

European issues
n°297
17th December 2013

Economic and Monetary Union reform: political ambition or division

Dominique Perrut

Abstract :

The reform of the Economic and Monetary Union launched by the European Council in June 2012 stands as a long term answer to the intrinsic weakness of the euro, which became apparent during the severe crisis lasting from 2010 to 2012. A review of the entire scheme, which rests on two pillars – Banking Union and economic governance, is planned for the European Council of December 2013. Here we put forward the decisive steps achieved with this reform as well as its potential shortfalls. This will lead us to some proposals. The profile of Banking Union is now being defined. Some questions are being raised about decision making procedures, which still rely excessively on colleges formed by Member States. Moreover regulatory divides between the euro zone and the rest of European Union could emerge. As for economic governance the framework set in place is starting to work. The strengthening of decision making bodies, the simplification and definition of new tools, notably to correct deviant national trajectories – these are the lines of progress to be achieved. Mid-term the path to a euro zone budget has to be set down. This step would complete the ambitious structure of the single currency. Hence the euro would, together with the European Central Bank, be given its second vital base. Progress like this, which would introduce real economic government, should be prepared with an institutional reform of the euro zone – a major element that is missing from the present roadmap.

The peak of the financial turbulence of 2011 and 2012 now seems behind us. This crisis, which posed a serious threat in terms of the euro zone's collapse, has, to date, been kept in check by extensive action on the part of the European Central Bank (ECB) on the markets and the announcement, on the part of political leaders, of an in-depth reform of Economic and Monetary Union.

As the European Elections in May 2014 draw closer, the outlook is sombre. Economic stagnation and rising unemployment (7.7% of the working population in 2008, 11.4% in 2012) point to extreme disparity between national economies.. In a climate like this the temptation towards euroscepticism is strong.

The roadmap for the euro set by the European Council of June 2012 aims to correct sustainably the single currency's original shortfalls which became apparent in the recent turbulence. The programme comprises two pillars, Banking Union and economic and budgetary governance. On the eve of the European Council on 19th and 20th December it seems appropriate to review this reform. To do this some main points about the euro

zone's present situation will firstly be provided, then the main, sometimes complex elements of the new scheme will be presented. We might then be able to gauge what has been achieved, identify weaknesses and potential dangers and look at the stages that still have to be completed.

1 – THE EURO ZONE CRISIS: A DIAGNOSIS

In this review of the euro zone we would like to recall firstly the shortfalls in the organisation of the single currency. We shall then discuss the banking sector's present situation and its impact on financing, before providing some extremely worrying macro-economic indicators.

1.1 – *The shortfalls in the euro's structure*

The recent euro crisis was triggered by the negative spiral that has been evident since the spring of 2010 between banking issues and sovereign debt. This turbulence brought two constitutive weaknesses of the

euro, launched in 1999 [1] to light. The first of these was the lack of any real budgetary and economic union designed to guarantee the convergence of national economies in the euro zone. The minimal level of discipline introduced in 1997 by the Stability and Growth Pact was not particularly binding and at the very start of the 2000's several Member States including France and Germany bypassed it. The second lacuna laid in the fact that banking supervision and bail-out measures remained in the realm of the national. The decentralisation of banking supervision prevented the provision of effective solutions to cross-border banking issues (vis-à-vis Dexia, Fortis or the Anglo-Irish Bank for example). The creation of the European Banking Authority (EBA) in 2010 was to provide responses to the lacuna in this dispersed supervisory system. But subject to a disproportionate range of specifications and lacking any real decision making power, it could not address the crises affecting cross-border banks effectively – since it functioned accord to a collegial system with poorly adapted management tools [2].

1.2 – Banking uncertainty and single market fragmentation

- **The feed-back loop between banks and sovereign debt.** Public financial imbalance and severe banking problems formed, notably in some countries (Ireland and Southern Europe), a negative cycle. Indeed in the euro zone sovereign borrowers and their domestic banks have been indissolubly linked for two reasons. On the one hand there is no supranational system for banking crisis resolution. On the other hand, an important share of banks' financial assets lies in sovereign bonds. As soon as there was any uncertainty about a State's solvency this impacted the banks immediately because of the depreciation of their sovereign debt portfolio. This vicious circle was worsened by the withdrawal of foreign investors and by the incentives given by some regulators to banks for them to increase their domestic sovereign debt portfolio [3].

