Remapping EMU

On the future Construction of Economic and Monetary Union

Policy Paper no 5

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Executive Summary[1]

The economic crisis has laid open deficiencies in the construction of the European Economic and Monetary Union. At its foundation, it was assumed that monetary integration would reduce the likelihood of asymmetric shocks. The crisis shows, however, that endogenous mechanisms may even amplify existing asymmetries. Without a lender of last resort, a common regulation and supervision of banks, a common fiscal policy and a co-ordinated economic policy the European Monetary Union is incomplete.

The European Council and the Commission have proposed reforms for the completion of Economic and Monetary Union. Among these proposals are the implementation of a Banking Union and an integrated economic and fiscal policy. In the long run, national government debt is to be mutualised at the European level. A European fiscal capacity shall be combined with an automatic transfer mechanism between member countries, in order to smooth business cycle differentials. Further proposals are intended to accelerate in future structural reforms by the member countries along the lines of the country-specific recommendations issued by the Commission and the Council.

A first step towards creating an integrated Banking Union has been taken by the introduction, albeit in an attenuated version, of a common bank supervision. However, key elements to secure the stability of the euro area are still missing. Measures recently decided under the acute pressure of the crisis ("Six-pack", "Twopack", "Fiscal compact", "Euro-plus Pact") are confined to structural reform and have de-facto suspended the operation of automatic stabilisers in the crisis countries. This severely undermines popular support in debtor and creditor countries alike for Economic and Monetary Union, to the point of jeopardising its existence.

Keywords: European Integration, European Economic Policy

JEL codes: E61, E62, F15

[1] This paper is an actualised version of an article in the Austrian Economic Quarterly by Ederer and Weingärtner (2013).

1. Introduction

The European Monetary Union has so far not been able to rid itself of its crisis. Five years since the outbreak of the global financial crisis and three years since the onset of the sovereign debt crisis, the euro area has once again slipped into recession. Unemployment is rising drastically, and in many countries government debt keeps heading up despite tight fiscal restraint. Meanwhile, one out of four persons below the age of 24 is registered as unemployed. In Greece, youth unemployment is above 60 percent of the age-specific labour force, in Spain 55 percent, in Italy and Portugal over 35 percent. While interest rate spreads on Southern European government bonds have eased after the announcement by the European Central Bank (ECB) to supply liquidity to an unlimited extent if necessary to prevent default, rates still remain high and complicate government debt refinancing, a renewed increase not being excluded. Budgetary cuts and the protracted recession have given rise to popular unrest in many countries as people feel being at the mercy of decisions taken at EU level. The sentiment vis-à-vis the EU has worsened markedly in both the European “centre” and the “periphery”, and a breakup of monetary union has still not been definitely averted.

In the early months and years of the crisis, the mainstream of the economic and political debate took the crisis as a singular phenomenon confined to a few countries, mostly in Southern Europe, resulting from excessive government deficits and debt or from an over-sized banking sector. This perception changed significantly as from the second half of 2011, when the systemic nature of the problem was increasingly recognised as a crisis of EMU as such. This is clearly illustrated by the reform proposals advanced at EU level. Initially, the focus was on the prevention of contagion (with the implementation of the “rescue funds” EFSF and ESM), the hardening of the Stability and Growth Pact (“Six-pack”, “Two-pack”, Fiscal Compact) and the closer monitoring of macroeconomic imbalances. It was only in 2012 that the European Commission, the European Council Presidency and the European Parliament elaborated first proposals for a reform of the architecture of EMU. So far, however, little of their ideas have been taken up.

2. Instabilities of an incomplete monetary union

The construction of EMU exhibits some deficiencies which became evident during the financial market and economic crisis. EMU is an incomplete monetary union and unstable in the long run. As revealed by the crisis, the euro area is not an optimal currency area. According to the corresponding theory (Optimal Currency Areas - OCA; Mundell, 1961), a monetary union is considered optimal if the participating countries are rather homogeneous in their economic structure and hence react to shocks in a similar way (symmetry), and if wages and prices are flexible and labour mobility high (flexibility). In that case, the frequency of asymmetric shocks is low and, in the event, the economies will smoothly adapt to such shocks[2]. When EMU was founded, monetary integration was expected to make for steady structural and institutional convergence among the member countries[3], which has proved over-optimistic. Although the poorer member countries enjoyed above-average economic growth and their income levels caught up towards the richer countries, a good deal of the relatively faster growth before the crisis was driven by debt-financed demand rather than by advances in productivity (Aiginger et al., 2012, Bertola, 2013, Ederer and Reschenhofer, 2013). National differences persist with regard to economic and fiscal policies as well as to product, financial and labour market institutions and are a potential source of asymmetries; the capacity to adapt to asymmetric shocks remains low.

The OCA theory focuses on adjustment mechanisms after exogenous shocks. However, the present set-up of EMU gives rise to a number of endogenous forces operating whereby the asymmetry of business cycles is reinforced and instability enhanced (De Grauwe, 2013). Thus, the single monetary policy with its uniform interest rate across the euro area implies that real interest rates were too low in countries with relatively higher growth and inflation, thereby adding to the growth of domestic demand. Conversely, real interest rates were too high for member countries with sluggish growth. This real interest rate effect outweighed the competitiveness effect working in the opposite direction, which generated sizeable current account surpluses and deficits. Unit labour costs drifted apart, such that southern European countries' price competitiveness weakened markedly vis-à-vis the northern countries, holding back the cyclical recovery in the southern periphery (Ederer, 2010).

Likewise, the consequences of financial market integration have been under-estimated (Kuenzel - Ruscher, 2013). The strong increase in cross-border capital flows and of financial assets worked towards destabilising the monetary union in the wake of asymmetric shocks. Sovereign debt is issued in a currency over which national governments have no control (De Grauwe, 2012). Unlike single states, the member countries of EMU do not have a lender of last resort. Given its mandate and the conception of its own role, the ECB was not in a position to guarantee the redemption of maturing government debt. If confidence in a country's public finances is undermined, a rising number of financial investors will be induced to sell that government's bonds, thereby driving up the interest rate. As a result, the likelihood of the country being able to pay back maturing debt diminishes. This in turn will undermine investor confidence in the country's ability to meet its financial obligations, triggering a self-reinforcing liquidity crisis. At the same time, capital will flow from the crisis-ridden periphery countries to stable Northern Europe where interest rates will decline and demand be strengthened, thereby amplifying asymmetric shocks. Moreover, the rise in refinancing cost may lead to the burden of public debt becoming unsustainable, with the liquidity crisis turning into a solvency crisis.

