Overcoming the Euro Area Crisis—Reforms and Results

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1 Introduction

With the Euro Area sovereign debt crisis starting in May 2010, the institutional arrangements of the Euro Area were tested in the extreme. Private and public debt levels in a number of member states (MS) reached historically high levels. Asymmetric real shocks and the inability to adjust exchange rates in a monetary union have forced unprecedented pressures into the labour market of several MS. Although being far from a uniform process, in some countries public indebtedness has been exacerbated by the financial crisis and recession, and this in turn has contributed to financial instability. In response to this difficult period, as this paper argues, European and national institutions have accepted these challenges and worked collectively towards appropriate policy responses. In particular, the pressing need to undertake fiscal consolidation in many countries and to avoid future fiscal crises in the Euro Area induced a wide array of national and European reform measures.

This paper gives a brief overview of these new policies, new instruments and preliminary results attributable to these measures that have been implemented to solve the financial and sovereign debt crises in the Euro Area. It is shown that comprehensive measures have been taken to respond to the current challenges and that some of these measures are bearing fruits already while others will be visible in the longer term.

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This paper is structured as follows: Each section examines one of the policy reform pillars, comprised of different policy measures that were introduced in response to the Euro Area financial and economic crises. The following section begins with the measures taken to stabilise budgets. Fiscal data are employed as to outline some of the concrete policy achievements that are already observable. Section 3 discusses policy measures that are the building stones towards new economic governance. Some data are provided to show how these measures have already helped stabilise economic imbalances. Section 4 presents the financial assistance mechanisms that were created in the wake of the crisis. Sections 5–7 provide information on additional policy measures taken on financial regulation, the foundations of a banking union and European Central Bank (ECB) crisis management. The diagram below illustrates the architecture of the stabilisation effort.

2 Stabilising Budgets

Despite differences in timing and magnitudes of private and public debt developments across Euro Area countries, public and private household indebtedness has generally shown a considerable increase in the most recent past.[1] In response to these developments, concrete Euro Area policies aim at stabilising national budgets in the long term and a new and improved budgetary surveillance process was introduced. The following sub-sections present four key reform measures that were taken—namely the reform of the Stability and Growth Pact (SGP), the Fiscal Compact, the European Semester and the Compact for Growth and Jobs. Recent data are presented to assess the preliminary achievements of these policy actions.

2.1 Reform of the Stability and Growth Pact

The *Stability and Growth Pact* is a rules-based framework for coordinating and monitoring national fiscal policies in the European Union. It was set up in 1997 in order to guarantee solid public finances—an important prerequisite for the correct functioning of the economic and monetary union. The 1992 Maastricht Treaty included convergence criteria for joining the monetary union, which were intended not only to ensure price stability and stable long-term interest and exchange rates but also to set maximum limits on MS' total indebtedness and net borrowing. Government debt was limited to not exceed 60 % of GDP, and deficits to not exceed 3 % of GDP. The SGP further refines these criteria and describes procedures to be followed after violation of these criteria.

By now it is generally accepted that this approach had two main defects: Firstly, it did not adequately allow for cyclical variation in budget positions, and secondly, it did not have an effective mechanism to discipline countries that exceeded the limits. In 2005, therefore, the pact was revised through the introduction of rules requiring structurally balanced budgets, which allowed cyclical effects and one-off items to be stripped out. A structural budget balance target encourages governments to take advantage of cyclical revenue gains during upturns to offset slippage in the overall budget balance during recessions, i.e. to let automatic stabilisers work. The policy intention was to address the first problem. However, the revision still did not offer a solution to the second problem mentioned above, namely it did not provide for effective sanctions when these rules were breached. Ultimately, it was the sovereign debt refinancing problem of some MS of the Euro Area that exposed these weaknesses. In order to rectify these problems, further extensive reforms to the SGP were undertaken. The new rules, which took effect in December 2011, aimed to ensure that greater budgetary discipline was not only demanded but also enforced. To this end, the terms of the pact were substantially modified and made more stringent in several areas. The reformed pact includes a preventive and a corrective arm:

[1] This trend is not confined to the Euro Area.

Preventive Arm

To prevent excessive debt ratios from arising in the first place, MS are expected to substantially reduce their new borrowing. Instead of maintaining a primary focus on limiting deficits to 3 % of GDP, the main emphasis is now on (1) achieving the medium-term goal of a structurally balanced budget and (2) establishing effective sanctions to foster compliance. This is similar to the priorities established under Germany's "debt brake"[2]. MS are required to submit annual Stability or Convergence Programmes[3] outlining the way they intend to achieve or maintain a balanced or close-to-balance budget in the medium term. In the ex post assessment, the Commission determines whether a MS has made sufficient progress towards the medium-term budgetary objective, which must be specified within a defined range of no more than −1 % of GDP. If the Commission finds evidence of significant deviation from the medium-term budgetary objective, this can be followed, in the case of Euro Area MS, by a sanction equal to an interest-bearing deposit of 0.2 % of GDP.

Corrective Arm

For the first time, a numerical benchmark has been stipulated for the reduction of excessive debt: Countries whose debt ratio exceeds 60 % of GDP are required to reduce the difference between their debt ratio and the 60 % target by 1/20 each year, even if their deficit is below 3 % of GDP. Otherwise, they face the sanction of an excessive deficit procedure[4].

[2] Since 2011, the German Federal Government has been required to reduce its structural net borrowing step by step through the so-called "debt brake," as enshrined in Germany's constitution. From 2016 onwards, the Federation's net borrowing, adjusted for cyclical fluctuations, will not be permitted to exceed 0.35 % of Germany's gross domestic product. A transitional period, lasting until 2020, has been established for the Länder. From then onwards, they will have to have structurally balanced budgets. A control account has been created, which should be balanced in the medium term. The control account will document non-cyclical deviations from the maximum permissible net borrowing that arise in each fiscal year. To accommodate cyclical fluctuations, additional net borrowing may be incurred during a downturn while in economic good times the resulting cyclical surplus reduces the maximum permissible net borrowing. In an emergency situation, a majority of the Bundestag can approve additional net borrowing. However, this must be accompanied by a binding amortisation plan which provides for the reduction of net borrowing above the standard threshold within an appropriate time frame. This guarantees that higher net borrowing in response to exceptional circumstances does not endanger long-term fiscal sustainability.

[3] Under the provisions of the Stability and Growth Pact, EU member states must each year draw up Stability Programmes (in the case of Eurozone members) and Convergence Programmes (for non-Eurozone countries aspiring to join the Eurozone). In these programmes, the member states must provide details of their fiscal policy strategy and report on their compliance with the Stability and Growth Pact.

