Euro Area Policies: Selected Issues

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EXECUTIVE SUMMARY

The selected issues paper accompanying the staff report discusses bank lending constraints (¶1 and Box 1 of the staff report), fiscal governance (Section VI.A of the staff report), governance of structural reforms (Section VI.B of the staff report) and financial reform challenges (Section VI.C of the staff report).

Chapter I argues that the recent divergence in external debt financing patterns of corporations suggests that bank lending constraints are binding. In the wake of the global financial crisis, bank lending growth to non-financial companies fell sharply, while net issuance of corporate debt soared. Survey results and disaggregated bank loan data indicate that bank loan supply constraints are driving this divergence rather than differences in risk profiles between large companies with access to capital markets and SMEs. Estimates suggest that a mounting bank credit crunch could shave about 1 percentage point off growth in both 2010/11. Therefore, fixing the banking sector is crucial.

Chapter II identifies the main gaps in the existing euro area fiscal framework and suggests key ingredients of desirable reforms to improve enforcement. First principles demand to think outside the box, possibly reopening the Treaty which will take time. Specifically, the euro-area’s new fiscal architecture should involve a central fiscal authority entrusted with the power to define and enforce deficit limits. However, much of the benefits of such a paradigm shift could be achieved by strengthening the enforcement procedure of the SGP. At the EU level, this would imply greater automaticity in moving up steps in the EDP during benign times, stronger discretionary powers to the Commission when sanctions have to be imposed, and non-pecuniary sanctions to avoid undermining adjustment efforts. Alternatively, enforcement of SGP-compatible deficit limits could also be achieved through coordinated reforms of national fiscal frameworks in the euro area. In such a setup, non-partisan fiscal councils could help enforce at the national level rules that reflect the spirit of the SGP.

Chapter III highlights the substantial benefits for euro area countries from deepening structural reforms to make monetary union more effective and sustainable. Current reform agendas differ across countries, but must focus on establishing a common set of regulations on labor contracts for all workers, without constraining job turnover; further activating tax and benefit systems; seeking employment-friendly wage bargaining; and fully liberalizing services sectors. Key actions to give more traction to the structural reform agenda at the supranational level should include: (a) strong commitment by the Eurogroup to structural reform, (b) integrated surveillance with the Stability and Growth Pact with clearly defined targets; and (c) more power for the Commission to issue warnings.

Chapter IV charts the state of play on financial sector reform and highlights the key challenges and opportunities opened up by the ongoing crisis. While there is agreement in principle on the setting up of a new European supervisory structure, comprising a new European Economic Risk Board (ESRB) and European Supervisory Authorities (ESAs), important details remains to be worked out and could determine the effectiveness of the new arrangements. In parallel, the Commission is planning useful steps to strengthen resolution tools at the national level. A pan-European resolution fund and resolution authority can further strengthen overall stability in a financially integrated region, such as the EU.
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I. EURO AREA: A BANK CREDIT CRUNCH?¹

A. Introduction

1. Recent bank losses could induce significant loan supply restrictions which would weigh heavily on the recovery of the euro-area economy. Since the eruption of the global financial crisis, European banks have suffered heavy losses. These developments could result in a “bank credit crunch” as argued e.g., by Holmstrom and Tirole (1997). Shocks that affect banks’ capital positions force especially the weaker banks to adjust loan supply to meet targeted leverage and capital ratios, as well as regulatory requirements.² Underlying this bank capital channel is the assumption that the market for bank equity is imperfect and that capital may be very costly to raise for banks during economic downswings.

2. The divergence in external debt financing patterns of corporations suggests that bank lending constraints are binding. To assess whether a bank lending crunch is mounting in the euro area, section II analyzes the external financing patterns of non-financial corporations as a means to disentangle loan supply from demand effects. Since early 2009, corporate credit costs have declined and net issuance of corporate debt has soared. At the same time, bank lending growth to non-financial companies has fallen sharply. Survey results and disaggregated bank loan data indicate that bank loan supply constraints are driving this divergence that rather than differences in firms’ risk profiles. Section III uses a simple, standard VAR model that features GDP, the interest rate, bank loans, the growth gap between bonds and bank loans and controls for external developments, to identify loan supply shocks. The model indicates that such recent shocks could subtract up to two percentage point from GDP growth over the next two years. Given that the analysis suggests that loan supply conditions could constitute a significant drag on the euro area recovery, we conclude that fixing the banking sector is crucial.

B. Is there a Bank Credit Crunch in the Euro Area?

3. There is little doubt that negative feedback loops between the real and financial sectors occurred in the euro area through a broad credit channel during the downturn. But disentangling loan supply effects, caused by large bank losses, from demand effects is a difficult task, especially if the analysis is focused on aggregate output and bank loans. Aggregate data show that the credit-to-GDP ratio is non-stationary and does not exhibit any obvious deterministic trend but do not reveal if bank lending supply constraints have had a

¹ Prepared by Thomas Harjes.

² See, ECB (2009a) for a comprehensive overview of the main monetary policy transmission channels involving banks.
negative impact on output. GDP led credit through most of the euro-area recession that lasted through 2008Q2-2009Q2 (Figure 1). Therefore, it is difficult to argue that aggregate credit or bank lending constraints caused the recession, though there have likely been pockets of credit rationing in some market segments.

4. **Demand factors are seen to have played a key role this far.** Bank lending growth to nonfinancial corporations has fallen steeply and recently turned negative. Both, the ECB in its various publications and policy statements and the EC in its 2010 Spring forecast explain weak lending growth primarily with subdued demand for corporate loans. They point to the fact that bank lending to households seems to have stabilized and the low level of bank lending to nonfinancial corporations could simply reflect weak demand. Indeed, along with value added, corporate investment activity slumped and working capital and inventories fell to very low levels. Moreover, bank lending surveys have pointed to the weak economic outlook as the main reason for tightening credit standards, while capital costs and banks’ access to market financing seem to have mattered considerably less in this regard (Figure 2).

5. **The recent surge in corporate debt issuance stands in stark contrast to bank lending developments (Figure 3).** The share of bank loans in total credit to non-financial corporations has fluctuated over the past decade (Figure 4). For the short period for which data are available, however, it is difficult to formally distinguish between regular variation over the business cycle and structural events, also because the beginning of the period was marked by a significant structural shift: the introduction of the euro and the 2002/03 banking crisis in Germany. Nonetheless, the recent divergence in bond issuance and bank lending is unprecedented.

6. The substitution of debt securities for bank loans by non-financial corporations could suggest binding bank loan supply constraints. Kashyap, Stein and Wilcox (1993) argued that changes in loan demand should affect all types of credit and other external financing sources in broadly the same way. A shift in the composition of corporate debt from bank debt to bonds would therefore imply a supply constraint. Oliner and Rudebusch (1996), however, suggested that such a shift at the aggregate level could also be caused by a shift in financing within the corporate sector from riskier SMEs to safer, large corporations. Credit may be redirected away from SMEs to large corporations because informational asymmetries magnify the premium charged for external debt for riskier SMEs during a downturn, a mechanism consistent with the broad view of the credit channel. According to this view, banks should also shift lending from SMEs to large companies as they lend to both. At the individual firm level where the level of risk is given there should not be any substitution according to this view and the bank and capital market debt mix should not change.

7. **The evolution of credit spreads, disaggregated bank lending data and survey results corroborate the view that there are binding bank loan supply constraints in the euro area.** Against the Oliner and Rudebusch thesis, credit spreads reflecting the premium for external debt fell while the shift in the composition of corporate debt from bank debt to
bonds occurred (Figure 4). Also, disaggregated bank loan data published by the ECB indicate that the debt mix of large corporations, with similar risk profiles, shifted significantly in favor of capital market debt. The data show a relatively stable ratio of large to total bank loans during the crisis and over the past years (Figure 5). Assuming that large loans are primarily extended to large companies, bank loans to large corporations must have fallen with a similar rate as total loans and large corporations have increasingly relied on capital market debt for external financing. Moreover, new surveys on the access to finance of SMEs in 2009 conducted by the ECB showed that both large corporations and SMEs had experienced a significant deterioration in the availability of bank loans with the net percentage (28 percent) of large firms reporting a deterioration similar to that of SMEs’ (32 percent, see Figure 6). These findings suggest that the euro area is facing a bank lending crunch.