- **The mistrust regarding bank balance sheets.** A recent report estimated bad debts held by European banks in 2012 at 1.190 billion € (nearly 1.000 milliards of which in the euro zone) meaning a multiplication of 2.3 since 2008 [4]. Nearly 60% of the euro zone's

2012 bad debts lay with four countries: Germany (179 billion €), Spain (167 billion €), Ireland and Italy. These astounding totals do not even throw all the light on the banking sector. Indeed asset assessment methods are barely homogeneous from one country to another, and accusations are made about regulatory forbearance, practiced by some national supervisors, which allow banks to "cook the books" - to hide bad debts or losses via the constant postponement of deadlines and complacent restructuring of debts [5]. In the Banking Union the ECB's first task will be to clarify, according to a homogeneous base, the state of the banking sector's health. Focus is now turning impatiently to Spain and also Germany.

- **From divides in the single market to credit access.** Since 2007 Banking and sovereign crises have led to a slowing in financial integration in the euro zone. "We have seen," says the EBA's Chair, "a lot of repatriation assets. Cross-border banking activity is at its minimum, at least since the introduction of the euro in 1999. Trust between supervisors has been damaged." [6] Several indicators of cross-border bank activity have been declining since 2008 after a withdrawal by the banks within their own national borders. Moreover we can see that within the euro zone bank loans have tended to stagnate since 2008, whilst the banks have strengthened their own capital by 400 billion €. On the part of the banks this has meant they have been reducing the relative share of, now excessive, debts in their balance sheets to the benefit of capital. The deleveraging of the debt is underway. The fragmentation of the single market, doubts about the solidity of the banks and the reticence of the latter sharpens fear about the financing of the economy. This especially affects businesses, whose outstanding loans calculated in September 2013 had fallen over one year by 3.5% [7]. Amongst businesses SME's are even more sensitive to banks' lending terms. Indeed their opportunities to access alternative funding are smaller and the cost of financing is often higher due to a lack of ratings of some firms by the agencies. However SME's create jobs. The restoration of the banks' situation, one of the aims of Banking Union, is therefore decisive for financing the economy, the recovery of growth and the resorption of unemployment, which is affecting euro zone countries in very different ways.

1. See D. Perrut "Banking Union in the roadmap for the euro" *European Issues*, n° 261, 10th December 2012, Robert Schuman Foundation.

2. *European Commission: Proposal on the Single Resolution Mechanism; and Financial Times, Regulator warns on nationalism over banks*, 18th November 2013,

3. See http://ec.europa.eu/internal_market/economic_analysis/docs/efsir/130425_efsir-2012_en.pdf

4. *PricewaterhouseCoopers, A growing non core asset market*, July 2012; *Financial Times*, 29th October 2013.

5. *The Economist, Cleaning the Augean Stables*, 26th October 2013; *Gentlemen, start your Audits*, 5th October 2013.

6. *Financial Times*, op. cit..

7. <http://www.ecb.europa.eu/pub/pdf/other/accesstofinancesmallmediumsizeenterprises201311en.pdf?acff8de81a1d9e6fd0d9d3b38809a7a0>.

1.3 – Divergence in national economies within the euro zone

Significant differences in national unemployment levels express the alarming disparity of situations between euro zone countries. With an average rate of 11.4% at the end of 2012 in the latter the percentage of unemployed has risen to nearly a quarter of the working population in Greece (24.3%) and is above this level in Spain (25.1%). In Portugal it totals 15.9% and 14,7% in Ireland. It lies just below the average in Italy (10.7%) and in France (10.2%). At the other end of the scale unemployment lies at 5.5% in Germany, 5.3% in the Netherlands and 4.4% in Austria. Declining employment prospects continued in the first half of 2013 in France, Italy and Portugal. This downturn has been particularly marked in Spain and Greece [8]. As for the GDP, which contracted by 0.7% in 2012 in the euro zone, we can now see slight growth in Germany (0.7%) and Austria (0.9%), whilst it lies at zero in France and Ireland. Italy (-2.5%), Spain (-1.6%), Portugal (-3.5%) and Greece (-6.4%) are in a recession to a greater or lesser degree. Public accounts in 2012 were in balance in Germany (0.1% of the GDP) whilst the public deficit lay at -3% in Italy and -4.8% in France. In Ireland, Greece, Spain and Portugal deficits range from -6% and -10% of the GDP. In terms of the level of 60% required in the Stability and Growth Pact, public debt rose to 80% of the GDP in Germany and 93% in France, as it did in Spain in 2012. In Ireland, Greece, Italy and Portugal public debt varies between 126% and 169% of the GDP.

The vicious circle between banking and sovereign crises, leading to the division of the grand market and the differing evolutions in national economies create a difficult context in which the euro reform plan is to be implemented.