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[2] The literature cites several additional criteria for optimal currency areas, such as product diversification, financial market integration, degree of openness etc. (Breuss, 2006, Handler, 2013).

[3] This is referred to as "endogenous OCA" theory. To what extent the euro area can be considered as an optimal currency area is further elaborated in Breuss (2006, 2011A) and Handler (2013).

A further aggravating factor is the close connection between the national authorities and the domestic banks[4]. The slump in government bond prices diminishes banks' fixed assets and thus their equity capital. As a consequence, the government is again called to support the banks. The financial situation of public authorities and banks is therefore closely tied to each other[5]. Further adding to the feedback loop described above are the repercussions of fiscal policy on aggregate demand. If the government reacts to the loss of confidence on the part of investors by cutting spending drastically, economic activity will be dampened (or an ongoing recession be deepened), adversely affecting public finances and requiring further fiscal restraint. In this way, the automatic budgetary stabilisers are effectively "switched off"[6].

These mechanisms complicate adjustments to asymmetric shocks since they exacerbate the underlying asymmetries. In the case of temporary shocks, no lasting adjustment may even be necessary as their impact may be accommodated by automatic stabilisers. This will, however, only be possible if financial market confidence is maintained during the critical phase and stabilisers are allowed to operate. The stability of monetary union takes priority over its capacity to adapt. In the case of permanent shocks, the automatic stabilisers are no substitute for the necessary adjustments; however, they may grant the economies more time for their implementation.

Without a lender of last resort, a joint regulation and supervision of banks, a common fiscal policy and a co-ordinated economic policy, the European Monetary Union is incomplete. It is not stable in a long-term perspective and in danger of breaking up in the event of crisis. The participating countries *de facto* face a similar situation as developing countries incurring debt in a foreign currency, being regularly prone to liquidity or solvency crises. The self-reinforcing crisis mechanisms illustrated above thus have to be eliminated by making economic and monetary integration truly complete. In principle, this can be achieved by the following, one another complementing measures (Aiginger et al., 2012, De Grauwe, 2012, Ederer, 2011):

- The creation of a common bank supervision and an authority for the resolution of banks in the case of insolvency as well as a common European deposit insurance would sever the close ties between government budgets and domestic banks (comprehensive banking union).
- The European Central Bank (ECB), by guaranteeing all government bonds issued in EMU countries to unlimited extent, becomes a lender of last resort. In this way, liquidity crises could be avoided before turning into solvency crises pushing an economy into a downward spiral of loss of confidence, financing problems and recession.

[4] The strong home-bias of European banks derives from the zero-risk valuation of government bonds which were traded as preferential liquid assets. As a consequence, European banks' portfolios were inadequately diversified. In addition, rating agencies graded countries on the basis of specific events rather than objective criteria, which led to exaggerated risk premia on government bonds during the crisis (Gros, 2013, Tichy, 2011).

[5] The origin of such a feedback loop can also be a banking crisis, like in Ireland, which puts severe strain on the government budget, leading to a crisis in public finances.

[6] A more elaborate description of these endogenous mechanisms is provided by Ederer (2011).

- Part of government budgets and public debt is mutualised at EU level. This reduces the risk of a looming loss of financial investor confidence and thus prevents a self-fulfilling crisis in individual countries. The danger of breakup of EMU will thereby decrease. Such a move should be combined with the set-up of an intra-EMU transfer mechanism in order to smooth differentials between national business cycles.

3. Initiatives and proposals by the EU

In June 2012, the President of the European Council presented a first report under the title “Towards a genuine Economic and Monetary Union” (Van Rompuy, 2012A), which was drafted in agreement with the Presidents of the European Commission, the Eurogroup and the European Central Bank. On the basis of the European Council Conclusions of June and October 2012, a further interim report was submitted in October (Van Rompuy, 2012B) and a final version in December 2012 (Van Rompuy, 2012C). In parallel, the European Commission elaborated “A Blueprint for a deep and genuine Economic and Monetary Union” (European Commission, 2012A), which was published in November 2012. Both reports contain proposals for far-reaching institutional reforms.

The report from the President of the European Council identifies four pillars of an integrated Economic and Monetary Union:

- an integrated financial framework which sets the cornerstones for a European Banking Union,
- an integrated fiscal policy framework,
- an integrated economic policy framework,
- democratic legitimacy and control of these frameworks.

This architecture is to be implemented in three stages where closer integration of the European Union in these areas is progressively achieved. The Commission proposal includes measures that in substance correspond to these four pillars of an integrated Economic and Monetary Union, without however citing them explicitly. These measures are classified by three time horizons, where the short-term measures could be executed within a period of 6 to 18 months without requiring a change of the Treaty. Over the medium term (18 months to 5 years), these measures are to be entirely put into effect. The long-term perspective stretches beyond 5 years. The Commission proposal largely covers the same ground as the Report of the European Council, partly reaching out further or elaborating the proposals of the latter.

3.1 Banking Union

As regards the first pillar, the integrated financial framework, the Reports by the Council and the Commission largely coincide. The integrated financial framework consists of three elements: the Single Supervisory Mechanism (SSM), a single authority for the resolution of insolvent banks and the harmonisation of national deposit guarantee schemes (DGS). The first stage provides for the implementation of SSM, along with the harmonisation of the national frameworks for bank resolution and deposit guarantees. According to the European Council Conclusions of

October 2012, the SSM was to be introduced as of 1 January 2013 and should have assumed the supervision of all banks in EMU from 1 January 2014 onwards. However, in December 2012, the responsibility of the SSM was significantly reduced. The SSM is now to take effect in autumn 2014 and to cover only part of the European banks (see Box "Banking Union"). The proposals for the harmonisation of the national frameworks for bank resolution and deposit guarantees, to be submitted after the adoption of the SSM Regulation, are still pending.