C. What Could be the impact of a Bank Lending Crunch on the Recovery?

8. Constrained bank loan supply could weigh heavily on the recovery of the euro-area economy. Bank lending remains the predominant external financing source of most corporations. Large corporations could escape a bank lending crunch by issuing their own bonds in capital markets, but other bank-dependent corporations, mostly SMEs would face binding credit constraints. The effect on growth should be significant as SMEs account for 60 percent of value added and 70 percent of employment in the euro.

9. A simple, standard VAR model suggests that the loans supply shock experienced in 2009 could lower GDP by about 2 percentage points during 2010-11. The model features GDP, the interest rate, bank loans, the growth gap between bonds and bank loans and controls for external developments. Other studies, e.g., Cara and Morgan (2006), use bank credit standards published by the Senior Loan Officer Opinion Survey to identify U.S. loan supply shocks. But if surveyed bank lending conditions, as in the euro area case, are primarily determined by overall economic conditions and the outlook, they may not help much in identifying loan supply shocks. Instead, our model uses the difference between the growth of non-financial corporate bonds and bank loans to identify loan supply shocks. A shortcoming of this identification procedure is that a rise in this indicator may well reflect benign developments such as capital market innovation or financial deepening. In particular, euro

3 Very large and highly-rated euro-area corporations usually have access to international capital markets but others may be constrained by relatively underdeveloped national capital markets, such as Germany’s.

4 The quarterly data are real GDP (q-o-q growth), the overnight interest rate, real bank loans (q-o-q growth), and the difference in annual growth rates of the stock of bank loans to non-financial corporations and debt securities issued by non-financial corporations over 1990:1–2009:4. Real GDP and GDP deflator data for 1995:1–2009:4 are from Eurostat, for 1990:1–1994:1, these data are from the Area-wide Model (AWM) database for the euro area, see Fagan, Henry and Mestre (2001). US GDP data and Moody’s Baa-Aaa spread are from by the Federal Reserve Bank of Saint Louis and all other data are from the ECB.
adoption may well have provided a bigger boost to corporate bond markets than corporate bank lending. Adding a dummy for this period, 1999–2001, to control for euro adoption does not have much of an impact on the results, however. Moreover, to control for external and global financial credit conditions, US GDP growth and the Moody’s Baa-Aaa spread are added as exogenous variables. Figure 7 plots the response of GDP to these variables. As expected, GDP growth is relatively persistent and falls significantly in response to interest rate shocks; a 100 basis point increase lowers GDP by about 1.2 percent after two years. The estimated response of GDP growth to a shock in bank loan growth is very small and only significant after several years. A shock to the bond/bank loan growth difference triggers a negative and significant effect on GDP after about two years; the recent 20 percentage point increase in the growth difference would thus reduce GDP by about 2 percent over the next two years.

10. **While results of this model should be taken cautiously, they are mostly confirmed by cross-country and analytical studies.** For most countries, banking crisis are not a common feature of the business cycle and are likely to entail other important features than variations in bank capital, for example a strong regulatory response. Cross-country studies can better analyze how recessions caused by financial crisis differ from others. The 2009 October WEO found that the negative repercussions of financial crisis induced recessions are deeper and longer-lasting and feature lower and roughly equal growth contributions from all major production inputs: capital/investment, labor and TFP. Abiad, Dell'Ariccia, and Li (2010) analyze “creditless” recoveries and find that they do occur but, growth is on average about two percentage points lower than otherwise. Moreover, many of these “creditless” recoveries were driven by exports. In an analytical study, Meh and Moran (2009) find that exogenous bank capital shocks create sizeable declines in output and investment using a DSGE model in which bank capital mitigates an agency problem between banks and their creditors.5

D. Conclusion

11. **As many European banks have suffered heavy losses in the wake of the global financial crisis, the bank capital channel is likely to constrain loan supply and therefore weigh on the euro-area recovery.** Recent financial sector developments suggest that a bank lending crunch is mounting in the euro area and, according to a simple VAR analysis, could slow growth by about 1 percentage point in both 2010/11.

12. **One way to reduce the negative effects of a bank lending crunch on economic activity could be to ensure adequate credit provision to sound SMEs through other channels than commercial banks.** In the context of the EU’s response to the crisis, many

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5 Especially the recent euro-area bank losses due to U.S. mortgage market exposure reflect an exogenous shock not directly related to the euro-area business cycle that led to a decline in bank capital.
countries put measures in place to facilitate SME’s access to financing but the uptake has been rather limited. The cost of assessing SMEs’ business situation and risks to ensure that loans are made to sound companies could be relatively high. Especially, where bank-SME relationships already exist, banks could do such assessments much more cost efficient and supervisors should ensure that their actions do not unduly limit the availability of bank credit to sound SMEs.

13. **More important though are further bank recapitalization, restructuring and consolidation of the banking sector and that regulatory reform decisions are made soon to reduce uncertainty.** Especially weaker banks need to raise additional capital, clean up their balance sheets and put forward a convincing business model embedded in a sound governance structure, or face restructuring, divesture or takeover. The desirability of long-term public ownership stakes is questionable as they may rather hamper than accelerate restructuring and consolidation of the European banking sector, especially across national borders.
Figure 1. Credit in Relation to Output

Note: Data on bank loans to non-financial corporations and securities other than shares issued by non-financial corporations are from the ECB and nominal GDP data are from Eurostat.
Figure 2. ECB Bank Lending Surveys (2003Q1-2010Q1)

Changes in credit standards applied to the approval of loans to or credit lines to enterprises (net percentages of banks reporting tightening credit standards)

Note: The net percentage is calculated as the difference between reported “increases” and “decreases.”
Figure 3. ECB Bank Lending Survey-The Effects of Capital Costs on Lending

Chart 8: Effect on Costs Related to Bank’s Capital Position and on Lending
(Percentages of banks reporting an impact)

Figure 4. Bond Issuance versus Bank Loans of Non-Financial Corporations
(Annual growth rates)

Note: Data on bank loans to non-financial corporations and securities other than shares issued by non-financial corporations are from the ECB. BBB (corporate euro bonds)-German Bund yields are from DataStream.
Figure 5. Ratio of Large over Total New Bank Loans to Non-Financial Corporations

Note: Large loans are defined as corporate loans exceeding 1 million euro. Data are from the ECB.

Figure 6. ECB SME Survey-Changes in the Availability of External Financing

Note: The net percentage is calculated as the difference between reported “increases” and “decreases.”
Figure 7. GDP’s Impulse Responses (VAR with 3 lags) to one Standard Deviation Shocks in the Endogenous Variables

Note: Staff calculations.
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II. GAPS IN THE EURO AREA FISCAL FRAMEWORK: OPTIONS FOR A NEW FISCAL CONTRACT

A. Introduction

1. For the second time in less than 10 years, the euro area’s fiscal framework\(^2\) is under severe stress. In both instances, the failure to encourage fiscal discipline in good times was key. Unsurprisingly, the increased flexibility during bad times that emerged from the first reform of the Stability and Growth Pact failed to address this flaw. Hence, a new debate has started on ways to improve the framework, and a high-level Task Force chaired by EU Council President Van Rompuy is expected to make concrete proposals by the end of October 2010. The concrete challenge in the design of fiscal policy rules and institutions is to devise credible and collectively sensible EU-wide mechanisms to limit national authorities’ discretion, while preserving their capacity to use such discretion when it is in their best interest to do so.\(^3\)

2. This paper first identifies the main gaps in the existing framework and suggests key ingredients of desirable reforms (Section II). While first principles demand to think outside the box, possibly reopening the Treaty,\(^4\) alternatives approaches could close existing gaps to a considerable extent (Section III).