[4] The Excessive Deficit Procedure (EDP) operationalises the procedure that is launched when the budget deficit and public debt exceed the thresholds of 3 % of deficit to GDP and 60 % of debt to GDP, respectively, and ensures that member states adopt appropriate policy responses to correct excessive deficits.

In Euro Area countries, the requirements are even more stringent. The reduction of both deficits and debt ratios is now subject to a graduated and largely automatic sanctions procedure. To this end, a new voting procedure has been introduced. A sanctions resolution recommended by the Commission is deemed to have been adopted if it is not rejected by qualified majority of Euro Area members. MS are required to fulfil minimum standards in order to ensure transparency and comparability. These standards include, for example, multiannual budget planning, numerical fiscal rules and more transparency on spending. Moreover, fraudulent statistics on deficits and debts will be subject to strict sanctions in the future. Falsified statistics will be punished by a fine amounting to 0.2% of GDP.

2.2 Fiscal Compact

The *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (generally referred to as the *Fiscal Compact)* was signed in March 2012 by all MS of the EU, except for the UK and the Czech Republic. By signing the treaty, these 25 countries have committed themselves to introducing long-term budgetary rules into their national legal systems, preferably at constitutional level. The intergovernmental treaty was introduced as a new, stricter version of the SGP. The key rationale of the treaty was the need of new treaty-based provisions to achieve the reduction of acute excesses of government debt as quickly as possible. The long-term prevention of excessive government debt was acknowledged as an important precondition for the functioning of an economic and monetary union.

Consequently, the treaty does not only inlcude new budgetary rules, but also a strengthening of the deficit procedure and enhanced policy coordination and control. The Fiscal Compact required MS to embed the newly established fiscal principles in their national legislation. By July 2013, ratification of the Fiscal Compact was notified by 21 MS of which 13 belong to the Eurozone. The fiscal governance reforms of the treaty are based on empirical evidence[5] that high public debt levels pose a threat to fiscal sustainability and growth. Therefore fiscal balances should be

[5] A lot of empirical work has dealt with the negative relationship between debt and growth. An often-cited study in this context was published by Reinhart and Rogoff in 2010. Reinhart and Rogoff (2010) found a nonlinear debt–growth relationship, suggesting that GDP growth drops more severely once government debt-to-GDP ratios exceed 90% (an IMF paper by Kumar and Woo (2010) had similar findings). The existence of a sharp turning point was explained by market perceptions of risk. Most recently, the Reinhart and Rogoff (2010) finding of a debt threshold has been called into question by Herndon et al. (2013) on grounds of identified coding errors and deficiencies in their original data set. In contrast to the finding of a sharp turning point to growth once debt attains a certain level, Herndon et al. (2013) suggest that growth rates merely decline with rising debt, which makes the relationship look rather linear. Beyond the question of linearity, both authors do provide conclusive empirical evidence for a negative association between debt and growth. A look at the literature confirms that firm conclusions on sharp turning points of the growth–debt relationship may be difficult. A more recent IMF publication (IMF World Economic Outlook 2012) found “no particular threshold that consistently precedes sub-par growth performance” but confirms a negative debt–growth relationship.

close to zero "over the cycle". Specifically, the new treaty contains the following changes to existing EU legislation:

1. New budgetary rules: The new treaty contains ambitious targets for national debt brakes. If the debt-to-GDP ratio of an MS is not well below the 60 % threshold, this MS is urged to set a medium-term objective whereby the structural deficit does not exceed 0.5 % of GDP. Thus, the Fiscal Compact goes beyond the existing requirements of the SGP's preventive arm (see above), which caps general government structural deficits at 1 % of GDP. Also, these automatic debt brakes have to be integrated in national law and will be monitored by the Court of Justice of the European Union. Moreover, the granting of financial assistance under the European Stability Mechanism (ESM) is closely tied to the Fiscal Compact. Any country wishing to claim ESM assistance must have ratified the Fiscal Compact and transposed the debt brake provisions into national law. This principle is enshrined in both the ESM Treaty and the Fiscal Compact.
2. Strengthening of the deficit procedure: MS in an excessive deficit procedure are required to put in place a budgetary and economic partnership programme, which is approved and monitored by the Council and the European Commission. If an MS fails to comply with deficit criteria in the future, there will be a semiautomatic opening of an excessive deficit procedure (by reverse qualified majority decision).[6]
3. Tightening of the policy coordination and control: The MS agree to work towards a common economic policy. To improve governance of the Euro Area and to facilitate the discussion and adjustment of all important reform plans of the MS, the Fiscal Compact calls for Euro Summits to be held on a regular basis—at least twice a year.[7]

2.3 European Semester

The *European Semester* was adopted by the European Council in June 2010 and first launched in 2011. This instrument's central task is to achieve common timetables for setting up national budgets, to coordinate economic policies and structural reforms within the framework of the Europe 2020 strategy[8] and thereby to improve the consistency, integration and implementation of necessary financial and economic

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[6] This means that semi-automatic decisions under the reverse qualified majority voting procedure—which previously applied only to the imposition of sanctions in accordance with the reforms to the Stability and Growth Pact—have now been extended to the launching of excessive deficit procedures.

[7] The treaty also provides for the organisation of a conference of representatives from the European Parliament and national parliaments to discuss budgetary policies and other issues covered by the fiscal compact.

[8] To be further discussed in Sect. 3.

reforms. Moreover, conclusions from the Macroeconomic Imbalance Procedure (MIP) and the Euro-Plus-Pact[9] will also be taken into account.

The European Semester covers a 6-month cycle which begins in January each year. In addition to policy coordination, MS are given political guidance and recommendations while their national budgets are still under preparation. This gives a stronger *ex ante* dimension to the coordination and surveillance of economic policy in the EU. In this way, the EU can react to developments in the MS, and the MS for their part can include European perspectives and guidance in their policies for the following year.

As part of the European Semester, the European Commission produces an Annual Growth Survey at the beginning of each year. The survey outlines the most important fiscal, economic and employment policy challenges faced by the EU and recommends priority measures to deal effectively with these challenges. Based on this report, the European Council formulates horizontal guidelines at its spring meeting in March. In April, the MS submit their Stability and Convergence Programmes (SCP) and National Reform Programmes (NRP) to the European Commission. Based on the Commission's assessment, the Economic and Financial Affairs Council (ECOFIN) adopts country-specific recommendations for the SCP and NRP. These are finally approved by the European Council at the end of June, which concludes the European Semester's 6-month cycle.

