Regaining Control in the Euro Area – Speaking Points Supporting the Presentation

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Faults in the Architecture Exposed by Crisis

- Faults in the architecture of the euro area did not provide warning signals sufficiently in advance on the deep macroeconomic and structural imbalances that grew in many Member States magnifying the exposure to the crises and slowing the adjustment of the economy.
- Indeed, the crises exposed a number of important gaps in EMU's architecture:
- Both, the public and private sector accumulated too much risk in good times. For example, windfall government revenues were often not used to decrease public debt and macroeconomic imbalances – such as private sector debt, housing bubbles, and external debt – were allowed to grow unchecked. These developments highlighted the need to increase risk prevention.
- The crisis also underlined the risks of financial instability within the euro area. We witnessed contagion effects between fragile Member States, as well as between non-financial corporations, the financial sector and public finances, creating powerful negative feedback-loops. The need to improve crisis resolution was strongly underlined.

EU Response

- Important work to address these challenges has been done in the Member States as well as at the EU and the euro area level.
- The Commission developed extensive analysis, including three rounds a year of fully fledged forecast aiming at building up a shared analysis. It also filled the gaps in the surveillance framework with some key pieces of legislation.
- The so-called Sixpack, Twopack and Fiscal Compact provide broader surveillance, better prevention mechanisms, stronger enforcement and greater national ownership of the rules.

- In the area of budgetary surveillance. More attention is paid to the operationalization of the debt reduction rule, with the so called 1/20th reduction target. New sanctions were introduced that will be phased in more gradually. And reversed qualified majority voting in the Council was introduced. The twopack introduced the notion of ex-ante assessment of draft budgetary plans on which the Commission would make an opinion on planned budgets before they would be voted. In case of "particularly serious non-compliance with the budgetary policy obligations laid down in the Stability and Growth Pact", the Commission can now request for a new draft budgetary plan. And it can also issue autonomous recommendations in case there is a risk that countries will miss their fiscal targets. Moreover, national fiscal governance frameworks have been significantly strengthened by sixpack, twopack and fiscal compact which should ensure more sound national decision making processes. Most of the rules have only been recently introduced, but so far, the Commission's assessment is broadly positive.
- In the area of economic surveillance, the addition of the Macro-Economic Imbalances Procedure has significantly strengthened our surveillance toolbox. The Procedure allows for an early warning system of the build-up of macro-economic imbalances with a view of detecting so that remedial policy action can be taken to avoid the potential imbalance causing systemic damage and unwarranted social consequences. In this context, the European Commission prepares an in depth analysis where relevant and can propose preventive recommendation but can also suggest to the Council a more corrective approach. For euro area Member States, this corrective approach comes with a rigorous enforcement toolkit consisting on the possibility to send back corrective action plans or in case of (repeated) insufficient action sanctions.
- The emergency funds – EFSF, EFSM and ESM – provide liquidity under the conditions of an adjustment programme.
- The Banking Union has been launched
- The importance of these steps should not be underestimated. Significant progress has been made in a short amount of time to improve the architecture of the EMU and prevent future crisis. This has contributed to restore confidence and anchor stability.

Financial Support

Also on the financial support side, a lot has happened since the crisis. At the outset, only temporary firewalls existed that were limited in time. With the ESM, a permanent and sizeable firewall was erected with appropriate governance arrangements. As stipulated by the Twopack countries that require funding of the ESM are to adopt a macroeconomic adjustment programme and the associated intensive monitoring by the Commission, the ECB and the IMF.

- The different stability mechanisms show an unprecedented level of financial solidarity. Reform efforts by the programme countries are of a similar size, however. Policy conditionality in all countries focused on four broad areas: fiscal policy, financial sector repair, labour market reforms and product market reforms. Correcting internal and external imbalances proved more challenging than expected and had to take place in a more difficult global and euro area environment. But despite these heavy headwinds, disorderly default was avoided and time was bought to build firewalls and prevent further contagion. More recently, the macro and financial situation is gradually stabilising in the programme countries, market confidence is being restored and Ireland has exited its programme. Despite this positive news, the social and economic situation for these countries remains challenging.

Rationale for Banking Union

- In the financial sector the main challenge from an institutional perspective relates to the euro area's highly integrated financial system in the context of large banking sector vulnerabilities and limited national fiscal space.
- A related problem is the fragmentation of the euro area's financial systems. Credit conditions have become highly divergent across the euro area, thus constraining recovery, especially in the more vulnerable economies, and impairing monetary transmission channels.
- Bank balance sheets need to be further strengthened in several Member States, and profit generation remains a challenge for many banks. The weak economic outlook and subdued corporate earnings, especially in countries under stress, imply asset quality deterioration and additional loan impairments.
- Specific efforts should also be made to restore credit flow to SMEs, which are the main driver of investment and employment in Europe and have been overly hit by financial fragmentation.