B. Fiscal Restraints in EMU: Rationale and Remaining Gaps

3. The combination of a centralized monetary policy with decentralized fiscal policies creates a unique configuration of interdependent policymakers (one central bank and multiple fiscal authorities) where coordination problems concern both the credibility of macroeconomic policies and their stabilizing role.\(^5\) The setup of EMU

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\(^1\) Prepared by Xavier Debrun. Without implication, thanks are due to Atilla Arda (LEG) and Wim Fonteyne (EUR) for advice, input and ideas.

\(^2\) The fiscal framework is mainly based on the Treaty’s Excessive Deficit Procedure (EDP) and two regulations forming the Stability and Growth Pact (SGP). Treaty provisions on multilateral surveillance, the EDP Protocol and Council Regulation on the EDP Protocol are part of the fiscal framework as well.

\(^3\) Policy discretion means that policymakers are free to choose the value of instruments under their control at any point in time, which implies the absence of any ex-ante commitment or binding constraint on specific actions such as those prescribed by a policy rule or another institution.

\(^4\) In this chapter, “the Treaty” refers to the Treaty on the Functioning of the European Union, unless specified otherwise.

\(^5\) Beetsma and Debrun (2004), and Beetsma and Giuliodori (2010) propose comprehensive surveys of the monetary-fiscal coordination issue in EMU.
attempts to solve these problems with a politically independent central bank mandated to deliver area-wide price stability, and a common set of rules and principles guiding the conduct of national fiscal and structural policies. The case for binding fiscal constraints in a fiscally decentralized monetary union ultimately rests on the fact that all member’s solvency constraints need to be simultaneously satisfied, effectively exposing the credibility of the common currency to fiscal policy mistakes by the weakest performer. A related argument is that the incentives to maintain fiscal discipline may be weaker in monetary union, as individual members expect to be bailed out if they cannot credibly secure solvency through adjustment on their own.

4. **Long-standing flaws that now need to be urgently addressed are:**

   a. The preventive arm of the SGP has failed to encourage the buildup of sufficient buffers in good (boom) times, slowing down the decline in public debts and limiting countercyclical firepower in bad (bust) times. This is most evident in countries where financial excesses and asset bubbles gave the illusion of structural improvements in budget balances, permitting unsustainable spending increases. Exclusive reliance on soft law in the preventive arm of the SGP is partly to blame.

   b. Weak governance aggravated the structural flaws of the SGP. The regular fiscal surveillance has been narrowly focused on procedural aspects and formal deficit limits, while the enforcement of the EDP was tainted by political considerations inherent to the ultimate responsibility of the Council in implementing the Procedure. The result was insufficient room for sound economic judgment to shape sensible policy recommendations, undermining the effectiveness of preventive legal instruments. As public debt developments took the backseat, the analysis of fiscal risks was insufficient to support a genuine risk-management approach to fiscal policy.

   c. The fiscal framework has been lacking centralized crisis management and resolution capacities, increasing the risk of ad-hoc bailouts. It took a panic on sovereign debt markets to conceive under the pressure of events a conditional credit facility accessible to euro area members facing financing stress.

C. **A New Fiscal Contract: Filling the Gaps**

5. **Two broad classes of reforms can be envisaged: those that create a central fiscal agency, and those seeking to perfect the existing framework within the boundaries of the Treaty or with only minor amendments to it.**

Central Agencies

6. **Perhaps the most natural solution to a coordination problem is to centralize decisions at a level where meaningful externalities can be internalized and scale**
economies, exploited for the good of all participants. Two models have recently received a lot of attention.

An independent fiscal agency

7. Two categories of proposals have been advanced to establish an independent fiscal agency (or a network of national agencies) with the explicit mandate to maintain government solvency: fiscal authorities, who akin to central banks, receive specific policy prerogatives to fulfill a well-defined mandate, and fiscal councils, which only play technical, advisory, and/or monitoring roles. All independent fiscal agencies build on (i) a simple and transparent mandate, (ii) instruments that the agency can freely use to constrain or incentivize national governments to act in a way consistent with agency’s mandate, (iii) independence from political constraints, and (iv) accountability (Debrun, Hauner and Kumar, 2009).

8. The main advantage of independent fiscal agencies is to strengthen fiscal discipline by fostering—or in the case of certain fiscal authorities, by imposing—a better use of policy discretion rather than subjecting budget aggregates to numerical limits bound to be undesirable in non-trivial circumstances. Hence, fiscal agencies can help strike a better balance between the credibility brought about by binding rules and the flexibility required by changing circumstances because they are insulated from the pressures nourishing indiscipline. Yet relatively few countries have adopted such institutions, and they often take the form of rather weak fiscal councils (Wyplosz, 2008).

9. In the EU context, the proposed fiscal authorities or councils often aim at strengthening the enforcement of the SGP (or replacing it altogether) and in some cases, at improving fiscal stabilization. Fiscal authorities would typically receive the power to set binding constraints on budgetary aggregates (Calmfors, 2003; von Hagen and Harden, 1995; Wyplosz, 2005), or even change selected policy instruments within pre-set limits (Wren-Lewis, 2002) and mandate across the board spending cuts (von Hagen and Harden, 1995). The tasks of fiscal councils are more varied and often revolve around independent monitoring and public assessments of governments’ commitments under the SGP. Their action could induce fiscal discipline by raising the reputational or political costs of reneging on public and measurable promises, and by promoting a better pricing of risk in financial markets. Some have also suggested that the fiscal council’s assessment could form the basis for a judicial enforcement mechanism through the European Court of Justice.
An EMU bond

10. Even closer to an embryo of fiscal federalism are recent proposals to create a single European bond (e.g., Delpla and von Weizsäker, 2010). By centralizing public debt issuance, two problems could be solved at once. First, one would limit the risk of contagious sovereign debt crises and high-debt traps in fiscally vulnerable countries. Second, terms of access to the common pool of financing (in terms of price or quantities) could be used as an incentive device to encourage compliance with the existing rules-based fiscal framework. Other benefits of such a mechanism include lower average borrowing costs—lower risk and liquidity premiums—and the creation of a deep sovereign bond markets comparable in size to the US treasury bond market. As existing proposals remain limited to first principles, it is beyond the scope of this paper to discuss the operational complexities that still require careful thinking.

11. Such an extensive pooling of resources represents a paradigm shift. To the extent that the common debt would be a joint and several liabilities, it would arguably turn the “no-bail-out” clause of the Treaty (Art. 125) on its head. However, as recent turmoil showed, the fragmentation of fiscal power and debt markets among national governments with varying records of fiscal discipline can be a direct threat to the stability, if not the very existence, of the common currency. Besides, the European Financial Stability facility (EFSF) adopted in response to extreme market stress creates an important precedent of resource pooling that could clear the way for a permanent mechanism along the lines of euro bond proposals.

12. The various proposals floated so far recognize two issues that require a new, independent institution to manage the process. The first is to address the moral hazard inherent to assistance schemes. On-lending of the proceeds of the common EU bond will need to be on conditions that discipline member states Pricing formulae could explicitly reflect the numerical limits on debts and deficits enshrined in the Treaty or deviations from the medium-term objectives for the structural balance. Such a disciplining mechanism would provide a smoother and more predictable pricing of risk than that associated with fragmented debt markets, while virtually eliminating the possibility of a sudden cut-off from market financing. It could also explicitly reward and penalize countries in function of their contribution to the creditworthiness of the scheme, thus providing the most creditworthy countries with an incentive to join. The second issue is that a mechanism needs to be available to deal in a

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6 This section draws on Fonteyne (2009).

