Completing EMU
Proposals of ELEC

European Economic and Social Committee
13 February 2014

Bernard Snoy
President International, ELEC
Professor, Institute of European Studies,
UCL (Louvain-la-Neuve, Belgium)

What is ELEC

- International non profit association founded in 1946 in Brussels : one of the oldest components of the European Movement
- Acts in complete independence
- A network of European economic decision makers of good will
- A forum and advocacy group promoting and putting timely intellectual pressure on European decision makers to further economic integration within Europe
- Contributing ideas to the creation and completion of the single market, including the integration of financial markets
- 12 national committees and four active sectoral commissions

Reasons for moving from single market to EMU

- Objective of creating competitive conditions as similar as possible to those prevailing in the USA for European enterprises : Customs Union, Common Market, Single Market, Economic and Monetary Union, eliminating the exchange risk for trade and investment.
- Realisation that full liberalisation of capital movements would be incompatible with fixed exchange rates and independent monetary policies (triangle of impossibility).
- Political reasons : Kohl-Mitterand deal linking the German reunification and German support for the EMU, desire to give a tangible symbol to EU citizenship, the euro seen as a drive for further political integration.
- Huge potential benefits to be expected from the process of monetary integration in terms of economic policy convergence, integration impact, enhancement of competition and transparency, and capacity to influence the regulation of globalization

Underestimation of what is required to ensure the sustainability of a monetary union

- Underestimation of the challenge of sustaining a monetary union with an unfinished single market, a low level of labour mobility (due to linguistic and cultural obstacles) and a modest budget at the EU level.
- Need for close monitoring and instruments (e.g. incomes policy and structural reforms) to restore competitiveness when the option of devaluation is no more there.
- Need for higher prudential requirements in cases of excessive credit expansion.
- Need for strict and consistent standards of bank supervision to prevent systemic banks from taking irresponsible risks (too-big-to-fail syndrome)

Weakness of the economic pillar of the EMU

- In contrast to monetary policy, Member States retain ultimate responsibility for economic policy within the EMU. There is not a genuine economic government of the Community acting as a single interlocutor to the ECB but only « the adoption of an economic policy based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives »(Article 119 of the TFEU).
- Member States are however required to conduct their economic policies with a view to contributing to the achievement of the objectives of the Union and to act in accordance with the principle of an open market economy with free competition (Article 120 of TFEU).
- Member States have to regard their economic policies as a matter of common concern and to coordinate them within the Council (Article 121 TFEU).

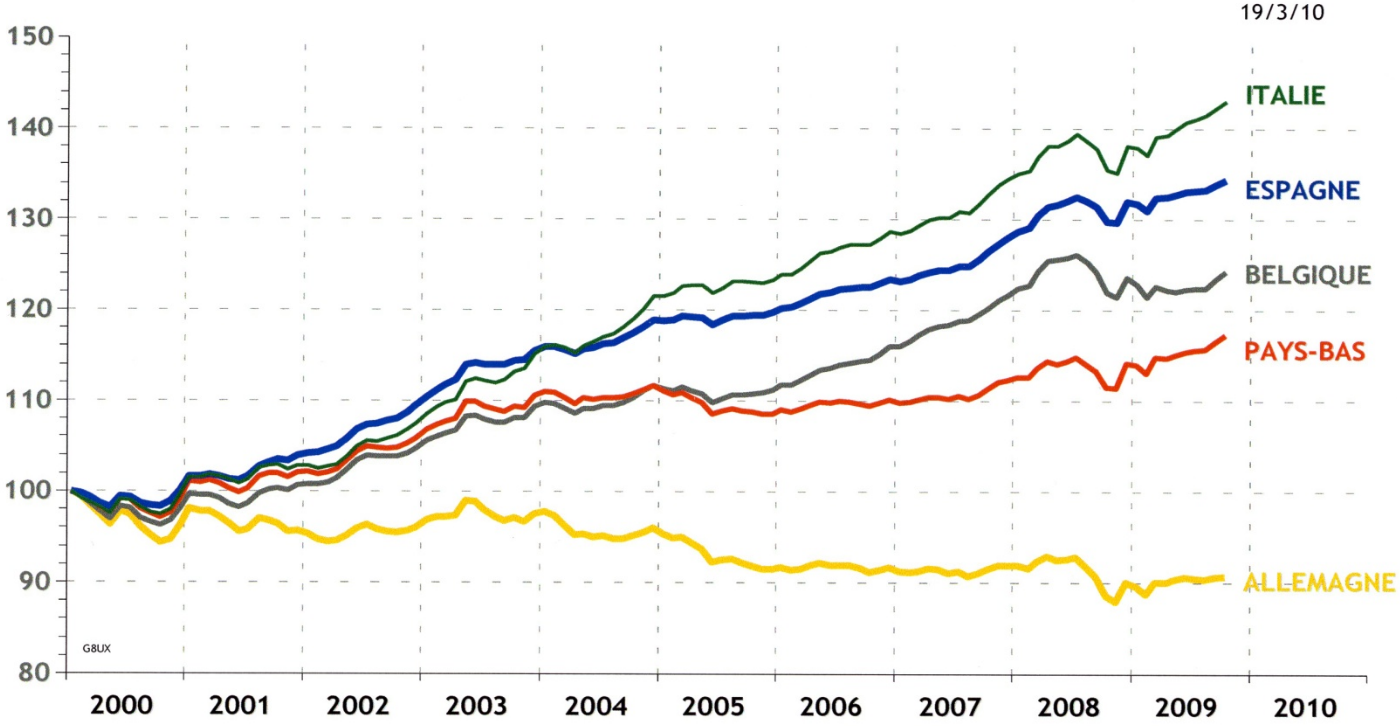
Weak Economic Governance in the eurozone

