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United in Diversity? The Relationship between Monetary Policy and Banking Supervision in the Banking Union

SAFE Working Paper No. 178

SAFE | Sustainable Architecture for Finance in Europe
A cooperation of the Center for Financial Studies and Goethe University Frankfurt

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United in Diversity?

The Relationship between Monetary Policy and Banking Supervision in the Banking Union

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May 2017

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Electronic copy available at: https://ssrn.com/abstract=2975998

Abstract

This paper analyzes the relationship between monetary policy and financial stability in the Banking Union. There is no uniform global model regarding the relationship between monetary policy-making on the one hand, and prudential supervision on the other. Before the crisis, EU Member States followed different approaches, some of them uniting monetary and supervisory functions in one institution, others assigning them to different, neatly separated institutions. The financial crisis has underlined that monetary policy and prudential supervision deeply affect each other, especially in case of systemic events. Even in normal times, monetary and supervisory decisions might conflict with each other. After the crisis, some jurisdictions have moved towards a more holistic approach under which monetary policy takes supervisory considerations into account, while supervisory decisions pay due regard to monetary policy.

The Banking Union puts prudential supervision in the hands of the European Central Bank (ECB), the institution responsible for monetary policy. Nevertheless, at its establishment there was the political understanding that the ECB should follow a policy of meticulous separation in the discharge of its different functions. This raises the question whether the ECB may pursue a holistic approach to monetary policy and supervisory decision-making, respectively. On the basis of a purposive reading of the monetary policy mandate and the SSM Regulation, the paper answers this question in the affirmative. Effective monetary policy (or supervision) requires financial stability (or smooth monetary policy transmission). Moreover, without a holistic approach, the SSM Regulation is more likely to provoke the adoption of mutually defeating decisions by the Governing Board. The reputation of the ECB would suffer considerably under such a situation – in a field where reputation is of paramount importance for effective policy.

As any meticulous separation between monetary and supervisory functions turns out to be infeasible, the paper explores the reasons. Parting from Katharina Pistor's legal theory of finance, which puts the emphasis on exogenous factors to explain the (non)enforcement of legal rules, the paper suggests a legal instability theorem which focuses on endogenous reasons, such as law's indeterminacy, contextuality, and responsiveness to democratic deliberation.

This raises the question whether the holistic approach would be democratically legitimate under the current framework of the ESCB. The idea of technocratic legitimacy that exempts the ECB from representative structures is effectively called into question by the legal instability theorem. This does not imply that the independence of the ECB should be given up, as there are no viable alternatives to protect monetary policy against the time inconsistency problem. Rather, any solution might benefit from recognizing the ECB in its mixed technocratic and political shape as a centerpiece of European integration and improving its transparency, responsiveness, and representativeness without removing its technocratic character.

Keywords

Banking Union, Monetary Policy, Financial Stability, Single Supervisory Mechanism, Democratic Legitimacy

A. “Two Souls Alas! Are Dwelling in My Breast”

Since November 2014, the European Central Bank (ECB) has enjoyed a tremendous increase in its powers: The Unified Banking Supervisory Mechanism – known as the Single Supervisory Mechanism, or SSM – began operating under the auspices of the ECB.[1] It has since been endowed with the task of supervising by now 125 banks in the Eurozone identified as significant.[2] The establishment of the SSM was the consequence of the desire to break the diabolic loop between banking crises and sovereign debt crises triggered by bank bailouts. The 2012 Spanish and Cypriot banking crises required the respective governments to bail out certain banks, raising sovereign debt to unsustainable levels. This prompted the European Stability Mechanism (ESM) to grant financial assistance to both governments for the recapitalization of the banking sector before the situation of private and public finance would decline further. With the ESM bearing the financial burden of banking crises resulting, amongst other, from flaws in the supervision of financial institutions by the member states, calls emerged for the europeanization of the supervision of systemically important banks, including a Single Resolution Mechanism and a common deposit guarantee fund alongside the SSM.[3] This followed the logic that whichever level of government bears the financial risks should be in charge of supervision.[4]

The ECB was entrusted with hosting the SSM, not only because it appeared as the most competent institution to discharge of that task,[5] but also because Art. 127(6) TFEU offered a seemingly convenient legal basis for conferring the task to the ECB.[6] However, giving the ECB supervisory powers potentially

[1] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, p. 63–89 (hereinafter “SSM Regulation”).

[2] Comprehensively on the establishment of the Banking Union: Niamh Moloney, ‘European Banking Union: Assessing Its Risks and Resilience’ 51 *Common Market Law Review* (2014) 1609, 1616.

[3] Van Rompuy et al., ‘Towards a Genuine Economic and Monetary Union’, 26 June 2012, EUCO 120/12, 4-5. On the Spanish and Cypriot Banking Crises see Tobias H. Tröger, ‘The Single Supervisory Mechanism — Panacea or Quack Banking Regulation?’ 15 *European Business Organization Law Review* (2014) 449, 456 et seq.

[4] On this principle see already Tommaso Padoa-Schioppa, ‘EMU and Banking Supervision’ 2 *International Finance* (1999) 295.

[5] See recital 13, Regulation 1024/2013; .

[6] Moloney (n 2) 1659; Eddy Wymeersch, ‘The Single Supervisory Mechanism: Institutional Aspects’ in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford University Press 2015) 100. Whether the SSM respects the limits of Art. 127(6) TFEU is disputed. In favor, emphasizing the fact that the SSM relies on the cooperation of national authorities with the ECB and that the latter retain specific tasks: Martin Selmayr, ‘Artikel 127’ in Hans von der Groeben, Jürgen Schwarze and Armin Hatje (eds), *Europäisches Unionsrecht*, vol 3 (Nomos 2015) marginal nos 53-55; Christoph Ohler, *Bankenaufsicht und Geldpolitik in der Währungsunion* (Beck 2015) 145-6; Jörn Axel Kämmerer, ‘Bahn frei der Bankenunion? Die neuen Aufsichtsbefugnisse der EZB im Lichte der EU-Kompetenzordnung’ *Neue Zeitschrift für Verwaltungsrecht* (2013) 830, 832-4; sceptical: Christian Waldhoff and Peter Dieterich, ‘Einführung einer gemeinsamen Bankenaufsicht auf EU-Ebene - ein Überblick über die Rechtsprobleme’ *Europäisches Wirtschafts- und Steuerrecht* (2013) 72, 75; Matthias Lehmann and Cornelia Manger-Nestler, ‘Einheitlicher Europäischer Aufsichtsmechanismus: Bankenaufsicht durch die EZB’ *Zeitschrift für Bankrecht und Bankwirtschaft* (2014) 2, 6-7; Ann-Katrin Kaufhold, ‘Die Europäische Bankenunion - vollendet

raises conflicts of interest between the monetary policy and supervisory functions of the ECB, as there is a high level of interdependence between monetary policy and the stability of the financial system (B.I.).

According to one view, the institutional arrangement for the SSM should avoid such conflicts of interest. Monetary policy decisions should not be influenced by concerns about financial stability, and vice versa (B.II.). In the context of the SSM, Germany successfully insisted on that position.[7] As a result, Art. 25(2) SSM Regulation provides for the meticulous separation of the monetary policy and supervisory functions of the ECB.[8] Supervision was entrusted to a separate Supervisory Board within the ECB. While the Supervisory Board cannot take binding decisions itself as primary law requires the Governing Council to take any decisions on behalf of the ECB,[9] the Governing Council may only accept or reject, but not modify the decisions proposed by the Supervisory Board, or otherwise act upon its own initiative in supervisory matters.[10]

However, others point to the interrelation between monetary policy and financial stability and argue for a more holistic approach (B.III.). This concern is not merely theoretical. In the last years, many stakeholders articulated their concerns about the stability of the European banking system due to the permissive monetary policy stance taken by the ECB. Thus, the need of many European banks to clean their balance sheets from risky assets in order to meet new capital requirements is believed to have prevented the expansionary monetary policy of the ECB from taking full effect.[11] Also, market participants have repeatedly voiced concern over the effects of the ECB policy rate at the zero lower bound on financial stability, as it reduces bank's profitability.[12] Conversely, the ECB's Longer-Term Refinancing Operations (LTRO), monetary policy transactions offering instruments with higher interest rates and maturities of up to four years, have contributed to financial stability by providing some relief for financial institutions with otherwise low profits.[13]

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unvollendet? Eine Zwischenbilanz' 32 *Zeitschrift für Gesetzgebung* (2017) 18, 33. Instrucive on the legislative history: René Smits, *The European Central Bank. Institutional Aspects* (Kluwer Law Internat. 1997) 356.

