Institutional Competition as an Alternative Mechanism for Harmonization in Monetary and Banking Unions

Sarkis Joseph Khoury

Retired

sjkhoury@earthlink.net

Clas Wihlborg

Chapman University

wihlborg@chapman.edu

Nov. 1, 2014

Abstract

The latest election for the European Parliament in May 2014 resulted in substantial gains for EU-skeptical parties across the EU. We argue on economic grounds that more flexible integration within the EU could increase the support for the integration process across the heterogeneous group of member states. In many areas the more flexible integration process could develop as a result of institutional competition. In other areas a minimum degree of harmonization may have to be imposed on all members. Costs and benefits from harmonization and requirements for efficient institutional competition are discussed generally as well as specifically for central banking in the EMU and for the regulatory framework for a Banking Union. There are indications that the EU has become more flexible with respect to new membership in the EMU but the push towards harmonized banking regulation is strong for members of the EMU. An alternative route to a banking union would be to impose minimum standards for bank insolvency procedures while other aspects of regulation would develop in institutional competition.

.

Key Words: Institutional Competition, Harmonization, Monetary Union, Banking Union

JEL Classification: F 15, F 55, G 18, H 80, K 33

Institutional Competition as an Alternative Mechanism for Harmonization in Monetary and Banking Unions

1. Introduction

A number of national referenda on membership in the monetary union (EMU) in Scandinavia and on the proposed EU constitution in the Netherlands and France revealed great popular skepticism in Western Europe towards the European integration process. The Lisbon Treaty that substituted for the proposed EU constitution was rejected by Irish voters in 2009.[1] These attitudes prior to the euro-zone crisis may be explained by distrust towards harmonization of institutions in countries where citizens have fundamental trust in domestic political processes, legal institutions and public administration. People in the formerly communist countries[2] with a need to strengthen legal and political institutions seem to have had a more positive view of the benefits of EU membership. before the debt crisis erupted in 2010.

The euro-zone crisis and the EU responses to the hardships in Greece, Spain, Portugal, Italy and, most recently, Cyprus may very well have created long lasting resentment among citizens in the economically weaker periphery towards the core and the Northern members. The latest election for the European Parliament in May 2014 resulted in substantial gains for EU-skeptical parties across the EU.

An integration process characterized by greater flexibility for member states to implement Directives on regulation and law in different areas could increase the support for EU membership and maximize its economic benefits for citizens across the EU. By flexible integration we mean essentially a multi-speed Europe where the harmonization of institutions occur among groups of member states in various combinations as a result of the conviction of citizens that the benefits of harmonization exceed the costs. In many areas the integration process would develop as a result of institutional competition. In other areas a minimum degree of harmonization may have to be imposed on all members.

[1] Ireland was the only country that put up the Lisbon Treaty to the test of voters.

[2] The formerly communist countries in Central and Eastern Europe may have seen EU membership as a way to rapidly benefit from the stronger legal and political institutions in Western Europe, and possibly as a hedge against the Russian risk factors.

In this paper we discuss what types of benefits and costs are associated with centralized harmonization of law and regulation in comparison with harmonization based on institutional competition. In light of the debt crisis in the euro-zone we focus on consequences of monetary harmonization within the European Monetary Union (EMU) and the Banking Union. The latter is currently under construction in response to perceived economic costs of a monetary union that is not complemented with additional harmonization in other areas.

Analyzing costs and benefits of centralized harmonization in specific areas we distinguish between the harmonization of discriminatory barriers to trade and mobility within the EU ("discriminatory harmonization") and the harmonization of national standards, regulation and law across the EU ("institutional harmonization"). The nature of costs and benefits of these types of harmonization are very different. In the financial sphere harmonization of capital requirements for banks is an example of institutional harmonization while the right of banks to operate cross-border within the EU in branches under a single license is an example of discriminatory harmonization.

Harmonization of institutions within one sphere, say monetary policy, is frequently associated with requirements for increased harmonization within other spheres such as fiscal policy and banking regulation. Efficiency gains from the original harmonization may not be realized without additional harmonization. Sometimes the secondary harmonization occurs spontaneously in response to pressures created by the original harmonization. In other cases, the secondary harmonization must be legislated and enforced by a regulatory apparatus. Costs and benefits of this secondary harmonization should be considered already at the time the first harmonization is evaluated.

Although we emphasize economic arguments in this paper it is necessary to recognize that the EU is very much a politically motivated project. The so-called Lisbon Agenda of 2000 (unrelated to the Lisbon Treaty of 2009) indicates that economic objectives are important for the EU and its member states. Furthermore, it can be assumed that the political sustainability of the EU depends strongly on the degree to which its economic objectives can be attained.

In Section 2 we discuss the requirements for additional integration from the creation of the monetary union based on recent developments within the EMU, where the crisis has led to calls for increased fiscal integration, the formation of a banking union and structural reforms in labor and product markets. In Section 3 we turn to benefits and costs of harmonization of legal and regulatory institutions. A distinction is made between the harmonization of national barriers to mobility (discriminatory harmonization) and the harmonization of law and regulation across member states (institutional harmonization). Section 4 focuses on institutional competition based on mutual recognition as an alternative, more flexible mechanism for integration and harmonization. Criteria for institutional competition to enhance the social value of regulation are discussed. In Section 5 we apply the criteria for institutional competition on the EMU and the proposals for a banking union within the EMU. A key issue here is to what extent "race to the bottom" can be avoided under mutual recognition of banking regulation and supervision. In Section 6 we summarize and draw implications for potential benefits and costs of increased flexibility of integration with institutional competition within the EU in the areas of monetary policy and financial regulation, in particular.

2. EMU and complementary harmonization requirements.

Since the euro-zone crisis erupted in 2010 we have seen attempts within the EU to integrate fiscal policy making, and regulation and supervision of banks. Calls for labor market reforms in the crisis countries can also be viewed as attempts to enhance the integration of labor markets.

Participation in the EMU implies the harmonization of institutions within the area of monetary policy. Although the European Central Bank (ECB) has sole responsibility for monetary policy, the monetary policy effects can vary across the euro-area.

The economic benefits of monetary harmonization were conceptualized in the Delors report, *One Union, One Money*, published by the European Commission in 1988. It built on the Werner report of 1970 and elaborated on the economic arguments in favor of a monetary union. Microeconomic benefits in the form of reduced transactions and information costs, as well as reduced exchange rate risk, were emphasized. Furthermore, the Report emphasized that free capital flows make any exchange rate regime along the spectrum between irrevocably fixed rates in a monetary union and freely floating rates unstable and crisis-prone. Credibility of fixed rates would be obtained only in a monetary union where exit is not an option. Thus, monetary institutions and policy should be harmonized.

It is well known that monetary harmonization has costs as well as benefits. Wyplosz (2006) points out that the disadvantages of a monetary union were passed over rather lightly in the Delors report. He takes the view that the omission of important elements of Optimum Currency Area (OCA) theory in the Commission's argumentation for a common currency "is the Monetary Union's original sin." The OCA theory spells out criteria for a country's choice of exchange rate regime. This literature was rich already in the late 70s (Tower and Willett, 1976) and it was revisited frequently in the early 90s when the Maastricht Treaty was negotiated (e.g. Wihlborg and Willett, 1991), as well as thereafter.

The most well-known and widely accepted criterion for a currency area is labor market flexibility in the form of either mobility within the area or flexibility of relative real wages across industries as well as countries. A second criterion is fiscal policy cooperation enabling transfers in case members are in different phases of the business cycle.

These criteria indicate that there is a need for complementary harmonization and coordination in response to monetary harmonization since macroeconomic adjustment will become more costly without simultaneous integration of labor market and fiscal policy making institutions if exchange rates cannot be adjusted.

There is general agreement that the EMU is indeed not an OCA in terms of labor market flexibility and fiscal policy. However, several economists have pointed out that the costs of the EMU in terms of macroeconomic adjustment are mitigated and even eliminated to the extent OCA criteria for fixed exchange rates are endogenous (Frankel and Rose, 1998). Such endogeneity could take the form of increased labor mobility and increased real wage flexibility as a result of the nearly complete credibility of fixed exchange rates within the EMU.