7 With the EFSF, the Council effectively achieved what an area-wide fiscal authority would have done: to preserve the financial stability of the monetary union by providing centralized fiscal backstopping in exchange of an intrusive surveillance of commitments by vulnerable entities to adjust their policies.
comprehensive and transparent way with individual euro area members facing financing difficulties.

**Strengthening the existing framework**

13. **Even though the magnitude of the crisis and its fiscal fallout provides a unique opportunity for enacting deep reforms, the appetite for a paradigm shift may be low, pointing to less transformative, but nonetheless ambitious options.** A starting point would be to ensure that all member states have the strong budget procedures and institutions required for—national and EU-wide—fiscal rules to be effective. In the euro area, binding legal instruments (e.g., a Directive pursuant to Article 136) could be used to foster convergence towards the highest standards of fiscal governance at the national level.

**Enforcement and governance**

14. **A credible enforcement of the pact requires modifying the role of the Council in implementing the EDP, a broader range of sanctions, and formal mechanisms to hold national governments accountable for fiscal commitments.** This can be done by: (i) introducing greater automaticity in moving up steps in the EDP during benign times, while giving stronger discretionary powers to the Commission when sanctions ultimately have to be decided; (ii) establishing non-pecuniary sanctions to avoid undermining adjustment efforts; (iii) and adopting measures that maximize reputational and political costs faced by offenders.

15. **Greater automaticity in the EDP would rebalance the 2005 reform of the Pact, which allowed for longer delays in adverse circumstances and was widely seen as a weakening the of SGP.** The idea is that in benign times, steps in the EDP could be made fully automatic and, in some well-defined circumstances—such as misreporting, and high and rising debt levels—could even be accelerated.

16. **The imposition of sanctions should nevertheless remain the outcome of a discretionary decision based on sound economic judgment.** Indeed, automaticity increases the risk of facing circumstances where imposing sanctions would be so counterproductive that abandoning the procedure could be perceived as a better course. At that stage, the role of the Commission could be increased by placing the decision to impose sanctions directly in its hands, with only a veto right from the Council decided at qualified majority or unanimity. Alternatively, the Council could have to publicly justify (for instance before the European Parliament) why it deviates from a Commission’s recommendation.

17. **A broader set of sanctions should be envisaged.** Pecuniary sanctions in bad times lack credibility because they only complicate adjustment. Hence, these sanctions should be imposed only in good times, while non-pecuniary sanctions (e.g., related to voting rights in the eurogroup) could be considered.
18. **National governments should face formal accountability requirements.** At the central level, ex-ante peer reviews of budgets (as proposed by the Commission and endorsed by the Council) are unlikely to be sufficient to foster a stronger sense of responsibility vis-à-vis commitments to sound public finances. More formal procedures could thus be envisaged. For instance, countries could be required to explain in a public hearing with the Council or the ECFIN committee of the European Parliament why they deviated from the previous recommendations. At the national level, a better integration of stability programs in national budget processes could also increase accountability.

19. **Surveillance should be expanded, opening the possibility to activate an EDP regardless of the deficit trigger if clear risks to public debt dynamics are detected.** Fiscal surveillance should be based on a broad set of indicators signaling imbalances whose unwinding could have a severe and durable budgetary impact. Signs of such imbalances could trigger early warnings. A greater role should also be given to the monitoring of expenditures. By mapping deficit targets into medium-term expenditure ceiling (to be adjusted for tax expenditure), one would establish more easily the extent to which revenue windfall are spent.

*More attention to debt sustainability and a Pact that binds in good times*

20. **The SGP should allow for the debt level to be used as an explicit trigger in the EDP.** Various options can be envisaged:

- EDPs concerning countries where public debt is above 60 percent of GDP could only be abrogated when they reach a structurally balanced position (or their medium-term objective). This would contribute to strengthen budget balances on average, and incidentally give teeth to the preventive arm of the Pact for countries exiting from excessive deficits.

- As the Commission proposed in its May 12, 2010 Communication, the EDP could even be activated regardless of the deficit trigger, if the decline in public debt towards the 60 percent reference value is deemed insufficient. One potential problem with that approach is that changes in public debt can reflect many other factors than policy decisions, including a host of "below-the-line" financial operations without lasting impact on the debt position. It would therefore be important to focus on the medium-term trend in public debt implied by unchanged policies.

21. **Safeguards for fiscal stabilization in bad times should be matched by symmetric incentives to tighten in good times.**

- The letter and the spirit of the EDP could be reconciled by giving a greater role to cyclical considerations and other developments influencing revenue buoyancy in the assessment of budgetary positions. The reference value specified in Treaty Protocol No 12 could thus be re-defined as the upper-bound of a nominal deficit range.
consistent with *structural* balance.\(^8\) The range would allow for inevitable uncertainty in the real-time estimation of cyclical positions.

- Taking the Treaty as given, member states could be incentivized to create “rainy day funds” (Sapir and others, 2003) or to run higher balances in good times by giving them credit during bad times for overperforming on fiscal commitments laid out in their stability programs. Alternatively, a fictitious “compensation account,” as in Switzerland, could allow adjustments to the deficit ceiling to the extent that they do not exceed accumulated overperformance on the account. Conversely, an overdraft position on the compensation account beyond a certain threshold would tighten the deficit ceiling triggering the EDP. The latter system could be centrally run (it involves no real money), avoiding manipulations or improper uses of rainy day funds at the national level. “Rainy day funds” could be mandated through a Directive pursuant to Article 136.

- Some hard-law elements could be introduced in the preventive arm of the SGP. This is the option preferred by Commission in its recent Communication, when it proposes mandatory interest-bearing deposits in case of insufficient progress towards the Medium-Term Objectives.

- Building on the successful experience of some countries, certain tax and expenditure items could be automatically adjusted to cyclical developments, complementing the work of automatic stabilizers (Blanchard and others, 2010). Again, Art. 136 could be used to leverage domestic reforms along these lines. One alternative would be to make part of the EU transfers to member states contingent on country-specific cyclical conditions.

*A third way: A Pact that binds through national frameworks*

22. **One possibility to secure an effective enforcement of the common rules would be to increase ownership at the national level by encouraging euro-area member states to transpose in their national fiscal frameworks the common objective of fiscal responsibility.** So far, the harmonization of national rules around the common objectives has been left mostly to members’ discretion. National fiscal rules have been on the rise since the inception of the SGP (see Debrun and others, 2008), and in current circumstances, leadership by large EMU members could deliver greater harmonization. If needed, more explicit coordination could be envisaged in the euro area on the basis of Article 136 of the Treaty.

\(^8\) The EDP Protocol can be changed by a unanimous decision of member states that does not require a potentially lengthy ratification process.
23. Regardless of the process, the harmonization of national frameworks should be guided by two principles: (i) rules compatible with the spirit of the SGP, that is at least structural balance close to balance or in surplus, and (ii) a credible national enforcement procedure which would be adapted to the particular context of each member states in terms of decentralization, form of government, and legal tradition. As credible enforcement requires a strong legal basis and an important dose of expert judgment, non-partisan national fiscal councils could be created with the mandate to monitor fiscal performance continuously, to analyze the contribution of policies to underlying fiscal developments, to advise on early preventive action in case slippages are detected, and ideally, to trigger a judicial procedure activating sanctions.

24. One interesting dimension of the “third way” is that the creation of these national fiscal responsibility councils with harmonized mandates and scope could effectively lead to the establishment of a European System of Fiscal Responsibility Council (ESFRC). It could work closely with the Commission, with a view to improving fiscal surveillance, enhancing the analysis of budgetary developments underlying EDPs, and strengthening horizontal coordination. It could also serve as a specialized vehicle for the ex-ante peer review of national budgets proposed by the European Commission.

