FONDATION ROBERT SCHUMAN

EUROPE AND THE GLOBAL FINANCIAL CRISIS

TAKING STOCK OF THE EU'S POLICY RESPONSE

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ABSTRACT

On 24th and 25th March the European Council approved the "European Stability Mechanism" and the "Euro Plus Pact". These decisions mark the end of a long series of reforms the origin of which can be traced back to in 2007 at the start of the biggest world financial crisis in 80 years. This destabilised the entire financial system and plunged the real economy into recession. As an extension to the financial crisis a massive deterioration in public finances struck several euro area Member States quite severely and compromised the credibility of the European single currency.

Financial turbulence and the euro crisis have revealed weaknesses in European integration and also raised awareness of the need to act together. The period covering 2008-2011 showed that the European Union is a political edifice that develops as crises occur. The latter drive integration along and have triggered off a dynamic to reform which had been deemed impossible since the failure of the French and Dutch referendum on the European constitution in 2005.

These 10 explanatory sheets present a summary of the way the European Union has faced the challenges raised by the financial turbulence ongoing since 2007. They aim to facilitate the understanding of the context of the crisis which the Union is experiencing and to provide a panorama of the reforms adopted to face this. The first six address the world financial crisis and measures taken both internationally and on a European level to manage the effects and reduce the probability of its repetition in the future. Within the European Union these measures notably include the creation of a new structure for financial supervision and high legislative production in terms of financial regulation. The last four sheets focus on the crisis and the euro and the reform of the Economic and Monetary Union.

SUMMARY

THE GLOBAL FINANCIAL AND ECONOMIC CRISIS IN BRIEF

FONDATION ROBERT SCHUMAN

SHEET 01

1. THE COLLAPSE OF THE REAL ESTATE BUBBLE IN THE US WAS AT THE ORIGIN OF THE CRISIS

The biggest financial and economic crisis since the 1930s originated within a specific sector of the American mortgage market, the sub-primes market. Sub-prime mortgages are a type of loan which facilitates access to housing by those who do not have the necessary guarantees to be eligible for ordinary loans (primes). Sub-primes are high yield mortgages entailing a considerable risk of default on the part of the borrower. Lenders counted on rising real estate prices to limit risks. In the event of default, they could always resell at a higher price. In 2006, this type of loan represented 10% of the American mortgage market.

The collapse of the real-estate bubble in the US betrayed the sub-prime logic. The average rate of default increased, rising from around 11% at the beginning of 2006 to over 20% in 2008.

2. SECURITISATION OF SUB-PRIMES FACILITATED CONTAGION WITHIN THE FINANCIAL SYSTEM

Securitisation is a financial operation which makes it possible to share risk. Loan portfolios are packaged together in one single product which is split into securities of varying degrees of risk. Hence, the risk of default is shared between many creditors. It is an effective guarantee as long as defaults remain isolated cases. However, when defaults occur massively at the same time – as was the case in the sub-prime crisis – securitisation spreads the risk across the entire financial system. The complexity and opacity of securitisation makes it hard to assess with certainty the actual exposure to "toxic" assets.

3. MUTUAL MISTRUST FREEZES THE INTERBANK MARKET

Uncertainty created a climate of mistrust in which banks stopped lending to each other. They have been forced to sell assets that had not yet been affected by the crisis. As a result, the massive sale of "good" quality assets also led to a fall in their price. Short of liquidity and in the light of the depreciation of their capital, many financial institutions found themselves on the brink of bankruptcy. Europe was affected as much as the US, illustrated by the nationalisation of Northern Rock, the biggest British mortgage bank, in February 2008.

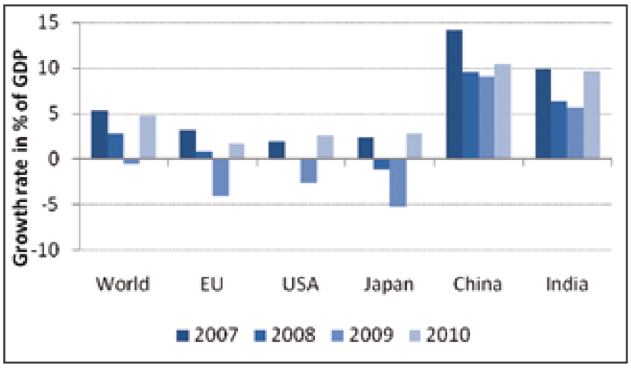
4. THE BANKRUPTCY OF LEHMAN BROTHERS SPREADS PANIC

The crisis peaked in September/October 2008 when the American authorities decided not to bail out the investment bank Lehman Brothers. Previously, the American state had decided to bail out several financial institutions, such as Bear Sterns, an investment bank, and the mortgage agencies, Freddie Mac and Fannie Mae. The decision to do otherwise in the case of Lehman Brothers destabilised the world's financial market. The insurance company AIG had to be saved by the American state; the investment banks Goldman Sachs and Morgan Stanley were transformed into commercial banks in order to be eligible for liquidity aid from the Fed. In Europe, Dexia and Fortis, two financial institutions with complex transnational ramifications, were bailed out by the Benelux countries and France.

Confronted with failures in the banking sector, public authorities face a dilemma: the difficult choice between the moral hazard of guaranteed rescue and the destabilisation of the wider financial system caused by the bankruptcy of systemically important institutions ("*too big to fail*").

5. THE FINANCIAL CRISIS TURNS INTO AN ECONOMIC CRISIS

Towards the end of 2008, the financial crisis started to hit the real economy. In 2009, global GDP contracted by 0.6%; this was the first global recession since the Second World War. However, the crisis did not affect all countries in the same way: while developed countries suffered a major contraction of their economies, emerging countries coped rather well. The EU's GDP declined by 4.1%, Poland being the only Member State to record positive growth. The average unemployment rate in the EU rose from 6.1% in 2008 to 10% in 2010 (in the USA 5.8% to 9.7%).



Source : FMI

The channels of crisis transmission: even though developed economies contracted the most, the crisis did not only affect the most financially integrated countries, which were directly exposed to "toxic" assets. The economic crisis spread through various channels: contraction in credit supply was undoubtedly the main channel of contagion: the credit crunch concerned in particular SME's which depend more on funding via banking loans than big companies. More generally, the decline in demand and the contraction of international trade contributed to the spread of the crisis: world exports fell by 12% in 2009. Correspondingly, countries that were most oriented towards exports suffered the high falls in GDP (Germany -4.7%, Japan -5.2%). Banks also reduced their exposure to emerging markets by rationing credit in their local branches and by stopping capital outflows towards these countries (in particular, Central and Eastern Europe). Developing countries were also affected to varying degrees: primary commodity exporters had to face sharp falls in prices; other developing countries were hit by reductions in remittances or in foreign direct investments (global FDI inflows declined by 37% in 2009).

6. PUBLIC INTERVENTION TO DEAL WITH THE CRISIS

Central Banks:

– The main central banks lowered their key interest rates to between 0 and 1%.

– They substituted the interbank market as "lenders of last resort".

– They reverted to non-conventional easing measures to stabilise the financial system: for example the explicit promise to keep key interest rates low for an extended period of time to reduce uncertainty; direct intervention on financial markets via the targeted purchase of financial products to influence their yield curve or to stimulate systemically important sectors of the credit market.

Governments:

– In developed countries governments supported struggling financial institutions by:

• Injecting capital to strengthen the banks' capital base;

• Providing guarantees to facilitate bank access to funding;

• Purchasing or guaranteeing "toxic" assets

➤ The degree of intervention varied significantly from one country to another. Bank rescue packages were largest in countries where the financial sector is big compared to the real economy such as in the UK.

– Finally, governments around the world have enacted sizable stimulus packages to support the real economy.

State Intervention in the banking sector (until June 2009)

		in bn EUR	in % of GDP
Germany	Commitments	700	28,1
	Outlays	151	6,1
France	Commitments	368	18,9
	Outlays	104	5,3
Italy	Commitments	n.a.	n/d
	Outlays	10	0,6
Netherlands	Commitments	265	44,6
	Outlays	99	16,6
Spain	Commitments	n.a.	n.a.
	Outlays	31	2,8
UK	Commitments	845	54
	Outlays	690	44,1
USA	Commitments	2491	22,3
	Outlays	825	7,4
Japan	Commitments	113	2,7
	Outlays	3	0,1

Source : Bank of Italy

Stimulus packages (until March 2009)

	in bn dollars	in % of GDP
Germany	130,4	3,4
Spain	75,3	4,5
France	20,5	0,7
Italy	7	0,3
UK	40,8	1,5
USA	841,2	5,9
Japan	104,4	2,2
China	204,3	4,8

Source : Brookings Institution

SHEET 02

CAUSES AND LESSONS LEARNED FROM THE GLOBAL FINANCIAL CRISIS

While it is easy to find the starting point of the global financial crisis in the sub-prime crisis, identifying the underlying causes is more complex. The crisis cannot simply be explained by one single cause. Instead, it can be traced back to a complex set of interdependent causes to which experts grant varying degrees of importance. Two main narratives shape the political response both at the international and the European level.

