THE EUROSYSTEM UNDER SIEGE:

THE CRISIS RESPONSE

of

THE EUROPEAN CENTRAL BANK

by

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Thesis

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Acknowledgements

In March 2018, I was sitting in a pub in Mayfair, London. An American trader in his early 50s was sitting at the table next to me chatting with a colleague who was in his early 20s and who just started at their firm. The senior professional explained the ropes of the business: how to do business and with whom. Then he said to the intrigued younger colleague, 'Since Lehman Brothers collapsed, everything has changed. No-one trusts anyone anymore.' The younger colleague looked baffled; not understanding how a single event on another continent that happened ten years ago could have any impact on his job. This anecdote captures the essence of my research project: Understanding the impact of ideas on institutional change during financial crisis. The financial sector and central banks have undergone profound change, nothing remained the same and my quest was to investigate this change.

During the four years of my research, I encountered several people I am indebted to and like to acknowledge my greatest thanks. First of all, to my first supervisor Nicholas Gane, who provided me with great advice and insight into developing my thoughts into a coherent thesis. His encouragement and criticism always helped me to move forward throughout the entire period. I would also like to thank my second supervisor Lynne Pettinger who had an eye for detail and always asked the right questions, shaping thoughts as well as text.

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The final paragraph is reserved for my girlfriend Micaela who has never shied away from delivering honest criticism. Without her mind and love to depend on, I would have never finished the thesis.

Declarations

I certify that the thesis I have submitted for the PhD degree at The University of Warwick is my work other than where indicated. The copyright of this thesis remains with the author. Quotation from the thesis is permitted provided that full acknowledgement is made. This thesis may not be reproduced without my consent. I warrant that this work does not, to the best of my knowledge, infringe on any other work.

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Abstract

In 2007, the certainties that had long guided financial markets evaporated. The financial and sovereign debt crisis fundamentally changed the financial system and the role of central banks. In the euro area, the European Central Bank (ECB) has gained enormous power and influence over the financial markets and national governments. In monetary policy, the ECB has introduced a wide range of new instruments to tackle the institutional and structural shortcomings of a destabilised financial system within an incomplete monetary union. This thesis makes a close assessment of these changes to analyse why and how the ECB has changed since the recent financial and sovereign debt crisis. It examine the questions: What were the ideational drivers for this change? And what were the lessons learned for the ECB from the crises? The thesis applies the economic ideational frameworks of post-Keynesianism and ordoliberalism as well as insights from neo-liberalism and Hyman Minsky on financial crisis dynamics to better understand the different forces that influence the decision-making of the ECB. The theoretical framework of epistemic communities also helps to better analyse the deeper implications behind the decisions of European central bankers and their interactions with commercial bankers. The thesis draws on 42 interviews with high-level decision-makers from central banks in Europe, commercial bankers, and government officials to investigate ideational change at the ECB and in the Eurosystem. The thesis argues that economic ideas play a major role in shaping decisions in the Eurosystem. However, during the financial crisis, the severity and the speed at which the system collapsed required policymakers to make pragmatic considerations rather than debate ideational factors. During this process, the ECB has developed its own identity that is continuously removing it from the ideational basis of ordoliberalism that shaped the founding documents.

Abbreviations

ABS	Asset-backed Securities
BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
BoE	Bank of England
BoJ	Bank of Japan
Bunds	Bundesbankanleihe (German sovereign debt)
CBPP1	Covered Bond Purchasing Programme
CBPP2	Covered Bond Purchasing Programme 2
CBPP3	Covered Bond Purchasing Programme 3
CDO	Credit Default Obligation
CDS	Credit Default Swap
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECJ	European Court of Justice
ECU	European Currency Unit
EFSF	European Financial Stability Facility
ELA	Emergency Liquidity Assistance
EMU	Economic and Monetary Union
EMI	European Monetary Institute

ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign Direct Investment
Fed	Federal Reserve System
FSB	Financial Stability Board
IMF	International Monetary Fund
LSAP	Large-scale Asset Purchases
LTRO	Longer-term Refinancing Operations
MBS	Mortgage-backed Securities
MRO	Main Refinancing Operations
NATO	North Atlantic Treaty Organisation
NCB	National Central Bank
OAT	Obligations Assimilables du Trésor (French sovereign debt)
RMBS	Residential Mortgage-Backed Security
SPV	Special Purpose Vehicle
SMP	Security Markets Programme
SNB	Swiss National Bank
TEU	Treaty of the European Union
OMT	Open Market Transactions
QE	Quantitative Easing

Key Events

07	February	1992	Treaty on European Union is signed (Maastricht Treaty)
01	January	1999	Introduction of the euro
01	November	2003	Jean-Claude Trichet assumes office
07	August	2007	Financial turmoil starts
15	September	2008	Lehman Brothers collapses
30	September	2008	Ireland guarantees deposits
05	November	2009	Sovereign debt crisis starts
10	May	2010	The ECB introduces the Securities Markets Programme (SMP)
19	November	2010	Jean-Claude Trichet sends letters to the Irish government to influence fiscal and structural policies
01	November	2011	Mario Draghi takes office
26	July	2012	Mario Draghi delivers ‘whatever-it-takes’ speech

See detailed table of key events in ANNEX 2.

Chapter 1

Introduction

> 'The ECB is becoming more powerful, more significant, more sophisticated and more complex. It is sucking power away from not only national central banks but also national parliaments.'
>
> Private sector banker who works closely with the ECB (PS2)

Three decades ago, central banking was an unexciting industry. Central banks became increasingly technocratic, their growing independence removed them from political influence and the de-regulation of the financial system during the 1980s and 1990s focused their responsibilities on monetary policy. Without political influence or oversight, career bureaucrats devised and implemented monetary policy for their countries. In the Western world, limited interventions were required owing to increasing economic growth and constraining mandates reduced the work of central banks on maintaining price stability. The purpose of central banks was to adjust interest rates and, support, if possible, economic growth, while keeping an eye on emerging asset price bubbles. Removed from political influence and established in extensive legal rights to ensure their independence, central bankers operated largely unnoticed by the public and most professionals in financial markets (*The Economist*, 2012). When the financial crisis unfolded in 2007, however, the disastrous effects of de-regulating the financial sector became apparent. In retrospect, the major central banks had had only limited success in spotting emerging asset bubbles. They did not contain increasing debts levels of governments and private households. Governments failed to overcome the structural problems of their economies, which played a part in the lead-up to the global financial crisis. This crisis pushed central banks into the public spotlight (Middleton et al., 2012, p.7), and leading central bankers, among others, Jean-Claude Trichet, Mario Draghi, Ben Bernanke and Marvin King became public figures. These unelected and technocratic leaders of the central banks became increasingly important in managing financial markets and guiding political expectations. The efficiency of technocratic institutions increasingly shaped the crisis response across the Western world or, as Mario Draghi put it, 'there was a time, not too long ago, when central banking was considered to be a rather boring and unexciting occupation. [...] Some thought that monetary policy could effectively be placed on auto-pilot. I can confidently say that this time has passed' (Draghi, 2013b).

This thesis asks: Why and how has the ECB changed since the recent financial and sovereign debt crisis? What were the drivers of this ideational change? What were the lessons learned for the ECB and the Eurosystem from the crises? While banking, and in particular central banking, have attracted little sociological interest to date, a number of critical thinkers such as Ann Pettifor (2016), Steve Keen (2017), Andrew Gamble (2009; 2014), Wolfgang Streeck (2008; 2014) and Simon Wren-Lewis (2015) have argued that the recent crises have not changed the thinking of politicians and mainstream economists to reform the financial sector in a meaningful way. These thinkers, who base their understanding of monetary policy and the financial sector on a critical reading of John Maynard Keynes and, to a lesser extent, on Hyman Minsky, argue that the non-standard and unconventional policies of Western central banks can make matters worse by laying the groundwork for another, possibly more significant, financial crisis. More than this, Pettifor (2016) argued that excess liquidity, the influence of central bankers on political issues, such as fiscal and structural reform in periphery countries, and the lack of restraint of bankers and investors in taking excessive risks will lead to an ever more polarised society that ultimately further enriches the few; something that will result in another economic and political crisis.

This thesis will contribute to existing sociological knowledge by teasing out the changing role of the ECB in the European financial and economic landscape in the lead up to and through the financial and sovereign debt crisis. Taking a critical perspective on the actions of the ECB and the financial sector since the outbreak of the financial crisis will help to understand the motivations and objectives of the different players in the market. The thesis uses a normative approach to unravel why the ECB moved from considering price stability as an absolute good to a more encompassing perspective on the financial system. To understand this change in policymaking, dominant concepts in central banking, such as independence, credibility and rules-versus-discretion, will receive detailed scrutiny to uncover the linkages between these concepts before and during the crises and their effects on the policy responses of the ECB between 2007 and 2015. To better understand why and how the ECB has changed as a result of the crisis, it is imperative to look back in time at the developments that led to its creation.

The European central banks underwent profound institutional changes during the early 1990s when the European governments decided to create the Economic and Monetary Union (EMU). Based on the Maastricht Treaty, signed in 1992, European governments integrated the central banks of the European Union (EU) to become the European System of Central Banks (ESCB). As part of the ESCB, several EU countries adopted the euro as their official currency, creating the Eurosystem in the process.[1] The ECB is at the centre of the ESCB and the Eurosystem and manages and coordinates the work of the euro-area member-state central banks. The Governing Council, currently consisting of 19 central bank presidents and the six executive board members of the ECB governs the Eurosystem. During the 2000s, this system was partially responsible for causing the thinking of European policymakers to converge to accept price stability and an independent central bank as paramount to achieving economic growth and financial stability across the euro-area. These ideas developed out of different schools of economic thought, predominately post-Keynesianism and ordoliberalism with influences from the Chicago School. This error in judgment led central bankers to overlook emerging asset bubbles and inflating debt levels. The thesis will draw on research on epistemic communities to better study the ideational frameworks among the central banking community (Haas, 1992a,b, 2001; Chapter 2). Thus, it will provide evidence on why epistemic communities converge on certain policy ideas and how they implement them.

Between 2009 and early 2010, the financial crisis underwent a period of stabilisation and recovery. The measures taken by central banks and governments seemed to be working to prevent a further meltdown of the global economy. The euro-area, however, was pulled back into recession once it became obvious to investors that the rising public debt burdens of euro-area periphery countries, which were partially the result of bailing out commercial banks, could threaten the survival of the euro-area. The sovereign debt markets of European periphery countries, the major source of funding for governments, underwent a dramatic downward trend compared to sovereign bond markets in core countries, such as Germany, the Netherlands and Austria. Developments on capital markets called into question the solvency of European governments, for the first time since the creation of the EMU (Beirne and Fratzscher, 2013). Southern European countries, such as Italy, Spain, Greece, Portugal, and Cyprus, as well as Ireland, collectively known as periphery countries, had difficulty

[1] Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland were the eleven out of 15 EU member states that adopted the Euro in the first wave.

refinancing their increasing public debt burdens. Western central bankers realised that price stability and independence could not, as had been assumed, inhibit the growth of asset bubbles and might hide rising debt levels.

These developments fundamentally changed the neo-liberal ideational paradigm of the 1990s and early 2000s which assumed that financial markets had perfect information and through that, would be able to self-regulate. This included that price signals would allow market participants to judge risk, including that of sovereign debt. However, as it turned out, this was not the case. The ECB was caught off guard in late 2009 when the Greek government announced its public budget deficit. A heated debate among governments and central banks emerged on whether the statutes of the ECB would allow it to implement expansionary monetary policy and provide emergency assistance to threatened member states. The debate revolved around who would ultimately pay the price, Greek society, the investors investing in periphery countries or the taxpayers of the core countries? The ECB took the decision when it introduced far-reaching asset purchasing programmes such as the Securities Markets Programme (SMP) and later the Outright Monetary Programme (OMT). These instruments and the various emergency lending programmes of the national governments decided that the Eurosystem had to pay for the debt of the periphery countries and the investors involved, with the national central banks (NCBs) having to take the most risk, unequally shared according to their capital key share. These decisions were not without controversy. The decision to introduce the SMP resulted in a profound loss of confidence and in financial markets and devastate the credibility of the central banks in the eyes of the European public. Two German Governing Council members resigned in protest, demonstrating the intensity of the debate on the crisis response of the ECB and signified that the differences of ideational preferences started to divide Europe. This debate considerably reduced the credibility of the ECB, in particular in core countries. Ironically, the decision to introduce the OMT, which shared several design features wih the SMP, increased the credibility of the ECB to unseen heights, fixating it at the top of the European crisis management and prevention effort. How was that possible?

Before the crisis, the general opinion of economists of different ideational sides was that the diffusion of state power and the deregulation of financial markets would lead to the globalisation of goods and services. The bestselling book, *The World is Flat* by Thomas L. Friedman (2005) was about the magnitude of positive change around the world as a result of globalisation. Friedman's work provided a glimpse into the pre-financial crisis world of peaceful cooperation among the major industrialised countries and the emerging nations in Asia and South America. The book argued that the global community would soon share the economic benefits of increasing global trade and technological achievements. Economic welfare would trickle down to all parts of society, regardless of whether they were i the developed or developing world (Friedman, 2005). The financial crisis, however, revealed that financial markets do not regulate themselves and have reached increasingly unsustainable debt levels. The technological advancements of globalisation and enhanced telecommunication technologies enabled financial institutions to devise complex financial products which increasingly removed the real economy from the financial sector and helped to mask the rising debt levels and structural differences among euro-area member states. Furthermore, the integration of global financial markets led to the increased exposure of banks and investors to financial products that were not yet recognised to be risky. The complexity and interconnectedness of the financial industry, among other reasons, were responsible for the global spread and severity of the crisis.

The question of how the subprime housing crisis in the United States (US) escalated and brought the global financial system to its knees has largely been answered (e.g. Jickling, 2010; Corneil and McNamara, 2010; Mizen, 2008). The conventional answer is as follows: housing mortgages and inflation rates are linked because homeowners often leverage their houses. Most people take out housing loans, pay about 20 percent as down payment and the outstanding amount are paid in monthly fees for up to 30 years. Thus, the ability of central banks to change key interest rates has a significant impact on the mortgage rates and, therefore, on the liquidity of large parts of society. Throughout the 1990s and the early 2000s, interest rates were low compared to previous periods. This increased the availability of affordable mortgages for large portions of the US public. The Community Reinvestment Act in the United States, passed in 1977, aimed at encouraging lower-income families to get mortgage loans. These mortgages were called subprime loans owing to their higher risk of default, which increased the overall debt levels of society. Initially, quasi-government agencies Fannie Mae and Freddie Mac bought subprime loans and those subprime mortgages were, therefore, indirectly guaranteed by the US government. Other types of private credit, such as credit card debt, car credit and credit for home appliances increased as well. At the same time, Western governments further deregulated financial markets to incentivise financial innovation and competitiveness (Booth, 2015). Central banks assumed that they could prevent swings in the business cycle by focusing on price stability. This assumption derived from the perceived positive track record of selected central banks, such as the Bundesbank and the Swiss National Bank (SNB), in reducing inflation rates and supporting economic growth.

Modern financial innovation in financial products advanced rapidly and increased the marketable debt levels. Products such as asset-backed securities (ABS), residential mortgage-backed securities (RMBS), collateralised debt obligations (CDOs), and credit default swaps (CDS) emerged and increased considerably during the 1990s and early 2000s. Between 2004 and 2008, major financial institutions issued nearly 2.5 trillion dollars in RMBS and more than 1.4 trillion dollars of CDOs. Agencies such as Fannie Mae and Freddie Mac issued another 6.6 trillion-dollars RMBS during their four-year period (Levin and Coburn, 2011, p.318). By 2016, the Bank of England (BoE) estimated the ABS market to be at about 10.7 trillion-dollars (Bank of England, 2007, p.20). In comparison, during the same year, the GDP of the United States was 13.9 trillion-dollars.

Innovation in financial products had two significant advantages for financial institutions. The introduction of CDOs during the 1990s made it possible for banks to bundle several mortgages up into one product and sell the new product to outside investors. Financial institutions reduced their risk exposure and circumvented capital requirements by selling CDOs. The investors who bought the products failed to see the inherent risks of a product that contained a mix of highly rated and lower rated mortgages. In theory, if a part of the CDO lost value, other parts would remain stable, decreasing the overall risk of default of the product. Therefore, rating agencies often rated CDOs with Triple-A because they assumed that the inherent risk in one CDO was limited, owing to its composition. The products, however, did not anticipate a system-wide default of mortgages caused by a countrywide collapse of the housing market.

A secondary market for similar products was developed to increase the trade of CDOs. Banks created new companies, so-called special purpose vehicles (SPV). The use of SPVs allowed banks to move part of their investment activity off their books, ultimately circumventing the minimum capital requirements that were designed to prevent bailouts of financial institutions (O'Hara, 2009, p.331). SPVs then engaged in repackaging ever more complex products, by dividing, for example, ABS or RMBS into tranches with different risks associated and merging them into new

CDOs. Several CDOs were repackaged into new CDOs, creating ‘CDOs-squared’ and, repackaged again, into ‘CDOs-cubed’. These products were then freely sold to other banks, credit agencies and insurance companies, who thought that they could reduce their risk exposure by holding these perceivably almost risk-free products. To make matters worse, what was not apparent at the time was that the purchasers of large amounts of ABS and CDOs were SPVs, often owned by the very banks that used these entities to circumvent capital controls (Mizen, 2008, p.538). Banks thought they sold toxic or under-performing CDOs to outside investors to reduce their risk exposure, but often their SPVs bought these products from third-party investors unaware of what these products consisted and from where they originated.[2] The secondary market became highly efficient in marketing and selling complex financial products across the world.

Another product that would later contribute to the crisis was the CDS, which allowed investors to profit from the failure of RMBS and CDOs. The seller of a CDS provided insurance to the buyer against the default of his loan, for which he received a fee.[3] CDSs started as a products to hedge debt risk but soon became part of a billion-dollars betting market with grave instances of ethical misconduct.[4] To make matters worse, the rating agencies played their part in this game. They allowed banks effectively to buy a rating for their financial products. The rating, as it later turned out, depended more on the fee the rating agency received from the bank for rating the product than on the product itself (e.g. Utzig, 2010; Angelides and Thomas, 2011, pp.199-222; Levin and Coburn, 2011, pp.243-317). As one analyst from Standard & Poor’s, the rating agency, would comment in an email to a colleague in April 2007, ‘We rate every deal [...]. It could be structured by cows and we would rate it’ (quoted in Levin and Coburn, 2011, p.331). The email shows how analysts at the rating agencies perceived their job. They provided ratings to any

[2]In this context, toxic assets are financial products for which there is no longer a functioning market. The value of these assets is highly uncertain and the owner is not able to sell them even to a steeply discounted price, because of the lack of a market for them (Law and Smullen, 2008).

[3]Short selling is a financial tactic where one sells stocks, securities, or commodities to another party without actually owning them. The seller hopes to be able to buy the product at a lower price before he has to deliver (Stevenson, 2010, sell short), Chapter 7.1.1).

[4]For example, Goldman Sachs, the investment bank, shorted two billion dollars of a CDO and sold it to investors without disclosing its position. As expected, the CDO lost value, but Goldman gained a 1.7 billion-dollars profit, of course at the expense of the clients who invested in the long-position. This example shows how financial institutions disregarded conflicts of interests and even bluntly exploited them. On another occasion, Goldman Sachs sold a CDO to investors without disclosing that a hedge fund, which had played a major role in selecting the assets contained in the CDO, held the entire short-position. Again, when the CDO lost value, the investors in the long-position lost about one billion dollars, while the hedge fund profited by about the same amount (Levin and Coburn, 2011, p.319).

financial product regardless of their real value or legal structure. These examples demonstrate the inherent ethical misconduct of a majority of actors in the market and the excesses of the financial system before the crisis.

Once the crisis hit, markets froze up, and banks had to include the losses of their SPVs on their books. The over-leveraged condition of most banks further multiplied the losses (Mizen, 2008, p.532). Most banks relied on short-term loans to fund their over-leveraged portfolios, but these became unavailable when inter-banking lending markets froze. This short-sightedness on behalf of the banks resulted in liquidity shortages once the crisis emerged. Mizen later argued that a 'Leverage of 20:1 transforms a 5 percent realized loss into a 100 percent loss of initial capital; thus, an investor holding a highly leveraged asset could lose all its capital even when default rates were low' (2008, p.539). It becomes evident that these different but strongly interlinked factors caused the financial system to collapse.

In retrospect, the crisis had several interconnected causes, and central bankers were not without blame. Central bankers kept an attitude of *laissez-faire* towards financial innovation, spurring it through de-regulation and reduced supervision. They took the superiority of the market as granted and focused on maintaining price stability. Once price stability was achieved during the early 1990s, central bankers worked on 'fine-tuning' their national economies by stabilising short-term output. Financial risk was, however, excluded from any intervention arguing that manipulating the interest rate was not a useful tool to 'fine-tune' specific elements of the financial sector (Stark, 2011). The wrong assumption that the financial market could correctly price its risk exposure further enhanced the fallout from the crisis. The short economic downturn during the dot-com crash in 2000 prompted the Federal Reserve System (Fed) to introduce an expansionary monetary policy that further raised the financial sector's appetite for risk. The large-scale intervention of central banks into the financial market led to the perception that the central banks would protect it from any turbulence (Stark, 2011).

In 2007, when the financial crisis started to emerge, central banks were quick to respond by creating innovative instruments. The ECB, for example, introduced far-reaching recapitalisation measures to provide much-needed liquidity to the financial sector. Although this proved to be effective in overcoming initial challenges of liquidity, it did not prevent national governments from taking on excessive debt to stabilise their banks when there was a fear that the collapse could further destabilise the financial system. The ECB was, therefore, unable to prevent the financial crisis from spilling over into a sovereign debt crisis in Europe. This spill-over was further intensified as a result of the incomplete institutional environment of the euro-area. At the start of the crisis, there were no mechanisms in place to support indebted member states. Indeed, the Maastricht Treaty actively prevented the ECB and the euro-area member states to support other member states. Thus, the responsibility of lender-of-last-resort (LLR) remained with the national governments rather than with the ECB. Since 2007, the ECB, however, has become a *de facto* LLR for euro-area banks (Garcia-de Andoain et al., 2016). In 2012 the euro-area governments overcame this design shortage and founded the European Stability Mechanism (ESM) to support euro-area member states that have liquidity shortages (see, page 166, footnote). The ECB has furthermore expanded its use of instruments, its networks with the private sector and reorganised its crisis management capabilities to address the crisis. In this regard, the European political and financial landscapes including the Eurosystem have changed as a result of the crisis.

1.1 Analysing the ECB

There are several reasons for why the ECB is worth exploring from a sociological perspective. First, the ECB is the only supranational central bank without a political counterweight. In comparison, the Fed, the Bundesbank and the SNB are integrated into federal structures that do not exist at the EU level. Second, the institutional design of the ECB was based on the convergence of ideas on the virtues of price stability and the independence of central banks among the European central banking community that lasted from the late 1980s until the outbreak of the financial crisis. These design features became important cornerstones of ordoliberal thought. The Maastricht Treaty negotiations that created the ECB allows us to assess how various national governments and their central bankers envisioned the ECB. Using these positions as a basis, this thesis analyses how the ECB conducted monetary policy from its inception in 1998 until the financial crisis in 2007 and how its operations have changed since 2007. The majority of the thesis explores why the crisis changed the institutional basis and conduct of monetary policy of the ECB. The thesis uses an event-driven research approach to increase the granularity of the case study selection; this approach starts with an analysis of an event to understand the decisions that led to a specific outcome (Aldrich, 2001, p.193). The reverse scenario would be an outcome-driven approach. There, the research would follow the decisions of an obvious outcome to understand the events that have led to this outcome. This approach, however, has several shortcomings that could bias the research, for example, interviewees tend to fall for a retrospective reconstruction of past events. This tendency can lead to them inflating their role during the event, blaming past adversaries or not adequately explaining mistakes (Aldrich, 2001, p.192).[5] Single events that had a significant effect on the ECB, its choice of instruments and its implementation of monetary policy, are used to assess the reasons for change. This thesis divides the events into two segments: financial crisis events that took place between 2007 and 2009 and sovereign debt crisis events from 2010 until 2015.

This thesis argues that during the financial crisis, from 2007 until late 2008 the ECB acted quickly and decisively in providing short-term capital to the financial market. Data from the interviews suggests that the ECB had to act quickly and make decisions on pragmatic grounds rather than enter into a debate on the advantages and disadvantages of different ideational frameworks (ECB1; BUBA3). When Lehman Brothers collapsed in September 2008, the ECB continued with its liquidity operations, but the impact on the financial system seemed to paralyse the ECB between September 2008 and mid-2009. During this period, the severity of the financial crisis affected several banks, which required bailouts from their national governments.[6] The limited LLR responsibility of the ECB reduced its effectiveness and it took the ECB several months to develop a strategy to restore liquidity and confidence in the market through monetary policy instruments, such as decreasing the key interest rate, expanding the balance sheet of the ECB and through supporting national governments to strengthen their regulatory and supervisory frameworks (Delhommais and Leparmentier, 2009; Trichet, 2009).

The second segment of the case study focuses on the sovereign debt crisis, which is further divided into two sub-segments. Between 2009 and 2010, the financial crisis turned into the sovereign debt crisis. During early 2010, after lengthy debates and divisions among Governing Council members, the ECB decided to implement an instrument through which it could buy sovereign bonds from strongly indebted periphery countries. Actors, such as the governments and the central banks of core

[5] In all interviews, only two participants blamed their superiors for insufficient handling of certain events during the crisis. Secondary research suggests that they were correct in their assumption demonstrating that their superiors failed to grasp the severity of the crisis.

[6] In Germany, the government agreed to a 30-billion-euro bailout of Commerzbank AG, the second largest bank in Germany on 08 January 2009 and to support Hypo Real Estate Holding with more than 142 billion euro. In France, extensive rescue packages were set-up to bailout the largest French banks. In addition, Austria, Portugal and Italy developed rescue packages totalling hundreds of billions of euro.

countries, foremost Germany, considered this decision to be a breach of the mandate (Reiermann et al., 2012). The decision to buy periphery country sovereign debt was a first turning point for the ECB, because it moved the ECB towards the edges of its legal mandate and challenged the ideational basis of its foundational documents. The asset-purchasing programmes created severe rifts among the Governing Council members, who had mainly worked together harmoniously before the crisis (Chapters 7 and 8). When Mario Draghi delivered his 'whatever-it-takes' speech, it marked a second turning point for the ECB during the sovereign debt crisis and signalled the beginning of a new era for the ECB. Draghi established the ECB as an entirely independent central bank regarding its operations and its goal setting, which stretched the mandate of the ECB to the limit to preserve the common currency (Chapters 7 and 8).

The seminal moments of the financial and sovereign debt crisis, as shown in Table 1.1, are assessed individually. After each of the crisis-related (Chapters 6 to 8), the final section is devoted to the institutional changes and the impact of ideas on these changes. The next chapter then starts off with another event-driven analysis and the cycle repeats.

Date	Implications
	Financial crisis
09 August 2007	BNP announces the closure of two hedge funds in the derivative markets. The financial crisis starts with the ECB providing an unprecedented amount of capital to the financial market (Chapter 6.1.1).
15 September 2008	Lehman Brothers collapses and the crisis intensifies. The ECB seems to be overwhelmed by the effects of this event (Chapter 6.1.2).
30 September 2008	Ireland guarantees deposits in a unilateral move. This decision heightens tensions with other national governments in the euro-area (Chapter 6.1.3).
	Sovereign debt crisis
5 November 2009	Greece announces difficulties to service its public debt, starting the sovereign debt crisis (Chapter 7.1).

10 May 2010	After weeks of intense negotiations, the European governments announce a rescue plan for Greece. The ECB becomes part of the Troika and introduces its first asset purchasing programme, the SMP. Both decisions pulled the ECB into the political realm and more onto the fringe of its mandate (Chapter 7.2.1).
19 November 2010	The ECB pressures the Irish government to implement reforms based on conditions. The ECB turns towards fiscal policy to save the euro-area (Chapter 7.2.2).
1 November 2011	Mario Draghi takes office. Leadership change is felt throughout the institution as well as financial markets and defines the remainder of the sovereign debt crisis (Chapter 8.1).
26 July 2012	Draghi delivers his 'whatever-it-takes' speech, reducing market pressure and overcoming the sovereign debt crisis (Chapter 8.2).

Table 1.1: Critical events during the financial and sovereign debt crisis

The case studies will allow analysing the decisive factors that led to an institutional and ideational change of the ECB during the financial and sovereign debt crisis. It provides granularity to the research process without losing sight of the bigger picture: the complex interaction among European national central banks, governments and financial markets. The research questions will further guide the research process.

1.2 Research questions

The actions and policy decisions of the ECB and the Eurosystem during the financial and sovereign debt crisis provide ample testing ground for a thorough analysis of the economic ideational drivers that shape policymaking. The thesis aims to discuss and provide evidence for the following research questions:

- Why and to what extent has the monetary policy of the Eurosystem changed as a result of the financial and sovereign debt crisis?
- What were the economic ideational drivers for this change?
- What are the lessons learned for the ECB and the Eurosystem from the crises?

The use of the economic ideational frameworks of ordoliberalism and post-Keynesianism and their application among the epistemic communities of central bankers in their interaction with commercial bankers allows us to address the following related questions:

- What is the role of epistemic communities in framing the narrative for economic ideational thought in the application of policymaking?
- What were the internal conflicts and points of cooperation of the epistemic community of central bankers during the financial and sovereign debt crisis? Why did the epistemic community of Euorpean central bankers not fall apart during the heights of the financial and sovereign debt crises, in particular considering the diverse cultural and ideational backgrounds of its members.

Looking back on how the ECB changed as a result of the crisis, the thesis will provide evidence and analysis of two critical concepts of central banking: independence and credibility. This leads to two further questions:

- To what extent and in what ways has the independence of the ECB changed as a result of the crisis? Has there been a paradigm shift in how the ECB applies its independence to achieve the outcome it desires?
- Has the credibility of the ECB increased or decreased as a result of the crisis?

The purpose of this thesis is to provide an assessment and answers to the questions above to understand better the changing role of the ECB that resulted from the financial and sovereign debt crisis. This will shape the discussion on the influence of economic ideational frameworks on central bankers. In 1992, the Maastricht Treaty created the EMU and founded the Eurosystem, headed by the ECB. The resulting system ensured that the NCBs work closely together to devise and implement monetary policy for a group of nations that now encompasses 19 European countries.[7] The severity of the recent financial and sovereign debt crisis exposed the euro-area to a significant threat to its very existence. Owing to the incomplete institutional environment and the lack of international coordination of economic and financial policies among euro-area governments, the ECB evolved to fill this void. As a result, the ECB has adapted its policies and asserted its position as the leading economic and financial institution that has self-declared itself as the saviour of the euro-area (Trichet, 2010d; Draghi, 2012a). This thesis focuses on monetary policy and omits discussion on other central banking topics, such as financial supervision, payment systems and economic research. Although the ECB has taken on far-reaching policy responsibilities in these areas, the scope of this thesis will not allow for a detailed discussion. This thesis uses the economic ideational frameworks of ordoliberalism and post-Keynesianism, with a critical view on neo-liberalism and Minsky's assessment of the business cycle to analyse high-level decision-making at the ECB and in the Eurosystem before and during the crisis. Economic ideas have a powerful influence on shaping, changing, and evolving policies of central banks and allow them to adapt to an ever-changing world, but not without conflict.

1.3 Methodology

The thesis uses data collected from semi-structured, in-depth interviews held with European senior central bankers, senior government officials and senior commercial bankers from various financial institutions. The insights from these interviews provide a unique perspective on how high-level policymakers from European central banks and senior commercial bankers consider the actions of the ECB. These perspectives will tease out why ideas shape policies and how these policies are perceived from outside groups during times of crisis. The aim of this thesis was to study the ideas that comprise the decisions and actions behind monetary policy. The perception of the central banking community and commercial bankers on policy decisions of the Eurosystem are an important factor in assessing the ideational changes of the ECB that resulted from the crisis. The interviews focused on the changing perception of key concepts of central banks, such as independence, credibility and governance, the changing relationship between the ECB and the NCBs of the Eurosystem as well as the influence of economic ideas on the decision-making process of the

[7] At time of writing 2018, legally, all EU member states, apart from the UK and Denmark, have to adopt the euro and join the euro-area once they meet the convergence criteria (European Commission, 2017).

Eurosystem central banks.

For this thesis, the interview method was primarily used to gather data. Interviews are considered integral to in-depth qualitative research because they allow to collect and analyse the intrinsic views and beliefs of the group under investigation. This is particularly the case for ideas that one cannot directly observe (Patton, 1980). All interviews were semi-structured to allow respondents more flexibility in answering complex concepts, policies, decisions, and instruments. Semi-structured interviews, in comparison to structured interviews are suitable for generating 'rich and illuminating data' (Robson, 1993, p.229). They allow interviewees to change the order of the topics and questions and provide the interviewer with the opportunity to ask for elaboration and pose further questions on specific areas (Britten, 1995). All questions were therefore formulated to be open-ended and did not force interviewees to give pre-defined answers.

Once the first interviews were conducted, an initial analysis helped to tease out more questions that the interview participants found relevant to the research. The emerging themes and ideas influenced the interviews that were conducted after September 2015. Key questions remained the same to retain consistency in the data, while sub-questions were added to go into more detail in specific areas. Furthermore, the semi-structured interview approach allowed the research to go into more detail in areas the individual interviewee deemed to be essential to explain his or her position or role during the crises. The interviews, furthermore, provided insight into the multiple layers of interaction and communication that exist among central banks and between central banks and financial markets. The interviews are divided between formal interviews and conversations. The formal interviews were partially recorded. Field notes were made for formal interviews and conversations to preserve information. The conversations resulted from discussions with senior officials that either did not have the time to set up an interview or did not want to participate in a formal interview process, often citing reasons of confidentiality. All conversations lasted between one and three hours, depending on time and circumstances. Often, multiple conversations with the same interviewees took place throughout the research phase. This approach made it possible to come back to interviewees after conducting other interviews and ask them again about their impressions. The wide variety and often detailed discussion with senior policymakers and commercial bankers provided a thorough grasp of decision-making of the ECB and its relationship with the NCBs in Europe and its impact on the private sector during the different stages of the crisis. The interviews were, apart from four, conducted face-to-face.[8]

Overall, the author conducted 42 interviews and conversations. Of those, 25 were formal interviews, and the remaining 19 were conversations. Of those 42, the author conducted 29 interviews or conversations with current or former central bankers. On the private sector side, 11 interviews and conversations were conducted. To highlight the professional background of some of the interviewees: Five interviews were held with current or former central bank board members in Europe (BUBA1; BUBA2; ECB5; ESCB1; ESCB3; BOE1; EU1). In total, 18 interviewees currently hold or held leadership roles in a European central bank (ECB1; ECB3; ECB5; BUBA1; BUBA2; BUBA3; BUBA6; BUBA8; BUBA9; BUBA10; BUBA11; BUBA12; DNB1; DNB2; DNB3; ESCB1; ESCB2; BOE1). Six professionals work in leadership roles in major international financial institutions (PS1; PS2; PS4; PS5; PS6; PS9). Two interviewees are renowned financial journalists covering central banks (PS3; PS8), and one interviewee works as a senior economist for a major UK-based economic think-tank and previously held a leadership role in the UK government (PS7). Two interviewees were on the Delors Committees (ESCB1; ESCB3), which provided the intellectual input for the creation of the EMU and the ECB, and one interviewee took a leading role in developing the EMU as part of the European Commission negotiation team (EC1). One interviewee was a former Minister of Finance of a Southern European country during the crisis and had extensive central banking experience (EU1). The diverse background of the interview participants within the community of central bankers and private sector bankers allows for a detailed analysis of the events that unfolded during the financial and sovereign debt crisis.

The interviews and conversations were conducted from August 2015 until August 2016 in London, UK, Frankfurt am Main, Germany and Amsterdam, the Netherlands. The majority of interviews were conducted in English while some interviews were conducted in German at the request of the interviewee. Four interviews were conducted over the phone due to time and location issues for some of the interviewees. Although central bankers and commercial bankers showed a high level of trust and confidence in the research approach, the nature and sensitivity of monetary policy at the highest level of decision-making often prevented them from being recorded. This sensitivity was particularly the case for participants working in mon-

[8] On the advantages of face-to-face interviews, see, Atkinson (1998); Denzin and Lincoln (1994); Hammersley and Atkinson (2007).

etary operations departments at various European central banks or for participants who held board positions at major commercial banks.

Although there is clear evidence that recording interviews provides better and more comprehensive data (Lofland et al., 2006), this was not possible in all of the cases (see below). Interviews that were not recorded were preserved through field notes made during and shortly after the interviews. Overall, the decision to conduct interviews with high-level decision-makers resulted in several challenges for the interviewer. First, access to any elite group in a leadership function is difficult to achieve. Economic and financial leaders, in particular, have a wide range of responsibilities. Meetings are often planned weeks in advance, but interviewees regularly changed the time of the meeting on short notice owing to changing market circumstances. Flexibility and time to support academic research is low among commercial banks. Second, elite groups are exposed to sensitive information and in financial markets, disclosed or leaked information can lead to price swings of assets. Thus, all interviewees took precautions not to disclose any information that could harm their financial institutions. Central bankers were cautious about providing current information about monetary policy decisions and their particular perspective on economic and financial data, and commercial bankers often refused to be recorded to prevent disclosing any strategic information to the public. Third, elite decision-makers tend to be particularly careful that their answers remain confidential. Thus, while most interviewees did not allow their conversations to be recorded, others went so far not to sign the confidentiality agreement so as not to be associated with the research at all. Those interviewees often worked in highly sensitive departments and only agreed to be interviewed under conditions of absolute confidentiality.

Several angles were deployed to overcome the three mentioned main challenges of interviewing elite decision-makers from central banks and commercial banks and at the same time to prevent the disclosure of sensitive information. First, the existing network in the financial community was exploited to get access to senior commercial bankers and central bankers in an initial thrust to find an entry point. In a second step, the author worked for the Official Monetary and Financial Institutions Forum (OMFIF), a network-driven research think-tank for central banks across the globe, as a part-time economic researcher. The work of OMFIF focuses on the role of central banks in the changing economic and financial global environment. During this time at OMFIF, the author participated in six 'closed-door' meetings that were subject to the Chatham House Rule, where leading European central bankers provided insights into the workings and strategy of their central banks. The speakers were two current ECB board members, one former ECB Executive board member, one senior advisor of the ECB president, one president of an international financial organisation, and one former leading Asian central banker. These meetings and day-to-day work at OMFIF, furthermore, provided an in-depth understanding about the mechanisms that foster the relationships between central bankers and commercial bankers.

From January until March 2016, the author joined the 'Strategic Issues relating to Monetary Policy Implementation' Division within the Market Operations Department at the Bundesbank as a post-graduate Researcher. This made it possible to conduct twelve interviews with team and division heads in the Market Operations Department and the Economics Department. During this time, daily informal lunch meetings were attended with individuals or groups of staff and senior officials. In March 2015, the research process was presented to a group of approximately 15 team heads and professionals from the Strategic Issues Division, which was followed by a 1.5-hour discussion on the research topic to gain an insightful perspective on how Bundesbank officials perceive their role in the Eurosystem. Furthermore, one day was spent on the Bundesbank trading floor to attend the morning meeting of Bundesbank officials who observe global capital markets from their offices in Frankfurt, New York, Tokyo and Singapore. The remainder of the day was spent watching large-scale asset purchases as part of the various Eurosystem asset purchases and several conversations with different members of the trading team.

These experiences helped to understand how the Eurosystem conducts its purchasing programme, how traders implement the decisions of the Governing Council and provided a detailed insight into the specific processes that are required to conduct large-scale asset purchasing programmes. Although most of the conversations and observations on the trading floor are, of course, classified, general information from the observations and conversations with traders will feature in the thesis. These three key entry points enabled access to this closed community among the financial elite and ensured that the subsequent theoretical research is based on data obtained from interviews and checked against observational, empirical evidence. It is, however, important to say that the data collected from the interviews is observational and should not be seen as facts. All interview participants volunteered to participate in the research project. The author preserved their anonymity.

1.3.1 Transcription, coding and analysis

The interviewer transcribed all recorded interviews to ensure consistency. Once the transcriptions were completed, a thematic analysis was conducted to identify patterns or themes. This allowed to find themes that the interviewees most frequently discussed unrelated to the questions asked. The semi-structured interviews allowed interviewees to answer in any way they saw relevant to the questions and the patterns that emerged were not immediately apparent to the interviewer. The thematic analysis therefore helped to make 'sense' of the rich data-set. It further helped as a basis for an initial interpretation of the data (Boyatzis, 1998) without relying on theoretical frameworks or research tools (Braun and Clarke, 2006).

Once this initial process was completed, the interview data was analysed using the approach developed by Ritchie and Lewis (2003). First, an index was generated to organise sentences and paragraphs within a theme. Each sentence or paragraph could have more than one index to allow for several themes and to establish a hierarchy of themes. For example, under the theme of 'independence' a possible sub-theme could be 'operational independence', or 'legal independence'. Second, this approach allowed to tag the data. This permitted going into more detail for many of the themes. In our example, 'operational independence' could be considered from the perspective of central bankers or commercial bankers. This provides another frame to analyse the debate. Tagging data allowed for acknowledging these differences and was particularly helpful in the elusive study of ideas. Third, the data was re-organised according to the emerging themes. This was done using Microsoft Excel. It was important not to remove the data from context, in particular, when using only short sentences. This further helped to outline the structure of the thesis and where each theme would be discussed. Fourth, the data was summarised and text that was unrelated to this thesis, was removed. For example, answers that concerned financial supervision were removed to condense the available data and focus it on monetary policy (for more detail on these processes see (Ritchie and Lewis, 2003, Chapter 9).

The data from the interviews appears in this thesis in two ways: As a direct quote or as a source to indicate that an interviewee agreed with an argument. The latter was particularly used when the interview was either not recorded or a conversation. This approach allowed for acknowledging the input without misquoting the interviewee. Each interview participant has a unique code (see ANNEX 1). This code indicates the organisation the interviewee worked for at the time of the interview. ANNEX

1 further shows the 'Position' of the interviewee at the time of the interview, the date the interview took place and the type of the interview. The type, as discussed above, differentiates between a formal 'interview' and an informal 'conversation'. The ranking of the interviewees in the table is random and one should not not deduct a hierarchy from it. Overall, apart from three interviews or conversations, all were conducted with professionals who had at least 15 years of work experience and leadership experience (for more detail see above).

A large number of official publications from European central banks, speeches held by ESCB policymakers and European politicians as well as a wide range of newspaper articles from different European countries were analysed to cross-check the data from the interviews, conversations and observations. This research approach allowed the author to verify the statements of the interviewees and provided a more in-depth understanding of the complex nature of the financial and the sovereign debt crisis and the role of the ECB and the Eurosystem in it. The data from those sources can, however, only provide a partial perspective on the complex events during the crises. Official publications and newspaper articles can be biased to support a specific argument. Although interviews often only provide a partial view on the unfolding events, semi-structured interviews allow for drilling down in areas where the interviewee might not want to provide a full perspective on or might provide deflecting answers. This particular perspective can then again be cross-checked with the sources above. The combination of both approaches enabled the construction of a comprehensive overview of the complex events and detailed data to analyse institutional and ideational change and the changing role of the ECB in the euro-area.

1.4 Outline of the theoretical framework

The thesis will employ a two theoretical frameworks focusing on ideas in communities to analyse the changing role of the ECB and its response to the financial and sovereign debt crisis. The theoretical work of Peter M. Haas (1992a; 1992b) on epistemic communities will be used to enable a better understanding of the ways in which policy decisions of certain groups, such as central bankers, are driven by ideas. Primary literature on ordoliberalism, post-Keynesianism, neo-liberalism as interpreted by the Chicago School, and the writings of Hyman Minsky will be used to explore the origins and development of these ideas, and to analyse their role in high-level decision-making within central banks, governments and the private sector through different waves of the financial crisis.

This thesis will focus, in particular, on ideas and actions of European central bankers, who, as public policy experts, fundamentally shaped the crisis response from 2007 on-wards. The work of Haas is here useful as it defines epistemic communities as groups of professionals (such as central bankers) that create policy-relevant knowledge for complex and technical problems, and have an authoritative claim to this knowledge (Haas, 1992b, p.3). A group of policy experts and decision-makers count as an epistemic community, according to Haas, if they have an in-depth and wide-ranging understanding of their policy area. These characteristics can be found in the central banking community in Europe.

Moreover, central bankers in Europe can be defined as an epistemic community because they are well connected through the institutional workings of the ESCB and share cooperative working relationships. They exchange ideas and information on a regular basis on different hierarchy levels and area of expertise. Although central banks are governmental organisations and the flow of information is hierarchical compared to private sector firms, there is a large number of expert groups, working groups and committees where professionals from different European central banks work closely together on a daily basis. There is, therefore, extensive flow of information between the central banks in the ESCB and, in particular, of those in the Eurosystem. Central bankers in Europe make up a relatively small group of financial experts compared to the wider European financial sector. They belong to a transnational policymaking elite that has the power and ability to devise and implement policy decisions that affect millions of lives on a daily basis (Chapter 2.3).[9] Working in a multi-institutional, multi-lateral system is complex, and interactions between central bankers from member countries are marked by cultural differences. This thesis will explore the convergence of key ideas on central banking in pre-crisis Europe through the spread and impact of the crisis. Although in post-crisis Europe the ideas among this group were often quite different (see Chapter 3), through the crises the ideas of this elite converged through the formulation of key policy prescriptions. However, before delving deeper into this line of argument, it is worth assessing other existing perspectives on communities of experts, in particular those that address the influence of ideas scholars working on policy formulation and the formation of policy paradigms.

[9] On a critique of allowing unelected technocrats make decisions that affect millions of lives see, Sinn (2014).

There are other conceptions of communities found in sociology and public policy, such as 'communities of practice' or 'communities of learnings' (Amin and Roberts, 2008; Lave and Wenger, 1991; Wenger, 1998, 2000). For example, Wenger (1998) argues that communities of learning can form on a daily basis among indi- viduals who share a common interest and use the interaction with others to learn from each other. Although this is a useful explanation of how and why groups form, the community of Eurosystem central bankers under investigation goes beyond this rather loose arrangement. The term and definition of an epistemic community, as defined by Haas, provides a better framework to analyse the institutional connections between central bankers from various central banks. They are not only connected by a common desire to better understand monetary policy but most importantly by a common mandate that they are required to achieve. In this context, it is worth mentioning Marion Fourcades elaboration of the interaction between economics and society (Fourcade, 2009) as well as Peter Hall's (1993) work on paradigms and institutions. These approaches are potentially better suited to explain this shared institutional connection among Eurosystem central bankers, for this reason it is worth assessing Fourcades and Halls work in more detail, not least because both have analyse policy change in economic institutions.

Fourcades develops the approach of 'Cultural Dimensions of Institutions', which centres on the ways by which 'political culture shapes the substance and orientation of knowledge' (Fourcade, 2009, p.20). She argues that the major institutions turn into actors through the collective work of their employees. Thus, major institutions shape economic interactions and continuously redefine the cultural, social and regulatory environment in which they operate. In this context, institutions connect political culture with economic knowledge (Fourcade, 2009, p.21). This economic knowledge is said to trickle down to society through different channels: 1) the 'order of learning' (higher education and scientific research); 2) 'administrative order' (policymaking conducted through the lenses of economic knowledge); 3) 'economic order' (economic relations informed through economic technologies) (Fourcade, 2009, p.21). Here, Fourcades work is closely related to the overall ideational theme of this thesis. For example, she argues that 'economic ideas and technologies are never fixed – they work continuously at their own revolution' (Fourcade, 2009, p.146-147), indicating that economic ideas are continuously being redefined and challenged by actors. Thus, a financial crash forces actors to develop new ideas and practices. These actors, while often being trained in parts and different avenues of these economic ideas 'constitute the main vehicles of these transformations'

(Fourcade, 2009, p.147). Fourcade argues that the process of economists shaping economic ideas that influence the different systems of economic organisation, such as the way neo-liberalism has shaped capitalism is not well understood and should receive more attention (2009, p.147). Fourcade references epistemic communities on an international level and argues that economists in universities, in governmental and nongovernmental organisations as wells as in multinational firms and newspaper organisations help to diffuse economic ideas across the globe (Fourcade, 2009, p.177). She uses the example of the Chicago School economists who helped to develop a neo-liberal narrative that influenced policymaking across the Western world and beyond. However, according to Haas definition, it is possible to label the economist at the University of Chicago as an epistemic community, but including all economists who might be influenced by their ideas would cast the net too wide. An epistemic community is exists when there is a direct channel of communication between members either through personal contacts or through conferences. The experts of an epistemic community work closely on policy related topics which require them to exchange information on a regular basis. Therefore, this thesis uses the concept of epistemic communities in a much more limited space and focuses on the understanding that an epistemic community is not only a group of like-minded professionals in one area of expertise or policy, but more of a group of policy experts that share a common goal, in the case of this thesis the mandate of the ESCB.

The work of Hall on paradigms and social learning is also potentially useful as it provides an understanding of how actors, in the case of European central banking, even within an organisation formulate policy ideas as well as share knowledge and social learning. In his seminal article 'Paradigms, Social Learning and the State', Hall developed a framework to investigate the influence ideas have on policy change and its effect on institutional change. Assuming that bureaucrats use social learning to enhance policies, Hall asks, 'How do the ideas behind policy change course? Is the process of social learning relatively incremental, [...], or marked by upheaval and the kind of "punctuated equilibrium" that often applies more generally to political change' (1993, p.276-277). The two central contributions of Hall on policy change are, first, to acknowledge that policymaker employ social learning to adjust their goals and instruments and, second, that change can occur to different degrees. He calls this process the three orders of change (Hall, 1993, p.279).

Hall argues that policymakers, politicians and policy experts use at least one policy paradigm. This paradigm consists of the goals they want to achieve, the instruments they want to use for that purpose, and the technical specifics of the instrument (Hall, 1993, p.278). Social learning occurs when individuals collect new information, asses it, compare it with past experiences and then use that information to apply it to their actions. We can speak of social learning when a policy changes as a result of this process (Hall, 1993, p.278). This framework focuses on policymakers in the bureaucracy and experts, for example from interest groups or research institutes, who work closely with policymakers. This framework reduces the impact of politicians on policymaking and puts greater weight on the bureaucratic organisation. This is not to say that politicians do not have an influence on policymaking, but that it only focuses the level of analysis on bureaucrats in order to test and apply the framework to economic policymaking. Indeed, Hall argues that in the case that politicians receive conflicting policy options from bureaucrats and experts, they have to decide on the policy. This creates a battle over authority among different groups of bureaucrats and of experts within and outside of institutions. Thus, when policy change occurs, it is likely to go hand in hand with a shift of authority over policy expertise in the bureaucracy (Hall, 1993, p.280).

At the beginning of larger shifts, there are a number of policy experiments of which some might fail to show the desired results. These failures will ultimately undermine the authority of the group of experts associated with the policy paradigm and might shift authority to another group of experts and, over time, the original paradigm is replaced with a new paradigm. This shift can occur gradually or relatively quickly, often as a result of a crisis that has undermined the authority of the policy prescription or is being made responsible for the crisis in the first place. To use a recent example, the financial crisis of 2007 undermined the authority of neo-liberal policy experts that argued for greater de-regulation of the financial sector. Fourcade uses the example of the financial crisis of 1998 to make a similar argument. There, the consensus of Western policy experts that Eastern Europe, East Asia and Argentina would experience a prolonged period of economic growth following the implementation of market-led or 'neo-liberal' policies failed to produce the desired and expected outcome, which in turn resulted in outspoken critique of the 'neoliberal creed' (Fourcade, 2009, p.146).

Hall's framework of policy learning here offers something different as it draws on Kuhns (1962) seminal work on scientific paradigm changes. Building on this, Hall argues that paradigms can lose their appeal by 'developments that are not fully comprehensible, even as puzzles, within the terms of the paradigm' (Hall, 1993, p.280). According to Halls theory as outlined above, first and second order change occurs when change is restricted to the instruments used to achieve the goal. These changes tend to be incremental and can occur several times throughout a given time span. The most fundamental policy change, in Halls paradigm a third order change, occurs when policymakers change their goals (Hall, 1993, p.279). However, Hall notes that first and second order change does not necessarily result in third order change (Hall, 1993, p.279).

In terms of the recent financial crisis, the central question to apply to Halls framework to is two-fold: first, has the current situation been discredited? Second, to what degree has it been discredited (Baumgartner, 2013, p.242)? Throughout the early 2000s, only marginal policy changes occurred. The Fed and the ECB lowered their interest rates to stabilise economic growth following the dot-come crisis in 2000. Once it became obvious that the mortgage and securitisation industry had become unsustainable, the status quo of the financial system was discredited. The policy behaviour of the central banks changed from a *laissez-faire* approach, that favoured minimum intervention into the financial sector, to an activist approach that focused on financial stability and curbing excessive lending activities. This change of policy behaviour constitutes a third order change, because there has been a radical change in policy direction and of the underlying policy ideas.

Haas acknowledges the usefulness of Hall's contribution to studying policy formation and change in 'epistemic-like communities' (1992b, p.7). He argues, however, that in Hall's framework, policymakers only persuade decision-makers in the case that they are not satisfied with the current policy and argue that they do no longer fit the present challenges. In Haas argument, epistemic communities continuously work together as a group of experts and are always aiming to influence decision-makers or are themselves decision-makers in a position to change policy direction and formation. Thus, this approach is useful for this thesis, because central bankers in the Eurosystem are working continuously together and their independent status allows them to implement policies without approval from other governmental entities. This thesis will, therefore, use the framework of epistemic communities developed by Haas to investigate policy creation, coordination and implementation during the financial and sovereign debt crises. It further removes the level of analysis from the literature on institutional change, which is a defining feature of Hall's work (see Hall, 1986) and focuses on the actor's approach within institutions. Indeed, the research on epistemic communities will provide an analytical framework to study the role central bankers play in shaping the policy response since 2007 because it helps to explain the creation and exchange of policy knowledge within a group of experts.