Evidence on endogenous institutional development enhancing wage flexibility and mobility in labor markets in particular is reviewed and discussed in De Grauwe and Mongelli (2005) and Willett, Permpoon and Wihlborg (2010). They conclude that the ambivalent political attitude towards labor mobility in many countries, and the evidence so far, indicate that the labor market criteria for a currency union have not been achieved endogenously. The inability of Greece, Portugal, Spain and Italy to adjust their relative cost levels without facing depression level unemployment offers a stark illustration of the macroeconomic adjustment costs associated with rigidities in labor and product markets within a currency union.

The fiscal policy criterion for an OCA stating that fiscal transfers should be possible within a currency union has encountered resistance within the EMU since government tax and revenue policies are recognized as national concerns with few exceptions. Some fiscal harmonization has been pursued with respect to VAT and, to some extent, corporate taxation. The motivation for harmonization in these areas is fear of tax arbitrage that can make a relatively high tax rate unsustainable.

Another area for a degree of fiscal harmonization is the overall fiscal stance, i.e. the government budget deficit. The incentives of national governments to run fiscal deficits when interest rates converged among members of the EMU were recognized at an early stage in the EMU. The "Growth and Stability Pact" with limitations on fiscal deficits (3% of GDP annually) was motivated by these concerns. The Stability Pact for the EMU can be viewed as a substitute for fiscal coordination, which, as mentioned, belongs to the OCA criteria for a currency union. Coordination recognizes that differences in economic conditions may require differences in fiscal stance and transfers among different parts of a currency area. Large-scale transfers within the EU are constrained by EU treaties except in the areas of agricultural policy and some types of funding for structural adjustment. Lacking fiscal coordination, the limited harmonization implied by the Stability Pact was supposed to prevent member countries from running up deficits that would threaten the ability of the ECB to attain its inflation target. The ineffectiveness of the Growth and Stability Pact has been widely recognized with Germany and France violating the pact already before the financial crisis.

The need for the fiscal integration implied by the Stability Pact has been debated since incentives to constrain deficit and debt creation could be created by increased interest rates on bonds issued by countries lacking fiscal discipline through the political process. The interest differentials between euro-denominated bonds issued by different governments were negligible or small before the global financial crisis erupted in 2008. Even then interest rate differentials did not increase dramatically during the period leading up to the Greek debt crisis in early 2010. It seems that market participants perceived the existence of an implicit insurance of sovereign debts before 2010 in spite of a no-bail out clause in EU treaties.

The perceived insurance of sovereign debt risk in combination with lack of fiscal policy harmonization within the framework of a weak Stability Pact had the consequence that countries with weak mechanisms for fiscal discipline were able to run deficits and to increase their debt to GDP ratios without having to face market penalties until the debt crisis was a fact.

Falling GDP in most countries during the financial crisis in 2008 and 2009, expansionary fiscal policies, bank bailouts and large current account deficits associated with lack of competitiveness combined to make debt to GDP ratios unsustainable in Greece to begin with, followed by Ireland and Portugal, and then Spain and Italy. In Ireland the enormous costs of bank bailouts contributed to an explosive rise in the debt to GDP ratio. Interest rates on the sovereign debt rose in 2010 as high as 15 percent for Greece, 11 percent for Ireland and 7-8 percent for Portugal. Interest rate differentials have subsided after the ECB's promise in July 2012 to buy sovereign debt of crisis countries and "do whatever it takes" to save the euro area in its current configuration.

As a consequence of these problems in the EMU periphery EU ministers have debated and agreed on a new Fiscal Pact involving increased supervision of and control over the fiscal stance of member states. It is almost impossible to imagine that this spillover of monetary integration into the fiscal sphere will not have further spillovers into centralized EU influence over countries spending and tax policies, which so far have been considered outside the domain of the EU.

The discussion so far refers to the original OCA criteria. During the 70s inflation became an important policy objective and one aspect of exchange rate regime choice.[3]

[3] The theory of monetary policy began to incorporate the game theoretic concepts of time-inconsistency, monetary policy rules and credibility (e.g. Kydland and Prescott, 1977, and Barro and Gordon, 1983).

Countries with low credibility with respect to anti-inflation policy could avoid the costs of a prolonged effort to gain credibility by joining the monetary union where the European Central Bank was given price stability as its only objective.

The cheap route to monetary policy credibility through EMU membership may actually have reduced the urgency to implement structural reforms in several countries. Such reforms would have been necessary outside the EMU to achieve credibility with respect to a low inflation target. The current sovereign debt crisis in Greece, Portugal, Spain and Italy may be partly blamed on the lack of reform of labor market institutions in these countries in spite of 10 years with the euro. Wihlborg, Willett and Zhang (2010) show that the real exchange rates of these countries appreciated almost continuously from the time they adopted the euro through. 2009. The only period of inflation convergence occurred during the years before the EMU was formed in 1999.

The stress on the banking systems in the crisis countries in the EMU led to calls for a banking union as an additional criterion for an OCA. The common monetary policy is predicated on the even transmission of monetary policy to different parts of the EMU. The even transmission has been hindered during the crisis by fragmentation of the banking systems. This fragmentation is the result of a strong linkage between sovereign and banking system risk. The high costs of bailing out distressed bank contribute to sovereign risk and sovereign risk weakens banks with a high proportion of domestic government bonds in their portfolios. The fiscal situation in many EMU countries is such that their governments cannot bail out domestic banks without creating a debt crisis. In this situation government promises of support for their banking systems lack credibility without back-up from other EU members.

The EU's response to the situation described above has been to propose the formation of a banking union with strongly harmonized regulation, centralized supervision and centralized crisis management. Thus, monetary harmonization has spilled over into demands for harmonization of the banking systems. Alternative mechanisms for achieving harmonization of banking systems are discussed in Section 5.

We conclude this section by noting that the EMU is now facing a critical choice between increased integration in a number of areas as discussed above or the possible break-up of the euro-zone. The costs of keeping the EMU in its current configuration without substantial reforms are likely to be very high.

3. Costs and benefits of discriminatory and institutional harmonization

In this section we distinguish between two kinds of harmonization within the EU. "Discriminatory harmonization" refers to the removal of national discriminatory trade barriers within the EU and the harmonization trade barriers towards non-EU countries. We use the term "institutional harmonization" to describe the adoption of similar standards, regulation, legislation and business practices in all countries within the EU. Such harmonization can be compelled by the EU's Council of Ministers or it can be the result of spontaneous adoption of similar legislation and practices in member states. In this section we examine benefits and costs of internal harmonization imposed by Directives. Spontaneous adoption of similar standards as the result of institutional competition is discussed in the next section.

The cornerstone of the EU from an economic point of view is the Internal Market program aiming at the ”four freedoms” in the markets for goods, labor, capital and services. The mobility generated within the Internal Market depend on both discriminatory and institutional harmonization. Discriminatory trade barriers may be explicit or they may be more subtle taking the form of, for example, costly testing requirements for imported goods, and delays in licensing procedures for foreign financial institutions. The free mobility within the Internal Market was originally defined by the absence of such external barriers within the EU accompanied by common discriminatory barriers relative to the rest of the world.

Institutional barriers are represented by differences in standards, regulation, legislation and business practices across countries. Language and cultural differences must be included in this category. Such barriers tend to increase the costs of trading with another country relative to trading domestically. This kind of trade barrier is not discriminatory if all economic actors are treated equally within each country. Instead it is a source of differences in information and transactions cost between domestic trading and international trading. These costs of non-discriminatory trade barriers represent one aspect of what can be called *costs of contracting and organization.* "Institutional harmonization" implies that such costs are reduced or removed.

Benefits and costs of discriminatory harmonization

The concepts of trade creation and trade diversion were developed as tools to analyze the effects of discriminatory trade barriers in the case when two or more countries remove external barriers relative to each other while they retain barriers relative to other trading partners. A country joining the EU will benefit from trade creation between the country and the EU. Trade diversion is the welfare reducing effect of decreased trade with discriminated non-EU trading partners which are substituted for by less efficient EU-internal partners. This substitution is welfare reducing because it implies that the lowest cost producer globally has been substituted for by the lowest cost EU producer.

Formal discriminatory barriers within the EU have been almost completely removed in the markets for goods. Capital is also generally mobile although there are sector specific exceptions as noted below. Some backtracking has occurred, for example, by the designation of 11 industries in France as "strategic" and off limits to foreign acquisitions.

Substantial barriers remain in the markets for labor and services. Barriers to mobility of labor from the new EU members were imposed in 2004 by 12 of the 15 old members. Other discriminatory barriers to labor mobility could take the form of strictly enforced qualifying requirements for foreign applicants to particular jobs.