1. THE CRISIS AS A FAILURE OF REGULATION AND FINANCIAL SUPERVISION

The first narrative considers the crisis mainly to be a failure of the regulatory and supervisory framework. According to this interpretation, financial players have operated in structures that led to an underestimation of risks and excessive risk taking.

Risk management failures in financial institutions:

– Remuneration practices encouraged risk taking and led to a focus on short-term performance (premiums in the form of options and shares without cash-out restrictions; bonuses linked to traders' annual performance, etc.).

– Inadequate risk assessment:

- Exposure to systemic shocks underestimated by risk models.
- Stress-tests too often based on too favourable economic conditions.
- Complexity and opacity of financial products complicated risk assessment: securitisation is a case in point. The "originate-and-distribute" model limited the interest in proper risk assessment.
- Lack of transparency in most financial markets, especially in over-the-counter (OTC) derivatives markets. OTC derivates are not negotiated on stock exchanges but privately between buyers and sellers.
- Excessive confidence placed on credit rating agencies: imperfect methodologies, conflicts of interest (those being rated pay for the rating, a practice referred to as "rating shopping").

Regulatory practices and financial supervision:

– The regulatory framework overestimated the capacity of banks to manage risk and, as a result, underestimated the level of capital that they should hold.

– Too much focus on micro-prudential regulation of individual financial institutions and negligence of more general developments and systemic risks.

– Problems in the exchange of information and coordination between the various players in financial supervision. There was no mechanism to guarantee that the identification of risk would initiate collective decision making.

2. THE CRISIS AS A RESULT OF MACRO-ECONOMIC IMBALANCES

The global financial crisis has been preceded by a period of particularly favourable economic conditions marked by abundant liquidity and low interest rates. These two factors contributed a great deal to the financial crisis. They have been the result of both expansive monetary policies in developed economies and global macro-economic imbalances.

Lax monetary policies, especially in the US after the dot.com crisis, led to credit growth which stimulated consumption and investments. The build-up of the real estate bubble, the explosion of which triggered the financial crisis, has been a direct consequence.

At the same time, considerable macro-economic imbalances have accumulated during the decade prior to the crisis. The huge US current account deficit is an expression of these imbalances and is reflected in the surpluses of Asian countries (notably China) and oil exporting countries (Middle East, Russia). Credit growth in the US has mainly been financed by the massive entry of capital from surplus countries.

Increasing demand on the part of the US has been satisfied by imports from China and other Asian countries. In exchange, the surpluses of these countries were invested in American government bonds and other low risk assets. As a result, low yields on bonds encouraged investors to look for investment opportunities offering higher yields (and entailing higher risks).

SHEET 03

THE REFORM OF THE GLOBAL FINANCIAL ARCHITECTURE

The global financial crisis has led to a significant political mobilisation at the international level to prevent the crisis from turning as bad as the one in 1929. The latter evokes memories of fragmented and purely national responses which have exacerbated its economic consequences.

The G20 is now at the heart of the new global financial architecture. Moreover, the role of several specialised institutions in the field of regulation and financial supervision has been enhanced, notably that of the International Monetary Fund (IMF) and the Financial Stability Board (FSB). These reforms also reflect a shift in the global balance of power in favour of emerging countries and to the detriment of established powers, in particular the European states.

1. THE G20: THE NEW STEERING COMMITTEE OF GLOBAL FINANCIAL AND ECONOMIC GOVERNANCE

The G20 was created in 1999 in response to the financial crises that hit emerging countries in the 1990s, notably the Asian crisis. Finance ministers and Central Bank governors from industrialised and emerging countries gathered once a year in this format.

In 2008, the G20 was promoted to become the steering forum of the world economy, from now on at the level of the Heads of State and Government. The rise of the G20 goes hand in hand with a loss of importance of the G8. Representing 85% of the world economy and 66% of the global population, the G20 is a better reflection of the realties in the 21st century.

G20 : members: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK, USA, European Union.
Other countries and regional organisations can be invited to join the summits.

Taking stock of five G20 summits: What has been achieved?

Washington	November 2008
Londres	April 2009
Pittsburgh	September 2009
Toronto	June 2010
Seoul	November 2010

– Coordination of measures to limit the effects of the crisis taken at the national level (support measures for banks, injection of liquidity by central banks, recovery plans etc.): coordination is necessary in order to optimise the policy response and to avoid problems of collective action (free riders). However, cooperation did not always occur smoothly or without protectionist reflexes. Two examples of this are the dispute over the "Buy America" clause in the US stimulus package and monetary disputes, especially criticism of the undervaluation of the renminbi.

– Definition of the reform agenda for financial regulation and supervision.

– Stepping up of the lending capacity of international financial institutions. The Washington summit, for example, increased the IMF's and the development banks' resources by 850 billion €.

– Reform of international institutions (IMF, World Bank, FSB, etc.) to make them more effective and increase their legitimacy, notably by acknowledging the growing influence of the emerging countries.

2. THE IMF REGAINS PROTAGONISM IN THE WAKE OF THE CRISIS

The IMF was one of the international organisations set up by the Bretton Woods Agreements in 1944. Originally, its main objective was to ensure the good functioning of the Bretton Woods monetary regime (a system of fixed but adjustable exchange rates) which came to end in 1971. The IMF has continually redefined its role throughout the oil crises of the 1970s, the debt crises of the 1980s, the challenges faced by transition economies after the Cold War and the debt crises of the 1990s. After a period in which the IMF's role has largely been discredited and weakened, the crisis brought the IMF back to the forefront of international politics. The IMF has some important instruments at its disposal to help its member states overcome the challenges raised by the crisis:

– Financial resources to help countries experiencing balance-of-payments problems: the IMF's lending capacity totalled 265 billion $ before the crisis. In April 2009, the G20 decided to triple this sum. For a long time, the IMF has been notorious for the 'tough' conditionality in its lending activities. During the crisis, the IMF has also introduced more flexible lending instruments.

– Bilateral and multilateral surveillance to ensure financial and macro-economic stability in member states and the global economy.

– Analytical expertise (World Economic Outlook, Global Financial Stability Report) and technical assistance.

With 187 members, IMF membership is almost universal. However, influence within the organisation depends primarily on the economic weight of member states. Each member state is attributed a quota share. Quotas determine the financial contribution members make to the IMF's financial resources. The distribution of quotas is reviewed every five years.

Under the impetus of the G20, the IMF's governance has been reformed. In December 2010, the 14th General Quota Review was undertaken. The reform provided for a doubling in quotas resulting in a 6% shift of the quota distribution in favour of emerging countries. China, South Korea, India, Brazil and Mexico are the main beneficiaries of the reform. With a share of 17%, the US maintains its power of veto (major decisions have to be taken with a majority of 85%). The Executive Board becomes more representative and is now fully elected. The Board comprises 24 seats, a maximum of seven being reserved for the Europeans. Europeans have therefore given up two seats and have to find an intra-European agreement (including Switzerland) with regard to the actual distribution of these seats until 2012.

3. FINANCIAL STABILITY BOARD (FSB)

The FSB is the successor to the Financial Stability Forum (FSF). The FSF was created by the G7 Finance Ministers and central bank governors in 1999 to promote financial stability. It is essentially a coordination body that aims to form a consensus on best practices in financial regulation and supervision and to identify vulnerabilities in the global financial system. Its secretariat is hosted by the Bank for International Settlements (BIS) in Basel.

The G20 summits in Washington and London initiated a reform of the FSF, renamed FSB. Its composition now takes better account of the growing role played by emerging countries and its mandate has been strengthened. These changes correct the wrong logic inherent to the FSF according to which the source of financial instability was mainly to be found in emerging economies and whereby developed countries monopolised the right to set rules for the rest of the world.

The FSB member countries have between one and three seats held by the Central Bank and/or the Ministry of Finance; countries with three seats are also represented by a financial supervisory authority. The 24 Member States (and their number of seats) : Argentina (1), Australia (2), Brazil (3), Canada (3), China (3), France (3), Germany (3), Hong-Kong (1), India (3), Indonesia (1), Italy (3), Japan (3), Mexico (2), Netherlands (2), South Korea (2), Russia (3), Saudi Arabia (1), Singapore (1), South Africa (1), Spain (2), Switzerland (2), Turkey (1), UK (3), USA (3). Moreover international organisations have seats in the FSB (BIS, European Commission, ECB, IMF, World Bank, OECD). Six sector-specific organisations developing international financial standards are also represented (for example, the Basel Committee on Banking Supervision).