2.4 Compact for Growth and Jobs

Many Euro Area countries (in common with many G20 countries) face an unprecedented need to restore fiscal sustainability through credible consolidation plans. For many of these countries, stabilising debt—let alone putting government finances on sustainable positions—constitutes a major challenge and requires sizeable fiscal consolidation. Notwithstanding the pressing need to consolidate, it should be recognised that "slamming on the brakes too quickly" may have serious implications for economic growth and social equity. This means that the long-term benefits of fiscal consolidation must be balanced against short-term (and perhaps medium-term) adverse impacts. However, there is a severe problem with abstaining from consolidation altogether, given the tendency of sovereign risk to adversely affect borrowing conditions in the broader economy.[10]

In many ways, the Compact for Growth and Jobs constitutes a balancing measure that aims to offset potential short-term side effects of consolidation under the

[9] Both to be further discussed in Sect. 3.

[10] There are additional reasons to be ambitious in fiscal consolidation: Looking ahead, the observable trend of population ageing in many Euro Area countries suggests more serious challenges for public finances in the future. Countries will be ill-prepared to cover these costs unless public finances are consolidated before the estimated period when demographic transition will be most burdensome on the budget. It also entails permanent costs, which would need to be addressed through structural reforms, including a review of pension entitlements.

Fiscal Compact. The Compact for Growth and Jobs was adopted in June 2012 by the European Council and makes € 120 billion of funds available for direct investments as follows:

- € 60 billion additional EIB (European Investment Bank) lending through capital increase,
- € 55 billion reallocation of Structural Funds and
- € 4.5 billion in Project Bonds.

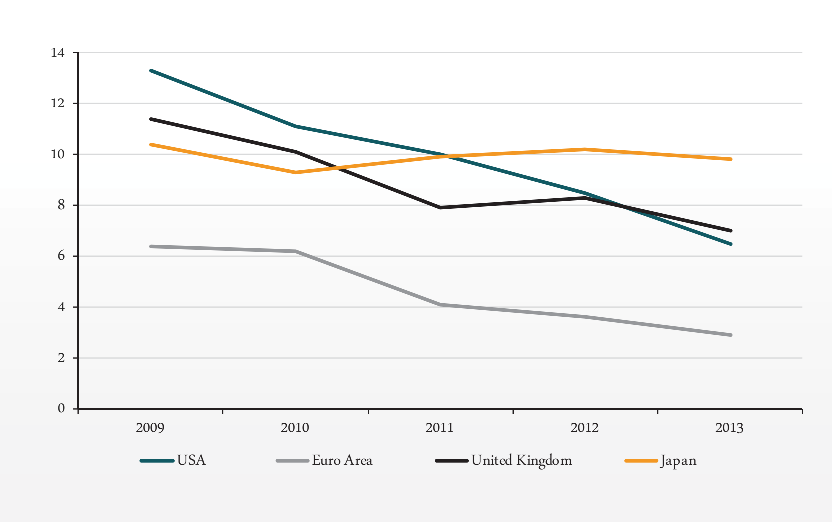
Nevertheless, the Compact for Growth and Jobs underlines the fact that MS should remain attentive to balance their fiscal accounts and follow "differentiated growth-friendly fiscal consolidation, respecting the Stability and Growth Pact and taking into account country-specific circumstances; particular attention must be given to investment into future-oriented areas directly related to the economy's growth potential and ensuring the sustainability of pension systems" (European Council 2012, p. 8).

2.5 Preliminary Achievements: Stabilising Budgets

Despite lingering uncertainty in financial markets, data confirm that progress regarding budget balances in the Euro Area has been made. Budget deficits as a percentage of GDP decreased significantly in the Euro Area on average. More interestingly, however, structural budget deficits also fell on average from 4.6 % in 2009 to 2.4 % in 2012. In its April forecast, the IMF anticipates a further decline in the average Euro Area structural budget deficit to 1.3 % in 2013. Special emphasis should be given to the reduction in the structural deficit because it demonstrates the effectiveness of the structural measures which the Euro countries have adopted to consolidate budgets. Of the deficit reduction anticipated for the 2009–2012 period, around three quarters of the total are due to a decline in the structural deficit and one quarter is due to cyclical and one-off effects.

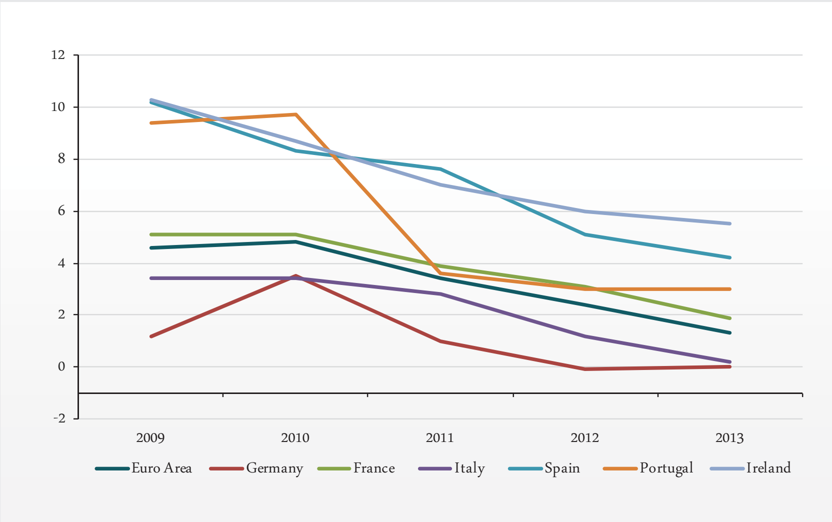
The goal of sustainable public finances cannot be achieved without reducing structural deficits. Under the SGP, countries that have not yet reached the medium-term budgetary objective of having budgets close to balance are required to reduce their structural deficits by at least 0.5 percentage points each year. Additional requirements apply to countries under excessive deficit procedures. Departing from structural budget consolidation to pursue fiscal policy that has no effect on the cyclical trend would have enormous consequences for individual countries' success in consolidating their budgets. A comparison of two scenarios demonstrates the implications of this for the 2013 budget deficit. The baseline scenario shows structural budget consolidation with a reduction in the structural deficit in line with the Stability and Growth Pact. An alternative scenario of fiscal policy that delivers a constant structural deficit, i.e. with automatic stabilisers operating fully, would in the case of France see its nominal deficit rise to over 5 % of GDP in 2013, compared to 3.5 % in the first scenario.

International comparison of deficits
(as % of GDP)



Sources: IWF Fiscal Monitor, April 2013.

Structural deficits
(as % of GDP)



Source: IWF Fiscal Monitor, April 2013

It should also be noted that deficits and overall debt in the Euro Area still appear low by international comparison. In 2012 for example, budget deficits in most parts of the world exceed the 3.3 % of GDP for the Euro Area, with the USA having a deficit of 8.6 %, the UK 8.3 % and Japan 10.1 %. Debt levels also compare favourably with other advanced countries.

