Cornell International Law Journal

Volume 33
Issue 1 *2000*

Article 6

Deficiencies in European Monetary Union's Credible Commitment against Monetary Expansion

Nahalel A. Nellis

Deficiencies in European Monetary Union's Credible Commitment Against Monetary Expansion

Nahalel A. Nellis*

Introduction

On January 1, 1999, most European Union (EU) Member States entered the first phase of monetary union.[1] Monetary union promises to stir competition and reduce the costs of transacting business in Member States across Europe.[2] However, monetary union also poses potential problems,

* J.D. Candidate, Cornell Law School, 2000; A.B., Stanford University, 1996. Research Assistant, Hoover Institution, 1996-97.

1. Sweden, Denmark, the United Kingdom and Greece (hereinafter "derogation states") have not yet joined monetary union. *See* Office for Official Publications of the European Communities, Your Business and the Euro: A Strategic Guide 12 (1999). Greece has expressed its desire to join by January 1, 2001. *See id.*

2. *See generally* Directorate General XV of the European Commission, Accounting for the Introduction of the Euro (1997). For example, from January 1, 1999,

33 Cornell Int'l L.J. 263 (2000)

particularly with respect to controlling the money supply among Member States. Politicians in Member States have incentives to attempt to increase the money supply to their respective countries to help relieve economic recession[3] and to satisfy personal political goals.[4] Only two months after monetary union, Germany's finance minister, Oskar Lafontaine, pressed the European Central Bank (ECB) to cut interest rates[5] to increase the money supply, because German interest rates were 0.5 to 1 percent higher than euro-zone rates.[6] The ECB refused to cut rates,[7] and the president of the ECB, Wim Duisenberg, blamed the weakness of the euro on pressure from politicians like Lafontaine.[8] Nor is Germany an anomaly: social democratic governments with similar priorities are now in power in nine out of the eleven participating Member States.[9]

This Note examines the possibilities for Member States like Germany to attempt to expand their money supply. As the German case indicates, there is a substantial probability that politicians in Member States will attempt to pursue fiscal or monetary expansion to bolster their own economies. According to its current position, the ECB claims responsibility for price stability and dismisses responsibility for unemployment or for fine tuning aggregate demand.[10] Governments have reacted disfavorably to this position. According to Duisenberg, after two months of monetary union, both the ECB and the European Commission feared that France and Germany would break principal commitments against government spend-

---

businesses may invoice in euros, hold a bank account in euros, make electronic payments in euros and, in most participating Member States, file tax and social security returns in euros. *See* YOUR BUSINESS AND THE EURO, *supra* note 1, at 9.

3. *See generally* Opinion of the Economic and Social Committee on "Employment Policy and the Role of Socio-economic Organizations in the Third Phase of Economic and Monetary Union," 1.3.2.2 and 5.4, 1999 O.J. (C 40) 12 (1998) (stating "if Member States fail to coordinate economic policies adequately, the single currency may well turn out to be an enormous disappointment" and that socio-economic organizations can cause inflationary pressures). Adjustment of the money supply to counter recessions (i.e., counter-cyclical policy) is termed "monetary policy" by economists. *See* JOSEPH E. STIGLITZ, ECONOMICS 681 (1993).

4. *Cf.* Geoffrey P. Miller, *An Interest-Group Theory of Central Bank Independence*, 27 J. LEGAL STUD. 433 (1998) (analyzing, in the context of the U.S. political economy, the methods used by politicians to extract funds from interest groups).

5. *See The Euro: Neurosis*, ECONOMIST, Feb. 27, 1999, at 73 [hereinafter *Neurosis*].

6. *See* Wolfgang Manchau, *ECB Faces Conflicting Signals From Euro-Zone*, FIN. TIMES, Mar. 9, 1999, at 2.

7. *See ECB Keeps Rates on Hold as Euro Hits New Lows*, AGENCE FRANCE PRESS, Mar. 4, 1999, at financial pages 1.

8. *See Neurosis*, *supra* note 5, at 73 ("Wim Duisenberg, the President of the European Central Bank, also blames the euro's weakness on politicians – most notably Oskar Lafontaine . . .").

9. *See Worst of Both Worlds: Conflicts Between Central Bankers and Politicians Could Leave the Euro-Zone with Complete Policy Paralysis*, FIN. TIMES, Feb. 10, 1999, at 24 (stating "the social democratic governments . . . are in power in all but two of the euro-zone's member states").

10. *See id.* Price stability is defined as keeping inflation between zero and two percent in the medium term. *See id.*

ing.[11] Such government spending by Member States, as well as monetary policy tools, can expand the money supply, effect price stability, and even threaten monetary union.[12] The Treaty on European Union (EC Treaty or Maastricht),[13] which established the ECB and European System of Central Banks (ESCB), was designed to impose commitments on Member States against monetary expansion.[14] But Member States have begun challenging the credibility of their commitments.

Law and economics, along with transaction costs economics, provides a theory to evaluate whether current Maastricht regulations provide a framework for credible commitments by Member States against monetary expansion.[15] This Note argues that the theory of credible commitments[16] reveals current deficiencies in Member States' commitment against monetary expansion. However, a comprehensive negative assessment is premature because additional rules may provide necessary commitments. This Note suggests that legal rulings by European Community (EC) courts and agencies, in common law fashion, can interpret broadly-drafted legal duties in order to fill the current gaps in Maastricht commitments.

Part I of this Note explains that governments will manipulate the money supply as a default rule and summarizes a Member State's rational incentives to try to expand the money supply. This section also provides background on the methods that central banks (and the ECB) use to manipulate the money supply, and the reasons this poses a problem under

11. *See ECB Keeps Rates on Hold As Euro Hits New Lows*, AGENCE FRANCE PRESSE, Mar. 9, 1999, at financial pages 1 (quoting Wim Duisenberg as saying "we share, with the European Commission, the concern over the determination, particularly of the large countries to adhere to the aims of the stability and growth pact," and defining the large countries as France and Germany.) The Stability and Growth Pact promulgates terms for euro zone countries to bring their budgets close to balance or even into surplus in the medium term. The Pact was finalized at the Amsterdam European Council in 1997 and has the force of law. *See* Patrick R. Hugg, *Transnational Convergence: European Union and American Federalism*, 32 CORNELL INT'L L.J. 43, 56 (1998); *see also* INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK, Oct. 1997, at 58.

12. *See, e.g.*, Peter B. Kenen, *The Transition to EMU: Issues and Implications*, 4 COLUM. J. EUR. L. 359 (1998) (stating "monetary union . . . can amplify differences in real economic conditions when its members experience different shocks and there is insufficient wage flexibility or labor mobility in the union.")

13. *See* TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Feb. 7, 1992, O.J. (C 224) 1 (1992), [1992] 1 C.M.L.R. 573 (1992) (available at <http://www.europe.eu.int/eur-lex/en/treaties/index.html>) [hereinafter EC TREATY].

14. *See generally* COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION, REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY (1989) [hereinafter Delors Report]. *See also* CARLOS JAVIER MOREIRO GONZALEZ, BANKING IN EUROPE AFTER 1992, at 80 (1993) ("[T]he legitimate concern of all Central Banks . . . is to assure the monetary authorities, called upon to manage a Federal European Bank [the ECB], a sufficient degree of independence vis a vis political authorities, which are always suspected of inflationary laxity regarding the financing of internal deficits through money creation."). In this Note, "monetary expansion" refers to expansion of a Member States' money supply by either fiscal or monetary policy.

15. *See infra* Part II; *see generally* Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON & ORG. 1 (1995) (discussing applications of the theory of credible commitments).

16. *See infra* Part II.

monetary union. Part II presents an overview of the theory of credible commitments. Part III analyzes how the legal framework of monetary union fails to induce Member States to credibly commit against monetary expansion. Currently, outside enforcement mechanisms are too weak to raise the costs of monetary expansion above the associated benefits. Also, the current legal structure allows Member States to circumvent prohibitions and externalize the costs of monetary expansion, which prevents their commitments from being self-enforcing. Part IV summarizes possibilities to create credibility by filling gaps in commitments through imposing broad legal duties. The Note concludes that, without modification, the present structure fails to create a credible commitment against monetary expansion.

I. Incentives to Change the Money Supply and Methods Used by Central Banks

A. Incentives to Change the Money Supply

In the absence of a comprehensive legal framework, politicians in Member States have tremendous incentives to manipulate the money supply.[17] Manipulating the supply of money in an economy can effect economic growth and welfare.[18] For example, changing the supply of money in the economy can avert or remedy a recession.[19] If the central bank suddenly pumps more money into the economy, people will have more money to spend. When consumers spend more money, they create more jobs. Thus, more money translates to higher employment and subdues the recession.[20]

However, monetary expansion can create problems, such as inflation,[21] which means a reduction (or dilution) in the value of each unit of

17. *See* Christos Hadjiemmanuil, The European Central Bank and Banking Supervision 11, n. 24 (Joseph J. Norton ed., The London Institute of International Banking, Finance & Development Law) (1996) (stating that even in regard to European monetary union, "political decision-makers in governments and parliaments are likely to abandon their professional commitment to price stability [because] the structure of their incentives is such that their economic policies will probably be influenced much less by long term considerations of sound money than by the desire to finance public spending and to manipulate monetary conditions for the purpose of achieving short-term economic growth, in order to procure political benefits and alleviate electoral pressures").

18. *See* Stiglitz, *supra* note 3, at 982 (presenting, in a general textbook on economics, the monetarists' approach to formulaic control of the money supply contrasted with the new Keynesian approach, which advocates additional use of discretionary monetary policies). *See also* Anthony Saunders, Financial Institutions Management 86 (1994) ("[U]nderlying the movement of interest rates is the strategy of the central bank or the Federal Reserve.").

19. *See* Miller, *supra* note 4, at 442-44. *See also* Stiglitz, *supra* note 3, at 915 and 922 (discussing Keynesian monetary theory and alternative ways that monetary policy works).

20. *See* Stiglitz, *supra* note 3, at 976-77 (discussing basic economic principles of inflation) and Saunders, *supra* note 18, at 86-97 (providing a financial model to measure risk to banks arising from adjustment of interest rates).

21. *See* Stiglitz, *supra* note 3, at 977 (discussing the Phillips curve). *See also* Michael J. Artis & Zenon G. Kontolemis, *Inflation Targeting and the European Central*

money.[22] Inflation imposes real costs on society. It distorts economic activity, forces people to reprice their real assets according to the changing (nominal) price level, and forces lenders to take costly efforts to avoid losing the value of their financial claims. Inflation also reduces the purchasing power of workers or beneficiaries on fixed incomes.[23]

Nevertheless, politicians often find that increasing the money supply (particularly before elections) works to their advantage.[24] Increasing the money supply creates short-term gains in the form of new jobs, while the long-term costs of inflation are slow to appear.[25] Politicians prefer to create new jobs quickly, but they want to be viewed as crusaders against inflation, not conspirators to cause inflation.[26] Incumbents may pressure the central bank to expand the money supply shortly before elections to help ensure that constituents are employed at election time.[27] After their re-election, they then can tackle any resulting inflation.[28] Changing the money supply thereby helps politicians' re-election campaigns. Politicians also may extract money from interest groups by promoting or merely threatening inflationary practices.[29]

In addition to purely political motives, politicians also have government interest motives for expanding the money supply. Expanding the money supply can help the government gain revenue, reduce its debt, and lower its trade deficit. If a government suddenly issues money to itself by borrowing from the central bank,[30] the government gains revenue and reaps all the benefits of monetary expansion. Yet, the ensuing inflation

---

Bank, ECO No. 98/4 at 2 (1998) (predicting and assessing a model for varying levels of inflation among Member States).

22. An analogy can be made to cutting a pie. The total pie represents the gross domestic product (overall domestic earnings) of an economy, and each slice of the pie symbolizes each unit of money in the economy. As the number of slices increases – i.e., as the supply/amount of money increases – each slice becomes proportionately narrower. Thus, if the size of the pie remains the same, each slice becomes narrower, and each unit of money correspondingly loses value. The phenomenon of reducing the size of the piece of the economy's productivity, measured by its money, or currency unit of account, is called inflation.

23. *See* Stiglitz, *supra* note 3, at 653 (discussing basic principles of inflation).

24. *See* Miller, *supra* note 4, at 442 and Hadjiemmanuil, *supra* note 17, at 11 n. 24.

