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Unusual Times, Unusual Measures. The ECB as a Driver of European Integration in Times Of Crisis¹

Abstract

Unusual times call for unusual measures. This paper demonstrates how neofunctionalist theory can be used to understand how the European Central Bank (ECB) has recently become a main driver of European integration. Since the onset of the European sovereign debt crisis, the ECB's policy can be characterised in two ways. Firstly, the ECB has endeavoured to prevent the disintegration of the Eurozone and safeguard the current level of integration. The Outright Monetary Transactions (OMT)-Programme of September 2012 is the key policy instrument of this initiative. Its legal nature is, however, disputed. Secondly, the ECB has started to use its discretionary powers to push for more integration in matters of financial regulation as well as economic and fiscal policy, thereby triggering a powerful spill-over effect.

Key words: European Central Bank, European sovereign debt crisis, European integration, Neofunctionalism

¹ This paper is based on research I carried out for a module in EU policies and policy-making at the University of Bath.

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1. Introduction: the EU in Times of Crisis

“No ex ante quantitative limits are set on the size of Outright Monetary Transactions.” (ECB 6th September 2012)

Unusual times call for unusual measures. On 2nd August 2012, the Governing Board of the European Central Bank (ECB) announced its programme of *ex ante* unlimited intervention in secondary sovereign bond markets with the above statement. This remarkable move can only be understood in the context of the existential crisis which the European Union (EU) continues to experience. The EU has tried to react to the crisis on various levels, resulting in the “creation of a new alphabet soup of treaties, arrangements, procedures and pacts” (Buiter/Rahbari 2012: 34).

The attainment of sound fiscal policy through the binding nature of the stability criteria, the harmonisation of economic policy and a better financial regulation are the aims behind the new instruments such as: the reinforced Stability and Growth Pact (SGP), the Fiscal Compact, the Macro-economic Imbalance Procedure (MIP), and the European Banking Authority (EBA) to name but a few. Simultaneously the troika of European Commission, ECB and International Monetary Fund (IMF) are imposing *ad-hoc* austerity measures in the struggling countries. But reform measures take time to implement and member states’ contributions to rescue funds are subject to intense negotiations while immediate financing needs must be met. Thus the ECB, as the only institution capable of preventing sovereign defaults, has stepped in with the Outright Monetary Transactions (OMT) Programme.

After monetary policy has already been integrated with the introduction of a common currency, demand for integration now also affects the aforementioned related sectors. These on-going events constitute a “textbook case of spill-over” in the sense of the neofunctionalist integration theory (Cooper 2011). In the following I want to analyse the impact of the crisis on ECB policy, with a particular focus on the OMT programme. I will use neofunctionalist theory to argue that the ECB – to date overlooked by neofunctionalists - has become a main driver of European integration. My argument is twofold. Firstly, the ECB tries to prevent a disintegration of the Eurozone and safeguard the current level of integration. Secondly, it has started to use its discretionary powers to push for more integration in matters of financial regulation as well

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as economic and fiscal policy. In the first part of this essay, I will present the major arguments of neofunctionalist theory according to Ernst B. Haas. This will be followed by an empirical analysis of the changing ECB policy in the second part, including a qualitative content analysis of key speeches by ECB president Mario Draghi. The time period in focus is from the announcement of the OMT programme spring 2013. In the conclusion I will critically assess my findings and point towards the future implications for European integration.

2. Neofunctionalism in Times of Crisis

“Who could dare to contradict its founder?” (Schmitter 2005: 264) Any political scientist who proposes a neofunctionalist analysis faces the strange situation that this theory has been declared “obsolescent” by its very founder, Ernst B. Haas (Haas 1975, Haas 2001: 29). Although Haas revised his statement in 2004 (Haas 2004: xix) his long silence on recent developments has left its marks on the “first grand theory of European integration” (Cooper 2011). Starting from an analysis of the ECSC, Haas developed his key concept: the “spill-over process” (Haas 1968: 284ff). But, crucially, none of the causal factors identified by him must necessarily be connected to a European background.

