The EU’s Reformed Institutional Framework and the Way Forward

This article focuses on measures taken in 2012 and 2013 to reform the EU’s institutional framework. These measures, which were largely based on provisions included in the Treaty of Lisbon, have increased the role of the European Parliament and of the national parliaments. Stronger parliamentary involvement and interinstitutional agreements on democratic accountability seem to counter the theory of a lack of democratic legitimacy; legitimacy would appear to be jeopardized more severely by an emerging “social deficit.” At the same time, governance has become more complex, as the Community method of decision making was mixed with intergovernmental decision making in crisis management and prevention measures, and as variable membership patterns have evolved. By establishing the European Stability Mechanism (ESM) for euro area countries and a facility for providing balance of payments assistance to non-euro area countries, the EU has set up permanent financial crisis management mechanisms. Fiscal governance reforms replicate the precrisis structure, and – as before – success depends on the commitment of Member States to implement reform measures. With more detailed reporting requirements and more ambitious timelines in the European Semester, economic governance has become more extensive. Yet European and Monetary Union (EMU) remains incomplete: By establishing a banking union, the EU Member States have transferred national sovereignty to the supranational level, but the reforms stop short of a fiscal union, for which the Treaty of Lisbon would need to be changed.

JEL classification: F15, F55, K0, N24, N44, O52
Keywords: EU economic governance reform, EMU, sixpack, twopack, fiscal compact, TSCG, banking union, SSM, SRM, SRF, European Stability Mechanism (ESM), outright monetary transactions (OMT), intergovernmental agreements

The financial crisis has demonstrated that reforming the EU’s institutional framework is in the interest of the European Union as a whole, but first and foremost, it is in the interest of the euro area Member States. In the past few years, a vast number of economic and financial reforms have been agreed by the European Commission, the EU Council of Ministers and the European Parliament as well as national parliaments. While the principal conditions governing Economic and Monetary Union (EMU) as laid down in the Maastricht Treaty remained unchanged, governance reforms have stretched the EU’s legal framework and its institutional architecture to the limit. The reforms aimed at managing the crisis and preventing future crises, reflecting lessons learned. At the time of writing (March 2014), Ireland had exited its adjustment program without further European support, sovereign financing conditions were easing, and the growth outlook for the euro area was more benign; hence, internal and external crisis pressures were starting to fade. The future will show whether and how Members States will implement changes in the Treaty of Lisbon – like the ones outlined in the blueprint for genuine EMU (Van Rompuy, 2012).

This article provides an update and a tentative evaluation of EU and euro area reforms introduced mainly in 2012.
and 2013\(^3\) with regard to crisis management, i.e. stabilization mechanisms, and crisis prevention, i.e. stricter rules applying to economic and fiscal policymaking, and creating the new EU financial supervisory architecture. To complete the picture, we also address the nonstandard policy measures with which the ECB – which was granted the status of an EU institution by the Treaty of Lisbon – responded to crisis to strengthen the financial stability of euro area Member States. The institutional section highlights the role of intergovernmental decision making versus Community method decision making in the reform process, explains which measures relate only to the euro area, and reviews the reforms from the perspective of accountability and democratic legitimacy as well as their impact on EU institutions. In its outlook section, the paper assesses possible issues for future changes of the Treaty, for instance fiscal union.

1 Reform of the EU’s Institutional Framework

The present (economic) governance structure of the EU has been established through several consecutive European Treaties and represents a set of compromises with regard to the principle of subsidiarity,\(^4\) the distribution of competences among EU institutions and Member States, and the application of special rules for the euro area. From an institutional point of view, the ongoing economic and financial reform process has led to more complex and differentiated decision-shaping and decision-making (see table 1).

The Community method\(^5\) of decision making, while ensuring fair treatment of all EU Member States, is quite time-consuming, so some of the recent governance reforms were established through much quicker intergovernmental decision making outside the traditional legislative framework of the EU (Gloggnitzer and Lindner, 2011). With hindsight, intergovernmental treaties were only employed in the cases of the Treaty on Stability, Coordination and Governance (TSCG), the European Stability Mechanism (ESM) and for the Single Resolution Fund (SRF). Using intergovernmental decision making was a precondition for the ESM, as the ESM is funded with euro area Member States’ money rather than with the EU’s own resources. Only ex post was the ESM linked to the Treaty by introducing Article 136.3 TFEU.

The unanimity requirement makes far-reaching alterations of the Treaty of Lisbon very difficult. Out of necessity, therefore, the Treaty provisions had to form a sufficient basis for all major institutional reforms. In the case of the banking union, it was challenging to find an adequate legal basis for the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Ultimately, Article 127.6 TFEU\(^6\) was invoked to provide the legal basis for conferring specific tasks in banking supervision upon the ECB, thus leading to a transfer of national sovereignty to the supranational level. Article 114 TFEU was invoked as the legal basis for the SRF, but this choice was highly con-

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\(^3\) This article serves as an update of the special issue of Monetary Policy & the Economy Q4/11 on economic governance. See inter alia Gloggnitzer and Lindner (2011).

\(^4\) Article 5 TEU distributes competences between the EU and its Member States.

\(^5\) EU legislation is initiated by a European Commission proposal negotiated by the Council of Ministers, with co-decision by the European Parliament.

\(^6\) At an informal meeting in April 2013, the Ecofin agreed to work constructively on a proposal to change the Treaty and agreed that the ECB regulation should be appropriately adjusted, if necessary, in the event that Article 127.6 TFEU is amended.
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Controversial. Germany, for instance, would have preferred to base the SRM on Article 352 TFEU, which requires unanimity. According to the EU Legal Services (Council of the EU, 2013b), Article 114 TFEU may be a suitable legal basis as long as the SRM responds to a genuine need for uniform application of the rules on resolution that could not be achieved through other methods of harmonization and as long as the budgetary sovereignty of Member States is safeguarded.