4. SECTOR-SPECIFIC ORGANISATIONS

– The Basel Committee on Banking Supervision (BCBS):

• The BCBS is an international cooperation forum that aims to improve banking supervision. Its HQ is in the BIS in Basel. The BCBS was created in 1974 by the G10 Central Bank governors (Germany, Belgium, Canada, France, Italy, Japan, Netherlands, Sweden, UK, USA). Its membership base has been extended similarly to the reform of the FSB to include the emerging countries.

• The Basel Committee is renowned for the Basel Accords on minimal capital requirements, i.e. the ratio between the money that banks can lend and the capital they are required to hold (Basel I – 1988; Basel II – 2004; Basel III – 2010).

– Other organisations include: International Accounting Standards Board (IASB); International Organisation of Securities Commissions (IOSCO); International Association of Insurance Supervisors (IAIS)

FINANCIAL REGULATION AND SUPERVISION IN THE EU (I)

NEW INSTITUTIONS: STEPPING UP FINANCIAL SUPERVISION IN THE EU

The global financial crisis has triggered a great amount of legislative activity in the EU. A major part of the ongoing reforms featured in the Larosière report presented on 25th February 2009. The European Commission had asked the former Managing Director of the IMF to chair a high level group to elaborate reform proposals.

– Regulation: the rules which govern the activities of financial institutions
– Supervision: the processes and structures set up to ensure that the rules are respected

The crisis has revealed the fragmentation of financial supervision in the EU. The established mechanisms were poorly adapted to an integrated European financial market. To correct the shortcomings of the existing system, a new European financial supervisory framework has been established. In January 2011, four new supervisory institutions became operational.

1. FINANCIAL SUPERVISION IN THE EU BEFORE THE CRISIS: A HIGHLY FRAGMENTED SYSTEM

The national financial authorities are the foundation of financial supervision in the EU. Until recently, they have operated under the roof of three European supervisory committees:
– The Committee of European Banking Supervisors (CEBS)
– The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)
– The Committee of European Securities Regulators (CESR)
These committees, which only had consultative powers, have been unable to overcome the differences in national supervisory traditions and to form a coherent supervisory framework.
– Most technical rules were defined nationally and significant differences between member states persist. Moreover, the powers of supervisory authorities varied from one member state to another. The result was an uneven application of the regulatory framework across the EU. This kind of fragmentation is detrimental to financial stability – for example when it allows financial activity to move where supervision is weak.
– The EU's financial supervisory system also lacked reliable mechanisms to settle differences pertaining to transnational financial activities.
– The exchange of information between national authorities was inadequate.
– In the event of a crisis, national authorities could not take coordinated emergency measures (the isolated ban on "short selling" by Germany is a case in point).

➤ In short, the EU's supervisory system proved to be difficult to manage. The Larosière report identifies as a main weakness the lack of any formal mechanism to ensure that the identification of risks leads to coordinated measures at the European level.

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2. THE NEW STRUCTURE OF EUROPEAN FINANCIAL SUPERVISION

On the basis of the recommendations of the Larosière group, the Commission elaborated proposals for the establishment of a new European system of financial supervision. On 22nd September 2010, the European Parliament approved the new supervisory framework proposed by the Commission. The decision was adopted by the Council of Ministers on 17th November 2010.

Three European Supervisory Authorities (ESA) and a European Systemic Risk Board (ESRB) started work in January 2011 and replaced the old supervisory committees.

3. THE "MACRO-PRUDENTIAL" ARM: THE EUROPEAN SYSTEMIC RISK BOARD (ESRB)

The ESRB is responsible for the supervision of systemic risks. It includes an early warning mechanism to ensure the solidity of the financial system as a whole. Its secretariat is situated within the ECB in Frankfurt.

Structure

– The General Board is the ESRB's main decision-making body.
– Composition: all of the governors of the European Central Banks, the President and Vice-President of the ECB, a member of the European Commission and the chairs of the three European supervisory authorities. The national supervisory authorities and the President of the Economic and Financial Committee (EFC) are also represented on the board, but without right to vote.
– The Steering Committee is responsible for the preparation of decisions. It comprises the Chair and first Vice-Chair of the ESRB, the Vice-President of the ECB, four other members of the General Board that are also members of the ECB General Board, the Chairs of the new European Supervisory Authorities, the President of the EFC and a member of the Commission.
– The Chair is elected for five years by the members of the General Board and the mandate is renewable. The ECB President will ensure the Chair of the ESRB for an initial period of five years.

How does the early warning system work?

– The ESRB identifies dangers for the entire financial system as a whole.
– It issues warnings and recommendations with regard to measures to be taken.
  • The addressees may be the EU as a whole (Council), one or several member states, one or several ESAs and one or several national supervisory authorities.
    • If the addressee agrees with the recommendation, he will have to communicate the measures being implemented to solve the problem.
    • If the addressee does not follow the recommendation, he has to provide appropriate justification ('act or justify'). If the justifications provided are considered inadequate, the ESRB informs the Council of Ministers.
– Generally, the ESRB's recommendations will be sent to the Council. In order to avoid over-reaction by the markets, publication of alerts and recommendations will be decided on a case-by-case basis.

4. THE "MICROPRUDENTIAL" ARM: THE THREE EUROPEAN SUPERVISORY AUTHORITIES (ESA)

– The European Banking Authority (EBA) – London
– The European Insurance and Occupational Pensions Authority – Frankfurt
– The European Securities and Markets Authority – Paris

The ESAs have replaced the three supervisory committees. The national authorities are still responsible for day-to-day supervision of the financial sector while the ESAs ensure a coherent application of the rules. As a link between macro and micro prudential supervision, a mixed committee ensures cooperation and the exchange of information between the ESAs and the ESRB.

The ESAs' mandate:
– To promote a single set of harmonious supervisory rules.
– To ensure the coherent application of the rules in the EU.
– To facilitate the exchange of information, coordination and agreement between the various national authorities, including within colleges of supervisors (which are responsible for the supervision of transnational financial entities). In this respect, they can promote risk assessment and initiate and coordinate EU-wide crisis simulations in order to assess the resilience of financial institutions.
– To supervise credit rating agencies.
– To exercise decision-making powers in emergency situations, including harmonised bans on certain financial products and activities, for example, "naked short selling".

The ESAs answer to the Council of Ministers and the European Parliament. Any restrictive decision taken by the ESAs is subject to control by the competent jurisdictions in the EU. Moreover, the ESAs are subject to the authority of the European Auditors Court and the European Anti-Fraud Office (OLAF).

REGULATION AND FINANCIAL SUPERVISION IN THE EU (II)

STRENGTHENING THE RESILIENCE OF THE FINANCIAL SYSTEM

A first set of reforms in the area of financial regulation pursues a dual objective: promoting financial stability and make the financial system contribute its share to the costs of the crisis:

5. CAPITAL REQUIREMENTS

The reform of the rules on minimum capital requirements is one of the measures aiming to make the banking sector more resilient in the future. The capital adequacy ratio is the ratio between the capital a bank must hold and the risks it incur in its activities (e.g. bank loans). This capital serves as a buffer to absorb potential losses.

The Basel Accords: the international framework of capital requirements.
Internationally, the rules governing capital requirements are defined by the Basel Committee on Banking Supervision (BCBS). The first Basel Accord dates back to 1988. The regulation of capital requirements at the global level is considered necessary to ensure that banks are able to absorb losses without causing systemic crises and to prevent a race to the bottom in terms of regulatory requirements by levelling the playing field.
In 2004, a second agreement succeeded Basel I. Basel II did not enter into force until January 2008 in the EU and April 2010 in the US. In response to the crisis and to remedy some shortcomings of Basel II, the BCBS adopted the Basel III Accord in September 2010. This agreement was approved by the G20 summit in November 2010.

The main changes in Basel III:

– An increase in minimal capital requirements – both in terms of the quantity and quality of capital held. Quality refers to a stricter definition of what counts as "Tier I" capital (the capital best suited to absorb shocks).

– Attenuation of the procyclicality of capital requirements through an anti-cyclical buffer of between 0 and 2.5% in addition to the minimal requirements. The Basel rules have always been criticised for their procyclical effect (due to the fact that risks and as a result minimum capital requirements – are underestimated in favourable economic periods which prevents the accumulation of adequate capital to absorb losses in times of crisis). The anti-cyclical buffer is to be activated in times of excessive credit growth.

