Marján Attila (ed.)

European Economic and Monetary Integration

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Table of contents - overview

Table of contents

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Editor's note

This volume discusses European economic and monetary integration in eleven chapters that cover the internal market, the Economic and Monetary Union, taxation and customs union, monetary policy, economic policy coordination. Part Two gives an assessment of some of the key elements of European political economics including crisis management efforts and potential political consequences of the crisis.

The Treaty of Paris was signed in 1951 establishing the European Coal and Steel Community and soon after a shortcut to political union was proposed by European founding fathers, but this idea never received political support. The failure of the plan to establish a European Defence Union and a political union had demonstrated that economic integration was the only practical way forward. As a result, the European Economic Community was established in 1958. Ever since, economic integration has been the backbone of cooperation between member states including the introduction of the euro in 1999.

At the same time it is important to understand the political aspects of European integration, since throughout the last seventy years of modern European history, economic and political developments have been inseparable. Therefore the second part looks into the political economy aspects of economic integration.

Our objective was to present an up-to-date university text-book for European studies and international finances majors.

I thank the devoted work done by the authors and proof-readers throughout the preparation of this book. I would especially like to thank Vanda Kopányi's help in English proofreading.

Marján Attila
April 2014

Part One: Economy

I. Historical development of European economic integration

1. Short history of European integration

This book discusses European economic and monetary integration. Nevertheless, it is unavoidable to briefly look at the political aspects of European integration, since throughout the last seventy years of modern European history, economic and political developments have been inseparable. Some of the key stages of economic integration are discussed in detail in the last part of this chapter.

After World War II (1939-1945) the necessity of some form of European cooperation became evident to avoid coming back to a confrontation among European states. The key issue was to find reconciliation between France and Germany to pave the way to guarantee peace. Already in 1946, the former British Prime Minister Winston Churchill pronounced a celebrated speech at the Zurich University to recreate the European Family and to provide it with a structure under which it can dwell in peace, in safety and in freedom. He argued that a kind of United States of Europe was to be built and the first step in the recreation of the European Family must be a partnership between France and Germany.

Soon after, the United States launched the Marshall Plan to alleviate the difficulties of European countries. The USA promoted the foundation of a centralised European organization that administered the delivery of the massive economic help of the Plan Marshall. In 1948, the Organisation for European Economic Cooperation (OEEC) was established with this aim. This was one of the first institutions that involved a great part of Western European countries. OEEC helped to liberalise trade among the member states, introduced ideas in favour of monetary agreements and enhanced economic cooperation.

In 1948, the Benelux system (customs union between Belgium, the Netherlands and Luxembourg) started functioning by introducing a common external tariff. This union had already been created in 1944, before the end of the World War II.

The first step in the process of foundation of the European Community was taken by the French foreign minister, Robert Schuman. In an inspired speech he proposed that France and Germany and any other European country wishing to join them pool their coal and steel resources. This plan of economic integration looked for developing the approach between France and Germany, moving definitively away from the possibility of war in Europe.

The 1950 plan proposed that Franco-German production of coal and steel as a whole be placed under a common High Authority, within the framework of an organisation open to the participation of the other countries of Europe. The pooling of coal and steel production should immediately provide for the setting up of common foundations for economic development as a first step in the federation of Europe. Also in 1950, the French government proposed the establishment of a European Defence

Community (EDC). This project was aborted in 1954, when the French Legislative Assembly vetoed its application. The EDC, that implied a strong military and political integration, was substituted by the Western European Union (WEU). Nevertheless, this institution never played a significant role.

In spite of the premature end of the defence union plan, the integration process went on. The Treaty of Paris was signed in April of 1951, establishing the European Coal and Steel Community (ECSC) (see more on this later). Its High Authority (predecessor of the European Commission) was presided by Jean Monnet. France, Germany, Italy, Belgium, the Netherlands and Luxembourg, 'the Six' made up this first European Community.

The failure of the EDC had demonstrated that a political and military union was an unrealistic goal: economic integration was the only practical way forward. The foreign ministers of the Six, presided over by the Belgian Paul Henri Spaak, met in a Conference in Messina (Italy) in 1955. The agreements they reached there meant a definitive step in the European construction: the 25th March 1957, member states signed the Treaties of Rome, establishing the European Economic Community (EEC) and the European Atomic Energy Community (Euratom) (more on these treaties later).

The Treaty establishing the EEC affirmed in its preamble that signatory states were "determined to lay the foundations of an ever closer union among the peoples of Europe". In this way, the member states specifically affirmed the political objective of a progressive political integration.

Member countries agreed to create a free trade area to dismantle all tariff barriers over a 12-year transitional period. In view of the economic success that freer commercial exchanges brought about, the transitory term was shortened and in July 1968 all tariffs among the EEC states were abrogated. At the same time, a common tariff was established for all products coming from third countries (customs union).

The other essential agreement included in the Treaty of Rome was the creation of a common agricultural policy (CAP). The CAP established protectionist policies that guaranteed sufficient revenues to European farmers, avoiding competition from third countries' products by guaranteeing agricultural prices. The Treaty of Rome also established the prohibition of monopolies (competition policy), and some degree of common policies in the area of transport.

So, the EEC Treaty of Rome created a very realistic and gradualist approach to building European integration, focussing mainly on the economy. This strategy established an integration that gradually incorporated diverse economic sectors and that created supranational institutions with increasingly important political competences.

The Treaty that instituted the Euratom aimed to create the conditions for developing a strong nuclear industry with adequate safety features.

In 1960, after negotiations to integrate the United Kingdom in the EEC broke down, the British government proposed the foundation of the European Free Trade Association (EFTA), Sweden, Switzerland, Norway, Denmark, Austria and Portugal joined it. It fell short of any political integration, and constituted a mere free trade area. Shortly after its creation nevertheless, Britain realized its mistake. Whereas the EEC witnessed a spectacular economic growth, Great Britain continued its downward economic trend in comparison to the Six. Therefore, in 1961 the British government requested the beginning of accession negotiations. However, the French government vetoed British accession in 1963 and in 1967 mainly because of the strong ties between the UK and the USA that was perceived contrary to French geopolitical interests. Eventually the United Kingdom joined the EEC – together with Denmark and Ireland – in 1973.

The 1973 economic crisis put an end to a period of impressive economic growth that European countries had enjoyed for a long time. Unemployment, inflation and the crisis of traditional industrial sectors characterized the economic reality of the EEC in the second half of the 70s and early 80s. Nevertheless, in 1979, the European Monetary System (EMS) came into force. At the same time, the European Currency Unit (ECU), the predecessor of the euro, was born. Member countries' currencies were tied in a narrow 2.5% band of fluctuation and national governments committed themselves to coordinate their monetary policies. It was the first significant step towards monetary union. The first direct elections to the European Parliament by direct universal suffrage were also held in 1979.

In 1985, the three countries of the Benelux, France and Germany signed the Schengen Agreement. Most of the member states would join it in subsequent years. It constituted the beginning of an ambitious initiative to guarantee the free movement of persons and the gradual removal of frontiers among the Community states.

In the second half of the 80s, the integration process received an important political impulse. The Single European Act came into force on 1 July 1987, the first modification of the founding treaties of the European Communities. The Single European Act represented the commitment to implementing a European market without frontiers, more economic and social cohesion, a European research and technology policy, the strengthening of the European Monetary System, and significant actions in environment. The key policy objective was to establish a common internal market until 1992 – an area without obstacles to free movement of goods, people, services and capital. Moreover, decision-making was alleviated by switching more to qualified majority voting from unanimity.

On the geopolitical scene, the first direct consequence caused by the collapse of communism in the EEC was the reunification of Germany in October 1990. Germany, with 80 million inhabitants and 30% of the GNP of the EEC, became the strongest member in the Community. Another important consequence was the emergence of a series of new potential member states from the former Soviet bloc.

Against this background a new Intergovernmental Conference was called to create a European economic and monetary union. After almost three years of debate, the European Council held in Maastricht in December 1991, approved the Treaty of the European Union, or the Treaty of Maastricht. The Treaty came into force on 7 February 1992, and it changed the official name of the EEC to European Union.

The Treaty has a structure based on three 'pillars': the first pillar, the central one, alludes to the Community dimension and comprises the arrangements set out in the EC, ECSC and Euratom Treaties (Community policies, Economic and Monetary Union etc.). The other two new pillars are not based on supranational competences as the previous one, but on the cooperation among the governments: the second pillar is the common foreign and security policy, the third is the area of justice and home matters.

The most important development is elaboration of the Economic and Monetary Union (EMU). The introduction of a European currency, the euro, was decided.

The EMU puts the finishing touches to the single market. Economic policy consists of three components. The member states must ensure coordination of their economic policies, provide for multilateral surveillance of this coordination, and are subject to financial and budgetary discipline.

The Treaty provides for the establishment of a single currency in three successive stages:

- The first stage, which liberalises the movement of capital, began on 1 January 1990.
- The second stage began on 1 January 1994 and provides for convergence of the member states' economic policies.
- The third stage began on 1 January 1999 with the creation of a single currency and the establishment of a European Central Bank (ECB).

Monetary policy is based on the European System of Central Banks (ESCB), consisting of the ECB and the national central banks. These institutions are independent of the national and Community political authorities. Special rules apply to two member states. The United Kingdom has not proceeded to the third stage. Denmark has obtained a protocol providing that a referendum shall decide on its participation in the third stage.

Side by side with the Maastricht Treaty in 1993, the single market and its four freedoms – the free movement of goods, services, people and capital – came to life. The Schengen agreement also entered into force, allowing EU citizens to move freely without any passport across the borders.

The subsequent treaties (Treaty of Amsterdam, Treaty of Nice) reinforced the Union's policy clout and the power of the European Parliament. In the early 2000s the EU started working on its major political project: setting up its 'Constitution' in the form of a constitutional treaty. This however was voted down in France and the Netherlands at national referenda. This undoubtedly paralysed the Union politically for a few years. In 2004 the "big bang" enlargement wave of ten countries (including eight former Soviet bloc ones) took place. To remedy the political situation brought about by the failed constitutional treaty and to react to the new reality of the European Union of 25 member states, the Treaty of Lisbon was adopted and it entered into force in 2009.

The Treaty of Lisbon has introduced significant changes to the EU system. It amends the EU and EC treaties, without replacing them. It strengthens the role of the European Parliament and national parliaments. In particular by the increase of co-decision procedures in policy-making ensures that the European Parliament is placed on an equal footing with the Council in most policy areas. National parliaments have greater opportunities to be involved in the work of the EU, in particular thanks to a new mechanism to monitor that the Union only acts where results can be better attained at EU level (subsidiarity). Together with the strengthened role for the European Parliament, this should enhance democracy and increase legitimacy of the Union. Thanks to the citizens' initiative, one million citizens from a number of member states have the possibility to call on the Commission to bring forward new policy proposals. The Treaty of Lisbon explicitly recognises for the first time the possibility for a member state to withdraw from the Union. Qualified majority voting in the Council is extended to new policy areas to make decision-making faster and more efficient. From 2014 on, the calculation of qualified majority will be based on the double majority of member states and people, thus representing the dual legitimacy of the Union. A double majority will be achieved when a decision is taken by 55% of the member states representing at least 65% of the Union's population. It also creates the function of the president of the European Council elected for two and a half years, introduces a direct link between the election of the Commission president and the results of the European elections, provides for new arrangements for the future composition of the European Parliament, and includes clearer rules on enhanced cooperation and financial provisions. The Lisbon Treaty details and reinforces the values and objectives the Union is built upon. It preserves existing rights while introducing new ones. In particular, it guarantees the freedoms and principles set out in the Charter of Fundamental Rights and gives its provisions a binding legal force. It concerns civil, political, economic and social rights. It also creates the function of the High Representative for the Union in Foreign Affairs and Security Policy, who is also vice-president of the Commission. Moreover, a new European External Action Service was set up to provide backup and support to the High Representative.