25. *See* Stiglitz, *supra* note 3, at 977.

26. *See* Miller, *supra* note 4, at 443. *See also* João Loureiro, Monetary Policy in the European Monetary System 69-70 (1996) (presenting a game theory model for political decisionmaking about inflation in the EU).

27. *See* Kenen, *supra* note 12, at 359.

28. *See* Loureiro, *supra* note 26, at 70 (stating that politicians have "the incentive to create surprise inflation"). *See also* Hadjiemmanuil, *supra* note 17, at 11 n. 24.

29. *See* Miller, *supra* note 4 at 438 (arguing that in the absence of institutional commitments against monetary expansion, politicians will seek to implement legislation that affects the money supply solely in order to make deals with the interest groups that would bear costs from such legislation).

30. As with politically-motivated expansion, the expenditure of central bank funds must be done in an unanticipated manner. Otherwise, according to the rational expectations theory of economics, the public will either hold less real money according to inflationary risk, or build inflationary buffers into private contracts. This would produce a net overall equal effect on employment. *See* Stiglitz, *supra* note 3, at 849-51 and 980-81.

implicitly taxes the public by diluting the money.[31] Likewise, if a government's debt is denominated in its currency, inflation devalues the currency and thus reduces the government's overall debt. Under certain conditions, countries can also reduce their trade deficit (balance of payments deficit[32]) and increase employment and output by creating inflation.[33] For example, if a small country has labor unions that demand wages at a price in excess of the optimal price (market clearing price), inflation can reduce the price of wages and lead to increased employment.[34]

Although any government has strong incentives to manipulate the money supply, governments (or their national central banks) in a common currency area such as the EU have even greater incentives.[35] In particular, governments can benefit from a collective action problem.[36] A collective action or "tragedy of the commons"[37] problem arises when a group agrees to refrain from a particular activity that, while individually beneficial, would harm the group as a whole. If all members uphold their commitment to not engage in the prohibited activity, (i.e., forego individual profits) the entire group benefits. However, members will have an incentive to violate their commitments where all the benefits arising from violation flow to the breaching member, while the entire group shares the associated costs.[38] Because the euro-currency area extends across eleven countries, the politicians of one Member State may spread the costs of inflation resulting from monetary expansion across all eleven countries, while localizing the benefits in their own country. Localization of benefits may be possible through Member State spending programs (fiscal policy) or by using the tools discussed in the following section.[39]

Consequently, in addition to incentives from anti-recessionary public policy, political self-interest, and governmental fiscal interests, politicians in monetary union have collective action incentives to expand their

---

31. *See* Kenen, *supra* note 12, at 359.
32. *See* Miller, *supra* note 4, at 439.
33. *See id.*
34. *See id.*
35. *See* MICHAEL EMERSON ET AL., ONE MARKET, ONE MONEY: AN EVALUATION OF THE POTENTIAL BENEFITS AND COSTS OF FORMING AN ECONOMIC AND MONETARY UNION 44 (1990).
36. For the classic text on collective action problems, *see generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION PUBLIC GOODS AND THE THEORY OF GROUPS (1971).
37. The "tragedy of the commons" problem often occurs in intergovernmental agreements involving ocean fisheries. For example, to prevent overfishing of the Grand Banks, all fishermen have a common interest in limiting their total harvest to what the fishery will support. However, each fisherman also has an incentive to maximize his immediate gain by taking out more fish. By doing so, the fisherman gains all the benefit of overharvesting (i.e., greater short-term profits), while the long-term costs of a depleted fishery are borne in common by all fishermen. *See* KENT BLADES, NET DESTRUCTION: THE DEATH OF ATLANTIC CANADA'S FISHERY 4, 9-10 (1995).
38. *See* OLSON, *supra* note 36, at 40.
39. *See* Part I, Section B, *infra*; *see also* Ross Cranston, *Banking and Investment Services: Implications of the New Financial Landscape*, *in* EUROPEAN SECURITIES MARKETS: THE INVESTMENT SERVICES DIRECTIVE AND BEYOND 45, 59 (Guido Ferrarini, ed., 1998) (arguing localized benefits can also occur by invoking emergency grants or lump-sum transfers of money from the European Union).

nation's money supply. Politicians also have incentives to change the money supply to fortify the economy against recession, both for their own self-interest and for the government's fiscal interest. Thus, without legal commitments against government intervention, Member State governments can be expected to manipulate the money supply as a default rule.

B. Methods Used by Central Banks To Change the Money Supply

The foregoing section described the reasons for a government to manipulate the money supply; this section describes the corresponding methods. National central banks (NCBs) of Member States and the ECB can manipulate the money supply using market operations and regulatory devices.[40] Market operations include open market operations,[41] adjusting the discount rate, and granting credits to standing lending facilities.[42] Regulatory devices include changing the reserve requirements on standing lending institutions.[43]

Both the ECB *and* the NCBs can perform open market operations.[44] This is done by selling debt instruments – mainly government bonds – on a financial exchange.[45] If an NCB or the ECB sells bonds, it reduces the money supply by the amount paid for the bonds on the exchange. If the bank buys bonds, it expands the money supply by the amount that the bank pays investors for these bonds.[46] The EC Treaty expressly provides each NCB (as well as the ECB) with the power to conduct open market operations.[47] This includes sophisticated types of market operations.[48]

---

40. *See* Lukas Menkhoff, Monetary Policy Instruments for European Monetary Union 8, 20-21 (1997) (arguing that open market operations will form the backbone of monetary policy and minimum reserve policy (regulatory devices) will be more prevalent).

41. *See infra* notes 44-48 and accompanying text.

42. *See id. See also* Peter B. Kenen, Economic and Monetary Union in Europe: Moving Beyond Maastricht 44, 55 (1995) (presenting an overview of the process and some potential dilemmas in open market operations under Maastricht).

43. *See* Menkhoff, *supra* note 40, at 20.

44. *See* Protocol on the Statute of the European System of Central Banks and of the European Central Bank art. 18.2 [hereinafter ESCB Statute] *in* Ralph Mehnert-Meland, Central Bank to the European Union 128 (1995). The ESCB Statute is annexed to the EC Treaty under Article 106(4). *See* EC Treaty, *supra* note 13, art. 106(4). *See also* Kenen, *supra* note 42, at 64 (presenting three models for open market operations under monetary union).

45. *See* Jonathan R. Macey & Geoffrey P. Miller, Banking Law and Regulation 15 (2d ed. 1997)

46. *See* Stiglitz, *supra* note 3, at 255-56 and 901 (defining bonds and describing their use in monetary policy).

47. *See* ESCB Statute, *supra* note 44, art. 18.2. *See also* Kenen, *supra* note 42, at 38 (outlining the powers of the ECB and NCBs).

48. *See* René Smits, The European Central Bank: Institutional Aspects 227-28 (1997) (outlining sophisticated market instruments). Both the ECB and the NCBs can engage in repurchase agreements and spot and forward transactions (buying and selling "outright") by lending or borrowing claims and marketable instruments, whether in EU or non-EU currencies, or precious metals. *See* ESCB Statute, *supra* note 44, art. 18.1. Under repurchase (repo) agreements, a central bank can buy an asset from the market, while agreeing to sell it back after certain period. This sellback reduces the money supply, but keeps collateral to hedge possible losses in the deal. Central banks may also

Three structural features, distinguishing the European System of Central Banks (ESCB) from the U.S. Federal Reserve system, may provide incentives for Member States to expand the money supply through open market operations. First, unlike the Federal Reserve (Fed) which has branches only in regions,[49] the ESCB has NCBs in each Member State.[50] This proximity may increase the NCBs' vulnerability to Member State political pressure and is equivalent to a Fed branch in every state of the United States. Second, almost every Member State in the EU has an autonomous financial exchange.[51] Exchanges in each Member State may allow monetary expansion to be localized geographically. In contrast, individual states in the United States do not possess their own financial exchanges. Third, whereas the Fed tightly regulates branch credit operations,[52] the ECB currently has looser statutory control over the NCBs. The ECB is limited to promulgating "general principles" for open market and credit operations both for itself and the NCBs.[53] These principles include the announcement of conditions under which the ECB and NCBs "stand ready to enter" into open market and credit operations.[54] Neither the ECB nor other EC institutions have yet defined the scope of these general principles.[55]

In addition to open market operations, both the NCBs and the ECB can adjust the money supply through its credit with standing lending facilities, such as credit institutions and other market participants.[56] If an NCB or the ECB lowers its interest rate to standing lending facilities or banks

---

lend with securities as collateral, or borrow against a pledge of securities, producing similar effects. This may involve the security (or foreign exchange) being delivered immediately (spot transactions) or at a later date (forward transactions). Buy/sell back transactions, another market instrument, determine the sale and repurchase simultaneously, but from two separate agreements that function like repurchase agreements. *See* SMITS, *supra*, at 228. The repurchase expands the money supply. *See also* MENKHOFF, *supra* note 40, at 19 (highlighting the importance of repurchase transactions).

49. *See* MARJORIE DEANE & ROBERT PRINGLE, THE CENTRAL BANKS 216 (1995).

50. *See* MEHNERT-MELAND, *supra* note 44, at 77; Rob Dixon, BANKING IN EUROPE: THE SINGLE MARKET 113 (1993).

51. *See* Cranston, *supra* note 39, at 62.

52. *See* DEANE & PRINGLE, *supra* note 49, at 216 and 218. *See also* KENEN, *supra* note 42, at 66 (arguing that the United States employs a tightly centralized model of control of the Fed branches).

53. ESCB Statute, *supra* note 44, art. 18.2.

54. *Id.*

55. According to Maastricht statutes regulating reserve requirements, the ESCB seems to envision a limitation on open market operations by limiting the amount of reserves or access to reserves by the NCBs. This assumes that existing reserves would be insufficient for a monetary expansion and that the NCBs cannot channel non-ESCB transactions to aid this monetary expansion. *See, e.g.*, Age F. P. Bakker & Guido F. T. Wolswijk, *Some Thoughts on the Monetary Framework in EMU*, *in* EUROPEAN MONETARY UNION: THE WAY FORWARD 86 (H.M. Scobie ed., 1998). *But see* MENKHOFF, *supra* note 40, at 20 (arguing that minimum reserve policy has been losing ground and is no longer considered a common instrument of monetary policy). If Menkhoff is correct, then the reserve policy is more of a disciplinary device on NCBs, rather than a tool for monetary policy.

56. See ESCB Statute, *supra* note 44, art. 18.2. *See also* KENEN, *supra* note 42, at 38 (describing ESCB transactions with credit institutions).

(e.g., its discount rate), these banks will borrow more money from the central bank and make more loans, thereby increasing the money supply. Any lending to credit institutions must be based on adequate collateral.[57]

The NCBs and the ECB also can change the money supply through regulatory devices.[58] These include changing the reserve requirements in standing lending facilities.[59] Lowering the reserve requirement increases the amount of money that banks or credit institutions can loan, which in turn increases the money supply. In addition, the Governing Council,[60] the primary decision-making body of the ESCB, can grant additional operational methods to effect the money supply.[61]

C. A Possible Legal Solution To Incentives To Manipulate the Money Supply

Legal provisions can provide Member States with incentives to keep their commitment against monetary expansion, notwithstanding the overwhelming political incentives to manipulate the money supply.[62] To clarify the implications of such a legal solution, the following section presents an analytical model to distinguish between the legal commitment itself, and the legal provisions that enforce this commitment. This analytical model is well-established and is termed the theory of credible commitments.

II. Overview of the Theory of Credible Commitments

The prior section analyzed the political incentives for a Member State to expand the money supply and the methods for central banks to expand the money supply. This section presents a theoretical background for evaluating government commitments against monetary expansion.

While originating in economics, the theory of credible commitments[63] can explain dilemmas pertaining to the enforceability of contracts, such as the EU's agreement against monetary expansion.[64] Before forming a contract, bargaining parties attempt to anticipate compliance problems that may arise after the contract is formed. If either party has complete author-

57. *See* KENEN, *supra* note 42, at 38.

58. *See* STIGLITZ, *supra* note 3, at 900-01 (discussing regulatory devices as monetary policy) and MENKHOFF, *supra* note 40, at 21 (discussing regulatory devices as applied to the ESCB).

59. *See* MEHNERT-MELAND, *supra* note 44, at 79.

