THE EVOLUTION OF EUROPE'S FINANCIAL STABILITY AGENDA

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Abstract

This thesis applies insights from Historical (HI) and Discursive Institutionalism (DI) to analyse the evolution of Europe's financial stability agenda from the signing of the Maastricht Treaty (1992) to the completion of Banking Union (BU) (2014). It aims to discover when and under what circumstances ideas have enabled and constrained important policy shifts within the Eurosystem, and to what extent structural rigidities have prevented change.

The thesis fills three gaps in the literature: i) no previous research has attempted to analyse the importance of ideas and structures on the development of financial stability policy within the Eurosystem. ii) it provides an ideational explanation for the growing supranationalisation of financial policy within the European Union (EU). In line with monetarist ideas, financial integration was promoted by the EU Commission and ECB as a means of harmonising financial conditions and improving monetary policy transmission within an increasingly 'market-based' financial environment. Yet as a result of this enhanced interconnection, it soon became clear that the ECB would need to become concerned not only with the delivery of price stability, but of financial stability too; iii) at the national level, little research has been produced on the relationship between national economic ideas, the regulation of domestic financial sectors, and how member-states prepared for EMU. This thesis shows why Spanish and German banks managed market-based financial trends dissimilarly, why the financial crisis affected the two countries differently, and why they subsequently expressed different policy preferences at the EU-level.

‘Process tracing’ is used as the overarching methodological framework, attributing causation to specific events and trends. Using this framework, the thesis adopts a comparative analysis of the Spanish and German financial systems. In total, 19 qualitative interviews were conducted with Spanish, German and European policymakers to gain a deeper understanding of the ideational and structural issues at play within each jurisdiction, as well as a thorough analysis of important speeches and policy documents drafted by national and European central bankers. Critical Discourse Analysis (CDA) was then used in conjunction with process tracing to examine text and data and to scrutinise policy-makers justifications for action or inaction.

The thesis uncovers clear examples of where ideas have acted both as enablers and constrainers of change, and where structures have dominated outcomes. One of the most important findings is that ideational contradictions or failures can lead to substantial institutional change. This occurred most notably during the 2010-12 sovereign debt crisis which revealed the inherent contradictions of the Maastricht framework. As the crisis intensified, the ECB realised that if price stability was to be maintained, interventionist financial policies would become necessary, leading to considerable conceptual stretching over what should constitute ECB monetary policy.

Ideas were also shown to have influenced the structure of the German and Spanish financial systems and the way they were impacted by the crash. In Germany, *Deutsche Bundesbank* (DB) non-interventionist policy ideas allowed financial institutions to accumulate asset-side risk, resulting in the crisis hitting Germany early in 2007. However, the liberalisation of German debt markets in the 1990s meant German sovereign bonds became viewed as ‘safe assets' during the downturn, allowing the German state to borrow to bail-out its financial sector.

In Spain meanwhile, BdE interventionist financial policy ideas facilitated important countercyclical practices which cushioned the initial crisis. But because Spanish banks relied on the production of Asset-Backed Securities (ABS) rather than inter-bank 'repo' markets for funding, Spanish bonds were not considered to have the same pedigree as German debt. Consequently, once the sovereign debt crisis took hold, Spain was forced to turn to Europe for support. Different financial ideas and regulatory practices within the DB and BdE thus had a considerable influence on the severity and timing of the crisis in each country.

This research also reveals that ideas acted as powerful constraints. From the 'institutional formation' of EMU at Maastricht which established price stability as the *raison d'être* for the existence of the ECB, the banks legitimacy and credibility became entwined with the successful implementation of monetarist policies. This restricted the scope of policy ideas aimed at improving financial stability, particularly before 2012.

Abbreviations

ABCP	Asset Back Commercial Paper
ABS	Asset-Backed Securities
AEB	Association of Spanish Private Banks (Asociación Española de Banca Privada)
BAC	Banking Advisory Committee
BaFin	Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht)
BBVA	Banco Bilbao Vizcaya Argentaria
BdE	Banco de España
BFA	Banco Financiero y de Ahorros
BIS	Bank for International Settlements
BSC	Banking Supervision Committee
BU	Banking Union
BVR	The National Association of German Cooperative Banks (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken)
CAM	Caja de Ahorros del Mediterráneo
CBPP	Covered Bond Purchase Program
CDA	Critical Discourse Analysis
CDU	Christian Democratic Union of Germany (Christlich Demokratische Union Deutschlands)
CEBS	Committee of European Banking Supervisors
CECA	Confederation of Spanish Cajas (Confederacion Española de Cajas de Ahorros)
CMBS	Commercial Mortgage-Backed Securities
CPE	Comparative Political Economy
CQS	Credit Quality Steps
CRD	Capital Requirements Directive
CSU	Christian Social Union in Bavaria (Christlich-Soziale Union in Bayern)
DG ECFIN	Directorate-General for Economic and Financial Affairs
DG FISMA	Directorate-General for Financial Stability, Financial Services and Capital Markets Union
DGS	Deposit Guarantee Scheme
DI	Discursive Institutionalism
DPS	Deposit Protection Scheme
DSGV	German Savings Banks Association (Deutscher Sparkassen und Giroverband)
EBA	European Banking Authority
EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice

ECSB	European System of Central Banks
EEC	European Economic Community
ELA	Emergency Liquidity Assistance
ERM	European Exchange-Rate Mechanism
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ECOFIN	Economic and Financial Affairs Council
ECSP	Enhanced Credit Support Program
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupation Pensions Authority
ELA	Emergency Liquidity Assistance
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FCD	Financial Collateral Directive
FROB	Fund for the Orderly Restructuring of Banks (Fondo de Reestructuración Ordenada Bancaria)
FSAP	Financial Services Action Plan
GDP	Gross Domestic Product
GIIPS	Greece, Italy, Ireland, Portugal and Spain
HGAA	Hypo Group Alpe Adria
HI	Historical Institutionalism
HICP	Harmonised Index of Consumer Prices
HRE	Hypo Real Estate
ICMA	International Capital Market Association
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPE	International Political Economy
IPS	Institutional Protection Scheme
KWG	German Banking Act (Gesetz über das Kreditwesen)
LOLR	Lender of Last Resort
LTRO	Long-Term Refinancing Operation
LTV	Loan-to-Value (ratio)
MBS	Mortgage-Backed Securities
MEP	Member of the European Parliament
MoU	Memorandum of Understanding
MPR	Macro-Prudential Regulation
MRO	Main Refinancing Operations

MRQ	Main Research Question
NCB	National Central Bank
NKM	New Keynesian Model
NPL	Non-Performing Loan
OMT	Outright Monetary Transactions
OECD	Organisation for Cooperation and Development
PP	Popular Party (Partido Popular)
PSI	Private Sector Involvement
QE	Quantitative Easing
SDP	Social Democratic Party (Sozialdemokratische Partei Deutschlands)
SEA	Single European Act
SGP	Stability and Growth Pact
SIV	Structured Investment Vehicle
SME	Small Medium-sized Enterprises
SMP	Securities Markets Program
SoFFin	Financial Market Stabilization Institution (Finanzmarktstabilisierungsanstalt)
SPV	Special Purpose Vehicle
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRQ	Subsidiary Research Question
SSM	Single Supervisory Mechanism
TEFU	Treaty of the Functioning of the European Union
TEU	Treaty of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union
ToA	Treaty of Amsterdam
VoC	Varieties of Capitalism
UN	United Nations
UNACC	National Union of Cooperatives (Union Nacionale de Cooperativas de Credit)
USA	United States of America

Technical Financial Terms

ABCP	A security backed by the expected cash flows from the interest on corporate debt
ABCP conduits	Institutions which buy debt from companies and then issue investors with commercial paper and act as middle-man between firms and the holders of ABCP
Asset-Backed Securities	Securities which derive their value from an underlying asset
Bad bank	A state backed Special Purpose Vehicle into which financial institutions are able to deposit their ‘toxic’ assets to remove them from their balance sheets
Collateral calls	Made by a repo lender when an asset in a repo transaction has reduced in price. This requires the counterparty to issue the lender more collateral to guard against default
Commercial paper markets	The trading of short-term unsecured promissory notes issued by companies
Consolidated regulation	Where the assets, liabilities, equity, income, expenses and cash flows of the parent (company) and its subsidiaries are treated as a single economic entity
Covered bonds	Corporate securities with recourse to a pool of assets that ‘covers’ the bond if the originator of the security (usually a bank) becomes insolvent
Fire sales	The mass selling of a specific asset class which lowers the price of the asset, sparking more sales and lower valuations
Full-allotment	When central banks provide unlimited liquidity during Open Market Operations, as long as counterparties are willing or able to provide adequate collateral
Haircuts	A reduction in the amount of money a creditor receives back from a borrower, or, a reduction in the amount of collateral a borrower receives at the completion of a repo trade
Keynesianism	The economic idea that expenditure is the key to economic stimulation and that state authorities can play a crucial role in

	generating economic and monetary stability through macro-economic interventions
Macro-prudential regulation	Financial regulation which aims to improve the stability of the financial system as a whole, typically by introducing countercyclical policies
Marked-to-market	When assets are traded or used as collateral in central bank repo operations not according to their original stated value, but by the price currently determined by the market
Market-makers	Firms that buy and sells securities, bonds or equities in large numbers at prices they displays on an exchange's trading system to facilitate market function
Micro-prudential regulation	Financial regulation which aims to improve the stability of individual financial institutions
Monetarism	The economic idea that increasing the supply of money can only ever lead to inflation over the medium-term. Central banks should therefore try to control the money supply by manipulating interest rates
Moral hazard	When the benefits of a certain action accrue to one party while the negative consequences become apportioned to another. This often incentivises actors to take unusual risks as liability has become detached from profitability
Mortgage-Backed Securities	A type of ABS which derives its value from an underlying group of mortgage loans
Neo-liberalism	A branch of economic liberalism which encourages non-intervention in markets, conservative fiscal policies and low inflation monetary policies
Open Market Operations	The buying and selling of securities by central banks in the open market in order to expand or contract the amount of money in the banking system and influence short-term interest rates
Ordo-liberalism	A branch of economic liberalism which aims to set a strong legal framework for markets to operate in which establish positive incentives and prevents 'moral hazard'
Price stability	The maintenance of low and steady price level increases (inflation)

Primary dealers	Firms that buy and sells securities and/or bonds in large numbers on the primary market, which they then sell on market exchange's
Private sector involvement	Private bondholders being asked to take haircuts on investments
Provisions	Capital banks are required to set aside to ensure financial stability in the event that loans it has provided are not repayed
Repo markets	Interbank repurchase markets where financial institutions borrow from one another by using collateral as a guarantee against non-repayment
Securitisation	The re-packaging of loans into tradable, income generating assets
Securitisation (synthetic)	Where assets are taken 'off-balance sheet' and liability is transferred from the originator of the asset to the holder
Securitisation (non-synthetic)	Where the asset remains on balance sheet and liability in the event of non-performance remains with the originator
Shadow banking	Financial institutions that act in the same way as traditional banks - as financial intermediaries that conduct maturity, credit, and liquidity transformation - but without explicit access to central bank liquidity, public sector credit guarantees, or regulatory oversight
Special Purpose Vehicle	Pools of assets that are held off-balance sheet by large financial institutions such as commercial banks or investment houses
Sterilisation	Monetary policy which seeks to hold the domestic money supply unchanged by using open market operations to drain off liquidity
Structured Inv. Vehicles	Institutions that roll-over shirt-term liquid commercial paper in order to invest in longer-term assets that have less liquidity but pay higher yields
Wholesale Markets	Capital markets in which financial institutions trade in securities, such as Treasury bills, commercial paper, derivatives and 'repo' agreements

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Chapter 1
Introduction

This research seeks to understand why financial stability evolved from being a secondary consideration to having an equal status with price stability within central banking circles (Bernanke 2011). Within Europe, the Treaty establishing Economic and Monetary Union (EMU) provided the European Central bank (ECB) with no direct responsibility for financial stability (Papademos 2006) and many legal provisions were enacted to try to prevent the bank straying from its original price stability mandate (TEU[1] 1992, Art.105). The task of delivering financial stability remained the duty of national financial supervisors and regulators within their respective jurisdictions (Duisenberg 2000[b]). Yet over the duration of EMU, the European Union (EU) and ECB became increasingly involved in financial stability initiatives and responsibility for its maintenance began to migrate away from member-states towards the supranational level. This research aims to track this process of change from 1999-2014 and to explain how important ideas and structures were in:

i) pushing the ECB to think more about and openly discuss financial stability
ii) advancing and justifying institutional change at the EU and national levels in relation to financial stability
iii) acting as restraints on institutional change at the EU and national levels

[1] Treaty on the European Union, also known as the Maastricht Treaty.

The main research question is:

To what degree can changing ideas and intuitional structures explain the evolution of Europe's financial stability agenda?

For the purposes of this research, the term 'financial stability' is defined and understood by the ECB as both the avoidance of financial instability, and the creation of a context within which financial markets are capable of performing healthily, with credit efficiently allocated to solvent firms and households (ECB 2005[b], p.131). Policies aimed at maintaining or establishing financial stability may comprise of: altering or implementing prudential regulations[2]; financial supervision, and; crisis management initiatives which may include central banks assuming a 'lender of last resort' (LOLR) capacity for banks, and/or a 'market-maker of last resort' function by conducting asset purchases to ease financing conditions by producing more liquid capital markets (Gabor 2016; Howarth and Quaglia 2016, p.26; Le Maux 2017; Mehrling 2016).

The research adopts an institutionalist theoretical framework to explain why the Eurosystem's financial stability agenda evolved between the signing of the Maastricht Treaty (1992) and the onset of Banking Union (BU) in 2014, and why different EMU member-states responded differently to market-based financial developments. It appropriates insights from both Historical (HI) and Discursive Institutionalism (DI) to understand how important ideas and institutional structures were in shaping the Eurozone's financial system through time.

[2] Financial regulation that requires financial institutions to control risk by amending financial accounting practices and capital buffers.

One of the central claims of HI is that institutions[3] are important because they help determine collective behaviour by structuring choices independently of actor preferences (Blyth et al. 2016, p.147, Hall and Taylor 1996, p.937). Institutions, which are assumed to be ridged or 'sticky', play a central role in shaping peoples goals and objectives by restricting behaviour deemed inappropriate or outmoded (Katznelson and Weingast 2005; March and Olsen 2004). HI therefore places a great deal of emphasis on the importance of history and structure in determining institutional continuity. The HI concept of 'path-dependence' posits that institutions tend to exhibit a great deal of permanence through time (Bulmer 2009, p.308), making institutional and policy change more difficult to explain.

DI meanwhile places greater emphasis on the role of ideas and their ability to engender institutional change (Blyth 2002; Schmidt 2010, p.4). Although DI accepts institutions help determine the social context within which actors operate, institutions themselves are ultimately constructed and sustained by foundational ideas. As a result, individuals are always capable of alternative thought processes and hence able to enact institutional change endogenously (Schmidt 2010, p.10). DI therefore tends to focus more on institutional transformation and the extent to which ideas and discourse help provoke societal adaptation.

Both approaches are excellent at helping frame explanations of continuity and change respectively. Yet each also contain weaknesses. The HI approach consistently views ideas as subservient to structures and, as a consequence, struggles to explain institutional change

[3] 'Institutions' are understood within this research as prevailing social rules and practices, political and economic structures, as well as ideas and assumptions that are used to help decision-makers form policy judgements (Béland 2009, p.702; Steinmo 2008, p.128; Hall and Taylor 1996, p.938).

(Blyth et al. 2016, p.148, Schmidt 2011, p.48). But because DI suggests people's ideational abilities are always capable of breaking free from societal constrictions (Schmidt 2010, p.10), it often fails to explain institutional continuity, particularly when that continuity is maintained in the face of ideational shifts.

Although no theoretical perspective is without pitfalls, by using insights from both approaches concurrently, this research seeks to establish a more comprehensive understanding of institutional evolution and to present a fuller explanation of when ideas and structures help determine political and economic outcomes at both the national and supranational levels.

Before the 2008 crisis, the ECB was said to have functioned according to a one objective (price stability), one instrument (short-term interest rate) policy framework (Blanchard et al. 2010; Gabor 2012, p.5), with scant consideration given to financial stability. There is broad agreement within HI and DI literature that the monetarist approach to economic policy – which had grown to prominence following the collapse of the Bretton Woods fixed exchange-rate system – bore significant influence over the design and structure of this framework (Quaglia 2008; Howarth and Loedel 2005; McNamara 1998). The monetarist 'price stability' agenda was geared solely towards the preservation of low inflation. Inflation was viewed as a symptom of excessive borrowing and government spending, but by raising interest rates when price level increases breached the two percent threshold, an effective break could be applied to reduce unwarranted lending (Rogoff 2003, p.45).

The ECB mandate for price stability was inscribed explicitly in Article 105 of the Maastricht Treaty (TEU 1992, Art.105). There was also instituted a strict separation of fiscal, monetary and financial authority, and a high degree of statutory independence issued to the ECB (Tognato 2012, p.25). These characteristics (predicated on monetarist ideas) intended to ensure the bank remained focused solely on the preservation of price stability (Howarth and Loedel 2005, p.53; Kaelberer 2003, p.370; Quaglia 2008, p.110). By separating the various strands of economic policy and preventing the ECB from monetary financing[4] and bailing-out member-states[5], it was thought price stability could be enhanced further by promoting market discipline in the sovereign bond markets and discouraging fiscal expansionism (Bibow 2015; Yiangou et al. 2013, p.227).

Importantly, this approach was thought not only to produce stable prices, but also contribute to the maintenance of financial stability. By anchoring inflation expectations, it was argued the efficiency of price information within financial markets became more accurate, reducing market volatility (Duisenberg 2000[a]). It was also assumed significant intervention by central banks beyond this narrow mandate could only generate suboptimal outcomes (Greenspan 2002; Issing 2008, p.65; Weber 2006). Responsibility for regulation and supervision was therefore retained at the national level through the principle of 'home country control' (Scheller 2006, p.111; Scherf 2014, p.64).

Yet even before the crisis, largely due to the contradictions within EMUs monetarist framework, things soon began to change. As European financial markets became more

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[4] Article 123 of the Treaty on the Functioning of the European Union.
[5] Article 125 of the Treaty on the Functioning of the European Union.

‘market-based’, with financial institutions coming to rely more heavily on securitisation[6] and wholesale financing (Gabor and Ban 2016; Hardie et al. 2013, p.700), measures taken to strengthen monetarist ideas and institutional continuity began to provoke institutional alteration. Financial integration was advanced as a means of promoting price stability by improving Europe’s interest rate transmission mechanism (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005). Yet this integration weakened the Maastricht framework by reducing market discipline in the sovereign bond markets[7] and gradually led the ECB to become increasingly anxious about the possibility of financial contagion. Consequently, the bank started to view financial stability as an objective in its own right (Papademos 2006; Padoa-Schioppa 2003; Trichet 2003).

This weakening of the Maastricht settlement prior to the 2007-8 crisis is conspicuously under-researched as it helped set the direction of future policy initiatives. The secondary sovereign debt crisis (2010-12) built on these trends and catalysed further institutional change. It placed EMU in an ‘existential emergency’ (Jones et al. 2016, p.1011; Schmidt 2014, p.189; van Rompuy 2011) which required the ECB and wider EU[8] to instigate more radical policy initiatives and hence represented a ‘critical juncture’ in the evolution of Europe’s financial stability agenda (Jones et al. 2016). Although the ECBs commitment to low inflation is generally acknowledged to have been maintained, the ‘extraordinary’ policies adopted by the bank in the wake of the 2010-12 crisis extended its reach into areas of fiscal policy and financial supervision (Högenauer and Howarth 2016; Weidmann 2016[a];

[6] The re-packaging of loans into tradable assets.
[7] Leading to significant increases in public and private sector borrowing in Southern Europe.
[8] Including the EU Commission, Council of the EU, and the creation of new EU institutions such as the European Stability Mechanism (ESM) and Single Supervisory Mechanism (SSM).

Whelan 2015), which had been expressly forbidden by EMUs creators (Duisenberg 2003; Hämäläinen 2002; Noyer 1999[a]).

The drive towards BU, which saw supervisory power migrate away from member-states through the Single Supervisory Mechanism (SSM) was a further noteworthy development (Beck 2015; Howarth and Quaglia 2013; Véron 2015). The ECB now directly supervises 130 of Europe's most significant financial institutions and has also gained authority over macro-prudential regulation (MPR) designed to counter market inefficiencies that were previously thought not to exist.

Nevertheless, despite these important changes, the ECB was also subject to post-crisis factors which constrained institutional and policy change. The ECB was slower to react to the crisis and far less radical than many other major central banks (Bibow 2015; Farrell and Finnemore 2016, p.585). It remains discursively committed to price stability (Draghi 2014[c]; Cœuré 2013[a]; Trichet 2011), and often sought to revert back to traditional monetary policy instruments at the earliest opportunity[9] (Economist 2012[a]; Howarth and Quaglia 2015, p.463).

Because the ECB was founded upon monetarist ideas, deviation from such concepts created both legal[10] and credibility problems for the bank (Bayoumi et al. 2014, p.25). Previous research has therefore sought to highlight the path-dependence of ECB policy (Salines et al.

[9] Examples of this include the raising of interest rates in 2011, and the 'sterilisation' of ECB purchased debt securities.

[10] A group of 35,000 German citizens challenged one ECB policy (the Outright Monetary Transactions [OMT] program) in Germany's Federal Constitutional Court (*Bundesverfassungsgericht*). Although the result was that the German Court fell into line with an earlier European Court of Justice (ECJ) ruling.

2011; Yiangou et al. 2013) and to show how monetarist ideas exerted a restraining influence on its actions (Blyth 2013[b]; Farrell and Finnemore, 2016). One original contribution of this thesis is to show that while the bank was indeed subject to such factors, traditional monetarist 'programmatic ideas' also became progressively weakened, allowing financial stability 'policy ideas' to emerge.

Additionally, EMU obliged member-states to abandon their own national currencies, cede sovereignty over monetary policy to the ECB, and provided a catalyst for increased Eurozone financial and economic integration. Yet despite this, national economic, political and financial distinctiveness continues (Cohen-Setton 2011; Gros 2017; Pelagidis 2009). NCBs, particularly before the crisis, retained substantial authority over financial regulation and banking supervision and continue to exert a significant influence over national and Eurosystem policy (Quaglia 2008, p.3; Scherf 2014, p.64; Scheller 2006, p.111). As well as examining the Eurosystem at the supranational level therefore, this thesis also includes comparative analysis at the national level.

Spain and Germany were chosen for this analysis on the basis of a 'most similar' structural comparison (Anckar 2008; Esser and Vliegenthart 2017, p.6). Before the crisis both countries maintained structural similarities and were categorised within the literature as 'bank-based' financial systems (Deeg and Posner 2016, p.441; Royo 2013[a], p.632; Vitols 2005, p.386). Their financial environments comprised of large private banks, smaller cooperative sectors and large 'politicised' public banking segments that maintained close relationships with local and regional politicians (IMF 2003, p.3; Johnson 1998, p.45; Royo 2013[c], p.25). Despite both countries central banks calling for a liberalisation of their public banking sectors

(Caruana 2001; DB 2003[b], p.45-6; Martín 2000), the only significant pre-crisis legislative changes targeting state-owned banks emanated from EU competition policy[11].

Notwithstanding these parallels, both systems were impacted differently both during and after the financial crisis. While previous research has explained *how* these difference manifested themselves, with German banks exposed on the asset-side and Spanish banks on the liabilities-side of their balance sheets (Hardie and Howarth 2013[a], p.104; Royo 2013[a], p.154), this research explains how ideas facilitated these differences and *why* Spanish and German banks reacted distinctly to the advent of 'market-based' banking.

While both nations NCBs gave voice to monetarist principles and extolled the virtues of fiscal restraint (Castro 2003, p.7; Commission 2004, p.19; Howarth and Rommerskirchen 2013, p.766), their versions of monetarism differed. The *Deutsche Bundesbank* (DB) subscribed to an orthodox version of monetarism informed by its ordo-liberal (*Ordnungspolitik*) ideology which opposed state intervention beyond the setting of a strong legal framework and the manipulation of interest rates (Bibow 2017; Brunnermeier et al. 2016, p.61; Bulmer 2014, p.1246). It also remained sceptical of short-term finance which it believed could hamper its ability to control monetary aggregates (Covil 1996; Gabor 2016, p.977). The *Banco de España* (BdE) meanwhile preferred to target inflation and therefore considered functioning short-term debt markets as conducive to an effective interest rate

[11] In the case of Germany, the EU Commission ruled in 2001 that state obligations for large German state owned banks (*Landesbanken*) be phased out by 2005 (Commission 2002; Lütz 2005, p.143;). In 2004, the Commission also ordered the German state to recover €3 billion it had loaned to *Landesbanken* via federal state deposits at below market rates (Commission 2005; DB 2005[b], p.72). In the case of Spain, prior to 2002, public figures accounted for more than half of the representatives on Spanish public banks (*cajas*) corporate boards. This risked the banks becoming defined as public institutions under EU law, resulting in corporate loans granted by *cajas* becoming classified as state aid, in violation of the EU's competition regime. The Spanish law on financial market reform (Ley Financiera, 44/2002) was passed to cap the number of representatives from public authorities at 50 percent to prevent breaching EU regulations.

transmission channel (Pellicer 1995, p.39). It also understood the value of countercyclical policies to help stabilise the business cycle (Ban 2016, p.46; Malo de Molina 2012, p.192) and implemented regulations to prevent widespread use of complex securities.

These divergent preferences gave rise to distinct ‘policy ideas’ (Schmidt 2014) in relation to financial stability which influenced the supervisory structure of each system. This resulted in different ‘market-based’ practices becoming adopted in each state. While the DB maintained a non-interventionist ‘bottom up’ approach to supervision and reluctantly liberalised capital markets to ensure the country became the *de facto* issuer of European ‘safe assets’ (Gabor 2016), the BdE undertook a more active role in supervising Spanish banks by discouraging ‘shadow banking’[12] activity and introducing countercyclical financial policies (BdE 2001, p.70-76; Deeg 2001, p.17; Lütz 2004, p.173; 2005, p.142; Pérez 1997[b], p.161).

These policy penchants, resulting from idiosyncratic financial ideas, had a direct bearing on the manner in which German and Spanish banks operated. Another original contribution of this research is to demonstrate that it was these ideational divergences which ultimately explain why German banks were affected more severely by the opening stages of the crisis[13], and why despite overcoming the initial crash, Spain was ultimately forced to disband

[12] Financial institutions that act in the same way as traditional banks - as financial intermediaries that conduct maturity, credit, and liquidity transformation - but without explicit access to central bank liquidity, public sector credit guarantees, or regulatory oversight (Claessens and Ratbovski 2014; Pozsar et al. 2013, p.1; Hardie et al. 2013, p.714).

[13] DB ‘self-regulation’ permitted German banks to amass huge amounts of asset-side risk (Cases 1996, p.180; Deeg 2001, p.17; Hassan 2014; Lütz 2004, p.173; 2005, p.142). Spanish regulation meanwhile discouraged the accumulation of asset-side risk through ‘consolidated regulation’ and macro-prudential intervention (Fernandez de Lis and Garcia-Herrero 2009; Jiménez et al. 2012).

its public banking sector and seek EU assistance in 2012[14] (Otero-Iglesias et al. 2016, p.32; MoU 2012).

This research therefore fills three important gaps in contemporary literature on European financial stability. Firstly, by combining DI and HI, it attains a more nuanced comprehension of the forces which enabled and constrained the development of financial stability policy within the Eurosystem. No previous research has attempted to analyse the importance of both ideas and structures on this evolution. Scholars have so-far either attempted to provide structural (Salines et al. 2011; Yiangou et al. 2013) or ideational (Farrell and Finnemore, 2016; Blyth 2013[b]) explanations for continuity. The few studies that have engaged with the role of ideas in explaining evolutionary institutional change (Röper 2017; Schmidt 2016) failed to also account for the striking institutional permanence of many aspects of the Eurosystem's financial system, or to examine the national and supranational levels of EMUs financial framework.

Secondly, it provides an ideational explanation for the growing supranationalisation of financial policy within the EU. It shows how as Europe's financial environment became increasingly 'market-based', the original structure of EMU[15] became at odds with traditional monetarist ideas (Gabor 2016). The need for integrated financial markets to transmit monetary policy aimed at controlling inflation meant that market discipline in the sovereign bond markets reduced and the risk of financial contagion became more pronounced. In this environment, maintaining a functioning interest rate transmission mechanism (in line with

[14] The BdE did not take steps to ensure Spanish debt became sought-after in the capital markets. Spain therefore did not experience the 'exorbitant privilege' of the 'flight to safety' which took place in relation to German debt during the crisis (Gabor and Vestergaard 2016).

[15] Which sought to delineate monetary, financial and fiscal policies (Bibow 2015).

monetarist programmatic ideas) increasingly required the ECB to engage with financial policy ideas aimed at quelling financial instability. While European institutions initially called only for greater monitoring and coordination at the EU-level (Jones et al. 2016, p.1019; Trichet 2004[a]; 2005[a]; 2005[b]; Vipond 1991), this evolved into demands for supervisory authority to migrate to the supranational level as problems intensified post-2007 (Barroso 2010; de Larosière 2009; van Rumpuy 2011).

Finally, at the national level, while ordo-liberalism (*Ordnungspolitik*) has been found by scholars to have influenced Germany's reaction to the crisis (Brunnermeier et al. 2016; Matthijs 2016; Nedergaard and Snaith 2015), with some notable exceptions (Lütz 2004; Zimmerman 2014), little research has been produced on the relationship between German economic ideas, the regulation of its financial sector, and the manner in which it prepared for EMU (Röper 2017). This lack of analysis is even more omnipresent in the case of Spain, where far less research has been focused. By investigating how these two countries NCBs viewed and addressed financial stability prior to the crisis, this research uncovers why Spanish and German banks managed the onset of 'market-based' financing and preparations for EMU differently. This in turn explains why banks within the two countries accumulated different balance sheet risks (Hardie and Howarth 2013[a], p.104; Royo 2013[a], p.154), why the financial crisis affected the two countries differently, and why they both expressed different policy preferences at the EU-level post-2007.

In terms of methodology, the 'process tracing' technique[16] was used to frame the research (Berman 2011, p.124; Gerring 2006; Steinmo and Thelen 1992, p.9). Comparative analysis of Spain and Germany was adopted to ensure each level of EMU was examined thoroughly, and a huge amount of secondary data was collated and set into a timeline from which key events and trends were identified. Data triangulation was also used to ensure information was garnered from (a wide and extensive) variety of primary and secondary sources[17] (Decrop 1999, p.159). From these sources it was possible to track ideational and structural changes that occurred within the Eurozone since its inception (Claeys et al. 2014, p.7).

Once particular issues and time periods had been identified as important, 19 in-depth qualitative interviews with relevant participants were conducted to drill down into specific areas (Vromen 2010, p.258). Respondents included members of the ECB, European Commission, DB, BdE and the Finance and Economics Ministries of Spain and Germany. This allowed specific events and ideas to be examined in greater depth and for the structural and ideational factors determining institutional change to be teased out (Parsons 2011, p.135).

Although some of the information needed for this research may have been obtained through the analysis of secondary sources alone, elite interviewing added an important additional layer to the data (Lilleker 2003, p.208). It also provided greater context and improved understanding of decision-makers motivations and the dominant ideas and practices within their organisations (Schonhardt-Bailey 2013, p.450). Despite some of the

[16] A method which entails a careful examination of history in order to focus more concisely upon specific time periods in order to establish causality.
[17] Secondary sources included: existing academic literature, ECB, DB and BdE board member speeches and interviews; official central bank documentation; interviews and speeches by German and Spanish Finance Ministers; and speeches by European Commissioners.

methodological and practical issues surrounding elite interviewing, it is often the most effective way to determine how subjective factors influence political and economic decision-making, and for understanding the incentives and preferences of actors (Berry 2002, P.682; Rathbun 2008, p.686-90).

Finally, the transcripts of primary interviews and secondary sources were analysed using Critical Discourse Analysis (CDA) (Wood and Kroger 2000, p.72). CDA allows for abductive research, with a constant movement from theory to the data and back. Alongside process tracing, it was used to examine data whilst incorporating historical context into the analysis of text and discourse (Wodak 2001[b]). The CDA concept of 'interdiscursivity' was used to discover instances in which two sets of ideas are expressed within one discursive event, allowing the evolution of ideas to be traced more effectively (Fairclough 2010, p.95; Wodak 2001[b]). CDA helped to detect the points at which one hegemonic idea became challenged or began to be replaced by another, helping to trace the evolution of financial ideas through time.

The remainder of this thesis is structured as follows:

Chapter two reviews the theoretical literature and critically examines the two theoretical approaches adopted for this research. It highlights examples of where DI and HI have been used previously to examine financial topics within the EU and where 'gaps' in contemporary research are currently located. It provides instances in which insights from HI and ideational research have been used together previously, and explains why utilising both approaches presents a more holistic and rigorous way to research the importance of ideas and structures in European political economy[18].

Chapter three outlines the research methodology. After describing the specific research questions this thesis answers, it recounts the methods DI and HI scholars have used to conduct investigations. It then explains in more detail why Spain and Germany were chosen as the 'strategic comparison', describes the process through which the research was conducted, and details the explicit methods that were used to both generate and analyse data in later chapters.

Chapter four examines the structure and ideational contexts of the German and Spanish financial systems before the 2007-8 crisis. It begins by looking at each system prior to EMU during the period of financial market liberalisation, before examining the two nations from 1999-2007. It explains how financial ideas influenced the specific regulatory and supervisory practices adopted by each NCB and shows how these differences influenced the way financial institutions adapted to the introduction of 'market-based' finance. It also reveals that although concerns were raised by both NCBs about the politicisation of public banks (Ayadi et al. 2009, p.41; Caruana 2003; 2001; Hardie and Howarth 2009, p.1020; Martín 2000), substantial institutional change was avoided. To explore this in greater detail, a 'critical case study' of two public banks, Bayerische Landesbank (BayernLB, Germany) and Caja de Ahorros del Mediterráneo (CAM, Spain), is included in the appendix.

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[18] Specifically, it sets out how this research draws on these two approaches by incorporating the HI intuitions of 'path-dependence', 'sunk costs', 'vested interests' and 'critical junctures' (Bulmer 2009; Capoccia and Kelemen 2007; North 1987; Posner 2007), and the DI insights of 'coordinative' and 'communicative' discourse, and the ranking of ideas into 'philosophical', 'programmatic' and 'policy' ideas (Schmidt 2014).

Chapter five looks at the ECB before the 2007-8 crisis. It begins by exploring the institutional and ideational foundations of EMU, before describing the early history of the euro from 1999-2007. It demonstrates that although price stability was the ECBs overriding objective during this period, financial stability concerns were far from absent (Padoa-Schioppa 2003; Papademos 2006; Trichet 2005). It discloses how EMUs monetarist framework contained inherent contradictions, meaning measures taken to strengthen institutional continuity provoked institutional change. It subsequently tracks how financial policy ideas became promoted throughout the pre-crisis history of the euro as European finance became progressively interconnected and market-based.

Chapter six explores the impact of the 2007-8 financial crisis on Spain and Germany between 2007-2014 and how each country dealt with the fallout. It reveals the importance of ideas and structures in helping to determine why these two countries were impacted differently by the crash and why post-crisis EU and ECB policies aimed at moderating the turmoil were received differently in the two countries (Restoy 2015; Schäuble 2011[a]). A 'critical case study' of the biggest bank bailouts in Germany and Spain, Hypo Real Estate (HRE – Germany) and Bankia (Spain), illustrate how the crisis affected financial institutions in the two countries. The chapter also shows how pre-EMU reforms in Germany placed German debt in a privileged position on the bond markets and why despite having a more conservative fiscal track-record, Spanish government debt was not as highly regarded as German sovereign bonds.

Chapter seven focuses attention on the aftermath of the crisis at the EU-level. It shows that whilst there has been significant structural and ideational change post-crisis, monetarist ideas continue to exert a strong influence and have been important in limiting more robust action. The chapter argues that while the ECB and EU Commission have often managed to overcome structural rigidities aimed at preventing intervention in financial markets (particularly after the ‘critical juncture’ of the sovereign debt crisis [Jones et al. 2016]), they struggled to cast aside ideational factors exerting a similar influence. It was these ideational constraints, rather than any structural restrictions, which proved most significant in slowing the pace of institutional change.

Chapter eight concludes the research by offering a concise response to the main research question and highlighting instances where ideas, structural factors, and ‘critical junctures’ proved significant to the evolution of Europe’s financial stability agenda. This thesis strengthens existing theoretical approaches by demonstrating how and under what circumstances ideas and structures are best able to influence institutional change and continuity through time. It also includes reflections on how various aspects of the research may have been conducted differently and suggests opportunities for further study.

Chapter 2

Theoretical Literature Review

Why have Historical and Discursive Institutionalist Approaches been used as the theoretical foundation for this research?

This research strives to understand the importance of both ideas and institutional structures in explaining continuity and change in relation to financial stability in the Eurozone, insights from both Historical (HI) and Discursive Institutionalism (DI) are used throughout this thesis. HI places a great deal of emphasis on the importance of historical and institutional structures in determining social outcomes and engineering institutional continuity (Bulmer 2009; Katznelson and Weingast 2005; Steinmo 2008). DI meanwhile places greater stress on the importance of ideas and their ability to manufacture institutional change (Blyth and Matthijs 2016; Schmidt 2010; Schmidt and Radaelli 2004).

Institutions are subject to pressures which seek to reform and to conserve their historical integrity. Occasionally, the capacity of institutions to exhibit ideational and structural path-dependency (Cox 2004) prevents new ideas from taking root and institutional change from emerging. At other times, new ideas are able to gain traction and institutions become capable of altering their pre-existing dynamics. By using insights from HI and DI together, this chapter argues a more comprehensive understanding of institutional evolution may be achieved, and a clearer indication provided of when and how ideas and structures ‘win out’ over each another.

This chapter sets out how an HI-DI analytical framework may be achieved in practice. It begins by critically examining both approaches before arguing that by combining insights from both approaches, the weaknesses of each may be mitigated and a more accurate comprehension of institutional evolution achieved. The second and third sections discuss examples of where HI and DI have been used previously in the literature on European finance, and highlights where gaps in contemporary research are currently located. The fourth section provides examples of previous studies where insights from HI and ideas research have been used concurrently. The fifth segment explores the literature surrounding dominant philosophical economic ideas (Schmidt 2014) within Germany and Spain (the two countries used for comparative analysis in this study) to facilitate discussion in the following chapters. The chapter then concludes by summarising the justifications for using insights from DI and HI together and outlines how this thesis addresses gaps in current literature by improving our understanding of when and how ideas and structures matter in explaining institutional continuity and change.

2.1 Historical and Discursive Institutionalism

The HI and DI institutionalist perspectives were developed in response to the behavioural studies of the 1960s and 1970s and the new institutionalist approaches of the 1980s and 1990s which sought to account for how and why institutions have meaning in political economy (March and Olsen 1989; Pollack 2009). These 'institutionalisms' are neither overarching theories, nor a specific method or set of methods, but rather conceptual approaches to the study social phenomena (Steinmo 2008, p.118).

Paul Pierson, one of the earliest scholars to use HI within the context of the European Union (EU), argues the approach is historical because it sees political and economic development as a temporal process, and institutionalist because it recognises temporal developments are wedded to institutions; be they understood as formal rules, policy structures, norms or values (Hall and Taylor 1996, p.937; Pierson 2000, p. 264-5). Within HI, the meaning of the term 'institution' is contested, but it is generally no longer understood as a simple surrogate for political organisation. The term now embodies a range of additional conditions including, according to one HI author, concepts as broad as 'stable, recurring pattern[s] of behaviour' (Lowndes 2010, p.61).

One oft-cited interpretation of the term is Hall (1986), who claims institutions may be understood as sets of formal rules, standard procedures that structure individual relationships, or as organised units used to arrange political and economic practices (Hall 1986, p.19). Streeck and Thelen (2005) meanwhile argue institutions should be understood more broadly as 'regimes': sets of 'collectively enforced expectations' which demand an expected conduct and 'rule-out' other forms of behaviour, helping to determine social outcomes[19] (Streeck and Thelen 2005, p.11-16). Nevertheless, there is broad agreement among HI scholars that institutions should be regarded as rules (be they formal or informal), that impose condition on human behaviour (Hall and Taylor 1996, p.938; Steinmo 2008, p.128).

[19] In their paper *The Logic of Appropriateness*, March and Olsen (2004) argue human activity within institutions is driven by rules governing appropriate and inappropriate behaviour. Rules are followed within an institutional setting because they are seen as respectful and legitimate. Actors seek to fulfil the obligations inherent to a specific institutional role or identity which tends to mitigate human conduct and set limits on the extent of behavioural divergence (March and Olsen 2004).

For DI and ideational theorists meanwhile, institutions are viewed in a slightly more complex manner. Whilst they accept institutions can provide coercing contexts within which agents conduct themselves, they also see them as contingent upon the thoughts, words, and deeds of individuals both internal and external to the institution itself (Schmidt 2010, p.4; 2008, p.314). In essence, institutions are seen as constituted by ideas which are, by their nature, adaptable to circumstance. This definition of institution, whilst making the term broader and downplaying their constrictive properties, does allow the relationship between structure and agency to be viewed more fluidly. Seen in this way, although institutions can impose constraints and conditions on human action, individuals are contemporaneously able to alter institutions through ideational and discursive practices (Béland 2009, p.702).

While imperfect, this research understands institutions as political and economic structures, dominant social rules and normative practices, but also as prevailing ideas that take the form of economic and political assumptions[20]. Although there may be many such 'dominant logics' within a society that coexist, and may even be contradictory to one another (Streek and Thelen 2009, p.116), they nevertheless act inherently to legitimise, constrain or alter existing organisational strategies and procedures. Failure to properly investigate the assumptions of decision-makers who use them to formulate policy proposals makes it harder to understand both institutional continuity and policy change (Béland 2009, p.705). This definition of institution enables this thesis to examine more extensively when and how ideas have been important in shaping the European financial system, and when and under

[20] Within the body of this thesis, the word 'institution' is generally used to denote organisational structures, e.g. the *Deutsche Bundesbank* (DB) and *Banco de España* (BdE), rather than the philosophical interpretation of 'institution'.

what circumstances structures have rendered them less significant, maintaining institutional congruence.

One of the central claims of HI is that institutions matter because they are the principle organisational determinant of collective behaviour and can structure choices independently of agent preferences (Blyth et al. 2016, p.147; Hall and Taylor 1996, p.937). Institutions are therefore viewed as an intrinsic part of the way in which we form our preferences, express our interests and pursue our goals (Katznelson and Weingast 2005). Many objectives, it is claimed, only make sense within a specific institutional setting, or even affect whether certain interests come to be expressed at all (Immertgut and Anderson 2008, p.348). This assumption is criticised by rational theorists who, while recognising that human motivation is complex, contend that individuals are inherently self-interested and have *a priori* goals and preferences which are not determined by institutions. Instead, institutions provide actors with additional information and certainty which they are then able use to their advantage (Hall and Taylor 1996, p.939). Here, individuals are assumed to have the cognitive capacity, time and emotional detachment necessary to pursue independent objective interests, which are rationally, rather than structurally given (Ward 2002, p.68).

Some, including Steinmo (2008) have reacted to these criticisms by claiming that HI can accommodate both the assumption that human beings are norm and rule followers, as well as self-interested rational actors. How one acts, he argues, depends on both the individuals' rationality and on institutional context (Steinmo 2008, p.130)[21]. In an attempt to unite the

[21] In this tradition, Tsebelis (1990), differentiates between 'efficiency institutions'; institutions that improve the efficiency and well-being of all, and 'redistributive institutions'; which seek to preserve the interests of a

two schools of thought, Katznelson and Weingast (2005) went as far as to claim that differences between HI and rational theory diminish or even 'disappear' when they examine how institutions help constitute and shape individual preferences, judgments, choices and outcomes (Katznelson and Weingast 2005).

Yet this leaves HI open to a further criticism. If agents are assumed to have predetermined objectively defined goals and intentions, and their interests are further constrained and channelled by the deterministic nature of institutions, it should be easy to predict human behaviour. Moreover, such ideational and structural constraints would make it extremely difficult for individuals to adapt to changing circumstances and engender institutional change. Yet as we have seen throughout the financial crisis, the future remains incredibly hard to predict (Haldane 2012) and institutions (however defined), capable of quite fundamental alteration (De Rynck 2014; Stein 2011).

In light of this, DI gives considerable weight to the role of ideas and discourse in explaining institutional and social change. Schmidt (2011; 2010) terms her DI as an umbrella concept for the vast range of works that underscore the substantive role of ideas and the collaborative process of discourse that generates and communicates those ideas to a wider audience (Schmidt 2011, p.47; 2010, p.3). According to Béland and Cox (2011), 'ideas' in social science research can be defined as 'causal beliefs' which serve as the connection between our minds and the material world through which we interpret our surroundings (Béland and Cox 2011, p.3). They provide guides for action and help us to address the many problems and challenges we face while living out our lives. For DI scholars, ideas are

specific group (Tsebelis 1990, p.104). Both such institutions may arise as a consequence of the economic rationality of dominant actors, but then subsequently help distort future economic and political outcomes.

therefore much more than just mechanisms through which we cognitively process our pre-determined interests, but are subjective and intrinsic modes which we use to conduct and monitor our actions and behaviour (Béland and Cox 2011, p.3-4).

Whilst DI accepts institutions can be constraining, it also claims they can deliver an enabling function by providing meaning and context to human action (Schmidt 2010, p.4). Institutions therefore become more than restraining exogenous structures, but are internalised within individuals themselves (Schmidt 2008, p.322). Although it could be suggested that such internalisation may strengthen institutional continuity, by considering it possible for people to preserve independent human agency, DI claims to better account for future uncertainty and institutional change (Schmidt 2010, p.13). Just as structures can frame and define the limits of appropriate actions, ideas and the iterative power of discourse are understood to have the power to change and mould institutions (Blyth 2002). Conceiving of ideas in this manner lifts them above structures in any explanation of social development. What becomes important are the ideas expressed, particularly during moments of uncertainty, rather than the institutional rules and norms themselves (Blyth et al. 2014, p.12).

Schmidt (2014) argues ideas may be categorised into three types (see table 2.1 below). 'Philosophical ideas' constitute 'webs of belief' and represent the deepest level of generalisation: worldviews, ideologies, philosophical principles, public philosophies and normative values. These modes establish the core understandings of individuals and societies regarding how the world works and what actions are subsequently deemed appropriate. Because of the intrinsic nature of these ideas, they are often the slowest to change, with any alteration or replacement taking place gradually (Schmidt 2014, p.194).

‘Programmatic ideas’ meanwhile (recognised as ‘policy paradigms’ within HI discourse [Braun 2015; Immergut and Anderson 2008, p.358]) are composed of an entire set of policy prescriptions, instruments and goals which constitute a broad conceptual approach to an area of policy (Schmidt 2014, p.196)[22]. Finally, ‘policy ideas’ are recognised as the most immediate ideational level and embody specific policies, norms, values, and political discourses applied to particular situations or circumstances (Schmidt 2014, p.196).

Table 2.1: DI ideational categories

Type of Idea	Strength of Idea	Description
Philosophical idea	Culturally ingrained and very resistant to change	Webs of belief, worldviews, ideologies
Programmatic idea	Resistant to change, but may be challenged during ‘policy windows’ or critical junctures	policy paradigms with sets of policy prescriptions which constitute a broad area of policy
policy idea	Most adaptable to change. May be used to challenge or strengthen philosophical and/or programmatic ideas	Specific policies or programs designed to address particular deficiencies in existing policy

Source: Adapted from Schmidt (2014)

This thesis builds on the work of Schmidt (2014) by showing that whilst these policy ideas are the least durable of the three categories, they are also the most dynamic as new policy ideas are frequently floated within political discourse and may be used to strengthen or undermine dominant philosophical and/or programmatic ideas.

[22] Kingdon (1995) argues such paradigms may be challenged during ‘policy windows’. These windows, he maintains, are fleeting moments (frequently repelled) in which traditional institutional practices become challenged by alternatives (Kingdon 1995, p.166). Similarly, HI scholars contend that such paradigmatic dislocations may only take place within ‘critical junctures’: periods of crisis which create windows of opportunity for old paradigms to be replaced by new ones (Braun 2015; Donnelly and Hogan 2012; Yim and Kim 2015).

Schmidt (2014) also argues these ideas are transmitted using two different types of discourse. ‘Coordinative discourses’ are used by individuals within institutions to communicate with one another. At the EU-level, this discourse is conducted during EU Summits and Council meetings as leaders debate and negotiate agreements behind closed doors. ‘Communicative discourse’ meanwhile is used by EU institutions to communicate to markets and EU citizens as they seek to instil external actors with confidence in their ability to deal with any issues which may arise (Schmidt 2014, p.189). Within central banking circles, this type of discourse has become increasingly important in recent years and has been used as a way to create and maintain institutional legitimacy and credibility (Hughes and Kesting 2014, p.329; Schonhardt-Bailey 2013, p.100). These insights from Schmidt (2014) in relation to the categorisation of ideas and discourses are also adapted by this thesis as they represent useful conceptual frames for understanding the strength and purpose of various concepts and dialogues.

Nonetheless, whilst DI’s focus on ideas can make it theoretically much easier to explain institutional change, cognitive processes alone cannot adequately capture all institutional evolution. This is particularly true when exploring the policy implementation process. Often despite changes in ideas, wider social attitudes and ‘dominant logics’, institutions can remain firmly resistant to modification (Dorey 2005, ch.7), or alternatively, may change in ways that were unintended (Pierson 1996, p.158; Thelen 1999, p.384). Even many ideational scholars accept institutions can ordain significant constraints on human behaviour and be very difficult to transform (Lieberman 2002, p.698; Schmidt 2008, p.4). A seemingly unanswered question in the literature therefore appears to be precisely when structures are dominant in determining policy outcomes, and when and under what circumstances ideas and human agency are capable of breaking free from these constraints and engendering institutional change.

A key aim of this thesis is to help answer this question. Table 2.2 combines insights from DI and HI and identifies scenarios in which ideas and structures 'win out' over one another. The table is referenced and expanded upon throughout the thesis.

Table 2.2: Ideational versus structural matrix

A) ideas trump structures	**->**	**institutional change**
B) structures trump ideas	**->**	**institutional continuity**
C) new ideas in old institutions	**->**	**accelerate policy change**
D) established ideas in new institutions	**->**	**hinder policy change**
E) new ideas in new institutions	**->**	**rapid policy change**
F) established ideas in old institutions	**->**	**sluggish policy change**
G) ideational contradictions or failures	**->**	**gradual policy / institutional change**
H) critical juncture	**->**	**rapid policy / institutional change**
I) ridged legal structure	**->**	**hinders policy / institutional change**

Source: Author (2018)

This innovation helps to more accurately account for how outcomes in European political economy are dictated. In A, C and E, ideational advances help induce institutional change, whilst in G, ideational failings and paradoxes help provide space for new ideas to emerge. In D and F, ideas act as agents for path-dependence, while in B, H and I, structures override ideas in determining institutional evolution.

A further core feature of HI is the contention that history, as well as institutions, matter for the conditioning of social behaviour. For HI, the functioning of institutions themselves are often imperfect and characterised by legacies of historic interactions (Pierson 1996, p.132). This means that nations, for example, are not viewed as functional homogeneous entities pursuing an established set of interests, but rather as collectives of historically wedded institutions all pursuing their own self-defined goals (Streek 2009, p.107). This has led to criticisms of the approach from Functionalist and Varieties of Capitalism (VoC) scholars who suggest distinctive national systems are the result of 'institutional complementaries', whereby national institutions align with one another to give countries an 'institutional comparative advantage' in the production of certain goods and services (Hall and Soskice 2001, p.18).

HI scholars retort that history shows institutions are frequently conceived as the result of political struggle and originally designed for purposes that may differ from their eventual utility (Pierson 1996, p.158; Thelen 1999, p.384). Furthermore, once an institutional policy direction has been established, the HI approach maintains that it becomes very difficult to change course. The core HI concept of path-dependency is used to explain why patterns of institutional evolution often tend to be slow-moving and incremental (Bulmer 2009, p.308). Path trajectories may be reinforced by 'positive feedbacks' which create increasing returns for continuity, 'sunk costs' which may be lost in the event of change, and entrenched 'vested interests' which may push for a continuity of the *status quo* (Bulmer 2009, p.310; Posner 2007, p.145). The concept of 'transaction costs' (North 1987; Williamson 1981) is also used to help exhibit the costs associated with institutional change and imperfect contracting. Path-dependency therefore establishes that early developments in the history of an institution can change the environment within it so drastically that subsequent developments will create different effects depending on past events (Hall 2003, p.385).

This thesis combines these concepts with notions gleaned from DI to show how ideas may be used both to strengthen and weaken institutional path-dependence through time. Tables 2.3 and 2.4 below advance the analytical matrix shown in table 2.1 above and provide further indication of how this research will combine insights from both approaches.

Table 2.3: How new ideas engender change in old institutions

C) new ideas in old institutions		
i) new philosophical ideas	Strongest structural resistance	• Rejected by existing institutional structure (path-dependence), or; • Very gradually adopted over a long period of time or crisis
ii) new programmatic ideas	Strong structural resistance	• Only adopted gradually through time, or; • During critical junctures • Can act to weaken existing structures
iii) new policy ideas	Least structural resistance	• Can strengthen existing structures and/or dominant ideas, or; • Undermine them, leading to gradual change which may be 'catalysed' during critical junctures

Source: Author (2018)

Table 2.3 illustrates that whilst new philosophical and programmatic ideas are often met with opposition within established institutions, new policy ideas generate the least structural resistance and may be used to either strengthen or weaken existing institutional customs. Table 2.4 shows that dominant philosophical ideas are the hardest to replace within new institutions, often because such institutions derive their credibility from established ideas. Policy ideas meanwhile (which again may weaken or strengthen conventional practices) face the least institutional resistance as they are the least fundamental to institutional identity.

Table 2.4: How established ideas hinder change in new institutions

D) established ideas in new institutions		
i) established philosophical ideas	Strongest structural resistance	• Rarely replaced (path-dependence) and only ever during critical junctures • Strengthen institutional structures
ii) established programmatic ideas	Strong structural resistance	• May be weakened gradually through time, and/or; • Replaced during critical junctures after a period of gradual weakening by new policy ideas • Strengthen existing structures
iii) established policy ideas	Least structural resistance	• May be weakened by new policy ideas that undermine established ideas and structures

Source: Author (2018)

One of the main criticisms of HI is that due to its reliance on concepts like path-dependence which emphasise continuity, the approach struggles to account for institutional change. One way HI researchers have tried to mitigate this critique is through the notion of critical junctures (Capoccia and Kelemen 2007, p.346). Such junctures denote acute instances which set institutions along specific developmental pathways. They are often conflictual encounters between various actors vying for control within an institutional setting and are frequently caused by 'exogenous shocks' to which institutions are forced to respond (Thelen 1999, p.388).

These critical junctures are understood to be particularly important during institutional formation (Capoccia and Kelemen 2007, p.342). Once the trajectory of an institution is established, it becomes very difficult to change tack. Additional junctures which radically alter established institutional *modus operandi* are said to remain limited to scarce and diminutive periods where the range of plausible choices available to decision-makers expand and the consequences of decisions become more acute (Capoccia and Kelemen 2007, p.343). Krasner (1988) describes this view as a 'punctuated equilibrium': a state of permanence interposed with short periods of flux.

Although Streeck and Thelen (2005) attempted to explain institutional change through the prism of HI by using means other than the notion of critical junctures[23], ultimately, while recognising subliminally that ideas can play a role in institutional change through *displacement* and *conversion*, this remains implicit and the approach still struggles to explain endogenous institutional change (Schmidt 2011, p.50). By recognising the power of ideas and human agency, and by conducting interviews with individuals working within European

[23] Streeck and Thelen (2005) suggested that the following processes could help HI theorists formulate descriptions of evolutional institutional transformation: Displacement; one 'dominant logic' or 'paradigm' in society coming to replace another, supplanting pre-existing institutions. Layering; the creation of parallel institutions which do similar jobs to the first. Drift; a slow transition caused by 'shifting contextual conditions'. Conversion; an institution given a new *raison d'être* by rules becoming reinterpreted or enacted in new ways Coran and Thelen 2016, p.65). Exhaustion; a 'gradual collapse' caused by the institution becoming surplus to requirements (Streeck and Thelen 2009, p.116-124).

organisations, this research hopes to attain a more nuanced understanding of the evolutionary institutional change that can take place between critical junctures.

Posner (2007) also tried to address what he sees as the over reliance on critical junctures in HI by looking at the integration of European financial markets. He concluded that a traditional application of HI could not satisfactorily account for the pick-up in financial integration during the late 1990s. He therefore argued that critical junctures act as 'catalysts' rather than causes of institutional change because although path-dependence can slow the pace of evolution, it cannot typically prevent it altogether (Posner 2007, p.145). What he suggests happens in reality is that small incremental adjustments throughout history are the real cause of institutional transformation, while critical junctures simply create an environment within which change already under way can occur more rapidly (Posner 2007, p.144). By looking more deeply at institutional evolution and analysing events which take place off the main policy path, Posner (2007) suggests further advances in our understanding of rapid periods of institutional change could be detected (Posner 2007, p.155).

These are valuable insights that will be incorporated into this research, yet akin to Streeck and Thelen (2005), Posner (2007) also fails to give a prominent enough role to ideas and human agency in explaining institutional change. Although he recognises financial integration during the late 1990s was a product both of history and the pulling together of 'legislative ideas that had been circulating for decades' (Posner 2007, p.150), he fails to expand on this intuition and explore how these ideas may have facilitated the incremental changes his paper discusses.

By bringing ideas into analysis and looking more closely at actor preferences, it may become clearer why HI notions like path-dependence may be shown to inhibit institutional change, but not preclude it altogether (Posner 2007, p.145, Streek and Thelen 2009, p.103). Continual incremental changes brought about by actor preferences and policy ideas may make existing arrangements more vulnerable to sudden shocks. By combining HI and DI concepts in this way, this research aims to provide new insights into the process of evolutional institutional change.

Indeed, some HI scholars have already taken the step of incorporating ideas into their work. policy paradigms within HI are understood to constitute a set of cognitive processes which provide actors with the tools they need to interpret specific events and help shape the range of policy options deemed legitimate (Braun 2015; Immergut and Anderson 2008, p.358). Such authors contend that even in times of crisis, policy change tends to have roots in previous thought structures (Immergut and Anderson 2008, p.349) and that any alterations frequently continue to be justified by drawing on predominant institutional assumptions (Cour-Thimann and Winkler 2013; Drudi et al. 2012, p.13). Any subsequent policy changes therefore tend to be rooted to historical thought structures and only introduced incrementally (Streek and Thelen 2005, p.4).

This illustrates the dichotomy between HI and DI. The difficulty with the HI approach is that the default position is always to stress continuity over change. Even when ideas are considered, policy paradigms suggest a further stifling of individual autonomy and a strengthening of path-dependency (Braun 2015; Immergut and Anderson 2008, p.358). Ultimately, HI consistently views ideas as subservient to structures and as a consequence struggles to explain institutional change. This contrasts with the DI approach which maintains that whilst institutions (including dominant political and economic assumptions), certainly help frame individual choices, in the end, agents ideational abilities are always capable of escaping societal constrictions and implementing substantial institutional refinement endogenously (Schmidt 2010, p.10).

This can result in DI struggling to explain institutional continuity. If institutions are constituted by ideas which are continually subject to change: why are institutions often so resilient, despite changing societal attitudes and policymakers efforts at reform? Moreover, as Schmidt (2010) freely admits, ideas and discourse cannot explain all institutional change as events outside of peoples control may occur, material conditions may change, and actions often have unintended consequences which were not the anticipated result of ideational processes (Schmidt 2010, p.12).
Given these flaws, although combining insights from HI and DI may mitigate some of the drawbacks of each, research incorporating both is still likely to suffer certain weaknesses, particularly when investigating material factors which may be better understood using a rationalist framework (Campbell and Pedersen 2001, p.9). Nevertheless, as this thesis aims to discover precisely when structures dominate the determination of policy outcomes and when and under what circumstances ideas are able to trump structural constraints and engender institutional change, using discernments from HI and DI is epistemologically coherent and offers the prospect of new and exciting insights becoming realised.

2.2 Historical Institutionalism and EMU

The European Central Bank (ECB) – along with the *Deutsche Bundesbank* (DB) and *Banco de España* (BdE) – together form the main focus of this research. A handful of scholars using an HI perspective have previously examined the ECB and its activities. This section critically analyses this existing literature whilst highlighting some of the gaps in contemporary research this thesis addresses.

Howarth and Loedel's 2005 book, *The European Central Bank: The New European Leviathan?* analyses the ECBs first seven years (1998-2005). Building on the work of McNamara's (1998) more ideationally focused work entitled *The Currency of Ideas,* Howarth and Loedel (2005) argue that EMU was founded on a neo-liberal consensus which focused on sound money or price stability[24], liberal economic reforms and an independent central bank (Howarth and Loedel 2005, p.15). This consensus, they argue, placed monetarism[25] and price stability at the core of ECB policy.

It was widely assumed prior to the 2007-8 crisis that in a 'divine coincidence' (Blanchard and Galí 2007, p.36) maintaining low inflation would not only lead to higher economic growth and lower unemployment over the medium-term, but also that monetary policy directed at maintaining price stability would reduce the incidence and severity of financial instability (Schwartz 1988, p. 53). Central banks therefore only tended to concern themselves with

[24] The desire for low and stable inflation facilitated by an independent central bank and conservative policies.
[25] The economic idea that increasing the supply of money can only ever lead to inflation over the medium-term. Central banks should therefore try to control the money supply by manipulating interest rates (Friedman 2002, ch.3).

financial stability in so far as insuring they maintained price stability and a functioning interest rate transmission mechanism (Bernanke and Gertler 2000, p.46; Noyer 1999[b]).

Whilst Howarth and Loedel (2005) were correct to assert that this (neo)liberal-monetarist policy paradigm exerted significant path-dependent pressure on the ECB during the pre-crisis period, and that these policies largely resulted as a legacy from the relative success of DB policies in Germany (Howarth and Loedel 2005, p.53), they also missed other important trends. Two key requirements of a monetarist policy framework are an even transmission of monetary policy to ensure interest rate adjustments are felt uniformly across a monetary area, and a commitment from governments to conservative fiscal policies to help restrict money growth. Yet measures taken by the ECB and European Commission to try to improve the functioning of monetary policy between 1999-2002 by encouraging financial integration[26] (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005) began to expose contradictions in ECB policy. Whilst this integration improved the transmission of monetary policy, it also allowed Southern European states to borrow much more cheaply, creating an explosion of credit in peripheral nations (Blyth 2013[a], p.78; Schnabl and Freitag 2011; Lynn 2011, p.61). This led the ECB to become much more concerned with policy ideas concerning financial stability and to a weakening of its original monetarist framework. Such underlying ideational trends may be lost using an HI only approach to research, but become more easily discernible when both HI and DI are incorporated into analysis.

[26] Such as the Financial Services Action Plan (FSAP, 1999) and the Financial Collateral Directive (FCD, 2002).

Verdun (1999) and Kaelberer (2003) looked specifically at individuals working within the European System of Central Banks (ESCB), with Kaelberer (2003) asserting that European central bankers have similar educations, adopt similar doctrines and conduct research and data management in similar ways; concluding (along with others, see McNamara [1998]) that since the mid-1980s, the European central banking community held a neoliberal consensus in the operation of monetary policy that conditioned the behaviour and policy objectives of EMU central banks (Kaelberer 2003, p.368).

Nevertheless, although Kaelberer (2003) emphasised the importance of this consensus, he also acknowledged its weaknesses. While central bankers have much in common, states and national central banks (NCBs) frequently disagree on policy and initiate different responses to similar stimuli (Kaelberer 2003, p.372). Such an overarching international consensus might therefore be weaker than localised ideas and structures within member-states and individual institutions in conditioning organisational behaviour and dictating policy outcomes (Lombardi and Moschella 2016, p.853). By exploring both the national and supranational levels of the Eurozone and conducting a strategic comparison of Spain and Germany, this thesis intends to shed further light on Kaelberer's (2003) analysis by discovering the extent to which ideas and structures at each level of the Euroarea have influenced policy decisions over the course of EMU history.

The second extensive piece written about the ECB using an HI perspective is Quaglia (2008) *Central Banking Governance in the European Union*. Like Howarth and Loedel (2005), Quaglia (2008) overlooked changes to ECB policy ideas in relation to financial stability and observed that the monetarist policy paradigm had remained unchanged at the bank since its inception (Quaglia 2008, p.135). She also claims there appears to be no consensus on any alternative economic paradigm, other than the one provided by the price stability framework (Quaglia 2008, p.110).

Yet unlike Howarth and Loedel (2005), Quaglia (2008) also focused on the national level of the Eurosystem, arguing NCBs have remained significant players within the ESCB and exercise considerable influence over EMU policy (Quaglia 2008, p.3). She devotes a great deal of attention to the DB in particular, whose ideas and policies she claims became diffused throughout much of Europe and the wider world through the formation of EMU (Quaglia 2008, p.47-74). The fact that the primary goal of the ECB outlined in the treaties is to maintain price stability – with economic and financial considerations coming secondarily (Cour-Thimann and Winkler 2013) – is due in large part, she suggests, to the successful implementation of DB policies at the EU- level.

Furthermore, she claims NCBs have resisted international and EU pressure towards greater convergence because national 'normative social orders' and 'polity ideas' which are 'sticky' resist changes to the *status quo* (Quaglia 2008, p.151). Specifically, Quaglia (2008) argues that aside from the DB losing overall control of monetary policy, it remained largely unchanged from 1998-2008 (Quaglia 2008, p.52). However, by using a longer historical lens and focusing more closely on ideas, it is possible to trace significant changes within ESCB NCBs[27].

[27] Including changes at the DB.

In Spain, BdE policy ideas implemented from 1998-2003[28] had a considerable impact on the activity of Spanish banks, the way they were affected by the growth of market-based finance, and the extent to which they were impacted by the initial stages of the 2007-8 crisis (Fernandez de Lis and Garcia-Herrero 2009, p.7; Saurina 2009[a]). With respect to the DB, the bank traditionally exhibited hostility towards short-term market-based finance (Gabor 2016, p.978; Trampusch 2015, p.122). Yet throughout the 1990s and early 2000s, it became much less concerned about market-based practices[29]. This had a profound effect on the activity of German financial institutions under EMU, with German banks amassing huge liabilities on the asset-side of their balance sheets (Detzer et al. 2017, p.68; Hardie and Howarth, 2013[b], p.104).

Indeed, the lack of attention paid to the growth of market-based financial activity within HI literature is striking. During EMU, European banks turned progressively towards securitisation and securities trading to help raise capital and provide liquidity (Gabor and Ban 2016; Hardie et al. 2013, p.700). There was also a rise in the number of non-bank financial institutions such as hedge, equity and money market funds that provided firms with alternative lending options. Yet there remains very little within HI literature that addresses these phenomena. Further, scholars traditionally associated with HI tend to use other conceptual approaches such as 'Varieties of Capitalism'[30] (VoC) or financial system typologies within Comparative Political Economy (CPE) to contextualise their work on

[28] Such as the Asset-Backed Securities (Law 926/1998); implementation of 'dynamic provisions' for Spanish banks (2000), and; the strengthening of Spanish 'Consolidated Regulation' (Law 19/2003).
[29] For example, in 1991 it softened its hostility to the production of Asset Back Commercial Paper (ABCP) [the trading of short-term unsecured promissory notes issued by companies]; in 1998 it dropped its opposition the creation of short-term treasury bills, and; in 1996 it abandoned its reserve requirements for banks conducting interbank lending in the 'repo' markets [Interbank repurchase lending where liquidity is provided in exchange for collateral] (Covil 1996; Deeg 1999; Röper 2017).
[30] See: Hall, P., and Soskice, D., 2001. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford & New York: Oxford University Press).

European and international finance (Deeg 2010; Hardie and Howarth 2013; Hardie et al. 2013; Mulé and Walzenbach 2017; Culpepper 2005).

Where HI has been used to explore international financial trends, it has tended to stress the resilience of domestic systems and the likelihood of national divergence in the interpretation of international financial codes (Mosley 2010). It has also highlighted the power of the state in shaping international regulatory regimes towards their own preferences, rather than looking at the significance of market-based developments that have taken place since the 1980s (Farrell and Newman 2010; Fioretos 2010). The failure of HI to incorporate transnational financial trends and EU specific financial regulation and supervision leaves a large gap in the literature that this research helps to fill (Deeg and Posner 2016, p.445).

More recently, Salines et al. (2011) looked at EMU between 1999-2010 using an HI perspective and argued that any change in the institutional governance framework of EMU during this period occurred through a 'layering' and 'redirection' (See Streeck and Thelen [2005]) of existing institutional structures (Salines et al. 2011, p.11). They claim that since the Maastricht Treaty (TEU 1992), EMU has remained broadly path-dependent and any post-1992 changes have been orientated around principles laid down in the Treaty (see also Verdun 2007). By downplaying the significance of some of the ECBs more radical post-crisis monetary policies[31], they conclude that throughout their period of investigation, even when subjected to the 2007-8 crisis, EMU appears to have followed the same path-dependent

[31] For example, prior to publication of Salines et al. (2011): The Enhanced Credit Support Program (ECSP, 2008) and the Covered Bond Purchase Program (CBPP, 2009).

trajectory, despite challenging internal and external circumstances (Salines et al. 2011, p.31).

Likewise, Yiangou et al. (2013) examined some areas of post-crisis ECB policy using an HI framework, focusing on the implications for further integration. In line with Salines et al. (2011) and Verdun (2007), they contend that the post-crisis policy positions of the ECB stem from EMUs institutional formation (Capoccia and Kelemen 2007, p.342; Yiangou et al. 2013, p.230). They also controversially suggest that the contentious Outright Monetary Transactions (OMT) program[32] remains fully consistent with Maastricht principles. They argue although purchasing government debt necessarily eases financing conditions for governments, because OMT support is contingent upon the implementation of macro-economic adjustment programs[33], it was specifically designed to avoid monetary financing and therefore conforms to the monetarist principles outlined in the treaties (Yiangou et al. 2013, p.234).

Salines et al. (2011) Verdun (2007) and Yiangou et al. (2013) each make the mistake of downplaying significant post-crisis policy developments. The claim of Yiangou et al. (2013), for example, that OMT is consistent with pre-crisis ideas and EMU treaties, is vociferously denied by, among others, the current DB President, Jens Weidmann (Weidmann 2016[c]; Kahn 2016). Their research fails to recognise that prior to 2010 the ECB would never have countenanced purchasing the sovereign debt of member-states (Issing 2002[b]; Noyer 1999[b]). Therefore whilst HI studies uncover aspects of ECB policy which have remained

[32] Which allowed the ECB to purchase Eurozone government bonds on the secondary market.
[33] Memorandums of Understanding (MoUs).

path-dependent, they miss important ideational developments and downplay structural change in order to conform to HI presuppositions.

Furthermore, whilst the ECBs monetary policy became increasingly expansionary to address financial instability post-2007, the EU also created additional organisational structures to help ease the financial and fiscal problems of peripheral nations. One such structure was the European Financial Stability Facility (EFSF), a sovereign bailout fund designed to assist member-states facing fiscal difficulties. Gocaj and Meunier (2013) argue that the creation of this fund established path-dependency in the European crisis management apparatus by narrowing future policy options. They maintain that the EFSF enshrined intergovernmentalism in the crisis framework which was later reinforced by the formation of the European Stability Mechanism (ESM).

Similarly, Verdun (2015) suggests that another category of 'copying' could be added to Streeck and Thelen's (2009) analysis of institutional change as significant parallels could be drawn between the transition of the European Monetary Institute (EMI) into the ECB, and of the EFSF into the ESM. She also claims that fiscal initiatives such as the so-called 'Six-Pack', 'Two-Pack', and 'Fiscal Compact' could be seen as a layering of the Stability and Growth Pact (SGP, 1997), in line with Streeck and Thelen's (2009) hypothesis.

This analysis, however, fails to explore the role of ideas in the creation of these institutions. Ordo- and neo-liberal ideas which sought to promote fiscal conservativism and limit 'moral hazard'[34] were crucial in helping shape ESM (Barroso 2011; ECB 2011[c], p.71-2). Any support emanating from ESM was made contingent upon Troika[35] enforced Memorandums of Understanding (MoUs) which govern recipient states fiscal policy. Moreover, ESM was only permitted to become a fiscal backstop for national financial systems once member-states had agreed to the creation of Banking Union (BU) which established a harmonised supervisory structure (Finnish and German Finance Ministries 2012). Failure to incorporate ideas into this analysis can therefore only ever provide a partial explanation of events during this period.

Jones et al. (2016) used HI to explain what they saw as the path-dependent nature of European integration. Incorporating the EU integrationist theories of Liberal Intergovernmentalism[36] and Neo-Functionalism[37], they argue that during critical junctures, member-states see the endurance of EMU as vital to their economic and geostrategic interests. As the consequence of a process they describe as 'falling forward', member-states then become prepared to submit to closer integration to guarantee the survival of the euro. However, because integrationist policies are often unpopular domestically, states are only prepared to go as far as is absolutely necessary to preserve EMU. Integration therefore follows a 'lowest common denominator' approach (Jones et al. 2016, p.1027).

[34] Understood as an incentive to take on risk where one is protected from its consequences.
[35] ECB, European Commission and International Monetary Fund (IMF).
[36] Broadly that European integration occurs as a result of intergovernmental bargains between member states which see the pursuit of further integration as within their national interests (see Moravcsik 1993).
[37] A theory which suggests that as countries integrate, 'spillovers' are created which encourage closer cooperation and integration in other areas (see Haas 1965).

Jones et al. (2016) also looked at BU and found that during each phase of financial integration[38], calls were made for a supranationalisation of financial supervision. But these calls were consistently rejected in favour of closer cooperation (Jones et al. 2016, p.1019). These are important findings which help reveal the reluctance of EU states to move towards a comprehensive EMU framework. Nevertheless, the research lacks analysis of national contexts and fails to explain why some nations seem more prepared to cede sovereignty than others[39]. Through comparative analysis, this research examines the importance of ideas and institutional structures in Spain and Germany to uncover why such national differences manifested themselves, and why each state adopted divergent attitudes towards greater supranationalisation of post-crisis financial policy.

Where all these HI studies exhibit weaknesses is in their tendency to downplay change in an attempt to highlight path-dependence. This leads to very significant structural trends and policy modifications which contradict the path-dependent narrative: such as the growth in market-based finance; the 2002 Financial Collateral Directive; the ECBs 2005 'mission statement' on financial stability (Trichet 2005[a]); the 2008 Enhanced Credit Support Programme (ECSP); Securities and Markets Program (SMP, 2010), and; OMT (2012), all being given insufficient weight in analysis (see Salines et al. 2011, p.31; Yiangou et al. 2013, p.234).

Not only that, but post-crisis ECB policies and the expansion of the banks' mandate to include financial stability and banking supervision required significant ideational shifts from

[38] For example, the Second Banking Directive (1989), Lamfalussy Process (2001), de Larosière Report (2009), etc.

[39] This is closely related to the debates within the broader fields of Political Science and International Relations (IR) - specifically within Comparative Political Economy (CPE) and International Political Economy (IPE) - which seek to understand the connections between national and EU systems in relation to EMU (see Mulé and Walzenbach 2017).

previous neo-liberal, monetarist thinking. Whereas it was formerly assumed that the best thing the ECB could do to help preserve financial stability was to maintain price stability (Duisenberg 2003; Noyer 1999[b]), it has since acknowledged the need to target asset prices to facilitate the smooth conduct of monetary policy (ECB 2010[b], p.24; 2011[d], p.100). The ECB has also become responsible for implementing macro-prudential regulations (MPR), which also entailed important normative consequences (Baker 2012)[40]. By trumpeting path-dependence and giving insufficient weight to post-crisis ideational, structural and policy change, these HI informed studies miss important underlying trends – such as the growth of financial stability policy ideas and the weakening of monetarist programmatic ideas at the EU-level – which may help explain institutional change.