In a second stage, the national frameworks for bank resolution are to be replaced by a Single Resolution Mechanism (SRM) at EU level, which shall take effect at the same time as the entire supervision of all banks by the ECB. A common authority for the supervision and resolution of banks shall abstract from national interests and deal with problems extending beyond a single country. In this way, negative feedback loops between the financial situation of banks and national authorities are to be severed. To this end, an independent institution, adequately endowed with legal competence as well as financial and administrative resources needs to be established; it shall be financed by a levy on all banks participating in the SSM and/or a credit line extended by the ESM to the SRM. In the event of bank resolution, the private sector is to bear the brunt of the financial burden. The deposit guarantees, for their part, are to remain at the national level, subject to EU-wide harmonisation. In this way, sufficiently large guarantee schemes are to be created which in the event of bank resolutions would prevent capital flight from the member country concerned.

Box 1 **Banking Union**

The Heads of State and Government of the euro area countries and the European Council invited the Commission on 29 June 2012 to elaborate a proposal for a Single Supervisory Mechanism (SSM) of banks (European Council, 2012). With the implementation of SSM, the ESM shall in future be authorised to directly re-capitalise insolvent banks. Afterwards, a Single Resolution Mechanism (SRM) should be put in place. On 12 September 2012, the European Commission submitted a "Roadmap towards a European Banking Union" (European Commission, 2012B) together with two draft Council Regulations.

The first draft Regulation (European Commission, 2012C) confers on the ECB the exclusive competence of prudential supervision of all credit institutions of the participating member countries[7]. Supervision is defined in Art. 4 of the Regulation by including the following tasks:

- to authorise credit institutions and withdraw authorisation,
- to assess acquisitions and disposals of holdings in credit institutions,
- to ensure compliance with prudential requirements on credit institutions in the areas of own funds requirements, large exposure limits, liquidity, leverage, and reporting and public disclosure of information on those matters,
- to impose capital buffers, including setting countercyclical buffer rates,

[7] The legal basis is Art. 127(6) TFEU.

- to determine whether the arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held by these institutions ensure a sound management and coverage of their risks,
- to carry out supervisory stress-tests on credit institutions,
- to participate in supervision on a consolidated basis, including in colleges of supervisors, in relation to parents not established in one of the participating member countries,
- to carry out supervisory tasks in relation to early intervention where a credit institution does not meet or is likely to breach the applicable prudential requirements, in coordination with the relevant resolution authorities.

The national authorities remain active in consumer protection, fight against money laundering, and the supervision of credit institutions from third countries with subsidiaries in member countries which offer cross-border services. Further competences of the ECB are regulated in Art. 9 to 11, notably the right to request information, to conduct general investigations and on-site inspections. The latter may also be carried out by the national authorities, but only under the authority of the ECB. The ECB obtains the right to impose sanctions and fines up to 10 percent of the total annual turnover.

On 12 December 2012, the Ministers of Finance of the euro area agreed on an amended version of the draft Council Regulation[8] that was adopted by the European Parliament on 19 March 2013[9]. The competence of the ECB was narrowed down, as the SSM shall cover only the following banks:

- the largest banks with assets above € 30 billion or over 20 percent of GDP,
- banks whose cross-border operations account for a major part of their business,
- credit institutions directly supported by the ESM or the EFSF,
- the three largest credit institutions of a country.

Whether a cross-border activity is of major importance shall be decided by the ECB on the basis of the share of cross-border assets and liabilities according to its own standards. All other credit institutions shall continue to be supervised by the national authorities. The ECB is given a say in the authorisation of credit institutions; it may raise an objection within 10 working days of the authorisation by the national authorities. The ECB shall take over supervision of the cited institutions as of 1 March 2014. However, the single supervision is delayed until autumn 2014. According to the ECB, 150 banks fall under its central supervision[10], 9 of which are Austrian banks[11].

The second proposal for a Council Regulation (European Commission, 2012D) concerns the amendment of Regulation 1093/2010 on the European Banking Authority (EBA). By defining the relative competences of ECB and EBA, conflicts of responsibility shall be avoided. The EBA

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[8] Council of the European Union (2013A).

[9] A final decision is expected for 10 September.

[10] http://www.ecb.int/press/key/date/2013/html/sp130131.en.html (visited on 2 June 2013).

[11] http://derstandard.at/1363708389430/FMA-glaubt-dass-Zeitplan-haelt (visited on 27 May 2013).

remains entrusted with the task of developing a harmonised regulatory framework (Single Rule Book) for bank supervision. The draft Regulation sets rules for reconciliation in the case of disagreement between ECB and EBA.

A further element for the stabilisation of the financial sector is the harmonised legal framework for European banks (Capital Requirement Regulation - CRR, Capital Requirement Directive - CRD IV), adopted by the European Parliament on 16 April 2013 and published in the Official Journal of the EU on 27 June. The uniform capital and liquidity requirements for banks will be effective on 1 January 2014. They follow the Basle-III Agreement, but with different transition periods for their implementation. In addition, management bonus payments shall be limited by the level of the beneficiary's regular income.

The Councils Conclusions of 28 June (European Council, 2013) acknowledges a deepening of the Banking Union. With the implementation of the SSM the ECB will, after balance sheet assessments and asset quality reviews of the affected banks, perform stress tests. Until then, the nation's resolution authorities should implement national backstops for resident banks.