60. *See infra* note 106.

61. *See* ESCB Statute, *supra* note 44, art. 20. This requires a two-thirds majority vote of the Governing Council. *See id.*

62. *See infra* Part III.

63. *See* OLIVER WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM 48-49 (1985) (noting that when ex post problems are anticipated ex ante, parties devise institutions to attempt to alter incentives to generate compliance with the bargain after contracting, stating "[r]ather than reply to opportunism in kind, the wise [bargaining party] is one who seeks both to give and receive 'credible commitments.'").

64. *See* GEORGE A. BERMANN, ROGER J. GOEBEL, WILLIAM J. DAVEY AND ELEANOR M. FOX, CASES AND MATERIALS ON EUROPEAN COMMUNITY LAW 22-26 (1993) (describing European integration, including European Monetary Union, as a set of treaties between contracting parties).

ity to breach the contract at will, or if no conclusive enforcement mechanism exists against both parties, then no "credible commitment" exists.[65]

Much of the theory of credible commitments originates in economics. Ronald Coase, a Nobel laureate in economics and a founder of law and economics theory at the University of Chicago, theorized that where transaction costs were zero and perfect information existed, exchanges would continue until no additional exchange could make a person better off without making someone else worse off.[66] Douglass C. North,[67] another Nobel laureate in economics, applied Coase's esoteric theory to demonstrate that economic growth can more easily be explained by studying reductions in transaction costs than by analyzing the traditional economic factors of production – land, labor and capital inputs.[68] North argued that reductions in transaction costs occurred through the imposition of rules or normative structures called "institutions," which establish formal or informal constraints on human behavior.[69] Consequently, such institutions not only can correct market imperfections, but also are necessary to improve economic performance in the real world, where transaction costs are positive.[70]

The theory of credible commitments identifies rules, enforcement mechanisms, or norms of behavior that "disable or render costly"[71] the use of discretionary power by a sovereign.[72] Two types of rules or norms achieve this effect and thus establish credible commitments to international agreements. First, an outside enforcement agency, such as the European Commission or the courts, can raise the penalties for breach of

65. *See* WILLIAMSON, *supra* note 63, at 49.

66. *See* Ronald Coase, *The Problem of Social Cost*, J. LAW & ECON. 1, 4 (1960). Professor Coase won the Nobel Prize in Economics in 1991.

67. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 4 (1990).

68. *See id.*; *see generally* DOUGLASS C. NORTH & ROBERT P. THOMAS, THE RISE OF THE WESTERN WORLD: A NEW ECONOMIC HISTORY (1973); DOUGLASS C. NORTH, STRUCTURE AND CHANGE IN ECONOMIC HISTORY (1981). Professor North won the Nobel Prize in Economics in 1993 for his contribution on economic structures.

69. *See* NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, *supra* note 65, at 4 (stating that institutions can be "formal constraints – such as rules that human beings devise – and [also] informal constraints – such as conventions and codes of behavior. Institutions may be created, as was the United States Constitution; or they may simply evolve over time, as does the common law.").

70. *See id.* at 5-6 (stating that "[i]nstitutions affect the performance of the economy by their effect on the costs of exchange and production. Together with the technology employed, they determine the transaction and transformation (production) costs that make up total costs."). *See generally* NORTH, STRUCTURE AND CHANGE IN ECONOMIC HISTORY, *supra* note 66.

71. Kenneth A. Shepsle, *Discretion, Institutions, and the Problem of Government Commitment*, *in* SOCIAL THEORY FOR A CHANGING SOCIETY 245, 250 (Pierre Bourdieu & James Coleman eds., 1991) ("Getting property rights right . . . involves not only . . . specifying rights and enforcing them, but it also means arranging political institutions so as to disable or render costly the exercise of discretionary authority.").

72. For purposes of this Note, a "sovereign" means a political entity that defines substantial rights within its jurisdiction. In the context of monetary union, "use" denotes a Member State's use of euros for its own benefit that effects the property value of the euro for all Member States.

international agreements above the benefits the government would receive from its breach.[73] Second, if an outside enforcement agency does not exist or is ineffective, self-enforcement mechanisms can establish a credible commitment if compliance with the agreement is in the sovereign's interests.[74] This can occur if the government constrains its own ability to act by establishing a self-created institution or legal structure whose existence raises the costs of breaching the agreement above the costs of maintaining the agreement. In effect, such institutions or legal structures force the government to internalize the costs of breaching the agreements; if these costs are high enough, breach is no longer an attractive option. Thus, to determine whether the institutions and legal structures of monetary union are credible commitments, an analysis must examine (1) whether outside enforcement creates penalties that exceed benefits for breach, (2) whether a self-created legal structure forces governments to internalize the costs of breaching the agreement, and (3) whether these costs exceed the costs for maintaining the agreement.

The concept of an outside enforcement mechanism (such as an overseeing court) is easy to understand, but the concept of a self-created institution or legal structure is more difficult. European history provides the best examples of self-created institutions,[75] particularly institutions that force sovereigns with direct loans to keep their debtor-creditor agreements.

---

73. The analysis is actually more complex. The enforcement agency must raise both (1) the costs and probability of enforcement plus (2) the benefits of keeping the agreement (times the probability that it will be kept), above the costs for (1) maintaining the agreement (times the probability that costs will occur) plus (2) the benefits of breach (times the probability of reaping these benefits). Uncertainty variables and irrationality variables could be added. To add additional layers of complexity, these calculations may not be only economic but also political. In addition, they do not involve the citizenry in the abstract but rather representative decision-makers who may have a dissimilar set of cost and benefit preferences than their constituents. The preferences of the gatekeepers to these decision-makers are particularly decisive because they decide when, under what circumstances, and with what options the decision makers will decide. *See* ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 67-121 (1994) (discussing parallel decision frameworks with complete and incomplete information). In this Note, I assume that the former end of the equation will not exceed the later end of the equation, at some point in time for some sovereign (Member State). Consequently, a Member State will desire change or wish to withdraw or seek amelioration for its plight.

74. *See generally* Weingast, *supra* note 15, at 2 (stating "the central component of a credible committment to a limited government is that these limits be self-enforcing").

75. *See, e.g.*, HILTON ROOT, THE FOUNTAIN OF PRIVILEGE: INSTITUTIONAL INNOVATION AND SOCIAL CHANGE IN OLD REGIME FRANCE AND ENGLAND (1994) (comparing credible commitments in old regime France and England); *see also* Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: Evolution of Institutions Governing Public Choice in 17th Cent. England*, 49 J. ECON. HIST. 803, 817 (1989) (arguing that after England's Glorious Revolution of 1688 laws of Parliament and other circumstances forced the Crown to keep its agreements, and prevented Parliament from breaking agreements like the Crown did, allowing the government to uphold property rights, as verified by evidence from capital markets); Avner Greif et al., *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745 (1994) (arguing that in the absence of an effective international legal system of contract enforcement, certain merchant guilds forced governments to perform their contracts by credibly threatening merchant embargos).

Historically, kings of England and France each had difficulty raising revenue by obtaining loans from their nobility, due to the Crown's inability to make a credible repayment commitment. A king in arrears could reduce the value of the "unit of account" for his debts by imprisoning his creditor,[76] canceling his loan agreements, or devaluing the "currency."[77] Lenders in both countries recognized that the Crown's commitment to repay its debts were not credible and avoided providing capital.[78]

England finally established a self-enforcing credible commitment to repay the Crown's debts in the 17th century. In post-Revolution England, Parliament assumed the power to audit and veto government expenditures.[79] The Crown's agreement with Parliament became self-enforcing because the changes resulted in greater commerce[80] *and* generated revenue for the Crown. The English Crown thus had no incentive to violate this legal regime.

In contrast, France failed to establish self-enforcing commitments during the 17th and 18th centuries.[81] In the 18th century, royal creditors tried to make the king face greater costs default by organizing individual financiers into corporate groups. These groups included the Farmers General, the offices of the financiers (*secrétaires du roi*),[82] and the Faculté de Droit[83]). The king's commitments to the corporations seemed credible because the corporations promised lower interest rates if no default

76. *See* F.W. MAITLAND, CONSTITUTIONAL HISTORY OF ENGLAND 298-301 (1908) (stating that the Star Chamber's equity rulings were considered an egregious exercise of arbitrary power); *see also* NORTH & WEINGAST, *supra* note 75, at 813 (arguing that such rulings reduced credible commitments). The firing of Chief Justice Coke (1616-17) and Crew (1627) and the Chief Baron of the Exchequer, Walter, also illustrate the erosion of credible commitments. *See id.*

77. The French monarchy commonly employed currency reform to cancel its debts. Coinage (*louis*) was denominated in livre, the unit of account. By allowing the value of the livre to decline, the Crown reduced some of its debt. *See* JOHN RILEY, THE SEVEN YEARS WAR AND THE OLD REGIME OF FRANCE 167 (1986); *see also* Hilton L. Root, *Tying the King's Hand: Credible Commitments and Royal Fiscal Policy During the Old Regime*, *in* 9 RATIONALITY AND SOCIETY 240, 246 (1989) (noting that "between 1689 and 1726 the equivalent of the *livre* in grams of silver declined from 8.33 grams to under 4.45 grams").

78. Lenders adopted several protective measures, including concealing assets from the king; refraining from transparent business ventures or obtaining crown approval; attempting to create credibility by person relationships with the king; and obtaining compensation through non-cash benefits. *See* ROOT, *supra* note 75, at 47-48.

79. These post-Revolutionary reforms stripped the Crown of its unilateral authority to disband Parliament and gave Parliament exclusive authority to raise new taxes, audit government expenditures, veto expenditures, and monitor placement of funds. *See* NORTH & WEINGAST, *supra* note 75, at 829-31 (also noting that post-Revolutionary political reforms limited the King's ability to cancel debt).

80. Lenders became more willing to finance enterprises in the wake of these reforms because they experienced lower risk that a demonstration of wealth would induce the sovereign to force loans. *See id.* at 817.

81. *See* ROOT, *supra* note 75, at 248.

82. Those who bought a *secrétaire* were paid salaries (*gages*) and had privileges. However, these benefits could be revoked if office-holders failed to meet the Crown's requests for capital. *See* ROOT, *supra* note 75, at 29.

83. *See id.* at 247-49.

occurred.[84] The king, however, could opportunistically breach commitments with different corporate groups, because he could default and externalize his costs on one corporate group, while simultaneously receiving new funds from another group.[85] The legal structure did not force the king to keep all his agreements – and thereby internalize all his costs – as Parliament required of the English kings.[86] Thus, although French kings honored some of the commitments they made with corporate groups, these commitments were not self-enforcing.

U.S. history also provides examples of credible commitments for central banks. For example, the Federal Reserve Bank's (Fed) independence from Congress is a legal custom rather than a legal requirement.[87] Theoretically, Congress could attempt to dictate the policies of the Fed by threatening to repeal its organic statute.[88] However, Congress has not threatened to replace the Fed's statute because this would impose drastic economic and political costs.[89]

In the past, however, other societal preferences led the U.S. government to respond differently. In 1834, for example, the Democratic Party opposed the existence of a central bank and prevented its recharter under the leadership of President Andrew Jackson.[90] The Democratic government faced no political penalty for violating the central bank commitment because the Party was newly-born, and its populist constituancy opposed

---

84. *See id.* at 251-52.

85. *See id.*

86. *See* JEAN-FRANÇOIS SOLNON, LA COUR DE FRANCE 523 (1987) (quoting Talleyrand "France seemed to be made up of a certain number of societies with which the government bargained. In this way, it kept each one under control using the credit that it had. Then the government turned to another, dealing with it in the same way. How could such a state of things continue?"). Root suggests that the difficulty in arranging negotiations among corporate groups led to the Crown's inability to negotiate out of its dilemma in 1789 Revolution. *See* ROOT, *supra* note 75, at 229.

87. *See* DEANE & PRINGLE, *supra* note 49, at 50-52 and 217-18.

