

BANKING REGULATION WITH VARIABLE GEOMETRY[§]

by

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Abstract

European integration today faces two conflicting forces, enlargement and deepening. Variable geometry has been proposed as a principle to make these two consistent with each other. It combines a core of integration shared by all members and with a set of peripheries, i.e., arrangements for integrated policies in which not all member countries participate. Variable geometry can take the form of concentric circles, relying on a hierarchical structure of the peripheries, and excentric circles, placing all peripheral arrangements on the same level. Using banking regulation as an example, we explore the consequences of these two models.

Concentric circles promote compromises among countries pursuing different goals to integration, but also create the risk that no compromise may be found. Excentric circles promote the formation of different groups among countries pursuing different goals and allow for a larger degree of variation. Thus, the two approaches would set the EU on very different paths. The hierarchical model leads to a union in which all countries will ultimately share the same, but relatively low level of integration. The alternative model leads to a union in which different members participate with different intensities and some of these members may reach a very high level of integration.

I. Introduction

Towards the end of the current century and well into the next, European integration will face two conflicting forces, enlargement and deepening of the European Union (EU). The impetus to enlarge comes from the restructuring of the political map of Europe following the end of the Cold War. After the break-up of the socialist block, countries of East and Central Europe have expressed strong desires to join the EU to speed up the transformation and modernization of their economies. The EU has signed Europe Agreements with the four *Visegrad* countries (Poland, the Czech Republic and the Slovak Republic, and Hungary) and the three Baltic republics, Bulgaria, Romania, and Slovenia. These agreements are "an important step towards economic integration in Europe" (Baldwin 1996, p. 4).¹ Among the current EU members, Germany is the keenest for Eastern enlargement. Chancellor Kohl worked hard at "his" Essen summit in the Fall of 1994 to obtain a firm promise for an Eastern enlargement in the foreseeable future from the EU. German politicians fear to be left alone in dealing with political instabilities in East and Central Europe otherwise, and that its involvement in East and Central European politics might draw Germany out of the EU.² Opposition against enlargement stems from its likely impact on redistributive policies in the EU. Since the new members will contribute little to the Community's resources in relation to their requests for transfers, those members --Greece, Portugal, and Spain-- and those sectors --mainly agriculture-- that are now the main beneficiaries are also the main opponents of an Eastern enlargement (Baldwin 1994, ch. 7). To keep the EU from becoming too much oriented towards the East, the Mediterranean countries have begun to pursue a Southern enlargement, lining up Malta and Cyprus as the next candidates for membership and giving Turkey a closer association.

The impetus to deepen European integration comes mainly from the older EU members who wish to strengthen European political integration and solidarity. Deepening European integration includes the realization of the European Monetary Union (EMU), but also closer cooperation in areas of social policy (e.g., the Social Charter), foreign policies and home affairs, and, ultimately, the vision of a European political union. As deepening in the EU has proceeded, conflicts have arisen also among the existing

members. The United Kingdom, for example, has objected to the EU drive for EMU and has asked and obtained an option, formalized in the Treaty on European Union (TEU), not to participate in monetary integration. Denmark has obtained a similar option. Other member countries, like Italy, while sharing the objective of monetary unification, find that they cannot meet the criteria for joining EMU by the prescribed deadline. In sum, tensions exist among existing members.

Enlargement will add additional tensions in the EU because it is bound to slow down the process of deepening. First, deepening raises the entry hurdle for the new comers (Baldwin, 1994). Second, the prospect of having to include less developed and politically less stable countries in deeper forms of European integration reduces the value of higher forms of integration for those old EU members striving for further deepening (von Hagen, 1995). Third, enlargement will raise the number of members that do not share the original members' vision of a European political union as the ultimate goal of European integration. This will make it harder to obtain the necessary consensus for deepening the community.

The growing dissatisfaction of those members that wish to go forward with deepening and feel being held back by the others has led to concept of *variable geometry* (VG) as a compromise. First mentioned by the late President Francois Mitterrand in a message to the French people on 31 December 1990, the idea was developed by Karl Lamers of the German Christian Democrats (CDU, 1994) and by Eduard Balladur (1994) in a response to that paper.³ At the heart of VG lies the distinction between a core and a periphery of the EU. The core includes what all members have in common in European integration. The periphery contains those policies that are shared by some but not all EU members. Thus, the principle of VG is that it does not require all members to participate in all areas of integration (Fратиanni, 1995b). This stands in stark contrast to the traditional doctrine that all EU members strive to participate fully in all existing areas of common or Community policies. VG would allow different members to achieve different degrees of integration not only temporarily - allowing new members time to achieve the common level of integration has been a principle of European integration since the first enlargement in the 1970s - but permanently.

The TEU incorporates some elements of variability, but not to the extent of VG. One such element is manifested in the derogations the U.K., Denmark, and Sweden obtained from EMU. Another one is the exemption the U.K. obtained from the social union. In the most recent enlargement, Sweden even obtained an exemption from the Single Market, though only in a negligible area.⁴ However, these exemptions and derogations clearly have exceptional character and, being the product of international treaty negotiations, are hard to be repeated. The recent proposals try to go beyond that and intend to introduce variability as a normal characteristic in European integration.⁵

This paper explores the political economy of VG in the EU using banking regulation as a specific example. Banking regulation represents an interesting case for at least two reasons. First, given the role of banking in financial intermediation, money creation, and the payment mechanism, this industry fits in two distinct EU activities. As being part of the financial industry, banking fits into the Single Market Program, a core and common area of the EU; for the rest banking fits into the EMU category. While EMU is considered today a common area of integration, just like the Single Market Program, tensions among the old members and between the old and new members are bound to make it more limited in scope. Second, integration of banking regulation creates both positive and negative externalities among the EU countries, depending on their different stages of financial markets development. Negative externalities, as well as positive externalities, are of particular interest to us because they influence the nature of VG. Generally speaking, the core will be defined in terms of activities that generate gains for all member countries, whereas peripheries include activities that may generate negative externalities.

The central message of the paper is that the German version of VG promotes compromises among countries pursuing different goals to integration in the same area, but also has a built-in risk that may lower the likelihood of an agreement and may in fact lead to no integration. The French version of VG promotes the formation of different groups among countries and a larger degree of variation in European integration. It turns out --perhaps an historical oddity-- that German interests would be better served by the French

proposal than the German proposal, whereas a country like Italy --and also France-- ought to prefer the German proposal to the French proposal.

