EU Report

ROADMAP FOR "GENUINE" ECONOMIC AND MONETARY UNION

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Centrum für Europäische Politik

KEY ISSUES

Objectives of the Report: The proposed measures are to improve the stability of the Euro Zone.

Affected parties: All citizens, politicians.

Pro: Credible insolvency and resolution rules for banks are essential.

Contra: (1) Financial institutions will still not be obliged to back sovereign bonds with equity.

(2) The plan to insure Euro countries so they can absorb economic shocks may result in these countries failing to make reforms to improve their ability to absorb shocks.

(3) Financial transfers to support economic reforms and "insurance" aimed at absorbing shocks can, at best, be based on the flexibility clause (Art. 352 TFEU) which requires unanimity in the Council.

CONTENT

Title

Herman Van Rompuy, President of the European Council, in close collaboration with José Manuel Barroso, President of the European Commission; Jean-Claude Juncker, President of the Euro Group; Mario Draghi, President of the European Central Bank. **Towards a Genuine Economic and Monetary Union**, Report of 5 December 2012

Brief Summary

- **Context and objective**
  - In order to ensure the future stability and integrity of the Euro Zone, the four Presidents of the European Council, the Commission, the Eurogroup and the European Central Bank (ECB) have designed a "roadmap" containing various measures for achieving "a genuine economic and monetary union" (EMU).
  - The "genuine" EMU is to include a "financial framework", an "economic policy framework" and a "budgetary framework" which are "intertwined" with each other.
  - The measures are to be implemented in a multi-stage process over the next few years (p. 2). This is to take place with consideration for "democratic legitimacy and accountability" (p. 17).

- **"Financial Framework"**
  - A "financial framework" is intended to reduce the likelihood of systemic banking crises and prevent a banking crisis from becoming a risk to the fiscal policies of Euro countries. For this purpose, there is to be rapid adoption of the following draft Directives and Regulations (p. 5):
    - the Regulation and Directive on capital requirements for banks and investment companies (Basel III) (see cep**PolicyBriefs**),
    - the two Regulations on the delegation of key tasks of banking supervision for all banks in the Euro Zone to the ECB (see cep**PolicyBriefs**),
    - the Directive on the harmonisation of national rules on deposit guarantee schemes (see cep**PolicyBrief**),
    - the Directive on bank recovery and resolution (see cep**PolicyBriefs**).
  - Once banking supervision is effective at the ECB, the European Stability Mechanism (ESM; see cep**PolicyBrief**) will be able to recapitalise banks directly (p. 6).
  - Once the Deposit Guarantee Scheme Directive and the Recovery and Resolution Directive have been adopted, the Commission will propose a "single resolution mechanism" (p. 6).
    - This is to
      - cover all banks supervised by the ECB,
      - ensure "actual timely and efficient resolution" and
      - reduce resolution costs to the lowest possible level.
    - The banking supervisory body is to decide whether a resolution is necessary.
    - Resolution is to be carried out by a new European resolution authority (p. 7).
    - Resolution is to be financed by (p. 7)
      - the bailing-in of the shareholders and "some creditors" as well as
      - a European Resolution Fund funded through risk-based levies on the banks.

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- The single resolution mechanism is to include a "backstop" by means of an ESM credit line granted to the single resolution authority. If the credit line is used and deficits subsequently arise, these are to be financed by levies on the financial industry (p. 7).

► **"Economic Policy Framework", particularly ex ante coordination and reform agreements between the Member States and the EU**

– As the Euro crisis clearly showed, the "unsustainable" economic policies of one euro area country can have negative repercussions on other euro countries (p. 13). An "economic policy framework" is therefore to be created which
  - prevents unsustainable national economic policies and
  - achieves "higher" rates of growth and employment.
– "Major" economic policy reforms by Member States are to be "coordinated" in advance (cf. Art. 11 Fiscal Compact, see cep**PolicyBrief**).
– The Euro area Member States are to conclude a compulsory individual "reform agreement" with the EU; for the other EU countries it would be voluntary.
  - The reform commitments contained in the reform agreement are to
    - remove "deficits" at an early stage at national level, which are detrimental to the functioning of the EMU, thus enhancing national competitiveness and promoting economic growth,
    - be based on the country-specific recommendations issued by the Commission during the European semester (see cep**PolicyBrief**).
  - The euro area Member States are to be supported in the implementation of the reform agreements by
    - the payment of "temporary, targeted and flexible" financial support (p. 4) funded by "national contributions", the EU's own resources or a combination of both (p. 12) and
    - the Commission will "inform" the national parliaments of the necessity for the reforms (p. 15).
  - The reform agreement is to contain a concrete implementation agenda, specific modalities for monitoring as well as reciprocal obligations on reporting and access to information (p. 15).
  - The national governments are accountable to their parliaments. They have to report to them on the progress of implementation. The Commission is accountable to the European Parliament (p. 15).
  - Reports on compliance with the reform agreement are published on a regular basis (p. 15).
  - In the event of "significant" economic or political changes, the reform contract can be renegotiated (p. 15).
– The coordination of economic policies in the field of taxation and employment is to be enhanced (p. 5).

