November 2015 and became fully operational on 19 October 2016 after the College of Commissioners appointed its members based on a proposal by the Commission President. It consists of a chair and four additional members to be appointed for 3 years (renewable once). The members of the EFB should act independently and should adopt advice by consensus. In October 2017, the EFB published its first Annual Report covering a wide range of topics from the appropriate euro area fiscal stance to SGP reform proposals (European Fiscal Board 2017).

The EFB could attempt to enlist existing authority by relying on national fiscal councils (the intermediaries) to orchestrate fiscal discipline indirectly. The EFB's direct interference with member states' fiscal policy choices is prohibited. Instead, it can compensate for its own capability deficits by relying on the intermediaries' local ownership and superior legitimacy with regards to the targets (Abbott et al. forthcoming). The advantage of this indirect mode of governance is that the orchestrator can effectively govern on a thin legal and political basis. The legal instrument to establish the EFB – a

Commission Decision – demonstrates the Commission's reluctance to use a stronger legal basis that would have forced it to take into account the member states' preferences (Asatryan et al. 2017). This allowed the Commission to bypass member states and to write a mandate for the EFB in line with its institutional self-interest. According to the Commission's decision of 21 October 2015 (2015/1937) the EFB's task is the 'evaluation of the implementation of the Union fiscal framework, in particular regarding the horizontal consistency of the decisions and implementation of budgetary surveillance, cases of particularly serious non-compliance with the rules, and the appropriateness of the actual fiscal stance at the euro area and national level.' In case the EFB identifies risks to the proper functioning of EMU, it can recommend specific policy options under the SGP. Former Eurogroup President Dijsselbloem referred to the EFB as 'the big European sister of the national fiscal councils' (Foy 2015). However, national fiscal councils are adamant about safeguarding their institutional independence and are reluctant to embrace the EFB as a central coordinator of their network (Asatryan et al. 2017). As part of its December 2017 reform package, the Commission has proposed a directive that would significantly strengthen the operational capacity of national fiscal councils (European Commission 2017b). The directive would provide national fiscal councils with more enforcement tools in case of non-compliance with the fiscal rule framework. At first sight, it seems surprising that the Commission is willing to further increase the competence and independence of national intermediaries at the expense of a loss of control. However, an orchestrator can compensate for a loss of control by seeking a higher level of goal alignment between itself and the intermediaries (Abbott et al. forthcoming). This is precisely what the directive would achieve because it would make national fiscal councils complicit in punishing deviations from the medium-term fiscal objective in line with the Commission's goal to increase compliance with the fiscal rules. In sum, orchestrating fiscal discipline can be an attractive mode of indirect governance if the need for a credible commitment makes it necessary to give up on control.

Table 2: Overview of four empirical examples of indirect modes of governance

	Goals	Mode	Consequences
ESM	▪ Provide financial assistance at low borrowing costs against strict conditionality to limit financial contagion ▪ Reduce the risk of moral hazard related to bailout funds	*Delegation*	▪ Member states control disbursement of funds and decision-making (*de facto* veto right for large MS) ▪ Reduced fiscal exposure and national audience costs

	▪ Prevent unlimited fiscal transfers		▪ Preserved budgetary sovereignty of national parliaments (mostly in creditor countries)
ECB/SSM	▪ Severing the sovereign-bank nexus ▪ Stop national regulatory forbearance ('national champions') ▪ Financial stability ▪ Harness synergies between micro- and macroprudential supervision ▪ End the era of taxpayer-funded bank bailouts	*Trusteeship*	▪ Marketization of traditionally strong bank-state ties ▪ Reduction of national economic policy discretion ▪ Credible commitment to financial stability ▪ SSM's authority is likely to increase over time ▪ Limited *ex post* controls to sanction the trustee
EMEF	▪ Supranational control of the Eurogroup Presidency ▪ Agenda-setting role for the Commission in the Eurogroup ▪ Align the goals of the Eurogroup more closely with the Commission's ▪ Gain indirect influence on the ESM's decision-making process	*Cooptation*	▪ Gradually divert agenda setting powers away from the member states towards the European level ▪ Broaden the reach beyond the boundaries of the Commission's formal authority ▪ Severing intergovernmental grip on the ESM's and the Eurogroup's decision-making procedures