Very often the increased leadership function of the European Council is deplored as lacking democratic legitimacy. A more detailed analysis shows that there are different interpretations

<table>
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<th>Economic Governance: Decision Making and Variable Membership</th>
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<td><strong>Community method</strong></td>
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<td>European Stability Mechanism (ESM)</td>
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<td>“Sixpack” of 5 regulations and 1 directive</td>
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<td><strong>Banking union – crisis prevention</strong></td>
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<td>Single Supervisory Mechanism (SSM)</td>
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<td>Single Resolution Mechanism (SRM)</td>
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<td>Single Resolution Fund (SRF)</td>
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<td>Deposit guarantee schemes</td>
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<td>Bank resolution and recovery directive</td>
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Source: Authors’ compilation.
of democratic legitimacy and accountability. Indeed, Pech (2011) points out that those who argue that the system is not democratic can be considered to fail to grasp that the EU’s institutional framework is remarkably consensus-oriented in its design and that most decisions are based on the Treaty of Lisbon. According to De Schoutheete (2012), the European Union is more Community-based than ever. The euro area Member States today accept Community control of their budget and their economic policy based on an intergovernmental agreement like the TSCG. Maybe the true debate today is not between the Community method and intergovernmental decision making, but rather between governance and government.

In the course of the crisis, the European Commission – the Community institution par excellence – acquired more responsibilities, e.g. in fiscal surveillance and monitoring. The European Parliament (2013a) stated that the Commission’s increased power had to be limited and monitored by Member States as well as the European Parliament in order to ensure accountability and democratic legitimacy. Indeed, according to the European Council (European Council, 2012), the role of parliaments is to be strengthened: Any further integration of policymaking and pooling of competences at the EU level must be accompanied by a commensurate involvement of the European Parliament. Member States have to ensure the appropriate involvement of their parliaments in the integration of fiscal and economic policy frameworks. In Germany and Austria, for instance, national parliaments have to be involved in decisions to grant ESM loans. A further example is the interinstitutional agreement between the European Parliament and the ECB (European Parliament, 2013d) that provides for the exercise of democratic accountability within the SSM. The obligations for the European Parliament to keep information confidential will remain binding even after the termination of the agreement.

Financial and economic spillover effects of the crisis countries fueled the need for more cooperation within the euro area. As a consequence, the differentiation between euro area Member States and non-euro area Member States became more pronounced – not only in crisis resolution, but also in future crisis prevention. The European Council of October 26, 2011, took note of a new governance structure for the euro area. Euro summits, i.e. meetings of heads of state or government of the euro area countries, were to provide strategic orientation in crisis resolution. During the past two years, euro summit topics have included funding of peripheral countries, setting up the ESM, and bank recapitalization. Compared with four euro summits in 2011, just one such summit was organized in 2013 (March). However, the regular meetings of the Eurogroup of finance ministers, including the European Commission and the ECB, are still at the core of euro area crisis management.

In fiscal governance reform, the sixpack and twopack framework also laid down different rules for euro area and non-euro area Member States, using Article 136 TFEU as the legal basis. This reflects the different intensity of fiscal reforms needed and potential spillover effects within the euro area. The sixpack strengthened euro area governance while increasing the gap between euro area and non-euro area countries (Pisani-Ferry et al., 2012).

For an overview of the new governance structure in the euro area, see chart 1 in Gloggnitzer and Lindner (2011).
Being at the core of the euro area, the ECB has gained in influence among the EU institutions. Centralized and efficient decision making by the Governing Council of the ECB allowed for a very active role in crisis response, i.e. extensive emergency support for the banking system and the announcement of outright monetary transactions (OMT). In its prospective role as a single supervisor, the ECB also gained new supranational powers in crisis prevention.

The banking union is generally open for non-euro area countries, which can “opt in.” This framework introduces a new form of variable membership already used for the TSCG, which will increasingly blur the line between euro area and non-euro area countries. While the EU Council stressed the importance of equal treatment of euro area and non-euro area SSM/SRM participants, the disincentives to join are heavy: Non-euro area Member States would have to have some form of access to backstops and would have to contribute to them. By joining the SSM, they accept the ECB as a supranational banking supervisor even if they do not share the currency.

2 Permanent EU Financing Mechanisms for Stabilization

Fiscal and macroeconomic imbalances and the high level of integration of European financial markets led to spillovers from individual countries to the euro area as a whole. International capital flows – first inflows, then sudden stops and outflows – even worsened contagion. Whereas the EU had an adequate facility in place even before the crisis for providing balance of payments assistance to non-euro area countries, it lacked a stabilization mechanism for euro area countries. Therefore, in the course of the crisis the euro area established temporary financial stabilization mechanisms for euro area countries, i.e. bilateral loans, the EFSF (European Financial Stability Facility), and the EFSM (European Financial Stabilisation Mechanism). Finally, the European Stability Mechanism (ESM) evolved as a permanent crisis management tool for euro area countries, alongside balance of payments assistance for non-euro area countries.

The Treaty establishing the ESM entered into force on September 27, 2012, and represented a decisive step toward permanent financial solidarity among euro area Member States (Gloggnitzer and Lindner, 2011). The purpose of the ESM is to provide financial support to euro area countries in crisis on the basis of strict conditionality. The Court of Justice of the European Union (2012) ruled that the tasks and functions of the ESM do not violate the no-bailout rule of Article 125 TFEU. To safeguard the financial stability of the euro area as a whole and of its member countries, the ESM, at present, offers five financial assistance instruments:

1. ESM precautionary financial assistance for ESM members with sound economic fundamentals in the form of (1) a precautionary conditions credit line (PCCL) or (2) an enhanced conditions credit line (ECCL).

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8 As of July 1, 2013, the European Financial Stability Facility (EFSF) is not allowed to make new loan agreements. Of the total lending volume of EUR 440 billion, EUR 188.30 billion have been lent to Ireland (EUR 17.7 billion), Portugal (EUR 26.0 billion) and Greece (EUR 144.6 billion).
9 For a detailed discussion of all financial stabilization mechanisms, see Nauschnigg and Schieder (2011).
10 The first meeting of the ESM Board of Governors, comprising the finance ministers of the euro area, took place on October 8, 2012, in Luxembourg.
2. Financial assistance for the recapitalization of financial institutions of an ESM member through loans to that ESM member, so-called indirect recapitalization.
3. ESM loans to ESM members experiencing severe financing problems and thereby putting the financial stability of the euro area at risk.
4. Primary market support facility: By purchasing bonds of an ESM member on primary markets, the ESM can, for example, support the exit strategy of that ESM member from an economic adjustment program.
5. Secondary market support facility: By purchasing bonds of an ESM member on secondary markets, the ESM can address contagion, should the analysis of the ECB recognize risks to financial market stability under exceptional financial market circumstances.