From an ideational perspective, the ideational frameworks of the different economic schools of thought, such as ordoliberalism, post-Keynesianism and neo-liberalism shape the ideas and policy responses of the epistemic community of central bankers and have an impact on the financial markets perspective of commercial bankers. As will be examined in more detail in Chapter 2, ordoliberalism emerged in Germany during the 1920s and was manifested in the economic policy framework of Western Germany following the Second World War. This alternative economic and social policy framework was developed to stand in contrast to the Nazi regime, and later on, to Keynesian policy prescriptions. Ordoliberal thought aimed to develop an economic framework that could overcome the statist economic order of the Nazi regime while at the same time prevent the *laissez-faire* liberalism found in the UK. The preeminent German ordoliberal scholars, among others, Walter Eucken (1989; 2004), Franz Böhm (1937), Wilhelm Röpke (1944) and Alfred Müller-Armack (1966) provided the intellectual foundation of the emerging social democratic policy framework. The hallmark of ordoliberal thought was the idea that rules and economic structure facilitate competition better than the mere exchange of goods, as found in classical liberalism and later in neo-liberal doctrine. This foundation was based on limited intervention of governments and the importance of competition in the market place. Even today, German economists and policymakers are still influenced by the writings of the early ordoliberal scholars, mentioned above. The ideas on establishing rules as the basis for economic governance can be found in the creation of the Bundesbank in 1957. The Bundesbank was developed as a rules-based institution that adhered to price stability. This institutional blueprint was adopted by the ECB in the founding documents of the Maastricht Treaty in 1992. This thesis argues that although the Bundesbank and the ECB share these institutional design features, the financial and sovereign debt crisis has allowed the ECB to develop its own identity. This emerging identity increasingly focuses on the stability of the financial system and fights to prevent the break-up of the euro-area rather than adhering strictly to price stability.

In France, for example, post-Keynesianism emerged as the predominant economic policy framework. Based on the writings of John Maynard Keynes (Keynes, 1978, 2008), policymakers argued for active government intervention to smooth out the business circle and promote economic growth. The Banque de France was long an integrated part of the French Treasury and only became independent as a result of the requirements for the creation of the Eurosystem. French policymakers argued that economic policy can only be successful if monetary and fiscal policy are conducted in consideration of it. Thus, in contrast to German economic policy, France used monetary policy as only one instrument among many to support fiscal policies and price stability, and it was not seen as a priority. This line of thought was, furthermore, embraced by the Southern European countries, such as Spain, Italy, Portugal and Greece and has resulted in a division between these countries and the core countries, Germany, the Netherlands, Austria and Belgium, which adhere to ordoliberal ideas. Chapters 5 to 8 provide more insight into the debates between Governing Council members that emerged from these different economic policy approaches and the changing identity of the ECB.

To provide another layer of analytic depth, the writings of Hyman Minsky on the rise and fall of the business cycle will receive detailed scrutiny (Minsky, 1982a,b, 1988). He argued that once confidence in an economy rises, banks increase their lending activity to firms and individuals with less regard to the safety of the collateral. Thus, banks leverage proportionally higher to their own liquidity while firms weaken their debt-to-equity ratio. Once the lending becomes unsustainable for banks, they have to increase the interest rates of the inter-bank lending market or the economy threatens to overheat and the central bank has to increase its interest rates, which, in both instances makes lending more expensive. To cover the costs, firms have to reduce their investments and banks have to sell-off parts of their portfolio. These developments ultimately lead to a recession. His ideas developed during the early 1980s came largely true during the financial crisis in 2007 and there are increasing signs that commercial banks are starting to over-leverage their positions, once again, ten years later (Chapter 2.2.3).

Before going into more detail on the ideational writings of the various economic schools of thought and Minskys work on business cycles, it is imperative to better understand how and why ideas influence monetary policy decision-making. Figure 1.1 provides an example on how ideas influence these policy decisions. Several key factors, such as education and career background can have an influence on the economic thought of the individual or the group. This can shape the perspective of the wider public, politicians and the media and together help to formulate the ideas of decision-makers, in this case central bankers, or commercial bankers. Ideas help individuals and groups to navigate a changing world by providing a road map (as

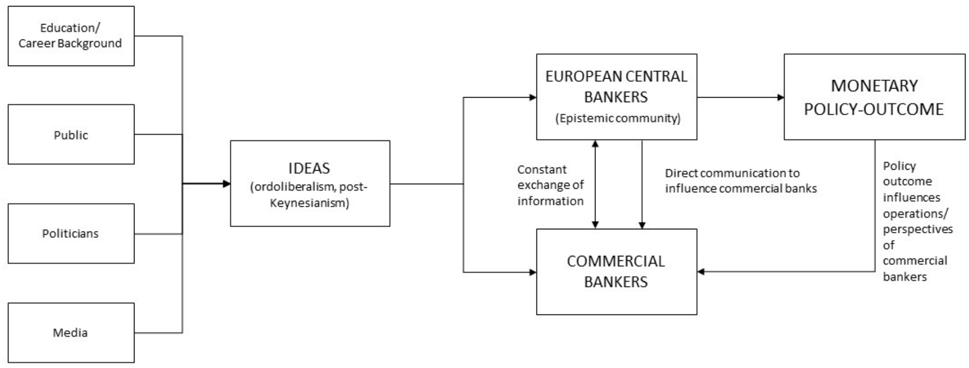

Figure 1.1: How ideas influence policy outcome

outlined by (Goldstein and Keohane, 1993) or formulate choices, preferences and normative assumptions (Blyth, 2002). Thus, ideas shape the perspective of central bankers in devising the policies and the strategies to implement them and the perspective of commercial bankers in how they perceive these policies as well as their strategies to exploit these policies. There is a constant flow of information between central bankers and commercial bankers at various levels in the hierarchy and between different business units. For example, commercial bankers in regulatory reporting update central banks and supervisory bodies in regular intervals about the credit information of their customers. This information feeds into monetary policy decisions. Another example can be found in equity and fixed income trading and sales departments, which require instant communication about interest rate changes, differences in collateral requirements and the overall state of the market and the economy. Central banks can use the extensive information they receive from the different commercial banks in their communication to influence financial markets. A positive example of this communication strategy will receive detailed scrutiny in Chapter 8. Thus, at the end of this process monetary policy decisions are made. These decisions, in turn, influence commercial bankers in their perspective on financial markets and the central banks as well as central banks that undergo a lessons learned process following the implementation of a policy. Again, Chapters 7 and 8 will take a closer look at the lessons learned from the Securities Markets

Programme (SMP) that shaped the Outright Monetary Programme (OMT).

The theoretical framework will focus on the role economic ideas play in shaping monetary policy. The epistemic community of central bankers in Europe provides a testing ground because the dominant economic ideational frameworks, such as ordoliberalism, post-Keynesianism and neo-liberalism have shaped the their understanding of financial markets before the crisis and the response to it. The European central banking community has converged on its understanding of how an ideal central bank should be institutionally designed and operate. However, as a result of the crisis, this understanding has undergone profound changes and the division between Northern European countries and Southern European countries, including France, has considerably increased in recent years.

1.5 Structure of the thesis

The thesis is structured into six chapters that loosely follow the historical development of European central banking since the early 20th century. Following this introductory chapter, the second chapter outlines and discusses the analytical framework build around the research on epistemic communities (Haas, 1992a,b, 2001). It underscores that the European central banking community is an epistemic community that has worked together since the early 20th century and has seen a revival of cooperation since the foundation of the EMU in 1992. Nevertheless, during the financial and sovereign debt crisis, there were disagreements and intense debates among the members of this community. The second part of the second chapter, therefore, assesses the theoretical features of ideational economic frameworks of ordoliberalism and post-Keynesianism as well as makes reference to the Chicago School, which was responsible for providing the intellectual input of financial regulation. The writings of Hyman Minsky will feature as a theoretical basis of making sense of financial booms and bust cycles. These strands of economic thought had a profound impact on the institutional design of the EMU the Eurosystem and the ECB, which later influenced the policy response of the Eurosystem to the financial and sovereign debt crisis. The challenges and disagreements among the central banking community in the Eurosystem will be explored throughout the thesis using the theoretical frameworks discussed in Chapter 2.

Chapter 3 provides historical background on central banking and discusses key concepts in central banking that later became an integral part of the institutional design and the ideational basis of the ECB. For example, the period of the Gold Standard introduced concepts such as rules and discretion in policymaking and later on had an influential role in shaping the central banker's perspective on price stability. The period of Bretton Woods witnessed the increasing use of central bank independence to reduce the influence of politicians on monetary policy decisions. During the period of the Great Moderation, research emerged on the relationship between independence and price stability.

Chapter 4 outlines the creation of the EMU and the ECB in the Maastricht Treaty. It analyses the major achievements and greatest shortcomings of the institutional design of the EMU and the ideational impact on the ECB. This chapter will furthermore contrast the career trajectories and involvement of Jean-Claude Trichet and Mario Draghi in the negotiation process of the EMU to explore the role of leadership in the design process and their perspectives on central banking. This assessment of career trajectories allows to more thoroughly assess why both presidents made specific policy choices during different stages of the financial and sovereign debt crisis.

Chapter 5 analyses the setup of the ECB. It takes an in-depth look at the different institutional features of the Eurosystem, such as independence, mandate, strategy, and instruments as well as the shortcomings of this design. It argues that the ordoliberal and post-Keynesian ideational frameworks had a profound impact on the design features of the ECB and that those features often prohibited the ECB from acting decisively during the sovereign debt crisis. Assessing the different features will provide a basis for the following analysis on how and to what extent the ECB changed during the crisis.

Chapter 6 analyses the crisis response of the ECB to the financial crisis from 2007 until 2009. The ECB has used non-standard policies and instruments to provide liquidity and ease the credit flow. It was a pacesetter for other major central banks and managed to lose its stigma of being a central bank behind the curve. Yet, it was unable to prevent euro-area member states from sliding into the sovereign debt crisis. This chapter will draw out the first phase of policy and institutional change and the impact of ideas on these developments.

Chapter 7 moves on to the sovereign debt crisis. This chapter analyses why the institutional and policy understanding of the ECB changed during this time from developing innovative and decisive policy solutions to the financial crisis to being slow and opaque in its initial response to the sovereign debt crisis. The chapter argues that the ECB remained almost helpless during the onset of the sovereign debt crisis in finding an adequate response, partially owing to its constraining mandate and partially owing to its lack of an adequate 'lender-of-last-resort' (LLR) responsibility. The ECB, however, emerged as the primary guardian of the euro-area despite the challenge to find a policy response aligned with its mandate (Trichet, 2010d; Draghi, 2012a). It reached into the political sphere in periphery countries and introduced the SMP in the first step towards government debt financing and forced periphery countries to implement structural reforms in another breach of the mandate.

Chapter 8 asks why the design failures of the ECB have had a profound impact on the sovereign debt crisis. While the financial crisis could be tackled using either conventional and non-standard policy mix of providing liquidity and taking on risky assets, the sovereign debt crisis required an innovative policy response from the ECB, including the creation and deployment of non-conventional policies. The chapter argues that the crisis was only able to be averted when Mario Draghi stepped outside of the policy framework during his 'whatever-it-takes' speech in 2010. His decisiveness moved the ECB to a new dimension of responsibility within the euro-area. Draghi's actions were, however, only possible, because Jean-Claude Trichet had previously cleared the path. Trichet introduced the SMP as a predecessor of the OMT and demanded fiscal and structural reform from Ireland, Spain and Italy long before Draghi took similar actions in 2012.

Chapter 9 concludes the thesis by summarising the main findings and it provides an outlook on the changing nature of central banks in the coming years. The data from the interviews indicates that euro area central banks will become increasingly specialised in their responsibilities and tasks. This will furthermore influence their relationship with the commercial banking sector and governments.

Chapter 2

Theoretical framework

> 'I think Jens Weidmann, Wolfgang Schäuble are poster children for an economic policy, [...] but it belongs to the stone-age. It has been overtaken by much more progress in economic thought. It is the same with the US how ignorant policymakers are of advanced economic thinking and how harmful that is to the people that elect them'
>
> US-based financial journalist (PS3)

In policymaking, ideas play a dominant role in shaping policy outcomes. There are several lines of thought about how ideas are perceived to act, in particular in times of crisis. In these instances, ideas can be seen as road maps for the overall direction of policymaking, as switches that allow policymakers to change course, or as focal points that provide certainty in situations with imperfect information (Goldstein and Keohane, 1993). Ideas can also be seen as strategic points that are highly contested by interest groups to achieve their desired outcome (Blyth, 2002). This thesis uses the theoretical framework of ideas derived from economic thought to explain policy decisions and outcome during the financial and sovereign debt crisis. This allows to analyse why a group of policymakers, in this case central bankers, arrived at certain policy decisions and how these decisions were perceived by an external group, in this case commercial bankers. Before going into detail of these groups, using the conceptual framework of epistemic communities (Haas, 1992a,b), it is imperative to define and review the existing literature on ideas in policymaking. This thesis argues that during the financial crisis that started in 2007, ideas played a subordinated role in policymaking and pragmatic decisions were required to overcome the fast-moving deterioration of the financial system. During the sovereign debt crisis that started at the end of 2009, ideas moved to the foreground of policy decision-making. Two groups of economic thought, ordoliberalism and post-Keynesianism, emerged on opposing ideational sides and aimed to influence policy decisions. In the euro-area, the core countries, Germany, Austria, Belgium and Netherlands, and the Southern European countries, France, Italy, Spain, Portugal and Greece, met at opposing ends of the spectrum of economic ideas. While the former group of countries argued along ordoliberal ideas focusing on price stability and a restrictive monetary policy, the latter group argued for expansionary monetary policy that allowed them to refinance their excessive public debt levels.

This chapter discusses the literature on ideas around the seminal work of Goldstein and Keohane (1993) to provide a theoretical basis for the assessment of defining European central bankers as an epistemic community and analysing economic thought in this context. The first part of this chapter will therefore discuss ideas and policymaking in times of crisis, the second part will analyse to what extent the European financial central banking community constitutes an epistemic community and whether this has an impact on ideas of the group and its impact on policy outcome. The third part will analyse and compare different lines of economic ideational thinking in ordoliberal and post-Keynesian thought as well as perspectives that have shaped European thinking. This section focuses on ordoliberal and post-Keynesian thought as well as related areas of economic thought, such as neo-liberalism as interpreted by the Chicago School and Hyman Minskys assessment of the business cycle. This will allow developing a comprehensive framework to assess the changing role of the ECB in Europe following the crises.

2.1 Ideas in policymaking: Definition, role and impact

In sociology as in in other areas of social science, the concept of ideas has been extensively dealt with and, yet, remains contested and without a clear definition. What remains is the agreement that ideas have a transformative power to shape policymaking, policy decisions and policy outcome. Ideas come in different shapes and sizes that should be analytically separated from each other: Ideas can be cognitive and provide actors with the required tools to make sense of how things around them work. They allow policymakers to analyse problem-sets and develop solutions. Ideas can further be normative and provide a value system that helps actors to distinguish between ‘good and bad’. This is an important factor for policymakers to devise policies that are taken on by the public. The more positively the policy is received the less power the government requires to enforce it. Ideas can also shape preferences through actors desires, including cognitive and normative elements (Rueschemeyer, 2006, p.228). When taking all three elements, cognitive, normative and preferences together, ideas form a framework for actors to make sense of the world around them, set up their normative moral and ethical standpoint and identify their preferences.

There are, furthermore, three levels of generality of ideas that influence the perspective of policymakers. On a basic level, there are the policy solutions for the problem in question (Schmidt, 2008, p.306). The second level are the ideational paradigms that shape policies (Majone, 1998; Hall, 1993). These paradigms originate in the educational and career background of the policymaker and are further honed in the institution he works in. Thus, ideas of policymakers can converge towards accepting certain paradigms of how an ideal policy should look like, often through lessons learned. This makes the policymaking process more efficient because the paradigm guides the creation process of the policy (Sabatier and Jenkins-Smith, 1993). Ideally, these paradigms already encompass the cognitive and normative elements of the ideas used to devise a policy. On the third and final level, there are the 'worldviews' or *Weltanschauung* that shape the overall perspective of policymakers without being specific to policymaking. This element is, of course, again heavily influenced by the upbringing and society of the policymaker. This 'deep core' of the policymakers belief system helps to give context and meaning to the problem to be solved with a policy (Sabatier and Jenkins-Smith, 1993; Jobert, 1989; Hall, 1993).

Blyth developed another perspective on the role of ideas in policymaking. He argued that economic ideas are can help to make sense of the institutional environment agents act in. Economic ideas allow agents to acknowledge a crisis and develop possible pathways out of the crisis. Thus, economic ideas allow agents to interpret the economy around them in terms of normative assumptions and empirical assumptions (Blyth, 2002, pp.10-11). Furthermore, Blyth points out that during times of severe crises, the high level of uncertainty will make it difficult for policymakers to identify their goals to allow for third order change. The uncertainty might be even so high that the policymakers have difficulties identifying their goals in the first place (Blyth, 2002, p.32). In an uncertain environment, the preferences and the outcome of decisions are less clear to them and observers (Dunlop, 2011, p.2).

To make sense of policymaking in central banking, in particular, in light of the recent financial and sovereign debt crisis, this thesis relies on the assumption that the economic ideational framework of central bankers has fundamentally changed on all three levels of ideas, as defined by Rueschemeyer 2006, p.228. The cognitive element of ideas in how and why monetary policy is conducted has changed beyond recognition in recent years. When the financial crisis broke out, central bankers had to adapt to fast changing circumstances. As the data from the interviews will show, central bankers in the Eurosystem relied on pragmatic decisions-making rather than on the ideational framework that was in place before the crisis. Within days of the first signs of financial turmoil, the Eurosystem introduced novel instruments and an unprecedented amount of liquidity to quickly adapt to changing circumstances. The normative element of the pre-crisis economic ideational framework was still in place. There was no deviation from reconsidering the importance of the mandate of price stability. The normative element was predominately changed during the sovereign debt crisis. During this time, previously held assumptions of the Eurosystem that monetary policy should focus on price stability and a restrictive monetary policy were questioned partially out of necessity and partially from the Southern European member states. The threat to the euro-area from the sovereign debt crisis was imminent and the solutions at hand were hardly aligned with pre-crisis thinking. This led to fierce debates between core and periphery countries on the normative superiority of ideas from both groups.

Finally, the preferences of the epistemic community of Eurosystem central bankers have fundamentally changed as a result of the crisis. This is mostly felt in the changing relationship between the ECB and the NCBs as well as between the ECB and national governments. Euro-area central bankers, in particular their leaders, no longer play a limited role in economic governance. They have taken centre stage during the crisis an fought and uphill battle to increase their influence in this area. The ECB, and by extension the Eurosystem, have taken on increasing responsibility in various areas, such as supervision, financial stability and payment systems. They no longer rely on the goodwill of national governments to reform their economies to converge the euro-area. The ECB has in several instances demonstrated its preference to integrate the euro-area using its power over the supply of money by coercing member states into adhering to its conditionality. The question that remains is how the European community of central bankers operates and why is it successful in shaping policy outcomes that keep the financial system and euro-area afloat. The conceptual framework of epistemic communities will provide the analytical groundwork to answer this question.

2.2 European central bankers as an epistemic community

When taking a closer look at policy decision-making in central banks it becomes obvious that the global and in particular the European central banking community can be considered an epistemic community as devised by Haas (1992b). Haas defines epistemic communities as a group of professionals that create policy-relevant knowledge for complex and technical problems and have an authoritative claim on this knowledge (Haas, 1992b, p.3). This group of policy experts has an intimate and comprehensive understanding of the policy area they work in. Both features can be found in the central banking community. Focusing on monetary policy, the macroeconomic problems in a modern globalised world are highly complex and owing to this complexity are also very technical. Central bankers have to constantly stay up to date with developments in financial markets and challenges that arise in one part of the world can quickly have knock-on effects around the globe. The same is true for policy decisions.

Haas further defined an epistemic community along four features. First, epistemic communities are a group of professionals that share normative and principled beliefs that provide the foundation for the interaction among the community members. These principled beliefs are mediated through norms and institutions (Haas, 1992b, p.3). The global central banking community shares normative and principled beliefs about challenges and their solution. On a global level, central bankers have institutions in place that allow the regular exchange of ideas. One example is the Bank of International Settlement, where high-level policymakers of 60 central banks meet regularly to discuss macroeconomic developments and policy ideas as well as outcomes. Another example on the global level is the yearly meeting at Jackson Hole organised by the Kansas City Federal Reserve where about 120 high-level central bankers meet with experienced economists and policymakers to discuss current events. On the European level, the central banking community is, of course, even more deeply connected through the European System of Central Banks (ESCB) and the Eurosystem as well as the ECB. There is a process of policy learning among central banks in Europe and beyond, but this does not acknowledge the deep connection central bankers share with their colleagues in tackling similar problem-sets. The concept of epistemic communities, therefore, provides an advantage in studying central bankers. As Chapter 3 argues, the ideational framework that emerged during the 20th century of how an ideal central bank should operate was manifested first in the Maastricht Treaty in 1992 and later in the daily operations of the ECB and the Eurosystem. In particular, the European central banking community considered price stability and independence to be of paramount importance during the Maastricht Treaty negotiations. Thus, the central banking community in Europe shares normative and principled beliefs.

The second feature that defines epistemic communities are the belief systems of these groups. An epistemic community has similar or shared problems that are confronted through comparable means individually or together and result in desired outcomes (Haas, 1992b, p.3). For example, during the period of the 1970s, stagflation and high oil prices increased the pressure on European welfare states. Central banks reacted by reducing inflation to maintain financial stability and enhance economic growth. The Bundesbank, in particular, was successful in achieving this objective and subsequently became the role model for the ECB (Kaltenthaler, 2005). Thus, in this instance, the epistemic community pooled its knowledge to overcome challenges and achieved the desired objective.

Third, members of an epistemic community are able to validate notions. This allows them to be able to judge knowledge in their area of expertise using pre-defined criteria (Haas, 1992b, p.3). The European central banking community is a well-educated and well-connected group of policymakers that meet on a regular basis. One former central bank governor mentioned that, officially, he had to meet other heads of central banks on more than 100 days per annum, with most events taking place over several days which has to be counted on top of the official meetings (BUBA2). Although these regular meetings allowed high-level policymakers to become well acquainted with each other and enabled them to regularly exchange ideas, it took a large amount of travelling as these events were spread around the world, reducing the time high-level central bankers had time to manage their central banks and engage with actors from their own country. To put this in perspective, high-level commercial bankers often also travel to these events, thus, there is the opportunity to exchange information even if the meetings take place in different countries. Nevertheless, these events provided a resourceful ground for increasing the network among central bankers, most of them remain closed to only a selective few, and, more often than not, other members of the financial community, journalists and the interested public are being excluded from participating. The cooperation increased when the Eurosystem was founded in 1998 and increased considerably again when the financial crisis emerged in 2007 (BUBA2; BUBA12; BUBA11). Indeed, the financial crisis has further increased the number of physical meetings and several telephone conferences are being held each week on different levels of the Eurosystem central banks (BUBA12). This has gone so far that each sub-division head has a secure phone in which the direct lines of key officials are saved. This includes the telephone numbers of the ECB president, and other central bank presidents from the major central banks (BUBA12; BUBA11).

The fourth defining feature of an epistemic community is that its members share a common policy enterprise that is driven by the desire to enhance human welfare as a consequence of their shared professional expertise (Haas, 1992b, p.3). The European central banking community pursues the goal of price stability in its desire to enhance welfare (BUBA1). Although the crisis has resulted in a wide-ranging debate about the pursuit and benefits of achieving price stability during severe financial crises, the mandate of the ESCB requires all national central banks (NCBs) to work towards that goal. In addition, today, there is a regular and established exchange of economic ideas among the central banking community and the financial sector. This takes place between the local financial sectors and the NCBs as well as directly with officials from the ECB. During the financial and sovereign debt crises, the ECB increased its country-specific knowledge to strengthen its awareness of market conditions in the euro-area member states (ECB3). This has contributed towards financial stability and a better understanding of the factors that foster economic growth in each member state.

All four features that define an epistemic community have been relevant and evident in the European central banking community since at least the 1980s. Since the convergence of beliefs in price stability and independence during the 1980s, the European central banking community has put extraordinary effort in maintaining the price level and ensuring the independence of their central banks. The creation of the ECB as constitutionally the most independent central bank in the world and its primary mandate that focuses exclusively on price stability are a case in point. In addition, during the financial and sovereign debt crises, the epistemic community of European central bankers pulled together to overcome the challenges as well as increased its understanding of the role of the financial sector in a modern and globalised economy, which will receive further attention in Chapters 6 to 8. European central banking has developed into a closely connected industry that is able to validate its arguments against the previous experiences of a high number of different countries. Regular meetings allow for an active exchange of information and ideas. Last, the European central banking community is committed to enhancing welfare across European society. The focus of central banks on ensuring price stability is an important element to achieving this goal (Chapters 6 to 8).

Ideas play a crucial part in framing the debate on policies and discussing the policy outcomes that emerge within a group as well as from the perspective of the group (Haas, 2001, p.11579). In policymaking, epistemic communities can use their authoritative knowledge on a specific policy area to help formulate policies that are reflective and critical about their implementation and outcome. Epistemic communities can further use logical reasoning to develop cause-and-effect relationships about policies, provide alternative ideas about how various issues are connected and provide advice to anticipate the result of the policies (Haas, 1992b). The economic ideational frameworks can provide road-maps to allow policymakers to adapt to changing circumstances. As Chapter 6 will indicate, during the initial phase of the financial crisis, these economic ideational frameworks only played a minor role in shaping policy decisions at the ECB. During the sovereign debt crisis, however, policymakers often argued along ideational lines of economic thought. Thus, the authoritative knowledge of central bankers on monetary policy coupled with the basic ideas of various lines of economic thought allowed them to navigate around major challenges.

The existence of epistemic communities has been identified in a variety of areas of policy expertise on the national and international level. Identified groups of experts can be found in environmental policy, pollution control (Haas, 1992b), environmental regulation (Zito, 2000) as well as EU governance (Zito, 2001). Other epistemic communities were found in the formulation of vehicle safety standards (Porter, 2011) and international telecommunication policy (Cowhey, 1990).[1] For this thesis, Verdun (1999) has written the most relevant study of central bankers as an epistemic community. Her work, *The Role of the Delors Committee in the Creation of EMU*, focused on the involvement of a group of central bankers in the creation of economic and monetary union. She analysed why the Delors Committee managed to find consensus on the design of EMU and the ECB within a relatively short period of time. Verdun argued that the committee consisting of experts provided an additional layer of legitimacy and knowledge for policymakers to move forward with economic integration. The Delors Committee allowed policymakers to refer their questions back to a group of experts to factor in their decision-making process. On the creation of the EMU and a single currency, a former Delors Committee member argued that 'it was not seen as a quite as radical step as it may appear now in the light of the crisis' (ESCB3). Thus, perspectives change with changing circumstances. Research on epistemic communities provide the tools to investigate

[1]More studies on epistemic communities can be found in International Organization, Vol. 46, No.1, Winter, 1992. In this volume, Haas introduced the concept and debated it with other social scientists.

the changing perspectives. The four defining characteristics of Haas (1992b) provide a basis to compare and contrast how and why economic ideational change has occured in an epistermic community.

Dunlop (2011) has pointed out that the research still lacks case studies and theoretical depth, despite the promising studies on epistemic communities mentioned above. She argued that although the number of studies is extensive, citing Haas' 1992b contribution, the actual application of the four-fold system of defining features remains vague at best (Dunlop, 2011, p.4). For Dunlop, this mainly stems from the difficulty in first identifying and gaining access to those experts that are part of an epistemic community (Dunlop, 2011, p.4; Wright, 1997, p.11). This difficulty of gaining access is particularly true for the closed industry of central banking. The community of central bank policymakers is extraordinarily well connected and networked, but largely keeps to itself in its meetings and events that take place around the world. As mentioned in Chapter 1, these meetings exclude the interested public, the financial sector and journalists only receive a glimpse of the debates that take place to decide on policy directions. A high-level official from the ECB argued in the interview that the ECB is transparent where it is possible but retains the right to operate without full transparency. This mainly stems from the fact that transparency can result in financial speculation (ECB1). A senior official from the Bundesbank adds to these statements that the ESCB as a whole has only pretended to be more transparent but in reality, has not significantly increased its transparency. It has only become more transparent when political pressure demanded it, but the overall monetary policy operation has not become more transparent (BUBA3). Another senior official from the Bundesbank provided similar insights during the interview. He argued that too much transparency can 'disenchant' monetary policy, which can reduce its effectiveness (BUBA12). Although the crisis has moved central banks into policy debates, the experts still have considerable influence on implementing the policy of their choosing. Their interests tend not to be short-term benefits, but, ideally, are focused on long-term welfare enhancement. Thus, compared to other groups that offer policy approaches, central bankers aim to fulfill their mandate rather than achieving a political goal. This makes it more difficult for outside groups to influence their decisions. The independence of the central bank underlines this commitment to remain above politics and focus on the overall welfare of society.

In a crisis environment, where existing policies either stop working efficiently or become redundant due to changing circumstances, the collective knowledge of epistemic communities can help to navigate a changing macroeconomic environment. In contrast to interest groups or political parties that might have accumulated an expert knowledge in a specific area, epistemic communities tend to be experts that implement policies and tend to not be entrenched in stigmatised policy debates. Members of epistemic communities can provide analysis and interpretation of policy recommendations of politicians or the civil society (Haas, 2001, p.11579). This is particularly the case in central banking. Central banks are technocratic institutions that have for most of the second half of the twentieth century operated outside of political debates where possible (Chapter 3). However, during periods of severe stress in 2010 and again in 2012, policy debates became stigmatised on the most effective options for reducing the public debt challenges of periphery countries. In particular, the Bundesbank, supported by a group of core countries, protested the use of an expansionary monetary policy that would support periphery countries. Thus, during times of severe crisis, epistemic communities can become entrenched in framing policy decisions according to the ideational presumptions of some members of the group. There is a constant debate on ideas, paradigms and ideational frameworks going on in central banks. The close working relationships between members of the epistemic community, in particular, in Europe, allows for these ideas to converge towards similar shared belief systems. This process of convergence shapes the epistemic community and can even force members out of this group if they cannot longer agree with the ideas of the group. A recent example are the resignations of Axel Weber and Jürgen Stark over their disagreements with the asset purchasing programmes (Chapter 7).

However, Blyth pointed out that during times of severe crises, the high level of uncertainty makes it difficult for policymakers to identify their goals, which in turn makes it difficult for them to change their policy direction. The uncertainty might be even so high that the policymakers have difficulties in identifying their goals in the first place (Blyth, 2002, p.32). In an uncertain environment, the preferences and the outcome of decisions are less clear to them and observers (Dunlop, 2011, p.2). If an epistemic community exists in the area that is affected by the crisis, this group might be able to overcome it, because it can pool its knowledge and resources. The close working relationships, the trust among its members and the shared level of knowledge and expertise can have a positive impact on the changing the paradigm of ideas to allow for a major change in policy direction. At the same time, if the crisis is not severe or drags on for a long period of time, not all members might be convinced of the need to change the paradigm. This phenomenon can be observed during the financial and sovereign debt crisis. Once the crisis hit shore in 2007, the leading central banks, in particular the ECB and the Fed, acted in concert to overcome the initial liquidity crisis (Chapter 6; Irwin, 2013). However, when the crisis dragged on between the first half of 2008 until September 2008, the policy medicine of the central banks diverged again, with mixed results. The severity of the crisis following the Lehman collapse, however, merged the epistemic community again and resulted in several months of closely coordinated efforts to stabilise the global financial system Irwin (2013). Once the goals are redefined, and the paradigm change is underway, ideational processes can support actors to stay focused on achieving their goals (Blyth, 2002; Genieys and Smyrl, 2008; Chapter 4).

When researching epistemic communities, it is beneficial to move the level of analysis further down to the individual level and analyse career backgrounds and perspectives of key decision-makers. Recent research has provided evidence that central bankers are significantly influenced by their past career paths and future career incentives in these decisions (Adolph, 2013). This has in impact on how and why professionals enter the epistemic community of central bankers. Generally, central bankers have three types of backgrounds. One variant is that they either undergone vocational training that often includes a university degree. For example, the Bundesbank still has its own university that specifically trains students in all aspects of central banking and they have to undergo several internships at the Bundesbank. This experience provides them with a detailed understanding of the role of central banks and a deep network across the Bundesbank. It however, also narrows their perspective on central banking and not on the financial system as a whole. Other central bankers come from the commercial financial sector. Central banks are open to this outside perspective and have the relevant network to stay up-to-date with developments of the commercial sector. Central bankers can also come from other government departments, such as supervisory bodies or related departments such as the treasury. These professionals tend to link the central bank to their government through their network. Thus, there are different pathways, predominately based on educational and professional background, which enable a person to enter the epistemic community of central bankers. According to Adolph (2013), central bankers spend on average approximately five years in a central bank. Afterwards, they return to careers in finance or government (Adolph, 2013, p.15). Interestingly, Adolph's research showed that central bankers with a background in working for commercial banks are more likely to be inflation averse than central bankers with a background in government. For commercial bankers, their inherent desire to protect the portfolio from inflationary pressure influences their decision when they work on deciding on policy direction in central banks. In contrast, a central banker who seeks a career in government might tend to show willingness for higher inflation, which might be viewed favourably by politicians who aim to attract additional votes through short-term economic improvement (Adolph, 2013, p.28). This line of argument can be expanded to voting behaviour on central bank committees. Adolph shows that there is a correlation between career backgrounds and voting for either conservative or expansionary interest rates alternations (Adolph, 2013, p.139). Therefore, one can assume that not only future career plans have an impact on how a central banker votes for and conducts certain monetary policy (ECB1; Chapter 6.2). It further demonstrates that the background of central bankers matters. Chapter 4.2 will make a close assessment of the career trajectories of the ECB presidents Jean-Claude Trichet and Mario Draghi, which will demonstrate that their careers were instrumental in moving them towards this position.

2.3 Ideas in economic thought during the 20th century

During the 20th century, two competing branches of economic thought emerged that became the pillars of Western economic ideological developments: Keynesianism and neo-liberalism. The dominant ideas of both branches have shaped the intellectual forces of Western European economic policymaking and central banking. Post-Keynesian thought argued for government intervention, predominately for counter-cyclical fiscal spending, to reduce the volatility of the business cycle. In contrast, neo-liberal thought argued for a restraint of governments to intervene in the market to allow market forces to shape the economy. Within neo-liberal thought, the influences of the Chicago School and ordoliberalism are visible on the economic framework of the euro-area and its financial system. According to Foucault, this stems from the fact that both forms of neo-liberalism share their objection to the Keynesian policy framework and their desire to avoid government intervention into the economy and society (Foucault, 2008, p.79). The Chicago School, however, is today mostly associated with free market economics and the deregulation of the financial system and often argues that financial stability derives from price stability (see, e.g. Schwartz, 1988, 1995).

Ordoliberalism, the German variant of neo-liberalism also subscribed to the merits of price stability but further argued for a rule-based framework to enhance competition. Government intervention was permitted as long as it fostered the competitive forces of the market economy. France used post-Keynesianism as the basis of its economic and financial policymaking while the US and the UK built their economies on an interpretation of the Chicago School. Most importantly, the deregulation of the financial sector during the 1980s was born out of this line of thought, which most countries of the euro-area prescribed to, albeit to a different degree. Ordoliberal ideas can be found in the economic and financial structure of Germany and European core countries, such as Netherlands, Belgium and Austria. Ordoliberal ideas are furthermore visible in the EU institutions. For example, the ECB focuses on keeping inflation low, the European Commission devotes much time to competitiveness and the European Court of Justice oversees a rule-based legal system. Post-Keynesianism, owing to its application in France and ordoliberalism, as the German interpretation of neo-liberalism, are of particular relevance for this thesis. Both approaches in economic thought have shaped the institutional design of the ECB during the Maastricht Treaty negotiations and the crisis response of the governments during the financial and sovereign debt crises. Assessing these different economic ideational frameworks will allow this thesis to analyse the impact of these lines of economic thought on European central banking and monetary policy. It will allow to analyse the influence of economic ideas and ideologies, such as Keynesian and neo-liberal thought on the perspectives and motivations of high-level policymakers and experts that are part of an epistemic community.

2.3.1 Post-Keynesianism

The immediate post-war period, in particular in France, was marked by the rise of Keynesian thought. The French government embarked on a course that would rely on state intervention and economic planning to manage the economy. France favoured post-Keynesian policies that would reduce swings of the business cycle and promote economic recovery and full employment, while at the same time neo-liberal ideas were introduced and market-based individualism and the self-organisation of private actors was encouraged (Kuisel, 1983, p.249).[2] This policy mix, heavily influenced by Keynesian ideas, resulted in a period of nationalisation of major companies and industries during the 1940s and 1950s. When John Maynard Keynes published his book *General Theory of Employment, Interest and Money* in (2008), he changed the basis of the modern understanding of the economy. Based on classical economics developed by Adam Smith, David Ricardo and John Stuart Mill, pre-Keynesian, classical economic thinking assumed that market mechanisms ensured that econom-

[2] For a detailed analysis on the changing relationship of French policymakers from post-Keynesian ideas to more neo-liberal ideas see, Denord (2015, pp.45-63).

ies would manage themselves and ultimately operate at full employment. In practice, policymaking was more difficult than leaving the economy to itself.

The two major achievements of Keynes were, first, to shift the paradigm of economic thinking to accept that the spending behaviour of consumers, governments and investors determines employment and output. Thus, active government intervention can have an impact on spending and, therefore, should be used to manage the economy. Second, Keynes argued that the modern capitalist system is defined by an inherently unstable system of periods of boom and busts. Indeed, Keynes argued that production and output would come to a halt if consumers, governments or investors had no money to spend. Therefore, aggregate demand underpins economic productivity (Keynes, 2008). During the 1930s, most economists, apart from the inner circle of Keynes, believed in market correcting forces that allowed the capitalist system to rid itself of excessive risk-taking and over-consumption. It was, further, assumed that governments, should they decide to intervene to prevent the natural market correction, would make matters worse (Marglin, 2016). Keynes describes what he called the trade cycle as follows,

> 'By a cyclical movement we mean that as the system progresses in, e.g. the upward direction, the forces propelling it upwards at first gather force and have a cumulative effect on one another but gradually lose their strength until at a certain point they tend to be replaced by forces operating in the opposite direction; which in turn gather force for a time and accentuate one another, until they too, having reached their maximum development, wane and give place to their opposite' (Keynes, 2008, p.313).

He argued that business cycles occur naturally in a capitalist system because market expectations can drive asset prices up and down, depending on the current market environment. This has a direct impact on employment and the efficiency of companies. Keynes criticised classical economics for assuming that the price of labour determines the level of employment. He argued, in contrast, that the aggregate demand for labour determines the level of employment because wages do not fluctuate to the extent classical economists assumed. There is always a part of the labour force idle or between jobs without offering their labour to the market (Keynes, 2008, pp.4-5). Thus, competitive markets alone cannot deliver full employment, even in the long-run. Governments have to intervene to allow for an increase in demand for labour. In contrast, classical economic thinking attributed the high unemployment during the Great Depression to high and rigid wages. According to Keynes, in a modern economy, unemployment and under-investment persist until governments used interventionist policies to overcome the depressing conditions. Keynes went on to claim that even reducing wages or cutting benefits would not allow for an increase in the level of employment without any incentives from the government (Keynes, 2008). Thus, to decrease unemployment, Keynes proposed demand-side policies that would allow governments to encourage companies to increase production, which in turn would require more labour to manufacture these products. In particular, during times of crisis, demand-side policies would reduce the negative effects of the business cycle (Eatwell and Milgate, 2011, p.346).

Beyond the impact of wages on employment, Keynes considered excessive saving to be another major problem for a healthy economy. He assumed that any unused capital could accelerate decreasing consumer demand and business expectations in the short-run. Thus, excessive saving can create a negative loop. Consumers save their excess capital, which in turn reduces consumer demand. The reduction of consumer demand results in a negative outlook for the economy. Reduced consumer demand encourages consumers to save even more, making the whole economy worse off. To overcome unemployment without reducing wages as well as excessive savings, Keynes proposed an active fiscal policy. In times of crisis, the government should refrain from balanced budgets, as classical economics had previously proposed, and invest in infrastructure. The counter-cyclical measures would enable the government to save money during a boom, which it could spend during a recession. This would reduce the time of the downturn of the economy. During an upswing, governments could raise taxes, thus reducing the chances of overheating the economy and receiving income that could be used to counter a downswing. This policy approach would increase the government budget and prevent the economy from overheating and would furthermore reduce the risk of inflation when private investments is abundant. Should economic growth decline, extensive infrastructure investments and reduced taxes encourage employment and increase the stability of the wage level.

The post-Keynesian thinking was further advanced during the 1950s when A.W. Phillips developed the so-called Phillips Curve, which explained the relationship between unemployment and inflation (Phillips, 1958). His research allowed positive testing of Keynes' theories against 60 years of British economic data. The Phillips curve showed the unemployment rate on the X-axis and the inflation rate on the Y-axis. Thus, Keynesian economists argued that the Phillips curve is negatively sloped and it predicted that there is a clear trade-off between inflation and unemployment.

The curve provided policymakers with a simplified choice. The government could choose between the two ideal types of either low inflation and high unemployment or the opposite.

Today, we can trace back the success of Keynesian thinking in economic policymaking in the post-war period to three critical factors. First, Keynes ideas, despite their novelty, could be phrased in simple and accessible terms, making them easy to understand for policymakers with diverse backgrounds and the informed public. Second, economic instability and government mismanagement between the world wars reduced the free operation of market forces. The reconstruction effort increased the necessity of managing the economy. Third, the structure of the book *General Theory* allowed policymakers to divide it into segments that could be implemented and measured, increasing the vocabulary of policy information among policymakers (Eatwell and Milgate, 2011, p.347). This indicates that academics can play a major role in shaping policy decisions by providing the theoretical groundwork of possible policy outcomes. In the case of the epistemic community of central bankers, there is an intensive exchange of ideas and information between academics and central bankers. This has an impact on the economic ideational frameworks among the community and their perspective on policy decisions.

The rise of Keynesian ideas in managing the economy had another impact on monetary policy. Fiscal policymaking is, by nature, more reliant on the discretion of experts. This was particularly true during the years of economic recovery following World War II. The increasing use of fiscal policy, as advocated by Keynes, invited policymakers to use discretion in monetary policy. Even until the late 1960s, individual decision-making was still considered to be imperative for successfully implementing monetary policy operations. Milton Friedman, the Chicago School economist who would later not only be instrumental in the rise of monetarism and the collapse of Keynesianism as well as the introduction of rules in monetary policy, observed in 1962, 'the extent to which a system of this kind is really a system of rule by man and not by law and is extraordinarily dependent on the personalities involved' (Friedman, 1962b, p.235). The reliance on post-Keynesian thinking in France gradually reduced during the 1970s. The French economy, among other Western economies, experienced rising oil prices, recession and high unemployment. This created an economic environment that post-Keynesian thought could not provide a policy solution for. Increased government spending was unable to significantly reduce unemployment and increase economic growth and further increased inflationary pressure. During this time, the Chicago School and its most prominent thinker, Milton Friedman, became the dominant line of thought across the Western world. The Chicago School argued for the non-intervention of governments in the economy. This would allow market participants to exchange goods and services freely. The price would signal any information to all market participants. The role of the central bank was to ensure that prices remain stable to increase confidence among consumers and investors (Friedman, 1968, p.13). Friedman believed in the ability of the central banks to keep the economy in check and balance out the business cycles through intervening in the money growth rate by increasing or decreasing the interest rate (Friedman, 1968, p.14). However, central banks should aim to control those factors that it deemed important, or as Friedman put it, 'of the various alternative magnitudes that it can control, the most appealing guides for policy are exchange rates, the price level as defined by some index, and the quantity of a monetary total' (Friedman, 1968, p.15). Among those three indicators, for Friedman, the most important is price stability. The central bank has, however, to be cautious, because it cannot predict the result its monetary actions might have on the price level (Friedman, 1968, p.15). Friedman's ideas about monetary policy, in particular his preference for price stability, became a major pillar in modern ordoliberal thought in Germany and by extension, of the ECB. During the 1970s, the integration of Friedman's interpretation of monetarism and ordoliberal thought among policymakers of the Bundesbank helped to create the necessary instruments to overcome the stagflation of the 1970s. The Bundesbank became the role model for the ECB. The institutional design of the ECB as an independent, multi-national central bank and the predominant focus on price stability were modelled after the Bundesbank. Ordoliberalism played a major role in transferring the ideas of the Bundesbank to the ECB during the foundation process and until the financial crisis. As Chapters 6 to 8 will show, the ECB increasingly developed its own identity during the financial crisis and in particular during the sovereign debt crisis.

2.3.2 Ordoliberalism

The German post-war history of its economic ideational framework, its application and its central bank could not be more different from the French experience that operated under a post-Keynesian policy framework. Following the Second World War, an important question for German politicians and policymakers was how to legitimise a state that was responsible for the atrocities of the war? Furthermore, considering that Germany was entirely occupied, the legitimisation process had to take into account that the state does not exist (Foucault, 2008, p.102). A group of economists, academics and lawyers at Freiburg University worked on an alternative economic framework since the 1930s that stood in contrast to classical economics, Keynesianism and the statist-socialist system propagated by the Nazi regime. These academics developed the economic and social framework that became known as ordoliberalism.

In more detail, in ordoliberal thought, responsibility of the political system is to provide an overall structure, or 'order' to the market (Starbatty, 2002, p.253). Ordoliberalism, 'ordo' from the Latin word for order, was developed out of the desire, first, to overcome the theoretical assumption of historical determinism that was prevailing during the 19th century in Germany. The works of Marx, Hegel and Weber are evident examples of the idea that in order to understand the economic interactions among actors, the historical experience provides a rich source of information. Second, ordoliberalism was developed to prevent the state from intervening at its own discretion into the free market mechanism. In the eyes of the ordoliberal scholars, unregulated government intervention in the economy had a devastating effect during the Weimar Republic and during the later years of the Third Reich. This interpretation of using rules and regulations to govern economic interactions would come to the forefront during the 1980s, when other European countries opened u their financial system and make them prone for the crisis. The German financial system tended to be more regulated compared to the systems in the UK and the US. Third, ordoliberalism was developed and provide order to the market economy based on classical liberalism in which market forces can fluctuate with significant negative effects on an unprotected society while at the same time remain in intellectual opposition to the socialist and statist economic orders propagated by the Nazi regime (Riese, 1972, p.27).

At the beginning, the ordoliberal thinkers shared a similar understanding of Keynes to salvage liberal ideas from the dysfunctional capitalist system and developed a more advanced, socially conscious form of capitalism. Indeed, Adam Smith, the main thinker behind classical liberalism, did not recognise the essential role of government to enforce rules and the role of institutions in providing a framework to strengthen competition (Vanberg, 2001, p.46). The similarities between Keynesianism and ordoliberalism were, however, only superficial and ordoliberalism, later supported by the ideas of the Chicago School, quickly emerged as a fierce competitor to post-Keynesian ideas (Dardot and Laval, 2013, p.38). As Foucault puts it, the Chicago School and ordoliberalism share the notion that 'Keynes [is] the common enemy, which ensures that criticism of Keynes will pass back and forth between these two neo-liberalisms' (Foucault, 2008, p.79). According to Foucault, ordoliberalism and Chicago School neo-liberalism furthermore share a distaste for the repulsion of a planned economy controlled by government intervention. Keynes was much more positive about the role of the government to govern the economy (Foucault, 2008, p.79). Ordoliberalism developed into a holistic framework of political economy that integrates economic, political, social, and legal concepts. In this ordoliberal framework, the government should provide 'order' to the economic system. It is there where the Freiburg School distanced itself from other dominant forms of economic thought and from neo-liberalism at the time, yet with overlapping features with the Chicago School and Austrian School (Foucault, 2008, pp.75-100). These schools of thought moved beyond classical liberalism. Ordoliberalism rejects the notion of *laissez-faire* as a guiding principle and instead defines itself as a unique form of neo-liberalism by assigning a prominent role to the state. It is the responsibility of the state to endure that the market economy functions efficiently without preventing free market forces to allocate resources freely.

Compared to other forms of neo-liberalism and similar to Keynes, the close ties of early ordoliberals to the German post-war government resulted in the development of a policy framework that enabled policymakers to have a road-map of how to rebuild and transform the German economy following the Nazi regime and World War II: free market economy based on competition (Sally, 1996). Nevertheless, one should not confuse the German 'Rhinish' system of capitalism with its variant of 'social market economy' and the ideational framework of ordoliberalism. All three versions of understanding capitalism coexist in Germany and share similarities, but, upon closer inspection, are vastly different to each other. While the Rhinish model supports the German model of involving employers and employees in the decision-making processes of companies to create greater cohesion and more sustainable directions of firms, the social market economy component focuses less on firms and more on a redistribution of capital to prevent a large gap between high and low earning incomes as well as child and women support in the male breadwinner model of 'Rhinish' capitalism. Ordoliberalism resides within these two ends of the spectrum and provides a framework to establish rules and a competitive order (Dardot and Laval, 2013, p.204; Hall and Soskice, 2001).

Walter Eucken, an economist, and the lawyers Franz Böhm and Hans Gromann-Doerth founded the Freiburg School during the 1930s. Other prominent members included Alfred-Müller Armack an economist working as the head of the policy department in the German economic ministry under Ludwig Erhard, who himself was a proponent of ordoliberal ideas. Alexander Rüstow, a sociologist and economist, and Wilhelm Röpke, a Professor of Economics, who had to live in exile in Istanbul and Geneva to escape the Nazi regime, owing to his contrasting ideas on how the economy should be structured. Adolf Lampe, a German economist and Leonard Miksch a political economist and policymaker during the late 1940s can be added to the list of relevant intellectuals of the ordoliberal school of thought.

The 'order' of the economy that the Freiburg School advocated came through policy regulations, guidelines and rules. To better protect individuals from the state and interest groups and to make social processes and interactions more efficient, the early ordoliberals focused their efforts on developing a rule-based framework to structure competition. State intervention was tolerated, even desired, as long as the state would ensure the functioning of the free market (Glossner, 2008, p.31). The intervention of the government into the market was, however, not tolerated to the extent Keynes would have preferred. Government intervention was solely envisioned to strengthen the competitiveness among market participants and not to smooth out the business cycle. It becomes evident that ordoliberalism is a distinct form of neo-liberalism owing to its argumentation that freedom can only derive from structured interactions between market participants. Franz Böhm argued, 'the rule of law of the free market economy only acknowledges freedom within the framework of order. During a conflict between freedom and order, the point of view of order takes precedence' (Böhm, 1937, p.101).[3] This statement manifests the opposition of ordoliberalism to other forms of neo-liberalism that propagate freedom and self-regulation.

Keynes and the leading ordoliberals lived through the Great Depression of 1929 but came to different conclusions about the policy failures of the European governments. They advised their governments to undertake different policy approaches following the Second World War (Riese, 1972, p.45). Keynes criticised the Anglo-Saxon tradition of neo-classical and classical liberalism for the lack of appropriate state intervention to mitigate the negative effects. In contrast, Eucken came to the conclusion that state intervention and non-intervention can both have negative effects and there should therefore be clear rules guiding market interaction. Rüstow explained, 'the new liberalism [...] that I and my friends stand in for, demands a

[3] Author's own translation.

strong state, a state above the economy, above interests, that is, where it belongs' (1963, p.258).[4] Thus, the ordoliberals considered that the state had to be strong to steer the market and mitigate the negative effects of recession without impeding the economy. Again, whereas Keynes argued for state intervention to control and reduce the volatility of the business cycle, Eucken recommended using only state intervention to enhance and facilitate competition to provide order in the market (Eucken, 1989). Ordoliberal thinkers assumed that the state would be bound by rules and could not intervene in the free market without the clear necessity of making the market more efficient. Thus, ordoliberalism acknowledges a role for the state, albeit a limited one. The state should protect society from the excessive fluctuations of a deregulated market economy, yet without infringing on competition (Eucken, 2004, p.241; Bonefeld, 2012, p.633; Schnyder and Siems, 2013). These very different perspectives on the role of the state in governing markets resulted in the ideational differences in economic and monetary policy between post-Keynesianism and German ordoliberalism. Both lines of economic thought, ordoliberalism as a guiding ideational framework and post-Keynesian as a guiding objection to policymakiing, influenced the institutional design and policy approach of the Bundesbank. The ECB was later modeled after the German Bundesbank (Kaltenthaler, 2005). It is, therefore, imperative to analyse the role ordoliberal thought has played in developing the institutional design of the Bundesbank to better tease out the relevance of ordoliberalism to the crisis response of the ECB from 2007 onwards.

2.3.2.1 Ordoliberal vision of monetary policy

The Bundesbank adhered to two distinct features that would later shape the design of the ECB: price stability and independence. Following the Second World War, the US government favoured an independent central bank in Germany, modelled after the Fed, to reduce the power of the German federal government and its possible desire to finance the recovery phase through an expansionary monetary policy. This led to the creation of the Bank deutscher Länder (BdL). The BdL was based on the federal system of the Weimar Republic and drew on its characteristics of the Fed for its independence and decentralised governance, which reduced the chances for political opportunism. In 1957, the Bundesbank Act reorganised the BdL into the Bundesbank and made it 'independent of instructions' from the German government (Bundesgesetzblatt, 1957, section 12). It protected the Bundesbank from being subject to political influence over its decisions. The Bundesbank Act, furthermore, introduced the mandate that focused the Bundesbank on ensuring price stability

[4] Author's own translation.

(Gesetz über die Deutsche Bundesbank, Section 3). Thus, ordoliberal influence can be seen in the focus of the Bundesbank on price stability, while independence was considered controversial among ordoliberal thinkers.

For Eucken, price stability was of paramount necessity to allow market participants to receive correct signals about the state of the economy (Freytag, 2002, p.114). He argued, that ‘the key is to make the price mechanism function. Any economic policy will fail, which is not able to do that’ (Eucken, 1989, p.255).[5] Eucken made two arguments. First, a competitive market order cannot function without a stable currency. He linked price stability to the competitive order by arguing that successful monetary policy has to focus on price stability to ensure competition where possible. He urged that, ‘all efforts to achieve a competitive order are in vain, as long as the basic stability of the price of money is not secured. Monetary policy is, therefore, the primacy of a competitive order’ (Eucken, 2004, p.256).[6] Two, a government might be convinced of the merits of using a stable monetary system to support the competitive market order, but it is inherently difficult to achieve such an order. Eucken provided new ideas on achieving price stability through a rule-based framework (2004). This line of thought became a key element of ordoliberal thought and other neo-liberal frameworks, such as the monetarism of the Chicago School (Friedman and Schwartz, 1963).

Eucken was, however, less enthusiastic about an independent central bank. He argued that internal and external factors influence central banks with different degrees of success and have a negative impact on monetary policy. He maintained:

> ‘Experience shows that a monetary constitution, which provides the monetary policy leaders with freedom of action, puts more trust in them than what in general they can be entrusted with. Lack of knowledge, weakness against interest groups and public opinion, false theories, all of which influence the leaders to harm their entrusted responsibility’ (Eucken, 2004, p.257).[7]

Eucken was critical of central bankers that relied on discretion rather than rules. He argued that monetary policy requires clear rules to reduce the probability of central bankers mismanaging their responsibilities. His concerns were aligned with the Freiburg School line of thinking regarding the negative view of preventing in-

[5] Author’s own translation.
[6] Author’s own translation.
[7] Author’s own translation.

terest groups and other factors to influence monetary policy. Eucken's reservations also concerned that leaving monetary policy in the hands of central bankers without providing a clear framework for them would not be an effective safeguard against expansionary monetary policy. He added in his book *Grundsätze der Wirtschaftspolitik* published in 1952, 'in particular, in today's situation, there is a major threat that an automatically constructed monetary constitution is abused for inflation' (Eucken, 2004, p.257).[8] Nevertheless, over time, German society began to consider a conservative monetary policy and price stability as fundamental elements of socio-economic and political well-being (Howarth and Loedel, 2003, p.53). The years following the Second World War became known as the *Wirtschaftswunder*. First the BdL and later the Bundesbank used a conservative monetary policy approach to curb inflation from the high economic activity during the post-war years. The German public later, therefore, associated price stability and a restrictive monetary policy with economic growth.