EFB	▪ Evaluation of the implementation of the Union fiscal framework ▪ Improve compliance with the SGP (lower debt levels and budget deficits) ▪ Propose SGP reforms ▪ Assess euro area fiscal stance ▪ Cooperate with national fiscal councils ▪ Reestablish the credibility of the Commission as a trustworthy rule monitor	*Orchestration*	▪ Limit discretionary interpretations of the fiscal rules ▪ Enlist national fiscal councils to govern fiscal policy indirectly ▪ Increase local ownership of and compliance with the fiscal rules ▪ Commission can 'bypass' member states as veto players ▪ Strengthening of horizontal consistency of the decisions and implementation of budgetary surveillance ▪ overcome credible commitment problems despite scarce authority in fiscal policy at the European level

Source: author's own compilation

6.5. CONCLUSION

The traditional intergovernmental modes of indirect governance are *delegation* and *trusteeship*. This chapter has shown that by enlisting authority either through *cooptation* or *orchestration* supranational actors can deepen European integration despite new intergovernmental dynamics that tend to favor a repatriation of authority to the national level. The two cases, EMEF and EFB, indicate that the latter two modes of indirect governance feature prominently in the integration toolkit of the European Commission even if they are not always successful. Indirect governance allows supranational agency to 'bypass' potential veto points controlled by intergovernmental forces and, thereby, govern beyond the scope of their formal authority. It also provides the opportunity to reign in intergovernmental fora like the Eurogroup by coopting its President through increased powers and prestige. In the post-euro crisis period, the Commission might increasingly rely on *cooptation* and *orchestration* because they address various challenges that the European integration process faces at its current juncture. First, they offer a soft way of integration that draws on the already existing authority and capabilities of intermediaries and, hence, they do not require any additional financial resources. Thus, they lower the price of deeper integration. Second, no treaty change is required to establish a co-optor or an orchestrator because they can operate on a 'thin' legal and political basis. An ordinary Commission

Decision that does not involve co-legislation by the European Parliament or the Council is often sufficient. Third, *cooptation* can help supranational actors to reign in powerful intergovernmental actors whose preferences have diverged. Fourth, orchestration can help supranational actors to overcome 'second-order' credible commitment problems. The creation of the EFB marked a crucial step towards regaining lost credibility in the EU's fiscal framework. However, the chapter has also revealed that *cooptation* and *orchestration* can encounter several obstacles. The co-optor might not be able to offer enough benefits to the co-optee to bring him under the shadow of hierarchy. The Eurogroup President is a powerful actor in its own right and does not need to be a Vice-President of the Commission to heighten her standing because she has the backing of the collective eurozone Finance Ministers. Similarly, enlisting intermediaries can be challenging. National fiscal councils might prefer to pronounce their independence rather than being orchestrated by the EFB.

The cases discussed in this chapter indicate a tendency towards moving competences to the supranational level but not without mobilizing expertise and resources at the national level. Overall, the rapid institutional change played out against the backdrop of an unprecedented crisis that threatened the survival of the euro area as a whole (Schimmelfennig 2015). While the crisis was a major driver of institutional reform in the case of the ESM and the SSM (Gocaj and Meunier 2013; De Rynck 2016), it played less of a role in the case of the EMEF and the EFB. This is notable because the latter two examples illustrate how supranational actors could deepen integration even without strong intergovernmental backing in 'normal times'. Many scholars have interpreted the crisis through a historical institutionalist perspective in which path dependency and critical junctures ultimately have determined the crisis outcome (Gocaj and Meunier 2013; Verdun 2015; Jones, Kelemen, and Meunier 2016). A promising avenue for future research to enhance our understanding of the rapid institutional change during the euro area crisis could be to apply the concept of 'chronic instability' defined as '*multiple, frequent, and connected* episodes of disjunctive change' (Bernhard 2015, 977).