88. The powers of the Federal Reserve Board originated in the Federal Reserve Act of 1913. *See* Federal Reserve Act of 1913, 12 U.S.C. §§ 221-503 (1994) and 12 U.S.C. §§ 1841-1850 (1994 & Supp. II 1997). This act created bank clearinghouses. *See* MACEY & MILLER, *supra* note 45, at 16. The present structure of the Fed and the responsibilities of the Board of Governors of the Fed were firmly fixed in the Banking Act of 1935. *See* DEANE & PRINGLE, *supra* note 49, at 215. Banking Act of 1935, 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997) (originally in 12 U.S.C. ch. 614, 49 Stat. 709). *See also* JOINT ECONOMIC COMM., 99TH CONG., MONETARISM, INFLATION AND THE FEDERAL RESERVE 42 (Comm. Print 1985) (stating, in an essay by Benjamin M. Friedman, that the independence of the U.S. central bank is "always strictly limited" but varies over time, and such independent exercise of monetary policy is "not independent of the existing [sic] structure of policymaking institutions, of course [because] the basic reality in this case is the implicit threat of wholesale change by simple amendment of the Federal Reserve Act, should the Administration and Congress agree on the need").

89. *See* DEANE & PRINGLE, *supra* note 49, at 218-19.

90. *See* Edward Meese III, *Putting the Federal Judiciary Back on the Constitutional Track*, 14 GA. ST. U. L. REV. 781, 790 (1998) ("Andrew Jackson disputed the [U.S. Supreme] Court's decision, withdrew the federal treasury from [the Second Bank of the United States], deposited it in state banks instead, and vetoed Congress's bill renewing its charter.").

the bank.[91] No outside enforcement mechanism existed in the early 1830s, and the Democratic Party could externalize most of the costs from violating the central banking commitment onto the opposing Whig Party.[92] Thus, the incentives of the Democratic politicians were uniformly aligned towards violating the banking commitment, which President Jackson breached using outrageous methods.[93] For the Democratic party, the commitment to a central bank was not self-enforcing.[94]

III. Analysis: The Monetary Union Framework For Creating Credible Commitments

This section applies the theory of credible commitments to the legal rules of the EC Treaty. The terms of the EC Treaty prohibit Member States from expanding their money supplies. However, as argued in Part II, Member States have powerful incentives to violate these terms, unless the legal structure makes the commitment credible. A credible commitment occurs if (1) outside (or external) enforcement creates penalties that exceed the benefits accruing from breach, or (2) if a self-created legal structure forces governments to internalize the costs of breaching the agreement and these costs exceed those incurred in maintaining the agreement.

Subsection A outlines the basic legal structure of monetary union, and argues that conflicts of interests by decision makers promote ruptures in credible commitments. Subsection B examines deficiencies in the first type of credible commitment (i.e., those based on external enforcement) and concludes that the current deficiencies in the legal structure allow Member States to circumvent outside penalties for breaching commitments against

91. At the time, the Democratic populist constituents distrusted the Northeastern financiers and the Second Bank of the United States, which was associated with the Whig Party. *See* James L. Pierce, The Future of Banking 36 (1991) (stating that Jackson vetoed the bank in 1832 because "Jackson's belief in states' rights, his concern for agrarian issues, and his distrust of banks in general and the economically and politically powerful Bank of the United States in particular had predisposed him to oppose the bank").

92. *See id.*

93. These methods included Jackson usurping the role of the judicial branch and declaring the central bank to be unconstitutional. *See* Meese, *supra* note 90, at 790 (stating that although the constitutionality of the Second Bank of the United States was affirmed by the Supreme Court in McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), Jackson disputed this decision as grounds for his veto). *See also* quotation in *supra* note 90.

94. In other countries, similar problems continue to exist today. For example, when Argentina passed the Central Bank Reform Act of 1992, the act intended to give Argentina's central bank autonomy from all powers of the state. The act stated that among the central bank's essential functions were commitments to preserve the value of the peso and eliminate temporary self-advances and self-purchases of government securities. Initial success in attracting international capital made this bank reform law appear credible, because the government would seemingly not want to threaten the new inflow of capital into the economy. Later debt-spending by the Menem administration, however, cast financial doubts over whether the central bank was allowing expansion of the money supply at the behest of the government. *See* Geoffrey P. Miller, *Constitutional Moments, Precommitment, and Fundamental Reform: The Case of Argentina*, 71 Wash. U. L.Q. 1061 (1993).

monetary expansion. Subsection C analyzes deficiencies in the second type of credible commitment (i.e., those based on self-enforcement) and concludes that the legal structure allows Member States to externalize the costs of breach. In this sense, the current legal structure does not support credible commitments.

A. Commitments and Conflicts in The Basic Legal Structure of Monetary Union

Seen from a distance, EU organizations seem to be able to control the money supply by controlling the issuance of bank notes, defining and implementing monetary policy, and overseeing payment systems. Provisions in the EC Treaty attempt to structure the monetary union to prevent Member States from expanding the money supply. The ECB and the ESCB administer the monetary union.[95] The ECB has legal personality[96] and has exclusive right to authorize the issue of banknotes within the Community.[97] The ESCB is composed of both the ECB and the NCBs,[98] and its primary objective is to maintain price stability (to prevent inflation).[99] The ESCB's relevant basic tasks are to define and implement the monetary policy of the EC and promote the smooth operation of payment systems.[100]

In addition to regulating monetary policy, the Maastricht provisions attempt to prevent monetary expansion by government expenditure (fiscal policy). To limit Member States' ability to use fiscal policy, the Treaty forbids the ESCB from assuming debts or obligations of central governments or regional, local or other public authorities or public firms, with the exception of mutual financial guarantees for the joint execution of specific projects.[101] As a result, Member States cannot finance monetary expan-

95. *See* DIXON, *supra* note 50, at 113.

96. *See* JOSEPHINE SHAW, LAW OF THE EUROPEAN UNION 133 (1996).

97. *See* EC TREATY, *supra* note 13, art. 105a(1). Issuing money is a considered the heart of traditional state functions. *See* J.A. USHER, THE LAW OF MONEY AND FINANCIAL SERVICES IN THE EUROPEAN COMMUNITY 177 (1994).

98. *See* EC TREATY, *supra* note 13, art. 106(1).

99. *See id.* art. 105(1) (Without prejudice to the primary objective of price stability, the ESCB "shall support the general economic policies of the Community with a view to contributing to the achievement of the objective of the Community . . . ."); *see also* Bakker & Wolswijk, *supra* note 55, at 80.

100. *See* EC TREATY, *supra* note 13, art. 105(2), first indent and fourth indent. The other two tasks of the ESCB are to conduct foreign exchange operations consistent with the provisions of Article 109 of the EC Treaty and to hold and manage the official foreign reserves of the Member States. *See id.* art. 105(2), second and third indents.

The term payment systems refers to the intermediate stages of money transfer from one party to another. Defining such systems is complex. The economic definition is "every item suitable for use as a means of payment – such as cash, cheques and credit cards – and every network" through which money is transferred from one party to another – such as a bank-to- customer network, bank-to-bank network, or postal service. But the legal definition, which involves passing of liability, is "the correct and complete fulfillment of a pecuniary obligation that consists of the final transfer of the absolute availability of money due to the creditor." MARIA CHIARA MALAGUTI, THE PAYMENT SYSTEM IN THE EUROPEAN UNION 11, 22 (1997).

101. *See* EC TREATY, *supra* note 13, art. 104b; *see also* MEHNERT-MELAND, *supra* note 44, at 81.

sion through loans from the ESCB. Member States also cannot shift their public debt and other commitments onto the coffers of other Member States or the EU.[102] After stanching the ability for Member States to obtain loans from the ESCB, the EC Treaty limits Member State self-financing by limiting government deficits and prescribing procedures to trim away "excessive" government deficit.[103]

Although Maastricht provisions regulate monetary policy and attempt to limit fiscal policy, conflicts of interest in ESCB decision-making impede credibility, because these conflicts may effect decisions about the *enforcement* of commitments. In addition, as argued in the next subsection, these enforcement provisions are weak. If the EU legal structure both did not impose a conflict of interest on enforcement decision-makers, and had strong enforcement penalties or rewards, the strength of outside enforcement mechanisms would present a much more credible commitment against monetary expansion: the first type of credible commitment). Enforcement is a concern because, as argued in Part I, Member States have strong incentives for monetary expansion. Also, the legal structures provide the ESCB with (1) branch NCBs in each Member State rather than regional branches, as does the Fed; (2) looser control over these branches than the Fed; (3) financial markets existing in almost each Member State, allowing the capacity for somewhat localized open market operations; and (4) little to no control over Member State fiscal policy, for tax and spending.[104]

A conflict of interest exists among most of the members of the central ESCB decision-making body, the Governing Council. The Governing Council is comprised of all governors of the NCBs[105] and the Executive Board.[106] These make decisions for both the ESCB and the ECB.[107] How-

102. *See* MEHNERT-MELAND, *supra* note 44, at 81.

103. *See* EC TREATY, *supra* note 13, art. 104c(2)(b); *see also* Protocol on the Excessive Deficit Procedure *in* MEHNERT-MELAND, *supra* note 44, at 164. Excessive government deficit is defined, in part, as a ratio of 60% of government debt to gross domestic product at market prices. *See id.*

104. *See supra* notes 49-53.

105. *See* EC Treaty, *supra* note 14, art. 106. The Governing Council consists of all the governors of the NCBs. Governing Council members may only vote if present (unless teleconferencing exists under art. 12.3); each has one vote and actions are by simple majority. A quorum of two-thirds of the members is required for voting, but the President may convene an extraordinary meeting without regard to quorum. *See* ESCB Statute, *supra* note 44, arts. 10.1 and 10.2.

106. The Executive Board includes the President, the Vice-President, and four other members of professional standing and recognized experience. *See* ESCB Statute, *supra* note 44, art. 11.1; EC TREATY, *supra* note 13, art. 109a(2)(a). The current members of the Executive Board are President Wim Duisenberg, from Holland; Otmar Issing, chief economist (and former chief economist of the Bundesbank), from Germany; Tommaso Padoa-Schioppa, in charge of banking supervision and international relations, from Italy; Eugenio Domingo Solans, in charge of payment systems, from Spain; Sirrka Hämäläinen, chief comptroller of the currency, from Finland; and Christian Noyer, in charge of internal administration, from France. *See* Wolfgang Münchau, *Who Are Those Masked Men?*, THE INTERNATIONAL ECONOMY, Sept./Oct. 1998, at 20-23.

107. Decision-making organizatins include the Governing Council, the Executive Board, and – as long as some Member States derogate from monetary union – the

ever, a majority of decision-makers in the Governing Council of the ESCB and ECB perform two jobs. Although the governors of the NCBs simultaneously sit in the Governing Council of the ESCB and the ECB, these same governors also must administer their NCBs in a non-EU national capacity.[108]

Despite their bifurcated duties, NCB governors have extensive powers to decide issues regulating monetary expansion, including sole power to decide certain lay issues, and cannot be removed without a supermajority vote. In the Governing Council, the governors of NCBs – together with the Executive Board – formulate the monetary policy of the Community, adopt guidelines, and make decisions to perform the ESCB's basic tasks.[109] NCBs are obliged to follow these guidelines and instructions, and the NCB governors and Executive Board in the Governing Council enforce compliance.[110]

Many important decisions regulating monetary expansion are decided solely by the NCB governors.[111] Only the NCB governors determine

---

General Council. *See* EC TREATY, *supra* note 13, art. 106(3); *see also supra* note 1 (listing current derogation states). A third organization, governing coordination with non-participating Member States, occurs in the General Council, which includes the members of the Governing Council and representatives from non-participating Member States. *See* EC TREATY, *supra* note 13, art. 109l(3); ESCB Statute, *supra* note 44, art. 53. Members of the Executive Board other than the President and Vice-President do not have the right to vote in the General Council. The General Council's tasks are to take over the exchange rate functions of the European Monetary Institute in art. 109l(5) – which coordinated exchange rates before monetary union – and to help include the nonparticipating states in monetary union under the process of Article 109k. *See* USHER, *supra* note 96, at 176. Otherwise, the General Council is somewhat separated from direct decision-making because under Article 47.4 of the ESCB Statute, "the General Council shall be informed by the President of the ECB of decisions of the Governing Council." *Id. See also* Rules of Procedure of the General Council of the European Central Bank, 1999 O.J. (L 075) (1998) (giving the rules of procedure of the General Council).