The Bundesbank developed a conservative stance on monetary policy and learned to use its independence from the government to achieve price stability, a core feature of ordoliberal monetary policy. The Bundesbank has subordinated all other policy objectives to fulfill its mandate of price stability. The focus on price stability led to fierce disagreements between Bundesbank officials and the government. As Otmar Emminger, the former Bundesbank President and German central banker from 1951 until 1979, recounted, the Adenauer government had strong reservations about accepting independence, because it wanted to involve monetary policy in supporting the reconstruction process. The Adenauer government feared that focusing on price stability would slow down the reconstruction of the German economy (Emminger, 1986, p.77). Southern European governments argued along these lines during the financial and sovereign debt crisis. Again, the Northern European central bankers argued in favour of price stability while Southern European central bankers demanded an accomodative monetary policy to increase economic growth. This furthermore demonstrates a rift in the epistemic community over a feasible approach to recovery. The deterministic approach to monetary policy in Germany, coupled with ordoliberal thinking, led to the post-World War II economic policy framework that focused almost entirely on price stability and continues to do so, guarded by the constitutional independence of the central bank.

According to ordoliberal thinking, the value of money and the monetary system

[8] Author's own translation.

are an essential part of a functioning economy and the well-being of society. They provide the means for exchange and production, channels information about demand and supply across industries and the possibility of allocating resources. The link between the economy, the state, and society is crucial to understanding the dynamics of different actors and institutions in a market economy. A functioning monetary system is at least as important for prosperity as the technological and organisational achievements of the economy (Dirninger et al., 2007, p.334). Indeed, a dysfunctional monetary system can have disastrous effects on all parts of economic life and society. The main role of central banks is to prevent these events from happening and to strengthen economic growth.

2.3.3 The Chicago School and the 'Minsky moment'

When Margaret Thatcher and Ronald Reagan came to power in 1979 and 1981, respectively, the ideas of the Chicago School transformed into a policy framework that would inform economic and financial policymaking across the Western World. The Chicago School line of thought particularly affected the governance of financial markets in the United States and the United Kingdom from the 1980s until the financial crisis in 2007. Post-Keynesianism was rejected owing to its difficulty to develop adequate answers to the years of stagflation and rising commodity prices since the 1970s. Ordoliberalism began to adopt monetarism, developed by Milton Friedman of the Chicago School, in its economic ideational framework. The role of the central bank was reduced to ensuring price stability. Governments deregulated financial markets, and politicians, as well as economists, argued in favour of a *laissez-faire* approach towards the free movement of capital. The basis for this argument was the assumption that financial markets had perfect information about any market situation because the price for any asset, commodity, financial product and debt would signal to other market participants the value of it. The financial crisis then showed that this was not the case.

The financial crisis has questioned the sustainability of the Anglo-Saxon variant of neo-liberalism. In the Chicago School tradition of neo-liberalism, the government refrained from intervening to ensure the supremacy of the market. When taking a critical look at the different strands of economic thought, it becomes evident that the influence of the Chicago School on policymakers allowed financial institutions to detach themselves from the real economy with limited governmental oversight until the financial crisis erupted in 2007. The American economist Hyman Minsky has questioned the economic understanding of the Chicago School (Minsky, 1982a,b, 1988). Being influenced by Keynes, Minsky argued that economic theory should allow for agents to be irrational. He argued in 1982:

> 'The abstract model of the neoclassical synthesis cannot generate instability. When the neoclassical synthesis is constructed, capital assets, financing arrangements that center around banks and money creation, constraints imposed by liabilities, and the problems associated with knowledge about uncertain futures are all assumed away. For economists and policy-makers to do better we have to abandon the neoclassical synthesis' (Minsky, 1982a, p.5).[9]

Minsky developed a theory of understanding the business cycle in financial markets. His theoretical model starts when the economy is doing well. Firms have low equity-to-debt ratios and hedge their risks. Banks are willing to lend, albeit with caution. Thus, lending is restricted to low-risk investments. However, when risks are small, investments turn out positive and the confidence of companies and banks grows, or as Minsky argued, 'existing debts are easily validated and units that were heavily in debt prospered: it pays to lever' (Minsky, 1982a, p.65). Over time, banks and firms reduce their risk perception (Keen, 1995, p.611). This second phase of the cycle suggests to investors that economic growth is imminent. It attracts investors to spend more with less hedging which results in rising asset prices and increasing debt levels. In order to fund this phase, external cash is required. Banks are more willing to lend to investors because they themselves are confident about the future of the economy (Minsky, 1982b, pp.120-124). Once the euphoria of the market kicks into overdrive, financial institutions become 'demanders in one and supplier in another set of financial markets at the same time' (Minsky, 1982a, p.123). This leads to an interconnectivity of the financial system that might not have occurred during more conservative times. The rising demand for investments increases the interest rates on the money market.[10] This development can increase to the extent that financial markets get detached from the interest rate of their central bank, making monetary policy ineffective (Minsky, 1982a, p.123). In their desire to fund ever more investments, banks begin to over-leverage their positions. Inflation will set in and increase asset prices as well. During these times, another actor enters the stage: the Ponzi financier (Minsky, 1982a, p.70). This type of actor trades on euphoric market con-

[9] The neoclassical synthesis was largely developed by John Hicks and Maurice Allais following the publication of the *General Theory* by John Maynard Keynes. It aims to integrate Keynesian thought into neo-classical thinking.

[10] The money market is the market for short-term loans (Black et al., 2009, money markets). An example is the overnight lending market where financial institutions lend money to each other to fund short-term liquidity needs.

ditions predominately by borrowing capital to fund the investments. The servicing costs on these investments is often much larger than the income derived from them at this stage. But the anticipated income in the future allows the Ponzi financier to borrow capital to fund investments. This behaviour decreases the stability of the overall economy (Keen, 1995, p.612).

The actions of the Ponzi financier and the overconfidence of bankers and companies ultimately leads to rising interest rates and unsustainable debt levels. To fund new investments, investors and companies have to sell parts of their portfolio. This can lead to a stagnation of the economy where the Ponzi financier might be unable to service the increasing debt owing to the economy-wide sell-off of assets. Banks start to increase their interbank-lending interest rates to cover the increasing risks from speculative investments in turn decreasing available liquidity. This leads to some assets becoming illiquid and investors reducing the prices of illiquid assets to sell them. Once the asset markets become flooded with undervalued assets, confidence of investors shrink, liquidity retracts and the boom turns into a panic (Minsky, 1982a; Keen, 1995, p.613).

The major problem that occurs is that the debt levels are detached from the return on equity of the investments. The panic leads to an alignment of both, yet, only if asset prices deflate or liquidity inflates. According to Minsky, if the system experiences a rising inflation during a recession, the debt levels are quickly absorbed. This might lead to an expansive reflation of the economy, but the recession is neither deep nor prolonged (Minsky, 1982b). The bigger problem occurs if the inflation rate is low when the asset bubble bursts. Low inflation rates cannot adequately absorb high debt levels. Companies have to continue to sell their assets, restructure their businesses and are at extreme risk of going bankrupt. Thus, according to Minsky, a period of asset price deflation reinforces the depression rather than correcting it (see, Minsky, 1982b; Keen, 1995, p.613). Although Minsky wrote this argument during the 1980s, it could without question have been written post-2007. The similarities with the initial financial crisis of 2007 are easy to spot. Speculative, over-leveraged investments led to a collapse of confidence, which drew liquidity from the system and caused the collapse of major financial institutions. The hypothesis of Minsky was that optimism and easy access to capital leads investors to move away from safe hedge investment and start investing in highly risky investment on the Ponzi end of the Minsky spectrum. The build-up of the financial crisis made this worse because modern financial products and rating agencies allowed financial institutions to change the composition of their risk exposure and suggested to investors that their investments were safe. A system-wide collapse of the underlying assets of these products reversed the perspective of a risk-free investment and led to the breakdown of the international financial system. Thus, investors bought assets that they thought allowed them to diversify their risk and hedge their exposure while in reality, the product was far out into the Ponzi category (Yellen, Yellen).

When analysing central banks, Minsky argued that if they undergo 'a period of rapid changes in the structure or in the mode of functioning of financial markets occurs, then the efficacy of central bank actions has to be re-examined' (Minsky, 1957, pp.171). In 1957, Minsky argued that financial institutions evolve to seek new profit opportunities. Therefore, central banks have to evolve with them to efficiently manage monetary policy. However, the policy decisions of central banks can have an impact on the direction of the evolution of financial institutions, which can have side effects that might affect and misdirect the actual outcome of the desired policy (Minsky, 1957, p.172). Minsky considered 'a policy of monetary constraint' to have a positive effect on financial innovation and institutional change (Minsky, 1957, p.187). From his perspective, there was no need to, for example, reduce interest rates to encourage financial innovation and to facilitate the profit-seeking of financial institutions. Central banks, however, will always have difficulties in controlling inflation in a dynamic financial market, and therefore financial innovation should not be incentivised if the current cycle of the economy permits it (Minsky, 1957, p.187). From this argument is derived the prescription that central banks should not intervene in the market to stabilise the economy beyond acting as lender-of-last-resort (Minsky, 1957, p.187). Indeed, for Minsky there is a conflict of interest if the central bank, on the one hand, intervenes in the market and, on the other hand, acts as a 'lender-of-last-resort'. This conflict of interest mainly stems from a moral hazard problem of central banks in protecting major financial institutions over smaller banks. Large financial institutions can take on a higher level of risk and are protected from seeking new profit opportunities because they know that the central bank has to intervene to protect them to prevent a system-wide shock. Thus, Minsky argued that the central bank should not be taken hostage by major financial institutions and allow them to fail if their risk-taking is too excessive (Minsky, 1985, pp.17-18). When applying this to the recent financial crisis, the decision of the US government to allow Lehman Brothers to fail had major repercussions and negative effects on the US and global economy. The global financial system and the dynamics and levels of trust in it have entirely changed as a result of this event.

Taking Minsky's argument in perspective, it should be mentioned that the global financial system has changed beyond recognition between 1985, shortly before the wave of financial deregulation and the collapse of Lehman Brothers in 2008. Thus, Minsky's argument holds true for most financial institutions, but not for system-relevant banks that have become 'too-big-to-fail'. However, one interviewee, who was a former central bank governor from an Eastern European EU member state argued contrary to Minsky:

> 'I think central banks have faster and better information about what is happening in the markets and are therefore able to react quicker and better to contain problems that hit the banking system or individual banks. Secondly, because they are independent from government, they are more likely to take action when it is inconvenient for government to take action. Potentially to close down a bank or do things like that. There again I do not claim that makes them, because I already indicated that their independence although legally enshrined, they can be put under pressure but still, their ability to act is still much better then supervisory agencies that are directly controlled by government or Minister of Finance' (ESCB2).

He makes the argument that central banks are better equipped to deal with financial institutions that are under severe stress because central banks have more information on financial markets than other government agencies. Their independence provides another protective layer against political influence from politicians and financial institutions. When Minsky developed his argument, central bank independence was not as widespread as it is today and the academic literature on this phenomenon was only just emerging. Thus, one should keep in mind that important foundations of the international financial system, including the role and institutional design of central banks, have fundamentally changed since the late 1980s.

During the two decades before the financial crisis, the Chicago School neo-liberals, argued that financial markets would increase economic prosperity if governments would allow them to regulate themselves (called the economic theory of regulation, developed by Stigler, 1971; Posner, 1971 and extended by Peltzman, 1976). Mainstream economists favoured little to no government intervention in financial markets. They assumed that the financial market had all the information required to govern itself, using price signals as an instrument to coordinate demand and supply. This assumption turned out to have fatal flaws when the financial crisis struck the US and European economies. The system did not anticipate a system-wide collapse of the housing market. This had repercussions on the entire system and not only on isolated areas.

Since the 1980s and until the financial crisis, the role of central banks has been focused on ensuring price stability to increase certainty among market participants. Financial crises have been a recurring feature since the beginning of the 20th century. Although not all crises have the same reasons and effects, in most cases, uncertainty about the direction or the feasibility of the market played a major role in increasing panic among investors. Thus, central banks aimed to develop instruments and tools to make markets stable. Since the late 1980s, the convention of central bankers has been that establishing price stability will reduce uncertainty and that market participants will be able to assess supply and demand as well as risks themselves. In most Western countries, central banks have been restricted to monetary policy with little to no responsibility in financial supervision and financial stability. Indeed, the central banking community was generally convinced that financial stability would naturally come through price stability. In a speech in July 2006, then-Vice President of the ECB, Lucas Papademos, argued 'by eliminating market distortions and uncertainties arising from inflation and anchoring inflation expectations, price stability also contributes to financial stability' (2006). This statement is an indicator of the inherent belief of high-level central bankers that price stability will ultimately lead to financial stability.[11]

While central bankers began to focus on price stability, globalisation and the rise of modern telecommunication technologies connected international financial markets. The flaw in this line of thinking emerged when the financial crisis aptly demonstrated that financial markets are not simple institutional structures that constrain actors to arrive at a common good but are, rather, vast networks of actors of different sizes, motivations and power that are not entirely influenced by price stability. Central banks could not, as it turned out, achieve financial stability through price stability. Monetary policy, including so-called fine-tuning instruments, were too crude to constrain actors and prevent short-term investments. The financial crisis and the European sovereign debt crisis have ultimately changed the composition of actors in the financial system. Nevertheless, critics, such as Pettifor (2016), argue that the behaviour of actors in the market has not changed to the extent that the financial system has now become more sustainable. There are still inherent risks

[11] Other well-known central bankers and monetary policy experts who share this view are Issing (2002, 2003b), and Schwartz (1988, 1995).

situated within the post-crisis financial system that mostly stem from increasing debt burdens of governments and private households. Despite central banks taking on responsibilities in financial stability and supervision, financial markets remain inherently unstable. Commercial banks, for the most part of their investment activities, do not direct their credit creation power towards increasing the prosperity and welfare of society.

2.3.4 Interviewees' perspective on economic ideational thought

This chapter has so far assessed why the different ideational economic frameworks emerged in Europe and the United States during the 20th century. It showed that the ideational developments of post-Keynesianism and ordoliberalism in particular had a profound impact on central banking and the structure of the global financial system. The ideational thought of the Chicago School has shaped the financial system, and Minsky's analyses have helped to better understand the role of investors and central banks in the financial system. The data from the interviews provides valuable insights to further analyse the perspective of central bankers and commercial bankers on the forces of post-Keynesianism and ordoliberalism in creating and shaping the ECB. The perspectives of the interviewees will further support the analysis of the crisis response of the ECB to understand the influence these ideas had on the ECB since 2007. The responses diverged and while some acknowledged that the ordoliberal ideas had prevented the worst of the crisis owing to its focus on rules-based decision-making and price stability, others have argued, from a post-Keynesian perspective, that the euro-area financial and sovereign debt crisis has turned for the worse because of the lack of a discretionary policy response and deflationary pressure.

A private sector interviewee from the United States who closely follows euro-area politics and the actions of the ECB had a critical view of the influence of ordoliberal ideas on the crisis response of the ECB. For the interviewee, Trichet's role involved moving the ECB towards a rule-based institution modelled after the Bundesbank:

> 'I think Trichet was eager to prove that he could be more German than the Germans. [He] came out of a background – I knew Trichet pretty well when he was in France as treasury and at the central bank there. He came out of a background that accepts the premise that deficits are bad and orderly economy requires a balanced budget and all that, which I, as a Keynesian, totally disagree with and I think in retrospect it has

> proven to be damaging for Europe, for European integration, for the world economy and specifically for the European economy' (PS3).

The interviewee critically argued that the German reliance on rules rather than discretion has increased the focus of policymakers to tackle deficits. During the financial and sovereign debt crisis, the desire to reduce deficits by introducing austerity measures has made the recovery phase for most European states more difficult and painful. The desire of German policymakers to lecture Southern European governments about their fiscal spending and public expenditure has become a symbol of the euro-area sovereign debt crisis (see, Hockenos, 2017; Blyth, 2013; Mahnkopf, 2012. The interviewee blames the negative developments of the euro-area economy on the institutional design of the ECB and the role German high-level policymakers play in the negotiations and policy decisions to overcome the crisis. He further argued,

> 'The only country that has clearly benefited so far from the euro is Germany and that is no surprise, because it is set up as a Deutschmark written large and the ECB [...] is definitely the Bundesbank written large. The only thing that makes it, distinguishes it at all from the Bundesbank is that now you have an Italian in charge of it and some other people on the board who can somewhat meliorate a hard-line, a German line. I think Jens Weidmann and Wolfgang Schäuble are poster children for an economic policy, [...] but it belongs in the stone-age. It's been overtaken by much more progress in economic thought' (PS3).

This statement reveals the perspective of a 'Keynesian' on the role the German policymakers Weidmann, the current Bundesbank president and Schäuble, the former Minister of Finance, have played during the crises. According to the interviewee, the ECB was entirely modelled after the Bundesbank without taking into regard the economic and political differences among the euro-area member states. He, further, argued that these ideas are outdated and should not be used to influence an economic and financial framework for the 21st century. When taking a closer look at the role austerity measures have played during the euro-area financial and sovereign debt crises, it becomes apparent that most interviewees have blamed Germany for imposing these measures on periphery countries while at the same time draining liquidity from their economies. One interviewee, who was a high-level policymaker at the Bank of England (BoE) argued,

> 'The challenge of the euro-zone, [...] is that the dominant power [Germany] is running a highly deflationary current account surplus [...]. How

can they [the periphery countries] build up their supply of euros, if they are running current account deficits? If they run current account deficits, they will run out of money and if they run out of money [...] they go bust. [...] That is what is happening in the euro-zone. The peripheral states are on a race to the bottom. Everybody is trying to outcompete everybody else. That is not a productive way, terribly deflationary' (BOE1).

The interviewee is referring to the trade surplus of Germany. According to him, the surplus is draining liquidity from the periphery countries. It is difficult for the smaller periphery countries to compete with Germany. The austerity measures that are being imposed on those countries from Germany eventually makes the situation worse. The interviewee points to a possible way out,

> 'But the only way to do that, if you have something like that, is for either to [...] have a hegemon, which is willing to borrow, which is willing to run deficits, which is willing to liquefy the whole economy for the benefit of those outside, but ultimately for the benefits of themselves. Germany would grow faster, if Greece was growing at five percent and if that requires Germany to transfer money to Greece, then it may be the right thing to do' (BOE1).

The interviewee argued that the policy approach of Germany to enforce austerity measures on the periphery countries while at the same time it has a major export surplus and therefore drains liquidity from those countries will result in a 'race to the bottom' for them. Thus, his solution to this is that Germany has to import more than export from the periphery countries. Germany has to run a deficit to provide enough liquidity to the periphery countries. This was the case before the financial and sovereign debt crisis. When the financial crisis broke out, investors from core countries, including Germany withdrew their investments, effectively draining liquidity from the periphery countries. Relying on their ordoliberal perspective, German policymakers aimed to not run a public deficit. This, however, reduced investment activity and reduced demand for goods and services from periphery countries, which further drained capital. Another interviewee, who was a member of the original Delors Committee, and, thus, deeply involved in the decision to adapt ordoliberal ideas for the creation of the ECB, argued,

> 'I think ordoliberalism is a general and sound theory that you have to focus a lot on the framework for economic discipline. And the background

> rules rather than getting too much involved in activist and interventionist policies and to that extent I think that is still a relevant influence on German attitude' (ESCB3).

The interviewee argued that ordoliberalism focuses on 'economic discipline'. The German government and policymakers tend to refrain from an activist or interventionist policy approach. Throughout the crises, the German government has demanded a reduction of public spending across the euro-area. The interviewee further maintained that 'this attachment to rules and principles, to the framework of economic policies rather than to detailed individual interventions that is clearly still a premise in German economic policy in Germany and in Europe' (ESCB3). He argued that the German preference for having a rule-based economic policy framework across the EU is linked to the lack of a discretionary policy approach to tackle the crisis. The German government has demanded austerity measures that do not allow for an interventionist policy approach. Thus, the interviewee from the Delors Committee argued that the preference of the German government is to have an ordoliberal economic framework applied across the euro-area to reduce the threat of a crisis. He argued, 'if it would have a good ordoliberal system, you would not get into a crisis - that is still the opinion underlying much of German thinking as far as I can see' (ESCB3). This statement referred to the German government's desire to implement policies that are aligned with the ordoliberal ideational framework to overcome the crises. The German government continuously insisted that only a reduction of fiscal spending can bring the desired outcome of reducing the public budget and make the economies of the periphery countries more efficient and importantly, more competitive. Thus, fiscal discipline, based on a rule-based economic framework is imperative for overcoming the crises, according to the German government (see, Berghahn and Young, 2012, pp.774-775; Dullien and Guérot, 2012).

A former board member of the ECB argued along similar lines that the ECB has been very effective within the rule-based framework. Yet, he argued that the ECB has also used discretionary elements to overcome the financial and sovereign debt crisis:

> 'I tend to think in monetary policy terms more in rules vs discretion. The ECB has been shaped as a rules-based institution Rules are very important in the way the ECB has performed and has worked. On the other hand, the ECB has shown the ability to use discretion within the rules in a very effective manner, and I think in the end, again, this is not that different from what the Bundesbank has done in the past' (ECB5).

This is a more nuanced view of the role of ordoliberalism and post-Keynesianism as economic frameworks of the ECB and its decision-making process. The interviewee argued that the ECB was able to use discretionary policy within the rules set by the foundational documents, including the mandate. The interviewee went on and argued,

> 'The ECB, by following this tradition, now some people may not like it so much and may consider that the ECB has been too active, but we should not forget that this is the worst crisis since World War II. It is even an existential crisis. If one looks back at main issues on which the ECB and some of its governing council members have disagreed, like the SMP [Securities Markets Programme] or the OMT [Outright Monetary Transaction], whatever-it-takes and even QE [quantitative easing], I think in the end, the ECB proves to be able to use all of the discretion within its rules in a very effective manner' (ECB5).

Thus, the interviewee argued that the ECB has used its instruments within the limits of its mandate. There had been considerable tensions among ECB Governing Council members and euro-area national governments about whether these programs were within the limits of the mandate during the development and implementation of phases (Chapter 7.2 and 8.2). The thesis will take an in-depth look at these debates and the impact they had on the institutional and ideational change of the ECB during the financial and sovereign debt crises.

Why did the financial systems of the United States and Europe collapse during the summer of 2007? When taking an ideational perspective on these developments, several observations can be made. The neo-liberal line of thought, in particular of the Chicago School, that financial markets can govern themselves because all information is in the price of the assets turned out to be wrong. Despite a revival of post-Keynesian thought during the first months of the crisis, most governments prescribed harsh austerity measures to reduce public debt, which had disastrous consequences for the economy and lending activity. Assets started to deflate and private debt levels rose, demonstrating the effects of Minsky's model. In Germany and other European core countries, such as the Netherlands, Austria and Belgium, ordoliberal thought experienced a revival with its prescription of sharpening rules to govern the financial sector. The data from the interviews has demonstrated that the central banking community perceives the influence of ordoliberal ideas to play an important role and some interviewees are critical about the policy decisions and demands of the ECB, and in particular, of the German government. Yet, the underlying challenge of the current Western economies is still the dominance of financial institutions. The implications of how these different ideational frameworks have informed the design of the ECB and its actions during the financial and sovereign debt crises are at the heart of this thesis. To better understand the dominance of the financial sector, it is imperative to go beyond an institutional perspective on ideas that frame the economic debate. However, ideas turn into policies through the implementation of policymakers. The final section of this chapter will investigate why the central banking community has formed a cohesive group of experts that have shaped the policy response of the ECB. The theoretical model of epistemic communities, developed by Haas in 1992, will allow to tease out the strengths and weaknesses of the central banking community in Europe.

2.4 Conclusion

This chapter has discussed the role epistemic communities play in shaping policy formation and outcomes. Indeed, the analytical framework of epistemic communities allows to analyse the influence of ideas of economic thought on policymaking and the changing perspective of policymakers during times of severe stress. This framework helps to chain ideas to people and their perspectives on a crisis. Utilising the tools of the research behind epistemic communities allows to identify and trace back how and why ideas in central banking have changed as a result of the crisis and what impact that change had on the crisis response of the ECB and the Eurosystem. The following chapter will outline the historical developments that led to the creation of Economic and Monetary Union (EMU) and the ECB. In more detail, as mentioned above, epistemic communities have the advantage of being able to overcome uncertain and complex technical challenges owing to their greater knowledge in specific policy areas. The financial and sovereign debt crisis has significantly tested this authoritative expert knowledge of the central banking community in Europe and beyond. Politicians strongly relied on the expertise and networks of central bankers to overcome critical junction points during the crisis (Chapters 6.1.2 and 7.1.1). To better understand these developments, it is imperative to investigate the historical developments of central banking in the 20th century.

Chapter 3

A short history of central banking in the 20th century

> 'The whole thought of commitment, [...] is so important in modern macro-economics. Economic policies become more efficient if they are based on clear commitments by central banks and other major policy actors [...]. It was in sharp contrast relative to earlier times when a more Keynesian view and a more discretionary view of economic policy was predominant among economists'
>
> Former Delors Committee Member (ESCB3)

During the 20th century, ordoliberal and post-Keynesian thought as well as Chicago School economics emerged as powerful economic frameworks that shaped the monetary policy of Europe. To better understand the influences of economic ideational thought on central banking theory on the key concepts of monetary policy - independence, price stability, rules versus discretion and credibility – this chapter investigates these developments from a historical perspective. The history of central banking during the 20th century was marked by profound challenges and swings and culminated in the Maastricht Treaty negotiations which unified the European central banks and created the single currency. These negotiations were the constitutional manifestations of the ideational developments of the previous century and ultimately had an impact on the crisis response of the ECB. This chapter will first provide a theoretical and historical discussion of the aforementioned key concepts, rules versus discretion, independence and credibility and their impact on price stability. Major economists, such as Henry Simons and Milton Friedman, argued about the most effective balance between rules and discretion for policymakers to achieve an optimal monetary policy. When the Bretton Woods regime collapsed during the 1970s, the Bundesbank emerged as the premier inflation-fighting institution in Europe. Its success was traced back to its independent status, which became a major pillar for the Maastricht negotiations. All of these events resulted in shifts of responsibility to manage the economy in the relationship between governments and their central banks during the Maastricht Treaty negotiations.

3.1 Rules versus discretion: Central banking until 1945

One of the key concepts in policymaking that ordoliberals and post-Keynesians clashed over was the question about the degree of rules or discretion a policymaker should have to achieve the best outcome for society. From 1873 until 1914, European nation-states established the gold standard as the primary monetary framework. It had two main features: first, each European currency could be converted into gold at a fixed price, and, second, private citizens could freely import and export gold.[1] The key responsibility of the central bank was to maintain the convertibility of currency and to control the money supply. Monetary policy was primarily used to facilitate or to resist the inflow of capital and goods. Proponents of the framework hailed it for its perceived self-regulating nature. For example, in the case of an outflow of gold from one country, its central bank could increase its discount rate to stop the outflow and correct balance of payments (Goodman, 1992, p.26). During the period of the gold standard, cooperation among central banks was well established and supported the feasibility of the monetary framework. This cooperation was necessary for stabilising the system and facilitating trade between the European empires. The senior central bankers from the major European empires knew each other in person and worked together to ensure that the framework remained stable. The close coordination and cooperation among European central bankers showed the emergence of a transnational epistemic community (Eichengreen, 1984, p.66). The two rules outlined above ensured that there was no major deviation from the monetary policy framework.

The debate on rules in monetary policymaking gained considerable influence and traction in the Chicago School from the 1930s onwards. The two major proponents, Milton Friedman and Henry Simons, developed monetary policy frameworks based on clear rules. Simons (1936) argued that the Great Depression that devastated the Western economies in 1929 demonstrated the inherent instability of the financial system and that the Federal Reserve System (Fed) further aggravated this instability by relying on discretionary monetary policy. He argued,

[1] The Bank of England was founded in 1694; the Banque de France was founded in 1800; the Deutsche Reichsbank was founded in 1876; the Banca d'Italia was founded in 1893 and the Fed was created in 1914.

> 'An enterprise system cannot function effectively in the face of extreme uncertainty as to the action of monetary authorities or, for that matter, as to monetary legislation. We must avoid a situation where every business venture becomes largely a speculation on the future of monetary policy. [...] [D]efinite, stable, legislative rules of the game as to money are of paramount importance to the survival of a system based on freedom of enterprise' (Simons, 1936, p.3).

Simons, coming from the neo-liberal Chicago School, argued that free markets cannot effectively function in an unstable financial and monetary system. The central bank should, therefore, use a framework based on monetary rules to prevent financial institutions to exploit monetary swings. Interestingly, Simons did not trust central banks to use standard monetary policy instruments such as open market transactions and changes in the discount rate to stabilise the financial system. He argued that the Treasury Departments should administer the supply of money. To put it in his words, 'the task [of stabilizing the price level] is certainly not to be entrusted to banking authorities, with their limited powers and restricted techniques, as should be abundantly evident from recent experience [referring to the Great Depression]' (Simons, 1936, p.22). He proposed that the 'ultimate control over the value of money lies in fiscal practices - in the spending, taxing, and borrowing operations of the central government' (1936, p.22).

Friedman developed his rule-based monetary policy framework by building on the work of Simons (1936) and his research on the Great Depression with Anna Schwartz (Friedman and Schwartz, 1963). Friedman argued that contracting the money stock leads to severe economic contractions, resulting in financial and economic crises. He observed this phenomenon in statistical data from the Great Depression. Friedman argued, that 'the tight money policy from early 1928 on and the associated lack of growth in the money supply which coexisted with economic expansion but contributed to both the occurrence and the severity of the 1929 downturn' (Friedman, 1969, p.181). To overcome this challenge, Friedman followed Simons' advice and proposed that central banks should be guided by a money-growth rule that eliminates the political influence on discretionary policymakers and that separates monetary policy more clearly from fiscal policy (Friedman, 1960, p.90). The effects of mismanaging the money stock became visible during the German hyperinflation and Great Depression during the 1920s.

Central banking changed with the onset of the First World War. Governments encouraged their central banks to finance the war effort. The rise of left-wing parties moved domestic concerns, most prominently unemployment and social welfare, to the centre of economic policymaking debates. In addition, the gold standard could not be retained during the First World War, because governments did not allow gold to leave the country (Eichengreen, 1984, 1992). The resulting debate politicised monetary policy further and resulted in politicians increasingly taking over control of the monetary policy direction (Simons, 1936). The breakup of the gold standard during the First World War and the increasing influence of politicians on monetary policy led to the deterioration of the cooperation among the major central banks in Europe. Other sources of increasing mistrust were shifting political and economic power from the British Empire to the United States during the First World War and the high reparation payments forced on Germany as well as the collapse of the Austro-Hungarian Empire, which increased instability across the European continent (Clarke, 1967, pp.19-22). The epistemic community of European central bankers started to break up without retaining the transnational character. The First World War and the collapse of the gold standard resulted in decreasing levels of cooperation. In retrospect, the interwar years of Germany were transformative for monetary policy for the European continent. As a response to the shifting political climate and economic instability, a fixed set of rules became an integral part of Germany's post-World War II ordoliberal economic doctrine.

During the first half of the 20th century, Germany experienced years of monetary instability, government pressure on central bank policymaking and devastating abuse of power from political elites. The years following the First World War led to an increase of inflation that was largely fuelled by the Reichsbank under the direction of the German government. Those years generated deep-rooted memories among the German public of the effects of an ill-conceived monetary policy (Feldman, 1993). The German Reichsbank contributed to the economic mismanagement of the 1920s and early 1930s. It first financed the war effort during the First World War and later on financed the reparation payments through an expansionary monetary policy. The effects of the devaluation of the German Mark had a devastating effect on the German society. It led to widespread hunger and disease, and the middle classes lost large parts of their wealth. The political aim to stabilise the mark between 1922 and 1923 inflicted even worse economic conditions on the lower social classes. Hyperinflation was brought under control through a currency reform and the introduction of the Reichsmark in August 1924 resulted in the so-called Golden Twenties from 1924 until the Great Depression in 1929. These years helped to foster the positive perception of the benefits of a stable currency (Sprenger, 2002, pp.214-218). The average income per capita increased approximately four percent during these years and brought prosperity and stability to Germany (Henning, 1993, p.88).

The Great Depression of 1929, however, reversed these trends and produced severe consequences, once again, for the German economy and society. The Dawes Plan (1924) and the Young Plan (1929) were designed to stimulate the German economy through loans provided by investors from the United States following the devastation of the First World War. In 1929, the US economy went into a deep recession, and US investors withdrew their loans from Germany. The outflow of capital led the German economy to experience a significant fall in production output, which was followed by high rates of unemployment. The outfall from the 1929 Great Depression was proportionally higher compared to other European countries owing to the higher volume of investment from US investors that resulted from the US investment activity incentivised by both plans (Ritschl, 2013). Chancellor Heinrich Brüning introduced a wide range of austerity measures that had a deflationary impact on the German economy. From the perspective of Brüning, these measures were designed to strengthen his hand in international negotiations to liberate the Weimar Republic from reparation payments (Brüning, 1970). The German public, however, was still deeply afraid of inflation and mistook these policies for increasing inflation. This paradox, similar to the arguments brought forward by Friedman when looking at the US experience, further increased the government's power over managing the economy, despite its mismanagement in implementing deflationary policies during a deflation and pushed the German society towards accepting fascism and extremism during the early 1930s (Myerson, 2004, p.208).

Indeed, these policies undermined the legitimacy of the democratic system and were a significant factor in the rise of extremism on the left and the right (Jones, 1988, p.208). As Strange and Calleo pointed out, 'the German tribal memory heightens political awareness of the long-run penalties attached to inflation and, therefore, substantially assists inflation resisting policies' (1984, p.111). Thus, the experiences of high inflation, years of economic depression and high unemployment and the rise of fascism during this period that resulted in the Second World War made German society skeptical about misusing the central bank to finance government expenditure. In retrospect, the years between the world wars, however, left the German public with a general sense of fear from fiscal mismanagement and expansionary monetary policy. The German public viewed these misguided policies as the major reasons behind political radicalisation and war. Haggard and Webb captured these German sentiments,

> 'West German interpretations of interwar history typically attach great importance to fiscal deficits and hyperinflation as causes not only of severe economic distress but also of the rise of fascism. Thus, West Germans tend to view price stability as a more important policy objective than full employment, even though Germany also suffered from extraordinarily high unemployment rates between the two world wars. These perceptions of cause and effect had a profound influence on post-war economic policy and institutions, such as the independence of the Bundesbank' (Haggard and Webb, 1993, pp.153-154).

This sense of resisting an expansionary monetary policy had a profound impact on the institutional design of the post-war German central banking system. The fear of the public of high inflation rates prevented the Western German government from using monetary policy to finance the reconstruction effort. The fear of inflation of the German public has remained a major feature in influencing German economic and financial policymaking throughout the 20th century.[2] Overall, these macroeconomic and social developments, on the one hand, led to the rise of fascism and, on the other hand, to the creation of ordoliberal thought. Following the Second World War, ordoliberal ideas played a major role in the reconstruction effort, the role of monetary policy and the institutional design of the Bundesbank (Marsh, 1992; Berger, 1997, Chapter 2). Rules became an integral part of the post-World War II economic framework of Germany and have until today remained an important feature of German and European economic governance. During the financial and sovereign debt crises starting in 2007, the German government and Bundesbank strongly resisted any measures that could increase inflation despite the downside risk of deflation (Chapters 6 to 8).

The work of Friedman and the historical experiences of the Western economies during the 20th century influenced the studies of Kydland and Prescott (1977) and Calvo (1978). In their seminal work, Kydland and Prescott (1977) argued that policymaking is ineffective if it is time-inconsistent. This is the case when short-term outcomes are not compatible with long-term goals. Therefore, the decisions taken to overcome short-term problems might negatively affect long-term goals. To

[2] for an overview of German fear of inflation see, Granville (2013, p.131-133).

overcome the issue of time inconsistency, Kydland and Prescott argued for rules in policymaking: 'current decisions of economic agents depend in part upon their expectations of future policy actions' (1977, p.474). According to their public policy model, the discretion of policymakers in devising and implementing their policies should be constrained by established rules. Barro and Gordon (1983b) expanded the theory of the rules versus discretion debate in policymaking and monetary policy. Applying this approach to central banking, Barro and Gordon (1983b) argued that central banks should be governed by rules to reduce the discretionary influence in monetary policymaking to a minimum. They declared that 'outcomes are shown to improve if a costlessly operating rule is implemented in order to pre-commit future policy choices in the appropriate manner' (Barro and Gordon, 1983b, p.589). The rule ensures that central banks do not deviate from their committed policy direction. In the process, central banks would increase their reputation and credibility. Otherwise, a discretionary policy approach could lead to higher inflation than the public assumes (Barro and Gordon, 1983a). The history of European central banking has seen shifts between emphasising rules and discretion. As mentioned above, the period of the gold standard was fully based on established rules. The period between 1914 and 1945 saw the disintegration of rules and the rise of discretion, which ultimately led to financial and economic instability, further emphasising the importance of rules in ordoliberal thought.

3.2 Central bank independence: The converging views of central bankers

From the Second World War until the collapse of the Bretton Woods system in 1973, economic thinking in the Western world underwent a paradigm shift. The Bretton Woods Conference introduced a system of fixed exchange rates in which the US Dollar was pegged to the convertibility of gold and the Western countries pegged their currency to the US Dollar. This created fixed exchange rates where other currencies were pegged to remain within a bandwidth of the price for the US Dollar. The rise of post-Keynesian thinking increased the feasibility of the system because monetary policy lost its appeal as a tool to manage the economy. While the German economy became dominated by ordoliberal thought that sought competition with clear rules, the French economy increasingly leant towards a discretionary monetary policy framework influenced by post-Keynesian thought. Overall, the French economy became increasingly coordinated and monetary policy became an integral component of the economic policy framework of the French government.

Indeed, German economic ideas and the government's relation to the Bundesbank contrasted with the institutional environment and governance in France. The Bundesbank was made independent from the government at a time when the French government increased its control over its central bank. France used its central bank primarily to support fiscal policies through an interventionist monetary policy. This was based on a post-Keynesian understanding of actively managing the economy through fiscal and monetary policy. The Bundesbank, in contrast, was mandated to keep prices stable. Over the years, the Bundesbank became known as a conservative central bank that focused on price stability and prided itself on its independence (Lohmann, 1998). The combination of price stability and independence as supporting concepts in central banking became key elements of the institutional design ECB and can be traced back to the developments of the post-World War II period.

The debate on rules versus discretion is closely linked with the debate on the independence of a central bank (Alesina, 1988, p.38-43). Monetary policy can have an impact on output and boost the economy in the short-run. Elected politicians might misuse the re-distributive power of monetary policy to win an election or to enhance the appearance of their policies. The party in power might be tempted to use this ability before an election to increase their chances of re-election. However, because rational agents anticipate this boost, it directly increases inflation, with no immediate positive impact on output and employment (Kydland and Prescott, 1977; Barro and Gordon, 1983b). The argument maintained in response that if technocrats conduct monetary policy they will not pursue these short-sighted targets and are free to act in the interest of society in the long-term (see, Bernhard, 1998; Bernhard et al., 2002, p.711-712; Eijffinger and De Haan, 1996, p.208).[3] To counter inflationary bias, for example, Rogoff (1985) suggested delegating monetary policy to a central bank that is credible enough to reduce this bias and resist government pressure, as the ability to achieve price stability is said to be strengthened if it is removed from political influence. Thus, delegating monetary policy, guided by the mandate, helps to eliminate the political influence of political parties. Bernanke summarises these findings and links them to the concept of credibility in a speech delivered to fellow central bankers in 2010:

> 'a central bank subject to short-term political influences would likely not be credible when it promised low inflation, as the public would recognize

[3] For a discussion on the negative side effects of technocratic decision-making removed from political oversight, see, Majone (1998, p.14-15).

> the risk that monetary policymakers could be pressured to pursue short-run expansionary policies that would be inconsistent with long-run price stability. When the central bank is not credible, the public will expect high inflation and, accordingly, demand more-rapid increases in nominal wages and in prices. Thus, lack of independence of the central bank can lead to higher inflation and inflation expectations in the longer run, with no offsetting benefits in terms of greater output or employment' (Bernanke, 2010).

Indeed, theoretical research shows that central bank independence has a positive impact on long-term prosperity and economic well-being of society. As discussed below, the academic literature of the late 1980s and early 1990s suggests that independent central banks deliver better policy outcomes than central banks that are subject to political influence. Bade and Parkin (1988) compare the relationship between the central bank and the government and the appointment of the governor across Western central banks (1988, p.25). They find that countries that have an independent central bank have a lower average inflation rate compared to countries where the government controls the central bank. Along similar lines, Grilli et al. assess the institutional differences and the resulting policy decision of OECD governments and conclude that central bank independence has almost only positive effects on an economy. They go so far as to argue that having a central bank is like having a 'free lunch' with no repercussions on real output growth and costs (Grilli et al., 1992, p.375). Cukierman (1992) and Cukierman et al. (1992) developed an index system to measure the degree of independence of central banks and their ability to reduce inflation. Their research provides a clear indication that there is a correlation between central bank independence and low future inflation and Alesina and Summers (1993) confirm their results. Alesina and Summers criticise, however, the view that an independent central bank has only a positive effect on low inflation and no positive impact on overall macroeconomic performance (see, Cukierman, 2008; Cukierman and Webb, 1995; Alesina and Stella, 2010). As a result, academic research began to focus on the different policy responses from the major central banks and their impact on the correlation between inflation and independence (Cukierman, 2008).

Drawing on the example of the Bundesbank, research during the 1990s further demonstrated that once a central bank is removed from political and social pressures and influences, it has the ability to focus on stabilising inflation in the medium-term, which in turn has a positive impact on economic prosperity (Alesina and Summers, 1993; Kaltenthaler, 1998). Research suggested that clear rules that allow for having an independent central bank remove the time-inconsistency problem because policymakers aim to keep achieving their goals established in rules. The goals of central bankers converged towards a mandate that focuses on price stability and, in the case of some central banks, additionally on economic growth, just as it is the case at the Fed (Alesina and Summers, 1993; Cukierman, 1992; Eijffinger and De Haan, 1996). Removing central banks from political control and preventing them from financing fiscal policies was considered a significant step towards establishing price stability and enhancing economic productivity (Cukierman, 2013, p.374). As mentioned above, in principle, an independent central bank prohibits elected politicians' misuse of monetary policy for achieving short-term goals. Further, even though politicians might not influence a central bank, inflationary pressure can result from the time-inconsistency problem, should a central bank not be credible enough to keep inflation at bay (Fischer, 2015). Rogoff (1985) and Walsh (1995) maintain that making central banks independent from political influence can overcome the time-inconsistency problem because policymakers aim to keep achieving their goals established in the rules. The goals of central bankers converged towards accepting a mandate that focuses on price stability and, additionally on economic growth, just as it is the case at the Fed (Alesina and Summers, 1993; Cukierman, 1992; Eijffinger and De Haan, 1996).

During the 1990s, research, however, emerged indicating that there was no clear positive correlation between central bank independence and price stability in Western economies (de Haan, 1997). This research challenged the consensus of the central banking community. For example, Banaian et al. argued that research should focus on the channels through which central bankers can be exposed to political pressures rather than assuming that an institutionally independent central bank is enough to defend against these pressures (1998, p.11). Temple (1998) warned that researchers should be more careful in indicating countries where there is no correlation between central bank independence and price stability (see, (Hayo, 1998; Hayo and Hefeker, 2002; Hefeker and Hayo, 2008). This line of argumentation declared that index measures, developed by Cukierman (1992), Cukierman et al. (1992) and Alesina and Summers (1993), are weak indicators for proving that central bank independence and inflation are negatively correlated (Debelle and Fischer, 1994). Forder (2005) pointed out that the literature on independence, which compares the legal statutes and the appointment of the governor, fails to deduce any future behaviour of the bureaucracy. Incentives and constraints influence the behaviour of actors, not the legal statutes of the organisation (Forder, 2005, p.852; on this debate see, Siklos, 2008, p.804).

However, during the mid-1990s, studies emerged, most notably, Campillo and Miron (1997), Hayo (1998), Posen (1993, 1995), that argued that social and cultural factors have an impact on the correlation between independence, rule-based policymaking, and positive policy outcomes. For example, Posen (1993, 1995) and Hayo (1998) postulated that the underlying social, economic and political factors, the institutional setup of a country and its history in maintaining price stability determine whether a country achieves low inflation. These factors are therefore only partially influenced by an independent central bank. CBI is a factor that is not necessarily relevant to achieving price stability. Thus, a society that has a cultural aversion towards inflation does not necessarily need an independent central bank to demand a conservative monetary policy from its government.

Bibow (2004) criticised this approach for misunderstanding the theoretical foundations in Keynes (2008) and Friedman (1962a, 1972). Combining research on central bank independence with the aforementioned debate on rules and discretion, Bibow (2004) emphasised that Keynes' view on discretion in monetary policy was that each policy should be made conditional on changing circumstances. The policymaker should have the discretion to change policy directions if the macroeconomic conditions changed. The discretionary aspect of policymaking is particularly important during times of crisis when circumstances change in unforeseeable directions and require the expert judgment of technicians to prevent devastating outcomes. This level of discretion, however, has to be dependent on democratic principles and oversight as well as on a high-level of accountability and transparency. To put it differently, Keynes envisioned a system of checks and balances that constantly constrained an independent central bank (Bibow, 2004). Friedman, in contrast, opposed an independent central bank. In his view, a central bank should be constrained by a set of rules that would prohibit the influence of governments and individuals (Friedman, 1960, 1962a). Friedman, for example, considered 'fine-tuning' to be de-stabilising, creating uncertainty in the process (Bibow, 2004). Without establishing rules, policymakers might be tempted to disregard their commitment to the long term and pursue short-term goals, thus, making the strategy time-inconsistent. Bibow (2004) further argued that when taking the opposing views of Keynes and Friedman together, a central bank should not be at risk of being detached from politicians and society. Removing a central bank entirely from political influence makes it impossible for the central banker to conduct a welfare-enhancing monetary policy (Bibow, 2004, p.7).

When this conflicting research emerged during the 1990s, the previous arguments favouring an independent central bank had already started to translate into the practical world, resulting in an increasing number of independent central banks. The negotiations over the Maastricht Treaty had already been completed and established the ECB as among the most independent central bank in the world. Indeed, in Europe most central banks were part of the national governments until the Maastricht Treaty established that all central banks in the euro-area have to be independent to join the Eurosystem.[4] This institutional requirement reduced the opposition of the Bundesbank on the topic of transferring its sovereignty to the supranational level. The German central bank was initially concerned that Germany would be subject to higher inflation rates once the sovereignty of monetary policy was lost. A third argument was that a numerical inflation target has a good chance to anchor inflation expectations around a clearly defined target (Duisenberg, 2001;Issing, 2003b, p.12). Despite the conclusions drawn by the critics (see, Posen, 1993, 1995; Hayo, 1998), today, the mainstream consensus remains in favour of maintaining that independence has a positive effect on price stability and, thus, makes central banks more efficient (see, de Grauwe, 2012a, p.157).

During the 1990s, the increased independence from governments inevitably put central banks in Europe in a position where technical expertise and long-term stability were considered more relevant than short-term political achievements. In addition, the growing importance of the financial sector and its deep connections with most actors in the real economy provided central banks with a channel to influence the economy by relying on the financial industry. Thus, over time, central banks positioned themselves between the government and the financial industry and became an indispensable partner for governments to influence the economy. The favourable economic climate further provided proof that an independent central bank working closely with the financial sector to achieve price stability for the whole economy was preferred to direct government interference. Further evidence of the advantages of an independent and technocratic central bank came during the Asian crisis in 1997. European central banks prevented adverse shocks that challenges that emerged from Asia.

[4]Other non-euro examples of independent central banks include the Reserve Bank of New Zealand, which became independent in 1989 and the Bank of England, which gained its independence in 1997.

3.3 Central bank credibility: Challenges of the post-Bretton Woods era

While independence became increasingly important during the 1980s and early 1990s, the post-Bretton woods period that started in 1971 had a major effect on credibility. When US President Richard Nixon unilaterally decided to cancel the international convertibility of US Dollar to gold, a system of freely floating fiat currencies emerged and fluctuating exchange rates resulted. Thus, the credibility of the central bank became more important to influence the exchange rate as well as inflation rates. Furthermore, the increased instability of exchange rates and the resulting volatility of prices, in addition to increasing fiscal deficits that were a result of Keynesian demand management, and high oil prices led to an increase of inflation and unemployment across Western countries. Previously, it was believed that there could not be high inflation and high unemployment at the same time. The years of high inflation and high unemployment, and the subsequent recessions during the 1970s turned this worldview on its head. The 1970s provided ample evidence to the contrary. To overcome these supply-side shocks, the political and economic attitude towards central banks during this time shifted from dependent central banks executing the monetary policy decision of the government and supporting fiscal policies through active intervention in the money stock to one that sought to provide central banks with more independence over their policies to achieve price stability and actively reduce inflation. These developments led to the fall of post-Keynesian thought and the rise of monetarism in devising monetary policies (Kitterer, 1999, p.185). The Bundesbank, compared to other major central banks, such as the Banque de France, the Fed and the BoE, used a policy mix that focused on keeping prices stable. The work of Friedman and the collapse of Bretton Woods turned monetarism into the dominant line of thinking in central banking.

Post-Keynesian thought failed to provide satisfactory answers to the paradox of rising unemployment and rising inflation. What became known as 'stagflation' signaled the end of post-Keynesian thought and the rise of monetarism. The post-war years saw the rise of extensive welfare states that reshaped the wide-ranging redistribution of capital. Social democracy became an integral part of European governance. During the period of the Bretton Woods monetary regime, monetary policy was only sparsely used to manage domestic economies (Cottarelli and Giannini, 1997, p.4). This changed during the late 1970s when post-Keynesian policies could no longer provide policy solutions to the changing macroeconomic trends after the collapse of the Bretton Woods system in addition to rising domestic concerns of welfare and social provision. During the late 1970s, the rise of the new right and its focus on monetarism put pressure on post-Keynesian thinkers to accommodate the forces of a changing social democracy. The public became disenchanted from the redistribution of capital and the failures of government to provide for public goods. This led to the rise of orthodox economic thinking that focused on individualism rather than collectivism, on monetarism rather than post-Keynesianism, on financial deregulation rather than regulation and on the importance of the exchange of goods as opposed to increasing competitiveness (Foucault, 2008).

For monetarists, the market has the capacity of maintaining equilibrium. This equilibrium can only be disturbed by external shocks, but even in the case of these, the market should be left to its own devices. The market will be able to restore the equilibrium and there will be no need for government intervention. The role of the government is reduced to safeguard the market mechanisms and fiscal and monetary policy should be kept to a minimum because it distorts the free operation of the market. The central bank should focus solely on the supply of money (Tsoulfidis, 2010, p.315-316). Friedman, a key monetarist who had been influential in establishing the Chicago School doctrine and the demise of post-Keynesian thought from the 1970s onward, wrote that 'inflation is always and everywhere a monetary problem in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output' (1970, p.24). Monetarist, therefore, argued that the trade-off between unemployment and inflation is temporary. There is always a minimum level of unemployment because there are always people who are either between jobs or registered as unemployed for other reasons, such as receiving benefits, motherhood, and fatherhood. These people do not offer their labour to the market, yet their decisions have an impact on the flexibility of wages, which results in a natural level of unemployment in the long-run. Monetarists believe that the Phillips Curve is vertical as there is no direct trade-off between inflation and unemployment. The Philips Curve assumes that all prices (including the price of labour) are flexible and adjust to clear the labour market. In theory, no involuntary unemployment should exist. Friedman's famous proposition on the relationship between inflation and unemployment reads:

> 'There is always a temporary trade-off between inflation and unemployment; there is no permanent trade-off. The temporary trade-off comes not from inflation per se, but from unanticipated inflation, which generally means, from a rising rate of inflation. The widespread belief that

> there is a permanent trade-off is a sophisticated version of the confusion between "high" and "rising" that we all recognize' (1958, p.11).

This argument is crucial for any debate on central banking. According to Friedman's theory, private agents have perfect information about the amount of money in circulation. Thus, if the money supply increases, agents will swiftly demand higher wages. Hence, central banks cannot stimulate the economy by using expansionary policies, because this only increases the nominal price and not the real output of the economy. Over time, the differences between these two schools of thought have decreased, and economists have mainly agreed that in the long run the Phillips Curve is indeed vertical at the natural rate of unemployment. In the short run, however, there is a trade-off between inflation and unemployment.

During the late 1970s, monetarist thinkers, such as Friedman, developed effective policy approaches that reduced inflation and unemployment after painful disinflation. On the basis of these successes, Western governments started to deregulate the financial sector, restructured the welfare state, and praised individualism. In the financial sector, strategies that only allowed for 'winner-takes-all' outcomes were part of the problem why the financial sector became unsustainable in the run-up to the 2007 financial crisis. Ideas that came out of monetarism resulted in a policy approach that reduced interest rates to record lows. These developments, furthermore, led to the self-regulation of the financial system, which became partially responsible for the financial crisis in 2007.

Following the collapse of Bretton Woods, the Bundesbank became known for its conservative monetary policy that fully aimed at price stability. It developed a strong track record in keeping inflation low (Beyer et al., 2008; Frenkel and Goldstein, 1999; Deutsche Bundesbank, 1995). The policy approach pf the Bundesbank was influenced by the monetarist ideas of Friedman and coupled with an ordoliberal interpretation of rules and competitiveness. This reputation was further strengthened during the 1970s when Western countries experienced high inflation. Germany, using a policy approach that aimed at price stability, retained relatively low inflation rates. The Bundesbank introduced new instruments to meet the changing macroeconomic environment and successfully contained inflationary pressure. Confronted with floating exchange rates and high inflation, the Bundesbank required an instrument that could anchor inflation expectations and over time achieve price stability. By targeting the money supply, prices became more stable. In retrospect, Bernanke (2003) argued in a speech delivered to business leaders, that 'the Bundesbank indirectly targeted inflation, using money growth as a quantitative indicator to aid in the calibration of its policy. Notably, when conflicts arose between its money growth targets and inflation targets, the Bundesbank generally chose to give greater weight to its inflation targets' (Bernanke, 2003; Bernanke and Mihov, 1997).[5] This provided the Bundesbank with a clear objective and made it more accountable towards government and the German public as well as the financial sector. The narrower focus on one objective, the increased accountability and the success of the Bundesbank to bring down inflationary pressure, led to more research on the correlation between central bank independence and the achievement of price stability (Bade and Parkin, 1988; Alesina, 1988; Alesina and Summers, 1993; Grilli et al., 1992). As mentioned above, in France, the Banque de France was well-established under the government and was *de facto* a department of the French Treasury. This resulted in a considerably higher inflation rate compared to its German neighbour, which had a negative effect on competitiveness. These macro-economic differences further proved the case that there is a positive correlation between independence and price stability.