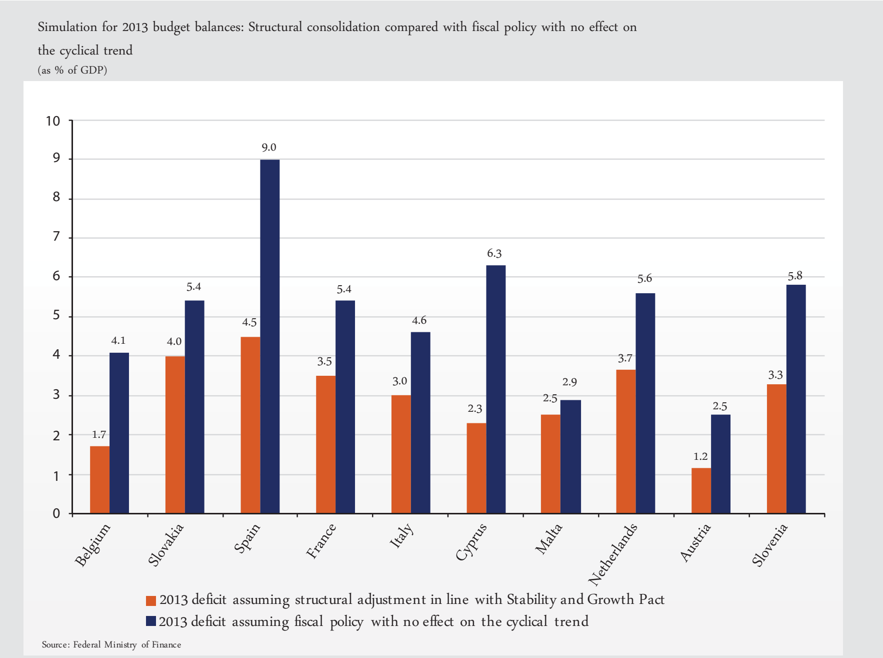


Table 1 Debt levels and dynamics. (Source: IMF Fiscal Monitor April 2013)

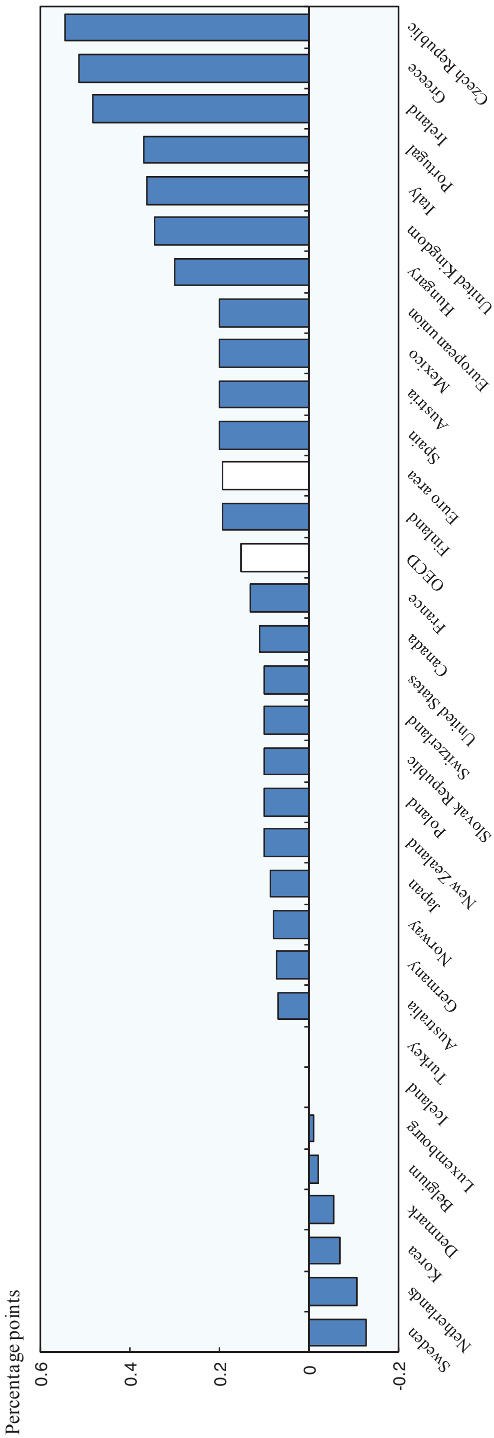
General government gross debt (% of GDP)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
G20—advanced economies	102.0	108.8	113.3	117.7	117.9	118.2	117.7	116.9	116.1	115.1
G-7	106.6	114.7	119.9	124.7	125.2	125.8	125.4	124.7	124.1	123.4
Eurozone	80.1	85.6	88.1	93.1	95.1	95.3	94.6	93.5	91.8	89.9
USA	89.1	98.2	102.5	106.5	108.6	109.8	109.5	109.3	109.4	109.7
Japan	210.2	215.0	229.3	237.1	244.5	247.0	249.7	251.5	253.2	254.8

These facts support the view that the reform approach described above, with structural budget consolidation coupled with resolutely implemented structural reforms, is the right course to pursue, is yielding first positive outcomes and should be continued.

The figure below shows that the change in overall responsiveness to *Going for Growth*[11] recommendations across Organisation for Economic Co-operation and Development (OECD) countries from 2009-10 to 2011-12 was particularly high in the European crisis countries. This confirms the notion that especially countries such as Greece, Spain, Ireland and Portugal are committedly following structural reforms. One can be reasonably hopeful that the positive impact of these reforms on growth will materialise once the usual time lags have passed.

[11] Going for Growth is the OECD's flagship report on structural policies, where it identifies and reviews progress on key priorities to achieve strong and sustained growth in each OECD country.

Change in responsiveness to Going for Growth recommendations across OECD countries from 2009-10 to 2011-12



Source: OECD (2013), *Economic Policy Reforms 2013: Going for Growth*

3 Stabilising Economies

The second major reform pillar is the move towards new economic governance. Major steps in this realm include the Europe 2020 Strategy, the Euro Plus Pact and the MIP, which are briefly described below. Although many of the positive results of these policies may only become visible in the longer term, some of the policies are bearing fruits already, especially the correction of macroeconomic imbalances.