Haas was puzzled by the question of whether the logic underlying the European unification process could also be applied to other projects of regional integration or even to global integration (Haas 2001: 23). After all, Haas only used post-1945 Europe as a “laboratory of international cooperation” (Cooper 2011). His ontology was one in which actors make decisions according to “soft rational choice” (Haas 2001: 23). They seek to maximise their self-interests but interests are derived from underlying values which can be transformed in the course of the integration process (ibid.). Haas’ findings that neofunctionalism is not readily applicable to other regions (ibid.) might be explained by this constructivist element in combination with the particular historical context. As his attempts to establish a general theory of regional integration did not bear fruit, neofunctionalism is now understood as a theory of European integration. Today its main opponent is liberal intergovernmentalism (Sandholtz/Stone Sweet 1998: 12, 30).

The spill-over process captures the “expansive logic inherent in the sector integration principle” (Haas 1968: 313) whereby integration of one sector leads to integration in another,

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related sector. Here a high degree of economic transaction is important as a necessary condition (Haas 1968: 283/4)². After the initial integrating step, the spill-over process is caused by shifting political expectations towards the supranational level, i.e. actors increasingly direct their lobbying activities towards supranational institutions (Haas 1968: 291ff). It can also be caused by the supranational institutions themselves which use and increase their discretionary powers (Haas 1968: 299ff) and develop an “independent *esprit de corps*” (Schmitter 2005: 260). As a result of the integration process, voting patterns and rules will change from hard-bargaining and unanimous voting (Haas 1968: 291, 301). Traditionally, the actors identified on the European level have been the Commission (and its precursors) and the European Court of Justice (Sandholtz/Stone Sweet 1998: 12). In this essay it will be argued that the ECB has a similar capacity for furthering integration in times of crisis.

Neofunctionalism is a dynamic theory which predicts constant change to the institutional set-up of the EU but no clear-cut *finalité*. This is exemplified in the preamble of the Lisbon treaty which calls for “*an ever closer union* among the peoples of Europe” (TEU, own emphasis). A stable outcome could be anything between the extremes of “encapsulated intergovernmental organizations to emergent supra-states” (Schmitter 2005: 260). The dynamics released by the original integration, however, have not proceeded smoothly. Instead, European integration has always been “a story of false starts, inertia, setbacks and, finally, incremental progress” (Cooper 2011). De Gaulle’s “empty chair” policy may be the most prominent example of this but it is certainly not the only one. Contemporary neofunctionalists claim this not to be a refutation of neofunctionalism because the theory never predicted a quasi-automatic process (Sandholtz and Stone Sweet 1998: 1, Schmitter 2005: 257/8).

Haas, however, maintains neofunctionalism erroneously did presuppose quasi-automaticity regarding integration (Haas 2001: 23)³. But Haas’ self-criticism of the 1970s was mistaken; globalization did not, as he expected, fragment policy-making in the EU and hinder quasi-automatic integration (Haas 2001: 29, Haas 2004: xix, Sandholtz/Stone Sweet 1998: 4). Rather his initial argument that spill-overs towards economic unity will happen because economic integration is seen as the “only means of survival in a global setting” (Haas 1968: 298) is still applicable today particularly with reference to the emerging powers. An unresolved puzzle for neofunctionalism is flexible integration. Haas did not foresee sector integration in which only

² A range of additional causes of spill-over effects have been identified in more recent texts (cf. Sandholtz/Stone Sweet 1998: 11, Schmitter 2005: 261/2).

³ Schmitter departs from empirical analysis and offers a more significant theoretical criticism of the “dual paradox” of neofunctionalism (Schmitter 2005: 262/3).

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willing member states take part. He would expect member states to converge in the long-term rather than retaining an asymmetric degree of integration across sectors. The economic and monetary union and the most recent integration tendencies among Eurozone countries paradoxically both confirm and refute neofunctionalist analysis.