The Bundesbank used the desired inflation rates as transparent intermediate targets, establishing either a numerical target or a margin of the desired money growth. Using the instrument of announcing either a numerical target or a bandwidth of where the inflation rate should be, the Bundesbank was able to use market forces to bring inflation to the desired target. In retrospect, the Bundesbank was not always able to hit the target, but in the medium-term, it showed significant results in reducing inflation during the 1970s. This strategy, furthermore, had the advantage that by pre-defining the inflation rate, the Bundesbank was transparent in its monetary policy while at the same time market participants were aware that it was committed to achieving this target. In addition, linking the target with the goal, the credibility remained high when any of the variables changed (Bernanke and Mishkin, 1992, p.7). Overall, academics highlighted that monetary targeting was primarily a commitment device which helped to constrain future decisions that were not in line with the mandate or objectives (Soderstrom, 2005; Beyer et al., 2008).

[5] The Bundesbank's monetary targeting, from 1975 until 1998, showed several similarities with inflation targeting that was introduced by the Central Bank of New Zealand in 1990 and is today in use by the majority of central banks of developed countries. When using inflation targeting, the central bank announces an official numerical inflation target for a specific time horizon. Hereby the central bank targets the money growth, defined as the aggregate of central bank money in circulation and the bank deposits held by the citizens (Bernanke and Mihov, 1997, p.25). In monetary targeting, the central bank announces an intermediate target rather than a desired inflation rate and aims to achieve this target. The goal of both strategies is to achieve price stability. However, the ECB does not define itself as an inflation-targeting central bank, its numerical inflation target of close but below two percent, however, forces it to achieve an inflation target in the medium term.

Furthermore, a floating exchange rate and the shift from using fiscal policy to monetary policy to stabilise price levels provided the Bundesbank with a more effective policy authority than the Banque de France. Financial markets adhered to the recommendation of the Bundesbank because it was able to act even against its government. Furthermore, the clear distinction between monetary policy and fiscal policy helped to manage the price levels more precisely than the Banque de France (Kitterer, 1999, p.186). Once the inflation rate increased between 1973 and 1974, the Bundesbank was prepared to use the new set of policy tools to effectively counter the high inflation and rising unemployment. The Bundesbank immediately reduced monetary expansion and prevented inflation from spinning out of control. Once unemployment rose, the Bundesbank cut interest rates and moved towards an expansionary monetary policy. At the same time, the government introduced policy measures to encourage investment and employment (Kitterer, 1999, p.187). The concerted efforts of the Bundesbank and the German government helped to prevent the German economy from falling into recession. Nevertheless, the Bundesbank was independent of the government in its decision-making. However, despite an economic recovery that set in as early as 1975, the inflation rate remained high throughout the late 1970s and particularly increased during the second oil shock in 1979. This was a bigger threat to those economies that did not focus on price stability and where an expansionary fiscal policy further contributed to the rising inflation, such as France.

3.4 Conclusion

This chapter has traced back the European history of central banking during the 20th century. It has demonstrated that the conceptually significant features of modern central banks were drawn from historical examples. Although space has not allowed featuring the importance of the Federal Reserve in this debate, the discussion on the developments in Europe has provided ample evidence that historical narratives influenced the relationship between rules and discretionary policy choices, independence, credibility and price stability. The following chapter will investigate the historical and theoretical debates that strongly influenced the negotiations during the early 1990s on founding a common European central bank that would later encompass 19 member states. France and Germany took up the two major negotiations sides and, thus, their economic perspective on these concepts, narrated by their historical experiences, played a major role in establishing the ECB. Beyond the ideational frameworks, the role Jean-Claude Trichet and Mario Draghi played in the negotiation process informed their understanding of the Eurosystem and later influenced their decision-making during the financial and sovereign debt crisis.

Chapter 4

Founding EMU and the ECB

> ‘I think Trichet was eager to prove that he could be more German than the Germans. [He] came out of a background - I knew Trichet pretty well when he was in France as treasury and at the central bank there. He came out of a background that accepts the premise that deficits are bad and orderly economy requires a balanced budget and all that, which I (as a Keynesian) totally disagree with and I think retrospect it is proven to be damaging for Europe, for European integration, for the world economy and specifically for the European economy’
>
> US-based financial journalist (PS3)

From the 1980s onwards, the rise of monetarism, the shift of industries away from manufacturing, the change in flexibility of labour markets, the deregulation of the financial sector and the growth of global trade spurred a period of economic prosperity of the developed world. The Western central banks regained control over high inflation rates during the late 1970s, and until 2007, when the financial system went into recession, developed economies showed great monetary and financial stability. This period became known as the ‘Great Moderation’. The collapse of communism led to the assumption that the ‘end of history’ had been reached, where capitalism has turned out to be the most effective economic system (Fukuyama, 1992). There are various interconnected reasons behind why the developed world experienced economic growth and stability during this period. In monetary terms, the success of central banks in containing inflation led to the converging view that central banks had reached an ultimate answer to macroeconomic instability. Modern telecommunication technologies and the deregulation of the financial sector spurred global economic expansion. The development of new financial products, which allowed investors to restructure and re-sell their risk, increased their ability to leverage their positions. The perceived risk was smaller for investors. Risk models, however, did not assume the possibility of a system-wide collapse.

The Western central banking community fully embraced monetarism and started to focus almost exclusively on the inflation rate. Indeed, as Sandholtz pointed out, 'prior to the shift of the 1980s, governments often implemented expansionary policies to stimulate growth and sustain employment, at the "cost" of high inflation. The new belief was that price stability was the foundation for growth and employment in the long-term' (1993, p.34). The financial sector was considered to be an efficient market that could regulate itself and, owing to its ability to share risks, was perceived stable and freed from large-scale recession. The widespread belief was that the financial sector would only partially experience downturns. The central banking community assumed it had itself arrived at an 'end of history' in how to manage the economy. The success in achieving price stability was largely attributed to the independent relationship of the central bank to the government (Chapter 3.2). Following the monetarist line of thought based on the writings of Milton Friedman and ordoliberal ideas, if the government cannot misuse monetary policy to finance its fiscal expenditure, the central bank can focus on keeping inflation rates low.

This period, furthermore, showed a paradigm shift of ideas on how central bankers perceived their role in managing the economy and how they would design an 'ideal' central bank. In 1992, European central bankers came together to develop the institutional layout for the ECB. The first part of this chapter draws out the paradigm shift of ideas of central bankers during this time. It argues that their thinking on major central banking concepts converged and led to the key design features of the ECB. The two most relevant features are (a) its mandated focus on price stability and (b) its independence to safeguard its mandate. As discussed in Chapter 3, the experiences of the German and French central banks during the 20th century were instrumental in arriving at this point. The second part of this chapter will discuss the role Jean-Claude Trichet and Mario Draghi played during the Maastricht Treaty negotiations and whether this had an impact on their leadership style during the financial and sovereign debt crisis.

4.1 The foundation of the Economic and Monetary Union

The differences in economic ideas between France and Germany became increasingly apparent during the negotiations of the Economic and Monetary Union (EMU). The French government argued for more discretion of policymakers in monetary affairs. The Southern European countries unofficially aligned their preferences with the French and supported this argument. This ideational framework included oversight from Treasury officials on monetary policy (Howarth, 1999). Germany and other central European countries rejected these ideas and instead demanded strong institutional structures and rules. Their thinking persisted that rules would prevent the risk of monetary financing of sovereign debt. In contrast to German monetary policy, France and the Southern European countries had a history of using such policy to reduce their public debt burden. The German negotiation team, therefore, pushed for several measures in the Maastricht Treaty that reduced the exposure of risk-sharing among member states in the event of a solvency issue. The independence of the ECB and its commitment to price stability aimed at preventing any liability of the Northern European governments towards Southern European governments. These conflicting views can be traced back to the diverging economic views of post-Keynesianism and ordoliberalism.

In 1988, the European Community summit in Hanover, Germany, created a committee, chaired by then-President of the European Commission, Jacques Delors, to develop the guidelines for integrating the European market. The so-called Delors Committee was comprised of central bank governors from twelve member states, and, Alexander Lamfalussy, then-General Manager of Bank for International Settlements (BIS), Niels Thygesen, a professor of economics from Denmark and Miguel Boyer, then-President of the Banco Exterior de España.[1] Together, they produced the Delors Report in 1989, which planned three stages of economic integration to achieve economic and monetary union. The first phase, starting on 1 July 1990, consisted of complete freedom of capital transactions, strengthened cooperation among European central banks; improved economic convergence between European countries and free use of the European Currency Unit (ECU), the forerunner currency of the euro. The second stage, starting on 1 January 1994, saw the establishment of the European Monetary Institute (EMI), the predecessor of the ECB; increased coordination of monetary policy among the member states; prohibited central bank credit and strengthened central bank independence. Stage Three, starting on 1 January 1999, introduced the euro, ushered in the Stability and Growth Pact and fixed the conversion rates as well as intra-EU exchange rate mechanism (Delors, 1989).

The report prescribed that 'the System would be committed to the objective of price stability' and to attain this, European central banking system, consisting of the central bank governors and other board members, 'should be independent of

[1]The founding members of the EMU were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

national governments and Community authorities' (Delors, 1989, p.21-22). This recommendation was later fully adopted in the Maastricht Treaty, which established the ECB as an independent central bank focusing on price stability. The historical dimensions of the German past influenced the German government's preference to move forward with deeper economic integration. Then-chancellor Helmut Kohl was a staunch pro-European idealist who argued that political integration would follow economic integration (Kaltenthaler, 1998, 2002, 2005; Kahn and Jacobson, 1989). Thus, during the negotiations, the ideas among European central bankers and politicians converged on independence and price stability and became the cornerstones of a common European monetary union.

For the supranational central bank, the founding members agreed on a design that mirrored the Bundesbank. The ECB would become independent from political influence and its primary mandate would focus on price stability. To gain credibility and to commit the German government to move the joint central bank to the supranational level, Delors convinced politicians from the founding members of the EMU to invite their central bankers to design the ECB. Involving central bankers in the process helped to turn French thinking around, from supporting post-Keynesian demand-side policies to a ordoliberal-influenced monetarism (Dyson and Featherstone, 1999, p.691). Delors indirectly created a situation where decision-makers at the Banque de France and the Bundesbank were open to discussing EMU and a common European central bank. The ECB would considerably reduce the power of the Bundesbank, which had become the dominating central bank in Europe and, at the same time, reduce the French treasury's control over its central bank owing to the requirement to make the Banque de France independent from the government (Dyson and Featherstone, 1999, p.691). The integration of the European central banks increased coordination and eliminated opportunistic policy decisions, a move which disadvantaged individual member states. For example, reducing the exchange rate during an economic crisis became impossible for member states. More than twelve years later, this feature would considerably reduce the ability of Greece and other periphery countries, which had weak competitiveness, to overcome the sovereign debt crisis (Copelovitch et al., 2016, p.833).

Once the founding governments of the EMU decided on the independence of the ECB, the next milestone was to establish the credibility of the central bank. The founding members, again, used the Bundesbank as the model for achieving this milestone. The ECB received a narrowly defined mandate focusing primarily on price stability. This mandate would link it to the long-established track record of low inflation of the Bundesbank (Issing, 2000, p.146). During the negotiations, German policymakers were, therefore, convinced that the ECB enjoyed credibility as long as it followed the rules set out in the founding documents, including the mandate. Indeed, the German government aimed to lock in the institutional arrangements to reduce the risk of economic crises. According to the German ordoliberal worldview, a crisis should not occur in the first place owing to the creation of and adherence to rules. Rules and long-term institutional security were seen to prevent economic and political difficulties in the first place. Thus, flexibility in decision-making under adverse conditions was considered to be a danger that could lead to the next crisis. The French government was initially against using rules and instead favoured more flexibility and discretion for policymakers. Stemming from its post-Keynesian economic policy approach, France endorsed ex-post intervention over cementing rules in institutions. In the French tradition, the government prefers to manage a crisis on a case-by-case basis, using flexibility, within a limited set of rules (Brunnermeier et al., 2016, p.85-86).

Nevertheless, the German government successfully negotiated the introduction of the no-bailout clause in the Maastricht Treaty, which states that neither the Union nor any single member state will be 'liable for or assume the commitments of central governments, regional, local or other public authorities' (Maastricht TEU, 1992, art. 125). When there is a risk of defaulting on sovereign debt, the German government argued that countries will spend less through fiscal policy and focus more on structural policy. In other European countries, monetary policy was regularly used to support fiscal expenditure. The ECB would not be allowed to continue this tradition. The Maastricht Treaty prohibits the ECB from using monetary policy for budgetary spending. This prohibition extends to removing the 'lender-of-last-resort' (LLR) responsibility of the ECB. Thus, the ECB was not allowed to bailout banks or euro-area governments (see below, Section 4.4.1). The Stability and Growth Pact, introduced in 1997, strengthened the incentive for countries to keep their government deficit below three percent of GDP (Breuss, 1998; Dyson and Featherstone, 1999).

The independence of the ECB would further limit the ability of national governments to demand an expansionary monetary policy. The consensus among the European central banking community that central bank independence has a positive impact on price stability led to a significant *de jure* independence of the ECB (Chapters

3.2 and 5.1.2). To recount the discussion in the previous chapter, while the Bundesbank was established as an independent institution to reduce the centralised power of the German government following the Second World War, the Banque de France remained under government control until the Maastricht Treaty. The French government favoured a centralised system to align fiscal and monetary policy. However, empirical and theoretical research during the 1980s and early 1990s maintained that there was a positive correlation between independence and price stability (Bade and Parkin, 1988; Alesina, 1988; Grilli et al., 1992). The conviction among academics that independence supports price stability went so far that Alesina and Summers (1993) argued that there is a 'free lunch', with no apparent costs for output or economic growth if the central bank is independent. When research started to show a negative or insignificant correlation between independence and price stability starting in the mid-1990s, the negotiations on the ECB had already been completed, and the founding members had decided that the ECB would have a high *de jure* independence. Beyond the *de jure* institutional design of the ECB, the *de facto* application of its instruments and policy capacity is similarly important. The negotiations for the EMU were driven in large part by pro-European politicians and policymakers.

Jean-Claude Trichet and Mario Draghi played a role in developing the EMU and the ECB as part of their countries' negotiation teams. Their career paths and roles during the negotiations influenced how they perceived the ECB as well as why they chose a specific responses to overcome the financial and sovereign debt crises. Trichet and Draghi played a major role in shaping the ECB during the Maastricht Treaty negotiations and eventually during the crises. This chapter will focus on the career development and personal styles of leadership of Trichet and Draghi. The decisions of Trichet and Draghi shaped the policy responses of the ECB at the highest level of the ECB decision-making apparatus. The ECB was analysed about the influence of its presidents over decision-making within the organisation and when engaging with the financial market, governments and the public (Basham and Roland, 2014). The personal impact of the two presidents on overcoming the financial and sovereign debt crisis will help to investigate the ideas of both presidents to develop an understanding of how they reacted to the crisis. This investigation will provide further insights into the role of the leadership of the presidents of the ECB amid the financial and sovereign debt crisis.

4.2 Central bank leadership and the role of personality

Throughout the 20th century, central bankers commonly practised a discretionary policy approach (Chapter 3.1). At a time when rules were often less defined and less enforced, high-level central bankers enjoyed an extensive degree of policy discretion in conducting monetary policy and in engaging with governments and financial markets. In 1944, Karl Bopp, a central banker of the Federal Reserve Bank of Philadelphia, stated that 'a single individual may dominate a central bank so completely that the history of the institution for a period can be written accurately only with reference to that individual's life' (1944, p.271-272). Considering the extraordinary monetary circumstances in Europe during the first half of the twentieth century, it is not surprising he made such a statement. The rise of post-Keynesian ideas in managing the economy further increased the reliance of policymakers on using discretionary policies to stimulate economic recovery after 1945. This practice continued well into the second half of the 20th century. During the 1960s and 1970s, individual decision-making was still considered to be imperative for successful monetary policy operations. Milton Friedman observed, 'the extent to which a system of this kind is really a system of rule by man and not by law and is extraordinarily dependent on the personalities involved' (Friedman, 1962b, p.235). Shortly after, Friedman's comments, Norman Whittlesey, the US economist, observed, 'a notable feature of central banking in the twentieth century has been the extent to which the current scene, here and abroad [in Europe and United States], has been dominated by a few outstanding personalities' (1970, p.219).

Taking a closer look at leadership in central banking, it becomes evident that during the Great Moderation, central banking theory and practice around the globe converged regarding leadership and policy approaches. As discussed in Chapter 3.1, the discretionary policy was only reduced during the late 1980s, owing to the increasing complexity of financial markets, the growing independence of central banks and the move towards more technocratic decision-making to achieve price stability. The assumption among Western central bankers and academics was that inflationary pressure would be a relic of the past and the business cycle would achieve an optimum balance that would lead to continued economic growth once the central banks achieved price stability. Leaders became administrators of a technical organisation that predominately focused on attaining the mandate. The recent financial and sovereign debt crisis turned this thinking around. The institutional role of the presidency became imperative in overcoming the financial and economic challenges starting in mid-2007.

Jean-Claude Trichet and Mario Draghi have considerably shaped the institutional design and policy approach of their central bank. Comparing the leadership style and policy choices of both ECB presidents can provide insights into the European approach to crisis management and into how the choice between rules and discretion can influence individuals' (Siklos, 2008, p.81). The different leadership styles of Trichet and Draghi further demonstrate the changing relationships between the ECB and other actors, such as national central banks (NCBs), the national government or financial institutions, throughout the financial and sovereign debt crises.

Before becoming the second president of the ECB, Trichet spent his life as a civil servant in the French public administration (excluding two years in the private sector following graduation). He received his first degree from the Nationale Supérieure des Mines de Nancy in civil engineering and pursued further degrees in economics and politics at the University of Paris and Science Po Paris. In 1971, Trichet graduated from the elite university École Nationale d'Adminstration to join the public service. After a short stint at the Department of L'Inspection Générale des Finances, the auditing and supervisory body of the French economy, Trichet began his career at the Direction Générale du Trésor. At the time, this department was the main planning centre for the centralised economy of France. As discussed in Chapters 2 and 3, the French government provided guidance and intervened with corrective measures into the economy as it saw fit, while in Germany, the reliance on ordoliberal thought in policymaking restrained the government from intervening in the market. Nevertheless, at the Direction Générale du Trésor, Trichet received his first experience in managing monetary affairs as well as fiscal and structural policy approaches, which for him, coming from a French background, supported each other.

Trichet took on increasingly responsible roles at the French Treasury. In 1978, he became an advisor to then-President of France Valéry Giscard d'Estaing on economic and monetary affairs as well as industry, energy and research and development. From 1985 until 1991, Trichet became the head of international affairs at the Treasury. This role propelled him onto the international stage and made him the Chair of the Paris Club, a group of 20 countries that actively negotiated debt restructuring in Latin America, Africa and the Middle East. His role as the Chair of the Paris Club prepared Trichet for the negotiations during the European financial and sovereign debt crisis more than 20 years later (Trichet, 2010d; Atkins, 2007). Among the

European leaders at the time, Trichet had extensive experience in dealing with the challenges of a sovereign debt crisis (Basham and Roland, 2014; Pauly, 2011). He would later say about himself that 'my professional life has been one of frequently dealing with the financial crisis' (Trichet, 2010d). Indeed, Oliver Garnier, a personal advisor of Trichet at the French Treasury during the 1990s, said about him, 'one of his strengths is his ability to manage a crisis – he enjoys that' (Garnier, quoted in Financial Times, 2007). According to his adviser, Trichet took personal satisfaction in overcoming financial and economic crises. His approach of carefully navigating the strategic and diplomatic challenges of securing bail-out deals and debt restructuring for the euro-area periphery countries can be traced back to his experiences as the head of the Paris Club.

In 1992, Trichet became Governor of the Banque de France, shortly before it was made independent from the French Treasury. In this capacity, Trichet was able to learn the intricate policy approaches of monetary policy that stood in contrast to his previous experiences with fiscal and structural policy. He was among the few policymakers on the Executive Board of the ECB, at the time, who had experience in monetary, fiscal and structural areas of economic and financial policymaking (only Gertrude Tumpel-Gugerell had a short career stop as an economic advisor to the Austrian financial minister Herbert Salcher).[2] Throughout his years at the French Treasury and later at the Banque de France, Trichet's career shows institutional continuity (Basham and Roland, 2014, p.11).

Institutional diversity marks the career of Mario Draghi. His career path changed often between the private and public sector and within the types of public sector institutions. He received his doctorate in economics from the Massachusetts Institute of Technology under the supervision of the two Nobel Prize laureates, Franco Modigliani, who contributed to the understanding of the modern business cycle and Robert Solow, who received the prize for his work on economic growth (Dinmore and Atkins, 2011). Draghi spent a considerable length of time as a professor of finance and macroeconomics at various Italian universities and was an Executive

[2]Vice President Lucas Papademos had an academic career and later joined the Greek central bank, eventually becoming Governor. This was almost ten years before becoming prime minister of Greece. Otmar Issing was also an academic who first joined the Bundesbank before becoming Chief Economist of the ECB in 1998. Tommaso Padoa-Schioppa was an Italian career central banker with no work experience outside of the international central banking community. Eugenio Domingo Solans worked at the Bank of Spain and Spanish commercial banks. The only member with experience in central banking and economic governance was Gertrude Tumpel-Gugerell, who had a three-year stint (1981-1984) as economic advisor to the Austrian financial minister.

Director at the World Bank. Between 1991 and 2001, Draghi became a civil servant at the Italian Treasury. During this time, the sustainability of the Italian sovereign debt level significantly worsened, because the government introduced high interest rates to stabilise the exchange rate to achieve the minimum requirements of joining the euro. High interest rates, however, made government borrowing expensive and the inefficient public budget allocation further increased these difficulties (**?**, p.22). His primary responsibility at the Italian Treasury was to modernise the Italian economy. Draghi implemented far-reaching reforms that would increase privatisation to incentivise competition among Italian firms, stabilise the annual budget and interest rates. His reforms helped Italy to join the euro as part of the first wave of participants. Draghi gained considerable crisis-fighting expertise during this period. After a two-year stint at Goldman Sachs, the investment bank, where Draghi worked on the European strategy, he went on to become the Governor of the Banca d'Italia in December 2005 (Draghi, 2017; Basham and Roland, 2014, p.11).

When Draghi joined the Bank of Italy in December 2005, he had to rebuild the tarnished reputation of the institution. His predecessor, Antonio Fazio, was heavily criticised and, ultimately, was forced to resign amid evidence that he rigged the competition to prevent the Dutch bank ABN Amro from buying the Italian bank Banca Antonveneta. It was the first deal that involved a foreign investor purchasing an Italian bank and was strongly resisted by parts of the Italian economic elite. They feared that international competition could be harmful to the profitability of the banking sector. Draghi, however, restored confidence in the Banca d'Italia through a large-scale reorganisation of its operations Kroet and Oliveira, 2015; Draghi, 2011b. This experience helped Draghi to understand the opportunities and challenges of central bank credibility. Rebuilding the trust of a central bank in the financial market provided valuable lessons on the relationship between the market and the central bank that he would later use as the President of the ECB. In 2005, Draghi became a Governing Council member of the ECB and from 2006 until 2011 chaired the Financial Stability Forum (FSF), which became the Financial Stability Board (FSB) in 2009. The FSB consists of the G20 countries and major international organisations, such as the ECB, the European Commission, the International Monetary Fund (IMF), the OECD and the World Bank. Chairing the FSB increased Draghi's international reputation among government officials and central bankers. It further provided him with experience in dealing with sovereign governments over financial and economic regulatory matters.

4.2.1 The involvement of Trichet and Draghi in creating the ECB

When taking a closer look at the different experiences in institution building between Trichet and Draghi, Basham and Roland (2014) argued that Trichet was more involved with the Maastricht Treaty negotiations than Draghi. Indeed, Draghi only became part of the Italian Treasury team in 1991, when most of the negotiations were already completed (Dyson and Featherstone, 1999, p.514). As head of the French Treasury, Trichet was involved in the negotiation process from the beginning. At that time, the question of deeper European integration focused on the cooperation between France and Germany. Italy played a minor role during the negotiations and it was, therefore, primarily concerned with joining the euro during the first wave rather than providing policy input on the institutional design of EMU. Although Draghi was involved in the process, the German and French governments took the lead in negotiating the institutional design of the economic and monetary union, including the ECB. Thus, while Draghi was only partly involved in the negotiations over the founding elements of EMU and the central bank, Trichet was at the centre of these negotiations (Dyson and Featherstone, 1999, p.495).

Trichet's thinking on the benefits and perils of a German-influenced monetary policy changed during the negotiation process. At the beginning of the Maastricht negotiations, he fought the idea of creating an independent European central bank, because Trichet reasoned that it would mean a loss of power and influence for the French Treasury. However, witnessing the exchange rate instability of the European currencies during the late 1980s and the strong support for deeper European economic and monetary integration among other European leaders, the thinking of the French policymaking elite, including Trichet's, turned around. From favouring a dependent central bank, the French governing elite began to support the creation of an independent European central bank (Dyson and Featherstone, 1999, p.177-178). Despite being sceptical about moving sovereignty of monetary policy to a supranational institution, Trichet adapted to the new situation and made greater European economic and monetary integration his life goal (Dyson and Featherstone, 1999, p.178). François Mitterrand, the then-French President, instilled in Trichet a sense of contributing to the *construction européenne* where France could modernise and flourish as part of the European project (Dyson and Featherstone, 1999, p.177). Once it became apparent that France and Germany would move forward with deeper integration, Trichet adapted his thinking from being sceptical at first to being outright pro-European. Indeed, Basham and Roland argued that Trichet had a very different relationship to this new institution compared to other high-level policymakers, including Draghi (Basham and Roland, 2014, p.13). The negotiations on the founding of the EU affected Trichet's perspective on the institutional design of the central bank. Throughout his presidency, Trichet focused on fulfilling the mandate of price stability and guarding the independence of the ECB (ESCB3, see below). This stringent focus on the mandate of the ECB played a major role in the debates between governments and the NCBs on an appropriate crisis response.

Basham and Roland (2014) have argued that his role during the Maastricht negotiations made it difficult for Trichet to see past the narrow mandate of the ECB. His previous career experiences constrained his scope of action during the crisis. his experience in debt relief negotiations, on the one hand, prepared him well to tackle the financial crisis between mid-2007 and late 2009. On the other hand, the instruments that were needed to prevent the sovereign debt crisis from spiraling out of control were inconceivable with his thinking on price stability and his understanding of the mandate of the ECB. Providing financial assistance to illiquid financial institutions was part of the traditional LLR role of central banks. Trichet, therefore, only reluctantly introduced an expansionary monetary policy to support indebted countries. Yet, Trichet pushed the Governing Council to raise interest rates at the first sight of increasing inflation rates (Chapter 6.1.1).

The role of Trichet in setting the agenda during the Maastricht negotiations demonstrates that the design of the ECB constrained his actions. His deep involvement in the creation of the ECB resulted in his deep intrinsic motivation to keep prices stable and operate an independent central bank. He could not circumvent the goal of price stability by using discretionary policies without directly interfering with his work during the Maastricht negotiations. Indeed, Trichet used the diplomatic skills he had acquired during his years on the international stage as Head of the Paris Club and in leadership roles at the French Treasury and the Banque de France to defend the independence of the ECB jealously against political interests. US economist, Adam Posen, for example, said, 'Trichet seems to have handled Sarkozy with the appropriate amount of disdain [...]. It is evidence that the ECB has come of age; it is not inherently on the defensive' (quoted in Financial Times, 2007). As will be further discussed in Chapter 6.1.1, there was a constant row between Trichet and Sarkozy over the policy actions of the Eurosystem. For example, when the Governing Council decided to increase interest rates in the summer of 2008, Sarkozy criticised the actions of the ECB for focusing too strongly on its mandate of price stability rather than on facilitating economic growth (Reuters, 2007). Trichet distanced himself from the monetary policy preference of the French government and the statement from Posen indicates that the ECB had become an independent institution that would not take advice from national governments. Trichet announced in his last press conference in October 2011,

> 'Let me only mention that we are credible when you look at the past. We have delivered price stability, [...], for 332 million of our fellow citizens, a price stability that is in line with our definition and is better than it was over the last fifty years before the euro. And for the future, we are equally credible with respect to delivering price stability over the next ten years' (Trichet, 2011a).

This statement shows Trichet's extraordinary belief in the virtues of delivering price stability, even in adverse situations. Once in charge of an organisation with the primary mandate of containing inflation, Trichet narrowly pursued policies that would ensure price stability. This policy stance was much to the delight of the Bundesbank and the German government. Indeed, 'one German central banker speaks approvingly of Trichet as "our convert"; another comments that, for Germany it is incomparably better to have a French ECB president carrying out a Bundesbank-style policy in Frankfurt than a German president carrying out a Banque de France-type policy in Paris' (quoted in Marsh, 2009, p.226).

Another line of argument is that the circumstances of the process that led to his nomination constrained Trichet. The Maastricht Treaty assesses that the euro-area member states have to choose an ECB president unanimously and based on his or her conviction for price stability. To put it differently, the nominee should have a reputation for achieving price stability. In 1998, Duisenberg was appointed as the president of the EMI, the predecessor of the ECB, with the option to serve as president of the ECB when it started its operations in June 1998. There was a consensus among the European governments that Duisenberg showed a track record for a conservative monetary policy during his time at the De Nederlandsche Bank. In April 1997, the French government suggested that the first President of the ECB should be Michel Camdessus, then-President of the IMF and a French national. This suggestion started a prolonged high-level row between the French and German governments on whether the first president of the ECB should be French and whether the influence of the French government, to force this decision, would infringe on the independence of the ECB. The Governing Council had to take a vote on whom it would recommend as its next president because it was a requirement under the Maastricht Treaty (Maastricht TEU, 1992, art. 109a). The Governing

Council voted unanimously to support Duisenberg and in a historical coincidence, Trichet, then-President of the Banque de France, voted for Duisenberg as well (Berger, 1998, p.195). Before the vote, Trichet had asked the government in Paris if it had any objections but did not receive an answer. It only later emerged that the French government was predominately occupied with a domestic strike that it did not notice the crucial vote of the Governing Council (Berger, 1998, p.195). When it came to light that the Governing Council had voted in favour of Duisenberg, then-President of France Jacques Chirac considered this an attempt to circumvent his campaign to put a French official at the head of the ECB. Chirac increased his objections to Duisenberg and threatened to veto the decision (Donnelly, 2004, p.195).

Duisenberg ultimately proposed that he would voluntarily step down when the first four years of his eight-year nomination were over and that Trichet could then replace him (Kaelberer, 2001, p.196-197). The French government accepted this option, and other European governments did not object to it. The struggle over the nomination of the first president of the ECB was considered a French victory, but a breach of the independence of the ECB. The high-level row between the European governments about the nationality of the first president reduced the credibility of the ECB at the start of its operations (*The Economist*, 2003). One former Delors Committee member assessed Trichet's character traits during the interview with the author,

> 'He was pretty orthodox. The Germans were in the end, comfortable with him. He had more problems with the French, in fact, his own country, than with the Germans. That is quite true. He was maybe always aware of the very history of his own nomination - he needed to have good relations with Germany' (ESCB3).

The interviewee argued that Trichet became more accepted by the German government than by the French. This is in line with the previous argument that Trichet was constrained by the mandate owing to his role in negotiating the design of the ECB and his personal conviction that stable prices are beneficial to the French economy, despite strong resistance from the French government. The interviewee further linked the policy approach of Trichet during his times at the ECB to his nomination. The interviewee captured the role of national sentiments during the nomination of the ECB president. The national attitudes of the European governments played a vital role in the nomination process of the first president of the ECB. Thus, when Trichet became president of the ECB, he was aware of these diplomatic rows over his nomination and the German government's position towards his person. Trichet's firm belief in price stability, his narrow focus on the mandate of the ECB, and the historical dimension of his nomination put him at odds with his former French colleagues at the French Treasury and the Banque de France even before the crisis. Trichet's focus on price stability increased the pressure of French politicians and public officials to abandon the desire for expansionary monetary policies at the beginning of the crisis.

4.3 Conclusion

This chapter has analysed the different positions of the French and German governments during the Maastricht Treaty negotiations. While initially the French favoured a discretionary monetary policy, the German resistance and desire to develop a joint central bank with a mandate on price stability that is independent from government influence changed the negotiation position of the French government. During the course of the negotiations, Trichet became convinced that stable prices would support French economic growth. The chapter argued that his role in the negotiation process constrained his policy decisions during the financial and sovereign debt crisis. He could only reluctantly support policies that did not infringe on the mandate. In contrast, Draghi, who played a limited role during the EMU negotiations, was less constrained by the mandate and has repeatedly demonstrated that he would stretch the interpretation of the mandate to overcome challenges (Chapter 8). The data from the interviews supports this claim. The following chapter will take an in-depth look at the institutional setup of the ECB and the Eurosystem. It will assess the unique design features and shortcomings of the ECB and the Eurosystem, and, will use this analysis as a basis for the discussion on why and to what extent the ECB changed during the financial and sovereign debt crisis.

Chapter 5

Setting up the ECB

> 'The ECB was given a rather well-defined objective, mainly to maintain medium-term price stability. That made it unnecessary to have political backing. The fear when the ECB was designed was that if there were a European federal authority on the fiscal side that would pose a major threat to the European Central Bank as it had happened in many other nations that participated in the euro-area as well other countries in the world. It was quite a deliberate decision, but as it turned out, of course, you cannot quite as neatly separate price stability from the other tasks' (EU3).
>
> Former Delors Committee Member (EU3)

> 'No single currency known in history has survived without a political union.'
>
> Private sector banker from the UK who works closely with the ECB (PS2)

The ideas of how an effective central bank should operate converged during the Maastricht negotiations. The negotiations on the Economic and Monetary Union (EMU) were pivotal in this process. The outcome of the negotiations resulted in the establishment of the European System of Central Banks (ESCB), which entailed all national central banks (NCBs) of the EU member states and the Eurosystem. As part of the ESCB, the Eurosystem consists of the NCBs of the euro-area member states and the European Central Bank (ECB).[1] The ECB, as well as the NCBs of the Eurosystem, is independent of the euro-area national governments. The primary mandate of the ESCB is to safeguard price stability.

Throughout the crisis, the Eurosystem members vigorously debated the relevance

[1] As of the time of writing, September 2018, members of the euro-area are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain

and importance of price stability in a financial system under severe stress. The present chapter will use the previous discussion of the history of central banking and the outcome of the Maastricht Treaty negotiations to show the process of converging ideas and outline and evaluate the main design features of the ESCB and the application of these features in the Eurosystem. These design features had a profound impact on how the Eurosystem later approached the crisis. This chapter will investigate different institutional design aspects, price stability and independence, of the setup of the ECB. This section will, furthermore, discuss the strategy of the ECB and the instruments it primarily used before the crisis to fulfill the mandate. An understanding of the original independence, mandate, strategy and instruments is vital in analysing the institutional change during the crisis. These discussions will provide the backbone of the analysis for Chapters 6 to 8.

5.1 The institutional design of the Eurosystem

5.1.1 Governance

The ESCB is the organisation of currently all 28 NCBs of the EU and the ECB. The Eurosystem consists of the ESCB member states that have adopted the euro. The countries that have not yet adopted the euro are excluded from participating in the monetary policy of the Eurosystem. However, they are connected to the Eurosystem through the ESCB and are, therefore, also committed to price stability and to working closely with the Eurosystem on different central banking matters (Scheller, 2004, p.49). The only EU countries that do not have to join the euro-area are the United Kingdom and Denmark. The General Council that governs the ESCB consists of the 28 presidents of the NCBs and the President and Vice President of the ECB. The Governing Council governs the Eurosystem and consists of the 19 heads of the NCBs that have adopted the euro and the six members of the Executive Board of the ECB (see Figure 5.1). The Governing Council decides the direction of monetary policy in the euro-area.

The ECB works in close cooperation with the NCBs to devise and implement monetary policy operations. The NCBs are largely responsible for the daily operations of monetary policy and other matters of central banking, such as economic research, financial supervision and payment systems. The Governing Council is responsible for deciding the direction of the Eurosystem. These are, however, first discussed in various working groups consisting of central bankers from different NCBs to develop policy ideas and strategies. Once the policy is developed, the Governing Council decides whether or not it should allow its implementation. The decentralised structure of the Eurosystem requires the NCBs to execute the policy decision following its approval. Thus, the NCBs are to a large extent responsible for carrying out the decisions of the Governing Council using various monetary policy instruments (see below Chapter 5.1.4.). The key interest rates are the minimum bid rate on the main refinancing operations as well the marginal lending and the deposit facility. Other tasks include the conduct of foreign exchange operations, the management of the official reserves, and the operation of the payment system of the Eurosystem TARGET-2 (European Central Bank, 2008d, p.13). Owing to the financial crisis, the ECB and some of the NCBs, such as the Bundesbank and the Banque de France, have taken on increased responsibilities in ensuring financial stability and supervision.

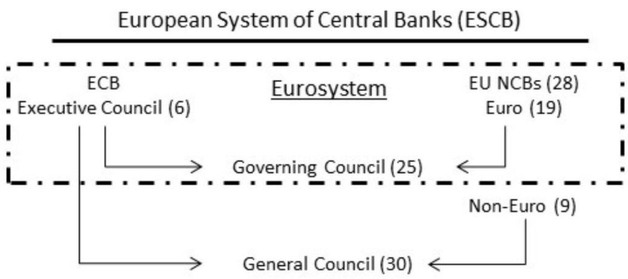

Figure 5.1: European System of Central Banks

The ECB is the only existing supranational central bank that consists of sovereign nation-states. The decentralised structure of the ESCB allows taking the institutional, political, economic and cultural diversity of the European countries into account. This argument becomes even more apparent when taking a closer look at the market structure of the Eurosystem. The diversity of the countries of the Eurosystem requires an in-depth knowledge of the financial and economic conditions in each country. Compared to the US and the UK, euro-area capital markets are shallow and make financialisation difficult for small and mid-cap firms. Most companies receive credit from local banks, so-called *Hausbanks* rather than from external investors. Therefore, a large number of credit institutions exist in the euro-area.[2] The NCBs maintain close relationships with the banks in each country and a purely centralised central banking institution could not do justice to these structural and

[2]In 2016, there were 5,906 credit institutions active in the euro-area and 7,720 in the EU as a whole. This statistic shows that the euro-area countries have a proportionally high amount of credit institutions (see, European Central Bank (2008b).

cultural differences in each country. Nevertheless, the NCBs have an advantage in maintaining the relationships with local banks in their countries. However, it is too soon to say what impact this might have on the scope of activities of the NCBs, in particular, in smaller countries, beyond being the partner of commercial banks for the main refinancing operations.

The Bundesbank operated its monetary policy on a decentralised basis during the first years of its existence. This framework was adopted for the Eurosystem (Quaglia, 2008, p.134; Chapter 2.1.2). During the late 1990s, when the Eurosystem came into existence, the main criticism of a decentralised monetary policy was that it was more complicated to execute monetary policy operations in a decentralised system (Buiter, 1999, p.204). This criticism faded when the Eurosystem started its operations and it became evident that the NCBs have an advantage in working with their national commercial banks in different European financial centres (Padoa-Schioppa, 2004, p.83-85). In the long-term, several interviewees from different NCBs and the ECB argued that the ECB will draw more responsibility and ultimately power towards the centre (BUBA1; ECB3; ECB5). At the same time, NCBs will take on specific responsibilities which they operate for the whole of the euro-area.[3] Another Bundesbank official argued in the interview that smaller NCBs favour this approach owing to their limited capacity and resources. These smaller NCBs cannot fulfill all central banking responsibilities including European monetary policy operations, financial stability and financial supervision in a complex and integrated financial system at the same time (BUBA12). Thus, these NCBs rely on larger NCBs and the ECB to take on complex responsibilities. As a result of the crisis, the ECB has increased its country-specific knowledge (ECB3) which is further evidence for draining responsibilities towards the ECB.

5.1.2 Mandate

The mandate that governs a central bank is a legal provision that sets out what the central bank has to achieve. In the Eurosystem, the mandate is a defining feature of what the ECB and the NCBs have to accomplish. The mandate of the Eurosystem has an impact on the *de jure* and *de facto* independence and the strategy of the ECB and the NCBs. The Maastricht Treaty sets out in Article 105(1): 'the primary objective of the ESCB shall be to maintain price stability.' This requires the ESCB

[3] The TARGET-2 system is an example of this development. The Bundesbank is operating the payment system for the entire Eurosystem rather than having each NCB having overlapping responsibilities in this area (BUBA1).

to contain inflation and prevent deflationary pressure. The secondary mandate is concerned with 'general economic policies'. Article 127(1) argues that,

> 'Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4' (Maastricht TEU, art. 127(1)).

Article 105(1) mandates the ESCB to maintain price stability as its primary goal. Although it is required to support 'general economic policies', the ESCB has to first and foremost focus on achieving price stability. This approach of structuring the mandate has allowed the 'The ECB appears to be the ultimate "narrow" central bank; it literally has a mandate for price stability [...]' (Schinasi, 2003, p.3). Thus, the importance of this narrow mandate was well intended during the foundation of the ESCB. A former member of the first Delors Committee recounted the decision to define the mandate of the ECB and its unique position for not having a political counterpart while at the same being prohibited to getting involved in the political sphere.

> 'Because the ECB was given a rather well-defined objective, mainly to maintain medium-term price stability this made it unnecessary to have political backing. [...] It was quite a deliberate decision, but as it turned out, of course you cannot quite as neatly separate price stability from the other tasks. When price stability is under shock to the extent we see here then a central bank has to act more forcefully and it does look like a more political actor' (ESCB3).

This statement demonstrates that the decision to have a narrow mandate on price stability was formed during the Maastricht Treaty negotiations. The interviewee acknowledges that in retrospect, and considering the severity of the crises, the ECB had to act 'forcefully' to overcome the challenges. This has made it appear more like a political actor. The ESCB is further required to comply with Article 4, which establishes the close coordination of economic policy to create a single market and the introduction of a common currency. In more detail, Article 4(3) refers to the importance of price stability: 'these activities of the Member States and the Community shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payment' (Maastricht TEU, 1992, art. 4(3)). The assumption is that price stability ensures competitiveness, makes it possible to compare relative prices over time and contributes to financial stability (European Central Bank, 2008b).

As discussed in Chapter 2.1.2, Eucken was convinced that price stability is the key element to ensure that competition can function unconstrained in a market economy. In the event that prices fluctuate, price signals would lose their value in showing the real value of a product. Thus, competitiveness would be influenced negatively (Eucken, 1989, p.255; Freytag, 2002, p.114). During the 1970s, the Bundesbank tackled stagflation by adhering to its mandate of price stability. Thus, the Bundesbank retracted its monetary expansion while the German government increased fiscal spending. This cooperation between the Bundesbank and the government allowed for price stability and overcoming inflationary pressure (Bundesbank, 1974, p.1 and 45). The Bundesbank model of price stability and independence became widely accepted as the norm for the effective conduct of monetary policy. A decade later during the Maastricht Treaty negotiations, the Bundesbank became the role model for the ECB. A senior official from the European Commission, who was closely involved in the Maastricht negotiations, argued in the interview that the provisions of the mandate and the independence of the ECB were easily accepted by the governments of France and Italy. Those elements were not considered controversial. Only the external relations of the ECB and the exchange rate policy caused concern in terms of their adaptability and feasibility in a currency union (EC1). This demonstrates the credibility of the Bundesbank in applying price stability and independence for overcoming economic challenges and increasing economic growth. The financial and sovereign debt crises, however, tested these virtues to the limit.

As a comparison, when taking a closer look at the mandate of the Federal Reserve System (Fed) it becomes obvious that it is more complex because it prescribes Fed to 'maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates' (Board of Governors of the Federal Reserve System, 1977). Thus, the Fed is required equally to maintain price stability and support employment levels. The mandate of the Bank of England (BoE), by contrast, is slightly different as it demands, the BoE to '(a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment' (Bank of England, 1998, art. 11). In this case, the BoE seems to also have a dual mandate that has an equal concern for both price stability and economic growth and employment. However, the BoE focuses predominately on price stability and only partially targets other economic factors. The UK Parliament and the BoE have a different perspective on the interpretation of the mandate. While the Parliament argues that the BoE should set both parts on an equal footing, the BoE argues that it only has the instrument of setting interest rates, which makes it difficult to influence economic factors (House of Commons, 2007, p.19-20). The comparison to the mandates of the Fed and the BoE demonstrates that the ECB is not alone in focusing on price stability. The major difference to those mandates is that the ECB almost exclusively focuses on its primary mandate: price stability. The three mandates, however, have in common that the central banks have the ability to interpret their mandate and how much weight they assign to each part of it. This shows the degree of independence from government that all three central banks have (see Dow, 2014). The next section will take an in-depth look at the independence of the ECB and its similarities and contrasts to the independence of other central banks. It will predominately focus on the independence of the ECB before the crisis. A detailed analysis of the changing importance of independence of the ECB during the crisis will be provided in Chapters 6 to 8.

5.1.3 Independence

As discussed in Chapter 3, the academic debate on central bank independence emerged following the collapse of the Bretton Woods regime and the subsequent success of the Bundesbank in containing inflationary pressure. Today, our understanding of central banking independence has further advanced. Blinder offers a useful definition: 'central bank independence means two things: first, that the central bank has the freedom to decide how to pursue its goals' (1999, p.54). Blinder refers to goal independence. It is an integral part of central bank independence in Europe (Crowe and Meade, 2008). Although governments define the mandate and provide the *raison d'être* for central banks, central banks can independently define their goals within the limits of the mandate. In the case of the Eurosystem, the euro-area member state governments have articulated the mandate for the ESCB in the Maastricht Treaty. Again, the ECB can independently define the goals necessary to achieve this mandate. The ECB decided to narrow down its mandate of price stability. It announced a numerical goal of below two percent of the Harmonised Index of Consumer Prices (HICP) in the medium term (European Central Bank, 2018a). Thus, the ECB took full advantage of having goal independence (see below).

Blinder further defines that central bank 'decisions are very hard for any other branch of government to reverse' (1999, p.54). He refers to the government's inability to undermine any decision the central bank has taken to achieve its mandate. Once the central bank has taken a decision on, for example, the instrument, the government has no legal right to interfere with this decision. Former ECB Executive Board member Lorenzo Bini Smaghi has assessed the different options governments have to influence an independent central bank. He argues that a government can use an excessive fiscal policy that might undermine monetary policy operations if they focusing on low inflation and overall price stability. Another option is to influence the appointment of a board member (Bini Smaghi, 2007). The French government tried and partially achieved this influence when it attempted to push the other euro-area national governments to choose Trichet over Duisenberg as the first president of the ECB (Chapter 6.1.1).

A national government can also influence the financial means a central bank has for its daily operational expenses. In the context of the Eurosystem, the national governments should refrain from reducing the financial independence of their NCBs, without which they could not carry out the tasks of the Eurosystem (Bini Smaghi, 2007). The governments are, by custom, further advised not to interfere using other measures that run counter to the policy decision of the central banks of the ESCB. This has not prevented national governments from trying to influence the decisions of the Governing Council. As discussed in Chapter 6.1.3, beyond the example of the French government aiming to force the decision to appoint a French national to become the first president of the ECB in 1998, the German government pressured the Governing Council to adopt an accommodative monetary policy to support economic growth in Germany and during the initial period of the financial crisis, the French government under Sarkozy criticised the ECB for its use of instruments.

However, despite the independence of central banks, these organisations are still, to varying degree, dependent on the institutional and legal relationship, accountable to their parliaments and their national governments. The degree of autonomy differs between central banks and remains a fluid concept. On the national level, even an independent central bank does not act in a political vacuum but tends to coordinate its policy approach to some extent with governments (Majone, 2014, p.173). In theory, an independent central bank does not succumb to the government demands if those demands are against the nature of the mandate. However, on the supranational level, fiscal and structural policy is difficult to coordinate between member states. Governmental resistance to an independent central bank are also much more difficult to coordinate than when there is a political counterbalance to the central bank. The only official channel is through the NCBs, which work with their national governments. The highest level of coordination between the Eurosystem and the national governments are the meetings of the Eurogroup, which consists of the euro-area Ministers of Finance and which meets once a month. The daily operations of the Eurosystem are decided by the Governing Council and its members are required to decide in the interest of the euro-area as a whole and not in the national interest. Nevertheless, any other branch or agency of government or in the case of the ECB any national government or any other EU institution are by law prohibited to overwrite a decision taken by the Eurosystem (Maastricht TEU, 1992, art. 7). The legal provisions of the Maastricht Treaty outline the *de jure* independence of the ECB. Article 107 outlines the independence of the ECB by stating:

> 'when exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and this Statute, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks' (Maastricht TEU, 1992, art. 7).

The legal provisions in the founding documents of the ECB argued for a strong position within the political and institutional environment in the EU. The Treaty established that the national central banks of the European Commission have to be independent of political influence on the national or international level as a requirement for becoming part of EMU. The Treaty outlines that 'Each Member State shall ensure [...] that its national legislation including the statutes of its national central bank is compatible with this Treaty and the Statute of the ESCB' (Maastricht TEU, 1992, art. 108). This article sets out the requirements of the national governments to make their central banks legally independent before they join the ESCB (Lenihan, 2008).

The ECB is unique in the sense that international treaties rather than national legislation codify the mandate and the foundational documents (Brentford, 1998, p.89). The member states have to ratify unanimously any changes to the constitutional basis of the ECB. In most euro-area countries, these votes often preclude the requirement of majority votes of their national parliaments. The international character of the ECB increases the legal obligations and makes the *de jure* independence of the ECB particularly strong. In comparison, the judicial independence of the Bundesbank can be revoked with a simple majority vote of the German Bundestag and is, therefore, much weaker than the *de jure* independence of the ECB (de Grauwe, 2012a, p.152). To change the foundational treaty of the ECB would mean gaining the required votes at the national and supranational levels. Any attempt at changing the legal foundations of the ECB would furthermore affect the constitutional basis of the EU. To change an international treaty through unanimous voting is a difficult task and provides the ECB with a strong independence effectively based on international constitutional law. The diverse political environment of the EU further strengthens the independence of the ECB and it is, therefore, deeply anchored in the institutional setup of the EU. It is difficult to remove it formally, because it is unlikely that there will be a unanimous agreement to change the statutes of the ECB, owing to the diverse views among the EU member states on central bank independence (Gros, 1998, p.356).

When bearing the German post-war history of its central bank in mind, it is likely that the German government would veto any campaign that aims at circumventing or reducing the *de jure* independence of the ECB and, by implication, that of the Bundesbank. The German veto alone would be sufficient to prevent a treaty change. Price stability and independence of the central bank are an integral part of the German understanding of how an effective central bank should operate. All other responsibilities, such as financial stability and supervision, were subordinated to monetary policy. As argued above, other European countries accepted these two virtues relatively easily during the Maastricht Treaty negotiations and had, apart from isolated incidents, not challenged this understanding (EC1) (see, Chapter 4.1). Therefore, a strong consensus exists among the European central banking community and politicians that central banks should operate independently from governments and that price stability ensures economic growth and reduces the volatility the business cycle. The financial and sovereign debt crisis challenged both assumptions (Chapters 6 to 8).

The years between the conclusion of the Maastricht Treaty negotiations and the start of the operations of the ECB saw the implementation of the three stages of the EMU. The European Monetary Institute (EMI) was founded to supervise the second stage of the monetary union (Chapter 4.1). In 1997, Wim Duisenberg became the president of the EMI, and once it was dissolved in 1998, he became the first President of the ECB. Nevertheless, there were tensions between the European national governments, the other European supranational institutions and the ECB about the independent nature of the ECB right from the beginning of its operations of the ECB.

In 2003, the case Commission of the European Communities vs. European Central Bank ruled by the European Court of Justice (ECJ) addressed the legal boundaries of the independence of EU institutions. The ECJ decided that although the ECB is independent of political influence, it is still part of the European Community (Case C-11/100, Case C-11/100). In the words of the ruling, 'recognition that the ECB has such independence does not have the consequence of separating it entirely from the European Community and exempting it from every rule of Community law' (Case C-11/100, Case C-11/100, para. 135). The ruling established that the ECB falls under the legislative power of the European Community. The ECB cannot act outside or against the legal provisions of the European Commission regardless of its judicial independence. When taking decisions, the ECB has to abide by the rule of the law of the EU and has to take the overall direction of the EU into consideration. The ruling defines the limits to the legal independence of the ECB. Beyond clarifying the position of the ECB within the EU, the EoJ decision argued that all community institutions, in particular the European Commission, the European Parliament and the ECJ, are independent of the political influence of the EU member states as well. The ruling specified,

> 'Community institutions such as, notably, the Parliament, the Commission or the Court itself, enjoy independence and guarantees comparable in a number of respects to those thus afforded to the ECB. In that regard reference may, for example, be made to Article 213(2) EC, which states that the Members of the Commission are, in the general interest of the Community, to be completely independent in the performance of their duties' (Case C-11/100, Case C-11/100, para. 133).

The ruling argued that community institutions, such as Parliament, the Commission and the ECJ have a similar independence as the ECB. Thus, this ruling established a high-level of *de jure* independence of the community institutions. The ruling further clarified that officials from the EU institutions are prohibited from taking advice from national governments.

> 'That provision states, in terms quite close to those used in Article 108 EC, that in the performance of their duties the Members of the Commission are neither to seek nor to take instructions from any government or from any other body and, further, that each Member State undertakes not to seek to influence those Members in the performance of their tasks' (Case C-11/100, Case C-11/100, para. 133).

At the same time, member states are not allowed to influence the performance of the tasks of EU institutions, such as the European Commission or the ECJ. The legal provisions made in the ruling are often missing in the debate on the independence of EU institutions, including the ECB. The underlying question is why the ECB is the only EU institution that is actively defending its decisions on the grounds of its legal independence, while institutions such as the European Commission and the European Parliament are much more influenced by national sentiments and political gamesmanship? It can leverage this institutional feature to the extent that the national governments of the Eurosystem do not question its independence and that it can use its independence to increase its influence over national governments. One can determine that, first, the exposure of the European Commission and the European Parliament to political pressure on their decisions derives from their inability to establish a similar *de facto* independence as the ECB. Considering the complex and diverging policy areas that the European Commission and the European Parliament have to deal with makes it more challenging for them to operate above political interests. The ECB has a narrowly defined mandate in monetary policy that allows it to focus primarily on price stability. In the case of the European Parliament, removing it from political influence would undermine the very nature of its existence.