Crisis management

25. Even the best-conceived systems can and do fail. Because debt crises are triggered by liquidity problems, a conditional financing mechanism should be created to avert market disruptions (credit rationing and excessive risk premiums). To minimize moral hazard and maximize credibility, the facility should be paired with enhanced high-frequency monitoring capabilities at the center, along with an immediate escalation of the Excessive Deficit Procedure to Article 126-9, whereby the Council has full authority to request specific measures within a pre-defined time frame against the threat of sanctions. In the face of extreme stress, one option would be a transfer system which could take the form of highly-concessional loans with extensive grace periods. Again, the moral-hazard and weaker ex-ante market discipline arising from an explicit assistance scheme further strengthen the case for improved surveillance stricter enforcement mechanisms developed above.

D. Concluding Remarks

26. Extreme sovereign market stress was a wake-up call to euro-area leaders that fiscal discipline was a collective responsibility requiring more solid institutional underpinning. An intense debate is now burgeoning on desirable ways to enhance the euro’s fiscal foundations.

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9 This would likely require an amendment to Art. 126.
27. As guardian of the Treaty, the Commission took the lead in issuing a set of recommendations to address key issues in the operation of the SGP, including a greater focus on debt sustainability in the EDP, more binding preventive instruments, a broader analysis of risks, and ex-ante peer review of budget proposals. However, more fundamental steps are needed. In particular, the flawed enforcement procedure of the SGP needs repair, which almost inevitably implies amending the Treaty. Indeed, European leaders’ proclaimed willingness to strengthen the common fiscal framework by expanding the arsenal of sanctions will remain cheap talk as long it is not accompanied by a serious commitment to make these sanctions inevitable when violations of the rules are patent.

28. While a long-lasting configuration of the euro-area’s fiscal architecture arguably involves a central fiscal authority entrusted with the power to impose legally binding and enforceable deficit limits to member states, much of the benefits of such a paradigm shift could be achieved by tightly coordinated reforms of national fiscal frameworks. It was argued that Article 136 of the Treaty, which gives to the Council potentially great room for maneuver to enhance budgetary cooperation in the euro area, forms a useful basis to set up a European System of Fiscal Councils. In such a setup, non-partisan fiscal councils would help enforce at the national level rules that reflect the spirit of the SGP (structural budget balance or surplus), coordinated by the Commission with a view to improve fiscal surveillance and strengthen the national ownership of the common rules.
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III. NARROWING THE GAP BETWEEN AN OPTIMAL CURRENCY AREA AND EMU: INTEGRATING THE LABOR MARKET

“Europe stands at the crossroads. We either go ahead—with resolution and determination—or we drop back into mediocrity. We can now either resolve to complete the integration of the economies of Europe; or, through lack of political will to face the immense problems involved, we can simply allow Europe to develop into no more than a free trade area.”

Commission White Paper to June 1985 European Council on Completing the Internal Market

1. This conclusion is even more valid today than it was twenty five years ago. The Single Market is now well advanced, and completing it remains key to revitalizing prosperity in Europe. But to ensure the continuity of EMU and make the most of European integration, enhanced adjustment capacity through the labor market will be needed.

2. Theory suggests four main channels through which equilibrium can be restored in presence of asymmetric shocks or asymmetric reactions to common shocks: market-driven price and wage adjustment, policy induced fiscal adjustment, risk-sharing against country-specific shocks through fiscal transfers and labor mobility. It is broadly agreed that, during its ten years of its existence, EMU has lacked the capacity to cope with such shocks due to inadequate price and wage adaptability, insufficient fiscal retrenchment in good times, ill-targeted EU budget transfers and poor labor mobility between Member States. This note argues that further harmonization of labor and social models is essential to enhance the adjustment capacity of markets and labor mobility within the area, while clarifying the role of EMU-wide fiscal transfers in the face of asymmetric shocks.

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1 Prepared by Esther Perez Ruiz.
A. Structural Reform During The Lisbon Decade: Where Does Emu Stand?

3. **The launch of EMU and the Lisbon Strategy did not mark a breakthrough in structural reform.** The Lisbon Strategy was set up in 2000 to ensure that euro area members strengthen market forces to underpin their adjustment capacity. High expectations that the absence of exchange rate flexibility would generate an impetus to structural reform did not materialize during the early Lisbon years (van Poeck and Borghijs, 2001, Duval and Elmeskov, 2006, European Commission, 2008). Neither did implementation in EMU clearly outperform reform progress in non-EMU OECD countries following the 2005 mid-term review of the Lisbon strategy.

4. **There were notable advances in deregulating product markets but less visible progress in core labor market areas.** Euro-area members took important steps towards opening product market access. Labor market reform also progressed in activating female and older workers, but stalled in the areas of labor taxation, employment protection legislation, collective bargaining and unemployment benefits, all considered key to the adjustment capacity of EMU economies.

<table>
<thead>
<tr>
<th>Compliance with Going for Growth recommendations of structural reforms: 2005-2008</th>
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<tr>
<td>Implementation score</td>
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<tr>
<td><strong>Recommendations to:</strong></td>
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<tr>
<td>Reduce entry and operational controls</td>
</tr>
<tr>
<td>Reduce administrative costs, public ownership and reform corporate governance</td>
</tr>
<tr>
<td>Reform disability and sickness schemes, remove incentives to work at older ages, or reduce impediments to female participation</td>
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<tr>
<td>Reduce labor taxation and reform labor market policies</td>
</tr>
<tr>
<td>Overall compliance with Going for Growth recommendations 2005-2008</td>
</tr>
</tbody>
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Sources: OECD Going for Growth 2010 and IMF Staff calculations. For each country group, scores are computed as the cross-country arithmetic mean of the degree of follow-up with annual OECD recommendations, as coded in the following manner: 3=action taken leading to removal of recommendation, 2=action taken, 1=no significant measure, and 0=policy relapse.

5. **Labor market efficiency is still much lower than in the 1960s.** Labor market institutions became less employment friendly in Europe between the 1960s and the mid-1980s. Thereafter, higher employment rates and more rapid productivity growth in the US directed the attention towards the role of institutions in explaining differences in performance and created some political momentum for labor market reform in Europe in the run up to EMU, continuing during the Lisbon years. Even so, efficiency of European labor markets—as measured by the position of Beveridge curves—stays far way from its starting position in the 1960s (Nickell et al., 2001).
6. **EU driven reforms have succeeded when accompanied with clear powers, but failed when reliant on peer pressure.** Since the beginning, the Lisbon Strategy adopted a two-handed approach combining product market reform at the EU level with labor market and social policy reform at the national level. A top-down approach towards product markets seemed appropriate, as reform in these areas was generally perceived as essential and uncontroversial. By contrast, preferences over labor market and social models were considered country-specific and their case for reform less compelling. Still it was hoped that resolute actions by the center to implement reforms in products markets would enhance
national incentives to carry out labor market improvements as they tend to be mutually reinforcing (Berger and Danninger, 2007); that countries would learn from best practices; and that intra-zone competitiveness spillovers would force non-reforming countries to follow active reformers. And soft coordination would eventually suffice to overcome the political resistance to labor market reform at the national level. However, these expectations were not met:

- The absence of immediate pressure on exchange rates and the illusion of unlimited external financing under EMU made reforms to sustain competitiveness less compelling.

- Advances in product market reform did not increase incentives to reform core labor market institutions enough to overcome the fierce resistance by large groups of insiders.

- Learning spillovers across Member States were not fully exploited as governments were first and foremost constrained by political economy considerations. Reform episodes during the Lisbon years were characterized by piecemeal rather than comprehensive packages, often involving direct compensation to losers or complex trade-offs between institutions to overcome resistance in particular areas by compensating losers in other areas (Tompson and Price, 2009). This very much limited the scope for importing best practices or avoiding mistakes committed abroad. For instance, in the area of employment protection legislation, while some countries suffering the worst from labor market dualism in terms of efficiency and equity struggled to ease regulations of incumbents (Spanish 1994 and 1997 labor market reforms), others embarked on “two-tier reforms” (Hartz 2002-05 reforms of Germany, Treu 1997 and Biagi 2002 reforms in Italy) as a means to increase flexibility at the margin. As regards collective bargaining, whereas some countries quickly internalized the consequences of EMU to wage setting, wage increases in some others worsened the competitiveness impact of their relatively weaker productivity.