2.3 Discursive Institutionalism and EMU

There has been some significant engagement with both EMU and the EU integration process within ideational scholarship. The central principle of DI, that institutions are founded upon ideas, has found voice in a number of important works in relation to EMU, the EUs Single Market, and European integration more broadly (Brunnermeier et al. 2016; Blyth and Matthijs 2016; Jabko 2006).

Before the crisis, McNamara (1998; 2006) argued that actors rely on conceptual frameworks to help them understand the world around them, and their position in it (McNamara 2006,

[40] Macro-Prudential Regulations (MPR) oblige public authorities like central banks to intervene in markets (for example by increasing or reducing banks' capital requirements) in order to counter 'efficiency' problems that were previously thought not to exist (Baker 2012). Such is the ideational shift that MPR required of the ECB, the banks own Macro-Prudential Research Network report spoke of a 'new paradigm' for MPR (ECB 2014[a], p.13).

p.820). The broad ideational positions national elites hold with regards to the nature of their domestic economies and the goals and instruments they assume monetary policy should manipulate, she contends, directly informed their positions on EMU prior to the euro (McNamara 1998, p.56-7). She maintains that the collapse of the Bretton Woods fixed exchange-rate system, the failure of post-Bretton Keynesianism and the relative success of German monetarism, all fed into the enhanced receptiveness of economic and political leaders to a new economic paradigm (McNamara 1998, p.157). What she termed the 'neo-liberal consensus' centred on the achievement of price stability above all other policy goals. Any deviation from price stable policies, such as embarking upon expansionary monetary or fiscal policy, was said not to produce higher demand and employment, but rather inflation, which drives down the exchange-rate, creating further inflation and balance of payments problems (McNamara 1998, p.62).

She argues these ideas became diffused throughout the European Community[41] (EC) and that monetarism and the 'neoliberal consensus' underpinned EMU from its creation. She even suggests that the Single European Act (SEA, 1986)[42] and single currency may never have materialised without this consensus (McNamara 1998, p.175). For McNamara (1998), EMU may even have been devised as a way to 'lock in' price stable, austere fiscal and liberal financial ideas (McNamara 1998, p.171) and are therefore integral to what the Euroarea is[43].

[41] Principally through elite engagement within the Economic and Financial Affairs Council (ECOFIN) and the Committee of Central Bank Governors, which prior to EMU was the main forum through which EC central bankers consulted and communicated with one another (McNamara 1998, p.158).
[42] The SEA removed barriers to trade and increased labour mobility and capital flows.
[43] Indeed, as we have witnessed since the financial crisis, in a monetary union designed without fiscal transfers and with restrictions placed on government borrowing, 'austerity' and internal devaluations are demanded of Eurozone nations that have experienced competitiveness and/or fiscal problems (Blyth 2013[a,c]).

McNamara (1998) demonstrates effectively how ideas can not only become incorporated into institutions and political-economic organisations, but are foundational to them. Engagement with monetarist, price stable policies is intrinsic to a proper understanding of what the euro is and how the ECB has operated since its inception. However, McNamara fails to explain why (given the broad 'policy consensus' she claims existed at Maastricht) French and German preferences in particular differed so radically (Brunnermeier et al. 2016, ch3-4; Sadeh and Verdun 2009, p.291). Whilst the German government pressed for an independent central bank focused solely on the delivery of price stability, the French sought to incorporate an 'economic government' into the European architecture as a direct counterweight to monetarist ideas. Whilst the French ultimately backed down and accepted a monetarist EMU framework, there is little evidence to suggest traditional French state-centric *dirigiste* ideas were fundamentally altered by the creation of the euro (Dyson 2000, p.13; Howarth 2002, p.172; Jabko 2006, p.163; Schmidt 2007, p.6). This suggests a closer examination of national economic ideas may be needed to fully understand the evolution of EMU.

She also fails to pay close enough attention to history and path-dependency at the European level. The Werner Plan – which anticipated member-states moving in a three stage process towards an integrated monetary union – was first propagated in 1970, before the last attempt to preserve the Bretton Woods system in December 1971[44] (Garber 1993, p.463). Therefore although monetarist ideas may have been integral to the EMU established at Maastricht, plans to create a single currency were made before monetarist ideas had taken hold in Europe. Indeed, there has been a striking continuity in the basic concept of

[44] The 'Smithsonian Agreement'.

EMU – of transferring monetary sovereignty without fiscal policy – throughout the history of the European project. The path-dependent content of the Werner Plan (1970) and Delors Report (1989) is remarkable and not given sufficient weight in McNamara's work (Verdun 2007, p.208).

Dyson (2002[a]) likewise tries to explain European integration through the commitment of EMUs architects to policies dedicated to price stability. In line with McNamara (1998), Dyson (2002[a]) argues neo-liberal ideas became internalised within the EMU framework (Dyson 2002[a], p.14), providing the ideational context within which European elites became embedded. This context then altered the configuration of constraints and opportunities available to actors and privileged certain interests and courses of action over others (Dyson 2002[a], p.2-4).

Underhill (2002) builds on these assumptions and claims the internalisation of these imperatives within EMU constituted a 'stability culture' which now permeates large tracts of European thinking: including financial, fiscal and monetary policy (Underhill 2002, p.42). He suggests the root of this stability culture can be traced to Maastricht and the primacy given to price stability over employment and growth. This stability orientated thinking, he argues, has since seeped into other policy fields. This initially occurred through the SGP (1997) – which set limits on net government borrowing and deficits – closer financial market integration through the Single Market Program, and financial market liberalisation (Underhill 2002, p.44).

Neither Dyson (2002[a]) nor Underhill (2002) however fully explore the extent to which these European imperatives were transmitted to the national level. Although many consider Germany, for example, to have a 'stability culture' (Bibow 2013, p.615; Howarth and Rommerskirchen 2013; Mertes 1994), it is difficult to argue such a culture has been conveyed to many of Europe's Mediterranean countries (Lynn 2011, ch.6). Although Radaelli (2002) accepts a stability culture had not transmitted entirely into the Italian political and economic system at his time of writing, the imposition of an independent ECB, SGP, and the role of EMU as a 'Stabilisation State', he argued, would ultimately ensure the principles of 'European stability culture' would permeate into the Italian state (Radaelli 2002, p.213). Given Italy's national debt currently stands at over 130 per cent of GDP and the nation has the fourth largest debt market in the world, the extent to which such a culture has pervaded the country in the years hence it is debatable.

By paying insufficient attention to national level continuity, these authors lack a comprehensive understanding not only of how ideas are transmitted through international fora, but also of the resilience of national political and economic systems. Indeed, despite free capital movement since the 1980s, closer financial market interdependence generated by the growth of market-based finance and attempts to integrate interbank lending markets (Gabor and Ban 2016, p.618; Jabko 2006), domestic financial systems have remained remarkably distinct (Jones 2005, p.54; Mulé and Walzenbach 2017). National path-dependence therefore remains essential to fully understand how the Eurosystem operates.

Jabko (2006) meanwhile adopted a 'strategic constructivist' approach[45] to claim that the EU Commission advanced EMU by tailoring different messages to different groups. Under the EMS, the French believed the power of the market had become too constraining. Moreover, as the EMS became anchored by the *Deutsch Mark*, the *Banque de France* had already lost significant sovereignty over monetary policy. The Commission therefore sold EMU to the French a way of reasserting some semblance of monetary authority over the markets (Garrett 1993; Howarth 2001). Although Germany was initially opposed to the single currency, the Commission ultimately persuaded the country to join EMU by describing it as a way of entrenching price stability and fiscal discipline in Europe. Contrary to other ideational theorist, Jabko (2006) therefore claims it was not a convergence of ideas that made EMU possible, but rather that the Commission was able to sell the project by making different arguments to different audiences (Jabko 2006, p.147).

Jabko (2006) introduces some good theoretical insights, particularly in relation to different justifications being used to achieve specific policy objectives. This research builds on this by examining the extent to which the ECB has continued to justify post-crisis policies in terms of maintaining price stability, whilst simultaneously becoming increasingly concerned with financial stability objectives. That said, while HI tends to overplay the role of policy paradigms as constraints on action, Jabko (2006) fails to pay sufficient attention to them. Although ideas and broad theoretical frames can contain contradictions and leave scope for interpretation and institutional change (Jabko 2006, p.8), they can also set broad parameters for acceptable policy and restrain institutional alteration (Streeck and Thelen 2005, p.11-16). The ECB was slower to embrace 'extraordinary' monetary policies than

[45] In which identifies the politics of ideas, rather than the ideas themselves, as agents of institutional change.

most other advanced central banks as the ‘path-dependent’ legacy of monetarist ideas remained integral to the banks credibility and legitimacy.

In relation to the impact of the financial crisis at the EU-level, relatively little ideational research has been produced, and even less on the evolution of the ECBs concern for financial stability. Nevertheless, there have been some references to the role of ideas in the usage of heterodox monetary policies by the ECB, and in the literature surrounding the growing importance of financial stability policies more broadly (Farrell and Finnemore 2016; Schmidt 2016; Blyth 2013[b]).

Farrell and Finnemore (2016) argued briefly that although the crisis has fundamentally changed the environment within which the ECB operates, the bank has been incapable of altering its price stability ideas. They suggest that despite the ECB recognising conventional monetary policy in the new macro-economic environment is incapable of maintaining both price and financial stability, it has remained committed to traditional monetary policy (Farrell and Finnemore 2016, p.585). While these authors accept the ECB has begun to manipulate more unorthodox policy tools, they submit that it has maintained its pre-crisis, legalistic, communicative discourse by continuing to insist that the aim of these adjustments is solely to maintain price stability, and that the new measures do not reduce the banks political or operational independence (Farrell and Finnemore 2016, p.585).

Blyth (2013[b]), argues the slow response of the ECB in 2009-2010 to the sovereign debt crisis was due to the constraining effect of the pre-existing monetarist paradigm. He discounts the role of organisational structures in limiting ECB action and instead maintains that the banks' tentative behaviour was testament to the power of ideas in determining outcomes (Blyth 2013[b], p.209). Because Blyth (2013[b]) argues the ECB bought so prodigiously into pre-crisis monetarist ideas, which were heavily tied to the notion of 'efficient markets' and the optimality of previous regulatory practices, the bank has continued to stick to its pre-crisis narrative, regardless of the weight of evidence supporting change (Blyth 2013[b], p.210).

Although Blyth (2013[b]) and Farrell and Finnemore (2016) are right to argue the ECB was reluctant to alter its monetarist programmatic ideas and therefore slow to respond to the crisis, their analysis misses the fact the bank began moving away from a strict monetarist interpretation of central bank policy and towards an engagement with financial stability objectives long before the crisis erupted. Under EMU, the ECB became increasingly concerned with the implications of an integrated and market-based Eurozone overseen by national financial regulators and supervisors on financial stability (Trichet 2003; ECB 2000[d], p.62). Moreover, during the crisis, the ECB began implementing policies which it would never have sanctioned before the crash, even adopting bond buying programs and MPR which signify clear shifts from traditional philosophical and programmatic ideational practices (Baker 2012; Brunnermeier et al. 2016, p.5).

Schmidt (2016) acknowledges this shift in ECB policy but argues that while the bank has altered its operational stance, it has maintained a commitment to price stability within its communicative discourse as price stability policy ideas provide legitimacy to the banks' actions (Schmidt 2016, p.1033). Because the ECB had more institutional autonomy than other EU bodies, it was also able to use this discursive continuity to disguise a reinterpretation of its mandate, allowing it to assume responsibility for saving the euro during the sovereign debt crisis ‘in plain view’ of market participants (Schmidt 2016, p.1049). By using ‘communicative’ discourse in this way, the bank was able to claim its actions were entirely consistent with the Treaties, despite overseeing a clear extension of its responsibilities.

Although Schmidt’s (2016) analysis is largely correct, it misses the importance of ECB monetarist ideas in promoting the discursive and policy continuity highlighted in other studies (Farrell and Finnemore 2016; Blyth2013[b]), as well as the gradual strengthening of policy ideas in relation to financial stability. Critical junctures, such as the 2010-12 sovereign debt crisis (Jones et al. 2016, p.1011), can often be a catalyst for institutional change already underway (Posner 2007), with policy change frequently having its origins in previous thought structures and policy developments (Immergut and Anderson 2008, p.349). The ‘critical juncture’ of the 2010-12 crisis may therefore have allowed financial policy ideas (which had remained stunted prior to the crisis), to gain greater influence and catalyse more vigorous institutional change.

Within broader ideational literature, Baker (2012) looked at the increased popularity of MPR in the wake of the 2007-8 crash and concluded that macro-prudential polices gained credence as a result of incremental ideational changes complied over the previous 20 years. However, from late 2008 onwards, change became more rapid as policymakers presided over an important ideational transition by explicitly recognising the significance of counter-cyclical policies (Baker 2012, p.113). This resulted in regulators and supervisors, including the ECB, beginning to accept the importance of intervention and of setting limits on financial market activity – representing a significant ideational shift from the pre-crisis neo-liberal orthodoxy of reverence for efficient markets. Although the financial crisis acted as a catalyst for these developments, both Baker (2013; 2012) and Moschella (2011) stress the gradual advancement of these policy ideas which evolved during previous financial crises, such as those in Mexico (1994) and Asia (1997-8) (Moschella 2011, p.123)[46].

Grabel and Gallagher (2015) maintain that we should not be surprised by this post-crisis desire for interventionism, arguing that the current crisis has simply intensified ongoing ideational changes while providing space and impetus for definitive policy adjustment (Grabel and Gallagher 2015, p.3). These authors each produced important findings. This thesis seeks to build on their results by exploring the extent to which broader ideational change took place within pre-crisis EMU, and how such evolving financial ideas may have influenced the ECBs response to the crisis.

An ideational shift is also said to have occurred in the field of post-crisis monetary policy. Prior to the crash, the established view was that monetary policy should focus exclusively on price stability. Since then, this understanding has been questioned and increasing attention has been devoted to financial stability (Moschella 2014, p.136). Although few consider the previous monetary consensus to have been abandoned entirely, there is a growing acceptance that central banks need now to secure both monetary and financial stability objectives (Bernanke 2011; Moschella 2014, p.144; Praet 2011). Uncovering the extent to which financial goals have become incorporated into the policy frameworks of the ECB, DB,

[46] Indeed, (Baker 2012) showed that references to MPR could be found as far back as 1986 (BIS 1986, p. 2).

and BdE over the duration of EMU, and the reasons behind this shift, will provide the main focus of this research.

Finally, Gabor (2014[a]) also claims that the evolution of central bank monetary policy cannot be fully understood using HI arguments. She looked at the policy lessons central banks drew from the unconventional monetary policies adopted by the Bank of Japan (BoJ) in the early 2000s and found that the monetarist New Keynesian policy framework provided the lens through which lessons were interpreted. This meant other central banks, including the ECB, viewed the BoJs bond purchasing programs as an extension of loose monetary policy[47] rather than as a way of improving the funding conditions of financial institutions by allowing them to sell less liquid assets to the central bank (Gabor 2014[a], p.198).

This, Gabor (2014[a]) argues, was due to the incommensurability of New Keynesian monetary ideas with the purchase of government bonds which was seen as irrelevant to the functioning of the interest rate transmission channel. These purchases were also thought to reduce central bank independence as well as lower funding costs for governments and were therefore directly at odds with traditional monetarist thinking (Gabor 2014[a], p.197). While important in helping to show how ideas can shape the way organisations view financial problems and understand policy solutions, Gabor's (2014[a]) work does not touch upon some of the structural restraints the ECB faced in attempting to move away from its traditional ideational framework (ECJ 2012; TEU 1992, Art.105). It also lacks a discussion of non-monetary post-crisis measures implemented at the EU-level[48], or any examination of

[47] Signalling to financial markets the commitment of the BoJ to maintain low real interest rates (Blinder 2010, p. 3).
[48] Such as MPR and ESM.

the national dimension of the Eurosystem, including how NCBs viewed and tried to influence EU and ECB policies (Khan 2016). This thesis therefore aims to broaden Gabor's (2014[a]) analysis of the way central banks have come to understand market-based finance into these areas.

2.4 Uniting the HI and DI Approaches

Some academics within political economy have previously attempted to marry insights from HI and DI into a single conceptual frame. Cox (2004) did this through the notion of 'ideational path-dependence' (Cox 2004). DI claims institutions are constructed upon ideational foundations, which often exert a constraining influence that impacts their subsequent development (Hay 2011, p.69). In his study into Scandinavian welfare systems, Cox (2004) argues that although the welfare states of Scandinavian countries have been constantly evolving, the 'idea' of a distinctive system persists, even as the definition of what constitutes such a system becomes ever more difficult to define[49]. Policymakers, Cox (2004) suggests, must at least pay lip-service to this popular idea due to the 'stickiness' of the model's reputation to have any hope at maintaining electoral popularity (Cox 2004, p.206).

This research builds on these theoretical innovations by using the HI notion of path-dependence to help explain the durability of philosophical and programmatic ideas (Schmidt 2014). It reveals how policy ideas can be used to undermine, weaken or 'stretch' overarching programmatic ideas, without those original concepts losing their emotional

[49] Parallels here are easily discernible with the work of Jabko (2006), who demonstrated that ideas concerning the EU Commissions' Single Market Programme were ill-defined and understood differently by different groups.

appeal or usefulness in justifying policy actions. Some ideas seem so highly regarded that policymakers are obliged to justify their proposals for reform by making reference to them, despite any level of conceptual stretching that may be required to locate new policies and reforms within the existing paradigm (Cox 2004, p.216). These concepts are crucial to establishing a coherent path towards to the use of both the HI and DI within the same methodological approach, and will be used to explore the ECBs continued commitment to price stability.

The concept of ‘cognitive locking’, where ideas become rooted within a particular institutional setting, has also been developed in other fields of comparative politics. Berman (1998) explained that the Weimar Republic’s Social Democratic Party (SDP) failed to fight Germany’s interwar economic problems with counter-inflationary policies due to traditional HI institutional path-dependence, coupled with an ideational legacy within the SDP that prevented the party from reducing spending (Berman 1998). This insight may be useful when exploring the ECB’s willingness to embark upon ultra-loose monetary policy. Not only did the institutional structure of the bank constrain action through various statutory provisions, but so too did the domination of monetarist ideas and the legacy of German ordo-liberalism (*Ordnungspolitik*).

A contemporary source of note that has attempted to entwine the HI and ideational approaches, as well as explore Eurozone financial stability issues, is Braun (2015), who made two interesting theoretical observations. Firstly, using HI concepts, he argued current literature understates the importance of critical junctures in economic crises because during these ‘emergency’ phases, policymakers sometimes act without reference to previously dominant thought structures. At this point, according to Braun (2015), policy decisions may be guided neither by any old nor new policy paradigm. Crisis managers therefore (often without realising) set precedents at this crucial stage which leave their mark on the ideational and institutional landscape (Braun 2015, p.420).

Secondly, Braun (2015) states that it is not possible to determine whether a dominant idea or set of ideas is likely to be replaced simply by looking at whether or not a crisis has occurred. He suggests a dominant economic idea is not necessarily undermined by economic instability, as long as it can account for the occurrence of such crises within the theory and offer direction on how to deal with it. A policy paradigm is less likely to be displaced if it maintains 'crisis preparedness' and offers solutions going forward (Braun 2015, p.420). The crisis solutions offered by traditional monetary policy since Walter Bagehot (1873)[50], Braun (2015) maintains, coupled with the incompleteness of EMU[51], meant that post-2007, the ECB was the only institution capable of stepping in and preventing a collapse of EMU (Braun 2015, p.436).

Yet Braun (2015) purports that during the crisis, an ideational shift did take place because the no-bailout and Bagehot rules were broken by the ECB propping up 'too-big-to-fail' financial institutions. Because the ECB began accepting reduced quality collateral that expanded the banks' balance sheet and increased moral hazard, Braun argues a fundamental tenet of EMU became altered (Braun 2015, p.434). This, however, fails to consider the impact of the ECBs mark-to-market collateral framework which continued to

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[50] Who argued that in times of financial panic, central banks should lend freely to solvent banks with good collateral at a high rate of interest.
[51] With no common banking or fiscal authority during the crisis.

discriminate against lower-rated sovereign bonds in repo transactions and exacerbate pro-cyclicality (Gabor and Ban 2016, p.630). Moreover, by focusing on the crisis itself and failing to take a more longitudinal approach to the study of the Eurosystem, it also underplays the importance of the ECBs financial stability agenda before 2008. It could indeed be argued that the seeds for ECB action in 2008 were in fact sewn much earlier[52].

Finally, Lombardi and Moschella (2016) looked specifically at the ECBs post-crisis bond purchasing programs and discovered that both ideational and structural factors were at play in dictating policy parameters. They found that the banks legal structure which prioritised price stability over other policy goals, and the ECBs 'economic doctrine' which promoted monetary dominance, help explain why the bank was reluctant to take extraordinary measures (Lombardi and Moschella 2016, p.852). Yet they also found the banks institutional independence from member-states gave it room for manoeuvre and provided it with legal justification for its eventual bond purchase programs (Lombardi and Moschella 2016, p.865).

While this paper is important as one of precious few studies to explicitly incorporate structural and ideational explanations for institutional behaviour, it only looks at a very narrow field of ECB policy in a short period of EMU history. Presently, no HI or DI research has taken sufficient account of the rise of market-based finance[53]; the changing role of government debt as collateral in short-term debt markets, or; the difficulties these issues

[52] Since the euro was created in 1999, the ECB and wider EU have become increasingly concerned with and active in financial stability initiatives. For example, through the First and Second Banking Directives (1977 and 1989), and the completion of the Financial Services Action Plan (2000) which set common rules for Eurozone collateral (Commission 1999, p.8).

[53] Either in explaining the evolution of national financial systems, or in the development of central bank policies.

raise with respect to the cognitive locking of monetarist central bank thinking (Gabor 2014[a]). While government debt continues to be seen primarily as a question of fiscal policy, its importance in the fields of monetary policy and financial stability as a result of the growth of market-based banking has been largely neglected. This research aims redress this oversight.

2.5 German and Spanish 'Philosophical Ideas'

The preceding pages have concentrated on the supranational level of the Eurosystem. Yet the ESCB exists as a federation, with NCBs maintaining important roles in the implementation and operation of monetary and financial policies (Cohen-Setton 2011; Gros 2017; Quaglia 2008, p.3). The purpose of this section is to examine current scholarship on the dominant ideas found within the German and Spanish central banks, and how they are understood to have influenced central bank policy.

To understand why Spain and Germany were impacted differently by the 2007-8 crisis, and why they pursued different policy objectives at the European level[54], it is necessary to explore the extent to which pre-crisis ideational idiosyncrasies may have led to divergences in the way Spanish and German banks were regulated. This may explain why banks in each state accumulated different sorts of balance sheet risk[55], why they were affected differently

[54] Subsidiary Research Question 2.
[55] German banks were exposed on the asset-side of their balance sheets through the accumulation of peripheral and 'sub-prime' debt, while Spanish banks became exposed on the liabilities-side of their balance sheets by over lending to the real estate and construction sectors (Hardie and Howarth 2013[a], p.104; Royo 2013[a], p.154).

by the crash, and why their national governments reacted differently to supranational policies aimed at mitigating its effects.

This section sets out the core philosophical ideas of the DB and BdE. Differences between these ideas, as well as in the 'programmatic' and 'policy' ideas of the two NCBs (which form the focus of later chapters), are sketched out in table 5 below. These ideational dissimilarities are very important for understanding how the crisis unfolded in each nation.

Table 2.5: Levels of financial ideas

	ECB (pre-crisis)	**Deutsche Bundesbank**	**Banco de España**
Philosophical Ideas: Webs of Belief	**Neo-liberalism**	**Ordo-liberalism**	**Neo-liberalism**
Programmatic Ideas: Policy Paradigms	**Monetarism (contemporary)** • Inflation targeting • Aversion to countercyclical policy	**Monetarism (orthodox)** • Money growth targeting • Aversion to countercyclical policy	**Monetarism (idiosyncratic)** • Inflation targeting • Role for countercyclical policy
Policy Ideas: Policy Agendas	• Price Stability (inflation) • Fiscal conservativism • Financial Integration • Financial stability (weak)	• Price stability (M3) • Fiscal conservativism • Financial stability (non-interventionism)	• Price stability (inflation) • Fiscal conservativism • Financial stability (interventionism)

Source: Adapted from Schmidt (2014)

GERMANY: *DEUTSCHE BUNDESBANK*

To fully understand the euro crisis and the EUs reaction to it, it is essential to explore literature relating to the dominant financial ideas of Europe's largest country, Germany (Matthijs 2016, p.379). Due to the size of Germany's economy and the countries centrality to the European project, Germany is often regarded as Europe's 'indispensable nation' (Sikorski 2011) and more tends to be written about the German financial system and German financial ideas than those of peripheral nations like Spain. The dominant economic idea in the country, ordo-liberalism (*Ordnungspolitik*), is said to have deeply influenced EMU from the outset and to have been largely responsible for its conservative, rule-based structure (Allen 2004; Bibow 2013, p.612; Bulmer 2014, p.1246).

Ordo-liberal ideas have helped condition and constrain plausible options for German policy-makers for decades[56] (Dyson 2002[c], p.174; Matthijs 2016) and were originally developed by German speaking economists as a reaction to the consequences of unregulated liberalism during the early twentieth century (Dullien and Guérot 2012, p.2). Many authors point to the hyperinflation of the early 1920s Weimar Republic as the time when ordo-liberal ideas became grounded into the collective conscience of the German people (Schmidt 2014, p.193). This hyperinflationary period is often refereced to explain why Germans tend to be so weary of governmental borrowing and monetary expansionism (Polonyi 2011; Tognato 2012, p.137), and has even been sighted by Germanys' Federal Finance Minister, Wolfgang Schäuble, as one of the key reasons Germany considers the accumulation of Government debt to be such a serious issue (Schäuble 2011[a]). Indeed, Germany's experiences of hyperinflation – which became seared into German folk memory

[56] Particularly within the DB.

(Atkins 2011) – underpinned the DBs post-war commitment to a culture of central bank independence and monetary stability (Bulmer 2014, p.1246; Fairness 2016).

The central contention of ordo-liberalism (*Ordnungspolitik*) postulates that governments should regulate markets to ensure actual results approximate the outcomes which would be achieved in a perfectly competitive market (Nedergaard and Snaith 2015, p.1096; Wren-Lewis 2014) and that individuals and countries should not be incentivised to take on risk at the expense of others.

The word *ordo*, Latin for 'order,' points to a rejection of *laissez-faire* economic principles and towards a system in which the state constructs a strong regulatory environment for markets to function (Oliver 1960, p.133–134; Wörsdörfer 2010, p.23). Unlike Keynesian theory, it discourages state intervention beyond the setting of a robust legal framework (Brunnermeier et al. 2016, p.61) and strongly rejects the idea of using expansionary fiscal and monetary policies to help stabilise the business cycle (Bulmer 2014, p. 1246; Dullien and Guérot 2012, p.2; Siems and Schnyder 2014, p.389).

Importantly, although there is significant overlap in this respect between ordo-liberalism, neo-liberalism and monetarism, ordo-liberalism (*Ordnungspolitik*) came first (Nedergaard and Snaith 2015, p.1102) and constituted the 'dominant logic' (Streek and Thelen 2009, p.116) within German policy circles long before monetarism gained hegemonic global status (Garber 1993, p.463; McNamara 1998). Indeed, the success of German monetarist policies has been widely regarded as one of the key factors explaining the rise of monetarism throughout the late twentieth century (Howarth and Loedel 2005, p.15; Kaelberer 2003, p.369; McNamara 1998, p.157).

Table 2.6: German and EU 'philosophical' ideas

Ordo-liberal Principles	Expression in EU	Keynesian Alternative	Neo-liberal Alternative
Avoidance of moral hazard	The 'no bail-out clause'; Refusal to accept debt mutualisation through a common DGS[57] or 'Eurobonds'	Fiscal transfers beneficial to assist states in distress	Debt should be individualised and subject to market forces
Preference for stable monetary aggregates	ECB aim to maintain inflation at below 2%	High inflation acceptable to stimulate growth in a crisis	Low inflation preference
Regularity in economic policy established through strong legal framework	Implementation of fiscal frameworks: SGP[58], 'Fiscal Compact' etc.	Policy flexibility is necessary to help tackle a crisis	Legislation should be kept to a minimum. Outcomes can be predicted through the behaviour of 'rational' actors
Interventionism (other than through the setting of a legal framework) should be resisted	An independent central bank reluctant to expand monetary policy beyond interest rate manipulation	Monetary and fiscal expansionism required by the state to boost growth	Government borrowing kept to a minimum, market forces best allocate scarce resources
Overarching concern with stability	Maintain low public debt and deficits	Deficits should be used as a counter-cyclical measure	Low tax and spending is the best way to stimulate an economy

Source: Author (2018); Nedergaard and Snaith (2015)

In Germany itself, the 'economic miracle' (*Wirtschaftswunder*) which took place in West Germany throughout the post-war period (Blackstone and Walker 2012) was largely attributed to the economic oversight provided by the DB[59], and to adherence to economic

[57] Deposit Guarantee Scheme.
[58] Stability and Growth Pact.
[59] Widely regarded as the 'epicentre' of price stable, ordo-liberal ideas (Blackstone and Walker 2012; Dyson 2002[c] p.177; Nedergaard and Snaith 2015, p.1097; Young 2014, p.279), the DB became one of the most

and fiscal rules (Atkins 2011). These factors together secured the *Deutsche Mark* as one of the world's strongest and most successful currencies. Within the DB, ordo-liberalism was established at its ideational core and became fundamental to the central bank's understanding of events, and of itself (Schmidt 2014, p.194).

The founding fathers of ordo-liberalism (*Ordnungspolitik*) were the economist, Walter Eucken, and two lawyers, Franz Böhm and Hans Grossmann-Doerth, all from the University of Freiburg (Siems and Schnyder 2014, p.379). Europe's experiences with Communism and National Socialism encouraged post-war Germans to limit discretionary government action (Atkins 2011). From the very beginning therefore, ordo-liberals stressed the need for a strong and stable legal framework to prevent excessive state control (Bulmer 2014, p. 1246; Nedergaard and Snaith 2015, p.1097), and to avoid power differentials between producers and consumers undermining market function (Siems and Schnyder 2014, p.379). Consequently, ordo-liberalism and German democracy share very strong legal foundations, with many government officials being proficient with legal training[60].

Crucially, ordo-liberalism (*Ordnungspolitik*) also stresses the importance of avoiding 'moral hazard'. This phenomenon is generated by the 'free-rider problem': When individuals or institutions cannot be held accountable for their actions, bad behaviour goes unpunished and the consequences of such behaviour become felt by those other than the culprit, leading to an incentivisation of reckless behaviour (Berger and Hershey 1994; Stiglitz 1983).

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respected institutions in post-war Germany and was even seen by many to represent a moral authority in the country (Tognato 2012, p.45), with its commitment to price stability viewed as the guarantee of a free and democratic order (Howarth and Loedel 2005, p.54; Issing 2002[a], p.23; Lynn 2011, p78).

[60] Including Wolfgang Schäuble, the German Minister of Finance, who was set to become a professor of law before turning to politics.

Ordo-liberalism (*Ordnungspolitik*) therefore couples economic arguments with a moral conviction that if rules are to be effective, inappropriate behaviour should be penalised, whatever the impact on the individual, society or country (Atkins 2011; Brunnermeier et al. 2016, p.66; Nedergaard and Snaith 2015, p.1098). The 'liability principle' (*Haftungsprinzip*) – the idea that those who take the risk should bear the cost – seeks to prevent moral hazard by ensuring market participants are not incentivised to free-ride (Pies and Sass 2010)[61]. These ideas help explain the German aversion to risk-sharing, which often allows feckless actors to profit from the responsible behaviour of others.

Another popular concept within German society is the 'Social Market Economy' (*Soziale Marktwirtschaft*)[62]. Although this idea evolved from ordo-liberal thinking, it coexists with ordo-liberalism (*Ordnungspolitik*) as an alternative 'policy program' (Schmidt 2014, p.196). Social Market ideas substitute a strictly rule-based economic liberalism for one in which the state assumes a duty to promote market conditions which result in an amenable social balance (Glossner 2010, p.11). It attempts to establish a socio-economic system that incorporates both economic freedom and social security, and formed one of the bedrocks of German post-war policy (Felice 2015, p.79). Social Market ideas, however, are less comprehensive and far less prescriptive than ordo-liberalism, and contain many of ordo-liberalisms core values.

Several papers have been published on ordo-liberalism and how these philosophical ideas have influenced Germany's post-crisis response. Matthijs (2016) argues ordo-liberal ideas

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[61] Former Italian Prime Minister, Mario Monti, once remarked: 'For Germany, economics is a branch of moral philosophy' (Monti 2012).
[62] First discussed by Alfred Müller-Armack (1947): Wirtschaftslenkung und Marktwirtschaft – Hamburg.

advanced by Germany at the European level not only worked against Germany's national interest by advocating policies which weaken domestic demand, but also made the crisis worse by insisting on 'austerity' measures being taken by states suffering fiscal problems (Matthijs 2016, p.378). Steinberg and Vermeiren (2016) meanwhile viewed the German government's commitment to ordo-liberalism using an HI framework and argued that due to traditional economic ideas, Germany and other 'northern' European states refused to sanction inflationary policies to help rebalance competitiveness in the Eurozone. This resulted in the ECB having to implement unorthodox monetary policy to deal with the threat of deflation (Steinberg and Vermeiren 2015, p.404).

Brunnermeier et al. (2016) also looked at the impact of ordo-liberalism (*Ordnungspolitik*) on Germany's response to the crisis, arguing it represented the 'world view' (*Weltanschauungen*) of many German policymakers (Brunnermeier et al. 2016, p.17) and heavily influenced the structure of EMU. According to Brunnermeier et al. (2016), Germany remained opposed to ESM, expansionary monetary policy and a common deposit protection scheme (DPS) because of its ordo-liberal preferences for fiscal conservativism, monetary stability and fear of moral hazard (Brunnermeier et al. 2016, p.218).

However, whilst these scholars highlight the connection between ordo-liberalism and German monetary and fiscal policy, they fail to explore the connection between these ideas and German financial regulations (Röper 2017). German regulatory preferences, grounded in ordo-liberal principles, may help explain why German banks reacted to market-based finance in the way they did, and why they were impacted so harshly during the initial crisis period. Existing literature also fails to expound why despite the DB, Federal Finance and

Economics Ministries all opposing state ownership of Germany's large public banks[63] (*Landesbanken*), they were unable to sever the link between the state and public financial institutions. Each of these studies therefore also pays insufficient attention to the structure of the German financial system[64]. This thesis aims to redress these oversights by analysing the significance organisational structures as well as ideas in limiting institutional evolution.

SPAIN: *BANCO DE ESPAÑA*

Prior to democratisation, Spain was governed by an autocratic military leader, General Francisco Franco. The ideational driving force behind the regime was the suppression of socialism and parliamentary democracy and the advancement of traditional 'Spanish Catholic Authoritarianism'. Catholicism and the military formed the two pillars of Franco's Spain, with strict control from the centre (Barton 2004, p.246-8).

Under this regime, government officials implemented a technocratic, interventionist model and used financial restrictions on capital and interest rates to advance political goals and allocate preferential credit to favoured groups (Cases 1996, p.180; Lukauskas 1997, p.3; Pérez 1997, p.69). This state controlled credit allocation system formed a fundamental part of Spanish economic policymaking and subordinated monetary and financial considerations (Martín-Aceña et al. 2014, p.58; Pérez 1997, p.80). The philosophical idea of Spanish Catholic Authoritarianism however largely died with Franco and throughout the latter years of the regime and into the 1980s, liberal ideas began to penetrate state institutions,

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[63] Largely for ideational reasons in that ordo-liberalism does not favour state ownership (German Economics Ministry: interview #11, 2015).

[64] The German banking system maintains a 'three pillar' structure consisting of public, private and cooperative banks (see figure 4.7: Structure of German's banking system).

particularly within the Finance Ministry and the BdE’s Research Service (Tortella and Garcia-Ruiz 2013, p.150).

Despite the Franco regimes preference for state control, liberal ideas had many sympathisers in Spain, largely thanks to the influence Heinrich Freiherr von Stackelberg, a German ordo-liberal economist who settled in Madrid during the 1940s (Ban 2012). Due to the following he amassed, Spain became the only non-German speaking country in which ordo-liberal ideas gained significant influence (Ban 2016, p.109). Although von Stackelberg died in 1946, his followers helped implement the economic Stabilisation Plan (1959), and an amalgamation of ordo- and neo-liberal economic ideas flourished throughout the Franco period. Liberal advocates gained positions of power and influence during the 1960s and 1970s, particularly within the BdE and Finance Ministry (Ban 2012, p.150).

By the 1970s, neo-liberal ideas had become dominant, particularly within the BdE’s Research Service which became the country’s premier economic research institute. While Spain continues to be viewed in the literature as a ‘state influenced’ or ‘mixed-market’ economy (Molina and Rhodes 2007; Schmidt 2007), neo-liberal economic and financial policies increasingly became seen within state institutions as a way of advancing Spain economically, as well as paving the way towards EC membership (Brias 2002; Lukauskas 1997, p.97-8). By the 1990s, Spanish economists had become some of the most influential international standard bearers of neo-liberal and monetarist thinking (Ban 2016, p.136), with the BdE becoming one of the first central banks to promote inflation targeting over the pursuit of monetary aggregates (Debelle 1997; Goerlich et al. 1995; Tortella and Garcia-Ruiz 2013, p.160).

While some research has been produced which examined the effects of the crash in Spain, and the BdE and Spanish governments responses to it (Otero-Iglesias et al. 2016; Quaglia and Royo 2015; Royo 2013[a,b,c]), none has looked at the importance of BdE neo-liberal philosophical and idiosyncratic monetarist programmatic ideas[65] on; the formation of Spanish regulatory practices; how these practices may have impacted Spanish banks behaviour within the new market-based financial environment, or; on Spanish preferences towards post-crisis policies implemented at the EU-level. This research aims to address these oversights and reveal the extent to which ideas and structures are responsible for the particularities of Spain's post-Franco financial system.

2.6 Conclusion

This chapter outlined the respective strengths and weaknesses of the DI and HI approaches and how they have been used within the literature to explore various aspects of European political economy. Whilst HI is convincing when applied to research seeking to explain the idiosyncrasy of national financial systems (Deeg 2005; Lutz 2004[a]; Vitols 2005), the falling forward of European integration (Jones et al. 2016), and the path-dependence of ECB monetary policy (particularly pre-2007 [Howarth and Loedel 2005; Quaglia 2008]), it contains weaknesses in other areas.

HI views institutions as constricting to human behaviour and can therefore often be overly deterministic. Despite the concept of critical junctures which allows for institutional change

[65] Unlike German monetarism, Spanish Monetarism reserved a role for countercyclical policies and due to inflation targeting, was less concerned about short-term finance that the DB which continued to target M3.

during crisis periods (Capoccia and Kelemen 2007, p.341; Thelen 1999, p.388), it struggles to account for change emanating from within institutions themselves (Blyth et al. 2016, p.148; Schmidt 2011, p.48). As a result, HI interpretations of post-crisis ECB policy shifts often tend to be understated (Salines et al. 2011; Yiangou et al. 2013). HI also finds the important liberalising developments of the previous three decades problematic to explain (such as 'market-based' finance and the changing role of government debt). As soon as one conceives of ideas as being able to break free from institutional norms, institutions lose their constrictive properties and the concept of path-dependence loses its allure.

DI meanwhile is very useful for understanding institutional change, but suffers from other weaknesses. It envisages institutions as being constituted by ideas (Schmidt 2010, p.10), which by their very nature are subject to constant change and modification. As a result, it struggles to account for institutional resilience. DI also has a tendency to overplay the importance of ideas. Suggesting for example that a European-wide policy consensus could be responsible for EMU (McNamara 2006; 1998) belies the fact monetary union was proposed many years before monetarist ideas became dominant (Garber 1993, p.463), as well as the intense negotiations which took place prior to Maastricht (Jabko 2006; Sadeh and Verdun 2009, p.291). The approach also struggles to explain the path-dependence of national financial systems, and to fully account for different national responses to post-crisis ECB policies, ESM and BU.

The chapter then described how, buy using insights from both approaches, the weaknesses of each may be mitigated. By incorporating the many HI concepts which help account for path-dependence into an ideational framework which recognises that different levels of ideas have different strengths and durability (Schmidt 2014), it may be possible to better conceptualise when and under what conditions ideas are able to generate institutional change, and when institutional structures are able to repel demands for reform. The notions of conceptual stretching, and ideational and discursive path-dependence, were shown likely to be crucial to this endeavour (Cox 2004; Jabko 2006; Schmidt 2016).

The chapter also highlighted key trends which had been missed by HI and DI scholarship to date. It specifically pointed to a lack of research on the rise of market-based finance, the changing role of government debt and the cognitive locking of monetarist ideas by European central bankers. Contemporary research also seems to have neglected the growth of financial ideas at the supranational level (undermining programmatic monetarist ideas), and the role they have played at the national level in crafting financial regulations and determining post-crisis policy responses (Röper 2017). Using insights from HI and DI together, this research addresses these gaps while seeking to better understand the process of gradual ideational and structural change and each level of EMU.

Chapter 3
Methodology

This thesis seeks to understand *why* and in what ways the financial stability agenda within the Eurosystem (at both the national and supranational levels) evolved over the lifespan of the euro, and how influential ideas and structures were in constraining and enabling this change. This chapter describes the research methodology adopted by this study and begins by outlining the research questions established to broach this enquiry. It then explores what methods have been used to conduct HI and DI research in the past, before moving on to explain why process tracing was adopted as the overarching methodological framework. The following section goes on to clarify why Spain and Germany were chosen as the strategic comparison for the research, and what it is about these two euro member-states that makes them such interesting subjects to contrast. In the penultimate section, the reader is taken through the research process and the specific applied methods that were used to both generate and analyse data in later chapters. The final section concludes.

3.1 Research Questions

The Main Research Question (MRQ) asks the following:

To what extent can changing ideas and intuitional structures explain the evolution of Europe's financial stability agenda?

This research is primarily concerned with how financial stability came to be viewed initially as a secondary consideration within central banking circles, to attaining co-equal status with price stability (Bernanke 2011). Within Europe, the Treaty establishing Economic and Monetary Union (EMU) provided the European Central Bank (ECB) with no direct responsibility for financial stability (Papademos 2006) and many legal provisions were made to prevent the bank straying from its price stability mandate (TEU 1992, Art. 105). The task of defending financial stability remained the duty of national regulators and supervisors (Duisenberg 2000[b]). Over the duration of EMU however, the European Union (EU) and ECB became increasingly involved with financial stability issues and responsibility for its maintenance began to migrate away from member-states towards the supranational level. This research aims to track this process of change from 1999–2014 and explain how important ideas and structures were in:

i) pushing the ECB to think more about and openly discuss financial stability
ii) advancing and justifying institutional change at the EU and national levels in relation to financial stability
iii) acting as restraints on institutional change at the EU and national levels

The thesis breaks down the MRQ into three subsidiary research questions which are addressed in subsequent chapters.

Subsidiary Research Question 1 (SRQ1):

Why has the ECB become increasingly attentive to financial stability concerns?

Although the ECB was initially handed very limited competence over financial stability, even before the crisis, it began discussing financial stability as an independent concern - even producing a mission statement on the topic in 2005 (Trichet 2005[a]). Following the 2007-8 financial crisis, the ECB took a much more active role in trying to stabilise European financial markets, culminating with the completion of Banking Union (BU) in November 2014[66]. This question seeks to explain why this evolution took place, and to assess the importance of the ideational and structural factors which helped facilitate it.

The question is tackled in two parts. Using the start of the financial crisis in 2007 as a natural analytical break, chapter 5 looks at the evolution of the ECB's financial stability agenda from 1999-2007, while chapter 7 looks at the ECB's reaction to the crisis from 2007-2014. Using insights from DI and HI throughout, attention focuses on the importance of history, structure and ideas in both aiding and constraining institutional and policy change at the European level.

Subsidiary Research Question 2 (SRQ2):

Why did German and Spanish financial institutions react differently to the advent of market-based banking and the creation of EMU?

[66] At this time the ECB was handed direct responsibility for supervising the Eurozone's 130 largest financial institutions.

This question is tackled in chapter 4 and examines the importance of ideas and structures in explaining how the *Deutsche Bundesbank* (DB) and *Banco de España* (BdE) liberalised their economies, conducted monetary policy, supervised financial institutions and prepared for EMU. The chapter shows how different financial ideas led directly to different supervisory practices becoming adopted in each country, and the impact this had on banking activity and the desirability of Spanish and German sovereign debt. The appendix also contains a critical case study of two public banks, Caja de Ahorros del Mediterráneo (CAM) and Bayerische Landesbank (BayernLB) to highlight structural similarities between the Spanish and German financial systems. It reveals the typical problems found within Spanish and German public banks[67], and uncovers the political obstacles their two central banks faced while trying to reform their respective public banking sectors.

Subsidiary Research Question 3 (SRQ3):

Why were Spain and Germany impacted differently by the financial crisis, and why did they pursue different policy objectives at the European level?

This question is addressed in chapter 6, with analysis commencing at the start of the financial crisis in 2007[68]. Given the structural similarities between the Spanish and German financial systems, this research expects to uncover ideational reasons which may explain why Spain and Germany were impacted differently by the crash, why the Spanish system subsequently changed more radically than its German counterpart, and why each country pursued different post-crisis policy preferences at the EU-level.

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[67] Which often related to their linkages with regional politicians, see chapter 4.
[68] Again, analysis concludes with the commencement of BU in November 2014.

Chapter 6 also contains a critical case study of two public bank bailouts in Germany and Spain: Hypo Real Estate (HRE – Germany) and Bankia (Spain). These cases are deemed critical because they represent both extreme cases – with HRE denoting Germany's only modern-era bank nationalisation (Scally 2014), and Bankia's collapse forcing the Spanish government to seek EU assistance (De Olza 2013) – but they also magnify the difficulties found within many other banks in the two countries. These examples therefore also provide a degree of generalisability (Flyvbjerg 2006, p.226; Yin 2003, p.40), revealing common problems within the two systems. The case of Bankia is particularly important because it also represented *the* critical juncture for both Spain and Europe. The collapse of this bank not only forced wholesale change of the Spanish public banking system (De Olza 2013; Royo 2013[b], p.200), but also obliged the ECB to embark upon more expansionary monetary policy and ultimately led to the creation of BU (Citibank 2012; Otero-Iglesias et al. 2016).

3.2 HI and DI Methodological Approaches

Within HI, there is no established methodology to which all authors ascribe and many HI scholars tend to mix rationalist and constructivist methodologies when compiling their research, depending on the subject of enquiry (Immergut 2005, p.250; Pierson 1996, p.131; Steinmo 2008, p.130). Indeed, many HI studies have employed both quantitative and qualitative methods to examine both broad and more specific themes which are said to influence institutional behaviour. Because HI contends that the past can influence the present through tangible, structured political organisations as well as through more subjective ‘institutions’ such as conceptions around broadly accepted patterns of behaviour (Immergut 2005, p.242), a variety of methods may be deemed appropriate.

Yet there are some methods which appear time and again in HI research. Because HI is principally concerned with *explaining* the significance of and institutional structures and past events in determining social outcomes (as opposed to *predicting* future occurrences [Steinmo 2008, p.134]), it tends to adopt methods designed to accommodate in-depth longitudinal historical study. HI research also frequently seeks to contrast national institutional developments to show how historical events can impact institutions differently (Hopkin 2002, p.302). If similar exogenous events can be shown to have struck different institutions and generated contrasting results, it becomes difficult to refute the importance of institutions themselves in determining social outcomes. Therefore comparative historical analysis is frequently used in the design of HI studies to draw attention to event similarities and to identify factors which help explain differential outcomes within cases (Thelen 1999, p.374).

The comparative method is a distinctive approach that offers a richer set of observations (especially regarding causal processes), than other methods are able to provide (Hall 2003, p.397). It enables contemporary political and economic developments to be perceived in greater depth, and in their historical contexts, while helping to show why institutional developments are frequently challenged by conservative elements, and why change tends to occur on a slow and cumulative basis (Steinmo 2016, p.110). While accounts of single cases can produce evidence of possible explanations for the way history unfolded in a specific setting, there may be alternative and equally plausible explanations offered by other scholars examining the same phenomena. Comparative analysis allows these alternative possibilities to be checked against other cases, showing one explanation to be potentially more plausible than others (Hopkin 2002, p.286).

Because HI is less interested in predicting future outcomes than explaining past events (Steinmo 2016, p.110) quantitative deductivist methods are not generally adopted in HI research. Instead, qualitative process tracing techniques are frequently used to help tease out the historical and political processes behind subjects under investigation (Steinmo and Thelen 1992, p.9). Process tracing allows phenomena to be investigated in ample detail using thick descriptions (Hall 2003, p.393), and enables a greater depth of understanding by recognising the importance of history and context in fully comprehending and explaining social development (Bennett 2008, p.704; Collier 2011, p.824). The technique involves a detailed systematic tracing of history by identifying causal mechanisms which explain specific events or outcomes (Beach and Braun-Pedersen 2013, p.1), and can be found in many examples of HI research (Quaglia 2008; Thelen 2003).

Analogous techniques are also popular within ideas research as DI similarly attempts to explain past events rather than predict future ones. However, whereas HI research attempts to show the importance of structure and path-dependence on historical events, DI tries to demonstrate the importance of ideas and discourse in explaining institutional change. Schmidt (2008) argues that only by adopting a research style capable of incorporating the societal constructs of ideas and discourse can we fully understand the reasons behind both institutional change and continuity. Any research attempting to examine the importance of ideas and discourse should therefore firstly define the norms, rules, world views and cognitive frameworks within the area of research, and then try to establish correlations between these ideas and policy outcomes. Longitudinal analysis is therefore often best suited to exploring a history which goes beyond moments of crisis and looks deeper at less obvious causal mechanisms (Saurugger 2013, p.902).

Hay (2011) also trumpets the benefits of a longitudinal approach to DI research, asserting that retrospective process tracing should be foundational to ideational study as it can help demonstrate how different cognitive influences emerge and develop over time. This allows ideational scholars to be better able to assess the impact of ideas on any given institution (Hay 2011, p.79). Berman (2011) and Parsons (2011) both argue, that 'careful reconstruction and process tracing' should form the bedrock of ideational scholarship (Berman 2011, p.124) and are an 'unavoidable method of ideational argument' (Parsons 2011, p.135).

Nevertheless, it is accepted that historical process tracing alone cannot be relied upon to produce reliable, empirical work. Over reliance on the method would enable critics to argue economic pressures and material considerations may have played a greater role in any particular outcome and may question the part played by ideas in the process. Although most academics accept people have ideas and that they play some kind of role in policymaking, many also contend that these ideas only retain space for a small residual amount of autonomy outside the predetermined boundaries of 'fixed' rationality, socialisation and historical context. Consequently, Parsons argues, cross-case comparative analysis to support process tracing can strengthen a discursive argument and demonstrate how different ideas can create different outcomes by causing people to act in different ways (Parsons 2011, p.135).

Many HI (Steinmo 2016, 2008; Thelen 1999) and DI (Hay 2011; Parsons 2011; Saurugger 2013) scholars hence argue that historical and ideational researchers should rely on process tracing and comparative analysis as the cornerstones of their research designs. These methods, they claim, are able to plot both the evolutionary development of ideas and structures, and help show how different ideas and histories can create different outcomes in different contexts.

Finally, there is also a large amount of support within HI and DI literature for the use of in-depth qualitative interviews which focus on the beliefs, understandings and personal experiences of interview subjects (Vromen 2010, p.258). There is a sense that large-scale quantitative questionnaires would give an insufficiently robust insight into the thought processes and determining factors which influence individual behaviour within an institutional setting. The purpose of comparative analysis and process tracing is to attain a deeper understanding of not only the formal institutions of a given locality or organisation, but also to grasp the informal norms and expectations which also pervade. Surveys are judged insufficient to give a nuanced enough comprehension of the perceptions and trade-offs individuals are willing to make, and the belief structures which help govern their behaviour (Steinmo 2016, p.109). Semi-structured qualitative elite interviews are therefore deemed preferable within both HI and DI when generating data in the field work phase (Quaglia 2008, p.12; Schmidt and Radaelli 2004, p.205).

3.3 Methodological Framework: Process Tracing

Having justified the use of DI and HI as the theoretical framework for this study (chapter 2) and having outlined the types of methods the two approaches tend to use when conducting research, namely: process tracing, comparative analysis, and qualitative interviews; the following sections describe which methods this research adopted and explains why they were best suited to answer the research questions detailed above. It also expounds why these methods are epistemologically compatible with HI and DI and how combining them enables the generation of valid and reliable results.

PROCESS TRACING

As touched upon above, the process tracing method carefully plots historical events while seeking to find answers to causation and is often sighted by DI and HI scholars as an indispensable part of their investigative toolkit (Berman 2011, p.124; Parsons 2011, p.135; Thelen 1999, p.374). This method provides the analytical framework for the entire research, allowing for the inclusion of detailed comparative analysis, critical case studies, thick descriptions of important events and trends, and critical discursive analysis of important texts. The approach was adopted as a way of systematically plotting broad historic events within the Eurosystem and in seeking to establish ideational and structural causation.

Process tracing initially requires an enormous amount of data to ensure valid and conclusive results, ideally from a wide range of different sources (George and Bennett 2005, p.206; Tansey 2007, p.765). The method then helps narrow down the scope of such material in a way which does not weaken the research going forward, and that establishes causality with the help of counter factual arguments[69]. It adopts a systematic examination of historical evidence analysed in light of pre-established research questions (Collier 2011, p.823), whilst explicitly recognising the importance of sequencing and context in understanding and explaining social phenomena (Bennett 2008, p.704; Collier 2011, p.824).

Process tracing was ideally suited for this study as establishing what factors explain the evolution of Europe's financial stability agenda throughout EMU history necessarily requires longitudinal historical investigation. To understand why the ECB was initially inattentive to financial stability concerns and why this began to change as EMU evolved, it is imperative to accurately grasp the historic context of the Eurozone both before and after the financial crisis. Moreover, comprehending why the German and Spanish financial systems were impacted differently by the crisis (Howarth and Quaglia 2015, p.460; Otero-Iglesias et al., 2016, p.17) requires an even longer historical lens which extends prior to the creation of EMU.

Process tracing does however suffer from limitations when applied to areas of investigation which are large in scope (rather than to succinct historical periods), as it has a tendency to identify a single explanatory variable across an entire period (Collier 2011, p.827). But by using insights from DI and HI, this weakness is mitigated as each approach focuses on different explanatory variables (ideas and structures) to explain institutional continuity and change. Within a study exploiting both approaches therefore, process tracing is perfectly suited is it provides a methodology capable of identifying when either ideas or institutional structures were most relevant in dictating outcomes.

[69] Trying to picture what may have happened if a specific event or phenomena had not occurred.

Process tracing was used throughout this study to identify, describe and explain key events which occurred between the collapse of the 'Bretton Woods' fixed exchange-rate system in the 1970s, to the completion of BU in 2014, that led Europe, Spain and Germany to their current positions. Once a comprehensive timeline was created for the period by evaluating existing literature and secondary data, information was analysed to tease out key themes and ideas which dominated European institutions over the duration of study. In this instance, process tracing worked to affirm potential explanations whilst eliminating others after a thorough and even-handed analysis (Bennett 2008, p.705-7), allowing for assessment of how and why some ideas gain traction and triumph over others (Bennett 2008, p.717).

In relation to SRQ1, process tracing was used to find explanations to how and why certain key concepts such as price stability and central bank independence became the foundational ideas upon which EMU was constructed (TEU 1992, Art.105), why financial stability was initially overlooked at the EU-level (Issing 1999[a]; Papademos 2006), and why it has since become an overriding preoccupation (ECB 2011[b], p.83; Papademos 2009; Trichet 2010[a]). Because process tracing seeks to establish a causal chain of events that can be traced back through time, it was also particularly helpful when addressing SRQ2. Here, it allowed the causal mechanisms in regards to the way Spain and Germany dealt with the rise of market-based finance to be teased out, revealing the ideational and structural factors which explain differences in national financial regulations. Process tracing was therefore not only an invaluable first step in becoming familiar with the data and in searching for important themes and events which warranted further analysis (Collier 2011, p.824), but as an overarching approach in which different theories, concepts and methods could be accommodated and causal links established.

Process tracing also helped identify critical junctures, which are particularly important in HI analysis, and are said to establish starting points for many ‘path-dependent’ processes (Capoccia and Keleman 2007, p.348; Pierson 2004, p.135). The signing of the Maastricht Treaty (1992) marked one such juncture (Verdun 2007; 2015, p.231; Yiangou et al. 2013, p.225) as it set the course of EMU history by establishing monetarist ideas at the heart of the single currency (Heipertz and Verdun 2010, p.24; Jabko 2006, p.170). While it was initially assumed that the 2007-8 financial crisis represented a second critical juncture (Braun 2015, p.422; Verdun 2015, p.222), closer analysis revealed that it was in fact the ‘sovereign debt crisis’ (2010-12) – with the collapse of Bankia in May 2012 representing its apex – which should be regarded as Europe’s real critical juncture (Citibank 2012; Otero-Iglesias et al. 2016; Schmidt 2014, p.189). It was this period, rather than the initial crisis phase, which marked a fundamental shift in both the Spanish and European approaches to tackling financial instability.

3.4 Research Structure: Comparative Analysis

Why Spain and Germany?

Because the Eurosystem contains diverse economies and financial systems (Micossi 2015, p.9), and pertains at both the national and supranational levels, concentrating analysis at the EU-level alone would be inadequate to obtain a true picture of EMUs institutional transition. National authorities and central banks (NCBs) remain important institutions (Cohen-Setton 2011; Gros 2017; Quaglia 2008, p.3) and therefore warrant attention by scholars of European political economy[70]. This research seeks to uncover why Eurozone member-states adopted different approaches to financial stability prior to the 2007-8 crisis[71], the extent to which ideas and structures were responsible for the differential manor in which they were impacted by the crash, and why different levels of enthusiasm were exhibited by governments and NCBs towards European policies aimed at alleviating its effects[72] (Restoy 2012; Weidmann 2015).

Given this, and the benefits that may be obtained by using comparative study within a DI-HI framework (Hall 2003, p.397; Thelen 1999, p.374), analysis of two Eurozone countries were included in addition to EU-level analysis to generate more reliable results. This section underscores the reasons for choosing Spain and Germany for this detailed comparative component.

'Three-Pillar' Banking Structure

The two countries were chosen on the basis of a most-similar structural comparison (Anckar 2008; Esser and Vliegenthart 2017, p.6). Although Spain and Germany were impacted differently by the crisis, prior to this, their financial systems exhibited many structural likenesses. Both had 'three-pillar' banking systems (Bleuel 2009, p.2; Maudos and Vives 2017, p.567; Stefanelli 2010, p.24; Zimmermann 2014, p.487) consisting of large

[70] This is particularly true of Germany, whose ordo-liberal (*Ordnungspolitik*) ideas are said to have heavily influenced the structure of the Eurosystem (Howarth and Loedel 2005, p.53; Quaglia 2008, p.47-74).
[71] SRQ2.
[72] SRQ3.

international banks (which mainly relied on global markets for liquidity), regional public banks known as *cajas* (Spain) and *Landesbanken* and *Sparkassen* (Germany), as well as smaller cooperative sectors. The public banks in both countries were heavily politicised, both in the sense that regional governments often relied on them to fund local projects (IMF 2003, p.3; Johnson 1998, p.45; Royo 2013[c], p.25), and also in that many had representatives from political parties located within their corporate governance frameworks (Cardenas 2013, p.9; Simpson 2013, p.12; Tortella and García-Ruiz 2013, p.183).

The appendix includes a critical case study (Flyvbjerg 2006), of two of these public banks (CAM and BayernLB) to provide an illustration of the extent to which this politicisation had taken root by 2007. Many of these institutions provided large amounts of credit to their autonomous regions (*Comunidades Autónoma*, Spain) and Federal States (*Länder*, Germany) and had close relationships with local businesses and governments (IMF 2003, p.3; Santos 2014, p.19). Before the crisis, depositors in Spain and Germany maintained a larger proportion of their cash in public banks than in any other EU member-state (Smith 2001, p.127), revealing the particular importance of this sector to both countries.

Both systems were also principally supervised by their respective NCBs, which struggled to make significant reforms to their public banking sectors (Deutsche Bank 2004, p.6; Smith 2001, p.136). Post-2007, the majority of these institutions in both nations had to be bailed-out through government interventions, state funded mergers, emergency loans and recapitalisations, as well as helped kept afloat by Eurosystem Emergency Liquidity Assistance (ELA), Long-Term Refinance Operations (LTROs) and bond purchase programs. Such measures began with assistance provided by the German government to the state-owned IKB Deutsche Industriebank AG (IKB) in July 2007 and the Sachsen Landesbank takeover by Landesbank Baden-Württemberg (LBBW) the following month. Spanish *cajas* managed to weather the initial financial storm, but were heavily affected by the secondary sovereign debt crisis between 2010-12[73] (Howarth and Quaglia 2015; Otero-Iglesias et al., 2016).

Financial System Typologies

In order to justify the choice of Spain and Germany for comparative analysis in more detail, it is necessary to touch upon the literature surrounding typologies in Comparative Political Economy (CPE), and where Spain and Germany are located within this field of research. Financial system typologies distinguish between the corporate governance structures found in national financial institutions, the methods by which such institutions and businesses tend to obtain funding (Hardie et al. 2013, p.691), and the types of relationships they build with customers. For many scholars, the way a nation's financial system operates forms the epicentre of its particular 'variety of capitalism' (Hall and Soskice 2001) and is constitutive of the economy more broadly (Deeg 2010, p.309).

For a considerable period, the CPE work of reference on national financial systems was Zysman's *Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change* (1983), which distinguished between 'credit-based' and 'capital-market-based' financial systems (see Allen and Gale 2000; Deeg 2010; Hardie and Howarth 2013; Hardie et al. 2013). Over time, this conception evolved to divide financial systems into 'bank-based'

[73] To illustrate differences and similarities between the way Spanish and German banks were impacted by the crisis, another 'critical case study' (Baxter and Jack 2008) of two financial institutions, Bankia and HRE, is provided in chapter 6.

and ‘market-based’ systems (Hardie et al. 2013 p.692; Levine 2002; Vitols 2005, p.386). Financial institutions in bank-based systems are usually said to finance themselves in a traditional manner through customer deposits. Loans are not securitised but remain on balance sheet and are not hedged to offset potential losses in international markets (Hardie et al. 2013, p.707). Here, banks are the most important players in the financial system and are frequently involved in long-term relationships with corporate clients. This ‘relational banking’ or ‘patient capital’ structure allows banks to exercise influence in client firms through equity stakes and representation on company boards (Deeg 2010; Vitols 2005). This arrangement is said to support niche firms, allowing them to finance long-term investments and maintain market share. This bank-based, insider-controlled stakeholder corporate governance structure has traditionally been the mainstay of German corporate governance arrangements (Goyer 2007; Hackethal et.al. 2006, p.432; Vitols 2005, p.386). Although less is generally written about the Spanish financial system, it is also said to be characterized by strong strategic coordination (Royo 2013[a], p.632) and is frequently categorised as a predominantly bank-based system (Deeg and Posner 2016, p.441).

Market-based financial systems meanwhile are seen as a core element of more liberal economies, such as the United Stated (US) and Great Britain, where more attention is paid to market signals through price fluctuations (Goyer 2007, p.200; Hardie et.al 2013, p.3). Financial institutions depend much more heavily on wholesale markets and securities for funding. The ownership of firms tends to be floated and dispersed between various share-holders, and contractual rather than relational banking tends to dominate.

Nonetheless, the encroachment of the market into bank-based systems following the liberalisation of international financial markets has led many to question the continued expediency of the bank-market dichotomy (Hardie et al. 2013, p.695). In traditional bank-based models, commercial banks make loans to customers, keep those loans on their balance sheets, make a profit on the interest they charge, and finance lending with customer deposits (Pozsar 2009, p.13). Yet this model no longer holds for most advanced economies with almost all financial systems containing at least some elements of market-based financing. Lending decisions have become at least partly driven by the banks own creditworthiness and ability to borrow money in the wholesale markets, undermining long-term relational banking (Hardie et.al. 2013, p.696).

Deeg (2010) argues many banks have sold their long-term equity stakes to free up capital to invest in more profitable ventures (Deeg 2010, p.8). Larger firms in particular have begun accessing external financing by issuing securities, and there is much evidence that as banks retreat in the wake of the financial crisis, 'shadow banks' appear to be taking on a growing share of lending to small- and medium-sized enterprises (SMEs) (McBride 2014). Even in Germany, the number of capital market-based financing options available to SMEs are steadily increasing (Sandvoss 2007, p.2).

In Spain and Germany, both the form and functioning of their respective financial systems on the lead up to the crisis increasingly adhered to market imperatives (Hardie and Howarth 2013[b], p.109; Royo 2013[b], p.155), making the distinction between market and bank-based systems less useful (Dixon 2012, p.585). Indeed, Deeg (2010) and Hardie et al. (2013) argue that the literature is moving away from trying to categorise national financial systems and is instead looking towards micro-level analysis of individual financial institutions. Nevertheless, although the categories may now be blurred, comparative typologies remain helpful for depicting a conceptual frame for seeking to understand the general structure of national financial systems, and particularly for identifying hybrid arrangements combining features of both. It is commonly accepted that within this context, both Spain and Germany represent bank-based financial systems (Deeg and Posner 2016, p.441; Royo 2013[a], p.632; Vitols 2005, p.386) and that although financial marketisation became more important in both states before the crisis, it is not clear market imperatives loomed larger in one over the other. The literature therefore suggests that given how differently the crisis affected the two countries, explanations other than financial system typologies may hold the key to understanding this divergence.

As touched upon in the previous chapter, the central banks and finance ministries of Spain and Germany exhibited different ideas at all three levels of abstraction. Spanish and German institutions are understood to exhibit different philosophical ideas (neo- versus ordo-liberalism), programmatic ideas (different interpretations of monetarism) and policy ideas (intervention versus non-intervention in financial stability policy)[74] (Schmidt 2014). Comparison of these two nations could therefore reveal the importance of ideas in facilitating institutional change and continuity under EMU. Both states were not only affected differently by the crisis, but adopted very different positions on post-crisis attempts by the EU to improve financial stability; particularly with regards to the European Stability Mechanism (ESM), 'extraordinary' ECB monetary policy and the creation of BU (BdE 2012, p.12; Brunnermeier et al. 2016, p.218; Linde 2013; Münchau 2016). The German financial

[74] See table 2.5.

system also proved more resilient to change than its Spanish counterpart (particularly from 2012 onwards) despite both systems continuing to be classified within the literature as 'bank-based' (Deeg and Posner 2016, p.441; Quaglia and Royo 2015, p.488).

3.5 Applied Methods

Having outlined the theoretical and methodological frameworks[75], and having described the structure the thesis assumed[76], the following section describes the applied methods that were used to conduct this study and how the research was directed from a practical perspective.

Data Triangulation

Within process tracing, the selection of text and data marks a crucial step in the research process (Reisigl 2017, p.54), with data triangulation seen as critical to facilitate balanced research (Meyer 2001, p.30; Wodak 2001[b], p.65). 'Triangulation' is a term derived from a navigation strategy that uses multiple points of reference to plot more accurately an object's exact location (Jick 1979, p.602). Stemming from the work of Denzin (1978), there are generally said to be four different types of triangulation: theoretical, data (Decrop 1999, p.159), investigator (Mathison 1988, p.14), and methodological (Downward and Mearman

[75] Historical and Discursive Institutionalism combined with process tracing.
[76] A comparative analysis of the European level, Spain and Germany.

2007, p.83). This research however only used one, data triangulation, to ensure construct validity[77] (Yin 2003, p.100).

Data triangulation involves the use of different sources of data within one study, and by incorporating both primary and secondary data within one project (Decrop 1999, p.159). In this way, construct validity is achieved by preventing one specific type of data enacting overdue significance on the conclusions of the research. In order to understand and evaluate the importance of history, structure and ideational factors on the decision-making apparatus of the Eurosystem, numerous sources of secondary data were required to ensure as comprehensive and as thorough analysis as possible (Yin 2003, p.100). These data sources included speeches by leading politicians and central bankers, secondary elite interviews, and articles written by EU officials[78], national political figures and central bankers.

The ECB, Commission, DB and BdE also produce official documents which are readily available to view online. The ECB publishes a regular *Monthly Bulletin*[79], working papers, occasional papers, research papers and a bi-annual *Financial Stability Review* (from 2004 onwards). The DB and BdE likewise issue similar material which was particularly important in helping to track institutional opinion on policy proposals. The Commission too circulates economic papers and policy documents, and all these organisations maintain readily assessable and extensive English language material on their websites.

[77] Correlating inferences with a number of measures or data points so as to ensure that the pattern of correlations is accurate (Westen and Rosenthal 2003).
[78] Particularly those who have been involved in the higher echelons of the ECB and EU Commission.
[79] Re-named the *Economic Bulletin*, January 2015.

Some of the most important secondary data sources proved to be: ECB, DB and BdE board member speeches; secondary ECB, DB and BdE interviews, and; speeches given by German and Spanish Finance and Economy Ministers. From this material it was possible to track discursive changes within the Eurozone and to follow how attitudes, ideas, justifications and policies evolved through time (Claeys et al. 2014, p.7). The resources of the Bank for International Settlements (BIS) were particularly useful as it maintains a comprehensive set of transcripts from central bank speeches on its website dating as far back as March 1997. Similarly, DB Annual Reports (*Geschäftsbericht*) and Financial Stability Reviews (*Finanzstabilitätsberichte*), BdE Annual Reviews (*Informe Annual*) and Financial Stability Reviews (*Estabilidad Financiera*) and ECB *Financial Stability Reviews* and *EU Banking Sector Stability* reports were especially helpful[80].

Generating Primary Data - Qualitative Elite Interviewing

Both DI and HI accept that institutions help formalise ideas and discourses (Capoccia 2016; Schmidt 2010, p.3; Titscher et al. 2000, p.174). To try to understand how ideas are formed within institutional contexts, large scale quantitative questionnaires would have provided insufficient depth into the thought processes and structural factors which influence human behaviour. Surveys and structured interviews are generally judged ill-equipped to provide a nuanced enough understanding of the perceptions individuals hold and the trade-offs they are willing to make to advanced their goals (Steinmo 2016, p.109; Vromen 2010).

Due to the nature of the questions this research aims to answer, the usual criticisms of qualitative interviews: that they lack objectivity and are ill-suited to generalise from (Kvale

[80] Analysis of these specific publications can be found in chapters 4 and 5.

1994), hold little water. Indeed, a quantitative approach to an ideational and subjective area of research would have been wholly inappropriate. Therefore although a great deal of care needed to be taken to prevent interviewer bias and to avoid the subjective preferences of the researcher seeping into the analysis of interview data (Boyatzis 1998, p.35), this study generated primary data through the conducting of qualitative 'semi-structured' interviews with relevant participants.

Whilst it has been argued that fully structured and/or unstructured interviews are ultimately impossible to attain as each contains some degree of structure in order to abstract information and some degree of judgment when considering which questions to ask (Mason 2004, p.62), the approach to interviewing adopted for this project took a more qualitative line. A list of open-ended questions specific to each institution (see appendix III) were constructed based on previous research into the structural and ideational importance of factors which may influence institutional continuity and change. Time was then given to allow respondents to talk through and describe events and processes in their own time, as they saw fit. A total of 19 interviews were conducted, 17 of which were one-on-one, with two containing two participants. Three participants had worked at two of the institutions under investigation, allowing them to discuss aspects of both. The average length of time given for each interview stood at 1 hour and 3 minutes, with the shortest being 32 minutes and the longest 1 hour 45 minutes. Further details are laid out in table 3.1 below.

This thematic, biographical approach is similar to what Burgess (1988) describes as 'conversations with a purpose', containing a fluid and adaptable structure (Mason 2004, p.62). This method sits well within the ontological and epistemological positions of DI and

Table 3.1: Primary Qualitative Interview Sample

Institution	Department	Number of Participants	Position	Interview Number
ECB	Monetary Policy	3	Senior Economist	1
			Economist	2
			Economist	3
	Financial Stability	1	Economist	4
	SSM	1	Economist	1
DB	Financial Stability	1	Head of Division	5
	Monetary Policy	0		N/A
BdE	Research Department	4	Head of Division	6
			Economist	7
			Economist	8
			Economist	9
	Financial Stability	0		N/A
	Financial Stability and Resolution	1	Senior Economist	10
German Economics Ministry		1	Deputy Head of Division	11
German Finance Ministry	European Economic and Monetary Affairs	1	Head of Division	12
Bundestag	Finance Committee Secretariat	1	Senior Officer	13
	Budget Committee Secretariat	1	Senior Officer	13
Spanish Foreign Office	European Union	1	Head of Division	14
Spanish Economics Ministry	Macroeconomic Analysis and European Affairs	1	Senior Economic Advisor	15
Spanish Treasury		2	Chief of Staff	16
			Chief of Staff	16
Commission	DG ECFIN	3	Head of Division	17
			Economist	2
			Economist	3
	DG FISMA	1	Head of Division	18
European Parliament	Committee on Economic and Monetary Affairs (UK)	1	MEP	19
	Total:	24(19)		

Source: Author (2018)

HI, allowing individuals within institutions to express their views organically, in their own words and at their own pace (Wood and Kroger 2000, p.72). Through such open-ended accounts, researchers can gain information about the discursive deliberations that accompany decision-making, and supplement official data with first-hand authentication (Tansey 2007, p.767).

Although some of the information required for this research may have been obtained without interviewing, for example, through the qualitative thematic analysis of secondary speeches, interview transcripts and articles authored by relevant officials (See Rosenhek 2013, p.256), interviewing added a valuable additional layer and further depth to the data (Lilleker 2003, p.208). It also helped provide context and improved understanding of people's motivations (Schonhardt-Bailey 2013, p.450). Despite some of the methodological and practical issues surrounding elite interviewing, it is often the most effective way to determine how subjective factors influence political and economic decision-making, and for understanding the incentives and preferences of actors (Berry 2002, p.682; Rathbun 2008, p.686-90).

Qualitative Interview Sampling

Taken originally from Grounded Theory[81], 'theoretical' sampling dictates that researchers come to the study of a phenomenon with some pre-conceptions and prior knowledge of specific groups and/or institutions. Based on this knowledge, the researcher selects certain groups or individuals which are most likely to be able to assist with the project (Corbin and

[81] A research approach which enables researchers to seek out and conceptualise latent social patterns and structures through the process of constant comparison (Scott 2009).

Strauss 1990, p.420). The aim is not to be representative *per se*, but to speak to as many people as deemed necessary to provide enhanced insight.

One of the main sampling issues in conducting research of this nature is gaining access to relevant individuals who can add intuition to the field of investigation. Elite access can be a major sampling problem (Goldstein 2002, p.669), particularly when such individuals would ideally include former Presidents of the EU Commission, ECB, NCBs and government ministers. Nonetheless, this problem may be overcome by considering the 'wider universe' of the research. Within the scope of this project, all financial institutions of the EU (ECB - including the SSM[82] - DG-ECFIN[83], FISMA[84], ECOFIN[85] and the Eurogroup[86]), government economics and finance ministries, representatives of political parties, and commercial financial institutions may be considered useful interview respondents. This provides a potentially very large sampling frame.