The plan of this paper is as follows. Section II reviews the principles of banking regulation in the EU. Section III defines the concept of VG. Section IV analyzes the relevant themes of political economy using banking regulation as a specific example: The choice of a particular form of VG and the treatment of banking regulation within it. Section V ends with the main conclusions.

II. Principles of Banking Regulation in the EC

II.1. Reasons for Financial Regulation

Two basic motives explain financial regulation. One motive for regulating the financial industry is the same as the motive for regulating any other industry, namely to protect producers from the effects of competition. The other motive for financial regulation --one which is usually emphasized in the literature-- finds its *raison d'être* in market failures. Along this second dimension, it is useful to distinguish three reasons, each leading to different modes and instruments of regulation.⁶ The first is the protection of small depositors against the risk of bank failure. It is motivated by the observation that small depositors find it hard and excessively costly to monitor the lending activities of their banks, and are therefore unable to prevent banks from pursuing too risky lending strategies. Small depositors are, therefore, exposed to excessive risk and supply suboptimal amounts of savings to the banking sector.

Banks can insure their deposits to avoid this problem. But deposit insurance is difficult to organize on a market basis, because information asymmetries between the insurer and the bank make it impossible to price deposit risk in an actuarially fair way, and mispricing risk induces moral hazard on the part of the insured (Chan, Greenbaum, and Thakor, 1992). As a result, bank deposits are commonly insured by government agencies or cooperative industry arrangements promoted and enforced by the government. Banks are typically charged flat fees for the insurance - e.g. the pre-reform FDIC in the US. The resulting incentive for the depositors to reduce their monitoring activities can be mitigated by setting upper limits

on the insurable amounts. To address the moral hazard problems for the banks, the providers of deposit insurance typically introduce other elements of banking regulation such as capital requirements and publication requirements.⁷

The second reason for financial regulation is to prevent financial contagion, i.e., the effects large withdrawals of deposits at one bank may have on the banking industry. Financing illiquid assets with liquid liabilities is a central activity of banks. The mismatch in maturities between bank assets and liabilities creates the risk that depositors run to withdraw their funds from a bank even when a slight suspicion arises that the bank is unable to repay its liabilities (see, for example, Diamond and Dybvig, 1983). Since the bank's reserves are limited, each depositor wants to be first in line to obtain his deposit before the bank shuts down, hence the self-propelling nature of the bank run. If depositors at other banks read the closing of one bank as a signal that their banks as well are in financial trouble, the run can spread to other banks (Tirole, 1992).

Bank panics can be prevented by strengthening the credibility of the banks' promise to honor their liabilities. Regulatory strategies to prevent bank runs involve measures to convince depositors of the financial soundness of the banking sector, such as prudential rules limiting the risk exposure of the banks and forcing them to hold sufficient reserves to meet sudden increases in the demand for cash. Furthermore, bank panics can be prevented by a credible lender of last resort (LLR), i.e., an institution that guarantees the liquidity of the banking system. If depositors are assured that the bank can always obtain the necessary reserves to pay out their deposits, the value of being first in line disappears and bank panics do not arise. Note that this bank runs-related LLR (R-LLR) function addresses a different type of problem than deposit insurance. Deposit insurance comes into play when the bank's liabilities exceed the value of its assets --i.e., the bank is insolvent-- whereas R-LLR aims at correcting an externality that results from maturity transformation of solvent banks.

The third reason for financial regulation is to preserve the integrity of payments mechanisms (Goodhart and Schoenmaker, 1993; Hartman, 1995). Payments systems help to economize on the reserve medium

(mostly central bank money) and to avoid long delays in payments. They create credit relations among the participants during the time interval between the initiation and the final settlement of all payments. This is particularly true in *net* settlement systems, where funds are transferred only on the basis of the net interbank positions at the end of a settlement period, but also in *gross* settlement systems, where funds are transferred for every transaction, if such systems contain overdraft facilities. Thus, payment systems create their own credit risk. If a participant proves unable to meet its obligations, all other participants may be affected, given the interdependence of credit relations. The systems would then grind to a halt and all payments would have to unwind to isolate the failing institution from the other participants, a procedure that would be lengthy, costly, and at times impossible.

To avoid such a breakdown, the clearing agent, often the central bank operating the system, must stand ready to provide the system with the necessary reserves if one or more participants are unable to honor their liabilities. Thus, the smooth operation of payments systems demands another, a payments-related (P-LLR) lender of last resort function. To reduce the credit risk thus shifted on the P-LLR provider, mechanisms like overdraft and float pricing and the requirement of collateral can be used. However, credit risk is not completely eliminated unless transactions are settled in real time, on a gross basis, and without recourse to overdraft facilities, a costly procedure.

The P-LLR function is quite different from the R-LLR function. The latter focuses on banks' liquidity in the context of credits and debits banks create voluntarily after assessing their counterparts. In contrast, a payments system makes banks extend credit to other banks without choice nor assessment of their counterparts, as these credits result from the activities of other banks (Angelini and Passacantando, 1993; Goodhart and Schoenmaker, 1993). For this reason, regulatory provisions surrounding the P-LLR and the R-LLR functions are different. The latter focuses on the quality of the bank's assets, its reserves and its capital. In contrast, P-LLR related regulation requires information about the quality of its risk controls, computing and back-up facilities and network technologies over and above information about the solvency of the bank.

Banking regulation in these three areas can and does involve different institutions. Deposit insurance, LLR functions, and prudential rules (inclusive of capital adequacy ratios) can be delivered cooperatively by the banking industry, the central bank, or another government agency specializing in these activities, or by a mixture of all three.⁸ In Germany, for example, deposit insurance is provided by an industry fund operating under the auspices of the Bundesbank⁹; prudential rules and their enforcement are the authority of the independent Federal Regulatory Authority for Financial Institutions, while payment-systems related regulation falls under the jurisdiction of the Bundesbank. The ability of a central bank to provide, in principle, unlimited liquidity by creating claims against itself makes this institution the most credible LLR provider.