108. *See* TOMMASO PADOA-SCHIOPPA, THE ROAD TO MONETARY UNION IN EUROPE: THE EMPEROR, THE KINGS, AND THE GENIES 232 (1994) (noting that decentralization within the ESCB has sometimes been confused with retention of strong national jurisdiction in supervision and that confusion may exist whether (in carrying out supervisory responsibilities) a NCB is acting under national powers or as part of the ESCB). ESCB Statute art. 14.4 grants to the NCBs the power to perform functions on their own responsibility and liabilities; these functions "shall not be regarded as part of the functions of the ESCB." ESCB Statute, *supra* note 44, art. 14.4; *see also infra* note 111 for the text of 14.4 The Governing Council can limit these functions only if it finds, by a two-thirds majority, that they interfere with objectives and tasks of the ESCB. *See id.*

109. *See* MALAGUTI, *supra* note 101, at 282. The Executive Board's implements these decisions. *See id. See also* KENEN, *supra* note 42, at 66 (stating that "governors of the national central banks will have more influence in the ECB than presidents of the Federal Reserve Banks . . . [because] they will all be voting members of the Governing Council, where they will outnumber the members of the Executive Board . . ."). Kenen further argues that NCB governors are likely to oppose any method of monetary management that benefits one Member State over another. *See id.*

110. *See* MALAGUTI, *supra* note 101, at 283 *and* ESCB Statute, *supra* note 44, art. 14.3. NCBs can be compelled to disclose necessary information. *See* ESCB Statute, *supra* note 44, art. 14.3.

111. *See* Niall Lenihan, *The Role and Framework of the European System of Central Banks*, 1090 PLI/Corp 463, 467 (1999) (stating "a crucial operational feature of the [ESCB] is that, while monetary policy will be established by the ECB Governing Council

reserve requirements, the allocations of profits earned by NCBs, and the expenditure of revenue by NCBs and the ECB for administering monetary policy. These include decisions taken under Articles 28 (capital reserves of the ECB), 29 (key for subscription of the ECBs capital), 30 (transfer of foreign reserve assets to the ECB), 32 (allocation of income produced by NCBs), 33 (allocation of net profits and losses of ECB) and 51 (derogations from Article 32 in the case of large relative differences in NCB's income).[112] In addition, NCBs can perform functions other than those specified by the ESCB.[113]

Moreover, the EC Treaty currently grants the Governing Council only limited power to restrict the activities of the NCBs. Specifically, the Treaty provides that the Governing Council can limit the functions of the NCBs if it determines by a two-thirds majority that these functions interfere with the objectives and tasks of the ESCB. However, in practical terms, the NCBs may circumvent the Council's authority without great difficulty. The number of votes cast is weighted according to each NCB's share of subscribed capital in the ECB.[114] For example, in the case of Oskar Lafontaine's opposition, if the German NCB governor also opposed a Governing Council limitation on German monetary expansion, then Germany and another state probably could prevent a two-thirds majority. Hence, an NCB effectively could prevent the Governing Council from limiting the NCB's functions. Also, the Treaty does not prescribe how the Council may limit the NCBs' functions or define the permissible extent of such limitations.[115]

---

meeting in Frankfurt, monetary policy will be implemented on a decentralized basis through the 11 national central banks. Open market operations pumping liquidity into the financial system, or withdrawing liquidity, will be conducted through the dealing rooms in the 11 national central banks."). *See also* ESCB Statute, *supra* note 44, art. 10.3. These include decisions taken under Article 28 (capital reserves of the ECB), Article 29 (key for subscription of the ECBs capital), Article 30 (transfer of foreign reserve assets to the ECB), Article 32 (allocation of income produced by NCBs), Article 33 (allocation of net profits and losses of ECB) and Article 51 (derogations from Article 32 if large relative differences exist in NCB's income). On these issues, voting is weighted according to the NCB's share of subscribed capital in the ECB; governors who cannot be present for the vote may appoint a proxy. A decision by a qualified majority passes by two-thirds of the subscribed capital of the ECB and one-half of the NCB shareholders. *See id.*

112. *See* ESCB Statute, *supra* note 44, arts. 28-33, 51.

113. *See id.* art. 14.4 ("[N]ational central banks may perform functions other than those specified in this Statute, unless the Governing Council finds, by a two-thirds majority of votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.").

114. *See id.* art. 14.4; *see also* MATTHIAS BRUECKNER, VOTING AND DECISIONS IN THE ECB, ECO No. 97/29 (1997) (arguing that the statutory rule leads to inefficient outcomes and that sidepayments increase the efficiency of voting decisions in the ECB).

115. The Statute states merely that "national central banks may perform functions . . . unless the Governing Council finds . . . ." ESCB Statute, *supra* note 44, art. 14.4; Lenihan, *supra* note 109, at 467 (stating that monetary policy will be implemented on a decentralized basis). The Governing Council can also compel an NCB to disclose necessary information. *See* ESCB Statute, *supra* note 44, art. 14.3.

In sum, the basic legal structure of monetary union creates outside enforcement mechanisms and sets objectives for these mechanisms. However, the decision-makers for these outside enforcement mechanisms may have conflicts of interests between their official EU capacity in the Governing Council and their administration of NCBs. This possible conflict of interest impedes the establishment of credible commitments because those members with potential conflicts of interest (e.g., NCB governors) have sole authority to decide important monetary expansion issues, and cannot be reproved without a supermajority vote. As the next section argues, the EC Treaty allows further commitment deficiencies through weak enforcement sanctions and sets a high threshold for censuring the actions of the NCBs themselves. Thus, costs are unlikely to exceed the benefits accruing to Member States for expanding the money supply.[116] By failing to create penalties that exceed benefits for breach, the legal structure of monetary union fails to establish credible commitments based on external enforcement.

B. Incompleteness of Outside Enforcement Mechanisms

The first type of credible commitment (based on outside enforcement) may not exist because external enforcement institutions currently lack effective sanctions to impose costs on Member States that exceed benefits for breaching their commitment against monetary expansion. For purposes of the credible commitment analysis, the external enforcement institutions include sanctions by the ECB and other Community institutions.

1. *ECB Sanctions*

As mentioned above, the ECB can promulgate rules that have the force of law.[117] The ECB can issue regulations on restricted topics[118] that are binding on Member States, and the ECB can issue binding decisions.[119] However, the ECB can only impose very attenuated sanctions for violations, and these limited sanctions reduce the credibility of the ECB as an outside enforcement mechanism. The EC Treaty currently limits sanctions to fines or periodic penalty payments having a maximum total of about 1.8

116. *See supra* Part III.

117. *See* Lenihan, *supra* note 109, at 466; *see also* EC TREATY, *supra* note 13, art. 108a(1).

118. *See* EC TREATY, *supra* note 13, art. 108a(1) (limiting ECB regulations to tasks defined in ESCB Statute Article 3.1, first indent, Articles 19.1, 22, 25.2, and in acts of the Council under 106(6)). The ECB can issue regulations that define and implement the monetary policy of the Community (ESCB Statute art. 3.1, first indent), set minimum reserves for "credit institutions" (ESCB Statute art. 19.1), regulate clearing and payment systems (ESCB Statute art. 22), perform tasks to supervise "credit institutions" and other financial institutions except insurance (ESCB Statute art. 25.2), or under the acts of the Council in Article 106(6). However, sanctions do not apply to these topics unless adopted by the Council as provided in ESCB Statute art. 42 and EC Treaty art. 106(6).

119. *See* EC TREATY, *supra* note 13, art. 108a(1) and (2); ESCB Statute, *supra* note 44, 34.2, first and third indent. The ECB can also issue recommendations and opinions with no binding force. *See id. See also* HADJIEMMANUIL, *supra* note 17, at 36.

million euros.[120] In other words, the penalties for failure to comply with the outside enforcement mechanisms of the ECB are solely pecuniary. When a Member State faces recession – including dramatic noncompetitiveness of industry and labor unemployment – fines and periodic penalty payments of 1.8 million euros seem unlikely to outweigh the benefits from monetary expansion. The increase in a Member State's gross domestic product (GDP) from counter-cyclical monetary policy and government expenditure will almost certainly exceed the impact of monetary sanctions. Consequently, ECB sanctions do not adequately enforce Member States' commitments against monetary expansion.

Even more seriously, ECB sanctions currently do not apply to certain areas involving monetary policy. Although the ECB can issue regulations on a range of issues pursuant to under Article 108a(1) of the EC Treaty, its enforcement authority is limited.[121] The Treaty provides that the ECB's fines and penalty payments only apply within the limits and conditions set by the European Council under Article 106(6).[122] Under the EC Treaty, the ECB is not authorized to impose sanctions regarding prudential supervision of credit and financial institutions or regarding payment systems,[123] because Article 106(6) makes no reference to these provisions.[124] In addition, the ECB may not impose sanctions to help meets its obligation "to define and implement the monetary policy of the Community."[125] Consequently, the ECB can issue regulations on issues under 108a(1), but is not authorized to have sanctions to enforce those regulations.[126]

120. *See* EC TREATY, *supra* note 13, art. 108a(3); ESCB Statute, *supra* note 44, art. 34.3 *and* MEHNERT-MELAND, *supra* note 44, at 87. The ECB can impose a maximum fine of 500,000 euros, together with a maximum penalty payment of 10,000 euros per day for no longer than six months (resulting in a maximum sum of about 1,800,000 euros). *See* Council Regulation 2532/98, art. 1(a) and (b), 1998 O.J. (L 318) (1998) (promulgating the exclusive regulation that allows the ECB to impose an infringement procedure on a national central bank performing tasks of the ESCB).

121. *See* EC TREATY, *supra* note 13, art. 108a(1).

122. *See id.* art. 108a(3) ("[W]ithin the limits and under the conditions adopted by the Council under the procedure laid down in Article 106(6), the ECB shall be entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions"); *see also* ESCB Statute, *supra* note 44, art. 34.3; SMITS, *supra* note 48, at 494 (listing ECB sanctions and stating that no specific sanctions apply if not referenced in EC Treaty Article 106(6) or ESCB Statute Article 42). The European Council is specially composed of Member States' Economic and Finance Ministers for decisions on areas of capital payments and economic and monetary policy. *See* EC TREATY, *supra* note 13, Declaration (No. 3) on Part Three, Title III, Chapter 4 and Title VI.

123. *See infra* section C.

124. Article 22 of the ESCB Statute refers to payment systems; Article 25.2 refers to prudential supervision of credit institutions and financial institutions. *See* SMITS, *supra* note 48, at 494.

125. *See* ESCB Statute, *supra* note 44, art. 3.1 *and* HADJIEMMANUIL, *supra* note 17, at 32 (describing these strictly advisory functions).

126. *See* ESCB Statute, *supra* note 44, art. 3.1 (the equivalent of EC Treaty Article 108a(1) is not listed among the enforcement provisions of EC Treaty Article 106(6)). Article 106(b) gives the ECB power to enforce regulations for ESCB Statute Articles 4, 5.4, 19.2, 20, 28.1, 29.2, 30.4, and 34.3; these are discussed herein.

Even where the ECB may impose sanctions, it remains dependent on other Community institutions and secondary legislation, except that it may impose direct sanctions for violations of minimum reserve requirements of credit institutions. Other provisions for fines and penalty payments are only invoked on the basis of the European Council's secondary legislation.[127] The European Council must also pass secondary legislation for the ECB to impose sanctions for improper collection of statistics[128] or to grant "other instruments of monetary control."[129] In sum, because the ECB primarily has only weak, curtailed or indirect enforcement rights through other institutions, its ability to impose direct sanctions is limited to imposing 1.8 million euros in fines and penalty interest or punishing credit institutions that violate minimum reserve requirements.[130]

2. *Non-ECB Sanctions*

Apart from sanctions by the ECB, the sanctions of other outside enforcement mechanisms are similarly weak, and thereby impede creation of external enforcement credible commitments. Article 103 of the EC Treaty provides that the European Council can make "recommendations" to a Member State[131] when it violates the broad economic guidelines of the Community[132] or "risks jeopardizing the functions of economic and monetary union."[133] As a stiffer penalty, by qualified majority vote, the Council can make a public announcement that the offending Member State contravened the Council's broad guidelines.[134]

Sanctions comparable to fines and penalty payments also exist if Member States breach deficit and debt requirements. If a Member State

127. *See* ESCB Statute, *supra* note 44, art. 34.3; MEHNERT-MELAND, *supra* note 44, at 87.