Proposals for bail-in rules and a Deposit Guarantee Scheme were made in the presidency compromise on 26 June (Council of the European Union, 2013B) in the form of a draft Directive on Bank Recovery and Resolution (BRRD). The draft includes four main resolution measures: the (partly) sale of a business, creation of a bridge institution, asset separation and bail-in measures. A national resolution fund should reach 0.8 percent[12] of covered deposits within 10 years and could be assembled with a DGS, which should reach 0.5 percent of covered deposits. Cross-national borrowing is an option. The resolution fund pitches in if the costs of a bail-in are higher for shareholders and creditors than in the matter of a resolution ("no creditor worse off principle"). Deposits beneath € 100.000 would be ranked higher than eligible deposits. Covered deposits, secured liabilities, employee pension benefits and remunerations, goods and services which are critical to the daily functioning of an institute and weekly short term liabilities to the interbank market and payment system would be excluded. National resolution authorities could exclude claims of a bail-in if they cannot be liquified in time, to secure the continuity of critical functions, to avoid contagion and to maintain the "no creditor worse of principle". The Commission must be informed 24 hours prior to exclusion and has the right to veto or alter it. Exclusions can be absorbed by creditor substitution or by contributions by the resolution fund. Only after a minimum bail-in of 8 percent resolution funds can step in for a further 5 percent coverage of liabilities. If creditor substitution is not an option or if the maximum backing of the resolution fund is exploited, alternative funding can be claimed. In such circumstances, the ESM or governments can provide direct contributions. An agreement on the BRRD is planned for autumn. The negotiations concerning the bail-in rules could extend to 2018.

The ESM direct re-capitalisation was addressed in a statement by the Heads of State or Government of the euro area on 20 June (Council of the European Union, 2013C). It includes criteria for an ESM re-capitalisation: (i) An ESM member is not able to support struggling banks without putting its financial sustainability at risk, (ii) the financial stability of the euro area as a

[12] The Commission's draft mentions 1 percent.

whole is at stake, (iii) the institution is not able to maintain its capital requirements and cannot re-capitalise itself from private sources, (iv) the institution is system-relevant. The Commission's assistance approval and decision for state aid conditionality is required to retrieve direct re-capitalisation. The ESM re-capitalisation is limited to € 60 billion and evaluated by external experts and guided by the ECB in the matter of the capital requirement supervision. The Re-capitalisation is structured as follows: Private capital resources (from shareholders and creditors) will be utilised first. An ESM member must contribute capital up to 4.5 percent (legal minimum Common Equity Tier 1). The ESM backstop is not active until then. If the ESM backstop steps in, member countries still contribute 20 percent of the public assistance for the first two years, 10 percent after. Institution specific conditionality should be implemented; including decisions on management salaries and bonuses. The ESM codetermines the dimension of the backing; in extend as a shareholder and in conditionality matters. The affected institute has no voice.

After the SSM and the ESM re-capitalisation are installed, the SRM should be put in place. The European Commission made a proposal in this regard on 10 July (European Commission, 2013A). An agreement should be reached by the end of 2013 and should be adopted in 2014. The SRM would then apply from January 2015. The legal basis of the SRM is Art. 114 TFEU. The SRM would operate as follows:

- The SRM concerns all banks in member states participating in the SSM (circa 6000)[13]. The ECB as the single supervisor over European banks indicates if a bank is in trouble.
- The still to be created board for single resolution consisting of delegates of the ECB, European Commission and national authorities prepares the liquidation of a bank in trouble. The board applies the Single Rulebook on bank resolution as defined in the draft BRRD.
- The European Commission decides on the basis of the board's recommendation, whether and when a bank is liquidated. The European Commission also sets out the parameters and tools utilised for the resolution.
- National authorities execute the resolution under board supervision. The board is able to provide performance requirements directly to affected banks.
- A single resolution fund is established which is financed by contribution from the banking sector ex ante as defined in the Commission's draft BRRD[14]. The fund is controlled by the board for single resolution and replaces the national resolution funds.

3.2 Fiscal and Economic Union

As a second pillar of a "comprehensive Economic and Monetary Union" the Report of the Council cites an integrated fiscal policy framework. In the short run, the already adopted stricter

[13] Under the current SSM regime the ECB would only supervise a small fraction of this number.

[14] The Council of European Union's draft BRRD and the Councils Conclusions of 28 June mention national resolution funds.

rules of the “Six-pack”, the “Two-pack” and the Fiscal Compact shall be implemented (see the three Boxes “Economic governance framework”). The Regulations of the “Two-pack” already provide for the *ex-ante* co-ordination of the annual budgets of the EU member countries.

In the medium term, a European central fiscal capacity along the lines of the US fiscal federalism is to be created in order to accommodate country-specific shocks at EU level and thus prevent the transmission of these shocks to other member countries. As a first step, a financial incentive, limited in scope and time, for member countries to introduce structural reforms shall be provided in the second stage, on the basis of contractual agreements between the EU institutions and the member countries (see below). Such agreements shall be binding for the euro area countries and voluntary for the other EU members. They are supposed to trigger a convergence process that is deemed to be a precondition for the fiscal capacity to be transformed in the third stage into an instrument of cyclical stabilisation.

The fiscal capacity is conceived as a mutual insurance system between Member countries, with contributions from and to national budgets to be paid according to a country's business cycle situation. Two options are being discussed:

- In a macroeconomic approach, the national contributions would be assessed on the basis of the cyclical variations of revenue and expenditure or of a gauge of economic activity (e.g. Gross Domestic Product).
- Alternatively, the contributions would be directly linked to a specific government scheme, e.g. unemployment insurance. In this case, the central fiscal capacity would be a supplement to the national unemployment insurance systems, only serving to cover the cost of cyclical unemployment.

The fiscal capacity is not supposed to provide one-way and regular transfers and is not a tool for smoothing income differences; each country shall pay contributions and receive subsidies over the business cycle. Endowment with own resources and the possibility of financing via the capital market are also tentatively envisaged. Compliance with the contractual provisions shall be a key condition for participation in the hedging mechanism of the fiscal capacity. The conclusion of agreements is foreseen also for the third stage of deeper integration. Transfers from the fiscal capacity shall then be made contingent upon the regular compliance with the contractual obligations.