[7] Kern Alexander, 'European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism' 40 *European Law Review* (2015) 154, 165; Kämmerer (n 6), 832.

[8] See also the Decision of the European Central Bank on the implementation of separation between the monetary policy and supervision functions of the European Central Bank of 17 September 2004, ECB/2014/39.

[9] Art. 129 and 282 (2), TFEU, in conjunction with Art. 12.1, ECB Statute.

[10] Art. 26 (8), SSM Regulation.

[11] Stefano Micossi, 'The Monetary Policy of the European Central Bank (2002 to 2015)' LUISS Guido Carli School of European Political Economy Working Paper No. 2015/4, 28.

[12] E.g. Christian Siedenbiel, 'Banken und EZB geben sich gegenseitig Schuld an der Misere', Frankfurter Allgemeine Zeitung, 5 October 2016, <http://www.faz.net/aktuell/finanzen/anleihen-zinsen/deutsche-banken-kritisieren-geldpolitik-der-ezb-14466320.html>.

[13] Martin Hellwig, 'Financial Stability, Monetary Policy, Banking Supervision, and Central Banking' Preprints of the Max Planck Institute for Research on Collective Goods <http://www.coll.mpg.de>, 3-4. On LTRO, see ECB, 'ECB announces measures to support bank lending and money market activity', Press release, 8 December 2011,

This paper takes issue with the alleged strict separation between monetary policy and financial supervision in the legal framework of the SSM. Whatever the economic merits of a more holistic approach, should the ECB opt for it, one might seriously doubt whether the SSM Regulation or the European Treaties would provide an insurmountable legal hurdle. In fact, a purposive reading of the Treaties reveals that monetary policy may take into account considerations relating to financial stability (C.I.). The same applies *mutatis mutandis* to supervisory decisions under the SSM Regulation, which should pay heeds to monetary policy transmission (C.II.). It seems that the SSM Regulation repeats past mistakes of the legal framework of Economic and Monetary Union by imposing presumably strict legal Rubicons that would hardly stand the test of practice under constantly changing, rather unpredictable cricumstances. The paper suggests a legal instability theorem, which explains this observation (C.III.). This finding casts serious doubt on the technocratic legitimacy of the ECB. It corroborates claims to step up its democratic legitimacy (D.). Ultimately, a deliberative understanding of the law, which considers the law as a guideline for procedures and argumentative processes, might be more successful for the governance of the Economic and Monetary Union (EMU) (E.).

B. Economics: From Functional Separation to Holistic Approaches?

I. The Tradeoff between Monetary Policy and Financial Stability- Accept or Ignore?

Hardly anyone would doubt today that monetary policy and the stability of financial institutions are highly interrelated. In fact, many argue hat there are tradeoffs between inflation-targeting monetary policy and prudential supervision geared towards financial stability.[14] Various channels for the transmission of monetary policy account for this interrelation. One of them is the bank lending channel. Accordingly, monetary policy affects the supply of money to banks and their refinancing conditions, hence their capacity to lend and thus their performance.[15] This has an impact upon financial stability. Another channel

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<https://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html>. See also the Decision of the European Central Bank of 29 July 2014 on measures relating to targeted longer-term refinancing operations, ECB/2014/34, OJ L 258/11 of 29 August 2014 and subsequent modifications.

[14] Ben S. Bernake, 'The Effects of the Great Recession on Central Bank Doctrine and Practice' Speech at the Federal Reserve Bank of Boston 56th Economic Conference, Boston, Massachusetts <https://www.federalreserve.gov/newsevents/speech/bernanke20111018a.htm>, 12; Ferre De Graeve, Thomas Kick and Michael Koetter, 'Monetary policy and financial (in) stability: An integrated micro–macro approach' 4 *Journal of Financial Stability* (2008) 205; Itai Agur and Maria Demertzis, 'Will Macroprudential Policy Counteract Monetary Policy's Effects on Financial Stability?' IMF Working Paper WP/15/283 (2015); Kern Alexander, 'The ECB and Banking Supervision: Building Effective Prudential Supervision?' 33 *Yearbook of European Law* (2014) 417, 423; Armin Steinbach, 'The Lender of Last Resort in the Eurozone' 53 *Common Market Law Review* (2016) 361, 367.

[15] Ben S Bernanke and Mark Gertler, 'Inside the black box: the credit channel of monetary policy transmission' National bureau of economic research Working Paper No w5146 (1995); Stefan Glatzl, *Geldpolitik und*

is the balance sheet channel. Accordingly, rising interest rates lead to decreasing bond prices as companies face higher costs of capital and as investors find it more attractive to leave their money in their bank deposits instead of investing them in the real economy.[16] This constrains the capacity of bank customers to borrow as the value of the assets they may pledge, or may have pledged, as collateral for their loans decreases.[17] Lower performance of banks as a result of lower demand for credit as well as the declining value of assets pledged as collateral give rise to stability concerns. Conversely, financial supervision affects the transmission of monetary policy by affecting the capacity of banks to create money through lending. This leads to questions about the right way of dealing with the tradeoff between monetary policy and financial stability. The choice seems to be twofold – to accept or to ignore.

II. The Theory of Functional Separation

During the decades preceding the Financial Crisis, the theory and practice of central banking frequently ignored the trade-offs between monetary policy and financial stability and preferred the institutional separation between central banks and financial supervisors. This resulted from the economic crises of the postwar era and the way they shaped economic theory.

At the time of the introduction of financial supervision alongside central banking – a process that spanned in most jurisdictions from the 19th century to the aftermath of the Great Depression or even beyond[18] – the interplay between monetary policy and financial supervision had little impact on institutional choices. Rather, the choice between an integration model, where the central bank exercises supervisory functions, or a separation model, under which supervision is assigned to a separate authority, often reflected different traditions in dealing with banking crises. The integration model derives from the function of central banks as "lenders of last resort".[19] According to Bagehot, lending of last resort should only be granted to banks with a lack of liquidity, not with solvency problems.[20] Once the central bank took over the risk of lending

Bankenaufsicht im Konflikt. Die Pflicht der Mitgliedstaaten zur Unterstützung der EZB im Bereich der Preisstabilität unter besonderer Berücksichtigung der Bankenaufsicht (Nomos 2009) 192-212.

[16] 'Why do interest rates tend to have an inverse relationship with bond prices?', Investopedia <http://www.investopedia.com/ask/answers/04/031904.asp>.

[17] Anil K Kashyap and Jeremy C Stein, 'The impact of monetary policy on bank balance sheets' 42 *Carnegie-Rochester Conference Series on Public Policy* (1995) 151.

[18] For the US: Alejandro Komai and Gary Richardson, 'A brief history of regulations regarding financial markets in the United States: 1789 to 2009' National Bureau of Economic Research Working Paper No w17443 (2011) <http://www.nber.org/papers/w17443.pdf>; for England: Forrest Capie, *The Bank of England* (Cambridge University Press 2010); for Germany: Christoph Müller, *Die Entstehung des Reichsgesetzes über das Kreditwesen vom 5. Dezember 1934* (Duncker & Humblot 2003); for France: Alain Plessis, 'The history of banks in France' in Manfred Pohl (ed), *Handbook on the History of European Banks* (Elgar 1994).