On request of an ESM member and after the assessment of the appropriate instrument, the ESM Board of Governors may decide to grant financial support on strict conditionality. This means ESM members first have to sign a Memorandum of Understanding (MoU) outlining an adjustment program to be implemented to ensure future economic and financial stability. Reviews of the agreed adjustment program will be conducted by the so-called Troika, consisting of the European Commission, the ECB and the IMF. In accordance with IMF practice in exceptional cases, an adequate and proportionate form of private sector involvement (“bail-in”) must be considered. The consideration of bail-ins is seen inter alia as a condition for financial markets to evaluate sovereign risk in a correct way. Furthermore, ESM members agreed to include standardized and identical collective action clauses (CACs) in all euro area government bonds issued after January 1, 2013. This is to ensure orderly sovereign debt restructuring.

The ESM’s overall lending capacity is EUR 500 billion, the authorized capital stock EUR 700 billion, comprising EUR 80 billion of paid-in capital and EUR 620 billion of committed callable capital. The ESM has preferred creditor status. On the funding side, the ESM issues capital market instruments and engages in money market transactions. So far, Spain has used ESM financial assistance to recapitalize financial institutions, and Cyprus has received an ESM loan. The remaining lending capacity of the ESM is EUR 449.7 billion (see also table 2).

With the ESM, the euro area has created a flexible and quite adaptable financial mechanism for crisis management. In June 2013, against the background of an emerging banking union (see section 5), the Eurogroup of Finance Ministers endorsed principles for a sixth financial assistance instrument, i.e. financial support for recapitalization going directly to banks. This constitutes a change in principle, as only sovereign states can so far be beneficiaries of ESM-supported programs. The main aim of this instrument is to avoid spillovers from financial market crises to sovereign debtors. The lending capacity of this instrument is intended to be limited to EUR 60 billion within the overall lending capacity of EUR 500 billion.

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11 In all EU country adjustment programs, the IMF also lent money, usually one-third of the whole amount. Without prejudice to its role as a lender, the IMF is seen as a neutral arbiter when negotiating an MoU among EU Member States.

12 Austria's contribution key to the ESM is 2.7824%; its subscription to the authorized capital stock is EUR 19.4 billion, which is the limit of its liability. Austria's share of paid-in capital is EUR 2.2 billion, to be fully paid in by the first half of 2014.
so as not to endanger the AAA rating of the ESM. However, before this backstop at the European level is available to banks, private investors have to be bailed in and national public financial resources have to be used for bailout, and the Single Supervisory Mechanism (SSM) has to be in operation.

The European Financial Stabilisation Mechanism (EFSM) was originally set up temporarily by the EU Council in May 2010 based on Article 122.2 TFEU, under which the economic and financial crisis is interpreted as an exceptional circumstance beyond the control of Member States. The European Commission was empowered to borrow up to EUR 60 billion on capital markets for euro area Member States with an implicit guarantee by the EU-28 budget. EUR 48.5 billion of the EFSM have been used for loans to Ireland and Portugal. At a meeting in May 2010, the Ecofin ministers agreed that the EFSM will stay in place as long as needed to safeguard financial stability.

The Danuta Hübner report suggests that the outstanding funding capacity in the EFSM could be transferred to the framework of balance of payments assistance (European Parliament, 2013c). However, there seems to be a political agreement with the U.K. to replace the EFSM by the ESM, so that there will be no U.K. liability for euro area member states in future (Thompson, 2011).

Under Article 143 TFEU, the European Commission is empowered to borrow funds of up to EUR 50 billion on behalf of the EU-28 to assist non-euro area Member States threatened with balance of payments difficulties. During the crisis, Romania, Hungary and Latvia received balance of payments assistance amounting to EUR 13.4 billion. To make the same financial assistance facilities available to non-euro area Member States as under the ESM, the European Commission proposed in 2012 to introduce corresponding precautionary and bank recapitalization instruments. Precautionary instruments have been available for non-euro area Member States since the revision of the existing regulation in 2013. Loans for directly recapitalizing financial institutions via the framework for balance of payments assistance have, however, been rejected by the Member States so far.

### Table 2

<table>
<thead>
<tr>
<th>Financial assistance mechanisms</th>
<th>Total lending volume</th>
<th>Financial assistance granted</th>
<th>Remaining lending volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFSF</td>
<td>440</td>
<td>188.30</td>
<td>(11.5)</td>
</tr>
<tr>
<td>EFSM</td>
<td>60</td>
<td>48.5</td>
<td></td>
</tr>
<tr>
<td>Bilateral loans</td>
<td>84.80</td>
<td>57.70</td>
<td>(11.5)</td>
</tr>
<tr>
<td>Balance of payments assistance</td>
<td>50</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>ESM</td>
<td>500</td>
<td>50.3</td>
<td>449.7</td>
</tr>
</tbody>
</table>

Source: Authors’ compilation (April 2, 2014).

1 Bilateral loans were granted to Greece (EUR 52.9 billion out of EUR 60 billion) and Ireland (EUR 4.8 billion).

3 ECB/Eurosystem: Outright Monetary Transactions

Although not directly related to the institutional reforms implemented by the EU, nonstandard monetary policy measures by the ECB played a significant role in European crisis management. The ECB had since the beginning of the crisis undertaken nonstandard monetary policy measures (i.e. extensive emergency liquidity support for euro area banks), all in line with the ECB’s primary objective of maintaining price stability, to sustain a functioning monetary policy transmission mechanism and the singleness of its monetary policy (Cour-Thimann and Winkler, 2013). However, in the course of 2012, investors had increasingly started to speculate on the reversibility of the euro, leading to severe tensions on euro area government...
bond markets. In order to address these tail risks, President Draghi announced in London on July 26, 2012 that “The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough” (ECB, 2012d).