– Introduction of a leverage ratio and new ratios relating to liquidity risks.

The EU capital requirement directives date back to 2006 (2006/48/CE and 2006/49/CE). In October 2008, the European Commission put forward a first amendment that was followed by a second proposal in July 2009. In line with Basel III, the proposals aim to improve the quality and quantity of the capital held by banks as well as to introduce anti-cyclical buffers. Furthermore, definitions of capital requirements need to better take into account risks associated with securitised products.

A reform of capital requirements is also planned for the insurance sector (Solvency II).

6. ORDERLY RESOLUTION OF BANK FAILURES

The lack of rules allowing an orderly resolution of bank failures without running the risk of destabilising the financial system as a whole proved costly for the taxpayer. Bank rescue packages during the financial crisis amounted to around 13% of the EU's GDP.

The European Commission is preparing a legislative proposal on crisis management. It suggests setting up a harmonised network of national resolution funds. In the long term, a single EU-wide resolution fund could be established.

To contribute to the orderly resolution of banks, the funds may be used to finance a certain number of measures: bridge banks; total or partial transfer of assets and/or liabilities from ailing financial institutions; good bank/bad bank split.

Taxing banks is one way to make the banking sector contribute to the funding of resolution funds. Some member states such as Sweden, UK and Germany have already introduced a bank tax or have decided to do so. The European Commission proposed that the 27 EU Member States introduce this type of tax to finance resolution funds. However, there is no consensus on this issue: France and the UK for example would like to see the revenues of the bank levy directly attributed to the public budget. Countries such as Italy, which did not engage in costly bank rescues during the crisis, dismiss the idea as such.

7. DEPOSIT GUARANTEE SCHEMES

The question of protecting depositors is closely linked to the issue of bank failures. A bank crisis exposes depositors to the risk of losing their money; bank runs to withdraw money can contribute to destabilising the financial system.

During the global financial crisis, the decision was taken to guarantee up to 100,000 € per depositor in the EU. It is vital to establish a harmonised level of protection in the EU in order to prevent savings from being moved towards countries where rules provide the greatest protection in times of crisis. Unequal protection may also lead to varying degrees of protection within the same country; this could lead to a situation where clients of local bank benefit from a different degree of protection than clients of a branch of a foreign bank.

The aim is to establish a deposit guarantee system pre-funded by the private sector and which would only be subsidised exceptionally by public money. Moreover, the Commission is exploring ways to improve insurance guarantee systems.

The idea of a tax on international financial transactions has been put forward as a measure to stabilise the financial markets and to make financial players contribute to the costs of the crisis. While the tax has been rejected by the G20, some EU Member States, notably France, Germany and Austria, have suggested its introduction at the EU level.
An Austrian proposal is based on a tax rate of 0.01%. Proponents of the tax argue that it would penalise in particular speculative financial flows and would not damage the real economy.
Sweden and the UK do not want to implement a tax on financial transactions without the participation of the US and other major financial centres. They fear that it will be detrimental to the EU's attractiveness as a financial centre.
According to the European Commission, a tax on financial transactions could generate significant revenues (about 20 billion €, and even ten times this amount if derivatives were to be included). However, the introduction of such a tax would involve practical problems, mainly due to the fact that 70% of tax revenues would be generated by the City of London. This would also be an argument against introducing a tax on financial transactions in the euro area alone.
On 8th March 2011, the European Parliament voted a resolution in favour of a global tax on financial transactions. In case that the tax cannot be implemented globally, the EU should set the example.
The idea of taxing financial transactions is not new. Originally, it was developed by the economist James Tobin in the 1970s.

8. CREDIT RATING AGENCIES (CRA)

Overreliance on CRAs has been a major factor contributing to the global financial crisis. CRAs assess the creditworthiness of borrowers (companies or states) and the quality of financial products.

The CRA's main weaknesses:

– The financial crisis called into question methodologies and risk models used to establish ratings. CRAs failed to anticipate the impact of systemic shocks, as for example the collapse of the real estate bubble in the US and the contagion via securitisation, which brought down prices of financial products that had actually received the best rating (AAA).
– Conflicts of interest: CRAs are paid by the entities they are supposed to assess. This practice allows "rating shopping" (i.e. choosing the agency which is likely to publish the best rating).
– Lack of competition: the CRA market is dominated by three American institutions (Fitch, Moody's and Standard & Poor's).

A first regulation on CRAs was adopted in 2009. It entered into force on 7th December 2010. CRAs must register and submit to rules aimed at improving transparency and avoiding conflicts of interest.
– Publication of models, methods and main hypotheses on which CRAs base their ratings;
– Publication of an annual transparency report;
– Establishment of an internal control system to ensure the quality of ratings;
– The CRAs' boards must include at least two members who are remunerated independently of the agency's economic performance.
In view of the role played by CRAs in the euro debt crisis the European Commission suggested the revision of the CRA regulation in June 2010. A new proposal aims to strengthen the supervision of CRAs and reserves a central role in this regard to the new supervisory authorities.
In addition, issuers of structured financial instruments will have to provide all CRAs with the information they have transferred to the agency chosen to make the rating (thereby making possible the publication of unrequested ratings).
To increase competition among CRAs, the Commission is looking into structural measures - for example the creation of a European credit rating agency.

FINANCIAL REGULATION AND SUPERVISION IN THE EU (III)

MAKING THE FINANCIAL SECTOR MORE TRANSPARENT AND MORE RESPONSIBLE

A second set of measures aims to improve the transparency of financial markets. Until the crisis, many products, players and financial operations escaped the scrutiny of financial regulation. The European Commission has set itself the objective of filling the gaps in the regulatory framework.

9. ALTERNATIVE INVESTMENT FUNDS (AIF)

AIFs raise funds to invest in companies. They have not been at the origin of the financial crisis. But they played a role in transmitting risks. They often employ investment strategies that are extremely open to risks associated with complex and opaque financial products. The best known type of AIFs are undoubtedly hedge funds, but the term also refers to other types of funds (real estate funds, commodity funds etc.).

In October 2010, an agreement was reached on the Directive on Alternative Investment Fund Managers (AIFMD). AIFMs must respect a certain number of rules in order to be allowed access to the EU market. They must submit to a passport system (there will be a passport for European managers and a passport for AIFMs from third countries). Managers from third countries will have to subscribe to international rules against money laundering and tax evasion in order to obtain a passport.

The European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) have an important role to play in supervising AIFs and ensuring the implementation of the passport system. The ESMA, for example, can order national regulators to ban hedge fund activities if they pose a threat to stability.

The elaboration of the directive was complicated by the fact that hedge fund activities in the EU are highly concentrated in the UK where 80% of hedge funds operate.

10. DERIVATIVES

Derivatives are financial products whose value depends on underlying variables (raw material prices, interest rates, monetary developments). They are financial contract between two parties linked to the future development of the underlying variable.

Derivatives are often used to hedge against risks. For example, an aeronautical company can conclude a contract giving it the right to purchase steel at a fixed price until a given date. In this case, the value of the derivative depends on the development of the price of steel. If it increases, the company will benefit from the contract; if the price falls, the contract is less attractive.

Credit default swaps (CDS) are an example of a derivative product. They are mainly used as an insurance against the default of a debtor. In the event of insolvency, losses incurred by the creditor are absorbed by the CDS.

But the CDS can also be used for speculative purposes, as has been the case in the euro debt crisis (i.e. "betting" on sovereign default). As the markets see the risk of default increasing, the purchaser of a CDS would benefit due to an increase in its value ("naked CDS")

The derivatives market has grown substantially over the last decade. Nearly 90% of derivatives are not traded on stock exchanges, but over the counter (OTC). OTC transactions increase the opacity of the derivatives market since it remains unclear who sells what to whom. There is a high risk of loss if one party does not make the necessary payment at the moment when it is due.

Short selling is the practice of selling assets, for example derivatives, without owning them with the intention of buying them back later at a lower price. If the value of the under-lying asset decreases between the time of sale and its delivery the seller makes a profit. This practice can provide liquidity to the market, but it also entails risks for the stability of the entire financial system (for example, artificial downward spirals). Naked short selling is seen as a particular problem (i.e. when an asset that is to be sold has not even been borrowed). The risk of failure to deliver is very high.

In September 2010, the European Commission adopted two proposals in the area of derivatives:

a. Improving transparency and risk management of OTC transactions

– information on all European transactions must be transmitted to central trade repositories and be available to the supervisory authorities

– standard derivative contracts must be cleared by a Central Counterparty (CCP) to reduce the risk of default (an OTC derivative cleared by a CCP has to respect higher guarantee requirements).