[19] Charles Goodhart and Dirk Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision Be Separated?' 47 *Oxford Economic Papers* (1995) 539, 541.

[20] Walter Bagehot, *Lombard Street. A Description of the Money Market* (1873) 48 et seq.

of last resort from informal bankers' clubs, it required detailed information about the financial situation of commercial banks to be in a position to assess their solvency in case of a crisis. This model prevailed i.a. in Great Britain between 1979 and 2000.[21] By contrast, jurisdictions where banks tend to get bailouts from the treasury rather than having the central bank act as a lender of last resort, tended to opt for a separation model and assigned financial supervision to one or multiple separate authorities within the hierarchy of government.[22] Germany is an example for this model.[23]

In the post-war period, the case for the separation model became underpinned by economic considerations relating to the interconnection between monetary policy and growth. Governments regularly providing short-term economic stimulus through expansive monetary policy. In the long term, however, such growth was not sustainable, resulting merely in higher inflation.[24] To address this time inconsistency problem, the monetarist school established by Milton Friedman called for independent central banks.[25] Along similar lines, the theory of functional separation developed by Jan Tinbergen emphasized that each regulator should only perform one task in order to carry it out with the necessary consequence and with the appropriate instruments available.[26] The central bank's policy rate was considered as a perfect instrument for inflation targeting in accordance with the neoclassical-Keynesian synthesis, but not for preventing asset bubbles and the related stability risks.[27] These functions should therefore better be assigned to different authorities.[28]

An institutional separation of monetary policy from other functions and their transfer to an independent central bank should thus protect monetary policy against short-sightened politics as well as the distractions of other economic policy objectives. This view corresponed well to the epistemology behind (neo)liberalism, which doubts the capacity of the state to perform the incredibly complex task of steering the economy in a comprehensive fashion.[29] Accordingly, singling out different functions and assigning them to different actors has the benefit of reducing complexity.

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[21] Goodhart & Schoenmaker (n 19), 539; Mike Buckle and John L. Thompson, *The UK financial system: Theory and practice* (4 edn, Manchester University Press 2004) 334 et seq.; Alexander Thiele, *Finanzaufsicht* (Mohr Siebeck 2014) 193 et seq.
[22] Goodhart and Schoenmaker (n 19) 543-4.
[23] Thiele (n 21).194-5; on the origins of the German model, which can also be traced back to the desire of the Nazi regime to control financial supervision, see Müller (n 18) 382-5.
[24] For many: Hellwig (n 13), 12-3.
[25] Friedman Milton, *A Program for Monetary Stability* (New York: Fordham University Press 1960) 77; Milton Friedman, 'The Role of Monetary Policy' 58 *The American Economic Review* (1968) 1.
[26] Jan Tinbergen, *Centralization and decentralization in economic policy* (North Holland Pub. Co. 1954) 75.
[27] Alan Greenspan, 'Economic Volatility' Proceedings of Federal Reserve Bank of Kansas City Symposium, Jackson Hole <http://www.federalreserve.gov/boarddocs/speeches/2002/20020830/default.htm>.
[28] Cf. Peter Docherty, 'Basel II and the Political Economy of Banking Regulation-Monetary Policy Interaction' 37 *International Journal of Political Economy* (2008) 82, 92-3.
[29] Cf. Friedrich von Hayek, *Law, Legislation and Liberty*, vol 1: Rules and Order (Routledge 1974) 8-31.

Subsequently, the separation model gained traction around the world since about the 1970s, and massively so during the 1990s.[30] Two historical factors contributed to this development. First, with the establishment of deposit guarantees and the expansion of the financial sector and the development of a highly liquid interbank market, the function of the central bank as a lender of last resort temporarily lost significance.[31] Second, the success of central banks in bringing the buyoning inflation rates of the 1970s under control by taking a monetarist stance and focusing on price stability recommended the separation model to policy-makers.[32] Certainly, not all Member States of the Eurozone follow the separation model. Although the independence of central banks has constitutional status,[33] no similar dogma exists with respect to the separation of monetary policy from supervisory functions.[34] Also, some jurisdictions mix elements of both models, such as the United States. While the Federal Reserve does have important supervisory powers, they do not extend over all financial institutions.[35] And there is no consensus as to whether it is preferable to have just one or several supervisory authorities.[36] Nevertheless, the trend towards a separation model has been clear.

III. After the Crisis: Towards A More Holistic Approach?

The experience of the financial crisis called the theory of functional separation into question. An overly strict separation might generate systemic risk and compromise the effective protection of financial stability. This has prompted calls for a holistic approach that unites the diverging policy goals.

As concerns systemic risk, the financial crisis provided a dramatic illustration of the disadvantages of a strictly enforced separation model in case of a systemic event. In such a situation, conducting monetary policy regardless of financial stability concerns could put the banking sector at risk. Likewise, supervisory measures that do not take due account of their monetary policy implications could jeopardize the central bank's much needed liquidity injections.[37] Ben Bernake, the Chairman of the Board of Governors of the

[30] Simone Polillo and Mauro F. Guillén, 'Globalization Pressures and the State: The Worldwide Spread of Central Bank Independence' 110 *American Journal of Sociology* (2005) 1764, 1770-1.
[31] Goodhart & Schoenmaker (n 19) 544-5.
[32] Rosa M. Lastra, 'Central Bank Independence and Financial Stability' 18 *Revista de Estabilidad Financiera* (2010) 51; Vasso P Ioannidou, 'Does monetary policy affect the central bank's role in bank supervision?' 14 *Journal of Financial Intermediation* (2005) 58, 59; Raphaël Franck and Miriam Krausz, 'Why separate monetary policy from banking supervision?' 36 *Journal of Comparative Economics* (2008) 388, 389.
[33] Art. 130, 282 (3), TFEU.
[34] Rosa María Lastra, *Legal foundations of international monetary stability* (Oxford Univ. Press 2006) 90.
[35] See chart in Federal Reserve System, *The Federal Reserve System. Purposes & Function* (10th edn, The Federal Reserve System 2016) 77.
[36] Lastra (n 34) 96.
[37] Committee on International Economic Policy and Reform, 'Rethinking Central Banking' Brookings Institution (2011) <https://www.brookings.edu/research/rethinking-central-banking/>; Hellwig (n 13) 21; Thorsten Beck and

Federal Reserve at the time, therefore went so far as to assing to systemic stability the same significance as to price stability with regard to the mandate of the Federal Reserve.[38] The De Larosière report admonished that monetary policy should take credit growth into consideration as the availability of excess liquidity during a period of low inflation had led to the buildup of risk in the banking sector.[39] With its LTRO window, the ECB adopted a monetary policy instrument that had the explicit purpose of improving financial stability, and thus, monetary policy transmission, by offering attractive conditions to commercial banks in a period characterized by low performance and little trust.[40] In that respect, LTRO shows as close an interdependence between monetary policy and financial stability as the ECB's Outright Monetary Transactions programme showed it for the relation between monetary and fiscal policy.[41] In the event of a systemic crisis, measures to protect against risk need to take a holistic stance.

But the crisis also gives reason to reconsider whether there are good reasons for a closer coordination between monetary policy and financial supervision even in normal times, outside periods of systemic risk. The crisis has refreshed awareness of the tradeoff between monetary policy and financial stability. The credit crunch has demonstrated that the transmission of the monetary policy impulses of the central bank to the financial markets and the ability of these impulses to increase or reduce the quantity of money, depends on the smooth intermediation of the financial sector.[42] Conversely, the effects of the current low-interest phase on the banking industry show how monetary policy conditions might compromise financial stability.[43] Some argue that there is therefore a need for consistency between monetary policy and financial supervision to render both effective.[44] It is unclear which goal would be served if both policies pull on the opposing ends of one and the same string.