2. Introduction to economic integration

Economic integration is the harmonisation or unification of economic policies among different states through the partial or full abolition of tariff and non-tariff restrictions on trade and through other means of economic cooperation. The economic rationale for the increase of trade between member states of economic unions is to benefit from economies of scale, higher productivity and comparative advantages. Political reasons normally also play a role in pursuing economic integration. Globalisation has helped development of economic integration all over the world which can take place on regional level, such as the European Union, the ASEAN (Association of Southeast Asian Nations) the NAFTA (North American Free Trade Agreement) or on intercontinental scale (such as the proposed Transatlantic Free Trade Area between the EU and the USA).

The theoretical framework of economic integration was established by Jacob Viner[1] (1950) who also defined trade creation[2] and trade diversion[3], terms used for the alteration of interregional flow of goods caused by changes in customs tariffs in an

1 Jacob Viner (1892 – 1970) was a Canadian economist One of the mentors of the early Chicago School of Economics in the 1930s, he was one of the leading figures of the “Chicago faculty”.

2 Trade creation: trade flows are redirected due to the formation of a free trade area or a customs union. With the formation of economic union, the cost of the goods affected is decreased, leading to an increase of efficiency of economic integration. Hence, trade creation's essence is in the elimination of customs tariffs on the inner border of the unifying states (usually already trading with each other), causing further decrease of price of the goods, while there may be a case of new trade flow creation of the goods between the states which decide to integrate economically.

3 Trade diversion: trade is diverted from a more efficient exporter towards a less efficient one by the formation of a free trade agreement or a customs union.

economic union. According to the findings of Béla Balassa[4] dating back to the 1960s, as economic integration increases, the barriers of trade between markets diminish. Balassa found that supranational common markets, with their free movement of economic factors across national borders, naturally generate demand for further integration, not only economically (via monetary unions) but also politically – and, therefore economic communities evolve into political unions over time.

In relation to economic and monetary unions, the theory of optimum currency areas by Mundell[5] (1961) and its subsequent fine-tunings should also be referred to. The theory postulates that asymmetric shocks undermine the stability of the economy in the economic integration, so if these shocks cannot be controlled, a floating exchange rate regime is a better option (as opposed to a currency union). It also sets out the basic criteria for a sustainable currency union:

- Sufficient level of labour mobility across the region. This includes physical ability to travel (visas, workers' rights etc.), lack of cultural barriers to free movement (such as different languages) and institutional arrangements (such as the ability to have pensions transferred throughout the region).
- Sufficient level of capital mobility, plus price and wage flexibility across the region.
- Existence of a risk sharing system such as an automatic fiscal transfer mechanism to redistribute money to areas or sectors which have been adversely affected. This usually takes the form of taxation redistribution to less developed areas of a country or region.
- Participant countries in the currency union should have similar business cycles (when one country experiences a boom or recession, other countries in the union follow). This makes it possible for the common central bank to apply growth enhancing policy in downturns and to fight inflation during booms. But if countries in a currency union have idiosyncratic business cycles, then optimal monetary policy may diverge and member states may be made better off without a joint central bank.

According to Balassa, there are seven stages of economic integration:[6]

- Preferential trading area;
- Free trade area;
- Customs union;
- Common market;
- Economic union, or single market;
- Economic and monetary union;
- Complete economic integration.

4 Béla Alexander Balassa (1928–1991) was a Hungarian born economist, professor at Johns Hopkins University. He is best known for his work on the relationship between purchasing power parity and cross-country productivity differences (the Balassa-Samuelson effect), also known for his work on revealed comparative advantage.

5 Robert Alexander Mundell (born1932) is a Nobel Prize-winning Canadian economist. A professor of economics at Columbia University.

6 Balassa, Bela: *The Theory of Economic Integration*. Routledge Revivals Routledge, 2013. p.2.

These stages differ in the degree of unification of economic policies, with the highest one being the complete economic integration of countries, which would most likely involve political integration as well at some stage.

A preferential trading area is (also: preferential trade agreement, PTA) is a trading bloc that gives preferential access to certain products from the participating countries. This is done by reducing tariffs but not by abolishing them completely. The European integration worked like this at the time of its inception.

A ‘free trade area’ (FTA) is formed when two or more states partially or fully abolish custom tariffs on their inner border. To exclude regional unfair exploitation of zero tariffs within the FTA there is a rule of certificate of origin for the goods originating from the territory of a member state of an FTA.

A ‘customs union’ is a free trade area that introduces unified tariffs on the external borders of the union (CET, common external tariffs). In other words customs union is a trade agreement by which a group of countries charges a common set of tariffs to the rest of the world while applying free trade among themselves. It is a partial form of economic integration that offers an intermediate step between free-trade zones (which allow mutual free trade but lack a common tariff system) and common markets (which, in addition to the common customs tariffs add a series of common economic rules). The EU Customs Union (since 1968) means:

- No customs duties at internal borders between the EU member states;
- Common customs duties on imports from outside the EU;
- Common rules of origin for products from outside the EU;
- A common definition of customs value.

A common market is a first stage towards a single market, and may be limited initially to a free trade area with relatively free movement of capital and of services, but not so advanced in reduction of the rest of the trade barriers and without a massive level of harmonisation of economic legislation.

An economic union, or single market combines customs union with a common market and a massive level of economic rule harmonisation between member states. A fiscal union introduces a shared fiscal and budgetary policy. In order to be successful the more advanced integration steps are typically accompanied by the unification of economic policies (tax, social welfare benefits, etc.), reductions in the rest of the trade barriers, introduction of supranational bodies, and gradual moves towards political integration.

An economic and monetary union combines economic union with monetary union: common monetary policy, fixed exchange rates, or rather a common currency. In the case of the eurozone, although a monetary union, the existence of a true economic union still cannot be claimed (more on this in subsequent chapters).

Complete economic integration is the final stage of economic integration. At this point of economic integration, member countries have handed over almost all tools of economic policy to the common (federal) level. This involves monetary policy, banking union, fiscal union, massive or full harmonisation of almost all areas of economic and social policies.

A different staging of economic integration (which in fact better reflects European developments) is offered here[7]:

- Free trade area;
- Customs union;
- Common market;
- Single (internal) market;
- Economic and monetary union.

On single market, economic and monetary union and on tax and customs policy subsequent chapters provide detailed information. In the last part of this introductory chapter the first steps of economic cooperation are discussed.

3. Major stages of early European economic integration

3.1 European Coal and Steel Community (ECSC) [8]

The ECSC Treaty was signed in Paris in 1951 and brought France, Germany, Italy and the Benelux countries together in a Community with the aim of organising free movement of coal and steel and free access to sources of production. In addition to this, a common High Authority supervised the market, the respect for competition rules and price transparency. This treaty is the origin of the institutions as we know them today.

The first Community organisation was created in the aftermath of the Second World War, when reconstructing the economy of the European continent and ensuring a lasting peace appeared necessary. Thus the idea of pooling Franco-German coal and steel production came about and the European Coal and Steel Community (ECSC) was formed. This choice was not only economic but also and primarily political, as these two raw materials were then the basis of the industry and power of the two countries. The underlying political objective was to strengthen Franco-German solidarity, banish the spectre of war and open the way to European integration.

The Treaty establishing the European Coal and Steel Community was signed in Paris on 18 April 1951 and entered into force on 23 July 1952, with a validity period limited to 50 years. The Treaty expired on 23 July 2002. The common market as advocated by the Treaty opened on 10 February 1953 for coal, iron ore and scrap and on 1 May 1953 for steel.

The aim of the Treaty, as stated in Article 2, was to contribute, through the common market for coal and steel, to economic expansion, growth of employment and a rising standard of living. Thus, the institutions had to ensure an orderly supply to the common market by ensuring equal access to the sources of production, the

7 Marján Attila: *Az Európai Unió gazdasága*, HVG, Budapest, 2006. p. 99.
8 Source: http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_ecsc_en.htm.

establishment of the lowest prices and improved working conditions. All of this had to be accompanied by growth in international trade and modernisation of production. The Treaty introduced the free movement of products without customs duties or taxes. It prohibited discriminatory measures or practices, subsidies, aids granted by states or special charges imposed by states and restrictive practices.

The Treaty was divided into four titles. The first dealt with the European Coal and Steel Community, the second with the institutions of the Community, the third with economic and social provisions and the fourth with general provisions. It also included two protocols, one on the Court of Justice and the other on relations of the ECSC with the Council of Europe.

The ECSC Treaty is more than just a common market legislation for steel and coal, since it is the origin of the institutions as we know them today. It established a High Authority, an Assembly, a Council of Ministers and a Court of Justice. The Community had legal personality. The High Authority was the independent collegiate executive with the task of achieving the objectives laid down by the Treaty and acting in the general interest of the Community. It was made up of nine members (of whom not more than two of any one nationality) appointed for six years. It was a truly supranational body with power of decision. It supervised the modernisation and improvement of production, the supply of products under identical conditions, the development of a common export policy and the improvement of working conditions in the coal and steel industries. The High Authority took decisions, made recommendations and delivered opinions. It was assisted by a Consultative Committee made up of representatives of producers, workers, consumers and dealers. The Assembly was made up of 78 deputies, who were representatives of the national Parliaments. There were 18 each for Germany, France and Italy, 10 for Belgium and the Netherlands and 4 for Luxembourg. The Treaty assigned supervisory power to this Assembly. The Council consisted of six representatives of the national governments. The Presidency of the Council was held by each member state in turn for a period of three months. The role of the Council was to harmonise the activities of the High Authority and the general economic policy of the governments. Its approval was required for important decisions taken by the High Authority. The Court of Justice consisted of seven judges nominated for six years by common agreement between the governments of the member states. It ensured that the law was observed in the interpretation and implementation of the Treaty.

In pursuance of its goal, the ECSC had means of information, powers of consultation and the power to make checks. In the event that companies did not respect these powers, the High Authority could impose punishments such as fines (maximum of 1% of annual turnover) and penalty payments (5% of the average daily turnover for each day's delay). On the basis of the information obtained, forecasts were made to guide the activities of those involved and determine how the ECSC would act. The ECSC was funded by levies on coal and steel production and by contracting loans. The levies were intended to cover administrative expenditure, non-repayable aid towards re-adaptation, and technical and economic research (which needed to be encouraged). The funds received from borrowing could only be used to grant loans.

With regard to production, the ECSC played a mainly indirect, subsidiary role through cooperation with governments and intervention in relation to prices and commercial policy. However, in the event of any decline in demand or shortage, it could take direct action by imposing quotas with the aim of limiting production in an organised manner or, for shortages, by drawing up production programmes establishing consumption priorities, determining how resources should be allocated and setting export levels.