These rules will apply to both financial and non-financial companies which conclude more than a certain number of OTC transactions.

The ESMA will be responsible for identifying standard derivative contracts (i.e. those which must be cleared by the CCPs). It will also ensure the supervision of central trade repositories and will be a member of colleges of supervisors of CCPs operating in several member states. It will also define the thresholds to identify which companies must submit to rules of increased transparency and CCP clearing.

Central Counterparties (CCP) function as intermediaries between two parties to a transaction ("the buyer to every seller and the seller to every buyer"). They manage the risk if one of the parties defaults on its payments.

A trade repository is an institution which records the details of transactions on the derivative markets.

b. Measures relative to short selling and CDS

Naked short selling and naked CDS will not be banned as requested by several states. However, the sellers of these products will now have to make sure to be in possession of the asset concerned at the moment when it is due to be delivered. Regulators may temporarily ban naked CDS.

The Commission's proposal also aims to improve coordination related to short selling and CDS-related activities in the EU. In exceptional situations, the supervisory authorities will be able to restrict or ban short selling. The ESMA will be able to decide a 24h ban on short selling targeted at specific persons, if their sales cause declines of more than 10% of specific financial instrument.

11. CORPORATE GOVERNANCE AND REMUNERATION

The weaknesses of corporate governance with regard to internal risk management have been highlighted as a major contributing factor to the financial crisis. Moreover, remuneration practices have promoted excessive risk taking and a focus on short–term performance.

In the EU, binding rules on remuneration have been adopted. They apply to banks and investment companies:

– at least 50% of variable remuneration has to be paid in shares that must be retained for a specific period of time

– bonuses paid in advance without cash-out restrictions are limited (20% to 30% of the variable remuneration),

– the payment of at least 40% of variable remuneration must be deferred by at least three to five years.

The Commission is planning to set out comparable rules for other financial establishments and insurance companies.

New legislative initiatives are planned for 2011 in view of extending the responsibility of boards of directors and of improving the supervision of executive committees.
– Improving the ability of boards of directors to supervise the management of financial establishments (for example, by limiting the number of mandates that can be held by members, introducing eligibility criteria and thereby guaranteeing greater expertise).
– Enhancing the role of risk managers within companies (for example, by allowing them to report directly to the board).
– Creation of a risk committee within the board
– Greater involvement of shareholders in company governance
– Greater involvement of external auditors and supervisory authorities (for example by enabling them to attend board meetings)

12. • PREVENTION OF MARKET ABUSE

A review of the directive on market abuse is being prepared. The directive dates back to 2003. It provides a framework to address insider trading and market manipulation.

A review planned in 2011:
– closing regulatory gaps that widened with increasing financial innovation.
– extending the directive's remit (to OTC derivatives).
– discouraging insider trading and market manipulation via the threat of effective investigation and strict sanctions (increasing the powers of the regulatory authorities, setting a minimum amount for fines).

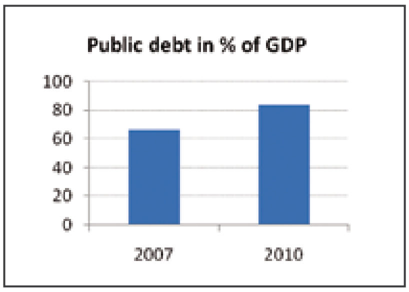
SHEET 07

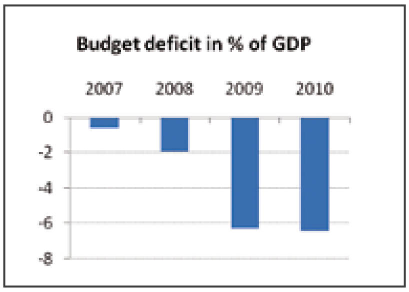
FROM THE FINANCIAL CRISIS TO THE EURO CRISIS

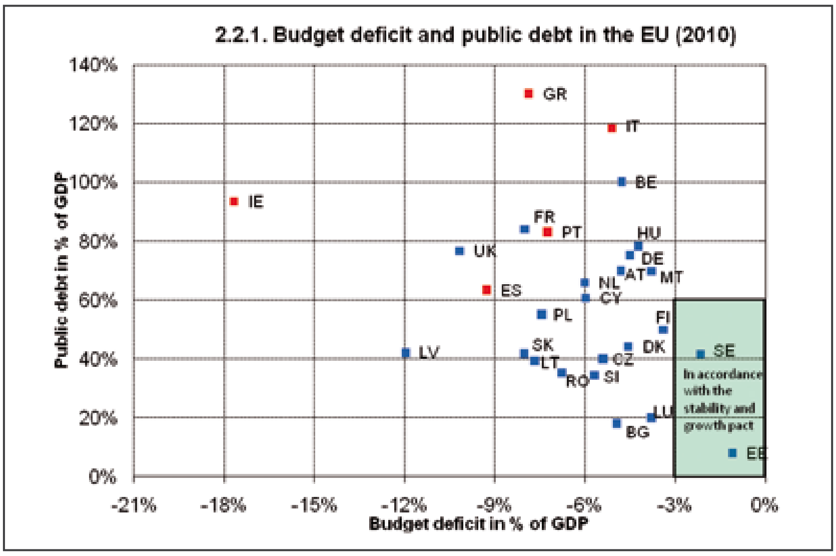
1. THE FINANCIAL CRISIS HAS LED TO A MASSIVE DETERIORATION OF PUBLIC FINANCES

The global financial crisis has severely hit national budgets in the euro area. The 2009 recession considerably reduced public revenues and weighed heavily on the welfare state. Moreover, states have committed to bank rescues and to costly recovery plans. In 2010, none of the euro area countries was in the position to respect the Stability and Growth Pact. Between 2007 and 2010, public debt in the euro area rose from 65% to 85% of GDP.

L'impact de la crise sur les finances publiques dans la zone euro







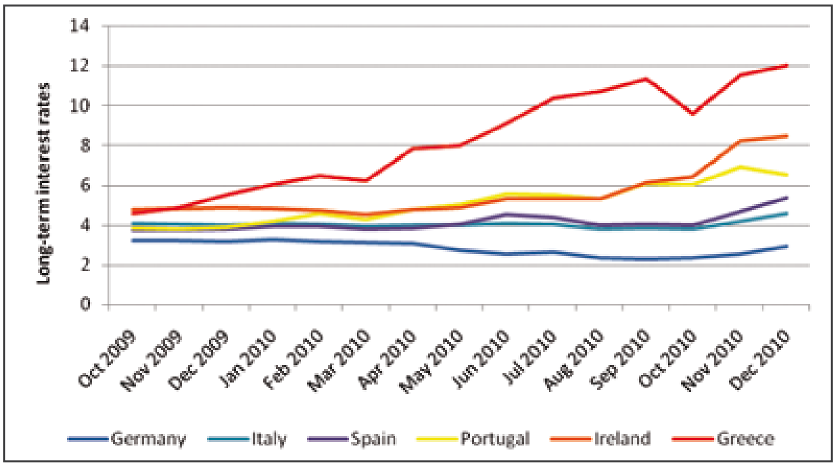
Source: IMF, World Economic Outlook, October 2010.

2. EURO AREA COUNTRIES FACE REFINANCING PROBLEMS

Simultaneous to the worsening of public finances, market confidence in the creditworthiness of some euro countries has eroded rapidly. These countries have to pay considerably higher interest rates if they want to refinance themselves on the markets. Hence it is increasingly expensive for them to service their debt which threatens to become unsustainable.

Interest rates on government bonds have diverged markedly, especially since April 2010. The situation of the so-called PIIGS (Portugal, Ireland, Greece, Spain) is particularly alarming. In December 2010, Greece's rate was four times higher than that of Germany; Ireland had to pay three times more interests than Germany. Rising interest rates were partly blamed on speculators betting on sovereign defaults. But they are also the expression of serious doubts about the financial sustainability of the states in question. Moreover, credit rating agencies played a key role in spreading fears about the PIIGS' ability to repay their debts.

Divergence of long-term interest rates in the euro area



3. FROM THE GREEK CRISIS TO THE EUROPEAN FINANCIAL STABILISATION MECHANISM

– The Greek crisis started on 16 October 2009 when the new government admitted that the budgetary deficit would rise beyond 10% of GDP. Indeed, Greece was due to record a budgetary deficit of 14% in 2009. Public debt was to rise to 115% of GDP. As a result, the rating agency Fitch downgraded Greece below the level of "A", an unprecedented downgrading of a European country.

– In February 2010, Greece was placed under budgetary supervision by the Commission. The Eurogroup gave Greece one month to implement its austerity plan. This led to strikes and demonstrations.