In the area of services, agreement on a new Services Directive was reached in 2006 after years of negotiations. The agreement is considered a failure by those aiming for completely open markets within the EU while others consider it an important step towards free trade in services like media, postal services, water, gas, electricity, health and insurance.

Many financial services are dealt with under special directives for banking and investment services. These Directives proclaim free trade in financial services but there are many ways for individual countries to protect, for example, domestic banks and securities exchanges. In particular, domestic supervisors in member countries have the ability to favor domestic financial firms relative to foreign competition by means of more or less strict supervisory practices and requirements. The current movement towards a banking union with one supervisor addresses this issue.

Trade creation associated with external harmonization is often associated with greater competition and the potential for exploiting economies of scale. Baldwin (1989) showed that the medium term growth effects of these factors can be substantially larger than the static welfare gains from trade creation.

Costs of external harmonization arise as a result of trade diversion. The most obvious cases of trade diversion caused by EU barriers towards the rest of the world are trade in agricultural products and textiles. The expansion of the EU into Eastern and Central Europe may have led to the inclusion of more efficient producers of these products and increased intra EU trade in agricultural products. There is a cost to the importing countries if the new members substitute for more efficient producers outside the EU.

Tendencies towards trade diversion will be strengthened if the EU chooses an increasingly discriminatory stance relative to, for example, the Asian economies, which are becoming highly competitive in the production of relatively sophisticated products and services such as mobile phones and engineering services. These countries are also endowed with human capital to an increasing extent. A strict immigration policy in comparison to US policy implies that the skilled or potentially skilled people settle in the USA rather than in Europe. Thus, by becoming a member of the EU, a country could suffer losses from trade diversion in important industries, as well as in some kinds of labor services.

For the purposes of this paper an important aspect of external harmonization within the EU is that the removal of discriminatory trade barriers is a prerequisite for institutional competition. We return to this issue in Section 4.

Benefits and costs of "Institutional Harmonization"

Examples of institutional harmonization are the creation of common rules with respect to product liability, health standards, financial regulation, corporate law, bankruptcy law and labor law to mention a few areas. There are costs of cross-border contracting and organization associated with differences across countries in these respects. Language and cultural differences must be included among factors creating such costs.

Taking the case of language harmonization as an illustration it is obvious that there are both costs and benefits from requiring all economic transactions to be prepared and concluded in, say, French. Certainly, there are great benefits to working in the same language across the EU but there would be substantial costs for those who must learn the common language, and who may never learn the nuances of it. Furthermore, the agreed upon language need not be the least cost language to learn and use if the political process leading to the language decision is biased in favor of a specific country.

The removal of institutional differences implies that transactions costs decline. The firm expanding into a foreign country with a different institutional environment must acquire knowledge and legal expertise to deal with, for example, consumer organizations and potential suits in an unfamiliar environment. Even after the introductory stage the firm may have to keep two legal teams employed in order to deal with lawsuits in different legal environments. This kind of trade barrier is not discriminatory if all economic actors are treated equally within each country. Instead it is a source of differences in information and transactions cost between domestic trading and international trading. Differences in language, standards, regulation and law create costs of contracting and organization across borders.

If trade with EU countries expands as a result of cost savings after a country has joined and harmonized, for example, specific product standards then the trade expansion represents a shift in comparative advantages. The shift in trade from outsiders to member countries is not associated with welfare reducing trade diversion in this case.

The trade creating effects of internal harmonization has made it attractive on the EU- agenda for increasing integration. However, there are potentially substantial costs associated with internal harmonization if it is imposed across all member countries.

Much work goes on within the EU on harmonization of rules and regulation in the areas of environment and health, financial services, corporate law, accounting, labor laws, etc. Benefits of harmonization are obvious in cross-border transactions but there are costs as a result of differences between EU-mandated rules for contractual arrangements and the most efficient rules for a country given its legal and regulatory system, legal history, conventions, and business practices. Furthermore, there is no guarantee that the political process leads to the most efficient harmonized rule or regulation. Some countries will certainly be able to enjoy benefits of institutional harmonization if an EU Directive mandates rules that are similar to the countries' old rules. In other countries the harmonized rules are likely to be associated with substantial costs.

Sykes (2000) points out that differences in, for example, preferences and income between jurisdictions imply that their optimal regulatory policies are likely to differ as well. He also point out that optimal regulatory policies are often unknown. This means that costs and benefits of mandatory harmonization are not easily observed or understood in several areas. One reason is that benefits and costs of particular rules and regulatory solutions are often controversial, and they are likely to differ across countries. A second reason is that a particular law or regulatory measure can be a part of a complex system of laws, regulation, conventions and business practices affecting economic incentives and activities. Much regulation of the financial services sector, as well as corporate law belongs to this category of rules. For example, corporate governance systems and mechanisms, that differ substantially across the EU, are the result of a set of laws in the areas of company law, investor and creditor protection law, financial sector regulation and, not least, conventions that have developed over decades in different cultural and legal environments.[4] The complexity of social systems implies that in a number of areas we do not know how institutions should be designed optimally. If a number of experts would be asked how they would want to legislate in order to develop the optimal corporate governance system, each expert would come up with a different solution even if they were referring to the same country.

When costs and benefits of harmonization and approaches to harmonization in the EU and elsewhere are discussed, both differences in preferences and the complexity of social systems must be taken into account. The case for mandatory harmonization of particular laws and regulatory approaches seems to be based on the presumption that a “best practice” can be identified and applied in all EU members.

---

[4] Schmidt and Spindler (2002) argue that there is strong path-dependence in efficient corporate governance systems.

Consider the relatively simple case of harmonized rules on work hours in the EU. Is there a case to be made for an EU wide "best practice" with respect to daily and weekly work hours? The number of continuous work-hours a person can deliver productively is likely to depend on a number of conditions in the work environment, a person's health and stamina, as well as psychological factors. All these conditions vary across countries as well as within countries. Furthermore, wage rates are likely to reflect an aggregate of all these conditions. Thus, harmonization in one dimension reduces the ability of people to achieve their desired trade-offs among all factors affecting the work environment and wages.

Similar arguments can be made with respect to health standards for products. Restrictions on, for example, the contents of fat refer to only one of many product characteristics that are traded off against each other and the product price. Even if we grant the case for restrictions on fat contents there is no obvious best practice for all of the EU where product characteristics of all kinds and nutritional practices vary substantially. The appropriate restriction in a particular country may very well depend on how different kinds of food and drink are balanced in the diet.

In the financial sector capital requirements for banks offer an interesting illustration of the issues, since the Basel Committee has long been striving to harmonize these requirements worldwide. The EU implements the international agreements in Directives. One stated objective of capital requirements is to create a "level playing field" for banks with different home countries. However, the ratio of capital to assets is only one of many factors that influence the likelihood of bank failures and associated losses for depositors. For example, differences in bankruptcy laws imply that the risk associated with a certain type of loan is different as well. Competitive conditions, accounting rules, deposit insurance schemes and, therefore, the strength of market discipline vary as well across the EU. Unless all these aspects of the banking environment are harmonized, equal capital requirements for similar types of loans establish a de facto "unlevel playing field".

4. Institutional competition as an alternative mechanism for "institutional harmonization"

Harmonization or a substantial degree of harmonization within the EU can be achieved in many areas through other means than Directives that must be implemented in all member states. In particular, "institutional competition" among countries setting their own laws, regulations and standards can be encouraged. Institutional competition implies that that there are political incentives in a country to adopt another country's institutional structure fully or partially in order to improve its economic performance. Thus, it requires that the political process is responsive to the economic interests of citizens. The greater the mobility of goods, services, capital and labor the greater is the scope for institutional competition.

In principle, free trade in goods and services is sufficient to create a degree of institutional competition with respect to law and regulation affecting supply conditions in each country. Comparative advantages in the production of various products and services would be affected by domestic and foreign regulation. If the political process is responsive to citizens' preferences, regulation affecting supply conditions would adapt in competition among producers. Ideally, regulatory differences would remain among countries to the extent preferences with respect to regulation affecting supply conditions differ. Examples of such regulation are labor safety standards and regulation of emission of pollutants. The country with high tolerance for pollution would obtain a comparative advantage in products generating pollution in production.