In certain circumstances, such as a manifest crisis, the High Authority could fix maximum or minimum prices either within the Community or in relation to the export market. In order to ensure that free competition was respected, the High Authority had to be informed of any action by member states which was liable to endanger it. Furthermore, the Treaty dealt specifically with the three cases which could distort competition: agreements, concentrations and the abuse of dominant positions. Agreements or associations between companies could be cancelled by the High Authority if they directly or indirectly prevented, restricted or distorted normal competition.

The Treaty also dealt with the commercial policy of the ECSC towards third countries. Although the powers of national governments remained in place, the Community had a number of powers such as setting maximum and minimum rates for customs duties and supervising the granting of import and export licences, as well as the right to be kept informed of commercial agreements relating to coal and steel.

Furthermore, the power of the High Authority prevailed in the fields of dumping, the use by undertakings outside the jurisdiction of the Community of means of competition contrary to the Treaty and substantial increases in imports which could seriously threaten Community production.

The overall achievements of the ECSC were positive. The Community was able to deal with crises, ensured balanced development of the production and distribution of resources and facilitated the necessary industrial restructuring and redevelopment. Steel production increased fourfold as compared to the 1950s. Coal production declined, as did the number of people employed in the sector, but it reached a high level of technological development, safety and environmental quality. The ECSC's systems of social management (early retirement, transitional allowances, mobility grants, training, etc.) were of great importance in dealing with crises.

3.2 European Economic Community (EEC) [9]

The Messina Conference of June 1955 endeavoured to add a new impetus to European construction. The Committee responsible for drafting the new treaties submitted two drafts in 1956:

- the draft on the creation of a general common market;
- the draft on the creation of an atomic energy community.

9 Source: http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_eec_en.htm.

The Treaties of Rome were signed accordingly in March 1957. The first Treaty established the European Economic Community (EEC) and the second the Euratom Treaty. These two Treaties entered into force on 1 January 1958.

After the failure of the European Defence Community, the economy, which was less subject to national resistance than other areas, became the focus of supranational cooperation. The establishment of the EEC and the creation of the common market had two objectives. The first was to transform the conditions of trade and manufacture on the territory of the Community. The second, more political, saw the EEC as a contribution towards the functional construction of a political Europe and constituted a step towards the closer unification of Europe.

In the preamble, the signatories of the Treaty declare that:

- "determined to lay the foundations of an ever closer union among the peoples of Europe, resolved to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe;
- recognising that the removal of existing obstacles calls for concerted action in order to guarantee steady expansion, balanced trade and fair competition;
- anxious to strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less-favoured regions;
- desiring to contribute, by means of a common commercial policy, to the progressive abolition of restrictions on international trade;
- resolved by thus pooling their resources to preserve and strengthen peace and liberty, and calling upon the other peoples of Europe who share their ideal to join in their efforts".

These intentions were worked out subsequently by creating a common market and a customs union and by developing common policies at European level.

Article 2 of the EEC Treaty specifies that "The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of member states, to promote throughout the community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the states belonging to it".

This common market is founded on the well-known 'four freedoms', namely the free movement of persons, services, goods and capital. It creates a single economic area establishing free competition between undertakings. It lays the basis for approximating the conditions governing trade in products and services over and above those already covered by the other treaties (ECSC and Euratom).

Article 8 of the EEC Treaty states that the common market will be progressively established during a transitional period of 12 years, divided into three stages of four years each. To each stage there is assigned a set of actions to be initiated and carried through concurrently. Subject to the exceptions and procedures provided for in the Treaty, the expiry of the transitional period constitutes the latest date by which all the rules laid down must enter into force. The market being based on the principle of free competition, the Treaty prohibits restrictive agreements and state aids (except for the derogations provided for in the Treaty) which can affect trade between member states and whose objective is to prevent, restrict or distort competition.

The EEC Treaty abolishes quotas and customs duties between the member states. It establishes a common external tariff, a sort of external frontier for member states' products, replacing the preceding tariffs of the different states (customs union). This customs union is accompanied by a common trade policy. This policy, managed at Community level and no longer at state level, totally dissociates the customs union from a mere free-trade association.The effects of dismantling customs barriers and eliminating quantitative restrictions to trade during the transitional period were very positive, allowing intra-Community trade and trade between the EEC and third countries to develop rapidly.

Certain policies are formally enshrined in the Treaty, such as the common agricultural policy (Articles 38 to 47), common trade policy (Articles 110 to 116) and transport policy (Articles 74 to 84). Others may be launched depending on needs, as specified in Article 235, which stipulates that: "If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Assembly, take the appropriate measures." After the Paris Summit of October 1972, recourse to this Article enabled the Community to develop actions in the field of environmental, regional, social and industrial policy.

The EEC Treaty establishes institutions and decision-making mechanisms which make it possible to express both national interests and a Community vision. The institutional balance is based on a triangle consisting of the Council, the Commission and the European Parliament, all three of which are called upon to work together. The Council prepares the standards, the Commission drafts the proposals and the Parliament plays an advisory role. Another body is also involved in the decision-making procedure in an advisory capacity, namely the Economic and Social Committee. The Commission, a college independent of the governments of the member states; appointed by common agreement, represents the common interest. It has a monopoly on initiating legislation and proposes Community acts to the Council of Ministers. As guardian of the treaties, it monitors the implementation of the treaties and secondary law. In this connection it has a wide assortment of measures to police the member states and the business community. In the framework of its mission the Commission has the executive power to implement Community policies.

The Council of Ministers is made up of representatives of the governments of the member states and is vested with decision-making powers. It is assisted by the Committee of Permanent Representatives (COREPER), which prepares the Council's work and carries out the tasks conferred on it by the Council.

The Parliamentary Assembly originally had only an advisory role and its members were not yet elected by direct universal suffrage. The Treaty also provides for the creation of the Court of Justice. In compliance with the Convention on certain common institutions, which was signed and entered into force at the same time as the Treaty of Rome, the Parliamentary Assembly and the Court of Justice are common to the EEC Treaties and the Euratom Treaty.With the entry into force of the Merger Treaty in 1967, the Council and the Commission become institutions shared by the three Communities (ECSC, EEC and Euratom) and the principle of budgetary unity was imposed.

3.3 Euratom (European Atomic Energy Community)[10]

Initially created to coordinate the member states' research programmes for the peaceful use of nuclear energy, the Euratom Treaty today helps to pool knowledge, infrastructure and funding of nuclear energy. It ensures the security of atomic energy supply within the framework of a centralised monitoring system.

To tackle the general shortage of 'conventional' energy in the 1950s, the six founding states (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) looked to nuclear energy as a means of achieving energy independence. Since the costs of investing in nuclear energy could not be met by individual states, the founding states joined together to form Euratom.

The general objective of the Treaty is to contribute to the formation and development of Europe's nuclear industries, so that all the member states can benefit from the development of atomic energy, and to ensure security of supply. At the same time, the Treaty guarantees high safety standards for the public and prevents nuclear materials intended principally for civilian use from being diverted to military use. It is important to note that Euratom's powers are limited to peaceful civil uses of nuclear energy.

The objective of the Euratom Treaty is to pool the nuclear industries of member states. In this context, it applies only to certain entities (member states, physical persons, and public or private undertakings or institutions) which carry out some or all of their activities in an area covered by the Treaty, i.e. special fissile materials, source materials and the ores from which source materials are extracted.

The specific tasks of Euratom are:

- to promote research and ensure the dissemination of technical information;
- to establish uniform safety standards to protect the health of workers and of the general public and ensure that they are applied;
- to facilitate investment and ensure the establishment of the basic installations necessary for the development of nuclear energy in the EU;
- to ensure that all users in the EU receive a regular and equitable supply of ores and nuclear fuels;
- to make certain that civil nuclear materials are not diverted to other (particularly military) purposes;
- to exercise the right of ownership conferred upon it with respect to special fissile materials;
- to foster progress in the peaceful uses of nuclear energy by working with other countries and international organisations;
- to establish joint undertakings.

10 Source: http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_euratom_en.htm.

The institutional structure of the Euratom Treaty is broadly similar to that of the EEC Treaty and is built around the same "institutional triangle" (Council, Commission and European Parliament). Thus, the fulfilment of the tasks entrusted to the Community is ensured not only by the European Parliament, the Commission and the Council, but also by the Court of Justice and the Court of Auditors. Each institution acts within the limits of the powers conferred on it by the Treaty. The Council and the Commission are assisted by an Economic and Social Committee acting in an advisory capacity. The Community institutions are responsible for implementing the Treaty and for the two specific Euratom bodies: the Supply Agency and the Safeguards Office (which carries out physical and accounting checks in all nuclear installations in the Community).

Although the Euratom Treaty gives the Community no strict, exclusive powers in certain fields, it retains real added value for its members: on the basis of this Treaty, the Commission has adopted recommendations and decisions which, although not binding, set European standards. In addition, it must be stressed that other Community policies, for example the environment and research policies, also have a marked impact on the nuclear industry.

The value added by Euratom and the EU can be seen particularly clearly in the context of enlargement. As a result of Euratom, the EU pursues a harmonised Community approach to nuclear energy with which candidate countries must comply.

Although the member states retain most powers in these fields, a degree of uniformity has been achieved at international level with the aid of a series of treaties, conventions and initiatives which, one by one, have pieced together an international regulatory framework governing activities in the nuclear sector (the Convention on Nuclear Safety).

Unlike the EC Treaty, no major changes have ever been made to the Euratom Treaty, which remains in force. The European Atomic Energy Community has not merged with the European Union and therefore retains a separate legal personality, while sharing the same institutions. In future, the application of the Euratom Treaty will need to continue focusing on the security and safety of nuclear materials. The Euratom Community will need to continue helping to guide the development of the nuclear industry and ensure the observance of high standards of radiation protection, safety and security.