2 – A REVIEW OF THE REFORM OF THE ECONOMIC AND MONETARY UNION

The European Council of December 2013 will cover all issues relative to this reform launched in June 2012. It can be summarised according to two main pillars – Banking Union and economic governance. Banking Union aims to introduce centralised supervision and to

provide the EU and the euro zone with preventive and curative tools to protect the taxpayer and the economy in the event of banking default, as set out by the G20. As for economic governance a general framework is being established in the Union focusing on budgetary discipline and the coordination of economic policy. In this system the euro zone countries form a subgroup subject to more restrictive measures, together with possible sanctions. Let us now look at each of these two pillars before offering an assessment in the following section.

2.1 – Banking Union

Within the overall reform of the EMU, Banking Union might be presented as a structure comprising two complementary parts - the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) for banking crises. The introduction of centralised supervision is deemed as the prerequisite for the direct recapitalisation of banks in the euro zone by the European Stability Mechanism (ESM), in order to break the negative cycle seen between sovereign debt and bank vulnerability. Non-euro zone Union Members can join the Banking Union.

2.1.1 The Single Supervisory Mechanism

It was on 15th October 2013 that single supervision really started with the final agreement of the Council on two regulations that govern this scheme [9]. One concerns new ECB missions in this context, whilst the other adapts the functioning of the European Banking Authority (EBA) regarding this new structure.

- **The scope of single supervision.** Since the entry into force of the SSM on 4th November 2013 the ECB has to undertake preparatory tasks together with the EBA. This work notably involves diagnosing the big banks before the deployment of the SSM's full remit, in a year's time i.e. in November 2014. Regarding the euro zone the ECB will be responsible for the supervision of all banks (around 6,000 of them), but will only directly supervise a group of around 130 [10]. Indeed only banks whose total balance exceeds 30 billion € or 20% of their home country's GDP and those which are receiving European aid [11]. This group represents around 85% of all banking assets in the euro zone.

8. Statistical data in this part taken from the ECB <http://www.ecb.europa.eu/pub/pdf/stapobo/spb201311en.pdf>

9. EU Regulation 1024/2013 from the Council of 15/10/13 granting the ECB specific missions; EU Regulation 1022/2013 of 22/10/2013 modifying regulation 1093/2010 establishing the European Banking Authority.

10. The criteria retained for the direct supervision of banks in the SSM by the ECB will include – in November 2014 – qualitative elements (Regulation 1024/2013, Art. 6-4).

11. This aid can be granted by the European Stability Mechanism

As for the other banks supervision will be ensured on a daily basis by the respective national authorities, according to a set of instructions issued by the ECB with the obligation of reporting back to the latter. The ECB will be able to supervise of any one of these banks directly. Moreover the ECB will retain the exclusive supervision of certain tasks in all banks notably comprising bank licensing and the withdrawal of that licensing, the supervision of acquisitions and sales, and even decisions to tighten up certain prudential rules [12].

- **SSM governance.** This will be ensured by a Supervisory Council comprising a President, a non-member of the ECB's Council of Governors, of a Vice-President from the ECB's Board, of four members of this establishment and a representative of the national supervisory authority of each Member State participating in the SSM [13]. The Council's supervisory decisions will be taken by simple majority, except those relative to the implementation of European supervisory texts for which a qualified majority will be required.

- **The sharing of regulatory tasks between the ECB and the EBA.** The respective roles played by the EBA and the ECB in the regulatory field in the context of the SSM deserve particular attention. Indeed it is here that we believe there to be a risk of tension between the two authorities.

The EBA, which is an independent authority, created in 2010 (following on from the Committee of European Banking Supervisors, established in 2004) aims to ensure the effective, harmonised implementation of regulation and supervision of the European Union [14]. The revision of the EBA's initial regulations, in view of the introduction of the SSM, plans for a change in the way votes are taken. A qualified majority comprising a double simple majority, both amongst SSM members and within other countries, is now necessary [15]. The EBA coordinates the work of the national supervisory authorities, assesses the risks within the banking sector (by way of stress tests) and if necessary it plays the role of mediator, enjoying a certain number of binding powers. However this Authority's main task is to draft (Art 8) the Single Rulebook. The base of this rulebook is provided in the CRD IV legislative package (see *below*). In addition to this the EBA is responsible for

the Single Supervisory Handbook. The harmonisation of banking rules aims to guarantee the terms of fair competition in the Union and to complete the single market. Some European laws (directives and regulations) have since the Lisbon Treaty in 2009, planned for the delegation of power to the Commission in the adoption of delegated acts focusing on non-vital issues. In the banking sector this may concern regulatory and implementing technical standards. These concern for example, the assessment of non performing loans or certain types of assets. This system of delegation is notably part of the transposition in Europe of new international banking rules that aim to guarantee the solidity of the banks based on capital requirement, liquidity and leverage ratios (the so-called Basel III rules). Transposition in the Union was undertaken in the CRD IV legislative package adopted in July 2013, entering into force at the beginning of 2014 [16]. This forms the base of the European Single Rulebook. The EBA's mission is therefore to draft this series of rules in detail by working with the delegations planned for within the CRD IV package. For the EBA this means establishing technical standards projects submitted for approval by the Commission which will turn them into either binding regulations or decisions [17].