Although high-profile individuals who currently occupy senior positions within the EU and national governments are unlikely to have the time to participate in research of this nature, such actors often give interviews to quality newspaper and media titles, speeches at events and press conferences, as well as publish their own articles and blogs (see Buti 2014; Schäuble 2011[a]). A relatively thorough understanding of their theoretical and practical positions can therefore be obtained through such secondary sources. Due to the salient and topical nature of financial instability in Europe and the response of institutions like the ECB

[82] Single Supervisory Mechanism.
[83] Directorate-General for Economic and Financial Affairs.
[84] The Directorate-General for Financial Stability, Financial Services and Capital Markets Union.
[85] Economic and Financial Affairs configuration of the European Council.
[86] Economic and Financial Affairs configuration of the European Council consisting only of Euro member-states.

to enhance their public communication strategies (Draghi 2014[a]), there is a great deal of elite discourse readily available in the public domain.

Individuals lower down the chain of command meanwhile, for which there is less attributable literature, can often provide valuable insights into the everyday functioning of institutions. Such persons offer specific knowledge of various departments within organisations that those at the top may be less able to provide. Seeking respondents who can convey knowledge of different institutional functions help improve the depth of research and add value to the sample of informants (Weiss 1995, p.17). Each respondent was therefore chosen on the basis that there was a likelihood of new information coming to light, with the aim to cover all relevant departments within the organisations under study to generate a holistic picture of the institutions in question.

However, the issue of respondents not necessarily being entirely honest with the interviewer is a problem for qualitative interviewing (Berry 2002, p.680). Interviewees may try to present themselves or their organisation in an overly positive light, or convey a creative version of events which fits with their own interpretations, but does not necessarily align with observed empirical facts (Ball 1994, p.97–98). Those involved within the higher strata of institutions are also under intense pressure to speak ‘on-message’ and may therefore be less able to give as detailed answers as desirable, skewing potential results. Likewise, such individuals could also be concerned about their historical legacies and public perceptions, which may mean their reconstruction of events contain strategic omissions or increased emphasis on certain aspects (Berry 2002, p.680; Rathbun 2008, p.689). Talking to people who do some of the more ‘hands-on’ work therefore, and who have lower public profiles, may even provide more insightful acumens than those at the top. Homan (1991) and Ostrander (1995) have also suggested that less influential people may be less skilled at deflecting questions and hence more likely to answer truthfully[87].

Within this research therefore, as is the case with the majority of political research, elite interviewing tends to involve less well known participants with ‘close proximity to power’ (Lilleker 2003, p.207), partly due to issues surrounding access (Goldstein 2002, p.669), but also because they may be more likely to answer honestly and have less reason to by coy about institutional failures or setbacks (Homan 1991; Ostrander 1995; Rathbun 2008, p.689). Sampling for primary interviews within this project therefore did not rely on obtaining the ‘big names’ within European institutions, but instead tried to ensure a wide range of relevant organisations were represented. Interviews were also conducted anonymously, with direct quotations left unnamed to ensure respondent confidentiality. This knowledge provided interviewees with more confidence to speak freely about their experiences without fear of any backlash.

In terms of size, qualitative samples must be large enough to guarantee that most, if not all, important ideas and concepts under investigation are uncovered and discussed by the sample (Mason 2010, p.2). But equally, if the sample is too large, the data produced may become repetitive and eventually, superfluous. When data collection reaches this point of ‘saturation’ (Glaser and Strauss 1967) and new data fails to add any additional depth, no further interviews are necessary. Rather than representing a population then, the aim of

[87] Interview subjectivity can also be reduced by honing interview techniques. For example, asking respondents to critique their own case by asking them to outline an alternative point of view, or by moving to different questions should the interviewee fail to deviate from ‘the party line’ (Berry 2002, p.680).

generating primary data was to improve understanding of the complexities of EU and national institutions, the relationships between them, and the process of change which has unfolded throughout the history of the Eurozone. A strategic and illustrative approach is therefore preferable to any attempt to be representational (Mason 2004, p.135; Tansey 2007, p.771).

Critical Discourse Analysis

The transcripts of primary interviews and secondary sources were analysed using process tracing, in conjunction with Critical Discourse Analysis (CDA). CDA contains some key assumptions. It assumes that to understand institutions and institutional change, it is necessary to study their discourses and examine justifications for action (Fairclough 2010, p.349). It presumes that discourses are inherently ideological (Jones 2012, p.15) because institutional structures are legitimated by the ideologies of powerful groups which are expressed as written and verbal communications (Fairclough 2010, p.58; Reisigl and Wodak 2009, p.88; Wodak 2001[a], p.3). It therefore sees language as a social phenomenon that contains meaning and value that is detectable through the study of context-specific discourse (Fairclough 2010, p.272; van Dijk 2008, p.5).

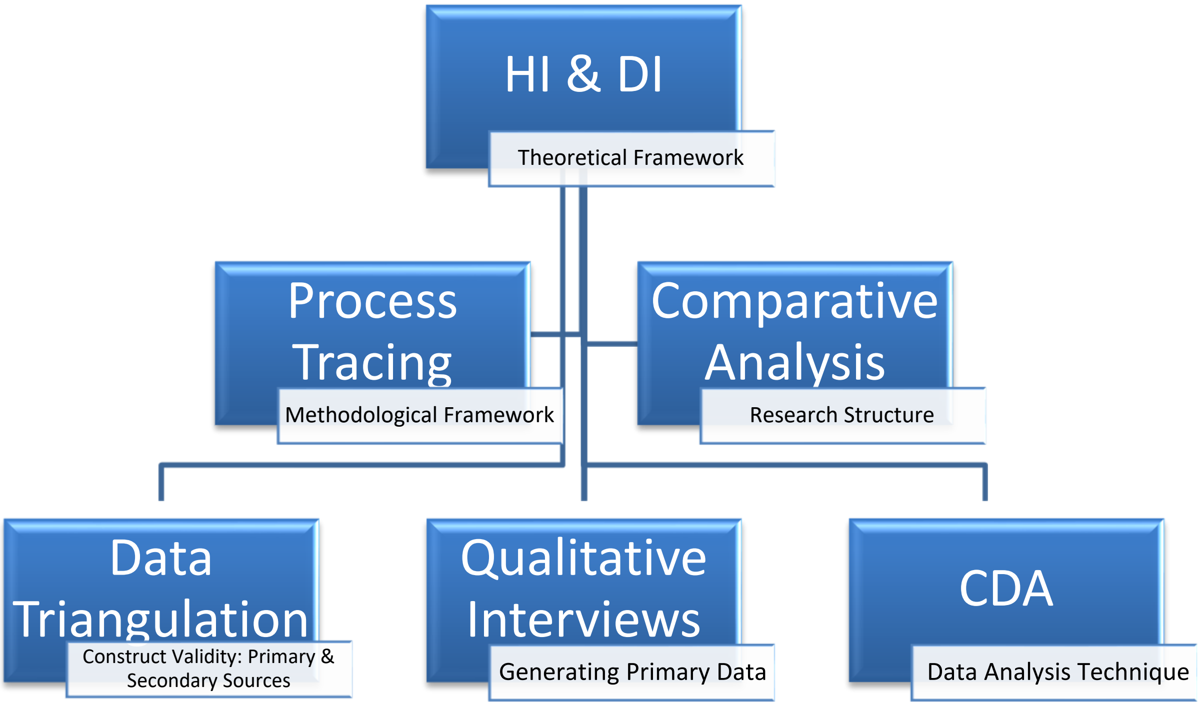
The concept of 'interdiscursivity' is used within CDA to denote a discursive event in which two sets of ideas are expressed (Fairclough 2010, p.95; Wodak 2001[b]). CDA is therefore able to detect the point at which one hegemonic idea becomes challenged or starts to be replaced by another. Moreover, readers and listeners are not regarded as passive recipients of discourse. Individual actions and ideas are said to be influenced by language (Wodak 2001[a]), helping to explain institutional change.

Although CDA does not view discourse as powerful on its own, it does see it as a means of gaining and maintaining power (Reisigl and Wodak 2009, p.88). CDA therefore often tends to focus on mass-media coverage and power relations between ruling elites and the wider population (Meyer 2001, p.24). While mass-media is not the focus of this research, central bank communication has much in common as it aims to influence markets, decision-makers, and wider populations (Draghi 2014[b]). Moreover, central banks have increased the frequency and transparency of their communications in recent years (Hughes and Kesting 2014, p.329; Schonhardt-Bailey 2013, p.395), allowing for the possibility of more in-depth research using CDA.

CDA also tends to use mid-range theories such as DI and HI to serve the analytical aims of its research while using grand theories such as Marxism to act as the ideological foundation (Fairclough 2010, p.282; Wodak 2001[b]). Indeed, the 'critical' component of CDA is sometimes interpreted as a Marxist social critique (Reisigl 2017, p.50). Others meanwhile understand the 'critical' aspect of CDA as simply maintaining distance from data by preserving a focus on continuous self-reflection while undertaking research (Reisigl and Wodak 2009, 87). This latter interpretation is the understanding this thesis applies to CDA. While this study combined insights from DI and HI to serve as the analytical lenses, it is not grounded in a meta-theory. Because it does not aim to explore power relations or inequalities between countries or peoples, or to take any moral position on the suitability or otherwise of certain policies or ideas, no such overarching theory was considered necessary.

The intention is not to judge the merits or de-merits of European institutions or policies, but simply to attest to the importance of ideas and structures during their formation.

Figure 3.1: Methodological matrix



Source: Author (2018**)**

3.6 Conclusion

This chapter began by outlining the specific research questions this thesis poses. To address these questions, and to attest to the significance of ideas and structures in determining institutional change, HI and DI were chosen to establish the overarching theoretical framework. To ensure epistemological coherence, the chapter examined which research methods tend to dominate in existing DI and HI studies. It confirmed that the majority of scholars in these fields find the most effective methods for helping to understand structural, historical and ideational change are process tracing, comparative analysis and qualitative interviews. Each of these techniques aim to find causality between structures, ideas and events, and to reveal how ideas are tied to action (Hay 2011, p.79; Parsons 2011, p.135; Schmidt 2008, p.308).

The chapter demonstrated that adopting process tracing as the principal methodological framework has strong epistemological backing and robust peer precedent (Berman 2011; Hay 2011; Parsons 2011; Saurugger 2013). By conducting in-depth historical analysis and producing thick descriptions of key events and ideas, process tracing can help uncover the structural and ideational causal mechanisms at play throughout institutional transition. At the national level, this endeavour was assisted by the adoption of comparative analysis and the selection of a most-similar structural comparison between Spain and Germany (Anckar 2008; Esser and Vliegenthart 2017, p.6). These countries were chosen because despite their structural similarities (Deeg and Posner 2016, p.441; Royo 2013[a], p.632; Vitols 2005, p.386), each financial system adapted differently to the onset of market-based banking, were impacted differently by the 2007-8 financial crisis, and subsequently pursued different objectives at the EU-level in response to the crash. By comparing these two nations, it was considered possible to explore the institutional and ideational factors which best account for this differentiation.

With regards to the applied methods this research adopted, data triangulation was shown to provide greater construct validity by making use of a number of different sources and data types (Meyer 2001, p.30; Wodak 2001[b], p.65; Yin 2003, p.100). This helped ensure no one set of information could dominate analysis and skew results. The inclusion of primary elite interview was also deemed imperative to uncover further in-depth ideational, discursive, attitudinal and practical changes within the institutions under investigation (Rathbun 2008, P.686-90; Schonhardt-Bailey 2013, p.450). Semi-structured qualitative interviews which allow respondents to discuss and elaborate on matters they considered of importance were reasoned the most empirical method for gathering primary data in relation to ideas and the internal workings of relevant institutions (Berry 2002, p.682).

Finally, CDA was used in conjunction with process tracing to analyse primary and secondary data in an attempt to detect ideational and structural causation through language and text (Fairclough 2010, p.58; Reisigl and Wodak 2009, p.88; Wodak 2001[a], p.3). Using these methodologies and applied methods, the thesis now moves on to explore the evolution of Europe's pre-crisis financial stability agenda, beginning at the national level with a comparative analysis of Spain and Germany.

Chapter 4
Pre-Crisis National Financial Systems

Why did German and Spanish financial institutions react differently to the advent of market-based banking and the creation of EMU?

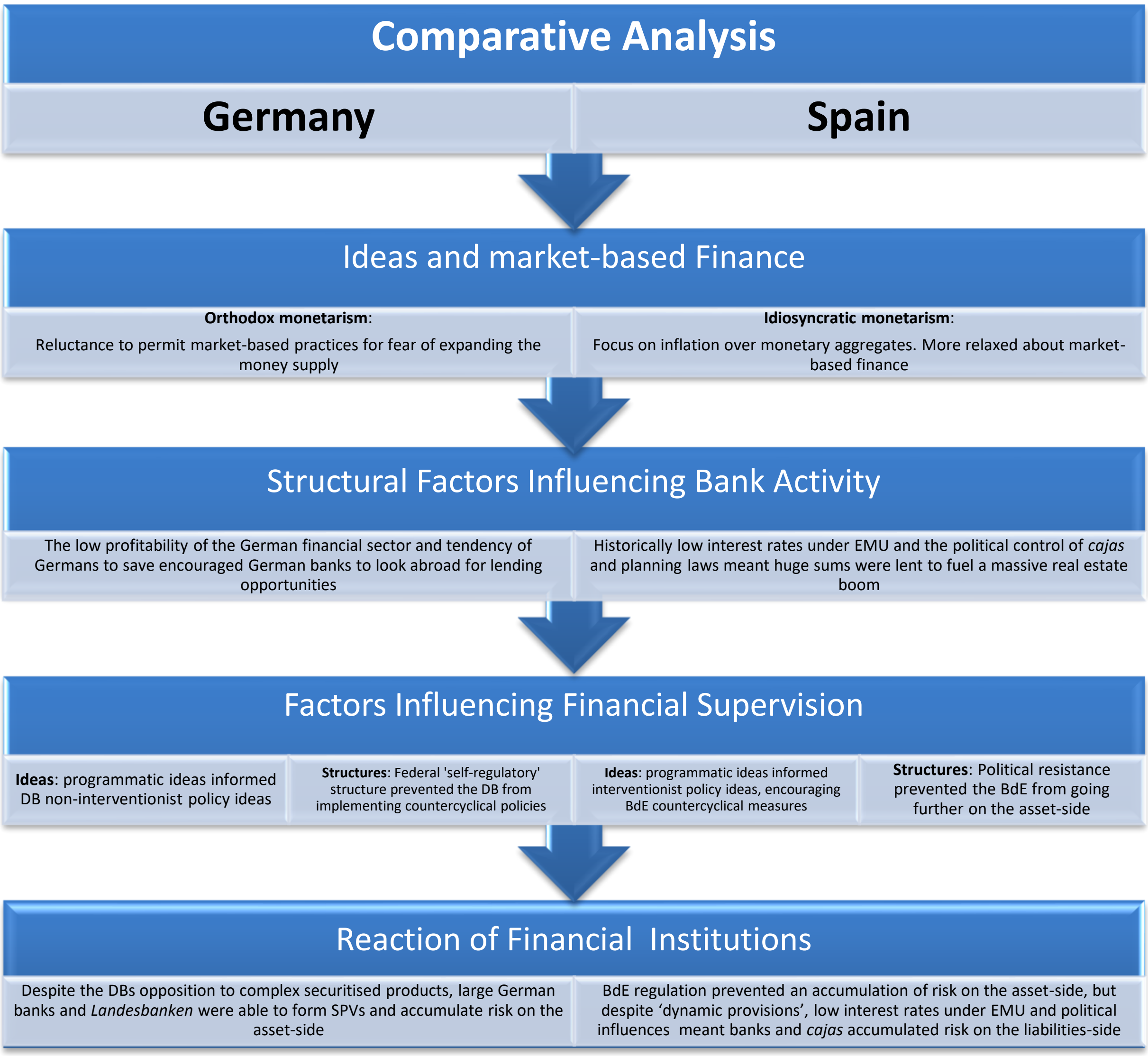
Previous studies have made important discoveries in relation to *how* Economic and Monetary Union (EMU) member-states were shaped by the growth of market-based finance and *how* the differing extent of their marketization influenced the degree to which they were impacted by the crisis (Hardie et al. 2013; Howarth and Quaglia 2015; Röper 2017). In Spain and Germany, variances were shown to have materialised amid their financial institutions composition of risk, with German banks exposed on the asset-side and Spanish banks on the liabilities-side of their balance sheets (Hardie and Howarth 2013[a], p.104; Royo 2013[a], p.154). By using Historical (HI) and Discursive Institutionalism (DI), this research goes further by revealing how institutional ideas and structures explain *why* these differences materialised. The chapter shows *why* ideationally idiosyncratic national central banks (NCBs) supervised financial institutions in the manner they did, and *why* this led to different practices becoming adopted across the Eurosystem.

From the 1970s until the 2007-8 crisis, European financial markets underwent a period of sustained liberalisation and 'marketisation'. Yet while securities markets became global pre-2008, their regulation and prudential treatment remained national - even within the

Eurosystem (Thiemann 2012, p.40). This chapter examines the interplay between ideas and structures in Spain and Germany, arguing specifically that important ideational differences between the countries NCBs, the *Deutsche Bundesbank* (DB) and *Banco de España* (BdE) – both prior to and during EMU – were crucial in determining how the two financial systems adjusted to the acceleration of market-based practices, prepared for EMU, and adapted to life under the euro. These differences, coupled with structural specificities, ultimately explain why Spain and Germany were impacted differently by the crisis, and why they subsequently pursued different policy priorities at the EU-level in its aftermath.

Figure 4.1 below illustrates the thrust of the argument. Before EMU, different interpretations of monetarism led to different DB and BdE attitudes towards monetary policy and the role market-based finance (Covil 1996; Gabor 2016, p.977; Pellicer 1995, p.36). Once EMU was established, structural factors with regards to the impact the single monetary policy had on the two countries (coupled with the low profitability of the Germany system [Commission (2014[c], p.40; Hardie and Howarth 2009, p.1019] and Spanish political links between politicians and public banks [Molinas 2013]), lead to financial institutions in each state adopting different market-based practices. Dissimilar DB and BdE supervisory policy ideas – resulting from their particular interpretations of monetarism – also influenced the behaviour of Spanish and Germany banks in different ways, with the BdE assuming interventionist policies and the DB espousing a more 'hands-off' approach.

Figure 4.1: Why German and Spanish banks reacted differently to pre-crisis trends



Source: Author (2018)

Using process tracing and thick historical descriptions (Hall 2003, p.393), the chapter begins by analysing the evolution of the German financial system, exploring how important ideas and structures were in shaping DB attitudes towards liberalisation and financial stability. Specifically, it focuses on interbank repo markets, securitisation and counter-cyclical regulatory practices as these factors are crucial to understanding the mechanics of market-based finance. The following section focuses more explicitly on the structure of the German system: Looking in detail at the large and politically sensitive public banking sector. It uses insights from HI and DI to reveal that ideas, as well as concepts such as path-dependence and vested interests, are vital to elucidating German financial trends. The third section examines the evolution of the Spanish financial system and its adaptation to market-based practices. Again looking principally at the interbank repo markets, securitisation and counter-cyclical regulatory measures, it uses HI and DI to explore the role of ideas and structures in determining BdE regulatory and supervisory policies. The penultimate section evaluates Spain's large and historically significant public banking sector and its resistance to regulatory reform efforts. The final segment draws to a conclusion.

4.1: Liberalisation and Financial Supervision in Germany

Ordo-liberalism (*Ordnungspolitik*) has constituted the dominant philosophical idea within the DB and wider German policy circles since the end of the Second World War (Dyson 2002[c], p.174; Matthijs 2016). As chapter 2 underscored, its main features are that it seeks to establish a strong, rule-based framework, but beyond this advises against state intervention and micro-management (Siems and Schnyder 2014, p.379). It also attaches a great deal of importance to price stability and the containment of monetary aggregates by an independent central bank[88] in order to still confidence in the German currency (the *Deutsche Mark*) and anchor market expectations of a stable financial environment.

[88] Independence was critical as it allowed central banks to inhibit money supply by growth by increasing interest rates in the event of excessive private sector borrowing or government spending (DB 2012[a]).

Long before monetarism became accepted as the consensus economic view, this stability orientated position, informed by ordo-liberalism (*Ordnungspolitik*), represented the programmatic idea behind DB monetary policy (Garber 1993, p.463; McNamara 1998; Schmidt 2014). Although such ideas were often challenged by social-democratic governments[89] (Allen 1990, p.16; Childs 1994), the relative success of German monetarist polices were widely regarded as one of the key factors explaining the rise of monetarism throughout the late twentieth century (Howarth and Loedel 2005, p.15; Kaelberer 2003, p.369; McNamara 1998, p.157). These ideas, which rejected Keynesian notions of establishing countercyclical economic or financial policies (Bibow 2017; Economist 2015), fed through to produce non-interventionist policy ideas in relation to financial stability as it was feared moral hazard may be produced if interventions created inflationary effects (Dyson and Marcussen 2009, p.141). While the DB sought to construct a sound financial framework, it established what may be termed a 'bottom-up' supervisory structure, taking its regulatory cues from financial institutions themselves through the various German Banking Associations[90].

Importantly, despite the global shift towards market-based banking, it remained sceptical of short-term finance (Trampusch 2015, p.122) and hostile towards intermediary structures such as hedge funds and complex risk-transfer products which were seen to distort market discipline and operate exogenously to traditional supervisory regimes (DB 1999[b], p.29;

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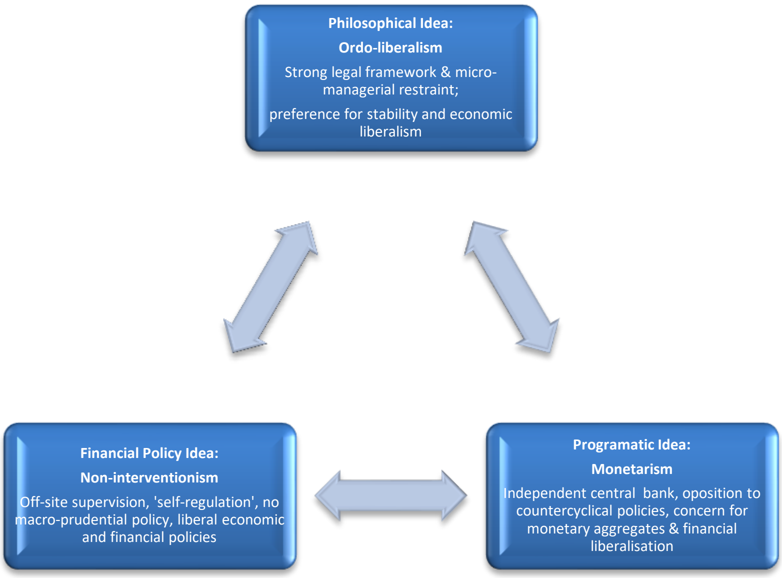
[89] Karl Schiller, Social Democratic Party (SDP) Federal Economics Minister (1966-72), was particularly important in this regard. During the 1960s and 1970 he attempted to promote Keynesian economic policies with the slogan, 'As much competition as possible, as much planning as necessary' (Childs 1990). Schiller was also responsible for creating the Council of Experts (*Sachverstdndigenrat*), known as 'the Wise Men' in 1963.

[90] The National Association of German Cooperative Banks (*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken*, BVR), the Association of German Banks (*Bundesverband deutscher Banken*) and the German Savings Banks Association (*Deutscher Sparkassen und Giroverband*, DSGV).

2004[c], p.40; 2005[a], p.48). The diagram below illustrates the interplay between these three levels of ideas (Schmidt 2008; 2014) and how they relate to German finance. These ideational characteristics are essential in explaining how the DB reacted to and facilitated financial liberalisation, and the attitude it adopted towards the supervision of its financial sector.

Figure 4.2: German financial ideas



Source: Author (2018)

MONETARY POLICY AND THE GROWTH OF MARKET-BASED FINANCE

For Germany, throughout the 1980s and 1990s, domestic liberalisation came partly in response to external forces in the shape of European Community (EC) competition policy pressed from member-states like Britain and adopted by the Commission (Helleiner 1995; Jabko 1999). But it also enabled advocates of reform within the country to drive forward liberalising measures, which were then pursued at the European level (Jabko 2006, p.64; Lütz 2005, p.141).

The DB and Federal Ministries of Finance and Economy all ascribed to ordo-liberalism (*Ordnungspolitik*). The Commissions' neo-liberal ideas, although distinct, in many ways coalesced with traditional ordo-liberal concepts (see table 2.5). This gave new impetus towards a significant relaxation of previous customs in other areas of the economy too, such as collective wage bargaining and corporate governance rules (Streeck 2009, p.33). The philosophical closeness between German ordo- and European neo-liberal thought is crucial to explaining why Germany agreed to move in a more liberal direction (Jabko 2006, p.20), demonstrating the importance of ideational factors in enabling institutional change.

Table 4.1 below outlines some of the key steps Germany took towards liberalising its financial system after publication of the Delors Report (1989) which confirmed the ECs intention to proceed with EMU[91]. The euro was expected to bring increased competition between members, especially in the finance sector. This led commercial banks in particular to press for enhanced regulatory liberalisation (Gabor 2016, p.977; Röper 2017, p.10), and for the Ministry of Finance (Trampusch 2015, p.120) and DB (DB 2004[a], p.47) to take steps to ensure Germany remained a viable financial centre. Such concerns pressed the government to introduce four Financial Market Promotion Acts (*Finanzmarktförderungsgesetz*), a Financial Market Promotion Plan (*Finanzmarktförderplan*) and a series of Tax Acts which eliminated price fixing, permitted the operation of hedge funds (2003) and brought German tax rules into line with foreign practices.

[91] The Report recommended a three-stage approach to establishing the single currency, with stage one beginning on the 1st July 1990.

Table 4.1: Important statutory financial liberalisation in Germany

1990 First Financial Market Promotion Act (Erstes Finanzmarktförderungsgesetz)	**1995** Second Financial Market Promotion Act (Zweites Finanzmarktförderungsgesetz)
• Stock exchange turnover tax abolished (from 1 January 1991) • Capital duty and stamp duty abolished (from 1 January 1992) • Financial futures contracts and trading in equity and bond options authorised • Permission to hold liquidity in certain money market instruments • Limited- term bond funds authorised	• Federal Supervisory Office for Securities Trading (Bundesaufsichtsamt für den Wertpapierhandel) established • Regulations on insider trading • Asset management companies allowed to invest in money market funds and engage in securities lending
1998 Third Financial Market Promotion Act (Drittes Finanzmarktförderungsgesetz)	**2002** Fourth Financial Market Promotion Act (Viertes Finanzmarktförderungsgesetz)
• New types of funds authorised[92] • Limited- term equity funds and equity index funds authorised • Investment opportunities in derivatives (up to 49% of contractual investment funds) • Investor protection and supervisory toolkit improved	• Capital gains from sales of shares in incorporated enterprises exempted from tax
2000 & 2003 Tax Acts	**2004** Financial Market Promotion Plan (*Finanzmarktförderplan*)
• Tax Reduction Act (*Steuersenkungsgesetz*, 2000): Official price fixing abolished • Investment Tax Act (*Investmentgesetz*, 2003): differences between foreign and domestic tax arrangements eliminated • Investment Modernisation Act, (*Investmentmodernisierungsgesetz*, 2003): Permitted hedge funds to operate, if they complied with rules concerning risk diversification	• Measures affecting asset management companies: capital requirements eased[93] • Unlimited scope to invest in derivatives

Source: DB (2015[c])

However, as an institution with strong monetarist programmatic ideas, the DB, unlike the Federal Finance Ministry, was initially sceptical about short-term market-based finance and deregulating interbank lending markets (Gabor 2016, p.978; Trampusch 2015, p.122). It worried that if banks abandoned the uncollateralised open-market liquidity operations[94]

[92] Pension-based contractual investment funds, mixed securities and property-based contractual investment funds and closed-ended funds in the legal form of a public limited company (investment stock corporations) were authorised for the first time.
[93] Maximum of €10 million in capital required (initial capital and additional own funds), regardless of contractual investment fund size.
[94] The purchasing of eligible paper from banks in exchange for reserves (DB 1991, p.101). Although open-market operations were the DBs main liquidity tool, it should also be noted that the bank did permit 'Lombard loans': short-term, relatively expensive collateralised loans to banks, under certain circumstances, as well as *Pensionsgeschäfte* and *Schnelltender* repurchase operations from 1985 to try to steer very short-term interest rates (Hardy 1998, p.649).

through which it conducted monetary policy, it would be much harder to control the money supply. Because the DB used monetary policy to target a specific monetary aggregate[95] (M3 from 1988), encouraging interbank repo transactions[96] and commercial paper markets[97] would have made this task more difficult (Covil 1996; Gabor 2016, p.977). It therefore employed restrictions on interbank repos by introducing a reserve requirement[98], and kept the Federal Finance Ministry from issuing short-term Treasury Bills (Gabor 2016, p.977; McCauley 1999, p.4). Such activity provides an example of outcome F as depicted in the ideational versus structural matrix, table 2.2 (chapter 2):

German market-based finance before EMU:
F) established ideas in old institutions -> sluggish policy change
Orthodox monetarist programmatic ideas established DB aversion to short-term finance and hindered financial liberalisation. Illustration 4.1

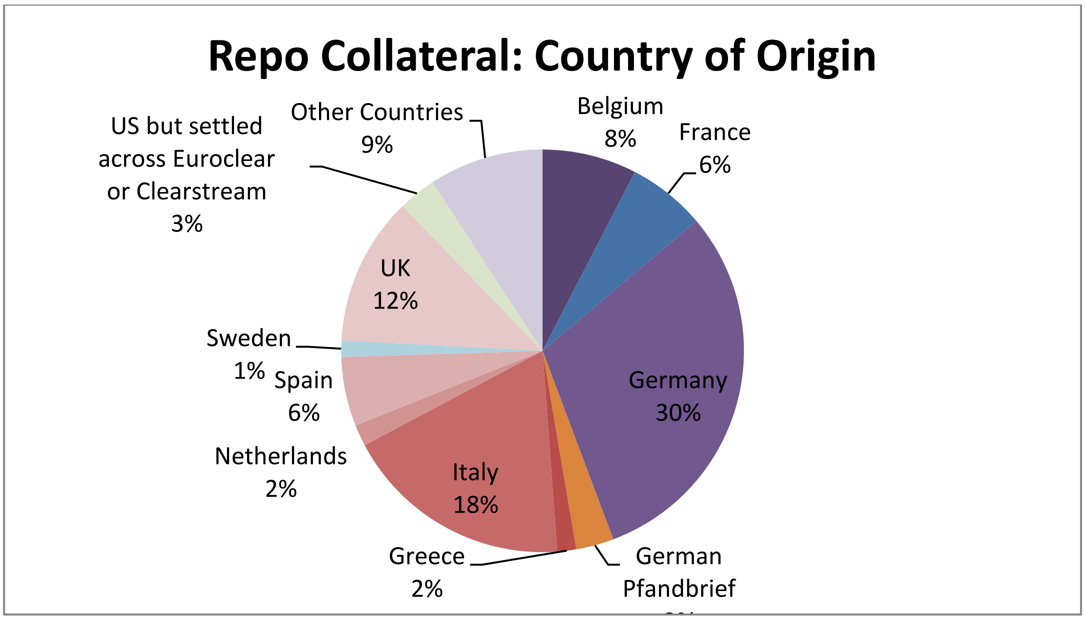
Until 1991, Germany also lacked a commercial paper market due to a combination of regulatory and tax barriers imposed at the behest of the DB (Deeg 1999, p.88). As a result, German firms increasingly began issuing commercial paper in foreign currencies in overseas markets. German banks also continued to conduct repo transactions, but in London rather than Frankfurt. Because Germany began to lose business, and under intense pressure from German firms, large banks, and the Finance Ministry, the DB eventually began to soften its strict monetarist position by implementing gradual technocratic change in preparation for EMU (Covil 1996; Deeg 1999, p.88; Röper 2017).

[95] As opposed to the ECB and Bank of England, for example, which target an aggregation of consumer prices.
[96] Where banks typically trade sovereign debt with one another temporarily for liquidity.
[97] The trading of short-term unsecured promissory notes issued by companies.
[98] German banks were forced to deposit a percentage of the loan with the DB, free of interest. Until March 1994 this requirement was 12.1 percent, although it was gradually lowered to 2 percent (Covill 1996).

In 1991 it suspended approval requirements for debt issuance, enabling the creation of a *Deutsch Mark* commercial paper market. In 1995 the government passed the Second Financial Market Promotion Act which permitted asset management companies to invest in money market funds and engage in securities lending. The DB also removed reserve requirements for repos in 1997 and dropped its opposition to the production of 2-year Treasury Bills (*Schätze*) in 1996. In 1998, the 'Bond Issues Auction Group' was established, creating a primary dealer system for short-term Treasury Bills and special 5-year Federal Bonds (*Bobls*) (DB 2002, p.154). These actions doubled the number of German banks active in domestic repo markets to 30 between March 1996 and April 1998 (BIS 1999, p.78; Gabor 2016, p.978; McCauley 1999, p.4), and stimulated the production of non-bank issued *Deutsch Mark* denominated securities and market interest in German debt.

A year after first issue, around half of all 6-month Treasury Bills (*Bubills*) were acquired by non-residents (DB 1996, p.29), transforming Germany into the *de facto* issuer of European 'safe assets', with German debt constituting around a third of all collateral in European repo transactions by 2001 (figure 4.3). Under EMU Germany remained the benchmark issuer of European sovereign bonds due to the record volume of issues, and because 10-year bond (*Bund*) futures remained an effective hedging instrument against interest rate risks, ensuring demand remained high (DB 2001, p.48). The DB thus appeared to understand the importance of sovereign bonds as collateral within financial markets and that shortages in their production could cause liquidity problems (DB 2002, p.62). Nevertheless, the eligibility criteria for collateral used in DB repos pre-EMU continued to be restricted as the bank sought to remain focused on monetary policy through the use of open-market operations whilst avoiding involvement in financial stability policies (Prati and Schinasi 1999, p.31).

Figure 4.3: Debt used in European repo transactions (2001)



Source: ISMA European repo market survey (2001)

Under the euro, however, the DB lost full control of monetary policy in exchange for voting rights on the ECBs Governing Council, altering the banks policy objectives. With no monetary aggregate to control, it gradually became less concerned about some short-term financial practices and expanding collateral eligibility. In 2002, the EUs Financial Collateral Directive (FCD) established a common tier 1 collateral framework for all Euroarea states, and in 2003, German banks responded positively to a consultation on extending the number of assets eligible as repo collateral. German banks were particularly keen to see bank loans included in the list, which the DB hoped would off-set the privileged status of government bonds which was thought to lower the cost of sovereign debt and reduce fiscal discipline, potentially threatening price stability by increasing the money supply (DB 2006[a], p.31-3)[99].

[99] In May 2004, the ECB Governing Council decided to gradually switch to a single extended list of eligible collateral for all EMU member-states (ECB 2004[a]). Prior to this change, only non-financial enterprises located in Germany were admitted to the German tier two list. After the changes, maturity limits on accepted

Whilst the DB retained full control of monetary policy and sought to control monetary aggregates, short-term finance was seen as a threat to ordo-liberal, monetarist principles. But under EMU, repo operations were no longer viewed this way as the ECB conducted monetary policy partly through the repo markets by targeting short-term interest rates to control inflation (ECB 2000[a], p.37-47; Weber 2005, p.15). Moreover, the diversification of collateral acceptable in repo transactions was actively encouraged by the DB to promote traditional ideas in relation to the importance of fiscal rectitude (DB 2006[a], p.31-3).

Under EMU, DB priorities shifted from hostility towards many market-based practices towards an enhanced concern for tight fiscal policy. DB research in 2003 concluded that under the ECBs inflation targeting regime, additional fiscal restraint may be required to achieve price stability than under the DBs approach of constant money growth (von Thadden 2003, p.28). Reducing the dependence of the financial system on sovereign debt was thought to diminish demand for government paper, increase market discipline in the sovereign bond markets, discourage government borrowing and reduce inflationary pressures. These new market-based policy ideas therefore became seen as a way to strengthen traditional 'philosophical' and programmatic ideas at the EU-level, representing as example of scenario C from table 2.2 (see below). The DBs objective of reducing reliance on sovereign debt as repo collateral was met with some success (figure 4.4), with only around 25 percent of collateral held in DB repo transactions consisting of government bonds by end-2004 (DB 2004[a], p.120).

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collateral were relaxed and debt denominated in any Euroarea country became accepted by the DB (DB 2006[a], p.34).

Market-based finance under EMU:

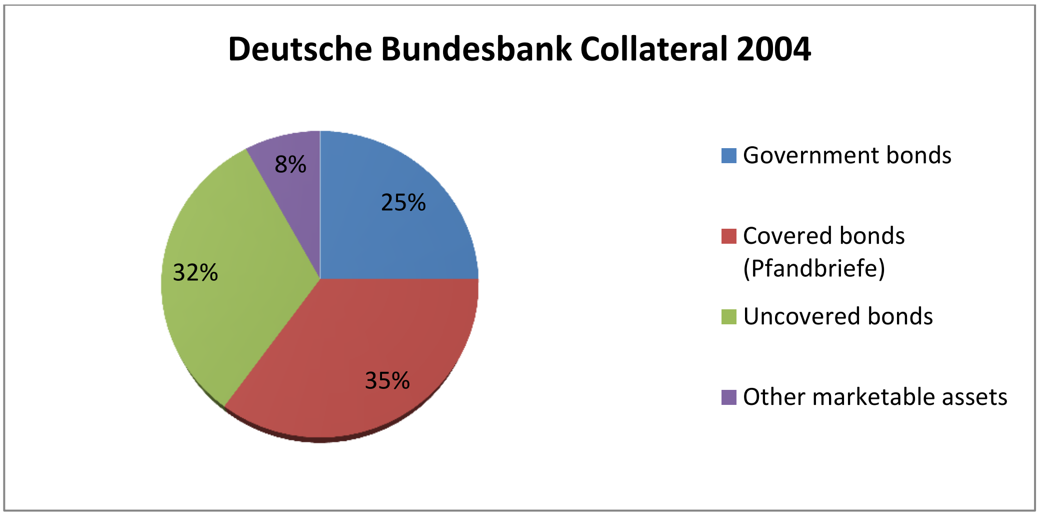
C) new ideas in old institutions -> accelerate policy change

iii) new policy ideas -> Strengthen existing
structures and/or
dominant ideas

Under the ECBs inflation targeting regime, the DB evoked new policy ideas aiming to expand collateral eligibility to promote traditional programmatic ideas.

Illustration 4.2

Figure 4.4: Collateral in DB repo operations (2004)



Source: DB (2004[a])

FINANCIAL CONCERNS UNDER EMU

How the DB viewed financial stability and reacted to potential threats to it is crucial to understand why market-based finance, EMU, and the eventual 2007-8 crisis affected the German financial system in the way it did. Due to increased financial activity in Europe[100]

[100] Largely facilitated by European financial integration and the rise of market-based banking.

and its loss of control over monetary policy, the DB began to discuss financial stability issues more frequently. Within its *Annual Reports* (*Geschäftsbericht*) and *Financial Stability Reviews* (*Finanzstabilitätsberichte* [from 2003]), the bank drew attention to some of its more pressing anxieties. These publications are analysed throughout this section, with the results in tables 4.2 and 4.3 below.

Table 4.2: Areas of concern within DB Financial Stability Reviews

	Bank profitability and provisioning	Global imbalances	Low growth, domestic demand & employment	Complex derivatives & hedge funds, "search for yield"	Exposure to US real estate	Landesbanken * (* Large Public Banks)	Exposure to Spanish real estate	Inter-bank markets
2003	✓	✓	✓			✓	✓	
2004	✓	✓	✓	✓	✓	✓	✓	
2005	✓	✓	✓	✓	✓	✓		
2006	✓	✓		✓	✓			
2007		✓		✓	✓			✓

Source: Author (2018)

As evidenced by these reports, under EMU, the main economic and financial problems were considered to be a lack of investment, low growth and low financial sector profitability (DB 2004[a], p.50). Due to these apprehensions, and the existence of DB ordo-liberal 'philosophical' and non-interventionist policy ideas which discouraged interference in financial markets beyond the setting of a strong legal framework, the bank failed to establish tough regulation on securitisation and off-balance sheet activity, or to increase risk provisioning for banks[101] (Thiemann 2012).

[101] All measures that would have been likely to produce a reduction in investment and bank profitability, but which were adopted by the BdE in Spain.

Table 4.3: Areas of concern within DB Annual Reports[102]

	Bank profitability and provisioning	Global imbalances	Low growth, domestic demand & employment	Complex derivatives & hedge funds, "search for yield"	Fiscal policy	Monetary policy / price stability / M3	Low credit growth and investment / strong saving	State bailouts and moral hazard	Stock Market
1999			✓		✓	✓		✓	
2000		✓	✓		✓			✓	
2001			✓		✓	✓		✓	✓
2002			✓		✓		✓	✓	✓
2003	✓	✓	✓		✓	✓	✓	✓	✓
2004	✓	✓	✓		✓		✓		
2005		✓	✓	✓	✓		✓	✓	
2006		✓	✓	✓	✓	✓		✓	
2007		✓		✓				✓	
2008	✓	✓		✓					

Source: Author (2018)

> *Although we have never been interventionist, what we knew before the crisis was that you need a sound and proper framework with the right incentives so that systemic risk does not accumulate*
>
> (DB: interview #5, 2015)

As the quote above reveals, the DB approach to financial stability centred not on interventionism, but on the setting of a robust legal framework which disincentivised banks from taking undue risk. This again helps underscore why the DB was initially so reluctant to encourage short-term finance, and continued to be concerned about the propagation of hedge funds, private equity funds and complex derivatives which it feared incentivised risk proliferation (DB 1999[b], p.31; 2004[c], p.40), (see tables above).

[102] Dates given are publication dates, not year under review.

Nevertheless, German banks still proved able to amass huge amounts of risk during the pre-crisis period. The extent to which national financial systems were impacted by the crash depended to a large degree on their exposure to off-balance sheet activity (Thiemann 2012, p.43), and that depended significantly on the pre-crisis financial ideas and policies of national regulators. As the quote above makes clear, despite financial liberalisation and the transition towards market-based banking, the DB upheld traditional non-interventionist policy ideas in relation to financial stability, resulting in a failure to take action on the risks German banks were accumulating on the asset-side of their balance sheets.

In Spain, the BdE introduced 'consolidated'[103] accounting rules which limited off-balance sheet activity and asset-side risk (Fernandez de Lis and Garcia-Herrero 2009, p.7; Saurina 2009[a]). Yet in Germany, no separate bookkeeping guidelines for banks were introduced until 2009. Instead, there was a single set of accounting regulations applied to all sectors equally, and considerable political opposition to splintering the overall accounting framework to intervene in specific areas of the economy (Thiemann 2012, p.50).

As a consequence, the DB did not examine the balance sheets or business compliance of individual institutions (which it felt may have compromised its independence [Deeg 2001, p.17; Zimmermann 2014, p.488]). Instead, German supervision consisted of a legalised off-site regulatory approach, often described as 'self-regulation', as the monitoring, auditing and enforcement of banking standards was left largely to the Banking Associations representing each of Germany's three banking 'pillars' (Cases 1996, p.180; Deeg 2001, p.17; Hassan 2014; Lütz 2004, p.173; 2005, p.142). This structural diffusion of financial authority

[103] 'Financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent (company) and its subsidiaries are presented as those of a single economic entity' (IFRS 2017).

meant the DB suffered both ideational and structural impediments to centralised intervention, lacking both the motivation and the means of intercession. Resultantly, from 2004, the DB presided over a financial system in which institutions progressively wound down provisions in pursuit of profitability, particularly within larger German public banks (*Landesbanken*) (DB 2004[a], p.35; 2005[a], p.69). Although by 2006 the DB recognised provisions were 'low' (DB 2006[c], p.57), it failed to take action to implement countercyclical capital buffers.

Nonetheless, despite the DB's non-interventionist approach and support for securitisation and off-balance sheet activity within the Finance Ministry (Asmussen 2006; Thiemann 2012, p.51), the DB remained sceptical of complex risk-transfer products and the role of hedge funds in the financial system. Tables 4.2 and 4.3 (above) show the DB began to voice concerns about these issues more frequently from 2004 onwards when hedge funds became operable in Germany and complex securitised products became more popular. The banks suspicion of these instruments was due largely to its adherence to ordo-liberal philosophical ideas. It feared complex non-synthetic[104] securitisation could create moral hazard by distorting market discipline and the proper functioning of the financial system (DB 1999[b], p.31; 2004[c], p.40). If the risk of holding complex securities were opaque and understood better by the originator than the buyer, 'shadow banks' could transfer risk much easier than under perfect market conditions, incentivising banks to extend credit to questionable borrowers and threatening systemic stability.

[104] Securitisation which transfers risk from the originator to the holder of the asset.

Figure 4.5: Securitisation and shadow banking

Securitisation (non-synthetic)

- The re-package of loans into readable assets
- Banks hold the asset on its ballance sheet, and/or remains responsible for the performance of the underlying loans once the asset is sold
- Examples include Covered bonds and some Asset Backed Securities (ABS)

Securitisation (synthetic)

- Created through Special Purpose Venicles (SPVs) to take assets 'off-ballance sheet'
- Credit risk is transfered from the originator to the holder of the asset
- Examples inclused most ABSs and Collateralised Debt Obligations (CDOs)

Shadow Banking (hedge, equity, insurance, money market firms etc.)

- Like traditional banks, they conduct credit, maturity and liquidity transformation functions
- Yet have no access to central bank liquidity or state guarantees, and operate without customer deposits
- They generate liquidity by transforming long-term assets into money-like Asset Backed Commercial Paper (ABCP) through SPVs

Source: Author (2018)

Whilst ordo-liberalism is enthusiastic about free markets, it maintains that they should operate within a clearly defined legal framework (Oliver 1960, p.133–134; Wörsdörfer 2010, p.23). Hedge funds however were seen by the DB to abuse regulatory arbitrage and distort market discipline (DB 2004[c], p.40). While the DB maintained a 'bottom-up', self-regulatory approach to German banks, it did not trust hedge funds in the same way, fearing they would fail to report their activities properly (DB 2004[b], p.28-9). Moreover, because generating large profits became increasingly difficult as yields became compressed under EMU, the DB worried hedge funds would take on unsustainable risk in specific sectors, creating pockets of systemic fragility (DB 2005[a], p.48). These concerns lead to hedge funds becoming liberalised much later in Germany than in 'Anglo-Saxon' countries like Britain and America. It was not until 2003 that hedge funds became permissible (table 4.1), and even after this date, the DB compelled them to operate within restrictive rules concerning the diversification of asset portfolios (DB 2015[c], p.40). Ideas and the banks traditional scepticism towards short-term finance are therefore essential to fully understand the DB's attitude towards financial stability, representing another example of scenario F from the ideational versus structural matrix.

German financial supervision under EMU:
F) established ideas in old institutions -> sluggish policy change
Ordo-liberal philosophical ideas and non-interventionist policy ideas hindered policy change and reinforced DB path-dependence towards non-interventionist financial supervision[105].
Illustration 4.3

Although larger commercial banks and *Landesbanken* had dealt in securitised products for years, before EMU, these tended to be restricted to more stable long-term sources such as covered bonds (*Pfandbriefe*) and unsecured bonds sold to individuals. While the risk of non-payment in the covered bond market is retained by the issuer of the security and is therefore classed as a liability, the risk of Asset-Backed Securities (ABS) non-performance is usually passed on to the holder of the product and is therefore traded as a financial asset[106]. For *Landesbanken* in particular, investing in these products (which were often originated abroad [table 4.5]), was the easiest way to expand given their prohibition from competing too strongly with local public savings banks (*Sparkassen*) due to their mutual ownership (Ross 2014[a]), and the broader structural specificities of the German financial system: namely the propensity of Germans to save and the low profitability of the domestic market (Commission (2014[c], p.40; Hardie and Howarth 2009, p.1019).

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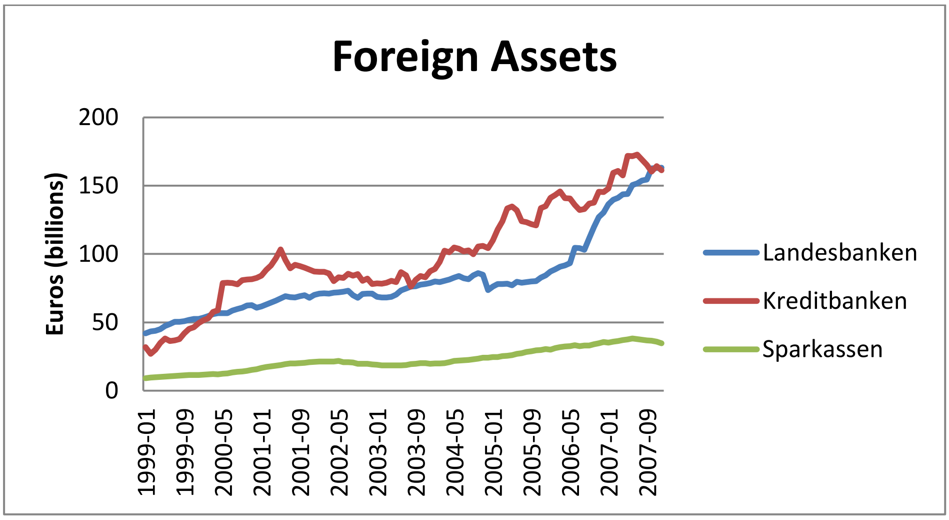
[105] Particularly in regards to the late liberalisation of hedge funds and the maintenance of non-interventionist financial regulation.
[106] In the case of synthetic ABSs.

Consequently, German banks increased their holdings of foreign securities to a far greater extent than domestic instruments. By end-2003, holdings of foreign securities had grown by over 70 percent to nearly €1.1 trillion (Remsperger 2005, p.10). Such investment frequently drew on the deposits of *Sparkassen*[107] at the expense of diverting funding from domestic 'parent capital' ventures (Borges and Bayoumi 2011, p.22; DB 2006[c], p.41; OECD 2010, p.94). This process intensified after 2005 (figure 4.6) as between 2001-2005, *Landesbanken* raised as much capital as they could at cheap rates prior to the expiration of their state liability guarantees (DB 2006[c], p.61). Once capital had been raised in the wholesale markets, they needed to find ways of investing the proceeds (Economist 2012[b]; Hassan 2014), creating an explosion of cheap credit for peripheral states (Micossi 2012, p.2) and drastically increasing the amount of market-based assets on their balance sheets (Borges and Bayoumi 2011, p.23; OECD 2010, p.94).

Figure 4.6: Foreign assets (€ billion) held by German banks



Source: DB Data (2017)

[107] *Landesbanken* act as regional central banks for the *Sparkassen* – see following section (4.2).

Table 4.4: Special Purpose Vehicles (SPVs)

Special Purpose Vehicles (SPVs)	
Pools of assets that are held off-balance sheet by large financial institutions such as commercial banks or investment houses	
Types:	
Structured Investment Vehicles (SIVs)	SIVs issue commercial paper that is continuously renewed or rolled over to invest in longer-term assets (such as ABS and MBS) that have less liquidity but pay higher yields. The SIVs earn profits on the spread between incoming cash flows (e.g. interest payments on ABS) and the highly liquid commercial paper it issues.
Asset-Backed Commercial Paper (ABCP) Conduits	Institutions which buy debt from companies and then issue investors with commercial paper. The commercial paper is backed by the expected cash inflows from the interest on the debt. As the receivables are collected, the companies are expected to pass funds to the conduit, which then passes interest to the note holders.

Source: Author (2018)

Although the shadow banking system in Germany itself remained small before the crisis, largely due to the DBs reluctance to encourage short-term finance (Gabor 2016, p.978; Trampusch 2015, p.122), large commercial banks and *Landesbanken* began making use of Special Purpose Vehicles (SPVs) in foreign locations to originate securities based on US mortgage debt (table 4.5) (Detzer et al. 2017, p.68). The increasingly marketised activity of German public banks, however, did not appear to concern the DB. The bank commented in 2006 that *Landesbanken* had made notable progress towards developing new business models in the wake of the withdrawal of their state guarantees, which were assessed positively by the markets (DB 2006[c], p.10). This demonstrates the evolution of DB thought under EMU. While before EMU DB programmatic monetarist ideas made it wary of short-term finance (DB 1999[a], p.82), by the 2007-8 crisis, it had become much less concerned about many market-based financial developments.

Table 4.5: German SPV usage (2007)

Bank	**Type**	**Location**	**Billion ($)**
Bankgesellschaft Berlin	*Landesbanken*	Delaware, US	2.1
Bayern Landesbank	*Landesbanken*	St. Helier, New Jersey	7.4
Commerzbank	Commercial Bank	Delaware, US	9.4
Deutsche bank	Commercial Bank	St. Helier, Jersey	14.7
Dresdner bank	Commercial Bank	George Town, Cayman Islands	8
DZ bank	Cooperative	London	4
Helaba	*Landesbanken*	Dublin, Ireland	1.9
HSH Nordbank	Commercial Bank	St. Helier, New Jersey	6.9
Hypo-Vereinsbank	Commercial Bank	St. Helier, New Jersey & Dublin, Ireland	4
IKB	Publically owned	Delaware, US	18.6
LBBW	*Landesbanken*	Bangore, Ireland	9.1
Sachsen Landesbank	*Landesbanken*	Dublin, Ireland	17.9
Westdeutsche Landesbank (WestLB)	*Landesbanken*	Dublin, Ireland	8.4

Source: Detzer et al. (2017)

Indeed, although it remained wary of complex derivatives which it feared distorted market forces and hedge funds that it saw as operating outside conventional rules (DB 2004[c], p.40; 2005[a], p.48), securitisation was thought to reduce demand for sovereign debt in the repo markets, improve market discipline in the sovereign segment and diminish the likelihood of fiscal expansionism (DB 2006[a], p.31-3). Its research gradually began to see market-based financial systems as inherently more conducive to economic growth (Fecht et al. 2005), and even as more stable than hybrid bank-market-based systems (Fecht 2003).

Additionally, two further concerns were highlighted consistently within DB *Annual Reports* (table 4.3): IMF calls for the creation of an 'insurance facility' for IMF member-states[108] (DB 2002, p.120; 2007, p.73), and; German government fiscal deficits and the consequent weakening of the Stability and Growth Pact (SGP) (DB 2005[a], p.83; 2004[a], p.93). In parallel to the banks later opposition to the European Stability Mechanism (ESM)[109], the DB feared establishing an 'insurance facility' would create moral hazard by encouraging reckless state borrowing (DB 2002, p.120; 2005[a], p.90). In the event of IMF assistance being provided, the DB argued funds should be conditional upon 'extremely strict' reform criteria (DB 2003[c], p.99) and prior 'haircuts' (reductions in payable debt) being taken by private bondholders[110] (DB 2002, p.119-20). These positions were formed as a direct consequence of ordo-liberal philosophical ideas in relation to the liability principle (*Haftungsprinzip*), which stresses that actors should bear the consequences of their own decisions (Stark 2015). Any departure from the liability principle was thought to create moral hazard and distort market discipline.

The bank also expressed deep concern about German government deficits and recorded its strong opposition to the weakening of the SGP (Zeitler 2005). The bank cited the diminution of the Pact as a 'major concern' (DB 2004[a], p.93) which constituted a violation of an 'inherent part' of EMUs foundations (DB 2005[a], p.83). The DB took this stance because its 'programmatic' monetarist ideas purport that sustained fiscal deficits expand the money supply and ultimately feeding through into higher inflation (Weidmann 2013). The bank therefore vehemently opposed the government's fiscal stance prior to the crisis, just as it

108 Automatic bailout fund called for in the wake of the Turkish and Argentinean bailouts of 2001.
109 A European bailout fund agreed in February 2012 in response to the European sovereign debt crisis.
110 Known as Private Sector Involvement, or PSI.

supported efforts to improve market discipline in the sovereign bond markets to reduce fiscal expansionism. Monetarist and ordo-liberal ideas were therefore crucial in determining DB attitudes toward fiscal policy.

SUMMARY

This section showed how ordo-liberal (*Ordnungspolitik*) philosophical ideas, orthodox monetarist programmatic ideas and non-interventionist policy ideas within the DB help account for the way Germany adapted to the onset of market-based finance, prepared for EMU, regulated its financial sector and explain the sorts of risks German banks accumulated pre-2007. It revealed how the traditional understanding of monetarism in Germany as a concern for monetary aggregates was the main cause of DB anxieties towards short-term interbank markets during the 1990s (Covil 1996; DB 1999[a], p.82; Gabor 2016, p.977). Yet under EMU and the ECBs inflation targeting regime, these same ideas eventually led the DB to call for the diversification of collateral eligibility in repo transactions as a means of reducing dependence on sovereign debt and promoting fiscal conservativism (DB 2006[a], p.31-3). These new DB policy ideas were therefore used by the bank to help strengthen traditional philosophical and programmatic ideas at the EU-level.

Literature to date has tended to underappreciate the significance of country-specific regulatory measures when analysing the effects of the crisis on national financial systems (Thiemann 2012, p.39). This chapter redresses this failing. While under EMU, the DB continued to exhibit its historical mistrust of hedge funds and complex derivatives (DB 2004[c], p.40; 2005[a], p.48), the DBs ordo-liberal (*Ordnungspolitik*) inspired non-interventionist policy ideas discouraged it from introducing countercyclical regulations (DB: interview #5, 2015). While Spain, for example, introduced measures to prevent the accumulation of risk on the asset-side of bank balance sheets (Fernandez de Lis and Garcia-Herrero 2009, p.7; Poveda 2012, p.248), the DB took no such action.

Structural factors were also important in explaining why German banks reacted to market-based developments and the creation of EMU in the way they did. The structural low profitability of the German financial system and the propensity of Germans to save (Commission (2014[c], p.40; Hardie and Howarth 2009, p.1019), encouraged German institutions to rapidly expand their holdings of foreign debt (DB 2006[c], p.41; Remsperger 2005, p.10), and for large private banks and *Landesbanken* to access such markets by creating SPVs domiciled in foreign financial jurisdictions (Detzer et al. 2017). German's supervisory system also handed much responsibility to financial institutions themselves through the Banking Associations (Cases 1996, p.180; Deeg 2001, p.17; Hassan 2014; Lütz 2004, p.173; 2005, p.142). Introducing a more centralised and intrusive regulatory approach would have incurred significant structural realignment and substantial sunk costs, thus reducing the ability of the DB to initiate interventionist measures.

Both ideational and structural factors are therefore crucial to understand *why* Germany's pre-crisis financial system evolved as it did, and hence HI and DI essential to improve our understanding of the process of institutional change through time.

4.2: The German Banking System

Although ordo-liberalism (*Ordnungspolitik*) represents the dominant philosophical idea orchestrating German's post-war economic thinking, sections of the country's banking system align more closely to Social Market preferences than pure ordo-liberalism (Smith 2001, p.136). While liberalisation acted to weaken the traditional structure of German banking, prior to EMU, each sphere of Germany's three-pillar arrangement (Bleuel 2009, p.2; Zimmermann 2014, p.487) performed a specific function and was strictly separated (Figure 4.7).

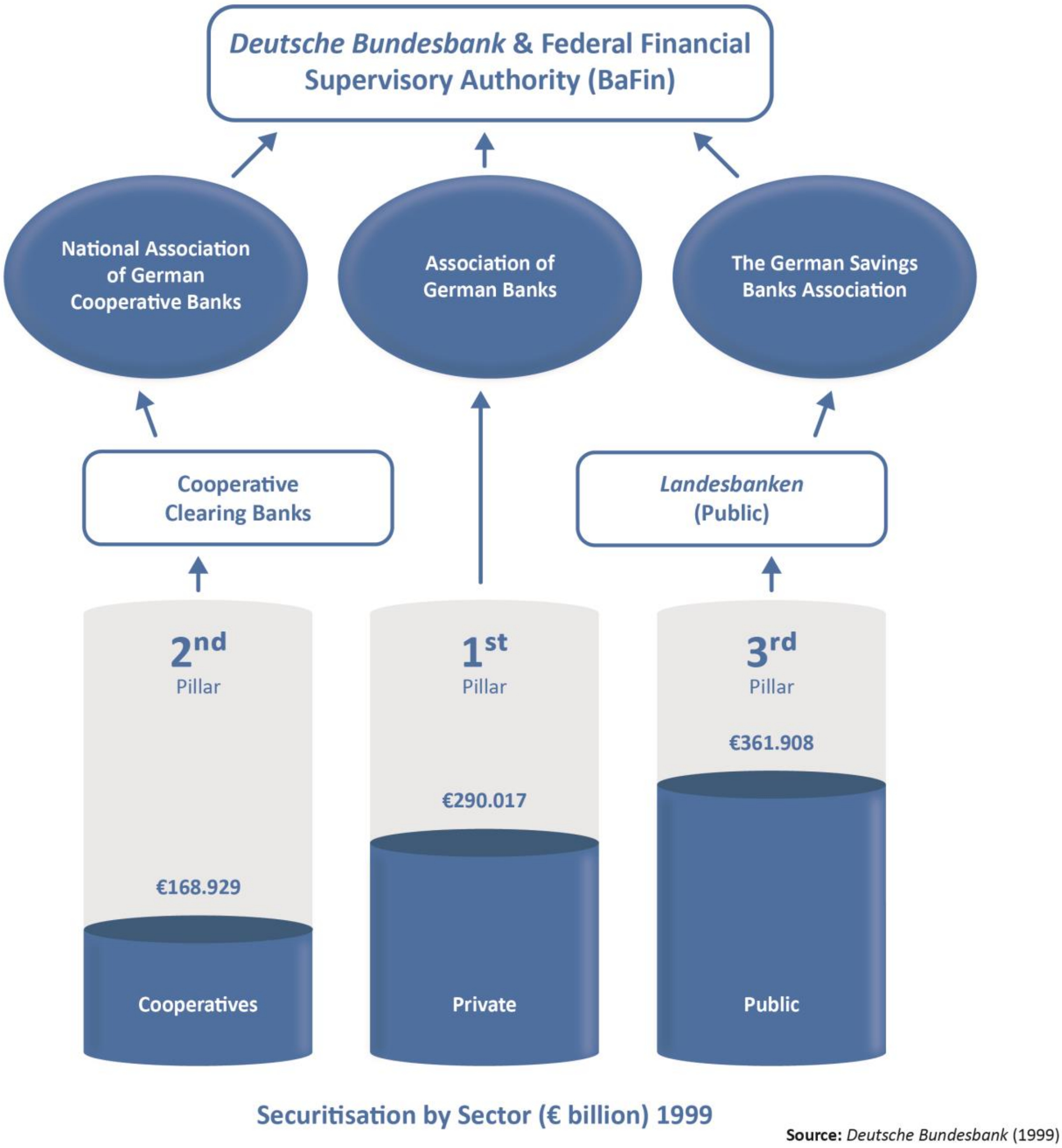
In the first pillar, private commercial banks (*Kreditbanken*) performed investment functions with profit maximisation as their primary focus. Before the crisis, Germany had a sizable proportion of large private investment banks with global reaches and diverse asset portfolios (table 4.6). Many, including Deutsche Bank and Commerzbank, were particularly active in generating market-based assets through their foreign domiciled SPVs (table 4.5).

Germany also had a very large number of cooperative banks (*Raiffeisenbanken* and *Volksbanken*)[111]. These institutions maintained societal functions and had their own central banks to perform clearing activities: DZ-Bank[112] and WGZ-Bank[113]. Before the removal of the 'identity principle' through the Cooperative Societies Act (*Genossenschaftsgesetz*, [GenG] 2006), cooperatives could only lend to members through mutual lending and saving arrangements (Biasin 2010). The removal of this principle, however, ensured they became

[111] The Cooperative Financial Network currently comprises 972 local cooperative banks (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, 2017).
[112] German Central Co-operative Bank (*Deutsche Zentral-Genossenschaftsbank*).
[113] West German Co-operative Central Bank (*Westdeutsche Genossenschafts-Zentralbank*) - Rhineland and Westphalia.

able to lend to anyone, regardless of membership. Aside from their regional orientation and separate associations, cooperatives now differ little from private banks (Faltermeier 2013, p.18).

Figure 4.7: Structure of German's banking system



Source: Author (2018)

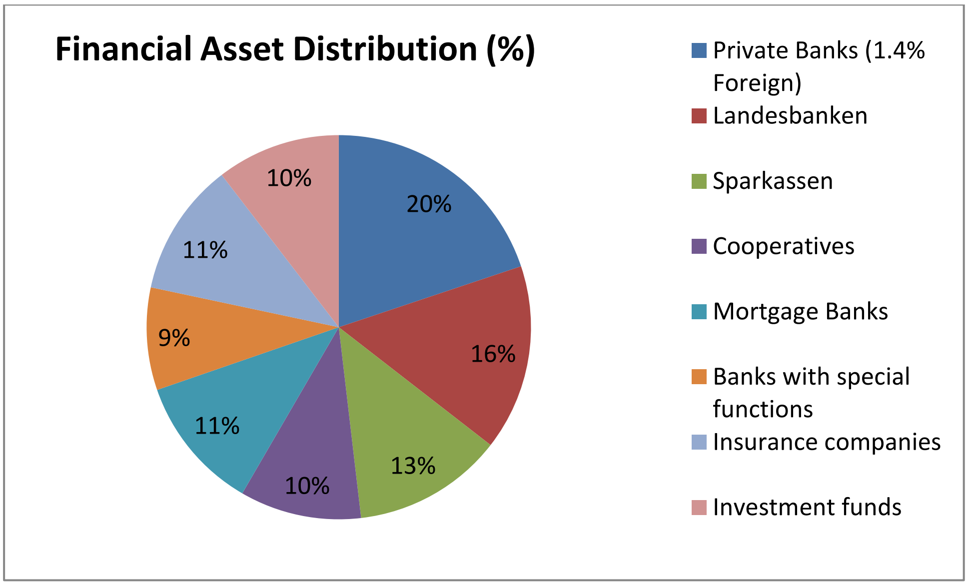
Table 4.6: German and Spanish banks in global top 50 (total assets, 2004)

Bank	Country	World Ranking	Ownership
Deutsche Bank AG	Germany	4	Commercial
Dresdner Bank	Germany	23	Commercial
Hypovereinsbank (HVB)	Germany	24	Commercial
Commerzbank	Germany	28	Commercial
Banco Santander	Spain	33	Commercial
DZ Bank	Germany	35	Cooperative
Landesbank Baden-Wuerttemberg	Germany	38	Landesbanken
Bayerische Landesbank	Germany	40	Landesbanken
KfW Group	Germany	41	State owned investment bank
Banco Bilbao Vizcaya Argentaria (BBVA)	Spain	45	Commercial
NRW Bank	Germany	46	Landesbanken
WestLB	Germany	50	Landesbanken

Before the crisis there were four private German banks in the global top 50 compared with two Spanish. Four *Landesbanken* made it into the listing, as well as a German state-backed investment institution and a central bank for the cooperative banks.

Source: The Banker (2004)

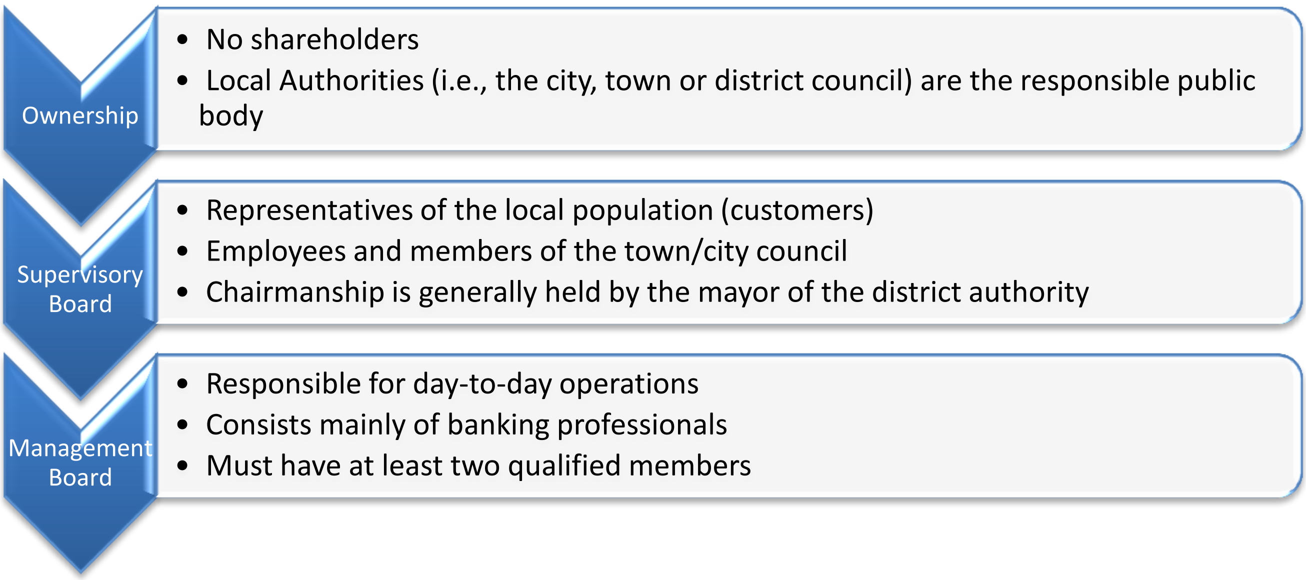
Figure 4.8: Structure of Germany's financial system at the birth of EMU (1999)



Source: IMF (2003)

Small public savings banks (*Sparkassen*) meanwhile are committed by their municipal ownership to serve their local region and are obligated to help cultivate local economic, social and cultural development (Simpson 2013, p.12)[114]. They numbered 414 in 2016 (BNP Paribas 2016, p.4) and are administered by local authorities. They traditionally formed the backbone of Germany's bank-based financial system, playing a key role in financing small and medium-sized enterprises (SMEs, *Mittelstand*) (Steinberg and Vermeiren 2015, p.393). Their supervisory boards are assembled from members of the local community and are usually chaired by local mayors. Any taxation raised through *Sparkassen* goes directly to help fund regional budgets (Simpson 2013, p.12).

Figure 4.9: *Sparkassen* structure



Source: Author (2018)

[114] According to the Bavarian Savings Banks Directive (SpkO), *Sparkassen* are defined as: 'Independent commercial enterprises owned by municipal governments with the task (public mandate) of providing all elements of society and the economy, particularly German small and medium sized enterprises (SMEs - Mittelstand) and the public sector, with appropriate and sufficient financial and lending services within the area they serve' (SpkO 2007).

These banks are supported by *Landesbanken*, which originally operated as regional central banks for the *Sparkassen*, providing them with investment and wholesale funding opportunities (Döring 2003, p.95). As a consequence of Germany's post-war federal constitutional system, each German region (*Länder*) had its own *Landesbanken* to provide:

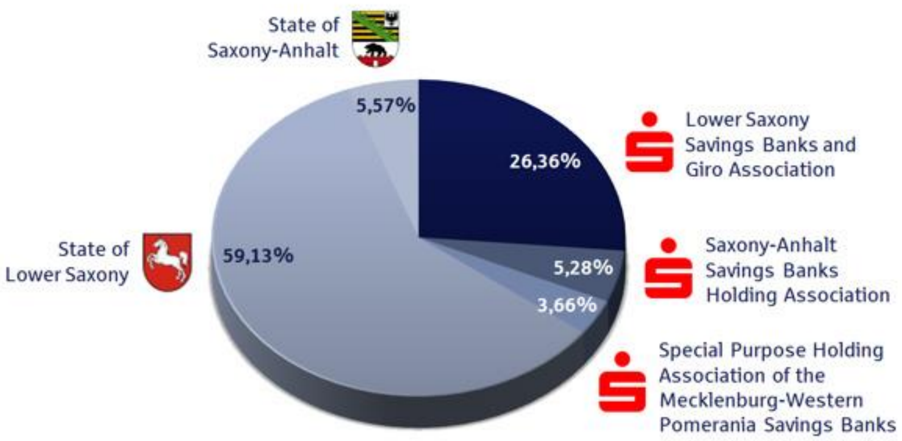
- Support to regional lenders
- Funding to regional governments and SMEs
- Regional economic development
- Subsidies for public works
- A counter to market failure and pro-cyclicality

Box 1: Example of *Landesbanken* Structure

Norddeutsche Landesbank Girozentrale **(NordLB)**

NordLB is almost 60 percent owned by the State of Lower Saxony, with minority stakeholders consisting of the State of Saxony-Anhalt and local *Sparkassen*. Of the 17 members of the banks supervisory board (*Verwaltunggsrat*); 5 are politicians, 4 are from *Sparkassen*, 3 are bank employees, 3 are from business and 2 from trade unions.

NordLB 'Ownership'



Source: NordLB (2017), adopted with permission: https://www.nordlb.com/nordlb/about-us/portrait/

This Social Market institutional structure meant that in exchange for providing these services, *Landesbanken* received state liability guarantees (Ayadi 2009, p.120; Dixon 2012, p.591), the maintenance obligation (*Anstaltslast*) and liability obligation (*Gewährträgerhaftung*). These ensured that in the event of default, the state would step in to fund the claims of creditors (Brunnermeier et.al 2004, p.24; Dixon 2012, p.591), allowing them to benefit from high credit ratings and low wholesale financing costs (Döring 2003, p.87; Smith 2001, p.127)[115].

However, as a consequence of the ascendancy of liberal economic and financial ideas, distinctions between the three-pillars of Germany's bank-based system started to blur, particularly under EMU. Especially important here was the behaviour of *Landesbanken*, which began operating outside of their traditional regions, diversifying financial activity and competing in the same markets as private banks (Dixon 2012, p.591; Grossman 2006; Lütz 2004; Smith 2001, p.128). As they continued to abandon their traditional business models by becoming heavily embroiled in foreign lending through investment in US and peripheral ABSs (Bleuel 2009, p.3; Sinn 1999) (see table 5 and figure 4.6 above), they became increasingly subjected to demands to be privatised.

As early as 1992, calls were made to this effect by the German Monopolies Commission (Ayadi et al. 2009, p.41). The Commission argued *Landesbanken* state guarantees handed them a competitive advantage by allowing cheaper access to wholesale financing. By the

[115] Two 'joint-liability schemes' (*Haftungsverbund*) – arrangements that ensure member banks are jointly liable if any are threatened with liquidation –continue to cover the public banks and cooperatives (Howarth and Quaglia 2016, p.76; Howat and Theodore 2016, p.4). Although their main function is to avert the bankruptcy of member institutions, they also cover customer deposits and are recognised as statutory deposit guarantee arrangements (DB 2015[b], p.48).

early 2000s, the German federal government, the Association of German Banks, the European Commission and DB all supported restructuring the sector (Hardie and Howarth 2009, p.1020). Yet despite this, local governments and the public banks themselves successfully resisted reform efforts, demonstrating the strength of structural path-dependence and an instance of scenario B from the ideational versus structural matrix.

