For a stronger European economic governance
The view of European banks

The European Banking Federation strongly supports the efforts of the European Commission, European Parliament, the Council and the EU national governments to strengthen EU economic governance. The adoption of the Package of Six legislative proposals will mark a new phase of economic coordination in the Economic and Monetary Union and a shift towards a path of higher economic and financial stability.

A year’s work in the direction of improving economic governance in the European Union has already yielded a number of positive outcomes. The framework of the EU-2020 Strategy provides national EU governments with a sense of direction, while the European Semester of policy coordination helps line up each EU Member State’s country-specific annual objectives as confirmed by the Commission and the Council. Should an EU Member State deviate from the set course of action, they become subject to the enhanced Stability and Growth Pact rules as described in the recently approved so called “six-pack” Legislative proposals. In case an EU Member State faces a serious liquidity or solvency situation, it will be able to turn to the European Stability Mechanism for financial support and an economic stabilisation and consolidation programme (see Background Note in enclosure for more detail).

Greater economic coordination, if respected and fulfilled in a timely fashion by all parties involved, will help bring about greater economic stability and alignment across the economic policies implemented at national levels, thus contributing to a favourable environment for banks in the EU to conduct their primary role of financial intermediation between lenders and borrowers.

The turbulence experienced in public finances over the past 18 months affects the stability of those banks exposed to the risk of national sovereign debt. In practical terms, owing to the fact that government bonds are (normally) treated as the safest possible investment in the bank funding structure, a number of banks exposed to government debt face a direct risk of undermining their liquidity positions and of downgrading their liquid assets.

This in turn may put under stress the financial system of the country itself, increasing the cost of funding for banks. As the main lender to the economy, and a sector tightly linked to the well-being of the rest of the economy, the banking sector advocates sound fiscal policies and enhanced economic stability. Banks themselves have also taken a path of stronger financial stability by cleaning their balance sheets and strengthening their capital base, in anticipation of the new regulation on capital and liquidity requirements for banks.

Measures of the enhanced Stability and Growth Pact currently under discussion would put in place a framework of rules and incentives that should help avoid such destabilising situations in
the future. However, to be successful, these measures should be adopted in a timely and responsible manner, and supported by a complete and all-encompassing commitment from all EU Member States.

This is why the EBF calls on the EU Member States to take the responsibility of finalising and adopting the Legislative Package, and of enforcing it in a timely and coordinated manner, thus contributing to the economic stability and prosperity of the EU and therefore the rest of the world.

*For information:*

*Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.*
Background Note

Ever since the beginning of 2010, the European Union has been undergoing a major overhaul in its economic governance. The need for such a reform was apparent, but it is the severity of the current economic crisis that has pushed the authorities to take a series of steps to reform the EU economic governance framework. Indeed, the EU foundations have created a dichotomous situation for the euro area countries. On the one hand, since 1999 the common monetary policy of the euro area has been exercised and governed by the European Central Bank, i.e. an EU level body, based on the European System of Central Banks (ESCB). On the other hand, the fiscal policy remains a national level matter, bound only by the commitment to the Stability and Growth Pact. While clearly spelling out the rules of budgetary discipline, the Pact foresaw no mechanism for automatic sanctions for countries disrespecting them.

Underlying Structural Weaknesses

The dichotomy arising from the leadership at EU-level of the monetary policy, and the handling at national-level of fiscal policy, in the absence of a strong and clear EU-level economic programme, meant that a number of governments of the EU countries let themselves be led by the winds of national political cycles, and set short-term economic priorities instead of sustainable, long-term economic growth programmes. Inevitably, the Stability and Growth Pact (SGP) came under fire a while before the crisis, because some larger euro area members (notably, France and Germany) ignored the SGP rules on more than one occasion. And as no sanctions were applied to curb such behaviour, a negative precedent was set.