The three types of banking regulation involve a reallocation of risk and, therefore, a wealth transfer. But those who benefit primarily are not the same in the three cases. Deposit insurance (particularly when the size of insurable deposits is limited) primarily benefits small savers. Prevention of bank panics benefits primarily equity owners of banks that are financially sound but would suffer from panics otherwise, as well as those on the other side of the maturity transformation provided by the banking sector, namely the individuals and firms who borrow from the banks. Securing the smooth functioning of the payments system generates a benefit for the banks and the users of the medium of exchange.¹⁰

In an international environment, the identification of the primary beneficiaries of banking regulation raises interesting and more complex issues. First, governments have a bigger incentive to protect domestic depositors against the risk of bank failure than foreign depositors. If deposit insurance is administered by a government agency or a central bank, it involves taxation of the general public for the benefit of bank depositors. Since a transfer of tax revenues to foreigner is not politically attractive, governments tend to be reluctant to rescue foreign bank depositors and delay payments or refrain from honoring their obligations altogether if the deposit losses are large.¹¹ The failure of Banco Ambrosiano in 1983 illustrates the point. The Italian Banco Ambrosiano Spa controlled a Luxembourg holding company, BAH, that became involved

in unauthorized and dubious transactions not properly scrutinized by either the Italian or the Luxembourg regulators. When the failure of the holding company brought down the Italian bank,

“... all the creditors of Banco Ambrosiano Spa were repaid promptly, creditors of BAH received only partial repayment after considerable delay. Disregarding the question of whether official supervision prevents bank failures, sophisticated market participants inferred that in the event of trouble, governments are unlikely to assist entities for which they do not have primary supervisory responsibility.” (Herring and Litan 1995, p. 102; our underlining).

Second, governments do have an incentive to extend the LLR coverage to foreign banks operating in their countries, since a run on or the illiquidity of a foreign bank operating in the domestic market may spill over to the domestic banking sector. Goodhart and Schoenmaker's survey of bank failures supports that point by illustrating governments' interest in rescuing foreign-owned banks operating in their domestic markets.¹² In contrast, governments are unlikely to care much about the ripples financially troubled, domestic banks may cause in foreign markets. This is nicely illustrated in the Herstatt case (von Hagen, 1992), when the German authorities closed down the operations of the bank after the German market ended but while the New York market was still in operation, not worrying about the financial distress this caused for Herstatt's New York creditors in unsettled daily transactions. By implication, governments will be reluctant to stand by as providers of LLR functions to domestic banks operating mainly in foreign economies. This, in turn, means that the incentive to enforce domestic regulation on banks operating abroad to reduce the risk exposure of foreign LLR providers is weak, since the benefit of the enforcement falls on the foreign government.¹³

II.2. Regulation and Competition

Regulation, even where socially desirable, raises the cost of doing business. Regulated financial institutions offer lower yields on their deposits and charge higher interest rates on their assets than unregulated institutions. Countries with tighter regulatory regimes offer more protection to depositors but tend to lose business to countries with looser regulatory regimes. Thus, the birth and the expansion of the

Eurocurrency markets was driven largely by the fact that the host countries (where offshore banks are located) compete with home countries through lower regulatory burden.¹⁴

A second link between competition and regulation evolves around the institutional design of banking regulation and, in particular, deposit insurance (Goodhart and Schoenmaker, 1993). In many European countries regulation and protection of depositors were traditionally organized on the basis of close cooperation between industry organizations and the central bank or a government agency. Such cooperative arrangements become much more difficult to maintain in an environment of fierce, international competition for two reasons. One, because competition tends to destroy the traditional, insider-club nature of industry relations, and, two, because banks have acquired additional activities, such as insurance, resulting in a fuzzier industry structure than the traditional one. The increasing intensity of competition has, therefore, induced a tendency to develop more formal structures of regulation and deposit insurance, turning away from the traditional approach.

II.3. The European Approach to Regulation

EU banking regulations distinguish between prudential supervision, deposit insurance, and maintenance of payments systems. This distinction mixes elements of all three basic functions of regulation, which, as argued above, all involve elements of prudential supervision. According to the Second Banking Directive of 1989, prudential supervision falls under the home-country principle. Accordingly, banks are regulated by the relevant authorities of their home countries irrespectively of where they do business in the EU, and regulatory authorities have the right and the obligation to regulate and supervise the activities of all banks chartered in their countries regardless of where these activities are performed. Since all member states accept this principle, national regulatory standards are mutually recognized.

Mutual recognition works if the participants trust each other and agree that the lowest national standard in the group is an acceptable minimum standard of regulation for all, or if the group has negotiated a common minimum standard. To facilitate trust and agreement, mutual recognition requires sufficient

homogeneity of preferences in the group. Through a variety of directives, such as the Own Fund Directive, the Solvency Directive, and the Large Exposure Directive, the EU has supplemented the home-country rule by a floor of minimum standards. This strategy was deemed superior to the alternative of ex-ante coordination that might provide a first-best solution but is more difficult to implement (Fратиanni, 1995a).

With the Directive on Deposit Guarantee Schemes, passed in May 1994, the home country rule has been extended to the area of deposit insurance. All financial institutions must participate in deposit insurance schemes. Beginning July 1, 1995, deposit insurance schemes must provide insurance for all deposits with maximum coverage no lower than 20,000 ECUs.¹⁵ Introducing the home-country rule in this area obviously implies that depositors in each country face different deposit risks at domestic and foreign banks. A bank operating in a foreign country can join the host country's deposit scheme voluntarily if that scheme provides higher coverage than the scheme of its home country.

The home-country principle does not apply with regard to regulation aiming at the maintenance of payments systems. All European central banks are involved in this area of regulation, even those, like the Bundesbank and the Danish Nationalbank, which are not involved in matters of prudential supervision. This involvement is a consequence of the fact that all European central banks are engaged in the operation of national payments systems.¹⁶ As each central bank in Europe remains responsible for the functioning of the payments system in its home country, subsidiaries of foreign banks are subject to the regulations of the national payments system such as solvency requirements, minimum transaction volumes, participation fees, technical requirements, and certification by the central bank. This principle has been maintained recently by the Working Group on EC Payment Systems, a committee of the EC central banks (Hartmann, 1995). It is partially inconsistent with the principle of mutual recognition because the national authorities charged with the maintenance of the payments systems need information and, hence, must rely on the monitoring activities of the regulatory agencies involved in ordinary banking regulation as regards foreign banks.