► **"Budgetary Framework"**

– Possible spill-over effects between euro area countries require a "budgetary framework" which ensures sound national budgetary policies and a greater "resilience" to economic shocks (p. 8).
– The EU is to establish an "insurance" between euro area countries to buffer country-specific "economic shocks" (p. 9).
– The "insurance" automatically pays transfers to a euro area country if
  - it has complied with its commitments under the reform arrangements (p. 10) and
  - there has been a "shock of a sufficient magnitude" (p. 11); this is the case where "thresholds" are exceeded which can be defined by way of
    - fluctuations in cyclical revenue and expenditure items or
    - "measures of economic activity" or
    - the trend in unemployment; in this case, transfers for newly unemployed people may be paid for a limited period.
– In order to finance the "insurance" a "fiscal capacity" is to be created which would be fed from national funds, the EU's own funds or a combination of both (p. 12).
– The question of whether the "fiscal capacity" would be able to borrow or issue debt in order to stabilise the economic cycle is to be examined (p. 12). In this case it would have to be clarified whether the fiscal capacity would have to show a balanced budget for the period.

Policy Context

On 28/29 June 2012, the European Council called on the four Presidents of the Council, Commission, Eurogroup and ECB, to draw up a "specific roadmap" in order to realise a "genuine" EMU. After publishing an interim report on 12 October 2012, Council President Van Rompuy presented this final report to the European Council on 13/14 December 2012. The heads of state agreed to put the proposal into more concrete terms in the European Council in June 2013.
On 20 March 2013, the Commission passed two communications on the next steps towards a genuine EMU. Communication COM(2013) 165 contains options and questions about binding reform agreements and on financial support for the reforms. In Communication COM(2013) 166 the ex-ante coordination of major economic policy reforms is discussed. The Commission intends to submit legislative proposals during the course of 2013.

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ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

"Financial Framework"

As envisaged necessary are stricter capital requirements for banks (see cep**PolicyBrief**) and a European banking supervision. The European banking supervision should not be carried out by the ECB in order to avoid jeopardising its monetary policy independence (Details in: cep**PolicyBriefs**).

It is absolutely imperative that financial institutions be obliged to back sovereign bonds with equity. This could significantly reduce the cost of a "hair-cut" and help to prevent developments like those seen in Greece where the hair-cut triggered a banking crisis. **This has apparently not been envisaged, even for the "genuine" EMU.**

The direct recapitalisation of banks by the ESM is only acceptable as a temporary solution. It takes place at the expense of the tax-payers of other euro area Member States and may cancel out the necessary incentive adjustment connected with the bail-in proposals (Details in: cep**PolicyBrief**).

Credible insolvency and resolution regulations for banks are essential. Without them, countries may be forced to keep system-relevant banks alive, at the expense of the taxpayer, in order to avoid their insolvency threatening other banks thus destabilizing the entire financial system (Details in: cep**PolicyBriefs**).

"Economic Policy Framework"

The main reasons for the crisis in the euro countries concerned are inflexible labour markets and high unit labour costs. The lack of willingness to reform in these countries cannot be overcome by way of the proposed systematic ex-ante coordination of major reforms. In the best case, measures which reduce competitiveness – such as the reduction of the retirement age or increase in the minimum wage – may be prevented. Even this is doubtful, however, because the other euro countries have no rights to intervene but can, at best, only apply group pressure which becomes more unlikely the more countries there are who are in need of reform.

In addition, it is unclear who decides which reforms are to be coordinated ex ante. If the respective euro country is able to determine this, it will only propose the coordination of reforms which it considers to be unproblematic. The Commission should therefore decide which reforms must be coordinated ex ante. Furthermore, there is a danger that competitive countries will be called upon to support reforms in the weak countries by reducing their competitive strength.