This negative spiral continued to damage the situation, until the financial crisis (an external shock to the economies) laid bare the underlying structural weaknesses of the euro area economies and growing economic imbalances.

Chart 1: Fiscal deficit in euro area countries, % of GDP

![Chart 1: Fiscal deficit in euro area countries, % of GDP](chart1.png)
In the midst of the financial and economic crisis, the ECB made its monetary policy stance more accommodative by reducing the main official refinancing interest rate from over 4% to 1% within a year’s time, in order to facilitate financial activity in the euro area. Subsequently, it launched a series of non-standard liquidity-enhancing measures. At the time of writing, the non-standard liquidity enhancing measures are still in place, and, given the gradual improvement of economic conditions and rising inflationary expectations, the official interest rate has been hiked to a level of 1.50%. Nevertheless, in the midst of the crisis, these measures were insufficient for banks to continue their business-as-usual, which is why the EU governments extended a significant amount of State aid to the banking sector thus helping to maintain the EU banking sector’s solvency, and limit the spill-over effects to the real sector. Each government’s measures were tailored differently, but the goal was the same: to prevent the financial markets, and consequently entire economies, from grinding to a halt.

The shaken EU financial systems and the compromised fiscal positions of some governments became the ultimate litmus test for economic sustainability of individual euro area countries. The first country to turn for external funding was Greece (reason: growing budget deficit and state debt combined with falsification of government budget statistics), followed by Ireland (reason: poor banking supervision leading to significant errors of judgment of sustainability of some systemic banks, making government deficit explode), and finally Portugal (reason: unsustainable debt and poor implementation of structural reform). Continuing sovereign debt crises in the euro area have been sending waves of unrest into the financial markets, pushing the 10-year government bond spreads very high, making it even more costly for the troubled governments to meet their debt obligations.
As the sovereign debt crisis in the euro area was unfolding, the EU authorities showed an unprecedented display of solidarity by establishing a (temporary) mechanism for stabilising troubled governments: the European Financial Stability Facility. The EFSF was the first step towards bridging the gap in the EU architecture.

**European Stability Mechanism**

The EFSF, a fund of a total of €750 billion, currently operates within the framework of the European Financial Stability Mechanism (EFSM) until mid-2013. Thereafter, the task will be taken over by a permanent solution: the European Stability Mechanism (ESM). The evaluation of the functioning of this mechanism will be undertaken by the European Commission, with the assistance of the ECB, after three years of its operation, in 2016 (see Box 1 on page 7 for more details on the ESM).

The ESM was designed only for the euro area Member States; however, in March 2011, the non-euro area Member States of Bulgaria, Romania, Poland, Latvia, Lithuania and Denmark signed the *Euro Plus Pact*, thus committing themselves to economic policy coordination, in return for gaining access to the ESM in case of need.

**Strengthened EU Economic Governance**

Aside from creating the mechanisms to deal with the crisis, the Commission had also been working on a system which would help prevent such crises from occurring in the first place. As a result, in the summer of 2010, the EU leaders launched a Task Force to reform both the EU and the euro area’s economic governance. This Task Force (TF) comprised the Finance Ministers from the 27 EU Member States, chaired by European Council President, Herman Van Rompuy. In September 2010, a special EU summit debated the final report of the Van Rompuy TF and fleshed out decisions on a mechanism of early warnings and gradual sanctions aimed at deterring errant governments from letting control over their public debt or deficits slip.

On 29 September 2010, the Commission introduced a package of six legislative proposals aiming to strengthen the Stability and Growth Pact and to introduce sanctions, which would become a normal consequence for countries in breach of commitments. (See Box 2 on page 8 for more details on the six legislative proposals).
These six legislative proposals are being debated by the Parliament and the Council and are to be agreed upon under the Polish EU Presidency. The details may yet change, but the core principles of strengthening the Stability and Growth Pact, as well as economic policy coordination at the EU level, should remain.