II. European single market

1. Introduction

The EU single market has been the cornerstone of the European integration since the Treaty of Rome (25 March 1957, 1 January 1958[11]). Its ultimate goal is to create level playing field for European firms so that they would become competitive in the global market. During the years since 1958 the initial aim of delivering the internal market has not only been fulfilled but the it has also become, by the continuous deepening and widening process, a single market of 28 member states and 550 million consumers. This evolution has been accompanied by major legal and institutional developments ensuring wide range of enforcement tools both for the Commission and the member states. The first step was the creation of the customs union by 1 July 1968, 18 months earlier than it was envisaged by the Treaty of Rome. These early years of the integration can be characterized by the so-called negative integration meaning the obligation for member states to refrain from creating new barriers and to eliminate the existing ones based on the 12 years roadmap towards the common market enshrined by the Treaty. The Milan summit of June 1985 adopted the white paper[12] presented by the Commission (drafted by Commissioner Cockfield) suggesting the adoption of nearly 300 measures to create an integral market by 1992 by eliminating fiscal, physical and technical barriers. It was the Single European Act (17 February 1986, 1 July 1987) which gave impetus to the positive legal harmonization by introducing the cooperation procedure and the qualified majority voting and in the legislative process by expanding the field of Community policies to R&D, environment and CFSP issues. The Treaty of Maastricht (7 February 1992, 1 November 1993) introduced the EU citizenship as part of the political pillar (justice and home affairs) of the integration, thus paving the way for the reform of the free movement of persons while the economic pillar, the Economic and Monetary Union was to be underpinned by the free movement of capital. Further reforms have been launched in the decision-making process by introducing the co-decision procedure (as present: ordinary legislative procedure under Article 294 TFEU) and expanding the qualified majority voting to further policy areas. Member states have transferred policy areas such as Trans-European Networks (energy, transport and telecommunication), industry, consumers, education, youth and culture to community policies. The EEA Agreement (17 March 1993, 1 January 1994) has widened the geographical scope of the internal market to Norway, Iceland and Liechtenstein (Austria, Finland and Sweden joined the EU in 1995). As Switzerland refused to sign the Agreement as result of a referendum, the economic relations between the EU and its member states and Switzerland is regulated by a

11 Date of signature, date of entry into force.

12 *Completing the internal market. White Paper from the Commission to the European Council.* Milan, 28-29 June 1985. Brussels, 14 June 1985. COM(85) 310 final.

complex system of Agreements. The area of freedom, security and justice was created by the Treaty of Amsterdam (2 October 1997, 1 May 1999) and some former Pillar III issues of the Maastricht Treaty have become part of the single market. The Treaty of Lisbon (13 December 2007, 1 December 2009) has created among other things the legal personality of the European Union and by attaching the Charter of Fundamental Rights to the Treaties it has provided the legal basis for the Court of Justice of the European Union (ECJ) to admit cases concerning the enforcement of fundamental rights during the application of EU (single market) law.

The EU law governing the single market is incorporated in the relevant provisions of the Treaties, in the secondary legislation (regulations, directives, decisions, recommendations and communications) and in the judgements of the ECJ. The law strictly related to the free movement is supported by detailed legislation in various fields of policies:

- R&D, industrial and intellectual property rights and market surveillance is strongly related to the free movement of goods;
- the mutual recognition of professional qualifications and the coordination of the social security systems and consumer protection is relevant from the point of view of the freedom of establishment, goods and services;
- the field of financial services is closely linked to the free movement of capital;
- policy areas like competition, state aid, public procurement, company law and accounting has very strong influence on EU citizens and businesses.

This chapter will give a broad insight into the legislation of the four freedoms but is not able to describe neither policies listed above, nor sectoral policies which affect the competitiveness of European businesses (energy, telecommunications, e-commerce, transport, etc.). Financial services are covered in detail in Chapter VIII.

1.2 General remarks

Under Article 3 of the TEU, the EU shall establish an internal market. Its goal is the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, as well as a high level of protection and improvement of the quality of environment. The Union promotes scientific and technological advance.

Article 119 of the TFEU declares that member states and the Union adopt an economic policy which is based on the close coordination of member states' economic policies on the internal market and on the definition of common objectives and is conducted in accordance with the principle of an open market economy with free competition.

The basic principle of the governing single market law is non-discrimination as stated by Article 18 of the TEU: "Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on the grounds of nationality shall be prohibited."

Another important feature of the legislation concerning the four freedoms is that there are no *de minimis* rules, meaning that unjustified restrictions are not allowed regardless of their value, size or minor impact on the market.

The internal market is an area without internal frontiers in which the free movement of goods, persons, services and capitals is ensured in accordance with the provisions of the Treaties. In order to establish and to ensure the functioning of the internal market, the EU adopts measures in accordance with the Treaties[13]. The legal basis of harmonization measures is Article 114 of the TFEU which empowers member states to adopt via ordinary legislative procedure[14] (qualified majority voting) approximation measures which have the aim of the establishment and functioning of the single market, while under Article 115 of the TFEU unanimous voting is required.

1.3 Possible exceptions[15]

Although the free movement principle does not guarantee absolute rights, the rights deriving from these rules may be regarded as absolute in a sense that the governing principle of the legislation always ensures the free movement, and exceptions, any possible restrictions must be based on the Treaty, the secondary legislation or the case-law of the ECJ and must be interpreted narrowly. An actual effect on the single market is not even a precondition for the ECJ to declare that a member state's measure is incompatible with the EU law: any national measure may be against the Treaty if it is liable to make less attractive the exercise of fundamental freedoms guaranteed by the Treaty. These national restrictions may only be justified if they

- are applied in a non-discriminatory manner,
- are justified by imperative requirements of general interest (or in other words, overriding reasons of general interest),
- are suitable for securing the attainment of the objective which they pursue and
- do not go beyond what is necessary in order to attain it.

Consequently, the ECJ has held[16] that the concept of restriction covers measures taken by a member state which, although applicable without distinction, affect access to the market for undertaking from other member states and thereby hinder intra-Community trade.

In short, restrictions must be justified by imperative requirements (see for every sub-chapter), must be non-discriminatory and must pass the test of necessity and proportionality.

13 Art 26 TFEU (1) and (2).

14 With the exception of fiscal measures, measures governing the free movement of persons and the rights and interests of employees.

15 The limits of member states' measures in the single market are stipulated by the ECJ in its famous Gebhard ruling (Case C-55/94, Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano).

16 Case C-400/08, Commission v Spain.

1.4 Governance of the single market

The timely and accurate implementation of the EU law and using efficient communication tools are prerequisites for the functioning of the single market. The most evident governance tools of the Commission are the Treaty based ones. The Commission has the exclusive power to draft and suggest legislative proposals and under Articles 258 and 260 of the TFEU, the Commission also has the power to initiate an infringement procedure against a member state. Infringement procedures on the one hand may be initiated because the member state has not transposed EU law in time (non-notification cases) and on the other hand because the member state is not applying EU law properly (infringement cases). National courts also play a very important role in enforcing EU law by asking for a preliminary reference of the Court of Justice of the European Union under Article 267 of the TFEU in national cases where the subject matter of the case is related to the implementation of EU law. Under Articles 106 and 108 of the TFEU the Commission has the right to make decisions (subject to appeal to the Court) in the field of competition and state aid cases.

Besides the legal remedies there are a lot of information and communication tools mostly developed and made available by the Commission. Member states inform each other and the Commission on their national legislation via various notification systems e. g. TRIS for technical notification, the services notification, a separate notification system for state aids and also one for notifying the Commission on national legislation which is transposing EU law. Communication tools help member states' citizens and businesses just like their authorities to act in their capacities and to resolve disputes when implementing EU law. The SOLVIT network[17] resolves cross-border disputes of citizens and businesses with member states' authorities, ECC-Net[18] resolves cross-border consumer disputes while the IMI system[19] helps national authorities to find their partners in the client's home member state when dealing with a client's authorization, registration or supervision. The single market scoreboard[20] (published twice a year) prepared by the Commission informs the European Council and the general public on the transposition deficit, transposition delay, on the number and duration of infringement procedures as well as on the duration of implementing the Court's judgements. The single market integration report annexed to the annual growth survey every year analyses the potential growth areas; the implementation and enforcement of the services directive, financial services, energy, digital and transport services. The European semester underpins the single market by involving single market/competitiveness reforms into the economic governance cycle. (For the economic governance see Chapter V.).

17 http://ec.europa.eu/solvit/contact/index_hu.htm.
18 http://ec.europa.eu/consumers/ecc/index_en.htm.
19 http://ec.europa.eu/internal_market/imi-net/index_en.htm.
20 http://ec.europa.eu/internal_market/score/index_en.htm.

2. The free movement of goods

2.1 The free circulation of goods

Under the jurisprudence of the ECJ[21], goods must be understood as products which can be valued in money and which are capable, as such, of forming the subject of commercial transactions. The definition of 'goods' has been clarified by the rulings of the ECJ several occasions. Works of art[22], coins, which are no longer in use as currency, bank notes and bearer cheques[23] are to be treated as goods. Electricity[24] and natural gas[25] also count as goods and so does waste, even when it is non-recyclable but the subject of a commercial transaction. Besides the general territorial scope (covering the whole EEA) the rules are also applicable to goods manufactured and/or marketed in the territory of Turkey[26]. The free movement of goods presupposes a functioning customs union with common external customs border and common customs tariffs. Within the territory of the customs union among member states the free movement of goods is ensured;

- customs duties and charges having equivalent effect are prohibited concerning both the export and the import,
- quantitative restrictions and measures having equivalent effect are also prohibited with some exceptions and
- member states are not allowed to create state monopolies of commercial character.

Customs duties and charges having equivalent effect among member states are prohibited under any circumstances[27]. Under the jurisprudence of the ECJ[28] the prohibition of the levying of any customs duty or charge having equivalent effect in trade within the Community covers any pecuniary charge levied at the time of or by reason of imports or export of the product in question which, by changing the cost price, has on the free movement of goods the equivalent effect of a customs duty.

As a general rule quantitative restrictions and measures having equivalent effect are also prohibited.[29] Quantitative restrictions cover any total or partial prohibition on imports, exports or goods in transit.[30] As quantitative restrictions are quite evident to judge member states tend to introduce more sophisticated measures to promote their

21 Case C-7/68, Commission v Italy.
22 Case 7/78 Thompson.
23 Case C-358/93 Bordessa and others.
24 Case C-393/92 Almelo v Energiebedrijf Ijsselmij.
25 Case C-159/94 Commission v France.
26 Agreement Establishing an Association Between the European Economic Community and Turkey (Ankara Agreement, signed at Ankara, 1 September 1963).
27 Art 30 TFEU.
28 Case 2-73, Riseria Luigi Geddo v Ente Nazionale Risi.
29 Art 34 and 35 TFEU.
30 Case 2-73, Riseria Luigi Geddo v Ente Nazionale Risi.

national products. These measures must be considered as ones having equivalent effect to quantitative restrictions, if they are capable of hindering intra-Community trade directly or indirectly, actually or potentially.[31] Typical trade barriers are

- national provisions related to the act of import (import licences, inspections and controls),
- national price controls (fixing or freezing prices, minimum or maximum profit margins) and reimbursement,
- national ban on specific products or substances,
- obligations to appoint a representative or to provide storage facilities in the importing member state,
- type approval,
- authorization procedures,
- technical regulations containing requirements as to the presentation of goods (weight, composition, presentation, labelling, form, size and packaging),
- restrictions concerning advertising,
- deposit obligations,
- indications of origin, quality marks, incitement to buy national products,
- obligations to use the national language,
- restrictions on distance selling (internet sale, mail order, etc.).

2.2 Exceptions

There may be, however, some reasons by virtue of which member states may lawfully restrict the marketing in their territories of products of different member states. Article 36 of the TFEU says that the ban on quantitative restrictions and measures having equivalent effect does not preclude prohibitions or restrictions justified on grounds of

- public policy, public morality or public security,
- the protection of humans, animals or plants,
- the protection of national measures possessing artistic, historic or archaeological value or
- the protection of industrial or commercial property.

These restrictions, however, may not constitute as means of arbitrary discrimination or a disguised restriction on trade between member states. All the aforementioned restrictions must be suitable for reaching the set goal and must not go beyond the limit of necessity, i.e. must be proportionate with the public goal. In case of challenged national regulation the burden of proof lies on the member state. Public policy goals (mandatory requirements) are elaborated by the ECJ; the protection of the environment, the protection of consumers, maintenance of press diversity, financial balance of the social security system, improving working conditions, road safety, cultural aims, fight against crime and protection of animal welfare.