- The reluctance to reform partly reflected the perception that voters punish reformist governments. However, the evidence suggests that reformist governments have the same likelihood of being re-elected as those that favor the status quo and that governments receiving a clear mandate to reform go on to be re-elected (Williamson and Haggard, 1994 and Buti et al., 2008).

C. Revisiting the Case For Structural Reform in EMU

7. Substantial benefits will emanate from deepening further structural reforms in EMU. Reform agendas differ across countries, but must focus on establishing a common set of regulations on labor contracts for all workers without constraining job turnover, further activating tax and benefit systems, seeking employment-friendly wage bargaining and
liberalizing fully liberalizing services sectors. Such a reform package will yield substantial returns:

- **Ensuring the sustainability of social models:** Social models that do not deliver high employment rates are not sustainable in the face of growing strains on public finances coming from population ageing and crisis-support measures. Key measures to lift employment growth include:

  ✓ **Improved labor market dynamism.** Countries where employment rules are strict display lower turnover and are likely to experience a marked increase in structural unemployment following downturns (Mourougane and Furceri, 2009, OECD 2009). In good times employment rates are the highest in labor markets characterized by intense labor flows (Garibaldi and Mauro, 2002, Sapir, 2006). Boosting labor flows will require a relaxation of regulation on labor contracts.

  ✓ **Generous but limited-in-time unemployment benefits** contingent on tightened activation and combined with effective training will protect workers during transitions, improve the quality of job matches, shorten unemployment spells and prevent job seekers from losing skills and drifting into inactivity. Past reforms of this kind (best represented by Denmark during the 90s and the Hartz reforms in Germany 2002–05), were subsequently followed by sustained employment creation.

  ✓ **Further activating female and older workers:** The labor supply of women and older workers has been found highly elastic to tax treatment and out-of-work benefits (OECD, 2005). Hence their participation could be raised substantially by making pension systems actuarially neutral and providing tax incentives for second earners.

  ✓ **Renewed impulse to the Single Market Program, especially in services sectors,** will amplify the employment returns of labor
market reform. Evidence shows that liberal product markets tend to reinforce the employment gains of labor market reform (Annet, 2007) and to reduce the persistence of unemployment following downturns (Guichard and Rusticelli, 2010).

- **Improved equity**: Equity tends to be stronger in Continental and Nordic countries, characterized by higher taxes and redistribution. Adequate unemployment support conditional on strict job acceptance requirements, a tax mix biased towards indirect taxation and a tradition of responsible wage formation preserve work incentives and healthy employment in Scandinavian countries but tend to generate an efficiency-equity trade off in Continental economies, where these features are less present. Mediterranean countries, ranking the lowest in terms of equity, would benefit from better education policies and a reduction in labor market dualism. The latter should improve social inclusion by reducing the wage premium of incumbents over outsiders and mitigating employment volatility.

- **Enhanced productivity**: Boosting competition in product markets through the completion of the Single Market Program will induce resource reallocation towards vibrant sectors and force companies to be more efficient either by fully exploiting economies of scale or encouraging innovation. Competition-restraining regulation is found to reduce innovation (e.g., Bassanini and Ernst, 2002, Jaumotte and Pain, 2005b) with the burden of regulation being greater the further a given country is away from best practice technology (Conway et al., 2006). A productivity-enhancing environment is especially needed in Southern countries.

- **A reduced impact of asymmetric shocks**: With more harmonized labor market institutions, common shocks would not have as large asymmetric consequences as observed in the current crisis and better institutions would facilitate the adjustment to asymmetric shocks. Monetary policy would thus be more effective and less strain would be put on national budgets.
**Higher labor mobility:** Strict employment protection, limited portability of pensions, long-lasting and passive unemployment benefits and weak active labor market policies have been identified in the literature as deterring labor mobility and impairing the adjustment capacity of EMU to asymmetric shocks (Wasmer and Janiak, 2008).

**Facilitating a rebalancing of regional growth:** Stringent product market regulations and labor market institutions—i.e. relatively tighter employment legislation, generous unemployment benefits, higher tax wedges and wage floors—tend to cause persistent deviations of wages from productivity improvements, especially in countries where collective bargaining is dominated by sheltered sectors (Berger and Nitsch, 2010 and European Commission, 2008). Regaining cost competitiveness through labor market reform will be important for countries with current account deficits larger than justified by fundamentals, specialized in low technology goods. Surplus countries can also contribute through a different set of labor and services market reforms that could reinvigorate domestic investment and demand.

### D. Delivering Structural Reforms

8. **Against this background, there are not just substantial benefits from reforms in euro area countries, but also from taking a simultaneous, comprehensive approach to make monetary union more effective and sustainable.** Moreover, a coordinated move can be expected to help overcome political resistance to reform while generating substantial synergies across reform areas and across borders. Key actions to give more traction to the structural reform agenda at the supranational level should include:

- **Pursuit of a more integrated labor market:** Properly functioning labor markets should be seen as an EMU public good and their harmonization—consistent with arts. 151 and 156 of the TFEU—considered as a desirable outcome. Recent proposals by the Commission and the ECB and early deliberations by the Van Rompuy Task Force signal awareness of these issues, but progress will need to go much further. Ideally, features affecting most directly price and wage formation, namely labor taxation, unemployment benefits, employment protection legislation and some aspects of collective bargaining should be subject to heightened coordination and surveillance.

- **Strong commitment by the Eurogroup to structural reform:** The peer review of fundamental structural reforms needs to be upgraded within the Eurogroup, which based on art. 136 of the TFEU should act as a collective body rather than engaging into political bargaining. Notably, it should provide systematic assessments and

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2 TFEU stands for Treaty of Functioning of the European Union.
communicate in a transparent manner the benefits of reforms and the costs of the status quo from a euro-area perspective. This political dialogue should help individual countries to take the consequences for other Member States into account when designing their national policies, thereby creating an EMU-compatible framework.

- **Integrated surveillance with the Stability and Growth Pact:** The Commission’s proposal to align in time the surveillance over structural reforms with fiscal policies and external imbalances is a welcome development. This should facilitate the analysis of policy interactions such as the effects of structural reforms on budgetary positions, the implications for fiscal consolidation of inadequate reform progress, and the role of the composition of budgets to support growth potential.

- **Surveillance over targets and policies:** As reforms usually take time to materialize or their positive effects may be blurred by changes in the economic environment outside the control of governments, surveillance should look both at performance indicators (e.g., employment growth) and policy indicators (e.g., labor market institutions).

- **More power to issue warnings:** Enforcement requires the Commission reaffirm its independence vis-à-vis the Council by issuing policy warnings (art. 121.2) with determination whenever it is judged that economic developments risk jeopardizing the proper functioning of EMU.

- **Sanctions and incentives to foster reform:** Financial incentives could be channeled through a reformed EU budget where disbursements would be closely linked to reform implementation. Currently, the Common Agricultural Policy and Structural Funds, whose disbursement is contingent on very weak conditionality, absorb more than 70 percent of the budget. A larger proportion of resources should be allocated to strengthen market adaptability, possibly through higher provision of funds for the regional competitiveness and employment objective and the European Global Adjustment Fund. Alternatively, access to financing through a common EU bond could be modulated on the basis of compliance with reform implementation.
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IV. FINANCIAL SECTOR REFORM IN THE EU: THE CURRENT STATE OF PLAY

A. Challenges and Opportunities

1. Financial sector reform in the EU is proceeding at a rapid pace, along multiple tracks. Institutional reforms focus on putting in place a framework for macroprudential supervision, and arrangements for better integrated cross-border microprudential supervision and streamlined rule-making. In the area of crisis management and resolution, the focus is on improving and harmonizing national frameworks. Regulatory reform of capital and liquidity standards is proceeding largely in tandem with the global reform efforts, in which the EU is closely involved. In the areas of hedge fund regulation, rating agencies, and credit derivatives time is needed to ensure the emergence of a globally consistent approach.