To make matters worse, the theory of functional separation seems to be based on certain assumptions which can no longer be taken for ganted under present market conditions. Financial intermediation does

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Daniel Gros, 'Monetary Policy and Banking Supervision: Coordination Instead of Separation' CEPS Policy Brief No 286 (2012) <https://www.ceps.eu/system/files/PB286%20Banking%20Supervision%20in%20ECB.pdf>

[38] Bernake (n 14) 5.

[39] Jacques De Larosière and others, 'Report of the high-level group on financial supervision in the EU' European Commission Brussels (2009) para. 48. The ECB had recognized the need for central banks to promote systemic stability even before the crisis: Lorenzo Bini Smaghi, 'Central Bank Independence in the EU: From Theory to Practice' 14 *European Law Journal* (2008) 446, 454.

[40] See *supra* (n 13) and accompanying text.

[41] See only ECJ, Case C-62/14 *Gauweiler et al. v. Deutscher Bundestag*, ECLI:EU:C:2015:400, judgment of 16 June 2015, paras 51 and 52.

[42] Committee on International Economic Policy and Reform (n 37) 5 et seq.; Olivier Blanchard, Giovanni Dell'Ariccia and Paolo Mauro, 'Rethinking Macroeconomic Policy' IMF Staff Position Note SPN/10/03 <http://www.imf.org/~/media/websites/imf/imported-full-text-pdf/external/pubs/ft/spn/2010/_spn1003.ashx> (2010) 5.

[43] See *supra* (n 12).

[44] Rosa M. Lastra, *International financial and monetary law* (2nd edn, Oxford Univ. Press 2015) 125.

not work as smoothly as the Efficient Capital Markets Hypothesis suggests.[45] Rather, in line with Hyman Minsky's prediction, they tend to build up risk that materializes in fairly regular crisis events.[46] Further, financial liberalization has increased the possibility of the market to extend credit. There is evidence that this has reduced the influence of the central bank policy rate on effective long-term interest rates. Financial markets have gradually de-coupled themselves from the generation of the base money by the central bank.[47] Overall, however, empirical evidence concerning the impact of the different models on aggregate welfare is still scarce and fraught with uncertainties.[48]

Faced with this situation, important voices in the economic literature favor a holistic approach, where monetary policy decisions pay due regard to financial stability concerns, and where supervisory decisions account for monetary policy effects. This would outweight the reasons that supported the theory of functional separation.[49] The holistic approach would not necessarily require institutional changes as it concerns the way in which institutions exercise their mandate, i.e. the information forming the basis of their decisions as well as their attitudes.[50] It could even be implemented under a separation model provided that the central bank and the supervisory authority coordinate their decisions. Not surprisingly, proponents of this view mostly have a certain affinity for Keynesian approaches to macroeconomics, which encourage holistic thinking. The opposite view maintains that monetary policy is simply too blunt for supervisory considerations and that the functions should therefore better remain separated.[51]

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[45] Cf. Eugene F. Fama, 'Efficient capital markets: A review of theory and empirical work' 25 *The journal of Finance* (1970) 383.

[46] Cf. Hyman P. Minsky, 'The Financial Instability Hypothesis' Levy Economics Institute Working Paper No 74 <http://www.levy.org/pubs/wp74.pdf>. On the rediscovery of Minsky after the crisis, see J. Barkley Rosser, Marina V. Rosser and Mauro Gallegati, 'A Minsky-Kindleberger perspective on the financial crisis' 46 *Journal of Economic Issues* (2012) 449.

[47] Based on econometric data: Hasan Cömert, *Central banks and financial markets: the declining power of US monetary policy* (Edward Elgar Publishing 2013) 89 et seq.

[48] Rishi Goyal and others, 'A banking union for the euro area' IMF Staff Discussion Note SDN/13/01 (2013) 14; skepticism about the merits of functional separation based on a model: Wolfram Berger and Friedrich Kißmer, 'Central bank independence and financial stability: A tale of perfect harmony?' 31 *European Journal of Political Economy* (2013) 109. Evidence from before the crisis: De Graeve et al. (n 14); Ioannidou (n 32).

[49] Goodhart & Schoenmaker (n 19) 547-8; Blanchard et al. (n 42) 11-13; Committee on International Economic Policy and Reform (n 42); Hellwig (n 13) 18-19. Overview of the most pertinent arguments pro and contra holistic approaches: Erlend W. Nier, 'Financial stability frameworks and the role of central banks: lessons from the crisis' IMF Working Paper WP/09/70 (2009) 14 et seq.

[50] David Green, 'The Relationship between Micro-Macro-Prudential Supervision and Central Banking' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision* (Oxford University Press 2012) 63 (3.32).

[51] Grégory Claeys and Zsolt M Darvas, 'The financial stability risks of ultra-loose monetary policy' Bruegel Policy Contribution No 2015/03 (2015) <https://www.econstor.eu/bitstream/10419/126694/1/823936880.pdf>, 12; Stefan Laseen, Andreas Pescatori and Jarkko Turunen, 'Systemic Risk: A New Trade-off for Monetary Policy?' IMF Working Paper WP/15/142 (2015) <http://www.imf.org/external/pubs/ft/wp/2015/wp15142.pdf>.

The call for more holistic approaches has not remained without practical consequences. The most obvious one is the establishment of macroprudential, or systemic, supervision in most developed jurisdictions.[52] Microprudential supervision has also not remained unaffected. Thus, the UK Financial Services Authority was dissolved and supervisory powers were transferred to the Prudential Regulation Authority, which forms an integral part of the Bank of England. Even Germany, the textbook example for the separation model, discussed conferring supervisory powers to the Bundesbank in the crisis aftermath.[53] In contrast, the idea of a strict separation that inspired the SSM Regulation seems to lean against the wind. In fact, this is not free from contradictions. One of the motivations behind the establishment of the SSM is the desire to better protect against systemic risks, especially those stemming from the interplay between fiscal and monetary policy. However, the SSM Regulation seems to open the gates for a different kind of systemic risk, that arising at the intersection of monetary policy and financial supervision. This raises the question as to how strict the separation between monetary policy and financial supervision actually is under the existing legal framework and whether it really excludes any attempt to pursue a more holistic approach in a categorical fashion.

C. Law: Legality of a Holistic Approach to Monetary Policy and Supervision

The preferability of a holistic is a question which I readily defer to the economics profession. From a legal perspective, the salient issue is whether any such kind of holistic approach would be in conformity with the current legal framework of the Economic and Monetary Union. In my view, the question is to be answered in the affirmative. Both the mandate for monetary policy and the supervisory powers of the ECB are formulated in a relatively abstract, open manner, which gives the European Central Bank sufficient scope for a holistic approach. The ECB can take due account of its monetary policy within the scope of its supervisory functions (or to take due account of supervisory concerns within the frame of its monetary policy) as long as such influence remains proportionate to the supervisory (or monetary) policy objective. It thus turns out that the legal framework of the ECB is more or less neutral form if it comes to the politics of separation versus integration and does not necessarily subscribe to the premises of a particular school of economic thought.

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[52] Ann-Katrin Kaufhold, 'Systemaufsicht. Der Europäische Ausschuss für Systemrisiken im Finanzsystem als Ausprägung einer neuen Aufsichtsform' *Die Verwaltung* (2012) 21.
[53] L Dalla Pellegrina, Donata Masciandaro and Rosario Vega Pansini, 'The central banker as prudential supervisor: Does independence matter?' 9 *Journal of Financial Stability* (2013) 415, 415-6: "great reversal".

I. Financial Stability as a Concern for Monetary Policy

Financial stability, understood as the "a condition where the financial system is able to withstand shocks without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payments in the economy",[54] is a legitimate consideration for the ECB in the formulation of its monetary policy. According to Art. 127(1) TFEU, the ECB's primary objective in the pursuit of monetary policy is price stability. This notion is open to interpretation.[55] It lends itself to a broad reading which allows monetary policy to take prudential considerations into account, as long as other treaty provisions are respected. This results from the act that that the attainment of price stability requires consideration of financial stability. In other words, one needs to understand the concept of price stability in a more holistic sense. The argument proceeds from textual via historic and systematic to purposive reasons.