Free trade in goods and services requires that there is mutual recognition of preferences reflected in regulation with respect to supply conditions. However, free trade would not require mutual recognition of regulation with respect to product characteristics affecting demand. Countries would be able to implement laws and regulation affecting demand conditions as they see fit. Institutional competition would affect only supply side conditions. The international trade regime under WTO is based on the presumption that countries remain sovereign with respect to non-discriminatory regulation affecting both supply conditions and characteristics of products and services. This trade regime also called, free trade with "territoriality-based national treatment" (Trachtman, 2000) limits mutual recognition and institutional competition to regulation and law affecting supply conditions in different countries.

In the situation described, harmonization of regulation and law affecting supply conditions would have costs to the extent there are different preferences with respect to regulation. Harmonization of characteristics of products and services would also have costs if preferences differ but could have benefits in terms of exploitation of economies of scale in production and reduced transactions costs in international trade as noted in the previous section.

What if we expand mutual recognition under free trade to include characteristics of products and services as well? This would imply that free trade would occur in all products and services as long as they satisfy regulation and standards in at least one of the countries practicing mutual recognition. Trachtman (2000) calls this regime "rootless jurisdiction) and he notes that mutual recognition, as well as harmonization, in this case would be associated with a loss of sovereignty for the countries with respect to regulation affecting product characteristics.

Free trade with mutual recognition in the sense described would introduce an element of institutional competition with respect to regulation affecting consumers. The outcome of this institutional competition with respect to characteristics of goods and services could lead to "race to the bottom," "race to the top" or to differentiated regulation with exporters in different countries supplying differentiated products and services to different consumer groups in importing countries. The last alternative may be considered an acceptable and even efficient outcome with respect to product characteristics for which social values do not differ from private values.

"Race to the bottom" would occur under mutual recognition if costly product characteristics are valued higher socially than privately. (for example, cigarettes generating relatively low medical costs, low alcohol content in wine, low transfat products). Consumers in most countries would prefer the relatively cheap products from the country with the least demanding regulation.

"Race to the top" would occur if the social valuation of (costly) product characteristics is lower than the private valuation. For example, if the regulators enforce some requirement on product safety but consumers generally value product safety higher than he regulator, exporters in a country with strict regulation would gain competitiveness by regulators enforcing relatively strict standards. One example is the aviation industry where airlines from countries known to be strict with respect to safety standards would gain a competitive advantage if the private value of safety standards exceeds the cost increase associated with these standards.

The dynamics of institutional competition implied by the conditions for “race to the top” and “race to the bottom” would in the limit lead to a situation where the strictness of regulation in each country corresponds to the private preferences for product characteristics as reflected in the political process as well as in the market place. The private preferences in this case would represent the average preferences for characteristics of product or services or the preferences of the “representative consumer” in each country. The implication of this regulatory dynamics would be that social preferences in a country, which can be revealed only through the political process, would not be reflected in regulation and law under strong institutional competition and mutual recognition of both demand side and supply side regulation.

The analysis of costs and benefits of institutional competition with mutual recognition of laws and regulation becomes more complex if we allow mobility or trade in factors of production as well as in goods and services since regulation of labor market conditions and conditions in markets for capital with mobile labor and capital affect supply conditions in markets for goods and services. For example, mutual recognition of regulation in labor markets with labor mobility implies institutional competition through mobility of labor as well as mobility of goods and services. Regulation of demand conditions in labor markets, which represent supply conditions in markets for goods and services are then subject to potential race to the bottom or race to the top. Without labor mobility, race to the top or bottom arose only in regulation of characteristics of products and services.

The discussion so far implies that a comparison of costs and benefits of institutional competition relative to costs and benefits of harmonization favors the latter when harmonization reduces transactions costs in international trade substantially, when there are strong economies of scale in production and when conditions for race to the bottom exist under mutual recognition. Institutional competition with mutual recognition is favored when preferences with respect to regulation differ substantially, when conditions for race to the top exist, and when the difference between social and private valuation of characteristics of products and services as well as of factors of production is small.

Additional considerations arise if ‘best practices” with respect to regulation in each country are controversial and when there is uncertainty about how regulation and law best represents citizens' preferences. Political economy considerations can also be important if laws and regulation, as well as their implementation, depends strongly on interest group politics.

Sykes (2000) views institutional competition as a remedy for the costs of harmonization associated with differences in preferences, business practices and legal traditions. In addition he argues that the case for regulatory competition and, thereby, for less direct cooperation and coordination across jurisdictions, is strengthened by differences in conditions for regulation, lack of knowledge about optimal regulatory policy, opportunities for experimentation with regulatory solutions, and the existence of disciplining capital movements, which can act as a constraint on regulatory capture and rent-seeking.

Vaubel (2009) argues that an information asymmetry between governments and voters favors competition among governments:"….”Providers of public goods are more effectively controlled by institutional competition than by their poorly informed voters”. Similarly, Kerber (2000) argues that "inter-jurisdictional competition may be superior way of supplying public goods and services.” He also points out that "only a competitive system of jurisdictions can be compatible with both decentralization and mobility” and that inter-jurisdictional competition "is largely ignored” within the EU in contradiction to the EU Treaty, wherein decentralization (subsidiarity) and mobility are prominent principles.

Both Sykes (2000) and Trachtman (2000) note that the choice in any particular area of law and regulation is not necessarily between complete harmonization through Directives that must be implemented identically in all member states and pure institutional competition with mutual recognition. Sykes ranks the degree of formal harmonization from very low under “pure regulatory competition” to very high with “agreement on uniform regulatory targets.” As intermediate cases he considers “minimum requirements agreements” and “agreements on non-homogeneous regulatory targets.” Thus, Sykes asks to what extent should regulators in different jurisdictions cooperate?

Trachtman (2000) compares three jurisdictional structures with different degrees of institutional competition. One, denoted “rootless jurisdiction,” corresponds to Sykes' pure institutional competition characterized by far-reaching mutual recognition. The second jurisdictional structure is “territoriality-based national treatment.” This structure constitutes the basic rule governing international trade outside the EU today. In combination with principles of non-discrimination in international trade this structure allows for sovereignty with respect to non-discriminatory regulation and free trade in goods, services and capital as the main conduit for institutional competition. Within the EU this structure describes the allocation of jurisdictional responsibility for law and regulation in areas wherein member states retain sovereignty.

The third jurisdictional structure in Trachtman is “managed recognition with essential harmonization.” He notes that the EU applies this structure in many areas as a constraint on institutional competition. “Essential harmonization” should reduce fears of “race to the bottom” as described below. In Sykes' terminology this jurisdictional structure would correspond to “minimum requirements agreements.”

One of the most studied cases of institutional competition is the area of corporate law in the USA where each state has its own law. Romano (2006) describes how corporate law has been developing and become increasingly harmonized while remaining dynamic.

She considers the “states as laboratories” and argues that “the law making pattern we observe indicates a dynamic process in which legal innovations originate from several sources, creating a period of legal experimentation that tends to identify a principal statutory formulation that is thereafter adopted by a majority of states. It is difficult to imagine that such dynamism could be generated by the centralized lawmaking that exists at the national level.” The main benefit of institutional competition in this case arises as a result of uncertainty about the privately and socially most efficient corporate law as noted in Sykes (2000). There is no reason to believe that there is a substantial difference between the social and private valuation of corporate law.

A couple of additional examples can serve to illustrate consequences of mutual recognition and institutional competition when there is mobility of both factors of production and goods and services.

International trade in trucking services would lead to institutional competition in regulation of the trucking business if there were mutual recognition of regulation with respect to drivers and trucks. In this case truckers subject to different regulation would be able to offer their services in different countries. Under ‘pure institutional competition” (“rootless jurisdiction”) mutual recognition of safety oriented regulation of drivers as well as of the trucks could lead to “race to the bottom,” since, presumably, the truckers would value safety regulation privately below the social value of such regulation. The country importing trucking services would lose sovereignty with respect to both traffic safety regulation and to the environmental impact of the trucks within its jurisdiction. On the other hand, “territoriality based national treatment” would imply that trucks operating within a certain jurisdiction would be subject to safety and environmental regulation in the country importing trucking services. If such regulation is costly to enforce an alternative to “territoriality based national treatment” would be what Sykes calls “agreement on uniform regulatory targets” or “minimum requirements agreements.” In both cases there would be some loss of sovereignty.

Mutual recognition of regulation of financial advisory and investment services would create institutional competition with respect to such regulation. Home country regulation of the behavior and qualifications of the services would be recognized by the host country. Race to the top would occur if the private valuation of the qualifications of the services exceeds the social valuation. Race to the bottom would occur if the social valuation of these services incorporates the concern that investors must be protected against their own lack of concern.