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7. CONCLUSION

The euro area crisis has been a catalyst for far-reaching institutional change in Europe. It resulted in a panoply of fragile *ad hoc* institutional arrangements often constructed under immense time pressure (Ioannou, Leblond, and Niemann 2015; Copelovitch, Frieden, and Walter 2016; Seabrooke and Tsingou 2018). Among the most crucial reforms were the six-pack, two-pack, fiscal compact, the ESM and the banking union. A decade after the start of the Greek crisis and 20 years after the introduction of the euro as the watershed moments in the history of European integration, it is timely to provide an outlook on which institutional responses to the euro area crisis are likely to remain a permanent feature of EMU's governance architecture going forward and which are likely to disappear again. I will hypothesize that where 'crisis overshooting effects' have increased the complexity of an institutional arrangement, it will remain in a state of 'chronic instability', i.e. a sequence of critical junctures that fail to produce institutional lock-in but rather lead to a rapid replacement of different regimes (Bernhard 2015), until its complexity is reduced again to a level generating institutional stability.

The Maastricht treaty introduced the subsidiarity principle which obliges the European Union to intervene only in case a member state cannot effectively deal with an issue on its own at the central, regional or local level (Fabbrini 2015, 245). An action taken at the European level should provide a clear value added. During the acute phases of the euro area crisis certain policy areas could be (temporarily) dealt with more effectively at the European level but, in other cases, the value added of actions taken at the European level was not always clear-cut. 'Crisis overshooting effects' thus refer to the overshooting of actions taken at the European level as compared to what would have been appropriate according to the subsidiarity principle. These 'overshooting effects' revealed themselves empirically by the fact that both, supranationalism and intergovernmentalism, featured prominently during the euro area crisis. Many recent controversies in European integration theory originate from the attempt to theorize the aforementioned 'crisis overshooting effects'. The 'new intergovernmentalists' argue that member states paradoxically pursue more integration (mostly through the European Council) but are reluctant to embrace more supranationalism at the same time (Bickerton, Hodson, and Puetter 2015, 705), whereas others have pointed out that this was at odds with the empowerment of the supranational ECB (Schimmelfennig 2015, 725).

In order to avoid the pitfall of extrapolating from what might be merely temporary 'crisis overshooting effects', I will try to anticipate the evolution of the future EMU architecture by assessing the degree of complexity in different issue areas. I conjecture that in issue areas where complexity has increased a coalition of smaller member states will form to demand a reduction in complexity. This is because complexity is likely to benefit the larger member states which possess the resources to navigate the complexity. Drezner (2009, 66) has argued that complexity benefits powerful states because it dilutes old focal points, weakens legal obligations and increases the transaction costs of compliance for all actors involved. Thus, one would expect smaller member states to oppose complexity and try to move towards institutional simplicity. The transition period from complexity to simplicity is likely to be characterized by 'chronic instability' because different institutions will rapidly replace one another. A stable institutional equilibrium will only be reached once a sufficiently large reduction in complexity has been achieved that relevels the playing field between larger and smaller member states. Newly created actors that render a regime complex more transparent and thereby increase the amount of information available to all actors could also help to reduce complexity. In the following section, I will first summarize the main findings of this Ph.D. thesis.

7.1. SUMMARY OF THE MAIN FINDINGS

Chapter 2 has shown that increasingly supranational institutions harness the authority that exists at the national level to build up their enforcement capacity. Non-compliance by member states is a serious problem for EU institutions against which they have very few remedies. Fostering local ownership through the creation of national institutions that are trusted by national audiences is one strategy by which supranational institutions can overcome their authority deficit in areas of 'core state powers' like fiscal policy (Genschel and Jachtenfuchs 2014). However, when multiple governors want to govern in the same issue area, they might be less effective because they tend to undermine each other's persuasive power. The troika institutions had very diverse reasons for promoting national fiscal councils in the EU, which led to the creation of heterogeneous fiscal councils. Tailor-made indices were used to persuade others of the superiority of their preferred fiscal council model, which I have termed *entrepreneurial benchmarking.* It facilitates the construction of the governor's cognitive authority over member states but can also lead to ambiguity if the indices end up measuring very different indicators. An often-invoked example in the literature is the spreading of the independent central bank model. The diffusion of national fiscal councils highlights that it is rather the exception than the rule that all actors converge around a single conceptual model, at least, during the initial institution-building process. However, it does not exclude the possibility that institutional convergence might ensue at a later stage.