A Genuine Banking Union

- A genuine banking union would help break the vicious link between the sovereign and the banks.
- It is also critical to ensure financial stability, reverse the process of financial fragmentation and restore the flow of credit to the corporate sector.
- A critical step towards restoring the full functionality of the financial system is the repair of bank balance sheets. This requires both transparency regarding the current health of bank balance sheets and proper recapitalisation where needed.

- The asset quality review and stress tests, ahead of the agreed launch of the single supervisory authority, will be instrumental in this respect. Recapitalisation will have to be underpinned by appropriate backstops.
- Significant progress has already been made with the agreement on the Single Supervisory Mechanism.
- But a full Banking Union will also require a Single Resolution Mechanism with a resolution fund and a credible fiscal backstop.
- The Banking Union alone is not a panacea and while we are constructing the Banking Union, the policy debate does not stop. Following the Liikanen report, the Commission has launched a proposal on the banking structure. The proposal would stop the biggest and most complex banks from engaging in the risky activity of proprietary trading. The new rules would also give supervisors the power to require those banks to separate certain potentially risky trading activities from their deposit-taking business.
- Work undertaken by, for example the OECD, demonstrated that the banking structure of banks is an important element to address complementary to the Banking Union for example enhancing the efficiency of the resolution process.

Specific Initiatives on Small and Medium-sized Enterprises and Long-term Financing

- The new Multinational Financial Framework (MFF) 2014-20 also foresees a specific programme for SMEs: the "Programme for the Competitiveness of Enterprises and SMEs" (COSME) to strengthen the competitiveness and sustainability of the Union's enterprises.
- In addition, the research arm of the MFF has specific instruments for SMEs: SMEs are encouraged to participate across the whole Horizon 2020 programme. They can engage in collaborative projects as part of a consortium and they are supported through a new dedicated SME instrument designed specifically for highly innovative smaller companies.
- A capital increase of EUR 10 billion was agreed for the European Investment Bank. The capital increase would target four focal areas for additional EIB action and would provide up to EUR 60 billion of additional financing over a 3–4 years period – additional to the EIBs current lending volume of EUR 50 billion a year. $1/4^{th}$ of the additional loans are earmarked for SMEs.
- The EU-EIB SMEs Initiative is designed to complement actions already prepared at EU level by combining resources of EU level financial instruments (more specifically COSME and Horizon 2020) with EIB/EIF own resource and European Structural and Investment Funds (ESI funds).
- The planned capital increase of the European Investment Fund (EIF) will provide a boost to the EIF based on two pillars: firstly, a capital increase of EUR

1.5 billion subscribed capital, including a cash contribution of EUR 560 million; and secondly, a mandate through which the EIB will make available up to EUR 4 billion in support of additional guarantees to be issued by the EIF over the next 7 years.
- The Greek Presidency has announced that it will take up this issue in the informal ECOFIN in Athens based on the follow-up communication on the green paper on long-term financing of the Economy foreseen for March, also discussing the report of the high level expert group on SME and infrastructure financing which was published in January.

Remaining Challenges in the Three other Building Blocks

- Despite the major governance overhaul strengthening fiscal governance, strengthening the preventive surveillance of imbalances and preventing contagion with the stability funds, Banking Union will not suffice and work should proceed on the three other essential building blocks of EMU.
- The urgency of the crisis and time pressures have prevented the euro area so far from moving from the consideration of country-specific recommendations to the consideration of policy measures and reforms that are needed for the well-functioning of the common currency as a whole.
- National policy making is being changed by Europe's new economic governance. There is a need for national processes to take active account of these developments, including stepping up interactions with the European level. In many Member States, there is a need for greater involvement of national parliaments, social partners and civil society in the process in order to increase ownership and improve the track record on the implementation of country specific recommendations. To address these problems the Commission proposed the contractual arrangement and ex-ante coordination in its Blueprint for a Deep and Genuine EMU.
- In general, monetary policy is an effective tool to deal with symmetric shocks. However, adjustment to asymmetric shocks can on the other hand be difficult, which is what we see currently. Adjustment to assymetric shocks requires deep reforms leading to greater flexibility and can be supported by other adjustment mechanisms. Given the size of shocks and their capacity to freeze up markets a role for a zone-wide insurance mechanism seems justified. Fiscal integration can be that mechanism, providing an ex ante framework for enforced fiscal discipline and temporary transfers and hence for more certainty that shocks will be contained. In this area, the Blueprint launched the discussion on having Eurobills and a redemption fund but also on a fiscal capacity for the euro area.
- A genuine EMU involves further transfers of sovereignty to the European level, which must be accompanied by steps ensuring strengthened democratic legitimacy, accountability and scrutiny.