31 Case 8/74, Procureur du Roi v Benoit and Gustave Dassonville.

2.3 The possible restrictions – harmonized products

However, the possibility to restrict the circulation of non-national products with referral to the quantitative restrictions or measures having similar effect does not apply to all products. In this context member states' margin of manoeuvre depends on whether the certain product is subject to harmonization or not. In the case of harmonized products common requirements for the (category of) products are set by old or new approach directives. The differentiation between old and new approach is relevant both from the point of view of the manufacturing and the marketing of the product. Old approach directives, adopted until the mid-80s, regulated the composition and the manufacturing of the products on a step-by-step basis which has led to the famous regulations like the one of cucumber curves.[32] The procedure has been replaced by the new approach legislation concentrating only on the main mandatory requirements concerning characteristics of the products, namely the level of protection of health and safety. It is up to the manufacturer whether he/she fulfils these criteria by referring to (harmonized) technical standards or by any other means with the same level of protection. Regulating by the new approach contributed to the competitiveness of member states' businesses since the directives left the flexibility necessary to reflect innovative ideas. Medical devices, machinery, electronic and electro-technical devices, toys, pressure equipment, measuring instruments, explosives, air-, rail- and water traffic equipment are regulated by new approach directives, while on the ground of safety requirements, road vehicles, tractors, cosmetics, chemical, pharmaceutical and alimentary products are still harmonized by old approach directives (i. e. by detailed legislative provisions). The conformity of the new approach products has to be assessed via the appropriate conformity assessment module[33] and if the product complies with the relevant directive a CE-marking has to be indicated on it. The free circulation of harmonized products may practically not be restricted since the mutual trust towards member states' products is ensured by unified manufacturing rules. This means that member states may not ban or restrict the free movement of products falling under the harmonized areas referring to Article 36 of the TFEU.

2.4 The possible restrictions – non-harmonized products

This does not mean, however, that products without common manufacturing rules may be prohibited to enter the market of the member states. Legislation is not able to keep up with innovation so there is a possibility to produce and market products without any harmonized manufacturing rules but profiting from the mutual recognition principle. This principle, which was developed by the ECJ in the famous Cassis de Dijon case[34], states

32 http://news.bbc.co.uk/2/hi/europe/6481969.stm.

33 Regulation 765/2008/EC setting out the requirements for accreditation and market surveillance relating to the marketing of products.

34 Case 120/78, Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein.

that no products may be restricted to enter the market of member states which have been lawfully manufactured and/or marketed in the territory of one member state. However, restrictions are allowed if they serve to satisfy the mandatory requirements relating in particular to the effectiveness of fiscal supervision the protection of public health, the fairness of commercial transactions and the protection of the consumer. The mutual recognition principle has been incorporated into the regulation 764/2008/EC requiring national authorities of the host member state to examine the level of equivalence of national legislations when it comes to marketing of products under the non-harmonized areas and empowers member states' authorities to impose necessary and proportionate measures if the level of protection of national legislation in the home member state is lower than that of the host member state. How do member states' authorities evaluate the level of protection in the home member state? Each member state must notify[35] their draft pieces of legislation to the Commission and other member states before planning to adopt a piece of national legislation in the non-harmonized areas. Member states and the Commission have 3 months to comment the draft. During this period the draft must not be adopted. The stand-still is extended by further 3 months if detailed opinions are sent. The member state must consult the concerns with the member states in question and must inform them of the legislation adopted after the consultation. This way member states may only adopt legislation in the non-harmonized areas if other member states agree. Under the jurisprudence of the ECJ[36] national legislation adopted by infringing the rules of the technical notification may not be relied upon.

In addition to the technical notification and to the obligation to apply the mutual recognition principle member states must also apply Article 36 of the TFEU for non-harmonized products and may only restrict their marketing if they fail to fulfil the conditions set therein. It is important to note again that member states may not impose barriers equivalent to quantitative restrictions on products considered as harmonized ones since the harmonization measure itself has the goal of setting common standards regarding a certain mandatory requirement (i.e. a member state is not in a position to restrict the importation of foodstuff on the grounds of a mandatory requirement, such as public health, if the manufacturing of foodstuff in question is subject to harmonization measures aiming at setting common food safety standards for the foodstuff).

2.5 Monopolies

Another important rule concerning goods is the one relating to the state monopolies of commercial character. As mentioned before, since the member states and the Union have to adopt an economic policy which is based on the close coordination of member

35 Directive 98/34/EC of the European Parliament and of the Council laying down a procedure for the provision of information in the field of technical standards and regulations and of rules on Information Society services.

36 Case C-194/94, CIA Security International/Signalson and Securitel.

states' economic policies, the internal market and the definition of common objectives and conducted in accordance with the principle of an open market economy with free competition. In addition, under Article 37 of the TFEU member states must adjust any State monopolies[37] of a commercial character so as to ensure that no discrimination regarding the conditions under which goods are produced and marketed exists between nationals of member states and must refrain from introducing new ones. However, the ECJ has held state monopolies justified[38] under certain circumstances;

- the monopoly must be justified with public policy objective,
- the activities of the monopoly may not go beyond the public policy objective (the distribution of alcoholic beverages may only be restricted in the retail segment and not in the whole trade chain if the policy objective is to prevent juveniles from drinking),
- the monopoly may not abuse its market position at the expense of consumers,
- the density of the retail network may not jeopardize the service of consumers,
- the delegation of the state monopoly may not be subject to conditions suitable for the discrimination of other member states' products (storage of appropriate size),
- the monopoly may not influence in a reverse way the trade of other member states' products,
- the selection criteria of the traded products by the monopoly may not be discriminative towards other member states' products and
- the advertising of the products sold by the monopoly must not prevent consumers to get familiar with new products, may not be able to channel consumer choices and may only serve information purposes.

3. The free movement of persons

During the years since 1957 the rights deriving from the free movement of persons have been extended from the economically active persons (workers) to practically all groups of persons and their family members even if they are third country nationals. The free movement of persons became a fundamental freedom attached to the EU citizenship.[39] Furthermore, the right to free movement and residence is a fundamental right enshrined by the Charter of Fundamental Rights.[40] It is important to note that the free movement of persons only relates to individuals since citizens or businesses moving or providing services across the borders can make use of the freedom of

37 The same applies to monopolies delegated by State to others.

38 Cases C-185/95, P. Baustahlgewebe GmbH v. Commission of the European Communities and Case C-387/93, Criminal proceedings against Giorgio Domingo Banchero. - Reference for a preliminary ruling: Pretura circondariale di Genova.

39 Art 21 TFEU.

40 Art 45 of the Charter of Fundamental Rights of the European Union.

establishment and the freedom to provide services. Another important limitation to the free movement rules is the one concerning persons under diplomatic protection (the heads of state and government, the foreign affairs ministers and persons officially accompanying them). These persons' visits and stays in another member state must be organized under the international law.[41]

3.1 Entry and residence

The freedom of movement and residence is regulated by directive 2004/38/EC. The directive creates three categories of stay; the entry and stay in another member state for not longer than three months, the right of residence up to five years and the right of permanent residence.

a) The directive declares that all Union citizens with a valid identity card or passport and their family members who are not nationals of a member state and who hold a valid passport have the right to leave the territory of a member state to travel to another member state and stay there for up to three months. Member states may require them to register within reasonable time which must not be shorter than three months. If a third country partner is required to have a visa in the host member state it shall grant such persons every facility to obtain the necessary visas. Visas must be issued free of charge, as soon as possible and on the basis of an accelerated procedure. The possession of a valid residence card issued for the third country family member by the home member state exempts him/her from the visa requirement.

b) Over 3 months of stay a residence certificate must be applied for. All EU citizens have the right of residence on the territory of another member state for a period longer than three months if they

  (i) are workers or self-employed persons in the host member state; or

  (ii) have sufficient resources for themselves and their family members not to become a burden on the social assistance system of the host member state during their period of residence and have comprehensive sickness insurance cover in the host member state; or

  (iii) are enrolled at a private or public establishment accredited or financed by the host member state on the basis of its legislation or administrative practice, for the principal purpose of following a course of study, including vocational training; and have comprehensive sickness insurance cover in the host member state and assure the relevant national authority, by means of a declaration or by such equivalent means as they may choose, that they have sufficient resources for themselves and their family members not to become a burden on the social assistance system of the host member state during their period of residence; or

41 Case C-364/10, Hungarian Republic v. Slovak Republic.

(iv) are family members accompanying or joining an EU citizen who satisfies the conditions referred to in the previous categories.

Member states may not lay down a fixed amount which they regard as 'sufficient resources' but they must take into account the personal situation of the person concerned. In all cases this amount shall not be higher than the threshold below which nationals of the host member state become eligible for social assistance or where this criterion is not applicable, higher than the minimum social security pension paid by the host member state. Applying for social assistance may not automatically generate a reason for denying the registration certificate, the personal circumstances of the applicant as a whole (family status, time spent uninterruptedly in the host member state, the circumstances of the work or study pursued) must be taken into account. The right of residence of family members derives from the right of stay of the EU citizen. However, if the family member performs any activities which qualifies him/her a union worker, he/she will be entitled to stay on his/her own right.

An EU citizen, who is no longer a worker or self-employed person, retains the status of worker or self-employed person if

(i) he/she is temporarily unable to work as the result of an illness or accident;

(ii) he/she is in duly recorded involuntary unemployment after having been employed for more than one year and has registered as a job-seeker with the relevant employment office;

(iii) he/she is in recorded involuntary unemployment after completing a fixed-term employment contract of less than a year or after having become involuntarily unemployed during the first twelve months and has registered as a job-seeker with the relevant employment office. In this case, the status of worker shall be retained for no less than six months;

(iv) he/she embarks on vocational training.

c) Over five years of lawful residence a permanent residence card may be applied for. The application may only be refused in the case of expulsion.

The directive requires that member states do not discriminate among EU citizens and their family members residing on their territories but access to social benefits outlined in Regulation 492/2011/EU may be denied during the first three months of their stay. Once acquired, the right of permanent residence shall be lost only through absence from the host member state for a period exceeding two consecutive years.

The right of free movement is not unconditional in the sense that non-discriminatory restrictions on the grounds of public policy, public security and public health may be imposed by member states in a proportionate way, not exceeding the limits of necessity. Economic and budgetary difficulties in member states do not serve as appropriate grounds for restrictions.

The host member state may only take an expulsion decision against Union citizens or their family members, who have the right of permanent residence on its territory, on serious grounds of public policy or public security. Before taking an expulsion decision the host member state has to take into account for example how long the individual concerned has resided on its territory, his/her age, state of health, family and economic situation, social and cultural integration into the host member state and the extent of his/her links with the country of origin.