The legitimacy of the crisis architecture has often been criticized as insufficient (Schmidt 2015; Falkner 2016; Sánchez-Cuenca 2017). Chapter 3 assesses the legitimacy of the national fiscal councils. It discusses different causes of the 'deficit bias' and traces how they are linked to the various conceptual models of fiscal councils that have been introduced in Chapter 2. Those arguing that overoptimistic forecasts are causing governments to produce permanent budget deficits propose an agent fiscal council that assesses the macroeconomic and budgetary forecasts of the government. By checking the accuracy of the official forecasts, the agent fiscal council produces technocratic input legitimacy because it aims at 'feeding' unbiased information into the fiscal policy-making process. Others argue that the predominant cause of the deficit bias is the 'common pool problem', i.e. the problem that higher spending commitments are often benefiting only a small part of the electorate whereas the burden is shared with all taxpayers. This group advocates for a trustee fiscal council that can actively steer fiscal policy to remedy the common pool problem. A trustee model would generate a high degree of output legitimacy because it would try to target a certain debt or deficit level similar to inflation-targeting independent central banks. Champions of the orchestrating fiscal council point to asymmetric information regarding the true state of public finances between voters and the government as the root cause of the deficit bias. The orchestration model relies on throughput legitimacy (i.e. 'governing with the people') because it aims to govern fiscal policy indirectly by empowering voters to adequately judge the 'true' state of fiscal affairs.

Chapter 4 has reviewed the ECB's role during the euro area crisis. It showed that the ECB's unconventional monetary policies (UMPs) and its troika membership created distinct threats to its political independence. First, it led to an unprecedented level of distrust in the ECB. Second, an elite dissensus on central bank independence emerged. Third, the ECB's various tasks nurtured the public perception that the ECB was overburdened and that it could not adequately fulfill its primary mandate (i.e. declining output legitimacy). In order to regain legitimacy and contain the threats to its political independence, the ECB turned to its conventional accountability channels like the 'Monetary Dialogue' with the European Parliament's ECON Committee. But this did not sufficiently address the challenge of dealing with highly diverse audiences in creditor and debtor countries. Ultimately, ECB President Draghi started a tour of national parliaments to reduce distrust by delivering tailor-made messages to national audiences. In his introductory remarks to parliaments of creditor countries, he reaffirmed the ECB's commitment to its primary mandate, whereas in debtor countries he highlighted the need for structural reforms. A list of the visited national parliaments confirms the finding that the empowerment of national parliaments creates an asymmetry because creditor parliaments gain influence at the expense of debtor parliaments (Moschella 2017). There is a striking correlation between the national parliaments visited by Draghi and their respective NCB's rank as a subscriber of the ECB's capital key. Large creditor countries are also large subscribers to the ECB's capital key and would have to shoulder a bigger share of the fiscal burden in case of adverse consequences of the ECB's unconventional monetary policies. This explains why national constituents in these countries have pushed for the ECB President to appear in their national parliament. In sum, the ECB was able to instrumentalize the absence of sufficiently formalized accountability channels with national parliaments for its own independence consolidation.

In Chapter 5, Culpepper and I have argued that the evolving preferences and power resources of large cross-border banks help explain the crucial political moves to European banking union. As they became larger and more European, the relative dependence of these banks on national regulators declined even as the dependence of states on these banks increased – resulting in a net rise in the structural power of large banks. These banks benefited from the supranationalization of supervision through reduced compliance costs and the effective opening of European markets. The political divergence in the interests of large international banks and small national ones eventually caused the German and the French governments' change of position in intergovernmental bargaining. Once in place, banking union accelerated balance sheet consolidation to the benefit of large banks that took over their weaker competitors. Since its inception the banking union has already propelled consolidation in the banking sector. The share of non-performing loans (NPLs) on banks' balance sheets and other 'legacy assets' has been reduced. National policy-makers' wiggle room for regulatory forbearance has been narrowed which leaves domestic banks without protection from foreign competitors. Thus far, mergers have been confined to the domestic market. National champions (Santander in Spain and Intesa in Italy) have taken over their struggling domestic competitors. The objective of the banking union to break the sovereign-bank nexus and to end the 'too-big-to-fail' problem has not been fulfilled.