***Landesbanken* path-dependence pre-EMU:**		
B) structures trump ideas	**->**	**institutional continuity**
		Illustration 4.4

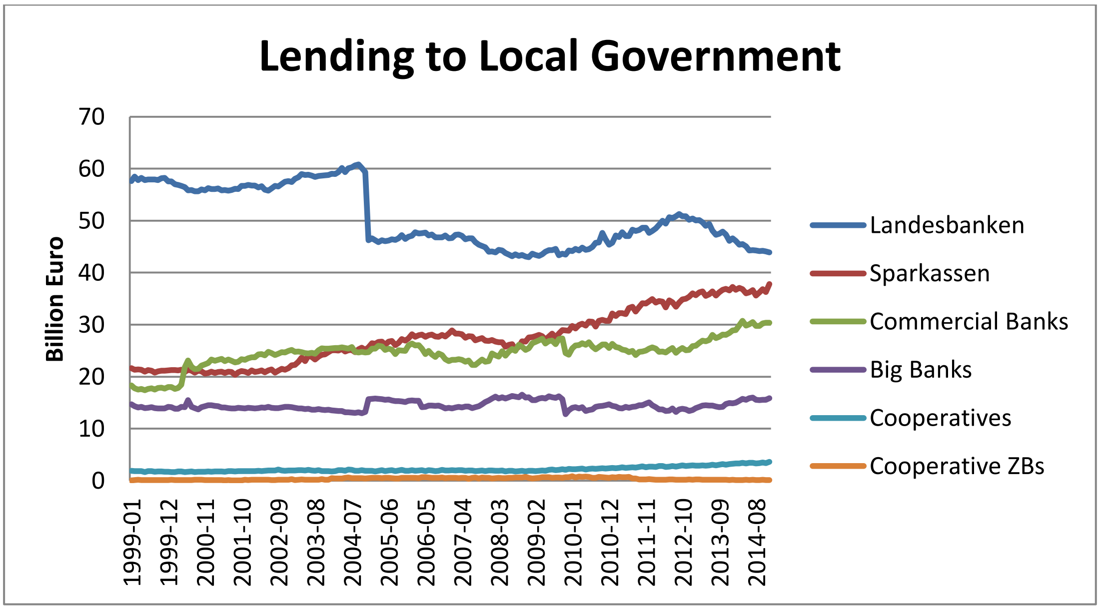
In 2003, the IMF also joined the chorus of voices calling for a fundamental restructuring of the German banking system and the elimination of its three-pillar structure. It argued the unsatisfactorily low profitability of the German system was largely attributable to the role of public banks (IMF 2003). Although the DB vigorously rejected this claim (DB 2003[b], p.43), it did accept IMF recommendations that changes should be made to the corporate structure of *Landesbanken*. The DB maintained that whilst reforms were:

> *Unlikely to involve a complete change from public to private ownership in the foreseeable future… Greater transparency and a better corporate governance structure are generally desirable at public sector institutions… Possible approaches include revising the statutory regulations… with a view to reducing the scope for political influence, [and] introducing a quota system for board membership according to interest groups*
>
> (DB 2003[b], p.45-6)

The DB was particularly keen to weaken the link between the state and *Landesbanken*. In 2001, it was still expressing concern that regional (*Länder*) deficits were too high, particularly in the new Eastern (*Flächenländer*) territories (DB 2001[b], p.57). The political connections between *Landesbanken* and regional politicians were therefore opposed by the bank for traditional ideational reasons concerning ordo-liberalism's unease with state ownership and intervention, but also for the same reason it favoured securitisation as a means of reinforcing market discipline in the bond markets (DB 2006[a], p.31-3): because it was concerned about fiscal expansionism and its effect on price stability (DB 2005[a], p.83; 2004[a], p.93).

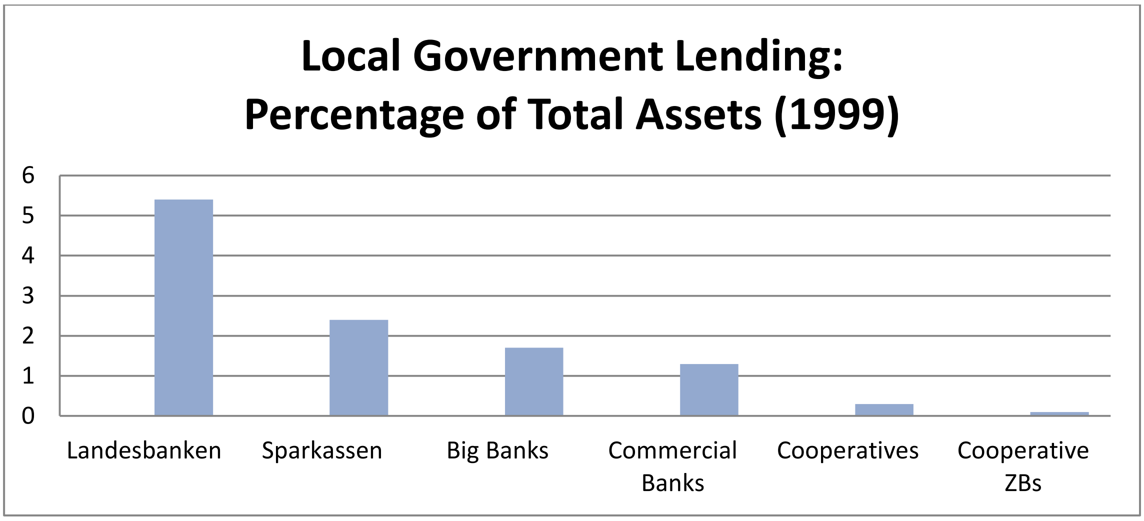
The political links to *Landesbanken* made it easier for local governments to borrow by issuing regional bonds (*Schuldscheine*). Part of the *Landesbanken*'s public mandate required them to lend cheaply to local government to help finance social projects[116] (IMF 2003, p.3). Although *Landesbank* domination in the field of local government lending began to wane under EMU as the three-pillar structure started to weaken[117], public banks still provided the bulk of lending to regional administrations before the crisis (figures 4.10 and 4.11). By

Figure 4.10: Lending to German local government



[116] This effectively made *Landesbanken* the central banks of *Länder* governments (Johnson 1998, p.45).
[117] Figure 4.10 shows a notable drop in lending to local government after the expiration of public guarantees in 2005.

Figure 4.11: Lending to German local government (% of total assets, 1999)



Source: DB Datasets (2016)

weakening the link between politicians and *Landesbanken*, the DB sought prevent loose fiscal policy at the *Länder* level and reduce threats to price stability.

Interviews conducted for this research also suggest a deep distrust of politicised banking within the ordo-liberal (*Ordnungspolitik*) Finance and Economics Ministries. Yet despite the desire for reform and the liberalisation that German finance has undergone, the essential structure of the public banking system remains and path-dependence has been largely preserved. Therefore although ideas are crucial to comprehend the motivation behind the desire for change at the federal level, path-dependence and political vested interests are also essential to understand structural resistance at the regional level:

> *I see frankly no signal to reform Landesbanken because they are so stable, because politicians are sitting there. On the municipalities side you have a certain director from one of the big two parties and the big two parties are managing certain things at the Länder level. When you need money for a big project it's much easier to go to a savings bank. To be blunt, it's not a typical German thing*

> *what's going on here. In industry we have a total open market economy, but in the banking sector we have a state approach, more or less.*
>
> (German Finance Ministry, interview #12, 2015)

This 'state approach', however, is often strongly defended by the political left and regional (*Länder*) governments (Hardie and Howarth 2013[b], p.108; Smith 2001, p.120). Regional politicians have sought to protect their financial patronage networks surrounding the public-banking system which provides positions of privilege for local officials (Behn et al. 2014; Ewing 2010; Lütz 2004, p.188). Politicians are able to use these banks as tools to further political objectives (Döring 2003, p.97; Münchau 2016) and hence oppose calls which would see a dissipation of their authority and influence. As a result, federal administrations have been unable to push through meaningful change.

By examining ideas, this research reveals the extent of the Federal aversion to politicised banking and the importance of ideational factors in forming financial policies and attitudes towards specific sectors (DB 2003[b], p.45-6; German Economics Ministry: interview #11, 2015; German Finance Ministry: interview #12, 2015). But the example of the *Landesbanken* also reveals that when political vested interests are instituted within a polity and oppose change, even ideas advanced by central government cannot override them. Appreciation of both ideational and structural factors is therefore crucial to fully understand the evolution of German finance.

Critical Case Study: BayernLB

See Appendix I

European Intervention

In the late 1990s, private European banks also began to question the system of *Landesbanken* state guarantees. In 1999, the European Banking Federation filed a complaint with the EU Commission, which ruled in 2001 that state obligations be phased out by 2005 (Commission 2002; Lütz 2005, p.143). In 2004, the Commission also concluded an investigation into the provision of state aid to *Landesbanken*. It ordered the German state to recover €3 billion it had loaned to *Landesbanken* via federal state deposits at below market rates (Commission 2005; DB 2005[b], p.72). Given the close relationship between politicians and *Landesbanken*, it seems unlikely that any reform efforts would have been possible without such external intervention (Smith 2001, p.136).

Moreover, even the Commission's intercession did not fundamentally alter the structure of German public banks and failed to remove state guarantees entirely. Regional (*Länder*) governments remain the ultimate owner of *Landesbanken*, so public support could still be forthcoming in the event of a crisis (as occurred post-2007). Guarantees were also made explicitly permissible, provided any financing the state delivers is remunerated at market rates, and *Landesbanken* continued to stand behind the *Sparkassen* due of their joint liability protection scheme (Brunnermeier et.al 2004, p.24)[118]. Consequently, this represents an illustration of scenario B from the matrix displayed in chapter 2 (table 2.2).

[118] This national path-dependence in the face of European reform efforts also demonstrates the limits of literature concerning 'Europeanisation', which seeks to explain European convergence amongst EU member-states (see Featherstone and Radaelli 2003).

Landesbanken path-dependence under EMU:		
B) structures trump ideas	**->**	**institutional continuity**
Path-dependence is particularly strong when political vested interests seek to maintain institutional continuity.		

Illustration 4.5

SUMMARY

This section provided an overview of the structural makeup of the German financial system which before EMU was widely regarded as a traditional bank-based system (Dixon 2012). It showed that its established three-pillar structure became weakened throughout the 1980s and 1990s as banks within each group became progressively marketised and able to offer similar financial services. This generated particular resentment towards *Landesbanken* which, before 2004, were able to borrow cheaply on wholesale markets and undercut competitors due to their state guarantees (Ayadi et al. 2009, p.41; Hardie and Howarth 2009, p.1020).

The DB, Federal Finance and Economics Ministries were each inherently distrustful of political involvement in financial institutions (German Economics Ministry: interview #11, 2015; German Finance Ministry: interview #12, 2015), with the DB holding *Landesbanken* partly responsible for *Länder* fiscal deficits which they believed could ultimately threaten price stability (DB 2004[a], p.93; 2005[a], p.83). Owing to these philosophical ordo-liberal and programmatic monetarist ideas, federal institutions wished to sever the links between *Landesbanken* and regional politicians. Ideas are therefore fundamental to properly understand the motivations behind the DBs public banking concerns. Yet to comprehend why the DB and the rest of the German federal state apparatus failed to implement significant reform, structural explanations are also required.

Insights from HI better account for how the vested interests of politicians who benefited from close relationships with public banks were able to maintain institutional continuity (Behn et al. 2014; Ewing 2010; Lütz 2004, p.188). Only the external intervention of the EU Commission managed to push through some limited changes, demonstrating the strength of institutional path-dependence. Therefore while DI insights reveal the influence of traditional ideas within German's central state architecture, HI concepts prevailed in this instance, largely due to Germany's decentralised, federal financial structure.

4.3: Liberalisation and Financial Supervision in Spain

Throughout the Franco period, the Spanish financial system was governed by the Ministry of Finance which had virtually complete control over finance and monetary policy. Between 1946–1959, the BdE was merely an accessory to the Finance Ministry, only becoming the official central bank in 1962 when it was nationalised and gained responsibility for implementing monetary policy (BdE 2013[a], p.13; Lukauskas 1997, p.77). As Spain entered the democratic era in the late 1970s, the BdE gradually attained greater influence and authority. The 1980 Law of the Governing Bodies of the Bank of Spain (*Ley de Organos Rectores del Banco de España*) handed almost all responsibility for banking supervision and accounting regulation to the BdE, which also gained greater political autonomy from the Finance Ministry (Martín-Aceña et al. 2014, p.64). The bank was eventually handed full independence in 1994 and joined the Eurosystem in 1999. Using process tracing, this section uncovers key themes and events which took place during this transition, and ascertains the ideational and structural factors behind Spain's conversion to a more liberal, market-based financial system.

Chapter 2 described how Spain was exposed to ordo-liberal (*Ordnungspolitik*) ideas during the 1940s[119]. Over time, these ideas became more neo-liberal in nature and predominated within the BdE and Finance Ministry (Tortella and Garcia-Ruiz 2013, p.150). The greater freedom and authority handed to the BdE therefore helped spur the process of liberalisation in Spain, exemplifying an instance of scenario E from the matrix displayed in table 2.2 (see illustration 4.6 below). This was aided principally by the BdE's Research Service which began exporting its neo-liberal and idiosyncratic monetarist thinking to a wider audience (Lukauskas 1994; Pérez 1997[a]).

This process intensified during the 1970s, culminating with the *Pactos de la Moncloa* in 1977 which introduced market principles to the Spanish economy (Ban 2016, p.39; Pérez 1997[a]). For Spain, creating a more liberal system based on market forces rather than central command and clientalism was a huge undertaking (Lukauskas 1997, p.125; Pérez 1997[b], p.136). While Spain is still described in the literature as a 'state-influenced' or 'mixed-market' economy (Molina and Rhodes 2007; Schmidt 2007), gradually, driven by the liberal reformist agenda within the BdE and Finance Ministry (Ban 2016; Brias 2002;

[119] The German economist, Heinrich Freiherr von Stackelberg, took up a teaching position in Madrid during the 1940s and amassed a large following. The intellectual decedents of this movement went on to claim positions of power and influence in the Franco government during the 1950s and 1960s (Ban 2016, p.109).

Lukauskas 1997, p.97-8), the Spanish economy transitioned from one of centralised control towards a more open, liberal system.

Liberalisation and market-based finance, post-Franco:
E) new ideas in new institutions -> rapid policy change
The newly influential BdE (1960s>) became infused with new neo-liberal 'philosophical' and 'programmatic' monetarist ideas, sparking rapid policy change.

Illustration 4.6

Table 4.7: Important statutory financial liberalisation in Spain

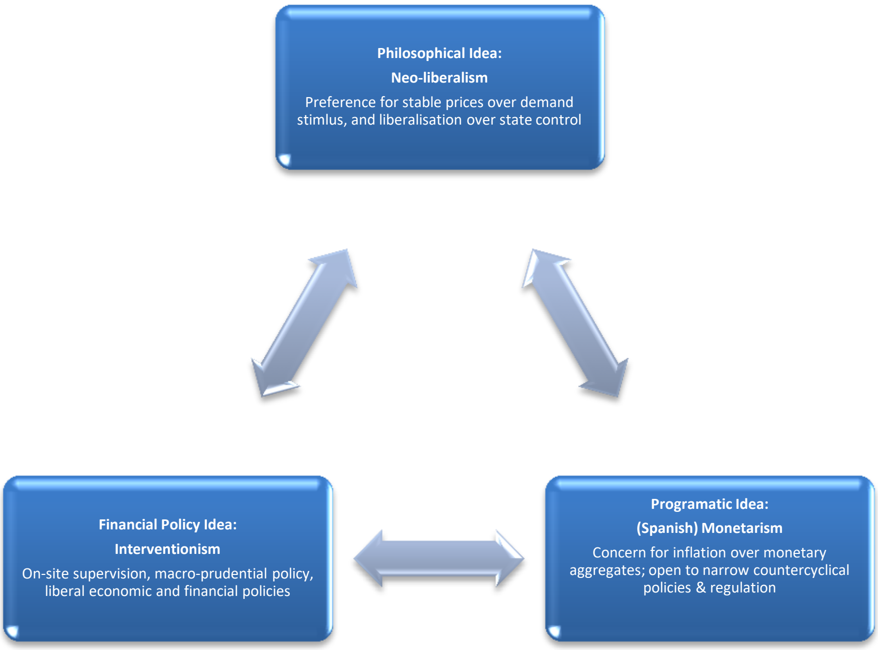
1977	Pactos de la Moncloa	Introduced market economics to the country. Price caps and compulsory investments (coeficientes de inversión obligatoria) were gradually eliminated
1980	The Law of Governing Bodies of the Bank of Spain	Transferred all responsibilities for bank supervision, discipline and sanctions to the BdE. Also granted additional autonomy from the Finance Ministry
1981	Regulation of the mortgage market (Law 2/1981)	Regulated the Covered Bond market for the first time
1986	Liberalization of capital movements (implemented 1992)	Implementation of EU Directive 88/361/EEC
1988	Securities Market Law (24/1988)	Numerous provisions governing the securities market, including ownership in repo transactions
1992	Securitisation Law (Law 19/1992)	Mortgage-Backed Securities (MBS) become legally tradable, permitting 'off-balance sheet' securitisation for mortgage-backed assets
1994	Autonomy of the Bank of Spain (Law 13/1994)	Gave the BdE full independence and a mandate for price stability, as required by EMU
1998	Royal Decree (Law 926/1998)	Other ABSs [other than MBSs] become permissible and tradable 'off-balance sheet'

Source: Author (2018)

Throughout the 1970s, BdE Governor Mariano Rubio, and Director of Research Services, Luis Angel Rojo, crafted the banks Research Service into the country's premier economic research institution (Lluch 1990, p.3). Rojo himself even wrote a book, *The New Monetarism* (1971), in which he strongly criticised the Keynesian economic consensus of the time. Importantly though, Rojo's thinking deviated from German monetarism through his belief that inflation was created not just by money supply growth, but by other factors too, such as excess demand in the labour market. He and the Research Service also failed to dismiss the value of countercyclical macroeconomic interventions which traditional monetarism thought harmful (Ban 2016, p.46). These programmatic Spain-specific monetary ideas laid the foundation for future interventionist, countercyclical financial policy ideas at the bank, and contrasted with German ordo-liberal (*Ordnungspolitik*) inspired ideas which aimed only to set a strong legal framework whilst limiting intervention to the manipulation of interest rates (Bibow 2017; Dyson and Marcussen 2009, p.141; Economist 2015).

Figure 4.12 below illustrates the interplay between the three levels of ideas (Schmidt 2014; 2008) and how they relate to Spanish finance. Neo-liberal philosophical ideas helped create a liberalising zeal within the BdE, leading to a rejection of programmatic Keynesian demand-stimulus policies and their replacement with an idiosyncratic Spanish monetarism more open to countercyclical state intervention (Ban 2016). This fed through to the deployment of interventionist policy ideas in relation to financial stability which helped establish a 'top-down' supervisory approach with countercyclical accounting methods introduced from the centre (BdE 2001; Pérez 1997[b]). In this respect, BdE neo-liberalism also differed from traditional neo-liberalism as it implicitly recognised that markets are capable of acting inefficiently. These ideational characteristics are vital in explaining how the BdE facilitated financial liberalisation, the approach it adopted towards financial supervision, and why Spanish financial institutions consequently reacted in the way they did to the growth of market-based finance and the commencement of EMU.

Figure 4.12: Spanish financial ideas



Source: Author (2018)

Spain began targeting the M3 monetary aggregate in 1973[120]. However, due to the combined impact of the international oil crisis, a domestic banking crisis and growing wage pressures, controlling the money supply became increasingly difficult. As a result, the BdE transitioned away from monetary targeting during the 1980s towards manipulating short-term interest rates in the pursuit of low inflation (Goerlich et al. 1995; Lukauskas 1997, p.205). In 1984 it started targeting a broader measure, the total liquidity of public assets ('ALP'), then in 1989 when Spain joined the European Exchange Rate Mechanism (ERM), it

[120] 15 years before the DB began targeting the same measure in Germany.

effectively abandoned targeting monetary aggregates altogether to peg the exchange rate. In 1994, Spain became only the seventh country in the world to officially ditch monetary targeting in favour of inflation steering (Debelle 1997) and the distinct monetarist ideas of the Research Service were crucial in facilitating this transition.

Figure 4.13: Evolution of Spanish monetary policy

Source: Author (2018)

These ideas also had important implications for financial policy. Before 1987, the BdE forced banks to hold sovereign debt in mandatory public debt coefficients. After this date, Spain abandoned this approach and begun organising sovereign debt auctions. To ensure its bonds were purchased at a reasonable price, it instituted a system in which 'market-makers' (*creadores de mercado* or 'primary dealers') were given privileged access at auctions, as long as they agreed to attend regularly and established debt placement targets with the Treasury and Financial Policy Directorate (Pellicer 1992, p.86). This began informally at first, but was implemented officially in July 1991.

Due to BdE concern for inflation over monetary aggregates, well-functioning, liquid interbank repo markets were seen as advantageous to the smooth transmission of monetary policy (Malo de Molina 2012, p.192). This contrasted to the DB approach which saw the expansion of interbank liquidity as detrimental to the provision of monetary targets

(Covil 1996; Gabor 2016, p.977). Therefore while the DB was reluctant to initiate regular public debt auctions and encourage short-term borrowing by introducing short-term Treasury Bills (Gabor 2016, p.977; McCauley 1999, p.4)[121], the BdE took the opposite view, embracing market-based financial developments.

Spain liberalised and removed interest rate controls from its interbank market in 1969 (Lukauskas 1997, p.111) and developed a functional repo market relatively early by global standards (World Bank 2010, p.24). Collateral for repos was initially restricted to high quality public paper, which often led to collateral shortages when the Spanish currency (the *peseta*) reduced in value (Cabrero et al. 1997, p.31-2). To combat this, as early as 1973 the Treasury began producing three-month Treasury Bills (with no specific budgetary purpose) with the aim of facilitating a better functioning interbank market (Pellicer 1995, p.36). The BdE maintained a daily presence in these markets, using repo operations to inject and drain off liquidity (Cabrero et al. 1997, p.14). These procedures were seen as crucial to facilitating a functioning interest rate transmission mechanism (Pellicer 1995, p.39), and the Securities Markets Law (24/1988) explicitly set out ownership rights in relation to repo collateral practices to support this process (Law 24/1988, Art.36).

In 1990, the BdE also began recording direct accounts for repos and from 1991, non-residents were no longer forced to pay tax on Spanish bond yields, leading to a sharp increase in external demand (Malo de Molina 2012, p.198). The contrast between BdE and DB attitudes and practices towards the interbank and short-term debt markets prior to EMU could hardly be starker, and distinctions between their interpretations of monetarist

[121] The DB failed to initiate its own primary dealer system until 1998 (DB 2002, p.154).

programmatic ideas are crucial to understanding this dichotomy. Illustration 4.7 shows how these events correspond to scenario C from the matrix displayed in chapter 2.

Spain's transition to market-based banking:		
C) new ideas in old institutions	**->**	**accelerate policy change**
iii) new policy ideas	->	strengthen existing structures and/or dominant ideas
New market-based policy ideas strengthened BdE programmatic monetarist ideas, helping facilitate inflation targeting.		

Illustration 4.7

Differences between the two NCBs also existed with regards to bank supervision. Although the BdE pursued a philosophical neo-liberal agenda in terms of its liberalising zeal and rejection of Keynesian monetary policy (Ban 2016; Rojo 1971), it maintained a more interventionist set of policy ideas in relation to financial supervision (BdE 2001; Pérez 1997[b]), which linked to its specific interpretation of monetarism (Ban 2016). While the DB favoured a 'hands-off', self-regulatory approach (Deeg 2001, p.17; Lütz 2004, p.173; 2005, p.142), the BdE preferred to nurture close relationships with institutions under its supervision, maintaining on-site inspections and requiring banks to submit large amounts of confidential material (BdE 2001, p.70 and 76).

In 1993, the BdE even took full control of Banesto bank and replaced its directors when an audit revealed an over valuation of assets (Pérez 1997[b], p.161; Poveda 2012, p.251). This was possible not only because of ideational dissimilarities, but also structural differences. Unlike the DB, the BdE acted as the accounting regulator for Spanish banks as well as their supervisor (Saurina 2009[a]; Thiemann 2012, p.39). This differentiated Spain's supervisory framework from the abstracted legalistic approach adopted in countries like Britain and Germany and permitted the BdE a much greater role in financial stability policy (Cioffi 2006, p.539; Lütz 2004, p.173; Royo 2013[a], p.647).

In September 2001, two years before the DB and three years before the ECB, the BdE launched a bi-annual financial stability publication (*Estabilidad Financiera*), in addition to its Annual Review (*Informe Annual*), outlining areas of potential concern. These publications are analysed throughout this section, with the results outlined in tables 4.8 and 4.9 below.

Table 4.8: Main concerns highlighted in BdE Financial Stability Reviews

	Low interest rates, credit growth & inflation	Housing Market	Securitisation[122] replacing deposits, increasing risk appetite & opacity	Bank Internationalisation (foreign exposure)	Inter-bank borrowing: more expensive than deposits & liquidity risk	Global financial Imbalances	Caja (un)profitability & exposure to doubtful assets	Stock Market
Nov 2002	✓			✓				✓
May 2003	✓	✓		✓			✓	✓
Nov 2003	✓	✓	✓			✓	✓	
May 2004	✓	✓			✓			
Nov 2004	✓	✓	✓		✓			
May 2005		✓	✓		✓			
Nov 2005		✓				✓	✓	
May 2006	✓	✓				✓		
Nov 2006	✓	✓				✓	✓	
May 2007	✓					✓		
Nov 2007			✓			✓		
May 2008		✓	✓		✓	✓		

Source: Author (2018)

[122] Including covered bonds (*cédulas hipotecarias*).

Table 4.9: Main financial concerns highlighted in BdE Annual Reports[123]

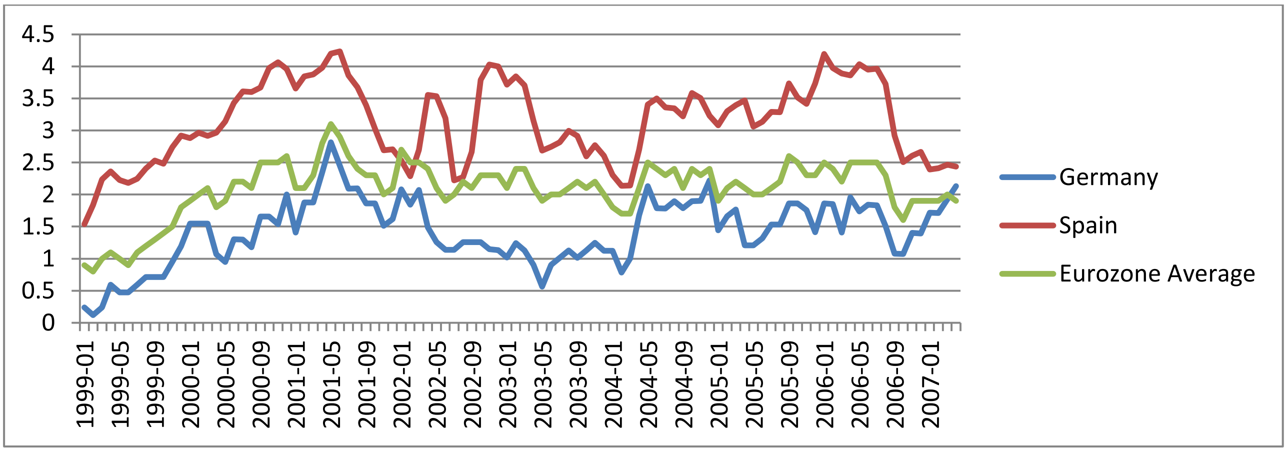
	Low interest rates, credit growth & inflation	Housing Market	Securitisation[124] replacing deposits, increasing risk appetite & opacity	Bank Internationalisation (foreign exposure)	Inter-bank borrowing: more expensive than deposits & liquidity risk	Global financial Imbalances	National loss of Competitiveness & Productivity	Government bond markets
1999	✓		✓	✓	✓		✓	✓
2000	✓				✓		✓	
2001	✓	✓		✓			✓	✓
2002	✓	✓		✓			✓	
2003	✓	✓					✓	
2004	✓	✓				✓	✓	✓
2005	✓	✓			✓	✓	✓	
2006	✓	✓				✓	✓	
2007	✓					✓		
2008	✓					✓		

Source: Author (2018)

True to its 'programmatic' ideational stance, the majority of issues concerning the BdE throughout the pre-crisis period related to the historically low interest rates Spain experienced as a result of euro membership, leading to inflation running higher than the Eurozone average (figure 4.14). Despite Spain's strong economic expansion, this phenomenon reduced Spain's competitiveness and prejudiced productivity growth, which continued to increase at an inferior rate to its European competitors (figure 4.15). These problems were highlighted in every *Annual Report* from the first issue (1999) to the final edition before the crisis in 2007.

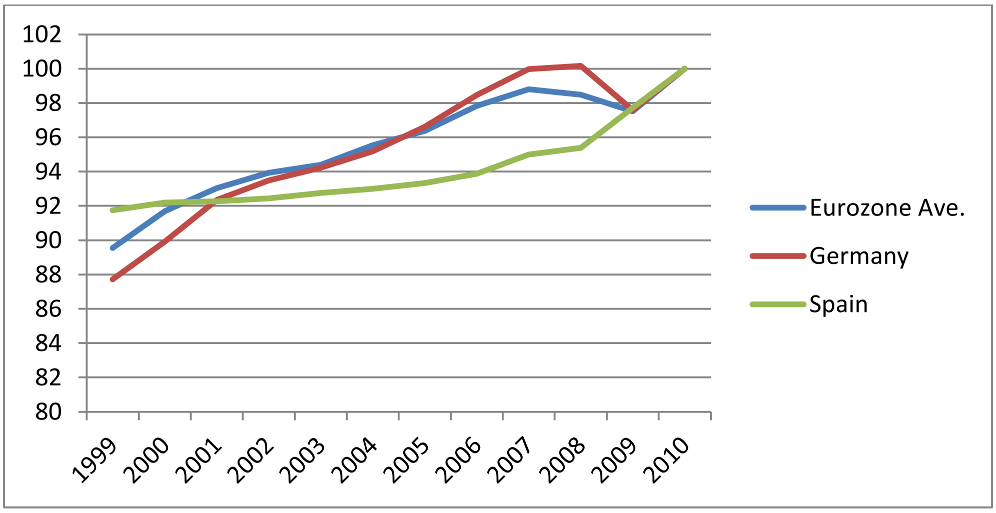
[123] Dates given are publication dates, not year under review.
[124] Including covered bonds (*cédulas hipotecarias*).

Figure 4.14: CPI Inflation (1999-2007)



Source: OECD Datasets

Figure 4.15: Productivity Growth (GDP per hours worked, 2010 = 100)



Source: OECD Datasets

The other major problem highlighted consistently throughout EMU was the issue of Spain's housing market. From 2001-2006 the bank worried increasingly about the unsustainable nature of Spain's property bubble, noting regular double digit price increases. In contrast to Germany which witnessed house price deflation under EMU (Ahearne et al. 2005, p.13), between 1997-2007, Spain's housing stock grew by almost 30 percent, while property prices rose 191 percent[125] (Royo 2013[c], p.14).

The BdE held EMUs low interest rate environment largely responsible for this phenomenon, coupled with domestic banks willingness to securitise mortgage loans to finance Spain's net borrowing position (BdE 2006[b], p.32; Cardenas 2013, p.7; De Barron 2011). By end-2005, non-residents held 73 percent of Spanish securitisations, against 40 percent in 2001 (BdE 2006[b], p.149), meaning that the Spanish financial system had become deeply interwoven with the rest of the Eurozone, and with Germany in particular:

> *The way in which we* [Spain] *benefited from financial liberalisation was though the securitisation of Spanish mortgages, sold to German banks. It was money in Germany that came to Spain in search of yield that created this housing bubble… It was completely reliant on the expansion of credit, and the expansion of credit was external credit*
>
> (BdE, interview #6, 2015)

As the quote above reveals, thanks to the 'benign neglect' of German and EU supervisors, many German financial institutions purchased large quantities of Spanish debt on the wholesale markets, compiling risk on the asset-side (Sinn 2014, p.92). Yet there was also another factor encouraging this phenomenon. Whilst non-Spanish banks use of repos increased dramatically under EMU, despite BdE repo market liberalisation, this trend did not extend to Spain (table 4.10) (BdE 2006[b], p.157).

This was partly because (unlike in Germany) the main assets used as repo collateral (sovereign bonds) were not being generated by the Spanish state due to net fiscal surpluses

[125] BdE researchers estimated that house prices had become 20 percent overvalued by 2002 (Ayuso and Restoy 2003).

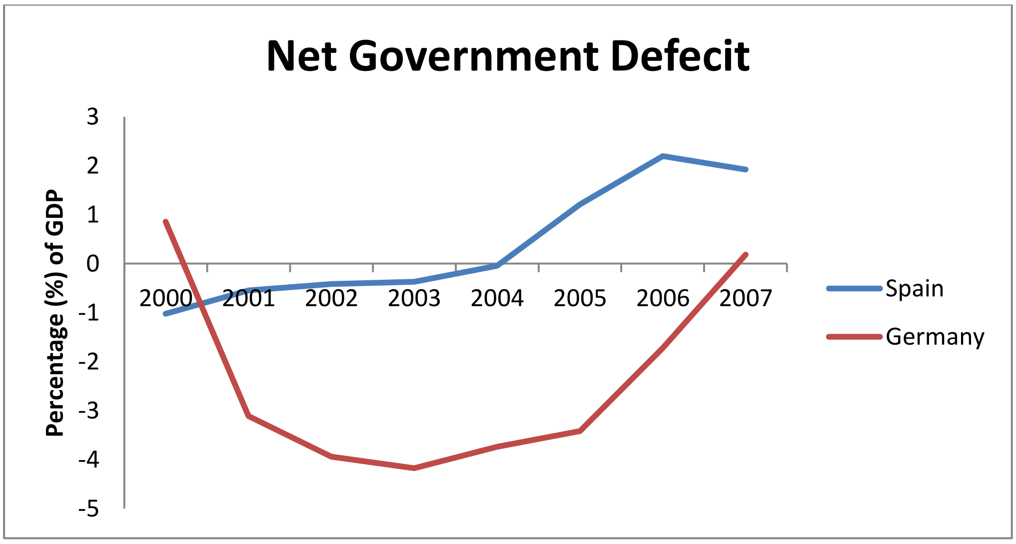
from mid-2004 which were used to offset rapid increases in household and corporate debt (BdE 2006[b], p.29). Indeed, despite the rest of the Eurozone compiling ever larger public deficits under EMU, Spain exhibited a 'Spartan-like' resistance to fiscal exuberance (Sinn 2014, p.57). Figure 4.16 contrasts government borrowing in Germany, which exceeded rules laid down in the SGP, with the surpluses recorded in Spain during the same period.

Table 4.10: Spanish repo business

	Spain		
	Interbank liabilities minus assets (% of GDP)	Total interbank liabilities (% GDP)	Total interbank assets (% GDP)
2007	2.5	6.7	4.2
2006	-2.8	0.6	3.4
2005	4.0	7.2	3.2
2004	4.3	5	0.7
2003	4.8	5.3	0.5
2002	0.8	3.1	2.3

Source: BdE (2007)

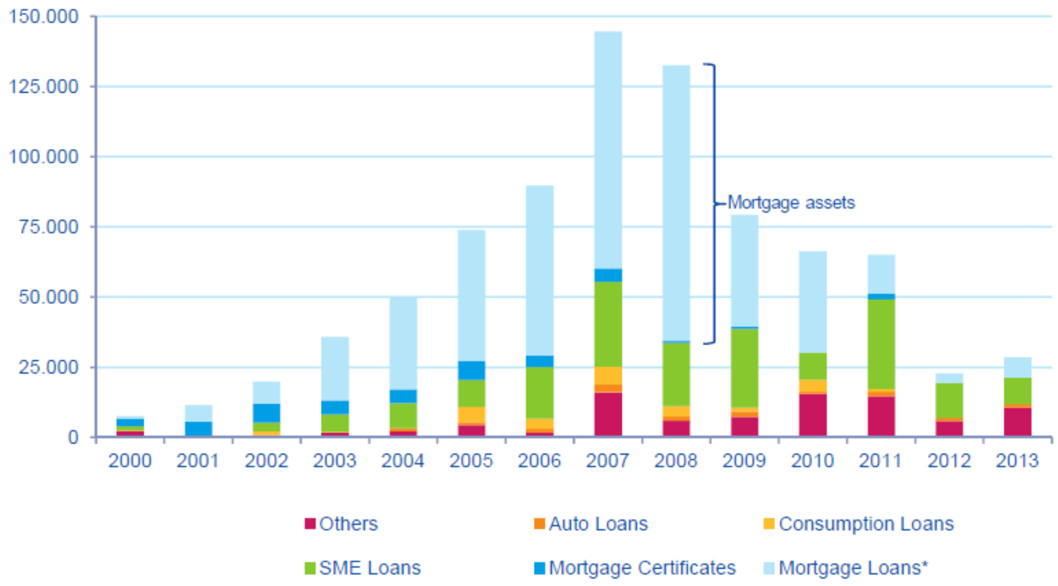
Figure 4.16: Spanish vs German net government borrowing under EMU



Source: OECD Data

This encouraged Spanish banks to obtain liquidity by selling Mortgage-Backed Securities (MBSs) (figure 4.17) – which became popular due to their favourable risk-weighting within the Basel II framework[126] (ECB 2005[c], p.25) – rather than through the repo markets. It also resulted in Spanish sovereign bonds having a minimal presence in the repo markets and therefore becoming less well regarded than German bonds. This is important for understanding why German government debt became so highly prized in the repo markets while Spanish bonds did not. It also ultimately explains why Germany was able to continue borrowing in the aftermath of the 2007-8 crisis whereas Spain was forced to seek EU assistance.

Figure 4.17: Spanish securitisation by underlying asset (€ millions)



Source: Millán, I., Securitization in Spain: Past developments and expected future trends. *BBVA Research* (2014, p.5). Re-published with permissions.

[126] Basel II (2004) was the second international financial regulatory standard framework agreed by the Basel Committee on Banking Supervision (BSBS). It required financial institutions to maintain a percentage of assets on their books to cover risks incurred by operations. It applied risk-weights to financial assets used as reserves by banks, depending on their perceived level of risk.

A further factor encouraging Spanish securitisation was the US Federal Reserve's lowering of collateral standards for repos in 1999 which increased demand for ABS across the globe[127]. The Fed believed that, as a consequence of tight US fiscal policy, the system would no longer contain enough US government paper to implement monetary policy through Open Market Operations (Gabor 2016, p.982). The lack of government borrowing in countries like the US and Spain therefore forced central banks to look beyond sovereign bonds as repo collateral, spiking demand for ABS (Gabor 2016) and helping to turbo-charge Spain's housing boom.

Spanish banks generally did not generate ABSs to redistribute risk[128], but to raise funds to facilitate lending at a time when deposits failed to keep pace with demand for credit (BdE 2005[a], p.43; 2006[a], p.30). In the case of Spanish covered bonds (*cédulas hipotecarias*) and most Spanish ABSs (particularly those originated by *cajas* [BdE 2005[a], p.45]), the originator of the security upheld management of the loans making up the asset[129]. While this allowed Spanish banks to maintain strong commercial relationships with their customers, it also meant the risk of non-performance largely remained on-balance sheet (BdE 2003[b], p.15; 2004[a], p.26), particularly after 2004 when accounting rules were amended[130] to ensure securitisations continued to be recognised where risk was not transferred (BdE 2005[a], p.30[131]).

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[127] This is particularly in Europe after the EUs Financial Collateral Directive (2002) lowered collateral requirements for European banks seeking liquidity from the ECB.
[128] This differentiated Spanish securitisation from the 'originate to distribute' model of found in other jurisdictions.
[129] In 2006, three-quarters of the assets securitised by Spanish deposit institutions were 'non-synthetic' and remained on balance sheet (BdE 2006[a], p.31).
[130] *Banco de España* Circular 4/2004.
[131] *Banco de Espana* (2004). Circular 2004: Credit Institutions, Public and Confidential Financial Reporting Rules and Formats (English Version). Madrid: Banco de España, pp.55.

The BdE therefore recognised Spain's financial conditions were particularly sensitive to developments in the real estate sector through external demand for ABSs (BdE 2006[b], p.149). In a bid to curtail this dependence and prevent excessive lending, the BdE strengthened its financial regulations in 2003 (Law 19/2003) by ruling that financial institutions with significant exposure to ABS would be regulated on a 'consolidated' basis, meaning all the assets of sister companies and SPVs pertaining to umbrella banking groups would fall under Spanish capital requirements[132] (Fernandez de Lis and Garcia-Herrero 2009, p.7).

This style of regulation was originally introduced in 1985, but the legislation contained no mention of investment services firms as they were only permitted in Spain after the introduction of the securities market reform law (Law 24/1988) (Poveda 2012, p.248). In 1992 rules were strengthened further to ensure mixed groups (e.g., banking and insurance) were subject to duel capital requirements as a banking group and a mixed group. These rules attempted to deal with complex financial conglomerates 10 years before the EU attempted to do likewise and fell squarely in line with BdE programmatic and interventionist policy ideas.

The 2003 amendments aimed to address the fact Spanish banks were becoming increasingly dependent on shadow banking and the production of synthetic securitisations (BdE 2006[b], p.149; Fernandez de Lis and Garcia-Herrero 2009). While German banks often used SPVs to originate US and peripheral MBSs, in Spain, these securities were mainly structured around domestic mortgage loans (BdE 2006[b], p.149). The new regulations forced Spanish 'shadow

[132] This measure was strongly resisted by Spain's large private banks which feared the move would reduce profitability (Tett 2008).

banks'[133] to become integrated within their parent commercial banks (or simply to become unviable), by ensuring capital buffers became applied to both activities jointly (Brañanova 2012, p.3). This drastically curtailed off-balance sheet securitisation in Spain, which by 2007 had reduced to around only 6-7 percent of total securitisation in the country.

Such activity that did then occur tended to take the form of simple 'plain vanilla' instruments (Fernandez de Lis and Garcia-Herrero 2009), far less opaque than more complex derivatives (Ordóñez 2011). These accounting changes, informed by BdE interventionist policy ideas, were crucial to curtailing the shadow banking industry in Spain and in sheltering the country from the initial stages of the crisis. These ideas helped maintain structural continuity in Spain and shows how combining insights from DI and HI together can improve understanding of institutional development:

Spanish interventionist financial regulation:		
C) new ideas in old institutions	**->**	**accelerate policy change**
iii) new policy ideas	->	strengthen existing structures and/or dominant ideas
New financial policy ideas strengthened BdE programmatic ideas and the existing institutional framework.		

Illustration 4.8

In 2000 the BdE also established a new framework for provisions, requiring banks to set aside additional capital against default. A lack of provisioning was one the key factors behind previous banking crises in Spain (Lukauskas 1997, p.167), and the positive economic environment in the country saw a significant reduction in nonperforming loans (NPLs). This

[133] Referred to as Specialised Credit Institutions (SCIs) by the BdE (BdE 2004[b], p.52)

resulted in Spain having the lowest ratio of loan loss provisions to total loans in the Organisation for Economic Cooperation and Development (OECD) by 1999 (Saurina 2009[a], p.1-2). To tackle this, the BdE became the only major central bank in the world to enforce countercyclical 'dynamic' or 'statistical' provisions before the crash (Fernandez de Lis and Garcia-Herrero 2009; Jiménez et al. 2012).

These measures took effect from July 2000 (Fernandez de Lis and Garcia-Herrero 2009, p.7; Saurina 2009[a]) and forced lenders to build up an additional €40 billion safety net to guard against future loss, costing banks around 10 percent of their net operating income (Saurina 2009[a]). The policy was hence not only intended to mitigate bad times, but also to cool lending at a time when the country was experiencing low real interest rates and strong credit growth (BdE 2001, p.43; 2013[b]; Fernández de Lis et al. 2000).

Table 4.11: Original statistical provisions (2000)

Months in Default	3-6	6-12	12-18	18-21	21+
Provision: % of loan	10	25	50	75	100

Source: BdE Circular 9/1999

Whilst other central banks and central bank governors were arguing macro-prudential regulation[134] (MPR) could do harm to a nation's economic prospects (Bernanke 2002; Duisenberg 2003; Greenspan 2002), and German banks were winding down provisions, the BdE, driven by policy ideas derived from its idiosyncratic interpretation of monetarism, was

[134] Defined by the IMF as the use of primarily counter-cyclical prudential (bank capital) tools to limit overall systemic risk (IMF 2013, p.6).

convinced implementing countercyclical regulations in the face of sustained credit growth could prove invaluable (Otero-Iglesias et al. 2016, p.27). Indeed, prior to the crisis, it cited pro-cyclicality as one of the biggest threats to long-term financial stability (BdE 2004[b], p.34-5).

Implementing dynamic provisioning, however, was politically difficult and was criticised both by the Spanish banking sector as well as the EU and faced stiff opposition from politicians (De Barron 2011). In 2004, the BdE was forced to revise the system in response to the EUs adoption of International Financial Reporting Standards (BdE 2005[c], p.13; Saurina 2009[a], p.2), ensuring that although other MPR measures were floated by BdE officials, no further policies were implemented:

> *There were discussions about using some* [additional] *macro-prudential measures like cutting LTV*[135] *ratios, but it was very difficult given the political and economic situation at the time*
>
> (BdE: interview #6, 2015)

While the BdE expressed concern about securitisation and lending to the construction sector (BdE 2005[a], p.43; 2004[a], p.23), Spanish banks maintained very low exposures to hedge and private equity firms (BdE 2005[a], p.58), and repo market borrowing also remained low[136] (BdE 2007[b], p.129). Consequently, when issues began to surface in the US sub-prime market in 2007, the BdE was confident of escaping the problems due to the low investment of Spanish banks in such assets, the almost non-existent Spanish shadow banking industry (BdE 2007[a], p.15-19; 2008, p.11), and the high quality of Spanish securities (BdE 2007[a], p.31). Yet despite all this, and the interventionist policies which

[135] Loan-To-Value Ratios: limiting the amount individuals can borrow depending on the equity they can raise.
[136] In stark contrast to other EU states, Spanish interbank borrowing even saw negative growth during 2006 (table 4.10).

helped delay the crisis in Spain, the BdE was ultimately unable to prevent the country suffering a catastrophic banking crisis.

Figure 4.18: BdE measures to slow credit growth

1998 Asset-Backed Securities (Law 926/1998)

- Legalised ABS market, but ensured high quility standards for covered bonds (*cédulas hipotecarias*) and MBS's.
- No 'originate to distribute' : Originators continue to play the role of credit managers with responsibility for monitoring and supervision.
- Securitised assets therefore mostly remained on the books of originating groups, meaning they were included in solvency ratios, reducing scope for off-balance sheet lending.

2000 Dynamic Provisions

- Dynamic 'statistical' provisions first introduced.
- Banks forced to provision 100% of loan value after 21+ months of non-payment (even in relation to property loans).
- The 2004 shift to international accounting standards reduced its scope, allowing provisions to be included in banks 'own funds'. Prior to the change, Spanish capital adequacy ratios were effectively 2% higher than the European average.

2003 Consolidated Regulation Strengthened (Law 19/2003)

- First introduced in 1985, but with no mention of investment services firms as they were only permitted in 1988.
- In 1992 rules were strengthened as banking groups solvency requirements were judged on a consolidated basis; and mixed groups became subject to duel capital requirements.
- The 2003 rules meant the exposure of all sister companies and SPVs pertaining to banking groups fell under Spanish supervision and capital requirements.

Source: Author (2018)

SUMMARY

The BdE and its Research Service subscribed to a distinct set of ideational preferences which framed their policy goals and objectives. Their neo-liberal philosophical ideas helped shape Spain's transition from an economy based on central control and clientalism to one based predominantly on liberal market forces (Ban 2016; Lluch 1990; Lukauskas 1997, p.97). The BdE's distinct interpretation of programmatic monetarist ideas also facilitated Spain's early shift from a monetary policy based on targeting monetary aggregates to one built on controlling inflation. By using process tracing, this section showed how important ideas were be in delivering substantive institutional change both within the BdE itself, and the Spanish economy more broadly.

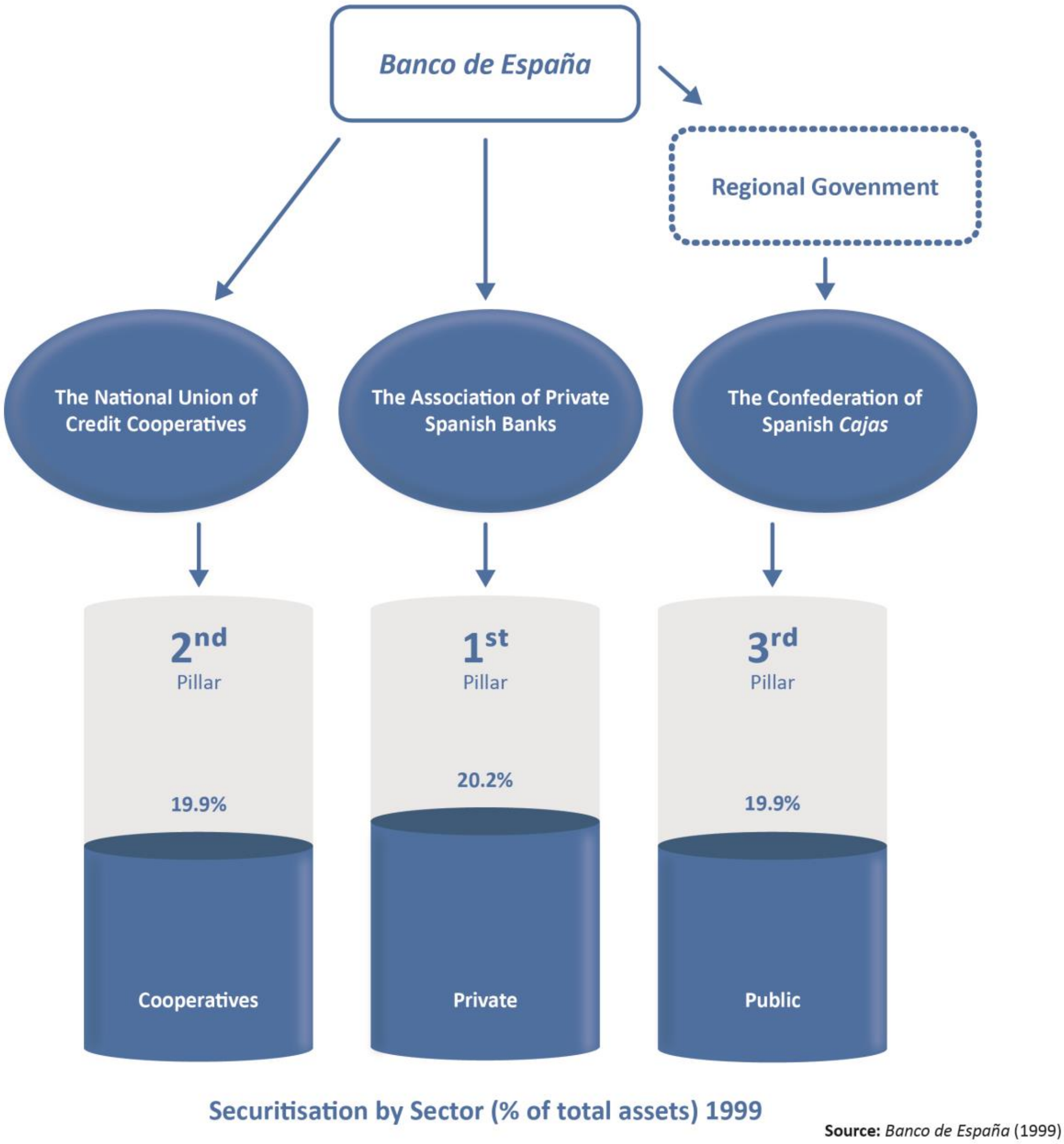
The BdEs reading of monetarism also had important implications for the advance of market-based finance in Spain and for the creation of Spain's repo market which was nurtured to ease monetary policy transmission (Pellicer 1995, p.39). These programmatic ideas also facilitated countercyclical interventionist policy ideas designed to maintain financial stability and reduce credit growth – concepts most central banks rejected before the crisis (Bernanke 2002; Duisenberg 2003; Greenspan 2002). These developments cannot be properly understood without recognising the extent to which ideas helped expedite important policy changes.

Yet while ideas are crucial in explaining pre-crisis financial developments, Spain's supervisory structure was also important. Spain's centralised supervisory architecture allowed greater scope for BdE intervention than that afforded to the DB in Germany. While Germany's decentralised framework prevented intervention, the BdE was handed supervisory, regulatory and accounting authority over its banks and maintained a personal presence on bank boards (BdE 2001, p.70 and 76; Saurina 2009[a]; Thiemann 2012, p.39). To fully understand the dichotomy between the German and Spanish approach to financial regulation, it is therefore necessary to analyse both ideational and structural factors, incorporating insights from HI and DI concurrently.

4.4: The Spanish Banking System

While the previous section focused primarily on ideas, this section concentrates chiefly on the structural dynamics of Spain's financial system. Akin to Germany, the Spanish system centred on three-pillars, consisting of private banks (*bancos privados*) cooperatives (*cooperativas de credito* or '*cajas rurales*') and public savings banks, (*cajas de ahorro* or '*cajas*') (Maudos and Vives 2017, p.567; Stefanelli 2010, p.24). Spanish private-universal

Figure 4.19: Structure of Spain's banking system (1978-2012)

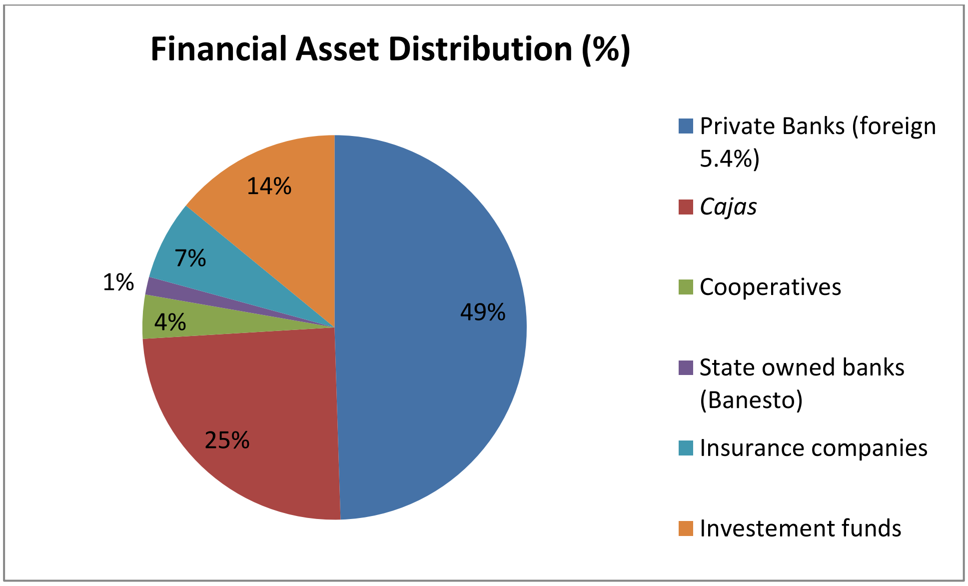


Source: Author (2018)[137]

[137] Banking associations are less important in Spain than Germany, with the National Union of Cooperatives (*Union Nacionale de Cooperativas de Credit* – UNACC), the Association of Spanish Private Banks (*Asociación*

banks existed principally to turn a profit, whilst the smaller cooperative sector distributed credit to members, primarily in rural areas. Before the crisis, the three most important private banks were Banco Santander, Banco Bilbao Vizcaya Argentaria (BBVA) and Banco Popular. Santander and BBVA in particular operated as large international investment banks (table 4.6) with substantial holdings in Europe and Latin America[138] (BBVA 2010; Elliott 2016; Tortella and Garcia-Ruiz 2013, p.164).

Figure 4.20: Structure of Spain's financial system at the birth of EMU (2000)



Source: IMF (2006)

Cooperatives meanwhile represent a small but steadily growing proportion of Spanish banking activity[139]. Since 1988 when *cajas* became permitted to operate outside their autonomous regions, cooperatives – which base their business models on localism and the

Española de Banca Privada – AEB), the Confederation of Spanish Cajas (*Confederacion Española de Cajas de Ahorros* – CECA) only becoming founded in 1969, 1977 and 2000 respectively (Stefanelli 2010, p.25).

[138] BBVA, for example, currently generates around two-fifths of its overall earnings from Mexico (Montijano and Penty 2016).

[139] Representing 3.7% of total assets in 2000, and 5% in 2014.

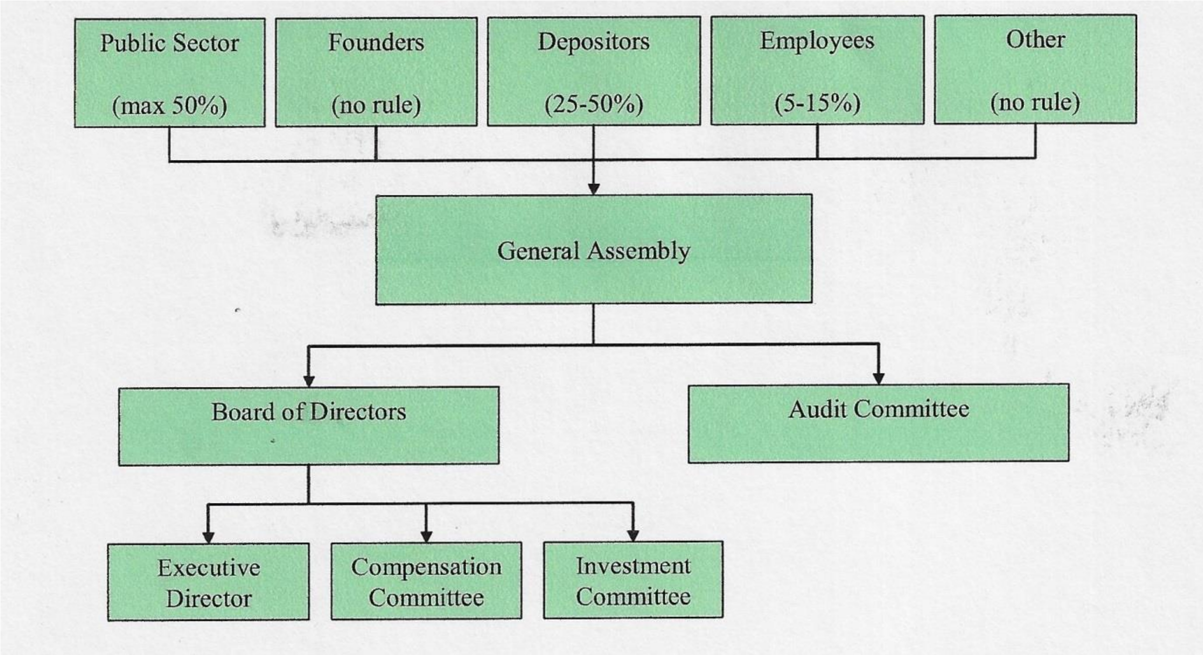
provision of services for their members – started to become more popular (Stefanelli 2010, p.35). There are now 73 regionally restricted cooperatives in Spain which, like German cooperatives, are still able to offer similar services to larger banks through their Association while maintaining local connections (Ruralvía 2017).

This segment concentrates principally on the *cajas* as they are the most important of the three-pillars for understanding how Spain came to be impacted so severely by the sovereign debt crisis (2010-12), and for illustrating how Spain's financial system adapted to the onset of market-based finance. Indeed, the crisis in Spain originated almost exclusively in the *cajas* whose lending stimulated a huge housing bubble they were unable to sustain once the market for ABS collapsed during the crash (Royo 2013[a], p.637; 2013[b] p.153; Garicano 2012[b]).

Cajas were originally state-owned and while made independent during the liberalisations of the 1970s, remained public law institutions, retaining strong connections to their local municipalities (Bülbül et al. 2013, p.15; Schmidt 2009, p.367). Analogous to German public banks, *cajas* were originally restricted to activity within their autonomous regions and were structured partly to advance social goals, using a proportion of their profits to invest in charity work for the benefit of local communities (Cardenas 2013, p.8; Caruana 2003, p.3; Minder 2012; Ysa et al. 2012, p.269).

Within the *cajas* corporate framework, the General Assembly was the most important structure and comprised the banks stakeholders. It performed a similar function to a shareholder meeting in a publically limited company and was responsible for providing its strategic orientation and selecting management (IMF 2006, p.8). Before 2010, the 'LORCA' law (1985) established the legal framework of *cajas* governing bodies, affording politicians a strong presence.

Figure 4.21: *Caja* corporate framework



Source: Reused with permission, "Spain: Financial Sector Assessment Program—Technical Note— Regulation, Supervision, and Governance of the Spanish Cajas" (IMF Country Report No. 06/215, p.8).

Regional governments directly appointed local politicians and businessmen to sit on corporate boards (Cardenas 2013, p.9; Molinas 2013; Tortella and García-Ruiz 2013, p.183), frequently leading to *cajas* being used as 'piggy banks' for regional representatives to distribute patronage (Minder 2012; Royo 2013[c], p.25; Tremlett 2012). This resulted in similarities being drawn between *cajas* and *Landesbanken* (Ayadi 2009, p.43; Beck 2012, p.16; Hernández et al. 2015, p.1), although unlike *Landesbanken*, *cajas* operated without explicit state guarantees[140].

Cajas were also part-regulated by the same politicians involved in their corporate governance (Cardenas 2013, p.9; Otero-Iglesias et al. 2016, p.26; Tortella and García-Ruiz 2013, p.183). The post-Franco constitution of 1978 granted Spanish regions a high degree of autonomy and significant influence over their local *cajas* (Molinas 2013). Consequently, unlike cooperative or private banks, *cajas* were subject not only to the supervision of the BdE, but also of regional governments who had a direct interest in the institutions profitability (Otero-Iglesias et al. 2016, p.26; Quaglia and Royo 2015, p.491; Ysa et al. 2012, p.266). This regional political control of *cajas*, coupled with authority over local planning laws, meant politicians were able re-zone large tracts of land and borrow cheaply to fuel a huge construction boom (Molinas 2013), resulting in *cajas* in particular accumulating huge levels of risk on the liabilities-side of their balance sheets.

Due to such governance problems, calls were made repeatedly by BdE officials to liberalise and reform *cajas* (Caruana 2001; Martín 2000). The IMF and OECD, as well as the Spanish Business Confederation (*Círculo de Empresarios*), all recommended privatising the sector (Euromoney 2000), arguing it was wrong for much of Spain's financial system to be lacking ownership and under the control of political parties (Stewart 2000). The former Spanish Finance Minister, Cristóbal Montoro, also called for the political presence in *cajas* to be reduced (De Barron 2011), and in 2003, BdE Governor Jamie Caruana again pressed *cajas* to

[140] Although in the case of *cajas* the system of ownership was complex, the ultimate guarantor in the event of bankruptcy was largely understood to be the Spanish state (Cardenas 2013, p.7).

professionalise their boards and concentrate on activities for which they were originally designed (Caruana 2003).

Yet despite these demands, political forces maintained their positions within *cajas* (Deutsche Bank 2004, p.6) and no domestic reforms were forthcoming due to the role of the autonomous communities (*comunidades autónomas*) in their supervision and the vested interests of politicians seeking to retain the *status quo* (Stewart 2000). The failure of the Spanish state to implement reform in the face of neo-liberal philosophical ideas at the BdE and calls for change from within the Spanish federal government points to the significance of vested interests in facilitating path-dependent trends - revealing an instance of scenario B from table 2.2. Indeed, as in Germany, the only limited reform that did take place in the sector came as a result of supranational edict from the EU Commission.

Path-dependence in Spain's *cajas*		
B) structures trump ideas	**->**	**institutional continuity**
The story of the *cajas* shows path-dependence is particularly strong when political vested interests seek to maintain institutional continuity. Illustration 4.9		

Critical Case Study: CAM

See Appendix II

European Intervention

Before 2002, public authorities accounted for more than half of representatives on *cajas* corporate boards. This risked the banks becoming defined as public institutions under EU law. As a result, some of the corporate loans granted by *cajas* may have become classified as state aid, in violation of EU competition rules. To prevent this, a law on financial market reform (Ley Financiera, 44/2002) was passed, capping the number of political representatives at 50 percent. This remained the only legislative reform to affect *cajas* until the commencement of the sovereign debt crisis in 2010, and may be cited as an example of 'Europeanisation': of EU member-states adapting to EU rules requiring regional harmonisation (see Featherstone and Radaelli 2003).

Table 4.12: Important pre-crisis *caja* legislative changes

1985	The 'LORCA' (Law 31/1985, 1985)	Established a new corporate framework for cajas. • Cajas free to open branches in traditional regions • Reduced political control by enhancing the power of depositors, founders, charitable organisations and others within the General Assemblies • Equalisation of the investment coefficient for commercial and savings banks
1988	STC 48 & 49 1988	Ended the 'regional principle', allowing cajas to operate outside of their autonomous region, but increased public sector representation
2002	La Ley Financiera (44/2002)	Reduced public sector representation to 50 percent

Source: Author (2018)

Summary

This section provided an overview of the Spanish financial system. Concentrating on the public banking sector, it drew parallels between the Spanish and German systems, and between *cajas* and *Landesbanken* in particular. It showed that despite internal and external calls to reform and privatise *cajas*, particularly within the BdE (Caruana 2001; 2003; Martín 2000), significant legislative change was avoided. This was largely due to the structure of existing institutional arrangements and the vested interests of politicians[141] who sought to maintain influence over *caja* activity (De Barron 2011; Molinas 2013; Pérez 1997[b], p.167; Royo 2013[b], p.175).

As with *Landesbanken*, it was only intervention in the form of European competition policy which managed to instigate some limited reform of the sector. This reveals the importance of incorporating the HI concepts of path-dependence and vested interests into analysis of European financial systems, which in this case were able to maintain continuity despite liberal reform efforts stemming from national and international organisations (Moe 2015, p.285). This demonstrates the significance of structural constraints as well as ideational factors on the evolution of European finance, and speaks to the benefits of combining insights from HI and DI in political economy research.

4.5: Conclusion

Why did German and Spanish financial institutions react differently to the advent of market-based banking and the creation of EMU?

[141] Who, as the 'critical case study' makes clear, were sometimes drawn into outright corruption (Cardinas 2013, p.16; Molinas 2013; Villoria et al. 2013).

This chapter showed how important ideas and structures were in shaping the evolution of German and Spanish finance and how each financial system contended with the investiture of market-based banking. Philosophical ideas in the form of ordo- and neo-liberalism, held predominantly within the two countries NCBs and finance ministries guided the process of liberalisation in each state (Ban 2016; Dyson 2002[c], p.174; Matthijs 2016). They also helped inform distinct 'programmatic' monetarist and financial 'policy' ideas in each nation.

Whereas the DB subscribed to traditional monetarist ideas advancing a concern for monetary aggregates, the BdE adopted an alternative interpretation and remained more concerned with inflation. Therefore while the DB was reluctant to liberalise short-term debt markets (Gabor 2016, p.978; Trampusch 2015, p.122), the BdE saw repo markets as a means of conveying effective monetary policy (Pellicer 1995, p.39). Although under EMU DB attitudes to securitisation began to change as it started to see private financial assets as a means of reducing demand for sovereign debt and therefore as conducive to price stability (DB 2006[a], p.31-3), it remained sceptical of complex risk-transfer products and hedge funds which it saw as capable of distorting market discipline and operating outside traditional legal frameworks (DB 2004[c], p.40; 2005[a], p.48).

The two NCBs also developed distinctive financial policy ideas which they derived from their contrary monetarist outlooks. Spain established an interventionist 'top down' on-site supervisory approach, tightly regulated its securities markets and introduced 'dynamic provisioning' (BdE 2001, p.43; Fernández de Lis et al. 2000). Conversely, the DB adopted a non-interventionist 'hands-off' approach to supervision, resulting in risk being accumulated on the asset-side of German bank balance sheets. These NCB policies cannot be fully understood without recourse to ideas at each level of abstraction[142].

Yet the chapter also revealed structures to be vital in explaining pre-crisis financial trends. The structural low profitability of the German financial sector (Commission (2014[c], p.40; Hardie and Howarth 2009, p.1019) helps illuminate why German banks and *Landesbanken* sought opportunities abroad, and Germany's decentralised, federal supervisory framework also partly expounds why the DB was unable to take more intrusive action to promote financial stability. Likewise, the low interest rate environment under EMU and political control of both planning regulations and *cajas* in Spain meant that despite 'top-down' on-site supervisory methods and a more interventionist approach to financial regulation (BdE 2001, p.43; Fernández de Lis et al. 2000), the BdE was unable to prevent regional politicians stoking the Spanish construction boom (Molinas 2013) and risk accumulating on the liabilities-side of bank balance sheets.

Moreover, despite repeated calls from national and international bodies to reform their respective public banking sectors (Caruana 2001; DB 2003[b], p.45-6; Euromoney 2000; IMF 2003; Martín 2000), change was resisted in both countries by embedded political 'vested interests' (Behn et al. 2014; De Barron 2011; Ewing 2010; Lütz 2004, p.188; Pérez 1997[b], p.167; Royo 2013[b], p.175). This shows that domestic path-dependent structures are able to resist changing ideas and calls for reform (even when pressure is applied by domestic and international organisations) if political vested interests are strong enough. The fact that the only (limited) pre-crisis reforms applied to *Landesbanken* and *cajas* came as a result of

[142] Philosophical, programmatic and policy ideas (Schmidt 2014).

supranational demands from the European Commission speaks to the strength of domestic path-dependence. Only by combining insights from DI and HI is it therefore possible to reach a comprehensive understanding of the factors determining the behaviour of German and Spanish financial institutions throughout this period.

Chapter 5
The Eurozone Pre-Crisis

Why has the ECB become increasingly attentive to financial stability concerns?

Ideational research on Economic and Monetary Union (EMU) has tended to focus almost exclusively on neo-liberal philosophical ideas (Blyth and Matthijs 2016; Kaelberer 2003; McNamara 1998), monetarist programmatic ideas (Baimbridge et al., 2001; Ban 2016; McNamara 1998), and policy ideas which pressed for further financial integration (Jabko 2006; Parsons 2003; Schmidt 2005). This chapter fills an important gap in the literature by exploring the extent to which the European Central Bank (ECB) also prioritised policy ideas in relation to financial stability before the 2007-8 crisis, and why it sought to do so. Appreciating how officials viewed financial stability before the crash is essential to understanding why the Eurozone was impacted in the way it was, and why European policymakers took the decisions they did in its aftermath (Borio 2011; Cooper 2008, p.25).

Using process tracing and discernments from Discursive (DI) and Historical Institutionalism (HI), the chapter furthers analysis of institutional change by tracking how financial stability ideas[143] evolved over the course of EMU. It reveals that true to insights from both these approaches, once the founders of EMU settled upon monetarism as their core

[143] Understood as notions concerning the manner in which financial systems operate and how institutional and systemic risk should be managed.

programmatic idea, the concept was 'locked in' through the creation of structural impediments which prevented the ECB deviating from its price stability[144] mandate. This ensured the bank maintained a strong path-dependent commitment to monetary stability above all else (Howarth and Loedel 2005, p.15; Quaglia 2008, p.110).

However, measures taken by the European Commission and ECB to try to improve the functioning of monetary policy subsequently exposed an innate contradiction within EMUs framework. The ECBs targeting of inflation through the manipulation of interest rates required financial integration to improve monetary transmission (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005). Yet EMU also imposed a strict separation of monetary, fiscal and financial policy to ensure bond markets discriminated between EMU sovereigns to promote fiscal conservativism. As Eurozone capital markets became more integrated, sovereign bond yields narrowed and the risk of financial contagion exacerbated, leading the ECB to become increasingly concerned with financial stability as well as price stability.

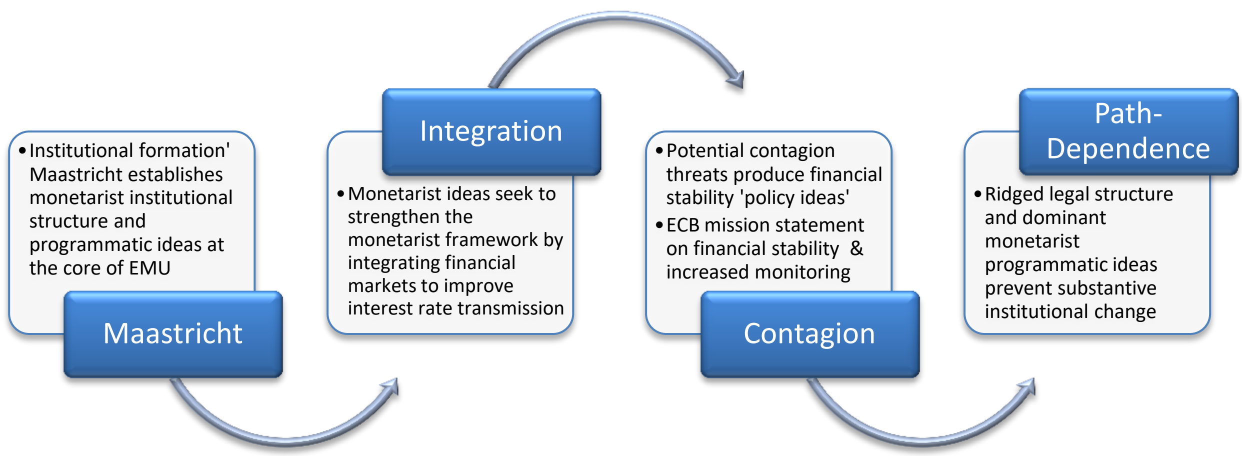
This sparked a gradual ideational transition from 2003 when ECB President, Jean-Claude Trichet, officially connected financial integration with financial fragility (Trichet 2003). ECB discourse then shifted from suggesting financial stability could be achieved simply by delivering price stability (Duisenberg 2003; Noyer 1999[b]), towards recognising financial stability as an objective in its own right (Padoa-Schioppa 2003; Papademos 2006; Trichet 2003). Nevertheless, despite this evolution, monetarist ideational path-dependence (Cox

[144] The maintenance of low and stable inflation.

2004) and EMUs stringent legal structure ultimately prevented extensive institutional change during the period.

Figure 5.1 below provides an illustration of the argument and shows how ideational change within EMU should not be viewed as a 'punctuated equilibrium' (Krasner 1988) between two critical junctures[145]. Rather, concern for financial stability strengthened incrementally as banking became more market-based and integrated. This supports the DI claim that the cognitive abilities of decision-makers are capable of breaking from structural impediments and enacting gradual institutional change endogenously (Blyth 2011; Hay 2011; Schmidt 2010).

Figure 5.1: EMU institutional evolution 1992-2007



Source: Author (2018)

[145] These 'critical junctures' are understood within the literature to be of the signing of the Maastricht Treaty (1992) which crystallised monetarist ideas at the supranational level, and the 2007-8 financial crisis (Braun 2015, p.422; Verdun 2015; 2007; Yiangou et al. 2013, p.225).

The chapter begins by exploring the structural and ideational foundations of the euro and analyses why the founders of EMU eventually settled upon the monetarist framework fashioned at Maastricht (Risse et al. 1999, p.152). It also discusses the extent to which financial stability was recognised as an independent policy objective at the supranational level during this time. The second section analyses the early history of EMU between 1999 and the eve of the crisis in 2007. In this segment, the reader is taken through developments which pushed the ECB to become progressively concerned about more than just inflation targeting and to enhance supranational financial oversight. The third section draws to a conclusion.

5.1 Birth of the Euro and the Primacy of Price Stability

In legal terms, the monetary policy of the ECB rests on three pillars: prohibition of monetary financing; central bank independence; primacy of price stability

(Issing 2008, p.54)

Under the forerunner to the Eurosystem, the European Monetary System (EMS), monetary coordination centred on the harmonisation of exchange rates. Recognising the structural and ideational developments which took place during this period is essential to understanding why the ECB was initially handed only a limited advisory role in relation to financial stability (Scheller 2006, p.111), and why the core function of the ECB was largely restricted to maintaining price stability.