3.1 Europe 2020 Strategy

Europe 2020 is a 10-year growth strategy (2010–2020) which replaces the Lisbon strategy. The strategy's central aim is to ensure that the EU emerges stronger from the crisis, with a smart, sustainable and inclusive economy characterised by high levels of employment, productivity and social cohesion. Therefore five headline targets were formulated:

1. Raising the employment rate of the population aged 20–64 from 69 % to at least 75 %,
2. Investing 3 % of GDP in research and development,
3. Achieving the "20–20–20" climate protection and energy targets by achieving at least a 20 % cut in greenhouse gas emissions compared with 1990 levels, raising the share of renewable energy in final energy consumption to 20 % and increasing energy efficiency by 20 %,
4. Reducing school drop-out rates from the current 15–10 % and increasing the share of the population aged 30–34 completing tertiary education from 31 % to at least 40 % and
5. Reducing the number of people at risk of poverty by at least 20 million.

In order to achieve these headline targets, the MS have set themselves concrete national targets in the above five areas. In the context of the European Semester, MS submit annual reports on their National Reform Programmes in which they detail progress made towards achieving their national targets.

3.2 Euro Plus Pact

The aim of the Euro Plus Pact is to further strengthen the economic pillar of the economic and monetary union and to attain better economic policy coordination. Its primary objective is therefore to promote and harmonise competitiveness, and to foster a higher degree of growth and convergence throughout the EU. Adopted in March 2011, the Euro Plus Pact is an agreement of the euro countries and six non-euro countries Denmark, Latvia, Lithuania, Poland, Bulgaria and Romania.

The pact focuses primarily on measures in policy areas that fall under the national competence of the MS themselves, such as:

- fostering competitiveness,
- boosting employment,
- enhancing the sustainability of public finances and
- reinforcing financial stability.

Every year the heads of state or government of participating MS commit themselves to a set of concrete actions in these priority areas, to be realised over the next 12 months. The choice of specific policy actions to achieve the common objectives remains the responsibility of each country. National Reform Programmes as well as Stability and Convergence Programmes must include reporting on the implementation of these measures. These programmes are then assessed by the European Commission, the European Council and the Eurogroup as part of the European Semester. Involving heads of state or government in the Euro Plus Pact ensures a high level of political commitment and visibility. This increases the pressure on MS to actually implement the planned measures on time. Furthermore, the pact demonstrates that MS are ready to intensify the coordination of national policies.

3.3 Macroeconomic Imbalance Procedure

The financial and sovereign debt crises have shown that existing instruments for monitoring fiscal and economic policies were incomplete. This allowed economic tensions and imbalances to arise in certain countries, which ultimately posed risks to the macroeconomic stability of the Euro Area and the EU as a whole. With the adoption of the euro, current account imbalances became entrenched within the Euro Area, as core countries tended to run surpluses and peripheral countries deficits.[12] The worsening of the current account balances of the peripheral countries seems to have occurred *pari passu* with the increasing surpluses of the core countries. These imbalances appear particularly pronounced by historical standards. While the Euro Area as a whole has remained close to external balance, considerable divergence in the current account balances among MS have emerged. The EU's new macroeconomic imbalance procedure was created to deal with this issue using appropriate instruments.

The new procedure aims to identify MS with—or at risk of—macroeconomic imbalances that may consequently threaten the stability of their own economy, the Euro Area and the EU as a whole. Such imbalances may result, for example, from overheating domestic economies, rapidly expanding credit volumes or fast-rising home prices. The procedure focuses in particular on MS with major competitive weaknesses. It contains an early warning system—an indicator-based scoreboard

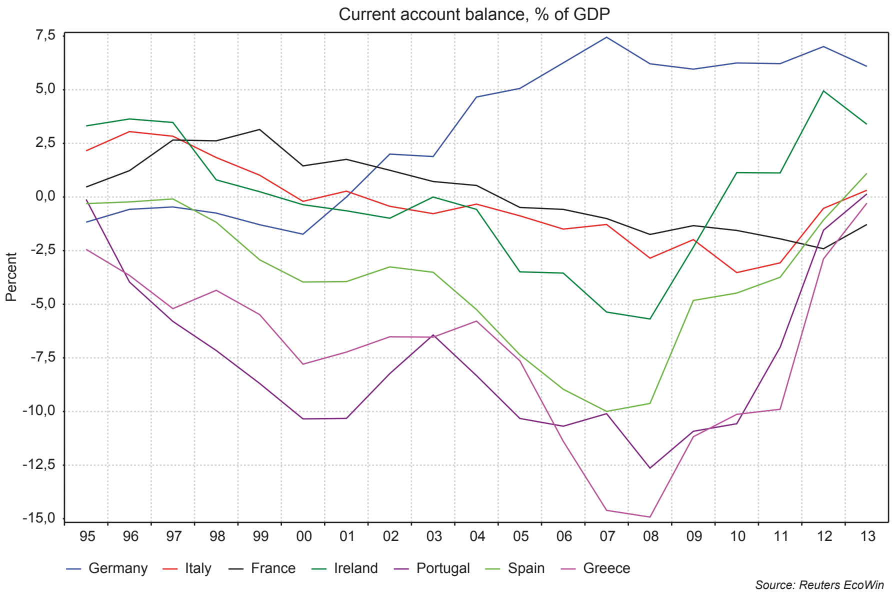
[12] For the purpose of this paper the periphery includes Greece, Portugal, Spain, Ireland and to a lesser extent Italy, while the core comprises Germany, the Netherlands, Austria and France.

that helps identify macroeconomic risks in MS at an early stage. If the indicators trigger an alert for a country, that country is bound to initiate corrective measures. As a last resort, (e.g. in the event of repeated failure to take appropriate countermeasures) MS can even face financial sanctions. Formally, the MIP is embedded within the European Semester.

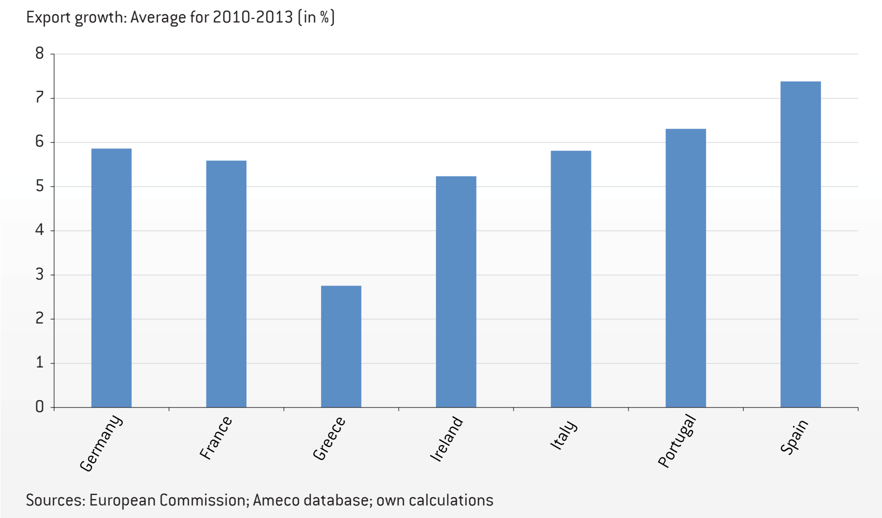
3.4 *Preliminary Achievements: Stabilising Economies*

First of all, it should be noted that many of the results of the substantial reforms in economic governance may only become observable in the longer term. Despite this time lag, there is some evidence that the correction of macroeconomic imbalances is making progress already. This may be interpreted as a sign of the first successes arising from the structural reforms implemented to date.