2. Financial sector reform poses particular challenges and opportunities for the EU. The recent (“sovereign”) phase of the crisis has underscored the financial interconnectedness among EU member states and between governments and banks. It has also confirmed the potential for common policy initiatives and integrated financial markets to mitigate the impact of a crisis. This calls for robust financial stability and resolution frameworks with strong European and cross-border elements that can cut the umbilical cords that currently tie banks and governments.

B. Macroprudential Supervision

3. The EU envisages establishing a European Systemic Risk Board (ESRB) to conduct macro-prudential supervision. As planned, the ESRB will not have binding powers but it will have a broad mandate to issue risk warnings and recommendations to any official counterparty in the EU. Follow-up will be sought through a “comply or explain” rule. The ECOFIN, along with the envisaged European System of Financial Supervisors (ESFS) will likely be its main counterpart. Central banks will occupy a large majority of the voting seats on the ESRB, but supervisors will be represented as well. Organizationally, it will be closely linked to the ECB and will not be a separate legal entity.

4. Little clarity exists on the modus operandi of the ESRB. Staff believe that its agenda should cover three broad aspects: (i) the risks posed by the largest and most interconnected financial institutions; (ii) increases in financial imbalances, such as credit-fuelled asset bubbles, both at the aggregate level and for particular countries or sectors; and (iii) changes in the structure and technology of the financial system that contribute to the

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1 Prepared by Wim Fonteyne and Erlend Nier.

2 For an earlier overview of these reform proposals, see Fonteyne (2009). Staff views on these proposals are outlined in IMF Staff (2009a).
build-up of systemic risks. All three aspects need continuous monitoring and assessment as to their implications for systemic risk. The key challenges will be to ensure that sufficiently strong action is taken to address only emerging build-up of risks and that the ESRB’s macroprudential analysis permeates the work of financial regulators and supervisors at all levels.

5. **A prime function of the ESRB will be to formulate policies and measures to contain risks related to systemically important institutions.** The crisis has underscored that certain institutions are too large, too interconnected, or too important to the real economy to be allowed to fail under standard bankruptcy proceedings. More robust, bank-specific resolution mechanisms are certainly part of the answer, but additional and rapidly adaptable policies are needed to reduce the probability and impact of failures of such institutions. One approach considered by the Basel Committee is to impose capital surcharges that are commensurate with an institution’s contribution to systemic risk. Alternatively or in addition, as envisaged in the United States, more direct structural measures could be taken, such as interventions that lead to the breaking up of large and complex institutions, when systemic risk cannot otherwise be effectively controlled. In a highly integrated financial market, such as the EU, the impact of failure needs to be assessed at the European, rather than the national level. And while implementation powers may be more appropriately vested in national supervisory authorities, the ESRB could play an important role in the calibration of measures and in providing guidance on the use of structural intervention.

6. **The ESRB also has an important role to play in addressing macro-financial imbalances.** The crisis has shown that the build-up of aggregate risks can be concentrated in particular countries and sectors, notably when trade imbalances lead to strong capital inflows (Merrouche and Nier, forthcoming). In a financially integrated region, national policies may be insufficient to forcefully address a buildup of systemic risk. It is therefore key to the acceptability, sustainability and development of the single financial market that the new European structures address this control deficit, working closely together with national authorities and providing effective answers to their concerns. In essence, a fundamental shift in prudential approach is needed, from trying to manage financial stability with national tools to doing so with European rules, tools, and policies. Notably, capital requirements and countercyclical provisioning could be calibrated EU-wide to uniformly reflect the riskiness of exposures, including risks related to sector and location (which may reflect country-specific systemic risks). The ESRB is uniquely well placed to guide such calibration.

7. **Finally, the ESRB will need to monitor the systemic risk implications of changes in the financial system.** The crisis has shown that changes in the structure and functioning of the financial system, including those prompted by innovation and regulatory arbitrage, can lead to a build-up of systemic risk. From a macroprudential perspective, the monitoring and assessment of structural change needs to encompass (i) changes in the way services are offered across sectoral lines (insurance, banking and securities), including notably the
provision of credit by non-banks; (ii) the robustness of the infrastructure supporting rapidly growing markets; and (iii) innovations in products and business models.

C. Microprudential Supervision and Rule-Making

8. The EU is establishing an integrated system of financial supervisors. The European System of Financial Supervisors (ESFS) will bring together the national supervisors with three new sectoral European Supervisory Authorities (ESAs) and a cross-sectoral Joint Committee. The ESAs will be charged with building a single rule book and harmonizing supervisory practices, and will have binding powers to mediate and settle disputes between supervisors. Cross-border groups will be supervised by standardized colleges of national supervisors.

9. Significant elements of the new supervisory architecture remain under debate. The architecture proposed by the European Commission is based on the recommendations of the De Larosière Group (De Larosière Group, 2009). The ECOFIN reached a compromise agreement last December that largely follows the Commission’s proposals but reinforced the fiscal safeguard provisions and tightened the voting procedures, thus weakening the powers of the ESAs. The European Parliament, by contrast, is seeking a significant strengthening of the new bodies, including through streamlined and more independent governance arrangements and limitations on the applicability of the fiscal safeguard clause to situations in which decisions impinge “directly and in a significant manner” on the fiscal responsibilities of member states. In addition, it seeks a leading role for the ESAs in the supervisory colleges of the largest systemic institutions; proposes to locate all three ESAs along with the ESRB in Frankfurt; and is seeking to complement the new architecture with a Banking Resolution Unit, a European Deposit Guarantee Scheme, and a European Financial Stability Fund. It also wants the new bodies to represent the EU in relevant international fora, and seeks a greater role for itself in rulemaking and accountability mechanisms.

10. A compromise might take time to reach. Intensive negotiations are ongoing between the Council, Parliament and Commission. Despite great willingness on all sides to move forward, the major differences between the Council and Parliament will take time to bridge. Hence, there is a significant risk of delays in the establishment of the new architecture, beyond the currently envisaged date of January 1, 2011.

11. In the staff’s view, the focus should be on the effectiveness of the new architecture. While undesirable, minor delays are an acceptable price to pay for a qualitatively solid agreement. The discussions can now best focus on practical improvements.

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3 The Commission’s proposals are available on the website of DG Markt: [http://ec.europa.eu/internal_market/finances/committees/index_en.htm](http://ec.europa.eu/internal_market/finances/committees/index_en.htm)
to the system, strengthening the ESAs’ binding powers and their roles in the colleges of the biggest groups, and establishing sound but time-efficient rule-making procedures that allow the ESAs to build a single rule book and deal effectively with macroprudential risks on the basis of ESRB guidance. The fiscal safeguard clause should be limited to cases in which ESA decisions have direct, identifiable, and sizable fiscal costs. An agreement in principle that the supervisory architecture will in the medium term be complemented with integrated crisis management and resolution arrangements would be highly desirable. It would set a clear objective while allowing more time to work out the specific design of these arrangements.

12. **The operationalization of the new architecture will present further challenges:**

- Continued efforts will be needed to establish a single rulebook, by harmonizing legislation and providing the ESAs’ with the necessary scope to establish technical rules. In this regard, consideration could be given to turning the CRD into a framework directive, with significant rule-making scope given to the European Banking Authority.

- Much work remains to achieve a desirable degree of information sharing, with access to information granted fairly automatically and instantly to all parties who are entitled to it. In staff’s view, this will require centralized prudential databases managed by the ESAs, to which banks could in due time report directly. There is also a need for sharing qualitative information through intensive contacts at all levels of the new architecture. A general reassessment of the proper level of confidentiality and the publication of a selected subset of non-sensitive prudential data would help increase market transparency and support effective financial stability policies.