Free trade with national treatment in these services would imply that services firms operating in a host country are subject to this country's regulation. In the insurance industry, free trade in insurance services with national treatment implies only that there is no discrimination between insurance companies in different jurisdictions while mutual recognition would imply that insurance services accepted by authorities in one jurisdiction can be offered in other jurisdictions. In the latter case of mutual recognition "race to the top" would occur if the private valuation of insurance industry regulation exceeds the social valuation.

Competition between different rules with respect to labor practices (work hours, safety standards, etc.) would be accomplished to some extent through non-discriminatory trade in goods since costs depend on such practices and strengthened further with high labor mobility. Mutual recognition would lead to "race to the top" if labor privately values strict labor standards higher than the standards imposed by regulation. There is a risk of race to the bottom if the regulatory standards are more strict than the privately preferred standards. If the social valuation equals the private valuation and this valuation varies across countries' regulators, different standards can be maintained without creating labor mobility since higher standards presumably come with a cost reflected in relative wages.

A controversial form of labor mobility occurs if labor employed in one country with low wages and standards can perform contract work in another country with relatively high wages and standards under mutual recognition. In this case the combination of wages and standards must be a reflection of differences in productivity. Assuming that the productivity of workers is embodied in the work-force, incentives to hire foreign contract workers would be low but if the differences in productivity depends on locational factors, the incentives of firms in the high productivity-, wage- and standards country to hire foreign low wage/low standards workers would be strong. Thus, workers in the high productivity country would face competition from workers in the low productivity country. The consequences of labor mobility in the sense of more permanent migration would not be as strong as the consequences of contract work across borders since the pay as well as the productivity would be linked to the residency of the workers. For these reasons, labor unions want to enforce identical rules and wages on all workers active within a certain jurisdiction whether they have migrated or not.

Corporate governance mechanisms are closely linked to rules and regulation within the financial sector. Harmonizing of one aspect of the complex maze of explicit and implicit rules that define corporate governance that can have very different effects in different countries with substantial differences in legislation, conventions and business practices. Corporate governance is also an area where a "best practice" is almost impossible to determine. Hertig and McCahery (2003) have suggested that institutional competition in the EU in complex legal areas could be enhanced by the implementation across the EU of one non-mandatory legislative solution (for example, EU company law) that is made available in each country in competition with existing national law.

These examples reveal that the costs and benefits of institutional competition relative to harmonization of institutions must be evaluated on a case by case basis taking the scope of free trade and mutual recognition into account. In the next section we apply the principles developed in this section on the emerging banking union in Europe.

5. Institutional competition vs harmonization in monetary and banking unions; costs, benefits and complementary harmonization.

In this section we apply the analysis of mutual recognition and institutional competition on central banking and a banking union. We begin with central banking within a monetary union in subsection 5.1 before turning to the banking union. Two EU approaches to the integration of markets for financial services have been formulated. The first was formally characterized by far-reaching institutional competition in the Banking Directive of 1992. The recent approach to a Banking Union implies strong harmonization and the formation of centralized EU institutions. We finally compare requirements for the two approaches to achieve their objectives and argue that the most efficient approach may include both formal harmonization and institutional competition.

5.1 Central banking

The EMU represents full harmonization of institutions responsible for monetary policy. Monetary policy is a pure public good for individuals and firms within a currency area as long as there is little opportunity for currency competition. Such competition would arise if central banks would allow mutual recognition of currencies. If currency competition were strong there is little doubt that institutional competition between central banks would be characterized by ‘race to the top” since individuals and firms would shun currencies with high and uncertain inflation. The high inflation central bank would either have to improve its performance or see its currency being abandoned.

Central banks in the industrialized world are powerful enough to prevent substantial currency competition within their jurisdictions as long as inflation rates do not reach hyperinflation levels. Thus, currency competition within the EU is likely to be weak, which means that the criteria for optimum currency areas discussed in Section 2 apply to countries' choice of exchange rate regime.

Applying the OCA criteria discussed in Section 2 it is not controversial to state that the original EMU included countries with institutional structures that were not suitable for a unified currency area. We mentioned, in particular, law and regulation affecting structural adjustment in labor and product markets, fiscal policy, and the transmission of monetary policy through the banking systems in Eurozone countries. In other words, the harmonization of monetary policy institutions went too far in light of the lack of harmonization of institution that could enhance structural adjustment across the euro-zone, strengthen the coordination of fiscal policy and prevent fragmentation of the monetary transmission mechanism through the national banking systems. It is also clear that many EMU members did not respond to economic pressures to reform their institutions.

The EU is now more stringent in enforcement of the Maastricht criteria for membership in the EMU.[5] New members in the EMU are not admitted unless they satisfy these criteria with respect to fiscal policy, national debt and long term interest rates. Thus, in the monetary sphere the EU is now practicing a higher degree of flexible integration than they did during the early days of the EMU. At that time the ambition seems to have been to include as many EU countries as possible in the monetary union.

There seems to be no flexibility with respect to membership in the EMU for the countries that have joined already, however. Thus, the countries in the Southern euro-zone must find ways to implement far-reaching institutional reform to satisfy OCA criteria and, thereby, avoid seeing other euro-zone members having permanently higher economic growth.

In Section 2 we noted that one of the areas where substantial reform has been proposed with the objective to reduce the fragmentation of the banking system within the EMU. The question we ask next is whether increased integration of national banking systems requires harmonization of regulation and law within a banking union or whether institutional competition could serve as an effective mechanism to achieve the stated objectives of the banking union?

5.2. Institutional competition in banking.

On the face of it banking regulation seems to satisfy many of the criteria for effectiveness of institutional competition, which were identified in Section 4. First, there is little agreement on what is the most effective regulatory structure in banking taking into account both efficiency and stability objectives. The lack of agreement reflects uncertainty about what an effective regulatory structure should look like. Second, he great differences within the EU with respect to corporate governance, bankruptcy law and business practices are likely to cause differences in efficient banking regulation and supervision. Third, banking is an area where regulatory capture of national regulators and rent-seeking of banks can

[5] The Maastrich criteria refer to limits on a country's national budget deficit relative to GDP, the level of national debt relative to GDP and the long term interest rate relative to average rate in member states, as well as a minimum period of a fixed exchange rate while participating in the exchange rate mechanism (ERM).

distort the regulation and supervision in favor of national banks. Sykes (2000) noted that institutional competition among regulators can reduce the scope for regulatory capture. Barth et al (2013) provide evidence from the financial crisis 2007-2009 supporting the view that regulatory capture is an important problem in the banking sector. Fourth, the private value of stability and trust in banks and financial institutions is very high. The ease with which bank runs can develop is evidence of the high private value of trust. The regulatory structure for banking promoting financial stability is very much motivated by concerns with potential bank runs that may cause systemic problems. Thus, conditions for race to the top exists in institutional competition with respect to regulation promoting financial stability.

In spite of the conditions for "race to the top" in regulation promoting financial stability the financial crisis and the euro-zone debt crisis can be viewed as evidence of failure of institutional competition in the banking sector during the last few decades. The likely explanation for this failure is that basic requirements for efficient competition among banks have not been satisfied. In other words, efficient institutional competition in regulation requires that markets for banking services are characterized by efficient competition among banks.

The failure of competition in banking to promote efficiency in terms of stability and trust in banks can be explained by the high degree of explicit and implicit protection of banks' depositors and other creditors. This protection has the consequence that banks do not compete for funding by promoting their skills in risk-management that would reduce their default risk. Depositors and other creditors "undervalue" low default risk when they choose which bank to deposit and invest in. In particular, relatively large, "systemically important" banks seem to enjoy relatively high implicit creditor protection. A recent IMF report presents estimates of the value of the implicit subsidy relatively large banks enjoy.[6]

[6] See IMF (2014). The IMF Global Financial Stability Report cites estimates that the funding subsidy for large banks in 2013 amounted to 15 basis points in the US, 20-60 basis points in Japan and the UK, and 60-90 basis points in the euro area.

There is also an academic literature providing evidence that banks respond to explicit and implicit protection of creditors by increasing their default risk.[7]

One can ask why banks' incentives to take on more risk and, thereby, to increase the risk of financial crises seem to have increased in spite of the existence of conditions for institutional competition within and outside the EU to strengthen the regulatory framework for financial stability. To answer this question we consider how the regulatory framework for banking with its focus on financial stability has failed to create conditions for efficient competition within the banking sector.