The figure below shows that the precrisis trend of diverging current account balances within the Euro Area has generally reversed since 2008. Current account deficits in particular have fallen in Spain, Greece and Portugal. Recent data by the European Commission show that current account deficits as a percentage of GDP fell from 9.6 to 0.5 % in Spain, from 12.6 to 1.5 % in Portugal and from 14.9 to 4.6 % in Greece between 2008 and 2013.

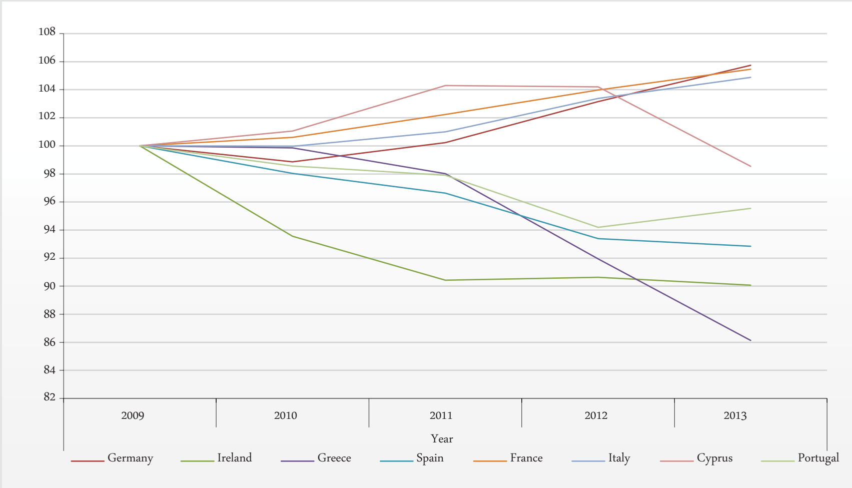


Although an important factor behind this, the decline in current account deficits is not just a result of the fall in domestic demand leading to lower imports. Recent supply-side improvements also contributed to the correction of current account imbalances: Exports have climbed considerably in some deficit countries. In Portugal and Spain for instance, annual export growth between 2010 and 2012 averaged around 7 %. Germany's current account surplus with other Euro Area countries has decreased substantially compared with the precrisis period, with domestic demand being bolstered by growth in employment and income. Although a more nuanced view may point out intercountry difference, the tendency is that current account imbalances decline. In many deficit countries, the excesses in the domestic sectors over the past years (i.e. a strong focus on domestic consumption, frequently in conjunction with a boom in construction) are increasingly being corrected. A reallocation of labour and capital resources from shrinking domestic sectors to growing export-oriented sectors is underway.



A change in relative prices is important to create incentives to achieve this realignment. If the restructuring continues, the economies concerned will experience lasting stabilisation, providing a boost for their labour markets, among other things. Nevertheless, time is required for the shift in the focus of production from domestic consumption to exports, and this is leading to a temporary increase in unemployment. Complementary structural reforms are important so as to open up new job prospects and prevent unemployment from becoming entrenched.

Nominal unit labour costs
(2009 = 100)



Sources: European Commission, Ameco database; own calculations

In many of the countries that were particularly hard hit by the crisis, competitiveness is improving, as demonstrated, e.g. by falling unit labour costs in these economies. In Ireland and Greece, nominal unit labour costs are expected to decrease by 10 % between 2009 and 2012. Spain and Portugal have seen unit labour costs fall by 6 % over the same period. The World Economic Forum's recent Global Competitiveness Report—which places Germany among the six most competitive countries worldwide, ahead of Japan, the UK and the USA—confirms that many of these countries have improved their competitiveness.

The sustainable reduction of current account deficits requires this improvement in international competitiveness on the part of countries such as Cyprus, Greece, Portugal and Spain to continue. Steps must be taken to ensure that wage developments in these MS continue to grow competitiveness and that rigidities on product markets continue to be dismantled.

4 Financial Assistance Mechanisms

The refinancing crisis in several Euro Area members made it necessary to establish a package of financial assistance mechanisms. Measures such as the European Financial Stability Mechanism (ESFM), the European Financial Stability Facility (EFSF) and ultimately the ESM were set up to support MS in difficulty and thereby preserve financial stability.

4.1 European Financial Stability Mechanism

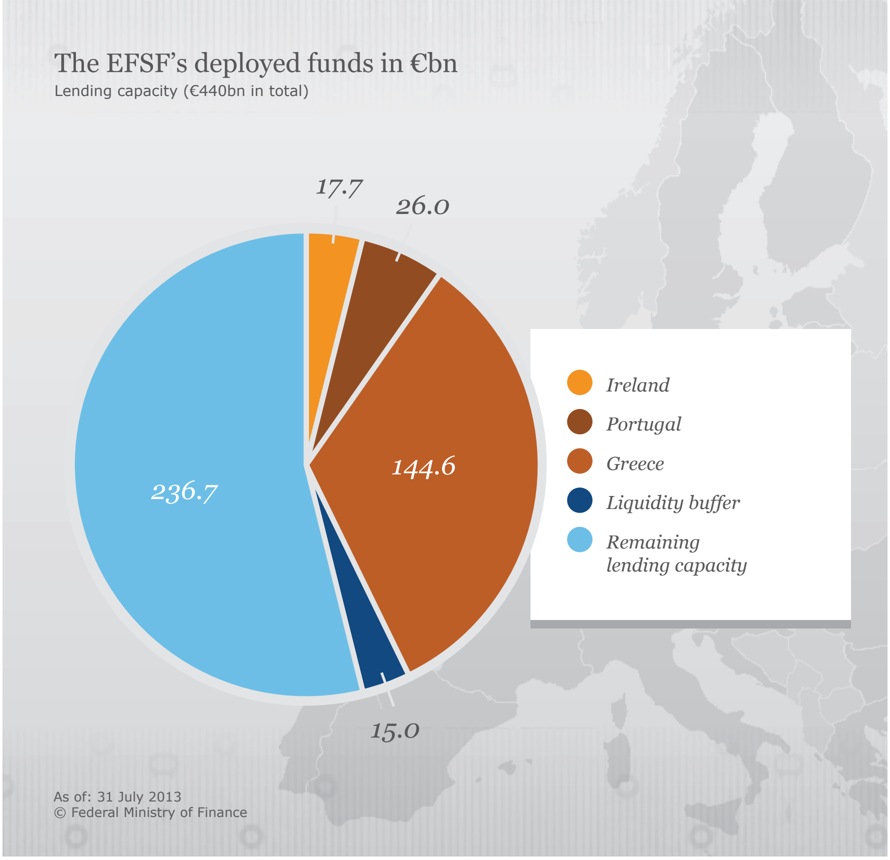
The EFSM is part of the temporary euro rescue package put together in 2010 (along with the EFSF and contributions from the IMF) and contributes € 60 billion to the rescue package's capital resources. Germany's share of the funding corresponds to its share of the EU budget, which is around 20 %. Once the permanent ESM was coming into force, the EFSM was wound down.