3.2 Taking up a job and entitlement to social benefits

The right to work in another member state entails the right

- to accept offers of employment actually made,
- to move freely within the territory of member states for this purpose,
- to stay in a member state for the purpose of employment,
- to remain in the territory of a member state after having been employed in that state.[42]

Member states may only impose restrictions on the grounds of public policy, public security or public health in a non-discriminatory manner, not exceeding the limits of necessity and non-discriminatory. Member states are not obliged to liberalize positions necessary to fulfil public service duties but under the ECJ's jurisprudence[43] only if the position is closely associated with the fulfilment of the public duty. As Union workers have privileged rights in the Union's territory, it is necessary to collect its definition as it is stated in the Court's rulings. In the Hoekstra case[44], the ECJ ruled: "Nothing in the Treaty leads to the conclusion that these provisions have left the definition of the term 'worker' to national legislation. On the contrary, the fact that the Treaty mentions certain elements of the concept of 'workers', such as employment and remuneration, shows that the Treaty attributes a community meaning to that concept. It would therefore be deprived of all effect and the objectives of the Treaty would be frustrated if the meaning of such a term could be unilaterally fixed and modified by national law. Even if, for the sake of argument, the expression 'wage-earner or assimilated worker' appeared in the legislation of each of the member states, it could not possibly have a comparable meaning and role, so that it is impossible to establish the meaning by reference to similar expressions which may appear in national legislation. The concept of 'wage-earner or assimilated worker' has thus a community meaning, referring to all those who, as such and under whatever description, are covered by the different national systems of social security." The ECJ went further on in the case Levin[45], declaring that even a person working part-time is a Community worker even if he/she has applied for social assistance (case Kempf[46]), while in the case Lawrie-Blum[47] it declared: "The essential feature of an employment relationship is that a person performs services of some economic value for and under the direction of another person in return for which he receives remuneration. The sphere in which they are provided and the nature of the legal relationship between employee and employer are immaterial as regards the application of Article 48." In the Steyman case[48] the notion of remuneration has been interpreted as it includes remuneration in kind received in return for services provided

42 Article 47 of the TFEU.
43 Case C-152/73, Giovanni Maria Sotgiu v Deutsche Bundespost.
44 Case C-75-63. Mrs M.K.H. Hoekstra (née Unger) v Bestuur der Bedrijfsvereniging voor Detailhandel en Ambachten.
45 Case C-53/81, D. M. Levin v Staatssecretaris van Justitie.
46 Case C-139/85, R. H. Kempf v Staatssecretaris van Justitie.
47 Case C-66/85.Deborah Lawrie-Blum v Land Baden-Württemberg.
48 Case C-196/84, Udo Steymenn v Staatssecretaris van Justite.

for a religious community, while in the case Antonissen[49] the notion of worker has been extended to job-seekers after having lost their jobs. The notion of the EU worker today means any worker of the member states who has once benefited from the free movement or has retained this right anytime in his life.

The core feature of Article 45 of the TFEU is principle of anti-discrimination based on nationality between workers of the member states as regards employment, remuneration and other conditions of work and employment. So the general principle of anti-discrimination laid down in Article 18 (referred above) is specifically focussed on the free movement of workers. This provision has served as a basis for the regulation 492/2011/EU (and its predecessor 1612/68/EEC) and directive on the equal treatment in the field of employment.[50] Regulation 492/2011/EU prohibits both direct and indirect discrimination interpreting indirect discrimination as measures applicable irrespective of nationality, the exclusive or principal aim or effect of which is to keep nationals of other member states away from the employment offered. The ECJ has dealt with anti-discrimination cases in a number of times delivering well-known judgements as in the Gravier case[51] (declaring that foreign students are entitled to pay the same tuition fees), in the Grzelczyk[52] (requiring member states' solidarity towards EU workers in case of transitional difficulties in their social situation) and in the Bidar case[53] (interpreted students' loans with preferential interest rates as means of long-term support for living, thus member states are not required to open it towards foreign students referring to transitional difficulties). Under regulation 492/2011/EU workers are entitled to the right to take up a job, job-seeking assistance, the right to preferential tax rates and social benefits (including social housing), the right to vocational education and training (including university studies) and the collective rights (join collective agreements and trade unions). However, as mentioned before, member states have the possibility to limit the access to these benefits to the first day of the fourth month of the stay in the other country.

3.3 The direct effect of the Treaty provisions

Article 45 of the TFEU has direct effect meaning that these provisions may be invoked before national courts even if the national legislation is not in line with the Treaty. This principle has first been declared in the famous Van Duyn[54] case in the context of

49 Case C-292/89, The Queen v ÍImmigration Appeal Tribunal ex parte: Gustaff Desiderius Antonissen.

50 Directive 2000/78/EC establishing a general framework for equal treatment in employment and occupation.

51 Case C-292/83, Gravier v City of Liege.

52 Case C-184/99, Rudy Grzelczyk v Centre public d'aide sociale d'Ottignies-Louvan-la-Neuve.

53 Case C-209/03, The Queen v London Borougn of Ealing and Secretary of State for Education and Skills, ex parte Dany Bidar.

54 Case C-41=74, Yvonne van Duyn v Home Office.

workers, explaining that the Treaty provisions are clear and simple without any need for further clarification, therefore suitable for direct application of national courts. The ECJ, however, went much further in the cases Walrave and Koch[55] and Bosman[56], obliging professional associations to recognize direct effect of the Treaties, while in the Angonese case[57] it was clearly stated that discrimination on the grounds of nationality is prohibited among individuals as well. So the Treaty provisions do not only have vertical (state-individual) but also horizontal (individual-individual) direct effect.

3.4 The need of a cross-border element

As described above, there must be a cross-border element in the case so that the rules of free movement could be relied on. The cross-border element may be embodied by meeting the requirements of the notion of Union worker, but in its rulings, the ECJ has widened the scope of applicability of the test in MRAX[58] judgement. In its milestone judgement in the Carpenter case[59] the ECJ ruled that the UK is not in the position to expel the third country national wife of Mr Carpenter, whose residence permit has expired, because Mr Carpenter was occasionally providing cross-border services and if his wife had been expelled he would have been deprived of the possibility of a normal family life when he pursued his activity outside the UK. In the Zambrano case[60] the Colombian parents of a child of a Belgian national were prohibited to be expelled otherwise the child, who is an EU citizen, would be deprived of his family. This would be contrary to the UN Convention on the Rights of the Child, a treaty which Belgium is also a contracting party to. In the McCarthy case[61], however, the ECJ has refused to recognize the cross-border element of the Irish-British dual citizen who has solely been living in the UK and only wanted to move with his Jamaican husband by changing her UK passport to an Irish one.

3.5 Exceptions

Free movement rights enshrined in Article 45 of the TFEU may only be restricted by public policy, public security and public health reasons. The acceptability of public policy reasons can be illustrated by the previously mentioned Van Duyn case, in which

55 Case C-36/74, Walrave and Koch v Association Union cycliste internationale.
56 Case C-415/93, Bosman.
57 Case C-281/98, Roman Angonese v Cassa di Risparmio di Bolzano SpA.
58 Case C-459/99, Mouvement contre le Racisme, l'Antisémitisme et la Xénophobie (MRAX) v État Belge.
59 Case C-60/00, Mary Carpenter v Secretary of State for the Home Department.
60 Case C-34/09, Gerardo Ruiz Zambrano v Office national de l'emploi.
61 Case C-434/09, Shirley McCarthy v Secretary of State for the Home Department.

Ms Van Duyn was to be expelled for belonging to the Scientology church. In this case the ECJ has declared that the personal conduct of a person shall be interpreted as a person's decision to join the church. The Orfanopoulos[62] and Olivieri[63] cases can serve as good examples for public security. In these cases the ECJ has stated that the mere fact of conviction is not a sufficient and automatic reason of expulsion since member states must evaluate the complexity of the person's personal circumstances, whether the crime has been committed negligently or intentionally, maybe repeatedly and the severity of the crime. Public health interests are justifiable in case of diseases with epidemic potential and other infectious or contagious parasitic diseases.

3.6 Third country workers

Although member states all suffer from the phenomenon of unemployment, Europe's firms are in constant need of skilled workers. This is why the Commission has proposed to liberalize the free movement rights of certain categories of third country workers. Two directives have already been approved by the legislators. The directive 2003/109/EC[64] regulates the right of stay and of social assistance of third country workers. Under this directive third country nationals with sufficient and continuous resources for living covered by health insurance may enter into the territory of member states and have the right to reside and work in the territory of the EU. The other directive is the so-called 'blue card' directive[65] enabling highly-skilled third country nationals to enter, stay and work in an EU member state if his remuneration offered for the job is at least 150% higher than the average wages in the member state. The 'blue card' also gives access to third country workers to the social assistance system of the member state concerned. After having stayed at least 18 months in the member state he will be entitled to accept a job offer in accordance with his qualifications in another member states. The directives on intra-corporate transfers and on third country trainees have not been adopted yet.

3.7 Problems and the possible way forward

It has been a long process since the right of free movement has been extended to its present significance. The ECJ has been actively contributing to this development

62 Case C-482/01, Georgios Orfanopoulos and others vs Land Baden-Württemberg.
63 Case C-493/01, Raffaele Oliveri v Land Baden-Württemberg.
64 Council Directive 2003/109/EC concerning the status of third-country nationals who are long-term residents.
65 Council Directive 2009/50/EC on the conditions of entry and residence of third-country nationals for the purposes of highly qualified employment.

which is a clear sign of the member states' difficulties in applying legislation and their endeavour to interpret them in a restrictive manner, especially the ones concerning social benefits. From the ECJ's ruling it has become self-evident that restrictions may not be based on the economic needs or financial difficulties. It is worth to see that problems might not only occur in receiving member states; sending member states may also face the difficult aspects of free movement from the point of view of losing possibly competitive workforce. No surprise that all the Greek, Spanish and Portuguese accession treaties, followed by the EU10, the EU2 and the Croatian one which introduced transitional measures concerning the free movement of workers. Spain has even applied the safeguard clause vis-à-vis Romanian workers. The problems cumulated in autumn 2013 by publishing an article about the British Prime Minister David Cameron's concerns in the Financial Times[66] but the free movement of persons is subject to debates in other member states as well. The problems are strongly related to the incomplete Economic and Monetary Union. Member states with differing competitiveness strategies, societal policies and social systems are not ready to extend economic coordination over the scope of the stability and growth pact. Shifting the costs to meet the Maastricht criteria on less coordinated economic policy measures lead to imbalances in the non-coordinated measures and asymmetries in the employment and social field. This caused among other things, heavy migration. One must bear in mind that the free movement of persons, besides being the most attractive freedoms for the citizens, is the basic component of the internal market through contributing to the equalization of the optimal balance of the demand and supply of labour, to the labour market adjustments and in the long run, the competitiveness of the EU's businesses on the global market. The right to the free movement has been transformed into the fundamental right of every EU citizen deriving from the Charter of Fundamental Rights. Bearing in mind all these factors the Commission is trying to find forward-looking legal, institutional and financial responses. Legal proposals of the Commission, the implementing directive of the posting of workers, the directive on the free movement of workers adopted in 2013, and the draft regulation on EURES, aim at creating a better coordinated labour market and equilibrium regarding member states' responsibility and the possibilities of citizens. The joint employment report with the annual employment and social benchmarks are published each year. The Commission and the member states may recommend economic policy measures for member states in question. During the programming period of 2014-2020, 23% of cohesion resources must be used to reach ESF goals and at least 20% of ESF resources are to be planned to reduce poverty and social exclusion. Besides a €6 million agreement has been reached for the financing of the youth employment initiative, e. g. the national measures implementing youth guarantee initiative.