In early August 2012 the Governing Council of the ECB announced that the euro area central banks may conduct outright monetary transactions in secondary markets for euro area government bonds – i.e. purchase (and sell) such bonds – without ex ante limits at the short end of the yield curve, but under certain conditions (ECB, 2012e). The OMT program is of (potentially) outstanding importance, in particular in terms of its stabilizing impact on crisis dynamics since 2012. Even if OMT is simply based on the use of existing instruments – and there was no need for any change in the institutional setup of the ECB for its introduction – it was received as a marked change or extension of monetary policy implementation by the ECB to tackle the crisis situation more effectively.

The OMT program was designed with particular care to comply with the prohibition of monetary financing laid down in Article 123 TFEU (ECB, 2012f). The underlying consideration is that price stability can only be guaranteed if the independence of the ECB is maintained. Thus, the purpose of OMTs is not to supplement or substitute government economic policy measures. To ensure that secondary market purchases of public debt instruments will not under any circumstances be used to circumvent the objectives of the prohibition on monetary financing, they can only be carried out subject to strict conditionality. Countries either have to take out a fully-fledged ESM macroeconomic adjustment loan or an Enhanced Conditions Credit Line, provided that they include the possibility of ESM primary market purchases (see section 2). Generally, Eurosystem intervention on government bond markets is strictly dependent on three conditions: First, the monetary policy transmission mechanism must be impaired; second, the euro area Member State in question must fulfill strict conditionality; and third, it must have market access or be in the process of regaining access. These conditions also require assessment by the ECB’s Governing Council. The announcement of OMTs on August 2, 2012, had the desired effect insofar as it increased the financial stability of the euro area at a time of a severe impairment of the monetary policy transmission mechanism. So far, the OMT program has not been used, but President Draghi reiterated in 2013 that it is ready to be activated, the conditions are known, and that it is as effective a backstop as ever.

4 Fiscal Policy Reform
4.1 Sixpack and Twopack

Before the crisis, the Stability and Growth Pact (SGP) had not provided...
sufficient incentives to correct fiscal imbalances, and it lacked rigorous implementation and commitment by EU Member States. Sanctions for noncompliance were never applied. The European Commission itself weakened the credibility of the SGP by ceding willingly to Member States’ demands for a soft interpretation of rules (Busch, 2013). Fiscal governance reforms undertaken after the crisis were aimed at addressing these problems but to a large extent replicated the precrisis structure (Mody, 2013) and its (dis)incentives. To strengthen the SGP, the European Parliament and the EU Council adopted a package of new fiscal rules that was more stringent for euro area Member States than for non-euro area Member States. This package consisted of five regulations and one directive (“six-pack”) which entered into force on December 13, 2011. Two additional regulations (“twopack”) designed to further enhance economic integration and convergence among euro area Member States and laying down clear rules for countries seeking EU financial help entered into force on May 30, 2013.

Fiscal governance reform introduced the following new elements:

1. To ensure long-term financial sustainability, an “expenditure benchmark” was introduced to help assess progress toward a country-specific medium-term objective (MTO) for budgetary balances. A quantitative definition of a “significant deviation” from the MTO, which had been missing so far, for the first time gives the EU the opportunity to set minimum requirements for budgetary frameworks.

2. According to Article 126.2 TFEU, the deficit and debt criteria should have equal importance in the excessive deficit procedure (EDP). However, in past surveillance procedures, the debt criterion was largely ignored, as quantitative criteria were missing. Following reform, an EDP can now be introduced if a Member State’s debt exceeds 60% of GDP and not just if the budget deficit is above 3% of GDP.

3. A minimum budgetary framework requires Member States to improve budgetary planning and execution. Euro area Member States have to adhere to tighter timelines than non-euro area Member States (see box 1). Given the crisis experience with malfunctioning national institutions, like budget authorities or debt agencies, this reflects a first attempt at institution-building at a national level.

4. The macroeconomic imbalance procedure (MIP) aims at identifying and addressing macroeconomic imbalances in EU Member States at an early stage and extends the Commission’s surveillance competences toward convergence and competitiveness. An annual Alert Mechanism Report based on a scoreboard of 11 macroeconomic indicators is used to identify potential external and internal imbalances. Thresholds of indicators signal that there might

17 In its third Alert Mechanism Report, the European Commission (November 2013) identified 16 Member States at risk of macroeconomic imbalances. For France and Italy, the European Commission will further assess the persistence of imbalances; for Germany and Luxembourg, the risk related to their respective external positions, which are in surplus.

18 The headline indicators consist of the following 11 indicators: current account balance, net international investment position, real effective exchange rate, export market shares, nominal unit labor cost, deflated house prices, private sector credit flow, unemployment rate, private sector debt (consolidated), general government sector debt, total financial sector liabilities.
be specific problems, which in turn trigger in-depth reviews of economic developments in Member States. Member States under an excessive imbalance procedure (EIP) are obliged to submit a corrective action plan setting out their national corrective policy measures.

5. To improve implementation, reverse qualified majority voting (RQMV) was introduced, for example for the adoption of EIP sanctions. RQMV implies that a recommendation or proposal of the European Commission is considered adopted by the EU Council unless a qualified majority of Member States votes against it.

6. Euro area countries are now subject to financial sanctions already under the preventive arm of the SGP and when experiencing excessive macroeconomic imbalances.

7. Euro area countries in serious financial difficulties are now subject to more stringent rules. If EMU financial stability is threatened, the EU Council (acting by qualified majority on a proposal from the European Commission) may recommend that a Member State seek financial assistance and prepare a macroeconomic adjustment program, and may take out a loan, e.g. from the ESM. Furthermore, such countries will be subject to post-program surveillance until they have paid back a minimum of 75% of the financial assistance received.

Like before the governance reform, the success of the new rules depends on effective implementation by Member States and national ownership. However, procedures and adherence to timelines have become more complex, and the number of reports to be drafted and submitted by Member States has increased. The European Semester, which was designed to improve implementa-

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**Euro Area Member States and the European Semester**

**Before April 30**

Euro area Member States submit their stability programs and national reform programs to enable the EU to monitor complementarities and spillover effects between fiscal and structural policies.