A division exists today among the member countries concerning the degree of involvement of the central bank in prudential supervision.¹⁷ Strong and weak central bank involvement coexist in the EU: Among the 14 current central banks in the EU, six - the Austrian, the Belgian, the Danish, the German, the Finnish, and the Swedish central bank - are not involved in supervision at all or have only a small administrative role. In these countries, banking supervision under the jurisdiction of separate government agencies. The remaining central banks have substantial responsibilities in this area. This division is reflected in the text of the TEU which, in contrast with EMU, is vague about banking regulation and supervision, beyond the regulation and supervision of ECU clearing systems and cross-border payments (see Table 1).

Table 1
The TEU on Banking Regulation, Supervision, and Payment Mechanism

- The European System of Central Banks (ESCB) is assigned the role of promoting “the smooth operation of payment systems” (Protocol N. 3, Art. 3.1, Council 1992, p. 149).
 - The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.” (Protocol N. 3, Art. 3.3, p. 149).
 - The ECB [European Central Bank] and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries.” (Protocol N. 3, Art. 22, p. 158).
 - The ECB may offer advice to and be consulted by The Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.” (Protocol N. 3, Art. 25.1, p. 159).
 - The ECB may perform specific tasks concerning policies relating to the prudential supervision of credit institutions with the exception of insurance undertakings.” (Protocol N. 3, Art. 25.2, p. 159).
 - The EMI [European Monetary Institute] shall ... facilitate the use of the ECU and oversee its development, including the smooth functioning of the ECU clearing system.” (Protocol N. 4, Art 4.1, p. 173).
 - The EMI shall in particular ... promote the efficiency of cross-border payments (Protocol N. 4, Art. 4.2, p. 174).
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In sum, prudential supervision, deposit insurance and, though not mentioned explicitly, R-LLR are likely to remain under national authority and, furthermore, will not necessarily be an area of competence of the central banks, since they currently fall under the competence of other government agencies or industry arrangements in some countries. Even in the domain of payment systems, the current interpretation is that the Treaty places the responsibility with the national central banks rather than with the ECB (Hartmann, 1995). More on the subject below.

II.4. The Irrelevance of the Home-Country Rule in the EU

The assignment of regulatory competencies in the EU currently reveals a peculiar pattern. Rather than distinguishing between the different economic types of regulation, the EU puts all prudential-rules legislation and its enforcement under the home-country principle. Presumably, this assignment was motivated to facilitate competition in the banking market and among national regulatory approaches. In contrast, the regulatory activities involving resource transfers generally remain under the jurisdictions of the host countries. Deposit insurance, which in principle falls under the home-country rule, leaves banks the option to apply the host-country principle.

The assignment of home and host-country rules according to instruments rather than functions of banking regulation will make the home-country rule practically irrelevant for the EU. We base this prediction on the fact that the current system creates an overwhelming incentive for banks to charter in the national markets where they operate and adopt the different national regulatory regimes, through subsidiaries, rather than operate from a single base across borders, through branches. This incentive results from the competitive disadvantages foreign branches face in domestic markets. To begin with, deposit insurance of a foreign branch lacks credibility due to the home government's reluctance to effect transfers to citizens of other countries. This implies that depositors will turn away from foreign branches unless they are compensated by an appropriate risk premium. In order to avoid such premia, banks will find it more attractive to set up subsidiaries, under national licenses, and accept the host country's regulatory

requirements to participate in the national deposit insurance scheme. Furthermore, the inability to participate in the national payments system restricts foreign branches in competing with domestic banks. This, again, creates an incentive to accept the regulatory requirements of the host country to enjoy the benefits of the national payment system. Last but not least, R-LLR is bound to remain a national function if for no other reason than it has been ignored by current EU regulations.

In sum, despite the nominal prevalence of the home-country rule, banks have strong incentives to conform to national regulation. As a result, member states will continue to use diversity in regulation as barriers to entry. On this basis, we will proceed in our analysis with the assumption that countries can unilaterally set regulatory standards for their own markets.

III. Concepts of Variable Geometry

The incentives national governments will retain in operating different regulatory systems make it unlikely that these governments will readily agree on a common EU-wide standard. If so, this raises the possibility of VG in the financial sphere. With VG, the members of the EU have choices regarding the policy areas in which they wish to participate with other countries in common, integrated policies and arrangements for policy cooperation. The important constitutional question is: To what extent these choices must be structured and limited?

The most radical form of variability is *Europe à la carte*. *A la carte* means literally that each member country would be free to "pick and choose" in what areas of integration it would want to participate. There would be no restrictions on how policy spheres could be combined, meaning that each of them would be treated independently of the others. The attractiveness of this model lies in the fact that no member is constrained to accept any common policy that it dislikes.

VG is a more restricted version of variability than *Europe à la carte*. Critical in VG is the distinction between a common *core* of integration, to which all EU members must adhere, and a set of *peripheries* or optional integration areas. Critical in VG is the question of what goes in the core and what in the

peripheries.¹⁸ There are two aspects to this question. One, which policy domains must be in the core, and, two, by which principles can members choose among peripheries. About the former three principles apply. First, the core establishes basic common values all EU members share. The free movement of goods, services, capital, and people --that is, the Single Market -- is undoubtedly part of the core. In contrast, neither monetary integration (MU) nor social policy belong to the core in light of the fact that the EU has already granted "derogations" in these policy domains to some member countries.¹⁹

Second, the core can be regarded as an instrument to construct package deals. To illustrate, take the Single Market as an example. In the past, member countries were often unwilling to accept particular elements of the Single Market unless they were compensated for unavoidable adjustment costs. The EU has been able to push forward the process of integration by offering attractive side deals to those members. The existence and growth of regional, structural, and social funds must be interpreted as part of package deals to expand the size and depth of the core.

Third, the core must include all policies that regulate the creation of peripheral spheres of integration, i.e., it includes the constitution of the EU. As an implication of these three criteria, the logic of VG is that coordination of policies in peripheral areas can take place only if it does not endanger the integrity of the core.

IV. Banking Regulation and Variable Geometry

In this section, we explore how VG might work for the EU using banking regulation as a specific example. We proceed in three steps. In the next section, we consider where banking regulation should be placed in the framework of VG. Following that, we discuss the organization of the periphery in the context of banking regulation and EMU. Finally, we bring enlargement into the picture to show how it affects the results of VG.

IV.1. Banking Regulation: Core or Periphery?