- Weak impact of the annual Broad Economic Policy Guidelines;
- Adoption of the Stability and Growth Pact in 1999 : focus placed too exclusively on public finance; weak preventive arm with no sanction; sanctions coming too late in the dissuasive arm, reluctance of the Council of Ministers to apply them; violation of the Pact in 2003 by Germany and France; excessive deficits in Greece, Portugal, Italy but also Belgium and France.
- No sufficient attention given to other macro-economic disequilibria (e.g. private indebtedness and balance of payments disequilibria) and to the drift in competitiveness.
- Failure of financial markets and rating agencies in assessing risks associated with sovereign debt in the eurozone.
- Weakness of the instruments (Open Method of Coordination) to implement the Lisbon strategy, aimed at addressing the underlying weaknesses in the real economy of the EU.

| Mardi 23 mars 2010 |

Perte de compétitivité

Taux de change effectif réel



Source : Banque Degroof, Belgium

Weakness of available instruments to deal with the crisis

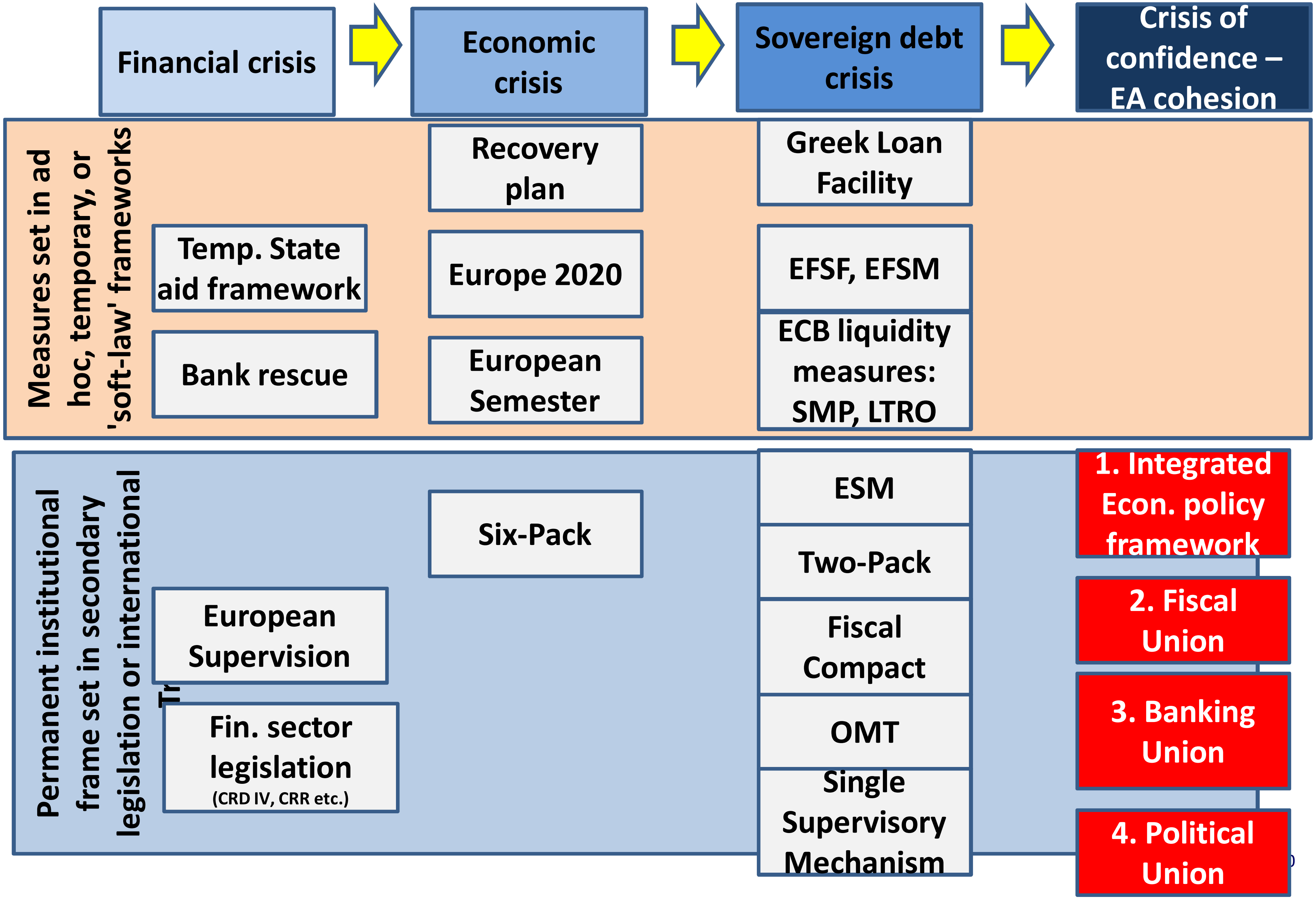
- The « no bailing out » principle (article 125 TFEU) lead to the absence of mechanism to help euro-zone members in difficulty : still to-day this principle creates a suspicion of illegality of efforts to alleviate the debt of Greece. .
- Medium Term Financial Assistance Facility reserved for countries that were not in the euro (art. 143).
- Limitations in the mandate of the ECB and prohibition of monetary financing of budgetary deficits (art. 123).
- Modest size of the EU budget, limited potential of Cohesion Funds and of the EIB.
- Article 122 al. 2 (natural disasters or exceptional occurrences beyond the control of a member State) had to be interpreted in a creative way to provide a legal basis for assistance.