Chapter 6 contributes to the debate about EMU's governance architecture. Throughout the history of European integration member states have predominantly relied on *delegation* and *trusteeship*. In the post-Maastricht era, member states have increasingly grown weary of the European Commission and have delegated more and more competences to *de novo bodies* (Bickerton, Hodson, and Puetter 2015). *Cooptation* and *orchestration* (Abbott et al. 2015a, 2015b, forthcoming) enable supranational actors like the Commission to deepen European integration despite these new intergovernmental dynamics. Classifying the European Stability Mechanism (ESM), the European Central Bank (ECB), the proposed European Minister of Economics and Finance (EMEF) and the European Fiscal Board (EFB) according to the aforementioned modes of indirect governance demonstrates under which circumstances a certain mode is likely to emerge. Where capacity-building takes place at the European level, member states prefer to delegate competences to an agent that they tightly control to minimize 'agency loss' (the case of the ESM). Governing bodies that can take decisions with large distributive implications will attract co-optors wanting to gain influence on the co-optee's decision-making process (the case of the EMEF proposal). In contrast, when member states want to reaffirm their credible commitment, they are more likely to empower an institution over which they have less control but which is highly capable (the case of the ECB/SSM). The ability of supranational institutions to make a credible commitment is very limited because it cannot delegate its scarce authority to a new body. Thus, creating an independent orchestrator that can harness the existing authority at the national level allows supranational institutions to make credible commitments (the case of the EFB).

7.2. THE CONSEQUENCES OF THE EURO AREA CRISIS' OVERSHOOTING EFFECTS

In this section, I will assess whether the institutional responses to the euro area crisis have increased or reduced complexity. In line with the hypothesis at the beginning of this chapter, I conjecture that where 'crisis overshooting effects' have increased the complexity of an institutional arrangement, it will remain in a state of 'chronic instability' (Bernhard 2015). On the other hand, in issue areas in which complexity is likely to be reduced in the future, institutional stability will ensue.

There are various ways in which complexity can be measured in a given issue area. One straightforward method to assess the degree of complexity is by counting the number of institutions, actors, rules and/or veto points in a given issue area[15]. According to this method, complexity has increased in all the issue areas examined in this Ph.D. thesis. In area of fiscal governance, for example, the European Commission's Fiscal Governance database shows a steep increase in the number of national fiscal rules in the EU since 2012 (European Commission 2019, 133). The new generation of fiscal rules, however, had become increasingly complex compared to the fiscal rules enshrined in the Maastricht treaty. The Maastricht rules were simple and their interpretation was straightforward. This put the public at large in a position to monitor them without any external help. However, complex fiscal rules created demand for actors that could interpret the rules and manage their complexity. In other words, rule complexity begot an increase in the number of actors in fiscal governance via the creation of fiscal councils. Fiscal councils were supposed to increase the amount of available information and enhance transparency within the issue area. The example highlights the potential pitfalls when trying to measure complexity. In this section, I will take a forward-looking perspective and try to outline a trajectory for the likely evolution of complexity which has undoubtedly increased in all issue areas of fiscal and financial governance in EMU since the euro area crisis.