In the following we will discuss and compare two different EU approaches to financial regulation with the objectives of creating an integrated and competitive market for banking services in the EU. We call the first approach "Single Banking License with Home Country Control." It was implemented in the Banking Directive of 1992. This directive had mutual recognition and institutional competition as important components. The second approach, a "Harmonized Banking Union," is in the process of being implemented. It is characterized by far-reaching harmonization of regulation, supervision, deposit insurance and crisis management procedures.

5.3 Single Banking License with Home Country Control

The EU Banking Directive was one part of the 1992 program to create an Internal market with free mobility of products, services, labor and capital. The Directive provided the right for any EU bank to set up branches across the EU under a single license issued by the home country. These branches would all be subject to home country regulation and supervision for safety and soundness. Deposit insurance for branches would also the responsibility of the home country. There was less attention to crisis management although home country control would include this aspect of the legal framework for banks.

The Banking Directive incorporated mutual recognition of safety and soundness regulation and supervision while host countries retained jurisdiction over consumer protection in banking services. As a result of mutual recognition of host country regulators and law, and free mobility of capital the Banking Directive formally established conditions

[7] See, for example, Prabha and Wihlborg (2014)

for institutional competition with respect to safety and soundness regulation and supervision in the EU while banks would be able to provide services across the EU.

In spite of the opportunity to establish branches across the EU only a small part of cross-border banking within the EU takes has taken place through branches. Instead most cross border banking developed through subsidiaries under the formal jurisdiction of host country regulators and supervisors. One reason for the preference for subsidiaries could have been that subsidiary organizations generally enjoy greater financial synergies than branch organizations.[8] This is particularly important if bankruptcy costs are high and the likelihood of bailout in a crisis situation is high. At the same time subsidiary organizations have not had a disadvantage with respect to operational synergies because they have been able to integrate operations and functions across subsidiaries in spite of the legal separation.[9]

Another explanation for the preference of operating cross borders in subsidiary organizations is that both home and host country supervisors have objected to large cross-border operations in branches. Host country authorities have not accepted the idea of having large banks in their jurisdictions under foreign control. Home county authorities have been uncomfortable with deposit insurance responsibility for depositors in foreign branches. In other words, supervisors have not accepted the principle of mutual recognition in spite of its formulation in the Banking Directive. Although the Directive states that banks have the right to set up cross-border branches they are unlikely to do so without the approval of supervisors in both home and host countries.

The lack of acceptance of the principle of mutual recognition among European bank supervisors weakened institutional competition in supervision and safety and soundness regulation. As a result supervisors were able to favor domestic banks as “national champions” without having to fear that depositors would flee the domestic banks. The

[8] Luciano and Wihlborg (2014). A subsidiary organization can economize on bankruptcy costs since individual subsidiaries are able to enter bankruptcy.

[9] Sweeney et al (2007) analyze the case of the pan-Nordic bank Nordea. This bank is the result of the merger of four major banks in four Nordic countries. It operated subsidiaries in the four countries while having the strategic objective of integrating functions across the subsidiaries strongly. In 2004 the bank developed plans to reorganize as a branch organization but the plan fell through as a result of objections from supervisors as well as for internal reasons.

likelihood of bailouts in case the domestic banks became insolvent contributed further to lack of institutional competition with respect to the quality of regulation with respect to risk-taking.

The banking system that developed during the 1990s and the first years of the 2000s was characterized by increasing concentration on the national level and cross-border operations in strongly integrated subsidiaries that could not be separated in distress. For this reason bankruptcy costs for large banks became very high. The transparency of the regulatory jurisdiction over banks' assets in a crisis, in particular, suffered. To make the situation worse, only few countries had established legal frameworks for resolving banks in distress.[10] Crisis management and resolution became a complex procedure involving authorities in home and host countries with conflicting interests. All these factors strengthened the perception that many banks were both "too big to fail" and to "too complex to fail."

The only available option for managing crisis in an important bank was to bail out banks' creditors by issuing guarantees for their claims. Competition among banks to become a particularly safe bank hardly existed.

In spite of the early acceptance of mutual recognition as a principle and, therefore, of institutional competition the regulatory framework within the EU failed to produce a safe and sound banking system in Europe. Current reforms and proposals to harmonize regulation and supervision can be viewed as responses to this failure of institutional competition. However, we can ask what reforms would be required for the intentions of the Banking Directive with respect to institutional competition to be realized?

We argue that the failure of mutual recognition and institutional competition was caused by the strong implicit protection of banks' creditors. Banks' incentives to compete for funding by means of good risk-management were weak in spite of the high private and social value of good risk management. Misdirected private sector competition in banking

[10] Wihlborg (2012)

had the effect of turning institutional competition into a race to the bottom instead of race to the top.

This reasoning implies that institutional competition may work in the desired direction with respect to efficiency and stability of the banking sector if implicit protection of banks' creditors can be eliminated. This means that governments must develop procedures for resolution of distressed banks which make it credible that large creditor groups will not be bailed out and this credibility must be achieved without creating risk of contagion from the closure of one or more large banks. The procedures for resolving distressed banks must be effective, credible and guarantee equal treatment of creditors in all countries in order to gain de facto mutual recognition.[11] Is it possible to establish effective distress resolution procedures for the EU without the far-reaching harmonization envisioned in the banking union? We return to this issue after discussing the recent work within the EU to create a Banking Union..

5.4 Harmonized Banking Union

Since 2008 the European Commission has proposed 28 new rules to better regulate, supervise and govern the financial sector. Most of these rules are now in force or being finalized (European Commission, 2014). According to this Memo one objective is that "tax payers will not foot the bill when banks make mistakes." Another is to "break the vicious circle between banks and national finances" in the Eurozone. The banking union should allow "for centralized application of EU-wide rules for banks in the euro area (and any non-euro Member states that would want to join." Thereby the supervision should not be prone to protection of national interests.

The new regulatory framework establishes common rules for banks in all 28 Member States, set out in a "single rulebook." The Capital Requirements Directive and Regulation (Memo 13/690) should prevent banking crisis in the first place. If banks fail,

[11] See Wihlborg (2012)

the Directive on Bank Recovery and Resolution, BRRD, (Memo 14/297) sets up a common framework to manage the process of winding down the banks. All EU savers are guaranteed that deposits up to euro 100,000 are protected (Directive on Deposit Guarantee Scheme, DGS, Memo/14/296).

As of November 2014 the European Central bank (ECB) will be the supervisor of all 6000 banks in the euro area. The Single Supervisory Mechanism, (Memo/13/780) sets out the framework for supervision that should ensure that all banks abide by the "single rulebook." The Single Resolution Mechanism, SRM, (Memo/14/295) entering into force on January 1, 2015, establishes a Single Resolution Board, SRB, and a Single Resolution Fund, SRF, to manage and fund the resolution process even for cross-border banks. "Bail-in" and resolution functions would apply from January 1, 2016, but requires an intergovernmental agreement to enter into force.

Daniele Nouy, the Chair of the Supervisory Board of the Single Supervisory Mechanism, states that "the goals are to perform supervision with a truly European view, to ensure the effectiveness of the Supervisory Board, to foster convergence of supervisory practices and to integrate local supervisory practices to the benefit of all SSM members" (Nouy, 2014). A Supervisory Manual covering issues such as "methodology for the Supervisory Review and Evaluation Process (SREP), off-site and on-site reviews, risk assessments, and model validations." should ensure that "the same supervisory standards will be applied across Banking Union."

This description of the Banking Union along with the quotes from an important Chief Supervisor shows clearly that the ambition with respect to harmonization of regulation of banks is very high. The regulatory framework leaves no room for institutional competition among regulators and it seems intended to ensure that banks in all Member States follow the same rulebook enforced by the Single Supervisor.

There are costs and benefits of the envisioned banking union relative to the current system. The main cost is likely to be associated with the common rule-book for banks and the application of the same "European" supervisory model and methodology. It seems unlikely that the common rulebook and the supervision can accommodate the great variety in corporate governance, insolvency law, enforcement and business culture across Europe.[12] Contracts for various types of credit differ substantially in explicitly and implicitly. Thus identical looking contracts are likely to be associated with very different risk levels.

A second cost is associated with the dynamics of lending and supervisory practices. Increased centralization reduces the ability to innovate and learn. Best practices in different countries are supposed to be incorporated in the common rulebook and supervisory mechanism but once practices are the same experimentation and innovation is likely to decline relative to a pluralistic system.