Conditions for a sustainable EMU

- Monetary pillar
- *Fiscal pillar*
- *Economic pillar*
- ➢ *Financial pillar*

De Nederlandsche Bank
Eurosysteem

The EU's crisis response in perspective



Completing the EMU requires

- Deepening the single market , following the recommendations of the Monti Report
- Economic Union, at least a reinforced integrated economic policy framework, with both macro-economic and structural components
- Elements of Fiscal Union
- Banking Union
- Political Union , underpinned by a vibrant civil society, including social partners, a genuine vision of the future and a stronger sense of European identity

Economic Union

- Having a genuine stategy : Europe 2020 Strategy
- Six Pack
- European Semester
- Fiscal compact
- Growth and Employment Pact
- Two Pack
- Permanent European Stability Mechanism

Europe 2020 Strategy

- After the semi-failure of the Lisbon stategy and in the aftermath of the economic and financial crisis of 2008, the Commission, followed by the European Council launched in 2010 the Europe 2020 Strategy.
- Europe 2020 puts forward three mutually reinforcing priorities :
- - smart growth : developing an economy based on knowledge and innovation
- - sustainable growth : promoting a more resource efficient, greener and more competitive economy
- - inclusive growth : fostering a high-employment economy delivering social and territorial cohesion.

Targets of the Europe 2020 Strategy

- 75% of the population aged 20-64 should be employed
- 3% of the EU's GDP should be invested in R & D
- The « 20/20/20 » climate/energy targets should be met (including a 30 increase to 30% of emissions reduction if the conditions are right)
- The share of early school leavers should be under 10% and at least 40% of the younger generation should have a tertiary degree
- 20 million less people should be at risk of poverty
- EU targets to be translated into national targets and trajectories
- Need to move to a more ambitious strategy including education and training and revitalized industrial and social policies

Six Pack

- Fiscal surveillance complemented by macro-economic surveillance
- More effective enforcement measures : applied at an earlier stage and enforced more consistently and more strictly unless there is a majority to not to apply them.

European Semester

- EU-level policy coordination tool and surveillance framework which is part of the broader aim to strengthen economic governance .
- Adoption by the European Council early in the year of priorities for fiscal consolidation and structural reforms.
- All Member States will translate these priorities into their Stability (for euro-zone members) or Convergence (for non euro-zone members) Programmes and National Reform Programmes.
- The Commission analyses these programmes and formulates proposals for country-specific opinions and recommendations for adoption by the June European Council.

New Treaty on Stability, Coordination and Governance

- Treaty on Stability, Coordination and Governance in the EMU, signed on 2 March 2012 by 25 countries. The UK and the Czech Republic stay away.
- Balanced budget rule and automatic mechanism to take corrective action, based on country-specific medium term objectives, in the framework of the overall objective of having the budgetary position balanced or in surplus.
- Obligation to transpose the « balanced budget » rule into the countries' national legal systems, through binding, permanent and preferably constitutional provisions, subject to the jurisdiction of the Court of Justice of the EU.
- Assistance from the new European Stability Mechanism conditional on the ratification of the Treaty.
- Economic policy coordination : all major economic policy reforms to be discussed ex ante and coordinated.

Growth and Employment Pact

- Announced in June 2012
- € 120 billion mobilised, among others to increase the capital of the EIB, and reorientation of € 55 billion of structural funds money
- Connecting Europe Facility for transport , energy and broadband communications
- Making the digital single market operational by 2015
- Promotion of research and innovation
- New industrial policy : Programme for the Competitiveness of Enterprises & SMEs (COSME)
- Overall reduction of regulatory burden
- More growth friendly tax policies
- « Employment package » of the European Commission, set of documents, looking into how EU employment policies intersect with a number of other policy areas in support of smart, sustainable and inclusive growth (e.g. professional mobility)

Two Pack

- Stronger legal basis for assessing and coordination Member States policies.
- More explicit rules and procedures for enhanced surveillance of Eurozone countries in distress.

Van Rompuy’s ideas to be further discussed

- Greater ex ante coordination of member states’major economic policy reforms (Art 11 of TSCG) : the Commission will propose a framework in the context of the European Semester
- Social dimension of the EMU
- Feasibility of « mutually agreed contracts for competitiveness and growth »
- Solidarity mechanisms to support such contracts

Supportive ECB Monetary POlicy

- Standard monetary policy : maintenance of low short term interest rates
- Non-standard policies : liquidity management and financial intermediation policies designed to avoid that dysfunctioning financial markets lead to wider financial stability risks .
- Securities Markets Program leading the ECB to increasingly accept government bonds of highly indebted countries as collateral and then more and more to purchase such bonds, which is controversial and has lead to several high profile resignations (Axel Weber & Jürgen Stark) .