**May/June**

The European Commission and the EU Council assess the stability and national reform programs and issue country-specific recommendations referring to fiscal policies, structural reforms, employment and social aspects as well as financial market stability. If a Member State experiences macroeconomic imbalances, corresponding recommendations may be included as well.

**Before October 15**

Euro area Member States submit their draft budgetary plans for the following year to the European Commission and the Eurogroup for assessment. The European Commission can require a revised draft budgetary plan, but the sovereignty of household approval by national parliaments will not be compromised.

Euro area Member States subject to an EDP are also required to submit an economic partnership program, on which the EU Council adopts an Opinion.

Member States have to assess in detail which of their investments have the potential to create more growth and jobs, and their deficit reduction efforts have to stay flexible in economic downturns.

**By December 31**

Euro area Member States must have adopted their budgets for the following year.
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tion, provides first and foremost timelines for (ex ante) coordination of fiscal and structural policies (see box 1).

In 2013 the European Commission and EU Member States found it useful to interpret the new governance rules in such a way as to take into consideration the developments of the crisis. For example, at the end of 2013, 17 countries\(^9\) remained subject to an excessive deficit procedure, in different stages and with different deadlines for correction. In May 2013, for instance, the European Commission announced that it would extend by two years the deadline for France and Spain to correct their excessive deficits. In both cases, the European Commission took into consideration the worse-than-expected growth prospects and demanded that the correction be embedded in profound structural reforms at the national level. While Spain had a financial stability adjustment program, the Commission does not have means at its hands to enforce reforms in France. In the same vein, the Council (Council of the EU, 2013a) endorsed in November 2013 that the use of national public backstops for bank capital injections would benefit from a specific treatment under EDP rules.

Not least due to these developments, the ECB was most critical of the new fiscal governance provisions. While being an important step forward, the legislative packages adopted fall short of the “quantum leap” that the ECB’s Governing Council had advocated. In particular, the new framework still leaves considerable room to exercise discretion in executing fiscal and economic surveillance and enforcing compliance, which could seriously weaken the effectiveness of the reforms. Another critical issue in the eyes of the ECB is the symmetric approach to macroeconomic imbalance indicators. When analyzing imbalances in competitiveness or current accounts, the European Commission treats excessive deficits or surpluses in an equal way, i.e. both could be seen as potentially disruptive and fraught with spillover effects. Furthermore, the ECB suggests that the RQMV should be extended to the maximum possible to improve automaticity in decision making and to boost credibility. Financial sanctions should not be subject to being reduced or canceled on grounds of exceptional circumstances (ECB, 2011a and ECB, 2012a). At the other end of the opinion spectrum, the European Parliament was dissatisfied with the emphasis put on budget consolidation in the new provisions. Austerity alone was not delivering the desired results, so it cannot be the only response to the crisis (Pepper, 2013).

In its position as a co-decision maker, the European Parliament pressed for a broader focus than the one on fiscal discipline and requested the consideration of a social dimension of EMU.

4.2 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) or “Fiscal Compact”

Although the sixpack and the two-pack created a more stringent framework for economic and fiscal governance in the EU, in the eyes of some Member States, more and other measures were needed (ECB, 2012b). The reform efforts led to the intergovernmental Treaty on Stability, Coordination and Governance (TSCG) among 25 Member States – also called fiscal compact – which entered into force on January 1,

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\(^9\) Croatia, Malta, Denmark, Cyprus, Austria, Belgium, the Czech Republic, the Netherlands, Portugal, Slovenia, Slovakia, Poland, France, Ireland, Greece, Spain, United Kingdom (in reverse chronological order).
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The TSCG further promotes policy coordination and commits its members to growth through convergence and competitiveness. The Treaty, for instance, introduces ex ante coordination of major economic policy reforms, ex ante reporting of national debt issuance plans by Member States, and obligatory “debt brakes,” or balanced budget rules, for national budgets.

The TSCG leaves fiscal policies in the competence of Member States, explicitly recognizing national fiscal authority and responsibility. For that Member States had to incorporate a balanced budget rule modeled on the idea of the Swiss and German debt brake (Feld, 2012), into national law – preferably of a constitutional nature – by January 1, 2014. According to the balanced budget rule, national budgets must be in balance or in surplus, a criterion that is met if the annual structural government deficit does not exceed 0.5% of GDP. In exceptional circumstances, deviation from the balanced budget rule is allowed. The European Court of Justice will verify the national implementation of the balanced budget rule and can impose a penalty of up to 0.1% of GDP payable to the European Stability Mechanism (ESM), should a Member State fail to comply with its ruling. Establishing a balanced budget rule strengthens the credibility of sound fiscal policies on a national level. The fiscal compact balances national fiscal responsibility and euro area solidarity, as the granting of financial assistance under the ESM is conditional on having ratified the TSCG by March 1, 2013.

A number of provisions included in the TSCG mirror concepts existing in the SGP and the sixpack but are partly more stringent, like the tight time frame that goes beyond SGP requirements concerning MTOs. If a euro area Member State breaches the deficit criterion, RQMV applies to all stages of the EDP. This strengthens the European Commission’s role via an intergovernmental treaty. In addition, Member States subject to an EDP have to implement comprehensive structural reforms accorded in an economic partnership program. The EU Council has to endorse these programs, and the European Commission has to monitor their implementation according to the SGP. With the exception of the balanced budget rules, the success of the TSCG also depends on Member States’ commitment to implementation. The fiscal compact does not contribute to reduce the complexity of the overall surveillance framework but represents a layer that has been added to the existing rules (Peers, 2011).

5 Banking Union: New EU Financial Supervisory Architecture

The concept of the “financial trilemma” (ECB, 2011b) states that a stable financial system is incompatible with financial institutions integrated across borders and financial supervision performed by national authorities only. As a consequence, financial stability requires national supervisory policies to become more integrated at the European level, a transparent rules-based framework for prompt corrective action and ex ante burden-sharing arrangements in the case of bank recapitalization and resolution.