The main component of the EMS was the Exchange Rate Mechanism (ERM) which was introduced on the 13th March 1979 in a bid to reduce exchange rate variability between members and support monetary stability. The ERM pegged member currencies to each other within a variance of 2.25 percent of a basket of averages, known as the European Currency Unit (ECU). As guardian of the largest and most important economy in the system, many came to view the *Deutsche Bundesbank* (DB) as the *de facto* central bank for the entire EMS, and the *Deutsche Mark* as the ERMs currency anchor (Heipertz and Verdun 2010, p.22; Howarth and Loedel 2005, p.18; Nedergaard and Snaith 2015, p.1099). Anders Fogh Rasmussen, the former Danish Minister of Economic Affairs, complained in 1991 that:

> *If the Bundesbank's Directorate even blinks, it sends shock waves through the capital markets across the whole of Europe without us having even the slightest means of intervention*
>
> (Rasmussen 1991, no page)

If the DB raised interest rates to reduce inflation in Germany, other central banks were effectively forced to do likewise to keep parity with the *Deutsche Mark* (Levitt and Lord 2000, p.121; Sinn 2014, p.28). Through this inadvertent German dominance of the system, Dyson (2000) argues the EMS acted as an 'elite socialisation mechanism' through which monetarist conceptions of price stability became dispersed (Dyson 2000, p.128). Importantly, monetarist ideas which derived from ordo-liberalism (*Ordnungspolitik*) dominated in Germany long before 'neo-liberalism' and monetarism became the consensus Western economic view (Garber 1993, p.463; McNamara 1998; Nedergaard and Snaith 2015, p.1102). Indeed, the perception that it was ideas emanating from the DB that provided the ideational framework for EMU is widely asserted within HI and DI literature (Bibow 2013; Blyth 2013[a], p.141; Dyson 2002[c]; Quaglia 2008, p.47-74).

For the DB, the pursuit of price stability was the *raison d'être* for the existence of both central banks and monetary policy. Monetarist ideas were seen as more than just salient economic policies, but the very foundation of a stable socio-economic order. In 2002, former Bundesbanker and ECB Chief Economist, Otmar Issing, put the argument as follows:

> *Stable money, stable prices: these are the very foundations of a well-functioning market economy… However, the case for price stability goes beyond the purely economic sphere. Price stability, the ability to rely on stable money, is the basis for trust in the interaction among economic agents, trust in property rights, trust in society and trust in the future more generally. Trust in stable money is also the basis for a free society, the ability of people to take decisions and plan their future for themselves*
>
> (Issing 2002[a], p.23)

The success of monetarist policies in Germany and the heightened linkages wrought by the EMS undoubtedly helped spread stability orientated ideas across the continent (Blyth 2013[a], p.141; Jabko 2006, p.170). It created substantial policy synchronisation among European central banks and provided member-states with a powerful example to emulate (Dyson 2000, p.129; McNamara 1998, p.6; Quaglia 2008, p.73).

However, the extent of neo-liberal and monetarist ideational convergence between the nations of Europe is often overstated in the literature (Quaglia 2008, p.104). Although there are similarities between neo- and ordo-liberalism, there are also important differences (see chapter 2). This meant, for example, that philosophical ideas within the ordo-liberal German Federal Economics Ministry, Federal Finance Ministry and DB, remained distinct from those in the Spanish Ministries of Economics, Finance and the BdE, which tended to subscribe to neo-liberal ideas (Lukauskas 1994; Pérez 1997[a]; Tortella and Garcia-Ruiz 2013, p.150). Moreover, negotiations over the creation of EMU were not straightforward and discussions were often fraught with differences of opinion within states (Dyson and Featherstone 1999, p.33) as well as between them (Jabko 2006, p.178; Radaelli 2002; Sadeh and Verdun 2009, p.291).

At the 1991 Intergovernmental Conference on EMU, the French government sought to incorporate an 'economic government' into the Eurosystem's architecture as a direct counterweight to the independent ECB envisaged by monetarist nations such as Germany and the Netherlands. Although the plan was ultimately rejected, it demonstrates that programmatic monetarist ideas had not converged to the extent often assumed (Dyson 2000, p.13). Whilst the French reluctantly accepted a monetarist EMU framework, there is little evidence to suggest traditional French ideas concerning a preference for growth and social order over fiscal conservativism and price stability were ever fundamentally altered by the creation of the euro (Jabko 2006, p.163).

Nevertheless, the signing of the Maastricht Treaty (TEU 1992) was viewed by many HI scholars as a critical juncture for European monetary cooperation (Verdun 2015, p.231; 2007; Yiangou et al. 2013, p.225), and by HI and ideational scholars alike as a crystallisation of German ideas at the EU-level (Heipertz and Verdun 2010, p.24; Jabko 2006, p.170). The new ECB was considered 'the *Bundesbank* writ large' (Dyson 2002[b], p.186), and its mandate for price stability became inscribed explicitly into Article 105 of the Maastricht Treaty:

The primary objective of the ESCB[146] shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community

(TEU 1992, Art.105)

This philosophy became etched not only into the ECBs founding documents at EMUs institutional formation (Capoccia and Kelemen 2007, p.342), but also into the manner in which the bank operated. The standard New Keynesian Model (NKM) that provided empirical justification for price stable monetary policy (Gabor 2013, p.10) suggested that constant low-levels of inflation delivered a zero 'output gap', defined as the difference between the level of actual and potential economic output (Blanchard and Galí 2007). This 'divine coincidence' (Blanchard et al. 2010, p.200) implied that even if central bankers wished to increase economic activity, the best they could do was to maintain stable inflation. The quote below from Otmar Issing demonstrates the degree to which this thinking was accepted by the ECB:

Economists are in substantial agreement on the benefits deriving from price stability. They also broadly share the view that the best contribution that monetary policy can give to the efficient functioning of monetary economies is to ensure price stability

(Issing 1999[a], no page)

Expansionary monetary and/or fiscal policy designed to stimulate growth and employment during normal times was understood to create inflation in the medium-term as people over borrow and over spend, increasing the amount of money in circulation (Weber 2006). Loose economic policies, leading to greater risk-taking, leveraging, and ultimately to higher inflation, would therefore require future interest rates to be raised higher than usual to

[146] European System of Central Banks (ESCB).

prevent further inflation. This would create an economic slowdown and lower than trend growth, producing a net loss to society (Hämäläinen 2000[a]; Hannoun 2012).

The *Tinbergen Rule* (Tinbergen 1952) further established that one instrument can only ever achieve one objective. Monetary policy, it was therefore assumed, should only be used to maintain price stability using policy interest rates (Gabor 2012, p.5; Hämäläinen 2002; Noyer 1999[a]). Any attempt to use monetary policy for a financial stability purpose was thought dangerous and counterproductive (Bernanke and Gertler 2000, p.46).

Therefore although Europe's ideational consensus may not have been as deep or as widespread as generally assumed (Jabko 2006, p.178; Radaelli 2002; Sadeh and Verdun 2009, p.291), there certainly existed a dominant set of economic and financial concepts woven into the fabric of EMU. As table 5.1 (below) illustrates, there was a general subscription to broad neo-liberal philosophical ideas at the EU-level (McNamara 1998, p.56-7), and an explicit commitment to monetarist programmatic ideas in the treaties (TEU, 1992). This translated into policy ideas which promoted the manipulation of traditional monetary instruments to achieve price stability and, it was assumed, financial stability also (Duisenberg 2003; Noyer 1999[b]). The institutionalisation of these preferences at Maastricht represented a critical juncture which has since exerted powerful structural and ideational path-dependent forces on the ECB and broader Eurosystem (Farrell and Finnemore 2016, p.584; Yiangou et al. 2013; Salines et al. 2011, p.31).

To the extent independent financial policy ideas existed at the European level in 1992, they advanced non-interventionism (in line with DB preferences), as interfering in markets was generally considered counterproductive (Issing 2002[b]; Noyer 1999[a]). Indeed, the European Commission actively opposed the implementation of countercyclical accounting methods for Spain in 2000[147] because they did not conform to the non-interventionist supervisory and accounting consensus of allowing banks to model their own provisioning requirements (Otero-Iglesias et al. 2016, p.50). European involvement in financial stability policy was therefore initially restricted to coordinating national regulations and facilitating information sharing.

Table 5.1: EU-level ideas at the founding of EMU

Level of idea	Description	EU Ideas	Examples
Philosophical Ideas: Webs of Belief	World views & public philosophies that underpin the core understandings of individuals and society	Neo-liberalism	• Competition policy • Stability and Growth Pact
Programmatic Ideas: Policy Paradigm	Paradigms which support a conceptual approach and set an overarching policy program	Monetarism	• Commitment to price stability • 'No-bailout-clause'
Policy Ideas: Policy Agenda	Ideas contained within specific policies, norms, values, and political discourse	1. Price Stability 2. Financial integration 3. Financial stability (weak)	1. Inflation 2% or lower 2. Banking & Collateral Directives 3. ECB advisor to the Commission

Source: Adapted from Schmidt (2014)

Financial Stability at the Birth of EMU

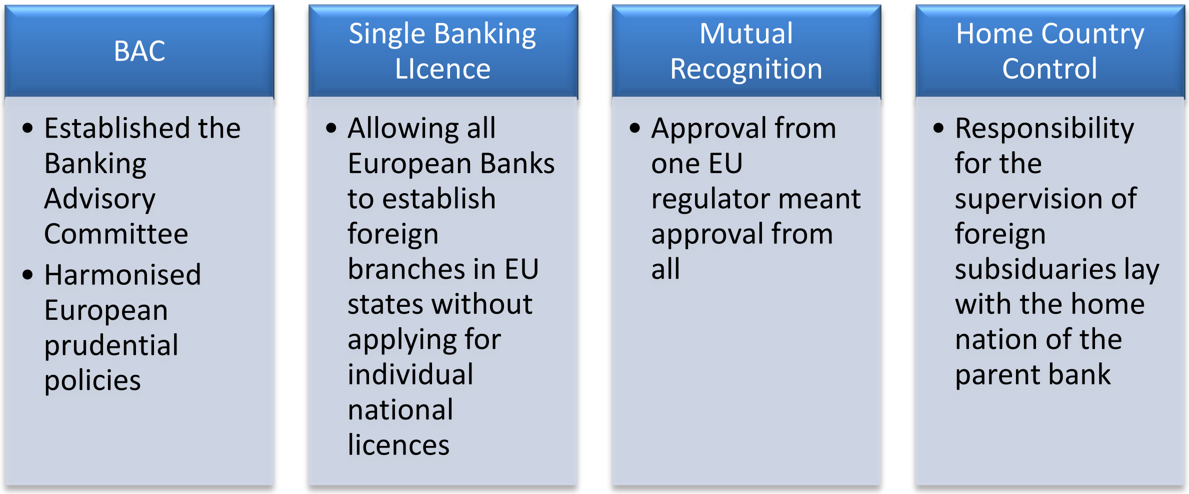
When the EMS was created in 1979, two international bodies already existed which helped coordinate financial policy within the European Economic Community (EEC). The first was the Basel Committee on Banking Supervision within the Bank for International Settlements

[147] 'Dynamic provisioning', see chapter 4.

(BIS). Founded in 1974, it was created in response to the collapse of the 'Bretton Woods' fixed exchange-rate system which generated significant financial market turmoil, notably culminating with the collapse of Bankhaus Herstatt in West Germany (BIS 2016). Its objectives were to enhance financial stability by improving the quality of global banking supervision and to create a forum for regular cooperation between members.

Within the EEC more specifically, the Banking Advisory Committee (BAC) established under the First Banking Directive (1977) was attached to the European Commission. It comprised of representatives from member-states' supervisory authorities, finance ministries and central banks, with its primary aim to assist the Commission in preparing prudential legislation for Europe's banking sector (Commission 2000, p.5). The directive also set a precedent for permitting supranational involvement in financial policy and for beginning the process of harmonisation in prudential tasks (Dermine 2002, p.4). European policymakers even briefly considered creating supranational financial regulation during this time, but eventually came down on the side of 'mutual recognition' and national responsibility (Jones et al. 2016, p.1019; Vipond 1991). This demonstrates that although supranational involvement in financial stability had not yet extended into areas of risk-sharing or joint liability, there was implicit recognition of the need for European-level participation in financial policy, even before EMU.

Figure 5.2: Key EU Banking Directive (1977 and 1989) achievements



Source: Author (2018)

Europe-wide financial stability initiatives stepped-up further once proposals for EMU were set in motion. The Delors Report (1989) recommended creating a single currency with a three-phase transition from EMS to EMU. Stage I ran from the 1st July 1990 to 31st December 1993, establishing free capital flows and closer coordination of national monetary policies. At this early stage, structural changes to better facilitate discussion of financial concerns were made through the creation of the Banking Supervisory Sub-Committee to the Committee of Governors. Stage II began in July 1994 with the foundation of the European Monetary Institute (EMI) – the forerunner to the ECB – governed by its President Alexandre Lamfalussy. In this stage, the Banking Supervisory Sub-Committee became a Sub-Committee of the EMI. Once the EMI evolved into the ECB, it transformed into a full Banking Supervision Committee (BSC) (Commission 2000, p.11). The BSC was tasked with better coordinating member-state financial regulation and supervision and provided a 'key forum' for discussing financial stability issues during the early years of EMU (Padoa-Schioppa 1999[a], p.302).

There were also explicit legal provisions handed to the ECB in relation to financial stability. Article 105(5) of the Maastricht Treaty gave the bank the task of contributing:

> *To the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system*
>
> (TEU 1992, Art. 105[5][148])

Article 105(6) also provided an enabling clause. With the agreement of other EU institutions, the ECB may be granted further:

> *Specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertaking*
>
> (TEU 1992, Art. 105[6][149])

The ECB was also responsible for monitoring Euroarea financial markets through its 'two-pillar' monetary strategy (figure 5.3). The ECBs overarching objective was to maintain a quantitative definition of price stability, interpreted initially as an annual increase in the Harmonised Index of Consumer Prices (HICP) of below 2 percent. But the way it monitored threats to this objective was by analysing monetary, financial and economic data collected by national central banks (NCBs) and collated centrally at the ECB (Cecchetti and Schoenholtz 2008, p.8; ECB 2000[a], p.37-47).

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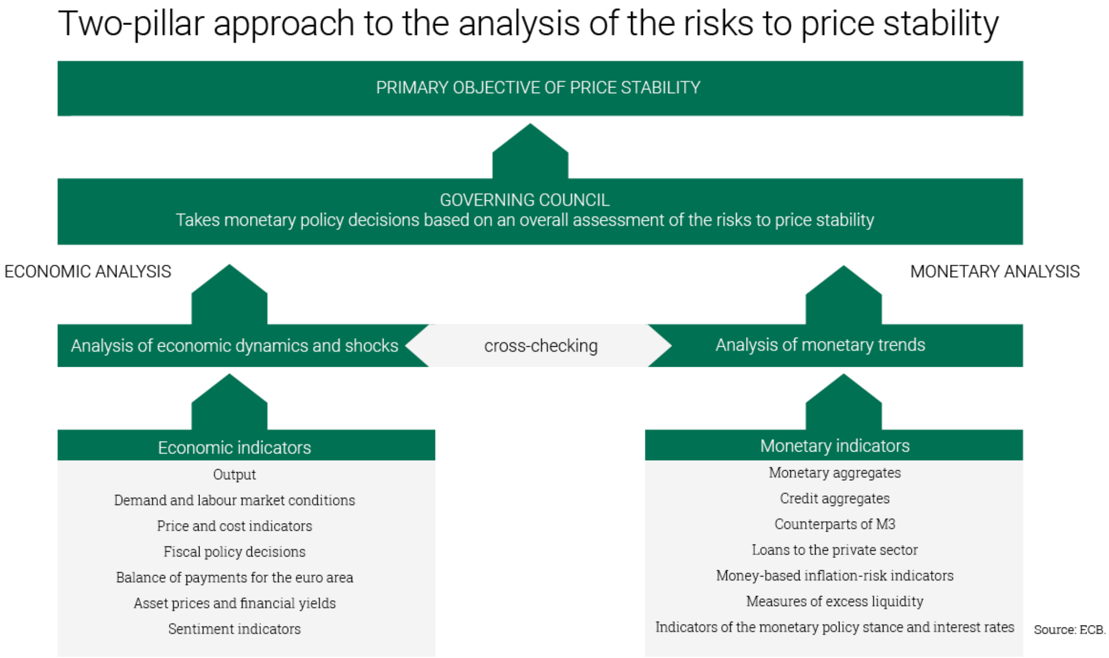
[148] Also Article 3(3) of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.

[149] Also Article 25(2) of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.

Figure 5.3: The ECB's 'two-pillar' monetary policy



Source: Bank of Lithuania (*Lietuvos Banko*). Bank of Lithuania website (2018): https://www.lb.lt/en/how-monetary-policy-works

The second pillar gave a prominent position to the role of money, signalled by a reference value for M3[150] monetary growth of 4.5 percent (DB 2000, p.39; Duisenberg 2000[c]), another technique borrowed from the DB (Brunnermeier et al. 2016, p.318; DB 1999, p.84; Issing 2008, p.93). But the first pillar analysed a wide range of additional economic and financial gages to give the Governing Council a comprehensive understanding of specific effects which may threaten the primary objective (ECB 2000[a], p.42). Developments in financial markets and the performance of asset prices were therefore always closely monitored by the ECB (Micossi 2012, p.3), but were analysed strictly in relation to how such movements may affect interest rate transmission and future price developments (ECB 1999[a], p.42), as the quote below makes clear:

[150] The broadest measure of the money supply which includes all currency in circulation as well as liquid financial products.

The maintenance of price stability in the Euroarea is the primary objective of the single monetary policy. All aspects of the ECB's monetary policy strategy serve the achievement of this primary objective

(ECB 2000[a], p.47)

Restraints on ECB Authority

Since independence is a core element of democratic legitimacy, it must be accompanied by the strict application of controls… This obligation, which is the flip-side of its independent status, effectively imposes discipline on the central bank to perform its tasks in line with its mandate

(González-Páramo 2005, no page)

Although the ECB was structured to monitor financial stability and provided a forum for financial ideas through the BSC, its competences with regards to financial stability were restricted both ideationally and structurally. In terms of ideas, there was broad agreement within international central banking circles at the time of EMUs founding that central banks should not target asset prices or intervene generally in matters of financial stability (Bernanke and Gertler 2000, p.46; Greenspan 2002). This attitude was expressed by former ECB Vice-President, Christian Noyer in 1999:

Of course, it goes without saying that financial markets can also be wrong in their assessment of the fundamental determinants of asset prices. International investors can sometimes be influenced by fads and self-fulfilling beliefs which drive prices away from their fundamental determinants. Asset price 'bubbles' can emerge. However, it is very difficult for policy-makers to identify such misalignments and bubbles

(Noyer 1999[a] no page)

In the absence of policymakers ability to spot bubbles as and when they occurred, uncertainty over how asset prices may react to changes in monetary policy (Remsperger 2006), and the professed belief that any attempt to prick an asset bubble would trigger a ‘panic’ or ‘severe recession’ (Bernanke and Gertler 2000; Greenspan 2002; Issing 2002[b]), it was argued the best course of action central bankers could take was to provide the financial system with stable monetary conditions (Noyer 1999[b][151]).

These ideas manifested themselves into the structure of the Eurosystem. The ECB was established as one of the most independent[152] central banks in the world (Howarth and Loedel 2005, p.53; Nedergaard and Snaith 2015, p.1103; Quaglia 2008, p.120)[153]. It was commonly assumed that independence enabled central banks to achieve the associated goals of fiscal discipline and price stability by preventing governments from artificially boosting economic output through government borrowing (DB 2012[a]; Issing 2002[a], p.27; Noyer 1999[c]).

By controlling interest rates, central banks were able to influence the cost of borrowing, counteracting any governmental stimulus which often tended to coincided with the electoral cycle. Central bank independence was therefore heralded as a necessary check on politicians seeking to temporarily spur economic growth for their own electoral gain (Blinder 1998, p.50; Nedergaard and Snaith 2015, p.1103; Polillo and Guillén 2005, p.1768), and as

[151] ‘The achievement of price stability is also of high importance for the stability of the financial system… At the ECB, we play our part in the evolution of the Euroarea financial system by providing it with stable monetary conditions. By creating an environment of price stability, we allow private sector agents to focus their attention on the questions that are most relevant to their activities and to take advantage of benefits of this stable environment, such as the lengthening of their planning horizons. There is a lot of empirical evidence that safeguarding price stability is the optimal contribution that a central bank can make to the maintenance of financial stability and that those two goals are actually complementary’ (Noyer 1999[b]).

[152] Understood as the expelling of political influence over monetary policy decisions.

[153] As outlined in Article 108 of the Maastricht Treaty (TEU 1992, Art.108).

the most efficient way to safeguard price stability (Alesina and Summers 1993; González-Páramo 2005)[154].

For the ECB, however, independence also provided an additional function. Independence and a limited mandate prevented risk-sharing and fiscal transfers between member-states (Sandberg 2015, p.3). Any wealth transfer from savers to borrowers instituted by the ECB constituted a political act to which EU leaders had not agreed. Such actions could therefore threaten its independence and undermined its legitimacy (Feldstein 2011, p.7; Sibert 2009, p.7). Monetary, fiscal and financial policies were thus purposefully separated under EMU, with supranational authorities only handed responsibility for monetary policy (Bibow 2015).

For these reasons, even areas of financial stability policy which for generations had been regarded as core central bank competences were retained at the national level. Despite the importance of the 'lender of last resort'[155] (LOLR) facility in safeguarding financial stability, this capability was retained by NCBs in a bid to de-couple monetary and fiscal policy, and to forestall any moral hazard problems generated by well-regulated financial systems having to bailout irresponsible Eurozone states (Bibow 2015, p.22; Duisenberg 1999[b][156]). Emergency Liquidity Assistance[157] (ELA) was instead provided by NCBs, with the risk of loss remaining on NCB balance sheets (Praet 2016[a]), creating a two-tier system of ESCB balance sheets to prevent joint liability.

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[154] The assertion that central bank independence does indeed lead to greater prices stability has since been questioned. See: Daunfeldt and de Luna (2008).
[155] The provision of emergency central bank liquidity to solvent financial institutions against eligible collateral.
[156] Article 14.4 of the Statute of the European System of Central Banks and of the European Central Bank: with regard to the provision of ELA to individual credit institutions.
[157] Central bank repurchase ('repo') loans using collateral deemed ineligible to access the ECBs marginal lending facility.

Moreover, while the ECBs collateral framework encouraged financial institutions to treat all Eurosystem sovereign debt the same way during interbank 'repo' trades[158] - creating an implicit 'subsidy' to lower-rated member-states that weakened fiscal discipline (Buiter and Sibert 2005) – ECB repo operations were 'marked-to-market' to reinforce market discipline and limit supranational risk-sharing. This meant if the markets began to view a member-states sovereign debt as risky, the ECB would require additional collateral to set aside against default, placing further pressure on yields and generating pro-cyclical effects (Gabor and Ban 2016, p.627).

NCBs also retained exclusive authority over the supervision of domestic financial institutions (Alford 2006, p.396; Bibow 2015, p.21; Scheller 2006, p.111), the conduct of open-market operations, and responsibility for feeding in economic data to the ECB (Cecchetti and Schoenholtz 2008, p.14; Duisenberg 2000[a]). On financial matters therefore, the ECB was initially restricted to surveying financial markets, monitoring key financial players, structuring the payment and securities settlement systems, and developing an advisory role in the production of financial legislation (Duisenberg 1999[a])[159].

A number of further restrictive provisions were placed in the Treaties to prevent the ECB transgressing into areas deemed unnecessary solely for the preserve of price stability, and which may have seen funds shift from one member-state to another (Frankel 2015, p.430). It was acknowledged that the political benefits enjoyed by Governments from deficit

[158] Repurchase agreements where banks temporarily borrow cash from central banks in exchange for collateral (usually sovereign debt securities).
[159] Article 6.2 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank: 'The General Council shall contribute to the ECB's advisory tasks under Article 4 and Article 25.1 of the Statute'.

spending, or by economies and banks through over lending, tended to be preserved at the national level, while the negative effects in the form of higher interest rates due to increased debt could be felt by all euro-members (Issing 2008, p.193; Papademos 2004; Weidmann 2016[b]). The authors of TEU therefore included explicit legal provisions (figure 5.4 below) intended to avert moral hazard and prevent the ECB directly purchasing government bonds to support loose fiscal policy and bailing-out failing Eurozone governments (Bibow 2013, p.617; ECB 2016[a]; European Parliament 1998).

These practices and treaty articles should be viewed collectively as a way of limiting the ECBs responsibility to the preservation of price stability, reducing the possibility of collective wealth transfers and moral hazard, and of promoting stability orientated monetary policies across the Eurozone. Importantly, they were also a means of enforcing market discipline on Eurozone governments to prevent expansive fiscal policy (Yiangou et al. 2013, p.227).

Figure 5.4: Maastricht Treaty restrictions on ECB financial activity

Article 104 (123 of TEFU)	• **The prohibition of monetary financing**
Article 104a (124 of TEFU)	• **The prohibition of privileged access to financial institutions**
Article 104b (125 of TEFU)	• **The 'no-bail-out clause'**

Source: Treaty of the European Union (TEU, [Maastricht Treaty], 1992)
Treaty on the Functioning of the European Union (TEFU, [Lisbon Treaty], 2007)

Although he accepts markets can often over-price and under-price sovereign risk at different phases of the financial cycle, the quote below from ECB Executive Board Member, Benoît Cœuré, underscores the ECBs belief in the power of market discipline to help steer governments towards the nostrum of stability orientated policies:

> *The construction of the Euroarea – the monetary financing prohibition enshrined in the EU Treaty, the 'no-bailout-clause' – is deliberately intended to encourage markets to differentiate between Euroarea sovereigns based on their fiscal sustainability (market discipline). The idea is that the exercise of market discipline will provide a continuous assessment of government actions, which will in turn lead to sounder policies*
>
> (Cœuré 2016)

While Eurozone nations were politically able to pool monetary sovereignty, there was little appetite amongst the public or policymakers alike to institute further risk-sharing measures, mutualise banking supervision, or implement fiscal transfers between states (Schuknecht et al. 2011, p.5). This restrictive, legalistic framework should therefore be viewed as a result of these political decisions, and as a way of maintaining traditional monetarist programmatic ideas as the touchstone of Eurosystem operations.

It should also be noted that further fiscal restrictions other than those provided by market discipline, like the Stability and Growth Pact (SGP, 1997), were also enacted to help maintain price stability by keeping borrowing low and preventing wealth transfers through the need for state bailouts (Issing 1999[b]). The SGP aimed to curb government borrowing by setting a budget deficit limit of 3 percent GDP and an overall government debt ceiling of 60 percent GDP. The Treaty was particularly important for the Dutch and German governments who feared many countries that joined the euro in the initial phase had a relatively short history of fiscal prudence (Levitt and Lord 2000, p.147). The SGP was also regarded as an essential element of EMU by the ECB to prevent excessive deficits and avert the need to react with restrictive monetary policy (Duisenberg 1999[a]; Quaglia 2008, p.125).

SUMMARY

Although the philosophical neo-liberal and programmatic monetarist ideational consensus within pre-EMU Europe was not as widespread as often claimed (McNamara 1998), these principles, together with a non-interventionist approach to financial policy and belief in the importance of fiscal conservativism and central bank independence, broadly formed the ideational foundation of EMU. Germany and the DB were particularly important in promoting these ideas (Dyson 2000, p.128; Heipertz and Verdun 2010, p.46; Quaglia 2008), which consequently levied an 'ideational path-dependence' (Cox 2004) on future ECB action.

During this period it was widely assumed that if price stability was maintained, financial instability could be avoided (Bernanke and Gertler 2000, p.46; Noyer 1999[b]). It was therefore asserted that the ECB should focus on preserving price stability, while authority over financial supervision was retained by national bodies. Nonetheless, a precedent of European involvement in financial policy was established through the First (1977) and Second Banking Directives (1989), and the inclusion of the BSC within the ECB. The ECB was also handed responsibility for monitoring Eurozone financial data under the first monetary pillar, established itself as an advisor to the Commission on future financial policy, and had an enabling clause inserted into the Treaty (Art.105[6] TEU). This provided a foundation for future ECB financial influence.

Yet the bank was also hamstrung on financial stability by the federal structure of the ESCB and the Treaty articles prohibiting monetary financing, privileged access to financial institutions and the 'no-bail-out' clause (figure 5.4). These provisions, including the application of 'mark-to-market' accounting practices, were not only incorporated to help preserve price stability, but to prevent sovereign risk-sharing, moral hazard and encourage market discipline in the bond markets (Frankel 2015, p.430; Schuknecht et.al. 2011, p.5).

5.2 Pre-Crisis EMU (1999-2007)

The ECBs early years were epitomised by a search for credibility (Cecchetti and Schoenholtz 2008, p.4). It is one thing to model a central bank on the DB and endow it with independence and a price stability mandate, but quite another to be seen as credible by the markets (Howarth and Loedel 2005, p.143). This could only be achieved by communicating a consistent communicative discourse (Hughes and Kesting 2014; Schmidt 2010), formulating a coherent monetary strategy, and delivering a stable economic environment over the medium-term. As the HI approach suggests, the ideational and structural foundations of EMU established at the critical juncture of Maastricht exerted a profound path-dependent force on the ECBs goals and objectives (Immergut and Anderson 2008; Katznelson and Weingast 2005), and its credibility became interwoven with the preservation of price stability (González-Páramo 2005; Quaglia 2008, p.110; Sibert 2009).

Over the first nine years (1999-2008), the ECB delivered on this objective and conveyed an average HICP inflation rate of 2.06 percent. Long-term interest rates also remained low due to low levels of uncertainty about future inflation expectations (Cecchetti and Schoenholtz 2008, p.18; Issing 2008, p.141-4). Yet in the background, two significant developments took place which had important financial implications. Firstly, financial liberalisation resulted in banks becoming increasingly marketised, meaning they became progressively less dependent on customer deposits for funding and instead relied on the production and trade of securities to raise capital (ECB 2002, p.9). Secondly, under EMU, European financial markets became much more tightly integrated (Cœuré 2012). This was encouraged by coordinated ECB and Commission policies which aimed to facilitate harmonised interest rate transmission[160] across the Eurozone (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005).

During the early years of EMU, much of the ECBs financial discourse simply discussed transition to the euro and the importance of promoting financial integration (Hämäläinen 1999). As this integration and market-based financing became more pronounced, and cross-border financial linkages became larger and more complex, financial stability became a more pressing concern, particularly from 2003 onwards. Although the ideational and discursive commitment to price stability remained, the bank began talking much more openly about financial stability issues (tables 2 and 3), and started to recognise that preventing financial contagion in a closely interconnected Eurozone would require more than just the delivery of low inflation (Papademos 2006; Trichet 2005[a]). This pre-crisis

[160] 'The process through which monetary policy decisions affect the economy in general and the price level in particular' (ECB 2016, no page).

Table 5.2: ECB speeches which include discussion of financial stability issues

Year	Specific Financial Stability Concerns	Financial Integration	Financial System and Banking Supervision	Total
1999	1	3	5	9
2000	3	10	5	18
2001	0	5	4	9
2002	3	7	7	17
2003	6	2	7	15
2004	5	12	5	22
2005	10	17	5	32
2006	6	11	13	30
2007	11	10	19	40

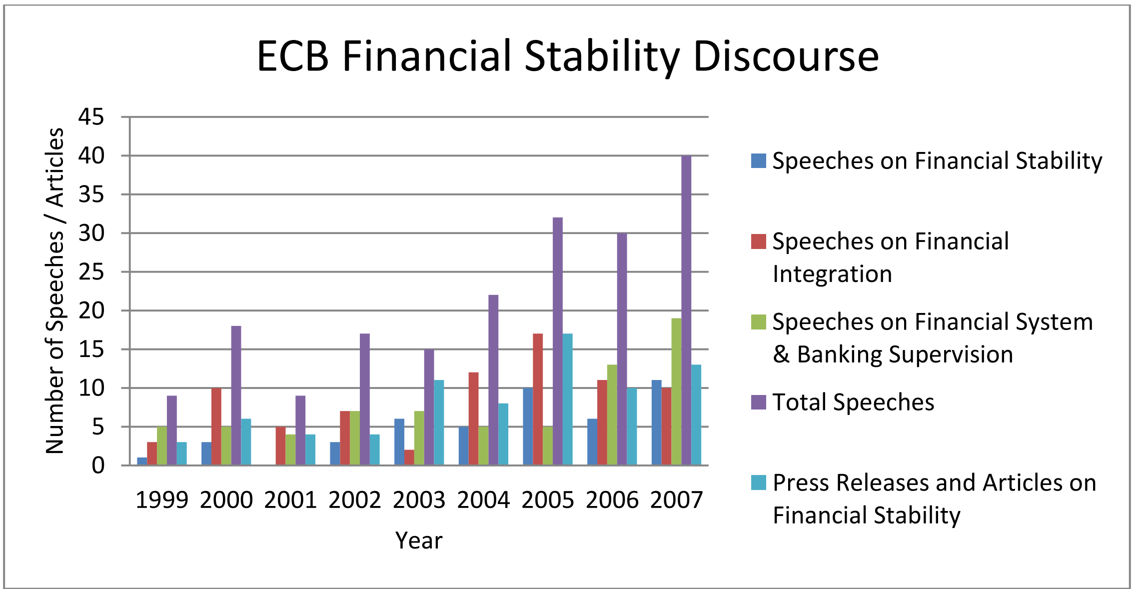
Source: ECB, Author (2018)

Table 5.3: ECB articles and press releases concerning financial stability

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007
Number	3	6	4	4	11	8	17	10	13

Source: ECB, Author (2018)

Figure 5.5: Visualisation of ECB discourse (tables 2 and 3)



Source: Author (2018)

period therefore demonstrates path-dependent characteristics which fall in line with HI analysis, but also gradual ideational changes which are better explained through DI. By adopting insights from both these approaches and by continuing to use process tracing to detail important events and trends, the following section tracks and analyses these institutional developments from 1999-2008.

Market-Based Banking and Financial Integration

Beginning with the collapse of the Bretton Woods system in 1973 and the subsequent growth of neo-liberal philosophical ideas, global capital controls became liberalised, leading to an internationalisation of finance (McNamara 1998, p.50; Padoa-Schioppa 1999[b]). This was particularly true in Europe where throughout the 1980s, 1990s and early 2000s, the Commission led attempts to liberalise and integrate EU capital markets through the Single Market Program (Jabko 2006; Story and Walter 1997, p.254; Underhill 2002, p.36).

Before the deregulation of capital markets, banks held liabilities on their balance sheets and generated profits on the interest they received until the loan was repaid (Pozsar 2009, p.13). The development of 'securitisation'[161] enabled banks to restructure these loan payments and transform them into tradable assets. Debt instalments could be separated out and sold individually, or bundled up as pools of debt and sold to investors as an income generating investment. This meant banks could make more loans because the risk of non-performance was frequently no longer borne by the issuer of the debt, but by the holder of the asset, taking the risk 'off-balance sheet' (Deeg 2010, p.7; Adrian and Shin 2009, p.11). The advent of securitisation and technical innovations like the TARGET electronic payments system

[161] The pooling of debt into structured instruments which are then sold to third party investors as income generating assets.

enabled huge amounts of money to be generated through financial market activity and dispersed across borders (Stockhammer 2004, p.720).

Because of these innovations, as well as manipulating interest rates, the ECB (via NCBs) was given the power to conduct open market operations where the bulk of pre-crisis liquidity was provided to the banking system (ECB 2011[b], p.104). The weekly main refinancing operations were the most important open market procedures the ECB executed before the crisis[162] and aimed to influence very short-term interest rates in the pursuit of price stability (Duisenberg 1999[a]; ECB 2011[b], p.107; Issing 2008, p.125). They adjusted the supply of central bank money by allowing financial institutions to borrow liquidity from the Eurosystem in exchange for collateral via repos. Although the ECB always tried to preserve a 'separation principle' between its monetary stance of maintaining price stability and the liquidity management procedures through which it implemented its policies (Bordes and Clerc 2013, p.66; ; González-Páramo 2007; Trichet 2008[a][163]), these operations also helped stabilise financial markets by keeping banks flush with funds (DB 2000, p.36).

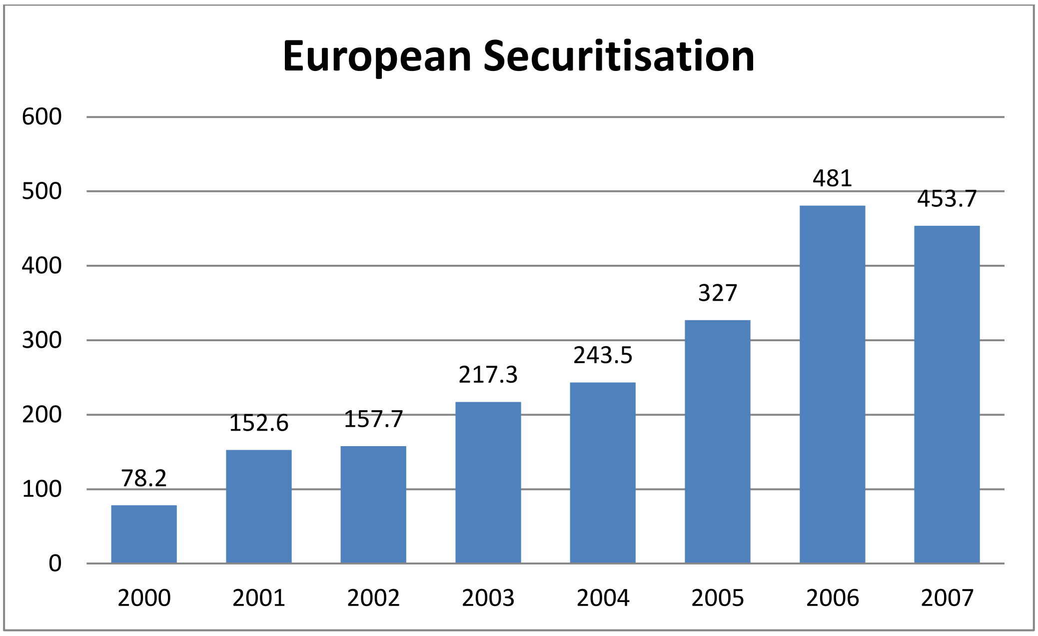
Under EMU, the ECB expected securitisation and non-bank intermediation to intensify as low interest rates, increased competition and the reduced profitability of traditional banking activities encouraged banks to take on more risk (ECB 1999[a], p.41; 1999[b]; 2000[c]).

[162] At its meeting on 8th June 2000 the Governing Council decided to alter the tender of its main refinancing operations and switch to a 'variable rate tender' using a multiple rate auction procedure whereby the ECB sets a minimum bid rate and banks accepting the highest interests rates became endowed with liquidity (ECB 2000[b]).

[163] 'The ECB makes a clear separation between, on the one hand, the determination of the monetary policy stance and, on the other hand, its implementation using liquidity operations. The monetary policy stance is determined so as to serve the primary objective of the ECB, namely the maintenance of price stability. The implementation of the stance through liquidity operations aims at steering very short-term money market rates close to the ECB's key policy rate (the minimum bid rate in the Eurosystem's main refinancing operations)' (Trichet 2008[a]).

Indeed, market-based banking became much more prevalent under EMU, with the total value of securitized assets rising from €47 billion in 1997 (Deeg 2010) to almost €500 billion ten years later.

Figure 5.6: European securitisation issuance (€ billion)



Source: European Securitisation Forum (2008)

Much of this growth came as a direct consequence of ECB and Commission policies (Jabko 2006). In 1999, the Commission published its Financial Services Action Plan (FSAP) containing 42 legislative proposals aimed at removing variances in national regulations and legal systems (Commission 1999)[164]. This, along with the single currency, created an environment within which European financial institutions were able to borrow from one another more easily. While integration in the retail segment remained sluggish (Baele et al., 2004; Cabral et al., 2002), it accelerated markedly in the wholesale debt markets (Cœuré 2016; Duisenberg 2000[c]; ECB 1999[a], p.41; Hämäläinen 2000[b]), which tripled in volume

[164] The FSAP was adopted by the European Council in March 2000.

to €6 trillion between 2001-2008 (Gabor and Ban 2016, p.617). As customer deposits fell under EMU (ECB 2005[c]), financial institutions began relying increasingly on short-term lending from the interbank repo markets.

Whereas traditional bank deposits are usually guaranteed by home sovereigns, there are no such guarantees in the repo markets and assurances are instead provided by collateral (Gabor 2012, p.17). This collateral (usually government bonds or asset-backed securities [ABS][165]) is 'marked-to-market', meaning value is derived not from assets stated worth, but by the prevailing market price. This means collateral prices can fluctuate quite dramatically. Daily 'margin calls' are made by lenders (DB 2005[b], p.30), and if asset prices deteriorate, 'collateral calls' may be requested to set aside additional assets against default, or a 'hair cut'[166] taken from the stock the borrower retrieves at the end of the agreed term (Blyth 2013[a], p.23-6; Gabor 2012, p.15; Hardie et al. 2013, p.709). As discussed above, the ECB also adopted these practices when conducting its own repo operations to reduce moral hazard and encourage market discipline, despite most European central banks prior to EMU not assuming 'mark-to-market' methods (Gabor and Ban 2016, p.627).

Once capital markets became liberalised and market-based banking and securitisation become established practice, there were good ideational reasons for the ECB to encourage financial integration (ECB 2003[a], p.55). Aside from increasing efficiency, generating higher returns for investors and improving the provision of finance for lucrative businesses (Baele et.al 2004, p.7; Duisenberg 2000[a]; Levine 2001), more integrated money markets helped

[165] In the US, US Treasury securities in outstanding repos ranged from between 56 percent and 66 percent between 2001-2006, with agency and mortgage-backed securities (MBS) accounting for about 15% each. Corporate bonds made up the rest (ECB 2006[a]).
[166] The amount of collateral repurchased being reduced due to a fall in the price of the collateral.

smooth the transmission of monetary policy (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005). A single monetary policy loses its singleness if different member-states experience different real interest rates (Bibow 2015, p.64). For a central bank constructed on a monetarist ideational platform of tackling inflation, harmonised interest rates and an integrated Eurozone money market were considered a *sine qua non* for the successful implementation of monetary policy and delivery of price stability (ECB 2003[a], p.58; Papademos 2005).

The ECB therefore developed a Master Agreement sponsored by the European Banking Federation and backed by the Commissions' 2002 Financial Collateral Directive (FCD). The FCD committed member-states to the removal of constraints on banks' use of repos by establishing a simplified legal framework for collateral, as well as proposals for a single pan-European central counterparty (ECB 2002[a], p.11; 2004[a]; Tumpel-Gugerell 2006). Despite ECB recognition that integrated interbank markets risked creating financial contagion during a downturn[167] (ECB 2000[d], p.50; 2002[c], p.56), this Directive provided the basis for a European repo market where financial institutions could move liquidity and collateral across borders without obstacles (Bibow 2015, p.64; ECB 2002[b], p.55-68; Gabor and Ban 2015, p.618).

Importantly, these capital market reforms not only led to an increase in Euroarea financial integration, but also to a gradual weakening of EMUs monetarist framework by exposing the paradox of a currency union which sought to implement a single monetary policy through an

---

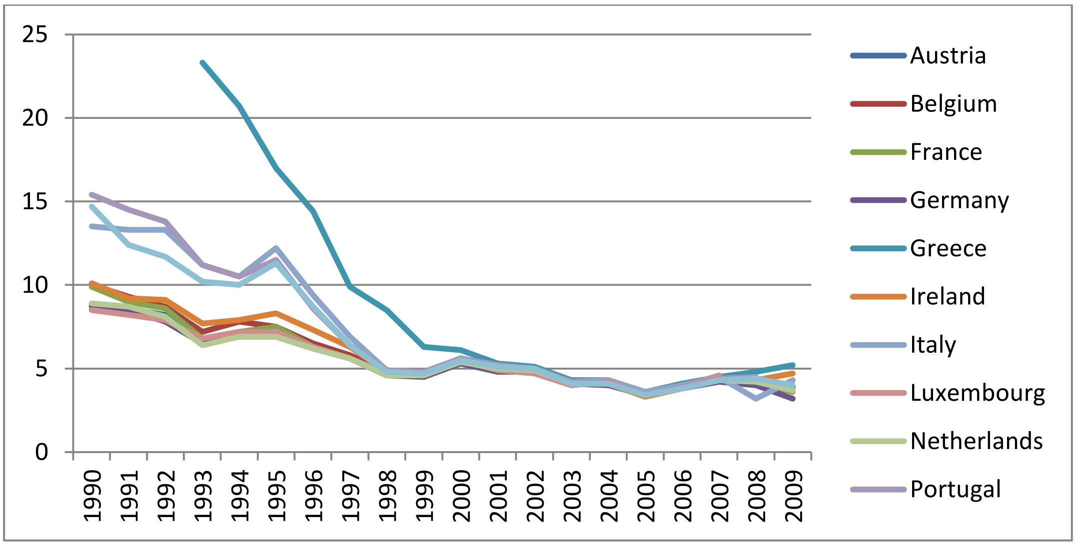
[167] Integrated money markets can generate problems by increasing the likelihood of cross-border financial contagion (Commission 2007[b], p.37; McNamara 1998, p.50; Story and Walter 1997, p.254). If one bank suffers financial difficulties and reneges on its liabilities to other financial institutions, those institutions themselves may face severe financing problems.

integrated interbank market, whilst concurrently requiring market discipline in the sovereign bond markets to maintain fiscal discipline. The Master Agreement, FASP and FCD boosted demand for securities and bonds accepted as collateral in the repo markets (Gabor and Ban 2016, p.621; Pozsar 2014, p.10-12). Because the ECB began to treat all Euroarea sovereign bonds the same in repo transactions, it made little difference to market participants whether they invested in German *Bunds* or Greek bonds as each could be traded in exchange for liquidity. This ensured all Euroarea sovereign bonds (even those from the periphery), said to account for around 80 percent of EU repo collateral (ICMA 2015, p.8), became important and sought after assets (Gabor 2016, p.984).

The no-bailout-clause and other structural mechanisms implemented at Maastricht were put in place to separate monetary and fiscal policy and encourage investors to discriminate between sovereigns (Bibow 2015, p.22; Cœuré 2016). Yet these collateral reforms had the exact opposite effect: converging yields, reducing market discipline and easing fiscal pressures. As figure 5.7 (below) indicates, there is a clear correlation between these repo policies and converging bond yields. These policies appear to have been far more successful at achieving convergence than the Maastricht Treaty articles were at encouraging market discrimination. Programmatic monetarist imperatives which drove the process of financial integration therefore weakened the neo-liberal structure of EMU and acted to mask fundamental underlying structural differences between member-states, creating a well of cheap credit for peripheral nations (Blyth 2013[a], p.78; Lynn 2011, p.61; Schnabl and Freitag 2011). This shows how ideational contradictions can lead to institutional change through time, depicted by scenario G from table 2.2:

Financial integration:		
G) ideational contradictions or failures	->	gradual policy / Institutional change
Monetarist attempts to enhance financial integration and improve monetary policy transmission reduced market discipline in the sovereign bond markets.		
		Illustration 5.1

Figure 5.7: Eurozone 10-year sovereign bond yields



Source: UN Data (2017)

Figure 5.8 below illustrates how monetarist ideas aiming to maintain price stability through inflation targeting within a market-based financial environment led the ECB and Commission to press for further financial integration to enhance the transmission of monetary policy (Issing 2008, p.214; Tumpel-Gugerell 2005). These actions however led directly to a slow diminution of the philosophical and programmatic ideas upon which EMU was founded by weakening discipline in the sovereign bond markets and converging interest rates, encouraging 'southern' states to take on more public and private debt (Sinn 2014, p.77).

This required the ECB to recognise that within an integrated and marketised European financial system, it would need to do more than simply generate price stability to ensure financial stability (Tricht 2003; Padoa-Schioppa 2003), leading the bank to evolve its pre-crisis financial policy ideas.

Figure 5.8: The cause of ECB concern for financial stability

Source: Author (2018)

In 2001 the EU launched the Lamfalussy Process[168]. Although a supranationalisation of EU financial regulations was considered at this stage to be a step too far (Alford 2006, p.396; Duisenberg 2001), this initiative sought to converge European supervisory practices and enable the EU to respond rapidly and flexibly to developments in European financial markets (Commission 2007[a], p.2). The Process introduced public hearings and opportunities for outside bodies to comment on financial legislation. It created a network of

[168] Named after the former EMI President Alexandre Lamfalussy.

committees, engaged national financial ministries and supervisors, and facilitated a substantial shift in financial regulation away from national bodies towards the supranational level (Posner 2007, p.142)[169]. During preparation for the Process, the ECBs role and participation was discussed. ECB Executive Board Member, Sirkka Hämäläinen, commented in 2002 that:

> *Even though it is self-evident and without doubt that the unambiguous primary goal of the monetary policy in the ECB is domestic price stability… it also has effects, via numerous channels[170], on global financial stability…* [Therefore] *close co-operation between the central banks and supervisory authorities is needed to transfer and exchange information*
>
> (Hämäläinen 2002, no page)

This quote shows that whilst the ECB remained officially outside the Lamfalussy Process, a realisation quickly emerged that as European financial markets became more market-based and integrated, the ECB would need to cooperate with national financial authorities more closely and to take a deeper interest in Euroarea financial affairs (ECB 2000[d], p.64; Hämäläinen 2002).

GROWING CONCERN FOR FINANCIAL STABILITY

At the turn of the century, the ECB had as its primary goal the attainment of price stability. But it had also become an active participant in European finance. It enthusiastically promoted European financial integration to help facilitate monetary policy transmission

[169] 2004 saw the creation of the Committee of European Banking Supervisors (CEBS) as part of the Lamfalussy Process, with the aim of facilitating further supervisory convergence, cooperation and information sharing (ECB 2007[a], p.40).

[170] Namely, the elimination of exchange rate volatility inside the Euroarea and reduced vulnerability of the area to global exchange rate turbulence. The significance of the ECB and its close contacts with other important central banks, Hämäläinen argued, also improved global readiness to react promptly in the event of a crisis (Hämäläinen 2002).

(ECB 2003[a], p.58) despite recognising such integration increased the risk of financial contagion (ECB 2000[d], p.62). As a result, by as early as 2003, the beginnings of a more substantial ideational shift in relation to financial stability started to emerge within the ECB and wider central banking community.

Scholars and practitioners from the BIS began to question the perceived wisdom of the ‘continuity view’ that price stability was a ‘prerequisite’ for financial stability (Schwartz 1995). They suggested the ‘new environment’ of low inflation and low interest rates could generate a situation whereby price and financial stability policy could conflict, creating a trade-off between the two (Borio et al. 2003; Borio and Lowe 2002; White 2006). This they argued may occur by a central bank maintaining low interest rates in line with its price stability mandate, which consequently encouraged over borrowing and asset price inflation in financial markets. There is evidence that although the ECB did not recognise the possibility of a trade-off – given the legitimacy of the institution was premised on monetarist programmatic ideas and the preservation of price stability – it did at least begin to engage with such matters (Issing 2003).

The bank also began to voice concern over the form European financial integration was starting to take, with highly integrated capital markets and negligible cross-border retail activity (Baele et al. 2004; Cabral et al. 2002; Trichet 2003). It therefore increasingly argued that central banks could not afford to simply ignore financial stability whilst maintaining price stability (Padoa-Schioppa 2003).

Although in the final few months of his presidency, Wim Duisenberg continued to argue:

> *The best contribution a central bank can make to prevent financial bubbles from forming and bursting is to continue pursuing a monetary policy aimed at maintaining price stability*
>
> (Duisenberg 2003, no page)

In the same year, Executive Board Member Tommaso Padoa-Schioppa insisted that:

> *While both inflation and deflation are detrimental to financial stability, price stability is certainly not a sufficient condition for financial stability… tools primarily intended for maintaining price stability, interest rates and market operations, can at times be used to promote financial stability* [particularly during a downturn]
>
> (Padoa-Schioppa 2003)

These are important remarks and the contrast between the two speakers is stark. Dr Padoa-Schioppa's comments show for the first time a discursive shift in ECB communicative discourse with external parties (Schmidt 2008; 2010) concerning the inability of price stability policies alone to maintain financial stability. The quote also voices the idea that monetary policy tools may at times be used to promote financial stability rather than just price stability. This signifies a substantial shift in ECB thinking and the two quotes together represent a clear example of interdiscursivity (two competing ideas being aired by the same institution [Fairclough 2010, p.95; Wodak 2001{b}]), as the bank evolved its ideational and discursive approach to price and financial stability.

2003 also saw a change at the helm of the ECB, with President Duisenberg (a Dutchman) replaced (largely at the insistence of the French government) by Jean-Claude Trichet, former Governor of the Bank of France (*Banque de France*). This change heralded a renewed focus on financial stability. In only his third speech on the 26th November, just over three weeks after taking office, the new president delivered an address entitled 'Financial Stability'. In it, he struck a very different tone from that of his predecessor:

> *The single currency, the ESCB and single market for liquid reserves – the money market in euro – are creating a much more interconnected European financial system than is usually acknowledged… [The ECB should therefore begin]… enhancing its activities in the field of European financial stability* [to prevent potential problems]
>
> (Trichet 2003, no page)

He drew attention to the fact investors had begun moving away from bank deposits towards direct and collective security investments and commented that banks hold significant exposures in relation to non-bank financial institutions which themselves suffer from direct market exposures. He went on:

> *These concerns are severe and great caution is warranted in the reform of accounting standards… When bank capital is largely based on risk and risk increases in a recession, macroeconomic consequences might arise through a pro-cyclical reduced ability of banks to lend… The deepening market integration experienced in the EU has given rise to the need for enhanced supervisory cooperation and common financial stability surveillance*
>
> (Trichet 2003, no page)

Under the presidency of Jean-Claude Trichet and long before the financial crisis, the ECBs commutative discourse towards financial stability started to look a lot different. This came as a direct consequence of monetarist programmatic ideas which successfully encouraged a rapid integration of EU capital markets. In terms of concrete policy actions, however, the ECB remained hamstrung both structurally and ideationally by the structure of EMU and the dominance of non-interventionist policy ideas derived from traditional monetarism. The bank therefore only acted to improve transparency by increasing the number of articles and reports on the subject and by stepping up its internal coordinative discourse (Schmidt 2014), increasing the number of discussions concerning financial stability in the Governing Council (Trichet 2003).

By end-2005, the ECB had also formulated a mission statement for the Eurosystem, incorporating financial stability into its charge:

> *We in the Eurosystem have as our primary objective the maintenance of price stability for the common good. Acting also as a leading financial authority, we aim to safeguard financial stability and promote European financial integration*
>
> (Trichet 2005[a], no page)

This statement provides another example of interdiscursivity (Wodak 2001[b]) as it encapsulates nicely both the path-dependence one would anticipate from HI, and the ideational change one would expect from DI. We can see the continuity of monetarist ideas which reaffirm price stability as the ECBs primary objective, but can also view the ideational shift towards greater concern for financial stability. Although monetarism remained weaved into the fabric of the ECB and the credibility and legitimacy of the bank continued to depend on the maintenance of price stability (Högenauer and Howarth 2016), there becomes a clear acceptance that the delivery of price stability alone would be insufficient to guarantee financial stability within a progressively integrated and market-based financial system (Papademos 2006; Trichet 2004[a]; 2005[a]).

As a consequence, the bank developed new financial policy ideas. It enhanced the monitoring of financial developments at the supranational level (Trichet 2003; 2004[a]; 2005[a]; 2005[b]) and produced two new publications: *EU Banking Sector Stability* reports and the *Financial Stability Review*. Both tended to concentrate on similar topics, but *EU Banking Sector Stability* publications focused specifically on the banking sector, while *Financial Stability Reviews* took a broader perspective.

The main concerns raised in these publications are discussed throughout this section and are set out in tables 5.4 and 5.5 below. They show that the ECB drew consistent attention to the exposure of many states banking systems to inflated real estate prices. These exposures, it suggested, may occur either directly through non-performing loans (NPLs) during a downturn, or indirectly by holding ABSs underpinned by commercial or residential property (ECB 2003[b], p.31; 2005[a], p.79; 2006[a], p.23). It worried too about interstate financial imbalances both internal and

Table 5.4: Main concerns within *EU Banking Sector Stability* reports

	Real Estate exposure & ABS	Profitability / Weak Economy	High Corporate & Household Indebtedness	Complex Securitisation & Hedge Funds	Global Imbalances / US Debt	Low Provisions	Search for Yield / low credit standards	Low Deposits / Interbank Borrowing [171]
2003, Feb	✓	✓			✓			
2003, Nov	✓	✓	✓					
2004, Nov	✓	✓	✓		✓		✓	✓
2005, Oct	✓		✓	✓	✓	✓	✓	✓
2006, Nov	✓		✓	✓	✓	✓	✓	✓
2007, Nov	✓	✓		✓	✓		✓	✓

Source: Author (2018)

[171] Liquidity risk concerns, but mainly anxieties about profitability.

external to the Euroarea (ECB 2005[b], p.9; 2006[a], p.10), as well as high levels of household and corporate debt facilitated by historically low interest rates (which the ECB believed was partly caused by the successful implementation of monetary policy [ECB 2005[b], p.11]) and increased banking competition (ECB 2005[c], p.23; 2006[a], 2007[c], p.11).

Table 5.5: Main concerns within *Financial Stability Reviews*

	Real Estate exposure & ABS	Profitability / Weak Economy	High Corporate & Household Indebtedness	Complex Securitisation & Hedge Funds	Global Imbalances / US Debt	Low Provisions[172]	Search for Yield / High Asset Prices	Interbank Markets and Liquidity
2004, Dec	✓	✓		✓	✓		✓	✓
2005, June	✓		✓	✓	✓	✓	✓	
2006, Dec	✓		✓	✓	✓	✓	✓	
2006, June	✓		✓	✓	✓	✓	✓	
2006, Dec	✓		✓	✓	✓		✓	
2007 June	✓		✓	✓	✓		✓	✓
2007 Dec	✓			✓	✓		✓	✓

Source: Author (2018)

This competition and low interest rate environment led to a ‘search for yield’ by financial institutions, including hedge funds (ECB 2005[a]), which lowered credit standards and inflated asset prices on the run up to the crisis (ECB 2004[b], p.9; 2005[b], p.11; 2006[a], p.9). While the ECB was fully aware of these problems and consistently drew attention to them, it had neither the ideational nor policy tools to deal with them:

> *It’s as if our models weren’t working in the sense that something must be wrong. Aren’t we too successful? But we had money growth and we were looking at it*

[172] Because of low Non-Performing Loan (NPL) rates.

> *because we designed the ECB to be like the Bundesbank, but then there were even people like [redacted] who… would say things like, maybe you should just abandon the monetary pillar because you… are just introducing noise to the communication*
>
> (ECB: interview #3, 2015)

As the quote above shows, although the ECB recognised credit growth was becoming uncomfortably high and a search for yield was under way, the banks mandate extended only as far as controlling inflation. Despite the improved monitoring and communicative discourse with market participants, the ECB was structurally and ideationally restricted from intervening in financial markets (Papademos 2006). Therefore whilst over the course of the pre-crisis period a substantial ideational shift took place in relation to financial stability (which is best explained with insights from DI), it was also constrained by path-dependent forces (better understood through HI). EMUs legalistic structure prevented the ECB implementing interventionist financial policy ideas, and its legitimacy and credibility remained tied to the delivery of price stability (Praet 2016[b]; Issing 2001). Scenarios D and I from table 2.2 are therefore each relevant for EMU during this period.

The ECBs monetarist framework:		
D) established ideas in new institutions	**->**	**hinder policy change**
ii) established programmatic ideas	->	strengthen existing structures
I) ridged legal structure	**->**	**hinders policy / institutional change**
A combination of established programmatic ideas and a ridged legal structure meant financial stability policy ideas failed to provoke fundamental institutional change.		

Illustration 5.2

President Trichet therefore ruled out targeting asset prices, attempting to prick asset bubbles and even the so-called 'leaning against the wind' strategy whereby policymakers increase interest rates to slightly above the level necessary to maintain price stability in the hope of slowing asset price increases and creating more leeway for rate reductions during a downturn (Trichet 2005[c]). Instead, the ECB merely advocated increased transparency; price stability analysis being conducted over the longer-term to accommodate monetary developments; monetary analysis to include an assessment of financial market liquidity to spot potential issues early; and the publication of regular financial stability publications (Papademos 2007[a]).

With regards to interbank repo markets, the discrepancies between the two publications are due to the fact *EU Banking Sector Stability* reports mainly drew attention to the markets 'micro' role in plugging liquidity shortages. Because they were often used by banks as a replacement for customer deposits, they improved bank profitability (ECB 2004[c], p.10; 2005[c], p.21; 2006[b], p.21). *Financial Stability Reviews* meanwhile tended to take a 'macro' view and discussed anxieties about contagion risks (ECB 2004[b], p.83; 2007[b], p.153; 2007[c], p.31). While Trichet directly addressed worries about repo market contagion in a speech in 2004 (Trichet 2004[a]), these risks were little discussed within written publications between 1999-2007.

The reason for this lack of attention on the potential contagion effects of repo markets was due to the ECBs growing confidence in its ability to deliver a stable economic and financial environment within a monetarist EMU framework. National financial supervisors had implemented liberalising market-based measures to ease banks financing conditions in preparation for the euro (Gabor 2016, p.978; Malo de Molina 2012, p.198). During the early years of EMU, the ECB and Commission built on this foundation by implementing the FSAP (1999) and FCD (2002). These policies were deemed so successful that the interbank market was considered too big and too liquid to fail.

> *Liquidity is just trust. I mean, I will lend you money unconditionally if I trust you, if I don't trust you, I don't give you liquidity it's as simple as that…* [redacted] *always used to say that the European interbank market would never fail because it was so liquid. But what he was actually saying is that it cannot fail because everybody trusts each other so much. But if you take that trust out it fails instantly*
>
> (Commission: interview #18, 2015)

As this quote from a member of the Commission's Financial Stability and Monetary Affairs Directorate makes clear, the amount of liquidity and trust within European capital markets meant little consideration was devoted to the possibility of their collapse. In the repo markets, this trust extended even further as banks provided liquidity in exchange for collateral that was secured against highly rated government debt or real estate loans. Even if interbank liquidity did dry up, there was little reason to suspect banks may become unable to obtain liquidity as the ECB accepted such a wide range of collateral in its Open Market Operations (ECB 2004[b], p.83; 2006[a], p.72; Ullrich 2006). This confidence in the interbank market and in the collateral underpinning it also explains the ECBs failure to discuss European 'safe assets' before the crisis.

While the German government sought to stimulate demand for German bonds prior to EMU, the need for a specific European debt security backed by ECB firepower was regarded as neither necessary nor desirable. It was considered unnecessary because it was assumed 'flight to quality' would benefit all Eurozone government bonds during a downturn, limiting contagion effects[173] (ECB 2005[b], p.149), and it was thought undesirable because the existence of a 'safe asset' was expected to weaken market discipline and reduced fiscal pressures on EMU governments. The Maastricht framework was specifically structured to encourage discrimination between sovereigns (Bibow 2015, p.22; Cœuré 2016) and creating a safe asset would have undermined this monetarist structure. By 2003, Germany had already raised fears that bond market participants viewed the no-bailout-clause as un-credible, as they were failing to distinguish between EMU sovereigns (Heppke-Falk and Hüfner 2003, p.3). Monetarist nations were therefore unlikely to have accepted any moves towards weakening market discipline still further by creating a mutual sovereign debt security.

SUMMARY

As a consequence of market-based banking and ECB programmatic monetarist ideas, during EMU, the Commission and ECB pushed for closer European financial integration (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005). This was particularly successful in the interbank repo markets after the completion of the FCD (2002) which aimed to harmonise financing conditions across the Eurozone and allow for the smooth implementation of monetary policy. This integration was pursued despite ECB acceptance that one likely consequence could be increased financial instability (ECB 2000[d], p.50; 2002[c], p.56). Recognising the dominance of monetarist ideas is therefore essential to

[173] During the initial phase of the crisis in early 2007, interest rates for all EMU member-states did indeed start to decline (ECB 2007[c], p.80), with little divergence visible until late 2009 (figure 5.7).

understand the ECBs position on financial integration and why an EMU-wide money market was deemed so important.

Crucially however, these initiatives also acted to weaken traditional monetarist ideas as they reduced market discipline in the sovereign bond market and converged interest rates on government debt, allowing peripheral states to borrow more cheaply (Blyth 2013[a], p.78; Schnabl and Freitag 2011; Lynn 2011, p.61). This reveals the inherent contradiction at the heart of the Maastricht framework which called both for inflation targeting to be implemented through the manipulation of interest rates, and for bond markets to discriminate between EMU sovereigns in a bid to separate monetary and fiscal policy. The history of EMU has since proven these two ideals cannot be maintained simultaneously.

At the birth of EMU, responsibility for financial stability remained with national regulators and central banks considered the delivery of price stability to be the best way to promote financial stability (Issing 1999[a]; Noyer 1999[b]). But closer integration heightened contagion risks, resulting in the ECB monitoring and communicating its financial stability concerns more explicitly (Padoa-Schioppa 2003; Papademos 2006; Trichet 2003). A clear ideational shift therefore took place within the ECB during this period, along with a definitive change in ECB communicative discourse.

While insights from DI help contextualise both these developments, significant path-dependent trends could also be detected. Structural factors explain why despite drawing attention to financial stability concerns, the ECB remained powerless to implement interventionist policy ideas aimed at tackling them. National regulators remained in control of national financial systems (Bibow 2015, p.21; Scheller 2006, p.111), which meant the ECB had neither the tools nor the mandate to act on financial anxieties (Papademos 2006).

The legalistic structure of EMU exerted a powerful path-dependent force on the ECB, and the legitimacy and credibility of the institution remained wedded to the conveyance of price stability (Issing 2001; Praet 2016[b]). Indeed, even under the presidency of Jean-Claude Trichet, the bank remained committed to monetarist ideas and continued to promote financial integration while rejecting the use of monetary policy for any purpose other than the pursuit of price stability (Trichet 2004[b]; 2005[c]). Analysis of the pre-crisis period therefore shows that despite substantial ideational change, transformative ideas were compressed by the dominance of traditional ideas, and by the ridged structure of EMU, resulting in fundamental institutional change being avoided.

5.3 Conclusion

Why has the ECB become increasingly attentive to financial stability concerns throughout its history?

This chapter filled an important gap in contemporary literature by examining the extent to which the ECBs approach to financial stability evolved during the first 8 years of EMU. It showed although differences existed between member-states during the institutional formation of the euro (Capoccia and Kelemen 2007, p.342), monetarist programmatic ideas nevertheless became the ideational foundation of the single currency (McNamara 1998, p.56-7; Schmidt 2014). This ensured the ECBs primary objective throughout the period was the pursuit of price stability using policy interest rates (Howarth and Loedel 2005, p.15; Issing 2002[a], p.23; Quaglia 2008, p.110).

This sent the ECB on a path-dependent trajectory, knotting together monetarist ideas and inflation targeting with the bank's credibility and legitimacy (Cecchetti and Schoenholtz 2008, p.4; Issing 2001; Praet 2016[b]). Distancing the ECB from such ideas would have involved significant 'sunk costs' and brought into question the legality of its actions (González-Páramo 2005; Högenauer and Howarth 2016; Sibert 2009). Yet the chapter also showed that while financial stability was certainly viewed as a secondary, or even tertiary consideration behind price stability and financial integration during the early years of EMU, it was never wholly neglected and became increasingly important through time. Indeed, financial policy ideas always played a role within EMU (Micossi 2015, p.3), beginning with the Banking Supervisory Sub-Committee of the EMI and continuing with the BSC, the monitoring of financial data within the first monetary pillar, and the management of open market operations.

As European finance became increasingly interconnected and market-based programmatic monetarist ideas led the Commission and ECB to pursue integrationist policies aimed at improving interest rate transmission (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005). This began to expose contradictions within EMUs framework as other monetarist imperatives – such as the need for discipline in the sovereign bond markets – were counteracted by collateral policies which treated all Euroarea sovereign debt equally. These rules not only weakened monetarist principles regarding fiscal conservativism, but also exacerbated financial contagion risk (Papademos 2006; Trichet 2004[a]; 2005[a]). This realisation led the ECB to alter its contention that price stability should be the only objective central banks should pursue during ‘normal times’, towards recognising the importance of financial stability as an independent policy goal (Padoa-Schioppa 2003; Tricht 2003).

Therefore while the ECB undoubtedly displayed path-dependency through its commitment to price stability (Salines et al. 2011), the early years of EMU should not be viewed as a ‘punctuated equilibrium’ (Krasner 1988) either side of two ‘critical junctures’ (Capoccia and Kelemen 2007, p.346) in the form of the Maastricht Treaty (Verdun 2015, p.231 and 2007; Yiangou, et al. 2013, p.225) and the financial crisis (Braun 2015, p.422; Verdun 2015, p.222). Substantive ideational and discursive changes took place endogenously during this ‘normal’ period, which may easily be missed viewed solely through the prism of HI (Lieberman 2002, p.698; Posner 2007, p.145). By combining both HI and DI, the chapter exposed the ideational and structural forces constraining and enabling institutional change. As a result, it was able to fully account for why the ECB became increasingly attentive to financial stability concerns throughout the pre-crisis period.

Chapter 6

Post-Crisis National Financial Systems

Why were Spain and Germany impacted differently by the financial crisis, and why did they pursue different policy objectives at the European level?

Although the European Central Bank (ECB) has recently gained significant authority over financial supervision as well as monetary policy, the European System of Central Banks (ESCB) continues to exist as a federation, with National Central Banks (NCBs) maintaining important roles in the implementation and operation of monetary and financial policies (Cohen-Setton 2011; Gros 2017; Quaglia 2008, p.3). This chapter explores the extent to which pre-crisis structural and ideational idiosyncrasies between two ESCB central banks – the *Deutsche Bundesbank* (DB) and *Banco de España* (BdE) – led to divergences in the way Spanish and German banks were hit by the crisis, and to differences in the way each country reacted to supranational policies aimed at mitigating its effects.

While previous research has analysed the different ways Spanish and German banks dealt with the advent of market-based banking and *how* this influenced the timing and extent of the crisis in each state (Hardie and Howarth 2013[a]; Quaglia and Royo 2015; Royo 2013[a]), this chapter argues important ideational and structural dissimilarities evident before 2008 are crucial to explaining *why* the two nations were impacted differently. It also reveals the significance of these factors in determining *why* national responses to European Union (EU) policies aimed at combatting the financial and sovereign debt crises differed so visibly.

Using process tracing and employing insights both Historical (HI) and Discursive Institutionalism (DI), the chapter progresses chronologically, beginning with the initial phase of the crisis from 2007-2010. It asks why German banks were initially affected much more severely than their Spanish counterparts (Howarth and Quaglia 2015, p.460; Otero-Iglesias et al., 2016, p.17), and includes a critical case study of the German bailout of Hypo Real Estate (HRE) - the biggest bank nationalisation in German history (Scally 2013[a]).

The second section examines the start of the sovereign debt crisis between 2010-2012. This segment contains a critical case study of Spain's bailout of Bankia and explains why this event should be regarded as the climax of the sovereign debt crisis and as a critical juncture which catalysed change in both Spain and the wider EU (Romero 2012). It also explains why German and Spanish policymakers exhibited different levels of enthusiasm towards supranational policies which intended to diffuse the crisis; focusing specifically on the European Stability Mechanism (ESM) and the ECBs Securities Markets Program (SMP). The penultimate segment explores the German and Spanish authorities differing attitudes towards Banking Union (BU), while the final section draws a conclusion.

6.1: Initial Crisis Phase (2007-2010)

GERMANY

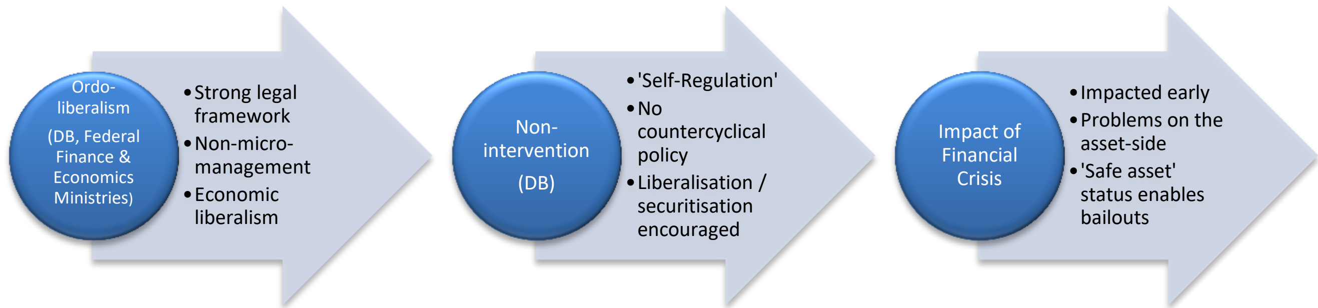
Because under EMU the DB and Federal Finance Ministry became less concerned about short-term finance and actively promoted German securitisation (Asmussen 2006; DB 2003[a], p.22; 2006[a], p.31-3), large German banks became marketised predominantly on the asset-side of their balance sheets (Hardie and Howarth 2013[a], p.104). Having invested heavily in foreign securities, once asset prices began to fall in July 2007, financing options began to dry up and the German banking system quickly became one of the most battered in Europe[174].

Germany was impacted so quickly by the crisis because of the vulnerability of assets held principally by large commercial banks (*Kreditbanken*) and *Landesbanken*[175]. The pre-crisis accumulation of such risk was facilitated by the DBs subscription to non-interventionist financial policy ideas which it derived from its ordo-liberal (*Ordnungspolitik*), monetarist approach to economic and monetary policy. The DB allowed German banks to run down their loan-loss provisions and failed to implement countercyclical policies which may have softened the initial crash (DB 2004[a], p.35; 2005[a], p.69). Pre-crisis financial ideas thus had a direct bearing on both the speed and magnitude of the crisis in Germany. These findings allow us to understand more comprehensively than any research to date the underlying reasons behind the severity of the crisis in Germany in 2007 (figure 6.1).

[174] Between 2008 and September 2012 around €646 billion was set aside to rescue German banks, the second-highest amount of any country after Great Britain (Ewing 2013; Spiegel 2013).
[175] Notably, in July 2007, IKB Deutsche Industriebank (FWB: IKBG) received a bailout package, and on the 26th August 2007, Sachsen Landesbank announced it was being taken over by Landesbank Baden-Württemberg (LBBW) after losses in the US sub-prime market meant it required an immediate cash injection of €250 million (Simensen 2007).

Due to the immediacy of financial turbulence and weakness of many large German banks, Germany was one of the first countries to create a so-called ‘bad bank’ (*Finanzmarktstabilisierungsanstalt*, SoFFin) through the Financial Market Stabilisation Act (2008). This voluntary scheme allowed banks to offload their ‘toxic’ assets to a government backed Special Purpose Vehicle (SPV[176]) in exchange for safe, interest-paying bonds able to be used in repo transactions across the Eurosystem (DB 2009[a], p.56). SoFFin provided €102 billion in loan guarantees and a further €80 billion in liquidity to recapitalise distressed banks (Zimmermann 2014, p.493).

Figure 6.1: Ideas and the German financial crisis



Source: Author (2018)

The fact Germany chose to create a voluntary program with few conditions to entry is telling. As the quote below from a German Economy Ministry official reveals, the government was reluctant to invest political capital in restructuring the banking system and little political pressure was directed towards reform (Röper 2017; Wilson 2012). It also

[176] A time limited financial entity created for a specific purpose.

exposes unequivocally the importance of ordo-liberal (*Ordnungspolitik*) thinking within the ministry and its dislike of the link between politicians and *Landesbanken*:

> *This is one of those ordo-liberal things that we don't think that the state can run business too well, and the Landesbanken are very good proof that they can't run banks very well. Of course to change a longstanding system like this takes some time. Some of the Landesbanken disappeared more or less by themselves thanks to the last banking crisis. I think we didn't try too much for their disappearance… but of course those banks are nothing you would build if you were setting up a new system on a green field. But they're there and it takes time to change*
>
> (German Economics Ministry: interview #11, 2015)

This quote illustrates that despite the dominance of ordo-liberal ideas in the ministry, the path-dependent structure of Germany's financial system was largely preserved. As highlighted in chapter 4, path-dependence in the *Landesbank* sector was facilitated by the vested interests of regional politicians who sought to continue using the banks to advance their own objectives (Rawcliffe 2007; Ross 2014[b]; German Finance Ministry: interview #12, 2015). To spur reform, the government could have imposed higher capital ratios and forced struggling banks and *Landesbanken* into the SoFFin program to change their business models (Spiegel 2008). Yet despite ordo-liberal (*Ordnungspolitik*) preferences for de-politicised banking, wholesale structural reform was avoided and path-dependence preserved.