The creation of fiscal councils was supposed to contribute to the reduction of complexity in the EU's fiscal governance architecture. Fiscal councils' promotion of fiscal transparency evens out existing informational asymmetries. They independently assess the government's macroeconomic and budgetary forecasts and, thereby, help voters to assess the fiscal performance of their government (see Chapter 2). Fiscal councils shall provide an independent check on the compliance with fiscal rules

[15] I owe this point to Prof. C. Randall Henning.

which remain overly complex and hard to enforce (European Fiscal Board 2017). The repeated reforms of the SGP indicate that the pact continues to be in a state of ‘chronic instability’. The latest overhaul of the rules following the euro area crisis has not brought about the desired institutional stability (Matthijs and Blyth 2018; Schön-Quinlivan and Scipioni 2017). Only simplified fiscal rules in combination with a high degree of enforceability will foster the public’s support for fiscal rules. Debrun and Jonung (2019) have argued that in designing fiscal rules a trilemma between simplicity, enforceability and flexibility exists. A radical proposal supported by Mody (2018, 456) would abandon fiscal rules entirely because in his opinion they have never worked. Eichengreen (2018, 168) predicts that European oversight over national budgets will remain a constant source of tension ‘guaranteed to incite a populist reaction’. The EFB as a strong supranational supporter of reducing fiscal rule complexity might foster institutional stability. In its 2018 annual report the EFB has made a proposal for a revamped fiscal framework that strikes a balance between simplicity, enforceability and flexibility (European Fiscal Board 2018). The key features of the reform proposal entail: (i) a medium-term debt ceiling of 60% of GDP, (ii) an expenditure rule for those member states with higher debt-to-GDP ratios, (iii) a reinforced sanctioning system, (iv) escape clauses for exceptional circumstances and (v) a more efficient surveillance cycle at the European level. A particular challenge in this regard will be to achieve a clear separation between the technocratic assessment of whether the fiscal rules have been complied with and the final (political) decision-making. The current complexity benefits the larger member states that possess the resources and the technical capacity to use the fiscal rules to their own advantage. Often large member states like Germany and France show a tendency to float the rules (see Buti and Pench 2004). This inevitably creates frustration with the fiscal framework in the smaller member states. In the medium term, these countries could form a coalition to push for a reduction in the rule complexity to rebalance the political playing field. However, Fabbrini (2015, 246) conjectures that such a counter-reaction from member states is far from certain as long as they are involved in the decision-making process. He observes that

> ‘in the intergovernmental policies of EMU it has been difficult to counter a process of centralization that has subtracted substantial discretion from member state parliaments and governments in budgetary and fiscal policy. Although intergovernmental institutions have intruded into member states’ budgetary discretion, the reaction to such intrusion has been uncertain. The member states can use the principle of subsidiarity to reclaim their decision-making power from supranational institutions, but such claims seem implausible in a context where the decision-making power has moved to the institutions of national governments, not to supranational institutions.’ (Fabbrini 2015, 246)

In sum, there are forces pushing in the direction of reducing complexity via the dissemination of impartial information through national fiscal councils and the supranational EFB. However, as long as member states maintain a minimum degree of national ownership due to the involvement in the decision-making process via intergovernmental bodies, pushback from a coalition of smaller states is uncertain. In the meantime, fiscal governance will remain in a state of 'chronic instability'. This will manifest itself in populist governments frequently challenging the European Commission's interpretation of the fiscal rules and in more bilateral negotiations between the Commission and non-compliant governments. Other empirical evidence that would validate such 'chronic instability' would be additional official Communications issued by the Commission on how to interpret the fiscal rules. Already, the so-called 'Vade Mecum' a 100-page long handbook that explains the EU's surveillance procedure of the SGP is updated every year. This makes it even harder to converge around a common interpretation of the fiscal rules across the EU.

Chapter 2 has shown that the troika institutions have been a prominent advocate of fiscal councils. The troika was tasked with negotiating financial assistance conditionality and monitoring its implementation progress (Hodson 2015; Moschella 2016; Henning 2017). With the exit of Greece from its third bailout programme, the tasks performed by the troika have largely been absorbed by the European Commission's new Structural Reform Support Service (SRSS) and the European Stability Mechanism (Ban and Seabrooke 2017). While the troika turned out to be a fragile actor coalition, the institutional change that it has instigated at the national level is likely to outlast its own existence and will remain a permanent feature of the EU's fiscal governance architecture.