The European Commission is perceived as a technocratic institution (Featherstone, 1994; Radaelli, 1999; Majone, 2005) which executes the policies of the European national governments (Pollack, 1997; Moravcsik, 1999). When taking a closer look, the European Commission is less technocratic than it appears. It works closely together with the European Parliament on a daily basis, which has resulted in a symbiotic relationship between the two (Egeberg et al., 2013; Fernández-Albertos, 2015). This has, of course, an impact on its decisions and how it arrives at these decisions. Furthermore, policies that have been decided by the European Commission and the European Parliament, such as policies in agriculture, environment and consumer protection, are implemented by the national governments and not, as in the case of the ECB, by the institution itself. Thus, each policy is again subject to interpretation by national officials that operate within different political and cultural institutional environments. Monetary policy operates differently in the euro-area. The Eurosystem NCBs work closely together to devise and coordinate policy decisions and instruments. Technocrats rather than politicians work in the Eurosystem with the single aim of achieving the common mandate (BUBA12). At least at an operational level, in contrast to the European Commission and the European Parliament, the Eurosystem central banks are further removed from political gamesmanship owing to the institutional independence of the Eurosystem as a whole. On the Governing Council level, decisions can take on a political nature owing to changing macroeconomic and political circumstances, and to extensive political pressure from national governments. However, the policies underlying the decisions taken by the Governing Council are already discussed and deemed acceptable to the Eurosystem NCBs on various working levels and by expert groups before they reach the Governing Council (BUBA12). Furthermore, the NCBs maintain close working relationships with domestic and international banks in their countries and the policy recommendations that reach the Governing Council are often already mediated with market participants and other domestic actors. Nevertheless, the ruling and its ramifications for the operation of the other European institutions should demand further research (ECB2; BUBA11; EC1).

5.1.4 Strategy

Devising a strategy to achieve its mandate is paramount for any central bank. The independence of the ECB allowed it to develop the strategy itself without interference from national governments (referring back to Blinder's definition of independence). The strategy of the ECB focuses on how to achieve price stability as prescribed in the mandate. Otmar Issing, the former Chief Economist of the Bundesbank who became Chief Economist of the ECB in 1998, was tasked with developing the strategy to achieve the objective of the mandate. The Governing Council adopted its stability-oriented monetary policy strategy in October 1998 (European Central Bank, 1998, 2009; Issing, 2003a, 1999). The ECB based its strategy on a quantitative definition of price stability and to achieve this quantitative definition of price stability, it devised 'two pillars' (European Central Bank, 1999, pp.44-45). The ECB defined price stability to be 'as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 %' (European Central Bank, 1999, p.46). This inflation target should be achieved 'over the medium

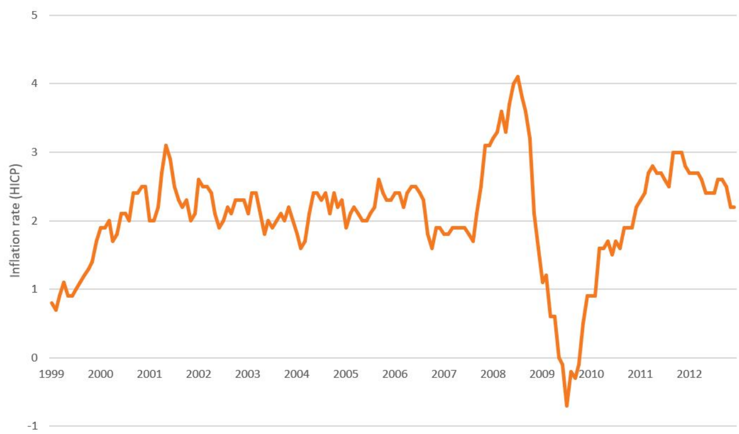

Figure 5.2: Inflation rate (HICP), annual percentage changes

Source: ECB Statistical Warehouse

term' (European Central Bank (1999, p.46); European Central Bank (1998)). The numerical definition of price stability strengthens the commitment of the ECB to achieve the mandate. The strategy further limits a potentially expansionary monetary policy of the ECB as it effectively anchors inflation expectations (Issing, 2003a, p.12). At the same time, the strategy is symmetric, because it considers deflation and inflation to be a risk to welfare enhancement (Issing, 2003a, p.5). Issing further argued, '[The former] can be substantially reduced by avoiding that inflation falls below some safety margin - say below a threshold of 1% – on a sustained basis' (Issing, 2002). Overall, Issing, approved by the Governing Council, defined a numerical bandwidth where inflation should fall into below, but close to, two percent (Issing, 2003a). When taking a look at the euro-area inflation rate between 1999 and 2015, it becomes obvious that there was a high fluctuation during the crisis years, while the period between 2001 and 2007 showed a remarkable stability around two percent. As Figure 5.2 indicates, the ECB had great success in keeping inflation within its defined bandwidth until the financial crisis.

Based on the definition of the strategy, it, further, entailed the so-called 'two pillars' of effective monetary policymaking. Monetary policy can have time lags from its implementation to taking effect, the so-called time-inconsistency. Therefore, the ECB argued that it has be foreword-looking in its strategy and, first, prescribe 'a prominent role for money, as signalled by the announcement of a reference value for the growth of a broad monetary aggregate' (European Central Bank, 1999, p.46). This approach was designed to allow the ECB to constantly monitor the supply of money in the Eurosystem. The first pillar outlines that inflation and deflation are foremost monetary phenomena (Issing, 2003a, p.20). The second pillar was 'a broadly based assessment of the outlook for future price developments and the risks to price stability in the euro area as a whole' (European Central Bank, 1999, p.46). The second pillar demands that the ECB conducts regular economic assessments to monitor inflation rates (Issing, 2003a, p.5). According to the ECB, the strategy helped to overcome initial concerns over transparency and accountability of the ECB. The policy approach of the ECB has shown that although it closely monitored macroeconomic projections in the euro-area, the ECB had remained firm in relying exclusively on these tools (Duisenberg, 2001; Issing, 2003a, p.25).

While the second pillar has not attracted much controversy, the first pillar has received criticism for a variety of reasons. A major concern is that there is no apparent relationship between the money growth M3 and the Governing Council's decision on interest rates (Gerlach, 2004, p.392).[4] This has gone so far that the Governing Council repeatedly argued that an increase in the money growth stems from exogenous factors, such as rising oil prices and changes to the preferences of commercial banks for their portfolio compositions and does not signal the 'risk to price stability' (Gerlach, 2004, p.292-293; Grilli et al., 1992, p.25). Therefore, it seems that the ECB has repeatedly missed warning signs of a rising asset bubble in different euro-area countries. Providing the mandate with a numerical definition without specifying what the details of the strategy entail turned the ECB, on the one hand, into a technical central bank and, on the other hand, into an institution that is not sensitive enough to the risks of price stability, such as inhibiting economic growth and potentially higher unemployment. Indeed, as discussed above, the independence, further, allows the ECB to operate above politics if it chooses to do so. The narrow numerical mandate and its strategy, however, came back to haunt the ECB during the financial and sovereign debt crisis. The mandate and the strategy constrained the ECB in its scope of action and the crises revealed that these factors made it difficult for the ECB to overcome extreme financial upheavals. Indeed, as the strategy and the mandate are deeply interconnected, the economists and policymakers have not only continuously debated the suitability of the strategy but also the sustainability of the mandate, in particular during times of crisis.

Before the crisis, there was a recurring debate over the following four questions:

[4] According to the ECB, M3 'is the sum of M2, repurchase agreements, money market fund shares/units and debt securities with a maturity of up to two years' (European Central Bank, 2008b).

(1) should the ECB change the ceiling from two percent to a higher percentile? (2) Should the ECB put equal weight on its primary mandate of price stability and its secondary mandate to support the general economic policies of the union? (3) Should the keep the mandate at two percent but allow for exceptions? Or (4) should the ECB not change its mandate to retain credibility (see, e.g. Ullmann, 2003, p.46-50). The financial and sovereign debt crisis opened up the debate again, because a narrow mandate of close to two percent inflation is difficult during an expansionary monetary policy, which is most likely required during an economic downturn. There are voices that the ECB should adopt a mandate that analyses the real economy in more detail, such as unemployment rates and economic growth. One interviewee, who is a US-based journalist comparing the policy decisions of the ECB and Fed, was in favour of this approach and stated:

> 'I think in principle it is a good idea. However, given the low level of political integration in the ECB and the lack of any democratic components to it, we have seen in the euro crisis that you can forget the European Parliament. It has been totally useless in this crisis. But given that lack and low level of political integration there is no political mandate to increase the economic mandate of the ECB. Yes, a good central bank would also take into account unemployment and other economic factors besides price stability [...]' (PS3).

The interviewee argued that the ECB should have an extended mandate that provides a larger role to increasing economic growth, including reducing unemployment. One can see the comparison the US-based journalist draws to the Fed. As discussed above, the mandate of the Fed requires it to support economic growth and policies that reduce unemployment. The interviewee claimed that the European Parliament did not act sufficiently during the crisis, which left the ECB to take on a political role yet without a political mandate. The interviewee argued that the ECB should expand its mandate to an economic mandate to overcome this institutional liability. Another interviewee from the public sector who has worked for the British government but has Southern European roots was also in favour of changing the mandate of the ECB but cautioned that the ECB would require more data to analyse the different economic situations of the euro-area (PS7).

However, an interviewee from the private sector who is advising central banks was strongly opposing the idea of mandate change. He argued, 'No I don't [...] think if you give central banks those kind of targets [percentage of unemployment] you are moving even more into the political sphere. You might as well abolish the Ministry of Finance and hand the economy over to the central bank' (PS2). The interviewee was British and his perspective on the relationship between the central bank and the Treasury comes out in this statement. He argues that central banks should only focus on delivering price stability and refrain from other targets that are in the responsibility of other government departments. He sees no benefit in allowing the central bank to manage the economy beyond price stability. A former board member of the ECB argued that considering the difficulties during the crisis years, the ECB has worked well to ensure that its primary mandate would stay on its target. He argued, 'well given the constraints, I would say that it has done a good job. I think with respect to price stability the overall result is good' (ECB5). He went on to argue that the ECB already uses its secondary mandate to analyse the macroeconomic conditions of the euro-area. He maintained,

> 'First of all, the ECB does not have a single mandate. The statue say that it has to support the economic policies of the Union. It is very good that it has a well specified primary mandate. It is subject to the ECB not being in a vacuum to implement policies and looks at the conditions in which the economy is developing. I would not change the mandate. Financial stability is the mandate of the SSM, the Single Supervisory Mechanism. It is well separated from price stability. Monetary policy would be primarily used to achieve price stability. This is by the way the case of all central banks except the Fed. It is the case of the Bank of England and most other central banks' (ECB5).

His statement not only teases out the relevance of the secondary mandate of the ECB, but also the emerging role of the Single Supervisory Mechanism (SSM) within the structure of the Eurosystem. Although he argued that there is no conflict of interest, there is certainly a wider spectrum of responsibilities and points of contacts with commercial banks and the Eurosystem as well as with the ECB. This might allow the ECB to have a more complete dataset when it takes decisions. The ECB does, however, bear the risk that it becomes invested in the interests of the private sector and has greater difficulty in deciding in the interests of society and not only of the financial sector. Hyman Minsky warned that a central bank might become involved with a commercial bank to the extent that the moral hazard prevents the central bank from allowing the commercial bank to collapse (Minsky, 1985, p.17-18). Indeed, as the interviewee pointed out, most central banks of developed nations have a mandate that entails price stability. Nevertheless, it is a question of weighing the different parts of a mandate. The ECB is particularly focused on price stability and does not concern itself with supporting economic policies of euro-area member states. This has partially changed as a result of the crisis, specifically because of the non-standard and unconventional instruments, such as the Securities Markets Programme (SMP) and the Outright Monetary Transactions programme (OMT) (Chapters 7.2.1 and 8.2).

5.1.5 Instruments

The previous sections have analysed the independence, the mandate and the strategy of the ESCB. The mandate prescribes the ESCB to conduct a monetary policy focused on price stability and the ESCB's independence ensures that the Eurosystem can operate without government interference. As discussed above, in October 1998, the Governing Council officially adopted its stability-oriented monetary policy strategy (European Central Bank, 1998, 1999; Issing, 2003a, p.46). Before the financial crisis, the Eurosystem had a range of instruments at its disposal which central bankers consider to be standard policy measures. To achieve the mandate, the ESCB is allowed to a) 'operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals'; b) 'conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral' (ECB, Protocol on the Statutes, art. 18). These instruments allow the Eurosystem central banks to engage with commercial banks to provide or retrieve liquidity from the financial system and take into account the high number of credit institutions in the euro-area. These measures are foremost tools to refinance banks. In the short term, these are called main refinancing operations (MRO) (up to one week), or in the long term, they are called longer-term refinancing operations (LTRO) (up to three months). The MRO is the primary monetary policy instrument. The interest rates the ECB charges on these operations make up the official reference rate. These loans are offered through a tender process to allow an equal opportunity to interested banks across the euro-area. The NCBs are responsible for working closely with their domestic banks and execute these operations. This allows banks to always to have a sufficient supply of capital. These operations then trickle down into the real economy, because commercial banks either have more or less capital to lend to corporates depending on the price, availability and maturity of the refinancing operations. The Eurosystem central banks aim to work together with at least 25 or more commercial banks on every transaction to have a clear picture of the market and not distort the bidding process towards selected financial institutions. The process does not favour any specific bank in any of the euro-area countries (BUBA15).

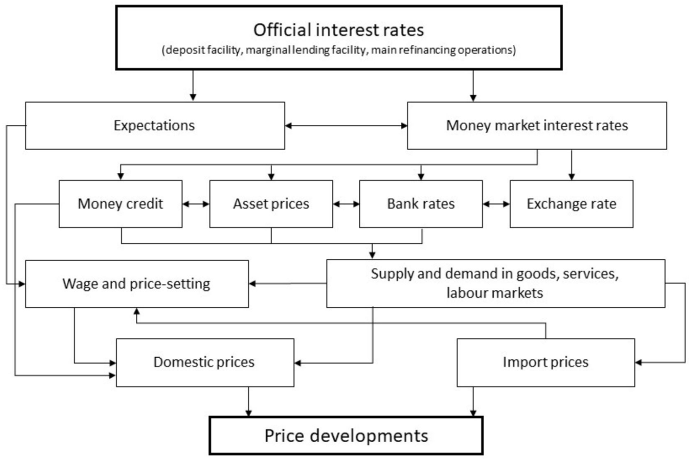

Figure 5.3: Transmission channel

In more detail, market participants can lend unlimited amounts of capital in overnight facilities against accepted collateral. Thus, financial institutions can effectively park excess liquidity and receive interest on it. The MRO and LTRO instruments create a corridor in which the overnight money market fluctuates, which is a reference point for market participants and provides the ECB with room to manoeuvre (Micossi, 2015, p.4). Financial institutions that provide credit are, furthermore, required to maintain minimum reserves with their NCBs. Collateral used as reserves has to have up to two years' maturity. These measures are designed to stabilise interest rates on the money markets to continuously have scarce liquidity to overcome short-term funding difficulties (Micossi, 2015, p.4). The eligibility of collateral is, furthermore, an essential channel for central banks to steer financial markets. Central banks can influence collateral by increasing or decreasing the availability or change structural requirements using the regulatory environment (Dudley and Debelle, 2015, p.4). For example, during early 2010, rating agencies started to downgrade Greek sovereign bonds, making them ineligible as collateral for the ECB. Thus, in May 2010, the ECB introduced a waiver for sovereign debt issued or guaranteed by the Greek government to circumvent funding difficulties (European Central Bank, 2010b). Other policy tools are foreign exchange swaps, collecting fixed-term deposits and issuing debt certificates, designed to drain liquidity (Micossi, 2015, p.4).

As Figure 5.3 shows, the key interest rate charged on the main refinancing operations is an important price signal for the economy and affects expectations of market participants. The Governing Council decides on setting the interest rate every two weeks. The ECB can affect wage setting and ultimately the price level when it combines the three key interest rates of the main refinancing operations and the lending facility and the deposit facility. Monetary policy is, therefore, directed to the real economy through the transmission channel. During the financial crisis, the ECB used non-standard measures to provide adequate liquidity by, for example, extending the short-term loans of the main refinancing operations from two weeks to three years and reducing the eligibility of collateral for commercial banks. In 2010 and again in 2012, the ECB feared that the transmission channel would break down and decided to make outright purchases in different sovereign bonds segments. This started a major debate across the euro-area between national governments, NCBs, various interest groups and the public about whether its narrow mandate allowed for this intervention (Chapter 7.2.1 and 8.2).

In comparison, the Fed uses outright purchases and sales of assets in the primary and secondary market as its main instrument. It constantly buys and sells US government bonds with varying maturities to and from selected banks. When the Fed buys US sovereign bonds, it credits the amount to the account the commercial bank has with the Fed, thus, increasing liquidity in the system (Board of Governors of the Federal Reserve System, 2017). These transactions can be further extended by agreeing that the Fed or the bank can repurchase any of the securities in the future (Rehbock, 2013, p.1). This approach is well-suited for the market-based economy of the US. During the financial crisis, the Fed considerably increased the volume of its purchases and extended the range of assets it would buy. It currently holds two trillion dollars (55 percent of its total assets) on its balance sheet. Before the crisis, the ECB did not consider making outright purchases in the sovereign debt markets of specific euro-area member states, mainly because its constitutional design explicitly prohibited it from making these transactions to prevent the ECB from supporting weak economies at the expense of stronger ones. Even after introducing the SMP and OMT, the ECB only holds about eight percent of total assets on its balance sheet (Rehbock, 2013, p.2). The Fed, despite its decentralised institutional structure, only executes monetary policy through the Federal Reserve Bank of New York and it only works with selected banks. Its key interest rate does not result from the borrowing rate, as is the case in the Eurosystem, it is the rate of the US overnight lending market between banks. The Fed influences this rate through its purchasing programmes and, therefore, makes daily interventions into the interbank lending market (Rehbock, 2013, p.2).

The institutional design of EMU and the Eurosystem has developed a central banking system that was able to manage a currency for now 19-member states. The key features, such as the mandate, independence and the instruments were tried and tested predominantly at the Bundesbank before they became a part of the Eurosystem. Several features that were negotiated in the Maastricht Treaty, however, did not live up to the expectations of central bankers and politicians to make the financial system stable. Indeed, the financial and sovereign debt crisis challenged the foundation of the euro-area, in particular, because of the missing lender-of-last-resort (LLR) function of the ECB and the 'one-size-fits-all' approach to monetary policy in a heterogeneous economic and political landscape. Both features have almost resulted in a collapse of the single currency.

5.2 Drawbacks of the Eurosystem

5.2.1 'Lender-of-last-resort'

In 1873, Walter Bagehot, the founding father of modern central banks, argued that central banks should lend as much as possible, in exchange for good collateral, in times of financial crisis. This would prevent a confidence crisis and a bank-run (Bagehot, 2012). This advice developed into the central bank mantra of the Western world. Historically, the lender-of-last-resort (LLR) was either the central bank or the sovereign. With the emergence of the modern central bank at the beginning of the twentieth century, the LLR responsibility in Anglo-Saxon countries moved to the central bank while in countries on the European continent, the LLR responsibility moved to the government. Depending on the circumstances and the company that required a bailout, either the central bank stepped in using monetary policy instruments or the government using fiscal policy means. Both would essentially ease liquidity shortages and overcome solvency issues. The creation of EMU made these processes more difficult because it moved sovereignty over issuing money to the supranational level. National governments lost the ability to borrow in their own currency and could no longer manipulate the exchange rate to reduce the value of their currency to increase competitiveness. This had far-reaching consequences for the sustainability of debt for governments in times of crisis. The decision to have a common currency on the supranational level made the concept of LLR more difficult to apply.

For example, during the 2007 financial crisis, the Fed and the US Treasury worked closely together to negotiate the bail-out of a number of insolvent financial institutions. Both institutions worked together either to support the failing financial institution or broker their sale to another financial institution (Chapter 6.1.1 on the Fed's role of brokering the sale of Bear Stearns to JP Morgan). There is, however, an inherent risk for the LLR that the company under stress is too big to be bailed out. Thus, there is often a close relationship between the central bank and the national government to cooperate on bailing out major firms. This can, however, have negative consequences if the company is beyond the capacity of the sovereign or if the central bank is prohibited from supporting the government, which is the case in the Eurosystem.

In modern financial markets, banks and governments are deeply interconnected. Banks rely on sovereign bonds to fund their lending operations. The sovereign bonds are used as collateral to borrow cheaper bonds with shorter maturities from central banks. Governments rely on banks to buy and hold sovereign bonds to fund the public budget. There is what De Grauwe calls a 'deadly embrace' between the lending behaviour of banks and borrowing behaviour of governments (2013, p.2). Financial institutions tend to lend on long maturity and borrow on much shorter maturity and have their liabilities mainly in deposits and saving accounts. Investors and customers can withdraw their investments very quickly, which makes them highly liquid. In contrast, the assets of financial institutions are mostly illiquid mortgages and long-term loans. The balance sheet of the bank is, therefore, unbalanced in terms of liquidity between lending and borrowing. The government has an unbalanced balance-sheet as well. It borrows money through liquid sovereign bonds but retains assets that are highly illiquid. The assets of governments are predominately infrastructure and tax claims. Infrastructure projects need years of development and are difficult to sell. Tax claims can only be extracted from a sovereign government and not be sold. To increase taxes when liquidity is most needed is furthermore difficult because the policy undergoes a long democratic process with an uncertain outcome (de Grauwe, 2013, p.4).

Considering the unbalanced nature of the balance sheets of the banks and governments, the deadly embrace occurs when a system-relevant bank experiences a large-scale withdrawal of its deposits. This most often occurs when investors and customers of the bank withdraw their deposits because they are afraid that the bank does not have enough liquidity, which will leave the customers without access to their money. Often customers and investors withdraw their money for as long as possible, and the sudden withdrawal of capital presents the bank with deeper liquidity problems. Thus, although the assets of the bank might still make it solvent, the nature of those assets makes them difficult to sell. A global financial crisis increases this risk. The bank is, therefore, solvent but has no short-term liquidity to pay back money to customers and investors. The government and the central bank have to make a choice. They can either step in by providing enough liquidity for the bank to survive the withdrawal of liquidity or let market forces decide the fate of the bank.

However, considering that a major bank most likely holds a high volume of sovereign bonds (even just to stay above the minimum capital requirements for its lending operations), the government might get into funding problems itself if the bank collapses. The government might not be able to pay the interest rate on its sovereign bonds. Furthermore, the threat that a bank collapses and the deposits of its customers are lost can spark a larger crisis that might question the liquidity of other banks. The difference between illiquidity and insolvency is not easily distinguishable, in particular in fluid market conditions. In times of a crisis when 'animal spirits', a term that Keynes first used to describe 'the spontaneous urge to action rather than inaction' (2008, p.161-162) start to guide actions, the public and the market might overreact and withdraw their deposits. This can push a bank from being temporarily illiquid to insolvent. In this situation, the government is well advised to act through fiscal policy and provide enough liquidity to calm financial markets. The central bank can do its part through monetary policy instruments, which allow for a much quicker and larger injection of capital. For example, it can provide emergency lending, buy assets from the bank to free up additional capital or lower as well as waive the collateral requirements.

The 'deadly embrace' turns deadly when banks demand higher interest rates from governments on their sovereign debt or when the government has taken on so much private debt that it can no longer service its debt through the budget. In a political environment in which the LLR responsibility lies with the government rather than with the central bank, this is a constant threat in highly indebted countries. In this case, a sovereign debt crisis can emerge. This can have two main scenarios: First, the bank is too big to fail, meaning that its liquidity needs are larger than the liquidity the government can provide through its budget or it is outright insolvent. Second, if the government transfers too much private debt into public debt, it risks becoming either illiquid or insolvent, which puts the government at risk of default. In both cases, the central bank can step in and provide the needed liquidity through an expansionary monetary policy that is either directly targeted at the financial sector or at the government. In the case of insolvency, the central bank funding can keep the bank afloat as long as it dissolves it in an orderly fashion or ensures that the government can service its debt.

The institutional design of the ECB, however, prohibits it from providing liquidity to individual banks. The NCBs are responsible for providing liquidity to the banks in their jurisdiction. The ECB, however, has to analyse these operations and can only agree to them if they are not affecting price stability (Apel, 2005, p.183). This design removed the fail switch. The ECB is further prohibited from bailing out a national government. These elements were added to the foundational documents of the ECB to reduce the moral hazard problem among European banks and governments. If banks or governments know that they will be bailed-out in case of illiquidity or insolvency issues, they might act more riskily than if they knew that this option was not possible. In addition, if a bank or government spends more than it earns and has to be bailed out, European taxpayers would have to pay the bill. For these reasons, at the request of the German government, the ECB only received a limited LLR role (Schulz-Forberg and Strath, 2010, p.49).

The LLR should work as a final barrier to ensure that the major banks and the government are liquid in times of severe crisis. The interconnectedness between banks and governments goes back centuries and bank runs have occurred on several occasions in the developed world throughout the past century. The novelty with the foundation of the ECB is that the central bank is not only removed from the national level, but it is by its founding documents prohibit it to act as an LLR. The sovereign debt crisis has brought this issue to the forefront of crisis management. All periphery countries apart from Ireland were already highly indebted compared to the EU and euro-area average. Once the financial crisis started, Ireland as well as the other periphery countries experienced a significant increase of debt level in percentage to GDP (see, Figures 5.4 and 5.5).

In the recent crisis, the loss of confidence in some of the national banks and the quick withdrawal of liquidity from foreign investors further reduced the ability of banks in periphery countries to fund them. National governments took on or guaranteed a large amount of the debt from the banks, reducing their ability to service the debt. It took the ECB several years to develop adequate instruments to circumvent its mandate on this issue. Instruments, such as the SMP, were used to reduce the

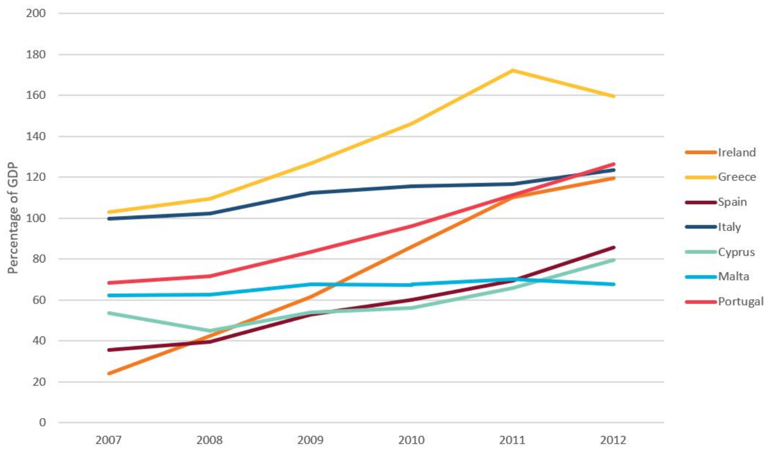

Figure 5.4: General government gross debt periphery countries (2007 – 2012)

Source: ECB Statistical Warehouse, (EDP concept), consolidated – quarterly data

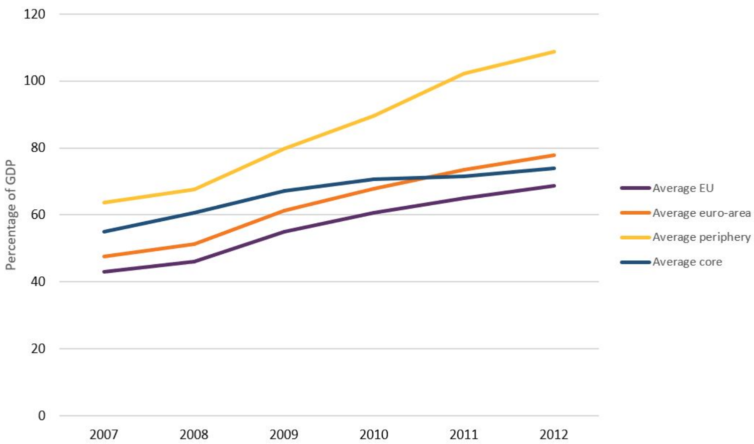

Figure 5.5: General government gross debt European averages (2007 – 2012)

Source: ECB Statistical Warehouse, (EDP concept), consolidated – quarterly data debt burden of periphery countries. The no-bail out clause and the prohibition of financing government expenditure continue to make using purchasing programmes ambiguous at best. The significant structural and institutional differences between euro-area member states have made it difficult for the ECB to develop a monetary policy that does not operate to a disadvantage of individual member states. The lack of a central government in an incomplete currency union has made these difficulties even more pronounced.

5.2.2 'One-size-fits-all'

The Euro-area was created to allow for the free movement of goods, services and people in order to integrate the European political and economic landscape. An important line of argument in monetary policy theory has rightly asked whether the Euro-area can survive without being an optimal currency area (OCA)? A 'one-size-fits all' monetary policy was long considered to be, on the one hand, indecisive, for example, large adjustment costs and a beneficial inflation rate might cancel each other out (Ricci, 2008, p.24). On the other hand, OCA is incompatible with countries that have a high level of structural and institutional differences, such as the euro-area member states (Jager and Hafner, 2013, p.320). The theory behind OCA was inspired by Mundell (1961), McKinnon (1963) and Kenen (1969) and, based on a post-Keynesian economic understanding, Mundell argued that a central bank of an OCA cannot simultaneously adjust for price stability, exchange rate stability and the free movement of capital (Mundell, 1961). The theory investigated the costs and benefits of establishing a common currency area. The many costs of a country of being part of an OCA included its inability to have a national currency, effectively causing the country to lose sovereignty over monetary policy. Devaluing the currency becomes impossible for individual countries, forcing them to use structural and fiscal policies to increase competitiveness. The benefits of OCA are, predominately, better cross-border investments, because exchange rate fluctuations and associated transaction costs do not exist. Further, trade in products and services across borders is easier because of price comparability (de Grauwe, 2012a). Padoa-Schioppa (1987) extended the framework by arguing that the task is made even more impossible considering that the free movement of goods, services and people will continuously shift economic forces across the currency area.

The strategy of the ECB argued that the key interest rates of the Euro-area should be the same across the union and reflect the economic conditions of all euro-area member states (Issing, 2003b). The drawback of this 'one-size-fits-all' approach was

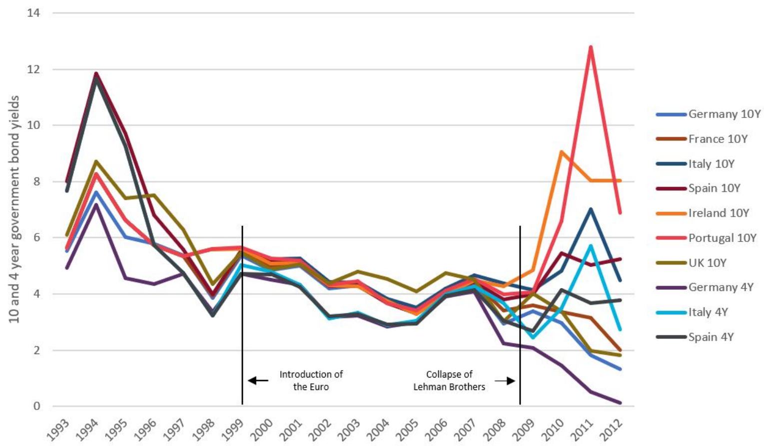

Figure 5.6: Euro-area 10-year government bond yields between 1993 and 2011

Source: Bloomberg, yearly data

that either free capital market forces would have to balance imperfections between member states or fiscal and structural policy interventions of the national governments were required if the national inflation rate was above or below the euro inflation rate. In retrospect, neither capital markets nor governments balanced the euro-area. Financial markets assumed that all member states had a similar inflation rate and default risks and their bond yields, therefore, converged to the relatively low level of the German Bunds (see, Figure 5.6). Periphery countries, such as Italy, Spain, Portugal, Ireland and Greece, refrained from reducing economic expansion during periods of growth, thus, further increasing the national inflation rates (see, Figure 5.5 and Chapter 7.1).

Issing, the former Chief Economist of the ECB, defended the 'one-size-fits-all' policy approach. The diverging economic conditions across the euro-area member states were less of a concern for Issing. He referred to the clear mandate to maintain price stability,

> 'a central banker must be charged and certainly is charged in Europe with the maintenance of a stable price for money. And there can be only one price for it, not as many as the regions, the provinces, the cities, the areas of human economic activity in which money is used' (Issing, 2001, p.448).

Issing asserted that price stability is the overriding principle of the ECB. Thus, stable prices will be a valuable tool for promoting the convergence of the different economic regions. Considering that the ECB has only a single mandate, it has to apply the same monetary policy across the EMU. In 2005, Issing summarised the concerns of a single monetary policy at the start of the EMU and how the mandate of price stability had a positive effect of converging these economies:

> 'The desirability of a single monetary policy for the euro area was highly debated at the start of Economic and Monetary Union (EMU). Indeed, the common judgment on the ECB's policy in the early stages was that it was too tight for low growth countries such as Germany or Italy, and too loose for high-growth countries such as Ireland and Spain. Complaints declined over time, due to the gradual reduction in the diversity of inflation rates and the stable dispersion of GDP growth rates among euro area members' (Issing, 2005).

Issing argued that critics who were against implementing a single monetary policy for structurally and institutionally diverse countries had been proven wrong after the first years of the euro-area. Although he acknowledged that the single inflation rate was difficult for low-growth as well as for high-growth countries, the convergence of the inflation rate helped to disperse GDP growth across the euro-area. The crisis, however, further revealed that the convergence among the euro area member states was less than it was anticipated in 2005 (Issing, 2008). The perceived convergence was largely hidden by cheap credits and the high exposure of core banks to periphery assets. Once the crisis hit, these flaws in the design became obvious. The lack of a fiscal re-balancing of the euro-area, high foreign direct investment from Germany to the periphery countries and cheap credit spurred by low-interest rates across the Western world masked the structural differences between the euro-area member states. When the crisis hit Europe, structurally weak periphery countries were unable to devalue their currencies to remain competitive with the core countries. The instant withdrawal of capital from the periphery to the core further intensified the crisis. These events limited the policy options of the ECB and the national governments. The stringent austerity measures imposed by the core countries on the periphery countries further increased the financial and economic difficulties of the euro-area as a whole.

5.3 Conclusion

EMU has so far been a great achievement in terms of economically integrating a highly diverse region. It has established institutions and channels to allow the free movement of goods, services and capital across the euro-area. Although the mandate, strategy and the instruments of the ECB were based on sound economic and monetary policy theories at the time of its foundation, the drawbacks of not having an LLR while operating in an incomplete OCA emerged as a real threat to the survival of the common currency. The ECB was unable to prevent housing and credit booms in periphery countries while other regions had periods of low growth rates (*The Economist*, 2009). The following chapter will turn towards the response of the ECB during the first two years of the crisis. During this time, the one-size-fits-all policy approach of the ECB discovered its limits. Chapters 6 to 8 will address, how the financial and sovereign debt crisis unfolded and tease out the policy response of the ECB. The ECB had significant difficulties in overcoming the severity of the crisis, specifically after the fallout from the financial crisis spilled over into the sovereign debt sphere. The instruments conceived during the 1990s were not designed to relieve financial pressure from corporates and national governments. Thus, the ECB, has fought an uphill battle to contain the fallout from the institutional mistakes that were made during the early 1990s. A detailed assessment of the ECB policy response to the financial crisis between 2007 and 2009 is necessary to better understand the ideational change of the ECB and the Eurosystem.

Chapter 6

The financial crisis hits the ECB

> 'Since 2008, there has been an extension of central bank powers. Had any government proposed them in normal times, there would have been an uproar.'
>
> Private sector banker from the UK who works closely with the ECB (PS2)

The financial crisis, which started in 2007, threw the Western hemisphere into an economic and political whirlwind and developed into the European sovereign debt crisis in late 2009. The drawbacks of Economic and Monetary Union (EMU) demonstrated the fragility of the financial sector the fundamental market differences among the member states. The crisis further demonstrated the instability of having a monetary union without a central government and no fiscal mechanisms to counter and eliminate asymmetrical shocks. The challenge is that financial and economic crises are no longer contained in one particular country (Shambaugh, 2012, p.157-159). The Eurosystem has undergone profound changes since this tumultuous period. The ideational frameworks and structures that governed the euro-area financial system have been critically redrawn. Traditional instruments used to tackle these types of crises, such as setting the interest rate on the main refinancing operations (MRO) or manipulating the exchange rate, were either not effective or not available in an incomplete currency area with extensive structural and institutional differences among member states. The European central banking community, in particular in the euro-area, pulled together to prevent the financial crisis from spiraling out of control. Thus, the ECB was among the first major central banks to take decisive action to increase liquidity. The data collected from the interviews reveals that the economic ideational framework that provided the basis of monetary policymaking before the crisis was quickly pushed aside to make space for a pragmatic and outcome-oriented approach, shared by the epistemic community of central bankers in the Eurosystem. This chapter analyses the major events during the financial crisis between 2007 and 2009 that led to a reconsideration of the economic ideational framework of ordoliberalism. It will further assess the role of the ECB during the instance of the Irish deposit guarantee. In this instance, the ECB, for the first time, stepped out of its mandate and politically pressured the Irish government to comply with the overall interests of the euro-area.

This chapter, therefore, argues that despite the previous influence of economic ideas on shaping the policy response of the ECB and the Eurosystem, during the financial crisis, Eurosystem central bankers decided under pragmatic considerations rather than ideational grounds. This allowed them to quickly adapt to changing circumstances. The ECB, however, for a short period of time, fell back into into its old habit of using ordoliberal ideas to influence its decision-making. During 2007, the ECB did not decrease interest rates and relied solely on providing liquidity through injections and swap agreements with other central banks. In the summer of 2008, when the crisis tensions decreased, the ECB increased interest rates to retrieve excessive liquidity from the financial market. Two months later, Lehman Brothers collapsed. This decision is now considered among the worst of crisis.

The financial crisis started on August 6, 2007, when American Home Mortgage, one of the major home loan issuer in the United States, filed for bankruptcy. Following the announcement, the mortgage market and real estate market in the United States further deteriorated and engulfed homeowners, lenders and, investors. On August 9, BNP Paribas suspended trading of three of its funds worth approximately two billion euros, stating that it was unable to value accurately its assets in both funds. Thus, the financial crisis effectively started, because financial institutions were unable to determine the real value of their assets (Mizen, 2008, p.532). The 'Minsky-moment' had arrived to the global financial system. The long period of economic growth of the Great Moderation led to over-confidence and over-investment among investors which resulted in a major collapse of the business cycle. Just as Minsky had predicted more than 30 years earlier, increased risk-taking among financial investors, fuelled by cheap central bank money resulted in the worst financial crisis since the Great Depression in 1929 (Minsky, 1982a; Chapter 2.1.3).

During the following months, more reasons emerged that had a direct impact on the emergence of the financial crisis. For example, the extensive provision of credits to low-income earners, ethical and moral misconduct among the financial elite and a bonus system that rewarded short-term deal-making over sustainable, long-term financing (Jickling, 2010; Corneil and McNamara, 2010). The complexity of financial products made it difficult to assess who owned the underlying assets and what their real worth was. The uncertainty of banks and investors not able to value their assets and the assets of their counterparts instantly led to a breakdown of trading activity in derivatives and bonds and equity markets dropped. Counterparty risk increased dramatically, making pricing of financial products difficult and sometimes impossible. Products that were considered to be low risk and almost default free, such as most asset-backed securities (ABS), credit-default obligation (CDOs) and credit-default swaps (CDS), were overnight considered to be high-risk investments. This led to a repricing of these products and trading came to an almost complete halt. Coupled with increased counterparty risk, banks did not lend to each other through the overnight lending market.[1] Thus the US and European inter-banking markets froze up. Within three days, the financial crisis turned for the worse, and the financial system required a swift and bold response from central banks. During the initial phase of the crisis, the ECB was the first major central bank to take action, and it was a pacesetter for other central banks (Verdun, 2017, p.209; Trichet, 2010e). The actions of the ECB had a decisive effect on containing the crisis from spilling over into the real economy. Nevertheless, GDP growth across the euro-area contracted and unemployment increased in periphery countries (International Monetary Fund, 2009; Gamble, 2009, p.36-37). In periphery countries, unemployment became a major issue. For example, in Spain, unemployment rose to more than 20 percent by 2010 (OECD, 2018).

6.1 9 August 2007: The financial crisis begins

On August 9, 2007, the same day BNP Paribas made its announcement, in an unprecedented move in its short history, the ECB intervened by injecting 94.8 billion euro into the overnight lending market. It was the biggest injection of capital in the history of the ECB, surpassing the 69 billion euro it made available on September 12, 2001 (Tett et al., 2007). Despite the unprecedented size of the injection, the operation could be considered a standard measure during a severe liquidity crisis. This measure was directed at stabilising interbank liquidity in return for collateral from European banks (Mizen, 2008, p.545). It was the first of a total of three overnight capital injections. The next day, the ECB provided another 61 billion euro to banks in Europe. Two days later on 13 August, the ECB once again responded by pumping yet another 47.7 billion euro into the market, totalling 203.5 billion euro within four

[1] The overnight lending market is a part of the money market in which banks borrow from each other only for one night. This allows banks to adjust their liquidity on a short-term basis. Some central banks, such as the Fed, target the interest rates charged on the overnight market to fine tune the supply of money in the economy.

days. Although other major central banks took similar steps, the ECB was leading the global effort to contain the financial crisis. The Bank of England (BoE), for example, reacted slower to the events and with less drastic actions. Then-Governor Mervyn King, considered the initial phase as a repricing of risk and did not see it as a breakdown of the global financial system. He believed in the superiority of the corrective forces of the market and, thus, only saw a limited need to intervene (Irwin, 2013, p.9-10 and 149). This Chicago School-inspired interpretation of the financial market turmoil stood in contrast to the ordoliberal and post-Keynesian interpretations of euro-area policymakers. Interestingly, central bankers at the Federal Reserve, who are predominately educated in Chicago School neo-liberalism, quickly reacted to contain the crisis and did not argue that there is a repricing of risks that can stop by itself underway. The severity of the financial crisis during the first weeks was significantly greater in the United States than in the UK, which might explain the different reactions. The decision of King not be part of the first central banks that reacted to the financial crisis is, furthermore, a sign that during severe crisis, the expert knowledge of an epistemic community can differ between members. The crisis unfolded within days and not every professional of the community of European central bankers was convinced about the outcome of the tensions.

In an initial non-standard action, the ECB agreed to a swap agreement with the Federal Reserve System (Fed) that allowed it to provide liquidity denominated in dollars to foreign banks in Europe. Banks have funding difficulties when the foreign interbank lending markets in which they operate deteriorate, because they have no access to liquidity from the foreign central bank. Using a swap line, their central bank can issue foreign currency in the same amount it receives in domestic currency without depleting its foreign reserves. These swaps were reciprocal to further strengthen the ability of central banks to provide liquidity to transnational banks. The swap lines were further extended to the BoE, the Swiss National Bank (SNB), and the Bank of Japan (BoJ).[2] Although the swaps were highly priced to discourage banks from using these facilities if they had no funding difficulties, the lack of liquidity made it an attractive choice for a large number of international banks (Papadia, 2013, p.5).

The unprecedented capital injections and the swap lines showed success when economic conditions strengthened and commodity prices increased during the first quarter of 2008. For example, the price of oil peaked in July 2008 at 145 dol-

[2] Over time, more central banks were included in the swap network, with the difference that the major central banks could withdraw an unlimited amount of money with up to three years of maturity, while smaller central banks could only withdraw a limited amount.

lars a barrel compared to 20 dollars a barrel in 2001 (Hamilton, 2009). However, the thought that commodity prices could increase as a result of cheap banking credits and the unprecedented amount of capital in the financial system did not sit well with ordoliberal influenced policymakers who desired higher interest rates to contain inflationary pressure from the capital injections. In France, Trichet had a reputation of opposing inflation. The French policymaking elite thought he was in line with the monetary policy thinking of the Bundesbank (discussed in Chapter 4.2.1; Barber and Atkins, 2011). A US-based journalist covering the Fed and the ECB and who knows Trichet personally, said about him in an interview with the author, that during the initial phase of the crisis, 'I think Trichet was eager to prove that he could be more German than the Germans' (PS3). This assessment demonstrated that the interviewee outlines the German economic policymaking elite, including Bundesbank central bankers, as an epistemic community and argues that Trichet aimed to be accepted by that group rather than the group of his own country. As it turned out, Trichet pushed the Governing Council towards raising interest rates and in July 2008, the Governing Council decided to increase the key interest rate by 25 basis points to 4.25 percent. This step was taken to ward off fears of inflation. Trichet elaborated on the sound economic fundamentals, despite signs of weak real GDP growth in the second quarter of 2008, despite growth in the first quarter (Trichet, 2008). At the time, the Governing Council considered this decision a well-adjusted policy measure to keep the ECB within its mandate. Jürgen Stark, then-Chief Economist of the ECB, who would later resign in protest over the asset purchasing program, defended the interest hike in July 2008, 'we took this step at the time, which is fully in line with our primary objective of maintaining price stability, to prevent second-round effects, with a view to avoiding the dis-anchoring of inflation expectations, even in times of money market tensions' (Stark, 2009). This demonstrates that the ordoliberals were well-satisfied with the decision. At this point, the Governing Council's decision-making was still considerably influenced by its origins in ordoliberal thought, despite initial signs of using a pragmatic approach to contain the crisis. This perspective would change towards the end of 2008. The capital injections were unprecedented, and, although needed at the time, the excessive capital was considered to increase inflation rates above the two percent threshold.

Looking back on his personal experience and career in monetary policy, Trichet's decision to push the Governing Council towards raising the interest rate was predictable. As discussed in Chapter 4.2.1, Trichet was acutely focused on maintaining the desired inflation rate. He identified himself with maintaining price stability, even in times of crisis. The rising oil prices and the first signs of recovery, at least in the euro-area, gave Trichet confidence to raise the interest rate (Trichet, 2008). In retrospect, however, this rate hike was criticised as premature considering that Lehman Brothers was only two months short of collapsing, indicating the ongoing stress in the system (Brunnermeier et al., 2016, p.326; PS7).

Between August 2007 and September 2008, the ECB overcame its stigma of indecisiveness in this initial phase of the financial crisis. During its short history, the ECB has often been considered a reluctant institution that required a long time to come to a decision and the policy decisions where often below the expectations of financial markets and governments (Verdun, 2017, p.209; Trichet, 2010e). The ECB had a preference to keep price stability, as defined in its mandate, over pursuing a deeper integration of the euro-area (Hodson, 2011, p.21). This prioritisation of policy decisions eventually led to the difficulties of the sovereign debt crisis, which started in 2010, when it became obvious that the euro-member state economies diverged on their economic fundamentals (Chapter 7).

Nevertheless, the ECB acted decisively when the crisis hit in August 2007 and it demonstrated that it had the financial firepower and the ability to act swiftly when required. This was despite having overlapping ideas and perspectives from then-13 different countries on the Governing Council. Looking back on the actions taken between August and December 2007, Trichet maintained in an interview with the *Financial Times* newspaper:

> 'The ongoing market correction that we are seeing, and I think that I would say, the ECB decision-making process has proved to be [...] lucid, as far as the diagnosis was concerned. Also, we proved our capacity to take a decision rapidly when needed, and that of course is important. I think, from that standpoint the external observers could see that we were able to decide rapidly. Fancy, that at the time we had the reputation of being incapable of taking a rapid decision. We were supposed to have a very long meditation, a decision-making process which was extremely laborious and lengthy, and it's not the case' (Trichet quoted in Atkins, 2007).

During the first months of the crisis, the ECB demonstrated that it was able to handle complex financial crisis situations in an innovative way. It injected an unprecedented amount of capital in the market and agreed to extensive swap lines with other central banks. This changed the perception of financial markets from considering the ECB to be slow and reactive to being proactive and flexible in its approach (Brunnermeier et al., 2016, p.326). Indeed, the financial community was impressed with the decisiveness of the ECB to tackle the financial crisis. In an interview with the *Financial Times*, Jim O'Neill, who was head of global economic research at Goldman Sachs, the investment bank, stated 'the speed at which the ECB responded and its steady tone [...] have been quite impressive' (*Financial Times*, 2007). Until the summer of 2008, the ECB correctly assessed the severity of the crisis and intervened in the market with bold and decisive actions. Although these actions prevented a shift of the financial crisis into the real economy in core countries, periphery countries, in particular, Ireland, Spain, Portugal, Greece and Italy, experienced contracting economies, high unemployment, (specifically among the youth population) and low to no growth. The premature interest rate rise in July 2008 further reduced economic growth in Southern European countries and Ireland.

In retrospect, an interviewee from the central banking community, who was closely involved in the creation of EMU as part of the Delors Committee seconded Trichet's statement above with a grain of salt, '[Trichet] is too defensive on his own record. [...] Trichet was too self-congratulatory for a long time. But he did act strongly during the first part of the crisis, and we have to give him credit for that' (ESCB3). To unpack this assessment of Trichet it requires looking back at Trichet's role in founding EMU and the ECB and in shaping the Euro during the first years of his presidency. As discussed in Chapter 4.2.1, during the foundation process of the EMU and in his capacity as the President of the ECB, Trichet became convinced that the 'one-size-fits-all' monetary policy of the ECB could only work if it focused solely on price stability. When financial turmoil appeared in the summer of 2007, Trichet did not hesitate to provide liquidity to the financial market. From his time as the Head of the Paris Club, he was well aware that a capital injections can stop a liquidity crisis. In addition, providing liquidity into the overnight lending market was well in line with standard monetary policy response during a crisis. Although setting up a swap agreement might fall outside of standard monetary policy, the major central banks quickly recognised the value of such a mechanism. Thus, Trichet had no difficulties in deciding that liquidity, if provided directly to banks, against good collateral and within a clear time frame of the lending operations, would have an impact on overall price stability across the euro-area. He took a short-term rise of inflation into account as long as it was temporary and the excess liquidity could be retrieved from the system through the use of standard operations. The ECB under Trichet decided to increase interest rates to curb possibly rising inflation. When the crisis slowed down, not least because of the ECB's quick and decisive decision-making, Trichet, and, by extension, the Governing Council, fell back into the pre-crisis *modus operandi* of an ordoliberal-influenced monetary policy that focused on price stability rather than taking measures to enhance economic performance across the euro-area. The French government, still influenced by post-Keynesian economic ideas on how monetary policy and fiscal policy should support each other, heightened its criticism of the actions of the ECB.

Between July 2007 and October 2008, the French government once again aimed at influencing the decisions of the ECB. Then-President Nicolas Sarkozy had been a long critic of the ECB for the supposed negative impact of ECB policymaking on the French economy. Throughout the summer of 2007, Sarkozy attacked the ECB on how it handled the crisis. He favoured a decrease of the interest rate to make lending cheaper for companies during the crisis (Murphy and Boyle, 2007). The ECB had, however, refrained from reducing the key interest rates to ensure price stability following the major capital injections. During a meeting of the European finance ministers and Governing Council members in Porto, Portugal, tensions rose between the French government and the ECB Governing Council on the weekend of 14 September 2007. Sarkozy was quoted in the French Newspaper *Le Monde*, as saying that the decision to inject liquidity without cutting interest rates would only benefit speculators and not the economy. He aimed at pressuring the ECB to focus more on growth and employment and less on price stability (Murphy and Boyle, 2007).

On this weekend, Trichet commented on Sarkozy's accusations that, 'everybody knows that we are not facilitating in any respect those who behave improperly' (quoted in Barber, 2007). Then-President of the Bundesbank Axel Weber commented on the continuing criticisms and claims of Sarkozy in harsher words: 'the news value of the French president's critique is zero. And it also has zero influence on the ECB behaviour. We do what is necessary, and what is necessary, we decide ourselves' (*Die Welt*, 2007).[3] Weber was long considered the potential successor of Trichet. Although supported by the German government, Weber's inflation-hawk attitude and his plain and outspokenness did not increase his chances among several euro-area member states, most importantly France. His public row with newly-elected President Sarkozy following the meeting in Porto might have further reduced his

[3] Author's own translation.

chances of becoming President of the ECB (*n-tv*, 2010). At the time, however, the German government backed Weber's claims and rejected Sarkozy's criticism and intention to influence the policy direction of the ECB. When the policy approach of liquidity injections and stable interest rate showed the first signs of success in stabilising the financial system in late August 2007, Sarkozy started to claim credit for his efforts to influence the ECB. At the Governing Council press conference on 6 September 2007, where it was decided that the key interest rate should remain unchanged, Trichet responded to a question from a journalist whether Sarkozy is correct in assuming that debating the ECB policy decisions can influence its decisions. Trichet rejected these claims, in unusually strong terms, and referred to the independence of the ECB,

> 'We are independent. We are independent because the Treaty calls upon us to be independent. By the way, the Treaty calls upon all executive branches in Europe not to seek to influence the central bank: Article 108 of the Treaty. The world over, nobody thinks that we could be influenced. But those who are claiming that they are influencing us are placing themselves outside the Maastricht Treaty. [...] That being said, we take our decision, and we took today's decision, unanimously, on the basis of our own analysis [...]. And if such calls that are contrary to the provisions of the Treaty were to have any influence, it would be in the reverse direction, for obvious reasons. But it is not the case, precisely because everybody knows that we are fiercely independent and that there is not the slightest doubt that we decide in this totally independent way' (Trichet, 2007).

In this statement, Trichet strongly defended the independence of the ECB. He argued that the Maastricht Treaty demands the ECB to be independent in its decisions. Those who aim to influence the decisions of the Governing Council are not adhering to the mandate and are 'placing themselves outside of the Maastricht Treaty.' The rift between the ECB and French government, however, ended differently than the two previous encounters with the French and German governments. To recap, during the late 1990s, the ECB was forced to accept that its first President, Wim Duisenberg would have to step down after four instead of eight years to make space for the French candidate Jean-Claude Trichet. Shortly later, the ECB, despite initial resistance, devalued the euro to accommodate the German government under then-Chancellor Gerhard Schröder.

Throughout the first years of the common currency, the euro was under severe pressure from market forces owing to the tensions from the dot.com bubble and the low credibility of the new currency. Investors doubted the survivability of the common currency and the EMU. This led to extensive exchange rate fluctuations (Tanzi, 2014, p.261). The euro was introduced on 1st January 1999, but it already fell below its launch value in October 2000. The newly elected Schröder government demanded the ECB to take accommodative monetary policy actions to reduce unemployment in Germany. Duisenberg rejected this demand and referred to the independence of the ECB, where the mandate would not allow the ECB to intervene in individual member states. Then-Minister of Finance of Germany Oscar Lafontaine retorted to Duisenberg's comments: 'Alan Greenspan has shown that you can simultaneously achieve inflation-free growth and growth in employment' (Andrews, 1998). He was referring to the dual mandate of the Fed to focus on price stability and economic growth, which has similarities with the mandate of the ECB. The mandate of the ECB, however, has an unequal focus on the two parts of the mandate. It focuses first and foremost on price stability before supporting economic growth.