The financial crisis exposed those failures in European financial super-

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20 The ratification process was completed on April 1, 2014. The United Kingdom is not part of the TSCG. The government of the Czech Republic had declared its intention to join in March 2014.

21 This is a lower general limit of a structural deficit than that set by the SGP, i.e. 1% of GDP for euro area Member States.
The EU’s Reformed Institutional Framework and the Way Forward

Therefore, the EU first established the European System of Financial Supervisors (ESFS) (see chart 1), which consists of three elements:

1. Three European supervisory authorities (ESAs) were established for the then EU-27 on January 1, 2011: a European Banking Authority (EBA) in London, a European Securities and Markets Authority (ESMA) in Paris, and a European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt. Their objectives are inter alia to provide an effective and consistent level of regulation and supervision across national supervisory authorities, to protect depositors and investors, and to strengthen international supervisory coordination. However, while the ESAs can, for example, ensure the consistent application of EU law or settle disputes between national supervisors, they have no decision-making competence over national authorities.

2. The European Systemic Risk Board (ESRB) under the responsibility of the ECB was established in Frankfurt on December 16, 2010, as the EU body in charge of macroprudential oversight. Its role is to contribute to the prevention and mitigation of systemic risks to the EU’s financial market stability by means of ex ante warnings and recommendations.

3. National supervisory authorities of the Member States.

In early 2012, it became increasingly clear that there is a strong linkage between bank debt and sovereign debt that raises the risks of contagion. Banks are usually strongly invested in government bonds (Rocholl, 2013), which can adversely influence bank balance sheets if sovereign risk premiums rise. On the other hand, over EUR 4.5 trillion of taxpayers’ money was used to rescue banks in the EU (European Commission, 2012a), and the fragmentation of financial markets within the Single Market was persistent. To address these problems in future, the Commission called for a banking union in May 2012, which was confirmed by a euro summit on June 29, 2012. The establishment of a banking union became, in fact, a major step in completing EMU. In December 2012, the European Council committed itself to a roadmap toward a more integrated financial framework (see also chart 1): a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Single Resolution Fund (SRF), new rules on deposit guarantee schemes, the Bank Recovery and Resolution Directive (BRRD), and a new directive on bank capital requirements (CRD IV).

The start of the SSM is planned for November 2014. With the SSM,
southern supervisory tasks will be transferred to the ECB as the competent authority providing direct supervision for all banks in the euro area. For the time being, the SSM (in cooperation with national supervisors) will supervise the most significant and systemically important banks in the euro area, i.e., about 130 banks. All tasks not explicitly conferred upon the ECB will remain with national supervisors, like consumer protection, the fight against money laundering, cross-border branches (European Commission, 2012d, European Commission, 2013e). The supervisory board of the SSM is to carry out preparatory work regarding the supervisory tasks conferred on the ECB and is to propose draft decisions to be adopted by the ECB’s Governing Council. A draft decision will be deemed to have been adopted unless the Governing Council objects within a certain time. The Board consists of four ECB representatives, one national representative of each participating country, a Chair (appointed for five years) and a Vice-Chair (chosen from the Executive Board of the ECB). Before the SSM becomes operational, the ECB will carry out a comprehensive assessment of bank balance sheets: an asset quality review for SSM participants (at present the Euro 18) and, together with EBA, a stress test for banks in the EU-28. If the comprehensive assessment results in additional capital requirements for banks, bail-in and bailout rules apply according to a general pecking order agreed by finance ministers on November 15, 2013 (Council of the EU, 2013a):

1. Bail-in: In a first instance, banks should raise capital in the market or from other private sources and retain profits. As the BRRD bail-in tool is not yet applicable till 2016, EU state aid rules will have to be respected, which in some cases provide for the bail-in of junior bond holders.

2. Bailout – national level: If a bail-in is not sufficient, Member States are to provide public backstops at the national level. In this context, the Commission will review whether the necessary tools including resolution mechanisms and public backstops are in place at a national level.

3. Bailout – European level: If national backstops are not sufficient for euro area Member States, ESM instruments will be available after an appropriate bail-in, in full respect of EU state aid rules. The direct recapitalization instrument with its EUR 60 billion exposure limit could also be used once the SSM has been established.

The Single Resolution Mechanism (SRM) forms the other key element of the banking union, and will cover all countries participating in the SSM. On March 20, 2014, the Council of the EU and the European Parliament reached an agreement on the SRM regulation. The SRM regulation provides for resolution guidelines and centralized decision-making by a Single Resolution Board (SRB) located in Brussels. Upon notification by the ECB that a bank is failing or likely to fail, or on its own initiative, the SRB would adopt a resolution scheme.

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23 The Governing Council of the ECB nominated Danièle Nouy as Chair of the Supervisory Board on November 20, 2013, and Sabine Lautenschläger, ECB Executive Board Member, as Vice-Chair on January 21, 2014.

24 For the key features of the comprehensive assessment, see ECB Communication of October 23, 2013 (ECB, 2013a).

25 For details, see Commission Communication, August 1, 2013.

26 Participating Member States: euro area Member States and those non-euro area Member States that decide to join the SSM and in consequence SRM, i.e. “opt-ins.”
for the bank in question, thereby determining the application of resolution tools and the use of the Single Resolution Fund (SRF). Decisions by the SRB would enter into force within 24 hours of their adoption, unless the EU Council, acting by simple majority on a proposal by the European Commission, objects or calls for changes. The national authorities execute the resolution under the control of the SRB. The SRB consists of an executive director, a vice executive director, four full-time appointed members and the representatives of the national resolution authorities of all the participating Member States. The European Commission and the ECB have observer status. The SRM will enter into force on January 1, 2015.

At the same time, the euro area Member States agreed to establish a Single Resolution Fund to underpin the SRM by way of an intergovernmental agreement. The intergovernmental agreement will specify how national funds are channeled into the SRF with a target level of EUR 55 billion (i.e. up to 1% of covered deposits of participating Member States) and how national compartments are progressively mutualized over a period of eight years, starting with 40% of the resources in the first year. SRF resources are to come from bank levies raised at the national level. Should a situation arise, either in the initial phase or in the steady state, in which the SRF is not adequately funded, the participating Member States agreed to set up bridge financing, i.e. an SRF backstop. The intergovernmental agreement would enter into force once it has been ratified by participating Member States that represent 90% of contributions to the Single Resolution Fund.