Another potential risk concerning free movement is the Swiss referendum against mass immigration. The EU-Swiss agreement on the free movement of persons is part of a package agreement (Bilateral I) signed in 1999. The termination of the agreements of the package, just like their entry into force may be implemented jointly, concerning

66 http://www.euractiv.com/uk-europe/cameron-free-movement-eu-needs-f-news-531982.

all seven[67] agreements. In the 9 February referendum the Swiss voted (by a small majority) for the introduction of a cap on immigration from EU member states which may lead to strains in EU-Swiss relations and may also jeopardise Switzerland's access to the single market.

4. Establishment and services

The right of establishment as declared by Articles 49, 55 of the TFEU has been the basic guarantee for individuals and businesses wishing to provide services in another member state. As the free movement of capital and the freedom to provide services have been elaborated in more and more details both by the ECJ and by legislative acts, this freedom has remained a safety net for cases not covered by the specific directives.[68] Article 49 of the TFEU has both vertical and horizontal direct effect, enabling individuals and businesses to refer to them in legal disputes. Again, it was the ECJ that provided for the basis of the application of these Treaty articles by interpreting the notion of establishment. In its judgement of the Gebhard case[69] it stated that the concept of establishment is broad allowing a Community national to participate on a stable and continuous basis, in the economic life of a member state other than his state of origin and to profit from it, so contributing to economic and social interpenetration within the Community in the sphere of activities as self-employed persons. In contrast with this, where the provider of services moves to another member state in order to provide his services there without the intention of establishment, he is to pursue his activity in the other member state on a temporary basis. The temporary nature of the activities in question has to be determined in the light not only of the duration of the provision of the service but also of its regularity, periodicity or continuity. The fact that the provision of services is temporary does not mean that the provider of services within the meaning of the Treaty may not equip himself with some form of infrastructure in the host member state (including office, chambers or consulting rooms) in so far as such infrastructure is necessary for the purposes of performing the services in question.

The freedom of establishment as declared in Article 50 of the TFEU includes

- as a general rule according priority treatment to activities where freedom of establishment makes a particularly valuable contribution to the development of production and trade,
- ensuring close cooperation between member states' authorities,

67 The seven bilateral agreements of 1999 (Bilaterals I) are mainly liberalisation and market opening agreements: 1) free movement of persons, 2) technical barriers to trade, 3) public procurements, 4) agriculture, 5) research, 6) civil aviation, 7) rail and road transport.

68 Case C-393/05, Commission v Austria, C-404/05, Commission v Germany, C-438/08, Commission v Portugal.

69 Case C-55/94, Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano.

- abolishing administrative procedures and practices resulting from national legislation,
- ensuring that workers after the end of their employment may remain in the territory of another member state for the purpose of taking up self-employed activity if they satisfy the host country's requirements,
- enabling nationals to acquire and use land and buildings situated in the territory of another member state,
- effecting the progressive abolition of restrictions on freedom of establishment in every branch of activity, both as regards of setting up branches, agencies or subsidiaries and enabling the entry of personnel into managerial or supervisory posts in them and
- coordinating the necessary safeguards for companies in the interest of members and third persons, with a view to making such safeguards equivalent throughout the EU.

4.1 The distinction between primary and secondary establishment

Article 49 of the TFEU states that the freedom of establishment prohibits member states to apply restrictions on the setting up of agencies, branches or subsidiaries; while Article 54 of the TFEU stipulates that companies or firms formed in accordance with the law of a member state (any company or firm constituted under civil or commercial law, except for non-profit companies) and having their registered office, central administration or principal place of business within the EU, shall be given the same right of establishment as individual natural persons. This means that natural persons are free to set up companies in any member state under the law of that member state. Companies are also free to incorporate companies or set up subsidiaries, branches or agencies in another member state. There is, however, an impediment justified by the ECJ[70] concerning the establishment of companies; they are only allowed to transfer their seats within the territory of the European Union if they meet the requirements laid down by the laws of their home member state. This means that if a British company would like to change its UK address of the seat to a Belgian one, the UK has the right to require the company to pay all fees to the state and compensate the workers and third parties according to UK law. In practice, a company is only able to transfer its seat to another member state after having been wound up in its home member state and incorporating again in the other one. In its Daily Mail judgement (see above) the ECJ has declared that "…unlike natural persons, companies are creatures of the law and, in the present state of Community law, creatures of national law. They exist

70 Case C-81/87 Daily Mail, which has been confirmed in judgements C-210/06, Cartesio oktató és Szolgáltató Bt. and C-378/10, VALE Építési Kft.

only by virtue of the varying national legislation which determines their incorporation and functioning… the Treaty, properly construed, confer no right on a company incorporated under the legislation of a member state and having its registered office there to transfer its central management and control to another member state."

4.2 Exceptions

Member states may apply their national measures liable to hinder or make less attractive the exercise of the freedom of establishment guaranteed by the Treaty if they

- are applied in a non-discriminatory way,
- are justified by public policy, public security and public health,
- are suitable for securing the attainment of the objective which they pursue and
- do not go beyond what is necessary to attain it.

5. The free provision of services

5.1 What is considered to be a service?

Services provided for natural or legal persons differ from the point of view of the subject of the service. Services like energy, transport, and postal services are called in the EU terminology as services of general economic interest (SGEI). Under Article 14 of the TFEU and Protocol No. 26 attached to it, the EU and the member states have the right to enact legislation regarding SGEI via ordinary (qualified majority voting) legislative procedure. They must take care that such services operate on the basis of principles and conditions, particularly economic and financial conditions which enable them to fulfil their missions. National legislation governing these services, even if they are provided by state monopolies or by companies with special or exclusive rights retained for the state, must be in line with EU rules concerning state aid and competition.

Member states are free to regulate the provisions of services of general interest such as education, basic health services, etc. since the provisions of the Treaties do not affect in any way these services.

There is, however, a third group of highly diverse services regardless whether they are B2B or B2C ones which represent more than 60% share of the GDP and of the employment which are called internal market services, the provision of which is regulated by Art 56 – 62 TFEU and by the services directive.[71]

71 Directive 2006/123/EC of the European Parliament and of the Council on services in the internal market.

The freedom to provide services is a residual freedom. Article 57 of the TFEU considers services which are normally provided for remuneration, in so far as they are not governed by the provisions relating to the free movement of goods, capital and persons. The notion of services particularly includes:

- activities of an industrial character;
- activities of a commercial character;
- activities of craftsmen;
- activities of the profession, irrespective of the fact that they are provided via establishment (Article 56 of the TFEU) or in a cross-border manner (Article 57 of the TFEU).

It is important to note that the list is an open list so any activities which cannot be covered by the other freedoms are enrolled to be a service. The ECJ has defined the notion of services in its various judgements. The activity may be performed by a self-employed person[72], even by a non-profit firm or a state-owned one[73] but not by a person in employment relationship. Remuneration may be even paid by third parties and not only by the recipient[74] which constitutes consideration for the service in question and is normally agreed upon between the provider and the recipient of the service.[75]

The other aspect of this freedom is concerning the recipients. In its Luisi and Carbone case[76] ruling, the ECJ confirmed that Treaty covers the situation of recipients as well as of providers of services and ruled that that the freedom for the recipient to move was the necessary corollary of the freedom for the provider. In its subsequent judgement[77] the ECJ has ruled that the prohibition of receiving a service on nationality grounds in a member state other than his home member state is against EU law.

It is important to note that under the TFEU member states are required to refrain from discrimination on the grounds of nationality both concerning services provided via establishment and the ones provided in a cross-border manner.

5.2 Exceptions under the Treaties

Under Article 62 of the TFEU the same exceptions apply as to the freedom of establishment; public policy, public security and public health. Overriding reasons of general interest justifying the public policy goals may vary country-by-country and time to time. The ECJ has justified inter alia the maintenance of order in society, consumer protection, the protection of workers, animal welfare, the preservation of the

72 Case C-36/74, Walrave and L.J.N. Koch v Association Union cycliste internationale, Koninklijke Nederlandsche Wielren Unie and Federación Española Ciclismo.

73 Joined cases C-51/96 and C-191/97, Christelle Deliège.

74 Case C-352/85, Bond van Adverteerders v the Netherlands State.

75 Case C-263/86, Belgium v Humbell.

76 Cases C-286/82 and 26/83, Graziana Luisi and Giuseppe Carbone v Ministero del Tesoro.

77 Case C-186/87, Cowan v Le Trésor Public.

financial balance of the social security system, the prevention of fraud, the prevention of unfair competition, the protection of the environment and the urban environment as overriding reasons of general interest and as the justifications of public policy references. Just like in the case of the other freedoms restrictive national measures may only be applied if they are non-discriminatory, necessary to reach the public policy/ public security/public health goal and do not go beyond the necessary limit.

5.3 The Services Directive

Some internal market services are not covered[78] by the directive. Nevertheless, it still covers a wide group of service activities which represent around 40% of the EU's GDP and employment. It covers services such as construction and craft industries, retail trade, the majority of regulated professions (lawyers, architects, engineers and accountants, for example), business services (office maintenance, management consultancy and publicity for example), tourism, real estate services and private education.

It is stipulated by the directive that member states must guarantee freedom of access to the service activity and the freedom to provide services throughout their territories. Concerning services provided via establishment member states had to screen their legislation and could only maintain authorization[79] which is non-discriminatory, justified by an overriding reason relating to the public interest, proportionate to that public interest objective, clear and unambiguous, objective, made public in advance, transparent and accessible. The authorization, as a general rule, shall be given for an indefinite period of time or if not, shall be automatically renewable. The directive lists certain authorization requirements which are prohibited in any circumstances (such as nationality or residence requirements, the case-by-case application of an economic test, etc.) and the ones which may be introduced but must be justified with an appropriate overriding reason of general interest, fulfilling the necessity/proportionality test (quantitative or territorial restrictions, obligation to provide service in a legal form, minimum number of employees, etc.). The latter are the so-called “requirements to be evaluated” and they must be reported to the Commission and to the member states which may comment the reported measure. The rights of cross-border service providers must be respected by member states. This means that authorization requirements must not be imposed. Cross-border service providers must not be required to be established or to be registered. Any restrictions can only be applied if they are non-discriminatory, proportional and justified for reasons of public order, public safety and public health and in addition are on the grounds of environmental protection and minimum employment requirements.

78 Financial services, telecommunication networks, transport, healthcare services, gambling activities and certain social services, services of general economic interest, secondments.

79 In advance registration requirement is also treated as authorization.

Member states must inform businesses of their legal requirements concerning service providing through the points of single contact[80] while national (central and local) authorities may use an internet-based software (IMI) in their national language to communicate with their partners when dealing with their clients with other member states.

The deregulation of the conditions concerning providing services has been a major achievement of the directive which, as calculated by the Commission[81], has contributed to the EU's GDP by 0.8% on average but it still has a potential of adding further 1.8% (if all member states fully implemented it). The unique characteristic of the directive is that own nationals and businesses benefit of it just like nationals and businesses of other member states, since the national requirements have significantly been simplified by the deregulation of activities.

It is important to note that services not falling under the scope of the directive are still covered by the Treaty, i.e. the principle of non-discrimination applies.