Supportive ECB Monetary Policy (2)

- Long Term Refinancing Operation (LTRO) :1 trillion € of three year money made available to all EU banks, in view of preventing a credit crunch and encouraging them to provide continued credit access to enterprises and governments (December 2011).
- « Outright Monetary Transactions » (OMT) programme: willingness to purchase without limit eurozone countries' short-term bonds in the secondary market provided these countries submit themselves to the « strict and effective conditionality » (i.e. programmes agreed with troïka) associated with support from the ESM (September 2012)
-

Elements of fiscal union

- Developing gradually a fiscal capacity for the EMU
- Limited fiscal solidarity over economic cycles : facilitating adjustments to country-specific shocks by providing for some degree of absorption at the central level ; to be structured in such a way that they do not lead to permanent transfers or undermine the incentive to address structural weaknesses.
- Other formulation : solidarity in support of « mutually agreed contracts for competitiveness and growth »
- Ability to borrow at EMU level through the establishment of a Treasury function with clearly defined responsibilities.

Elements of fiscal union (2)

- Pooling of some short term sovereign funding instruments (e.g.treasury bills) on a limited and conditional basis : see ELEC proposal for a two-year refinancing for all € bills/optional refinancing of bond maturities until 2015 ; see also graham Bishop's « Detailed Roadmap to a Financial and Banking Union » with the setting up of a temporary euro Treasury Bill Fund with *pro rata* liability.
- Also at the EU or euro-zone levels, greater use should be made of all existing instruments, including the EU budget, which would need to be substantially increased (and given revised priorities) to play a role more similar to that played by the central government in federal States (Mac Dougall Report of 1977 suggesting that a federal budget of at least 5 to 7% of the common GDP would be needed to sustain a monetary union).

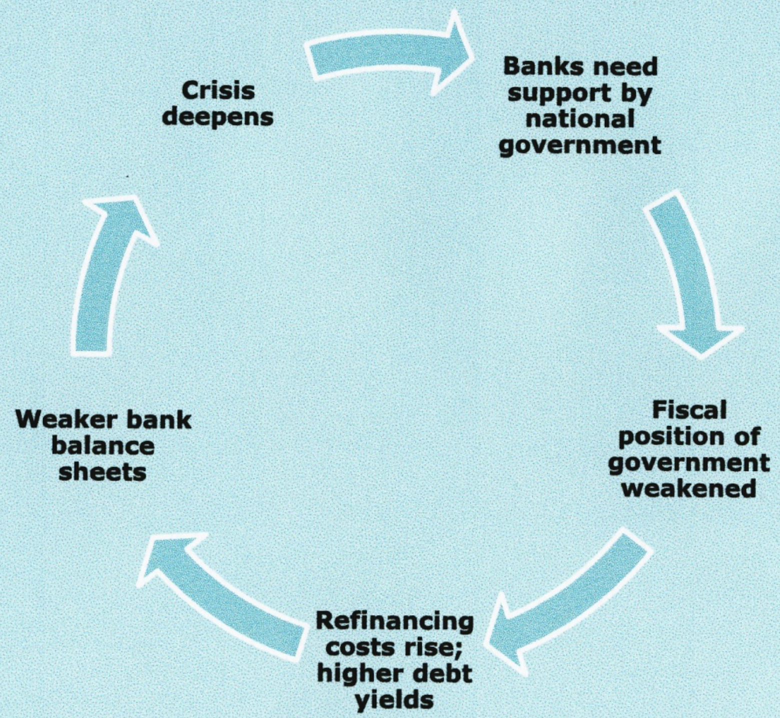
Why we need a European Banking Union Maintaining Financial Stability and the Integrity of the Single Market

The crisis has shown the inherent contradiction between pan-European banking and exclusive national responsibility for bank crisis resolution