4.2 European Financial Stability Facility

The EFSF is another element of the temporary euro rescue package put together in 2010 to respond to the acute sovereign debt crisis. The EFSF is a private-law corporation founded under Luxembourg law. It is authorised to grant emergency loans through mid-2013 to countries in the Euro Area if their problems pose a risk to the stability of the monetary union as a whole. It borrows on capital markets in order to lend, and the Euro Area countries provide pro rata guarantees on those loans up to a total of € 780 billion.

The EFSF has a lending capacity of € 440 billion. In the case of default, the MS are liable to the amount of their capital share. The financial assistance packages are only available to countries that adopt strict austerity and reform programmes to ensure that the causes of the debt crisis are addressed. This will be monitored by the so-called Troika of European Commission (EC), ECB and IMF. The chart below shows the EFSF's deployed funds as of February 28, 2013. In Juli 2013, EFSF and the EFSM were replaced by the permanent ESM (see below).[13]

[13] Not shown in the diagram below, Spain has been provided with sector-specific financial assistance up to € 100 billion in EFSF/ESM credits in order to stabilise its banking sector (this includes a security buffer, as the exact amount of assistance needed is not known yet). The credit will first be channelled to FROB, the government's restructuring fund, which will then distribute assistance to troubled banks. As of September 2013, € 41.4 billion have been effectively used.



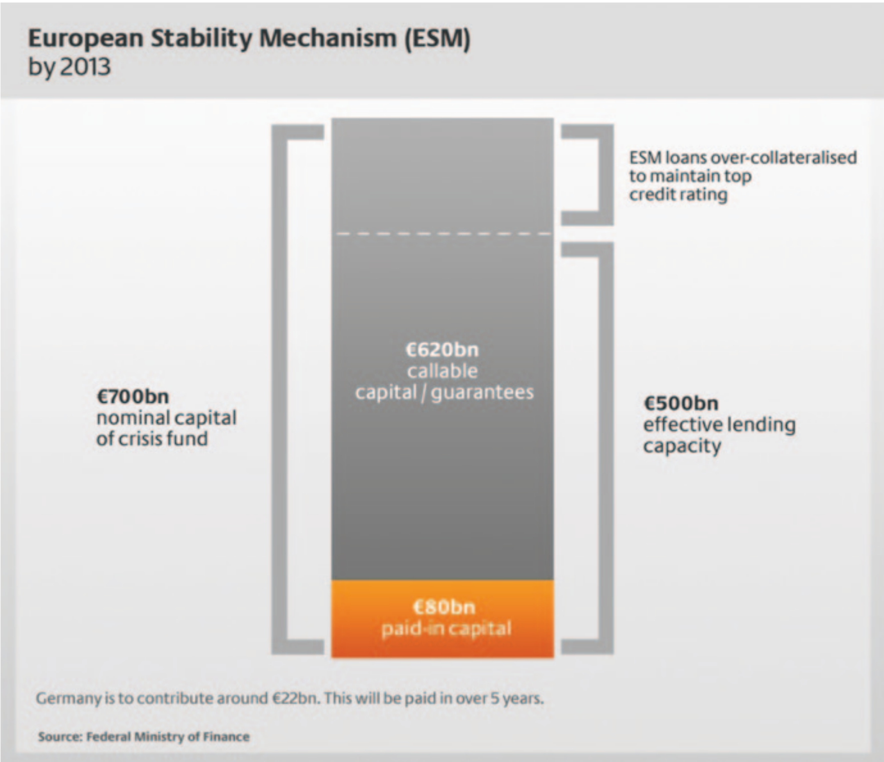
In addition to granting emergency loans, the EFSF (like its successor ESM) is authorised to use the following instruments:

1. Precautionary financial assistance: Like the IMF, the EFSF grants credit lines to MS with sound economic fundamentals that are experiencing short-term financial difficulties. The aim is to safeguard market confidence in otherwise strong economies and to prevent an actual crisis that might then spread to other countries.
2. Financial assistance to recapitalise financial institutions: Where specific problems in an MS's financial sector pose a risk to financial stability, the EFSF can grant loans to MS authorities that may be used to recapitalise financial institutions. European state aid legislation must be complied with. The recipient MS rather than the financial institution is responsible for repaying the loan and complying with the conditions attached.
3. Primary market purchases: The main objective of this instrument is to allow a country to retain access to the primary bond market or to allow it to regain access—for example after completing an adjustment programme. In such cases the EFSF participates by purchasing that country's new issues.

4. Secondary market interventions: Where the ECB has evidence of an extraordinary situation arising on the financial market or threats to financial stability, sovereign bonds can be purchased on the secondary market in exceptional cases. The aim of this measure is to support the functioning of the sovereign bond markets and to guarantee sufficient liquidity on those markets. Work is currently ongoing to implement the two options agreed in October 2011 to optimise the EFSF's lending capacity by partially guaranteeing sovereign bonds and to create Co-Investment Funds allowing a combination of public and private funding.

4.3 European Stability Mechanism

All Euro Area MS have agreed to establish the permanent ESM by international treaty as an international financial institution. Its purpose is to mobilise financial resources and make them available to Euro Area MS that are experiencing financial difficulties. It uses the same instruments as the EFSF (see above). The assistance is provided only under strict economic policy conditionality and only when it is indispensable for safeguarding the stability of the Euro Area as a whole.



The policy conditions are agreed as part of a macroeconomic adjustment programme that targets the affected country's economic and financial imbalances. In addition, the financial assistance is linked to ratification of the Fiscal Compact and—after the expiry of the relevant implementation period set out in the Fiscal Compact—coupled to implementation of the new debt rule. The Eurozone finance ministers have agreed to allow the ESM to enter into force already in 2012, earlier than initially envisaged. National ratification procedures have been finalized in the MS. The ESM will have a subscribed capital of € 700 billion. This is made up of € 80 billion of paid-in and € 620 billion of callable capital. The capital will be paid in five tranches, with the first two tranches paid during the course of 2012, and the remaining tranches to be paid in 2013 and 2014.