The third pillar of the Council proposal is an integrated framework for economic governance. In the short term, the Single Market is to be completed and become more adaptive through more flexible labour and product markets as well as through the promotion of labour mobility and reduction of deficits in labour qualification and skills. Contractual agreements on structural reform measures and the systematic *ex-ante* co-ordination of economic policy pursuant to Art. 11 of the Fiscal Compact shall underpin the Single Market over the medium term. The idea of contractual agreements was retained in the European Council Conclusions of October 2012. They shall co-ordinate national reforms, enhance competitiveness, growth and employment and prevent economic imbalances in the future or facilitate their correction. These agreements shall become mandatory for all EMU countries. They would span several years and be adjusted regularly. Implementation of the measures thereby agreed shall be financially supported by the fiscal capacity (see above), embedded into the "European Semester" and based upon the country-specific recommendations.

The proposals by the Commission go beyond those of the Council as regards the second and third pillar or develop them further. Further to the implementation of the "Six-pack" and "Two-pack", it is proposed for the short term to introduce a "Convergence and Competitiveness Instrument" (CCI). The latter shall be supplemented by a regulatory framework for the ex-ante co-ordination of major reform projects. Both instruments shall be anchored in secondary legislation and have been presented in two Commission Communications (European Commission, 2013A, 2013B). The CCI is supposed to implement the Council proposal of contractual agreements and financial support for their execution, and constitutes the first step towards a dedicated fiscal capacity at EU level. Subject of the contractual agreements are reforms, notably those based on recommendations formulated in the "European Semester" and the Macroeconomic Imbalance Procedure (MIP), with details and time-lines for their implementation. According to the Commission, the goal of structural reforms is to enhance adaptability and competitiveness of the member countries' economies. According to the proposal, the reform plans would be evaluated by the Commission, negotiated with the member countries and finally adopted by the Council. If no agreement can be reached, no financial support shall be granted. Member countries shall report on the implementation of projects in their National Reform Programmes in the context of the European Semester. Surveillance shall be with the Commission, with financial subsidies to be disbursed in tranches according to progress in the execution. In the case of non-compliance with the agreement, financial support shall be retained or suspended.

In an *ex-ante* co-ordination process of major economic reforms, elaborated in the second Commission Communication, national reform projects with spill-overs to other member countries or implications for the functioning of EMU as a whole shall be discussed at EU level before their adoption by the national legislator. Such reform projects concern all areas where repercussions on growth and employment as well as on price- and structural competitiveness may be expected. Reforms of labour, product and services markets as well as of tax systems are explicitly mentioned. Once again, the proposed framework shall be binding for all euro-area countries. The Commission and the Council shall give their opinion on the reform proposals and may recommend changes, which should then become part of the country-specific recommendations under the "European Semester". However, the decision on the reform projects rests solely with the national legislator.

As a further element of integrated economic governance, the Commission Report cites the Multiannual Financial Framework (MFF) 2014-2020, about to be adopted. It envisages tying cohesion policy, rural development and maritime and fishery policy more closely to the instruments of economic policy co-ordination. A Common Strategic Framework (CSF) overarches the respective funds and shall strengthen in future the link between them and the National Reform Programmes, the Stability and Convergence Programmes, the country-specific recommendations pursuant to Art. 212 and 148 TFEU and the corrective arm of the MIP. This link shall be established via contractual agreements between member countries and the

Commission subject to macroeconomic conditionality. The latter shall operate through two channels:

- Re-programming: upon invitation by the Commission, the member countries shall adjust the contractual agreements in order to integrate the Council Recommendations for the correction of excessive fiscal deficits, macroeconomic imbalances or other "economic and social problems" or in order to maximise the impact of CSF-financed measures on growth and competitiveness. If a member country does not follow up on such a request for adjustment, the Commission may suspend all subsidies under the CSF.
- Suspension: if a member country fails to implement the corrective measures required under the SGP and the MIP, the Commission may suspend all subsidies under the CSF.

The aim of the first channel is to ensure that henceforth the CSF funds will primarily finance programmes that help member countries to cope with "structural challenges". The Commission explicitly quotes reforms of labour markets and education systems, support for research and development, innovation and infrastructure a well as upgrading of the quality of governance, administration and statistics. The Commission would like to have its respective proposal for a Council Regulation (European Commission, 2013C) adopted without delay.

Finally, the Commission wants to move to a different consideration of public investment than so far. According to Art. 126(3) TFEU, the Commission in its Report initialising an Excessive Deficit Procedure shall consider whether the government deficit exceeds the amount of public investment. Accordingly, member countries may avoid an Excessive Deficit Procedure even if the deficit is above the reference value. In the preventive arm, deviations from the adjustment path towards the budgetary targets may be tolerated if a member country introduces "structural reforms" that improve the budget balance in the longer run. However, only temporary deviations from the Medium-term Budgetary Objective (MTO) shall be acceptable. The Commission intends to issue a Communiqué defining the respective guidelines for the adjustment path towards the MTO. It explicitly discards the idea of a "golden rule" whereby total public investment would be eliminated from the calculation of the deficit[15].

Over the medium term, the Commission proposal is for a still more stringent budgetary co-ordination, the extension of policy harmonisation to taxation and employment, and for the creation of an effective fiscal capacity. The latter shall be endowed with own resources and may finance itself via the capital market. According to the Commission proposal, the purpose of the fiscal capacity is to promote structural reform in the economies in distress. The authorisation to incur debt requires a change of the Treaty. The fiscal capacity shall be combined with a debt redemption fund along the lines proposed by the German Council of Economic Advisers ("Sachverständigenrat"; Bofinger et al., 2011). By means of this fund, part of national public debt would be mutualised, subject to strict conditionality and surveillance[16]. The objective of the debt

[15] The country-specific recommendations in the context of the "European Semester" 2013 already grant a number of member countries longer periods for the correction of their excessive deficits (European Commission, 2013D).

[16] For the proposal of the German Sachverständigenrat, see Ederer (2011). So far, this proposal has been firmly rejected by the German Federal government.

redemption fund is the reduction of government debt below the ceiling of 60 percent of GDP. For the Commission, a precondition would be the possibility to intervene more directly into national budgetary plans (see above). The fragmentation of financial markets shall be countered by the issuance of short-term bonds with a maturity of 1-2 years (Eurobills). The short maturity is intended to rein back moral hazard. In this way, a liquid market for European bonds could be created that would be attractive for investors and reduce the home bias of banks; at the same time, the effectiveness of monetary policy would be enhanced.