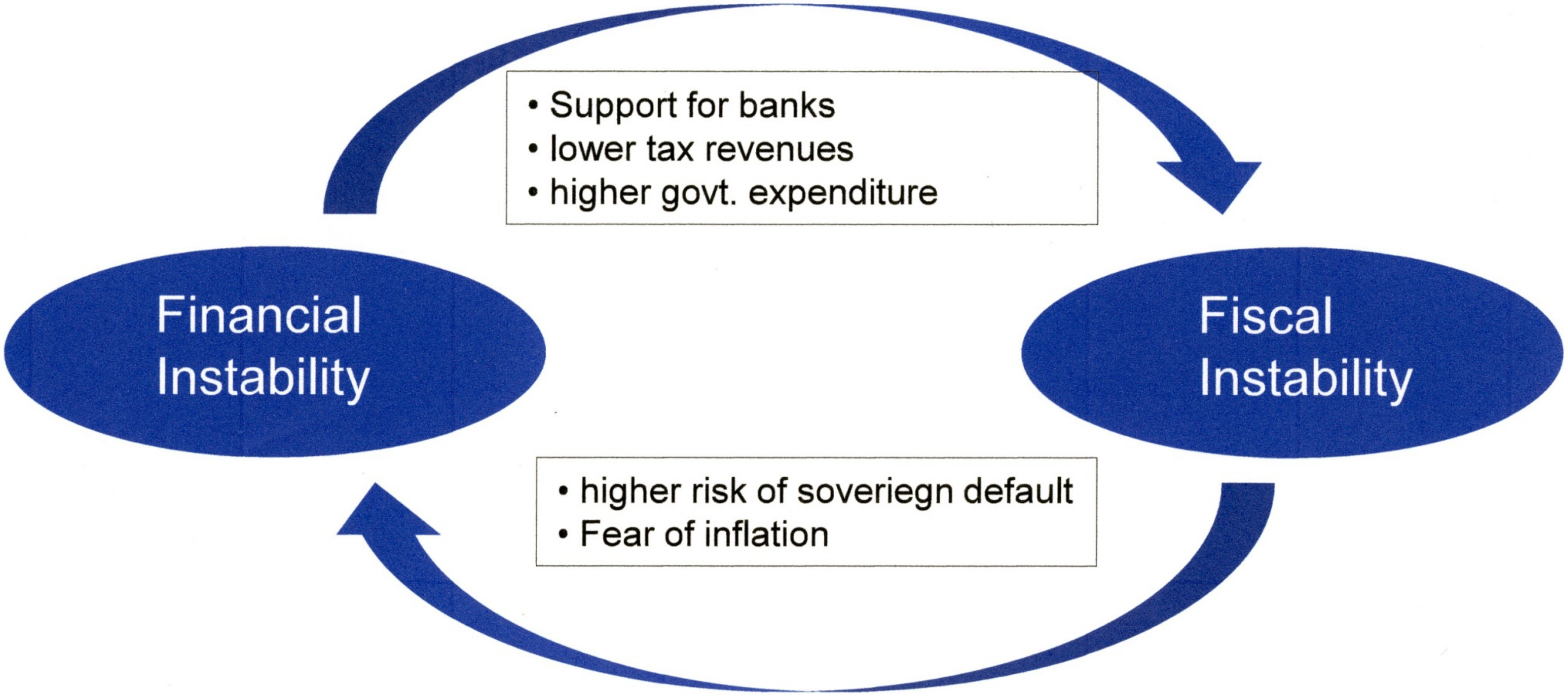
- Recent trends towards **fragmentation of the banking system, in particular in the Euro area**
- **Significant renationalisation of euro area banks' funding markets.**
- **Increased cross-country dispersion of access to and conditions of financing for companies and households.**
- **Cross-border capital flows have fallen sharply**
- **National supervisors have tried to introduce prudential Measures leading to fragmentation**

Why we need a Banking Union?

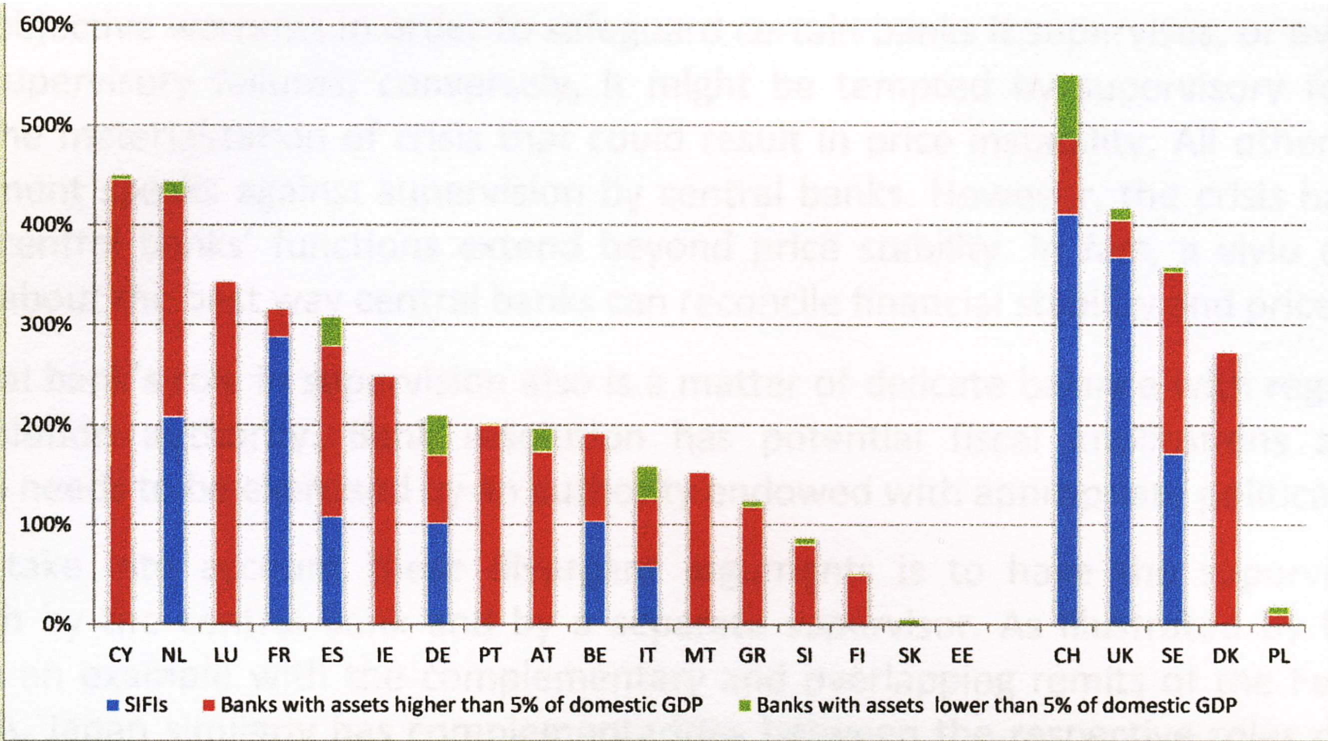
Negative feedback cycle between sovereigns and banks