The salvation of Germany's public banking sector and three-pillar structure was also due to the fact smaller public banks (*Sparkassen*) and cooperatives (*Raiffeisenbanken* and *Volksbanken*) remained domestically orientated and continued to lend to small and medium-sized enterprises (SMEs, *Mittelstand*) during the crisis (Röper 2017, p.18; Simpson 2013, p.20; Steinberg and Vermeiren 2015, p.397). As a result, the utility of Germany's

Social Market banking structure was not completely undermined, preventing alternative ideas from driving institutional change (Röper 2017, p.17). This ensured that Germany's public banking structure fought off ideational challenges and that scenario B from the ideational versus structural matrix was played out.

Three-pillar path-dependence:		
B) structures trump ideas	**->**	**institutional continuity**
Political vested interests and the continued functioning of smaller German banks prevent alternative ideas gaining traction.		

Illustration 6.1

Nonetheless, by January 2009 direct government intervention did materialise when Commerzbank, Germany's second-largest lender, became part-nationalised with the government taking a 25 percent stake. This was the first time in Germany's modern history that the state had taken ownership of a private consumer bank and was a matter of serious concern both economically and ideationally (Ward 2009; Zimmermann 2014, p.492). At the time, the centre-right *Die Welt* newspaper commented:

> *For decades, the widespread renunciation of an active role for the state in economic activities has been one of the pillars of Germany's economic success. In cases of emergency such as this, this rule must be broken… but… such actions must be restricted*
>
> (Die Welt 2009)

As this quote indicates, state intervention ran counter to ordo-liberal (*Ordnungspolitik*) orthodoxy and was therefore regarded as a retrograde step by many in the country. The liability principle (*Haftungsprinzip*), a key feature of ordo-liberalism (Pies and Sass 2010), stresses that moral hazard is created through wealth transfers and state bailouts, allowing investors to amass profits during good times while socialising losses in bad times (Dam and Koetter 2012; DB 2014, p.77). Such measures were therefore implemented with distinct unease (DB 2011, p.60; Hardie and Howarth 2009, p.1032; Ward 2009), with the DB making clear that in future, banks should be allowed to fail without jeopardising the stability of the system and creating moral hazard (DB 2009[b], p.12; 2014, p.74).

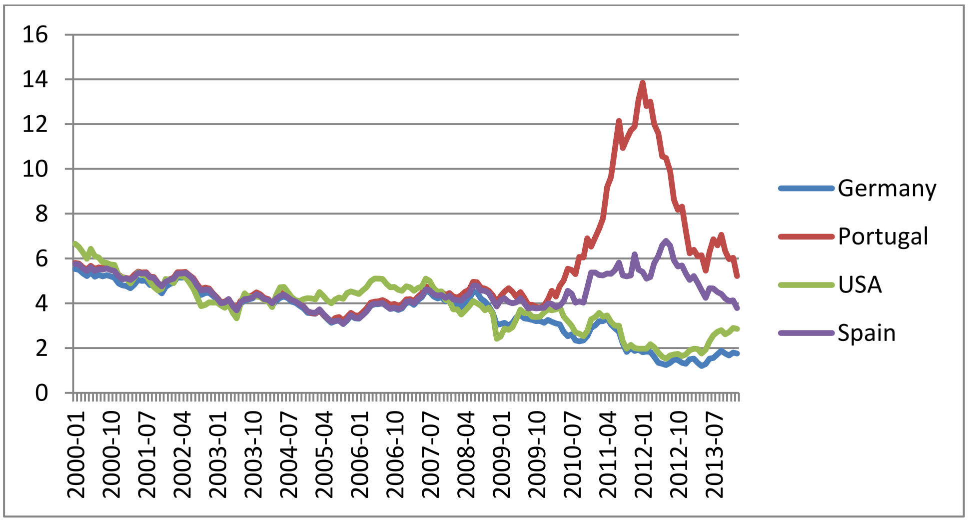
Nevertheless, in March, Germany's parliament passed the Expropriation Law (2009), giving the state authority to seize control of banks whose failure posed a risk to financial stability (Kollewe 2009; Mayer Brown 2009, p.4). This allowed SoFFin to take full control of HRE, and for a resolution vehicle (*FMS Wertmanagement*) to be created to manage bank liquidations (FMS Wertmanagement 2017). By 2014, although no small cooperatives (*Raiffeisenbanken* and *Volksbanken*) or savings banks (*Sparkassen*) had failed due to their traditional business models, all the larger commercial banks[177] and *Landesbanken*[178] were forced to accept state aid to help stabilise themselves (Gaulard et.al 2015; Ross 2014[b]).

This aid was given despite the ideational discordancy of bank bailouts with ordo-liberalism (*Ordnungspolitik*), the liability principle (*Haftungsprinzip*), and moral hazard, and without the government insisting upon structural reform (Münchau 2016; Röper 2017; Wilson 2012). Understanding the importance of institutional structures in Germany during the early crisis period is therefore critical, as bailout decisions were often taken with political-electoral and material considerations in mind and in opposition to dominant philosophical ideas (Bastasin 2012, ch.1; Dam and Koetter 2012, p.2353; New York Times 2008).

[177] Commerzbank, Deutsche Bank, Deutsche Postbank and HVB Group.
[178] With the single exception of Helaba Bank.

These state interventions nonetheless proved adequate to bring relative stability to the German system. Germany was able to take such action primarily because German debt had long been considered ‘safe’ by financial markets, resulting in low governmental borrowing costs. Under the European Monetary System (EMS), Germany was regarded as the *de facto* currency anchor (Heipertz and Verdun 2010, p.22; Howarth and Loedel 2005, p.18; Nedergaard and Snaith 2015, p.1099) and pre-EMU liberalisation over the production of short-term Treasury Bills and repo market rules meant German sovereign bonds remained prised financial assets. Germany therefore experienced the ‘exorbitant privilege’ of a ‘flight to safety’ (Gabor and Vestergaard 2016) during the crisis, with debt becoming cheaper to service than during ‘normal’ times. For nations less well regarded by the bond markets, such as Spain, the bailout of domestic banks proved much more costly as debt became more expensive to acquire.

Figure 6.2: Yield on 10-year government bonds (2000-2014)

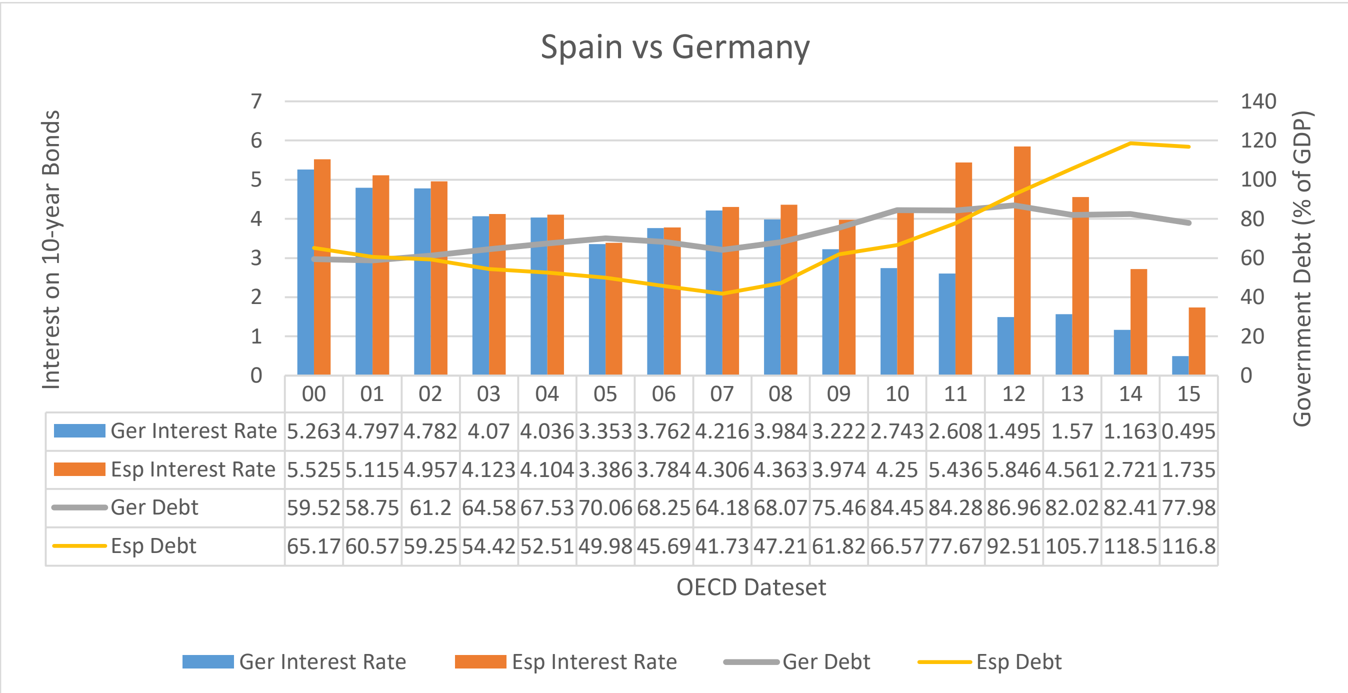


Source: OECD (2018)

The German government maintained that this divergence resulted from fiscal policy (DB 2000, p.49; Schäuble 2011[b]): Germany benefited from low interest rates because of its fiscal prudence, while peripheral states were punished as a consequence of financial mismanagement (Jones 2015). But this argument fails to grasp the importance of the repo markets and the desire of banks to hold safe assets. This appears much more important than fiscal policy in determining yield spreads, particularly during crisis periods.

As figure 6.3 shows, even before the crisis Germany found it cheaper to borrow, despite lower government debt and deficits in Spain. Interest on German bonds also began to fall and Spanish rates to rise between 2008-10, despite a banking crisis in Germany (which had not yet impacted Spain), lower government debt levels in Spain and similar fiscal deficits. The fact Germany could afford to borrow to bailout its financial system therefore bore little

Figure 6.3: Government debt versus 10-year bond yields

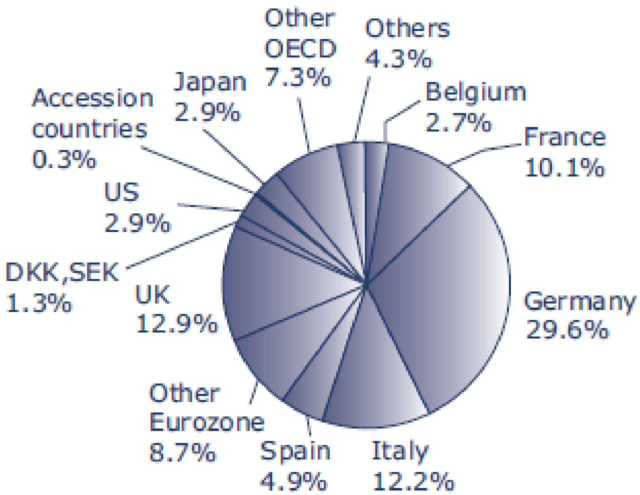


	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15
Ger Interest Rate	5.263	4.797	4.782	4.07	4.036	3.353	3.762	4.216	3.984	3.222	2.743	2.608	1.495	1.57	1.163	0.495
Esp Interest Rate	5.525	5.115	4.957	4.123	4.104	3.386	3.784	4.306	4.363	3.974	4.25	5.436	5.846	4.561	2.721	1.735
Ger Debt	59.52	58.75	61.2	64.58	67.53	70.06	68.25	64.18	68.07	75.46	84.45	84.28	86.96	82.02	82.41	77.98
Esp Debt	65.17	60.57	59.25	54.42	52.51	49.98	45.69	41.73	47.21	61.82	66.57	77.67	92.51	105.7	118.5	116.8

Source: Author, OECD data (2018)

relation to fiscal policy[179]. It instead had to do with Germany's pre-crisis reforms which placed German debt in a privileged position on the interbank markets (figure 6.4). Consequently, Germany was able to borrow from the bond markets to finance bank bailouts without direct outside assistance and without a fundamental reorganisation or modernisation of its 'three-pillar' structure (Ewing 2013; Hassan 2014; Hüfner 2010, p.5).

Figure 6.4: National bonds used as collateral in European repo transactions (2008)



Source: International Capital Market Association (2008)

This again highlights the importance of incorporating ideational and structural causation into a critical understanding of German's banking crisis. Pre-crisis policy ideas help explain why Germany was so severely impacted during the early stages. Germany did not implement 'consolidated' shadow bank regulation or countercyclical measures as Spain did (see chapter 4). Yet it was able to withstand the fiscal pressures of its bailouts and issue a raft of financial support measures due to actions it took pre-EMU to ensure the continuity of

179 Germany also consistently broke EU Stability and Growth Pact (SGP) rules between 2002-2005, while Spain ran government surpluses.

Germany’s status as a benchmark issuer of sovereign debt (Ewing 2013; Hassan 2014; Hüfner 2010, p.5). Structural characteristics meanwhile explain why smaller German banks were able to continue lending during the downturn (Röper 2017, p.18) and why despite holding philosophical ideas which stand opposed to state subsidies, the government decided (reluctantly) to step in to preserve Germany’s ‘three-pillar’ financial structure (Bastasin 2012, p.33; Ross 2014[a]).

Critical Case Study: Hypo Real Estate

HRE Group consisted of three parts[180] which together formed Germany’s second-biggest property lender (Commission 2008; HRE Group 2008; Wilson 2008) with a balance sheet worth over €400 billion[181] (Balzli and Dettmer 2009; Tyler 2008). It was the fifth German bank to be bailed-out in the wake of the crisis and the only German institution to be fully nationalised, representing the largest and most important of Germany’s bank bailouts (Kollewe 2009; Zimmermann 2014, p.491). Its example is also emblematic of the wider problems facing German’s financial system during the early crisis period.

Due to the unprofitability of the domestic market (Commission 2014, p.40; Hardie and Howarth 2009, p.1019) and the self-regulatory approach adopted by the DB, HRE, like many large German banks, invested heavily in US and peripheral Asset-Backed Securities (ABSs) which they originated off-shore through SPV programs (Detzer et al. 2017, p.68). Once the financial crisis struck and the market for such products collapsed, the risk premiums for

[180] Hypo Real Estate Bank, Hypo Real Estate Bank International and Depfa Deutsche Pfandbriefbank.
[181] €403 billion in 2008, of which €294 billion consisted of infrastructure loans (HRE 2008, p.85).

holding them increased exponentially[182]. This had an immediate impact on HRE and other banks conducting similar business.

Table 6.1: HRE asset exposure by country (2008)

Germany	23%
USA	16%
GIIPS[183]	26% (approx.)
Other	35%

Source: HRE Group Annual Report (2008, p.83)

The table above highlights HRE's high exposure to US and peripheral countries as a percentage of its overall balance sheet. The table below indicates how falling asset prices negatively impacted the banks' capital ratios. Such a large reduction in the figures between 2007-2008 meant the bank struggled to meet capital requirements and had fewer tradable assets with which to assess liquidity, resulting in its inability to meet financial obligations.

Table 6.2: HRE capital ratio (2007-8)

	2008	**2007**
Core Capital	€5.9 bn	€9.3 bn
Own Funds	€8.2 bn	€12.2 bn
Risk-Weighted Assets	€95.3 bn	€109.1 bn
Core Capital Ratio	6.2%	8.5%
Own Funds Ratio	8.6%	11.1%

Source: HRE Group Annual Report (2008, p.2)

[182] In the case of AAA rated Commercial Mortgage-Backed Securities (CMBS), premiums rose tenfold from 0.7% to 7%. For ABS, premiums rose from 5.5% to 13% (HRE 2008, p.29).
[183] Greece, Italy, Ireland, Portugal and Spain.

The troubles began for HRE when it purchased the Irish lender Depfa Bank[184] in October 2007 for €5.7 billion. Depfa pursued a highly profitable yet speculative business model: lending capital for long-term infrastructure and commercial property projects through borrowing obtained on the short-term money markets (Commission 2008; 2011, p.41). Once this funding channel collapsed after the failure of Lehman Brothers in September 2008, Depfa was forced to appeal to the wider HRE Group for capital.

Unfortunately, the wider group was also experiencing problems relating to poorly performing assets and HRE became unable to meet obligations (Commission 2008; 2011, p.41). In October 2008, despite reluctance from German officials, the government agreed a €50 billion partially state-backed aid package of loans and credit guarantees to bailout the lender (Bastasin 2012, p.33). HRE was eventually nationalised in October 2009 (Commission 2011; Reuters 2009), with SoFFin taking full control of all assets and liabilities. This action was taken as a 'last resort' by DB President Axel Weber and Bafin[185] boss Jochen Sanio (Frankfurter Allgemeine 2009), to prevent a total collapse of Germany's banking system[186] (Bastasin 2012, p.33; Manager Magazin 2009). In October 2010, *FMS Wertmanagement* was created as a winding-up vehicle for HRE. Based in Munich, it is the largest bad bank in Europe and is tasked with unwinding assets previously owned by the group (Commission 2011, p.44; FMS Wertmanagement 2017).

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[184] Depfa Bank was originally named Deutsche Pfandbriefanstalt, was founded in 1922 to provide residential property loans in Wiesbaden (Germany). It later opened an Irish subsidiary and transferred its headquarters to Dublin (Scally 2013[a]).

[185] Federal Financial Supervisory Authority (BaFin). The DB essentially acts as both a regulator and supervisor, while BaFin conducts accounting functions and ensures that established rules are followed (DB 2017[b]).

[186] Such a scenario would have been considered 'the end of the world' by German officials (Manager Magazin 2009).

The affair marked one of the biggest injections of state-aid of the entire financial crisis. Such support was made possible because of the ‘safe asset’ status of German government bonds (Gabor 2016, p.978; Röper 2017) which was facilitated by the liberalising measures introduced by the DB and Finance Ministry during preparations for EMU. These changes were predicated on traditional ordo-liberal (*Ordnungspolitik*) ideas and a reinterpretation of aspects of German monetarism which saw short-term finance as less threatening to price stability under a system of inflation targeting (Weber 2005, p.15). Ideas are therefore crucial to understand how the bailout of HRE and many other large German banks was made possible, while DB non-interventionist policy ideas (coupled with the decentralised structure of Germany’s regulatory framework) explain why German banks were permitted to invest so heavily in foreign assets (Reuter 2008; Spiegel 2008).

However, recognising structural dynamics is also necessary to comprehend the full picture. Bank bailouts were provided despite ordo-liberal philosophical ideas which opposed any weakening of the liability principle (*Haftungsprinzip*) (DB 2011, p.60; Hardie and Howarth 2009, p. 1032). The sunk costs involved in any ‘end of the world’ collapse of Germany’s banking system were considered too great to allow HRE and others to fail (Bastasin 2012, p.33; Manager Magazin 2009). A broad historical lens and recognition of ideational and structural factors are therefore essential to fully understand how structural path-dependence in Germany was preserved during the immediate post-crisis period.

SPAIN

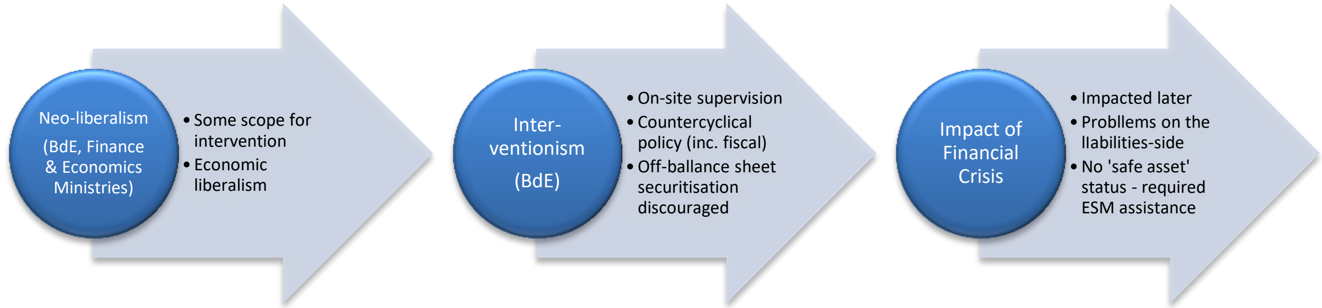
Before the crisis the BdE maintained distinct financial policy ideas, implementing strong interventionist regulation and countercyclical accounting standards. Unlike Germany therefore, Spain coped relatively well with the initial stages of the crisis (Howarth and Quaglia 2015, p.460; Otero-Iglesias et al., 2016, p.17). Due to consolidated regulation introduced by the BdE which severely restricted off-balance sheet activity, the liquidity support provided by Spanish banks to their SPVs was very low, just $7.08 billion in 2007 compared to $310.84 billion for Germany (Fitch Ratings 2007).

Until end-2010, dynamic provisions also helped dilute problems by allowing banks to draw down on the €40 billion safety net they accumulated during the boom. Evidence from the BdE shows that provisions worked largely as intended, dampening credit supply before 2007 while softening the effects of the crash in the immediate aftermath (Jiménez et al. 2012). This again shows how pre-crisis financial ideas and the policies they gave rise to are crucial to explaining why countries were impacted differently by the crisis, and why Spain was able to withstand the early fallout[187] (Otero-Iglesias et al. 2016, p.27).

Nevertheless, provisions and astute regulation proved insufficient to mitigate the full-scale financial crisis that was to follow (Garicano 2012[a]). German banks amassed asset-side risk on the lead up to the crisis by purchasing foreign debt which they used as collateral in the repo markets. Spanish banks meanwhile operated at the opposite end of the equation, by transforming loans into covered bonds and ABSs which were then sold to create funds for

[187] Although the first Spanish bank to receive assistance, Caja Castilla La Mancha (CCM), did so in March 2009, this was an outlier and it was not until 2010 that problems really began to emerge. Indeed, the worst episode of the crisis in Spain, the collapse of Bankia in May 2012, came three years after the German bailout of HRE.

Figure 6.5: Ideas and the Spanish financial crisis



Source: Author (2018)

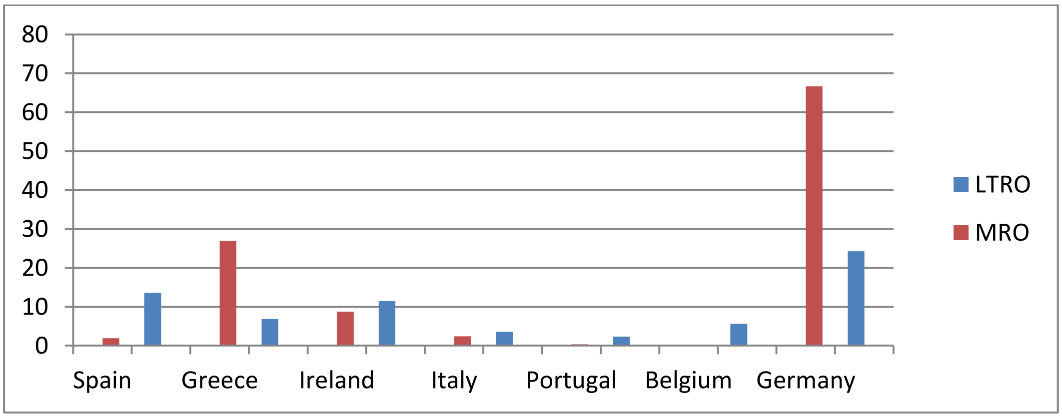
additional lending. The collapse in demand for securitised assets post-2008 therefore reduced the ability of Spanish banks to lend, contributing to the bursting of Spain's property bubble (Hardie and Howarth 2013[a], p.13; Tortella and García-Ruiz 2013, p.185). As Spain's central bank Governor, Miguel Fernández Ordóñez, pointed out:

> *The high dependence of the Spanish economy on external financing, as a result of many years of spending reliant on foreign savings, made it particularly sensitive to any turbulence that might undermine confidence and obstruct the access of banks to international financial markets*
>
> (Ordóñez 2008, no page)

This collapse in foreign demand for securities was felt particularly harshly in the *cajas* where securitisations, largely structured around mortgage loans, represented a higher proportion of balance sheet assets than in commercial banks (BdE 2005[a], p.45). Indeed, the Spanish crisis emanated almost entirely from the *cajas* whose lending had stimulated a housing bubble they were unable to sustain in the face of collapsing demand for ABS (Garicano 2012[b]; Royo 2013[a], p.637; 2013[b] p.153). Yet during the initial crisis phase, *cajas* continued securitising loans, but instead of selling them to investors, they traded them for liquidity via ECB refinancing operations, allowing lending to be sustained (Otero-Iglesias et al. 2016, p.25; Sinn 2014, p.159).

Although still a long way off Germany and Greece, by March 2010, Spanish banks had borrowed as much as €90bn in liquidity through the ECBs Main (MROs) and Long-Term Refinancing Operations (LTROs), around 15 percent of the bank's total balance sheet (figure 6.6). This is important because not only were Spanish banks (and *cajas* in particular) becoming increasingly dependent on 'extraordinary' monetary policies for funding, but MROs and LTROs only replace assets for liquidity temporarily. Ultimately, Spanish institutions would have to repurchase these assets, which were likely to have reduced in value (Gabor 2012, p.14). Moreover, over half of the liquidity generated by LTROs was ploughed back into Spanish sovereign bonds (Thomas 2012; Whittall and Gore 2014). Because collateral held in ECB repo transactions is 'marked-to-market', falling bond prices from mid-2010 resulted in borrowing via LTROs becoming increasingly expensive for banks holding Spanish government paper, creating further financing problems (Bindseil et al. 2017, p.6; Gabor 2016, p.990).

Figure 6.6: ECB liquidity provision (% of total balance sheet), 2010



Source: Bruegel Datasets (2017)

The Spanish government began taking action to avert the crisis in June 2009 with the creation of the Fund for the Orderly Restructuring of Banks (*Fondo de Reestructuración Ordenada Bancaria* – FROB). This came in response to liquidity problems at CCM in March and was intended to create an environment within which *cajas* could begin restructuring (Ysa et al. 2012, p.269; Moya 2009). In a continuation of traditional interventionist policy ideas, and in contrast to Germany's voluntary bad bank scheme, the BdE was given further interventionist powers to reject and modify viability plans, dismiss managers, impose new management, and restructure governance operations. It also set aside €9 billion[188] to facilitate a series of merges between *cajas* (BdE 2009, p.22; 2010, p.28). Although the mergers did not aim to change the basic governance model of *cajas*, it was expected economies of scale could be achieved, making them more efficient (Cardenas 2013, p.22; IMF 2012[b], p.12; Ordóñez 2009).

While interventionist pre-crisis BdE policy ideas help account for the delay to the Spanish crisis by reducing asset-side risk and increasing provisions, and can explain why the bank and FROB were handed further powers post-crisis, it is also important to recall structural dynamics. *Cajas* were extremely reluctant to restructure in the wake of the crisis. In the first few months, no funds were requested from the FROB and larger *cajas* refused to partake in the process. This was chiefly due to the hostility of regional autonomous governments (*comunidades autónomas*) to any outside influence over their *cajas* (Otero-Iglesias et al. 2016, p.41). Galicia even appealed to the constitutional court (*Tribunal Constitucional de España*) in protest at the prospect of a FROB inspired merger (Royo 2013[a], p.639), highlighting the strength of resistance the BdE faced while pressing reform.

[188] From which the FROB could leverage up to €99 billion (BdE 2009, p.22; 2010, p.28).

Within *cajas* themselves, loans were often reclassified and extended to conceal the true extent of losses in an attempt to buy time in the hope the economy would improve and asset prices recover. They also made loan books appear healthier by refinancing credit to struggling homeowners and businesses with lower interest rates and more liberal terms (Brat and Bjork 2013; Garicano 2012[b], p.80). Rather than write-off non-performing loans (NPLs), they participated in asset swaps by purchasing land, taking control of property firms, and extending loan maturities to protect borrowers from bankruptcy (Royo 2013[a], p.642). Yet despite preserving a supervisory presence within *cajas* corporate boards, the BdE did not take action to confront these issues (Garicano 2012[b], p.81). When questioned on this, one official gave the following response:

> *The Bank of Spain knew everything, we have reports and the onsite inspectors knew everything. There was a political problem within the Bank of Spain which is not as independent as we hoped it would be as a supervisor. Everybody knew that there was a bubble in the real economy. Everybody knew that we had a weakness because of the funding dependency of the cajas, but at the end of the day, what do you do? It's super scary*
>
> (BdE: interview #10, 2015)

As this quote demonstrates, the BdE faced strong resistance from politicians and *cajas* to any restructure of the public banking sector and to recognise losses from domestic real estate (BdE: interviews #7 & #10, 2015; Brat and Bjork 2013; Brunnermeier et al. 2016, p.189). In a similar situation to that experienced by the DB in relation to *Landesbanken*, it was path-dependent mechanisms supported and reinforced by traditional vested interests that created considerable structural and political resistance to BdE reform efforts (Buck 2017; De Barron 2011). This meant that scenario B from the ideational versus structural matrix is most illustrative of Spain's public banking system during this period. Although BdE interventionist policy ideas helped establish a delay to the Spanish crisis, structural-political imperatives helped determine the extent of the problems (Otero-Iglesias et al. 2016, p.37-40).

***Caja* path-dependence:**		
B) structures trump ideas	**->**	**institutional continuity**
Despite ideational imperatives, political vested interests and the structure of Spain's public banking sector prevented the BdE implementing institutional reform.		
		Illustration 6.2

SUMMARY

Previous research on the financial crisis made important discoveries in relation to the differences between German and Spanish financial institutions composition of risk (Hardie and Howarth 2013[a], p.104; Royo 2013[a], p.154). By exploring ideational and structural influences within a process tracing methodological framework, this research has been able to explain why these differences materialised.

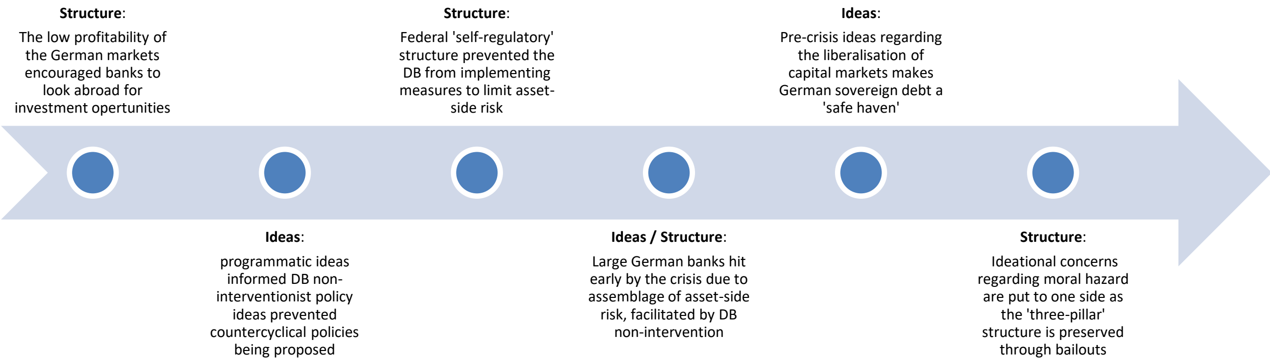
The nature of investments made by HRE and other German lenders were facilitated by the DBs ordo-liberal (*Ordnungspolitik*) non-interventionist approach to regulation and supervision (Commission 2014, p.40; Dam and Koetter 2012, p.2349; Lütz 2004, p.173). In Spain, consolidated accounting regulations implemented by the BdE meant Spanish banks, by contrast, tended not to involve themselves in off-balance sheet activity, complex derivatives, or short-term repo markets (Fernandez de Lis and Garcia-Herrero 2009; Ordóñez 2011). These different supervisory practices, rooted in distinct 'philosophical', programmatic and policy ideas, are crucial in understanding why German banks compiled so much risk on the asset-side while Spanish banks did not. They also help expound why the BdE introduced dynamic provisions before the crisis while the DB allowed German provisions to be wound down (DB 2006[c], p.57). This had a direct bearing on the timing and severity of the crisis in each country, evidenced by the emblematic example of HRE.

Ideas also explain why the DB liberalised its repo and short-term debt markets pre-EMU, and consequently why Germany continued to be regarded as a benchmark issuer of European safe assets (Gabor 2016, p.978; Röper 2017). This reveals why Germany was able to borrow so cheaply during the crisis and could afford to bailout its financial sector without instituting reform, while peripheral governments like Spain saw their borrowing costs increase (Gabor and Vestergaard 2016; Hassan 2014; Hüfner 2010, p.5).

However, recourse to ideas cannot explain the early phase of the crisis in its entirety and structures were also vital. The unprofitability of German's financial system[189] helps elucidate why German banks amassed foreign ABSs. Further, Germany bailed-out its banks and nationalised HRE despite such actions running counter to ordo-liberal (*Ordnungspolitik*) principles (DB 2011, p.60; Hardie and Howarth 2009, p. 1032). Although material considerations undoubtedly played a role in government calculations (DB 2009[b], p.33), so too did political imperatives and the desire to preserve the structure of the country's banking system (Dam and Koetter 2012, p.2353; New York Times 2008). This shows that path-dependent forces can override the ideational concerns of national authorities to maintain existing structures, even during times of crisis.

[189] Caused partly by the existence of Germany's large public banking sector (IMF 2003).

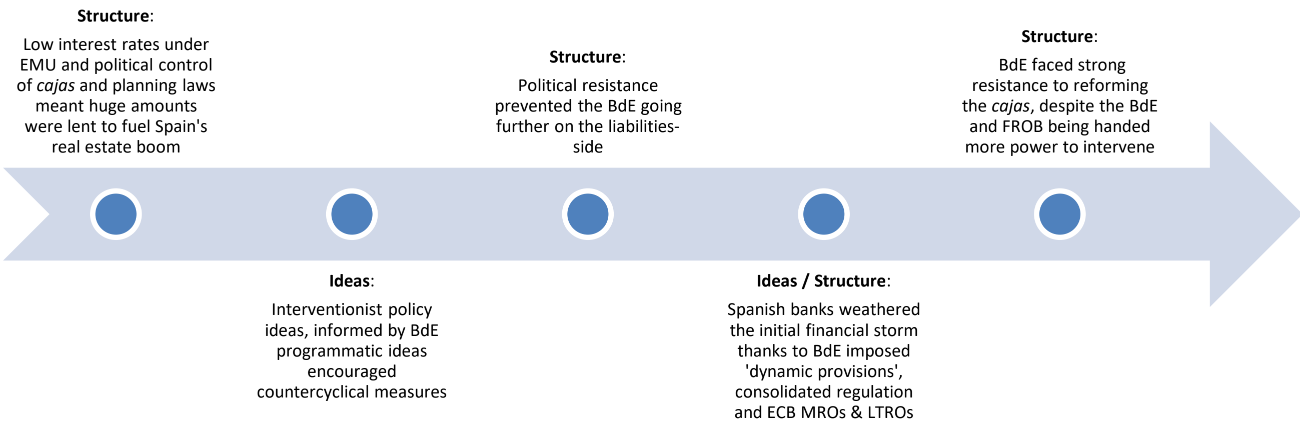
Figure 6.7: The evolution of German finance (1999-2010)



Source: Author (2018)

In Spain too, structural dynamics help uncover why the BdE continued to experience resistance to restructuring *cajas* despite intimate knowledge of their balance sheets (Buck 2017; De Barron 2011; Garicano 2012[b], p.81). These findings help fill an important gap in contemporary literature and show how our understanding of the crisis can be advanced considerably by using insights from DI and HI together to explain ideational and structural trends.

Figure 6.8: The evolution of Spanish finance (1999-2010)



Source: Author (2018)

6.2: The Sovereign Debt Crisis as a critical juncture (2010-2012)

GERMANY

Germany's bank bailouts had been costly[190], but due to the desirability of German government bonds, Germany found itself in a position of relative strength during this period. As a creditor state, the country was able to command a good deal of influence over the sorts of measures Europe took to combat the crisis (Lever 2017; Wren-Lewis 2015). With financial problems spreading across peripheral Europe and with the ECB legally prevented from monetary financing, on the 18th October 2010, the German Chancellor, Angela Merkel, and French President, Nicolas Sarkozy, met in Deauville, France, and provisionally agreed a Treaty that would create a permanent crisis fund able to loan money to EMU states facing fiscal distress (Brunnermeier et al. 2016, p.29).

Germany had originally sought to avoid constructing a lasting crisis mechanism and was adamantly opposed to expanding the European Financial Stability Facility (EFSF)[191] (Brunnermeier et al. 2016, p.218; Steinberg and Vermeiren 2016, p.393), just as it had opposed the automaticity of IMF bailouts during the 2001 Turkish and Argentinian crises (DB 2002, p.120; 2007, p.73). However, when it became clear that without fiscal assistance many Southern states would be unable to exit the crisis, the government eventually relented. Germany ultimately preferred assistance to come with democratic legitimacy and

[190] Between 2008 and September 2012 around €646 billion was set aside to rescue German banks (Ewing 2013; Spiegel 2013).
[191] A fund established in May 2010 in response to rising Portuguese bond yields and continued volatility.

moral hazard limiting conditions attached, as opposed to via the backdoor through ECB 'extraordinary' monetary policy (Sinn 2014, p.259).

In a further parallel between Germany's reaction to ESM and pre-crisis IMF proposals (DB 2002, p.119-20), at Deauville, Merkel and Sarkozy agreed upon the principle of Private Sector Involvement (PSI). PSI would have meant private bondholders being asked to take haircuts on investments, reducing the size of the required bailout package for ESM (Brunnermeier et al. 2016, p.30). As before, reducing moral hazard was the chief reason Germany pursued PSI inclusion:

> *The ESM will provide for private sector involvement. This is of very high priority to the German government. And for good reason: We have to deal with the problem of moral hazard. Risks and rewards should not be separated from each other. Investors – and that includes European bond holders – ultimately have to bear the risks as well as the rewards of their decisions… In the long run a division between risks undermines the foundations of capitalism – which needs risks and rewards to be inseparable*
>
> (Schäuble 2011[b])

This quote by Finance Minister, Wolfgang Schäuble, reveals the extent to which ordo-liberal (*Ordnungspolitik*) philosophical ideas and German policy at the EU-level had become interwoven[192]. The Finance Ministry sought to press ahead with PSI, despite the likelihood that forcing haircuts would have further eroded confidence in peripheral bonds and made the sovereign debt crisis much worse. The ECB set its stall against PSI for exactly these reasons, fearing it would create both a deepening and prolongation of the crisis (ECB 2011[e]; Smaghi 2011).

[192] Former Italian Prime Minister, Mario Monti, made a similar observation, remarking that: 'For Germany, economics is a branch of moral philosophy' (Monti 2012).

Although Germany was ultimately unable to force PSI into the ESM framework, it was able to have included other measures to reduce moral hazard. The final proposals allowed for a method for orderly default if a member-state was found to be insolvent, with debt seniority issued to ESM paper[193] (ESM 2011, Art.13). ESM was also signed as an intergovernmental treaty, with any extension of credit subject to unanimous agreement, handing a veto to each signature state and assuaging concerns EU taxpayers would be automatically liable (Dyson 2013, p.216; Gocaj and Meunier 2013, p.248; Spiegel et al. 2011). ESM support was also made contingent upon European Commission, IMF and ECB (so-called 'Troika') demanded Memorandums of Understandings (MoUs): agreements which outline how fiscal consolidation and economic reforms should be implemented (Barroso 2011; ESM 2011, Art.13)[194]. Just as Germany had sought to levy strict conditions on IMF loans before the crisis (DB 2003[c], p.99), it successfully pressed for MoUs to be levied upon beneficiaries of ESM funds.

Nevertheless, this 'sidestepping' of the Maastricht Treaty's no-bailout clause (Howarth and Quaglia 2015, p.473) represented for many in Germany a weakening of positive incentives and an abuse of the treaties (Beck and Prinz 2012, p.82; Henerlein 2015, p.21). Although the European Court of Justice (ECJ) ruled in 2012 that ESM did not break the no-bailout clause (Art.125 TFEU):

> *Provided that the conditions attached to such assistance are such as to prompt that member-state to implement a sound budgetary policy*
>
> (ECJ 2012, Art.137)

[193] Only IMF loans now take repayment precedence over ESM issued debt.

[194] As well as implementation of the 'Fiscal Compact'; The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

A group of German parliamentary members asked the German Federal Constitutional Court (*Bundesverfassungsgericht*) to examine the compatibility of ESM with Germany's constitution. They argued ESM committed Germany to funding limitless amounts of money without the countries only directly elected institution, the parliament (*Bundestag*), having any control (Bulmer 2014, p.1257). Although the court ruled ESM constitutional, so long as explicit parliamentary consent is sought before any further funds are provided (Bundesverfassungsgericht 2014; Fabbrini 2016, p.261; Janning 2014), the case showed many in Germany were reluctant to see the country take on responsibility for providing financial assistance to EMU states[195].

In a coordinated effort to try to quell financial turbulence, in the same month ESM was agreed, the ECB stepped up crisis mitigation activity and began implementing its Securities Market Programme (SMP). The ECB argued volatility in the sovereign debt market was impeding the transmission of monetary policy (Trichet 2010[b]). SMP aimed to restore the transmission channel by purchasing Eurozone government bonds on the secondary market to harmonise EMU interest rates (ECB 2010 [b], p.73).

This provoked even stronger resistance from many in Germany than the battle over ESM. SMP ran counter to orthodox DB 'programmatic' monetarist ideas which aim to control monetary aggregates and which remained sceptical about policies which go beyond the manipulation of interest rates (Scharpf 2011). Despite ECB 'sterilisations'[196], bond purchases were thought by the DB to exacerbate price pressures and threaten long-term price stability

[195] Particularly within the Christian Democratic Union and Christian Social Union [CDU/CSU] political parties.
[196] The ECB reabsorbed liquidity generated by SMP by extracting the highly liquid deposits through fine-tuning operations into fixed-term deposits. This aimed to keep banks' holdings of central bank liquidity unchanged, precluding any increases in monetary aggregates (ECB 2010 [b], p.24).

(Blackstone and Walker 2012; Carrel 2012; Weidmann 2017). Indeed, for many Germans, buying sovereign bonds was understood as tantamount to giving government's access to the printing press and represented a weakening of EMUs monetarist framework (Blackstone and Walker 2012; Brunnermeier et al. 2016, p.194; Sinn 2014, p.5). Governments, they thought, could also persuade banks within their jurisdictions to buy home sovereign debt[197], which banks could then sell to the ECB, mutualising losses and generating moral hazard.

DB President, Axel Weber, and the ECBs German Chief Economist, Jürgen Stark, both argued strongly against SMP, suggesting it would blur the lines between monetary and fiscal policy and reduce ECB independence (Meiers 2015, p.41; Weber 2010). Moreover, unlike ESM, SMP support did not come with accompanying MoUs, further weakening incentives for fiscal discipline (Buiter and Rahbari 2012, p.26).

Despite Weber being tipped to become the next ECB President, the decision to proceed with SMP triggered his resignation in February 2011 (Weber 2011). Weber was later followed by Stark in September who although cited 'personal reasons' for leaving (ECB 2011[a]), many suspect the reactivation of SMP in August and the purchase of Italian and Spanish bonds was the real motive for his exit (Blackstone 2011; Carrel 2011; Ewing and Kulish 2011; Müller et al. 2011).

These positions on ESM and SMP are consistent with monetarist and ordo-liberal (*Ordnungspolitik*) ideas and demonstrate the opposition of many in Germany to a weakening of the liability principle (*Haftungsprinzip*) and an increase in the risk of moral hazard (Nedergaard and Snaith 2015, p.1101; Pies and Sass 2010). Recognising the influence

[197] Which would lower public borrowing costs and reducing market discipline.

of these ideas on German policy is vital to fully understand the country's position during the sovereign debt crisis. The quote below from Finance Minister, Wolfgang Schäuble, emphasise again German's hostility to any weakening of the liability principle, and the importance of ordo-liberal (*Ordnungspolitik*) ideas in driving German sentiment:

> *One central lesson of the financial crisis was that markets could only function properly if risk-taking were not divorced from liability* [*Haftungsprinzip*]. *The loosening of this bond was a central factor of the crisis… Hence my unease when some politicians and economists call on the Eurozone to take a sudden leap into fiscal union and joint liability*
>
> (Schäuble 2011[a])

However, under EMU, 'core' European countries[198] jointly increased their credit exposure to peripheral states by huge amounts; in the case of Spain, by 550 percent (Lynn 2011, p.73). In 2011, German and French banks held more than US$1 trillion in exposures to Greece, Ireland, Italy, Portugal and Spain (GIIPS), making them highly exposed to redenomination risk (table 6.3). It could therefore be argued that the bailout of peripheral states through

Table 6.3: 'Core' European exposure to GIIPS (€ billion, 2011)

	Austria	**Belgium**	**France**	**Netherlands**	**Germany**	**Spain**
Total bank assets (€ trillion)	1.43	1.55	7.81	3.26	11.49	4.99
Portugal	1.6	3.5	26.9	6.5	36.4	84.6
Ireland	2.9	25.4	29.6	16.7	118.1	10
Italy	22.2	25.8	392.6	16.7	162.3	31.2
Greece	3.4	1.9	56.7	5.0	33.9	0.974
Spain	6.7	21.5	140.6	76.9	181.9	N/A
Total GIIPS exposure (€ billion)	36.8	78.2	646.5	150.5	532.73	126.8

Source: BIS (2011); CNBC (2011)

[198] Germany, France, Austria, Belgium and the Netherlands.

ESM and SMP was in many respects also an implicit bailout of the German financial system, mitigating further heavy losses on the foreign assets of German banks (Bloomberg 2012; Steinberg and Vermeiren 2016, p.393).

> *I witnessed several crises; Ireland, Portugal, Cyprus, I was always there engaged and Mr Asmussen [Jörg] when he was here at the time Secretary of State, when we went to Brussels, his first question was always, what is the exposure of German banks? This was his most important question. So you can imagine that the Left Party is right. The first aim was to safeguard German banks*
>
> (German Finance Ministry: interview #12, 2015)

As the quote above discloses, the exposure of German banks to peripheral debt was indeed an important consideration in German policy calculations. Although the government sought to uphold the rule-based Maastricht settlement[199], the critical juncture of the sovereign debt crisis instituted a real threat of peripheral redenomination and further losses for German banks. Therefore although the DB never reconciled itself with SMP (Telegraph 2012) as it came without democratic oversight and measures to limit moral hazard, the systemic risks and associated transaction costs (North 1987; Williamson 1981), coupled with German revulsion at backdoor ECB bailout operations, eventually forced Germany to concede ESM (Dyson 2013, p.219; Gocaj and Meunier 2013, p.249; Sinn 2014, p.259). While ordo-liberal (*Ordnungspolitik*) ideas thus helped slow institutional change at the European level and were successful at inserting measures to restrict moral hazard and joint liability into ESM (Nedergaard and Snaith 2015, p.1106) – meaning that scenario D from table 2.2 most accurately depicts this course of events – they were ultimately unable to prevent the creation of ESM or SMP.

---

[199] The prohibition of monetary financing; the prohibition of privileged access to financial institutions; and the 'no bailout clause' (ECB 2016[a]).

German ideational influence during the crisis:		
D) established ideas in new institutions	**->**	**hinder policy change**
Although ordo-liberal (*Ordnungspolitik*) ideas were unable to prevent ESM and SMP, they were able to limit supranational risk-sharing and tighten fiscal restrictions. Illustration 6.3		

SPAIN

While Germany entered the sovereign debt crisis from a position of relative strength and was able to meaningfully influence EU decision-making, Spain was less fortunate. The weakness of the *cajas* and, importantly, of Spanish government bonds, produced a lethal combination during this period. Spain therefore remained focused primarily on trying to tackle domestic problems. Although large privately owned Spanish banks had diversified asset portfolios and continued to fair rather well during the crisis (Otero-Iglesias et al. 2016, p.27), erosion in the value of assets linked to real estate created a real strain on the balance sheets of *cajas* (Royo 2013[a], p.640). The BdE therefore began forcing *cajas* to increase provisions with the intention of compelling them to request funds from the FROB and encourage merger activity. Although this strategy was successful, with 40 of the 45 *cajas* pressing for mergers by December 2010 (Ysa et al. 2012, p.270), it also had the effect of further restricting credit to the real economy, creating more downward pressure on house and land prices.

An additional problem was the mergers which eventually took place were often decided against political and regional rationales rather than economic ones (Cuñat and Garicano 2009, p.8; Tortella and García-Ruiz 2013, p.183). *Cajas* controlled by Popular Party (PP) politicians tended to merge with other PP *cajas*, resulting in two of the most problematic institutions, Bancaja and Caja Madrid, ending up within the same undercapitalised and eventually nationalised entity, Bankia. The two Galician *cajas*[200] merged, creating Novagalicia Banco, which was also later nationalised (Minder 2012), and a similar situation occurred through the merger of the Catalan *cajas*.

Of the three mechanisms used to integrate *cajas*: 15 percent were acquisitions; 46 percent full-mergers; and 39 percent Institutional Protection Scheme (IPS) mergers. IPS amalgamations were known as 'virtual mergers' and permitted each *caja* to keep its own brand, balance sheet and legal structure, allowing regional governing parties to retain control of both entities (Reuters 2010; Romero 2012). All full-mergers happened within the same autonomous region (*comunidades autónomas*) and all IPSs consolidations occurred across region, but with *cajas* involved governed by the same political party (table 6.4) (Ysa et al. 2012, p.271).

Despite the BdE being fully aware of the financial position of each *caja* prior to consolidation, in the end, it allowed mergers to take place on political grounds (Buck 2017; Garicano 2012[a]). This structural path-dependence, reinforced by political vested interests, is critical to ascertaining a full picture of the Spanish crisis. Despite the dominance of neo-liberal philosophical ideas and interventionist policy ideas within the BdE, it remained unable to use the crisis to de-politicise the *caja* sector. Although the government did

[200] Caixa Galicia and Caixanova.

introduce some limited reforms which constrained the politicisation of *cajas* in 2010[201], it was not until the apex of the sovereign debt crisis critical juncture – the collapse of Bankia – that wholesale change was finally forced through (Otero-Iglesias et al. 2016, p.30; Royo 2013[b], p.200; De Olza 2013). Spain's public banking sector is therefore best illustrated by scenario B during the crisis.

Spanish *cajas* during the crisis:		
B) structures trump ideas	**->**	**institutional continuity**
Despite severe problems in the *cajas* and BdE desire for institutional reform, politicisation continued.		

Illustration 6.4

[201] Royal Decree Law (11/2010): National government senior executives could no longer sit on *caja* assemblies or corporate boards, and representatives of government, public law institutions and public corporations on the governing bodies of *cajas* reduced from 50 percent to 40 percent.

Table 6.4: The integration of Spanish *cajas*

Process	*Savings banks involved*	*Type*	*Within/ across regions*	*Assets in (in euro M)*	*Requested aid from FROB (in euro M)*
1	CATALUNYA CAIXA Catalunya Tarragona Manresa	Merger	Within	76.649	1.250
2	UNNIM Sabadell Terrassa Manlleu	Merger	Within	28.548	380
3	La Caixa Girona	Merger	Within	271.338	
4	Cajastur CCM	Acquisition	Across	[See process 5]	
5	BANCO BASE CAM Cajastur-CCM Caja Cantabria Extremadura	IPS	Across	125.562	1.493
6	BANCO MARE NOSTRUM Murcia Penedes Sa Nostra Granada	IPS	Across	71.026	915
7	Unicaja Jaen	Merger	Within	54.817	
8	BANCO CAJA 3 CAI Circulo Badajoz	IPS	Across	20.145	
9	BANCO FINANCIERO Caja Madrid Bancaja Insular Laietana Avila Segovia Rioja	IPS	Across	334.508	4.465
10	NOVA CAIXA GALICIA Galicia Caixanova	Merger	Within	75.549	1.162
11	CAJA ESPAÑA-DUERO Caja España Caja Duero	Merger	Within	46.017	525
12	BANCA CIVICA Cajasol Guadalajara Navarra Burgos Canarias	IPS	Across	71.306	977
13	Cajasur BBK	Acquisition	Across	47.000	
14	BBK Kutxa Vital	Merger—failed but door left open for talks	Within	78.300	

Source: Ysa et al. (2012, p.268), reused with permission: Taylor & Francis Group Copyright Clearance Centre

Critical Case Study: Bankia

Unlike German banks, *cajas* – the institutions overwhelmingly responsible for the Spanish crisis (Garicano 2012[b]; Royo 2013[a], p.637; 2013[b] p.153) – did not invest heavily in peripheral or US 'sub-prime' assets. Instead, they lent extensively to the domestic real estate sector. They then used these loans to manufacture ABSs in order to raise more funds to extend further lending. In 2011, Bankia held assets worth almost €300 billion[202] (Bankia 2012, p.1), of which €95 billion consisted of mortgage-backed and other debt securities (Bankia 2012, p.20).

Table 6.5: Bankia exposure by country (2012)

Spain	73%
USA	-
GIIPS	-
Other	27%

Source: Bankia Annual Report 2012 (p.67)

Although the Bankia story is representative of the sector in general, its significance is amplified due to its size, and because its eventual collapse in 2012 marked a critical juncture for Spain which forced its government to turn to Europe for assistance[203] (De Olza 2013; Otero-Iglesias et al. 2016, p.30; Royo 2013[b], p.200). It also marked a critical juncture for Europe more broadly as it sparked efforts to create a Europe-wide Banking Union (BU) (Citibank 2012; Jones et al. 2016, p.1024; Otero-Iglesias et al. 2016).

[202] €298,366,696 end-2011; €279,243,017 end-2012.

[203] ESM funds were granted to Spain conditional upon wholesale reform of the *caja* sector (Crisp 2013; MoU 2012, p.13; IMF 2012[a], p.12).

Bankia-BFA represented the largest *caja* conglomeration in Spain. Beginning in 2010 as a merger between Caja Madrid and Bancaja[204], it was later joined by five smaller *cajas* in 2011[205], becoming the third largest bank in the country behind the two international giants, Santander and BBVA. To fully understand the Bankia crisis, it is first necessary to describe how problems originated in Caja Madrid.

By 2009, Caja Madrid was already experiencing funding difficulties[206] as well as a political 'war' within the PP concerning who should lead the bank (El Mundo 2010). The PP controlled both the regional government and City Hall. The President of Madrid's regional government (*comunidad autónomas de Madrid*), Esperanza Aguirre, attempted to replace Caja Madrid's President, Miguel Blesa[207], with the Vice-President of Madrid's government, Ignacio González (Tortella and García-Ruiz 2013, p.186).

This was opposed by the Mayor, Alberto Ruiz-Gallardón, who instead supported the former Minister of Economy and IMF Managing Director, Rodrigo Rato's candidacy. Rato eventually won the yearlong battle[208] and moved swiftly to increase his annual salary by more than €1 million[209] (El Mundo 2010; López-Fonsecael 2017; Royo 2013[c], p.196).

[204] Creating Banco Financiero y de Ahorros (BFA).
[205] Caja Insular de Canarias, Caja Ávila, Caja Laietana, Caja Segovia and Caja Rioja, creating Bankia-BFA.
[206] Its bonds were rated as B2 'junk' by Moody's.
[207] Who himself had no former banking experience and was reportedly handed the position as a result of his friendship with Prime Minister Jose Maria Aznar (Royo 2013[c], p.196).
[208] In order to try to smooth over tensions, Rato later gave a seat on the board of Bankia to Carmen Cavero, Ignacio González's sister-in-law and his wife's co-partner in a Madrid art gallery (Romero 2012).
[209] Rato and Blesa, who became appointed Chairman, together ran up bills of more than €15 million on company credit cards during their time in office. Blesa recently committed suicide after being handed a six year prison term for misusing company funds (López-Fonseca 2017; Montijano 2017).

Under pressure from the government and BdE, six months after his appointment Rato announced an IPS merger with Bancaja, another PP dominated *caja* based in Valencia. But Bancaja was experiencing the same liquidity problems as a result of over lending to the real estate sector as Caja Madrid, ensuring the new entity was equally unstable (Romero 2012; Royo 2013[c], p.197).

To deal with its overexposure to devalued real-estate assets, the BFA side of the business issued €4.5 billion in preferential shares and held on to poorly performing assets as a form of bad bank, while Bankia continued the banking side of the business, presenting itself as a new and untarnished institution (Cardenas 2013, p.36). To facilitate this, Bankia requested €4.465bn from the FROB in March 2011 and intensified efficiency savings by reducing operating costs by €550 million (Royo 2013[c], p.198)[210].

As Spain's financial situation worsened, Finance Minister, Luis de Guindos, ordered banks to set aside additional provisions equivalent to 45 percent of loans linked to real estate. Bankia was unable to meet this and on the 18th May 2012, requested government assistance (De Olza 2013). The government duly purchased a 90 percent stake in the bank with an injection of €23.5bn of state-aid. Following the nationalisation, Bankia-BFA recast its 2011 financial results which showed a €300 million profit to reflect an actual €3.3 billion loss (Romero 2012).

[210] In order to meet Core Tier One (CT1) capital requirements and secure further funding (Bankia 2012, p.8), Rato also decided to float Bankia on the stock exchange. Spanish banks were required to hold a minimum CT1 capital ratio of 10 percent of their assets. However, if they were listed on the Spanish stock exchange, this requirement was reduced to 8 percent (Bankia 2012, p.8; Cardenas 2013, p.36). Retail investors originally purchased shares at over €5 a piece, but by 2012 their price had slumped to less than €1 (Johnson 2011). During subsequent investigations, it came to light that supervisors within the central bank were aware of financial and management problems at Bankia and were convinced that the lender should not have be floated. One internal e-mail argued that Bankia was 'unviable', while others lamented the influence of politicians on the bank's board, describing the institution as a 'money-losing machine' (Buck 2017).

The fiscal pressure generated by this nationalisation caused yields between Spanish and German government bonds to diverge even further and proved to be the tipping point which led the Spanish government to seek an EU bailout package the following month (De Olza 2013; Romero 2012; Royo 2013[b], p.200; 2013[c], p.200). Whereas Germany had the luxury of its debt being highly prised in the repo markets (and therefore enjoyed lower borrowing costs during the crisis), despite an early liberalisation of its interbank market and an exemplary fiscal record before the crash (Lukauskas 1997, p.111; World Bank 2010, p.24), Spanish debt was not considered to have the same pedigree.

Table 6.6: Yield on Spanish and German 10-year government bonds (%, 2007-12)

	Jan '07	June '07	Jan '08	June '08	**Jan '09**	June '09	Jan '10	June '10	Jan '11	June '11	Jan '12	**June '12**
Germany	4.02	4.56	4.08	4.52	**3.07**	3.47	3.26	2.54	3.02	2.89	1.82	1.30
Spain	4.07	4.62	4.18	4.79	4.15	4.24	3.99	4.56	5.38	5.48	5.40	**6.59**

German bailout of HRE

Spanish bailout of Bankia

Source: OECD

Whilst reputational factors and the structure of the two countries' economies can help account for some of this discrepancy, crucial too was the fact that under EMU, the Spanish government had ran fiscal surpluses as a counter to persistent current account deficits (BdE 2006[b], p.29). While Spain was therefore seen as a 'star pupil' within EMU, it failed to implement regular debt auctions and its bonds were little used within repo markets – ensuring they remained less desirable. Spanish banks also failed to use interbank markets to the same extent as many other European countries, preferring instead to issue ABSs to meet funding gaps (BdE 2006[b], p.29 and p.157). This resulted in Spanish bonds being less sought-after and less frequently used as collateral in repo transactions (Figure 6.4), meaning Spain had to pay significantly more to borrow than Germany at the epicentre of its crisis.

In light of Spain's fiscal problems, EU finance ministers offered Spain an aid package of up to €100 billion contingent upon the country accepting an MoU[211], which included a firm commitment to restructure the *caja* sector (MoU 2012). Just days later, the European Commission also unveiled plans to create an EU-wide BU to help break the 'doom loop' engulfing peripheral European banks and sovereigns (Howarth and Quaglia 2016, p.19). Bankia was therefore the catalyst that finally brought wholesale change to the Spanish *caja* sector, and shook European states of their hesitancy to deepen integration by handing greater financial authority to supranational entities.

By using process tracing to plot the temporal progression of the crisis, it becomes clear that the sovereign debt crisis, the collapse of Bankia, the ESM bailout and associated MoU, represented a definitive critical juncture for both Spain and Europe (Bulmer 2009, p.310; Capoccia and Kelemen 2007, p.346; Posner 2007, p.145). For Spain, the exogenous pressure applied by the MoU finally allowed state authorities to dispel political vested interests and provided an opportunity to fundamentally transform, liberalise and professionalise the *caja* sector.

[211] Which was insisted upon by Germany (Weidmann 2012).

In July, to comply with the MoU the government again strengthened BdE powers to intervene in failing institutions and the FROB gained authority to resolve banks by forcing shareholders and creditors in rescued institutions to take losses before state-aid was provided (Cardenas 2013, p.24; Gordon 2012). The government also created a bad bank, Sareb, into which Spanish banks could deposit 'toxic' assets (Otero-Iglesias et al. 2016, p.31). By end-2012 the nationalised *cajas* had transferred €36 billion worth of assets to Sareb at an average discount rate of 63 percent of their gross book value (Eurostate Research 2013; Royo 2013[c], p.211).

In 2013, Spain implemented the final requirement of its MoU through the passing of Law 26/2013 which forced *cajas* to ring-fence their banking and charitable activities, doing away with the *caja* banking model altogether[212] (Crisp 2013; IMF 2012[a], p.12; MoU 2012, p.13). Banks derived from *cajas* now contain private investors and seek profit in line with commercial banks. Banking foundations[213] though are still permitted to maintain a stake in credit institutions, with voting rights, which allow for the appointment or removal of a member of the banks governing body. Foundations are discouraged from owning a controlling stake (ECB 2013[c]), and only 25 percent of banking foundation board members (*patronos*) are now designated by political authorities. These institutions are also no longer supervised by their autonomous regions (*comunidades autónomas*) and have come fully into line with other banks (Otero-Iglesias et al. 2016, p.32).

[212] The only exemptions were the two smallest *cajas* which had not merged and had less than 10 million euros in consolidated assets.

[213] The foundations purpose is to pursue charitable and community work and to manage its shares in the credit institution.

SPAIN AND THE EU

In terms of Spain's attitude towards EU initiatives aimed at restoring financial stability, the merits or demerits were little discussed within BdE reports or speeches by BdE officials as decision-makers grappled with the domestic crisis. Nevertheless, it is possible to discern that the bank was far more relaxed about the creation of ESM than the DB. BdE neo-liberal philosophical ideas are less obsessive about the dangers of moral hazard and fiscal risk-sharing than DB ordo-liberalism (*Ordnungspolitik*). Even before the collapse of Bankia, the BdE supported ESM and decried the slow progress towards its completion, arguing that the scale of the crisis meant urgent steps were necessary to restore stability (BdE 2012, p.12).

Once the Bankia crisis erupted, Spain became a recipient of ESM funds. Without this assistance, as the quote below underscores, Spain would have struggled financially and politically to implement the necessary restructuring of its banking system:

> *Without it* [ESM] *we couldn't have finished the bank restructuring. It was very important. It was key to changing the international perception of the Spanish financial system, it was very, very important*
>
> (BdE interview #6, 2015)

Consequently, unlike Germany, the BdE and the Spanish state had few reservations about the creation of ESM, or about accepting money from the fund with the goal of implementing banking sector reform (Restoy 2012), as the quote below confirms:

> *Spain is quite proud that we only required, or only asked for, financial assistance for our financial sector, not for the whole economy*
>
> (Spanish Foreign Ministry: interview #14, 2015)

With regards to SMP, as a monetarist institution, the BdE initially expressed concern about over reliance on expansionist monetary policy to steer Europe through the crisis. It argued if such measures remained in place over an extended period they could: reduce the effectiveness of monetary policy; detract from the ECB's credibility; distort the relative price of assets; and delay necessary reforms in certain segments of Europe's banking system (BdE 2011, p.20).

However, as Spain became progressively afflicted by the sovereign debt crisis, it became increasingly anxious about the slow pace of EU reforms (BdE 2012, p.12). As a consequence, the BdE recognised ECB extraordinary monetary policy had become a linchpin of stability, providing an effective safety valve during turbulent times (BdE 2012, p.12). This less hostile attitude towards SMP may simply have come as a result of Spain becoming a recipient of

Table 6.7: Eurosystem SMP holdings by country (31st December 2012)

Issuer country	Outstanding amounts		Average remaining maturity (in years)
	Nominal amount (EUR billion)	Book value [1] (EUR billion)	
Ireland	14.2	13.6	4.6
Greece	33.9	30.8	3.6
Spain	44.3	43.7	4.1
Italy	102.8	99.0	4.5
Portugal	22.8	21.6	3.9
Total	**218.0**	**208.7**	**4.3**

[1]The SMP holdings are classified as held-to-maturity and consequently valued at amortised cost.

Source: ECB (2017)

SMP support. Indeed, 20 percent of all SMP bond purchases were Spanish in origin (table 6.7), reducing fiscal pressure on the Spanish government by lowering debt interest rates.

However, it is likely Spain specific programmatic monetary ideas also contributed to this more relaxed approach. The BdE worried more about inflation than monetary aggregates and remained open to measures aimed at smoothing the economic and financial cycles (Ban 2016, p.46; Lukauskas 1997, p.205). Idiosyncratic Spanish programmatic ideas therefore were not as opposed to SMP as orthodox German monetarism. When discussing this with a BdE Research Service official, the following response was offered:

> *We have a single monetary policy but we don't have instruments to face asymmetric shocks… At some points, especially viewed from Germany, it's seen that things in the Euroarea weren't that bad and they tend to think that there are problems for future inflation. But our point of view is that if you look at the Euroarea as a whole, clearly this was not the case. The vision of the Germans is too German*
>
> (Interview: BdE)

In other words, Germany's traditional monetarist ideas were perceived by the Research Service – the epicentre of BdE institutional thought (Lluch 1990, p.3) – as too stringent, particularly for a monetary union without a common framework for addressing asymmetric shocks. While BdE monetarism had always sought to maintain a stable price environment (Dolado et al. 1997; Martín-Aceña 2017, p.61), it also adopted a more flexible approach to countercyclical policy (Ban 2016, p.46; Fernández de Lis et al. 2000, p.16). Ideas are therefore able to shed further light on the source of difference between BdE and DB attitudes towards EU-level post-crisis initiatives.

SUMMARY

Ideational and structural explanations are needed to fully understand national responses to the sovereign debt crisis. Ideas explain DB opposition to SMP as its ordo-liberal (*Ordnungspolitik*) and monetarist philosophies reject interventionist countercyclical policy and measures which are likely to expand the money supply (Carrel 2012; Weidmann 2017). Ordo-liberalism's pre-occupation with the liability principle (*Haftungsprinzip*) and moral hazard were also central to Germany's initial opposition to ESM, its desire to insert PSI and MoUs into any bailout package, and in *Bundestag* members seeking to prevent ratification of the Treaty through the courts (Schäuble 2011[b]).

However, structural factors are also required to understand why Germany eventually relented. Although Germany wished to prevent a weakening of the rule-based Maastricht framework, sticking rigidly to the rules risked a total collapse of the Eurozone, entailing significant sunk and transaction costs through the redenomination of national debt (BIS 2011; Bloomberg 2012; CNBC 2011; Gocaj and Meunier 2013, p.251; North 1987; Steinberg and Vermeiren 2016). The Germans also hoped instituting ESM would bring an end to expansionary ECB monetary policy and allow the bank to maintain its path-dependent commitment to price stability (Sinn 2014, p.259).

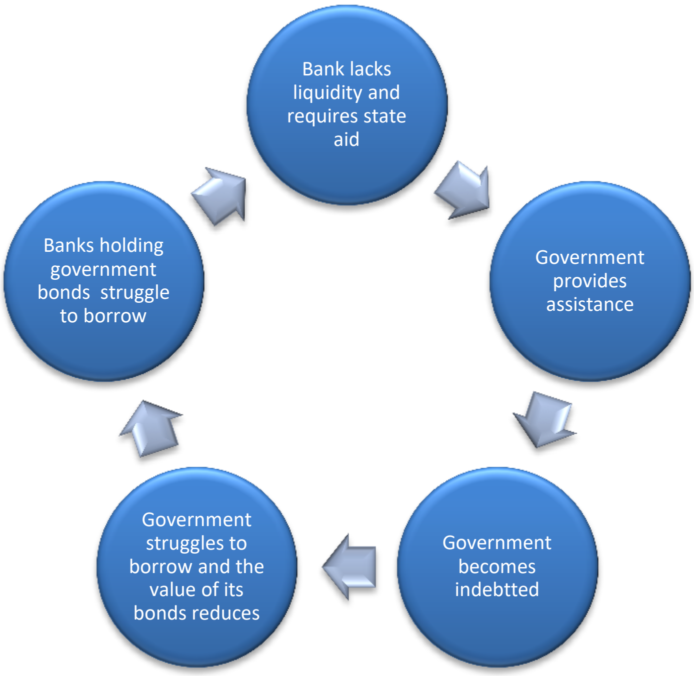
For Spain, structural explanations are most important when analysing its domestic banking sector. The government and BdE attempted to reform the *cajas* in 2009 with the creation of the FROB, yet the intended mergers were resisted by politicians aiming to maintain influence (Royo 2013[a], p.639). When the BdE later forced *cajas* to increase provisions, mergers were conducted, but with political rather than economic objectives in mind (Garicano 2012[a]; Ysa et al. 2012, p.271). Only the critical juncture provided by the collapse of Bankia and subsequent imposition of the MoU finally forced Spain to reform its public banking sector (De Olza 2013; Royo 2013[b], p.200).

With regards to the BdE's support for ESM and its more relaxed attitude to SMP, ideas maintain greater significance. Because the BdE often promoted domestic countercyclical measures, it supported ESM even before it appeared likely Spain would become a recipient of its funds (BdE 2012, p.12). On SMP, although the BdE did not initially approve of Eurozone dependence on expansionary monetary policy (BdE 2011, p.20), as the sovereign debt crisis intensified and EU reform efforts remained sluggish, it accepted ECB monetary policy had become the primary defender of Eurosystem stability (BdE 2012, p.12). Moreover, because the BdE was less concerned about monetary aggregates than the DB (Lukauskas 1997, p.205), it did not interpret the program as threatening to price stability (BdE: interview #7, 2015). Recognition of ideational and structural factors in both countries are therefore necessary to provide a full understanding of each nations approach to financial policy between 2010-2012.

6.3: The Creation of Banking Union (2012-14)

As the collapses of HRE and Bankia brought dramatically to light, many European financial systems and sovereigns become severely weakened as a result of the 2007-8 crash. Banks were forced to request funding from their governments, while the following bailouts made states more indebted. In the case of GIIPS countries (but not creditor states like Germany), this resulted in sovereign bonds becoming less valuable, making it more expensive to borrow. The falling value of such bonds placed further pressure on peripheral banks holding these assets, necessitating more government funding to sustain troubled institutions (Blundell-Wignall and Slovik 2011). This situation, illustrated in figure 6.9 below, became known as the bank-sovereign 'doom loop' and afflicted many 'southern' European countries (Bibow 2015, p.92; Huertas 2013, p.33).

Figure 6.9: The bank-sovereign 'doom loop'



Source: Author (2018)

In an effort to break this cycle, the Commission unveiled proposals for BU[214] in September 2012 (BdE 2013[c], p.51). This was to consist of a Single Supervisory Mechanism (SSM) for

[214] In the 4 Presidents report (2012), BU was originally referred to as an 'integrated financial framework' (van Rompuy et al. 2012[b]).

banks, handing the ECB 'ultimate responsibility for banking supervision' (Van Rompuy et al. 2012[a], p.6); a Single Resolution Mechanism (SRM) for resolving insolvent institutions, backed up with a Single Resolution Fund (SRF); a common Deposit Guarantee Scheme (DGS); a common backstop of temporary support to act as 'lender of last resort' (LOLR - a task eventually handed to ESM); and a Single Rulebook to apply to all EU states (Constâncio 2013; Schild 2015, p.4; van Rompuy et al. 2012[b]). Using the process tracing technique and insights from the HI and DI approaches, the following section assesses German and Spanish reactions to these proposals.

GERMANY

Although Germany's large international banks supported BU to create a level regulatory playing field across Europe (Howarth and Quaglia 2016, p 53; Speyer 2013), Germany remained subject to significant path-dependent pressure from regional governments, *Landesbanken* and smaller banks opposed to EU regulation that may have interfered with their traditional three-pillar structure (Howarth and Quaglia 2015, p.468; Münchau 2015; Strupczewski, and Heinrich 2015; Zimmermann 2014, p.497).

Due to their solid performance during the crisis, smaller German banks were reluctant to integrate towards a comprehensive European system and considered their own arrangements to have been proven effective (Röper 2017, p.18; Simpson 2013, p.20; Steinberg and Vermeiren 2015, p.397). Moreover, because the German self-regulatory approach is not purely law-based but constructed on informal agreements with Banking

Associations, it cannot easily be transplanted into a supranational framework[215] (Hassan 2014; Zimmermann 2014, p.495). Germany therefore had less incentive to seek the protection of BU than peripheral states like Spain (Howarth and Quaglia 2016, p.123).

However, the critical juncture of Bankia's collapse altered Germany's calculations on BU. Even in the months prior to Bankia's nationalisation, the Spanish government struggled to borrow, with one of its bond auctions falling short of its funding target (Guardian 2012; Toyer and White 2012). Bankia's collapse meant an external recapitalisation of the Spanish system could no longer be avoided. This made establishing the common backstop element of BU a top priority for European policymakers (German Finance Ministry 2012; Citibank 2012).

> *On Germany's urging, the European Council of 29 June 2012 made unmistakably clear that no direct assistance will be provided to banks until a unified European banking supervisor is in place. The Council also said that a supervisory authority on paper will not suffice; rather, it must be fully established and operable. This approach is in line with Germany's demand that liability must be inextricably linked with supervision and control* [*Haftungsprinzip*]*. These conditions have not been met in the current case involving Spain*
>
> (German Finance Ministry 2012)

Nevertheless, as the above quote suggests, Germany feared allowing nations with different supervisory systems access to the same backstop would create moral hazard. Germany and others therefore insisted upon SSM as a precondition for permitting ESM to directly recapitalise European banks (Finnish Finance Ministry 2012). Although Germany was originally very reluctant to see *Landesbanken* submit to SSM supervision (Fox 2012), moral hazard concerns surrounding support and supervision of similar sized *cajas* induced a

[215] This is also true of the 'joint liability schemes' (*Haftungsverbund*) which cover public and cooperative banks (Howarth and Quaglia 2016, p.76; Howat and Theodore 2016, p.4).

change of heart (Bibow 2015, p.22; Howarth and Quaglia 2016, p.100), resulting in both *Landesbanken* and merged *cajas* coming under direct ECB control.

The DB also supported SSM because it believed the mechanism would improve financial stability, allowing the ECB to exit extraordinary monetary policies and focus more keenly on price stability (DB 2012[b], p.82). Ideas are therefore crucial in explaining the German position on SSM. Although political path-dependent forces in Germany resisted the supranationalisation of financial supervision, philosophical ordo-liberal (*Ordnungspolitik*) moral hazard concerns and traditional programmatic monetarist ideas overrode conservative interests and encouraged Germany to petition for SSM[216]:

German approach to Banking Union:		
A) ideas trump structures	**->**	**institutional change**
Ideational moral hazard concerns overrode domestic structural opposition SSM.		
		Illustration 6.5

Yet due to pressure from Germany (amongst others), the SSM which entered into force on 4th November 2014 only saw the ECB take direct responsibility for 'systemically important banks'[217] (Donnelly 2014, p.993; Karkagiannis 2012). This meant smaller German banks which had remained opposed to SSM continued to be immune from direct ECB oversight. Moreover, national supervisors continue to play a key role in overseeing domestic

[216] Although Germany and the DB remained clear that they opposed SSM being administered by the ECB due to potential conflicts of interest between monetary policy and banking supervision (DB 2013[a], p.34; 2014, p.71)

[217] Institutions having: assets that exceed €30bl; assets that exceed €5bl and 20 percent of member-states GDP; or as being among the three most significant banks in an individual member-state.

institutions, whether deemed systemic in importance or otherwise (Bibow 2015, p.95; Lautenschläger 2014).