To implement these technical standards included in a delegated act adopted by the Commission the ECB will publish guidelines and recommendations as part of the SSM. If necessary it will be able to adopt binding decisions and regulations in order to clarify the way its missions are undertaken [18].

- **The full assessment undertaken by the ECB on banks.** Before taking on the direct supervision of the banks involved the ECB will undertake a three stage operation to clarify their situation [19]. This exercise, which has to be completed by October 2014, will pursue three goals: transparency, consolidation, and the strengthening of confidence. This work is due to lead to progress in the harmonisation of national supervisory practices which admittedly are disparate. The three stages planned for are as follows: firstly the banks will be assessed from a prudential point of view, i.e. in view of their vulnerability. This exercise will focus on all risks, -liquidity, leverage, and financing. Then there will be an asset quality review at the beginning of 2014 based on 2013's accounts, using

12. EU Regulation 1024/2013, Art. 4-1.

13. EU Regulation 1024/2013, Art. 26.

14. The EBA was created in 2010 (EU Regulation 1093/2010).

15. Art. 44 of the 2013 regulation modifying the 2010 regulation establishing the EBA.

16. The CRD IV package which transposes the so-called Basel III standards, adopted on 17th July 2013 includes the directive 36/2013 of June 26th 2013 and the regulation 575/2013 of June 26th 2013.

17. EU Regulation 1093/2010 establishing the EBA: articles 10 to 15 as well as art 16.

18. EU Regulation 1024/2013, art. 4.

19. ECB : Information paper on the full assessment.

some of the EBA's technical standards to check that the valuation of assets and their possible depreciation is well-founded. Finally stress-tests that aim to gauge banks' abilities to absorb shocks in times of crisis will be undertaken together with the EBA. If, after this exercise, the banks in question lack regulatory capital corrective measures will have to be taken. These will firstly involve the banks which might implement a whole range of existing methods: notably recapitalisation, profit retention, issuance of shares, assets' sales. If anything else is required public funds would then be mobilised according to European rules.

- **the intervention of the European Stability Mechanism (ESM).** After the start of the operational phase of the SSM in November 2014, the direct recapitalisation of banks by the ESM of SSM member countries could be undertaken [20]. A permanent, international financial institution, the ESM was created by the 17 euro zone members to protect the financial stability of this entity. It was launched on 8th October 2012 and took over from the European Financial Stability Facility, set in place in May 2010. The total capacity of the ESM for lending is 500 billion €. Its intervention can come in several shapes, notably loans to States in distress and intervention on the primary and secondary debt markets. As for the method to be used to recapitalise banks, covered by the SSM directly, these were the focus of a Eurogroup agreement on 20th June 2013. This body now has to set out the guidelines for these operations [21].

2.1.2 European resolution of bank failures.

The introduction of resolution mechanisms for ailing banks, together with the banking reform (Basel III) and the on-going regulation of the shadow banking system, comprise one of the three pillars of world financial reform launched by the G20 in 2008 and 2009, which is being steered by the Financial Stability Board (FSB). The latter has defined the guidelines to apply for bank resolution [22]. A resolution mechanism for ailing banks aims to put an end to the type of bank default management witnessed too often over the last thirty years, especially during the most recent banking crisis. This has led, in the absence of any appropriate mechanisms, to exorbitant costs for all (40% of the EU's GDP in terms of approved aid) [23], destabilising emer-

gency measures and a situation of moral hazard, ie incentives encouraging further irresponsible attitudes, since in the past private bankruptcies were almost systematically taken on board by the public sphere. According to the guidelines set down by the FSB the European project has learned from this unhealthy kind of management. The bank resolution mechanism has to be set in place by way of two complementary European laws. This is the draft directive for the recovery and resolution of bank crises that aims to introduce national harmonised systems in the EU[24] ; and the draft regulation on the Single Resolution Mechanism, SRM [25]. In view of Banking Union the SRM applies to the same perimeter as the SSM for a centralised implementation of the directive rules on resolution.