**Economic Policy Coordination**

These regulatory changes go in step with the European Semester of policy coordination (scheme), a concept for national budgetary surveillance at EU-level, before governments adopt national budgets and economic reform programmes. In March of each year, the European Council will set economic policy priorities on the basis of a Commission’s Annual Growth Survey. This report would provide the foundation for recommendations on budget and economic policies. In April, Member States will present draft budgetary plans to the Commission for analysis and comments, and by early July, the Commission will present an analysis of the draft budgets and may possibly suggest “country-specific policy guidance”. Further to that, in the second half of the year, national budgets will be finalised and brought back to the national parliaments for adoption.

This new procedure has been implemented in all EU countries since 2011, but surveillance is tighter for the euro area countries, where such a review mechanism acts as an early-warning system for states found to breach the Stability and Growth Pact, the latter setting a limit on public debt (60% of GDP) and budget deficits (3% of GDP).

While not impinging on the sovereignty of the EU Member States, it tightens up the economic policy coordination. This coordination is taking place in the broad framework of the EU-2020 Strategy for growth and jobs. This strategy outlines five targets to be achieved by 2020, as follows:

1. **Employment**: by 2020, three quarters of the 20-64 year-olds in the EU must be employed.
2. **R&D / innovation**: by 2020, 3% of the EU’s GDP (public and private combined) to be invested in R&D / innovation.
3. **Climate change / energy**: by 2020, greenhouse gas emissions to be 20% (or even 30%, if the conditions are right) lower than in 1990; 20% of energy must come from renewable energy sources; and energy efficiency must increase by 20%.
4. **Education**: by 2020, school drop-out rates must fall to below 10%; and at least 40% of 30-34-year-olds must be completing third-level education.
5. **Poverty / social exclusion**: by 2020, there should be at least 20 million fewer people in or at-risk of poverty and social exclusion.

(See Box 3 on page 9 for more detail on the EU-2020 Strategy)
Box 1: The ESM

Under this mechanism, the European Commission will contract borrowings on the capital markets or with financial institutions, up to a legally binding ceiling of € 60 billion, on behalf of the European Union (based on the Balance of Payments’ facility principle). This lending arrangement implies that there is no debt-servicing cost for the European Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission. In addition, the Mechanism envisages possible financial assistance to a euro area Member State via a special purpose vehicle (SPV), which will be established by intergovernmental agreement among all euro area Member States, which will guarantee, on a pro-rata basis, lending up to € 440 billion. This implies a maximum lending capacity of € 500 billion, with the total subscribed capital to the ESM being € 700 billion (from which € 80bn will be in the form of paid-in capital and € 620bn in a combination of committed callable capital and of guarantees from euro area Member States).

Setting up the ESM requires an amendment to The Treaty on the Functioning of the EU (Article 136).

The EU Member States seeking financial assistance under the ESM will present their case to the European Commission and the European Central Bank. The assistance will only be provided if the Member State commits itself to implementing a strict economic and fiscal adjustment programme. The Commission will then address the Council, who will adopt by qualified majority voting, the decision to extend the financial assistance to the Member State in need.

The ESM will distinguish between liquidity and solvency crises, based on a debt sustainability analysis (DSA) conducted by the European Commission and the IMF, in liaison with the ECB. In case of a liquidity problem, ESM support will be provided, conditional upon an adjustment programme, and private creditors will be encouraged to maintain their exposure. Should a country be diagnosed as insolvent, the Member State will have to negotiate a comprehensive plan with its private creditors, and liquidity assistance - under the ESM - may be provided. Private sector involvement is to be decided on a case-by-case basis; and in the unlikely case of insolvency, Collective Action Clauses (CACs), a simple tool to facilitate the discussion between a debtor and its creditors, will be implemented. CACs will be included in the terms and conditions of all new euro area sovereign bonds starting in June 2013; standardised and identical for all countries, providing the legal basis for the negotiation process with creditors. CACs will be consistent with those common under UK and US law after the G10 report on CACs. They will include aggregation clauses allowing all new debt securities issued by a Member State after 2013 to be considered together in negotiations.
### Box 2: The Six Legislative Proposals

1. **Legislative underpinning for the preventive part of the SGP:** to ensure that EU Member States follow prudent fiscal policies in good times to build up the necessary buffer for bad times, thereby ensuring convergence towards the Medium-Term Objective. Should a euro area Member State significantly deviate from prudent fiscal policy, the Commission may issue a warning.