On 11th April 2010, the Eurogroup adopted a 110 billion € aid package for Greece. A part of this package is provided by the IMF. In exchange, Greece undertakes reforms to stabilise its public finances.

– Greece's rescue package was not sufficient to calm the markets. At the end of April, the rating agencies downgraded Greece again. The downgrading of Portugal and Spain fuelled fears of a domino effect.

On 9th and 10th May 2010, the Finance Ministers established the European Financial Stabilisation Mechanism, this time for the entire euro area. The mechanism provides 750 billion € in loans and guarantees. It is fed by three different sources:

– A community support fund for the euro area (60 billion €): it enables the European Commission to lend money to countries in financial distress (by way of loans on behalf of the Commission, guarantees by member states and margins in the community budget). It adds to an already existing fund of 50 billion € put in place for EU countries outside the euro area.

– The European Financial Stability Facility (EFSF): the EFSF is a special purpose vehicle owned by euro area member states and is based in Luxembourg. It can issue bonds guaranteed by euro area countries amounting to 440 billion euros. Its effective lending capacity amounts to 250 billion €. On 11th March 2011, the Heads of State and Government of the euro area agreed to increase the facility's effective lending capacity up to 440 billion € and to allow the EFSF to purchase government bonds.

– The IMF contributes 250 billion €.

– In addition, the ECB has been prepared to purchase government bonds of euro area countries to stabilise financing conditions.

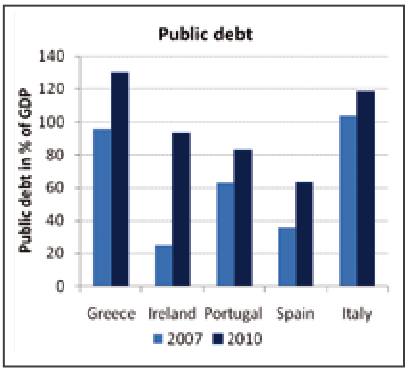
The aim of this mechanism is to curb market mistrust. The granting of aid is conditioned by significant austerity measures on the part of the beneficiary states.

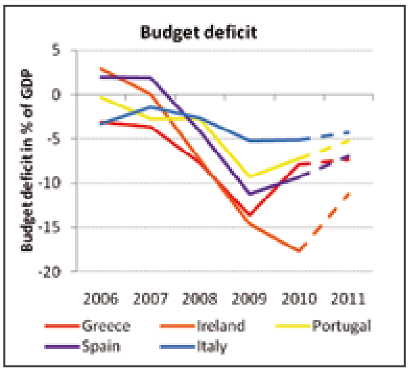
– For the time being, the EFSF has been activated for Ireland. The agreement was signed in November 2010 and the first payment made in January 2011. Currently, Portugal seems likely to be the next country forced to draw on the EFSF's resources.

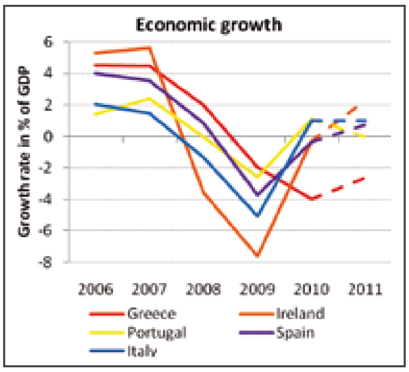
SHEET 08

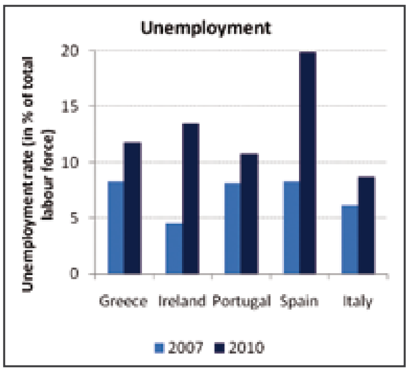
CHARACTERISTICS OF THE COUNTRIES IN TROUBLE

Greece, Ireland, Portugal, Spain and Italy are often lumped together when it comes to the debt crisis in the euro area. These five countries are all confronted with a massive deterioration of their public finances and are exposed to an effective or potential risk of not being able to refinance themselves on the markets without the support of their partners in the euro area. All five had to adopt austerity measures and major structural reforms involving painful adjustment. However, a closer look reveals that these five countries are facing extremely heterogeneous situations.









Source: IMF, World Economic Outlook, October 2010.

4. GREECE

– Basic problem: a lax budgetary policy which is not a consequence of the crisis, but which simply came to light because of the latter.

– With a budgetary deficit of 13.5% in 2009 and 7.9% in 2010 public debt reached almost 140% of GDP in 2010.

– If Greece was to refinance itself by selling government bonds, it would have to pay an interest rate of 12% – four times the rate of Germany.

– Greece's austerity plan includes cuts of 30 billion € by 2013 (a figure equal to around 15% of the country's GDP).

– Amongst others, the Greek government intends to increase revenues by raising the VAT rate from 19% to 23% and to limit expenditures by cutting salaries and pensions.

– Getting back on track will not be easy for the Greek economy: 70% of the country's value creation depends on domestic demand which is battered by austerity measures and inflation (4.6% in 2010 in comparison with 1.5% in the euro area). Moreover, tourism, one of the pillars of the Greek economy, suffered greatly during the crisis. Unemployment increased from 8.3% in 2007 to 11.8% in 2010.

In conclusion, the austerity measures are far from having contained the threat of sovereign default. Greece does not only face a problem of liquidity, but also one of solvency. The need to restructure the Greek debt cannot be ruled out.

5. IRELAND

– Ireland's situation is different from Greece's in that the public budget has been under control until just before the crisis. In 2007, public debt corresponded to no more than 25% of GDP.

– In 2008, Ireland was the first euro area country to enter into recession. GDP contracted by 3.5% (and by 7.5% in 2009).

– Originally, the Irish debt crisis was one of private debt. The collapse of the real estate market, which had been growing until 2007, hit the banking sector. When the Anglo-Irish Bank was in danger of going bankrupt, the government decided to nationalise it and to grant a guarantee to the entire banking sector. Hence, the state absorbed bank debt and transformed it into public debt.

– The budgetary deficit rose from 7.3% in 2008 to 14.6% in 2009 and to 17.7% in 2010. Public debt in % of GDP more than tripled between 2007 and 2010.

– On 21st November 2010, the government reluctantly communicated its request for aid to the European Financial Stability Facility.

– The government wants to cut the budget by 15 billion € by 2014, 6 billion in 2011. To raise revenues, the government implements a carbon tax and a tax on water; the income tax has also been increased. To curb spending, salaries of ministers and public servants have been reduced, as have been social benefits.

– Unemployment rose to 13.5% in 2010, notably affecting young people who are increasingly opting for emigration. Hence, domestic demand is low, but the export industry may stimulate recovery. For 2011, the IMF forecasts a growth rate of 2.3%.

6. PORTUGAL

– In Portugal, the main problem is neither the banking sector nor the real estate market. The Portuguese economy has structural problems.

– The average GDP growth rate did not even reach 1% between 2000 and 2010. The Portuguese industry has been gradually outpaced by international competition which intensified with the Eastern enlargement of the EU and competitive imports from Asia. Portugal has not managed to climb upwards on the value chain of international trade.
– In 2009, the budget deficit reached a record figure of 9.4%. Between 2007 and 2010, public debt grew from 62% to 83% of GDP.
– Austerity measures adopted include an increase in the VAT rate from 21% to 23%. Moreover, taxes on income and corporate income have been raised. Major investment projects have been postponed and state-owned enterprises privatised. The government decided to freeze salaries in the public service.
– Portugal is important for Spain's financial stability. Spanish banks have invested heavily in the country.

7. SPAIN

– Compared to other countries of the euro area, Spain's public debt is relatively moderate. During the crisis, debt increased from 36% to 63% of GDP, compared to an average of 84% in the euro area.
– The main weaknesses of the Spanish economy are the enormous unemployment rate of 20% (around 40% of young people) and the fall in housing prices. It is believed that the banking sector contains a large amount of toxic assets (180 billion €; half of these in savings banks).
– To reduce the budget deficit (11.2% in 2009), the Spanish government adopted an austerity plan comprising unprecedented cuts of 50 billion € to be made over three years. Added to this is a 15 billion € budget cut in 2010 and 2011.
– Measures to achieve these budgetary objectives include a VAT increase from 16% to 18%, a recruitment stop and a salary cut in the public service. In addition, the government has abolished a certain number of subsidies and reduced public investments.
– At the same time, the government adopted a comprehensive reform of the labour market, including, for example, a reduction in redundancy payments and an increase of the retirement age from 65 to 67.
– Positive effects expected from the austerity measures run the risk of being lost without economic growth: weak domestic demand impedes economic recovery. The Spanish economy contracted by 3.7% in 2009 and did not succeed in recording a positive growth rate in 2010.