The directive on bank recovery and resolution plans for the competent national authorities to be able to use preventive and early intervention tools. In the event of probable or proven bankruptcy, requiring a resolution procedure, the critical functions of the bank would be protected. It would then be up to the shareholders and creditors to assume the resolution costs and no longer the taxpayer. The directive's preventive chapter plans for the banks to set out recovery plans that they would adopt in the event of difficulties (if necessary the Authorities would be able to demand their implementation). It is also planned that the competent authorities define resolution plans to manage the banks that can no longer be saved and also that intragroup financial support agreements be concluded to halt the development of any potential crisis.

As far as resolution is concerned the national authorities are equipped with a toolbox to manage bank default. This notably includes: closure; bridge institutions (separation of the ailing bank's healthy assets or vital functions to create a bridge bank, which would then be sold off to another organisation); and the internal recapitalisation of the bank.

Moreover, as far as transnational groups are concerned, the project plans for cooperation between national authorities within the College of Resolution Authorities. Finally the financing of bank resolution will be undertaken by the national resolutions funds, themselves financed by the banks, notably according to their eligible

20. ESM: Treaty establishing the ESM, 2nd February 2012.

21. Conclusions of the European Council 24th and 25th October 2013.

22. Financial Stability Board, 2011, Key Attributes of Effective Resolution Regimes for Financial Institutions, October.

23. State aid to banks approved by the Commission represented 5.100 billion € (i.e. 40% of the European GDP) between October 2008 and October 2012. Use represented 1.6 billion € between October 2008 and December 2011 (i.e. 13% of the GDP). Cf. European Financial Stability and Integration, Report 2012, April 2013, European Commission, p. 19-21

24. Draft Directive establishing a framework for the recovery and resolution of defaulting credit establishments and investment businesses COM(2012) 280 final 6.6.2012.

25. Draft regulation on the single resolution mechanism, COM(2013) 520 final 10.7.2013.

deposits (around 1% of their total). The draft directive aims for these funds to use available financing in the 28 deposit guarantee systems, since in the long run the two systems could merge. The resolution directive is therefore closely linked to that – under discussion – regarding the harmonisation of deposit guarantees.

The draft Single Resolution Mechanism (SRM) is based on the following principles, in line with the rules included in the resolution directive. On receiving an alert from the ECB, the single supervisor, about an ailing bank, the Single Resolution Council (SRC) draws up a resolution plan defining the tools to be implemented. The Commission then decides on the bank's resolution. The SRC then asks the national authorities to implement – under its supervision – the detailed resolution plan which it has delivered. The Single Bank Resolution Fund, established under the SRC's supervision ensures the financing of the operation but not recapitalisation. This Fund is supplied by bank contributions (substituting those designed for national funds). The SRC cooperates closely with the European Stability Mechanism. In 2010 the Commission put forward a legislative proposal aiming to simplify and harmonise national deposit guarantee schemes [26]. This notably plans for acceleration in depositors' reimbursement procedures, ex ante financing of guarantee funds and the launch of solidarity between national systems, via mutual borrowing facilities. The project of rapprochement or merger of guarantee and resolution schemes planned for in the resolution directive is the focus of lively debate. The idea of centralising the deposit guarantee schemes, initially planned for in Banking Union has now been cast aside.

- **On-going discussions and deadlines.** The directive on banking resolution is the focus of a tripartite negotiation (Parliament, Council, Commission). Various amendments have been put forward by both Parliament and the Council on several points, notably involving how shareholders and creditors would bail-in; the level of the banks' contributions to the resolution fund (from 0.8 to 1.5% of eligible deposits). As for the Single Resolution Mechanism discussions are still focused on many points (fields of application, SRM governance and the structure of the Resolution Fund amongst others).

However the deadlines set by the European Council of June should be kept with an adoption of directives on the resolution and harmonisation of deposits for the end of 2013 and a political agreement on SRM at the same time in view of an adoption before the spring of 2014 [27].

2.2 – Progress towards economic government?

The economic governance of Europe now comprises a set of economic and budgetary rules which are part of two legislative "packs" (the Six-Pack and the Two-Pack) as well as of the Treaty on Stability, Coordination and Governance (TSCG). These measures are related to the European Semester which is an annual calendar setting the respective tasks of the institutions responsible: Commission and organisations that rally the States involved (European Council, Council of the Ministers Ecofin, Eurogroup for the euro zone). Within this framework the 17 euro zone States form a subgroup which is subject to stricter rules, and accompanied, if necessary, by almost automatic sanctions. We should now look at the three main elements of this quite complex structure.