While the DB supported SSM for large European banks, it consistently opposed other areas of BU which may have submitted the country to moral hazard or interventionist supervision (Guarascio 2016). The dominance of ordo-liberal (*Ordnungspolitik*) thinking is key to understanding this hesitancy. Moral hazard concerns were responsible for Germany's resistance to a European DGS (DB 2012[b], p.83; Zimmermann 2014, p.496), which if implemented may have seen domestic money guaranteeing German deposits used to rescue savers elsewhere (Khan 2015; Strupczewski and Heinrich 2015). German policymakers argued such a scheme would create fiscal transfers between member-states without proper institutional or political oversight (Lautenschläger 2012; Weidmann 2015). In a speech opposing greater fiscal risk-sharing, DB President, Jens Weidmann, quoted one of the original ordo-liberal (*Ordnungspolitik*) pioneers, Walter Eucken, in support of the liability principle (*Haftungsprinzip*):

> *I regard cross-border risk-sharing in respect of deposit protection as premature… Walter Eucken once got straight to the heart of the liability principle* [*Haftungsprinzip*] *with the succinct line: 'Whoever reaps the benefits must also bear the liability'. Without liability, a market economy system cannot function*
>
> (Weidmann 2015)

This quote, in line with speeches made by Finance Minister Wolfgang Schäuble (Schäuble 2011[a,b]), demonstrate the influence ordo-liberal (*Ordnungspolitik*) ideas continue to hold over the German establishment and the extent to which they are responsible for German policy preferences. These ideas also led many in Germany to oppose SRM as it had the potential to create a 'liability cascade' (*Haftungskaskade*) from German taxpayers to European depositors in the event of foreign bank resolutions (Schild 2015, p.15). To limit this prospect, the DB insisted shareholders and creditors of ailing banks should first bear losses before SRM funds are tapped (DB 2014, p.74).

Furthermore, since the de Larosière Report (2009), the EU has pushed for more interventionist countercyclical policies at the EU and national levels. The European Systemic Risk Board (ESRB) was created in 2010 to oversee macro-prudential regulation (MPR) (Commission 2013), and the ECB also developed its own directorate for Macro-Prudential Policy and Financial Stability in the same year (ECB 2010[d]). These developments run counter to traditional ordo-liberal policy ideas at the DB, where MPR is still considered a 'hard sell' (DB: interview #5, 2015). Although Germany has since created its own Financial Stability Committee (*Ausschuss für Finanzstabilität*) to consider MPR (DB 2013[b], p.39), largely due to its ideational antipathy towards intervening in markets beyond the setting of a broad legal framework, only one initiative beyond those contained within Basel III has been recommended[218] (German Finance Ministry 2016). Germany also opposed the wholesale transfer of MPR to the supranational level, fearing the exogenous imposition of countercyclical policies (DB 2012[b], p.84).

Through interviews conducted for this research, it became clear that rather than Germany change to fit increasingly interventionist European financial policy ideas, the DB instead believes Europe would benefit from applying ordo-liberal ideas more thoroughly:

[218] This relates to the introduction of additional instruments that will enable authorities to set supplementary requirements for residential mortgage lending, and came in line with recommendations from the ESRB and IMF.

I would be very surprised if the Bundesbank ever abandoned Ordnungspolitik. I think it's a big worry that Europe doesn't have more of it. But this is not a view other European countries would be willing to subscribe to, because the basic idea of that policy is that you need a sound framework, then half the work is done. Rather than micro-managing the economy, the framework is more important… And I really think this is very important thinking at the Bundesbank, that this is needed in Europe as well, this kind of thinking

(DB: interview #5, 2015)

It therefore seems unlikely that Germany will alter its position on the incomplete areas of BU anytime soon. Indeed, the reluctance of parties within German's financial system to submit to European oversight is further evidenced by the revision of the country's Banking Act (*Gesetz über das Kreditwesen* – KWG, 2015). Despite ECB criticism, amendments made to the Act gave the Federal Finance Ministry powers to maintain German regulation and sidestep SSM rules with regards to recovery plans, risk management and internal decisions. The new rules ensure that even for German banks directly supervised by SSM, the ECB is still required to apply country specific regulations (Jennen and Groendahl 2015)[219]. In a letter to the *Bundestag*, the ECBs Sabine Lautenschläger wrote that the new regulations 'contradict the spirit of the Banking Union' by facilitating regulatory divergence (Lautenschläger 2015).

Spain

Before the crash Spain's banking system was one of the least open to foreign banks in Europe, and apart from the 'big three', largely domestically focussed (Schoenmaker 2012). One may therefore have expected Spain to have little interest in supporting BU. But by

[219] Germany has also opposed moves to fully implement Basel III at the EU level through the CRD IV Directive. Due to German insistence, the Commission was reportedly forced to 'soften' its definition of core tier 1 capital in some areas, particularly with regards to 'silent participations' (state loans), which make up a significant proportion of the capital held by many publicly owned *Landesbanken* (Howarth and Quaglia 2013, p.336).

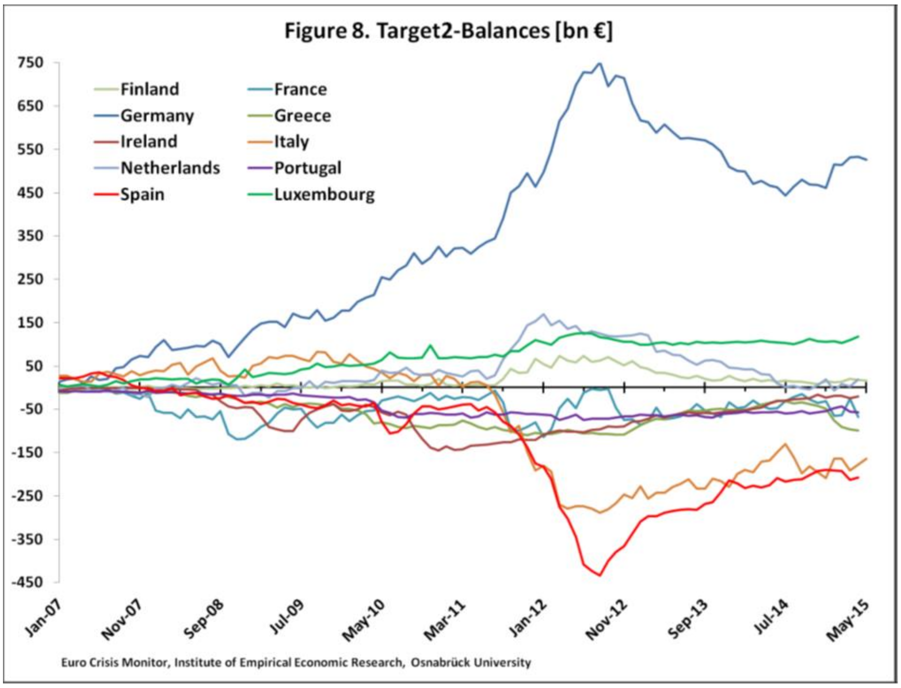
2012, the country had become deeply afflicted by the bank-sovereign doom loop and completion of BU was seen as its number one European policy priority (Restoy 2012).

> *We were pushing very strongly that this* [BU] *happens. We were not so focused on trying to get the best… although of course every single member-state tries to do the best for its national interest, but Spain had a very clear view that we have to move on, we have to set up new instruments, and that we need more Europe*
>
> (Spanish Foreign Ministry: interview #14, 2015)

As this quote shows, post-crisis, Spain was far less cautious than Germany about sharing liabilities or submitting to European financial oversight. It was keen to press ahead quickly with BU, even if this resulted in new arrangements not aligning absolutely with existing practices. This was essentially due to the critical juncture of Bankia's collapse which encumbered path-dependent predispositions in Spain. The country also hoped successful implementation would break the destructive debt cycle, bring renewed credibility to its financial supervision and allow *cajas* to be directly supported by ESM (BdE 2014, p.59; Linde 2013; Huertas 2013, p.33).

Spain's large banks supported BU for similar reasons to large German banks: to ensure supervisory equivalence and better facilitate cross-border operations (BBVA 2013, p.4). But they also promoted European oversight because financial markets treated European businesses and financial institutions differently depending on nationality (Restoy 2012). For Spanish banks, even those without questionable real estate assets on their balance sheets, this meant higher financing costs and a damaging fragmentation of EMU (BdE: interview #9, 2015; Commission: interview #18, 2015). BU, complete with common supervisory rules, fiscal backstop and SRM, was therefore strongly supported by Spanish banks as a way of harmonising market conditions (BBVA 2013).

Figure 6.10: ECB's Target2 balance sheet (2007-2015)



The graph shows that by 2012 when BU proposals were floated, German banks were depositing far more funds with the ECB's Deposit Facility than any other Eurozone member.

Spanish banks meanwhile were borrowing more than any other state through the lending facility, demonstrating the different funding conditions banks from each country were facing at that time.

Source: Reproduced by permission of the Levy Economics Institute from Bibow (2015, p.76)

Importantly, BU was also supported by the BdE which by 2012 was facing a crisis of credibility. Because *cajas* had re-financed NPLs and attempted to conceal the extent of poorly performing assets[220], post-Bankia, the central bank could only gain credibility by commissioning the accounting firm, Oliver Wyman (2012), to undertake banking stress tests and a comprehensive financial assessment (Garicano 2012[b], p.79; Otero-Iglesias et al. 2016, p.45). The results of this research meant that by 2013, the Spanish financial system had become completely transparent about previous failings. But it also needed to persuade

[220] Despite having onsite BdE officials checking *caja* activity.

markets that its supervisory approach had tightened. As the quote below shows, the easiest way to do this was to borrow credibility from the ECB. Indeed, the BdE even reorganised its internal governance structures to mirror the ECB's Directorate-Generals for banking supervision more closely (BdE 2014, p.60)[221].

> *If at some point you have some lack of credibility in your institutions, having an outside stamp actually gives you the credibility that you were doing the right things. And that allows you to buy yourself time… borrowing credibility from others. Which is why a lot of countries accepted the ECB*
>
> (BdE: interview #8, 2015)

Moreover, whereas Germany had complicated joint liability schemes linked to the country's Banking Associations that could not easily be replicated in the European context, Spain had a much simpler DGS and far fewer ideational reservations about shared liability. Consequently, Fernando Restoy, Deputy Governor of the BdE, actively pressed for a common DGS:

> *Bank crisis-prevention and management mechanisms are needed along with risk-mutualisation arrangements that minimise the link between national economic and fiscal conditions and the ability to preserve the value of bank liabilities in each jurisdiction. These requirements include a SSM as a prevention tool, a SRM that pursues the homogenous treatment of banks with viability problems and has a common fund to make this economically feasible, and an integrated DGS*
>
> (Restoy 2015, no page)

There are thus powerful structural explanations as to why Spain was so keen to pursue BU and was unconstrained by path-dependent imperatives. But there were also important ideational reasons too. Post-crisis, the ECB and ESRB were handed powers to impose

[221] In line with ECB / SSM practice, the BdE also started drawing a clearer distinction between monitoring and on-site inspection activities, which began being performed by different BdE teams (BdE 2014, p.60).

countercyclical policies with regard to capital buffers and accounting standards and encouraged MPR in other areas too, such as loan-to-value (LTV) ratios (ECB 2016[b]; ECB: interview #4, 2015). Given traditional interventionist policy ideas at the BdE, Spain was much more comfortable implementing these measures than the DB.

Furthermore, a similar accounting system to the dynamic provisions implemented by Spain before crash has since been adopted by the International Financial Reporting Standards (IFRS) board and by the EU through their expected credit loss provisioning mechanism (Cohen and Edwards 2017). New Basel III rules, also embraced by the EU through the Capital Requirements Directive (CRD IV), established a capital conservation buffer and countercyclical capital buffer to help limit and extend credit provision where necessary (Howarth and Quaglia 2013, p.336). These macro-prudential policies align succinctly with Spanish policy ideas. While the DB has been reluctant to implement MPR, Spain has since passed laws handing the BdE further competency in the application of macro-prudential instruments[222] (BdE 2017).

Spain therefore had few ideational or structural reasons to resist BU, and potentially had a lot to gain. Moreover, further integration coincides with traditional Spanish thinking on Europe. As the quote below from a Spanish Foreign Ministry official makes clear, Spain has consistently viewed Europe as a solution to its problems, and integration as a way of overcoming domestic structural inadequacies through modernisation and reform:

[222] Law 10/2014 on the regulation, supervision and solvency of credit institutions, and Royal Decree 84/2015.

> *For Spain, Europe was a way to solve the problem. Of course it was a global problem and Spain always looked at it as a global problem and looked to solve it globally, but also in a European way. I guess for Spain, the EU has been a way to solve its internal problems. Because it [the crisis] hit Spain in a different way compared to other countries because of structural circumstances – that's why we look for an EU solution*
>
> (Spanish Foreign Ministry: interview #14, 2015)

SUMMARY

Structurally, although Germany's large banks supported SSM supervision, Germany had reason to resist greater supranationalisation. The country's smaller banks did not welcome the spectre of more rules and regulations complicating their operating practices (Wilson et al. 2012), and because they had fared well throughout the crisis, their joint liability and DPSs were seen to have worked soundly (Howat and Theodore 2016, p.4; Simpson 2013, p.20). Despite the initial crisis impacting German's financial system hard, by 2012, the country was through the worst of its crisis and was resilient enough to withstand the fiscal demands of its bailouts. Germany therefore continued to exhibit path-dependence and opposed elements of BU (Münchau 2016; New York Times 2008).

While HI insights help us understand structural these dynamics, perhaps even more important was German policymakers subscription to ordo-liberalism (*Ordnungspolitik*) (Blackstone and Walker 2012; Dyson 2002[c] p.177; Nedergaard and Snaith 2015, p.1097; Young 2014, p.279). Recognising German moral hazard concerns is crucial to fully appreciating the countries position on BU. In this instance, ideas and structures worked hand-in-hand to slow the pace of change. Although the magnitude of the crisis forced Germany to relent to the creation of ESM, the DB and Finance Ministry were insistent that the fund should not be used to directly capitalise banks without SSM first being instituted to prevent regulatory arbitrage and moral hazard (German Finance Ministry 2012; Finnish Finance Ministry 2012).

Fears over moral hazard and a weakening of the liability principle (*Haftungsprinzip*) pressed Germany to oppose the common DGS (Weidmann 2015), and German policy ideas derived from ordo-liberalism (*Ordnungspolitik*) also explain its unease with interventionist European financial policies. Whilst MPR implemented at the European level introduced countercyclical measures to specific markets, German preferences centre on the creation of a strong legal framework without further state interference (DB interview #5, 2015). DI is therefore indispensable to fully understand Germany's post-crisis financial preferences.

For Spain meanwhile, the critical juncture of Bankia's collapse was all important. This weakened traditional path-dependence as the Troika imposed MoU forced the country to completely restructure its public banking sector. Instead of being met with structural resistance therefore, BU proposals were welcomed in line with Spain's traditional pro-integrationist stance, and as a means of breaking the doom loop which placed such strain on the country's government and financial system (Huertas 2013, p.33; Linde 2013). Due to the loss of credibility the BdE suffered from 2010-12 and the subsequent commissioning of the Oliver Wyman report (2012), the BdE and Spanish government were also keen to restore confidence in their supervisory framework. The most effective way to do this was to fully submerge the country into all aspects of BU, including the common DGS and SRM (BdE: interview #8, 2015).

But ideational factors are important in explaining the Spanish position too. Whereas EU interventionist post-crisis regulatory practices exist in opposition to DB policy ideas, the BdE had long viewed countercyclical policies as advantageous (Ban 2016, p.46; Fernández de Lis et al. 2000, p.16). With Spanish accounting practices largely adopted within Basel III and CRD IV, and MPR playing a central role in ECB and ESRB supervision, Spain had few ideational qualms about submitting to greater European oversight.

6.4: Conclusion

Why were Spain and Germany impacted differently by the financial crisis, and why did they pursue different policy objectives at the European level?

This chapter showed that to understand why the crisis impacted national financial systems differently, it is necessary to examine both ideational and structural mechanisms. Ideationally, pre-crisis policy ideas within NCBs were crucial in determining both the timing and scale of the crisis. Previous research showed how the makeup of bank balance sheets influenced the extent of the problems in Spain and Germany (Quaglia and Royo 2015; Hardie and Howarth 2013[a]; Royo, S., 2013[a]). This chapter deepened analysis by revealing why these differences occurred, and why Germany was able to withstand the fiscal pressures of its banking crisis whereas Spain was not.

It also revealed why German and Spanish positions differed on ESM, SMP and BU. Ideational differences explain why Germany was initially reluctant to support ESM (Monti 2012; Schäuble 2011[b]), whilst the concepts of sunk costs and path-dependence explain why it eventually relented (once moral hazard limiting measures had been installed) (Gocaj and Meunier 2013, p.251; Steinberg and Vermeiren 2016, p.389). Recognising ideational and structural imperatives is also crucial to fully grasp the German position on BU. While Germany was initially hesitant to submit to ECB oversight in a bid to preserve its three pillar system, moral hazard concerns eventually persuaded policymakers to agree to SSM (Weidmann 2015). Philosophical ordo-liberal (*Ordnungspolitik*) and programmatic orthodox monetarist ideas also account for the DBs unrelenting opposition to ECB extraordinary monetary policy (Brunnermeier et al. 2016, p.194; Scharpf 2011).

Ideational factors partly explain BdE support for ESM and its more relaxed attitude to SMP. The bank consistently promoted countercyclical measures pre-crisis which coalesced with its specific interpretation of monetarism (Ban 2016, p.46; Fernández de Lis et al. 2000, p.16). Consequentially, it supported EU countercyclical assistance during the crisis (BdE 2012, p.12), which coincided with traditional regulatory practices. Indeed, accounting procedures similar to those implemented by the BdE before the crash became incorporated within the Basel III and CRD IV frameworks (Howarth and Quaglia 2013, p.336), meaning that unlike the DB, the BdE was ideationally inclined to support BU.

Structurally, while the German system exhibited path-dependence with only limited institutional change (Röper 2017; Münchau 2016; Wilson 2012) – thanks to the safe asset status of German government bonds – the critical juncture of Bankia's collapse meant

Spain's public banking sector was forced into wholesale change (Crisp 2013; MoU 2012, p.13; IMF 2012[a], p.12). The resultant lack of credibility the BdE experienced also relates to this event, causing it to be more prepared to submit to ECB oversight to regain its integrity and prestige.

Chapter 7

The Eurosystem Post-Crisis

Why has the ECB become increasingly attentive to financial stability concerns?

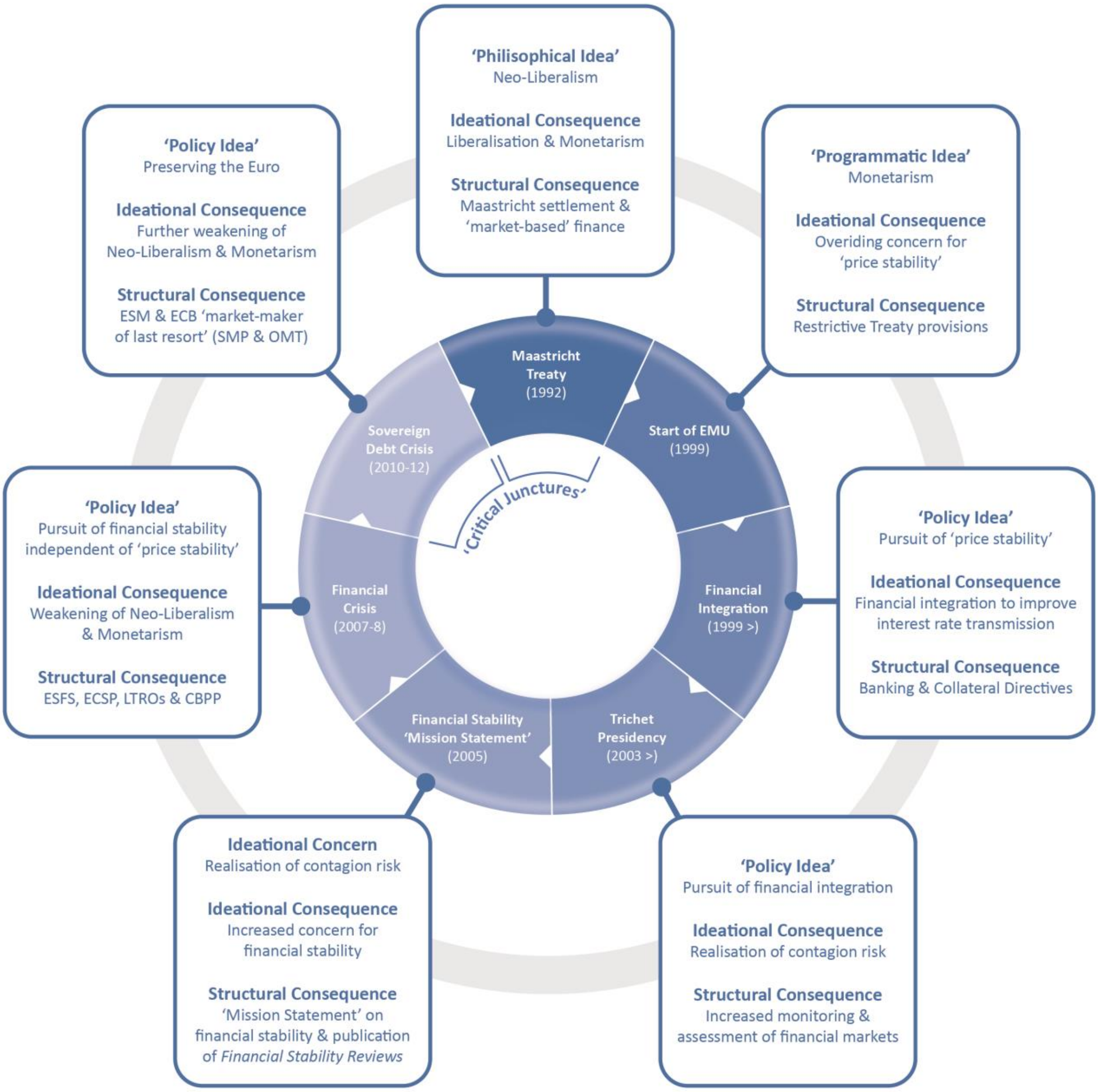
While previous research has examined the ideational, discursive and policy shifts that have taken place at the European Central Bank (ECB) post-crisis (Blyth and Matthijs 2016; De Rynck 2014; Schmidt 2016), by using process tracing, this chapter analyses the *process* through which change occurred. It explains *why* the ECB acted as it did, attributing causality to ideational and structural dynamics, and advances our understanding of how and why institutional change takes place. Figure 7.1 (below) provides an illustration of the following argument.

After the institutional formation of Economic and Monetary Union (EMU) at the critical juncture of Maastricht[223] (1992), measures taken early on to strengthen financial integration and monetary transmission (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005) led to increased concerns about the risk of financial contagion (Papademos 2006; Trichet 2004[a]; 2005[a]). This created a weakening of EMUs 'siloed' institutional framework (Bibow 2015, p.31; Gabor 2016, p.969) and resulted in President Trichet recognising the importance of financial stability as a distinct institutional objective (Trichet 2003; 2005[a]). Given these evolving pre-crisis ideas, this chapter argues that the critical

[223] Treaty of the European Union (TEU, 1992).

juncture of the sovereign debt crisis (Braun 2015, p.422; Verdun 2015, p.222), should be viewed not as the cause of institutional change, but as a catalyst, hastening a transition that was already underway (Posner 2007, p.145).

Figure 7.1: The evolution of financial ideas in the Eurosystem (1999-2014)



Source: Author (2018)

Once the 2007-8 financial crisis hit, the European Union (EU) and ECB became more interventionist, putting financial stability policy ideas into action by creating the European Financial Stability Facility (ESFS) and initiating the Enhanced Credit Support Program (ECSP), Long-Term Refinancing Operations (LTROs) and the Covered Bond Purchase Program (CBPP). Finally, the critical juncture of the sovereign debt crisis exposed the incompatibility of maintaining a single monetary policy, integrated capital markets and market discipline in the sovereign debt markets. This led to further conceptual stretching (Cox 2004, p.216) of the ECBs neo-liberal philosophical and monetarist programmatic ideas and to the bank reinterpreting its mandate to include preserving the euro as well as price stability (Matthijs 2016, p.380; Schmidt 2016, p.1049). This culminated with the ECB acting as the 'market-maker of last resort' by purchasing EU government bonds (Gabor and Vestergaard 2018; Le Maux 2017), and by becoming the financial supervisor to the entire Eurozone.

Continuing with this thesis' Discursive (DI) and Historical Institutionalist (HI) framework, the chapter begins by examining how the original 'credit crunch' period of the crisis unfolded in Europe between mid-2007-2010 and analyses how the ECB dealt with the fallout. The second section scrutinises the EUs response to the sovereign debt crisis (2010-12); focusing specifically on the creation of the European Stability Mechanism (ESM), the ECBs sovereign bond purchase programs[224] and the completion of Banking Union (BU). The final section draws to a conclusion.

[224] The Securities Markets Program (SMP) and Outright Monetary Transactions (OMT).

7.1 The ‘Credit Crunch’ – 2007-10

During the summer of 2007, US ‘sub-prime’ mortgage lenders began to make heavy losses. Because many European banks had invested strongly in US Mortgage-Backed Securities (MBS), liquidity began to dry up across the Western world. In August the ECB reacted by providing overnight liquidity to interbank money markets through ‘reverse repurchase operations’: lending liquidity to banks against eligible collateral that was repurchased the following day. This was initially conducted at the policy interest rate of 4 percent at ‘full-allotment’[225]. It also provided liquidity through its weekly Main Refinancing Operations (MRO) and two additional longer-term refinancing operations (LTROs) with 3-month maturities (Papademos 2007[b]). Within the first few hours of the crisis, the ECB pumped €95bn into Eurozone credit markets (Evans-Pritchard and Bland 2007; Trichet 2009[a]).

The ECB nonetheless emphasised that these operations did not change the overall stance of monetary policy (which remained committed to preserving price stability), and that it was not prepared to bailout banks with acute financing problems (Papademos 2007[b]; Trichet 2008[b]). In continued attempts to demarcate monetary, fiscal and financial policy, the ECB maintained its traditional approach to monetary policy. Despite meeting extraordinary liquidity demands, it increased its main refinancing rate throughout 2007 and 2008, reaching a peak of 4.25 percent in July 2008.

During the initial stages therefore, little changed for the ECB (Sinn 2014, p.150). It continued to maintain that interest rates were the only instrument through which monetary policy

[225] Meaning the ECB was willing to provide unlimited liquidity as long as banks were willing or able to provide adequate collateral (ECB 2014[c], p.36).

should be implemented; that monetary policy should not be used to combat financial instability; that asset-prices should not be targeted; and that it would not try to resolve solvency problems in European banks (Smaghi 2008; Trichet 2008[b]).

Then, on 14th September 2008, US banking giant Lehman Brothers filed for bankruptcy, causing global stock prices to plummet (Bibow 2015, p.69). Just weeks later, Germany's second largest property lender, Hypo Real Estate (HRE), was forced to apply for government assistance and financial institutions across Europe became starved of liquidity. As a result, ECB Open Market Operations became less about steering short-term interest rates and more about ensuring continued access to capital for solvent banks (Trichet 2008[d]). In September, a series of special term refinancing operations with a maturity of six weeks were also launched, meaning that by October, the outstanding amount of ECB refinancing had increased by around €270 billion from 2007 (Trichet 2008[d]).

Liquidity provision was stepped up further on 8th October 2008 when the ECB initiated its Enhanced Credit Support Programme (ECSP) with the expressed aim of 'reducing banks' funding costs' (Trichet 2008[f]), a clear deviation from strictly monetary objectives (Stark 2009[b]). The ECSP established a 'fixed-rate' tender procedure with 'full-allotment' and reduced collateral requirements[226] for all weekly MROs for 'as long as market conditions dictate' (Trichet 2008[d]). The ECSP marked another important step in the evolution of ECB financial policy and at end-2011 was still being described as 'probably the most significant non-standard measure the ECB is implementing' (González-Páramo 2011).

[226] By December 2008, the collateral threshold was cut to BBB- and interest rates reduced to 2.5 percent

Partly because the ECB faced structural hurdles, having no specific mandate in the treaties to pursue financial stability (Papademos 2006; ToA 1997[227], Art.127; Trichet 2008[e]), and partly because central banks generally did not feel comfortable breaking with the familiarity and continuity of traditional monetary instruments during the early crisis period (Bernanke 2011), the ECSP represented an attempt by the ECB to 'outsource' financial stabilisation to private financial institutions (Buiter and Rahbari 2012, p.28; Gabor 2014[a], p.200). This allowed the bank to continue monetary policy in a path-dependent fashion, whilst simultaneously expanding its liquidity operations to address financial instability (Stark 2009[a]).

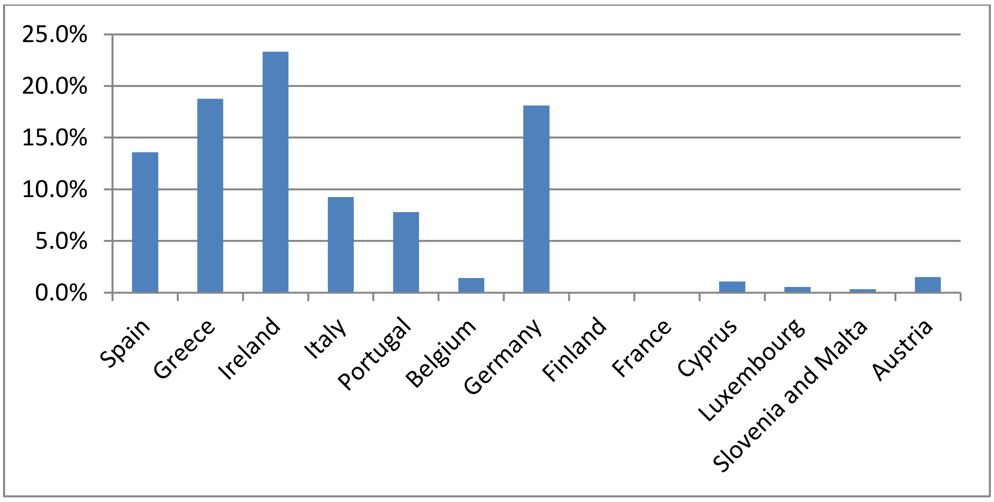
Yet these measures effectively meant the ECB had become 'lender of last resort' (LOLR) to European banks, a responsibility which had hitherto remained with National Central Banks (NCBs) through their Emergency Liquidity Assistance (ELA) facilities[228]. As the quote below makes clear, despite the ECBs reluctance to label its actions LOLR, it accepted it had begun to move far beyond any level of intervention it would have deemed appropriate before the crash:

> *The ECB has had to come up with some measures which it no way would have considered before* [the crisis]*… I don't want to term it this way because the ECB doesn't term it this way, but effectively, this lender of last resort… for the ECB to extend this emergency liquidity, it still has to be convinced that the institutions it's extending to are financially viable. So I don't know if that's lender of last resort in the broader sense… but it still has some lender of last resort function*
>
> (ECB: interview #2, 2015)

[227] Treaty of Amsterdam.
[228] ELA remained in place and continued to be operated by NCBs at further reduced collateral standards.

ECB activity during this period therefore reveals the path-dependence of ECB programmatic monetarist ideas and reluctance to abandon traditional monetary policy within EMUs ridged legal framework (Smaghi 2008; Trichet 2008[b]). Yet it also demonstrates the banks ideational transition towards recognising the need to implement policy ideas designed to combat financial instability (Stark 2009[a]; Trichet 2008[d]). Recognising both ideational and structural characteristics is therefore essential to fully understand why the ECB acted as it did during 2008.

Figure 7.2: Use of Eurosystem liquidity (MROs and LTROs, % of total), Dec 2011



Source: Bruegel Datasets (2017)

The ECSP was bolstered in May 2009 with the creation of one year LTROs, again with fixed-rate tender procedures and full-allotment. In response to rising Spanish and Italian bond yields the ECB went further still in December 2011 and launched LTRO IV, allowing banks to borrow capital for a three-year period using relaxed capital requirements (ECB 2009[a]; Steinberg and Vermeiren 2016, p.396; Wolff 2014). During this program alone the ECB provided over €1 trillion of liquidity[229] at an average interest rate of just 60 basis points (Buiter and Rahbari 2012, p.27; Gros 2012, p.39).

FROM LIQUIDITY PROVISION TO ASSET PURCHASES

As the crisis became more acute, it became increasingly apparent that liquidity provision would be insufficient to defend the stability of a financial system progressively dominated by market-based practices. LTROs acted to reinforce the bank–sovereign doom loop as many banks used the liquidity provided by these operations to purchase home sovereign debt (Steinberg and Vermeiren 2016, p.397). In Italy and Spain, over half the liquidity generated from LTROs was ploughed into home sovereign bonds, resulting in roughly 10 percent of their entire banking systems net value being invested in national debt[230] (Whittall and Gore 2014).

Banks typically choose to hold sovereign bonds because they are regarded as safe, liquid investments which play a critical role as collateral in the repo markets, allowing banks to access cheap liquidity (Cœuré 2016). For as long as peripheral governments failed to default and domestic returns remained low during the downturn, lending to the state at around 6 percent interest also produced a healthy return, as banks were able to borrow from the ECB at around one percent.

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[229] 'In the three-year LTRO 3 which was settled on 1 March [2012], 800 counterparties participated for a total amount of €529.5 billion, while in the three-year LTRO settled on 22 December 2011, 523 counterparties participated for a total amount of €489.2 billion' (ECB 2013[b], p.82).

[230] By 2012, domestic investors, including banks, pension funds and insurance companies owned 67 percent of Spanish government bonds (Thomas 2012).

But as the crisis continued, sovereign downgrades reduced the value of such bonds. Because collateral held in ECB repo transactions is 'marked-to-market', falling bond prices meant the ECB became forced to make 'margin calls', requiring additional collateral to be set aside against default (Gabor and Ban 2016, p.627). This practice effectively made borrowing via LTROs more expensive for peripheral banks holding national government paper and produced a pro-cyclical, destabilising effect on national financial systems (Bindseil et al. 2017, p.6; Gabor 2016, p.990). Moreover, because sovereigns traditionally act as the ultimate fiscal backstop for banks, the burden of re-capitalising and bailing-out troubled lenders fell directly to national treasuries[231] (De Groen 2015, p.2).

These market-based repo practices designed to prevent sovereign risk-sharing and fiscal transfers therefore eroded the distinction between fiscal and monetary policy (Bibow 2015, p.31; Gabor 2016, p.969) and exacerbated the doom loop between weak banks and sovereigns (Bibow 2015, p.92; Huertas 2013, p.33). Consequently, the ECB began shifting away from repo operations towards conducting outright purchases. This implied an acceptance by the ECB that during a crisis within a market-based financial system, it was necessary not only to provide liquidity against eligible collateral (LOLR), but also to become the 'market-maker of last resort' (Gabor 2016; Le Maux 2017, p.1055; Mehrling 2016, p.166) by purchasing less valued assets and allowing banks to improve their balance sheets and future lending capacity (Gabor 2012, p.14).

On 7th May 2009 the ECB announced a €60bl Covered Bond Purchase Program (CBPP) in response to rising spreads in the covered bond market and the destabilising effect this was

[231] In the Eurosystem NCBs are prevented from monetary financing (Art. 123 TFEU).

having on wholesale funding. The covered bond market is one of the most important privately issued bond segments in Europe and was a key source of funding for Euroarea banks, with the market having grown to over €2.4 trillion by end-2008[232] (ECBC 2009, p.88). The CBPP was described in monetarist terms as an attempt to increase the length of money market term rates and general liquidity in the interbank markets to facilitate monetary policy transmission as a 'building block' to ECSP (ECB 2010[a], p.105).

But CBPP had additional importance as it attempted to ease funding conditions for credit institutions and businesses by encouraging banks to extend lending (Beirne et.al 2011, p12; ECB 2009[b]). This further shifted ECB policy away from traditional programmatic ideas and towards financial policy ideas which sought to stimulate economic growth. CBPP1 ran from July 2009 to June 2010 (ECB 2010[b]), but because the ECB halted the program on schedule despite continued volatility, the same policy was used again (CBPP2) from November 2011 to October 2012 where another €40bl of covered bonds were purchased and held to maturity.

Although the purchases were 'sterilised' to limit inflationary effects by auctioning fixed-term deposits, there could still be legitimate questions raised about the ECBs continued independence, price stability credentials and moral hazard (Beirne et al. 2011; Borio 2010, p.11), as the bank began targeting a specific asset class and absorbing risk from predominantly Spanish and German banks who were the main issuers and traders of European covered bonds (Beirne et al. p.23).

[232] Having grown from around €1.5 trillion in 2003.

Table 7.1: Outstanding covered bonds by country (top 5) end-2007 (€m)

	Mortgage	Public Sector	Mixed Assets	Ships	Total
Germany	206,489	677,656		4,413	888,558
Spain	266,959	16,375			283,334
France	63,555	56,403	80,097		200,055
Ireland	13,575	51,204			64,779
Luxembourg	150	33,741			33,891

Source: European Covered Bond Fact Book (2008)

This action not only reduced the independence of the ECB as it acquired a vested interest in the success of Spanish and German banks, but it also had potential redistributive consequences (Gabor 2014[a], p.202). If the ECB buys debt the debtor fails to service, it will make losses that will invariably be borne by European tax payers as a whole (De Grauwe 2012[a], p.263; Weidmann 2014). This example thus demonstrates an instance of scenario G from the ideational versus structural matrix. In a market-based financial environment, maintaining a functioning interest rate transmission mechanism (in line with monetarist programmatic ideas), required the ECB to engage with financial policy ideas aimed at quelling financial instability and stimulating economic activity, weakening the original Maastricht settlement which expressly ruled out the targeting of assets (Issing 2002[b]; Noyer 1999[b]).

ECBs financial crisis response (2007-10):
G) ideational contradictions or failures -> gradual policy / institutional change
Monetarist ideas requiring a functioning interest rate transmission mechanism led the ECB to adopt financial policy ideas aimed at targeting financial assets that conflicted with traditional monetarism. Illustration 7.1

However, the reason the ECB chose to target covered bonds as opposed to other asset classes was precisely to try to limit aberration from its dominant 'programmatic idea' and restrict moral hazard. Covered bonds are corporate securities with recourse to a pool of assets that 'covers' the bond if the originator of the security (usually a bank) becomes insolvent. This recourse to the issuer distinguishes covered bonds from 'synthetic' Asset-Backed Securities (ABSs) which are originated to distribute and transfer risk from the issuer to the holder of the asset (Beirne et.al 2011, p.9). This detail was an important component of the ECBs justification for CBPP:

> *Financial support measures potentially involving the significant transfer of credit risk from financial institutions to the taxpayer clearly fall within the realm of fiscal policy. Our decision to conduct outright purchases of covered bonds is fully consistent with this fundamental principle. While they are expected to be effective in supporting credit, these purchases do not burden the Eurosystem with excessive credit risk*
>
> (Trichet 2009[b], no page)

Therefore although we see a very distinctive shift by the ECB towards more interventionist financial policy ideas, which would never have been sanctioned before the crisis (Issing 2002[b]; Noyer 1999[b]), the bank remained very mindful of its obligation to limit risk-sharing between member-states and to minimise fiscal repercussions. The ECB justified its decision to act in the covered bond market precisely because it argued such purchases did not cross the Rubicon from monetary into fiscal policy (Trichet 2009[b]). The program also finished on schedule despite continuing market instability, feeding into the suspicion that the ECB was uncomfortable using heterodox monetary leavers and reluctant to move away from its 'programmatic' ideational heritage (Economist 2012[a]; Pisani-Ferry and Wolff 2012, p.3).

The ECB also remained discursively couched in monetarist language, with price stability continually evoked as justification for new heterodox policy initiatives (Cœuré 2013[a]; Trichet 2011). During a speech in Munich in July 2009, President Trichet justified CBPP by reinforcing the claim that despite the introduction of unorthodox measures, the ECB continued to embody the monetarist ideals of the *Deutsche Bundesbank* (DB):

> *With the creation of the euro, that* [German] *stability culture has been fully 'Europeanised'*[233]*, and was given a legal face in the Maastricht Treaty and an institutional face in the form of the ECB… we conduct all our policies in full continuity of our mission which started ten years ago, with foundations that have a much longer history and which are well anchored in the most stable monetary policy in Europe – the pursuit of price stability*
>
> (Trichet 2009[b], no page)

For the ECB, still a relatively new institution, maintaining credibility during the crisis was crucial, and this explains the discursive path-dependent commitment to price stability and Germanic stability culture exposed in the quote above[234]. Monetary policy uses communicative discourse to channel expectations, and credibility is often realised by nurturing discursive consistency and clarity (Hughes and Kesting 2014, p.333; Schonhardt-Bailey 2013, p.100). It is therefore difficult for central banks to significantly alter long-held ideas whilst at the same time preserve credibility (Schmidt 2016). Because the credibility and legitimacy of the ECB was predicated on the maintenance of its independence and defence of price stability (González-Páramo 2005; ECB 2011[b], p.91; Sibert 2009, p.7) – each of which were explicitly outlined in international treaties – policy justification continued path-dependently and change evolved more gradually than in other advanced

[233] For literature on 'Europeanisation' see Featherstone and Radaelli (2003).
[234] The European Commission also continued to use monetarist language, see: Rehn 2011.

central banks. This shows how established ideas in new institutions can hinder policy change:

ECB monetary policy (2007-10):
D) established ideas in new institutions -> hinder policy change
Despite implementing interventionist financial policy ideas, the ECB maintained traditional monetarist communicative discourse and continued to try to separate monetary policy from measures taken to restore financial stability. Illustration 7.2

Supervisory Initiatives

In response to growing financial instability, on the 25th February, the de Larosière Group of experts presented their report at the request of the Commission and recommended increasing financial supervision at the EU-level, stating:

> *The ECB could play a major role in a new European supervisory system* [by] *ensuring adequate macro-prudential supervision in the EU*
>
> (de Larosière 2009, p.42-44)

The report built upon previous attempts by the EU to integrate and supranationalise financial supervision (Alford 2006; Jones et al. 2016). It argued for structural institutional change through the creation of a European Systemic Risk Council (ESRC) under the auspices of the ECB (headed by the ECB President), which would be tasked with issuing early risk warnings and making recommendations on macro-prudential regulation (MPR) (de Larosière 2009, p.44).

The introduction of MPR at the European level represented a further substantive ideational shift from pre-crisis thinking (Baker 2012, p.113; Moschella 2014, p.137). MPR challenged pre-crisis neo-liberal philosophical ideas by recognising markets can often generate herding behaviours and perverse incentives and that central banks therefore need to do more than simply maintain price stability to ensure financial stability (Baker 2013, p.116; Moschella 2014, p.143). As this Senior Economist at the ECB put it:

> *Macro-prudential policy must recognise that markets have some frictions, have some inefficiency… we often call them externalities created by the behaviour of one agent acting as a system as a whole… So this externality, this inefficiency if you will, needs to be there for macro-prudential policy to have a role*
>
> (ECB: interview #4, 2015)

MPR aims to strengthen the resilience of the financial system as a whole, rather than simply focus on the soundness of individual financial institutions (Papademos 2009). It does this by imposing countercyclical prudential requirements and capital buffers, as well as more fiscally targeted measures[235]. All of this required a significant deviation from neo-liberal philosophical ideas which, although recognised the possibility of market failure, saw markets as inherently stable and efficient. A member of the Commissions' Directorate-General for Economic and Financial Affairs (DG ECFIN) acknowledged this ideational shift and summarised the change thusly:

> *I think the paradigm that was prevailing before the crisis… was the Efficient Market Hypothesis. So basically, there may be ups and downs and there will always be periods of bubbles and periods of bubbles bursting, but overall the financial integration trend was towards a better allocation of risk and so forth. What we know now is that this clearly is not the case. We have seen massive financial integration at the European level before the crisis, and this financial*

[235] Such as loan-to-value and loan-to-income ratios for mortgage borrowers, the implementation of which remains with member-states.

integration has been associated with very little risk diversification, actually it has been associated with risk concentration in some geographical areas and in some specific markets. So this idea that left alone financial markets can function and deliver first best, or even a second best initiative has definitely gone

(Commission: interview #17, 2015)

Importantly however, in line with the ECSP, the introduction of MPR allowed the ECB to manipulate new tools distinct from monetary policy to help stabilise financial markets, whilst allowing traditional monetary instruments to remain focused on price stability:

The ECB has the following view on that: its primary mandate and its primary objective continues to be price stability. This remains the overriding objective. Subject to that, one can develop tools and activate instruments that we now have, in order to contain financial stability risks, through the macro-prudential tools

(ECB: interview #4, 2015)

The de Larosière report (2009) upheld the view that although the ECB should develop a role in MPR, micro-prudential policy[236] should remain a national competence:

The ECB is primarily responsible for monetary stability. Adding micro-supervisory duties could impinge on its fundamental mandate… [and] *could result in political pressure and interference, thereby jeopardising the ECB's independence*

(de Larosière 2009, p.43)

The report came to this position because macro- and micro-prudential authorities use similar tools, but apply them with different objectives in mind (Crockett 2000). This may

[236] Regulations which aim to secure the stability of individual financial institutions, without concern for broader systemic consequences.

leave scope for potential conflict between the two arms of regulation[237] (Angelini et al. 2012, p.20; Osiński et al. 2013 p.8). Responsibility for micro-prudential regulation may also leave the ECB prone to political pressure from member-states keen to secure rules more befitting of their own jurisdictions, threatening its political independence (de Larosière 2009, p.43). The report therefore instead recommended creating a distinct European System of Financial Supervision (ESFS) to better coordinate national micro-prudential policies (de Larosière 2009, p.47).

At the Economic and Financial Affairs Council (ECOFIN) meeting of the 1st-2nd December 2009, the Council agreed to create three new European institutions to supervise banking, insurance and securities markets within the ESFS (Commission 2013):

- The European Banking Authority (EBA)
- The European Insurance and Occupation Pensions Authority (EIOPA)
- The European Securities and Markets Authority (ESMA)

The overarching European Systemic Risk Board (ESRB) entered into force on 16th December 2010, and the three ESFS institutions two weeks later on 1st January 2011 (Commission 2013). They were each tasked with promoting supervisory cooperation and advising the Commission and ECB on matters relating to their areas of competence (Quaglia 2013, p.24). While member-states were willing to enhance cooperation, they remained reluctant to supranationalise financial regulation (Jones et al. 2016, p.1022). Indeed, some have argued that because these institutions lack any binding authority to impose measures on member-

[237] For example, during a downturn, a macro-prudential regulator may require financial institutions to draw down on their reserves and extend lending, while micro-prudential regulators may wish to see capital barriers extended to protect the stability of individual banks.

states (Commission 2009), and because they are staffed by national regulatory authorities, they were in fact created by member-states as a way of increasing national control over EU financial policy. This view however was not shared by everyone:

> *I saw their creation as a power grab by Europe and wish they hadn't been created. I wish that responsibility had remained with the nation states. The difficulty is that the crisis originated in the United States and then came to London. In the early stages of the crisis it was very much viewed as an Anglo-Saxon and a London problem… You in London have failed to regulate your market, so we will now supervise you. And we lost that argument*
>
> (UK MEP: interview #19, 2015)

Indeed, these institutions represent a structural change from the mutual recognition of national rules towards an institutionalisation of harmonised EU financial laws. Under specific circumstances, these bodies can issue direct judgements on banks within member-states (Busuioc 2013, p.12). It is therefore difficult to see their development as anything other than a transfer of authority away from member-states and towards the EU, with former Commission President, Jose Manuel Barroso, describing the transition as a 'silent revolution' towards greater supranational economic governance (Barroso 2010).

SUMMARY

Although the ECB initially moved very quickly to extend capital to financial markets, between August 2007 and October 2008, capital was simply 'frontloaded' and given an extended maturity (Stark 2008). The ECB continued to maintain that interest rates should be the only tool of monetary policy and that monetary operations should not be used to resolve solvency problems in banks (Smaghi 2008; Trichet 2008[b]). Traditional monetary policy, and the separation principle (Stark 2008) between liquidity and monetary operations were therefore maintained.

However, further change was detectable after the collapse of Lehman Brothers and HRE. Although the ECB's programmatic monetarist ideas were largely retained, they were weakened and supplemented with interventionist policy ideas[238] which were designed both to improve the interest rate transmission channel and support financial and economic stability (Trichet 2009[a]). The ECSP was created explicitly to pursue financial stability objectives (Trichet 2008[f]), and as more and more assets were brought onto the ECBs balance sheet, the likelihood of significant redistributive consequences in the event of non-performance intensified (Borio 2010, p.11; Brunnermeier et al. 2016, p.373; Lombardi and Moschella 2016, p.855). This had a corresponding impact on the independence of the ECB (particularly with respect of CBPP) and provides a clear example of how changing policy ideas, even when implemented with the intention of strengthening traditional programmatic ideas, can help generate important structural changes.

The de Larosière report (2009) also recognised the need to promote financial policy ideas and endorsed the view that the ECB should play a direct role in orchestrating and setting MPR, handing the ECB responsibility for both price and financial stability. This represented a clear break from neo-liberal philosophical ideas as it overtly acknowledged that in an integrated market-based financial system, greater coordination and intervention by regulators was necessary to prevent damaging pro-cyclical effects (Baker 2012, p.113;

[238] The evolution of financial 'policy ideas' had begun in the pre-crisis era but developed more rapidly post-2007.

Moschella 2011, p.124). These ideas led directly to tangible institutional change and to the creation of the ESRB.

Crucially however, handing the ECB responsibility for MPR was intended to facilitate path-dependence in the field of monetary policy. MPR tools were to be used to fight financial instability, while monetary policy was to remain fully focused on price stability (Papademos 2009). Therefore despite incorporating interventionist policy ideas which weakened neo-liberal philosophical ideas and EMUs siloed institutional framework[239], the ECB attempted to uphold monetarist programmatic ideas in the field of monetary policy. It is here that the institution derived most of its credibility and legitimacy (ECB 2011[b], p.9; González-Páramo 2005; Sibert 2009, p.7), and where its founding ideas were most deeply embedded (TEU 1992, Art.105). Therefore although important institutional and ideational change took place during this period, ideational and discursive path-dependence remained strongest in the ECBs commitment to price stability.

Moreover, interventionist policies were implemented reluctantly by the ECB (Buiter and Rahbari 2012, p.7; De Grauwe 2012[b]; Lombardi and Moschella 2016, p.852). The fact safer covered bonds were purchased over other asset classes, and that CBPP1 finished on schedule despite continued market volatility, evidences this reality (Economist 2012[a]; Pisani-Ferry and Wolff 2012, p.3). Unlike other central banks (Benford et al. 2009, p.90), the ECB refused to instruct more radical policies such as Quantitative Easing (QE) until 2015[240] (Feldstein 2011, p.7; Lagarde 2013; Sibert 2009, p.7). Instead, it developed CBPP to limit

[239] EMUs legal structure attempted to separate monetary, financial and fiscal policy to prevent transfers of wealth and risk and to ensure the ECB remained focused wholly on price stability.
[240] The ECB embarked upon the Public Sector Purchase Programme (PSPP) on the 9th March 2015.

potential fiscal repercussions and designed the ECSP to allow monetary policy to be retained for price stability objectives (Gabor 2014[a], p.200; Stark 2009[a]). Any ‘extraordinary’ policies the ECB did implement also continued to be justified discursively in traditional monetarist terms (ECB 2010[a], p.105; Trichet 2009[b]).

7.2 The Sovereign Debt Crisis as a critical juncture

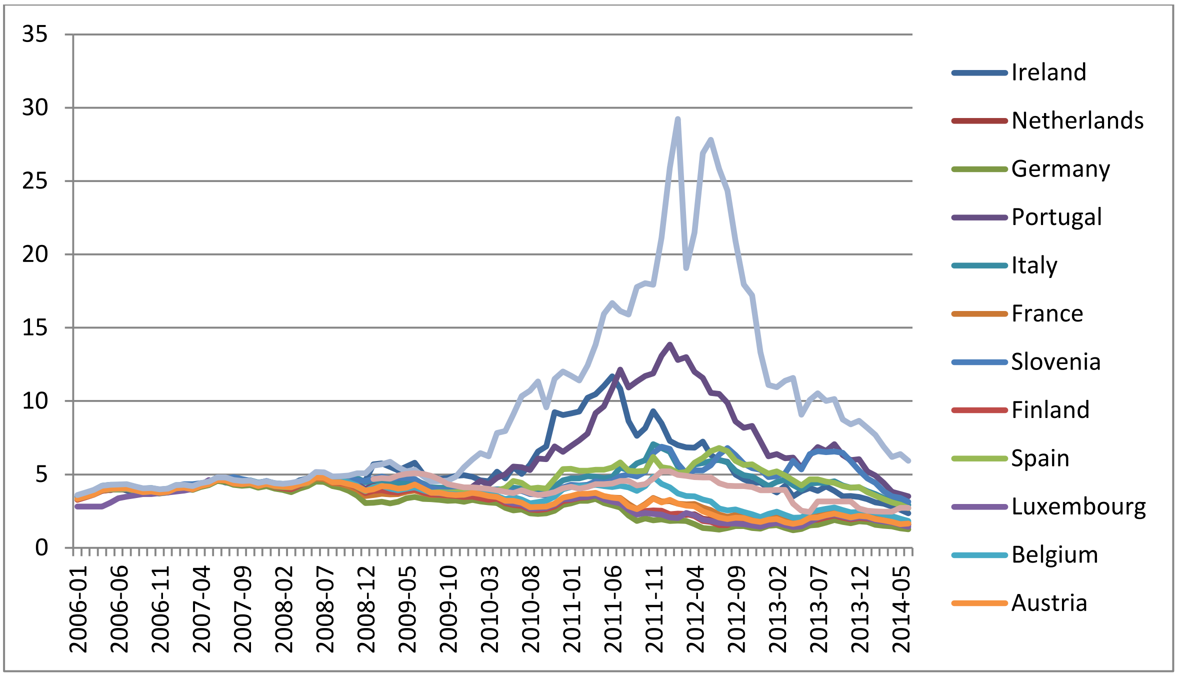
Before 2010, the ECB refused to sanction the purchase of government bonds to help stabilise financial markets[241]. But by this date, many peripheral governments were facing severe fiscal pressures in the wake of a series of bank bailouts, financial guarantees, and lower than trend tax receipts. LTROs and the ECBs mark-to-market collateral framework for repos further exacerbated the doom loop between peripheral banks and sovereigns (De Groen 2015, p.2; Gabor 2016, p.990; Steinberg and Vermeiren 2016, p.397), which dramatically altered the credit ratings and yield spreads of Eurozone sovereign bonds (figure 7.3). Peripheral states borrowing costs increased drastically while ‘safe havens’ like Germany saw yields reduce as financiers scrambled for somewhere safe to house their investments (Gros 2012; Klose and Weigert 2012).

Such was the scale of the problem that the sovereign debt crisis began to threaten the fiscal solvency of many peripheral nations and the existence of the euro itself (De Groen 2015; Farhi and Tirole 2015; Horváth and Šuster 2014, p.41). This led the ECB and other EU institutions to adopt far more radical policies which substantially broadened supranational authority into fiscal and financial policy areas. It is therefore the sovereign debt crisis, rather

[241] Despite many other leading central banks meanwhile initiated Quantitative Easing (QE) to help stabilise their financial systems and boost economic growth (Benford et al. 2009, p.90).

than the initial financial crisis, which should be viewed as the critical juncture (Capoccia and Kelemen 2007, p.346) which further catalysed substantive institutional change.

Figure 7.3: Eurozone 10-year Government Bond Yields (2006-2014)



Source: OECD Data (2018)

EUROPEAN 'BAILOUT' MECHANISMS

By May 2010 problems in Greece and Portugal meant some form of bailout mechanism could no longer be avoided to prevent peripheral states sliding into bankruptcy. Given the ECBs prohibition on providing such assistance (TEFU 2007, Art.125), an extraordinary ECOFIN meeting[242] was convened between 7th-9th May where ministers agreed details of a comprehensive package of measures, including the creation of the European Financial Stabilisation Mechanism (EFSM) and European Financial Stability Facility (EFSF) (De Groen

[242] A meeting of the European Council at the level of EU member-state finance and economics ministries (Council 2017[b]).

2015; Farhi and Tirole 2015; Horváth and Šuster 2014, p.41). The EFSM was operated by the Commission and given the ability to distribute loans of up to €60 billion. Funds were raised in the financial markets with implicit guarantees provided by the EU budget. The EFSF meanwhile had a total of up to €500 billion to distribute, but with strong conditionality attached to terms. The International Monetary Fund (IMF) also participated in this arrangement by providing an additional €250 billion, bringing the total size of the EFSF to €750 billion ($1 trillion) (European Council 2010).

The IMF, Commission, and controversially, the ECB, monitored the progress of reforms within states applying for EFSF assistance through the so-called 'Troika'. The management of programmes targeting fiscal adjustment and structural reform in individual member-states was a far cry from the ECB's pre-crisis role of simply maintaining price stability (Gros 2015, p.5). In a letter to the Irish Finance Minister in 2010, the ECB threatened to cut-off liquidity support for Irish banks unless Ireland agreed to a financial assistance programme (ECB 2010[c]), leading to criticism that the ECB was overreaching its mandate (Chopra 2015, p.5; Whelan 2015, p.20). It also threatened to cut off ELA to Cyprus, and in the case of Greece, actually did so. This led to further questions about the political independence of the ECB and to concerns from within the bank itself about whether it should play such a role:

> *The ECB has now got this new role as part of the Troika, which was something completely new that it had not done before, and there were many voices in the ECB who were saying they should not be involved in this kind of work… the conflict of interest is most difficult when you get to this financial viability topic… you've somehow got to be sure that the institution you are dealing with is viable… So this has been probably the most contentious issue about whether there is some sort of conflict of interest…*

> *The role of the ECB in the Troika was not the ECB deciding itself, 'yes, we want to be involved in the Trokia', it was invited by the Eurogroup*[243] *because of concerns that there would just be the IMF and the Commission and the potential problems of that constellation*
>
> (ECB: interview #2, 2015)

This quote is important because it demonstrates the ECB was itself reluctant to become involved in the Troika and to expand its area of competence far wider than initially intended. The reason it did so was because ever since the publication of Walter Bagehot's *Lombard Street* (1873), it has been generally accepted that during periods of financial panic, central banks should lend to solvent financial institutions with good collateral at high interest rates. Yet deciding which banks are insolvent and which are merely experiencing liquidity problems is notoriously difficult to judge during episodes of financial distress.

Braun (2015) argues that because the ECB lent to Eurozone banks at below pre-crisis interest rates through its LTRO programs, the ECB broke the 'Bagehot rule' and aggravated moral hazard (Braun 2015, p.432). But this fails to consider the impact of the ECBs collateral framework which continued to mark-to-market, resulting in banks holding peripheral sovereign debt having to take ever larger haircuts. Indeed, the haircut rates the ECB charges on sovereign collateral can vary from between 15-71 percent (table 7.2), meaning it can be over four times more expensive to generate liquidity for owners of peripheral debt than holders of sovereign bonds regarded as 'safe'. While these practices can increase pro-cyclicality and exacerbate the bank-sovereign doom loop (Bibow 2015, p.31; Gabor 2016, p.969; Whittall and Gore 2014), they also reduce the risk of moral hazard and help the ECB

[243] The 'Eurogroup' is an unofficial ECOFIN configuration consisting only of euro member-states.

differentiate between banks which are solvent and those which are not (Bindseil et al. 2017, p.11).

Table 7.2: ECB collateral framework for 'haircuts' (2017)

Credit quality	Minimum haircut	Maximum haircut
CQS 1-2 ("AAA – A")	0.5%	25.5%
CQS 3 ("BBB")	6%	38%
CQS 1-2 ("AAA – A")	12%	45%
CQS 3 ("BBB")	19%	63%
CQS 1-2 ("AAA – A")	12%	46%
CQS 3 ("BBB")	19%	65%
CQS 4 ("BB+")	42%	80%
CQS 5 ("BB")	54%	85%
Government bonds	15%	71%
Government-guaranteed bonds	23%	81%

Source: Bindseil, U., et al (2017)

'CQS' denotes 'credit quality steps'. These categories represent the maximum probability of default over a one-year horizon.

CQS 2 for example represents an asset class with a maximum probability of default over 1 year of 1 percent.

With the EFSF and EFSM still failing to quell market volatility, European leaders reached agreement on the need for a permanent crisis fund at a meeting of the European Council on 21st October 2010. The ESM came into force in July 2011 and succeeded the EFSF. It was founded on an intergovernmental treaty which effectively sidestepped the 'no-bailout-clause' (Howarth and Quaglia 2015, p.473) and was thus regarded by many as a violation of the treaties (Beck and Prinz 2012, p.42; Henerlein 2015, p.21). The new institution was given authority to lend up to €500 billion to Eurozone members facing fiscal pressures which threatened the stability of the Euroarea, but with assistance only provided with unanimous agreement from signatory states (Marzinotto et al. 2011, p.4).

Moral hazard concerns were mitigated by ESM support being made contingent upon Troika imposed macroeconomic adjustment programmes – Memorandums of Understanding

(MoUs) – which detail how fiscal consolidation should be implemented (Barroso 2011).

Indeed, the ECB stressed explicitly that ESM bailouts should:

> *Not create moral hazard, but rather strengthen the incentives for prudent fiscal and economic policies in all Euroarea countries… any financing under the ESM needs to be subject to very strong policy conditionality*
>
> (ECB 2011[c], p.71-2)

Nevertheless, a pooling of fiscal authority in this way necessarily spreads liability across the Eurozone and consequently creates a degree of moral hazard. The establishment of ESM therefore represents an additional weakening of the original principles upon which EMU was founded: price stability primacy, market discipline and fiscal conservativism[244] (Beck and Prinz 2012, p.42; Henerlein 2015, p.21). This led one Irish Member of Parliament, Thomas Pringle, to bring the ESM treaty before the European Court of Justice (ECJ).

Mr Pringle argued that the Treaty, which also permitted ESM to purchase government bonds on the secondary market through the Secondary Market Support Facility, impinged upon the ECBs exclusive right to conduct monetary policy and violated the prohibition of monetary financing (TEFU 2007, Art.123; ECJ 2012). It was argued that if buying government bonds constituted a fiscal operation, the ECBs bond purchases meant it had overstepped its mandate. If however they were deemed monetary operations, as the ECB claims, ESM purchases would have been illegal as only the ECB is permitted to conduct monetary policy in the Euroarea (Sinn 2014, p.290).

[244] Indeed, ESM recipient states pay a lower rate of interest than under the EFSF, and a much lower rate than the prevailing market price (Booth 2013, p.170).

In its ruling, the Court found that the objective of ESM: 'To safeguard the stability of the Euroarea as a whole', was distinct from the ECBs objective of maintaining price stability. Although it recognised that the stability of the Euroarea was likely to have repercussions for the stability of the euro, the ECJ judged that:

> *An economic policy measure cannot be treated as equivalent to a monetary policy measure for the sole reason that it may have indirect effects on the stability of the euro*
>
> (ECJ 2012, p.13, para.56)

ESM was therefore saved[245] by the ECJ conceptually stretching its idea of what constitutes monetary policy. Although the ECB has exclusive competence over monetary policy, it has only an indirect effect on price stability itself. Whist the ECB justifies its policies with reference to price stability; these policies only work through the altering of financial and economic conditions (Bibow 2015, p.26). The distinctions the Maastricht Treaty sought to draw between monetary, financial and fiscal policy are therefore necessarily artificial. Even though the ECJ was able uphold the distinction legally at an ideational level, the crisis revealed them to have little practicability. The creation of this new institution therefore substantially weakened the structure of EMU as originally conceived at Maastricht.

The case was also significant because it demonstrated that the EU was able to overcome legal challenges which aimed to prevent it extending its competences and shifting EMU in a more interventionist direction. HI suggests such formal structural impediments are the main reason institutions remain path-dependent and resistant to change (Pierson 2000, p. 264-5; Hall and Taylor 1996, p.937). Yet this case demonstrates that the EU was able to vanquish

[245] The Treaty eventually became ratified as part of EU law in January 2013.

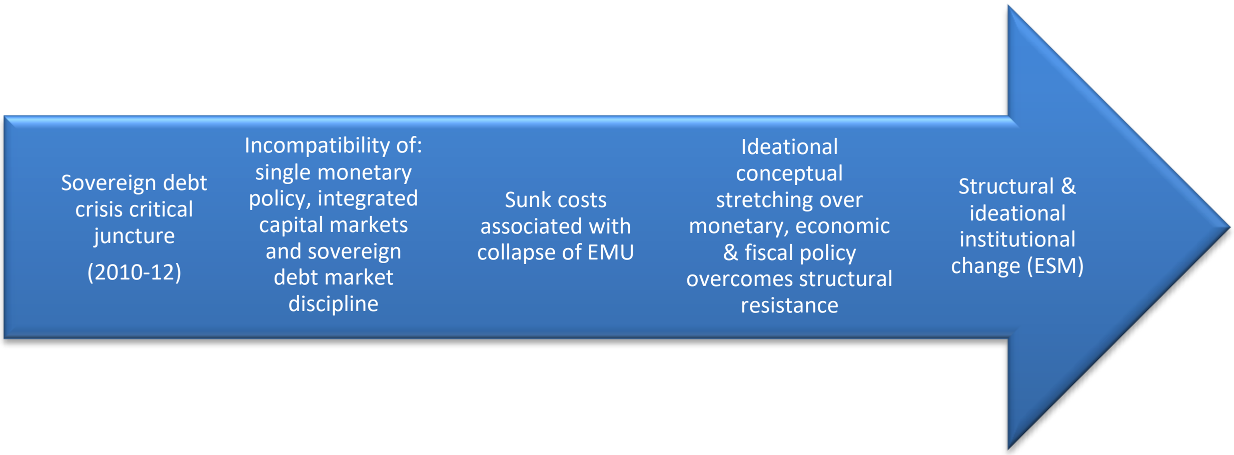
structural rigidities and institute substantial institutional alteration despite legal challenges from conservative elements aiming to maintain the *status quo*.

The creation of ESM:		
A) ideas trump structures	**->**	**institutional change**
Ideational conceptual stretching over what constituted monetary policy allowed the ESM to conduct similar policies to the ECB. This further weakened the original structural framework of EMU, as well as traditional monetarist programmatic ideas.		

Illustration 7.3

That said, HI insights remain important in helping to conceptualise events surrounding the creation of the bailout mechanisms as they represent a critical juncture in the evolution of EMU which exposed the incompatibility of a single monetary policy, integrated capital markets and market discipline in the sovereign debt markets (Gabor 2016). The Maastricht settlement was unable to withstand the sovereign debt crisis as it placed the euro in an existential emergency (Jones et al. 2016, p.1011; Schmidt 2014, p.189; van Rumpuy 2011). The EU became incapable of maintaining a workable distinction between the various strands of economic policy (Bibow 2015, p.26), abide by the no-bailout-clause (Beck and Prinz 2012, p.42; Henerlein 2015, p.21), and secure the future of the euro. The very real prospect of EMUs collapse and the sunk costs (Bulmer 2009, p.310; Klaus 2010; Posner 2007, p.145) involved in such a scenario was enough to override programmatic ideational constraints and structural rigidities, allowing significant institutional change to take place. Insights from DI and HI therefore reinforce each other in this instance and are both essential to fully understand events within the Eurozone during this period.

Figure 7.4: Process of causation: ideational and structural change (ESM)



Source: Author (2018)

MONETARY POLICY AND THE SOVEREIGN DEBT CRISIS

What was a critical juncture for EMU as a whole proved likewise for the ECB. At the same time EU leaders agreed to the creation of EFSF, the ECB initiated further interventionist initiatives in the form of the Securities Market Programme (SMP). This apparently aimed at restoring the proper functioning of the monetary policy transmission channel by addressing specific malfunctioning debt market segments (ECB 2010[b], p.24; 2011[d], p.100), including the sovereign segment, by purchasing Eurozone government bonds on the secondary market (ECB 2010[b], p.73).

This marked another substantial leap in the evolution of ECB balance-sheet activity[246], going further in undermining the banks institutional independence. However, just as before, the bank remained discursively path-dependent and was at pains to stress that the measures were not taken to assist distressed sovereigns:

[246] Adding €74 billion to the ECBs balance sheet by 2011 (Bibow 2015, p.71).

Impairments to the transmission mechanism of monetary policy are not necessarily [only] located in the interbank market but… in other financial market segments, and one prominent financial market segment was of course as of 2010 the sovereign segment, where we intervened directly in the sovereign market segment. But you know, not because we like to help the sovereigns but because we thought that this market is a key market that actually has a broader impact on financial conditions in the economy and which matters not only for the health of the banking system but also the financing conditions of households and firms

(ECB: interview #1, 2015)

The quote above outlines the ECBs contention that volatility in the sovereign debt market was creating secondary effects in the financial, stock, interbank and foreign exchange markets and that action was therefore required to ensure monetary policy remained effective[247] (ECB 2010[b], p.24; Trichet 2010[b]). The bank also argued taking such measures fell fully in line with its price stability mandate and that SMP did not threaten the principles of central bank independence, or the prohibition on monetary financing (Trichet 2010[a]). Due to 'sterilisations'[248], it also claimed bond purchases did not alter the stance of monetary policy (ECB 2010 [b], p.24).

Indeed, during the crisis, peripheral banks holding peripheral government bonds were forced to pay more to borrow in the capital markets than 'northern' European banks (Bindseil et al. 2017; Gabor 2016). This provides a certain validity to the ECBs 'transmission mechanism' argument for SMP. But not everyone was convinced and German monetarists were particularly sceptical (Weber 2011; Weidmann 2017[b]). Many ordo-liberals argued purchasing sovereign bonds was tantamount to giving governments' access to the printing

[247] This shows once more the incompatibility of maintaining a single monetary policy, integrated capital markets and sovereign debt market discipline as the bank became forced to intervene in bond markets to support peripheral paper and preserve harmonised interest rates.

[248] Through 'sterilisations', the ECB reabsorbed additional liquidity by extracting highly liquid deposits through fine-tuning operations into fixed-term deposits. This aimed to keep banks' holdings of central bank liquidity unchanged, precluding any increases in monetary aggregates (ECB 2010[b], p.24).

press (Brunnermeier et al. 2016, p.194; Sinn 2014, p.5). Governments, they argued, could persuade banks within their jurisdiction to buy home sovereign debt (lowering national borrowing costs and reducing market discipline), which they could then either sell to the ECB or use as collateral in LTRO programs, mutualising losses and generating moral hazard (Sinn 2014, p.156-7).

Axel Weber, the then DB President, and Jürgen Stark, the ECBs Chief Economist, both argued strongly against SMP, suggesting it would muddy the lines between monetary and fiscal policy and threaten ECB independence (Meiers 2015, p.41; Weber 2010). Unlike ESM, SMP support did not come with explicit fiscal or structural reform conditionality. It was therefore feared the program also had the potential to weaken fiscal discipline (Buiter and Rahbari 2012, p.26). This forced Weber to resign in February 2011 (Weber 2011) and Stark to do likewise in September[249]. Soon after his resignation, Stark made the following remark:

> *We are not the lender of last resort* [to governments] *and I do not advise European governments to ask the ECB to become lender of last resort… This will mean that the ECB immediately will lose its independence*
>
> (Stark 2011, no page)

These policy decisions and the subsequent criticism from German quarters highlight the extent to which the ECB had shifted from its pre-crisis position. For an institution created in the mould of the DB (Dyson 2002[b], p.186; Heipertz and Verdun 2010, p.46; Quaglia 2008, p.47-74), to generate such disparagement from DB officials is striking. The quote below from an ECB economist highlights the discomfort many traditional monetarists felt towards SMP, and the extent to which the policy represented a break from previous customs:

[249] Although Stark cited 'personal reasons' for leaving (ECB 2011[a]), many suspect his real motivation was the reactivation of SMP in August (Blackstone 2011; Carrel 2011; Ewing and Kulish 2011; Müller et al. 2011).

I think there was a really strong concern that if the program [SMP]*… had become too big, it could become a threat, or be seen to become a threat, to ECB independence… It's also relative to the reputation of the ECB at that time. I think the model of the ECB was so much based on the Bundesbank, steady-as-you-go, very considered and well-founded decision model, that the SMP, to the believers in that model, were a bit shocked*

(ECB: interview #2, 2015)

Yet not only did the ECB justify SMP by using traditional monetarist communicative discourse (ECB 2010[b], p.24; Trichet 2010[a]; 2010[b]), it remained reluctant to invoke heterodox policy and consistently sought to revert back to traditional instruments at the earliest opportunity (Economist 2012[a]; Howarth and Quaglia 2015, p.463). Rather than step-up SMP towards the end of 2010 as volatility continued, the ECB instead attempted to exit the policy and began weighting European debt according to its ratings to try to limit potential losses. This caused 'fire sales'[250] of peripheral paper and spiked yields (Brunnermeier et al. 2016, p.322), necessitating further SMP intervention in the New Year. Despite this, in March 2011, the program was again halted due to a lack of progress on EU fiscal initiatives aimed at limiting moral hazard (Bastasin 2015). This reveals how established ideas in new institutions can hinder policy change, expressed through scenario D (table 2.2):

ECB reluctance to use 'extraordinary' monetary policy:		
D) established ideas in new institutions	**->**	**hinder policy change**
ii) established programmatic ideas resistance	->	strong institutional
The ECB faced strong internal and external resistance to the implementation of SMP and sought to exit the policy at the earliest opportunity.		

Illustration 7.4

[250] The mass selling of a specific asset class.

This ideational conflict between traditional monetarist programmatic ideas which reviled central bank incursion into financial and fiscal policy, and policy ideas which sought to improve financial stability – with the ultimate aim of safeguarding price stability – became clear in discussions with members of the institution:

> *They have actually been doing fiscal policy. My view on this is that, thank God they have done this, on the one hand. On the other hand I think this is not their job and they should stop doing it! It's not their job to do fiscal policy. They should not be buying bonds, and of course they can't on the primary market, but even on the secondary market, okay, you don't violate any rules but it's still fiscal policy… it's not part of their mandate. It doesn't say anywhere you should do fiscal policy. You cannot sustain this for very long without compromising credibility. We had independent central banks for exactly that reason*
>
> (ECB: interview #3, 2015)

This quote illustrates succinctly the ideational dilemma confronting the ECB in 2010 and represents an example of interdiscursivity between two overlapping discourses (Fairclough 2010, p.95; Wodak 2001[b]). In no way did the bank feel comfortable using unorthodox policy levers or shifting from traditional ideas about how central banks should operate (Buiter and Rahbari 2012, p.7; De Grauwe 2012[b]; Lombardi and Moschella 2016, p.852). Yet the critical juncture of the sovereign debt crisis was such that if it was to maintain an effective monetary policy within a market-based financial environment, and path-dependence in the pursuit of price stability, heterodox measures were plainly necessary.