The text of the treaties does not necessarily compel a holistic reading. Art. 127 (1) TFEU does not even mention financial stability.[56] Only Art. 127 (5) TFEU stipulates that "[t]he ESCB shall contribute 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". The mere wording of this provision does not reveal whether it creates only an accessory competence for the ECB outside of its monetary policy mandate, or whether it implies that stability considerations may influence monetary policy decisions taken in accordance with Art. 127 (1) TFEU.

The drafting history reveals that the powers of the ECB with regard to financial stability were first included in the draft of Art. 3.1 of the ECB Statute – which reproduces the basic tasks of the ECB in accordance with Art. 127 (2) TFEU – but then relegated to Art. 3.3 of the ECB Statute.[57] This might imply that the powers relating to financial stability and prudential supervision are unrelated to the monetary policy mandate.

At first sight, this position appears to find confirmation in the systematic structure of the ECB Statute. Art. 25.1 of the Statute, the only provision of Chapter V on prudential supervision, assigns only an advisory

[54] Tommaso Padoa-Schioppa, 'Central banks and financial stability: exploring the land in between' in Vítor Gaspar, Philipp Hartmann and Olaf Sleijpen (eds), *The Transformation of the European Financial System* (European Central Bank 2003) 269, 287.
[55] ECJ, Case C-370/12 *Pringle vs Ireland et al.*, EU:C:2012:756, para. 53.
[56] Concluding that financial stability concerns therefore have no place in monetary policy: Helmut Siekmann, 'Missachtung rechtlicher Vorgaben des AEUV durch die Mitgliedstaaten und die EZB in der Schuldenkrise' in Thomas M. J. Möllers and Franz-Christoph Zeitler (eds), *Europa als Rechtsgemeinschaft-Währungsunion und Schuldenkrise* (Mohr Siebeck 2013) 101,145.
[57] Rosa María Lastra and Jean Victor Louis, 'European Economic and Monetary Union: History, Trends, and Prospects' 32 *Yearbook of European Law* (2013) 57, 82.

function to the ECB in supervisory matters.[58] However, the question is whether Art. 25.1 TFEU is enumerative.[59] One might as well argue that it is only enumerative for supervisory competences pursuant to Art. 127 (5) TFEU, which have no direct relation to monetary policy. The monetary policy competence of the ECB follows from Art. 127 (1) and (2) of the TFEU and does not need to be repeated in the chapter on supervision of the ECB Statute. But that alone does not *positively* empower the ECB to exercise its mandate in a holistic fashion. The same is true for the argument that it would not *contradict* the systematic structure of primary law if the ECB takes stability issues into consideration in its monetary policy, given that some National Central Banks follow an integrative model.[60] Thus, looking at the systematic structure of the TFEU and the ECB Statute does not provide a conclusive answer whether a holistic approach is admissible.

It therefore all depends on a purposive reading of the relevant provisions. Christoph Ohler argues that the interplay between monetary policy and financial supervision makes it necessary to read Art. 127 (5) TFEU expansively in the sense that monetary policy may also be guided by financial stability concerns. The liquidity of financial institutions depends after all on monetary policy.[61] One might take a further step and argue that the reverse is also true, namely that financial instability prevents effective monetary policy.[62] The effective transmission of monetary policy thus requires giving due consideration to financial stability. This recalls the argument advanced by the CJEU in *Gauweiler* to claim that measures of the ECB to ensure effective monetary policy transmission are covered by its monetary policy mandate.[63] This consideration is independent of the – still somewhat open[64] – question whether a holistic approach would produce better aggregate results, as the primary objective of monetary policy is price stability.

In conclusion, the purpose of the ECB's monetary policy mandate allows it to take into account financial stability concerns in the exercise of that mandate. In fact, financial stability considerations form an integral part of the monetary policy mandate. Along the lines of the Gauweiler case, the pursuit of financial stability concerns under the monetary policy mandate finds its limit in the proportionality principle.[65] Any tradeoff between monetary and supervisory considerations thus needs to have the objective of smoothening monetary policy transmission, and to be appropriate, necessary, and

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[58] Art. 25.1, ECB Statute. Art. 25.2 ECB Statute refers to Art. 127 (6) TFEU and has no relevance for the question under consideration.
[59] In this sense apparently Christian Waldhoff, 'Art. 127' in Helmut Siekmann (ed), *Kommentar zur Europäischen Währungsunion*, vol 2 (Mohr Siebeck 2013) marginal no. 69.
[60] Smits (n 6) 338-9.
[61] Ohler (n 6) 74.
[62] See *supra* n 42 and accompanying text.
[63] ECJ *Gauweiler* (n 41) paras 49-50.
[64] See *supra* n 48 and accompanying text.
[65] Art. 5 (4) TEU; ECJ *Gauweiler* (n 41) paras. 66 et seq.

proportionate to that objective. Where that line lies exactly is primarily entrusted to the discretion of the ECB. However, the ECB has to provide reasons, which are subject to judicial scrutiny.[66] The independence of the ECB does not stand in the way of a holistic approach, as the ECB's monetary policy pillar is exposed to the factual effects of other actors' decisions all the time anyway, whether they are political, legal, or administrative.

II. Monetary Transmission as a Concern for Financial Supervision

According to common wisdom, the SSM Regulation provides for the strict separation of the ECB's monetary and supervisory pillar. While much emphasis was put on this separation in public communications during the drafting process, the exact significance of that separation remains somewhat unclear. I argue that this separation does not stand in the way of a holistic approach to supervisory decisions which would give due consideration to monetary policy concerns. Its significance is mostly institutional. I base this argument on textual, systematic, and purposive reasons.

As concerns the wording of the SSM Regulation, it hardly reflects the public noise surrounding the separation issue during the drafting process. According to Recital 12, the SSM needs to ensure that "credit institutions are subject to supervision of the highest quality, unfettered by other, non-prudential considerations". The use of the word "unfettered" would indeed be difficult to reconcile with a holistic approach. However, the wording of article 25(2) of the SSM Regulation sets another tone. Accordingly, "[t]he ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy." The crucial terms of that provision do not appear to be as categorical and absolute as "unfettered". Thus, the terms "without prejudice to" and "[not] interfere with" seem to rule out any negative influence of supervisory decisions on monetary policy, but not necessarily beneficial ones. In that respect, it seems apposite to recall the logic of the holistic approach, which consists in exchanging short-term disadvantages against long-term mutual benefits. Making both financial supervision and monetary policy more effective in the long run can hardly be considered as prejudice or interference. The term "separate from" seems to refer to the organizational structure of the SSM within the ECB alone. Finally, for financial supervision to be "determined by" monetary policy would require monetary policy to have a dominant influence over supervision. This is not the intention behind a more holistic approach.

[66] See Art. 296 (2) TFEU; ECJ *Gauweiler* (n 41) para. 70.

The result of the textual analysis is confirmed by the context of the other provisions of the SSM Regulation. This brings the multiple institutional links that connect the monetary policy and supervisory pillars of the ECB into focus. The SSM Regulation does not establish a completely separate organization, as the theory of functional separation would have it. Despite the safeguards undertaken to separate supervisory from monetary policy decisions, such as the separation of the staff,[67] the duty to convene separate meetings of the Governing Council for each pillar, and the prohibition for the Governing Council to modify draft supervisory decisions,[68] etc., considerable linkages remain.[69] Notably, decisions concerning both pillars eventually come together in the Governing Council.[70] Further, the Chair of the Supervisory Board is appointed by the Council on the proposal of the ECB.[71] The most direct overlap concerns the position of the Vice-Chair of the Supervisory Board. She is an ex-officio member of the Governing Council and consequently participates in monetary policy decisions.[72] A comparable overlap exists in respect of the role of the President of the ECB as Chair of the European Systemic Risk Board. The provisions of Art. 25(2) SSM Regulation have to be read in light of these links. It seems difficult to deny that the latter would not relativize the former.