The "six-pack" is a framework for budgetary and economic discipline comprising six legislative measures (five regulations and one directive) [28]. It entered into force in December 2011. It is applicable to the 28 Member States, with stricter rules for those in the euro zone. This measure tightens the Stability and Growth Pact introduced with the single currency, which has been flouted so many times since. Budgets must converge towards balance mid-term. In relation to the GDP the public deficit must not rise beyond 3% and public debt beyond 60% (or this must at least decrease towards this limit). The Excessive Deficit Procedure, under the supervision of the Commission, aims to correct any deviation from the objectives. Sanctions are planned for euro zone members ranging from 0.2% to 0.5% of the GDP, with an adoption of procedures (inversed qualified majority) which makes them highly likely. Macro-economic supervision is also included in the European Semester. The Commission's Annual Growth Survey at the end of the year, marks the start of the annual set calendar and defines the EU's priorities. The States set out their programmes (budget and economic

26. European Commission, 2010, legislative proposal on deposit guarantee systems, COM(2010) 368.

27. Conclusions of the European Council dated 24th and 25th October 2013.

28. The Six Pack on budgetary discipline and macro-economic imbalances comprises five regulations n° 1173 à 1177/2011 and one directive 1173/2011.

reforms) that may be the focus of recommendations on the part of the Commission, before being adopted by the Ecofin Council. Moreover the new Macro-economic Imbalances Procedure comprises several stages starting off with the Commission's systematic assessment of the States' situation, which is then the subject of an Alert Mechanism Report. In the event of imbalance the Commission undertakes in-depth analyses of the countries in question and can launch an Excessive Imbalance Procedure which leads to the formulation of recommendations.

The "Two-Pack" is a coordination and supervisory framework for the euro zone countries. This measure entered into force in May 2013 [29]. The States submit their draft budget to the Commission which gives its opinion. In the event of excessive deficit a Member State has to submit a structural reform programme (that might focus on retirement pensions, public healthcare and taxation for example), in order to reduce its deficits. The States which are subject to an aid programme are placed under the enhanced supervision of the Commission.

The Stability, Coordination and Governance Treaty (TSCG) entered into force in January 2013 and involves 25 countries [30]. This Treaty is only binding however as far as countries in the euro zone are concerned (Art. 2). This pact includes the "golden rule" (fiscal compact) which is part of national legislation stipulating that the mid-term goals of structural deficits will be limited to 0.5% of the GDP (or 1% under certain conditions). Automatic corrective mechanisms are planned for in the event of deviation from these mid-term goals. Moreover the Treaty takes up measures in the Six-Pack and sets out the tightening of euro zone governance, with the organisation of informal twice-yearly summits bringing together the heads of State and government of the countries involved (Art. 12).

3 – IS THE WILL FOR A REFORM SUFFICIENT TO FACE THE RISKS OF DIVISION?

We should now assess the progress and extent of the on-going reforms by looking first to Banking Union

and the issues raised by the measures that have been adopted, then economic governance, which is being established and faces the acute difficulties experienced by the euro zone.

3.1 – Banking Union and EBA: the risks of regulatory division

The introduction of the new supervisory system seems to conceal some risks of division in terms of regulation and supervision, which could lead to the continued fragmentation of the single market [31].

3.1.1 - The risks of regulatory division.

- **The weaknesses of the European Bank Authority.** In spite of its transformation into an Authority in 2010 the EBA has not succeeded in overcoming the weaknesses of the Committee of European Banking Supervisors from which it took over. The collegial, peer-to-peer, and therefore, consensual mode of functioning deprives the institution of an effective decision making power. The completion of its tasks has indeed revealed its weaknesses, whether this concerns cross-border crisis management or undertaking bank stress-tests in 2010 and 2011. These two operations did indeed damage the EBA's credibility since the banks deemed to be healthy after these assessments required rescue a short time later.

- **The EBA and the ECB vis-à-vis SSM.** The new voting rules within the EBA lead to questions about its future decision making capabilities in its role as regulator. Won't the countries that are not in the SSM be tempted to form a minority oppositional block? Six votes (from non-euro zone countries) out of the 28 would be enough, i.e. barely one fifth, if 10 countries remain outside of the SSM, to counter the adoption of a text. And the motivation of non-euro zone Member States to impede decision making within this organisation will not be lacking. This might come from a desire to protect national supervisors' room to manoeuvre amongst the many options available in the CRD IV package (contra-cyclical buffers, i.e. additional capital that aims to counter speculative bubbles and the valuing method of certain assets for example). It might come from a quest for regulatory competition within the EU or vis-à-vis the USA. It might even be caused by the

29. The Two-Pack comprises two regulations (385/2011 et 386/2011).

30. Treaty on Stability, Coordination, Governance within the Economic and Monetary Union signed by 25 States on 2nd March 2012 which entered into force in January 2013.