128. *See* ESCB Statute, *supra* note 44, art. 5.4. In contrast to fines and penalty interest, the sanctions granted to the ECB for failures in collecting statistical information is "appropriate provisions for enforcement."

129. *Id.* art. 20, first and second paragraphs; MEHNERT-MELAND, *supra* note 44, at 80.

130. *See* ESCB Statute, *supra* note 44, art. 19.1. ESCB Statute art. 19.2 also gives the ECB power to impose "appropriate sanctions in cases of noncompliance" with minimum reserve requirements of credit institutions, if the European Council passes applicable secondary legislation. Hence, in the case of minimum reserves, the Treaty is more stringent. *See* Lenihan, *supra* note 109, at 468. *See also* European Central Bank Regulation 2818/98, 1998 O.J. (L 356) (1998) (promulgating specifics for regulation of the reserve requirements of credit institutions and credit institution branches within participating Member States).

131. The Community monitors Member States economic programs for consistency with these guidelines. *See* EC TREATY, *supra* note 13, art. 103(3). The European Commission submits reports on Member States' economic developments and their consistence with the broad guidelines to the European Council. *See id.*

132. Community institutions formulate broad guidelines for the economic policies of Member States under Article 103. Such guidelines are passed by qualified majority vote of the Council, upon recommendation by the Commission and with consultation of the European Council. *See id.* art. 103(2); *see also* HADJIEMMANUIL, *supra* note 17, at 35 ("[T]he ECB is not intended to replace the competent authorities, but only to assist in the performance of their functions.").

133. *See* EC TREATY, *supra* note 13, art. 103(4).

134. *See id.* art. 103(4).

violates a timetable for deficit adjustment, the EC Treaty provides for possible mandatory disclosure about issuance of bonds or securities, a possible mandatory non-interest-bearing deposit with the Community, and appropriate fines.[135] Of more substance but higher uncertainty, the European Council can "invite" the European Investment Bank to "reconsider its lending policy" for this Member State.[136] However, this sanction requires a two-thirds majority vote in the European Council, by qualified majority weight, after a recommendation by the Commission.[137]

The final remaining Community institution with power to sanction a Member State engaging in monetary expansion is the European Court of Justice. The Court of Justice's power is significant for creation of credible commitments and will be discussed at length in Part IV.

Hence, because of the current weakness of outside enforcement provisions (other than the Court of Justice), the outside enforcement institutions of monetary union currently do not seem to provide external enforcement-based credible commitments against monetary expansion. As noted above, the incentives for monetary expansion include public counter-cyclical policy benefits, political self-interest benefits, government fiscal interest benefits, and collective action benefits. When Member States are faced with a recession, all these benefits – including the prospective increase in aggregate GDP from monetary expansion – seem to outweigh the EC Treaty's weak sanction of fines and periodic penalty payments and related measures. When a Member State's government has the political ideology to use fiscal or monetary policy – as do many social democratic parties in power in Member States[138] – the Treaty's weak sanctions are even less effective. Consequently, the Treaty's current external enforcement provisions do not establish a credible commitment against monetary expansion.

C. Self-Enforcing Credible Commitment Problems in the Legal Structure

Although existing outside enforcement mechanisms do not establish the first type of credible commitments, a *self*-enforcing credible commitment[139] against monetary expansion may exist if (1) a self-created legal structure forces Member States to internalize the costs of breaching the agreement and (2) these costs exceed the costs for maintaining the agree-

135. *See id.* art. 104c(11) (stating "fines of appropriate size" but not specifying quantities) *and* MEHNERT-MELAND, *supra* note 44, at 80.

136. *See* EC TREATY, *supra* note 13, art. 104c(11), third indent. The European Investment Bank, governed by provisions of EC Treaty Article 198d-e, was established by the Treaty of Rome and provides investment loans to assist the funding of regional development projects in the EU, and to assist development projects by two or more Member States. Its revenue is derived from money subscriptions by Member States and from its own investments. *See* SHAW, *supra* note 96, at 132-33.

137. *See* EC TREATY, *supra* note 13, art. 104c(13). The voting is weighted by qualified majority numbers under Article 148; the breaching Member State's votes are excluded. *See id.*

138. *See supra* note 9.

139. *See supra* Part III.

ment. However, as the legal structure of monetary union presently allows Member States to externalize costs of breach, it fails to establish the basis for effective self-enforcing credible commitments. The problematic legal provisions include provisions regulating government expenditure and monetary policy. Specific deficiencies in the legal structure include provisions regarding credit access, credit institutions, and payments systems.

1. Problems in Credit Access

The Treaty currently fails to prevent credit access by Member States to the ESCB. Although, as described in Part A, the Treaty forbids the ESCB from assuming the debts and obligations of governments or public firms,[140] provisions barring the ESCB from extending loans to governments are less exhaustive. In theory, a NCB could try to expand the money supply by extending credit to a government pursuing fiscal policy or purchasing government bonds (monetary policy). Consequently, the Treaty prohibits credit or overdraft facilities acting between the ECB or NCBs and governments or public firms. Under Article 104(1), the Treaty forbids credit or overdraft facilities for any public entity, including central or local governments, public bodies, or public corporations.[141] The ECB and NCBs also cannot directly purchase debt instruments (such as government bonds) from any public entity[142] of a Member State after 1999.[143]

However, the EC Treaty does not address the indirect extension of credit – extension other than through credit or overdraft facilities – to government or public firms that may be used for monetary expansion. Indirect purchase of debt instruments from governments and public firms may be permissible, because the Treaty provisions only prohibit direct purchases.[144] In addition, the ESCB Statute actually provides for a financial agency relationship between the ECB and NCBs and governments and public firms, and the scope of this agency relationship has not yet been defined.[145] An NCB may also invoke its prerogative to perform functions

140. *See* EC TREATY, *supra* note 13, art.104b; MEHNERT-MELAND, *supra* note 44, at 81.

141. *See* EC TREATY, *supra* note 13, art. 104(1).

142. *See id.*

143. *See* Council Regulation 3603/93, art. 2(2), 1993 O.J. (L 332). Terminating on January 1, 1999, the NCBs of participating Member States could purchase "debt instruments" of another Member State's public sector, if these purchases were for the sole purpose of managing foreign exchange reserves. *See id.* art 2(1). The Regulation contains definitions (and restrictions) on the terms "overdraft facilities," "debt instruments," "public sector," "credit facilities" and "public undertaking."

144. *See* EC TREATY, *supra* note 13, art. 104(1). In Council Regulation 3603/93, 1993 O.J. (L 332) (1993), the EU Council does not define "direct purchases" but does indicate conditions that were not "direct purchases" and types of credits that were not "credit facilities." These are safe harbors, but do not prohibit other interpretations of "direct purchases." *See also* MEHNERT-MELAND, *supra* note 44, at 24 (transactions that are not "direct purchases" are in NCB transactions in derogating states and participating states or the ECB); KENEN, *supra* note 42, at 70 (Article 104 exempts open-market purchases).

145. *See* ESCB Statute, *supra* note 44, art. 21.2 ("The ECB and national central banks may act as fiscal agents for the entities referred to in Article 21.1," [i.e., "Community institutions or bodies, central governments, regional, or local or other public authorities, other bodies governed by public law, or public undertakings of Member States"].).

other than those specified by the ESCB,[146] and may include some form of credit extension as one such function.

Such extension of credit could be entirely permissible under Maastricht, although such action *might* effect the primary objective of price stability under Article 105(1).[147] An NCB governor faced with a recession has a number of legal arguments to favor a credit extension. The governor also could argue that the credit extension is unlikely to effect price stability, although prices across the euro zone may fluctuate slightly.[148] The governor could argue that this credit extension falls within the "general principles" for credit operations (and open market operations) promulgated by the ECB.[149] The Treaty itself also lends additional support, since it generally requires the ECB to seek to devolve operations to the NCBs.[150] Finally, the governor could argue that the financial measure is not a legal instrument that "obliges" financial institutions to hold public sector liabilities,[151] and that it may fall under the exception for prudential considerations provided in the Treaty.[152] Even if a majority of NCB governors and Executive Board members find these arguments objectionable, where the hypothetical governor's functions are not specified by the ESCB Statute (i.e., indirect extensions of credit), the Maastricht legal structure will approve the hypothetical governor's functions unless objections by NCB

146. *See* ESCB Statute, *supra* note 44, art. 14.4. The statute provides that these functions are performed at the responsibility and liability of the NCBs and are not regarded as part of the functions of the ESCB. *See also* PADOA-SCHIOPPA, *supra* note 106, at 232.

147. The ECB promulgates "general principles" for credit operations and open-market operations carried out by itself or by the NCBs. *See* HADJIEMMANUIL, *supra* note 17, at 32-34.

148. The primary objective of the ESCB is price stability. *See* EC TREATY, *supra* note 13, art. 105(1). *See also* DANIEL GROS, TOWARDS ECONOMIC AND MONETARY UNION: PROBLEMS AND PROSPECTS 32-34 (Center for European Policy Studies Paper No. 65, 1996)

149. *See* ESCB Statute, *supra* note 44, art. 18.2 ("the ECB shall establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions").

150. *See id.* art. 12.1, third paragraph, requiring the ECB to devolve to the NCBs to carry out ESCB operations "to the extent deemed possible and appropriate and without prejudice to this Article." *See also* SMITS, *supra* note 48, at 243.

151. This type of legal instrument is prohibited as "any measure establishing privileged access" under EC Treaty Article 104a(1). Council Regulation 3603/93, Article 2(2), 1993 O.J. (L 332), lists measures which are not privileged access under section 1(2), but does not stipulate that this list is conclusive.

152. *See* EC TREATY, *supra* note 13, art. 104a(1). Prudential considerations are defined as considerations that underlie national (Member State) law consistent with Community law, and "promote the soundness of financial institutions with the goal to strengthening the stability of the financial system as a whole and the protection of the customers of those institutions." Council Regulation 3603/93, art. 2, 1993 O.J. (L 332). Financial institutions are defined in art. 4 of this regulation. A simple argument is that such extensions of credit for monetary expansion strengthen the stability of the financial system as a whole (the text does not stipulate "strengthen price stability") and promote the soundness of these financial institutions.

governors and the Executive Board reach the high threshold of two-thirds votes cast.[153]

Thus, a self-enforcing credible commitment does not now exist to prevent Member States from expanding the money supply by extensions of credit. The legal structure seems to allow for extensions of credit by NCBs to Member States, and a Member State could thereby externalize its financing costs for monetary expansion.

2. *Problems of "Credit Institutions"*

The commitment against monetary expansion is also not now self-enforcing (fulfilling the second type of credible commitment) because of the lack of clarity in the ESCB's regulation of "credit institutions." The monetary policy of the ESCB hinges on the term "credit institutions." To conduct monetary policy according to the Treaty, the ECB and the NCBs may open accounts for "credit institutions, public entities and other market participants,"[154] and may conduct credit operations via "credit institutions and other market participants."[155] In addition to using credit institutions for accounts and credit operations, the ECB may (1) impose on credit institutions (including public credit institutions)[156] a minimum reserve requirement;[157] (2) supervise credit institutions' financial management;[158] (3) impose "specific tasks" related to their financial management;[159] and (4) "contribute to" the policies of authorities supervising credit institutions.[160]

153. *See* ESCB Statute, *supra* note 44, art. 14.4. The voting scheme is not one vote per member; rather, each voting member may cast a certain number of votes based on the capital contribution of his or her Member State.

154. *See id.* art. 17.

155. *Id.* art. 18.1. The ESCB can also conduct credit operations with "other market participants." *See* Lenihan, *supra* note 109, at 468.

156. *See* EC TREATY, *supra* note 13, art. 104(2). All restrictions on the use of credit and overdraft facilities, described in the last section, do not apply to public credit institutions. *See* ESCB Statute, *supra* note 44, art. 21.3. Thus, public credit institutions probably can *directly extend credit* to Member States' public entities, subject to a reserve requirement. The provision probably intends to make public credit institutions equally competitive with private institutions in the market for government financing.

157. *See* ESCB Statute, *supra* note 44, arts. 21.3, 19.2. The ECB can impose reserve requirements on credit institutions with accounts from the ECB and NCBs. The reserve requirements are determined by the Governing Council of the ECB. *See id.* art. 19.1. If credit institutions violate their reserve requirements, the ECB can impose penalty interest or other sanctions. *See id.* The bases for reserves and the ratio between reserves and bases and other sanctions for non-compliance can be decided by the Governing Council. *See* Article 42 of the ESCB Statute art. 19.2; MEHNERT-MELAND, *supra* note 44, at 79.