2. **Legislative underpinning for the corrective part of the SGP:** to avoid gross errors in budgetary policies. Debt developments are to be followed more closely and put on an equal footing with deficit developments as regards decisions linked to the excessive deficit procedure. Member States whose debt exceeds 60% of GDP should take steps to reduce it at a satisfactory pace, defined as a reduction of $\frac{1}{20}$ of the difference with the 60% threshold over the last three years.

3. **Enforcement of budgetary surveillance:** a new set of gradual financial sanctions for euro-area Member States. As to the **preventive part**, an interest-bearing deposit should result in consequence of significant deviations from prudent fiscal policy making. In the **corrective part**, a non-interest bearing deposit amounting to 0.2% of GDP would apply upon a decision to place a country in the excessive deficit procedure. This would be converted into a fine in the event of non-compliance with the recommendation to correct the excessive deficit. To ensure enforcement, a "reverse voting mechanism" is envisaged when imposing these sanctions, i.e. the Commission's proposal for a sanction will be considered adopted unless the Council turns it down by qualified majority voting.

4. **Requirements for the budgetary framework:** EU Member States must reflect the objectives of the SGP in the national budgetary frameworks, i.e. the set of elements that form the basis of national fiscal governance (accounting systems, statistics, forecasting practices, fiscal rules, budgetary procedures and fiscal relations with other entities such as local or regional authorities).

5. **Prevention and correction of macroeconomic imbalances:** will take place with the help of the *Excessive Imbalance Procedure* (EIP), a new element of the EU's economic surveillance framework. It comprises a regular assessment of the risks of imbalances based on a scoreboard composed of economic indicators (*key indicators of the euro area*). On this basis, the Commission may launch in-depth reviews for Member States at risk that will identify the underlying problems. For Member States with severe imbalances or imbalances that put at risk the functioning of the EMU, the Council may adopt recommendations and open an "excessive imbalance procedure (EIP)". A Member State under EIP would have to present a corrective action plan that will be vetted by the Council, which will set a deadline for corrective action. Repeated failure to take corrective action will expose the euro area Member State concerned by the sanctions.

6. **Enforcement measures to correct excessive macroeconomic imbalances:** if a euro-area Member State repeatedly fails to act on Council EIP recommendations to address excessive imbalances, it will have to pay a yearly fine equal to 0.1% of its GDP. The fine can only be stopped by a qualified majority vote, with only euro area Member States voting.
**Box 3: The EU-2020 Strategy**

The five strategic targets give an overall view of where the EU should be on key parameters by 2020. They are being translated into national targets so that each Member State can check its own progress towards these goals. These goals do not imply burden-sharing; they are common goals, to be pursued through a mix of national and EU action, and are interrelated and mutually reinforcing.

To boost growth and jobs, the Commission identified **seven flagship initiatives**, whereby both the EU and national authorities have to coordinate their efforts so they are mutually reinforcing. The flagship initiatives focus on **smart, sustainable and inclusive growth**, and comprise:

- Digital agenda for Europe
- Innovation Union
- Youth on the move
- Resource efficient Europe
- An industrial policy for the globalisation era
- An agenda for new skills and jobs
- European platform against poverty

The Commission called upon the civil societies to share the responsibility for achieving the EU-2020 Strategy by means of **exchange of good practices, benchmarking and networking**, which will help create a sense of ownership and dynamism around the need for reform.