31. Larosière J. de, 2012, "Supervision is even more important than regulation", *Confrontation Europe, la Revue*, October-December.

grievances of some host countries as far as the difficult and recurrent issue of trans-national group supervision is concerned, when the group's home supervisor has primacy over the host supervisors (the countries where company branches are established).

In opposition, within the SSM there will be strong incentive to stand together and centralise regulation and supervision. The ECB will certainly want to avoid conflict in terms of objectives at all costs between monetary policy and prudential requirements, born of a possible need to restore financial stability. Let us recall here that the supervisory function is to provide a safety net enabling the containment of banking risks and to avoid the central bank having to mobilise its prudential tools, i.e. to intervene as lender of last resort. Indeed these interventions are always delicate because they lead to perverse effects. The ECB might want to benefit from its new found regulatory powers to the full. A pessimistic scenario would reveal a slow transfer of regulatory powers over from the EBA to the ECB due to the EBA's decision-making inertia on the one hand and due to the ECB implementing its new attributions to the full on the other.

To prevent risks of supervisory division within the EU the corollary of the SSM's establishment should be a significant strengthening of the EBA's decision making powers. A governance structure comprising a limited board with a supervisory council (including the present college), would appear more appropriate so that the EBA can fulfil its specifications. Moreover the new voting rules – clinched during negotiations by non-euro zone countries – should be revised so that the EBA's regulatory drafting role is not impeded.

- The SSM: a weak incentive for non-euro zone countries. In spite of the offer made to non-euro zone countries (in the shape of close cooperation, Art. 7), the SSM's governance is not really attractive to the latter except if they are planning to join the single currency in the near future. Indeed the Supervisory Council's decisions, where non-euro zone countries would sit, will be subject to the approval of the Council of Governors (Art 26-8), where these countries would not be represented. We should expect that euro zone candidates will be the only ones – or nearly – to join the SSM.

3.1.2 – Banking Union is promising, but is limited.

Banking Union which is based on a legally-binding community legislative approach is full of promise. The main limitation to the process lies in the repetition of the collegial governance system (within the ECB's Supervisory Council; in the resolution colleges for cross-border groups, as part of the matching Directive; at the Single Resolution Council (within the SRM frame). Might the ECB's Supervisory Council not be strengthened by the creation of an internal board? As for the colleges the leaders' authority would have to be strengthened (focusing on the leader of the authority of the country of origin concerning cross-border groups for example). Moreover within the SRM the decision making process is still the focus of lively debate [32].

What kind of integration can we expect between financial solidarity measures? These comprise three mechanisms, the ESM, the Single Resolution Mechanism and the National Deposit Guarantee Funds. The merger or coordination of the National Resolution Funds and the National Guarantee Funds is still under discussion (at the time of writing). The ESM should serve as last resort support to the Single Resolution Fund and the National Deposit Guarantee Funds. The ESM may benefit from the support of the ECB, intervening on its secondary debt market [33]. How these measures are to function together would benefit from clarification. Indeed at the end of the day the credibility of Banking Union depends on that of its "backstop". The draft banking structure reform (introducing the separation of certain activities, notably trading on own account) still has to be published, ordinarily for the end of the year, after the Liikanen Report 2012 [34].

3.2 – Weak economic governance in the face of diverging economies

A reformed framework of economic governance for the European Union and especially for the euro zone is now being set up. It means assessing, bearing in mind the three urgent tasks set for economic and budgetary coordination, consolidating public finance; ensuring conditions for economic recovery; implementing a convergence dynamic of national economies which today demonstrate threatening disparity.

32. Gandrud C. & Hallergerg M., 2013, "Who decides? Resolving failed banks in a European framework", Bruegel, November.

33. Treaty establishing ESM, 2nd February 2012, Art. 44.

34. High-level Group on reforming the structure of the EU banking sector, 2012, Final Report, Chaired by E. Liikanen, 2 October.

3.2.1 – A measure, the complexity of which impedes its efficacy

In terms of its assets the new measure is flexible to a certain degree in the face of economic change (the deficit goal is defined mid-term and does away with cyclical effects) and includes corrective mechanisms (structural reforms are planned for a given country as part of the Excessive Deficit Procedure). However in terms of its inadequacies the system's complexity limits its efficacy. How for example do the TSGC measures work with the Six-Pack? Various parts of the reform apply to different perimeters (27 countries in terms of the six-pack, 25 in the case of the TSCG, 17 in that of the euro zone for the two-pack). Moreover voting rules are different depending on the series of measures [35]. Undoubtedly we should see in a structure as disparate as this the limits of the intergovernmental method which prevails in this area. Work aiming to strengthen economic governance might be undertaken as follows: simplification and consolidation of the system via the integration of the texts into one, seems vital to ensure its efficacy and legibility on the part of the citizen; stepping up procedures since the present sloth of the process is damaging its efficacy and is leading to threats lags with the economic cycle; and the strengthening of euro zone governance since, in order to rise to the challenges, the responsible, still informal organisations (euro zone summits, Euro-group), should be provided with specifications and clear powers.