The ESM Board of Governors comprises the Euro Area's finance ministers. Decisions are taken by unanimity, but for issues that require quick decisions, a majority representing 85 % of the capital shares is sufficient. The ESM also has a Board of Directors that is responsible for the day-to-day management of the ESM. In order to facilitate private sector participation, Collective Action Clauses (CAC) will be included (from 2013) in newly issued government bonds of all MS. In a restructuring situation an agreement between the state and its private creditors will thus become easier.

In sum, the European firewall capacity now totals around € 800 billion and consists of:

- € 188 billion pledged EFSF funding for Ireland, Portugal and Greece (second programme),
- € 53 billion in bilateral loans for Greece (first programme),
- € 49 billion from the EU budget under the EFSM for Ireland and Portugal and
- € 500 billion new lending capacity of the ESM.

5 Stabilising Financial Markets

Regarding financial regulation, Europe has also already taken action and further measures are planned. Some of them are briefly listed here:

- Implementation of Basel III (Capital Requirements Directive—CRD IV).
- Revision of the EU regulation on credit rating agencies.
- Revision of the Markets in Financial Instruments Directive (MiFID) and the current rules on market abuse and investment funds.
- More stringent regulation of over-the-counter (OTC) derivatives markets (European Market Infrastructure Regulation—EMIR).
- Curbing banking pay practices that encourage recklessness.
- Fundamental reform of European insurance supervision law (Solvency II).
- First discussions to regulate the shadow banking sector (G20).
- Consideration of reforms to the structure of the banking sector (Liikanen Group).

6 Banking Union

Another key reform step was the deepening of European banking sector integration. In this context the discussion of a European Banking Union with common bank supervision, restructuring and resolution has been pushed forward. The recent crisis demonstrated the speed and extent to which problems in the financial sector of one country may spread to another. This is especially the case in a monetary union: Local financial turmoil may quickly threaten the stability of the entire Euro Area banking system. The rationale for a banking union is thus that such developments and the underlying financial structures need to be managed jointly by EU or Eurozone MS.

This more integrated financial framework is being built upon three components: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) for banks and a system of deposit protection.

Following the political accord of EU ECOFIN ministers in December 2012, negotiations about the new SSM were concluded in 2013. The agreement will become operational in 2014 and will see the ECB (in collaboration with national supervisory bodies) having direct oversight of large Eurozone banks. To avoid conflicts of interest, an important feature of the SSM is the effective separation of monetary policy and banking supervision tasks within the ECB. A second important feature of the SSM is that national authorities of non-Euro Area MS have an option to participate in the SSM. Obviously, the concentration of more powers at the ECB implies a higher level of accountability and transparency. The Council's proposal of December 2012 addresses this issue by creating a Review Panel of SSM decisions from a legal point of view and, in particular, by defining the accountability of the SSM to the European Parliament. Last, but not least, the SSM builds the precondition for a possible direct recapitalisation of banks by the ESM.

A second element of the Banking Union is the establishment of an SRM. The draft Bank Restructuring and Resolution Directive lays out a harmonised toolbox of resolution powers and bail-in instruments. Negotiations are well underway.

The third element of the Banking Union is the establishment of a common system of deposit protection. A system, built on common EU standards, will be important in the future to ensure enhanced depositor confidence in the robustness of European banks. This element can also help reduce the risks of financial fragmentation that results from contagion fears. The corresponding draft Deposit Guarantee Schemes Directive is still under discussion.

7 ECB—Measures

Since the eruption of the sovereign debt crisis in the Euro Area in May 2010, the ECB has been in the spotlight of crisis management and resolution and agreed to a number of non-conventional measures:

1. *Securities Market Programme (SMP):* Since May 2010, the ECB repeatedly purchased government bonds from Eurozone countries on the secondary market. The current outstanding amount is € 190,7 billion as of September 24, 2013. The SMP expired in September 2012.
2. *Outright Monetary Transactions Programme (OMT):* The OMT was introduced in September 2012 and replaced the SMP. Under its provisions, government bond purchases are possible under strict conditions. A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate EFSF or ESM programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme. Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between 1 and 3 years may be bought without limit on secondary markets, and the ECB has waived its preferred creditor status. All purchases will be published and thus made transparent, although there have been no purchases yet. The excess liquidity generated will be fully sterilised through repo or open market operations.
3. *Longer-Term Refinancing Operations I and II (LTRO):* In 2011, the ECB Council announced two refinancing operations with a maturity of up to 36 months to support the real economy and to improve the liquidity situation in the euro money market.[14]
4. *Covered Bond Purchase Programme (CBPP):* In order to support the covered bond market which had suffered significantly in the crisis, the ECB launched the CBPP. [15]
5. *Emergency Liquidity Assistance (ELA):* ELA is an alternative to conventional refinancing operations of the central banks when regular refinancing is temporarily not possible. Commercial banks can get emergency loans from national central banks under certain conditions and after approval by the ECB's governing board. In the past, the ECB has decided to grant ELA to, inter alia, Ireland, Greece and Cyprus. The outstanding amounts of ELA operations are not explicitly published in the national central bank balance sheets or the aggregated balance sheet of the Eurosystem.

[14] LTRO I and II took place in December 2011 and February 2012, respectively, and accounted for the amount of € 489 billion (net allocation € 200 billion) and € 529 billion (net allocation € 314 billion) respectively. Due to recent early repayments the current volume of longer-term refinancing has been reduced to € 705 billion as of June 28, 2013. Net allocation represents the difference between the LTRO operation and ordinary refinancing operations that expired at the same time and were not replaced by another ordinary refinancing operation in the same amount.

[15] The first CBPP which ran until June 2010 had a nominal amount of € 60 billion. As of September 24, 2013, the outstanding amount was € 43 billion. In November 2011, the ECB launched a second purchase program for covered bonds amounting to € 40 billion maturing in October 2012 (CBPP2). The outstanding amount was € 15,7 billion as of September 24, 2013.

6. *Collateral requirements* for commercial banks have been substantially lowered for a number of ECB operations.

8 Conclusion

Europe has embarked on a remarkable journey of comprehensive reform to tackle the euro crisis. First results on fiscal consolidation and competitiveness have already been achieved. Other benefits of the reform measures will only be realised in the longer term. Despite the challenges the Euro Area has faced, and is facing today, the euro remains a strong reserve currency with low inflation. It is imperative that short-term crisis management measures are supplemented by sustained policy action to achieve sound public finances and higher growth potential in the longer term. Success will certainly not come overnight. What is needed is vigorous, steady policy implementation along agreed timetables.

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