- As the set-up will remain complex, there is a continuing risk that parts of the financial system will not be adequately supervised. The ESAs and the ESRB will need to avoid such supervisory gaps.

**D. Crisis Management and Resolution**

13. **The EU’s single banking market requires an integrated framework for crisis management and resolution.** The Commission intends to seek the EU-wide introduction of harmonized early intervention tools, bank resolution regimes and deposit guarantee schemes. It is also probing the political support for medium-term reforms to establish an integrated framework for cross-border banks. Staff supports such harmonization—which would strengthen national regimes and improve their interoperability—but urges the authorities to also work expeditiously toward putting in place a separate EU-wide regime for cross-border

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4 See European Commission (2010).
financial institutions. Its cornerstone would be a European Resolution Authority (ERA) armed with the mandate and the tools to deal cost-effectively with failing cross-border banks, supported by an industry-financed European Deposit Insurance and Resolution Fund (EDIRF) and a fiscal backstop. The European Parliament is preparing a motion asking the Commission to come up with legislative proposals to establish a similar integrated framework by end-2011.

14. **A framework of enhanced national resolution regimes and strong safeguards to improve cross-border coordination would be a useful step.** As set out in Čihák and Nier (2009) effective national resolution regimes are a necessary, but not sufficient precondition for effective resolution of cross-border firms. A common set of tools might include the powers to set up a bridge bank, to effect the sale of the institutions to a private bidder and the partial sale of assets and liabilities. In addition to the establishment of a common toolset, care is needed to remove obstacles arising from existing European and national law (including company and insolvency law) that might impede the effectiveness of resolution action, while safeguarding the interests of stakeholders through a process of judicial review. An effective coordination framework requires further steps, such as legal requirements for national authorities to have regard for consequences of resolution actions on other member states and principles for burden sharing that could be enshrined in law.

15. **A levy on the financial sector could further strengthen the resolution regime.** The EC recently proposed a risk-based levy on the banking system, so as to feed financial stability funds, which will also require a fiscal backstop. A key advantage of a dedicated fund is that it can be mobilized quickly to reduce systemic risks. A fund can aid the resolution of systemic institutions—by providing funding to a bridge bank and assisting in the sale of the institution to a third party—and enable early intervention, e.g., to force the sale of bad assets, including those arising from cross-border exposures. While some jurisdictions appear to prefer for levies to contribute to the general budget, it makes no difference to the public sector’s financial position whether a levy accrues to the general revenues or to a fund that invests in government assets. And while there is a risk that a dedicated fund can lead to moral hazard, such a risk can be mitigated by the introduction of an effective resolution framework that clearly circumscribes the use of funds and ensures that losses are borne by existing shareholders and creditors in the first instance, rather than the resolution fund.

16. **A pan-European Financial Stability Fund and European Resolution Authority offer clear advantages.** A pan-European Fund could be particularly useful in situations when individual countries are fiscally constrained. Indeed, the ongoing debates both on how to

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5 See Strauss-Kahn (2010), Fonteyne et al. (2010), and IMF staff (2010a).


7 See IMF Staff (2010c).
back-stop a European stress test and on what alternatives there might be to the ECB’s securities market program (SMP) point to potential benefits of a pan-European fund. However, such a fund needs to be coupled with sound mechanisms for its use, notably to preclude moral hazard, ensure good governance, and enable quick decision-making. The abovementioned combination of an ERA and EDIRF proposed by staff would achieve these objectives.

17. **The pending reform of deposit guarantee schemes (DGS) should be consistent with plans and progress on crisis resolution.** DGS reform is on a separate track from crisis management and resolution with an earlier timeline. The Commission’s proposals are expected to include significant harmonization, and possibly an EU-level deposit guarantee scheme. Any such scheme must be matched with a strong European element in supervision as well as a resolution framework that constrains national resolution strategies and avoids tilting incentives toward socializing losses. Ideally, it should lead to the establishment of the abovementioned EDIRF as part of a comprehensive crisis resolution reform package.8

18. **More immediate improvements of cross-border crisis management and resolution should also be pursued.** An ad hoc working group of the Economic and Financial Committee (EFC) has proposed strengthening and better articulating the role of the ECOFIN (as an intergovernmental crisis policy coordination forum and in terms of its role in the new supervisory architecture), creating an EFC crisis coordination cell, establishing a Crisis Management Group (CMG) or Cross-Border Stability Group (CBSG) for each large EU cross-border financial group, requiring such financial groups to prepare Recovery and Resolution Plans (RRPs), and making ex-ante preparations for ex-post burden sharing. Because of the key importance of having a neutral voice at the table, it would be advisable for the ESAs to be represented in the CMGs and CBSGs, with a mandate to mediate and monitor adherence to the 2007 crisis management principles and the relevant MoUs. In addition, the ESRB can play a useful role in crisis management. While the ESRB cannot, for legal reasons, be given immediate power to declare an emergency—and thus activate emergency powers on the part of the ESAs—it could nonetheless be consulted before an emergency is declared and use the power of its recommendations to achieve greater coordination of crisis measures across all sectors (banking, insurance and securities).

E. Regulatory Reform

19. **The Basel proposals constitute the basis for the EU’s regulatory reform in the banking sector.** In the spring, the Commission conducted a public consultation on modifications to the capital requirements directive (a package commonly referred to as “CRD IV”) in order to reflect the new prudential rules proposed by the Basel Committee on

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8 See IMF Staff (2009b) for detailed staff views on deposit insurance in the EU.
Banking Supervision in December last year. These proposals represent landmark changes to the existing prudential framework and include: common liquidity standards, a tightening of the quality of capital, introduction of a leverage ratio, measures to counter the risk of procyclicality, and greater emphasis on counterparty credit risk, including risks related to derivatives exposures. These proposals could significantly strengthen the resilience of the European financial system to future shocks. However, an area of concern is the (cumulative) impact of these proposals on the cost of financial intermediation in Europe. The solution may need to combine a robust calibration with consideration of the appropriate timing and pace of introduction.

20. **Regulatory reform needs to provide adequate scope for effective macro-prudential policies.** An important issue is how the work of the ESRB (and ESAs) will interact with the substantive regulatory reforms already in train. Current regulatory reform proposals leave limited room for supervisory discretion and do not explicitly envisage the ESRB to play a role in providing guidance on the use of such discretion or the detailed calibration of requirements. To take full advantage of the emerging European infrastructure, it may be useful for the EU to issue standards in the form of a framework directive, opening up scope for modular calibration by the European authorities. Examples are capital surcharges for systemically important institutions and capital requirements and buffers that respond to the build-up of financial imbalances, both in aggregate as well as in particular countries and segments.

21. **The proposed Alternative Investment Funds Managers (AIFM) Directive should seek to reconcile financial stability and open markets.** The final shape of the directive is still far from certain, with strong differences of view among member states on the merits and detail of the directive. The United States and United Kingdom, along with many others, have raised concerns about the treatment of funds and asset managers located outside the EU. It would be preferable that the discussion on the directive foster a global debate leading to an international consensus on the appropriate regulation of these fund managers.

22. **Strengthening derivatives and market infrastructures remains a key challenge.** An important issue is the extent to which the framework will force or “mandate” contracts to be cleared by central counterparties (CCPs). The concern is that mandation may force a CCP to clear contracts that are illiquid or for which risk management on the part of the CCP may otherwise pose particular challenges, in turn creating single-point-of-failure risks. A pragmatic solution may be for clearing to be mandated for sufficiently standardized and liquid contracts, whereas for other contracts full use is made of the capital framework, so as to...

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9 See IMF Staff (2010b) for the Staff’s input in the Commission’s consultation.

10 See IMF (2010).
penalize bilaterally cleared contracts and incentivize, rather than mandate the use of a CCP. The legislative proposals on these matters, expected in the first half of this year, need also reflect any progress made in the United States where similar issues are being debated as part of the U.S financial reform legislation.
REFERENCES