There are important benefits as well associated with the common supervisory mechanism. In particular, the "regulatory capture" of each national regulator by the major banks in its jurisdiction is bound to decline or be eliminated. There is little doubt that such regulatory capture is an important problem that weakens supervision of risk-taking and strengthens the tendency of national regulators and governments to bail out "national champions."

Over time, the "regulatory capture" could move up to the EU level instead so that the largest EU banks rather than the largest national banks would have the strongest leverage in their dealings with the supervisor. It is possible that we will see a consolidation within banking in the Eurozone with the objective of creating European banks with great political clout and possibly becoming "too big to fail." This development can be prevented, however, if the Single Resolution Mechanism becomes credible and effective.

The implementation of the Single Resolution Mechanism is the most important piece in the Banking Union. If it becomes sufficiently strong and eliminates "too big to

[12] Wihlborg et al (2001)

“fail” and other sources of implicit protection of banks’ creditors, the banking industry is most likely in for enormous adjustment and restructuring under stronger market discipline.

Stronger market discipline implies that banks will restructure based on true economies of scale and scope and not based on implicit subsidies. It will also reduce the need for detailed supervision of risk-taking and, thereby, reduce the regulatory burden that is likely to accompany the common rulebook.

We cannot here go into an evaluation of the Single Resolution Mechanism and the likelihood that it will become effective and credible. The European Parliament accepted principles for the Mechanism in April 2014 including the principle of “bail-ins” of unsecured creditors and the build-up of a Resolution Fund. Details remain to be worked out in intergovernmental conferences. These details are likely to be extremely important for the credibility of the Resolution Mechanism. One note of optimism is contained in reports that rating agencies have started to re-evaluate the strength of the implicit protection of large banks but the final judgment on future implicit protection of banks creditors is still out.[13] Differences in attitudes to bail-ins and bail-outs are great within the EMU and the EU. The pessimistic view is that a political compromise will lead to an agreement on a Single Resolution Mechanism with escape clauses that eliminate the credibility of statements that creditors of large banks will not be bailed out.

One potential area of tension within a Banking Union arises as a result of national responsibility for fiscal affairs and supranational responsibility for supervision and crisis management. Tax payers are ultimately the stakeholders in efficient supervision. Thus, incentives of supervisors and crisis managers should be aligned with interests of tax-payers. There is no European fiscal authority, however. A resolution authority requires access to fiscal resources as a source of funding and is ultimately accountable to tax-payers. Thus, a far-reaching banking union is inconsistent with national responsibility for fiscal policy. The build-up of resolution and deposit insurance funds should reduce the reliance on national tax-payers but the ultimate responsibility for funding must lie with tax payers.

[13] See “Regulators Plan End game for Too Big to Fail” in the Global Regulator. July/August 2014, Vol 12, Issue 7.

If the fiscal burden associated with resolution of banks can be allocated among Member States the Banking Union has the advantage of having very large fiscal resources behind it. This contributes to the credibility of delinking banking risk and sovereign risk.

5.5 Institutional competition and/or harmonization?

The relevant question is not whether the most efficient regulatory framework is characterized by harmonization or institutional competition but how they can be combined in the most effective way.

We have argued that both institutional competition and the Banking Union require effective and credible resolution mechanisms for banks and other large financial institutions in each member state, which eliminate implicit protection of creditors and reduce the risk of contagion to a minimum. Without such mechanisms in place under institutional competition with mutual recognition there is substantial risk of "race to the bottom" in strictness of regulation and supervision of risk-taking. In a banking union with a single supervisor and a single rulebook the implicit protection of large banks is likely to lead to a race among banks to become larger in order to maximize the value of implicit creditor protection, as well as the ability to "capture" the supervisor and the design of the single rulebook. Standardization of the rule book and supervisory practices may not allow variation across countries in response to institutional differences and innovation in the regulated banking system will slow. Differentiation and innovation must be left to the shadow banking system.

In our view an efficient regulatory framework would allow for differences in regulation and supervision in response to differences in corporate governance, corporate and personal insolvency law, enforcement of law and business practices. In this sense institutional competition under conditions of "race to the top" in terms of financial stability and efficiency seems desirable. Innovation in banking and supervision would also be encouraged in the in the same direction.[14] Institutional competition may also be the most

[14] Kahn and Santos (2005) analyze conditions leading to different allocations of regulatory and supervisory powers. These powers can be decentralized or centralized over jurisdictions.

effective way of reducing the impact of regulatory capture of national regulators.[15] The question is whether institutional competition in the design of resolution mechanisms would favor "race to the top" as well? If not, the efficiency of institutional competition is nullified.

It seems that pure institutional competition in resolution mechanisms could become a source of "race to the bottom" in terms of efficiency and credibility because the banks in countries with relatively efficient and credible resolution procedures would face relatively high funding costs. No country has an incentive to increase the risks facing banks creditors by reducing the implicit protection of their claims.

We draw the conclusion that there is a strong case for a degree of harmonization with respect to mechanisms that ensure credibility and efficiency of resolution procedures. One way to achieve this is harmonization with respect to important aspects of the resolution procedures. Another way is to allow individual member states to make mutual recognition conditional on important aspects of resolution regimes in home countries of banks. Such conditions must be subject to possible legal challenge in the European Court of Justice or countries can protect domestic banks too easily.[16]

Resolution procedures and deposit insurance responsibility on the national level raises the possibility that authorities in a relatively small country must resolve a bank with assets many times the size of the country and guarantee that depositors are promptly paid explicitly insured deposits. Iceland encountered this "too big to save" problem during the financial crisis. The remedies for this problem would be that resolution procedures minimize the need for fiscal resources and that deposit insurance funds are large enough to handle the failure of even the largest bank. It is inevitable, however, that fiscal authorities may have to contribute resources in the process of bank resolution if contagion is to be avoided.

6. Summary and concluding comments: towards flexible integration?

[15] The importance of regulatory capture and interest group politics in shaping banking supervision and regulation in the USA is analyzed in Kroszner and Strahan (2001)

[16] See Eisenbies and Kaufman (2007) and Lastra and Wihlborg (2007)

Both the EU and the USA are complicated structures with different degrees of institutional competition. Both subscribe to mobility of goods, services, capital and labor, which contribute to institutional competition although constraints on mobility of services and labor, in particular, are stronger in the EU than in the USA. Institutional competition is correspondingly stronger in the latter country.

In areas of legislation and regulation where EU countries relinquish some sovereignty the question at hand is whether the harmonization process should take the form of an agreed upon common set of rules. The alternatives are institutional competition with mutual recognition in important respects, and institutional competition with a minimum harmonization requirement. Each jurisdictional structure has benefits and costs. The benefit of harmonization would be a reduction of costs of contracting and organization of firms while the most obvious cost for each country would depend on the difference between the "best practice" in the institutional environment of the country and the practice induced or enforced by the EU. Another more long-term cost of harmonization could be that the ability to search for unknown "best practices" is hindered by standardized and relatively static regulation and law. On the other hand, the benefits of institutional competition cannot be obtained unless mutual recognition of laws and regulation leads to "race to the top." We have discussed conditions for "race to the top" versus "race to the bottom."

The analysis of relative costs and benefits of harmonization and institutional competition does not lead to a simple answer. Costs and benefits depend on the particular area of law and regulation we consider and, more often than not, the most efficient institutional structure within a particular area involves elements of both harmonization and institutional competition.

The areas of regulation we have focused on in this paper to illustrate requirements for harmonization and institutional competition to be efficient from an economic point of view are central banking in the EMU and banking regulation. In the area of central banking the initial objective seems to have been to include as many members as possible in the monetary union in 1999 at the neglect of requirements for a currency union to function effectively. The debt crisis has demonstrated the costs of this neglect.

The EU attitude towards monetary integration became more flexible with the inclusion of Eastern and Central European countries. Mutually agreeable flexible monetary integration seems to have become the de facto principle since then. Several countries were denied EMU membership or their memberships were delayed until they had mechanisms and institutions in place to sustain competitiveness within the EMU. The case of Lithuania, which was denied membership in 2006 is a case in point.

It is now widely accepted that a well-functioning monetary union requires harmonization and coordination in the areas of fiscal policy, labor market and structural adjustment, and banking regulation. We discussed the relative merits of strongly centralized harmonization of banking regulation in the emerging banking union and institutional competition with respect to banking regulation based on mutual recognition.