We have seen above that the motivation for banking regulation is different for different types of regulation. Deposit insurance aims at protecting the wealth of small savers and falls primarily under the jurisdiction of the host country where the protected individuals live. LLR functions aim at correcting negative externalities and also fall under the jurisdiction of the host market where the benefits from a well functioning payment mechanism and a stable financial system accrue.

The incentive to coordinate or integrate LLR functions derives from the benefit to create larger and integrated markets for banking services and payments systems. Both offer economies of scale and scope. In addition, an integrated banking market offers a more efficient and smoother allocation of capital, and an integrated payments system generates lower transactions costs in international trade. The impetus for creating integrated banking markets and an integrated payments system will thus come primarily from countries with highly developed and competitive banking industries that wish to expand and from countries with export-oriented industries that wish to rid themselves of the effective barriers to trade created by separation of banking markets and payment systems. In contrast, countries with weak and noncompetitive banking industries will resist such efforts. As noted in Section II, one motivation for regulating the financial industry is to protect producers from the effects of competition. Weak incumbents put pressure on regulators who tend to identify with the interests of the industry.²⁰

Consider Europe *à la carte*, first. Suppose that all EU members have the choice to participate in free integrated trade in goods and services, integrated markets for banking services, integrated payment system, and integrated LLR functions. There are three possible configurations: Countries with a competitive banking industry and a competitive goods industry would wish to participate in free trade and integrated banking markets and payment systems. Countries with competitive industries and non-competitive banking sectors would prefer free trade in good and services, common payment system, but would use domestic banking regulation as barriers to entry into the domestic banking market. Countries with non-competitive goods industries and competitive banking industries would wish to participate in an integrated banking market,

but use trade restrictions to protect their domestic industries. Countries with non-competitive goods and banking industries would opt to keep trade barriers in both areas.

The problem with Europe *à la carte* is that it does not encourage the formation of deals among the second and third group in which each group accepts open markets where it is weak in exchange for opening markets where it is strong. Europe *à la carte* would mean, therefore, free trade in goods and banking services only among the countries belonging to the first group. Disaggregating "goods" and "banking industries" further, one can see immediately that Europe *à la carte* would lead to a patchwork of sectoral free trade agreements rather than an integrated European market, as each country has some strong and some weak industries. Thus, by offering unstructured variability, Europe *à la carte* destroys the envisaged single market in goods, services and financial assets.

Let us now assume that the EU were to adopt VG as an organizational principle, and that free trade in goods and banking services were in the core because of positive externalities. If banking regulation were excluded from the core, countries with weak banking industries could use regulation to erect barriers to entry around their home markets. In this sense, uncoordinated banking regulation would threaten the proper working of the core. This line of reasoning presumably led the EU to introduce the home-country rule. However, as argued above, the home-country rule is unfit to achieve the desired results. The proper functioning of the core instead demands a minimal degree of coordination of banking regulation.

Since the host-country principle applies effectively, minimum standards are not relevant here. What matters is rather to limit the misuse of regulatory provisions as barriers to entry, i.e., to limit variation in regulatory provisions and assure equal treatment for domestic and foreign banks. Such monitoring of national regulatory activities could become an activity of the European Commission, whose task would be to enforce the proper working of the core. Beyond that, national regulatory functions could operate independently.

With an integrated market for financial services as part of the core contagious bank crises arising in one country may spill over to another country. If, for example, branches of Dutch banks became very active in

Northern Germany, a run on banks triggered in Rotterdam could easily spread to Dutch banks in Bremen and Hamburg and from there affect other banks in the German market. Thus, integration of banking markets creates a joint responsibility for maintaining the stability of the banking industry. The shared responsibility implies that there is a need to coordinate R-LLR across countries, too. Otherwise, national R-LLR providers would have an incentive to free ride on other countries' providers. As a result, there would be under-provision of R-LLR in the integrated banking market, generating too much market instability in equilibrium. But the independent provision of R-LLR by different governments in an integrated banking market is inefficient, since prudential rules set by one provider affect the risk exposure of other providers of R-LLR. Finally, R-LLR requires rapid action concerning banks located in various places in the integrated market. Independent providers are ill equipped to move fast.

In conclusion, R-LLR belongs to the core either under a common, European provider or through cooperation by national providers operating under identical prudential and regulatory standards.

Things are different with regard to deposit insurance. Again, some coordination is necessary to prevent countries from misusing deposit-insurance related regulation as barriers to entry. An incentive to integrate deposit insurance schemes comes from the incentive to pool risks. This incentive is independent of the existence of a common market in banking services, it may even be stronger where such a market does not exist, since market segmentation would reduce the correlation of default risk across banks. Since each government is interested in protecting its own citizens, the host-country principle creates no free riding among independent, national providers. Thus, apart from the risk-pooling incentive, there is no compelling reason to coordinate deposit insurance.

Just like other forms of insurance, the interest to pool risks is different among countries whose banking systems have achieved different degrees of financial stability. Countries with weak systems would like to pool with countries with strong systems, but not vice versa. This implies that forcing countries to pool deposit insurance will induce those countries whose banks represent low risks to opt for a low, suboptimal

level of insurance. Consequently, given the potential for a negative externality, deposit insurance should be placed in the EU periphery countries with similar banking industries to pool risk if they wish.

However, there is a link between R-LLR functions and deposit insurance that arises from the sequence of events. It is plausible that the LLR provider will be called first to rescue a bank; the provider is uncertain about the nature of the problem but injects reserves to keep the payments system running and prevent the bank failure at the same time. Deposit insurance becomes relevant only when the LLR provider subsequently realizes that the bank is insolvent and not simply illiquid. Thus, an incentive may arise for the LLR provider to judge in favor of closing down too often to preserve its own financial integrity. In this way, the LLR provider can shift risk to the deposit insurance provider.

This externality would suggest that LLR and deposit insurance be integrated and be part of the core, if LLR is part of the core to begin with. However, the externality can be solved by setting up a system of arbitration to which the deposit insurance provider can appeal if it feels that the LLR provider has misbehaved. The arbitrator could then force the LLR provider to repay the insurance provider. Anticipating arbitration would eliminate the incentive to shift risk.

Finally, the P-LLR function does not belong to the core as it is intimately linked to the payments system, which itself is not part of the core.