Another contested issue among neofunctionalist thinkers is if the delegation of competences to the supranational institution is always concomitant with a shift of political expectations towards the higher level (Haas 2001: 23, Sandholtz/Stone Sweet 1998: 17, Schmitter 2005: 257). This has important implications for the related question if, and to what extent, the EU suffers from a democratic deficit. That the Commission is “sovereign” in certain fields (Haas 1968:310) is not compatible with democratic principles because it has never been elected and is not fully accountable to any representative institution. Haas himself mentions a “desire to control the new administrative organ” (Haas 1968:313) but it seems to be restricted to increasing influence of lobby groups whereas he does not deal with parliamentary accountability.

The role of the European Parliament in the integration process has generally been underacknowledged by neofunctionalism (Schmitter 2005: 262). Not only the Commission seeks to acquire new decision-making powers, the European Parliament continuously strives for an increased degree of democratic control over the former (Rittberger 2006). Rittberger develops, very much in line with the neofunctionalist spill-over process, the concept of “democratic self-healing” (Rittberger 2006: 1227). It can be seen as a useful completion of neofunctionalist theory but the process has limited scope. Parliamentarisation on the European level can only be seen as democratisation if citizens’ loyalties have really shifted to the supranational level and thereby constitute a European public. Furthermore democratic control cannot be extended to *qua definitionem* independent institutions such as the European Court of Justice or the European Central Bank.

Haas’ theory was visionary in the sense that he noted in 1968 the absence of a common currency, common central banking, or of joint balance of payments arrangements (Haas 1968: 307) in the EEA which he seems to have assumed would follow later. For him it was “inconceivable that the liberalisation not only of trade, but of the conditions governing trade, can go on for long without [...] spilling over into the fields of currency and credit” (Haas 1968: 311). Now that the monetary union exists, the question is if a spill-over into all areas of economic policy will take place. Even though “the designers of the European Central Bank were very careful to insulate it from any relation with the Commission or with organized

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interests” (Schmitter 2005: 268), I will show in the following empirical analysis how the ECB manufactures spill-overs into financial regulation as well as general economic policy to ensure the irreversibility of the monetary union.

3. The ECB in Times of Crisis

The standard against which ECB actions need to be compared is its legal mandate as set out in the Treaties. The founders of the ECB created it as the institutional “twin sister” of the Bundesbank (Debrun 2001: 567), the independence of which is stated in Art 130 TFEU. Its primary objective is to maintain price stability (Art. 127 TFEU) and it is legally prohibited from purchasing government bonds (Art. 123.1 TFEU). In this regard it significantly differs from the institutional structure of the American Federal Reserve whose mandate includes the guaranteeing of “maximum employment” and allows it to buy government bonds (Federal Reserve 2000: Section 2A, 14b). In addition, the so-called “bail-out clause” determines that the EU or its member states cannot be held liable for another member states’ debt obligations (Art. 125 TFEU). However, the usefulness of these regulations has increasingly been called into question since September 2008.

The on-going crisis, which started as a financial crisis in the United States and spread to Europe, unfolded into a European sovereign debt crisis⁴ following Autumn 2009 when the Greek finance minister announced that the budget deficit for the coming year would be at 12,7% - significantly higher than expected and well above the Maastricht criteria (Drudi et al. 2012: 888). Both before and after the agreement on the bail-out programme of May 2010, Greece’s exit from the Eurozone has been the subject of much speculation and openly demanded by some, with possibly unforeseeable consequences, both economic and political, for the European Union (*EU Observer* 08.08.2012). Contagion effects and doubts about the sustainability of state finances – partly because governments took on private debt which banks had accumulated - in Ireland, Portugal, Spain, Italy and Cyprus have led yield spreads to rise enormously (ibid). Coupled with economic slow-down this produced a destructive combination and led the ECB to engage in a legal grey area as demonstrated above.

⁴ The term „Euro crisis“ is misleading because it is not a currency crisis. The Euro’s exchange rate against the main global currencies has remained more or less stable since the outbreak of the crisis, cf ECB 2012a.