According to the Commission, the future issuing of common debt requires in certain circumstances common control over national budgets. More stringent budgetary co-ordination should therefore include the right to veto a government household or to call for changes. With the possibility, provided for in the "Two-pack", for the Commission to call for changes in the national budget if the latter violates the commitments of the Stability and Growth Pact, the capacity of secondary legislation is exhausted. All competences beyond require a change in the Treaty. The following options are being considered:

- The Opinion given by the Commission on the national budgets on the basis of the "Two-pack" could be made binding.
- In certain situations, budgetary execution could be made liable to a revision.
- National budgetary legislation could be harmonised, and appeal to the European Court of Justice could be made in the case of non-compliance.

From the point of view of the Commission, the long-term perspective for the EU is a fully integrated Banking, Fiscal and Economic Union. This would require, as a fourth element, democratic legitimacy and accountability with regard to its decisions (see below), and hence major revisions to the Treaty. A comprehensive Banking Union includes common bank supervision and resolution, coupled with deposit insurance schemes in all member countries. A common financial guarantee could be provided on the basis of Euro-bills. A fully integrated Fiscal and Economic Union ought to be underpinned by a central fiscal capacity and mechanisms allowing to oblige member countries to take certain budgetary and economic decisions in given and well-defined circumstances. This would form the basis for the issuance of long-term stability bonds[17]. A central budget at EU level (fiscal capacity) is quoted as the most important element of a fully integrated Fiscal and Economic Union. The fiscal capacity shall serve to smooth asymmetric shocks and cyclical differentials, thereby supporting closer integration and convergence. Permanent transfers are to be avoided, structural reforms shall be supported and moral hazard shall be prevented by strict conditionality. The fiscal capacity may be organised via a mutual insurance, allowing risks of economic shocks to be pooled across member countries. It may also cushion symmetric shocks and be coupled with a debt facility.

[17] For the Commission proposals on stability bonds see European Commission (2011).

Box 2 **Economic governance frameworks: the Stability and Growth Pact (SGP)**

The Stability and Growth Pact (SGP) regulates the budgetary surveillance of EU member countries. It is based on the EU Treaties (Art. 121, 126 TFEU) and two Council Regulations (secondary legislation)[18].

Regulation 1466/97 refers to Art. 121 TFEU and deals with the preventive arm of the SGP. On the basis of reports by the Commission and the Economic and Financial Committee (EFC), the Council examines the compliance of the Stability Programmes (euro-area countries) and the Convergence Programmes (non-euro-area countries) with the common fiscal rules and whether the danger of an excessive deficit exists. Yardstick for the assessment of the Programmes is the Medium-Term Budgetary Objective (MTO), i.e., a structural budget balance close to zero (as from 2005: up to a deficit of 1 percent of GDP) or positive. If the danger of an excessive deficit exists, the Council shall address recommendations for adjustment of the budgetary plans and may make such recommendations public. In 2005, the member countries were granted the possibility to deviate from the MTO for reason of certain structural reforms. After introduction of the latter, the structural deficit shall decline by an annual 0.5 percent of GDP (Art. 5).

If the Commission assesses the existence of an excessive deficit, the corrective arm enters into operation according to Council Regulation 1467/97 (pursuant to Art. 126 TFEU). The Commission monitors budgetary developments according to the criteria of the "Protocol on the Excessive Deficit Procedure" (deficit ceiling of 3 percent of GDP; debt ceiling of 60 percent of GDP) that is annexed to the EU Treaty (Protocol Nr. 12). The Excessive Deficit Procedure (EDP) is initiated if the Council decides on the existence of an excessive deficit or that a member country violates the deficit criterion. The Council issues a recommendation on the correction of the excessive deficit and sets a first deadline for the implementation of the measures. If the first deadline is not met, the Council sets a second deadline with a path for correction that has to be followed within a year. If the second deadline is not met, the Council invites the member country concerned to publish additional information when issuing government bonds and to lodge a non-interest-bearing deposit of up to 0.5 percent of GDP. The Council may convert the deposit into a fine. Interest payments and fines are distributed to the member countries in compliance with the deficit criterion.

Economic governance frameworks: "Six-pack"

The "six-pack" entered into force on 13 December 2011. It consists of three Council Regulations (1173/2011, 1175/2011, 1177/2011) and a Directive (2011/85/EU) which change the fiscal policy framework of the SGP, and of two Regulations (1174/2011, 1176/2011) which define the procedure for the avoidance and correction of macroeconomic imbalances (Macroeconomic Imbalance Procedure MIP). In the preventive arm, the six-pack stipulates a reduction of the structural budget deficit (cyclically-adjusted balance) by an annual 0.5 percent of GDP as long as the MTO is not reached. In addition, expenditure growth must not exceed the medium-term rate of potential GDP growth and should remain below that rate as long as the MTO is not reached. New is the provision of sanctions in the preventive arm in case of non-compliance with

[18] For the anchoring of economic policy co-ordination in the EU Treaties see Ederer - Janger (2010).

the correction of the structural deficit or with the expenditure criterion (see below). The corrective arm now provides for the possibility to initiate the EDP if the debt criterion (60 percent of GDP) is violated. In this case, the country concerned must reduce the part of the debt exceeding 60 percent of GDP by one-twentieth per year.

Pursuant to Regulation 1173/2011, an interest-bearing deposit of 0.2 percent of GDP shall be called if a member country does not follow the Council Recommendations in the preventive arm. In the corrective arm, such deposit shall be non-interest-bearing. If a member country does not take the corrective action requested by the Council, the deposit shall be converted into a fine. The principle of "Reversed Qualified Majority Voting" (RQMV) strengthens the decision power of the Commission vis-à-vis the Council since sanctions will be imposed automatically unless rejected by a Council majority. The Council can impose a fine up to 0.2 percent of GDP, if the Commission finds that a member country has manipulated its deficit and debt statistics.