The purposes of monetary policy and financial supervision, respectively, corroborate the latter point. Given the mentioned tradeoffs between monetary policy and financial supervision, and taking into account the fact that financial stability also depends on smooth monetary transmission and thus the ability of the central bank to provide liquidity, at least three additional reasons support a holistic approach.

First, in democracies, decision-makers have to assume responsibility for their acts. Adopting the proposals of the Supervisory Board means that the Governing Council endorses them and accepts responsibility. But how can one accept responsibility for decisions that potentially cancel out each other?[73] It is difficult to imagine how the Governing Council or the Vice-Chair of the Supervisory Board would justify decisions that defeat each other to some extent. Apart from the paradoxical situation which this creates for the respective office holders, it would render democratic control of such decisions rather difficult. How should one criticize officeholders that adopt contradictory decisions except for the fact that they are

[67] Recitals 65 and 66, SSM Regulation.
[68] Art. 25(4), SSM Regulation.
[69] In this sense also Kämmerer (n 6) 832; Moloney (n 2) 1635; Eilis Ferran and Valia SG Babis, 'The European single supervisory mechanism' 13 *Journal of Corporate Law Studies* (2013) 255, 266.
[70] Art. 26(8), SSM Regulation.
[71] Art. 26(3), SSM Regulation.
[72] Art. 26(3) SSM Regulation.
[73] Cornelia Manger-Nestler, 'Die Bankenunion. Einheitliche Mechanismen zur Bankenaufsicht und -abwicklung' in Hermann-Josef Blanke and Stefan Pilz (eds), *Die "Fiskalunion"* (Mohr Siebeck 2014) 299, 325-6. See also Osman Sacarcelik, 'Europäische Bankenunion: Rechtliche Rahmenbedingungen und Herausforderungen der einheitlichen europäischen Bankenaufsicht' *Zeitschrift für Bank und Kapitalmarktrecht (BKR)* (2013) 353, 355.

contradictory? Adopting them at separate meetings might make the contradiction less visible, but does not eliminate it. Only a holistic approach would have that effect.

Second, if the Governing Council wants to avoid said contradictions, it seems likely to reject supervisory decisions which it believes would get into the way of monetary policy.[74] This would avoid the self-contradiction. But it would also give precedence to monetary policy over financial stability. This would be problematic on many levels. Economically, there is no reason to assume that suboptimal monetary policy would have more serious consequences than suboptimal financial supervision. Politically, it would be biased against taxpayers who might ultimately have to bear the costs of bank recapitalizations. And constitutionally, there is no reason to favor monetary policy over other economic policies. While Article 127 (1) TFEU does indeed prioritize price stability over other policy goals, that provision only applies to monetary policy and exchange rate policy, as Art. 119 (2) TFEU reveals with great clarity.[75] The separation envisaged by the SSM Regulation would end up in an asymmetry between monetary policy and supervision that seems difficult to justify.

Third, contradictory decisions would involve risks to the ECB's reputation and hence to monetary stability. Central banks depend on the trust of market participants. One possible way of earning such trust is by acting consistently. Contradictory or self-defeating measures emanating from the two pillars of the ECB would only undermine its reputation, and thereby its capacity for the effective conduct of monetary policy. The holistic approach seeks to avoid that risk.

In conclusion, contrary to the impression one might gain from the public debate, the SSM Regulation would hardly prevent a more holistic approach to financial supervision, should the ECB opt for it. The ECB, and especially the Supervisory Board, may give due consideration to monetary policy considerations in the discharge of their supervisory function, as long as this influence does not become dominant and – of course – respects the principle of proportionality.[76] The substantive rules relating to financial regulation provide many entry points for monetary policy considerations in supervisory decisions. One possible entry point is the liquidity coverage requirement[77] as well as other provisions on liquidity risk.[78] But what

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[74] Cf. Art. 26 (8), SSM Regulation.

[75] Helmut Siekmann, 'Art. 119' in Helmut Siekmann (ed), *Kommentar zur Europäischen Währungsunion* (Mohr Siebeck 2013) marginal no. 102; Waldhoff (n 59) marginal no. 7; Hugo J. Hahn and Ulrich Häde, *Währungsrecht* (2nd edn, Beck 2010) Sec. 15 marginal no. 14. Dissenting, arguing that the treaties give precedence to price stability: Manger-Nestler (n 73) 326.

[76] See *supra* n 65 and accompanying text.

[77] Art. 411 et seq., Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176/1 of 27 June 2013 ("CRR").

matters crucially for monetary policy transmission is the availability of credit to the real economy. Hence, the entire regulatory framework for capital requirements and risk management might contribute to the smooth transmission of monetary policy.

III. Towards a Legal Instability Theorem for Finance?

The foregoing analysis of the SSM Regulation holds an important lesson concerning the capacity of the law to steer behavior, and in particular to regulate issues of economic policy. That capacity is much more limited than many seem to suggest. After the no-bailout clause[79] and the concept of price stability,[80] the SSM Regulation provides yet another example of a legal rule that seemingly erects an insurmountable, rock-solid legal barrier – which then turns out to be much softer and malleable than expected faced with changing circumstances or increasing external pressure. In analogy to Minsky's financial instability hypothesis,[81] one might be tempted to propose a legal instability theorem for finance. This article might not be the right place to develop a fully-fledged legal theory. Suffice it therefore to outline with a broad brush some salient features such a theory may potentially have.

My starting point is Katharina Pistor's legal theory of finance.[82] Accordingly, the uncertainty of market developments and liquidity constraints make financial markets inherently instable. Law contributes to that instability as debts are nothing but enforceable legal obligations. In case of a crisis, many creditors try to enforce their claims at the same time, which would bring the system to a collapse. To avoid that consequence, obligations at the apex of the hierarchy of finance might not be honored to ensure the system's survival, while borrowers in the lower echelons of the financial hierarchy without systemic significance will have to pay.

All of the factors of instability observed by Pistor are exogenous to the law, including the simultaneous enforcement of contractual obligations, as this presupposes an external shock.[83] This is not surprising for a theory that is predominantly inductive and meant to explain empirically measurable causal relations. The legal instability theorem differs from Pistor's account in three respects. First, it focuses on the instability of the law rather than of financial markets; second, it considers a good deal of the sources of such

[78] E.g. Art. 86, Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, OJ L 176/338 of 27 June 2013 ("CRD IV").
[79] Art. 125 (1), TFEU.
[80] Art. 127 (1), TFEU.
[81] Minsky (n 46).
[82] Katharina Pistor, 'A legal theory of finance' 41 *Journal of Comparative Economics* (2013) 315.
[83] Id. 316.

instability as endogenous to the law – similar to Minsky's hypothesis, according to which financial instability results from the ordinary operation of financial markets and not necessarily from external shocks; and third, it considers issues of democratic legitimacy as a main driver of change – not merely power as defined by the financial hierarchy.[84]

I think that one can understand law's instability to a large extent as endogenous. This assumption derives from the hermeneutic nature of the law. Law is neither a piece of wood or iron, nor a computer program. It is a communicative practice whose existence is ultimately confined to the human mind – despite its undeniable social effects. Whether something is illegal or legal depends on processes of understanding which are based on language. The meaning of legal rules, like of language in general, derives from its usage in a certain context.[85] The meaning of legal rules therefore varies with our perceptions of their context and the construction of that context by those understanding and applying the law.[86] This makes law adaptable, especially to unpredictable and instable contexts such as financial crises. However, this comes at the cost of law's predictability. Reliance on the law to produce a certain effect in the future is therefore nearly impossible as long as one does not know that future.[87]

But how about numerical rules? Instead of a vague term like price stability, one might as well adopt a legal provision that stipulates a target of close to 2%. At this point, another feature of the hermeneutic nature of the law comes into play: one rule never comes alone; each rule is part of a context of rules that lend themselves to systematic interpretation. Interpretating a rule consists to a good deal in imagining and constructing the relations between that rule and other rules. This construction is situative, and it is therefore impossible to predict which rule will prevail. Thus, in theory, even a numerical rule might have to give precedence to another legal principle.