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The short-term stability of the Eurozone is the ultimate concern of the ECB. Stability is challenged by the fact that there exists a prohibitive interest rate for any member state of the monetary union (Krugman 2012: 183). If interest rates get too high, states can no longer refinance themselves and thus face sovereign default⁵. This is generally true for all states but is most threatening in the absence of a central bank which is formally allowed to act as a lender of last resort, as is the case in the Eurozone. Moody's downgrading of French sovereign debt in November 2012 exemplifies this logic: "Unlike other non-euro area sovereigns that carry similar high ratings, France does not have access to a national central bank for the financing of its debt in the event of a market disruption" (Moody's 2012).

Central banks are the institutions best-placed to avoid "self-fulfilling" prophecies of sovereign default (Buiter/Rahbari 2012: 18, Drudi et al. 2012: 891, 896). However, they can only be convincing if they are willing to use their entire resources – or at least make the markets believe they will do so (Krugman 2012: 185). Despite the Treaty prohibition on lending to member states or purchasing sovereign debt, the ECB has found ways to act in the crisis⁶. The Securities Markets Programme (SMP) which started in May 2010 can be interpreted as the ECB directly acting as a lender of last resort through sovereign debt purchases on the secondary market (Buiter/Rahbari 2012: 8). The OMT programme of August 2012 with its public declaration of "no *ex ante* limits" concerning the size of the programme can be interpreted as a promise of acting as a lender of last resort (ECB 2012). It helped to bring down interest rates demanded by the markets from periphery countries even though it has not (!) been officially used yet.⁷ Simultaneously, the ECB continued to purchase sovereign debt of periphery countries through other operations of which it does not make the composition public (Buiter/Rahbari 2012: 25). It is the authority to make the markets believe that it will do whatever is necessary to save the Euro that makes the ECB such a powerful actor for European integration in times of crisis – as long as it is not curtailed by the German constitutional court (*Financial Times* 10/06/2013).

The ECB, since November 2011, has also used a second option to engage as a lender of last resort, albeit indirectly (Krugman 2012: 186). Through unlimited lending to Eurozone banks

⁵ The maturity mismatch between sovereign's (and bank's) assets and liabilities aggravates this problem (cf Buiter 2012: 8ff).

⁶ The creation of the EFSF and its future permanent replacement, the ESM, were also due to legal considerations about the ECB exceeding its mandate. However, according to de Grauwe they will always suffer from a lack of credibility compared to the ECB (de Grauwe 2011: 12).

⁷ In spring 2013, Spain, Italy and Portugal paid around 4% for ten year government bonds. The Greece rate was still exceptionally high with 9,7 % whereas the low German rate of 1,3% remained unmatched, cf ECB 2013.

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against government bonds as collateral it can provide financial support to Eurozone sovereigns in a way “not even German law professors may be likely to mount a legal challenge against” (Buiter/Rahbari 2012: 28/29). The ECB justifies its actions against legal concerns with a smart reference to its price stability mandate. It argues that in the context of impaired money markets, safeguarding price stability requires unusual measures. Thus the ECB explains that OMT interventions are designed to “avoid destructive scenarios that might threaten price stability in the euro area. The aim is to ensure that the ECB’s monetary policy stance is transmitted more evenly to the real economy across euro area.” (Draghi 2012, see also 2012a)⁸. A more legally controversial justification is expressed in ECB jargon: “We have announced the Outright Monetary Transactions (OMTs) in order to eliminate the pricing of unwarranted tail risks in the bond markets” (ECB 2013a). This means nothing less than saying that redenomination fears– and thus rising bond spreads - are unjustified because the ECB is committed to ensuring the continued existence of the Euro. Here, therefore, it becomes more difficult to reconcile the ECB’s decisions on what are essentially political questions with the ECB’s mandate.