Council Regulation 1176/2011 deals with the avoidance and correction of macroeconomic imbalances. The Commission monitors annually whether in a member country the danger of a macroeconomic imbalance exists. To this end, the performance of member countries with regard to a scoreboard of eleven indicators is compared with the respective benchmark values. These indicators refer inter alia to the size of a current account deficit, the increase in unit labour cost and the average unemployment rate. If the Commission identifies an excessive imbalance in a member country, it initiates the respective procedure. The Council, on a proposal by the Commission, shall issue recommendations for corrective action. The member country concerned shall submit in due time a corrective action plan, to be assessed by the Council. If the Council considers the measures proposed insufficient, the member country has to submit a new plan within two months. Implementation will be monitored by the Commission. Regulation 1174/2011 deals with the enforcement measures for the correction of excessive economic imbalances. If the corrective action plan is not implemented, an annual interest-bearing deposit of 0.1 percent of GDP of the previous year shall be called. In case of persistent non-action by the member country, the deposit shall be converted into a fine.

Economic governance frameworks: "Two-pack", "Fiscal Compact", "Euro-Plus Pact"

The "two-pack" consists of two Council Regulations (472/2013, 473/2013) that amend the SGP. It was formally adopted by the Council on 13 May 2013 and entered into force on 30 May.

Regulation 473/2013 amends the provisions of the corrective arm of the SGP. It stipulates a harmonised time-schedule for national budgeting: publication of the Stability Programmes and the medium-term budgetary plans by 30 April, publication of the draft budget (planned budget balance, projection of revenue and expenditure etc.) by 15 October, budget adoption by 31 December. An independent council monitors compliance with the MTOs. The Commission may call for a correction of the budgetary plans if they violate SGP rules.

Regulation 472/2013 concerns member countries receiving financial assistance and hence being subject to closer surveillance by the Commission. The Commission monitors compliance with the macroeconomic adjustment programmes, while the countries concerned have to assure full co-operation. The Commission examines whether a programme needs to be adjusted; such adjustments have to be approved by the Council. If the programme and the recommendations are not followed up, the member country has to apply for technical assistance by the Commission. The authorities of programme countries may be invited for a debate in the European Parliament.

Unlike the SGP, the Fiscal Compact (Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union – TSCG) is an inter-governmental agreement outside the EU Treaties. After the Czech Republic has signalled its accession, the United Kingdom is the only EU member country not taking part in the agreement. The Fiscal Compact entered into force on 1 January 2013. Precondition had been that at least 12 euro area countries lodge their ratification in the Secretariat-General of the Council; this condition was met on 21 December 2012 when Finland lodged the ratification document. So far, 21 member countries have ratified the Fiscal Compact, 15 of which are euro-area countries. The Fiscal Compact requires that a structural deficit be no higher than 0.5 percent of GDP, unless public debt is "substantially" below 60 percent of GDP - in which case a structural deficit ceiling of 1 percent of GDP applies.

These requirements ("debt brake") shall be anchored in national constitutions or be adopted as constitutional law within one year after entry into force; otherwise the member country can be taken to the European Court of Justice whose verdict would be binding. In the event, a penalty of 0.1 percent of GDP may be imposed, to be paid to the ESM.

Member countries in an Excessive Deficit Procedure shall submit a budgetary plan including structural reforms to ensure a lasting correction of the deficit. The budgetary plan shall be submitted to the Council and the Commission for approval in the context of the EDP. Implementation shall be monitored by the Commission and the Council. In addition, the following obligations apply:

- Plans for major economic reforms must be co-ordinated with the EU authorities.
- As from 1 March 2013, national adoption of the Fiscal Compact is a pre-condition for the application for assistance by the ESM (laid down in the Fiscal Compact, p.7 and in the ESM Treaty, p.4).

The Euro-Plus Pact (EPP) was concluded in March 2011. 17 euro-area countries and 6 non-euro-area EU member countries have joined the EPP. The Pact mainly concerns the economic policy pillar of EMU. Competitiveness shall be enhanced through better co-ordination of wage policy. Moreover, the rules of the SGP shall be translated into national law, and countries shall introduce measures to stabilise the financial sector. This should facilitate convergence of national business cycles towards a "European business cycle". With regard to the implementation of the co-ordination measures that are defined annually, no sanctions are foreseen within the framework of the EPP (Breuss, 2011B, 2013).

3.3 Political Union

The fourth pillar of a deeper Economic and Monetary Union is democratic legitimacy and accountability. In this respect, the Council proposal remains rather vague. It cites as a principle that democratic control and account shall always take place at the same level at which a decision is taken. Accordingly, the European Parliament shall be involved in decisions taken at EU level, the national parliaments in national decisions. Reference is also made to information and reporting of national parliaments as well as to debates and co-operation between parliaments. Inter-governmental agreements concluded during the crisis shall be transposed into EU Law. External representation of Economic and Monetary Union shall be harmonised.

The proposal by the Commission states two principles: accountability shall always be incumbent at the level at which a decision is taken; and any transfer of sovereignty from the member countries to the EU level must be accompanied by a corresponding transfer of democratic legitimacy. In the view of the Commission, the democratic legitimacy and control of the short-term measures for a deeper EMU which are based on secondary legislation is ensured by the EU Treaties. Treaty changes, however, may imply changes in democratic legitimacy. By contrast, further inter-governmental agreements would restrain legitimacy and control. Deeper integration should therefore take place on the basis of the EU Treaties, with inter-governmental agreements remaining exceptional and transitory until the corresponding Treaty changes enter into force. Deeper integration shall build upon existing instruments and be implemented as much as possible through secondary legislation. Treaty changes should be made only if necessary.

For the short term, a dialogue is proposed whereby the European Parliament shall be involved into the "European Semester", like through a debate on the Annual Growth Survey and the country-specific recommendations. In a medium-term perspective, i.e., in case of Treaty changes, the Integrated Guidelines may, for example, be adopted by legal procedure by the Council and the EU-Parliament. Likewise, any decision to call for a revision of a national government budget should be taken jointly by the two institutions. Further proposals relate to the creation of a Euro Committee in the European Parliament, the strengthening of the responsibilities of the Commissioner for Economic and Financial Affairs in the direction of an EMU-Minister of Finance, a strengthening of the Eurogroup and of the European Court of Justice, and enhanced accountability of the ECB. Issues of legitimacy and control in the event of jointly issued bonds, of a debt redemption fund and of an autonomous fiscal capacity are briefly discussed. The large autonomy of a central fiscal capacity shall thus be combined with a reinforcement of control by the European Parliament.