Source : Nederlandsche Bank

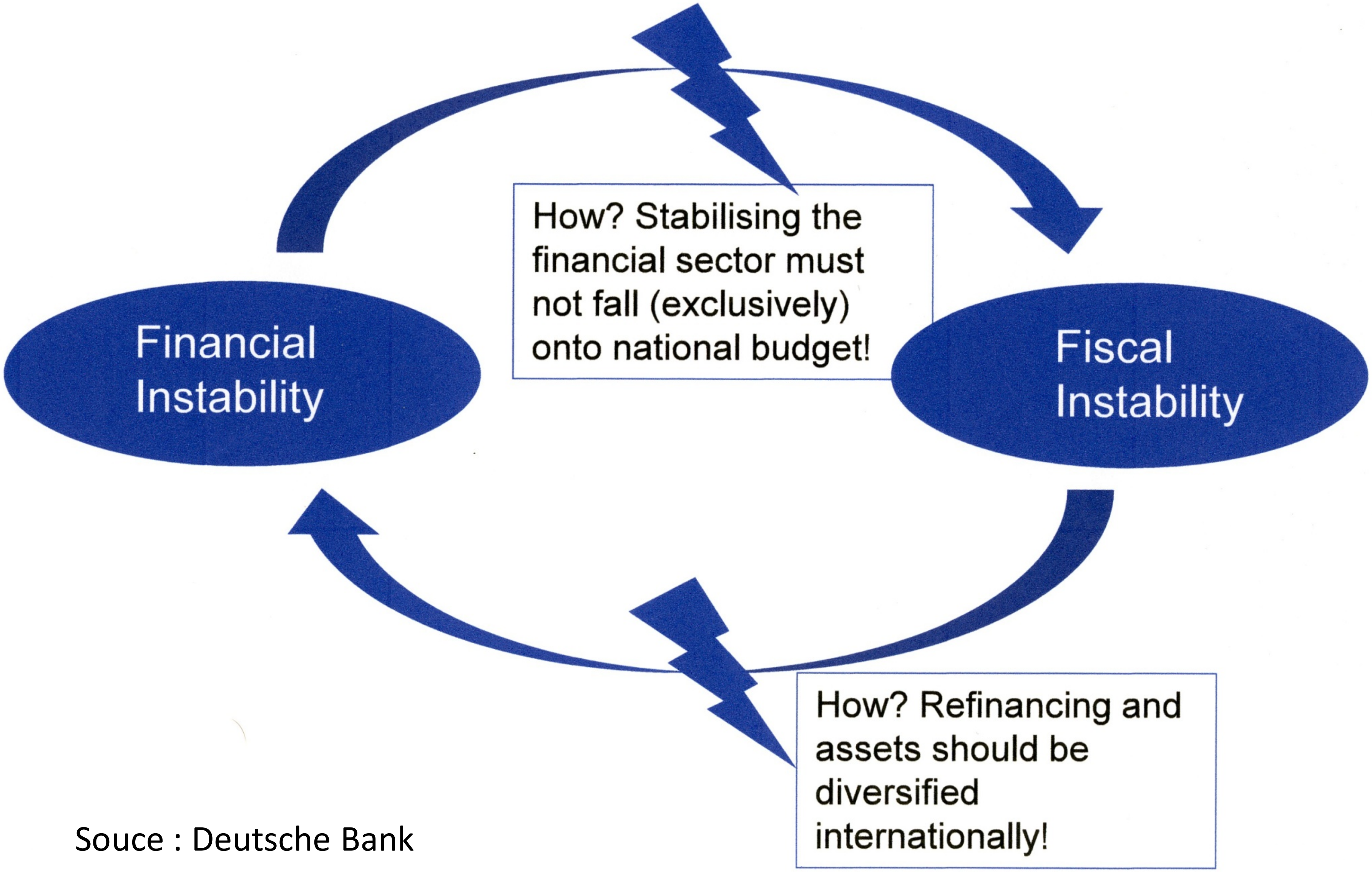


Source : Deutsche Bank



Note: Bank assets, including foreign branches and subsidiaries, as a percentage of home-country GDP. Source: The Banker, Bruegel calculations. Coverage of the banking system differs from country to country, but is generally close to 100 per cent. We single out G-SIFIs rather than E-SIFIs because of the absence of an authoritative list of E-SIFIs; for G-SIFIs we use the FSB's first list as of late 2011 (FSB, 2011). N.B. German savings banks are treated as separate in this calculation.

Source : Bruegel



Souce : Deutsche Bank

Other reforms at EU level

- Larosière Report of 2009.
- Setting up of European Systemic Risk Board for macro-prudential oversight of the financial system
- Setting up on 1 January 2011 of European System of Financial Supervision, including European Banking Authority, to ensure effective and consistent regulation and supervision across the EU banking sector and the creation of a single rulebook; however limits in capacity to arbitrate conflicts among supervisory authorities
- Organisation of stress tests
- New Capital Requirement Directive in July 2013
- Report of High Level Expert Group on reforming the structure of the EU banking sector (Liikanen Report)

Key principles of a Banking Union

- *Internal market must not be impaired:*

  Single rulebook applicable to all 27 MS

  The European Banking Authority (EBA) will continue to fulfill its mission as regards all Member States

- *Openness:*

  open to all MS; mandatory for Euro area MS

- *Material scope:*

  All banks in participating MS

- *No cherry-picking:*

  All MS participating in the SSM will also participate in the remaining elements of the banking union.