The credibility of the ECB was tarnished during both instances and it took the ECB several years to regain it. However, between 2007 and 2008, the ECB did not concede to the demands of the French government. The credibility of the ECB to remain independent, despite the pressure of the key member state France and the French national Trichet at the head of the central bank, increased considerably. Trichet and other Governing Council members were aware that the ECB and the Eurosystem required an untarnished credibility to overcome the finanical market tensions. Over the course of the crisis, the ECB become more assertive in its role and on several occasions resisted the pressure of national governments and in some instances would even dictate the terms for financial assistance and demand structural reforms to national governments. For example, the ECB directly pressured the member states Ireland, Greece and Italy to strengthen their structural reforms.

During the summer of 2008, the French government still criticised the ECB. Sarkozy warned the ECB to increase the key interest rates in June 2008, without success (*The New York Times*, 2008). Sarkozy, however, got his vindication in September 2008, when he took on the six-month term as the president of the European Council, which oversaw the collapse of the Lehman Brothers. This event forced the ECB to undertake an interest rate cut in October 2008 (Marsh, 2009, p.234). From the perspective of the French government, this decision was long overdue (see, also on page 46). The criticism of the French government on the ECB monetary policy decisions are, however, a reminder that relations between the ECB and key member states, such as the French insistence on a French national as first president of the ECB or Germany under the Schröder government, are not without tensions. However, the epistemic community of euro-area central bankers moved closely together to ward off any attempt of influence of national governments that could infringe on their superiority in assessing macroeconomic trends and develop as well as implement monetary policy.

The decisiveness in taking action, however, changed when the crisis became more severe after the collapse of Lehman Brothers. Initially the ECB, again, acted swiftly and responded with interest rate cuts, increased swap agreements with major central banks and provided even more liquidity through various instruments. Nevertheless, it became less of a pacesetter and the battle against the fallout from the subprime crisis was more dependent on the response of national governments. The uneven distribution of economic power, the incoherent and incomplete institutional environment of the EU and the drawbacks of EMU reduced the effectiveness of the ECB to overcome the crisis beyond providing liquidity. When a fiscal policy reaction coupled with the implementation of structural reform was needed, the ECB had to stand by and wait for the governments to take action. The lack of a coordinated fiscal policy among the euro-area member states resulted in very different policy approaches that most often were not aligned with each other. In addition, the limited lender-of-last-resort (LLR) responsibility of the ECB, and by extension the NCBs, further prohibited them from taking action when a bank had liquidity or solvency problems. As Charles Goodhart, the academic, pointed out, 'a cross-border bank is international in life but national in death' (2009, p.16). In 2016, the relative size of the financial sector in the euro-area was about 6.4 times larger than GDP (European Central Bank, 2017b, p.7). Thus, even if national governments would work closer together to support their national financial institutions, the overall size of the financial system might be beyond their capacity.

The financial crisis, from 2007 until 2009, required extensive intervention not only from the Eurosystem but also from the national governments. In most euro-area countries, banks had to be bailed out with public funds. In accordance with the institutional foundation of the ECB, when a bail out was necessary, national governments and not the ECB acted as LLR. The ECB only provided additional short-term liquidity to overcome temporary funding problems against adequate collateral. Consistent with its mandate, and the European central banking traditions, the ECB was often not directly involved in the bail-out negotiations of the banks that required assistance. The ECB focused on providing liquidity to the entire financial system rather than individual banks, while the NCBs had a wider palette of options to support their governments with stabilising individual banks owing to their local market knowledge and a close relationship with their national governments (Praet, Praet). The periphery countries, in particular, Ireland, which had an estimated debt burden of 41 billion euro from the bank bailouts (Hancock, 2014) and Greece, took on large amounts of debt to fund the bailouts of their failing banks. This shifted private debt to public debt and made refinancing increasingly difficult for the periphery country governments.

In the US, the Fed took on a different approach to support failing financial institutions. The Fed used its market knowledge and network to broker the sale of collapsing financial institutions to other companies. For example, the Fed supported JP Morgan, the investment bank, by providing 30 billion dollars to buy its rival Bear Stearns, which JP Morgan did for a symbolic two dollars. As discussed in Chapter 5.4.1, this intervention shows the difference in understanding the role of LLR between the Fed and the ECB. In the Eurosystem until the crisis, financial stability was a prerogative of national governments and not a task of the ECB. This changed as a result of the crisis. The EU has introduced several institutional changes to supervise and act on bank failures. An important step towards sharing the liabilities of a bank default was introduced in January 2015 with the EU's Bank Recovery and Resolution Directive (BRRD). Since then, the EU has developed a framework to deal with failing banks and if necessary dissolve them (European Parliament and European Council, 2014).

These institutional changes to the regulatory environment were not in place in September 2008, the major turning point of the financial crisis and, thus, the ECB had to step in with monetary policy. However, the decisiveness and boldness of the ECB during the first year of the crisis disappeared during the second year. Despite rising uncertainty and instability, the crisis response of the ECB between late-2008 and late-2009 was slow and showed a lack of direction. The national governments, although overwhelmed from the fallout from Lehman Brothers, started to implement bank bailouts and fiscal economic stimulus plans. European governments, for example, financially supported 114 banks between 2007 and 2013 (Gerhardt and Vennet, 2016).

When taking a closer look at the political and institutional landscape of the EU, it becomes obvious that although the euro-area is an incomplete political union there are mechanisms and institutions in place that ensure the regular exchange of ideas, policy advice and coordinate the implementation of policies across the EU. The European Council, the European Parliament, the Eurogroup and the European Commission have previously been inactive in coordinating financial stability and supervision. Those areas, including bank bailouts, were the prerogative of national governments. During the initial phase of the financial crisis, the institutional setup of the EU made it difficult for national governments to coordinate their efforts.

6.2 15 September 2008: Lehman Brothers collapses

On Saturday, 13 September, then-CEO of JP Morgan Chase James Dimon told senior management on a conference call, 'you are about to experience the most unbelievable week in America ever, and we have to be prepared for the absolutely worst case. [...] We have to protect the firm. This is about our survival. [...] There is no way, in my opinion that Washington is going to bail out an investment bank. Nor should they. [...] I want you all to know that this is a matter of life and death. I'm serious' (quoted in Sorkin, 2009, p.2-3).[4] His statement introduces the beginning of the second phase of the crisis that started on Monday, 15 September 2008, when Lehman Brothers filed for bankruptcy (Lehman Brothers Holdings Inc., 2008). This seminal event led to a significant intensification of the crisis across the world. Several interviewees from central banks and commercial banks recounted that Monday as a once-in-a-lifetime event. One Bundesbank senior official said that the Lehman collapse could be felt in 'every fibre of the Bundesbank' (BUBA8). Another senior official recounted that she was recalled from her secondment at the ECB to join an emergency team at the Bundesbank, because she was the only expert on ABS with previous private sector experience. On this emergency team, her responsibility was to assess the value of the ABS portfolio of the German subsidiary of Lehman Brothers (BUBA10). This gives an indication of how the central banks started to prepare for the worst during the first week after the collapse. The epi-

[4]It is important to note that Mr Dimon argued that the US government was not going to bail out an investment bank. The division between investment banks and retail banks is important. Investment banks use their own money to invest. When an investment fails, the investor loses money but tax payers are not affected. Retail banks use the money they receive through deposits to lend as credits against collateral. Should the credit default, the retail bank still has the collateral. With changing financial regulation during the 1990s, retail banks were allowed to develop investment banking divisions. This is considered a major reason why the financial crisis developed and affected the lives of ordinary citizens.

stermic community of euro-area central bankers required expert knowledge on these complex financial products and reacted quickly to overcome a potential information disadvantage. An interviewee from the private sector, who was a senior banker in a fixed-income department, said in June 2016 that he can still vividly remember the extreme nervousness and intense pressure on the trading floor that Monday (PS10).

Prior to the fateful weekend in September 2008, commercial bankers, as indicated in the statement above, assumed that governments would step in to prevent large system-relevant financial institutions from going bankrupt. As mentioned above, the US government had intervened by providing JP Morgan with 30 billion dollar emergency relief to fund its acquisition of Bear Stearns. When the US government refused to save Lehman Brothers two months later, the assumption of a bailout was shattered, leading to a drying up of interbank markets and an evaporation of confidence in counterparty risk. Financial institutions began to deleverage dramatically their balance sheets and halted their lending activity, while at the same time repriced their market and operational risks. This led to a collapse in international trade, in particular in financial products, and economic conditions began to worsen in all major advanced economies (Blinder, 2013, p.100-114). [5]

At its Governing Council meeting on 4 September 2008, a week before the Lehman Brothers collapse, the ECB kept MRO interest rate unchanged at 4.25 percent (European Central Bank, 2008a). During the week of the Lehman Brothers collapse, the financial sector in the euro-area experienced a period of great uncertainty. Despite the urgency to act, it still took the Governing Council several meetings until it decided in favour of reducing the interest rates. The ECB feared that the crisis could become even more acute and that the transmission process to steer monetary policy could be further damaged. On its meeting on 2 October 2008, three weeks after the collapse of Lehman Brothers, the ECB still kept interest rates unchanged. It took the Governing Council another week to realise that the interest rates should be lowered. On 8 October 2008 it was dropped by 50 basis points to 3.75 percent (European Central Bank, 2008b).[6] Between October 2008 and May 2009, the ECB lowered the main refinancing rate by 325 basis points to one percent (European Central Bank, 2008b; see, Figure 6.1).

Although this step showed some impact in stabilising financial markets, the ECB

[5] See Ollivaud and Turner (2015); and OECD (2009)) on financial crisis effects on economic conditions in advanced economies.

[6] See, Trichet (2011d) for his views on these decisions.

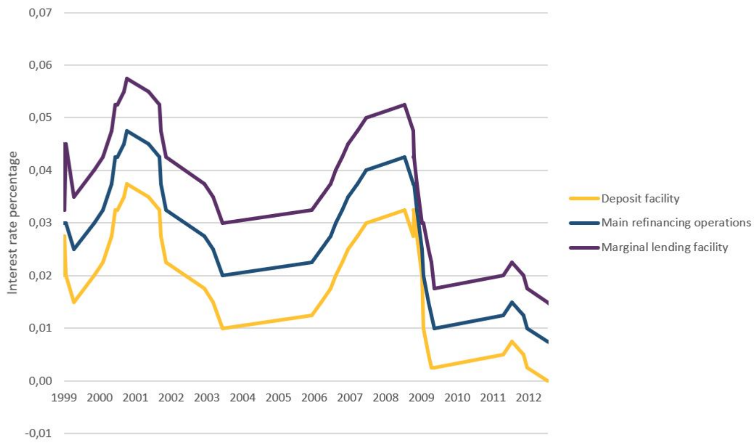

Figure 6.1: ECB main interest rates between 1999 and 2012

Source: ECB Statistical Data Warehouse

had to develop non-standard policy measures to regain its ability to conduct monetary policy. The collapse of Lehman Brothers had impaired the transmission process. The policy actions of the ECB, decreasing historical low-interest rates to directly support banks to reduce lending conditions for the real economy, were effective to prevent further liquidity shortages. The ECB bought time for financial institutions to deleverage their positions and increase their capital buffers. It, furthermore, bought time for governments to support social promises that had become increasingly expensive as a result of higher refinancing costs for euro-area member states (Streeck, 2014, p.225). A private sector interviewee, who is chief economist at a major German bank seconds the argument that the ECB bought time for politicians. He maintains, 'the ECB was able to implement decisions, which delivered the needed time for the countries and for the governments to implement the political decisions' (PS1). His statement shows a positive attitude towards the actions of the ECB, which stands in contrast to ordoliberal thinking among German commercial bankers. However, he further argues that 'this definitely has stretched the role of the ECB substantially and maybe from time to time the ECB was very close to its mandate. But for the time being, I would not say that the ECB is a political body' (PS1). Thus, the interviewee provides an insight into how commercial bankers viewed the actions of the ECB, even from a German perspective. Streek, in contrast, argued along ordoliberal lines that the ECB should be reminded of the rules that governed its institutions and underpin the mandate.

The measures of the ECB were designed to open the transmission process and to ease the credit flow to the real economy in the euro-area. Trichet called these measures 'enhanced credit support' and defined them as 'the special and primarily bank-based measures that are being taken to enhance the flow of credit above and beyond what could be achieved through policy interest rate reductions alone' (Trichet, 2009; European Central Bank, 2010d).[7] The Fed, in contrast, used a policy approach called 'credit easing' during the first years of the financial crisis where it bought private assets that had a risk of default. This included 425 billion dollars of mortgage-backed securities (MBS). For example, the ECB introduced several instruments that largely drew on the positive experience of the non-standard instruments during the first financial turmoil in 2007. It offered fixed-rate full-allotment (unlimited amount) of liquidity for all of its refinancing operations (González-Páramo, González-Páramo). This allowed the ECB to keep the transmission process open while the interbank lending market froze up. The ECB further reduced the criteria for eligible collateral to provide banks with more options to receive capital in exchange for assets. These two instruments were designed to address the liquidity difficulties of the financial market directly through the ECB's refinancing operations. The ECB increased the length of maturities of their refinancing operations from six months to up to three years to provide enhanced credit support to the companies and households. This operation significantly reduced the costs of credit and allowed financial institutions to plan with the liquidity on a longer time horizon. The ECB reintroduced its currency swap agreements with the Fed. Again, this policy was designed to allow multinational banks to finance their operations in US Dollar and euro through their national central bank (Cour-Thimann and Winkler, 2012, p.11-12; see, Trichet, 2009). The European economy continued to contract despite the actions of the ECB and the fiscal stimulus programmes and bank bailouts of the national governments. The excessive liquidity provided through the capital injections and swap agreements and lowered key interest rates did not induce financial sector confidence to the extent that commercial banks increased their lending operations to corporates. The ECB decided to step in to induce banks to start lending to corporates again.

In an unconventional step, the ECB introduced the first of ultimately three covered

[7] Trichet makes reference to the bank-based system of the euro-area. As discussed in 4.3.1, in contrast to Anglo-Saxon countries, the euro-area economy is financed through local banks rather than through capital markets and outside investors. This has an impact on the transmission process for the ECB. The challenge is to provide approximately 6,000 banks in the euro-area with equal access to liquidity (Chapter 5.1.1). The ECB designed policy instruments that would make refinancing for banks easier to access, cheaper and had a longer availability. For more detail on the differences between the US and EU programmes, see, Rehbock (2013).

bond purchase programmes (CBPP1-3), in July 2009 (European Central Bank, 2009). Covered bonds predominately originated in countries with a high density of *Mittelstand* companies, such as Germany, Denmark, France and Spain.[8] This type of corporate bond has the unique ability to recourse the assets it 'covers' if the originator, which is the bank, collapses. Thus, covered bonds are uniquely secured against failure through double protection, and, are, therefore, an important part of corporate financing and refinancing of banks. The CBPP1 was designed to buy 60 billion euro between July 2009 and June 2010. This measure allowed banks and companies to refinance their operations and enhance the availability of credit. The first CBPP was directed at the reduced availability of liquidity following the increasing market tensions, while CBPP2 and CBPP3 were more closely aligned with quantitative easing measures to revive the covered bonds market.[9] While the response from outside of the central banking community and central bankers were very positive, including from the Bundesbank (BUBA3; BUBA4), one private sector interviewee who leads a team of eight covered bond traders at a major German bank complained about the ECB intervening in the covered bond market to the extent that commercial banks were displaced. He argued that the ECB did not have to step into the market and, even if it did, not with the amount of capital it eventually used (PS5). The actions of the ECB have greatly reduced the profitability of his team owing to the lack of available covered bonds to trade and the low margins which made those trades unprofitable. A former ECB board member shared the concerns of the commercial banker in the interview with the author that 'now, of course, to some extent, it has also replaced the markets, which is true not only for the ECB but for all central banks' (ECB5). The interviewee acknowledged that some programmes, such as the covered bonds programmes, have crowded out other market participants despite the intention of the ECB to restart market activity in these segments. However, the size of the CBPP1 was only about 2.5 percent of the total covered bonds market, and, thus, the ECB considered that it would revive the market by reducing the yields on the covered bonds (Beirne et al., 2011, p.11; Cour-Thimann and Winkler, 2012, p.12). This example provides evidence that there are times, when the expert policy knowledge of an epistemic community is at odds with the real economy. In this market segment, central bankers are not seen as pulling the economy out of recession, but they are rather seen as prohibiting the free exchange of goods and services without government intervention.

[8] *Mittelstand* refers to small and medium sized companies that do not exceed approximately 500 million Euros of annual revenue.

[9] The CBPP2 was introduced on 3 November 2011 and ended on 31 October 2012. The CBPP3 started on 20 October 2014.

Beyond the introduction of new instruments and this profound intervention into the market, the ECB was drawn into the fiscal sphere and asserted itself in the conflict of economic ideational frameworks with national governments. For example, when the Irish economy came under severe stress, the government guaranteed deposits, which had major repercussions on crisis negotiations among the euro-area member states and the ECB. The ECB relationship with Ireland provides an insight into this process of economic ideational change during the financial crisis.

6.3 30 September 2008: Irish deposit guarantee

Ireland enjoyed years of economic growth during the Great Moderation. Low taxation, high foreign direct investment from European and US firms and comparatively low wages but overall high education standards have ensured a rapid economic growth throughout the 1990s and early 2000s (Fortin, 2000; Peet, 2004). When the financial crisis started in 2007, the Irish banking sector, however, experienced a significant financial and economic downturn. Irish banks borrowed heavily on the US bond market to fund an unsustainable housing boom that collapsed once liquidity tried up. During the period from 2003 until 2007, the six main Irish banks increased their bond holdings from 16 billion euro to about 100 billion euro, which equalled more than half of Ireland's GDP Whelan (2014). The housing boom attracted European banks to invest in Irish real estate, in turn closing the dependent relationship between the health of the Irish economy and the health of the continental European financial system. In retrospect, the Irish housing sector was not only overheated; it was funded by toxic products that led to the subprime crisis in the US (Chapters 1.1 and 7).

Once it became evident that the Irish financial system took a hit, foreign direct investment was reduced from approximately 138 billion euro in 2007 to 120 billion euro in 2008; foreign investors pulled another 11.5 billion of capital from loans out of the Irish economy (Central Statistics Office of Ireland, 2009). On September 30, 2008, two weeks after the collapse of Lehman Brothers, the Irish government decided to intervene and committed to guaranteeing bank liabilities and recapitalised the banks. The Irish decision to guarantee the deposits came as a surprise to the ECB (Chopra et al., 2015). These decisions were not approved by the ECB, which criticised the Irish government for its unilateral decision-making (European Central Bank, 2008c). Former board member Bini Smaghi recounted the events,

> 'The ECB learned about the issue and we found it was very surprising that a country comes out by itself - even in a situation in which the Irish were in, with a large banking system - to guarantee everything. It was surprising [...]. It was surprising that someone would embark on blanket guarantee by itself. It was a dangerous gamble' (Bini Smaghi quoted in O'Connell (2014).

Bini Smaghi criticises the Irish government for guaranteeing deposits and effectively turning the financial crisis into a sovereign debt crisis, because in case of default, it would have to take on bad loans. For ECB board members, this decision was seen as a dangerous option, considering that Ireland had a major financial sector with a potentially large amount of deposits to guarantee. The German government criticised Ireland for taking actions without consulting with the European Commission or the national governments beforehand. This was another instance where there were tensions between a national government and the Eurosystem and the ECB, in this case, with the Irish government. Compared to the French diplomatic row to appoint Trichet as the first President instead of Duisenberg during the late 1990s and the tensions between the Schröder government and the ECB to implement an accommodative monetary policy, the tensions between the Irish government and the ECB in 2008 demonstrated the ECB's ability to pressure national governments. By calling on other euro-area member-state governments, the ECB was able to isolate the Irish government over its decision, similar to the isolation France had to endure under Sarkozy during the summer of 2008 when he demanded a reduction of the key interest rates. As aforementioned, the German government criticised Ireland for its go-it-alone mentality. The isolation of the Irish government, however, only lasted for a short period.

On 5 October 2008, the German government reversed its position and announced that it would guarantee deposits for German consumers as well (Der Spiegel, 2008). This came a day after Germany criticised Ireland again at a European summit in Paris to develop a concerted action-plan for the financial crisis. *The Economist* argued that because Germany experienced a high-level of withdrawals after the Irish government guaranteed deposits, thus, the German government had to guarantee deposits as well (*The Economist*, 2008). The European crisis response toppled after Germany reversed its position on the guaranteed deposits (Gow and Chrisafis, 2008). The Irish deposit dispute demonstrated that under severe financial tensions, ideas played a subordinate role in responding to the crisis. The ECB and the national governments underwent a phase of diplomatic tensions that were dominated by practical considerations and resulted in implementing decisions that aimed at preventing weakening their national positions. Thus, national governments acted in disregard of the spirit of the EU and euro-area to refrain from implementing policies that leave another member state worse off. From the ECB perspective, the decision of guaranteeing deposits was unacceptable because it meant that national governments would develop individual solutions that were in the interest of their country but would reduce the crisis-fighting ability of other euro-area member states. The ECB was caught between the lines of competing national governments that acted in the national interest despite the intensive interconnectedness of the financial system.

The dispute was resolved only in November 2008, when the national governments announced a collateral action plan to provide 200 billion euro through the European Commission to boost the European economy (European Commission, 2008). While the EU slid into recession, the early case of the Irish and German unilateral policy-making points to the financial pressure investors exerted on national governments to retrieve their capital. As aforementioned, the ECB began to criticise national governments for their decisions during the financial crisis. Before the crisis, the ECB was at the receiving end of criticisms, and when it tried to hold its position, the ECB often lost credibility in the process, such as during the election of the first president or during the demands of the Schröder government for an expansionary monetary policy (Chapter 6.1.1). The events of 2008 showed that the ECB had become strong enough to criticise a national government without losing credibility and the following crisis years would further increase the ability of the ECB. At this point, however, the ECB preference to have a coordinated effort to overcome liquidity shortages rather than unilateral decisions was overturned when the German government decided to guarantee the deposits in Germany. During the sovereign debt crisis from 2010 onwards, the ECB found itself in a much stronger position and was not overturned during tensions with national governments (Chapters 7 and 8).

The concerns voiced by the ECB during the Irish deposit guarantee incident became a reality in 2010. The guarantees provided by the Irish government were set to expire during the second half of 2010. This forced the Irish government to issue about 30 billion euro in debt to fund the recapitalisation of the Irish financial system. The anticipation of the expiration of the Irish government guaranteed bonds led to an increase of the Irish government bond spreads, which in turn raised borrowing costs. Those costs increased to the extent that the government and banks lost access to international capital markets. This development worsened the Irish banking crisis, and it was also a major turning point for the role of the ECB in the euro-area.

Until September 2010, the ECB provided about 150 billion euro in liquidity to the Irish banking system, about 85 percent of the Irish GDP, taking on a full role of LLR (Thorhallsson and Kirby, 2012, p.808). Owing to the size of the intervention, it was the largest exposure of the ECB to a single country in its history. This alarmed the ECB, on the one hand, to take on an LLR responsibility, which was institutionally weakly defined and on the other hand, that a member-state contributing about one percent of the EU's GDP received almost a quarter of the ECBs available lending capacity. The ECB, therefore, moved towards involving the IMF and the European Commission for future lending activity, which was announced in November to be about 85 billion euro (Thorhallsson and Kirby, 2012, p.808; Murphy, 2010; see, Brunnermeier et al., 2016, pp.337-340). The ECB was, furthermore, concerned that this could set a precedent for other European countries to rely on Eurosystem funding. Indeed, not only the Irish government required a bailout from the euro-area and international institutions, including the ECB, but also Spain, for similar problems that derived from the deadly embrace, requested a bailout in 2012 (see Brunnermeier et al., 2016, p.196). The developments in Ireland and later in Spain were a prime example of the deadly embrace theorised by De Grauwe (Chapter 5.2.1). The overleveraged Irish banks required funding from the government. Two years later another round of funding became increasingly difficult for the Irish government and threatened to take the government down as well as the financial system (see Brunnermeier et al., 2016, p.183).

The crisis surrounding the Irish deposit guarantee exemplified the changing role of the ECB during the financial and sovereign debt crisis. When the Irish government guaranteed the deposits, the ECB was caught off-guard and strongly protested it. It could, however, not prevent other governments, in particular Germany, from following suit to prevent a withdrawal of funds. When the Irish guarantees set to expire two years later, the crisis re-emerged and this time, the ECB anticipated it. However, the ECB had to provide an extraordinary amount of liquidity in form of emergency loans to prevent a collapse of the Irish financial system. The ECB became the effective LLR for Irish banks, and ultimately for the Irish government. The amount of emergency assistance made the ECB uncomfortable and quickly sought assistance from the IMF and the European Commission. Interestingly, the ECB leveraged its position as LLR and sent several letters to the Irish government outlining fiscal and structural reforms as well as threatening to withdraw assistance

(Chapter 7.2.2). This intervention into the domestic affairs of a euro-area member state was unique for the ECB and critics correctly pointed out that the ECB overstepped its mandate (Kelpie, 2015). However, following the Irish deposit guarantee crisis, the ECB became increasingly self-assured and decisive in pressuring governments and investors into complying with its policy recommendations and monetary policy direction. The epistemic community of central bankers openly attacked governments and policymakers from other areas of expertise to force their perspective on decision-makers. During the initial phase of the Irish deposit guarantee affair, the efforts of the central banking community were without success, while during the second period, the ECB, with the support of the other NCBs, was able to succeed in pushing for fiscal and strucutral reform in some member-states. This change of the ideational and institutional basis of the ECB will receive more detailed attention below.

6.4 Ideational change and pragmatic decision-making during crisis

Between August 2007 and October 2008, the financial world changed. While financial markets started to melt down, central banks moved to the forefront of the crisis prevention efforts to tackle the fallout and avoid the crisis spilling over into the real economy. When the crisis happened, at first, the ECB appeared to be in control, because it provided an unprecedented amount of liquidity during the first months. For example, the ECB furthermore introduced various instruments within days of onset of the 2007 financial crisis for which it initially did not have the regulatory and structural requirements (BUBA15).[10] This shows that the Eurosystem reacted quickly during the financial crisis to provide liquidity to illiquid banks. After one year, in the summer of 2008, the ECB thought that the worst of the crisis was over as indicated by the interest hike in the summer of 2008. However, when Lehman Brothers collapsed, for a moment, it looked like central banks were overwhelmed and would lose control over the situation. The ECB's policy decision to increase the interest rate had to be reversed within months. During the first two years of the financial crisis, the Eurosystem was successfully able to reduce the high level of uncertainty and prevent an initial spillover into the real economy and a bank run in the euro-area. The ECB was able to coordinate the NCBs to find solutions quickly to overcome the liquidity shortage across the financial system. When the

[10]For example, at the beginning of the crisis, the Eurosystem central banks did not know where to book the capital when a bank uses any of the new instruments (BUBA15).

crisis seemed to retract, the Governing Council decided to increase the key interest rates, which in retrospect was too early, considering that the collapse of Lehman Brothers was only two months past.

Nevertheless, during the financial crisis, the ECB increased its international cooperation with other major central banks and within the Eurosystem. This increased level of cooperation turned out to be useful during the sovereign debt crisis, when reactions required a coordinated policy response. Drawing on the data from the interviews, it can be argued that the changes to the institutional setup of the ECB and its choice of instruments were not based on ideas but on pragmatism. The ECB might have appeared ideational prior to the crisis in terms of its focus on price stability, independence and its relationship with financial markets. This however, considerably changed during the first two years of the crisis. The debate on its independence and price stability resurfaced during the sovereign debt crisis but did not play much of a role from 2007 until 2008.

The analysis of the interview data demonstrated that the uncertainty in the market, the complexity of the causes of the crisis and the actors immediately responsible for the crisis and its containment did not allow for an ideational framework about how to best overcome the crisis to develop (BUBA3; ECB1; BUBA15). Most major central banks quickly realised that the financial system required liquidity (apart from the BoE) and took a pragmatic approach to inject it. In the case of the Eurosystem, the interviewees, in particular, those working for a central bank during the crisis, stated that they did not have the time to debate different economic ideational schools of thought and these, therefore, did not play a role in the decision-making process. Most interviewees from central banks argued that pragmatism superseded any ideational considerations (BUBA6; BUBA7; BUBA15; ECB2). Interviewees from the private sector, however, had more mixed impressions about the policy choices of the central banks. Some argued that the ECB acted in accordance with ordoliberal views similar to the Bundesbank ideas to resolve the crisis (PS2, PS3).

When taking a closer look at the question of whether the ECB decided in pragmatic or ideational terms and to what extent its decision-making was influenced by ordoliberalism or post-Keynesianism, the interviews with senior officials from different European central banks provided an insight. One Bundesbank senior official argued that the ECB has always been more pragmatic than the Bundesbank. Since the crisis, this notion has only increased. While the ECB considers itself a pragmatic central bank that decides in the interest of all euro-area member states without focusing on ideational frameworks, the Bundesbank became increasingly dogmatic (BUBA12). On the one hand, the Bundesbank was pushed into an ideational position where other central banks and the commercial financial sector expected it to decide according to ordoliberal principles with a strong monetarism focus (BUBA7). On the other hand, the Bundesbank was aware of this position and used its soft power that stemmed from the years that preceded the creation of the EMU. Bundesbank officials argued that they use ordoliberal arguments to anchor the Governing Council's decisions around the mandate on price stability (BUBA3). Even if the decisions reached at the Governing Council are not entirely in the interest of the Bundesbank's role as an ideational anchor for questions on price stability and independence prevents the Governing Council from straying outside of the mandate.

A senior official from the monetary policy operations team of the ECB, furthermore, argued that the Bundesbank remains an ideational central bank that uses its soft power to influence decision-making (ECB1). A senior official from the Bundesbank argued along similar lines and added that the ECB is focused on working in a manner removed from ideational debates. The ECB aims to decide based on pragmatic considerations while the Bundesbank is more ideational-oriented in its decisions (BUBA12). Thus, in policy debates that are discussed over a longer period of time, the Bundesbank developed arguments that are in accordance with its rule-based, ordoliberal framework. In terms of institutional identity, although the Bundesbank and the ECB share several institutional features and often have employees who have worked in both central banks over the course of their career, most prominently Otmar Issing and Jürgen Stark, the interviewees often argued that the ECB has developed its own identity that is beyond the ordoliberal ideational framework of the Bundesbank.

The ECB, in turn, used its narrow mandate to develop arguments that are above idealistic approaches to monetary policy. One interviewee from the Bundesbank argued that the quick escalation of the crisis did not allow for time to think about policy choices in ideational terms. The crisis required a pragmatic approaching order to develop the instruments that could transmit liquidity into the financial system (BUBA6). The crisis quickly engulfed the financial sector, in particular, after the bankruptcy of Lehman Brothers evaporated trust and certainty in financial markets. The major central banks simply did not have enough time to consider all available options, including whether an instrument would be suitable considering an ideational framework, such as ordoliberalism or post-Keynesianism (BUBA3; BUBA6; BUBA11; DNB2; DNB3; DNB4). Another senior official at the Bundesbank seconded the statement from her colleague and added that during the first two years of the crisis, the policy choices were decided on an ad-hoc basis, and the strategic benefits and perils were not discussed in much detail, predominately owing to the short period of time for developing a solution (BUBA3). Senior officials from the De Nederlandsche Bank argued in the interview that economic ideas did not play a prominent role during the financial crisis (DNB2; DNB3; DNB4).

The discussion above reveals that during the financial crisis, the ECB decided in a pragmatic way to overcome market tensions and provide liquidity (BUBA6; BUBA9; BUBA12). Despite these arguments, there were several instances when the ECB reduced its reliance on pragmatic decisions during the sovereign debt crisis. This resulted from letting different economic ideational frameworks, in particular, ordoliberal and post-Keynesian thought, influence the decision-making process when new policies were debated among central bankers, politicians and the public. The different national perspectives on the use of instruments to tackle the sovereign debt crisis made the decision-making process more political. This change has been felt particularly on the Governing Council level (ECB1; BUBA12; DNB1; DNB3).

A former Portuguese central bank board member summarised the debate in the interview as follows:

> '[T]here are different ideas between central banks mainly because they are influenced by national situations. The Bundesbank, for instance, has much more defended points of view from creditors while you probably have the Greek, or the Portuguese or the Spanish central bank defending more from the debtor side. You will always have these different perspectives on problems' (ESCB1).

This statement takes a defensive stance against the national influence on the decisions of the Governing Council. The interviewee states that the Bundesbank tends to argue from the creditor perspective while Southern European central banks tend to argue from the debtor perspective. The interviewee further argued that these different perspectives on problems will persist in the future. A senior official from the ECB confirmed that different opinions are, of course, debated in working groups and again in the Governing Council, which are influenced by national sentiments and perspectives (ECB1). Senior officials from De Nederlandsche Bank, in contrast, argued that the impact of these national sentiments is small and one should not forget that all central bankers of the European System of Central Banks (ESCB) focus on achieving the mandate and work towards this common goal (DNB2; DNB3; DNB4).

A British private sector employee confirmed his impressions from observing and working closely with the ECB, on the question whether the Governing Council, in particular, allows the influence of national ideas of their members to have an impact on their decision-making. The interviewee reflects,

> 'They will say that the remit is to look at the euro and the euro-zone as a whole. They are not there as representatives of their national central banks. They are there because of partly the treaty that established the ECB and partly because they seem to be the best qualified to do the job. It is interesting if you speak to them, quite a number of them, I think rightly, largely leave their national preoccupations at the door when they go into the council chamber' (PS2).

The interviewee argued that the Governing Council members do not allow national sentiments to play a role in their decision-making. Thus, the debate on whether national perspectives influence Governing Council members rages on. However, it is safe to say that professionals working with the high-level members of the ECB and NCBs assume that national sentiments do not play a major role in influencing decisions. Nevertheless, there have been several instances where national perspectives resulted in disagreements among Governing Council members; some such instances resulted in the resignation of Axel Weber and Jürgen Stark and the opposition of Jens Weidmann against the policy direction of the ECB under the leadership of Mario Draghi. During these instances of the sovereign debt crisis, as discussed in Chapters 7 and 8, the ECB would increasingly develop its own identity, which resulted in a policy direction away from its ordoliberal roots. Thus the resignation of Weber and Stark can be seen in the light of a changing identity that is increasingly tuned towards supporting members of the euro-area to prevent a breakup (Chapters 7 and 8). Furthermore, these episodes demonstrate that the expert knowledge within an epistemic community can be highly contested. Although all euro-area central bankers work towards a common mandate, some members have disagreed with the policy direction of the group and left the community.

The German and French governments, in particular, aimed to push the Governing Council towards a monetary policy that would support the direction of their national economies. The Governing Council, in turn, has also aimed to influence the decisions of several national governments. For example, during the initial phase of the crisis, this was the case in Ireland when the Irish government offered deposit guarantees. Over time, the Governing Council and in particular the members of the Executive Board became more sophisticated and decisive in pressuring national governments. Nevertheless, the Governing Council members conduct monetary policy for the whole of Europe and not for their individual countries. As the interviewee above pointed out, Governing Council members are chosen because they are the best qualified to do the job. This assessment can be challenged by considering the differences in the institutionalised political system of the euro-area member states. Each country has diverging processes when it comes to choosing the president of its NCB. The members of the Executive Board undergo a long and comprehensive nomination process. The EU governments recommend candidates which have to be considered by the EU ministers of finance. The ECB has the opportunity to comment on the eligibility of the candidate. The European Parliament interviews potential candidates in a public hearing from its Economic and Monetary Affairs Committee and deliberates the interview in a parliamentary plenary session. Yet, the European Parliament has no veto power to block the appointment. In a final step, the Council of the European Union, consisting of the heads of state and government, appoints the potential candidate. Thus, in the case of the Executive Board it is possible that candidates are chosen because they are best qualified to do the job. An interviewee from the ECB argued that the Governing Council members are not biased towards their national backgrounds and are independent. The underlying reason is that for most of them, the appointment as an Executive Board member is the last significant position in their career (ECB1). Thus, they do not have to support a specific group to obtain a future job. This might be more the case with younger officials (Adolph, 2013).

Ulrike Guérot and Thomas Piketty are critical of the nomination process of the ECB Executive Board (2018). They argue that it is not suitable for an institution that has increased its power and responsibilities since the onset of the financial crisis. Guérot and Piketty maintain that the Ministers of Finance should openly declare their candidate preferences and the reasons that led to their decision. In the particular, the limited and powerless role of the European Parliament is a concern for the two economists. Guérot and Piketty further recommend that the questions asked in the public hearing of the European Parliament should come at an earlier stage in the nomination process and should allow time for these questions to be openly debated among observers (2018). Their recommendations seem reasonable considering the extent to which the ECB has changed since 2007. Providing a transparent and open process would increase the credibility of each Executive Board member and in turn the credibility of the ECB (Guérot and Piketty, 2018). If the Governing Council members fully comply with the rule to decide in the interest of the entire Eurosystem, then why has the ECB not published the voting and, until 2015, the minutes of each council meeting? The decision to withhold this information was long based on the argument that this decision could potentially increase the transparency and credibility of the ECB, yet, considering that the Governing Council consists of central bank presidents from sovereign states, this could also negatively affect the presidents of the NCBs if investors and governments could find out their voting behaviour, thus reducing their independence on the Governing Council (Issing, 2013).

Economic ideational frameworks, such as ordoliberalism and post-Keynesianism played a subordinated role during the financial crisis. Before the crisis, in particular, ordoliberal thought significantly influenced decision-making at the ECB. The financial crisis required the ECB to decide on pragmatic grounds, based on technical information and within a short time frame. This was the case despite the composition of the ECB Governing Council, consisting of the presidents of all NCBs plus six Executive Board members, which have a wide range of views and differences on economic ideas. The underlying reason behind this phenomenon might stem from the fact that all council members and by extension all employees of the ESCB pursue the same objective: the mandate. The choice of instrument to achieve this objective is of course discussed at various stages in the process. The ideational impact of one particular school of thought, such as ordoliberalism or post-Keynesianism, can only be small in this deliberation. Thus, in times of crisis, institutions are more important than ideas for reaching a solution. Although one could argue that institutions without ideas are not sustainable, in times of crisis, pragmatism prevails.

On an actor level, in times of crisis, institutions need employees that can comprehend the situation and devise policy approaches to overcome the crisis. One interviewee, who was the president of a European central bank and has extensive experience in major international financial institutions outside of government, had a strong opinion on this argument:

> 'I am a firm believer of strong institutions. At the same time, if you put the wrong people in those institutions you cannot automatically expect the institution to churn out the right solutions. You need to fill

> the institutions with the right people, and clearly, in crisis, individual performance gets into the focus because individuals can put a stamp on finding quick solutions to problems. But these individuals who are needed in times of crisis can perform significantly better if they have solid institutions behind them, which produce the analysis from which a brave and clever individual can make the right decision and be there and change history' (ESCB2).

From the perspective of the interviewee, institutions need to be equipped with professionals that can find solutions to complex situations. The strength of the institution, however, is an important factor when finding a solution to tackle a crisis. As mentioned above, all euro-area NCBs work towards achieving the same mandate. This dedication to working closely together helped to reach answers during the crisis on different levels of the central banks and within different departments.

During 2007 and early 2008, the ECB changed in terms of its approach to the crisis and the intensification of working together in the Eurosystem. Considering the severity of the financial crisis, the ECB had to adapt to overcome the challenges. Once the crisis slowed down, the ECB, however, for a short period of time, tried to move back into its pre-crisis position. As explained above, the Governing Council decided to increase the interest rate to drain the excess liquidity from the system following the major capital injection intervention during 2007. In this context, the interest hike in July 2008 can be seen as falling back into the old preference for maintaining price stability over deeper European economic integration. This shows that institutions can move backwards. All indications, when looking at the policy response of the ECB and its subsequent change of role and position in the financial system, would not indicate that it would change back to a conservative central bank after undergoing such a wide-ranging change. However, from Minsky's perspective, the decision of the ECB to increase the interest rate to retrieve excessive liquidity from the financial system should be considered positive, because it actively works against an overheating financial system. The actions of the ECB were intended to make less capital available to investors to prevent them from taking on excessive risk.

6.5 Conclusion

This chapter analysed the policy response of the ECB during the initial phase of the financial crisis. It argued that the ECB was the first major central bank with a coherent crisis approach. It provided liquidity to the financial sector but kept interest rates stable for the first year. When the crisis showed signs of relief in mid-to-late 2008, the ECB decided to increase interest rates to prevent inflationary pressure. However, Lehman Brothers collapsed shortly thereafter and the crisis turned for the worse. This had an effect on the policy response of the ECB. Although the ECB eventually provided liquidity and reduced the key interest rate once again, the ECB was paralysed from these developments. National governments had to move forward to protect their financial institutions from failing as well. Thus, this behaviour might be an indicator that the institutional design, the mandate and the strategy of the ECB were designed to provide stability across the euro-area and in rare cases overcome the short-term liquidity shortages of financial institutions. From the ideational change perspective, ideas are less important in shaping a policy response during an initial phase than the literature assumed (see Blyth, 2002, p.32). During the recent financial crisis, the ECB had to act in a pragmatic sense rather than debating policy options that came from different spectrums of the euro-area member states. The wide range of national experiences with different types of crises might have had a positive impact on finding an adequate solution. The short time frame during which decisions had to be made often did not allow for prolonged debates. Overall, observers from the European central banking community and commercial bankers perceived the actions of the ECB as positive, excluding its interest rate increase in July 2008, which was seen as premature. From Minsky's perspective, this decision might have come at the correct time to retrieve the excessive liquidity from the financial system.

The financial crisis that started in 2007, therefore, demonstrated that the mandate of the ECB was well suited to fend off liquidity shortages. The epistemic community of central bankers was able to pull its expert knowledge together to quickly devise instruments and measures that counteracted any liquidity shortages in the euro-area and beyond. Indeed, without the close connection of European central bankers, that on a personal and institutional basis have often reached back decades, the financial crisis would have arguably been worse. However, during the sovereign debt crisis, the mandate constrained the actions of the ECB and the Eurosystem and the central banking community was, at first, unable to break out of its self-defined institutional and legal enclosure. Only after extensive debate and overcoming wide-ranging criticism did the ECB change its interpretation of its mandate to allow for an interventionist monetary policy. According to its founding documents, the ECB and the Eurosystem were institutionally prevented from intervening to support illiquid sovereign member states. The no-bailout clause and the prohibition to finance government expenditure are a case in point. The lack of a clearly defined LLR responsibility made it difficult for the ECB to stay on top of developments.The next chapter investigates the policy response of the ECB when the financial crisis turned into the sovereign debt crisis in November 2009. It argues that the first two years of the sovereign debt crisis saw the ECB fighting for its life without having the instruments at its disposal and coherent political needed support to overcome these challenges.

Chapter 7

The ECB fights for its existence

> 'In a crisis any decision by central banks has political implications. This is clear. But the important thing is that the decision is not motivated by political issues, but by adhering to the mandates and abiding by the rules that the ECB has set out.'
>
> Former ECB Executive Board member (ECB5)

In autumn 2009, the financial crisis turned for the worse when Greece announced difficulties in servicing its sovereign debt. This announcement fundamentally alternated the nature of the financial crisis. The interconnectedness of the global financial system brought the US subprime crisis to Europe within days. The collapse of Lehman Brothers one year earlier was immediately felt in the European interbank lending market and from there had an impact throughout the European financial system. Banks from euro-member countries were heavily invested in derivatives that turned out to be toxic and could no longer be sold or used as collateral. The toxic assets drained liquidity from the system and required the intervention of the ECB. Several European banks came into major funding difficulties. The national governments started to bail out their illiquid banks, which effectively transferred private debt into public debt. The collapse of the domestic economies, the fall in housing prices, in particular, in Spain and Portugal, and the increasing debt burden pushed the periphery countries into difficulties in repaying their sovereign debts.

The early phase of the sovereign debt crisis revealed that the institutional weaknesses of the Economic and Monetary Union (EMU) were the underlying reason for the crisis (European Commission, 2012; Enderlein, Bofinger, Boone, de Grauwe, Piris, Pisani-Ferry, Rodriguez, Sapir, and Vitorino, Enderlein et al., p.5). The euro-area failed to converge its economies since the introduction of the euro in 1999 (auf dem Brinke et al., 2015, p.6). The high public debt and low productivity among most Southern European countries, which were masked through incomplete or falsified accounting and complex financial products made it difficult for the ECB, the national central banks (NCBs) and the national supervisory bodies to assess the extent of the difficulties of individual member states (Rappeport et al., 2010). A former member of the Delors Committee stated 'we never anticipated that anything like [the sovereign debt crisis] would happen. We always thought that the Treaty, and afterwards the Stability and Growth Pact, establishing fiscal discipline, [would lead to] governments [...] respecting the fiscal discipline' (ESCB1). From his perspective, the Maastricht Treaty and the Stability and Growth Pact was not able to enforce fiscal discipline, which resulted in governments increasing public debt levels. This example indicates that the epistemic community of central bankers was taken by surprise when the financial crisis turned into the sovereign debt crisis. Euro-area central bankers lacked information on the extent of the sovereign debt of some of its member-states. Since then, the central banking community has become increasingly connected and the exchange of information has also considerably increased with the ECB at the heart of this operation.

The deeper reasons behind the sovereign debt crisis are, however, different in each country that faced distress. For example, Greece misreported its public budget for years, effectively hiding public finance mismanagement and poor fiscal policy choices (*Financial Times*, 2010). Spain saw its housing boom collapse and Ireland was heavily involved with complex financial products and saw several banks collapse as a result of liquidity shortages that resulted from an unsustainable housing boom (Shambaugh, 2012, p.161). The free flow of capital, goods, and services across EMU eroded competitiveness among periphery countries. Italy, Spain, and Greece had significant difficulties to compete with German and French products, considering that they had the same exchange rate (Eijffinger and Hoogduin, 2012, p.32). This removed the ability to depreciate the currency to increase competitiveness. The ECB, further, failed to lean against the real estate bubbles in Ireland and Spain by increasing the interest rate. Once the crisis hit, the institutional design of the currency union of the euro prevented the ECB from decreasing the interest rate to target the fallout from the collapsing housing bubble in both countries (Davies and Green, 2010, p.193). The ECB was, therefore, confronted with a new problem-set and, because of its narrow mandate, neither had the authority to intervene to stabilise member states nor the instruments available to intervene in the sovereign bond market. Within months, the ECB would acquire.

The strict interpretation of its mandate during the initial phase of the financial and sovereign debt crisis further reduced the ability of the ECB to design and implement a monetary policy that had a positive effect on growth and financial stability. The ECB, however, overcame its initial restricted policy approach with the introduction of the Securities Markets Programme (SMP) in May 2010. This instrument led to a major debate between the politicians and policymakers across the euro-area. The Governing Council board members Axel Weber, then-President of the Bundesbank and Jürgen Stark, then-Chief Economist of the ECB, resigned in protest of the SMP. The SMP, however, helped to reduce interest rates on sovereign debt from periphery countries. When the crisis flared up again in 2011 and 2012, the SMP was the predecessor to far-reaching instruments that the Governing Council, under the leadership of Mario Draghi, introduced to relieve the pressure financial markets inflicted on euro-area countries. Thus, the SMP can be seen as an important milestone in the economic ideational and policy change of the ECB. This chapter will assess the ideational shift among Governing Council members to that led them to accept an expansionary monetary policy using asset purchasing programmes that were largely forbidden in the Maastricht Treaty. The ECB and the NCBs of the Eurosystem fought for the preservation of the euro-area and had to devise new instruments to overcome the challenges. This chapter will provide evidence to understand better how ideas moved to the forefront when developing a policy framework to tackle the sovereign debt crisis. The rift between ordoliberalism and post-Keynesianism became obvious during this period, compared to the initial financial crisis phase. While the German government and central bankers argued that the SMP circumvented the mandate on price stability and the no-bail-out clause, French and Southern European policymakers welcomed the introduction of the SMP as an important instrument to relieve them from the pressures of capital markets.

7.1 5 November 2009: Greece announces debt problems

In November 2009, the financial crisis started to turn into the sovereign debt crisis in Europe, which, until late 2010 was a tumultuous time that almost resulted in the breakup of the euro-area. One after another, Ireland, Italy, Spain, Portugal, Greece, and Cyprus became unsustainably indebted. All of these countries, apart from Italy, required a bail out from the European national governments, with the help of the International Monetary Fund (IMF) and the ECB. The institutional system of EMU, as outlined in Chapter 5, required national governments rather than the Eurosystem to bail-out their banks, even when these were transnational and had significant operations in various countries, as discussed in Chapter 5.2.1 and Chapter 6. This institutional feature of EMU demanded that fiscal resources rather than monetary policy be used to bail out illiquid banks. Periphery countries, which relied to a large extent on Foreign Direct Investment (FDI) for their growth, were overwhelmed when foreign investors retrieved their investments within a short period of time. The capital flight saw the transfer of a significant amount of domestic wealth of individuals and corporates to other euro-area member states and the UK. This decreased taxable income for the periphery governments and reduced their ability to bail-out their domestic banks without the assistance from their NCBs or the ECB. These liquidity shortages had a negative effect on the sustainability of their budgets and led to what De Grauwe called, the 'deadly embrace' between banks and governments, as discussed in Chapter 5.2.1.

The ECB policy response to the sovereign debt crisis had a profound impact on its institutional design. In November 2009, the financial and economic difficulties of Greece started to surface. The ECB, however, announced on December 3, 2009, in a decision of the Governing Council, that 'the extraordinary liquidity measures that are not needed to the same extent as in the past will gradually be phased out, at the appropriate time' (European Central Bank (2009, p.7); Trichet (2010e, p.16-17)). The ECB reduced the availability of its non-standard measures that provided the needed liquidity to banks towards the end of the first two years of the crisis. At this stage, it appeared as if the ECB intended to return to a pre-crisis monetary policy stance, similar to its decision to increase the interest rate in the summer of 2008. In retrospect, attempting to phase out the non-standard measures can be considered a premature step. It further shows that the ECB did not anticipate that the debt problems of Greece could turn into a threat to the entire euro-area and its existence. When the sovereign debt crisis intensified between January and May 2010, the ECB seemed to stand by and watch the disaster unfold. While the national governments came together to develop a rescue plan for highly indebted euro-area member states, the ECB had difficulties in asserting its position as a crisis-fighting institution. The unclear and often prohibiting institutional design of EMU and the ECB reduced the ability of the ECB to act and caused it to make the wrong assessment about the short-term development of the crisis. Therefore, the first phase of the sovereign debt crisis, which lasted from early 2010 until late 2010, was the first time since the financial crisis erupted in 2007 that the ECB had to rely on national governments to develop a solution for the indebted periphery countries. Thus, the severity of the crisis required unprecedented policy actions from the ECB. In May 2010, the ECB introduced the SMP to overcome market tensions in the sovereign bonds segments. This decision, however, pushed the ECB to the boundaries of its narrow mandate and resulted in a wide-ranging debate about the credibility and independence of the ECB. In retrospect, the introduction of the SMP paved the way for Draghi's introduction of the OMT programme that helped to overcome the second phase of the sovereign debt crisis quickly.

The worsening economic and financial conditions in periphery countries, especially Greece, forced the ECB to act. Despite its independent nature and its narrow mandate to achieve price stability, the ECB could no longer remain above the political sphere. The pressure that financial markets created on member-state governments became an inherent risk to the survival of the currency union. For the first time, the ECB had to consider directly intervening in the sovereign bond market. This action was at first not conceivable with the mandate and with traditional monetary policy instruments and previous monetary policy decisions. Nevertheless, the severity of the financial and sovereign debt crisis required an innovative approach. During the sovereign debt crisis, the pressure that was exerted on weaker euro-area governments required the ECB to intervene in the market. Despite core country resistance that was arguably based on ordoliberal ideas, the actions of the ECB were necessary to overcome the challenges. The debate on the introduction of the SMP resulted in a heated debate that ranged between professionals with ordoliberal and post-Keynesian backgrounds.

In early November 2009, the newly elected Greek government under then-Prime Minister George Papandreou announced that the budget deficit of 2009 was at 12.5 percent of GDP, well above the 3.7 percent predicted in April 2009 and the three percent threshold in the Stability and Growth Pact (Barber, 2010). Greece revealed that its total debt stood at 113 percent of GDP, amounting to about 300 billion euro (*BBC News*, 2009). Major rating agencies reduced the rating of Greek debt, which moved it below investment-grade (Smith and Seager, 2009).[1] This downgrading of Greek sovereign debt made it difficult for the ECB to accept it as collateral. The Greek government initially responded by unveiling several austerity measures in January 2010. This decision was aimed at taking back control over its debt and reversing the declining economic conditions, rising unemployment and related social

[1] Rating agencies assign the highest ratings to those bonds of which the issuer is unlikely to fail to repay its debt. An investment grade bond generally has a high credit rating, depending on the agency between AAA and BBB- (Standard and Poors) or Aaa to Baa3 (Moodys). Central banks tend to only accept investment grade bonds as collateral for lending. The deeper reasons for this are that lending is risky and in the case of the central bank, the costs for default are ultimately paid for by the public. Therefore, central banks are obligated to only accept collateral that has a low risk of default.

costs of a disintegrating civil society (Featherstone, 2012). What became known as 'Grexit', Greece leaving the euro-area, was a constant threat to the stability of the euro-area and the EU for the remaining years of the crisis.

The ECB and governments of the euro-area member states, however, feared that Greece required a bail-out. In Figure 5.6, the bond yields of sovereign bonds are tracked between 1993 and 2011. Before the introduction of the euro, the German Bunds and the French OATs had relatively low yields while periphery countries had high yields. Once the euro was introduced, the yields quickly converged on the low level of the Bund and the OAT. This indicates that investors considered the risk of a German Bund or French OAT to be about the same as that of the Greek sovereign bonds. This continued to be the case even shortly after Lehman Brothers collapsed. Once Greece reported that its sovereign debt was higher than expected, investors started to reconsider their risk exposure to periphery countries. As a response, periphery country yields increased, while the Germany and France enjoyed a period of relatively cheap funding. This behaviour brought a new problem set for the ECB during the financial crisis. The diverging yields of sovereign bonds were partially responsible for turning the financial crisis into the sovereign debt crisis. The ECB had previously been able to contain the financial crisis by providing extensive liquidity into the overnight lending market and reduced interest rates to make borrowing cheaper.