IV.2. Organizing the Periphery

Two approaches have been proposed regarding the organization of peripheral areas under VG: the German *concentric circles* approach (CDU, 1994), and the French *excentric circles* (Balladur, 1994). Figures 1A and 1B give a visual interpretation of the two alternatives. In both proposals all member

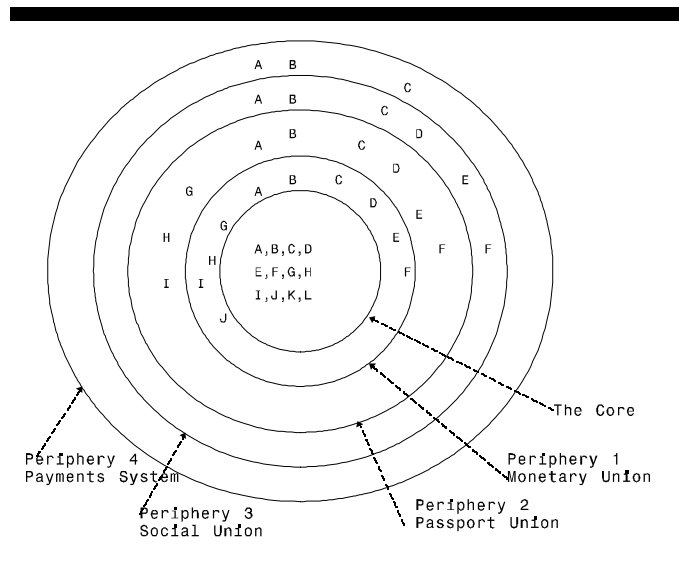


Figure 1A: VG: Concentric Circles

countries participate in the integration core of the EU. Under excentric circles, different sets of members may participate in different peripheral policy areas; the sets need not be fully overlapping: they can either partially overlap or not overlap at all. Under concentric circles, the structure of peripheries is more restrictive. Starting from the core, a member can only enter a particular sphere of integration if it participates in all the preceding ones. Thus, a subset of members may participate, say, in a common social policy, a smaller subset in MU, and an even smaller subset in a joint defense policy.

The figures reveal two important differences between the two models. One is that only the concentric circles define a sequence of steps countries must take to go from the core to the highest sphere of integration. In contrast, with excentric circles, each country can join the peripheral arrangement for which it is fit.

The second difference is that, with concentric circles, there is at most one peripheral arrangement for each sphere of integration. A country that wishes to participate in a particular sphere can only join the existing group or join no group. In contrast, excentric circles include the possibility of multiple cooperative arrangements among EU countries for the

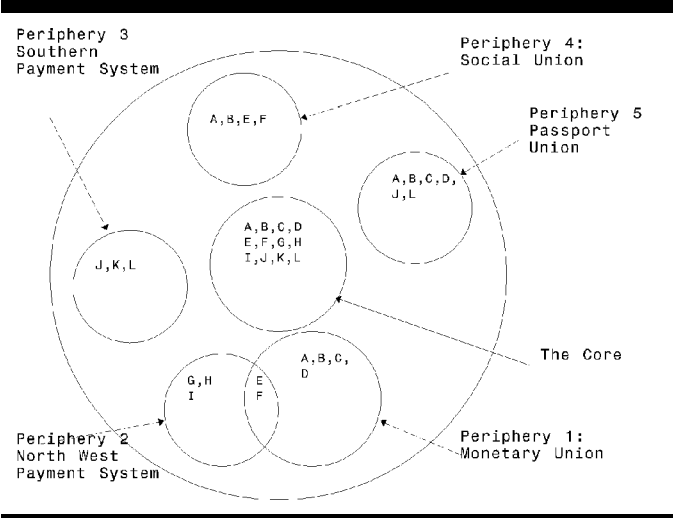


Figure 1B: VG: Excentric Circles

same field of policy, such as multiple, separate payments systems among different member countries. Similarly, excentric circles allow countries to overcome the problem of increasing heterogeneity of EU members in the process of enlargement: Countries with similar preferences or economic structures can form subgroups to set up cooperative arrangements and thus enjoy larger benefits from integration.

These two differences have implications for the governance of a union with VG. Given a set of existing circles, the formation of a new one and the definition of its contents will result from the initiative of a

subgroup of EU members. The question then is: Who can make the relevant decision to set up a new periphery and determine its members? Consider the concentric circles approach, first. The decision to set up a new periphery, not only affects the participants (the insiders), but all other EU members (the outsiders) simultaneously, since it determines how the entire EU proceeds with integration. Thus, the decision to set up a new periphery exerts a large externality on the outsiders. This suggests that all members be given a voice in the development of the new periphery. Otherwise, conflicts would invariably arise between insiders and outsiders who would feel uncertain about the sequence of further integration. Note that the negotiations over EMU proceeded under this principle.

Giving a voice to the outsiders in the decision making process would involve three aspects. One is that all EU members participate in the design of the new periphery, including its institutions. The resulting design would thus reflect the preferences of both insiders and outsiders. This implies that countries may refrain from forming new peripheries because outsiders' interference may force them to an inferior solution. The second aspect is that all members belonging to the farthest periphery would have to be given the option to join the next one, even if that is not deemed desirable from the perspective of the countries initiating the process. The third aspect is that future entry to the new periphery would have to proceed on the basis of rules passed at the time when the new periphery was formed. The easiest way to handle this would be to formulate entry requirements regarding the stage of economic development and stability of the prospective members. Since all members must agree in the first case, entry clauses for a higher sphere of integration cannot permanently exclude a member country that wants to participate. At best, entry requirements can delay entry of countries deemed undesirable by other participants.

The same type of externality does not exist under excentric circles. If a group of countries were to initiate a new periphery, outsiders would not be compelled to follow suit before entering other arrangements. This suggests that the design and the membership of periphery under excentric circles can be left entirely to the initiators of a new arrangement; membership enlargement can be decided by insiders. Thus, new spheres of integration reflect the preferences of the initiators more closely under this approach.