3.2.2 – What kind of economic rebalancing tools are available between the economies of the euro zone?

A new economic rebalancing tool has been introduced: structural reform in the two-pack. Five countries which were the focus of an Excessive Deficit Procedure subscribed to an economic partnership programme in 2013 with the Commission. Two other tools might also be introduced into economic governance.

Firstly this would entail a concerted rebalancing process between the countries of the centre and the periphery. Convergence like this might be sought owe to a reduction of existing gaps between the

countries in costs and prices, in order to revive domestic demand in countries at the centre and to stimulate exports in peripheral countries. Differentiated development in the pace of price and production cost increases might be sought to this end [36]. The creation of a euro zone budget might be considered as the second rebalancing tool. This proposal, mentioned at the end of 2012, both by the Commission and in the Van Rompuy Report was not taken up by the European Council [37]. This budget would help provide a response, in part, to the inadequacies of the present coordination system. In this tool some see a means to compensate the lack of rebalancing factors in Europe (via labour mobility and the flexibility of wages and prices) planned for in the reference theory on monetary union [38]. For it to have a stabilising function this budget would have to reach a certain weight in the zone's GDP (from 5 to 7%, for example) and activate "automatic stabilisers" by integrating more cyclically sensitive elements such as company tax in terms of revenues or unemployment benefits in terms of spending. If it is supported by the ECB the budget might then provide a backstop to the financial solidarity mechanisms.

CONCLUSION

The danger of division hangs over the single market as it does between the countries of the euro zone. The first step in the reform of the EMU has led to major progress but further progress is vital to counter the danger of collapse.

From the point of view of Banking Union the new framework should meet its goal of bank consolidation and the restoration of confidence. However unless the EBA is strengthened we fear that a progressive divide will emerge in terms of supervision between the euro zone and the other Union countries, thereby opening the way to regulatory competition and the fragmentation of the single market. Moreover the new organisations' decision making structure, which is of a collegial nature, also has to be strengthened.

As for economic governance, which has just been

35. Pisani-Ferry J., Sapir A., Wolff G. B., 2012, "The messy rebuilding of Europe", Bruegel.

36. ECB, Annual Report, 2012.

37. European Commission, 2012, Communication: detailed draft for deep, genuine Economic and Monetary Union, launching European debate, COM(2012) 777 final ; Van Rompuy H. President of the European Council, 2012, Towards a deep, genuine Economic and Monetary Union, 6th December.

38. Caudal N. & Al., 2013, "Un budget pour le Zone euro", Trésor-éco no. 120, October, Ministry for the Economy and Finance. Pisani-Ferry J., 2012 "Un budget pour la zone euro?", Bruegel, December Mundell R., 1961, "A theory of Optimum Currency Areas", American Economic Review, 51 (4).

set up, it will be impeded in terms of its efficacy and even its adequacy vis-à-vis the economic situation, because of its complex, cumbersome nature. An effort towards simplification has to be undertaken. The euro zone's governing bodies should be consolidated so that they can address three issues: the introduction of convergence tools for the euro zone economies; impetus towards a development policy following the trajectory opened up by the Commission's Single Market Act (1 and 2) [39]; a timetable setting out the establishment of a common budget for the euro zone. The latter would be the keystone to the EMU, providing the structure with total credibility. This stage would require prior institutional reform. But in the

roadmap for the euro, apart from the involvement of the parliaments, the reform of institutions has been a major omission.

Dominique Perrut

PhD in Economic Science (Paris-1), financial sector consultant in Paris, Dominique Perrut is the author of communications, articles and books focusing on financial Europe (*L'Europe financière et monétaire*, Nathan; *Le système monétaire et financier français*, Seuil, coll. Points). Associate researcher at the University of Angers – he also teaches European economy in France and Europe. He is a qualified member of Finance Watch.

39. European Commission, *Acts for the Single Market 1* (April 2011) and 2 (October 2012).

You can read all of our publications on our site:
www.robert-schuman.eu

Publishing Director: Pascale JOANNIN

THE FONDATION ROBERT SCHUMAN, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France, Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organisation of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.