If the long-term viability of the Euro is to be guaranteed, the ECB’s view is that more measures need to be undertaken. OMT interventions are a necessary, but not a sufficient condition to solve the crisis (Wyplosz 2012: 16). Thus what distinguishes OMTs from the ECB’s other sovereign debt purchases is its link to the adjustment programmes developed by the troika. OMTs are subject to “strict and effective conditionality” as this instrument can only be used if the country in question has signed a Memorandum of Understanding for a troika programme (ECB 2012, see also Wyplosz 2012: 12) Conditionality is seen as an important feature to prevent moral hazard and bring about the structural reforms required for economic growth and convergence in the Eurozone. Reform of labour and product markets is guided by a firm belief in Adam Smith’s invisible hand: “individual economic behaviour ... leads, in aggregate, to economic prosperity for all” (ECB 2013b, Adam Smith 1776 IV.2.9). The ECB has become an “active advocate” of such reforms (Drudi et al. 2012: 882, cf ECB 2012b, 2013b)⁹. Although the ECB argues that conditionality is necessary precisely in order to preserve monetary policy independence, it could be criticised that the ECB attributes itself a role in macro-economic policy-formulation (ECB 2013a).

⁸ The ECB also tries to increase its leverage by lobbying the European Investment Bank (EIB) to expand its lending to small and medium enterprises in crisis-hit periphery countries (*Handelsblatt* 16.05.2013).

⁹ It may legitimately be asked whether central bank independence does not apply both ways. In this case policy-makers, arguably, “seek or take instructions” from the ECB (TFEU 130).

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It also appears growth has indirectly been incorporated into the ECB's mandate when ECB president Draghi stresses the importance of monetary policy for the "Euro area economy, employment and price stability" (Draghi 2012a) – note that the primary objective of price stability is mentioned last. ECB president Draghi has also directly called on France – a country which is not under Troika surveillance - to ensure the country's competitiveness (Draghi 2012b). His plea is possibly motivated by the desire to avoid further downgrading action of French government bonds, as the outlook of its Aa1-Rating is set on negative (Moody's 2012).

Realising a "genuine economic and monetary union" is important for the ECB and makes further integration steps imperative (Draghi 2012). In particular, this means a financial, fiscal, economic and monetary union as laid out in the so-called Four Presidents-report (Rompuy 2012). The most important of these integrating steps is the financial union – also referred to as banking union – the creation of which has been decided after the ECB managed to find a compromise with the German government (*EU Observer* 2012). In the long-run this will mean not only a single supervisor within the ECB for the biggest Eurozone banks but also an EU wide deposit protection scheme (Rompuy 2012: 3), thus constituting a spill-over effect *par excellence*. The ECB is also cautiously aware of the undesirable dynamics that could be created if Eurozone countries take integration steps in isolation from the other EU members. It therefore tries to resolve tension between maintaining the "single currency and the single market" (Draghi 2012), for example by calling on non-euro area member states to participate in the supervisory mechanism of the financial union (*ibid.*).

Last but not least, the ECB's accountability needs to be explored. The effectiveness of ECB policies depends on European citizens' support and European integration in general depends on the democratic quality of its institutions (Kaltentaler et al 2010: 1262). Kaltentaler et al. show that ECB actions are mainly judged in terms of input legitimacy, less so but also importantly by standards of output legitimacy. The "politicisation" of the decision who should become the ECB's first president – and the same also applies for the recent decision on the successor of Jean-Claude Trichet – displays the importance of the ECB to European policy-makers and citizens as well as the neofunctionalist shift of loyalties towards the supranational level (Eichengreen 1998: 30). In order to increase the democratic input, *ex ante* controls are not possible in this context but a case for *ex post* oversight by the European parliament can be made (Elgie 2002: 194/5). Buitter and Rahbari's suggestions go even further: they would like

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the European Parliament to gain the power to dismiss the ECB's Governing Board collectively for incompetence (Buiter/Rahbari 2012: 8).

The problem with output legitimacy is the maintenance of price stability as stipulated by the ECB's mandate might not be sufficient to satisfy European citizens' demands. After all, the ECB's "strict anti-inflation mandate [...] was certainly not a result of a grass-roots European initiative to fight inflation" (Kaltentaler et al. 2010: 1269)¹⁰. The ECB is sensitive to the importance of legitimacy and contends that it functions according to the "highest standards of democratic accountability on all levels" (Draghi 2012a)¹¹. Accordingly, it makes reference to the Commission proposals for the financial union which would make the single supervisor accountable to the European Parliament and the Council (ibid.). ECB president Draghi presents the central bank's independence and accountability as "part of the same coin" (Draghi 2012). The demand for greater control of the supranational institutions (Haas 1968: 313) within the monetary union is manifest and the ECB attempts to satisfy these demands because it realizes that trust is political capital.