As a compensation for the possibility of permanent exclusion from a given periphery, outsiders are free to pursue alternative arrangements. All that excentric circles require is an agreement by all members that a new periphery neither interferes with the proper working of the core nor creates negative externalities to other peripheries. Following current practices, such a decision could be made by the European Council and/or the European Parliament upon recommendation by the European Commission. It would prevent countries from forming peripheries that reintroduce barriers to trade and mobility.²¹

IV. 3. VG Applied to Banking Regulation and EMU

Consider first the EU of 15 as it is trying to tackle the issue of EMU. To facilitate discussion, we distinguish three groups of countries, A, B, and C. Group A consists of countries with similar low-inflation preferences and highly developed banking industries willing to form a monetary union to lower transactions costs. In this group we would include Germany, Austria, Belgium, Luxembourg, the Netherlands, Denmark, Ireland, and France.²² Group B consists of countries which, having a lesser commitment to price stability and less developed banking industries, wish to join the monetary union of Group A to gain the credibility of low-inflation policies.²³ In this group we would include Italy, Spain, Portugal, Greece, Sweden, and Finland. Countries in group C have well-developed banking industries but are not keen on EMU. The United Kingdom clearly fits into Group C.

The desired outcome for A is to limit membership in the EMU and equip it with a highly integrated regulatory system for banks. This group would set up a common central bank managing a common payments system and acting as lender of last resort in both the P and R functions. Either the central bank or a common insurance fund would manage deposit insurance for them.

The desired outcome for B is to join EMU both to gain credibility and to have some influence over European monetary policy. In contrast, these countries would be less interested in integrated regulatory functions. A would have an incentive to exclude B from EMU because of the higher implied inflation rate (von Hagen and Süppel, 1994) and risk exposure of the common deposit insurance and payments system.

C's preferred outcome would be not to have both EMU and harmonized banking regulation since the latter would reduce the international competitiveness of C's banking industry. On the other hand, if EMU were created, C would have an incentive to join A to establish an integrated LLR and deposit insurance systems to remain competitive.

There would be different expected outcomes depending on the form of VG. Consider first the French excentric approach. Under this scenario, A could form EMU and exclude B which would be free to create alternative arrangements. If A and C had sufficiently similar banking structures and regulatory preferences, they could agree in integrating LLR , deposit insurance, and payment systems. The expected outcome would be the creation of at least two peripheries, a monetary union limited to A and an integrated LLR, deposit insurance, and payment system involving both A and C. The existence of two peripheries would dictate that LLR and deposit insurance could not be placed under the jurisdiction of the central bank of the monetary union.²⁴

Group B, while excluded from both peripheries, would have not lost relative to the initial situation of no monetary union and unintegrated banking regulation. This is true so long as the rules for setting up peripheries do not interfere with the core. Furthermore, B would be free to create peripheries of its own, for example a monetary union with a higher average inflation rate than the German-led monetary union.

The logic of VG changes under the German concentric approach which does not permit the formation of competing functional areas. Thus, all member countries would have to agree ex-ante on the sequence of integration --e.g., should EMU occur before or after integrated regulatory functions?-- and on a set of entry rules. The latter necessitate objective measures of performance to determine whether a country is fit to enter the next level of integration, witness the entry requirements formulated for EMU in the TEU. The ability to measure performance in a precise and independent way is critical in eliminating the potential for discrimination by the insiders against outsiders. The noted lack of precision of the TEU on banking regulation and supervision reflects the importance each member state assigns to this area and deep divisions among member states in reaching a common policy (Fратиanni, 1995a). This suggests that A would prefer

to create EMU before integrated banking regulation, a strategy that would allow A to set up tough standards and delay the entry of B. C would support A's position on the ground that monetary union would be delayed.

To obtain additional predictions, we need to know more about how group A would react to B's membership. Two scenarios are of interest: the first scenario assumes that an enlarged membership would reduce A's payoff without making it negative; the second assumes instead that A's payoff would become negative, a likely possibility if B's banks had financial troubles to add significant risk in running the common LLR and deposit insurance systems. Under the first scenario, A would form a monetary union combined with an integrated regulatory arrangement and try to harden as much as possible the entry requirements to monetary union, being fully aware that B's entry could only be postponed but not permanently denied. This is the situation that best describes the game in the EU now. The Franco-German block, which is the core of group A, has accepted the principle that the Southern countries, typified by Italy, cannot be excluded from EMU. Tough entry standards serve the purpose of aligning the Southern countries to the policies pursued by the Franco-German block. Under the second scenario, instead, A would refuse to set up an integrated regulatory arrangement. The end result would then be only one periphery, namely monetary union. Furthermore, if monetary union and integrated regulatory functions were deemed as strongly complementary by A, A would not join monetary union with B. In this case, concentric circles would inhibit the formation of any periphery.²⁵

In sum, A favors the excentric circles version of VG because that scheme permits to exclude B. In contrast, B prefers the concentric circles version of VG because it guarantees entry into higher spheres of integration even against the opposition of A, unless A is willing to deny itself entry. Group C's preference is ambiguous. It prefers excentric circles if monetary union happens anyway, but prefers concentric circles if group A's marginal benefit from including group B is sufficiently negative to preempt monetary union.

IV.4. The Consequences of Enlargement

For our analysis, enlargement to the East and the South of the existing EU can only have the consequence of adding countries characterized by weak banking sectors and low commitment to price stability. Consequently, enlargement increases the number of countries belonging to group B. New entrants may even be keen on joint regulatory functions, seeing an opportunity to shift some risk of bank failure to the common regulatory institutions.

Enlargement affects the outcome with excentric circles only in as much as the old and new members of group B may find it mutually beneficial to pool some regulatory functions among themselves. Thus, enlargement increases the scope for additional peripheries.

Under concentric circles, in contrast, enlargement raises A's concern that it will have to accept members in the monetary union and the regulatory arrangement that bring in negative externalities. In view of that, enlargement would induce A to raise the entry requirements for monetary union. C also would support this move. As a result, enlargement would slow down entry to monetary union of the original members of B. Furthermore, it would raise the likelihood of ending with either one periphery (monetary union) or none.

From this perspective, neither A nor B have an incentive to favor enlargement. However, as we have argued above, at least one member of A, Germany, favors enlargement for other reasons. Suppose that Germany can persuade the other members of group A to support enlargement. One way to resolve the conflict between A and B would be for B to accept the model of excentric circles on the condition that a monetary union including B be formed immediately. This would allow the original members of B to shut the new members off the benefits of monetary union. In this sense, enlargement could speed up the formation of a monetary union in Europe. Group A could then even form an additional, regulatory arrangement excluding group B to enjoy the benefits of a common payment system. Group C, finally, would favor both enlargement and concentric circles as a strategy to prevent both monetary union and common regulatory functions.