Throughout the first months of 2010, the economic situation of Greece worsened, and the capital flight from Greece increased the pressure on the Greek government to act. The increasing difficulties in funding public debt, despite far-reaching austerity measures, resulted in the Greek government's inability to reduce its budget deficit. The euro-area sovereign debt crisis intensified when other periphery countries also became the target of capital flight and investor speculation. As discussed in Chapter 3.3, credibility is of paramount importance in financial markets. As argued above, before the crisis, investors considered the default risk of all euro-area member states to be about the same. The announcement that Greece might not be able to repay its debt pulverised this thinking and financial markets began to see the error in considering all euro-area government bonds to have an equally safe credit rating, despite strong institutional and structural differences. Bond spreads started to rise for all euro-area government bonds, but really diverged once investors valuated periphery countries debt as riskier than core country debt (see, Figure 5.6). The credibility of the ECB to overcome these challenges with a 'one-size-fits-all' monetary policy started to evaporate as well.

The ECB worked on the assumption of one-size-fits-all, as discussed in Chapter 5.2.2. During the sovereign debt crisis, however, the ECB required a different monetary policy for each country. The ECB could not use the exchange rate mechanism to devalue a specific area, as its mandate prohibited it from buying sovereign bonds of any country to reduce yields, and it could not call on fiscal redistribution to crisis-struck countries, because of the lack of a fiscal union. The decreasing levels of credibility led to considerable uncertainty in the market. Until the financial crisis, investors assumed that the sovereign debt of periphery countries carried the same risk as the sovereign debt from core countries. The one-size-fits-all monetary policy and the convergence of ideas among the epistemic community of euro-area central bankers further fostered this assumption (Chapters 3 to 5). The first defining feature of Haas (1992b, p.3), 'a shared set of normative and principled beliefs', has influenced the assumption that periphery country sovereign debt remains virtually risk-free among central bankers despite the different economic and institutional basis. In this case, the similarity of ideas about the credibility of the solvency of Greece did not allow for this group to adequately price the risks of their investments. Following the announcement, Greece became politically unstable, strike activity increased, and violent demonstrations against austerity measures took place on an almost daily basis. This further decreased the investors' appetite to invest in Greek originated bonds and intensified the solvency crisis even more (Fontana and Schleicher, 2010).

The Greek government and the Greek banks had increasing difficulties to finding funding on international debt markets, and the interest rates paid on their existing debt continued to increase substantially. While the ECB had to consider its options, sovereign bond spreads of periphery countries began to rise.[2] The drawbacks of EMU became apparent when the crisis spread to Spain and Portugal. Similar to Ireland, Portugal and Spain had experienced an economic crisis following a crash of real estate prices starting in 2007. The national governments, therefore, had to step in and provide fiscal means to stabilise and stimulate the economies. The periphery

[2] Bond yields are an important indicator for an investor to assess the attractiveness of a bond. A difference in yield provides an indication of two different bonds with the same maturity, risk, and credit ratings. For example, a 5-year German Bund might be trading at three percent and a 30-year Bund at six percent, the yield spread would be three percent. The yield spread is key metrics on the level of risk associated with a bond. For example, when a bond is considered risky, an investor demands a high yield in return for taking the risk of default of this bond. Thus, should ratings go down, an underlying asset might not be valuable, or if there is a high risk of default, the yield will go up. The difference between this yield and the yield of another bond, in the case of the Bund, is the yield spread.

countries faced a dual dilemma: while they needed public money to bail-out their banks and guarantee deposits (as in the case of Ireland), they lost the funding they had relied on, partially from reduced fiscal resources, funding from capital markets and because of capital outflows to the core countries.

On April 8, the Greek 2-year bonds and 10-year sovereign bond spreads reached 652 basis points and 430 basis points, respectively. George Soros, the financier who became famous for betting against the British pound in 1992, said in an interview with the *Financial Times* in April 2010, 'It is 50-50 whether the eurozone breaks up. The damage that break-up would cause is so great, that I think that as people realise it, they will pull back from the brink [...] But we are at the brink now [...] a solution has to be found in a matter of days' (quoted in Tett and Giles, 2010). His statement shows two challenges for euro-area policymakers: scope and timing. First, Soros anticipated that a Greek default would not only push Greece out of the euro-area but might result in a break-up of the currency union. A loss in confidence of the financial market in national governments and the Eurosystem to protect the integrity of the euro-area and prevent a default of a member-state would have devastating consequences for the euro. To make matters worse, the threat that the euro might break-up decreased investors' appetite for euro-denominated debt, in particular, which originated in Southern European countries. Thus, debt became more expensive for sovereigns, banks, and corporates in the periphery countries. The rising sovereign bond spreads attracted investors to short-sell these bonds, further intensifying the crisis.[3] On 21 April, bond spreads further increased to 1552 basis points for the 2-year and 755 basis points for the 10-year bonds. The increasing spreads on sovereign bonds made it difficult for the Greek government to refinance its debt. The Greek crisis and the threat of Greece leaving the euro-area increased dramatically, again. On 23 April, the Greek government officially requested an international bailout (Kitsantonis and Saltmarsh, 2010). The following days in late April 2010 included intense negotiations between the European governments on whether or not and to what extent they should support Greece. Several challenges made the support for Greece difficult. First, the Maastricht Treaty was explicit in the no-

[3] In modern financial markets, an investor can short-sell an asset or commodities. This is achieved by borrowing assets from an owner and selling them to someone else (Black et al., 2009). When the prices drop, the investor can buy back the assets and give them back to the owner. The investor gains from the difference the falling price achieved. When the price of the asset goes up during the time of the trade, the investor has to return the number of shares and incurs a loss of the difference between the price he lends the shares and the price he repurchases them. During the financial crisis, several countries banned various forms of short-selling to protect companies from the downward pressure on their stocks.

bailout rule (Maastricht TEU, 1992, p.125). Euro-area member state governments and the ECB were prohibited from supporting each other through directly funding government debt (as discussed in Chapter 5.2.1). The ECB, the European Commission, and the IMF agreed to participate in the bailout negotiations and became later known as the Troika.

Second, Soros' statement reveals that a plan for preventing the default of Greece had to be found within 'matters of days'. Otherwise, investors would already have lost confidence in the Greek debt markets, which would have made a bail-out impossible, because of the risk appetite of investors and governments, or Greece would have to default on its debt before a solution could be found. In modern European financial markets, timing is crucial. Open borders and no capital restrictions allow investors to freely move cash around in the whole of the euro-area and often beyond. When the crisis intensified in Greece, the threat of investors pulling out their capital was imminent. The lack of liquidity would have put additional pressure on the already strained banks and firms in Greece. This uncertainty would have further increased the spread of government bonds and the ability of governments to refinance their debt would have been limited. During these first months of the sovereign debt crisis, it was unclear to central banks and governments whether the euro-area could survive the default of one of its member states. The exit of a member state from the euro-area would signal to markets and the political establishment that European integration is reversible, shattering any confidence left in the periphery countries.

On May 2, 2010, the Troika responded within two weeks and announced support for Greece with a three-year economic and financial restructuring programme, which entailed 110 billion euro (International Monetary Fund, 2010). The announcement, however, had little effect on bond spreads. On May 7, the 2-year and 10-year Greek sovereign bond spreads further increased to 1739 and 1287 basis points, respectively. These developments, in addition to the disclosure of fiscal policy and public budget mismanagement in periphery countries, led to a major crisis in confidence and further reduced the ability of Southern European countries to refinance their debt. Another concern for European policymakers was that fiscal sustainability in smaller countries became a threat to the breakup of the euro-area. The financial integration of the euro-area resulted in core countries holding a large portion of the private debt of banks from periphery countries (Eijffinger and Hoogduin, 2012, p.32). In the case of a Greek default, the exposure of core country banks to Greek debt and assets would have had major repercussions for all European economies

(Shambaugh, 2012). Thus, bailing out Greece was as much about stabilising the budget as it was about indirectly bailing out German and French banks (Rocholl and Stahmer, 2016, p.17).

Nevertheless, the financial crisis was arguably only the trigger that exposed the weaknesses in the EMU. The intimate relationship between financial institutions and governments to finance their sovereign debt only enhanced the impact of the crisis. This forced the euro-area member governments and the ECB to consider an exit of Greece from the euro-area. These overlapping and interacting issues became a major concern for the ECB right from the beginning of the crisis. The build-up of the crisis was only possible because central banks did not evaluate how the link between financial and sovereign debt risks could have a negative impact on the financial system and spill-over effects on the real economy (Gray, 2009, p.128).

In the years before the financial crisis, Southern European countries and Ireland experienced a high inflow of capital from the core countries, such as France, Germany and the Netherlands. Periphery countries relied on this capital to cover their investment and funding gaps. At the same time, investors in the core countries were heavily invested in toxic financial products from the US to cover their funding costs. Thus, when the crisis hit, European banks had to retrieve capital from the periphery countries to cover their losses from their derivative and bond trading desks. Some financial institutions came into liquidity shortages, and, without government support, became insolvent. Several European governments bailed out their banks to prevent a collapse of the financial system. In most continental European traditions, the responsibility of LLR was with the government and not, as it is the case in the Anglo-Saxon tradition, with the central bank. The ECB could not directly support failing financial institutions (Maastricht TEU, 1992, art. 125). In the US, the Fed actively negotiated take-over deals between banks and injected capital into particular institutions. This stems from the lack of the LLR idea in Europe. While the LLR function is an integral part of central banks in Anglo-Saxon countries, historically it is less developed in continental Europe (Chapter 5.2.1). The authority to assist banks during a financial crisis remained with the national governments.[4] Thus, the ECB saw itself as having to intervene in the rising sovereign bond yields and, as mentioned above, introduced the SMP a week later on 10 May. The following section will assess the debate on the SMP in more detail and the role of the epistemic

[4]The only option for national banks is to ask the ECB for a capital injection from the emergency liquidity assistance (ELA). Yet, again, the authority to grant this assistance and the risks associated with it lie with the NCBs. See a more detailed explanation below.

community of central bankers in developing as well as framing it.

7.2 10 May 2010: Introduction of the Securities Markets Programme

Considering the pressure on periphery government bonds, on May 10, the ECB was forced to intervene in the sovereign bonds market and for that purpose introduced the SMP. The SMP was designed to buy sovereign debt on the secondary market to enhance the transmission process and intervene in dysfunctional segments of the sovereign bond markets. As discussed in Chapter 5.1.4, the transmission process consists of several channels that allow central banks to use the financial system as an intermediary to influence the real economy. The used instruments, on the one hand, target the price developments of different assets, yields and the exchange rate, and, on the other hand, allow the central bank to ease or contract capital flows and credit availability (Walsh, 2014, p.2; see Figure 5.3). The transmission channel, therefore, theoretically provides the ECB with access to the financial system to influence it and ultimately achieve its mandate of maintaining price stability in the euro-area. The decision to introduce the SMP had a significant effect on the ideational foundation of the ECB. It moved from being predominately influenced by ordoliberal ideas to allowing post-Keynesian ideas to influence its decision-making. Jean-Claude Trichet, who previously strongly favoured ordoliberal ideas, moved his position towards his French roots of post-Keynesian thought when he pushed through the SMP. The ECB decided to 'sterilise' the operation, meaning that the liquidity injected through the SMP would be drained from the system and it should, therefore, not have an impact on price stability (European Central Bank, 2010c,e). The ordoliberal tradition of price stability is visible in this decision. Nevertheless, the fact that the SMP was an asset purchasing programme cannot be aligned with ordoliberal ideas. Therefore, despite the sterilisation, the SMP became one of the most controversial instruments and created rifts among Governing Council members (Tuori, 2013, p.36; Directorate-General for Economic and Financial Affairs, 2010). In a press statement, the ECB announced that owing to the 'exceptional circumstances prevailing in the market' (European Central Bank, 2010c), the SMP would allow the European System of Central Banks (ESCB) to:

> 'conduct interventions in the euro-area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments which are dysfunctional. The objective of this programme is to address the malfunctioning of securities markets

> and restore an appropriate monetary policy transmission mechanism' (European Central Bank, 2010c, see, European Central Bank, 2010a).

The instrument was designed to buy sovereign debt on the secondary market, meaning from financial institutions rather than directly from governments.[5] This design feature of the SMP circumvented the mandate of the ECB that prohibited any government financing. The instrument was used between May 2009 and September 2012. Two periods can be identified when the Eurosystem bought most of the sovereign debt. Approximately 60 billion euro were bought between May 2010 and July 2010 and another 140 billion euro between August 2011 and January 2012 (Eser and Schwaab, 2013, p.12). These periods are largely congruent with the two intense phases of the sovereign debt crisis. In total, the ESCB bought 210 billion euro of debt.

The SMP differed in three key features from the Large-Scale Asset Purchases (LSAP) of the Federal Reserve System (Fed), conducted between late 2008 and October 2014, and the Quantitative Easing (QE) of the Bank of England (BoE), conducted since March 2009. First, compared to the SMP, which was designed to re-activate the transmission process, the LSAP and QE were designed to make monetary policy more accommodative once the interest rate had reached the lower bound (for the US experience, see Williamson, 2017; for the UK experience, see Lysenko and Six, 2016; for a global overview, see Blot et al., 2015). Second, the SMP addressed government bond markets that were impaired and illiquid (Constâncio, Constâncio). Investors considered the sustainability of public finances of periphery countries as insufficient. Thus, investors' demand for sovereign bonds was reduced, further decreasing periphery countries' ability to refinance their rising debt burden. In contrast, the US and UK sovereign bond markets remained liquid throughout the crisis, allowing both countries to refinance their public debt (for the Fed, see D'Amico and King, 2013; for the BoE, see Joyce et al., 2011; for a review, see Kozicki et al., 2011; Meaning and Zhu, 2011). In the US and the UK, liquidity shortages were only of a temporary nature and could be resolved through central bank capital injections. Both countries, therefore, did not need the programmes to incentivise public demand for sovereign bonds; it was needed to provide liquidity to the overall system. Another difference between the SMP and the LSAP or the QE was the communication strategy used by the Fed, the BoE and the ECB. Because the LSAP and QE aimed to make monetary policy more accommodating, the Fed and the BoE regularly announced the

[5]On the primary market, governments sell their newly issued bonds to investors. On the secondary market, market participants trade already issued sovereign bonds.

size and duration of their purchases and intervened at regular intervals. The ECB used a similar approach when it introduced its QE programme in March 2015. In the case of the SMP, the ECB refrained from a transparent communication strategy. It only announced the start of the programme in May 2010 and its re-activation in August 2011. It did not disclose the number of its interventions nor the intervals of its purchases (Eser and Schwaab, 2013, p.7-8). The main reason behind this decision was to reduce the risk for the market either to interpret the ECB decision as a panic move or to challenge the ability of the ECB to intervene and discover its 'pain-threshold' (Hume, 2011).

The question remained whether the SMP was against the economic ideational foundation of the Eurosystem. The key point of conflict was on the question whether the SMP was a monetary decision to stabilise financial markets by restoring the monetary transmission channel or whether it was an intervention to strengthen fiscal resources in periphery countries and what impact that had on the ordoliberal foundation of the ECB. In the absence of capital market access for periphery countries, the SMP allowed for indirectly financing government expenditure. The instrument, therefore, experienced a high level of criticism from core countries' central banks, governments and commercial banks. This criticism had an impact on the governance of the ECB and reduced its credibility. It is, therefore, imperative to assess how the instrument has changed the institutional and policy understanding of the ECB during the first period of the sovereign debt crisis. For the first time in the history of the ECB, a disagreement between Governing Council members was revealed to the public. This went as far as violating the informal rule to not publicly criticise the decisions of the ECB council. The epistemic community of European central bankers has historically remained to itself and has continuously aimed only to release information as part of the monetary policy strategy. Weber's decision to publicly criticise the monetary policy decision of the Governing Council was a major breach of confidentially and trust for his colleagues (Neller and Kurm-Engels, 2010). In retrospect, it can be argued that while criticism of the SMP was not without merit, the programme was necessary to relieve periphery countries from their mounting debt pressures. In addition, the SMP was the direct predecessor of the OMT, which was designed based on the lessons learned from the failures of the SMP and had a significant effect on capital markets without the need of being implemented. The SMP, therefore, played an important role in the learning curve of the epistemic community of Eurosystem central bankers.

7.2.1 Criticising the SMP

The criticism of the SMP was largely two-fold: on the one hand, observers criticised the scope of the policy, arguing that the duration and amount of assets to be purchased were not enough to overcome the tensions in the market (de Grauwe, 2013; Belke, 2010). This line of criticism was post-Keynesian in nature, because considering the size of the sovereign bond markets in Europe, the short duration and the small and selective purchases were not enough to have a lasting impact. On the other hand, observers argued that the SMP was a breach of various articles of the founding documents of the ESCB (Tuori, 2013; Sester, 2012). This criticism argued along ordoliberal perspectives, because critics feared that the asset purchasing programme would blur the lines between fiscal and monetary policy (Dyson and Maes, 2017:162-163). Both criticisms were based on opposing economic ideational camps and had a direct impact on the credibility, independence and governance of the ECB.

The Belgian Parliamentarian and economist De Grauwe argued along post-Keynesian thinking when he criticised the scope of the SMP. He argued that the ECB 'structured [the SMP] in the worst possible way [...]. By announcing the program would be limited in size and time, the ECB mimicked the fatal problem of an institution that has limited resources' (de Grauwe, 2012b). De Grauwe argued that the ECB had to leverage the fact that it has unlimited resources in order to impress the market. Only this show of force would bring down sovereign bond yields. De Grauwe maintained that the SMP was the right choice to enable the ECB to become a lender-of-last-resort (LLR) for banks and sovereigns (de Grauwe, 2013). The size of the programme was, however, not correctly conditioned as it potentially allowed financial institutions to draw conclusions over the overall capacity of the ECB. As De Grauwe pointed out, the ECB failed to demonstrate to the financial market that it had unlimited resources. De Grauwe represents a community of core country economists with an extensive network in academia and central banking and has, throughout his career invested a great amount of time in investigating the institutional foundation of the ECB. He traditionally argues from a ordoliberal perspective, in particular, focusing on the short-comings of the LLR function. From his perspective, better rules would make the ECB more effective in dealing with financial and sovereign debt crises. De Grauwe argued, as mentioned above, that the ECB can only succeed in overcoming these challenges when it is fully committed to the role of LLR. The ECB, however demonstrated that it was not fully committed to the LLR function when it introduced the SMP (de Grauwe, 2011, 2013; Chapter 5.2.2). Thus, for De Grauwe, this lack of commitment could only be overcome when the SMP was designed to overcome the institutional weaknesses of the EMU and the financial market tensions, moving him towards a post-Keynesian argumentation.

Trichet, in contrast, argued that SMP was aligned with ordoliberal ideas specifically because of its limited scope and the sterilisation of the purchases. Both design features aligned it with the mandate of price stability (European Central Bank, 2010c; European Central Bank, 2010e. He argued that the 'The Securities Markets Programme should not be confused with quantitative easing. In simple words: We are not printing money. This confirms and underpins our commitment to price stability' (Trichet, 2010f). It remains unclear what has prevented the ECB from taking on a more decisive role as LLR. Whether it was its mandate to maintain price stability, its institutional foundation, or the criticism from core country actors, the ECB acted indecisively during the first phase of the sovereign debt crisis which caused the sovereign debt crisis to almost spiral out of control. Furthermore, as argued above, during the financial crisis, the ECB acted decisively and in a pragmatic fashion without allowing ideational considerations to creep into its decision-making. It lost this ability during the early phase of the sovereign debt crisis.

The German economist and academic Ansgar Belke, who has investigated the role of monetary policy on financial markets and the real economy, argued in contrast to De Grauwe's argumentation that 'the ECB should [...] avoid an "anything goes" monetary policy under all circumstances and keep the deliberate secondary market bond purchases within the SMP as exceptional, brief, targeted and limited in volume as possible' (Belke, 2010, p.362). The ECB should, therefore, only use the SMP intervention when it is absolutely necessary and then only to a limited extent. Belke argued that the ECB would encounter difficulties in clearly differentiating between accommodative monetary policy and targeted assistance of impaired transmission processes in fragmented bond markets. Therefore, the ECB should consider the SMP as a once-in-a-lifetime decision that was necessary owing to exceptional circumstances. In contrast to De Grauwe, Belke maintained that the ECB should refrain from using the SMP and the scope of the instrument was set up to have an impact that was too large on the sovereign bond markets of periphery countries. This demonstrated that there was a division even among core country economists with ordoliberal perspectives. In this example, De Grauwe and Belke are similarly established in the European epistemic community of central banking experts.

Another line of criticism emerged that was directed against the programme itself and further fuelled the debate. The criticism against the overall programme concerned separate issues of why the ECB should refrain from using the SMP and the ideational perspectives of critics was aligned closely with the ordoliberal perspective. First, critics argued that the SMP was disregarding the mandate of price stability of the ECB. Second, it was in violation of the no-bailout clause of the Maastricht Treaty (Maastricht TEU, 1992, art.125). Third, the SMP created a moral hazard for governments as it reduced the incentive of governments to implement structural reforms. Fourth, the ECB has only a limited role as LLR, which only covers providing liquidity to illiquid financial institutions and does not extend to sovereign governments of member states. To better understand the different dimensions of the criticism and their relation to ordoliberal and post-Keynesian thought in the Eurosystem, it is imperative to look at them in turn.

The ECB was criticised for the introduction of the SMP, because an expansionary monetary policy could violate the primary mandate to maintain price stability. Then-Chief Economist of the Deutsche Bank Thomas Mayer, who is well-respected among the banking community in Germany, argued that ‘the ECB has strayed far from its prime mandate to secure the purchasing power of the common currency and taken on the funding of governments and banks whose solvency is highly doubtful’ (Deutsche Bank Research, 2011, p.7). His main objection was that the ECB should not inject capital to support individual governments, because this would increase inflation and support states which are not solvent owing to their mismanagement of finances or lack of competitiveness. This ordoliberal view on the sovereign debt crisis and the actions of the ECB indicates that the major German banks were opposing the post-Keynesian potential of the SMP. Trichet, however, continuously argued that the actions of the ECB were in compliance with the mandate of price stability, and thus with ordoliberal values (Trichet, 2010d; Trichet, 2010e, p.17). To keep the monetary policy aligned with the mandate, Trichet argued that the ESCB would ‘re-absorb the liquidity injected’ (2010f). This sterilisation of the programme would reduce the risks of an increased inflation rate. Although Mayer and Trichet followed ordoliberal ideas, they had a very different perspective on the value and use of the SMP. Indeed, Trichet rebuked the criticism of Mayer and argued that the SMP allowed the ECB to intervene in the sovereign bond markets of insolvent periphery countries by disregarding the mandate of price stability. However, it has to be acknowledged that the sterilisation of the SMP was effective and liquidity absorbing operations were conducted until June 2014 (European Central Bank, 2010c). Trichet further clarified that the ECB distanced itself from the asset purchasing programmes of other countries which aimed at injecting liquidity into the system through bond purchases. He said in a press conference, 'from the very beginning, the aim of the programme has been to help us restore the functioning of our monetary policy transmission mechanism, and it is for the Governing Council to judge how best to do this. It is not quantitative easing; we are withdrawing all the liquidity that we are injecting' (Trichet, 2010a). Thus, the critique of Mayer does not seem to hold up entirely when checked against the operations of the ECB. Again, the ordoliberals argued that the SMP was against the mandate for injecting liquidity in the financial system and against the rules established in the Maastricht Treaty. Yet, as Trichet pointed out, the sterilisation of the SMP should align it with the mandate of the ECB and thus with ordoliberal ideas. In terms of the ECB supporting periphery countries that had solvency issues, it has potentially stepped outside of its mandate. The SMP, however, did not introduce excessive liquidity into the system owing to its sterilisation operations.

Furthermore, critics argued that the SMP was a violation of the no-bail-out clause of the Maastricht Treaty that was established to prevent the ECB and other member states from supporting each other by buying up government debt. This strand of criticism ultimately led to the resignation of Axel Weber, then-President of the Bundesbank and a potential successor of Trichet, and Jürgen Stark, then-Chief Economist of the ECB. The TEU states in Article 125 that 'the union shall not be liable for or assume the commitments of [...] any Member State' (TEU, art. 215). Article 123 of the TEU states that 'overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States [...] shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments' (TEU, art. 123). Trichet maintained that by buying on the secondary market, the ECB would not violate the articles set out in the treaty that prohibited government financing and the mandate that demands the ECB to maintain price stability (Trichet, 2010g,f).

Weber, however, criticised the Governing Council decision the following day. He said in an interview with the newspaper *Börsen-Zeitung*, 'buying sovereign bonds harbours considerable stability policy risks' (Weber quoted in Schaaf, 2010).[6] Weber further revealed that he did not vote for the SMP. The direct criticism of a policy decision of the Governing Council was an unusual step for a board member (see, above and Neller and Kurm-Engels, 2010.) The council members had before neither

[6] Author's own translation.

revealed their votes nor directly criticised their colleagues. Following his resignation, in an interview with the Spiegel, the newspaper, Weber argued that the decision to develop and implement an asset purchasing instrument was a major turning point for the operations of the ECB and the Eurosystem. He therefore felt he had to speak up and initiate open debate about the SMP. In the words of Weber, '[w]e weren't dealing with a routine decision, but an important change in direction, and that I could not keep my opinion to myself on such a fundamental issue' (Weber quoted in Mahler and Pauly, 2011). Throughout the year, Weber became increasingly concerned with the decision to implement the SMP. In October 2010, he remarked in a speech to the Shadow Open Market Committee symposium in New York City:

> There is no evidence that asset purchases have had any significant impact on average euro-area sovereign bond yields on which euro-area monetary policy must exclusively focus as its main transmission channel. But the SMP risks blurring the different responsibilities between fiscal and monetary policy. As the risks associated with the SMP outweigh its benefits, these securities purchases should now be phased out permanently as part of our non-standard policy measures (Weber, 2010).

Weber accused the ECB of using the SMP as a fiscal instrument. Indeed, the Maastricht Treaty codifies that the secondary mandate of 'the ESCB shall support the general economic policies in the Community' (TEU, art. 105(1)). The mandate, however, refers to the entire Eurosystem and not individual countries (Tuori, 2013, p.37). Proponents of the SMP have, however, argued that it is a monetary policy instrument. The ECB Executive Board member Benoît Cœré claimed, 'the SMP [...] fulfills a monetary policy purpose, and clearly falls within the mandate of the ECB. One, therefore, cannot claim that the ECB has become a fiscal player' (Cœré, 2011). Cœré maintained that the SMP is not a breach of the mandate and the ECB is, therefore, not becoming an actor in fiscal policy. However, Belke argued that there is an inherent risk that fiscal policy considerations might dominate monetary policy decisions (Belke, 2010, p.5). His position, from a German ordoliberal perspective, has merits because the asset purchasing programme weakens the negotiation power of the ECB and euro-area member states to enforce fiscal discipline in periphery countries. This debate demonstrates the tensions in the epistemic community of central bankers during the height of the sovereign debt crisis. The expert knowledge on policymaking decisions was highly contested and the complexity of the potential impact on the markets as well as on the institutional and legal foundation of the ECB and the Eurosystem made any arguments highly political.

On a related matter, other critics have pointed towards ensuring that the LLR responsibility should remain with the national governments and not with the ECB. Then-Governor of the Banque de France, Christian Noyer, outlined the risks of the SMP and the ECB's emerging role as LLR. He argued 'through [...] its non-conventional measures - including the SMP the Eurosystem has fully played its expected role [as LLR] [...]' (Noyer, 2011, p.3). However, as strong as his position is in this statement, Noyer quickly retracted it and argued that the ECB was correct to use the SMP to become more involved as an LLR. For him, the asset purchases might entail high risks that go beyond the LLR responsibility of a central bank. He argued:

> 'Having said that, it is clear that engaging in large-scale asset purchases of sovereign bonds is well beyond what should be expected of a central bank's role as a LLR. Moreover, large-scale asset purchases are not without risks. [...] they could also affect price and financial stability in the medium-run, by endangering the value of the central-bank money. Such risks do not necessarily materialize, but when they do, the repercussions are dramatic' (Noyer, 2011, p.3).

This shows not only the deep divisions over these matters among Governing Council members, but also the difficulty for them to assess the implications and wider effects of the SMP. The repercussions that might materialise should the assets default would be dangerous for the integrity of the central bank and in this case for the Eurosystem as a whole. It risks financial stability and might reduce the value of money. The governor of the Estonian central bank, Andres Lipstok, however, defended the introduction of the SMP. He argued, 'anyone who believes that the SMP is designed to provide lender-of-last-resort type financing to governments is completely misguided' (Lipstock quoted in *Reuters*, 2012). Thus, the Lipstock claimed that the SMP was not designed to provide LLR assistance to governments. These statements demonstrate the deep divisions among various Governing Council members of the ECB on the use of the SMP during the height of the sovereign debt crisis. It further reduced the credibility of the ECB, because, before the sovereign debt crisis, criticism on instruments or the actions of the ECB of Governing Council members was not revealed. The SMP however, resulted in a debate in which Governing Council members criticised the decisions and voting behaviour of individual members of the Council. Indeed, there was a turning point when Weber started to criticise the SMP. From this point onwards, Governing Council members were more outspoken about their personal opinions about instruments and monetary policy developments. The informal rule that decisions, voting behaviour and criticism against instruments and colleagues should not leave the council chamber is now consistently broken, which reduces the overall credibility of the ECB, its decisions and its instruments.

Issing, the former chief economist of the ECB and the Bundesbank, furthermore argued that the no-bailout arguments are on how the SMP affects the independence of the ECB. Issing criticised the decision in an interview with the *Financial Times*: 'a monetary union with a stable euro can only survive if central bank independence is fully respected. This implies that the ECB abstains from fiscal policy actions (such as buying sovereign bonds in secondary markets)' (Issing, 2011). He argued that the ECB would lose its independence and implied that it would further negatively affect the credibility of the ECB if it ventured into the fiscal policy sphere. In this case, it does not matter whether the ESCB buys government debt on the primary or secondary market because it is liable for the debt in any case. Compared to accepting debt as collateral, accepting debt that the financial market deemed toxic which has a high risk of default cannot be aligned with standard monetary policy practice. This puts the ECB into a difficult position considering its independence and credibility. If it holds considerable assets of individual member states that are at risk of default, it will not be able to objectively decide on whether a default would be possible. It could not afford a default of any member state (Tuori, 2013, p.38). The no-bailout rule was, however, not as strong as most had thought. The rule prevented the ECB from purchasing sovereign debt from primary markets; it does not prevent it from purchasing sovereign bonds on the secondary market (European Parliament, 2011, p.9). Interviewees from the private sector, who work in fixed income departments, argued that there is still the question of whether banks loaded up their sovereign debt portfolios shortly before the ECB executed its purchases (PS5; PS6, PS10).

The ECB was criticised for incentivising governments to put off much needed fiscal and structural reforms, which created a moral hazard problem. Much of the stability and coherence of the euro-area resulted from fiscal discipline. The Stability and Growth Pact was specifically designed to ensure that markets restrained their fiscal budgets (see, European Commission, 2018). The sovereign bond markets play a crucial role in signalling to governments that their fiscal expenditure might be in excess of their economic capacity. Bond spreads increased when markets lost confidence in governments to repay their debt, making future borrowing more expensive. This disciplined governments to reduce fiscal expenditure (Sester, 2012, p.159). The SMP took away this discipline and reduced the signalling power of markets. The rising bond spreads of periphery countries clearly signalled to central banks that the debt burden of the periphery countries was too high. Debt restructuring and more balanced expenditure were required. The SMP, however, allowed the periphery countries to continue to spend with limited regard to fiscal sustainability. The Governor of the Dutch central bank Klaas Knot outlined a number of relevant risks in a speech in October 2011. For him, unconventional

> ‘measures - and the SMP in particular entailed a number of risks. [...] To reduce pressure that markets exerted on governments to pursue fiscal discipline, [...] increasing risks of monetary financing of fiscal debt [...] financial risk for the Eurosystem’s balance sheet, which may eventually lead to fiscal transfers [...] risk that the Eurosystem will enter political waters, which will make the conduct of monetary policy more difficult’ (Knot, 2011).

Thus, the SMP incentivised governments to put off fiscal discipline while at the same time, it bought up the debt that was at a high risk of default. The two issues taken together have a negative effect on the independence of the ECB. These divisions among Governing Council members intensified when Axel Weber resigned in April 2011 and Jürgen Stark followed in September 2011 (Framke and Hübner, 2011). This instance demonstrates that the dynamics in the Eurosystem changed during the sovereign debt crisis compared to the period of the financial crisis. While decisions during the financial crisis were predominately decided on pragmatic grounds, during the sovereign debt crisis, ideational considerations moved to the forefront of the decision-making process. When the crisis only affected the financial system, a pragmatic approach to decision-making was used to tackle the fast-moving developments. The sovereign debt crisis, by contrast, affected the sustainability of the political system and the welfare of society at large, thus governments, and by extension, the central bank governors of the NCBs, pushed for ideationally influenced decisions that were in line with the national ideational frameworks, such as ordoliberal thought among German central bankers and post-Keynesian thought among the French and Southern European central bankers. In particular, the Bundesbank has since been considered as dogmatic rather than pragmatic (BUBA12; Chapter 6.2). These turbulent times on the Governing Council receded once Mario Draghi took office as President of the ECB in November 2011. This largely stemmed from a restructuring of the Governing Council and Executive Board following the resignation of Weber and Stark. Critics of the asset purchasing programmes were no longer part of the Executive Board.

This discussion of the SMP demonstrates the tension within the Governing Council and the wider epistemic community of central bankers about the interpretation of the mandate. The unusual market tensions during the first months of 2010, on the one hand, required decisive action from the ECB. On the other hand, the indirect government financing of periphery countries pushed the ECB into the fiscal and political sphere as well as to the fringes of its mandate. The debate showed that it was not entirely clear whether the ECB reached beyond its mandate to reduce market tensions. In late 2010, the ECB, however, forced fiscal and structural conditions on national governments in its role as LLR. The epistemic community of central bankers used their expert knowledge on monetary policy and wider economic theory to devise an instrument that could support national governments. They, furthermore, reinterpreted their founding documents on the LLR role of the ECB and the NCBs to overcome the sovereign debt tensions. The following section will assess why and how the ECB intervened into the domestic economies of Ireland, Spain and Italy. In these instances, the ECB acted beyond its narrow mandate.

7.3 19 November 2010: ECB demands conditionality

The previous section analysed the debate and criticism that was directed against the ECB for introducing the SMP. The ECB, in several instances, directly intervened into the domestic affairs of euro-area member states. Anticipating that the Irish government would request another bailout program, Trichet exchanged letters with then-Minister of Finance of Ireland Brian Lenihan. In the letter, Trichet argued that 'the large provision of liquidity by the Eurosystem and the Central Bank of Ireland should not be taken for granted as a long-term solution' (Trichet, 2010c). This was an unprecedented intervention for the ECB in the national sovereignty of Ireland, Spain and Italy in November 2010 and had major repercussions for the position and governance of the ECB during the remainder of the sovereign debt crisis. Trichet, in the name of the Governing Council, overstepped the mandate of the ECB, signalling an increasing confidence of the euro-area community of central bankers.

The ECB prescribed conditions under which the Irish government could request a bailout under the Emergency Liquidity Assistance (ELA) scheme. ELA allows solvent financial institutions to request central bank money to overcome short-term liquidity shortages (European Central Bank, 2017a). In November 2010, Trichet called on the Irish government that the ECB Governing Council could only 'authorize further provision of ELA to Irish financial institutions' should the Council ‘receive in writing a commitment from the Irish Government vis-à-vis the Eurosystem’ (Trichet, 2010c). To achieve this commitment, Trichet set out four demands: First, the Irish government shall request financial assistance from the Eurogroup. Second, it shall commit to conducting fiscal and structural reforms of the financial sector, but not without consent from the European Commission, the IMF, and the ECB. Third, the capital injection to Irish banks shall come from the international community, the ECB, and the Irish government, and, if necessary from cash reserves. Fourth, the Irish government has to fully guarantee any ELA funds and should step in if any bank missed payments (Trichet, 2010b). The letter further demanded a response from the Irish government before the markets opened on the following Monday.

Setting an ultimatum for a sovereign government was unprecedented for a European central bank and demonstrates the increasing assertiveness of euro-area central bankers. The restrictive mandate and institutional design of the ECB prevented it from demanding policy adjustments from governments. Nevertheless, during the height of the sovereign debt crisis, the ECB disregarded its foundational basis and leveraged its independence to gave an ultimatum to the Irish government. As mentioned in Chapter 5.1.2, the independence of the ECB did not only protect it from criticism coming from governments, it also provided it with a significant source of confidence to the ECB to influence fiscal and structural policy decisions of member state governments. The independence of the ECB prevented the governments from influencing the decisions of the ECB while the ECB had less institutional restrictions to do the same to governments. The ECB, in particular, prided itself on being aloof from politics before the sovereign debt crisis as discussed in Chapter 5. It was designed to be a technocratic institution that focused on a clearly defined mandate, which constrained it solely to monetary policy operations. The content and the tone of the letter demonstrated to governments and observers that the ECB changed its self-perceived position in the Eurosystem. It started to consider itself to be the guardian of the common currency. With the rising tensions of the crisis, the ECB increasingly took on the role of the protector of the euro-area (Trichet, 2010d; Draghi, 2012a). However, it was not only the euro-area that required a guardian, the severity of the crises resulted in the ECB itself fighting for its existence. The collapse of the euro-area would have left the ECB without a *raison d’être*. Yet, there was, of course, no higher authority that would have supported the ECB in protecting itself and the euro-area and the sustainability of the euro-area was called into question amid mounting pressure on sovereign bond markets. Regardless of these perceived changes to its role in the euro-area, the Maastricht Treaty does not grant the ECB the legal right to protect the existence of the euro-area, only the stability of the common currency (Bibow, 2012, p.20).

The conflict between the ECB and the Irish government once again revealed the institutional flaw that did not prescribe the ECB a clear LLR function and advisory function for governments. As discussed in Chapter 5.2.1, the NCBs are responsible for supporting national banks to overcome short-term shortages of liquidity. The ELA scheme was designed as a euro-wide frame. It did, however, not cover the liquidity issues of member states. The letters Trichet exchanged with the Irish government demonstrate that the ECB was concerned about the 'deadly embrace' between banks and governments (Chapter 5.2.1; de Grauwe, 2013). In 2012, the European finance ministers had already agreed to move forward with the Banking Union, which resulted in a shift of supervisory power from national authorities to the ECB, in particular for major and system-relevant banks. Considering that it was effectively an LLR to the Irish banks, the ECB had the right to inquire about the solvency and liquidity of these institutions (Wilsher, 2013, p.519). It was within the right of the ECB to advise the Irish government to seek financial assistance from either the ECB or the IMF to recapitalise its banks. The ECB is, however, prohibited from financing government expenditure. In any case, the ECB did not have the legal nor practical right to demand fiscal and structural reforms from the Irish government. The European Commission, the Eurogroup or the IMF were possibly the institutions that could have provided advice and direction on these fiscal and structural matters.

The ECB, further, decided to send similar letters to the Spanish and Italian government. In the letter to the Spanish government, Trichet set out demands to reform the labour market, implement reforms to adjust the Spanish public budget and product market reforms, including the rental market for housing. The conditionality was set against a time frame. The labour market reforms should be implemented within four weeks from receiving the letter. The letter showed that the ECB, once again, overstepped its mandate in demanding structural reforms from a sovereign government (Trichet, 2011c). It had neither *de jure* nor *de facto* jurisdiction for these reform demands. As with the letter to the Irish government, the letter to the Spanish government was co-signed by the President of the Spanish central bank Miguel Ordoñez. This arguably shows that the Governing Council considered these actions to be legitimate.

In August 2011, Trichet and Draghi, then-governor of the Banca d'Italia, decided to demand reforms from the Italian government (Trichet, 2011b). Again, the letter was signed by the NCB governor and not Trichet alone, as was the case with the Irish letters. Similar to the situation in Spain, the ECB did not alone pressure national governments but also relied on their national central banks in the Eurosystem to apply additional pressure and legitimacy. The letter to the Italian government was later considered to be part of an international scheme to force then-prime minister Silvio Berlusconi out of power (Walker et al., 2011). The French and German governments, with the support from the ECB, considered withholding ELA assistance, and with the help of the US government, withholding IMF funding to Italy until Berlusconi resigned (Mackenzie, 2014). Timothy Geithner, then-US Secretary of the Treasury, revealed, 'at one point that fall, a few European officials approached us with a scheme to try to force Italian Prime Minister Silvio Berlusconi out of power; they wanted us to refuse to support IMF loans to Italy until he was gone, [...] We told the President [Obama] about this surprising invitation, but as helpful as it would have been to have better leadership in Europe, we couldn't get involved in a scheme like that [...]. We can't have his blood on our hands' (Geithner, 2014, Chapter 11).

Two years later, when Draghi was president of the ECB, he seemed to have a different perspective on the role of the ECB in dictating fiscal and structural conditionality to national governments when commenting on the relationship between national governments and the ECB: 'I do not view it as the ECB's task to push governments into doing something. It is really their own decision as to whether they want to access the EFSF [European Financial Stability Facility] or not' (Draghi, 2012b).[7] Indeed, the threat of a break up of the euro-area was imminent during the first months of 2011. The now infamous involvement of the ECB in the ousting of Silvio Berlusconi, the former Italian prime minister, and Trichet's letters to various European governments demanding structural and fiscal reforms were only part of the ECB's efforts to protect the euro-area. Nevertheless, these measures were arguably beyond the narrowly defined mandate of the ECB (Legrain, 2015). The political actions taken by the ECB risked undermining its legitimacy. The following

[7]The EFSF was introduced in 2010 as a fiscal backstop to the crisis. It provided financial assistance to Greece, Portugal and Ireland. The capital came from issuance of EFSF bonds and other instruments on capital markets (see, EFSF, 2010). Since its introduction in 2010, the European Stability Mechanism (ESM) provides the services of the EFSF and has extended lending Spain and Cyprus. At time of writing (2018), only Greece requires active support.

section will take a closer look at the institutional and policy changes of the ECB during the phase of the sovereign debt crisis under the leadership of Trichet.

7.4 Ideational change as a result of the sovereign debt crisis

The ECB was confronted with an entirely different problem set when the financial crisis spilt over into the sovereign debt markets of Europe. The dismal public finances of the periphery countries in combination with over-leveraged financial activities in particular in Ireland and Spain and the misconception that EMU would result in the convergence of the European economies put increasing pressure on the euro-area. In 2010, it looked like EMU would collapse under its own weight, and the ECB, for a short period of time, seemed to stand by without being able to act. However, during this year, the ECB started to consider actions that were outside of its narrow mandate and proved to be more flexible than had previously been anticipated (Wilsher, 2013, p.57). The ECB policy decision to force Ireland and Greece to bend to its demands can be considered a major move of confidence in pressuring national governments to accept the conditions of the ECB. During the sovereign debt crisis, the goals of the ECB clearly changed from ensuring price stability to stabilising the financial system to influencing fiscal and structural policy decisions in selected countries. This demonstrates that the objectives of epistemic communities can change over time and during times of severe crisis, when their expert knowledge is either tested or contested. While the discussion on the opportunities and challenges of the SMP provided an insight into the inner workings of the ECB during times of severe crisis, it is imperative to consider the ramifications of the ECB actions. The data from the interviews allows us to assess the perspective of market actors on these decisions.

One former British central banker provided his critical view on the ECB during an interview, where he argued that 'it is quite clear [...] the three certainties which central bankers always had, which is certainty of mission, certainty of method and certainty of political support, have all evaporated' (BOE1). Indeed, what he called the three certainties have considerably changed over the course of the crisis. In the case of the ECB, the certainty of mission of the ECB has evaporated, or as the interviewee asks, 'was its mission to preserve the monetary stability of the euro-zone or was its mission to preserve the political stability, in particular, the membership of one member state? That is a huge transition' (BOE1). These questions come back to the debate on whether the ECB's role was to maintain price stability, safeguard financial stability or political stability across the heterogeneous euro-area. The shift of supervisory powers in 2012 from national authorities to the ECB has shifted the responsibility of the ECB and the Eurosystem central banks. The dominance of major financial institutions in the economy has led to a greater threat to economic stability in most countries. Thus, financial stability became a key prerogative of European central banks. Political stability, in particular that of the periphery countries, has occupied the activities of the ECB since 2010. The sovereign debt crisis has revealed the flaws of the institutional design of EMU and the difficulties of the ECB to implement a 'one-size-fits-all' monetary policy.

The SMP was developed to overcome liquidity tensions of periphery countries, resulting in a major debate among Governing Council members. Nevertheless, what is the role of the ECB in post-crisis Europe? Should it continue to focus on political stability? The interviewee who elaborated on the mission of the ECB above teased out another certainty which he thought the ECB lost, '[The ECB] lost its certainty of method from moving from the narrower definitions of monetary policy in which interest rates play the biggest role to a much wider definition of monetary policy in which quantitative easing and monetary financing have come into play' (BOE1). The interviewee argued that the mandate has proven to be more flexible than previously anticipated. The ECB was able, despite decisive resistance from Germany and other core countries as well as from Governing Council members, to develop and use instruments that financed government expenditure. Critics argued that it remains unclear how much sovereign debt banks have bought on the primary market with the sole intention to sell it on to the ECB for a profit (PS5; BUBA3). Finally, the interviewee pointed out that, '[the ECB] has lost its certainty of political support. In the period before 2008, the ECB could widely expect and certainly was offered the support of euro-zone governments. Now it is right at the centre of a dispute between euro-zone governments as to how the euro-zone should run' (BOE1). The clashes between the ECB and the French government over reducing the key interest rates in 2007 and 2008, the German government and the Bundesbank during the introduction of the SMP, the relentless pressure the ECB has put on periphery countries, in particular Greece and Ireland, to fulfill the conditions for financial assistance and the letters to the Irish, Italian and Spanish governments have revealed that the relationship between the national governments and the ECB and to some extent with the NCBs has become increasingly difficult. It remains to be seen how the relationships between these entities will develop over time.

7.5 Conclusion

This chapter analysed the ideational change of the ECB during the initial phase of the sovereign debt crisis between 2009 and 2010. During this period, the financial crisis turned into the sovereign debt crisis as a result of high government debt that resulted from government bailout of domestic banks, high fiscal expenditure, and capital flight from periphery countries to core countries in the euro-area. The ECB was confronted with a complex problem set that was, at first, beyond the capacity of the expert knowledge of the epistemic community. Although their transnational character allowed for a wide range of experiences and ideas to being exchanged, the sovereign debt crisis was an unprecedented challenge for this group of policymakers. While the financial crisis affected almost only the housing market and from there the financial sector, it could be largely contained by providing extensive liquidity. This prevented the inter-bank lending market from freezing up, increased certainty and confidence among investors and allowed corporates to have access to capital. The assumption that all euro-area sovereign bonds have the same risk exposure was shattered in 2009. This led to a repricing of sovereign debt, which had a negative effect on the overall euro-area economy. The mandate of the ECB was prohibited from intervening in individual countries. Initially, it used the interest rate and political pressure on national governments to push for structural reforms and provided financial means to periphery countries. The crisis, however, continued to worsen during 2009 and again in 2010. This led the ECB to introduce the SMP, which was a turning point for the role of the ECB in the crisis. Through the introduction of this instrument, the ECB became a dominant player in the sovereign debt crisis. It acted in a fiscal capacity to reduce bonds spreads and pushed for structural and fiscal reforms in its capacity as a member of the Troika and in its own capacity. As it turned out, however, the SMP did not completely contain the euro-area sovereign debt crisis. In 2011, only a year later, the sovereign debt crisis flared up again. The following chapter takes a closer look at these developments. It analyses the role of the ECB following a change of leadership when Draghi assumed office in November 2011. It argues that the ECB has undergone a dramatic transformation partially because of Draghi's leadership role and partially because he was able to build upon the institutional changes Trichet had started to implement. This turned the ECB into a powerful institution that was able to overcome the sovereign debt crisis and implement meaningful reform across the European financial sector.

Chapter 8

The ECB strikes back

> ‘On the face of it, central banks have got more power. In practice, I believe, the pressure on them and the expectations of them to solve problems have actually meant that they are often not able to use their formal powers to do the things they are really meant to do and they are acting beyond their mandate and acting sometimes like a quasi-arm of government.’
>
> Former Governor of an ESCB central bank

> ‘The ECB has had a good crisis and has emerged from it very powerful and will continue to be so.’
>
> Private sector banker from the UK who works closely with the ECB (PS2)

When Draghi assumed office in November 2011, the euro-crisis had returned after a short period of relief between late-2010 and mid-2011. Financial market tensions were high, uncertainty about the ability of periphery countries to service their debt obligations was wide-spread, and the national governments lacked a decisive solution to overcome the mounting challenges. These tensions were felt on the Governing Council. Towards the end of Trichet’s tenure, two board members, then-Bundesbank President Axel Weber and then-ECB Chief Economist Jürgen Stark resigned in protest of the decision to introduce the Securities Markets Programme (SMP) to finance government expenditure. As the previous chapter showed, the initial period of the sovereign debt crisis had a profound impact on the institutional and ideational capacity and use of instruments of the ECB. When the sovereign debt crisis returned in 2011, it took on a new dimension and threatened the survival of the Eurosystem and of the ECB. This chapter argues that Mario Draghi was a decisive leader who managed to overcome the worst period of the crisis owing to his ability to leverage the power of the ECB and exploit the incomplete institutional environment of the euro-area. The analysis will centre on the ‘whatever-it-takes’ speech of Draghi in July 2012, the subsequent financial market reactions and, the policy decisions of the ECB. Behind Draghi's 'whatever-it-takes' statement are developments that have turned European central bankers and their institutions into powerful players in international financial markets.

As aforementioned, before the crisis, the ECB prided itself in being a technocratic institution that operated above politics (Howarth and Loedel, 2003; for criticism see, McNamara, 2002; Chapter 5). It stringently focused on price stability. This instilled the feeling in governments and financial markets that central banks had reached an 'end of history' position (Chapter 4). Price stability was considered the key to achieving financial stability, economic growth and welfare across European societies. Financial crises were seen as small and isolated events that could be overcome through short-term liquidity injections. The crisis, however, fully changed our understanding of the role of central banks in financial markets and their impact on society at large. The crisis, furthermore, partially allowed the ECB to become a decisive European actor in crisis management and in restructuring the European financial landscape. In retrospect, Draghi's statement and the response of the market is evidence of the power of the ECB to influence financial markets. Although instruments such as the SMP were effective in the short-term to reduce sovereign bonds yields, Draghi's speech demonstrates the extent to which the persuasion and communication of central banks can have on financial markets in the long-term. Without actually having developed an instrument to back-up the statement, Draghi was able to reduce government bonds spreads considerably.

One former central bank board member of a Southern European country argued, 'When the interest rates between the crisis countries and Germany started to spread too much, just the threat of ECB intervening really stopped the spread to increase. That was really important for Italy and in part for Spain. If they would have lost that access to markets it would have been very difficult to support this all together' (ESCB1). The ECB introduced the Outright Monetary Transaction (OMT) programme only a few months later to back-up the 'whatever-it-takes' statement. The majority of interviewees acknowledged that Draghi's speech was the single most important event in containing the euro crisis. The following chapter will discuss the institutional and ideational changes that followed the events after Draghi took office. Draghi pushed for institutional reform within the ECB and the euro-area following years of financial and sovereign debt crisis. When the crisis arguably reached its height and threatened to break-up the euro-area, Draghi gave his now famous 'whatever-it-takes' speech, changing the course of the crisis and the institutional design of the ECB forever.

8.1 1 November 2011: Mario Draghi assumes office

When Mario Draghi assumed the office of the President of the ECB in November 2011, he inherited an Executive Board that had just lost Jürgen Stark, one of the most experienced policymakers on the board following his resignation after the bond purchasing programmes, and two new board members who had no previous central banking experience, Benoît Cœré and Jörg Asmussen. These circumstances provided Draghi, arguably, with room to manoeuvre (Framke et al., 2013). The events leading up to the appointment of Draghi and the resignation of two board members showed clear evidence that the otherwise relatively coherent epistemic community of Eurosystem central banks was in disarray over potential reforms and the conduct of monetary policy. The introduction of the SMP resulted in a major rift among different members of the community and the alliances among the ideas of different policymakers appeared to take shape.

As discussed in Chapter 4, the leadership style of the ECB president can have a major impact on the institutional design and policy direction of the central bank. The newly assembled Executive Board allowed Draghi to emerge as superior among his peers. He used his position and leadership ability to change the course of the ECB. Draghi got the opportunity right from the start when, on the day he took office, European stock markets dropped significantly. On 31 October 2011, the Greek government announced a referendum that would allow the Greeks to vote on whether the government could accept the EU rescue package of 100 billion euro loan and a 50 percent debt write-off (*BBC News*, 2011a). The call for a referendum increased uncertainty in the market and threatened the rescue of the euro-area member state that the euro-area, the European Commission in conjunction with the International Monetary Fund (IMF) planned for Greece.

After Trichet had strongly resisted sovereign bond purchases for years, and only reluctantly introduced and used the SMP, *The Guardian* reported, 'Mario Draghi's first day at work as the head of the ECB was spent buying up unseemly quantities of his own country's debt,' to avoid a spill over into periphery bond markets (*The Guardian*, 2011; Irwin, 2013, p.406). Thus, Draghi did what the German government had feared all along: he pushed for an expansionary monetary policy to ease market tensions (see, e.g. Kitzler and Levitz, 2011). The SMP enjoyed a period of activity between August 2011 until January 2012 after it had remained dormant since July 2010. By relying on the SMP, Draghi had an instrument to target periphery sovereign debt. From the day he took office, Draghi aimed at moving the Eurosystem towards accepting an expansionary monetary policy to overcome the sovereign debt crisis. This did not come without a struggle. The Bundesbank, headed by the newly appointed Jens Weidmann, following the resignation of Axel Weber in April 2011 in protest of the SMP, strongly criticised the ECB Governing Council decision to use the SMP to buy government debt from Italy and Spain, again. He argued that the SMP violated Article 123 of the Maastricht Treaty, which prohibited the monetary financing and debt purchasing from sovereign states (Maastricht TEU, 1992, art. 123). In an interview with the *Financial Times*, Weidmann declared, 'I cannot see how you can ensure the stability of a monetary union by violating its legal provisions' (quoted in Atkins and Sandbu, 2011). According to the assessment of Weidmann, the SMP not only violated the no-bailout clause of the Maastricht Treaty, but also violated the primary mandate of price stability, because asset purchasing programmes had created the risk of rising inflation rates. Weidmann linked this issue to a question of the independence of the ECB by further arguing, 'I think the prohibition of monetary financing is very important in ensuring the credibility and independence of the central bank, which allow us to deliver on our primary objective of price stability. [...] If we now overstep that mandate, we call into question our own independence' (quoted in Atkins and Sandbu, 2011). For Weidmann, the mandate and the independence of the ECB are closely related. When the ECB steps outside of its mandate, it allows external influences to creep into its decision-making process. This, he argues, reduces the independence of the ECB, and with it, the credibility of the Eurosystem.