Tasks conferred on the ECB

Mandate:

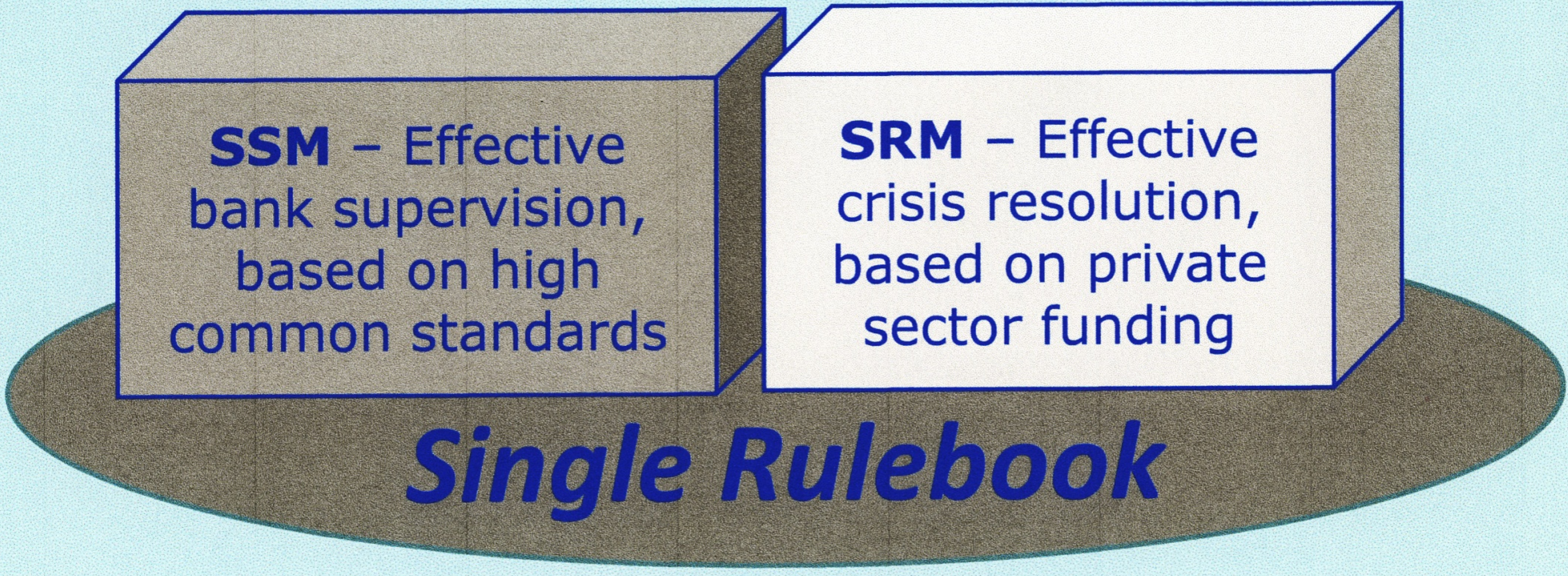
- **Promoting the safety and soundness of banks;**
- **Promoting the stability of the financial system**

Key supervisory tasks that are necessary to detect risks to banks' viability and take the necessary action.

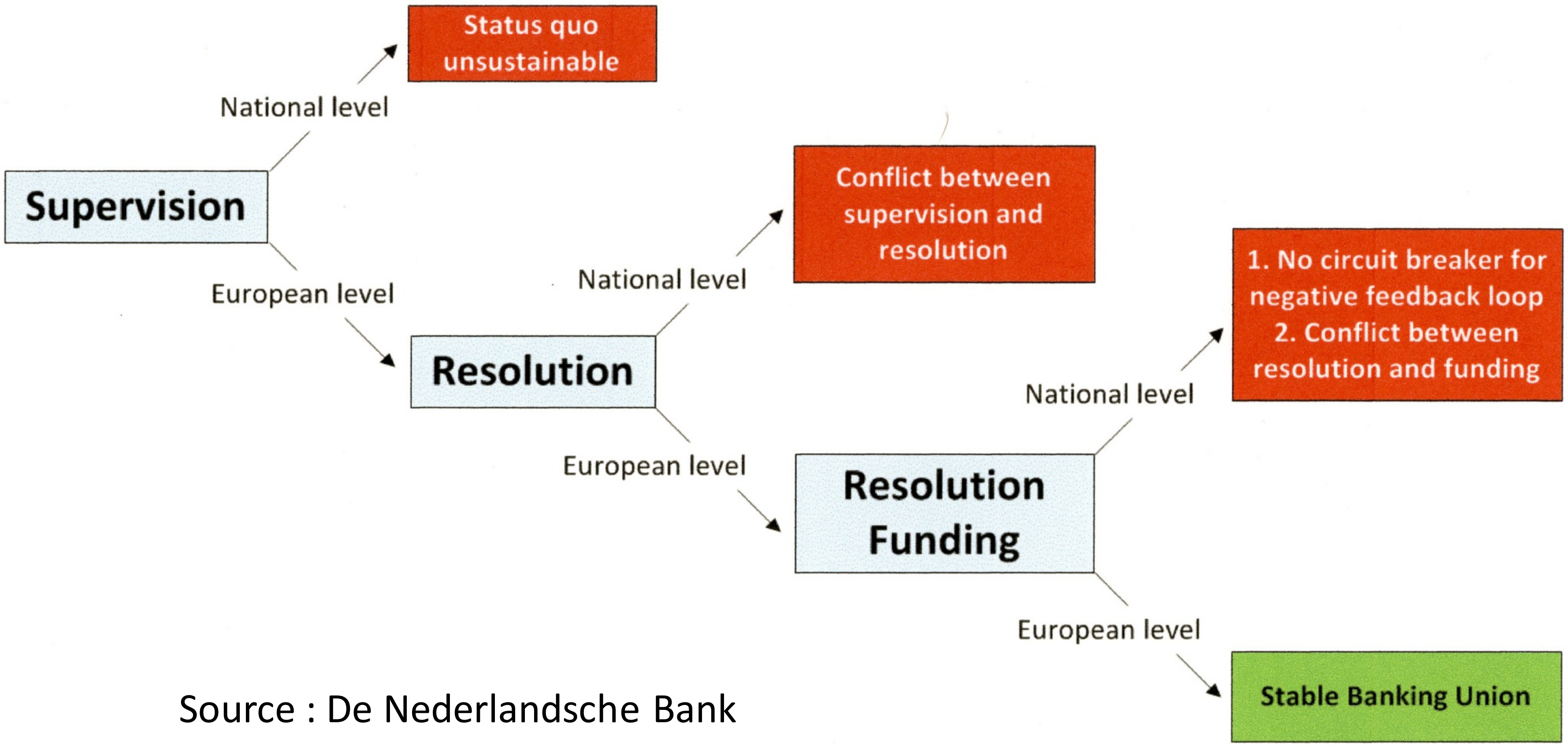
Notably:

- **Authorization and withdrawal of licence;**
- Ensure compliance with **requirements on capital, leverage and liquidity;**
- **Early intervention measures where a bank breaches requirements (coordinating with resolution authorities).**

Key elements of the Banking Union



Half-baked banking union is unstable



Source : De Nederlandsche Bank

Single Resolution Mechanism proposals

- 1. Effective resolution regime, including bail-in, to minimize taxpayer cost
- 2. Financing provided on a temporary and preferred basis
- 3. Resolution fund filled ex-ante by financial sector
- 4. First backstop is national government (in transition)
- 5. ESM is ultimate backstop for viable banks (in transition)

Principles governing resolution

- Shareholders bear first losses
- Creditors bear losses after shareholders in accordance with order of priority of their claims
- Management is replaced except when necessary for the achievement of the resolution objectives
- Individuals and entities are held accountable for the failure
- Creditors of the same class are treated in equitable manner
- No creditor should incur greater losses than would have been incurred if the entity had been wound up under normal solvency proceedings.

Recommendations of Liikanen Report

- Mandatory separation of proprietary trading and other high-risk trading activities.
- Effective and realistic recovery and resolution plans to be drawn up and maintained by the banks.
- Banks should buid up a sufficiently large layer of « bail-inable » debt ; development of designated bail-in instruments.
- Review of capital requirements on trading assets and real estate related loans ; more robust risk weights in the determination of minimum capital standards
- Strengthen corporate governance: promote risk management function; rein in compensation for bank management and staff; improve risk disclosure; and strenthen sanctioning powers.

Proposals of Commissioner Barnier for Structural reform of the EU banking sector

- Significant regulatory and supervisory reforms since 2008 : 28 pieces of EU legislation
- New rules proposed in January 2014 applying only to the largest and most complex EU banks (about 30 banks) with significant trading activities.
- Banning proprietary trading in financial instruments and commodities.
- Granting supervisors the power and, in certain instances, the obligation to require the transfer of other high-risk trading activities (market making, complex derivatives and securitisation operations) to separate legal trading entities within the group.

How to survive the transition?

- Stricter regime to force creditors to foot the bill for bank failure instead of taxpayers but with also a European Resolution Authority that will only come into force in 2018
- Uncertain transition where the eurozone aims for potentially conflicting goals : clean up balance sheets, breathe life into bank funding the economy, in particular SMEs, and keep a lid on taxpayer costs.
- In the meantime, still patchy national rules on how to cope with bank failures and only a hanful of countries with standalone resolution funds.
- European Stability Mechanism would become EU backstop facility on which the European Resolution Authority could draw the necessary resources, but presently it can only be only accessed through loans to Member States and with stringent conditions.
- Next challenge is stress tests in 2014 on 140 banks that the ECB will oversee directly.
- Proposal of a special European Banking Sector Task Force (Brueghel, 2012) to coordinate steps of crisis management.

Political Union

- Overarching principle: « to ensure democratic legitimacy and accountability at the level at which decisions are taken »
- Need for more democratic accountability at the euro-zone level : real debates about national economic and social policies not only in the Council of Ministers but also in the national and European Parliaments with a close association of civil society, including social partners in the European Economic and Social Committee .
- Reinforce sense of sharing a common destiny through new dimensions such as European defence, foster greater awareness of European identity, promote European patriotism, use debates towards European Parliament elections to define a clearer vision of our common future.

Philippe Herzog

Europe, réveille-toi !

Préfaces de Michel Rocard et Michel Barnier

Collection L'Europe après l'Europe

CONFRONTATIONS EUROPE

Le Manuscrit
www.manuscrit.com

Conclusion

The key issue is the future of Europe, the capacity of its institutions to make in time the right decisions and through Europe's integration, our capacity to be the master of our fate.

« Men at some times are masters of their fates,

The fault, dear Brutus, is not in our stars,

But in ourselves, if we are underlings ».

Cassius, in Julius Caesar of Shakespeare (Act I, Scene II)