8. ITALY

– Even before the crisis, Italy held the largest public debt in the EU (103% of the GDP in 2007; it then ranked 3rd in the world). Accordingly, the high level of the Italian debt cannot be attributed to the recent crisis, but was inherited from previous periods of time.
– Italy is far from experiencing the dramatic developments known in other euro countries. It has coped rather well with the crisis. To be sure, Italian GDP contracted by 5% in 2009. But the government did not have to intervene to massively bail out banks and the housing market remains stable.
– Italy has not enacted costly recovery plans (until March 2009 only 0.3% of GDP in comparison with Spain which mobilised resources amounting to of 4.5% of GDP).
– Unemployment increased slightly from 6.2% in 2007 to 8.7% in 2010. In 2010 and 2011, Italy expects growth, even though it will be weak.
– The government's austerity plan comprises cuts of 25 billion € in 2011 and 2012. These measures will mainly concern the public service.
– Even though Italy seems to have coped quite well until now, it is not unthinkable that the weight of the debt burden will become a threat. At present, Italy has to pay around 2% more interest than Germany to refinance itself on the markets. Again, this is far from the Greek rate but already close to that paid by Spain. In 2011, Italy will have to borrow around 273 billion € on the markets.

HOW TO REFORM THE ECONOMIC AND MONETARY UNION? (I)

Over the last ten years, the euro has contributed to economic and monetary stability. However, 2010 has demonstrated that the monetary union as a whole may also be vulnerable to financial and budgetary problems in one or more of its Member States. The debt crisis has highlighted the need for a thorough reform of the Economic and Monetary Union (EMU). This reform must in particular strengthen the EMU's so far underdeveloped economic pillar.

The European Council of 25th and 26th March 2010 mandated its president Herman van Rompuy to lead a task force to elaborate reform proposals for the EMU. The report was presented on 21st October 2010. In its proposals, the European Commission based itself largely on the recommendations made by the van Rompuy Task Force.
These proposals were, however, diluted by the Franco-German agreement of Deauville in the run-up to the European Council of 28th and 29th October 2010. Running against the spirit of the van Rompuy proposals (even before their actual publication), this agreement has been perceived as an affront and irritated smaller member states. In particular, France promised to support German demands for a Treaty change in exchange for concessions in the reformed Stability and Growth Pact.
EMU reform was approved by the European Council of 24th & 25th March 2011.

EMU reform pursues three main objectives:
1. The establishment of a permanent framework to manage crises and to help countries in financial difficulties. This involves replacing the present mechanism that will expire in 2013.
2. The strengthening of budgetary discipline. This notably calls for a reform of the Stability and Growth Pact.
3. The introduction of macro-economic coordination to reduce the imbalances that are tearing the euro area apart.

1. A PERMANENT CRISIS MANAGEMENT FRAMEWORK

– At the European Council of 28th and 29th October the Heads of State and Government agreed on the need for a permanent crisis management mechanism. The latter will replace the European Financial Stability Facility and the European Financial Stabilisation Mechanism, both set to expire in 2013.
– The European Council of 16th and 17th December prepared the way for a limited change to the Treaty on the Functioning of the European Union (TFEU) in view of establishing a European Stability Mechanism (ESM).
– Article 136 TFEU will be modified by adding in a third paragraph: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality". This amendment is adopted through the simplified procedure of article 48(6) TEU.
– The decision was formally adopted in March 2011. National ratification procedures will take place until the end of 2012. The new mechanism is supposed to be operational in 2013.

General Features of the New Mechanism:
– The ESM's functioning will be modelled on the European Financial Stability Facility.
– The ESM will have an effective lending capacity of 500 billion € (with a total capital base of 700 billion € to guarantee the top rating of AAA).

– The mechanism will comprise 80 billion € in paid-in capital and 620 billion € in committed callable capital. 40 billion € of the paid-in capital will be available as of July 2013. Euro area member states will contribute to the capital according to a distribution key mainly based on contributions to the capital of the ECB (for example France will contribute around 20%).
– The ESM's tool box will comprise short and mid-term loans as well as interventions on the government bond market.
– The ESM will offer loans under more favourable financial terms than the present EFSF. The granting of aid will be decided unanimously by euro Finance Ministers.
– Access to aid will be subject to strict conditionality in terms of budgetary reforms and macro-economic adjustments.
– The decision to grant aid will also depend on a prior debt sustainability analysis carried out by the European Commission in cooperation with the IMF and the ECB.
– The ESM is designed to provide liquidity aid for countries experiencing refinancing problems in the short- and mid-term but whose debt is sustainable.
– If the analysis reveals that the debt of a country is unsustainable and that the country in question is insolvent the latter will have to negotiate a restructuring of its debt with its private creditors. Once debt sustainability is restored, the ESM can provide liquidity assistance.
– EU Member States who are not part of the euro area will be able to take part on an ad hoc basis.

2. STRENGTHENING BUDGETARY DISCIPLINE

In order to avoid that European solidarity undermines efforts to implement sound budgetary policies, the ESM must be supplemented by a strengthening of budgetary discipline. Above all, this implies a reform of the EU's main budgetary coordination instrument, the Stability and Growth Pact (SGP). The latter's credibility has been seriously called into question during the present debt crisis. The Pact has not succeeded in inducing euro area countries to stabilise their budgetary situations in favourable economic periods. As a result, their fiscal room for manoeuvre was considerably limited during the crisis.

The SGP was adopted in 1997 to extend the budgetary rules of the Maastricht criteria beyond the starting date of the EMU.
The SGP pursues three objectives:
– Prevent free riding: as part of a monetary union, countries can be tempted to adopt lax budgetary policies without having to bear the consequences (rising interest rates).
– Maintain a sufficient level of financial leverage to be able to respond to asymmetrical shocks: the euro area is not an optimal monetary area in which an economic downturn in one country could be absorbed by the entire monetary area (notably through labour mobility). In the event of an asymmetrical shock or economic downturn member states must have sufficient financial resources to respond to shocks independently.
– Prevent sovereign defaults: in particular, situations that may give rise to Central Bank interventions are to be avoided since they jeopardise the ECB's independence.
The Pact comprises a preventive and a corrective arm. The preventive arm comprises coordination of budgetary policies: once a year euro area countries communicate their stability and convergence programmes in which they outline how they intend to achieve a sound budgetary situation.
The Excessive Deficit Procedure (EDP) is the corrective arm of the SGP. The EDP is initiated by the Council following a proposal by the Commission. A deficit is excessive if it exceeds 3% of GDP. Exceptions to this rule exist (for example, if the GDP contracts by more than 2%). Until recently, decisions to launch an EDP, the issue of recommendations to correct deficits, or – as a last resort – sanctions, have been adopted by the Council by qualified majority.

Measures to strengthen budgetary discipline

• Public debt is made an operational criteria of the SGP

To be in conformity with the SGP, it is no longer sufficient to simply have a budgetary deficit below 3% of GDP. From now on, more importance will be attributed to public debt levels and the sustainability of public finances. Member states which have debt levels above 60% of GDP and a deficit below 3% of the GDP can be subject to EDP if reductions of the overall debt level are considered insufficient.

• The SGP will be endowed with a more effective sanctions mechanism

The logic inherent to the SGP's sanction regime is flawed: decisions to adopt sanctions are subject to political influence within the Council. Member states are reluctant to push for sanctions, since they know that one day they may be targeted by an EDP. To remedy this flaw the Commission proposed an automatic sanction system. Governments would only have been able to lift sanctions by qualified majority. However, the Franco-German agreement of Deauville diluted the Commission's proposal by suggesting "semi-automatic" sanctions. The Council will decide by qualified majority to adopt sanctions which then apply automatically within six.

• The European Semester

The European semester is a new instrument to coordinate budgetary policies. It sets up a system of mutual assessment of budgetary policies. Member states submit their budgets for examination by the European Council and the Council of Ministers before putting them to the vote in their national parliaments. The budgetary assessment is based on a report of the European Commission. The "semester" was adopted on 7th September. It was inaugurated in January 2011.

• The enhancement of Eurostat and National Budgetary Institutions

Strengthening budgetary discipline presupposes independent analysis and assessment of budgetary policies. In this regard, the powers of Eurostat, the European statistics institute, will be enhanced. At the national level, Van Rompuy Task Force recommends reverting to independent bodies responsible for providing analyses, assessments and forecasts with regard to national budgetary policies.