Weidmann has remained a critic of the ECB decisions that relate to asset purchasing programmes ever since. He voted against the OMT in the summer of 2012 (Steen, 2012) and was against the introduction of wider QE measures from 2015 onwards (Jones, 2014). A senior official from the Bundesbank commented in the interview on Weidmann's position that he is not fundamentally against, for example, the SMP or the OMT, but Weidman was not convinced that it was necessary at the time of its implementation. France and Italy, however, wanted the implementation right away (BUBA12). The statement of the interviewee at the Bundesbank is in line with the interview of Weidmann with the *Financial Times*, where he warned about the negative side-effects of the SMP. Weidmann further argued, 'there's also a risk that you mute the incentives that come from the market. Recent experience has shown that market interest rates do play a role in pushing governments towards reforms. You have seen that in the case of Italy quite clearly' (quoted in Atkins and Sandbu, 2011). Weidmann repeatedly argued that the national governments should move forward with fiscal and structural reforms, rather than the ECB with asset purchasing programmes.

The European sovereign debt crisis took a turn for the worse in 2011. Markets became increasingly concerned about the commitment of the governments of Spain, Italy and Greece to reform and to modernise their economies and reduce their public budgets. At this point, financial markets, politicians and central bankers across the Eurosystem considered Italy as the biggest threat to the euro-area, because it was deemed to be 'too big to fail' (Elliott, 2011). Although the Italian government passed a substantial austerity package, bond spreads soared to a level where it narrowly lost access to financial markets (Cencig, 2012).[1] The spreads only receded once Silvio Berlusconi agreed to step down as prime minister (*BBC News*, 2011b).

The decision to restart the SMP despite opposition from the Bundesbank is not the only example of the changing leadership style and the decisiveness of Draghi during this first year in office. Only two days after he assumed the presidency, the Governing Council decided to reduce the key interest rate by 0.25 percent to 1.25 percent (Draghi, 2011a; European Central Bank, 2011). This was the first reduction in two years. As discussed in Chapter 6.1.2, Trichet's decision to push for an increase in the interest rate in 2008 is considered the biggest mistake of the ECB during the crisis. The epistemic community of Eurosystem central bankers followed Draghi's leadership to reduce interest rates despite heavily resisting such a decision during the presidency of Trichet. In particular the opposition of the Bundesbank was weak during the early months of Draghi's presidency. This shows that Draghi was well respected in the community and his leadership was accepted during this period of severe tensions. The key interest rates was reduced once again in December 2011 to one percent. On 3 November 2011, the ECB further announced the technical details of the Second Covered Bonds Purchasing Programme (CBPP2). This programme allowed the ECB to purchase 40 billion euro of covered bonds on the primary and secondary market over the period of November 2011 until October 2012 (European

[1] The European Commission assessed the reform plan of Italy for the period of 2011 until 2012 and acknowledged that the Italian government-initiated reforms that would strengthen the labour market and social policy albeit identifying areas that still required reform (European Commission, 2012)

Central Bank, 2011). He successively reduced the key interest rates and expanded the purchasing programmes to relieve the euro-area from the pressure being exerted on it by investors. Thus, within a week of Draghi becoming president, the ECB was back in crisis mode.

8.2 26 July 2012: 'Whatever-it-takes'

During the summer of 2012, the sovereign debt crisis and the role of the ECB fundamentally changed. Investors continued to put severe pressure on periphery countries throughout the first half of 2012. Greece faced being cut off from international debt markets, which would have resulted in a breakdown of refinancing the existing debt without the assistance from other states. The inability to refinance its debt would have eventually led to a breakdown of the Greek economy and the potential collapse of the single currency. Spain and Portugal were drawn into the sovereign debt crisis once again over fears that Greece might default. On July 26, 2012, Draghi stepped up to the podium at an investment conference in London to put an end to the threat of a breakup of the euro-area. Draghi read from his prepared notes to make similar comments on the outlook of the euro-area, which he had done in a similar fashion at different speeches shortly before. Topics included the current liquidity provision of the ECB and the convergence among euro-area economies (see, e.g. Draghi, 2012d,e). When he read from his hand-written notes, Draghi surprised financial markets and governments by saying that 'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough' (Draghi, 2012f). These two sentences changed the dynamic of the financial and sovereign debt crisis and the role of the ECB in the Eurosystem and beyond.

While there had been tensions between the ECB and national governments, such as with the French government of Nicolas Sarkozy between the summer of 2007 and the summer of 2008, the tensions with financial markets had a different and more threatening dynamic. The independence of the ECB that was codified in its founding documents elevated it above the direct influence of national governments and financial markets. However, financial market actors were not inhibited from exploiting opportunities in the financial markets that were against the interest of the ECB. Therefore, speculators could pressure national governments and weak financial institutions by either selling their holdings of bonds and equities or betting against them using derivatives. During the financial and sovereign debt crisis, the ECB had only intervened in the distortions of the sovereign bonds markets with

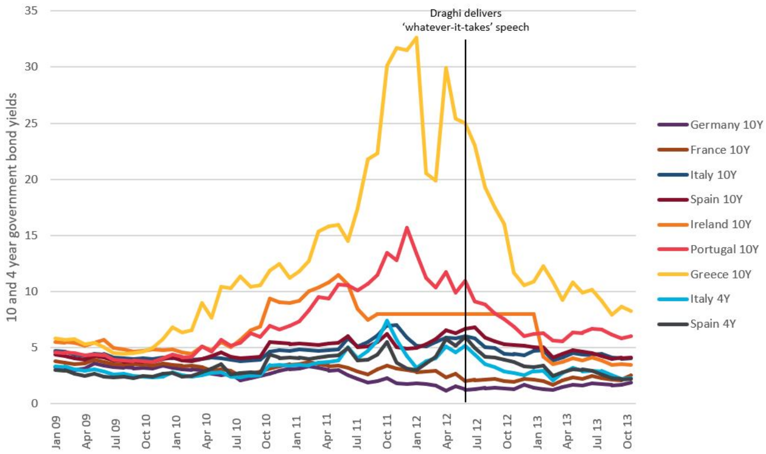

Figure 8.1: Italian and Spanish 10-year bond yields between 2009 and 2014

Source: Bloomberg

limited resources, as discussed in Chapter 7. This demonstrated to financial markets that the ECB might not have the ability to prevent the default of a euro-area member state. The 'whatever-it-takes' speech of Draghi turned the table of this assumption. He made clear that the ECB has the necessary resources and will deploy them to prevent a collapse of the euro-area. This instance demonstrated for the first time in the history of the ECB that it had become an actor that had the ability to dominate financial markets. Following the collapse of Lehman Brothers, the early months of 2010 and then again during the early months of 2012 in the lead-up to the 'whatever-it-takes' speech, financial markets were able to put immense pressure on euro-area member states and the ECB. This changed with Draghi's speech. The ECB became more powerful than the financial market and any national government, because it managed to establish the credibility and the instruments to effectively overcome any financial market pressure. The central banking community pushed ahead with policy reform in order to stabilise the euro-area economy and Draghi established himself as the unquestioned leader of this group of policy experts. Indeed, the perspective of financial markets on the determination of the ECB to act significantly changed following the comments of Draghi. His comments dropped bond spreads substantially across the euro-area. The impact of his words can be seen on the 10-year and 4-year Spanish and Italian government bond yields, which had risen to unsustainable levels prior to July 2012. Southern European countries were, again, able to refinance at much lower rates (Figure, 8.1).

When looking at Draghi's words in more detail, it becomes obvious that his comments were more nuanced than when only looking at the two sentences. Draghi did not only say that the ECB stands ready to do 'whatever-it-takes' to save the euro, but that it would do so by taking policy actions that are within the mandate of the ECB. Although this might have limited his available policy options, it increased the credibility of his statement. Draghi further said that the euro is irreversible:

> 'When people talk about the fragility of the euro and the increasing fragility of the euro, and perhaps the crisis of the euro, very often non-euro member states or leaders, underestimate the amount of political capital that is being invested in the euro. And so we view this, and I do not think we are unbiased observers, we think the euro is irreversible. And it's not an empty word now, because I preceded saying exactly what actions have been made, are being made to make it irreversible' (Draghi, 2012f).

Draghi argued that the euro-area member states had made a major political investment in the euro's creation and its operation. They had committed resources, capital and trust in the creation of the common currency and these commitments could not be reversed. According to institutional theory, established institutions are seldom discontinued when the political will of the stakeholders is provided. Institutions that undergo large-scale changes, but have the political backing, might change their operations or their objectives, yet they usually do not disappear.[2] Draghi only then continued with his comments that would define the sovereign debt crisis: 'but there is another message I want to tell you. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough' (Draghi, 2012f). As it was later revealed, Draghi's comments were made on his own initiative. His statement that the euro was 'irreversible' or that the ECB would do 'whatever-it-takes' were not previously discussed among senior officials at the ECB or the Governing Council. A few days later, Angela Merkel, the German

[2] An example of this argument is North Atlantic Treaty Organisation (NATO). With the collapse of the Warsaw Pact, it lost its *raison d'être* but it was not dissolved. NATO has changed and redefined its purpose and remains an important institution in Western defence politics. Another example is the change of mandate of the European Bank for Reconstruction and Development (EBRD). The EBRD was founded to support the reconstructing process of Eastern European countries after the fall of the Soviet Union. After almost 30 years, most of the Eastern European countries have been deeply integrated in the EU and only need limited assistance from EBRD. Instead of dissolving the institution, the EBRD has asked its stakeholders (governments) to redefine its mandate. It is now allowed to invest in Northern Africa, selected countries in the Middle East, and countries in Central Asia. It even has made a one-billion-euro investment in the four system-relevant banks of Greece (250 million euro each) and several hundreds of millions worth of investments for different purposes across Greece (European Bank for Reconstruction and Development, 2015, 2017, 2018).

Chancellor and Franois Hollande provided their support in a joint statement that the German and French governments were ‘determined, to do everything, to defend the euro-zone’ (Bundesregierung und Regierung der Franzsischen Republik, 2012).[3]

Politicians had repeatedly claimed that the European governments would go to extraordinary lengths to save the euro-area but did not have the impact Draghi had. Draghi’s initiative and the German and French governmental support of the ‘whatever-it-takes’ statement had a profound impact on euro-area financial stability (Brunnermeier et al., 2016, p.123 and 313). Markets knew that politicians were in no position to face down speculative investors. Draghi, as the President of the ECB and with the support of the wider Eurosystem, had different financial means at his disposal to prevent a collapse of the euro-area. Indeed, his decision to reverse the momentum of banks buying a protection for the case of a euro-breakup could only be made through a decisive statement in favour of protecting the euro-area (Brunnermeier et al., 2016, p.123).

When Draghi gave his now infamous speech, the ECB had not yet developed an instrument that could potentially save the euro-area from breaking up. It took the ECB until 02 August 2012 to announce that a new programme was being developed, which was only released on 06 September 2012. The Outright Monetary Transactions (OMT) programme was designed to support Draghi’s words and, therefore, reduce the sovereign bonds spreads to periphery countries, by restoring the transmission process (Draghi, 2012e). Draghi outlined the instrument in the press conference in September:

> ‘OMTs will enable us to address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro. Hence, under appropriate conditions, we will have a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro-area’ (Draghi, 2012a).

To overcome the same concerns that were debated during the time of the introduction of the SMP among Governing Council members and the wider public, Draghi announced during the press conference on 06 September 2012, ‘let me repeat what I said last month: we act strictly within our mandate to maintain price stability over the medium term; we act independently in determining monetary policy, and the

[3] Author’s own translation.

euro is irreversible' (Draghi, 2012a). Thus, Draghi was confident that combating high spreads on sovereign debt was well within the mandate of the ECB.

However, critics were quick to point out that, similar to the SMP, the OMT would once again be a breach of the mandate, because its purpose was to buy sovereign debt. Clemens Fuest, an adviser to the German Finance Ministry, summarised in an interview with *Reuters*, 'generally, the OMT has confirmed in Germany what people expected or feared from him [Draghi] – namely that he would move the ECB away from the German tradition and more towards a Latin-type currency union with a softer stance' (quoted in Framke et al., 2013). This meant that the ordoliberal values enshrined in the ECB might lose prominence due to Draghi taking decisions that were favoured by the French and Southern European governments. Indeed, the events that followed resulted in a major division among the epistemic community of central bankers in the euro-area. There was a threat that the Bundesbank under Weidmann would turn the German public against the core values of Draghi's 'whatever-it-takes' speech. Draghi had a plan: he phoned the German Minister of Finance Wolfgang Schäuble to ask him to convince Merkel to endorse his speech. He, further, spoke to Hollande in France to do the same, which eventually both did in a joint press statement (see above). For a moment, Draghi seemed to have outflanked Weidmann. Without the support of Merkel, Weidmann would either be isolated or would have to concede. For Merkel, facing re-election in 2013, Draghi's speech was a life rope because the collapse of the euro-area would have destroyed her prospects for a third term. A few days later on 2 August 2012, Draghi, however, either made a mistake or felt too confident following his successful speech shortly before. During the press conference following the Governing Council meeting, he was asked whether Weidmann opposed the decision for more bonds purchasing programmes. In previous press conferences, Draghi only responded that some Governing Council members had objections with the overall policy direction. In this instance, however, Draghi decided to single out Weidmann as the sole opposition, even saying his name (Draghi, 2012c). Officials at the Bundesbank were taken by surprise and ensured that this would not go unanswered. With a coordinated effort of speeches and leaks of information, the Bundesbank responded to Draghi's plans of saving the euro (Carrel et al., 2012).

Weidmann strongly opposed the OMT (Steen, 2012) and voted against it on the Governing Council meeting on 2 August 2012 (Draghi, 2012c). Similar to his opposition against the SMP, Weidmann argued that the OMT would breach the mandate of the

ECB because it would allow the Eurosystem to buy sovereign debt (Fischer and Szalay, 2012). This would further allow the risk associated with the underlying assets of this debt to be spread across the euro-area. Thus, taxpayers in core countries would have to take on the debt of periphery countries, which, according to Weidmann, would be an unfair reallocation of debt. Another line of criticism put forward by Weidmann was that the decision to use the OMT was too close to fiscal policy and, thus, would undermine the independence of the ECB (Weidmann, 2013; *The Economist*, 2012; Siekmann and Wieland, 2013). Although in hindsight, German Bundesbank officials have claimed, not in public, that Weidmann was never really against the OMT, only that he considered the timing of announcing the programme to be wrong (BUBA12). Without a fiscal and political union, asset purchasing programmes will not ensure the results necessary to overcome market tensions. Thus, the OMT might allow the Eurosystem to relieve politicians from the public pressure to further integrate the euro-area. From Weidmann's perspective, the instruments the ECB had already developed were sufficient to overcome the market tensions without disincentivising politicians from reforming the euro-area (Weidmann, 2013).

The German policymaker and former ECB Board Member for International and European Relations Jörg Asmussen, who was the successor of Jürgen Stark, supported the OMT programme and its potential effects on the sovereign bonds of periphery countries. During the hearing at the German Federal Constitutional Court on the decision of the OMT, Asmussen argued, 'I am firmly convinced that introducing the OMT programme was the right thing to do to ensure price stability in the euro-area. After all, a currency can only be stable if its continued existence is not in doubt' (Asmussen, 2013). Indeed, Asmussen pointed out that the OMT was different to the SMP and that its legal basis was firmly within the mandate of the ECB. First, the OMT had a stringent conditionality attached to it as part of the European Stability Mechanism (ESM), and each intervention was separately decided on by the Governing Council. This reduced the probability of governments exploiting the programme. Second, the OMT was designed to target sovereign bonds with only up to three years' maturity, thus, prioritising short-term intervention in markets. Third, the transparency of OMT was increased owing to regular updates and published information. Fourth, the ECB was to allowed to sell the assets it acquired through the OMT again at market prices. Fifth, the size of the intervention of the OMT was unlimited to give a strong signal to financial markets. Finally, the purchases made through the OMT would again be sterilised, similar to the purchases of the SMP (Asmussen, 2013). This episode demonstrates that the epistemic community of Eurosystem central bankers was often less divided along country specific lines. While there were signs that ideational alliances developed during the height of the sovereign debt crisis, with core countries and Southern European countries on opposite sides, the defence of Asmussen, a German policymaker, of the OMT indicates that these ideational sides were not clear cut.

The OMT was never used. The threat of Draghi to initiate a decisive intervention in the sovereign bonds markets was enough to reduce spreads. A senior official from the European Commission who was closely involved in the restructuring process of Greece said in the interview with the author that the 'words of Draghi were a decisive moment and gave a clear signal to speculators that they might lose' (EC1). One former euro-area central bank governor stated, 'the declaration by Draghi in September of 2012 that he would do "whatever-it-takes" to save the euro was really the major turning point for the euro crisis' (ESCB1). An interviewee from the private sector with extensive experience in observing European central banks and their policy decisions captured the effects on the market, 'the Draghi whatever-it-takes line is absolutely seminal. In the way that there was a stand-off between the ECB and the markets and the markets blinked' (PS2). To prevent the euro-area from splitting up, Draghi succeeded in calming down financial markets using direct communication to market actors. Draghi's previous experience in banking gave him an intimate understanding of financial markets and made him aware that banks started to take on ever larger hedging positions for the chance that the euro would collapse. To save the euro, his plan was to turn this momentum around, forcing banks to sell their assets to reduce their losses (Brunnermeier et al., 2016, p.122 and 355). The 'whatever-it-takes' speech ultimately changed the behaviour of markets towards crisis countries and instilled a new sense of hope across the euro-area. The market reaction to his statement demonstrates the influence the ECB can have on international markets. As mentioned above, this stemmed to a large extent from Draghi's credibility and the ECB's financial ability to deliver on those words. This event was a seminal point in European financial history.

8.2.1 Financial markets reaction to 'whatever-it-takes' speech

Draghi's speech showed that following years of the crisis, the ECB was able to regain control over the situation without actually using any monetary policy instruments. The direct communication with financial markets, later backed up by the French and German governments, was enough to calm financial markets without putting money on the line and in spite of criticism from the Bundesbank. When assessing the comments of the interviewees, it becomes evident that the ECB increased its impact on financial markets compared to the initial crisis years.

A former ECB Executive Board member explained in the following quotation the intensifying relationship between the ECB and the market, '[the ECB] has experimented with new instruments, which have proven very powerful' (ECB5). The ECB introduced several instruments that were either not used to the same extent before the crisis, such as extending the main refinancing operations or were created from scratch to tackle the unique challenges of the euro-area crisis. Those instruments included the SMP and the OMT and later QE and were all subject to continuous debate and criticism. The interviewee said of the impact of the ECB on financial markets that 'it is a power it has taken from the market and which one day it will have to give back to the market. But in present circumstances, I would say the ECB is able to influence the market very strongly' (ECB5). Thus, the interviewee acknowledged that it was necessary for the ECB to influence financial markets to contain the crisis, which showed negative side effects. From his perspective, the ECB, however, has to reduce its involvement in financial markets in the near future to allow financial markets to operate without intervention, based on a neo-liberal understanding of market dynamics.

Beyond the usefulness of the instruments of the ECB, the former ECB Executive Board member argued that communication is an important element of achieving a successful implementation of monetary policy. He argued:

> 'It is different to communicate about monetary policy and price stability during a crisis while you need to implement some non-standard instruments and while you need to protect the integrity of the euro. You also need to avoid destabilising forces, which may lead, again, to miss your targets in the long-term and means financial collapse. The ways to communicate have certainly changed, and it has not always been easy. The complication with the ECB is that you do not only have financial markets, but you also have people from 19 different countries with different cultures, languages, and different ways of communication. It is more difficult than in other parts of the world' (ECB5).

In his statement, the interviewee argued that the challenge for the ECB is to convey its policy ideas and decisions to its 19 euro-area member states. The Eurosystem is different to other currency unions, such as the United States, where cultural and language barriers are lower. The national central banks (NCBs) play a crucial role in communicating with their public and explaining policy decisions. The interviewee goes on and points out that communication can only go so far as the success the instrument:

> 'In the end, it is the success of the policy that will make it the best communication. Even in the most sceptical parts of Europe. It will only be the success that will prove the critiques wrong. Slowly this is what is happening. To me, it will take the time that is how the ECB will gain credibility in the end' (ECB5).

Thus, only the successful implementation of a policy will enable the ECB to use communication as a tool that can support the policy. The 'whatever-it-takes' speech was a case in point. The OMT was correctly designed to the extent that it did not have to be used. Interviewees from the ECB and the Bundesbank have confirmed this perspective (ECB1; BUBA3; BUBA12). A board member of the Bundesbank argued in the interview that credibility remains a priority for monetary policy. Similar to the statement of the former ECB board member, the Bundesbank board member argued that there are few things worse for monetary policy than losing credibility. 'Credibility is the core that makes monetary policy possible' (BUBA1). Draghi, in particular, has shown his ability to influence market sentiments directly. One former senior manager of the British Treasury stated in the interview with the author, 'Draghi has the confidence of the markets' (PS7). This comment refers to Draghi's ability to be accepted by actors in the financial market. While Trichet often appeared to be out of touch with financial markets and was more astute at representing the ECB in the presence of governments, Draghi seemed to have a more intimate understanding of financial markets in Europe (Brunnermeier et al., 2016, p.355).

In retrospect, most interviewees argued that the OMT should be considered the most successful instrument during the height of the sovereign debt crisis. The reasons behind the success of the OMT were first, Draghi's confident and successful announcement that the ECB would preserve the integrity of the euro. Second, the OMT, from the perspective of German central bankers involved in its development, was perfectly conditioned and had the correct size to have an immediate effect on the financial markets should it be used (BUBA12; BUBA3). This indicates that even central bankers from the Bundesbank considered the OMT to be successful. It indicates that epistemic communities can generate policy ideas that the entire community will eventually adapt. Thus, without potentially increasing the balance sheet of the ECB (OMT purchases were to be sterilised), the threat of a break-up of the euro-area was contained, and financial markets calmed down. Indeed, one year later, Draghi said in a press conference, 'when we all look back at what OMT has produced, frankly when you look at the data, it's really very hard not to state that OMT has been probably the most successful monetary policy measure undertaken in recent time' (Draghi, 2013a).

The 'whatever-it-takes' speech demonstrated the full capacity of charismatic leadership and the ability to guide market expectations. A senior member of the Bundesbank argued that the financial environment in Europe has become more complex. Therefore, the words have become more important than the actual policy decisions. The OMT has forcefully demonstrated this assumption (BUBA1; BUBA13). In December 2015, there was, however, a mismatch between what the ECB assumed the market reaction would be and what the market anticipated and then how it reacted. Draghi announced that the ECB would extend its quantitative easing (QE) program regarding quantity and eligible assets, cut interest rates below zero and keep the longer-term refinancing operations (LTRO) instrument in place. Despite these wide-ranging announcements, the euro dropped significantly (Draghi, 2015). The market sentiment was that the ECB did not do enough to ease market tensions. One former European non-euro governor put the events in perspective in the interview with the author:

> 'Yesterday, Mr Draghi delivered the speech where he announced that the ECB is cutting the interest rate on deposit with the ECB from -20 to -30. Which was apparently the general expectation of markets. He also said that QE is going to be extended until Spring of 2017. But because the way he talked he gave the impression, his style of speaking was not perceived to be soft enough. The euro shot up. I think this is crazy' (ESCB2).

The interviewee argued that the market overreacted in December 2015, and that the financial market community should focus more on the actual policies of the ECB rather than on the charismatic skills of the president. The statement further highlights that it is difficult for central bankers to guide market expectations in a near zero interest rate environment. Nevertheless, the market reaction in December 2015 clearly demonstrated the limitations of the power of the ECB in influencing market sentiments at crucial points in history (BUBA1; BUBA12; ESCB2). The board member of the Bundesbank, however, complained that financial markets cannot always fully grasp the dimensions of the programme (BUBA1). He argued that financial markets overestimate the role of monetary policy. According to his assessment, this stems from the fact that since the beginning of the financial crisis, the Eurosystem has been put into the position that it is the only institution that can act, while governments and other EU institutions stand by (BUBA1; Chapter 6.1.2). He demanded that monetary policy should play a subordinate role to fiscal and structural policies, otherwise it might lose its ability to influence financial markets when it becomes necessary (BUBA1; BUBA13). This is in line with the argument of the former governor from Eastern Europe (ESCB2).

8.3 Ideational change as a result of the presidency of Draghi

When Draghi took over the leadership, the ideational and institutional foundation of the ECB and its relationship to other NCBs, financial markets and governments changed remarkably. In contrast to Trichet, Draghi was not constrained by the Maastricht negotiations and the virtues of adhering to price stability at all costs. He implemented far-reaching policies that allowed the ECB to buy sovereign debt from Southern European countries. Nevertheless, Trichet had to fight an uphill battle to move the Governing Council to implement the SMP, while Draghi had it comparably easier in introducing the OMT after the precedent was set with the SMP. The political manoeuvring of Draghi was, however, completely different to that of Trichet and demonstrated his political gamesmanship and leadership style during times of intense crisis. By directly addressing financial markets rather than governments, he indirectly forced governments to sign on to his initiative and the actors in the financial market were impressed and found his threat to be credible. The OMT was never used proving, how potent Draghi's words were in delivering his threat.

However, the ECB under Draghi has, at best, worked at the fringes of the mandate (ECB1) or at worst, stepped outside of it (UK1; BOE1). The decisions are taken by the Executive Board and the Governing Council often had deep political implications. In the interview, a former ECB executive board member justified the decisions of the ECB during the sovereign debt crisis,

> 'In a crisis, any decision by central banks has political implications. This is clear. But the important thing is that the decision is not motivated by political issues, but by adhering to the mandates and abiding by the rules that the ECB has set out. [...] It is the rule, even if by following

> the rule, the decisions might have political implications. The motivation has to be non-political' (ECB5).

He refers to the implications the rules and discretion debate has on the highest level of decision-making of the Eurosystem and its impact on having to act politically. The Eurosystem is governed by clear rules that each member-state has to adhere to whether or not it receives emergency lending. However, the ECB can use discretion to amend the rules to the individual needs of a member-state, in particular, when it is severely affected by a financial or economic crisis. In addition, even if these decisions have political implications, which most decisions have owing to the importance monetary policy in the modern financial system, the motivation to act with discretion has to remain 'non-political' (ECB2). Therefore, as mentioned above, it remains important that the Governing Council members are taking decisions that are in the interest of the Eurosystem as a whole and not in the interest of a particular country or group of countries (Chapter 6.2). Draghi has aimed to remain above national considerations despite his decisions to extend the purchase programmes.

An official from the Bundesbank confirmed that he feels that the Governing Council is removed from actual central banking duties and that decisions tend to be influenced by political considerations. On a positive note, he argued that the Governing Council has a wider perspective on the Eurosystem than the different stages policies move through below. Therefore, the Governing Council does not have the time and protocols to discuss the advantages and disadvantages of each policy in detail. This has to happen on the levels below where experts in each area have the opportunity to discuss in more detail. The Bundesbank brings in new policy ideas at an early stage to have a higher chance of convincing its counterparts from other NCBs about the advantages of their recommendations (BUBA12).

When taking a perspective beyond the influence of Draghi on the changing position of the ECB, it becomes obvious that the ECB has used the crisis to remove itself further from the accountability constraints politicians face from the electorate. An interviewee from the private sector who advises central banks on strategic initiatives, including the ECB, has argued in the interview:

> 'The ECB has had a good crisis and has emerged from it very powerful and will continue to be so. The whole question of accountability, transparency and political legitimacy of the ECB actions is becoming a big issue if we ever revert to normal times. At the moment, politicians and electorates are prepared to not call the ECB to account. It is a bit like if

> your house is on fire, you are not going to tell the fireman off for coming in with muddy boots on the carpet. Similarly, so long as we are in this economic crisis, electorates and politicians are not going to raise a fuss about the growing powers of the ECB. I think one day people will again, particularly in Germany' (PS2).

This statement indicates that the ECB was able to use the crisis to strengthen its influence and impact on European politics. The interviewee hints at a reduced effort of politicians to hold the ECB accountable and within the bounds of political legitimacy during the current crisis. He further argued that this lack of scrutiny over the ECB might result in tensions if financial markets return to a longer period of stability and growth, or what he calls 'normal times'. This might only change if the crisis has been overcome and the economic conditions in periphery countries have stabilised, which would allow the ECB to raise interest rates. The interviewee assumed that once the crisis is overcome, electorates and politicians will question the accountability of the ECB. From his perspective, in particular, the German electorate will step forward to question the actions of the ECB. This is interesting because traditionally, the German electorate is in favour of a strong and independent central bank. However, as much of the discussion above has indicated, the choice and the timing of the instruments have raised much doubt among German public and monetary policy experts (BUBA12). The ECB, in particular under Draghi, has moved towards becoming a more Latin-oriented central bank ((Framke et al., 2013); Chapter 8.2). This argument is in line with its continuing expansionary monetary policy, something the German electorate increasingly questions. A British interviewee who previously worked for the UK government, but is now involved in a European think tank, argued along similar lines:

> 'In many ways, the ECB is even more independent than the others [Fed, BoE, Bank of Japan (BoJ)]. Because of the way the board is constituted, there is obviously a lot of political influence that can be put on the ECB itself. There is always the question of the Germans and if they are having an influence on what is happening [referring to the purchasing programmes]' (PS7).

This statement brings the argument back to the role Draghi played on the Governing Council and the previous assessments of the political influence that the highest decision body of the ECB is exposed to. The interviewee argued that the role of the Bundesbank and the German government is critical in influencing the decisions of the Governing Council. However, when looking back on the process of how

Draghi swayed the Governing Council of accepting the OMT by side-lining the Bundesbank and isolating it from the German government. He demonstrated that he has a high level of skill for political gamesmanship and that the influence of the Bundesbank is not as secure as most observers would acknowledge. The ECB has gained considerable influence during the crisis and has increased its dominance in the Eurosystem.

8.4 Conclusion

This chapter has analysed the influence and power of Mario Draghi during a time of severe market tensions. When the sovereign debt crisis re-emerged in late 2011, he used the full scope of available instruments to free periphery countries from market pressure. His actions demonstrated that Draghi was a decisive leader during stressful periods of the sovereign debt crisis. His 'whatever-it-takes' speech in July 2012 marked the zenith of his influence on financial markets. During his presidency, the ECB further expanded its responsibilities and power over financial markets, national governments, in particular of Southern European member states, but also over the NCBs of the Eurosystem. There is a clear institutional pull towards the centre of the Eurosystem. The NCBs have so far managed to retain most of their responsibilities, at least in a limited capacity. The major euro-area central banks, such as the Bundesbank and the Banque de France as well as the DeNederlandsche, have started to specialise in key areas of monetary policy. Therefore, the leadership of Mario Draghi has significantly transformed our understanding of central banking during times of crisis.

Chapter 9

Conclusion

> 'The lessons from the crisis? Well, I think the big lesson is that the ECB has tremendous power, people do not appreciate that.'
>
> Former Central Bank Governor of a Southern European euro-area member state (ESCB1)

This thesis has focused on analysing the policy response of the ECB and the Eurosystem to the financial and sovereign debt crisis. Central banks have taken on increasing responsibilities and have emerged as significant economic players throughout the Western world. This thesis helped to fill a gap in understanding the role of the central banks and their impact on society considering the limited amount of studies on central banking in sociology. The crisis years, from 2007 until 2012, significantly shaped the European societies, their financial systems and their central banks. To better understand these changes, the thesis has used the framework of epistemic communities, developed by Peter Haas (1992b), in order to investigate the questions: why and to what extent has the monetary policy of the Eurosystem changed as a result of the financial and sovereign debt crisis? What were the ideational drivers for this change? And what were the lessons learned for the ECB and the Eurosystem from the crises?

The financial and sovereign debt crisis has drawn out the weaknesses of relying on a deregulated financial sector. The shift towards deregulation and self-regulation during the 1990s has increased the complexity of financial markets, making it even more difficult for central banks to react to and mitigate crises. In the EU and the Eurosystem, the institutional environment and the depth and liquidity of financial markets were different among member states (Hall and Soskice, 2001). This made it particularly challenging for the ECB to find policy solutions that support the member states equally. Their policy decisions can have a significantly different impact on each member state. The ECB aimed to overcome these problems by relying on a policy mix that focuses on providing liquidity to banks and reducing the debt burden on governments.

This thesis discussed central banking and monetary policy from a sociological perspective. The impact of influencing the amount and flow of money in the financial system has a profound impact on all parts of society. Thus, sociological research should analyse the role of central banks in the financial system and their influence on society in more detail. There is a lack of research in sociology that investigates the policy actions of the major central banks, including the ECB, during the sovereign debt crisis and the purchasing programmes. This research has helped to fill a gap in this important area of sociology.

In more detail, Haas (1992b) developed the theoretical framework of epistemic communities, which the thesis uses in order to investigate the role groups of policy experts can play in overcoming challenges. While there are a number of different research approaches in sociology and political economy that focus on policy groups and communities (Fourcade, 2009; Hall, 1993; Amin and Roberts, 2008; Lave and Wenger, 1991; Wenger, 1998, 2000), the research on epistemic communities allows understanding why and how policy experts can closely work together – even across borders – to adapt to changing circumstances. The epistemic community of Eurosystem central bankers provides an interesting example of a group of highly trained public policy experts, in the area of monetary policy, that are bound together by the institutional construct of the Eurosystem. This community is further strengthened by the commitment to achieve the same goal: the mandate to maintain price stability and support the economic policies of the Eurosystem. Analysing the central banking community with its clearly defined objective during a severe financial and sovereign debt crisis has allowed this thesis to provide a comprehensive understanding on how epistemic communities operate during times of distress. Indeed, the epistemic community of Eurosystem central bankers has acted quickly and decisively during the initial phase of the crisis. They have exchanged ideas on policy options and instruments to tackle a variety of threats to the stability of euro-area. Haas' framework has allowed this thesis to investigate how an epistemic community works together and, in the case of central bankers, is able to implement its policies without government intervention. The framework of Haas has this research enabled to closely investigate the ideas of central bankers as part of the epistemic community of European central bankers.

The ECB was founded to ensure price stability among the euro-area member states and, once it is achieved, to enhance economic growth. During the crisis, monetary policy was primarily used to strengthen financial stability and to fund sovereign debt markets. The long-lasting, low growth period, deflationary pressures and financial and sovereign debt instability brought the ECB into uncharted waters. The use of unconventional policies, on the one hand, demonstrated the flexibility of the mandate of the ECB, but, on the other hand, stretched its instruments and operations to the maximum (Micossi, 2015).

Until 2007, the ECB perceived itself as a beacon of stability and successful monetary policy (Brunnermeier et al., 2016, p.316). Although the ECB quickly established itself as the main crisis-fighting institution in Europe, it underwent a dramatic change in its institutional and policy scope. The supranational character of the ECB allowed it, on the one hand, to provide a forum to exchange policy approaches and coordinate managing the fallout from the crisis among central bankers. On the other hand, the independence in monetary policy allowed the ECB to reach across borders and devise and implement far-reaching monetary operations. Beyond monetary policy, the ECB further advised and coerced European governments to move forward with fiscal and structural reforms to stabilise the European financial system and the euro-area economy. During the crisis, it became evident that the ECB had extended its scope from solely focusing on the mandate to also protecting the euro-area from breaking up (Chapter 7.2.2). The Governing Council of the ECB would go to extraordinary lengths to protect the euro-area (Brunnermeier et al., 2016, p.320). In particular, the two ECB crisis presidents, Trichet and Draghi, repeatedly coerced national governments and the financial sector into obedience (for Trichet, see Chapter 7.2.2 and for Draghi, see Chapter 8.2). Incidences, such as moving forward with the Securities Markets Programme (SMP) despite heavy criticism, sending letters to sitting governments, and the announcement of 'whatever-it-takes' are all signs that the ECB has used the financial and sovereign debt crisis to increase its power and influence in the euro-area and beyond (Chapter 8.2). Trichet and Draghi undertook extensive government bond purchase programmes to push for greater convergence and reduce systemic risks, often against the will of national governments and other Governing Council members.

Nonetheless, in various instances, critics pointed out that the ECB might have acted at the limits of or even beyond its mandate, especially when the ECB conditioned its support on fiscal and structural policy changes in periphery countries. These ideational changes of the ECB were driven in part by the ideational division between post-Keynesian and ordoliberal thought and in part by pragmatism.

While the foundation of the European System of Central Banks (ESCB) and the ECB can be considered the victory of ordoliberal ideas over post-Keynesian ideas during the late 1980s and early 1990s, the financial and sovereign debt crisis allowed post-Keynesian thought to re-emerge as a viable framework for policymaking. This was not immediately obvious during the initial phase of the financial crisis when pragmatism superseded ideational considerations (ECB1; BUBA3). The quickly changing market conditions did not allow the ECB to extensively think about policy decisions and discuss them from different economic ideational perspectives. Solutions had to be found to prevent the financial system to collapse. The data collected through interviews with high-level decision-makers of the central banks and commercial bank support this argument (Chapter 6.2).

During the first phase of the sovereign debt crisis, the decisions of the ECB, in contrast, were often influenced by economic ideational considerations. Alliances of ideational perspectives emerged on the Governing Council and led to a stand-off between core countries, favouring ordoliberal ideas, such as Germany, Netherlands and Austria and Southern European countries, aligned with post-Keynesian thought, such as Italy, Spain, Portugal and Greece. Tensions rose on finding policy solutions to the unprecedented problem of having governments collapse on the rising sovereign debt burdens of their countries (Chapter 7). These tensions changed their dynamic and pace when Draghi took over as president of the ECB. He managed to bring the sovereign debt crisis under control, using threats and coercion as well as an extensive asset purchasing programme. The tensions between him and officials from the Bundesbank, most importantly its president Weidmann, flared up regularly. This became particularly obvious when he side-lined Weidmann and isolated him from the German government during the summer of 2012 (Chapter 8.2). The data from the interviews has shed light on how central bankers and commercial bankers perceived the leadership style of Trichet and Draghi and the role of the national central banks (NCBs) in the intersection between central banks, financial markets and governments. While Trichet was perceived to be indecisive during the first months of the sovereign debt crisis, Drahgi was considered to be a decisive leader, who had the confidence of financial markets. These different perceptions of financial markets on the two ECB presidents had wide reaching implications on the role they played during the different phases of the financial and sovereign debt crisis (Chapters 6-7)

The thesis analysed different economic ideational changes and developments that led to the financial and sovereign debt crisis and the response of the ECB to overcome these crises. The thesis, furthermore, analysed the changing role of the Eurosystem in economic governance and the impact of economic ideas on these changes. Space and time did not permit an analysis of the responses of European governments to the financial and sovereign debt crisis. During the financial crisis, governments were initially overwhelmed and chose individual and national interest-oriented policy approaches to tackle the deteriorating financial and economic circumstances. These efforts focused on lender-of-last-resort (LLR) decisions to bail out their financial institutions and introduce economic stimulus programmes to support the real economy. The LLR function of the ECB was underdeveloped for a major central bank considering the success of ordoliberal influences on the Maastricht negotiations (Chapter 4.1). However, during the financial crisis, the ECB played a major role in coordinating policy responses of the Eurosystem and provided an unprecedented amount of liquidity. Nevertheless, as the case of the Irish deposit guarantee has demonstrated, the ECB was not always able to coordinate the policy responses. The Ireland deposit guarantee scheme was an incident when a national government undermined the coordinated policy response of the central banks, which had major knock-on effects on the entire crisis response and delayed it by several months.

When the financial crisis turned into the sovereign debt crisis in 2010, the ECB remained helpless for several months and awaited the coordinated response of the euro-area member state governments. Following the decision of the governments to support Southern European countries, the ECB introduced the SMP, which led to much controversy and resulted in the resignation of two German Governing Council members, Axel Weber and Jürgen Stark. Future research should analyse the role governments played in overcoming the financial and sovereign debt crisis. This could provide a better understanding of how governments and central banks can cooperate during severe financial and sovereign debt crises. Research could provide guidelines and analyses of how to reduce coordination failures among governments and central banks. Brunnermeier et al. (2016) have developed a comprehensive analysis of the role of governments in the Eurosystem. Although limited on the role of the ECB during the crisis years, the work provides points of departure for a more detailed analysis of the interrelations of the ECB and the national governments. This could become more complex when taking a detailed look at the role of national central banks (NCBs) in their countries and their relationship with their governments and again with the ECB as the supranational institution.

The research and the data from the interviews have indicated the direction the

ECB, and the Eurosystem will most likely take over the next few years. Several high-level interviewees have outlined their vision for the ECB and the NCBs in the Eurosystem. The ECB will, in the medium to long-term, draw more influence and responsibilities from the NCBs. This will particularly be the case in economic research and monetary policy formation. Although monetary policy implementation remains decentralised, the strategic direction and development of instruments will most likely move towards the centre (BUBA1). This development might reduce the influence of national central banks (NCBs) on the direction of monetary policy in the Eurosystem, the advantage of it is that it frees up resources and human resources for other tasks. Thus, the NCBs will become service hubs with specialised tasks that they can operate for the entire euro-area. The first signs of this development can be detected when looking at the how TARGET-2 is operated. The Bundesbank is managing the TARGET-2 payments for all NCBs in the euro-area. Another example is the bond pricing team of CEPH, where the Bundesbank, the Banque de France and Banca d'Italia work closely together to calculate and establish the theoretical and actual price of all sovereign bonds for the entire euro-area. In the near future, each NCB will take on tasks for the entire various tasks for the Eurosystem.

The ECB will take on increasing responsibilities in coordinating monetary policy with fiscal policy of the national government and will advise other European institutions on economic governance (BUBA2; ECB1; ECB2; ECB3). It has already taken on this responsibility as part of the Troika, where it advised the European Commission and the IMF on the economic challenges of the periphery countries. The ECB has furthermore developed its own identity during the financial and sovereign debt crisis that draws on ordoliberal and post-Keynesian thought and might be able to bridge the gap between these two camps in the euro area in the future. The ECB has moved beyond a purely ordoliberal institution and has allowed for post-Keynesian influences in its decision-making while adhering to rules, as envisioned in an ordoliberal framework for economic governance.

Overall, this thesis has established that economic ideas still play an important role in the central banking response during the financial and sovereign debt crises. However, when financial market tensions are high, central bankers opt for a pragmatic solution to overcome the challenges rather than deliberate the benefits and perils of ideational frameworks. Thus, ideational frameworks do not necessarily play a role in crisis management and can, at times, provide the basis for reducing the effectiveness of the crisis response. The consequences of having several economic ideational frameworks competing for dominance in one currency area can, at times, create severe challenges that threaten to break up the union, while at other times can provide extensive resources to draw on to find policy solutions to overcome the crisis. The crisis response has demonstrated both assumptions. Between 2007 and 2012, at several instances have the different economic ideational perspectives of the various economic actors resulted in almost inconceivable differences that often threatened a breakup of the euro-area. During the initial phase of the financial crisis, the ECB and the Eurosystem central banks were less affected, owing to their reliance on pragmatic policy response. Once the sovereign debt crisis emerged, this changed considerably. At other times, the different economic ideational lines of thought helped to shape the policy responses that provided benefits for all euro-area member states.

However, it is too early to say whether the ECB has effectively managed to overcome the financial crisis or whether it has only bought time for national governments, as Streek (2014) has argued. The ECB and the Eurosystem brought financial stability through effective monetary policy, increased supervision and a greater focus on overall financial stability. The ECB and the Eurosystem have, however, not been able to fix the underlying structural problems between the different euro-area member states. It has to work more closely with national governments to overcome this threat to economic and financial stability. The ECB can play a pivotal role as it provides a forum that can speak for the entire Eurosystem.

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ANNEX 1: List of interviewees

The positions of the interviewees indicated are at the time of the interview.

ACRONYM	POSITION	DATE	PLACE	TYPE
		EUROPEAN CENTRAL BANK		
ECB1	Senior Official	April 2016	Frankfurt	Interview
ECB2	Senior Official	June 2016	Frankfurt	Interview
ECB3	Senior Official	June 2016	Frankfurt	Interview
ECB4	Senior Official	June 2016	Frankfurt	Interview
ECB5	Former ECB Board Member	August 2015	By phone	Interview
		BUNDESBANK		
BUBA1	Board Member	March 2016	Frankfurt	Interview
BUBA2	Former President	August 2015	Frankfurt	Interview
BUBA3	Senior Official	February 2016	Frankfurt	Interview
BUBA4	Junior Official	January 2016	Frankfurt	Interview
BUBA5	Senior Official	January 2016	Frankfurt	Interview
BUBA6	Senior Official	February 2016	Frankfurt	Interview
BUBA7	Senior Official	February 2016	Frankfurt	Interview
BUBA8	Senior Official	February 2016	Frankfurt	Interview
BUBA9	Senior Official	February 2016	Frankfurt	Conversation
BUBA10	Senior Official	February 2016	Frankfurt	Conversation
BUBA11	Senior Official	February 2016	Frankfurt	Conversation

BUBA12	Senior Official	January 2016	Frankfurt	Conversation
BUBA13	Senior Official	February 2016	Frankfurt	Conversation
BUBA14	Official	February 2016	Frankfurt	Conversation
BUBA15	Senior Official	February 2016	Frankfurt	Conversation
DE NEDERLANDSCHE BANK				
DNB1	Senior Official	June 2016	Frankfurt	Conversation
DNB2	Senior Official	July 2016	Amsterdam	Interview
DNB3	Senior Official	July 2016	Amsterdam	Interview
DNB4	Junior Official	July 2016	Amsterdam	Interview
EUROPEAN CENTRAL BANKING COMMUNITY				
ESCB1	Former Deputy Director Southern European NCB	December 2015	London	Interview
ESCB2	Former President of Eastern European NCB	December 2015	London	Interview
ESCB3	Senior Economist and former Delors Committee member	August 2015	by phone	Interview
BOE1	Former Senior Official BoE	August 2015	London	Interview
PRIVATE SECTOR				
PS1	Chief Economist, major German bank	August 2015	By phone	Interview
PS2	Head of Public Sector, major consulting firm	August 2015	By phone	Interview
PS3	Journalist covering Fed and ECB	August 2015	By phone	Interview

PS4	Senior Banker, Deputy Global Head of Capital Markets, major German bank	March 2016	Frankfurt	Conversation
PS5	Global Head of Government Coverage, major German bank	March 2016	Frankfurt	Conversation
PS6	Global Head of Corporate Coverage, major French bank	December 2015	Frankfurt	Conversation
PS7	Former Head of UK Government Economic Service	August 2015	London	Interview
PS8	CEO of UK-based think tank	May 2015	London	Conversation
PS9	CEO of major German private bank	June 2016	Frankfurt	Conversation
PS10	Senior Trader Fixed Income	May 2016	Frankfurt	Conversation
PS11	COO of UK-based think tank	May 2016	London	Conversation
EUROPEAN COMMISSION AND EUROPEAN POLITICIANS				
EC1	European Commission Senior Official, decisive role in founding EMU	December 2016	London	Interview
UK1	Senior Politician (Labour Party)	February 2015	London	Conversation

EU1	Former Minister of Finance Southern European country with extensive central banking experience	February 2015	London	Conversation

ANNEX 2: Timeline

The table lists key events in the foundation and operation of the Eurosystem, implications for the euro-area and the ECB policy reaction that had an impact on its monetary policy.

DATE	**EVENT**	**IMPLICATIONS**	**ECB POLICY RESPONSE**
1 January 1999	Eleven states adopt the euro as their official currency	One of the largest currency areas is born	ECB starts operation
		2007	
9 August 2007	European interbank lending markets freeze-up	Liquidity problems for banks across Europe	ECB injects and unprecedented amount of capital, totalling, 94.8 billion euros, into the European financial system
13 August 2007	Continuing liquidity problems		Another liquidity injection of 47.7 billion euros
		2008	
3 July 2008	ECB increases key interest rate by 25 basis points	Key interest rate is raised too early. There is still high uncertainty in the market	This decision is considered the worst ECB decision of the crisis, in retrospect
15 September 2008	Lehman Brothers collapses	Seminal point in financial history. Global interbank markets seize-up	ECB buys up 425 billion dollars of MBS to ease credit flow but keeps interest rates unchanged

30 September 2008	Ireland announces a government guarantee for deposits and debts of its six system-relevant banks	This decision increases tensions among member-states, because investors capital is being diverted from other countries towards Ireland	Trichet exchanges strong letters with Irish government to demonstrate disagreement with the unilateral decision. The ECB steps into fiscal policy for the first time
5 October 2008	Germany announces to guarantee deposits	National governments use unilateral policy approach. Coordination of rescue measures collapse for several weeks	ECB strongly criticises this 'go-it-alone' mentality
8 October 2008	ECB announces reduction of interest rate and fixed-rate full allotment	High market uncertainty and volatility	ECB acts against the rising uncertainty in the market following the Lehman Brothers collapse
12 October 2008	European heads of state or government announce coordinated guarantees for senior bank debt and financial assistance to illiquid and insolvent financial institutions	Coordinated policy approach re-emerges	

16 November 2008	European Commission introduces 'European Recovery Plan' that provides 200 billion euros in temporary stimulus measures		
2009			
6 July 2009	ECB introduces first purchase programme of covered bonds (CBPP1)	First step of asset purchasing, which will eventually lead to the Quantitative Easing programmes	ECB uses unconventional policies to tackle the crisis that are at least at the fringes of its mandate
5 November 2009	Greece announces debt problems	This marks the start of the sovereign debt crisis	ECB has to face an entirely different problem-set that focuses on sovereign debt rather than financial illiquidity
3 December 2009	ECB announces that 'extraordinary liquidity measures [...] will gradually be phased out.'	At this point, the ECB does not expect that the debt problems of Greece will result in more 'extraordinary liquidity measures.'	ECB gets ready to reduce liquidity provision
2010			

8 April 2010	Greek 2-year bonds and 10-year sovereign bond spreads reach 652 basis points and 430 basis points respectively	The sovereign debt crisis intensifies and Greece becomes increasingly unable to refinance its debt	ECB has no conclusive answer on how to tackle the crisis within the limits of its mandate
21 April 2010	Bonds spreads once again increase to 1552 basis points for the 2-year and 755 basis points for the 10-year bonds.	The sovereign debt crisis worsens	ECB still unable to devise a policy reaction that relieves governments of funding difficulties
23 April 2010	Greece requests bail-out from euro-area member-states and the IMF		ECB involved in debt restructuring negotiations, eventually becoming part of the Troika (ECB, IMF, European Commission
7 May 2010	The 2-year and 10-year bond spreads further increase to 1739 and 1287 basis points respectively	Greece refinancing costs become unbearable	

10 May 2010	ECB introduces the Securities Markets Programme (SMP)	A decisive step towards purchasing government debt (yet, prohibited by the mandate)	ECB starts to buy government debt from periphery countries to reduce refinancing costs
19 November 2010	Ireland emergency loans, which it received in 2008, begin to expire	Ireland is still weak and it is not entirely clear whether it can repay its loans	Trichet exchanges letters with the Irish government, once again, demanding conditionality for continuing assistance from the ECB. The ECB steps into fiscal policy sphere, once more
2011			
30 April 2011	Axel Weber, President of the Bundesbank, resigns in protest of the purchasing programmes	Weber was the main critic of the purchasing programmes of the ECB and vocal voice of the core countries to keep the ECB on focusing on price stability	
9 September 2011	Jürgen Stark, Chief Economist of the ECB, resigns in protest of the purchasing programmes	The second German on the Governing Council resigns resulting in loss of influence of the core countries	

31 October 2011	Greek government calls for referendum on rescue package	Markets drop significantly	
1 November 2011	Mario Draghi assumes office of President of the ECB	Finanical markets are still in free-fall	ECB under Draghi re-activates the SMP to buy up sovereign debt from periphery countries
2012			
26 July 2012	Bonds spreads on periphery countries increase rapidly again	Heightening of the sovereign debt crisis	Draghi delivers famous 'whatever-it-takes' speech. Markets calm down instantly
6 September 2012	Introduction of the Outright Monetary Programme, the successor of the SMP	The ECB introduces another purchasing programme to back-up Draghi's speech	The OMT is perfectly timed and conditioned. The threat of using it alone allows the programme to remain dormant

ANNEX 3: Key Events

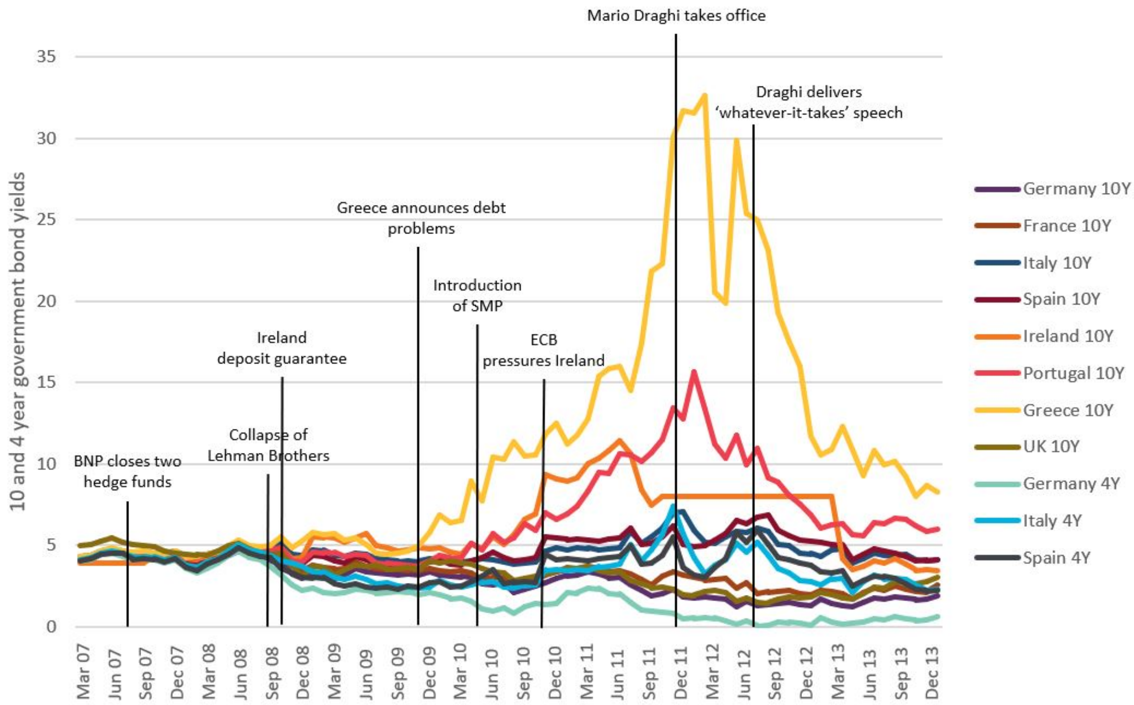

Figure 9.1: Key events seen on 10-year and 4-year sovereign bonds yields