In December 2013, the EU Council and the European Parliament agreed on new rules for deposit guarantee schemes. The new directive will strengthen the existing system of national deposit guarantee schemes; for instance, depositor information will be improved and access to guaranteed deposit amounts will be faster and easier. Depositors will continue to benefit from guaranteed deposit coverage of EUR 100,000, which had been questioned by the public EU-wide after program negotiations with Cyprus in spring 2013. Financing requirements for a deposit guarantee scheme are now harmonized, with ex ante funding of 0.8% of covered deposits to be collected from banks over a ten-year period (European Commission, 2013a).

The Bank Recovery and Resolution Directive (BRRD) agreed on December 12, 2013, will ensure that failing banks can be wound down in a predictable and efficient way with minimum recourse to public money. All banks will have to prepare plans for times of distress, and resolution authorities are provided with harmonized rules for the allocation of bank failure costs. Bail-ins start with shareholders and creditors (junior bond holders), and unsecured deposits (above EUR 100,000) will benefit from preferential treatment; deposits under EUR 100,000 are entirely exempt from bail-ins. The bail-in tool will apply as from January 1, 2016. Bail-ins are also backed by financial support from national resolution funds paid for by the banking sector. These national funds will have to be endowed up to a level of 1% of covered deposits within ten years. Bail-ins would apply at least until 8% of a bank’s total assets have been lost. Above this threshold, the resolution authority may allow

27 The case of Cyprus led to a change in two EU paradigms: Capital controls were introduced and, most importantly, the European debate on the hierarchy of bail-ins and bailouts reached a decisive point.
the bank to access resolution fund money up to a maximum of 5% of the bank’s assets (European Parliament, 2013b).

6 Outlook
Where will EMU and the euro area go within the European Union? Major integration steps were set out by Van Rompuy (2012) at the request of the European Council (see box 2). Some of these ambitious proposals would, of course, require Treaty changes. However, the Commission stated that it take reforms forward as far as possible within the limits of the Treaty of Lisbon and use regulations already in place (Corporate Europe Observatory, 2013). Currently, work is concentrating on blueprint measures which do not need a Treaty change, i.e. banking union, a pilot project on ex ante coordination of national reform policies and contractual arrangements (competitiveness and convergence instrument – CCI) to commit to structural reforms combined with financial incentives.

Governance reforms have stretched the legal and institutional framework of the EU to its limits. Procedures for possible changes to the Treaty might,

Banking Union – Timeline

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<td>EU state aid rules Bail-in tool applicable</td>
<td>CKU IV has to be implemented</td>
<td>Intergovernmental agreement for the SRP</td>
<td>SM super-vision starts; ESM direct bank recapitalization instrument available</td>
<td>SM comes into force BRRD applicable</td>
<td>Amended deposit guarantee schemes will be implemented in 2015</td>
<td>BRRD Bail-in tool applicable</td>
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Source: Authors’ compilation.

2012 Roadmap – Blueprint for a Genuine EMU
In this blueprint for a genuine economic and monetary union, Van Rompuy (2012) set out a roadmap to be realized in three integration stages comprising four intertwined building blocks:

Fiscal union
1. A stronger framework for fiscal governance at the national level and an increasing degree of common decision making on national budgets
2. Eventually, a limited fiscal capacity for the euro area to improve the absorption of country-specific economic shocks

Economic union
1. Systematic ex ante coordination of major national economic policy reforms, in particular of taxation and employment
2. Partnerships for growth, jobs and competitiveness, i.e. contractual arrangements or competitiveness and convergence instruments (CCI), to enforce structural policies, possibly including financial support

Banking union
Including financial backstops at the euro area level, i.e. for Member States participating in the SSM

Political union
Strengthened democracy, legitimacy and accountability

Box 2
therefore, be initiated in the legislative period of the European Parliament starting in June 2014. Some academics believe that the EU might have reached a “Hamilton moment” (Bullard, 2010) at which reconstruction of incentives and stronger cooperation in fiscal policy is possible. Bordo (2010) even identified the missing fiscal union as one of the main causes for the 2007 crisis. U.S. economic history might be a point in case – a successful monetary union was in the end based on a progressive deepening of fiscal union. Sargent (2012), on the other hand, pointed out that different combinations of fiscal and monetary policy can work as long as they are rule-based and coordinated, for example a credible no-bailout rule in combination with close surveillance of fiscal policies. Mody (2013) advocates a decentralized process where Member States and banks will either stabilize or renegotiate with their creditors.

Several ideas are discussed under the heading of fiscal union. Van Rompuy (2012) proposes a euro area fiscal capacity as an insurance-type mechanism to cushion country-specific economic shocks and support growth-enhancing structural reforms. The funding of this fiscal risk sharing could be based on national contributions and/or own resources with a possibility for common debt issuance. Further, a treasury function needs to be established. Van Rompuy does not mention a concrete figure for the size of such a fiscal capacity. To avoid moral hazard, net transfers could be linked to conditionality, i.e. compliance with commitments to undertake structural reforms. For the French finance ministry (Trésor-Economics, 2013), the crisis has shown that, even when coordinated, national fiscal policies do not suffice to ensure optimum macroeconomic and financial stabilization in the euro area. To deal with asymmetric shocks, the ministry proposes a significant central budget coupled with a borrowing capacity. This budget might consist of cyclical revenues, like corporate income tax, and might be used for countercyclical spending, e.g. unemployment benefits, but also infrastructure investment, innovation. Representing 2% of GDP, the euro area budget could assume 20% of the stabilization effected by national budgets. This euro area budget could be backed by central debt. Instead of a Treasury function, the French proposal only mentions a further strengthening of the euro area’s economic governance.