158. *See* ESCB Statute, *supra* note 44, art. 25.1. ESCB Statute art. 3.3 also provides that the ESCB can "contribute to the smooth conduct of policies" of entities regulated. *See also* HADJIEMMANUIL, *supra* note 17, at 32.

159. ESCB Statute, *supra* note 44, art. 25.2. The ECB and NCBs may also perform specific tasks on "financial institutions." *Id.* This term is also not defined in the Treaty. *See* Smits, *supra*, note 48, at 236. The term "financial institutions" also is used in Article 23 of the ESCB Statute, which says that the ECB and national central banks may establish relations with central banks and financial institutions in other countries. *See* ESCB Statute, *supra* note 44, art. 23; MEHNERT-MELAND, *supra* note 44, at 81.

160. *See* ESCB Statute, *supra* note 44, art. 3.3; EC TREATY, *supra* note 13, art. 105(5). ESCB Statute art. 3.3 provides that the ESCB shall "contribute to the smooth conduct of

Also, all restrictions on the use of credit and overdraft facilities[161] do not apply to public credit institutions, which are regulated like private credit institutions.[162]

The Treaty does not define credit institutions, despite the importance of the term. Therefore, the extent of the ESCB's control over banking institutions and regulations of monetary policy remains uncertain. Commentators argue that the lack of a definition shows a gap by the Treaty framers on considering the impact of the supervision of credit institutions on monetary policy.[163]

While the term "credit institution" does not have a fixed meaning under the Treaty,[164] the extent to which credit institutions will allow monetary expansion may depend on the scope of the term's definition.[165] The drafting committee of the ESCB, the Committee of Governors, referred to the definition used in the Community's First Banking Directive, which defines a credit institution as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account."[166] But this reference can be equivocally interpreted and probably was intended as a minimum definition.[167] This definition is also overinclusive, because many institutions receive types of deposits and grant credit, including commercial banks, investment banks, and money market funds.[168] Thus, the legal structure does not specify through which institutions the ESCB will conduct credit operations, regulate liquidity extensions (via minimum reserve requirements), or monitor financial management. Consequently, the Treaty contains a gap in the extent of the ESCB's regulation of monetary policy. Moreover, the Treaty does not restrict which public credit institutions can engage in fiscal policy (government

---

policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

161. *See supra* section C.1.

162. *See* EC TREATY, *supra* note 13, art. 104(2); ESCB Statute, *supra* note 44, art. 21.3.

163. *See* Rose Maria Lastra, *The Independence of the European System of Central Banks*, 33 HARV. INT'L L.J. 512 (1992) (stating that "disruptive effects" can result from the lack of a clearly defined banking supervisory role for the ESCB); *see also* SMITS, *supra* note 48, at 236 ("[T]he absence of clear language on the meaning of the term 'credit institution' seems to reveal that the issue of application of monetary policy to the subjects of prudential supervision has not received adequate reflection by [the] authors.").

164. *See* SMITS, *supra* note 48, at 236.

165. *See* Lastra, *supra* note 163, at 513. *See also* SMITS, *supra* note 48, at 236.

166. First Banking Directive, First Council Directive of 12 December 1977 (77/780/EEC), 1977 O.J. (L 322) 30, as amended.

167. *See* ESCB Draft Statute, Agence Eur., *Europe*, Document No. 1669/1670, Dec. 8, 1990, at 24. *See also* SMITS, *supra* note 48, at 237 (arguing that the central concern of the First Banking Directive was to protect creditors rather than considerations of monetary policy).

168. For an analysis of the U.S. approach to defining banks, *see* MACEY & MILLER, *supra* note 45, at 350 (examining parallel overinclusivity and underinclusivity in the definition of bank, in the context of the Bank Holding Company Act of 1956).

expenditures), such as industry-specific public procurement or general public assistance programs.[169]

The lack of a definition for credit institutions creates uncertainty about the extent to which the ESCB can control banking institutions, particularly public credit institutions, which are regulated like private credit institutions.[170] This may lead to the externalization of costs by grey-area institutions, eroding the second type of credible commitment. Yet, remedying this uncertainty is extremely problematic and calls the credibility of commitments into question. Amendments to the definition of "credit institutions" by the ECB or Community institutions would have drastic effect on the exercise of monetary policy, because any such revision would determine the categories of financial institutions supervised and managed by the ECB and NCBs.[171] Some commentators suggest that amending the definition of "credit institution" would violate the EC Treaty because such a drastic change in the scope of monetary policy must be accomplished only by a Treaty amendment, rather than by institutional legislation.[172] Such a loophole amendment procedure would give Community institutions the power to alter the scope of the EC Treaty and thus cast doubt on the credibility of Community institution commitments to restrict their own power.

As a result, the legal structure does not clearly define either the institutions through which the ESCB can exercise monetary policy, or the institutions that could be prohibited from influencing the money supply. Yet, remeding of these gaps would be extremely problematic and, in the absence of a Treaty amendment, could challenge self-enforcing credible commitments in the structure of monetary union.

3. *Problems in Payments Systems*

Currently, the second type of credible commitment also is impaired by gaps in the legal structure of payment systems.[173] These gaps must be

169. For an analysis of changes in the policies for public procurement in the EU, see CHRISTOPHER BOVIS, THE LIBERALIZATION OF PUBLIC PROCUREMENT AND ITS EFFECT ON THE COMMON MARKET 26 (1998).

170. *See* EC TREATY, *supra* note 13, art. 104(2).

171. The ESCB can open accounts with and regulate "credit institutions." *See* HADJIEMMANUIL, *supra* note 17, at 12-19 (analyzing regulation and prudential supervision of credit institutions).

172. *See* SMITS, *supra* note 48, at 238. In regard to amendments by Community institutions, a directive by the European Council would be require only a qualified majority under Article 57(2), pursuant to the procedure of Article 189b. As to amendments of the Treaty itself, amendment to the ESCB Statute, if proposed by the Commission, would require unanimity in the European Council, and an amendment recommended by the ECB would require unanimity in the ECB's Governing Council. *See* EC TREATY, *supra* note 13, art. 106(5); ESCB Statute, *supra* note 44, art. 41.

173. The term "payment systems" refers to the intermediate stages of money transfer from one party to another. The term's definition depends on whether it is being used in an economic or legal sense. The economic definition is "every item suitable for use as a means of payment – such as cash, cheques and credit cards – and every network" through which money is transferred from one party to another (e.g., a bank-to- customer network, bank-to-bank network, or postal service). The legal definition, which relates to the passing of liability, is "the correct and complete fulfillment of a pecuniary obligation

filled to allow the commitment against monetary expansion to be self-enforcing.

One of the ESCB's basic tasks is to promote the smooth operation of payment systems.[174] Under the Treaty, the ECB has an obligation to perform this task itself or delegate the task to the NCBs.[175] A payment system, in rough legal terms, transfers liability through the full performance of an obligation (of availability of money) due the creditor.[176] Payment systems serve as conduits for monetary policy operations and clear euro transactions, including travelers' checks, eurocheques and credit cards, and interbank transactions.[177] Transactions relating to monetary policy must be made through a specialized payment system (TARGET), but the execution of other large payments may be outside this system. Alternative non-EU large-value payment systems remain in operation.[178]

The Treaty gives little direction on the nature of activities to be performed through the ESCB to promote the smooth operation of the payments system.[179] The Treaty provides that the ESCB can establish facilities to ensure the efficiency and soundness of payment systems.[180] The ECB can also make regulations for this purpose,[181] and can perform "specific tasks" – which may involve payments systems – concerning policies relating to the prudential supervision of credit institutions and other financial institutions.[182]

Otherwise, the Treaty gives no other direction on the nature of activities by the ESCB to promote the smooth operation of the payments system. The Treaty is silent on the division of competence for this task between the ECB and the NCBs.[183] Also, the Treaty is silent in the division between the double powers of the ESCB payment systems and national payment systems, which are encouraged under the Treaty.[184]

---

that consists of the final transfer of the absolute availability of money due to the creditor." *See* MALAGUTI, *supra* note 101, at 22.

174. *See* Lastra, *supra* note 163, at 514; EC TREATY, *supra* note 13, art. 105(2), fourth indent.

175. *See* ESCB Statute, *supra* note 44, arts. 2, 9 and 22. Hadjiemmanuil notes that because most Member States run payment systems by the NCBs in their capacity as national authorities, rather than as members of the ESCB, it is questionable whether the EC Treaty means that the ESCB can manage the payment systems directly. *See* HADJIEMMANUIL, *supra* note 17, at 41.

176. *See* ICC PUBLISHING S.A., ICC WORLD PAYMENT SYSTEMS HANDBOOK 72 (1996) (defining payment systems generally as "a set of instruments, banking procedures and, typically, interbank funds transfer systems that ensure the circulation of money").

177. *See* MALAGUTI, *supra* note 101, at 334.

178. *See* HADJIEMMANUIL, *supra* note 17, at 41 n. 148 (discussing the TARGET system); *see also infra* note 190 and accompanying text.

179. *See id. See also* Lastra, *supra* note 161, at 514.

180. *See* ESCB Statute, *supra* note 44, art. 22.

181. *See id.*

182. *See id.* art. 25.2.

183. *See* Lastra, *supra* note 163, at 514. *See also* MALAGUTI, *supra* note 101, at 297 *and* HADJIEMMANUIL, *supra* note 17, at 41.

184. *See* SMITS, *supra* note 48, at 301 *and* MALAGUTI, *supra* note 101, at 298.

The dilemma over control of standards by the ESCB or national payment systems may determine externalization of costs (hence impairing the second type of credible commitment). A central dilemma of payment systems is reconciling the principles of decentralization, the free market economy, and minimal government involvement in the provision of services with the need to control the circulation of money, as a possible means of controlling the money supply.[185] If power to monitor payment systems belongs exclusively to the ESCB, then the NCBs would apply uniform monitoring standards. But if the NCBs could apply domestic standards to oversee payment systems, then they would have greater scope in establishing monitoring standards.[186] If the latter approach is taken – and recent Community reports favor this approach as following the principal of subsidiarity[187] – then different monitoring standards would apply to accessing the same supply of money. This would allow Member States with lower monitoring standards to externalize risk and associated costs onto the whole monetary system, thereby impairing the second type of credible commitment. In addition, proposals for decentralizing monitoring standards for access to payment systems assume that the NCBs will be minor operators on the market.[188] However, if the NCBs are active operators in their market (or wish to be active because of a recession), they could face a conflict of interest between standards for payment as market participants and as monitors (i.e., between their monetary policy payments and their domestic payments system standards).

The current payments system also allows non-participating Member States to externalize costs onto participating Member States. Under monetary union, Member States' NCBs can interlink large-value payment systems among NCBs and the ECB.[189] This system is named (TARGET).[190] However, a number of entities with lower commitments have access to TARGET. For example, the United Kingdom and Denmark are not yet participating in monetary union, yet their NCBs can still link up to TARGET and "channel euro payments into and from the system."[191] Commentators

185. *See* HADJIEMMANUIL, *supra* note 17, at 41 n. 148 (stating that payment systems and infrastructures will be maintained at the level of NCBs, rather than the ECB) *and* MALAGUTI, *supra* note 101, at 327.

186. *See* MALAGUTI, *supra* note 101, at 318. *See also* HADJIEMMANUIL, *supra* note 17, at 42 (noting that prior to monetary union, NCBs were cooperating on oversight of payment systems and minimum common features of payment systems).

187. *See* Working Group on E.U. Payment Systems, REPORT TO THE COUNCIL OF THE EUROPEAN MONETARY INSTITUTE ON THE TARGET SYSTEM (TRANS-EUROPEAN AUTOMATED REAL-TIME GROSS SETTLEMENT EXPRESS TRANSFER SYSTEM), A PAYMENT SYSTEM ARRANGEMENT FOR STAGE III OF EMU, (May 1995) (stating decentralized arrangements are to be preferred to centralization and the EU TARGET system would be used for monetary policy).

188. *See* MALAGUTI, *supra* note 101, at 334.