V. Conclusions

VG has been proposed as a solution to the problem of making enlargement consistent with the desire for deepening in the European Union. The characteristic feature of VG is the combination of a common core of integration with a set of peripheries, arrangements for integrated policies in which not all member countries participate. Two forms of VG are under discussion, one called concentric circles, relying on a hierarchical structure of the peripheries, and the other called excentric circles, placing all peripheries on the same level. Using banking regulation as an example, we have explored the consequences of these two approaches.

An important feature of European integration today is that different countries pursue cooperation in a given field of (economic) policy with different motivations. Another important feature is that the benefits from further integration shrink with increasing heterogeneity of the participants: integration among a small group of countries pursuing the same interest often seems more beneficial than integration with a large group of countries pursuing different interests. The two forms of VG have very different responses to these characteristics.

The concentric circles approach promotes compromises among countries pursuing different goals to integration in the same area, but in doing so it runs into the risk that “bundling” issues may lower the likelihood of an agreement; the status quo of no integration may in the end prevail. The excentric circles approach promotes the formation of different groups among countries pursuing different goals; consequently, it gives room for a larger degree of variation in European integration.

Our arguments suggest that the two approaches would set the EU on very different integration paths. The hierarchical model would lead to a union, in which all countries would ultimately share the same but relatively low level of integration. The alternative model would lead to a union in which different members “play the integration game” with different intensities; inevitably, some members would achieve a high degree of integration while others would opt for a lower degree. A practical corollary of these propositions is that countries like Italy would prefer the hierarchical structure of concentric circles because it would ensure a

common end result, whereas countries like Germany would prefer the non-hierarchical approach because it would ensure deeper forms of integration and would effectively discriminate among members with different intensities towards integration.

Ultimately, the choice between these two models depends on the vision the members have for the EU of the 21st century. If that vision stresses commonality, the hierarchical model will prevail. If the vision stresses opportunity for change, benefits from cooperation, and learning through new forms of integration, the alternative model will be chosen. The 1996 Intergovernmental Conference will have to address these issues and hopefully make a choice.

ENDNOTES

1. The Europe Agreements do not promise accession nor set a date or a time table.
2. The Lamers paper (CDU, 1994) makes this point very clearly.
3. For a review of the debate on variable geometry see Dewatripont et al (1995).
4. The accession treaty allows Sweden to produce and consume snuff which is prohibited in the rest of the EU.
5. See CDU (1994), Balladur (1994), and Bocquet (1994).
6. We ignore some secondary reasons related to the smoothness of the money supply process and credit allocation schemes driven by social policy goals.
7. Most industrial countries and all EU countries have subscribed to the capital standards defined in the *Basle Accord* under the auspices of the Band for International Settlements.
8. Folkerts-Landau and Garber (1992) argue that different jurisdictional responsibilities lead to different financial structures. A “broad” central bank, that is one that is responsible not only for monetary policy but also for lending in the last resort and regulation and supervision, enhances the development of liquid and securitized financial markets with an efficient payment system.
9. The central bank is the leader of the banking industry and organizes rescue operations, as in the case of the failure of Bankhaus Herstatt of Cologne in 1974.
10. In the last two cases, larger additional externalities to the entire economy exist. This is emphasized in Diamond and Dybvig's analysis of R-LLR.
11. In practice, governments have ways to limit the potential transfers of tax revenues to foreigners, e.g., by charging banks a fee for supplying deposit insurance and through the use of co-insurance. However, fair pricing of deposit insurance is extremely difficult, and international competition in financial services limits the scope for making banks pay for deposit insurance. Thus, we assume that the potential tax transfers are sizeable.
12. Goodhart and Schoemaker (1993, Appendix) For example, Banque Andes, with a large proportion of foreign shareholders, faced a run and received a line of credit from the Belgian Rediscount and Guarantee Institute. Also, the foreign-owned Banque Internationale pour l'Afrique Occidentale, BAII UBAf and Kuwaiti French Bank, and Al Saudi Bank were helped by the French regulator.
13. One may criticize our view of governments pursuing national economic interests by pointing at European economic integration as an example for fruitful economic cooperation. While we do not deny that there is a tradition of cooperation in Europe, we cannot help observing that day-to-day politics are often driven by economic self-interest.
14. This does not suggest that the trade-off between the two is linear or continuous.

15. In the transition period from July 1, 1995 to December 31, 1999 member states can limit the guarantee to 15,000 ECUs (Fратиanni 1995a, p. 160).
16. In most EC countries, central banks are involved only in payments systems handling large scale payments. Most banks leave the technical operation to private clearing houses, but execute the final settlement of payments on the central bank accounts of the participating banks. Central bank involvement in this activity is regarded as a necessary condition for effective use of monetary policy instruments (Hartmann,1995).
17. For a discussion of the pros and cons of a “broad” central bank see Folkerts-Landau and Garber (1992), Goodhart and Schoenmaker (1993), Baltensperger (1993), Angelini and Passacantando (1993), Frатиanni (1995a), and Masciandaro (1996).
18. Here, we will take a view from the principles and ignore the fact that the current members of the EU have already agreed on a set of common policies that might define a core.
19. The TEU grants derogations to Denmark and the U.K. on monetary union, and to the U.K. on social policy.
20. There is a significant body of literature that stresses the use of regulation as a rent-seeking activity (Mueller 1989, pp. 235-238).
21. Further designs of the periphery are, of course, conceivable. Here, we limit our attention to those that have been proposed in the political debate.
22. Group A corresponds to the first three groupings in Garrett (this volume, Table 6). Note that our criterion is much simpler than Garrett’s four-variable proxy for the expected economic consequences of being part of EMU.
23. For a discussion of such a constellation of preferences see Alesina and Grilli (1993) and von Hagen (1995).
24. A plausible alternative would be that group C limits its participation to the integrated deposit insurance fund and the R-LLR facility, counting on the incentive of group A to extend P-LLR coverage to C-banks operating in group A. Group A would then have an incentive to limit participation in its joint payments mechanism to banks complying with its regulatory standards.
25. Note that in our case “bundling “ issues raises the likelihood of no agreement, as in Alt and Eichengreen (1989). In contrast, much of the literature seems to suggest that “bundling” raises the likelihood of an agreement (see Eichengreen and Frieden, this volume).

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