4. Conclusions

The creation of a fully integrated framework of financial institutions (Banking Union) would reduce the mutual dependence between individual member countries and their banks and interrupt feedback loops between their respective financial situations. This would prevent a banking crisis in one country from turning into a crisis of public finances. The introduction of the Single Supervisory Mechanism (SSM) is a first step in that direction, even if the responsibility of the SSM has eventually been limited. Smaller banks remain excluded from common supervision. Yet, the crisis has shown that smaller banks may also become a potential source of instability. The likely stabilisation effect is therefore smaller than for a comprehensive Banking Union. However, it is not clear at which point the SSM is going to be established. A formal adoption by the European Parliament is scheduled on 10 September. The ECB would take its supervisory task 12 month later (Deutsche Bundesbank, 2013). The further elements of a

Banking Union, i.e., a common resolution mechanism and a common deposit guarantee scheme are still in an early stage of negotiation. Both the Single Resolution Mechanism (SRM) and a deposit guarantee scheme would have to be adequately endowed with financial resources at EU level, in order to be able to effectively prevent crises in individual countries. With both elements missing and the coverage of SSM limited, EMU remains vulnerable to crises.

The proposals for an integrated economic and fiscal governance provide for the mutualisation of debt at EU level to a limited extent over the medium term. By reducing the latent risk of loss of financial market confidence, this could prevent crises in individual countries from becoming self-fulfilling and limit the danger of break-up of EMU. The fiscal capacity shall be combined with an automatic transfer mechanism between countries in order to smooth the asymmetry of business cycles, which would also enhance the stability of EMU. However, implementation of these measures will take several years from now, in the best case. Indeed, the creation of an autonomous, self-financing fiscal capacity with the possibility to counter severe recessions is, if at all, a goal in a long-term perspective that has been vaguely formulated. The measures of "Six-pack", "Two-pack", Fiscal Compact and Euro-plus Pact constrain the scope for member countries to incur debt and shall prevent excessive expenditure growth in a cyclical upswing. However, in the current recession they are counter-productive as they "switch off" the automatic stabilisers (see above) and thus aggravate the slack in economic activity.

As long as the Banking Union is not completed and fiscal policy not fully integrated, the European Central Bank will remain the only guarantor for the stability of EMU. In August 2012, the ECB announced its intention to purchase government bonds of the crisis countries to an unlimited extent in the event of a liquidity crisis[19]. As a consequence, investor confidence stabilised and interest rate spreads on government bonds eased substantially. In this way, the ECB has to some extent become a lender of last resort. Liquidity crises can thereby be prevented before turning into solvency crises dragging the economies concerned into a vicious circle of confidence losses, financing problems and recession. On the other hand, this policy creates an incentive for countries to raise further debt (moral hazard). For this reason, the ECB intervention is tied to the condition that the country in question applies for support by the ESM and agrees with the "Troika" on an adjustment programme. While this would reduce the danger of moral hazard, aggregate demand in the country concerned would nevertheless suffer in the event of the EU imposing unabated fiscal retrenchment, thereby exacerbating the government's financing problems. Since the supply of liquidity by the ECB is subject to the approval by the ESM, there is the further risk of any country blocking the support. It would therefore be better to have an institution independent from the ECB dealing with the avoidance of moral hazard and to separate it from the function of lender of last resort. The Stability and Growth Pact may be considered as the embryo of such an institution.

[19] http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.

The most concretely elaborated proposals[20] are the CCI and the ex-ante co-ordination as well as the Medium-term Financial Framework for the next period. All these instruments aim at pushing ahead more forcefully with structural reform in the member countries along the lines of the country-specific recommendations issued by the Commission and the Council. The implementation of structural reform shall also be a precondition for the creation of a fiscal capacity. The emphasis on structural reforms which can be expected to have a positive impact on growth and employment in the medium term at best, coupled with fiscal restriction, is likely to exert further downward pressure on education and health systems as well as on social welfare provisions in the crisis countries. While it is envisaged to grant financial support within the framework of CCI, it is still uncertain whether it will be sufficient to cushion the adverse social repercussions, particularly since such support will only be temporary. Hence, the gap between the EMU member countries is likely to widen.

The policy conducted so far to cope with the crisis has drastically weakened popular support for EMU in the creditor and debtor countries alike. Although the proposals from the Council and the Commission foresee stronger democratic legitimacy and control as a fourth pillar of EMU, the plans remain vague and apparently do not reach very far. Notably for CCI and the ex-ante co-ordination, like with the existing governance framework, no parliamentary control is foreseen. Moreover, the proposals for a fully integrated Monetary Union lack a long-term vision for the EU (Aiginger et al., 2012). Social and environmental concerns, like the goals of the "Europe 2020" Strategy which have moved to the background during the crisis, find no reference. These risks further undermining the social and political cohesion in the EU and jeopardising the project of European integration in the long run.

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Project Information

Welfare, Wealth and Work for Europe

A European research consortium is working on the analytical foundations for a socio-ecological transition

Abstract

Europe needs a change: The financial crisis has exposed long neglected deficiencies in the present growth path, most visibly in unemployment and public debt. At the same time Europe has to cope with new challenges ranging from globalisation and demographic shifts to new technologies and ecological challenges. Under the title of Welfare, Wealth and Work for Europe – WWWforEurope – a European research consortium is laying the analytical foundations for a new development strategy that enables a socio-ecological transition to high levels of employment, social inclusion, gender equity and environmental sustainability. The four year research project within the 7th Framework Programme funded by the European Commission started in April 2012. The consortium brings together researchers from 33 scientific institutions in 12 European countries and is coordinated by the Austrian Institute of Economic Research (WIFO). Project coordinator is Karl Aiginger, director of WIFO.

For details on WWWforEurope see: www.foreurope.eu

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