The euro area crisis' overshooting effects are most evident in the changing role of the ECB and its visits to national parliaments. The ECB's unconventional monetary policy measures will remain a permanent feature of its expanded toolbox. The ECB's Outright Monetary Transactions (OMT) announcement put an end to the crisis by backstopping the euro area's sovereign bond markets (Chang and Leblond 2015; De Grauwe and Ji 2015; Matthijs and Blyth 2015). Even though the CJEU has confirmed OMT's compatibility with the EU treaties, OMT has rendered the process of acting as a true lender of last resort more complex. It is crucial to bear in mind that the activation of OMT is conditional upon an ESM programme. Thus, revisions of the ESM treaty by the member states can have knock-on effects on OMT itself and new legal challenges might follow. Mody (2018, 446) has stressed that 'OMT powers extend beyond QE rules and authorize the ECB to buy "unlimited quantities" of a member country's bonds'. However, OMT was designed to never be activated and it is therefore deliberately kept vague. I submit that this uncertainty about how OMT would work in practice fuels 'chronic instability'. Observable implications that would hint at continued 'chronic instability' in the ECB's lender of last resort function would be: further legal challenges due to a reformed ESM treaty forcing the ECB to clarify legal details, a complete reformulation of OMT or a replacement of OMT by a different instrument. Furthermore, Draghi's visits to national parliaments have increased the complexity of the ECB's accountability regime because it created a parallel forum next to the European Parliament. The ECB avoided to clearly state whether it considers visits to national parliaments a permanent feature of its accountability regime. The demand for such visits from parliaments might automatically recede as the politicization of the ECB decreases and public trust in the ECB returns. New unconventional monetary policy measures such as the new round of quarterly targeted long-term refinancing operations (TLTRO-III) might work in the opposite direction.

The banking union will remain a permanent feature of EMU's financial governance architecture. The Single Resolution Board (SRB) has already made a decisive contribution towards making large banks resolvable that before the financial crisis had been 'too complex to fail'. However, the supervision and resolution of 'significant' pan-European banks is still an immensely complex task. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) exhibit strong network features due to their reliance on the National Competent Authorities in the case of the SSM and on the National Resolution Authorities in the case of the SRM. This mechanism-based operating system is prone to turf battles and co-ordination failures (Moloney 2014, 1646f.). The SSM can formally trigger the resolution process by determining that a bank is 'failing or likely to fail'. However, the SRB can under certain circumstances also trigger resolution on its own (Howarth and Quaglia 2014, 138). Institutional overlap with regards to this crucial determination will impede swift decision-making. In addition, the new competences have increased the internal organizational complexity of the ECB. Respecting the internal 'Chinese walls' between its supervisory and monetary policy tasks is difficult in the day-to-day practice. Thus, we should not exclude the possibility that the SSM might become a stand-alone institution if the EU treaties were to be reopened in the future. In particular, the public might find it increasingly difficult to distinguish between the ECB's various roles. This complexity will make it harder to assign responsibility for an outcome to the appropriate ECB arm.