SHEET 10

HOW TO REFORM THE ECONOMIC AND MONETARY UNION? (II)

3. MACRO-ECONOMIC COORDINATION IN THE EURO AREA

In its report, Van Rompuy Task Force highlighted the detrimental impact of persistent gaps in competitiveness as well as of macro-economic imbalances on the good functioning of the EMU. It proposed stronger macro-economic coordination and supervision. The idea of closer coordination of economic policies is not new, but existing frameworks have been unable to prevent imbalances from arising.

A brief history of economic coordination in the EU:

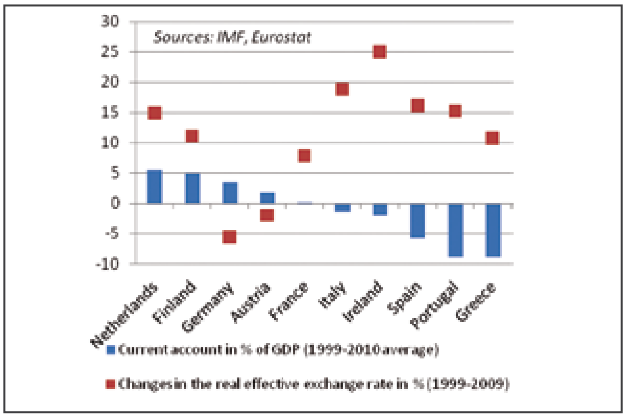
– The Maastricht Treaty introduced the coordination of economic policies as a Community objective. The Council elaborates the broad guidelines of the economic policies and issues recommendations to the states whose economic policies are not in line with these guidelines or run the risk of compromising the good functioning of the EMU (Art. 3 TEU; Art. 5(1), 120, 121 TFEU).

– The Amsterdam Treaty introduced "guidelines for employment" (Art. 5(2), 148 TFEU).

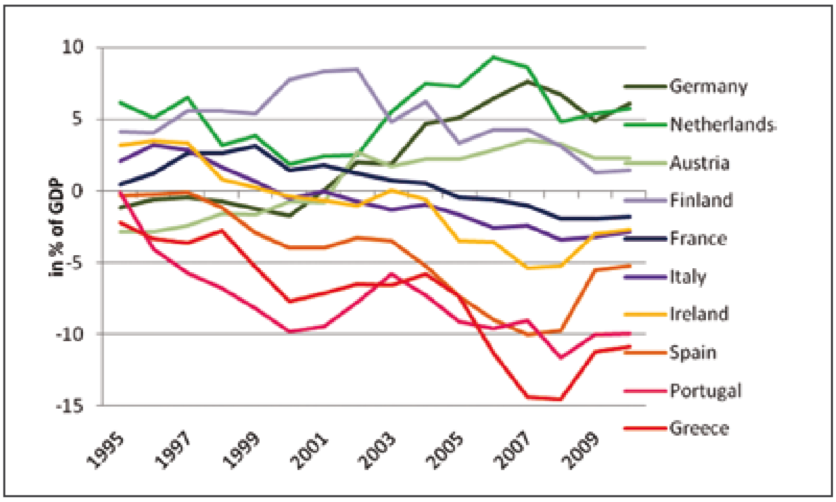
– The Open Method of Coordination (OMC) has been conceived as an instrument to achieve the objective of the Lisbon Strategy (2000) to transform the EU into the most competitive and innovative economy in the world. The OMC embodies characteristics of "soft" and decentralised governance: a third way between intergovernmental cooperation and community method. The aim is to promote the convergence of national policies by aligning them to commonly identified best practices. The OMC reverts to tools such as benchmarking and peer review rather than constraint.

Macro-economic imbalances

Between the time of the adoption of the euro and the world financial crisis, gaps in competitiveness between the euro area countries have increased considerably. The high growth of the real effective exchange rates in countries with big losses in competitiveness illustrates this development. At the same time, imbalances between countries with current account deficits, on the one hand, and surplus countries, on the other hand, have become larger. While the crisis attenuated the divergence of current accounts, competitiveness gaps continue to grow and may cause imbalances to widen again.



Divergence of current accounts in the euro area (1995-2010)



Source : FMI

Surplus countries (especially the Netherlands, Germany, Finland and Austria) are highly competitive. Their economies are characterised by a strong export-orientation and relatively weak domestic demand.

Deficit countries comprise mainly those affected by the debt crisis (Greece, Ireland, Portugal, Spain). They are partly economies having experienced catching up processes and have thus enjoyed massive inflows of capital for extended periods of time. This capital inflow has contributed to credit growth and housing bubbles. Deficit countries have suffered significant losses of competitiveness due to a mismatch between wage increases and productivity growth.

An intermediate group consisting mainly of Italy and France is characterised by a weak export performances, but with only moderate current account deficits.

4. WHY ARE MACRO-ECONOMIC IMBALANCES A PROBLEM?

It would be possible to argue that the debt crisis is not a crisis of the euro, but simply a problem of some countries on the periphery of the euro area which need to make an enormous effort to catch up in terms of competitiveness.

Current account deficits are, indeed, primarily a problem of the countries directly concerned. The financial crisis has demonstrated, for example, that countries with a current account deficit are more likely to see their public finances get out of control. However, given that the euro area is extremely interdependent, these imbalances can also negatively impact on the stability of the European economy as a whole.

The negative impact of macro-economic imbalances on the monetary union:
– The ECB sets a single key interest rate for the entire euro area: if macro-economic developments differ too much, the key interest rate may not be appropriate for economic realities in many member states.
– Budgetary problems in one country concern other euro area countries as well: the current debt crisis is a case in point. The burden of financial rescue falls on the states with sound budgetary policies. Moreover, debt crises can spread through financial markets and the banking sector.
– Since macro-economic imbalances cannot continue indefinitely, they lead to adjustments sooner or later. These adjustments are painful, first of all for deficit countries (austerity measures, structural reform). But adjustments in deficit countries will also impact on surplus countries, especially in an economic area as integrated as the EU (declining demand, contraction of trade).
– More generally imbalances damage confidence in the single currency.

5. STEPPING UP MACRO-ECONOMIC SUPERVISION

Van Rompuy Task Force advocated stronger macro-economic supervision. In its report, it proposes the establishment of an early warning system.

The early warning mechanism proposed by van Rompuy Task Force:

1. An annual assessment of the risks of macro-economic imbalances.
– The detection of excessive imbalances (actual or potential) would lead to an in-depth analysis of the country concerned conducted by the Commission.
- If the economic policies of a Member State are considered incompatible with the broad guidelines of the economic policies (or if they compromise the good functioning of the EMU), the Commission can address an early warning to the Member State in question.
2. An enforcement mechanism to guarantee the implementation of measures to be taken in the event of harmful macro-economic imbalances.
– In the case of serious imbalances, the Council decides, upon recommendation by the Commission, to declare the Member State concerned to be in a position of excessive imbalances.
– The Council addresses recommendations to the member state in question.
– Sanctions could be taken against member states in the euro area if the recommendations are not followed. Only euro area Member States would take part in the vote on sanctions based on article 136 TFEU (the vote of the state in question would not be counted).

6. THE CREATION OF A "EURO + PACT"

Gaps in competitiveness have been recognised as a problem at the highest political level. At the beginning of February 2011, Angela Merkel and Nicolas Sarkozy suggested a "Competitiveness Pact". The objective is to reduce gaps in competitiveness and to strengthen competitiveness in the euro area by "concrete measures" (in areas such as budgetary and wage policies). The idea was adopted by the Heads of State and Government of the euro area on 11th March 2011 under the name of the "Euro + Pact". The pact is also open to non euro area members.

LIST OF ABBREVIATIONS AND SYMBOLS

AIF	Alternative Investment Funds
AIFMD	Directive on Alternative Investment Fund Managers
BIS	Bank for International Settlements
BCBS	Basel Committee on Banking Supervision
CCP	Central Counterparty
CDS	Credit default swaps
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CRA	Credit Rating Agencies
EBA	European Banking Authority
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFC	Economic and Financial Committee
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
ESA	European Supervisory Authorities
ESFS	European system of financial supervision
ESMA	European Securities and Markets Authority
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
IMF	International Monetary Fund
FDI	Foreign Direct Investment
FSB	Financial Stability Board
FSF	Financial Stability Forum
GDP	Gross Domestic Product
G20	Group of Twenty
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IOSCO	International Organisation of Securities Commissions
OLAF	European Anti-Fraud Office
OMC	Open Method of Coordination
OTC	Transactions « over the counter »
PIIGS	Portugal, Ireland, Italy, Greece and Spain
SME	Small and medium enterprises
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
VAT	Value added tax

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