The different ways of acting as a lender of last resort and the integration steps advocated by the ECB can be seen as means to ensure the long-time irreversibility of the common currency in line with neofunctionalist logic. The same applies for its efforts to enhance ECB legitimacy. The ECB tries to use its political weight in every possible way to create the conditions necessary for a recovery of the periphery states and the long-term stability of the economic and monetary union. Its policy actions underline that the "concern for the proper functioning of the integrated sector" tend to lead to spill-over effects and supra-national authorities acquiring new competences (Haas 1968: 299/300). Fully concurrent with this logic, the ECB explains that "maximising the benefits of the single currency requires not only a strong ECB; it also requires additional strong common institutions" (ECB 2012b).

¹⁰ Moreover, although the ECB has a good record of achieving its price stability goal, Eurostat data suggests that European citizens' inflation perception does not match that reality. In the most recent available survey, 47% of European citizens over-estimated the 2010 rate (Eurostat 2012: 43).

¹¹ Recently, however, German concerns about the rotating system within the ECB's Governing Board which will come into effect when two new members join the Euro has caused headlines. The change is fully in line with neofunctionalist prediction of a transition towards majority voting (Haas 1968: 301) but it remains to be seen if the new system will be defended or altered (*Süddeutsche Zeitung* 2012).

4. Conclusion: Lessons from the Crisis?

In times of crisis the ECB has elected to design its monetary policy to the benefit of struggling member states in the periphery with the wider aim of ensuring the viability of the monetary union. The ECB's fate is intrinsically linked to the fate of the Euro. In order to prevent the "Eurodämmerung" (Krugman 2012: 166), the ECB is willing to bend its mandate and take on new responsibilities. Had the ECB refused to act as a lender of last resort, this would have meant the end of the common currency - *Fiat iustitia, pereat mundus*¹². Instead, the ECB has purchased sovereign debt and allowed banks to accept these as collateral, thus broadly interpreting Art 123.1 TFEU. The justifications provided for these monetary policy actions are revealing. The ECB presents the OMT-programme as necessary to ensure price stability and thus as fully compatible with its mandate. But at the same time it uses jargon to cryptically reveal what it cannot state openly, i.e. that the OMT-programme is designed to prevent the break-up of the Eurozone.

Moreover, the ECB has called on the European institutions and member states to guarantee further integration steps towards financial, economic and political union in good time. The conditionality of the OMT-programme helps to promote these reforms. Increased EIB lending is called for to make the ECB's policies more effective. Thereby the EIB strengthens one of its institutional partners. Neofunctionalist theory offers a convincing explanation for the on-going spill-over effects from the monetary sector into the areas of financial regulation and general economic policy. This process is not automatic, nonetheless a further transfer of sovereignty towards the supranational level seems inevitable. An analysis of European Commission and European Parliament action since the beginning of the crisis with neofunctionalist theory would likely reveal a similar support for further integration steps as well as an increase in lobbying to these institutions as expectations shift towards the European level.

Notwithstanding the difficulties associated with finding a lasting solution to the European sovereign debt crisis and the social hardships it has produced, two issues continue to preoccupy both policy-makers and neofunctionalists. Firstly, how viable is two-speed integration, e.g. a monetary union within a bigger single market, in the long-term and which

¹² Let there be justice, though the world perish.

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factors would motivate recalcitrant member states to engage in closer cooperation? In this regard the case of the United Kingdom is an especially hard nut to crack. And secondly, is there a democratic spill-over process and if not, how can the dynamic European integration process be matched with European citizens' expectations for democratic structures? This is an important task to fulfil if 'Brussels' is not to become a synonym for 'far away from citizens' influence'.

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