In our view an efficient regulatory framework would allow for differences in regulation and supervision in response to differences in corporate governance, corporate and personal insolvency law, enforcement of law and business practices. In this sense institutional competition under conditions of “race to the top” in terms of financial stability and efficiency seems desirable. Institutional competition may also be the most effective way of reducing the impact of regulatory capture of national regulators. However, the principle of institutional competition cannot be applied if most of the banking system has strong implicit protection of its creditors because the risk of “race to the bottom” becomes substantial. This would nullify any benefits from institutional competition.

We concluded that both institutional competition and harmonization within the Banking Union require effective and credible resolution mechanisms for banks and other large financial institutions in each member state in order to eliminate implicit protection of creditors and reduce the risk of contagion to a minimum.

There is a strong case for a degree of harmonization with respect to bank resolution procedures to avoid race to the bottom. Another way to avoid this is to allow individual member states to make mutual recognition of regulation and supervision conditional on important aspects of resolution regimes in home countries of banks.

We conclude with comments of a more political and speculative nature with respect to the integration process in the EU.

It is often taken for granted that harmonization within the EU lifts all countries, that is, it has net benefits for all by reducing transactions costs but the major driving forces for centralized harmonization have not been vindicated. The expected increase in economic growth for all member countries subscribing to the Lisbon Agenda has not materialized. Importing a Eurocentric institutional structure can burden business with new constraints and added costs affecting the comparative advantages of old and new members, without increasing economic growth and countries' capacity to deal with crises.

Flexible integration is to some extent a reality but there are indications that the political process of give and take among countries' leaders within the EU leads to excessive centralized harmonization with respect to regulation and legislation but insufficient harmonization in enforcement of the principle of non-discrimination in intra EU trade in goods, services, labor and capital (Sweeney, 2004).

It seems that obtaining legitimacy of EU institutions among citizens in this very diverse group of countries can only be achieved if the principle of flexible integration becomes more widely accepted. Flexible integration requires increased emphasis on institutional competition as an approach to harmonization in the long run.

There is a lesson from the American experience from the very early days as noted by Sweeney (2004) as well as from more recent events. The conditions for institutional competition are more present in the US than in Europe. As an example, Texas with its emphasis on a low income tax and low burden of regulation seems to be well ahead of California in the competition to attract business. This does not reflect race to the bottom, however, if Californians consider the services provided by the State and the lifestyle worth the higher tax. Differences in tax rates and regulation may simply reflect preferences with respect to business activities and conduct. If so welfare in both states is enhanced by differences in regulatory structures.

References

Barro, Robert J. and David B.Gordon (1983), **"A** Positive Theory of Monetary Policy in a Natural Rate Model**",** *Journal of Political Economy*, 91, (4), 589-610

Barth, J. R., Caprio, G., and Levine, R. (2012). *Guardians of Finance*. Cambridge, MA: MIT Press.

Burdekin, R., C. Wihlborg and T.D. Willett (1992), A Monetary Constitution Case for an Independent European Central Bank" *World Economy*, March, pp. 231-44.

De Grauwe, Paul (1996), Monetary Union and Convergence Economics" *European Economic Review*, Vol. 40 (3-5), 1091-102

De Grauwe, Paul and Francesco P. Mongelli (2005), "Endogeneities of Optimum Currency Areas; What Brings Countries Sharing a Single Currency Closer Together?", Working Paper Series No 468, European Central Bank

Eisenbeis, R.A. and G.G. Kaufman (2007), "Cross Border Banking: Challenges for Deposit Insurance and Financial Stability in The European Union" in Benink, H., C. Goodhart and R.M. Lastra (eds), *Prompt Corrective Action and Cross-border Supervisory Issues in Europe*, FMG Special Paper 171, London School of Economics

European Commission (1990), "One Money, One Market", *European Economy*, Vol 44.

European Commission (2014), "Banking Union: Restoring financial Stability in the Eurozone," Memo.14/294, April 15.

Frankel, J. A. and A.K. Rose (1998), "The Endogeneity of the Optimum Currency Area Criteria", *Economic Journal*.

Hertig, Gerard and James Mc Cahery (2003), "Company and Takeover Law in Europe: Misguide Harmonization Efforts or Regulatory Competition', *European Business Organization Law Review*, 179

IMF (2014), Global Financial Stability Report, Washingtoon D.C., April

Kahn, Charles M. and Joao A.C. Santos (2005), "Allocating Bank Regulatory Powers; Lender of Last Resort, Deposit Insurance and Supervision," *European Economic Review*, 49, 2107-2136.

Kerber, W. (2000), "Interjurisdictional Competition within The European Union," *Fordham International Law Journal,* 23, 217-249.

Kroszner, Randall S. and Philip E. Strahan (2001), "Obstacles to Optimal Policy. The Interplay of Politics and Economics in Shaping Bank Supervision and Regulation Reforms,"in Mishkin, F. S. (ed) *Prudential Supervision: What Works and What Doesn't?* University of Chicago Press, Chicago

Kydland F. and E. Prescott (1977), "Rules Rather than Discretion: The Inconsistency of Economic Plans", *Journal of Political Economy*, 85, pp 473-90

Lastra, R. and C. Wihlborg (2007), "Law and Economics of Crisis Resolution in Cross-border Banking" in Benink, H., C. Goodhart and R.M. Lastra (eds), *Prompt Corrective Action and Cross-border Supervisory Issues in Europe*, FMG Special Paper 171, London School of Economics

McKinnon, Ronald I. (1963), Optimum Currency Areas", *American Economic Review,* Vol. 53, pp. 717-25

Mundell, Robert A. (1961), "A Theory of Optimum Currency Areas", *American Economic Review,* Vol. 51, pp. 657-65

Nouy, D. (2014), "Towards the European Banking Union: achievements and challenges," Speech at the OeNB Conference, Vienna, May 12.

OECD (2004), Policy Brief on the Euro Area (July)

Prabha, A. and C. Wihlborg (2014), "Implicit Guarantees, Business Models and Banks' Risk-Taking through the Crisis: Global and European Perspectives," *Journal of Business and Economics*, Forthcoming

Romano, Roberta (2006), “The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters”, Mimeo, Yale law School

Schmidt, Reinhardt, H. and Gerhardt Spindler (2002), “Path Dependence, Corporate Governance and Complementarity”5 International Finance 311

Sykes (2000), “Regulatory Competition or Regulatory Harmonization? A Silly Question?” *Journal of International Economic Law*. 257-264.

Sweeney, R.J. (2004), *Building a European Union Constitution: Lessons from United States History*, Manuscript, Georgetown University

Sweeney, R.J., L. Goldberg and C. Wihlborg (2007), “"The Nordea Experiment: Evidence from Market and Accounting Data”, *Journal of Banking and Finance*, Vol. 31. No 4, 1265-86

Tower, Edward and Thomas D. Willett (1976), *The Theory of Optimum Currency Areas and Exchange Rate Flexibility,* Special Papers in International Finance No 11, Princeton University

Trachtman, J.P. (2000), “Regulatory Competition and Regulatory Jurisdiction” *Journal of International Economic Law*, 331-348.

Vaubel (2009), “The future of fiscal federalism and the need for global government: A response to Vito Tanzi,” *European Journal of Political Economy*, 25, (1), 133-136.

Wihlborg, C. (2012)*, Developing Distress Resolution Procedures for Financial Institutions,* SUERF Study 4/12

Wihlborg, Clas and Thomas D. Willett (1991), “Optimum Currency Areas Revisited” in Fratianni, Michele, Clas Wihlborg and Thomas D. Willett (eds), *Financial Regulation and Monetary Arrangements after 1992*, Elsevier-North Holland, Amsterdam

Wihlborg, C., S. Gangopadhyay and Q. Hussain (2001), "Bankruptcy Infrasttructure Requirements," Brookings-Wharton Papers on Financial Services

Wihlborg, Clas, Thomas D. Willett and Nan Zhang (2010), "The Euro Debt Crisis, It Isn't Just Fiscal", *World Economics*, 11, (4), Oct-Dec.

Willett, Thomas D., Orawan Permpoon and Clas Wihlborg, (2010), "Endogenous OCA Analysis and the Early Euro Experience", *The World Economy*, 33 (7).

Wyplosz, Charles (2006), "European Monetary Union: the Dark Sides of a Major Success", *Economic Policy*, (April)

*