The ESM was ridden by 'chronic instability' until it reached a stable institutional equilibrium with the decisions taken at the December 2018 Euro Summit. Throughout the course of the euro area crisis, the Greek Loan Facility (GLF) gradually morphed into the EFSF/EFSM and only later into the ESM. The ESM treaty, written at the height of the euro area crisis, is an incomplete contract, i.e. it does not provide sufficient guidance for all future contingencies (Farrell and Héritier 2007). For example, it left open under which conditions member states were eligible for a precautionary credit line and when banks could be recapitalized directly. It took six years after the ratification of the ESM treaty for the conditions for a precautionary credit line to be clarified and for the direct bank recapitalization tool to be removed. By having taken over the tasks of the IMF regarding financial assistance, the ESM has turned the troika 'regime complex' into a regional one (Henning 2017; Hodson 2015). This is likely to render its governance easier because now only European institutions are involved. However, there are a couple of reasons why non-involvement of the IMF in the future cannot be regarded as a certainty. First, Henning (2017, 241) has shown that the creation of a troika 'regime complex' benefited the creditors. By involving multiple institutions in the financial assistance programmes, creditors were able to expand their room for maneuver compared to a situation in which the only interlocutor would have been the Commission. Member states' mistrust of the Commission and their preference to control outcomes are likely to endure. Thus, powerful forces could counter a reduction in complexity unless the IMF were to decide on its own to abstain from future financial assistance programmes. Second, Hodson (2015) has argued that the IMF has become so entrenched in the EU that it should be regarded as a 'de facto EU institution'. Henning (2017, 243) points out that 'the presumption of Fund inclusion is written into the ESM treaty. While it is a presumption rather than a requirement, the choice of the IMF continues to be supported by divergent preferences among euro-area member states and unanimity in decisions on financial assistance'. Third, if Italy would require financial assistance from the ESM in the future, it is doubtful whether the firepower of the ESM would be sufficiently large (Mody 2018, 446). In such a scenario, IMF involvement would be needed simply to buy credibility with the financial markets. Nevertheless, some notable developments have increased the likelihood that the IMF will be excluded in future financial assistance programmes. In December 2018, the Eurogroup agreed upon a so-called 'term sheet' that sets out detailed steps for an ESM reform. The IMF did not receive any mention in the term sheet. One of the goals of the reform is to establish the ESM as a stand-alone credible bailout mechanism. Any involvement of the IMF would deal a huge blow to the reputation and credibility of a reformed ESM. The involvement of the IMF was already controversial before the troika and this controversy is likely to be even more pronounced during the next crisis because it would call into question recent EMU reforms. Moreover, it would stand in marked contrast to the notion of 'European sovereignty' that has recently emerged in response to the protectionist tendencies in world trade. A truly 'European sovereignty' would have to encompass the realm of financial assistance. The case for 'European sovereignty' in financial assistance might be even stronger if China manages to gain more influence within the IMF. In sum, there are powerful arguments to expect continued IMF involvement in the EU in the future, yet, these might be trumped for purely symbolic reasons.

7.3. THE FUTURE OF EMU

The debate about the future of EMU is at a crossroads. While the 'sovereignist' camp advocates for a complete repatriation of competences to the national level, the supranationalist camp pleads for a 'completion' of EMU. Eichengreen and Wyplosz (2016) have outlined four minimal conditions for the survival of the Euro. These can be regarded as a balanced compromise solution between the two rivalling camps. First, the authors argue that the ECB needs to be ‘normalized’. This would entail to free the ECB of any (legal) constraints to pursue a flexible inflation targeting strategy and to backstop government bonds if necessary. The ruling of the CJEU that found QE to be in line with the treaty has gone a long way towards achieving more legal certainty on the ECB’s unconventional monetary policy measures. Additionally, the disbursement of emergency liquidity assistance (ELA) should be completely supranationalized under the control of the ECB. Furthermore, the ECB should make further strides into enhancing its transparency. The authors advocate a reform of the decision-making in the Governing Council that would reduce the number of national representatives. According to Eichengreen and Wyplosz (2016, 26), a second minimum condition would be the creation of a European Deposit Insurance Scheme (EDIS). They argue that a ‘targeted’ mutualization of fiscal powers was warranted in this case to provide financial stability. Third, the authors advocate for a complete renationalization of fiscal policy to the national level. They point out that recent reforms have not worked and that member states are inherently reluctant to share fiscal resources. Thus, reinstating a credible no-bailout clause was essential to the functioning of EMU. Breaking the sovereign-bank nexus could be achieved by simply reducing the ‘home bias’ of banks. Finally, the authors require the removal of the debt overhang of member states to make the euro sustainable.

This Ph.D. thesis has shown that existing forces are already pushing in the direction of reaching some of the above outlined minimum conditions. Visits to national parliaments by the ECB President are one step towards enhanced accountability and transparency. Large banks with significant cross-border business in the EU are pushing for the creation of EDIS. The rise of national independent fiscal councils decentralizes fiscal policy within EMU and fosters local ownership of the fiscal rules. Finally, the latest ESM reforms and the introduction of single limp collective action clauses in the EU will facilitate debt restructuring in the future.

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