What, then, explains change in the law? Is it entirely dependent on subjective preferences, idiosyncratic constructions of the context of a certain rule within the legal order in a given situation? Or is change in the law simply a question of power – be it economic, political, institutional, social, moral, or cultural? While many of these factors might play a role, one should not overlook issues of democratic legitimacy – of the rules to be applied, the actors applying them, the entities affected by that application, and above all of the discourse surrounding their application.[88] Law – whether we are talking about legislation or adjudication[89]

[84] Cf., however, id. 323: Pistor hints at the significance of democracy for financial stability several times, but never really engages with this issue.
[85] Ludwig Wittgenstein, *Philosophische Untersuchungen*, vol 1 (first published 1953 J. Schulte ed, 16th edn, Suhrkamp 2004) Sec. 43.
[86] Hans-Georg Gadamer, *Wahrheit und Methode* (Mohr Siebeck 1960) 333-335.
[87] With respect to Dworkin's right answer thesis: Jürgen Habermas, *Faktizität und Geltung* (Suhrkamp 1992) 278-9.
[88] Cf. Ibid 272 et seq.

– ultimately needs to be acceptable, and in our present constellation, that usually requires democratic legitimacy. What sets democratic legitimacy apart from other factors inducing change in the law like economic, social, or other forms of power, is that its influence can be normatively justified. In that sense, purposive interpretation allows legal rules to change in parallel with processes of democratic deliberation. If the democratic consensus regarding a certain legal rule evolves as a consequence of these processes, courts might become less inclined to resist. At least, this appears to be a likely result in economic policy matters with distributive relevance, provided that no fundamental human rights are seriosly affected.

As emphasized above, this is still a very general, somewhat speculative theory for explaining legal instability in relation to macroeconomic regulation. Nevertheless, it might explain why the hope to erect a solid legal wall separating the SSM from monetary policy decisions might have been forlorn from the outset. The dichotomy between rules and discretion, a common reference point in economic theory, thus appears to be misleading, as rules are a lot more discretionary than the dichotomy suggests.[90]

D. Political Theory: The Democratic Legitimacy of the ECB

I. The End of Technocratic Legitimacy

The realization that the SSM and monetary policy might follow a holistic approach raises the question whether the ECB enjoys sufficient democratic legitimacy for that purpose. According to Article 10 (1) TEU, the Union and its member states are based on the principle of representative democracy. Article 130 TFEU, which ensures the independence of the ECB, constitutes an exception to this rule.[91] It is justified by the functional necessity to protect monetary policy from time inconsistencies.[92] However, this exception was based on the explicit assumption that monetary policy follows defined rules, and that its faithfulness to these rules is subject to political control and judicial review:[93] These assumptions are

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[89] On the democratic ramifications of judgments by (international) courts, see Armin von Bogdandy and Ingo Venzke, 'In Whose Name? An Investigation of International Courts' Public Authority and Its Democratic Justification' 23 *European Journal of International Law* (2012) 7.
[90] Cf. Finn E. Kydland and Edward C. Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans' 85 *The Journal of Political Economy* (1977) 473.
[91] BVerfG *Gauweiler*, decision of 14 January 2014, ECLI:DE:BVerfG:2014:rs20140114.2bvr272813, para. 59; with respect to Art. 88 of the Basic Law: BVerfG *Maastricht*, judgment of 12 October 1993, 89 BVerfGE 155, 208-9; Fabian Amtenbrink and Rosa María Lastra, 'Securing Democratic Accountability of Financial Regulatory Agencies - A Theoretical Framework' in R. V. De Mulder (ed), *Mitigating Risk in the Context of Safety and Security - How Relevant is a Rational Approach?* (OMV 2008) 115; Stanjo Dinov, 'Europäische Bankenaufsicht im Wandel' *Zeitschrift Europarecht (EuR)* (2013) 593, 606.
[92] See *supra* n 25 and accompanying text.
[93] E.g. Otmar Issing, 'The Eurosystem: Transparent and Accountable or 'Willem in Euroland'' 37 *JCMS: Journal of Common Market Studies* (1999) 503.

incompatible with the legal instability theorem. Accordingly, the functions of the ECB are much more vaguely defined and it is uncertain how they will develop in the future.[94] The technocratic, expertise-based legitimacy of the ECB, on which the ECB has tried to capitalize by a strategy of "hyper-scientization" in the form of a myriad of conferences and papers produced by its directorate for research,[95] therefore convinces less and less[96] – especially now after the highly controversial decisions concerning access to normal lending windows and Emergency Liquidity Assistance for Greek banks during the Greek debt crisis in 2015.[97]

The allocation of supervisory powers to the ECB increases its democratic deficit as financial supervision has enormous distributional consequences.[98] A further aggravating factor is the independence enjoyed by the ECB for its supervisory functions, as necessary as it may have been to protect the ECB's independence in respect of monetary policy.[99] And it should be mentioned that the adoption of a holistic approach to monetary policy and financial supervision would intensify the problem. While one cannot say that the holistic approach would favor financial stability over price stability, or vice versa, as it works in both directions, it is yet unclear how the ECB would balance financial stability and price stability in a specific situation, should it ever adopt a holistic approach. As necessary as one might deem a holistic approach for the effective fulfilment of the ECB's two principal functions, it increases its discretionary powers – those for which democratic legitimacy is most needed. This calls for a rethinking of the democratic legitimacy of the ECB.

II. Undoing Central Bank Independence?

In light of these difficulties, some take a radical step and call into question the value of the ECB's independence. On the one hand, this view is held by considerate observers of economic policy, who recall that independence is only justified as long as the central bank follows only one clearly defined policy

[94] See also Jakob De Haan and Sylvester C. W. Eijffinger, 'The Democratic Accountability of the European Central Bank: A Comment on Two Fairy-tales' 38 *Journal of Common Market Studies* (2000) 393, 397-8.
[95] Stephanie L. Mudge and Antoine Vauchez, 'Fielding supranationalism: the European Central Bank as a field effect' 64 *The Sociological Review Monographs* (2016) 146.
[96] For an early critique see Lawrence William Gormley and Jakob De Haan, 'The democratic deficit of the European Central Bank' 21 *European Law Review* (1996) 95.
[97] Cf. Case T-368/15, Order of the General Court (Fourth Chamber) of 14 July 2016, *Alcimos Consulting SMPC v European Central Bank*, ECLI:EU:T:2016:438; for a detailed account, see DIEM25, '#TheGreekFiles. Why independence is impossible without greater transparency' (2017) <https://diem25.org/wp-content/uploads/2017/02/170217_DiEM25_ECB_Campaign_Background_EN.pdf>.
[98] Cf. Franck and Krausz (n 32).
[99] Art. 19, SSM Regulation.

goal.[100] Accordingly, reassigning monetary policy to the treasury would amount to a return to the early postwar period – a period that many consider as one of exceptional growth and equality. On the other hand, there are some who simply disagree with the ECB's policy rate at the zero lower bond and see it as a threat to price stability and – most importantly, their own personal wealth. This view seems to be held predominantly by persons at the very right end of the political spectrum.[101] However, to the author's knowledge, proponents of these views have not produced new solutions for the time inconsistency problem that would make an independent central bank superfluous. As concerns the last mentioned view, the goal of its proponents may well be not to replace ECB independence with something else, but to replace the ECB with supposedly independent national central banks.