Therefore, whilst it is important to stress how far the ECB shifted during the sovereign debt crisis, it is also imperative not to overlook aspects of continuity. Although the bank implemented financial policies through ECSP, CBPP, MPR and SMP, it still attempted to use traditional monetary policy to tackle inflation. Whilst other central banks across the world were slashing rates to record lows and embarking upon huge asset purchase programs, on 7th April 2011, the ECB actually began raising interest rates. It increased its main refinancing rate from 1 percent to 1.25 percent in April, and again to 1.5 percent in July sighting 'upside risks to price stability', despite noting a 'slower pace' in the expansion of economic activity (Trichet 2011). Therefore while the ECB was forced to act upon policy ideas which went far beyond the intentions of its creators, it remained reluctant to do so and consistently attempted to move back towards pre-crisis ideational norms (Farrell and Finnemore 2016, p.585; Pisani-Ferry and Wolff 2012, p.3; Schmidt 2014).

Change advanced more rapidly with the anointment of President Mario Draghi who assumed office on 1st November 2011. Just as the appointment of President Trichet in 2003 provoked ECB recognition that Eurozone financial integration had helped generate potential for financial fragility (Trichet 2003), President Draghi understood that without a commitment by the bank to support EMU sovereigns, the single currency faced the prospect of total collapse. Draghi held decidedly less orthodox ideas than his predecessor[251] (Blyth and Matthijs 2016, p.26; ECB: interview #2, 2015) and in almost his first act as president on 9th November, decided to cut the main refinancing rate to 1.25 percent, then to 1 percent just a month later (ECB 2011[d], p.84). Yet these rate reductions failed to prevent an escalation of the sovereign debt crisis over the spring and summer of 2012 (IMF 2012[a], p.5). Under mounting pressure from markets and with interest rates on Italian and Spanish bonds reaching unsustainable levels after the collapse of Bankia[252], the ECB was forced to implement more extraordinary measures.

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[251] 'Mario Draghi has worked in the financial markets, he has a very different mentality, or philosophy, about central banking, certainly than Trichet' (ECB: interview #2, 2015).
[252] Spain's third largest financial entity (see chapter 6).

Previously, moral hazard concerns about bond purchases and bailouts, legal restrictions on monetary financing, worries about credibility and German disapproval meant it was very difficult for the ECB to provide discursive support for unorthodox policies (Buiter and Rahbari 2012, p.27). The worsening critical juncture, however, altered this hesitancy as it became a greater imperative to reassure markets than to try to soothe hawkish sensibilities regarding the ECBs continued commitment to monetarist programmatic ideas (Schmidt 2016). In a speech on 26th July 2012, Draghi adopted a very different communicative discourse and spoke directly to the markets by saying:

> *The ECB is ready to do whatever it takes to preserve the euro… and believe me, it will be enough*
>
> (Draghi 2012[a], no page)

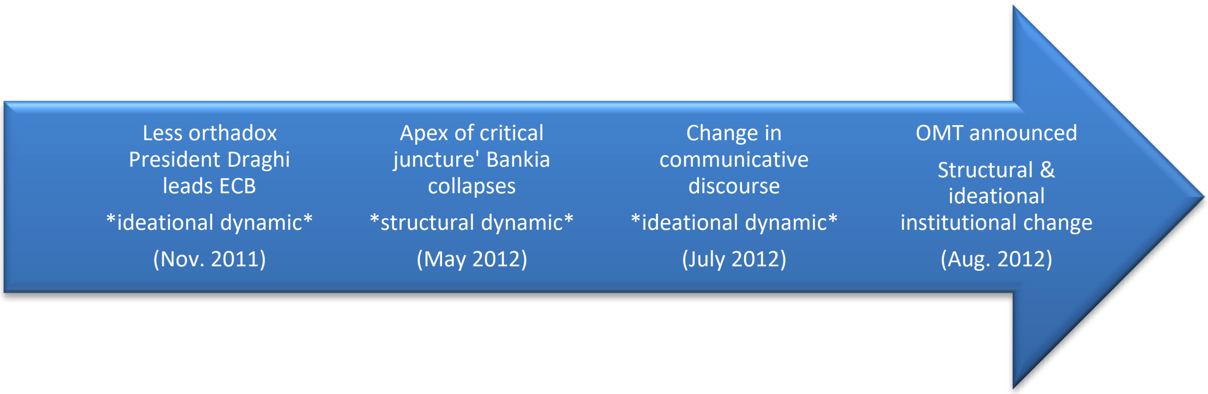
Although the discursive commitment to price stability remained[253] (Brunnermeier et al. 2016, p.320; Schmidt 2016, p.1034), this new language implied the ECB was prepared to purchase government bonds in unlimited quantities (Blackstone and Walker 2012). The mere recognition by markets that the ECB was primed to take such action led almost immediately to rates on Italian and Spanish 2-year government bonds decreasing by around 2 percent (Altavilla et al. 2014, p.5). This is a powerful example of communicative discourse having a direct impact on the course of history (Schmidt 2014, p.202).

The speech was followed in August with the announcement of the Outright Monetary Transactions (OMT) program which replaced SMP. From the perspective of the wholesale

[253] '[OMT] builds on an established monetary policy doctrine that has gained prominence not least because it has been successfully pursued by the Bundesbank for several decades. Namely that the central bank should be endowed with a clear price stability mandate and, within this mandate, should be allowed – in fact obliged – to use its instruments in full independence to deliver price stability' (Draghi 2014[c]).

markets, OMT was successful because it put an end to uncertainty about the collateral qualities of Eurozone sovereign debt, providing ‘free-of-charge insurance’ for bond investors (Sinn 2014, p.2). While LTROs tended to increase pro-cyclicality, OMT committed the bank to creating money to purchase struggling countries’ debt in the secondary markets without limit, guaranteeing demand for peripheral paper (Gabor and Ban 2015, p.16).

Figure 7.5: Process of causation: ideational and structural change (OMT)



Source: Author (2018)

At the same time, this policy fundamentally altered a major plank of ECB ideational orthodoxy which had shaped the previous 13 years of EMU (Blackstone and Walker 2012; Micossi 2015, p.19). The bank effectively reinterpreted its own mandate to include responsibility for preserving the euro as well as price stability (Matthijs 2016, p.380):

> *In contrast to both the initial purchases of government bonds and possible quantitative easing, the programme of Outright Monetary Transactions (OMTs) is aimed at a very specific risk, namely the so-called tail risk of the Euroarea falling apart*
>
> (Draghi 2014[d], no page)

OMT required a significant degree of conceptual stretching (Cox 2004, p.216) to encompass the policy within the ECBs price stability framework as it shifted sovereign risk onto the banks' balance sheet – mutualising potential losses, weakening market discipline and diluting the distinction between monetary and fiscal policy (Sinn 2014, p.2). Such a step was made possible largely because of the strict operational independence handed to the ECB, coupled with low-levels of structural accountability (Claeys et al. 2014). This allowed the bank to manoeuvre more freely than other European institutions (Schmidt 2016, p.1034), empowering it to move to the margins of its mandate with little recourse available for those holding alternative views (Gros 2015, p.13; Lombardi and Moschella 2016, p.858).

Although coming much later than other internationally renowned central banks, these ECB interventions targeting specific market segments overtly acknowledged that the 'neo-liberal consensus' around pre-crisis philosophical ideas no longer holds (Dyson 2002[a], p.14, Kaelberer 2003, p.368, McNamara 1998, p.170). Indeed, in some respects, pre-crisis ECB thinking has been turned on its head. Whereas before the crisis the bank argued price stability was the most effective policy a central bank could pursue to ensure financial stability (Duisenberg 2003; Issing 1999[a]), it now also argues the reverse: that financial stability is necessary for a functioning interest rate transmission mechanism and the maintenance of price stability[254] (ECB 2011[b], p.83; Papademos 2009; Trichet 2010[a]).

[254] 'The ECB does believe that, and does stand on the fact that price and financial stability complement each other, meaning that price stability helps to improve financial stability and vis-a-versa. Not least because a more stable financial system helps the transmission of monetary policy signals and thereby helps anchor inflation expectations and control inflation – so this complementarity exists' (ECB: interview #4, 2015).

Yet the commitment to price stability has remained constant. As the quote below from a former ECB Economist makes clear, traditional programmatic ideas have not dissolved entirely and orthodox monetary tools are still preferred:

> *I think what has really changed is the way people are trying to think... I think people are looking at financial variables and financial analysis much more than they did before… But I wouldn't say there has been any shifting* [in monetary policy]*… Why? Because they believed they had the right model, and they still believe they have the right model for deciding upon monetary policy in the Euroarea*
>
> (ECB: interview #2, 2015)

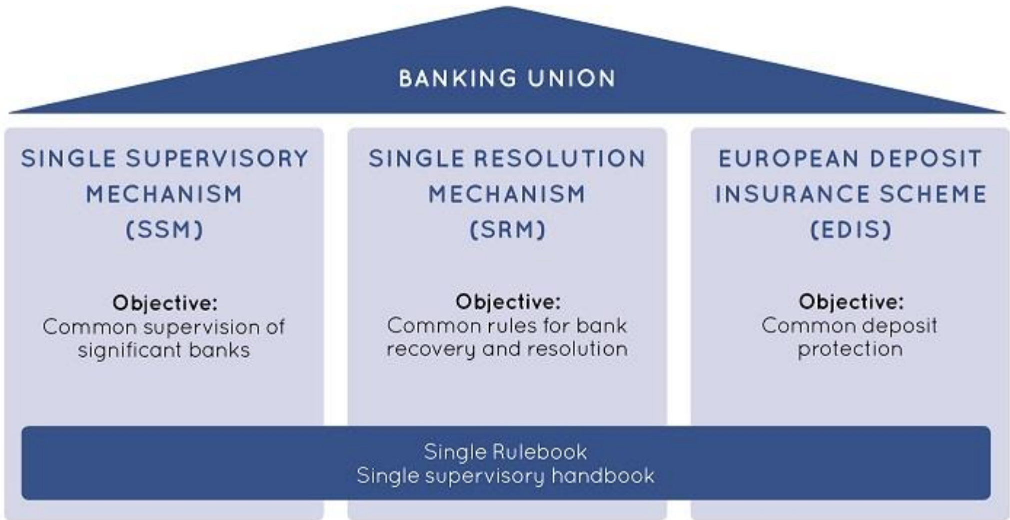
Indeed, whilst significant structural and ideational change took place to address the contradictions of the Maastricht framework, many of these changes were implemented with a view to maintaining path-dependence in monetary policy (Draghi 2012[b]; 2014[d]; Issing 2008, p.86; Yiangou et al. 2013, p.231). To accurately grasp why institutional change at the EU-level evolved as it did, it is therefore necessary to understand how Europe's integrated and market-based financial environment developed in response to ECB and Commission attempts improve monetary transmission. This then gave rise to financial policy ideas which aimed to address Maastricht's incongruities, while simultaneously preserving traditional monetarist programmatic ideas in the field of monetary policy. Policies adopted at the EU-level throughout this period should therefore be viewed as an attempt to incorporate both sets of ideas into the structure of EMU, without fundamentally reconstructing the institutional fabric of the Eurosystem which would have damaged the ECBs credibility and necessitated a change to the treaties[255].

[255] Something few were willing to countenance (Commission: interview #18, 2015).

Banking Union

In September 2012, just over 3 months after the collapse of Bankia, the Commission unveiled proposals for a European Banking Union (BU) in a further effort to break the doom loop between weak banks and sovereigns (van Rompuy et al. 2012[a]). This was to consist of a Single Supervisory Mechanism (SSM) for banks, handing the ECB 'ultimate responsibility for banking supervision' (van Rompuy et al. 2012[a], p.6); a Single Resolution Mechanism (SRM) for resolving insolvent banks, backed up with a Single Resolution Fund (SRF) to help finance resolutions; a common Deposit Guarantee Scheme (DGS); a common fiscal backstop

Figure 7.6: Illustration of Eurosystem Banking Union



Source: Bank of Austria (*Oesterreichische Nationalbank*, 2017)
https://www.oenb.at/en/financial-market/three-pillars-banking-union.html

of temporary support to act as LOLR for banks (handed to ESM); and a Single European Rulebook to apply to all EU states (Constâncio 2013; Schild 2015, p.4; van Rompuy et al. 2012[b]).

The report stated in its conclusions that the ECB should be handed micro-prudential supervisory authority as well as responsibility for MPR (van Rompuy et al. 2012[a], p.2[256]), marking a huge turnaround from recommendations made just three years earlier in the de Larosière Report (2009). That report had claimed handing the ECB direct supervisory power over financial institutions would result in political pressure that could jeopardise the banks' independence and ultimately endanger price stability (de Larosière 2009, p.43).

Placing the bank in charge of financial supervision made monetarists distinctly uneasy because it increased the risk of monetary and financial policy decisions coming into conflict (DB: interview #5, 2015). If, for example, it was felt interest rates should be raised to protect price stability, but doing so would increase funding costs for banks and therefore exacerbate the risk of financial instability, the ECB may face a significant regulatory dilemma (Claeys et al. 2014, p.11; Copelovitch and Singer 2008, p.663). Indeed, the view of the DB on this point could hardly be clearer[257]:

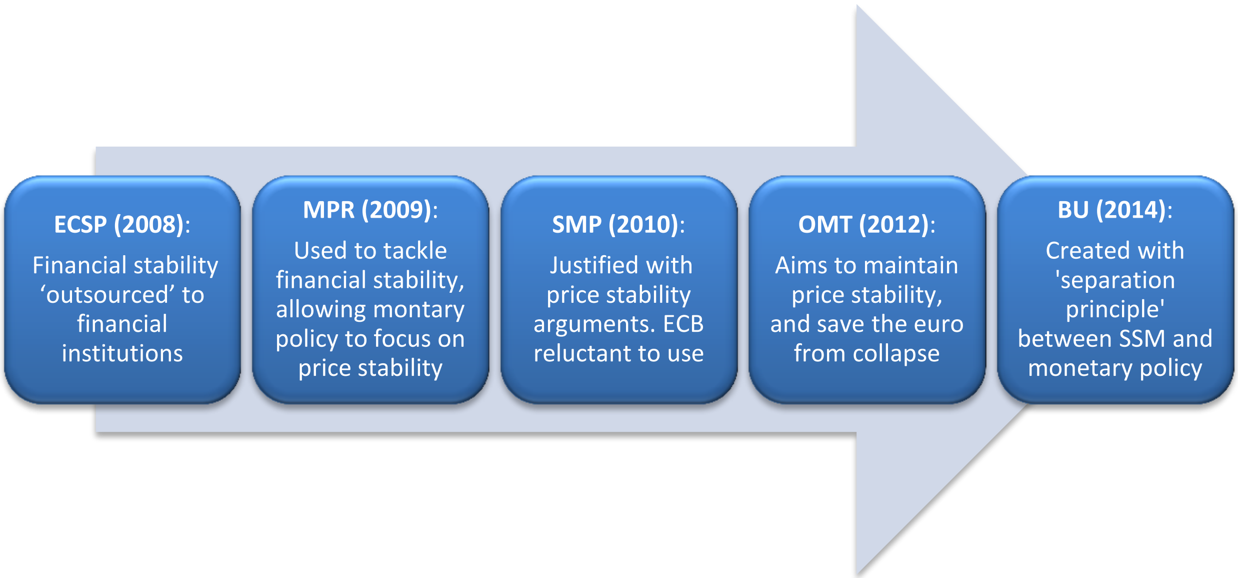
> *This is very clear. Banking supervision should be in a separate institution to the ECB. This should have been done when setting up European banking supervision… This is a danger and this needs to be managed. It is a flaw in the European institutional framework. The Bundesbank has always been very clear, and it is also my personal view, that this is absolutely necessary to get banking supervision out of the ECB*
>
> (DB: interview #5)

Nevertheless, despite these objections, the ECB was handed supervisory authority over SSM. But to try to neutralise concerns about operational conflicts and threats to its independence, the bank maintained a clear distinction between its monetary and

[256] The full Report was published in December and entitled: *Towards Genuine Economic and Monetary Union* (2012). It was also referred to as the '4 Presidents Report'.
[257] See also: DB 2014, (p.71) and DB 2013[a], (p.34).

supervisory commitments (Mersch 2013). Indeed, the separation principle is now no longer viewed as a separation between monetary policy objectives and liquidity operations used to steer short-term interest rates (which have become virtually indistinguishable), but as a separation between monetary policy and micro-prudential supervision (ECB 2014[b]; ECB: interview #2, 2015[258]). This is a further example of a trend visible throughout EMU whereby the ECB has attempted to create new instruments to tackle financial instability whilst aiming to maintain path-dependence in pursuit of price stability (figure 7.7).

Figure 7.7: ECB attempts to integrate financial stability policy ideas with its path-dependent commitment to price stability



Source: Author (2018)

[258] ‘I think what’s important for the separation principle is that the decisions are prepared on a separate basis… I should assess my information that I have on economic developments to achieve the objective the central bank - or the monetary policy side… The same is true for the supervisory side who also look at this information and accesses this information form their perspective and prepare decisions towards their supervisory objective. As you know, in terms of decision making, there’s certainly some interaction that the Governing Council in a non-objection procedure has to look at the supervisors decisions, but it also of course has the monetary policy decisions… I think from the perspective of keeping objectives and tools separate, I think that’s probably not so difficult, in my view’ (ECB: interview #2, 2015).

Yet the ECBs involvement in micro-prudential supervision is evidence nonetheless that orthodox monetarist programmatic ideas have been eroded significantly. While it was originally argued the manipulation of interest rates was all that was required to maintain price stability (Hämäläinen 2002; Noyer 1999[a]), and that central banks should not target financial objectives (Issing 1999[a]; Noyer 1999[b]), the ECB now argues it is necessary to tackle financial instability through both micro- and macro-prudential regulation to uphold its primary objective:

> *This combining of monetary and supervisory functions reflects the fact that, for monetary policy authorities, financial stability is obviously key. A stable financial system with sound and solvent banks supports the smooth transmission of monetary policy and ultimately contributes to macroeconomic stability… Conversely, financial imbalances can be a genuine threat to price stability*
>
> (Mersch 2013, no page)

While insights from DI concerning the strength of ideas and how they are communicated help conceptualise the process of ideational and institutional change throughout EMU, the overall objective of maintaining price stability has remained constant and is best explained using insights from HI. From the pre-crisis monitoring of financial data to the formation of a mission statement on financial stability (Trichet 2005[a]), to the post-crisis creation of ECSP, CBPP, SMP, OMT, and the establishment of BU, the ECB has progressively obtained ever greater responsibility for protecting financial stability. But at every turn, policies have been justified on the grounds of defending price stability, and the legitimacy and credibility of the bank remains tied to its preservation (ECB 2011[b], p.91; Högenauer and Howarth 2016; Hughes and Kesting 2014, p.333). This institutional evolution occurred not as a response to one financial trauma, but advanced incrementally through financial policy ideas which were developed to manage the structural paradoxes of EMU[259].

BU nevertheless remains incomplete (Commission 2012[a]; Howarth and Quaglia 2015, p.476; Véron 2015, p.5). National governments have retained vetoes over whether or not resolution processes should be triggered for banks within their jurisdiction (Gabor 2014[b], p.3), and the creation of a common DGS has been shelved due to member-states reluctance to risk-share and establish fiscal transfers which may generate moral hazard (Donnelly 2014; Feldstein 2011, p.7; Lagarde 2013; Sibert 2009, p.7). Many European nations remain strongly opposed to initiatives that would see domestic bank deposits being used to rescue savers in other countries, and which would shift EMU irrevocably from its siloed institutional structure (Strupczewski and Heinrich 2015; Yiangou et al. 2013, p.231).

7.3 Conclusion

Why has the ECB become increasingly attentive to financial stability concerns?

Using process tracing, this chapter analysed the process through which institutional change has taken place at the EU-level since the 2007-8 financial crisis. It established causality between ideational and structural imperatives which have both enabled and constrained

[259] EMU created a currency union in which monetary policy was delivered through the manipulation of interest rates which required integrated interbank markets; whilst simultaneously aiming to promote fiscal conservativism by harnessing market discipline in the sovereign debt markets.

the advance of Europe’s financial stability agenda, and improved our understanding of how and why institutional change takes place. Since 2007-8, EMUs original Maastricht framework has been substantially weakened. The old distinctions between financial, monetary and fiscal policy have become blurred (Bibow 2015, p.26; Borio 2010, p.11), and the ECB no longer holds non-interventionist policy ideas in relation to financial stability. It is no longer true to say that the ECB believes the best thing a central bank can do to aid financial stability is to ensure price stability. Consequently, the ECB can no longer meaningfully be described as ‘the Bundesbank writ large’ (Dyson 2002[b], p.186), not least because of the DB’s relentless post-crisis disapproval of its actions (Blackstone and Walker 2012; Hesse et al. 2016).

Yet this transition should not be viewed as a ‘punctuated equilibrium’ (Krasner 1988) enabled solely as a result of critical junctures (Capoccia and Kelemen 2007, p.341; Thelen 1999, p.388). Change evolved gradually, beginning, as chapter 5 showed, with closer financial integration and the subsequent weakening of market discipline in the sovereign bond markets. This unfolded as a result of traditional monetarist ideas aiming to improve the transmission of monetary policy by promoting capital market integration (Gabor and Ban 2016, p.618; Issing 2008, p.214; Tumpel-Gugerell 2005). Change was then accelerated by the financial crisis as the EU and ECB became increasingly interventionist in the pursuit of financial stability. Institutional innovation developed through the creation of the ESFS, and by the ECB evoking interventionist policy ideas in the form of the ECSP, LTROs and CBPP, which further weakened Maastricht’s original architecture.

The critical juncture of the sovereign debt crisis later exposed the incompatibility of attaining each of Maastricht's three original policy objectives: of maintaining a harmonised monetary transmission channel in the pursuit of price stability; of encouraging market discipline in the sovereign bond markets; and of maintaining a separation between monetary, financial and fiscal policy - within an integrated and market-based financial system. This realisation lead the ECB to exploit its institutional independence, implement further interventionist measures and to begin operating at the limits of its mandate (Lombardi and Moschella 2016, p.858; Gros 2015, p.13) by reinterpreting its objectives to include preserving the euro as well as price stability (Matthijs 2016, p.380; Schmidt 2016, p.1049). This conceptual stretching (Cox 2004, p.216) facilitated ventures into policy areas the ECB would never have countenanced before the crisis, and culminated with the bank acting as the 'market-maker of last resort' by purchasing EU government bonds (Gabor and Vestergaard 2018; Le Maux 2017), and by becoming the financial supervisor to the entire Eurozone.

But crucially, many of these policies were intended to facilitate path-dependence in the field of monetary policy. The ECSP attempted to outsource financial stability to financial institutions (Buiter and Rahbari 2012, p.28; Gabor 2014[a], p.200), CBPP targeted covered bonds specifically because the ECB believed purchasing these assets specifically would not constitute fiscal policy by transferring risk between member-states (Trichet 2009[b]), and MPR was adopted as a tool to help tackle financial instability whilst allowing monetary policy to remain focused on price stability (Papademos 2009). Therefore despite developing interventionist policy ideas which weakened traditional neo-liberal philosophical ideas and the siloed institutional framework of EMU, the ECB attempted to uphold its programmatic ideas in the field of monetary policy where it derived the lion's share of its credibility and legitimacy (ECB 2011[b], p.91; Högenauer and Howarth 2016; Hughes and Kesting 2014, p.333).

Indeed, despite the structural and ideational changes which have taken place since the financial crisis, the bank still operates and communicates distinctively from other major central banks (Constâncio 2014; Draghi 2014[c]). The ECB was founded upon monetarist programmatic ideas, which, despite changing circumstances and new and evolving policy ideas, it has found impossible to secede from entirely. It continues to assert that its traditional monetary stance is appropriate (ECB: interview #1, 2015; ECB 2011[b], p.83), and to justify 'extraordinary' policies in terms of protecting price stability. A full picture of the ECBs institutional evolution and growing concern for financial stability can therefore only be fully appreciated by using insights from HI and DI concurrently, allowing analysis to account for the impact of both ideas and institutional structures on the process of institutional change through time.

Chapter 8

Conclusion

To what extent can changing ideas and intuitional structures explain the evolution of the Europe's financial stability agenda?

This thesis enhanced the analysis of the Euroarea's financial system and advanced our understanding of institutional change in a number of ways. Although not the first study to explore the importance of ideas and structures, it is the only research to date to have combined insights from Historical (HI) and Discursive Institutionalism (DI) to examine the Eurosystem. Moreover, whereas most research on the Eurosystem tends to focus on either the national or supranational levels (Bulmer and Paterson 2013; Hardie and Howarth 2005; Royo 2013[a,b,c]), this thesis examined both to provide a more rounded picture of institutional change.

Whilst there has been a good deal of research produced since the 2007-8 financial crisis on the European Central Banks' (ECBs) response to the turmoil, and on national (although chiefly German) preferences relating to European Union (EU) policies aimed at reducing financial instability (Bibow 2017; 2013; Bulmer 2014), the vast majority of such work has focused on economic, rational-choice, or liberal intergovernmental[260] explanations (Bulmer and Paterson 2013; Jones et al. 2016; Schild 2015). There has been relatively little examining

[260] For an example of the liberal-intergovernmental approach, see: Schimmelfennig, F., 2015. Liberal intergovernmentalism and the euro area crisis. *Journal of European Public Policy* [online], 22(2), pp.177-195

the importance of ideas on post-crisis financial policy formation[261] (Hughes and Kesting 2014, p.336). Because institutions are often founded on an ideational premise (Dyson 2002[a]; McNamara 1998), with ideas constantly evoked as justification by policymakers (Jabko 2006; Schmidt 2016, 2014) or even regarded as the primary drivers of policy action [Matthijs 2016], the neglect of ideas and the way they interact with organisational structures to help enable and constrain institutional change is a serious omission.

Most studies concentrating on the supranational level have tended to emphasise ECB path-dependence, downplaying the significance of ideational, structural and policy alterations (Hardie and Howarth 2005; Quaglia 2008; Salines et al. 2011). In contrast, this research examined continuity and change in equal measure. It provided explanations for the gradual elevation in importance attached to financial stability, and for the incremental transfer of responsibility for its preservation away from member-states towards the EU-level.

The remainder of this conclusion provides an answer to the main research question by demonstrating instances where ideas and structures have influenced the evolution of Europe’s financial stability agenda. Using the matrix below (which has been referenced throughout this thesis), it shows how examples of institutional change may be categorised to better understand the relationship between ideas, structures and institutional change.

[261] With a few notable exceptions, see Blyth and Matthijs (2016), De Rynck (2014) and Schmidt (2016).

Table 8.1: Ideational versus structural matrix (revisited)

A) ideas trump structures	**->**	**institutional change**
B) structures trump ideas	**->**	**institutional continuity**
C) new ideas in old institutions	**->**	**accelerate policy change**
i) new philosophical ideas	->	strongest institutional resistance
ii) new programmatic ideas	->	strong institutional resistance
iii) new policy ideas	->	least institutional resistance
D) established ideas in new institutions	**->**	**hinder policy change**
i) established philosophical ideas	->	strongest institutional resistance
ii) established programmatic ideas	->	strong institutional resistance
iii) established policy ideas	->	least institutional resistance
E) new ideas in new institutions	**->**	**rapid policy change**
F) established ideas in old institutions	**->**	**sluggish policy change**
G) ideational contradictions or failures	**->**	**gradual policy / institutional change**
H) 'critical juncture'	**->**	**rapid policy / institutional change**
I) ridged legal structure	**->**	**hinders policy / institutional change**

Source: Author (2018)

Ideas as Agents of Change

One of the key findings of this research is that, in line with DI, ideas are particularly adept at helping transform institutions progressively through time (Schmidt 2008, p.316). It unearthed several instances where this could be proved. The gradual dominance of neo-liberal philosophical ideas and monetarist programmatic ideas resulting from the discrediting of post-war Keynesianism led to a steady liberalisation of economic practices across the developed world. This gave rise to structural change in the form of market-based banking and price stability policy ideas becoming adopted by the majority of the world's advanced central banks (Deeg 2010; McNamara 1998, p.50; Padoa-Schioppa 1999[b]).

G) ideational contradictions or failures	**->**	**gradual policy / institutional change**
Inflation and poor economic performance in the 1970s discredited Keynesian ideas which were gradually replaced with neo-liberal philosophical and monetarist programmatic ideas.		

Illustration 8.1

Within Europe, these ideas and policies were activity promoted by the European Commission and imported with varying degrees of enthusiasm into the institutional character of member-states (Jabko 2006; Story and Walter 1997, p.254; Underhill 2002, p.36). Liberal ideas were embraced by the *Deutsche Bundesbank* (DB) and *Banco de España* (BdE). Although the DB was reluctant to liberalise short-term debt markets, neo-liberal ideas coalesced with traditional ordo-liberal (*Ordnungspolitik*) concepts (Jabko 2006, p.20; Lutz 2005, p.141) and were promoted by German state institutions. In Spain, liberalisation ensued the collapse of the Franco regime in 1975 and the neo-liberal reformist agenda within the Finance Ministry and BdE's Research Service (Ban 2016; Brias 2002; Lukauskas 1997, p.97-8). Advancing neo-liberal policies was also seen as a way of modernising Spain's centralised clientelist economy and better aligning the country with contemporary European practices[262] (López 2014, p.76; Menéndez-Alarcón 2000, p.334; Zapatero 2010).

[262] Although these policies were successful, liberalisation in Spain was not accomplished to the same degree as in Anglo-Saxon countries, and Spain is still regarded as a state influenced or mixed-market economy (Molina and Rhodes 2007; Schmidt 2007).

C) new ideas in old institutions	**->**	**accelerate policy change**
Neo-liberal ideas were adopted by Spanish and German NCBs and finance ministries, accelerating the processes of liberalisation and market-based financing.		
Illustration 8.2		

Further gradual ideational change took place through the growth of financial policy ideas at the EU-level. At the euro's founding, it was widely believed the only contribution a central bank could make to help preserve financial stability was to ensure price stability by manipulating interest rates (Bernanke and Gertler 2000, p.46; Blanchard and Galí 2007, p.36; Noyer 1999[b]). Competence over the supervision of banks and responsibility for fiscal policy was left to member-states, with a strict separation maintained between the three policy areas (Bibow 2015; Dermine 2002, p.4). Yet chapter 5 showed how financial policy ideas – particularly with respect to financial integration and financial stability – grew in importance throughout the pre-crisis era.

Under EMU, ECB monetarist ideas professed that a truly single monetary policy required a harmonisation of European capital markets (Issing 2008, p.214; Tumpel-Gugerell 2005). This led to closer financial integration, greater risk of financial contagion and a growing awareness that the EU needed to become involved in efforts to maintain financial stability[263] (Commission 2007[b], p.37; Trichet 2004[a]). During the pre-crisis period, measures taken to this effect included: producing a mission statement on financial stability in 2005; increasing transparency; producing an assessment of financial market liquidity in

[263] Particularly after Jean-Claude Trichet became ECB President in 2003.

monetary analysis; price stability analysis being conducted over a longer-term; and the publication of regular *Financial Stability Reviews* from 2004 onwards (Papademos 2007[a]).

E) new ideas in new institutions -> rapid policy change
New financial policy ideas rapidly gained traction within EMU, particularly after Jean-Claude Trichet became ECB President. Yet due to the strength of 'programmatic' monetarist ideas, radical change was avoided until after the 2007-8 crisis. Illustration 8.3

In Spain and Germany too, the gradual liberalisation of financial markets and the advance of market-based finance began to generate important changes, weakening their respective bank-based three-pillar financial systems (Dixon 2012, p.591; Grossman 2006; Lütz 2004). In Germany, due to the DB and Ministry of Finance's desire to maintain Germany as a key European financial centre, and to preserve the country as a benchmark issuer of European debt, its repo and commercial paper markets were liberalised (despite DB hesitancy) during the 1990s (McCauley 1999; DB 1996, p.29). Partly as a consequence of this liberalisation, and the bottom-up, non-interventionist policy ideas pursued by the DB[264], financial institutions accumulated huge amounts of risk on the asset-side of their balance sheets.

In Spain meanwhile, despite an early liberalisation of interbank markets, banks primarily complied risk on the liabilities-side (Royo 2013[a], p.154). As a result of the BdE's particular interpretation of monetarism (Ban 2016, p.46), it developed interventionist financial policy ideas and implemented important countercyclical regulatory and accounting practices (BdE 2001, p.43; Fernández de Lis et al. 2000). This meant Spanish banks were forced to set aside

[264] Which were derived from its ordo-liberal philosophical ideas.

additional provisions, were largely prevented from originating synthetic securitisations, and did not rely on repo markets for funding. Instead, public banks in particular over-lent to the housing and construction sectors which struggled to repay loans once the financial crisis struck (Garicano 2012[b]; Royo 2013[a], p.637; 2013[b] p.153). These different ideas within the DB and BdE had a significant bearing on the severity and timing of the crisis in each country, with Germany impacted almost immediately in 2007 and Spain much later in 2010.

A) ideas trump structures	**->**	**institutional change**
NCB financial policy ideas had a direct impact on the way financial institutions adapted to market-based practices before 2007.		

Illustration 8.4

Within the ECB, the financial crisis acted as a catalyst for ideational change already underway (Posner 2007, p.145). European financial integration and market-based banking meant contagion effects across the Eurozone became amplified from 2007 onwards. This increased the need for financial policy ideas which began to further weaken traditional monetarist programmatic ideas. The Enhanced Credit Support Program (ECSP) (2008) and Covered Bond Purchase Program (CBPP) (2009) used monetary policy to support financial institutions and target asset markets (Trichet 2008[f]). These financially focused programs carried implications for fiscal redistribution and therefore also for the ECBs traditional independence and price stability orientation (Beirne et al. 2011; Borio 2010, p.11; Kirshner 2003).

Once the critical juncture of the 2010-12 sovereign debt crisis began to envelop the continent, financial ideas evolved more quickly. The ECB realised that in an integrated market-based financial system, it became necessary not only to manipulate traditional monetary policy, but to pursue financial stability too to deliver a financial environment in which price stability could be maintained. Consequently, in 2010, the bank became the market-maker of last resort (Gabor 2016; Le Maux 2017; Mehrling 2016) by purchasing Eurozone government bonds through the Securities Markets Program (SMP) and later through the Outright Monetary Transactions Program (OMT). These policies represented significant deviations away from traditional monetarist principles (Blackstone and Walker 2012; Micossi 2015, p.19) and towards greater intervention. Whereas before the crisis price stability was seen as a necessary condition to achieve financial stability (Duisenberg 2003; Issing 1999[a]), post-crisis the ECB executives argued the reverse: that action was required to stabilise financial markets in order to guarantee long-term price stability (ECB 2011[b], p.83; Papademos 2009; Trichet 2010[a]). This represents a fundamental reorientation of pre-crisis thinking.

OMT was particularly important because not only did the policy significantly alter the ECBs previous discursive approach which sought to play down the significance of heterodox policies, it also encompassed a conceptual stretching of the banks' mandate to include preserving EMU (Cox 2004, p.216; Matthijs 2016, p.380; Schmidt 2016, p.1049). The ECB understood that under strained financial conditions, unless it was prepared to stand behind the currency and support Eurozone sovereigns, there was a real danger peripheral states would be forced to redenominate their debt (Draghi 2014[d]), causing very significant transaction costs, particularly for creditor states. At this critical juncture, the sunk costs involved in such a failure catalysed further ideational and discursive change. This reality demonstrates how insights from DI and HI are both required to provide a more rounded understanding of institutional change.

G) ideational contradictions or failures	**->**	**gradual policy / institutional change**
The twin crises of 2007-8 and 2010-12 exposed the inherent contradictions of the Maastricht framework[265]. This led to a realisation that if the ECB was to maintain price stability within an integrated, market-based financial system, interventionist financial policy ideas would be unavoidable.		

Illustration 8.5

Ideational concerns were also crucial in the creation of Banking Union (BU) (Howarth and Quaglia 2016, p.89). Chapter 7 showed that after the collapse of Bankia, the Spanish government became unable to recapitalise its financial system, necessitating a request for assistance from the European Stability Mechanism (ESM). Although Germany was at first reluctant to agree BU and to see its *Landesbanken* submit to European supervision (Fox 2012), Germany and other states eventually agreed to a common fiscal backstop for European banks on the proviso that harmonised European supervision was introduced to limit moral hazard and regulatory arbitrage (Finnish Finance Minister 2012). These philosophical ordo-liberal (*Ordnungspolitik*) moral hazard concerns led directly to the creation of BU.

The more interventionist approach of the Single Supervisory Mechanism (SSM) to the regulation of banks also aligned closely to Spanish financial policy ideas, partly helping to explain Spain's enthusiasm for the project. In Spain, memories of previous banking crises

[265] Which sought to prevent the ECB engaging with financial and fiscal policies while handing the bank responsibility for maintaining price stability (and a harmonised interest rates transmission mechanism) within an integrated, market-based financial environment.

crafted a desire for more intrusive state involvement in the monitoring of bank operations (Molina and Rhodes 2007, p.234; Lukauskas 1997, p.167). These interventions became more advanced throughout EMU in the form of dynamic provisions and consolidated shadow banking regulation (Brañanova 2012, p.6; Saurina 2009[b]). Post-crisis, the shift towards European macro-prudential regulation (MPR) therefore corresponded well with traditional Spanish ideas. However, in the Spanish case, inclusion in BU also provided much needed supervisory credibility in the wake of the crisis in the *cajas*, and this also played a very significant role in generating Spanish enthusiasm for the project (BdE: interview #6, 2015; Spanish Foreign Ministry: interview #14, 2015).

A) ideas trump structures	**->**	**institutional change**
German ordo-liberal moral hazard concerns overrode structural resistance from public banks and facilitated institutional change through the creation of ESM and BU. In Spain, BdE policy ideas aligned closely to supranational financial ideas, and the *caja* crisis meant minimal structural opposition to ESM and BU.		

Illustration 8.6

IDEAS AS CONSTRAINTS

DI suggests that ideas may be used to promote institutional continuity as well as change (Schmidt 2010, p.4; 2008, p.312; Lieberman 2002, p.698) while HI also points to policy paradigms as an important explanation of institutional path-dependence (Braun 2015; Immergut and Anderson 2008; Streek and Thelen 2005). Another important finding of this research is that ideas are most likely to exert such influences when they become rooted within institutional frameworks (Blyth et al. 2016, p.151).

Monetarist programmatic ideas became enshrined at the institutional formation of EMU (Capoccia and Kelemen 2007, p.342; Yiangou et al. 2013, p.230), becoming embedded within the treaties and in the minds of European central bankers (Hall 1993; McNamara 1998, p.144). These ideas suggest that if central banks limit themselves to preserving price stability then financial stability and economic growth naturally follow (Bernanke and Gertler 2000, p.46; Blanchard and Galí 2007, p.36; Noyer 1999[b]). The ECBs legitimacy and credibility became entwined with the successful implementation of such policies (ECB 2011[b], p.91; González-Páramo 2005; Sibert 2009, p.7). Therefore whilst European financial integration, market-based banking and collateralised finance (encouraged by monetarist and neo-liberal ideas) altered the structure of the Eurosystem, the ECB was limited prior to the crisis in the extent to which it felt able to promote policy ideas pertaining to financial stability.

Even during the crisis, the ECB attempted to uphold the distinction between monetary, fiscal and financial policy. In 2008, it outsourced financial stability to financial institutions through the ECSP (Buiter and Rahbari 2012, p.28; Gabor 2013, p.20). In 2009, it tried to restrict the fiscal policy ramifications of bond buying by limiting its purchases to covered bonds[266]. After publication of the de Larosière Report (2009), it also sought to establish a distinct set of MPR instruments to tackle threats to financial stability while preserving monetary policy to fight threats to price stability (Papademos 2009; ECB: interview #4,

[266] Covered bonds are corporate securities with recourse to a pool of assets that covers the bond if the originator of the security becomes insolvent. This recourse to the issuer distinguishes covered bonds from synthetic Asset-Backed Securities (ABSs) and was cited by the ECB as proof that purchasing covered bonds did not constitute fiscal intervention (Trichet 2009[b]).

2015)[267]. Even once the critical juncture of the sovereign debt crisis struck in 2010, it often tried to pull back from interventionist measures as early as possible and to revert to traditional monetarist instruments (Bibow 2015, p.6; Brunnermeier et al. 2016, p.322; Micossi 2015, p.19). In 2010, instead of stepping up SMP as the crisis worsened, the ECB tried to exit the use of extraordinary monetary policy (Gabor 2012; Pisani-Ferry and Wolff 2012, p.3) resulting in SMP being reinstated in 2011[268].

Whereas Quantitative Easing (QE) was used to inject central bank liquidity into the global economy and help stimulate growth elsewhere (Benford et al. 2009, p.90), ECB policy only committed to repairing the interest rate transmission mechanism in the pursuit of price stability (Cœuré 2013[b];González-Páramo 2011). The ECB even raised interest rates in 2007, 2008 and 2011 despite providing huge amounts of liquidity to the financial system and presiding over weak economic growth (Farrell and Finnemore 2016, p.585; Pisani-Ferry and Wolff 2012, p.3; Schmidt 2014). The constraining influence of monetarist ideas on ECB action was therefore irrefutable, particularly until the launch of OMT and the agreement of BU in 2012.

Throughout the period under study, the ECB also maintained a discursive path-dependent commitment to price stability (Cœuré 2013[a]; Trichet 2011). Even when the ECBs communicative discourse altered in recognition that the bank had assumed responsibility

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[267] However, while previous economic thought had considered markets to be efficient and therefore un-requiring of countercyclical measures, the adoption of MPR necessarily accepted the fallacy of this argument and the need for policy-makers to become much more active in the pursuit of financial stability (Baker 2013, p.116; Moschella 2014, p.143). MPR allowed the ECB to maintain its programmatic ideas in relation to monetary policy, while weakening traditional philosophical neo-liberal ideas.

[268] And also leading to the resignations of Stark and Weber from the ECBs Governing Council (Blackstone 2011; Carrel 2011; Weber 2011).

for saving the euro as well as preserving price stability[269] (Schmidt 2014, p.202), it still justified its actions by making price stability arguments (Constâncio 2014; Draghi 2012[b]). Programmatic monetarist ideas therefore acted as a discursive foundation throughout the duration of this research and remain important in maintaining the banks legitimacy and credibility.

D) established ideas in new institutions	**->**	**hinder policy change**
ii) established programmatic ideas	->	strong structural resistance
The ECB relied upon monetarist ideas for credibility and legitimacy. Although the bank became increasingly interventionist during the crisis, such policies were implemented reluctantly, delaying more radical policy decisions and constraining institutional change.		

Illustration 8.7

At the national level too, ideas were shown to exert path-dependent forces on policymaking. This was particularly true in Germany where philosophical ordo-liberal (*Ordnungspolitik*) ideas had a very strong institutional foundation (Jacoby 2014, p.75; Nedergaard and Snaith 2015, p.1097; Schmidt 2014, p.194). Due to concerns about moral hazard and shared liability, Germany often sought to prevent European measures which advanced greater risk-sharing and initially attempted to prevent the creation of ESM due to unease about distributing capital across borders (Brunnermeier et al. 2016, p.218; Schäuble 2011[a]).

[269] As a result of President Draghi's speech in which he declared the ECB would do 'whatever it takes' to save the euro (Draghi 2014[d]).

At the behest of Germany (amongst others), ESM support was made conditional upon acceptance of Memorandums of Understanding (MoUs), monitoring by the Troika, debt seniority and implementation of the Fiscal Compact (Barroso 2011; ESM 2011, Art.13). ESM remained an intergovernmental body and its actions subject to unanimous agreement by all signature states (Dyson 2013, p.216). Although material interests inevitably played a role in German decision-making (German Finance Ministry: interview #12, 2015; Schild 2015, p.15), ordo-liberal (*Ordnungspolitik*) ideas were shown to have exercised a significant influence over German actions and policy preferences.

F) established ideas in old institutions -> sluggish policy change
DB ordo-liberal concerns regarding moral hazard and liability sharing made Germany reluctant to accept ESM. It only did so once mitigating provisions were included in the Treaty. Similar concerns also prevented Germany signing up to all elements of BU[270]. Illustration 8.8

THE SOVEREIGN DEBT CRISIS CRITICAL JUNCTURE (2010-12)

This research also revealed that, true to insights from HI, institutional change occurs most rapidly during critical junctures (Capoccia and Kelemen 2007, p.348). Such a juncture occurred at the supranational level during the European sovereign debt crisis.

At the institutional formation of EMU (Capoccia and Kelemen 2007, p.342), monetarist programmatic ideas were enshrined which sought to separate monetary policy from economic, fiscal and financial policies. The ridged legal structure of EMU included a ban on

[270] Particularly the common Deposit Guarantee Scheme (DGS).

monetary financing[271]; a prohibition on privileged access to financial institutions[272]; and a no-bail-out clause for governments[273]. Fiscal restraints were initiated through the Stability and Growth Pact (SGP, 1997) to cap borrowing and maintain price stability. Although chapter 5 confirmed an ideational evolution taking place within the ECB before the crisis (Padoa-Schioppa 2003; Trichet 2003), the banks' ability to take action on financial stability was largely restricted by the ridged legal structure of EMU and the dominance of monetarist ideas.

However, once the sovereign debt crisis arrived[274], these ideational and structural restraints became less resilient. The crisis created a doom loop between weak banks and sovereigns, forcing the ECB to intervene in financial markets to improve monetary policy transmission (ECB 2010[a], p.105; 2010[b], p.24; 2011[d], p.100). The ECBs independence enabled the bank to operate at the margins of its mandate (Schmidt 2016, p.1034), eventually becoming the market-maker of last resort by purchasing private and public sector debt. While these extraordinary measures resulted in the distinctions between fiscal, monetary and financial policy becoming blurred[275] (Bibow 2015, p.26; Borio 2010, p.11; Braun 2015, p.435; De Grauwe 2012[a], p.263), the sunk costs associated with a collapse of EMU were considered too great to prevent the ECB taking unorthodox action.

After the collapse of Bankia in Spain, structural demarcation between the different realms of economic policy weakened further as the ECB was placed in charge of European financial

[271] Article 123 of the Treaty on the Functioning of the European Union.
[272] Article 124 of the Treaty on the Functioning of the European Union.
[273] Article 125 of the Treaty on the Functioning of the European Union.
[274] Which began in 2010 with the Greek bailout and culminated with the collapse of Bankia in Spain.
[275] And therefore weakening EMUs Maastricht framework.

supervision (Bibow 2015, p.26; Micossi 2015, p.19; Blackstone and Walker 2012). This meant the ECB became directly responsible for both price and financial stability, despite objections from monetarist individuals and institutions, including the DB and its President, Jens Weidmann (Weidmann 2013; DB: interview #5, 2015). EMU therefore experienced significant ideational and structural change after this critical juncture, in spite of conservative attempts to maintain the Maastricht settlement.

At the national level too, despite pre-crisis calls to reform Spanish *cajas*, the country's public banking sector proved stubbornly resistant to change (Caruana 2003; 2001; Martín 2000). Once crisis struck, the BdE initially tried to resolve problems in *cajas* by encouraging them to merge with one another, but this often led to problems becoming exacerbated (Garicano 2012[a]). As Bankia[276] collapsed, Spanish bond yields reached 7 percent, and the country had no choice but to accept an ESM bailout which came with strict MoU protocols, including a commitment to restructure the *cajas* (IMF 2012[b], p.12). Unlike Germany, Spain was therefore unable to contain its financial crisis unilaterally, resulting in significant structural change.

A further example of where a critical juncture delivered institutional change was in relation to ESM. By the end of 2010 when ESM was agreed, there was a real risk Euroarea debt could be redenominated into national currencies. The likely large and damaging transaction costs resulting to Germany and other creditor states pushed them to accept the creation of ESM, despite weakening the no-bailout clause (Howarth and Quaglia 2015, p.473) and further wilting of EMUs monetarist principles (Beck and Prinz 2012, p.82; Henerlein 2015, p.21).

[276] A conglomeration of 7 smaller Spanish *cajas*.

Here again, the sunk costs associated with a collapse of the existing structure was enough to assuage German ideational concerns (leading to path-dependence in the continued existence of EMU), but further weakened EMUs original monetarist framework (Gocaj and Meunier 2013, p.248).

H) critical juncture	**->**	**rapid institutional change**
The critical juncture of the sovereign debt crisis (2010-12) hastened interventionist ECB policy change. It also facilitated institutional change at the supranational level through ESM and BU. In Spain, it forced further institutional change by obliging the government to disband *cajas* altogether. Illustration 8.9		

The Importance of Structures

This thesis also found ideas seem to be less important, and structural path-dependence more important, where political vested interests are capable of blocking reform in spite of ideational clamour for change (Bulmer 2009, p.310; Posner 2007, p.145). This was found to be most prevalent at the national level. Chapter 4 showed how despite supervisors and regulators in both countries favouring a modernisation of their respective public banking sectors (Ayadi et al. 2009, p.41; Caruana 2003, p.3-4; Hardie and Howarth 2009, p.1020), vested interests in the form of regional politicians strongly resisted reform efforts[277] (Cardinas 2013, p.16; Döring 2003, p.97; Lütz 2004, p.188; Villoria et al. 2013). Indeed, such was the resistance to change that the only significant alterations forthcoming before the crash came in response to EU competition policy (Commission 2002; Lütz 2005, p.143):

[277] The chapter included critical case studies of Bayerische Landesbank (BayernLB) and Caja de Ahorros del Mediterráneo (CAM) to highlight structural issues and the politicised nature of Spanish and German public banks.

capping political representation in the *cajas* at 50 percent, and forcing *Landesbanken* to renounce their state liability guarantees.

B) structures trump ideas	**->**	**institutional continuity**
Path-dependence and the vested interests of regional politicians prevented public bank restructuring in Spain and Germany before the crash, despite philosophical ideas within their NCBs pressing reform.		

Illustration 8.10

The legal structure of EMU, which rested on the three pillars of monetary financing prohibition, central bank independence and price stability (Issing 2008, p.54), helped slow the advance of financial policy ideas at the European level. The Maastricht Treaty (1992) created a siloed economic architecture in which monetary policy was transferred to the supranational level, while fiscal policy and financial policy remained under national control (Bibow 2015). Treaty articles were inserted which aimed to prevent the ECB venturing into alternative policy fields (Sandberg 2015, p.3). Even post-crisis, ECB policies which extended its authority into areas of fiscal and financial policy[278] were met with legal challenges[279], acting as restraints on institutional change (ECJ 2012; Roland 2013).

The three pillar structure of German finance also generated structural resistance to BU. Although the country's large banks supported BU to create a harmonised European regulatory system (Howarth and Quaglia 2016, p 53; Speyer 2013), *Landesbanken*, *Sparkassen* and the cooperatives remained opposed EU oversight which they believed could impede their traditional framework (Howarth and Quaglia 2015, p.468; Münchau 2015;

[278] Including by becoming the Eurozone's financial supervisor and market-maker of last resort.
[279] In Germany and in the European Courts of Justice (ECJ).

Strupczewski and Heinrich 2015; Zimmermann 2014, p.497). The DBs self-regulatory approach and German joint liability schemes (*Haftungsverbund*) could not easily be replicated at the supranational level (Hassan 2014; Howarth and Quaglia 2016, p.76; Howat and Theodore 2016, p.4; Zimmermann 2014, p.495), producing strong local resistance to change. Indeed, BU remains incomplete (Commission 2012[a]; Howarth and Quaglia 2015, p.476; Véron 2015, p.5). Proposals for a common DGS have been shelved (Donnelly 2014; Feldstein 2011, p.7; Lagarde 2013; Sibert 2009, p.7) and, partly as a consequence of German resistance, the ECB has only gained direct responsibility for Europe's systemically important banks, meaning smaller German banks have yet to fall under direct ECB supervision (Donnelly 2014, p.993; Karkagiannis 2012).

I) ridged legal structure	**->**	**hinders policy / institutional change**
The Maastricht framework and German three pillar system each exerted path-dependent forces which hindered institutional change, particularly prior to the sovereign debt crisis.		

Illustration 8.11

Structural factors also help to explain why financial institutions in each country accumulated risk on the opposite sides of their balance sheets before the crisis. In Germany, banks enjoyed ample liquidity pre-crisis, largely due to the inclination of Germans to save large portions of their earnings. This, coupled with the low profitability of the domestic market (Commission (2014[c], p.40; Hardie and Howarth 2009, p.1019), meant banks increasingly looked abroad for investment opportunities[280]. *Landesbanken* also benefitted from government guarantees until 2005, allowing them to raise huge amounts of cheap capital on

[280] This was particularly true of *Landesbanken*, which tended not to compete too strongly with *Sparkassen* due to their mutual ownership (Ross 2014[a]).

the wholesale markets, which they then invested in foreign ABSs (DB 2006[c], p.61; Economist 2012[b]; Hassan 2014). Moreover, while the BdE was able to implement regulation which prevented a build-up of asset-side risk in Spain, the decentralised structure of German supervision meant the DB had less capacity to employ interventionist measures (Deeg 2001, p.17; Lütz 2004, p.173; 2005, p.142).

In Spain, structural dynamics partially expound why banks and *cajas* tended not to invest in complex foreign assets, but instead amassed risk on the liabilities-side. The low interest rate environment under EMU, coupled with the banks willingness to securitise and sell mortgage loans to foreign investors, meant Spanish banks enjoyed abundant liquidity pre-crisis (BdE 2006[b]; Cardenas 2013, p.7; De Barron 2011). As a consequence of *cajas* control by regional politicians who simultaneously exercised authority over local planning laws, this capital was used predominantly to stoke a huge domestic housing and construction boom[281] (Molinas 2013).

LESSONS

These findings have important ramifications for policymakers as they demonstrate that both ideas and structures matter when it comes to institutional reform and that ideational principles can be equally as prescriptive as quantifiable measures. Greater engagement with ideational concerns and structural dynamics may therefore lead to greater understanding between parties, particularly during negotiations within international fora. It also showed that while actors are better able to reach compromise during periods of crisis, ideational

[281] This liabilities-side risk was realised once the sovereign debt crisis took hold and mortgage borrowers became unable to repay their loans.

priorities continue to be advanced and remain important in justifying policy decisions (ECB 2010[a], p.105; Trichet 2009[b]; Schäuble 2011[b]; Weidmann 2015).

The thesis also provides assistance to academics seeking to better understand and theorise when and how ideas and structures matter in political economy. Rather than continuing with the dichotomy between HI and DI, scholars may be advised to combine insights from each to provide fuller explanations of institutional continuity and change; illuminating *why* as well as *how* events unfold as they do (Schmidt 2016, p.1036).

Limitations and Future Research

The first limitation of this research was interview sampling. Although a thorough, valid and reliable piece of research may have been produced on this topic without conducting elite interviews (See Rosenhek 2013, p.256), this project aimed to deepen knowledge of institutional ideas by talking directly to individuals within institutions themselves (Lilleker 2003, p.208). Two departments, however, refused to partake in the research: the BdE's Financial Stability Department and the DB's Monetary Policy Department.

In the case of the BdE, the reason for this is likely to be that post-Bankia, its Financial Stability Department came in for particular criticism. As a consequence, interviews conducted with other BdE divisions suggest that the department's director, Jesús Saurina, blocked members of his team participating in external research which may produce results critical of its performance (BdE: interview #6 #10, 2015). In the case of the DB's Monetary Policy Department, the DB has perhaps been more critical of post-crisis ECB monetary policy than any other European central bank (Wolf 2013). The reason it refused to participate is therefore likely to be that any unguarded criticisms of the ECB from staff may have further exacerbated tensions between the two institutions, as well as threatened the ECBs independence which the DB fought so hard to establish (Howarth and Loedel 2005, p.18).

One important factor this research paid only scant attention to was the significance of leadership (Schmidt 2016, p.1043). Presidents Trichet and Draghi were both responsible for a significant shifting of ECB attitudes towards financial stability in 2003 and 2011 respectively. Within his first month of taking office, Trichet began to speak much more openly about financial stability and how the EU should respond to prevent future problems (Trichet 2003). Within just 8 months of President Draghi assuming the role, he broke with erstwhile ECB discourse by promising to do whatever it takes (Draghi 2012[a]) to save the euro, reinterpreting the ECBs mandate to include preserving EMU (Matthijs 2016, p.380).

The research also neglected other important leaders, including Chancellor Merkel, Prime Minister Rajoy and President Sarkozy, as well as the effects of interest groups, think tanks, rating agencies and investors, all of which help determine national and supranational policy objectives (Schmidt 2014, p.189). Indeed, Matthijs (2016) claims to have identified four episodes where German policy statements by crucial players were shown to have impacted directly on financial market activity (Matthijs 2016, p.385). Leadership and the influence of powerful individuals and organisations could therefore provide another fascinating area of research and help to deliver further insights into the way institutions evolve.

In an attempt to focus on the ideational and structural reasons behind Spain and Germany acting as they have under EMU, the thesis also largely ignored important material considerations which may be better analysed using a Rational Choice Institutionalist framework. While this research touched upon the contention that bailouts of peripheral nations were also implicit bailouts of the German and French financial systems (Bloomberg 2012; Fuhrmans and Moffett 2010), more focused analysis on such material considerations may reveal further insights into why some European countries post-crisis preferences took the form they did, and how important such considerations were in determining each nation's stance on ESM and BU.

The research also paid scant attention to Greece, Ireland, Portugal and Cyprus, as well as influential northern member-states, all of which helped shape the nature of the crisis. Greece in particular was the catalyst for the sovereign debt crisis and the history of EMU cannot be properly understood without knowledge of the Greek disaster. However, this thesis has intended to provide neither a comprehensive history of the Euroarea nor of the euro-crisis. It has instead tried to discover how ideas have evolved throughout EMU and why financial stability concerns transitioned from a fringe anxiety during the creation of EMU towards becoming a central preoccupation. To do this at the national level, a most similar structural comparison between countries provided more valid results than examining Greece, which was unequalled in its pre-crisis fiscal profligacy and economic mismanagement (Lynn 2011, ch.6).

This research was not an attempt to provide any deep analysis of BU, ESM or EMUs increasingly stringent fiscal architecture. It did not attempt to argue whether these institutional changes were and are positive or negative, nor give any prediction about their success or failure. Where these institutions have been referenced is solely in relation to the ideational and structural dimensions required to bring them to fruition.

Finally, an important post-crisis development this thesis did not discuss was the ECBs policy of forward guidance. This effectively involves talking to markets to manage expectations about future interest rates (Cœuré 2013[a]). Future research may combine DI and HI with quantitative research techniques to discover how ECB discourse impacts financial market movements across different Eurozone countries.

APPENDICES

Appendix I
Critical Case Study: BayernLB

Corruption and politicisation have been widespread in Germany's *Landesbanken* over a number of years (Scally 2013[b]). Even before the financial crisis, Bankgesellschaft Berlin, the then *Landesbanken* for the region of Berlin, almost bankrupted the city in 2001 when it attempted to conceal £500 million in losses relating to the sale of part of its investment business in the Cayman Islands (Paterson 2001). A more recent example, however, is Bayerische Landesbank (BayernLB), which implemented a significant number of high-risk investments that yielded huge sums for large investors and politicians, including the late populist and anti-immigration Austrian politician, Jörg Haider (Bryant 2010; Telegraph 2010).

Whilst being supervised by a number of Christian Social Union (CSU) politicians, including Edmund Stoiber[282] (the then President of the Bavarian free-state), BayernLB bought a €1.6 billion, 67.08 percent stake in the Austrian based bank Hypo Group Alpe Adria (HGAA) before the crisis in 2007 (BayernLB 2009; Detter and Fölster 2015). Stoiber played a critical role in this process, stating publically when the Croatian National Bank tried to resist BayernLB's takeover HGAA's Croatian arm, that the decision was 'unacceptable' and placed a 'severe strain' on Bavaria's relations with Croatia (Radosavljevic 2007).

[282] Others included Kurt Faltlhauser (former minister of finance), Erwin Huber (former Minister of Economics), Günter Beckstein (former Minister of the Interior) and Georg Schmid (former Secretary within the Ministry of the Interior).

HGAA conducted high-risk operations in the Balkans and Eastern Europe which soon became 'toxic' once crisis struck. This resulted in Bavarian taxpayers being forced to bailout BayernLB and a criminal investigation being launched (Ewing 2010). Several of BayernLB's former managers were placed under investigation for insider trading and later faced trial (Schäfer 2008). Many CSU politicians, including Stoiber and former CSU party leader, Erwin Huber, gave evidence as part of the enquiry (Ziet Online 2010). Although in 2014 Munich courts ruled that there was insufficient evidence to convict the men, out of court settlements were reached, with Michael Kemmer, BayernLB's former Chief Executive between 2008-2009, fined €20,000 (Ross 2014[b]).

In further controversy at the bank, Bernie Ecclestone, former Chief Executive of Formula One (F1), was also connected to a $44 million bribe said to have been paid to BayernLB's former Chief Risk Officer, Gerhard Gribkowsky, to ease the sale of the bank's shares in a holding company that had guaranteed to keep Ecclestone as F1 Chief Executive in 2006 (Le Blond 2014). Gribkowsky later served over 5 years in prison for corruption over the scandal.

Yet despite these controversies and huge losses, regional politicians continue to have a vested interest in maintaining the current structure of Germany's public banking system.

> *I think there are still a lot of vested interests in maintaining the status quo, especially in the public sector where politicians see Landesbanken and savings banks as ways of influencing economic policy*
>
> (Rawcliffe 2007[283])

[283] Managing Director for Financial Institutions at Fitch Ratings. Quoted in Hurst and Gould (2007).

Local politicians have therefore been unwilling to allow the bank to collapse or become swallowed up by rivals (New York Times 2008). BayernLB was handed a €10 billion bailout by Bavarian taxpayers in November 2008 (Schäfer 2008), the banks Supervisory Board continues to operate with regional politicians in prominent positions, and the Board remains the setter of remunerations (BayernLB 2016, p.11).

This case study helps show that path-dependence is strongest when political vested interests maintain a central position in any institutional structure. *Landesbanken* were able to repel reform efforts by federal authorities, including the DB, due to their political connections and the desire of local politicians to maintain their patronage networks (German Economics Ministry: interview #11, 2015; Hurst and Gould 2007). Despite state bailouts running directly counter to ordo-liberal philosophy[284], taxpayers were still asked to pick up the bill for *Landesbanken* failure across Germany to maintain the integrity of the country's three-pillar structure (Röper 2017; Schäfer 2008).

[284] Bailouts create 'moral hazard' by allowing firms to amass profits during good times while socialising losses in bad times (Dam and Koetter 2012; DB 2014, p.77; Pies and Sass 2010).

Appendix II
Critical Case Study: CAM

While most *cajas* experienced governance problems and political capture, Caja de Ahorros del Mediterráneo (CAM) was described as 'the worst of the worst' by BdE Governor, Miguel Ángel Fernández Ordóñez (Biot 2012), and its case neatly encapsulates the relationship between regional governments and *cajas* (Cardenas 2013, p.16).

In 1997 the autonomous community of Valencia (*comunidad autónomas de Valencia*) changed the law relating to *cajas*, allowing the ceiling for direct political appointees permitted to serve on *cajas* governing boards to rise to 28 percent. This, together with other municipal appointments (another 28 percent), ensured politicians were able to decisively control *caja* activity in the region (Santos 2014, p.19).

The law also transferred supervision of the three regional *cajas* to the *Instituto Valenciano de Finanzas*, a body with no previous experience in banking supervision (Santos 2014, p.19). The president of CAM, Modesto Crespo, was handpicked by Francisco Camps, a Popular Party (PP) politician and President of Valencia's regional government. Crespo and CAM's Director General, Roberto López Abad, then proceeded to fill the board with appointees who were incapable of scrutinising the banks activity. Such individuals included a checkout worker, a sociologist, a designer, a dance teacher, an artist and a university psychologist (Tremlett 2012).

Over six years, board members, senior executives and their families received €161m in loans, in some cases at zero percent interest (Biot 2012). Their wages were also boosted by being handed well-paid positions on the boards of companies owned or part-owned by CAM (Tremlett 2012). Like other Spanish regions where political control over planning laws and *caja* activity created huge construction booms (Royo 2013[c], p.25; Molinas 2013), Crespo and Abad helped finance many regional pet projects, including a Sydney-style opera house and the biggest aquarium in Europe (Cardenas 2013, p.17). Furthermore, just two days before the bank's collapse in July 2011, CAM lent €200 million to the Valencian government, administered by the PP, who then proceeded to block any investigation into the activities of *cajas* (Tremlett 2012).

Despite collapsing the bank and forcing the national government to provide CAM with an injection of €2.8 billion to meet its capital requirements, and a liquidity line of €3 billion to ease its sale to Banco Sabadell for the sum of €1 (Commission 2012[b]), senior executives still reportedly received a total of €13 million in early retirement packages (Cardenas 2013, p.18).

Appendix III
Example Interview Questions

Spanish Finance Ministry, Treasury and Foreign Ministry

- Can tell me a little about some of the things you are currently working on? And what your main responsibilities are day-to-day?
- Would you say that the role of the Ministry and it's interaction with European institutions changed since the 2008 crisis?
- Within Germany, much is made of the counties belief in 'ordo-liberalism' and 'stability culture'. Are there any comparably dominant ideas in Spain?
- What specific measures has the Ministry been pushing at the European level to try to aid Spain's economic and financial position? How receptive has Europe been to these calls?
- How closely do you work with the BdE? And how is policy coordinated at the European level between the two?
- Do you think the objectives of the Ministry within Europe will alter if Spain were to elect a more left-wing Government in the upcoming elections?
- Many argue German-centric price stability ideas provided the underlying economic ideology within pre-crisis EMU. Do you agree with this analysis? Has this changed post-crisis?
- Do you think disagreements between 'northern' European states, including Germany, and some of the 'southern' states are due largely to political or genuine economic differences?
- To what extent are Germany and other creditor states responsible for the Eurozone's poor economic performance since the crisis?

- How has the more ‘interventionist’ approach of the ECB post-crisis been received in Spain?
- How involved are you with the *Fondo de Restructuración Ordenado Bancaria* (FROB) bank recapitalisation fund?
- Do you think the creation of SAREB has been a success?
- In April 2012 the BdE began forcing banks to re-evaluate and disclose their refinanced loan books. Was this in response to European pressure and/or the ECB’s Comprehensive Assessment (Oct 2013)?
- Given the different levels of financial health within the Eurozone, the different lending constraints within each state, and a single European monetary policy, how important is it to retain some control over financial policy at the national level?
- How has regulation of the *caja’s* changed since the crisis?
- Before the crisis, Spain came in for much criticism regarding its ‘dynamic provisioning’ methods. What were policy-makers at the European level saying at that time?
- How hard did Spain push for the introduction of MPR at the European level, both before and after the crisis?
- Do you think what happened in Spain played an important role in Europe becoming more comfortable with MPR?
- Do you think ‘consolidated’ financial regulation worked well in Spain? Do you think the rest of Europe could learn from the Spanish example?
- Do you see a potential conflict between micro and macro-prudential regulation?

Banco de España

- Can you begin by telling tell me a little about some of the things you are currently working on? And what your main responsibilities are day-to-day?
- Generally, how do you think the role and importance of national central banks within the ECSB has changed since the 2008 crisis?
- Were Spanish central bankers reluctant to see financial oversight move away from Spain and towards the European level post-crisis?
- Within Germany, much is made of the counties believe in ‘ordo-liberalism’ and ‘stability culture’. Are there any comparable theories and ideas within Spain?
- What specific measures have the BdE been pushing at the European level to try to aid Spain’s economic and financial situation? How receptive has Europe been to these calls?
- Do you think Spain maintained a different attitude towards monetary policy than the pre-crisis consensus? Did Spain push for a different approach at the European level?
- Does the BdE see a role for monetary policy in assisting financial stability?
- Do you see a potential conflict between the objectives of price stability and financial stability?
- How has the more ‘interventionist’ approach of the ECB post-crisis been received in Spain?
- Do you see a potential for conflict between increased ECB interventionism, bond purchases and central bank independence?
- How has the regulation of *cajas* changed since the crisis?

- Before the crisis, Spain came in for much criticism regarding its ‘dynamic provisioning’ methods. What were policy-makers at the European level saying at that time?
- Did Spain push for the introduction of MPR at the European level, before and after the crisis?
- Do you think what happened in Spain played an important role in Europe becoming more comfortable with MPR?
- Do you see a potential conflict between macro and micro-prudential regulation?
- How involved are you with the *Fondo de Restructuración Ordenado Bancaria* (FROB) bank recapitalisation fund?
- Why did it take until April 2012 for the BdE to begin forcing banks to re-evaluate and disclose their refinanced loan books?
- How important was the ESM in helping the Spanish banking system to recover?
- How influential was Spain in pressuring the ECB to publish the Comprehensive Assessment (Oct 2013)?
- Do you think the creation of SAREB been a success?
- Given the different levels of financial health within the Eurozone, the different lending constraints within each state, and single European monetary policy, how important is it to retain some financial policy at the national level?
- To what extent has financial stability replaced price stability as the primary macro-economic policy concern within the Eurosystem?
- Do you see any potential conflict between the objectives of price and financial stability?

- Do you think ‘consolidated’ financial regulation worked well in Spain? Do you think the rest of Europe could learn from the Spanish example?
- Do you see a potential conflict between micro and macro-prudential regulation?
- Many argue German ordo-liberal ideas were foundational to EMU. Do you agree with this analysis? Do you think Europe is beginning to move away from this German model?
- Do you think disagreements between ‘northern’ European states, including Germany, and some of the ‘southern’ states are due largely to politics, or genuine economic differences?
- To what extent do you think Germany and other creditor states approaches to the crisis are responsible for Europe’s poor post-crisis economic performance?
- Do you think the objectives of the BdE within Europe would alter if were Spain to elect a more left-wing Government in the upcoming elections?

<u>German Finance Ministry and Economics Ministry</u>

- What are you are currently working on? And what your main responsibilities are day-to-day?
- What specific measures has the Ministry been pushing at the European level? How receptive has the EU been to these calls?
- How closely do you work with the *Bundesbank*? And how is policy coordinated at the European level between the two?
- How important is ‘ordo-liberalism’ (*Ordnungspolitik*) and ‘stability culture’ within the Ministry and to Germany more widely? Do these ideas affect the decisions, aims and objectives of the Ministry?

- Would you say Germany is pursuing an ordo-liberal agenda at the EU level?
- What reforms are being pursued in Germany, and at the European level, to improve competitiveness and make public finances sustainable?
- Is there room for economic investment and stimulus in these reforms?
- To what extent has advancing a 'Stability Culture' across the EU been pursued by the Ministry? Do you think it has worked?
- What measures did Germany requesting the Spanish to take in exchange for ESM?
- Do you think ECB monetary policy was too loose on the lead up to the crisis?
- Do you think disagreements between 'northern' European states, including Germany, and some of the 'southern' states, including France and Spain, are due largely to political or genuine economic differences?
- Why has the more 'interventionist' approach of the ECB post-crisis been so heavily criticised in Germany?
- Why has Germany been resistant to implementing Basel III fully into CRD IV?
- Why has Germany been reluctant to see the completion of Banking Union with a common bank deposit insurance scheme?
- Why has Germany been seeking to implement an amendment to the Banking Act?
- Do you think the close relationship between politicians and *Landesbanks* has created problems?
- Why has the *Landesbank* sector been so difficult to reform?
- Overall, what would you say have been the main changes within the Finance Ministry since the 2007-8 crisis?

- Would you say there been any change in terms of economic ideas within the Ministry, and Germany more widely?

Deuteche Bundesbank

- How has the role of the DB and of national central banks within the ECSB changed since the 2008 crisis?
- What powers still remain with the DB in terms of monetary and financial stability policy?
- What are you currently working on?
- What specific measures have the DB been pushing for at the European level in response to the crisis? How receptive has Europe been to these calls?
- Do you believe that the ECB has neglected it's 'price stability' approach to monetary policy post-crisis?
- Why is the more 'interventionist' approach of the ECB so unpopular in Germany?
- Do you see a potential for conflict between increased ECB interventionism, bond purchases and central bank independence?
- Do you think disagreements between 'northern' European states, including Germany, and some of the 'southern' states are due largely to politics, or genuine economic differences?
- To what extent do you think financial stability has replaced price stability as the primary macro-economic policy concern in the Eurosystem?
- Do you see any potential conflict between the objectives of price and financial stability?
- What are the DBs views on Macro-Prudential Policy?

- Do you consider there could be a potential for conflict between micro and macro-prudential policy?
- How important do you think the Spanish 'dynamic provisioning' experiments were in Europe becoming more comfortable with MPR?
- Why was Germany so reluctant to see the SSM handed responsibility for smaller German lenders and to see financial regulatory oversight move away from Germany towards the European level?
- How important are ordo-liberal ideas within the DB today?
- Is price stability so important because of Weimar hyperinflation?
- Do you believe German price stability ideas were incorporated into the ECB before the crisis? Do you believe these ideas have been retained?
- Do you think 'consolidated' financial regulation could work for the rest of Europe?

<u>European Commission</u>

- Can you tell me a little about how the Commission operates and outline the specific responsibilities of your division?
- How are policy disagreements within the Commission resolved? And how are final decisions about what to present to 'trilogue' made?
- What contact does your department, and the Commission in general, have with representatives of individual member-states and member-state institutions?
- Were national central banks and regulators reluctant to see financial oversight move away from nation states and towards the ECB and EBA?
- How has the crisis changed the role and importance of national central banks and regulators within the ECSB?

- How does your department interact with the ECB? What contact do you have?
- In what ways has the department changed in response to the 2008 financial crash?
- To what extent has financial stability become an objective for the Commission?
- How important do you consider macro-prudential regulation to be? Is it seen as the Commission's main tool in combatting financial instability?
- How important were the Spanish 'dynamic provisioning' experiments in Europe becoming more comfortable with MPR?
- Do you believe that the Spanish approach to securitisation and the regulation of shadow banking could become implemented at a European level?
- Why has the ECB been primarily charged with bringing financial stability to the Euroarea, as opposed to another institution like such as the EBA?
- Do you see any potential conflict between the objectives of price and financial stability?
- Could SSM dilute the ECB's price stability objective?
- Why was it decided to put the SSM in charge of only 130 of the EUs largest banks, whilst nearly 6,000 other banks remain supervised by national regulators?
- Given the different levels of financial health within the Eurozone and the different lending constraints within each state, how sensible is it to impose homogeneous regulation across the Euroarea?
- Do you think disagreements between 'northern' European states, including Germany, and some of the 'southern' states, including France and Spain, are due largely to political or genuine economic differences?
- How important do you consider the ESM has been in helping Europe (and particularly Spain) recover from the financial crisis?

- What further steps do you believe are necessary to create what Mr Van Rompuy called ‘a genuine economic and monetary union’?
- What challenges do you see lying ahead for the Euro and for European financial stability?

<u>European Central Bank</u>

- How would you describe the ECBs monetary policy stance before the 2008 crash?
- Has any of the models or underlying assumptions used in helping to generate ECB monetary policy changed since 2008?
- How important have financial stability concerns become in the policy decision-making process? Does this constitute a substantial shift from past thinking?
- How strictly is the ‘separation principle’ between financial and price stability policy observed? How do you view the ECBs mandate in this regard?
- Do you see any potential for conflict between a central bank pursuing both price and financial stability objectives?
- How far is the issue of credibility linked to the objective of price stability for the ECB, and for the Eurozone as a whole?
- Do you regard asset purchases as a challenge to central bank independence? How does the ECB square QE with Article 123, TFEU which forbids monetary financing, and Article 125 which forbids governmental bail-outs?
- Do you consider the rift between the ECB and DB in terms of expansionary monetary policy to be down to political pressure from within Germany, or due to a genuine difference of economic ideas?
- Do you think the ECB is moving away from its origins as the ‘Bundesbank writ-large’?

- How important were the Spanish 'dynamic provisioning' experiments in the ECB becoming more comfortable with macro-prudential regulation?
- Do you see a potential conflict between micro and macro-prudential regulation?
- Do you believe that the Spanish approach to (consolidated) securitisation and the regulation of shadow banking could become implemented at a European level?
- Now that the ECB has oversight of the SSM, SRM, uses 'extraordinary' monetary policy and is becoming increasingly interventionist, do you consider the current 'Monetary Dialogue' arrangements provide sufficient democratic oversight?

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