189. *See* KENEN, *supra* note 42, at 60 *and* HADJIEMMANUIL, *supra* note 17, at 41 n. 148 (stating that Member States have adopted a strategy based on minimum harmonization of national systems and a common infrastructure, the TARGET system, that implements payment arrangements based on principles of efficiency, market orientation and decentralization).

190. *See supra* note 185; *see also* SMITS, *supra* note 48, at 301.

191. SMITS, *supra* note 48, at 303-04.

argue that this could allow externalization of costs by non-participating Member States and lead to the breakdown of the system. In particular, because non-participating Member States' central banks and credit institutions have lower reserve requirements, They can put NCBs and euro zone credit institutions at a competitive disadvantage if they have unrestricted access to capital markets.[192] Neverthless, the payments system may have to absorb this externalization of costs by non-participating Member States, because screening access to TARGET may violate "fundamental freedoms on the common market," particularly the free flow of capital.[193]

In sum, the mere existence of legal commitments does not make them credible. The Maastricht legal arrangement permits conflicts of interest in enforcement decisionmaking and provides weak sanctions for outside enforcement, impeding the first type of credible commitment. Moreover, deficiencies in payment systems, the scope of credit institutions, and credit access allow Member States to externalize the costs of monetary expansion, impairing the second type of credible commitment. Member State commitments through the Maastricht legal arrangement consequently lack credibility.

IV. A Judicial Solution

Judicious use of monetary expansion by NCBs may be beneficial to promote harmonization of the Community. The benefits of wise monetary policy are evident to U.S. citizens from the exploits of the current Fed, under the guidance of Alan Greenspan.[194] A wise NCB monetary expansion may provide a precise, area-specific tonic to a Community member economy.[195] The costs may also be bearable. The short-term inflationary costs of such an expansion would be distributed across the Community, but an economic recovery ultimately would benefit the Community in the medium to long run. The total control of money by centrist Community personnel would dwindle occasionally, but this may not be appalling.

The judicial machinery of the Community could be used to keep Member State monetary expansion in check. Unlike other outside enforcement mechanisms and sanctions, the EC Treaty provides a substantial

192. *See* Mehnert-Meland, *supra* note 44, at 54.

193. Smits, *supra* note 48, at 303. Smits recommends access restrictions on the NCBs of Member States with a derogation. *See id.* at 303-04. The rule-of-reason test applies (e.g. the ECJ ruling in Cassis du Dijon and Keck v. Mithouard), and Smits argues there are objective reasons to limit the access of non-participating NCBs (required by the test) because of a close connection between TARGET access and monetary policy. However, the burden is on EMU banks to argue that use of the system for monetary policy purposes necessitates a deviation from the fundamental freedoms of the common market. *See id.* at 304.

194. *See* Deane & Pringle, *supra* note 49, at 227-28 (commenting on Greenspan's use of a hands-on supervisory role for the Fed).

195. *Cf.* Kenen, *supra* note 42, at 66 (arguing that the ECB is likely to adopt a distributive model rather than a tightly centralized model (as in the United States) because a centralized model requires (1) a large ECB funds market for commercial banking and lending, (2) a well integrated euro-dominated security market, and (3) large holdings of such securities by commercial banks, and these conditions do not exist).

outside enforcement mechanism through the European Court of Justice.[196] Currently, this outside enforcement does not create a credible commitment against monetary expansion because the Court of Justice has not sufficiently interpreted Maastricht provisions relating to European monetary union. However, while the EC Treaty creates weak enforcement provisions by the ECB and European Council, the European Court of Justice has jurisdiction over many issues involving monetary policy,[197] as well as jurisdiction concerning the obligations of NCBs under the Treaty.[198] Specifically, the ECB can bring action against a NCB for failing to fulfill an obligation under the Treaty.[199] The ECB can also bring action to protect its "prerogatives."[200] But a NCB governor can be relieved of office only if the *Court of Justice* finds "serious misconduct" or lack of fulfillment of conditions required for performance of duties, based in the EC Treaty or any rule of law, through a referral after a ECB Governing Council decision (or by the governor himself).[201]

However, litigation over monetary expansion currently cannot be assumed to cut against breaching Member States. A private right of action exists for any third person whom an ECB regulation or decision directly and individually concerns, but to whom the regulation or decision is not addressed.[202] "Any party" can bring action asserting that an ECB regulation is inapplicable[203] by claiming lack of competence; infringement of an essential procedural requirement; infringement of the EC Treaty or any rule of law relating to its application; or misuse of powers.[204] These claims include an omission by the ECB infringing the EC Treaty.[205] The Court of Justice can review the legality of regulations and decisions by the ECB.[206] Moreover, the Court of Justice's decision is binding on the ECB.[207] The

196. *See* MEHNERT-MELAND, *supra* note 44, at 87-88 (outlining the role of the European Court of Justice in European monetary Union).

197. *See* EC TREATY, *supra* note 13, arts. 173 and 175, fourth paragraph (stating the Court of Justice has jurisdiction over all proceedings by or against the ECB that fall within the ECB's field of competence).

198. *See id.* art. 180(d); MEHNERT-MELAND, *supra* note 44, at 50-51. *See also* SHAW, *supra* note 96, at 245-246 (discussing the authority and effects of rulings of the Court of Justice).

199. *See* EC TREATY, *supra* note 13, art. 180(d) (citing Article 169, which provides that the Commission can bring reasoned opinion and also suit against a member failing to perform).

200. *Id.* art. 173, third paragraph; *see also* SHAW, *supra* note 96, at 246. The Treaty does not define these "prerogatives." *See* EC Treaty, *supra* note 13, art. 173.

201. *See* MEHNERT-MELAND, *supra* note 44, at 77-78; ESCB Statute, *supra* note 44, art. 14.2.

202. *See* EC TREATY, *supra* note 13, art. 173, fourth paragraph.

203. *See id.* art. 184; *see also* SMITS, *supra* note 48, at 347-48.

204. *See* EC TREATY, *supra* note 13, art. 173, second paragraph.

205. *See id.* art. 175, first paragraph.

206. *See id.* art. 173, second paragraph. *But see* MIGUEL POIARES MADURO, WE THE COURT: THE EUROPEAN COURT OF JUSTICE AND THE EUROPEAN ECONOMIC CONSTITUTION 15-16 (1998) (arguing that the legal discourse between the Court and other institutions depends on the bargaining power of institutions and their management of contingent conflicts).

207. *See* EC TREATY, *supra* note 13, art. 176.

ECB is liable for damages by its institutions or servants in the performance of their duties.[208]

The Court of Justice can interpret several broadly-drafted duties under the EC Treaty and thereby create a credible commitment through the severity of the court's external enforcement mechanism. Maastricht imposes certain duties on Member State governments in regard to their economic policies. A key aspect of the Treaty is the non-influence principle of Article 107, which prohibits monetary union institutions and Member States from seeking or taking instructions.[209] Numerous analyses have been made of this provision, but at a minimum,[210] the non-influence article incoherently rubs against articles mandating that the ECB consult and "debate" with the European Parliament and consult with Community institutions.[211] The Court of Justice would need to interpret the Treaty to eliminate this lack of

208. *See id.* art. 215, second and third paragraphs.

209. *See id.* art. 107. The non-influence principle seeks ambitiously to insulate the ESCB from political pressure. In comparison to the legal independent-status language of the Bundesbank, the ECB statute is considerably stricter. The Bundesbank Act, § 12, second sentence states "in exercising the powers conferred on it by this Act, the Bank is independent of instruction from the Federal Cabinet." In contrast, the language in Article 107 states "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." *Id.*; *see also* SMITS, *supra* note 48, at 172, n. 116. This applies to any and all tasks of the ESCB and ECB, not just monetary policy functions. *See* Lastra, *supra* note 161, at 489. Theoretically, influence can occur on the ESCB and the ECB. Through politicized appointment of the Executive Board and NCB governors, absence of prescribed long terms of office, presence of representatives from the Council and Commission in Governing Council meetings, accountability to European Parliament art. 109b(3), and informal and formal contacts with national governments.

In practice, the line dividing arguments and pressure is thin. Difficulties in proving pressure are also tremendous, requiring real evidence and systemic monitoring by the Community. Government representatives have much more opportunity for exchange of information and consultation in the EMU than in some Member States. Exchange of information and consultation is envisaged between the Ecofin Council, the Commission, and the ECB. The President of the Council and a member of the Commission may participate (but not vote) in the meetings of the Governing Council of the ECB (pursuant to EC Treaty art. 109b(1)) and the General Council (pursuant to ESCB Statute art. 46.2). Heads of State or the Commission President may be present during part of the proceedings when visiting the ECB. *See* SMITS, *supra* note 48, at 173, n.123. This contrasts with the Netherlands and Sweden, for example, where economic meetings do not include the Royal Commissioner or the Crown's agent, respectively. *See id.* n.119-20. According to this thesis, a Court of Justice decision is necessary to better define the scope of Article 107.

210. However, only Community and Member State political entities are prohibited from endeavoring to influence the ESCB. *See id.* at 161, n.56. Therefore, private organizations and entities are not statutorily prohibited from seeking to influence the ESCB, although the ESCB may not receive instructions.

211. Article 107 may be drafted in overly strict language. Several commentators have argued that Article 107's prohibition on receiving instruction should not be strictly construed. For example, Smits argues that the ECB's obligation (pursuant to EC Treaty art. 109b) to present its policy to the European Parliament clashes with Article 107's prohibition on receiving instructions "from any other body." *See id.* at 179. For instance, Article 109b(3) provides for a "general debate" in the European Parliament on the ECB annual report, which contains yearly projections for monetary policy. In addition to Maastricht provisions that clash with this legal duty, such rules of statutory construc-

clarity between consultation and influence before a Member State representative's interaction with the ESCB could be considered improper. In addition, Member States have a duty pursuant to Article 103(1) to coordinate their economic policies according to the broad guidelines set by the Community under Article 102a.[212] Other duties imposed by Treaty seem to be aspirations rather than actual duties. Member States are required to conduct their economic policies by the principles of "an open market economy with free competition, favouring an efficient allocation of resources,"[213] and by the principles rendered in Article 2, including "sustainable and non-inflationary growth respecting the environment," high employment and social protection, increased standard of living and quality of life, high convergence of economic performance, and economic and social cohesion and solidarity among Member States.[214] Also, Member States must comply with the principles of Article 3a, namely, stable prices, sound public finances and monetary conditions and a sustainable balance of payments.[215]

Although these provisions are broadly-drafted and contain difficulties in proof, the Court of Justice could rule that monetary expansion violates any such legal duty. This type of ruling by the Court of Justice could put the court's machinery behind enforcement of the Member States commitment against monetary expansion. Depending on the facts of the judgment, this type of enforcement may raise the costs to a Member State above the benefits of monetary expansion. Thereby the Court of Justice could fill the gaps in Maastricht's legal and institutional arrangement and create an external enforcement-based credible commitment against monetary expansion.

Conclusion

Within two months of monetary union, Member States have begun trying to affect an expansion of the money supply to ameliorate recessions. Member States and their politicians reap strong benefits from trying to expand the money supply, including public benefits from public countercyclical economic policy, benefits for political self-interest, benefits to government fiscal interests and benefits from collective action problems within the euro zone. The legal structure of monetary union intends to commit Member States against monetary expansion. But this commitment is not credible because deficiencies exist in provisions relating to outside enforcement (the first type of credible commitment) and self-enforcement (the second

tion would call into question why Maastricht contains consultative provisions, if no influence can be exerted on ECB officials.

212. *See* EC TREATY, *supra* note 13, art. 103(2); *see also* HADJIEMMANUIL, *supra* note 17, at 32-34.

213. EC TREATY, *supra* note 13, art. 102a; *see also* BERMANN ET AL., *supra* note 69, at 1201.

214. EC TREATY, *supra* note 13, art. 2.

215. *See id.* art. 3a, as referenced by Article 102a; *see also* BERMANN ET AL., *supra* note 69, at 1201.

type of credible commitment). Deficiencies exist in outside enforcement because conflicts of interest may exist among the decisionmakers for outside enforcement, NCBs can perform functions outside the ESCB and the sanctions for violating monetary and fiscal policy provisions are weak or nonexistent. Deficiencies exist in self-enforcement because the legal structure does not internalize costs by allowing credit access by governments, indeterminate costs and regulation of "credit institutions," and defects in payment systems. As a result, without modification of the legal arrangement, commitments against monetary expansion may not withstand future Member State action.