A compulsory reform agreement increases the level of commitment of reform undertakings. The fact that agreements are to be prepared on the basis of the country-specific recommendations of the Commission – rather than the Council – is appropriate. **The Commission cannot**, however, **force the euro countries to commit to making specific reforms. The fear is, therefore, that only those reforms will be included in the reform agreement which the contracting euro country would have carried out in any case.**

Financial transfers to support reforms and as a "reward" may provide an incentive for structural reforms whose positive effects will only appear in the medium to long term but which in the short term will have high political or fiscal costs. The failure to undertake such reforms may lead to a country having to apply for financial aid which can result in high costs in other euro countries. Since the Eurogroup cannot force individual countries to undertake specific reforms prior to applying for financial aid, financial transfers may help to ensure that reforms are nevertheless undertaken. This advantage is however accompanied by a significant disadvantage: financial transfers to support reforms **harbour the risk of a windfall gain.** This can even go as far as the situation where a euro country does not undertake the reforms until transfers are promised to it in return. **Since willingness to reform** in many euro countries **is currently in decline, merely discussing such a transfer system may be harmful.**

"Budgetary Framework"

The planned "insurance" of euro countries to buffer country-specific **economic shocks increases the incentive for these countries to intentionally refrain from undertaking painful reforms aimed at increasing their shock absorption capability**, because they are being released from part of the burden in the event of a shock. And this problem will not be solved by the fact that only those euro countries who meet their reform commitments will receive money, because, firstly it is doubtful that reform agreements will actually contain important reforms and, secondly, there is a danger that the political pressure in the case of a shock will be so great that even those euro countries who have not met their commitments will receive transfers. Greece is still receiving financial aid although it is not implementing the agreed reforms.

Transfers on the basis of the trend in short-term unemployment can result in countries with high levels of long-term structural unemployment having to pay money to countries with lower unemployment which is however increasing in the short term. Politically this is difficult to convey.

Legal Assessment

Cf. cepPolicy Briefs on the legal assessment of capital requirements (see cep**PolicyBriefs**), banking supervision (see cep**PolicyBriefs**), deposit guarantee schemes (see cep**PolicyBrief**) and bank recovery and resolution (see cep**PolicyBriefs**).

Legislative Competence

As in the case of the bank resolution Directive, the creation of a single resolution mechanism can be based on the internal market competence (Art. 114 TFEU).

The EU is competent for the ex-ante coordination of economic reforms: it can coordinate, monitor and assess the economic policy of all Member States (Art. 121 TFEU). It can also issue measures which are only applicable to the euro countries in order to strengthen coordination and monitoring of budgetary discipline (Art. 136 (1) TFEU).

The conclusion of reform agreements between the Member States and the organs of the EU comes under the coordination and monitoring of economic policy (Art. 121 and Art. 136 (1) TFEU). **Financial transfers to support economic policy reforms,** however, go beyond the coordination and monitoring of economic policy and are not therefore covered by this. They **can at best be based on the flexibility clause** (Art. 352 TFEU). This states that the EU can act if it is necessary in order to realise the aims of the EU treaties – which includes the establishment of an economic and monetary union (Art. 3 (4) TEU). **For this,** however, **unanimous agreement of the Council is required.**

The "insurance" to cushion against shocks, which are intended to minimise the consequences for the euro country affected, goes beyond the monitoring and coordination competence (Art. 136 TFEU) and **can** therefore **at best be based on the flexibility clause** (Art. 352 TFEU).

Subsidiarity

In principle, a "genuine" EMU can only be realised at EU level. Compliance with the principle of subsidiarity depends, however, on the exact form of the measures.

Proportionality

Depends on the exact form of the measures.

Compatibility with EU law

The ESM is based on an international law treaty between the euro countries. The ESM Treaty has so far only allowed the recapitalisation of countries. In order to be able to recapitalise banks directly, the purpose and principles of the ESM Treaty would have to be changed (Art. 3 and Art. 12 ESM Treaty).

Compatibility with German law

In the event that national funds are used to finance the "fiscal capacity", the level of the German contribution must be limited and foreseeable because the budgetary responsibility of the German Bundestag cannot be "assigned to other players by way of vague budgetary authorisations" (Federal Constitutional Court - Bundesverfassungsgericht (BVerfG) "Euro-Rettung", Case No. 2 BvR 987/10 inter alia, par. 125). Permanent "mechanisms", which amount to the acceptance of liability for the decisions of other countries, are unlawful, especially where they involve consequences which are difficult to calculate (cf. BVerfG "Euro-Rettung", Case No. 2 BvR 987/10 inter alia, par. 128).

Conclusion

It is imperative that the "Financial Framework" should include a requirement for banks to back sovereign bonds with equity; this is not envisaged however. The direct recapitalisation of banks by the ESM is only acceptable as a temporary solution; the tax-payers of other euro area Member States bear the cost. The fear is that the compulsory reform agreement, which is to be part of the "economic policy framework", will only include those reforms which the contracting euro country would have carried out in any case, because the Commission cannot force the euro countries to commit to making specific reforms. The planned insurance of euro countries to buffer country-specific economic shocks, which is to be part of the "budgetary framework", increases the incentive for these countries to intentionally refrain from undertaking painful reforms aimed at increasing their shock absorption capability. Financial transfers to support economic reforms and the "insurance" to cushion against shocks, can at best be based on the flexibility clause (Art. 352 TFEU) which requires unanimity in the Council.

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