At the height of the sovereign debt crisis, Eurobonds were proposed and widely debated. Issued by the euro area Member States and endowed with a joint and several guarantee, these bonds were supposed to reduce funding costs for highly indebted euro area Member States. As Eurobonds involved moral hazard problems and were believed to violate Articles 123 and 125 TFEU, they would have required a Treaty change and some transfer of national fiscal sovereignty to a supranational entity. Beck et al. (2012) think that the need for Eurobonds might to some extent disappear with a strong banking union. However, following a commitment to the European Parliament – a supporter of more solidarity in EMU – the Commission set up an expert group on debt redemption funds and euro bills (European Parliament, 2013b). The group will present its report no later than in March 2014.

28 The Delors Report (1989) proposed around 2.5% of GDP; the MacDougall Report (1977) between 7.5% and 10% of GDP.
29 See for instance Micossi et al. (2011)
Crisis resolution measures were mostly geared toward stabilization, budget consolidation and structural measures, which in turn led to rising social pressures mostly in program countries of the euro area. In this context, the European Council (2013a) confirmed the relevance of using a scoreboard of key employment and social indicators and their application in the European semester with the sole purpose of allowing a broader understanding of social developments. In the course of the crisis, it was acknowledged that a lack of job creation and very high long-term and youth unemployment can lead to social spillovers in the euro area. Indeed, a study commissioned by the Austrian Federal Chancellery (Fernandes and Maslauskaite, 2013) concludes that the emerging “social deficit” in the EU is threatening the legitimacy and the sustainability of the European project. Labor market and pension reforms have been accelerated as one consequence of the crisis, and social policies were used as internal adjustment variables. Investing in human capital and infrastructure, reinforcing the fiscal basis for social spending, adopting a cyclical adjustment fund in EMU and defining common social standards could form a social dimension of EMU.

In the past, Member States could never agree on a finalité, or final model, for the (economic) integration of European countries, even less so on the role of the euro area. The Treaty of Lisbon only speaks of an ever closer Union, a concept which has been recently challenged by the United Kingdom. As the euro area undertakes the integration required to make the euro work, U.K. Chancellor of the Exchequer George Osborne in 2013 sees a need for constitutional reforms to make sure that those countries which are not in the euro can remain in the EU. On the other hand, in 2014 French President Hollande stated that he saw the Franco-German tandem at the center of an economic and social convergence initiative including corporate tax harmonization to set the European idea in motion again. He proposes a gouvernement de la zone euro with the objectives of growth and employment and including a financial capacity. For the future, Pisani-Ferry et al. (2012) have developed three possible scenarios:

1. Scenario 1 is a two-speed European Union with a coherent euro area. This implies that only the euro area moves to an efficient and democratically legitimate, fully fledged monetary union with a fiscal and banking union, which also implies direct access to tax resources to provide for a transfer union. This development would benefit the whole EU but would end up with the coexistence of two areas.

2. Scenario 2 describes a fragmented EMU unwilling to cede further fiscal and financial sovereignty, with “one money” but several, fragmented financial markets.

3. Scenario 3 points to the variable geometry within the EU as a whole as well as within the euro area. The dividing lines between the EU-28 and the EA-18 are blurred; in EMU, the necessary coherence, stability and efficiency might not be reached.

7 Conclusions

The bank and sovereign debt crisis did not originate in the EU and the euro area. However, it laid open not only the weaknesses of the economic, fiscal, financial and institutional construction of EMU, but also weaknesses at the level of the Member States. A number of governance reforms undertaken to balance these shortcomings reflected lessons learned, but stretched the EU’s legal and institutional framework to the
limit. Also, Member States’ willingness to implement further reforms has slowed down considerably, reflecting the easing of crisis pressures and the desire to be the master of their own house.

Fiscal governance has become more extensive, intrusive and complex. There are more procedures and timelines to be adhered to; reports to be drafted by Member States are more numerous. The crisis showed that in some euro area Member States, commitment to reforms lacked the political consensus at the domestic level, sometimes reflecting the fact that national economic institutions were not able to deal with the requirements of EMU membership. The idea that the functioning of national institutions has to be improved is slowly taking root, for instance through better budgetary planning and execution. Also, the obligatory introduction of a balanced budget rule into national law points into a new direction of governance, namely the explicit recognition of a national fiscal responsibility and the decentralized mandatory implementation of European rules. The Commission’s competence in surveillance has been strengthened and broadened to competitiveness. But as before, the success of the new rules depends to a large extent on the effective implementation by the Member States.

Among the EU institutions, the ECB has gained in stature. With the Securities Market Programme and OMTs, the ECB bought time for crisis resolution as well as economic and financial reforms in Member States. Banking union brought new executive powers for the ECB: With the Single Supervisory Mechanism, Member States transferred sovereignty in bank supervision to the euro area level. The banking union also comprises direct bank recapitalization by the ESM and the setting up of a common Single Resolution Fund, which represent a further mutualization of risk at the euro area level besides the ESM. However, mutualisation continues to be in principle by pro-rata guarantees, no joint and several guarantees have been added, mainly due to moral hazard problems. Several provisions under the banking union also change the paradigm on burden-sharing of the costs of, at least, future crisis: Costs will be distributed from taxpayers to banks and investors, i.e. by ex ante funding of the SRF, by harmonized deposit guarantee schemes, and by well-defined bail-in rules. Summing up, Banking Union represents the single-most important integration step among past reforms.

Until now, reforms have stopped short of a Treaty change. At the same time, the particular integration needs of the euro area seem to make such a Treaty change imperative. A heavily debated and still outstanding issue is the establishment of a fiscal union among euro area Member States. However, the funding of transfers implied by, for instance, a central fiscal capacity would involve a controversial negotiation process about contributions and control of a Treasury function.

Overall, the governance reform was less intergovernmental and more based on the Community method of decision making, which should ensure fair treatment of all EU Member States. The European Parliament has gained more importance, and the national parliaments also play an increased role. Indeed, some critics hold that the emerging “social deficit” in the EU is the real threat to the legitimacy and sustainability of the European project. Only the future will show whether the governance reforms undertaken offer a stable framework for crisis prevention and resolution, or whether the euro area will need a gouvernement de la zone euro as proposed by France’s President Hollande.
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