III. Democratizing an Independent ECB

Besides the lack of viable alternatives for solving the time inconsistency problem, calls to strip the ECB of its independence miss the significance of independent institutions for European integration. According to Antoine Vauchez, European integration has mostly been advanced by the independent, expertise-driven institutions of the Union –the Commission, the CJEU, and the ECB. He argues that the independent institutions are at the center of the Union's legitimacy – and not the Parliament, whose elections face a smaller and smaller voter turnout despite the nomination of *Spitzenkandidaten*. By contrast, the independent institutions set a healthy counterweight to ordinary intergovernmental settings. This provides them with a form of legitimacy that is not apolitical and purey technocratic, yet does not rely on traditional parliamentary representation.[102] Instead, democratic control over these institutions first was in the hands of member states governments, and is now mostly exercised by domestic courts.[103]

Faced with current anti-European sentiment, which has brought the independent institutions under pressure,[104] Antoine Vauchez has spearheaded calls for strengthening their democratic accountability.[105] In particular, it seems necessary to develop mechanisms of control and accountability at the European

[100] Wolfgang Münchau, 'Central bank independence is losing ist lustre' Financial Times, 19 February 2017, <https://www.ft.com/content/6ed32b02-f526-11e6-95ee-f14e55513608>. This position refers to Issing (n 93).
[101] Katie Allen, 'Mario Draghi defends ECB independence after German criticism', The Guardian, 21 April 2016, <https://www.theguardian.com/business/2016/apr/21/mario-draghi-defends-ecb-independence-german-criticism-central-bank-eurozone-interest-rates>; Alice Weidel, 'Der EZB Einhalt gebieten', 22 March 2016, <https://www.afdbayern.de/alice-weidel-der-ezb-einhalt-gebieten/>.
[102] Antoine Vauchez, *Démocratiser l'Europe* (Seuil 2014), especially at 45-6; Antoine Vauchez, 'The Appeal of Independence: Exploring Europe's Way of Political Legitimacy' TARN Working Paper 7/2016 (2016) <http://dx.doi.org/10.2139/ssrn.2881913>.
[103] Vauchez, *Démocratiser l'Europe* (n 102) 51-3, 57-8.
[104] Id., 59 et seq., 77-9.
[105] Id. 80-1.

level to escape the trap of nationalism. In this respect, various options exist for strengthening democratic control over the ECB.

First, the ECB could increase its output legitimacy by stepping up its transparency. It has already made considerable progress in that respect as the Governing Council is now publishing the results of its monetary policy meetings.[106] But the availability of individual bank data might help the public to review the performance of the ECB as a supervisor and to strengthen the ECB's reputation[107] – especially in controversial cases such as Monte dei Paschi.[108] Further, in cases where the legality of ECB acts is in question, the ECB may simply publish its assessments of the legal situation, just as any administrative authority provides a reasoned opinion on its views.[109]

But transparency alone does not enable effective control – the ECB needs to be responsive to public debate. This usually requires some kind of institutionalized mechanism for holding the ECB to account.[110] In that respect, the parliamentary scrutiny of the ECB is moving in the right direction.[111] The ECB's accountability towards the European Parliament extends over both its monetary policy and its supervisory activities.[112] National parliaments, by contrast, can only hold the Supervisory Board accountble[113] or their own national central bank,[114] but not the ECB, despite its involvment in the so-called troika.[115] These differences in accountability are difficult to justify in view of the close links between monetary policy and supervision,[116] especially under a holistic approach.

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[106] Cf. 'ECB to adjust schedule of meetings and to publish regular accounts of monetary policy discussions in 2015', ECB Press conference of 3 July 2014, <https://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_1.en.html>.
[107] Christopher Gandrud and Mark Hallerberg, 'Does Banking Union Worsen the EU's Democratic Deficit? The Need for Greater Supervisory Data Transparency' 53 *JCMS: Journal of Common Market Studies* (2015) 769.
[108] See only Alex Barker, Claire Jones and Rachel Sanderson, 'Brussels and ECB split on Monte dei Paschi's capital proposals', Financial Times, 23 February 2017, <https://www.ft.com/content/9635b04c-f923-11e6-bd4e-68d53499ed71>.
[109] Cf. Diem25 (n 97).
[110] Instructive: Ruth W. Grant and Robert O. Keohane, 'Accountability and Abuses of Power in World Politics' 99 *American Political Science Review* (2005) 29, 36.
[111] Moloney (n 2) 1611; cf. also Recital 48, SSM Regulation.
[112] Cf. Art. 20, SSM Regulation, in conjunction with the Interinstitutional Agreement between the European Parliament and the European central Bank on the practical modalities f the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism.
[113] G. Lo Schiavo, 'From National Banking Supervision to a Centralized Model of Prudential Supervision in Europe? The Stability Function of the Single Supervisory Mechanism' 21 *Maastricht Journal of European and Comparative Law (MJ)* (2014) 110, 125.
[114] Deirdre Curtin, 'Democratic accountability of EU executive power. A reform agenda for parliaments' in Federico Fabbrini (ed), *What form of government for the European Union and the Eurozone?* (Hart 2015) 171, 185.
[115] Thomas Beukers, 'Constitutional changes in Euro government and the relationship between the ECB and the executive power in the Union' in Federico Fabbrini (ed), *What form of government for the European Union and the Eurozone?* (Hart 2015) 95, 109 (on Draghi defying accountability before national parliaments).
[116] Id., 109.

Ultimately, the question arises whether the ECB's technocratic legitimacy can be enhanced by greater representativeness, yet without stripping it off its identity as an expertise-driven institution.[117] At the moment, the ECB is extremely far removed from electoral accountability. The Governing Council is composed of the heads of the National Central Banks of the Eurozone and the Executive Board, appointed by the European Council on a recommendation of the Council and after consultation with the European Parliament and the Governing Council (Art. 283 TFEU). This composition and the related appointment procedure make it virtually impossible for voters to influence the composition of the most important body of the ECB in any meaningful way. It rather appears as the more or less random result of a whole series of elections – and backroom deals – at the European level to some extent, yet mostly still at the domestic level. This hardly provides the Governing Council with sufficient legitimacy given the policy implications and high level of discretion involved in the discharge of its functions.[118] It would help a lot to make the governing council more representative in one way or another which would strengthen – and not compromise – its independence. For example, one might give the European Parliament the right to appoint the members of the Governing Council in a single, comprehensive vote, including perhaps only a limited number of representatives of the National Central Banks.

E. Towards a Deliberative Paradigm of the Law

The hopes cherished in respect of the theory of separation may have been disappointed. Legal barriers are all but rock-solid, as the legal instability theorem explains. Still, such barriers find their way into current legislation again and again, as the example of the separation between monetary and supervisory functions in the SSM Regulation shows. However, there is no point in trying to nail pudding to the wall. Hence, it might enhance the governance of the EMU if those making and applying financial regulation took the unfeasibility of these barriers more seriously.

This would imply moving from a substantive paradigm of law to a deliberative one.[119] By that I mean an understanding the law primarily as a guideline for decision-making processes, one that structures future decisions in a procedural and argumentative sense and determines their overall direction, yet without determining future legal decisions with precision. Such a paradigm appears to be commensurate to contemporary democratic capitalism and its unpredictable and crisis-prone existence. Under the deliberative paradigm, law legitimizes public authority not by casting in stone decisions taken at a certain point irrespective of future developments, but by ensuring that democratically adopted decisions adapt to

[117] Vauchez, *Democratiser l'Europe* (n 102) 83.
[118] Id., 90 et seq.
[119] Habermas (n 87) ch. 9.

changing circumstances and by establishing feedback channels between the demos and the decision-makers for that purpose.

Thus, the deliberative paradigm advocates a more flexible idea of the law. Paradoxically, though, this might be conducive to greater economic and political stability. It allows finding situatively adequate and acceptable solutions between diverging policy goals. In that sense, diversity might ultimately foster unity.

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