6. The free movement of capital

The articles of the Treaties concerning the free movement of capital are the ones which have changed the most remarkably over the times. In the Treaty of Rome the gradual liberalization of capital movement has been envisaged, a stand-still provision has been introduced and its implementation was supported by the first directive listing capital movements into A, B and C lists. On the basis of the empowerment incorporated into the Single European Act of 1986, directive 88/361/EEC[82] has been adopted envisaging the full liberalization of capital movements until 1 July 1990 and containing a detailed but open list of capital movements. It was the Maastricht Treaty which introduced the present wording of the TFEU liberalizing all capital movements. Although directive 88/361 has been repealed the ECJ in its judgement in the Trummer case[83] has rendered its annex with the classification of capital movements to be relied upon. Forms of capital movements are direct investments, investment in real estate, operations in securities and other financial instruments dealt with by the stock market, operations in units of collective investment undertakings, operations in current deposit accounts with financial institutions, credits relating to commercial transactions, financial loans and credits, securities, other guarantees and rights of pledge, physical import and export of financial assets and personal capital movements. The ECJ in its rulings[84] provided

80 http://ec.europa.eu/internal_market/eu-go/index_en.htm.

81 Josefa Monteagudo, Aleksander Rutkowski and Dimitri Lorenzani: *The economic impact of the Services Directive: A first assessment following implementation*. European Economy. Economic Papers 456. June 2012.

82 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

83 Case C-222/97, Manfred Trummer and Peter Mayer.

84 Case C446/04, Test Claimants in the FII Group Litigation, Case C157/05, Holböck.

for the interpretation of capital movements as "investments of any kind undertaken by natural or legal persons and which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out an economic activity".

6.1 Direct effect

It is in the Bordessa[85] case that the ECJ has declared the Treaty provisions having direct effect while classifying the authorization and a priori registration requirement for physical cross-border cash transfer. In the Sanz de Lera case[86] the direct effect has been stipulated for cross-border physical cash transfer concerning third countries as well.

6.2 Exceptions

There are two ways for member states to justify their restrictive measures. Article 65 (1) b) of the TFEU empowers them to take requisite measures to prevent infringements in the field of taxation and the prudential supervision of financial institutions, lay down procedures for declaration of capital movements for purposes of administrative or statistical information or take measures on the grounds of public policy or public security. The other possibility is referring to Article 65 (2) which is pointing back to the exceptions of the freedom of establishment; public policy, public security and public health. The ECJ in its judgements[87] required a direct link between the restriction introduced by the member state and the public policy goal it is referring to. In the Svensson and Gustavsson case[88] the ECJ found preferential loans applicable only from Luxembourg-based banks on the territory of Luxembourg as against the Treaties. Subsequently in the Verkooijen case[89] the ECJ declared the rule of the Netherlands which prohibited non-nationals to profit from preferential taxes on dividends as incompatible with the Treaty. In the latter cases the ECJ has not found a direct link with the national measure and the public policy goal, therefore, ruled against Luxembourg and the Netherlands. The ECJ just like in the case of other freedoms is examining the potential effect of the national measure in question of the market; an actual distortion/influence of the market is not a precondition of the infringement of the Treaty. Furthermore, in the British golden share case[90] it stated that any restriction

85 Joined cases C-358/93 and C-416/93, Aldo Bordessa and others.
86 Joined cases C-163, 165 and 250/94, Sanz de Lera, Jimenez and Kapanoglu.
87 Cases C-478/98, Commission v Belgium (Eurobond), C-204/90, Hans Martin Bachmann v Belgian State.
88 Case C-484/93, Peter Svensson and Lena Gustavsson v Ministre du Logement et de l'Urbanisme
89 Case C-35/98, Staatssecretaris van Financiën v Verkooijen.
90 Case C-98/01, Commission v United Kingdom.

suitable for discouraging investors from the market are considered as measures not in line with the Treaty.

6.3 Privileges granted by states in privatized companies (golden shares)

Although Article 345 of the TFEU guarantees member states the choice of governing system concerning property ownership, states are usually agreed to have shareholding rights corresponding to their value of shares in the company. Yet, governments tend to retain privileges/special rights (veto, multiplied vote or voting cap) in privatized companies. These endeavours of the governments may only be in line with the Treaties if they serve a legitimate public policy goal. The ECJ has acknowledged[91] the security of energy supply as one of the legitimate goals if they are defined by objective criteria, the limits of exercising the rights is defined by law and the way the state exercises its rights is publicly available. Restrictions must be proportionate, so if the state has the privilege embodied in approval, the approval must not be the precondition of the decision. The decision must be limited in time, must be justified and may not be substituted by a less burdensome measure.

6.4 The rules governing the purchase of immovable property

The purchase of immovable property has been liberalized by the Maastricht Treaty and the directive 88/361/EEC. As previously seen the freedom of establishment includes enabling nationals to acquire and use land as well as buildings situated in the territory of another member state. Denmark, Portugal, Spain and Austria had temporary derogations from these provisions and so did member states which joined the EU later. The unique nature of the immovable property among the other capital factors has been justified by the ECJ in its various judgements interpreting the legality of public policy goals referred to by the member states. Among immovables the regulations for acquisition of ownership of a secondary residence and of the agricultural land must be distinguished. As for secondary residence, regional planning, the favourable land ownership arrangement as a result of the restructuring of rural land holdings, the possibility to pursue independent economic activities save for tourism and the protection of environment are considered as justifiable overriding reasons of general

91 See Cases C-367/98, Commission v Portugal, C-483/99, Commission v France and C-503/99, Commisson v Belgium.

interest.[92] As for the acquisition of ownership of agricultural land the particular nature of agricultural activity, which results from the social structure of agriculture and from structural and natural disparities between the various agricultural regions, may justify national restrictions in certain circumstances. The preservation and creation of an economically healthy, medium and small-scale agricultural estate and building plots, the restricted quantity of the free building plots, the land planning objective, the public interest of preserving, strengthening or creating a viable agricultural community, the sympathetic management of green spaces and the countryside as well as encouraging a reasonable use of the available land by resisting pressure on land and preventing natural disasters, just like the efforts to ensure a fair standard of living for the agricultural community are seen as justified by the ECJ as public policy goals. Besides the possible justifications of the overriding reasons of general interest, the ECJ gave clear instructions on their acceptability provided that

- they pursue in a non-discriminatory way an objective in the public interest and
- they are appropriate for ensuring that the aim pursued is achieved and do not go beyond what is necessary for that purpose.
- Furthermore, where the granting of prior authorisation is concerned, such measures must be based on objective criteria which are known in advance and which allow all persons affected by a restrictive measure of that type to have a legal remedy available to them.

Furthermore, in the Festersen case[93] it ruled that the requirement for acquiring an agricultural property that the acquirer take up fixed residence on that property is not a proportionate measure to reach the public policy goals.

6.5 Bilateral investment treaties of member states

The development of the acquis concerning the free movement of capital has had major influence on the legal status of bilateral investment treaties (BITs) concluded by member states, the consequence of which depends on whether the investment treaty is concluded between member states and third countries (third country BITs) or between member states (intra-EU BITs). Third country BITs are forbidden to be concluded under the TFEU since the Maastricht Treaty which prohibited the restrictions on payment and capital movements both between member states and between member states and third countries and empowered the Council to restrict payment on capital movements under certain circumstances, to act in cases of serious disturbances threatening the Economic and Monetary Union, and to implement acts in the field of common foreign and security policy. The Treaty, by declaring this,

92 Case C-302/97, Klaus Konle v Austria, Case C-423/98, Alfredo Albore v Tribunare civile e penale Neapel, Joined Cases C-515/99, C-527/99, C-540/99, Hans Reisch and others v Bürgermeister des Landeshauptstadt Salzburg.

93 Case C-370/05, Uwe Kay Festersen.

brings the inevitable consequence of the member states' loss of this capacity since directly applicable Treaty provisions may not be overridden by national measures, not even international agreements concluded by member states. Therefore, Article 307 of the EC Treaty (which is today Article 351 of the TFEU) has ordered member states to adjust their third country BITs. The ECJ in its judgements delivered in the infringement cases against Sweden, Finland and Austria has stated that these countries had infringed EU law by not having made reference in their third country BITs to the prevailing measures of the EC Treaty. The Lisbon Treaty empowers the Union with legal capacity enabling it to conclude international agreements in its own competence. The EU's competence is fixed in regulation 1219/2012/EU which retains member states' competence to conclude BITs with third countries which are in line with EU law until the agreement between the EU and the third country concerned enters into force. Member states must notify the Commission of their planned agreements and their drafts must be submitted to the Commission as well. This way the Commission is given the opportunity to conclude an EU-wide agreement with the third country if member states wish so.

The other aspect of BITs is the intra-EU BITs and their compatibility with EU law. Most of the 2004 accession round countries, as well as Romania and Bulgaria had previously concluded these types of agreements with EU15 countries. As these agreements concur with the articles of the Treaty on the free movement of capital, they are incompatible with the EU law. The European Commission is elaborating a draft so that a structural solution to this problem could be found.

III. History of the Economic and Monetary Union

1. Background

The common currency, the euro is now part of everyday life (currently) in eighteen member states of the European Union and it is also a key player of the global capital market. The Economic and Monetary Union is the most ambitious EU policy in our time and as many say it is one of the boldest economic experiments of all time. The number of the countries (member states and others) that join it increases despite the global economic and financial downturn. The single currency presents undeniable advantages, among others it lowers the costs of transactions in the single market, makes the prices of goods and services comparable, and strengthens the role of Europe at international level. Nevertheless, the structure of the Economic and Monetary Union (EMU) is not perfect. While the monetary union was established solidly, completion of the economic union has not caught up to it. The difficulties and reforms of the recent years have made clear that there is still a lot to do. The establishment of the genuine EMU is one of the top priorities on the European agenda. But to understand the present shortcomings of the EMU we should have a short overview on the history of the European monetary integration.

The EMU of the European Union is the highest level of economic integration that the European Union achieved so far. But the economic union and the monetary union as well are categories of economic theory. If the economic integration of a group of countries reaches the level of a customs union it could develop further towards an economic union and/or a monetary union. In theory a monetary union is a level of economic integration where two or more states share the same currency and form a single market that is based on their customs union. The economic union is not a prerequisite of a monetary union but its sustainable functioning requires such a high degree of cooperation in economic policy that an optimal monetary union should be accompanied by an economic union as well. However, the monetary union (or at least currency union) has different types in reality. There are informal unions that mean a unilateral adoption of a foreign currency (e.g. euroisation of Kosovo). It is a more formal way if the adoption of a foreign currency happens by an agreement (e.g. euro in Monaco, San Marino and the Vatican). But the highest level of the monetary union is when member states establish a common supranational monetary policy like in the EMU. From a different point of view the monetary union can be realised by the introduction of a fixed exchange-rate system among the currencies of the member states (like the EMU from January 1999 to December 2001). In this system parallel currencies continue existing but the banknotes of the different currencies are only non-decimal denominations of each other. This solution could ease the political sensitivity over the loss of the "national money" but does not solve fully the problem of the exchange of currencies. The optimal solution however is the introduction of a common currency that could maximise the positive effects of the monetary union.

Furthermore beyond theories there were functioning monetary unions in Europe earlier already and the EMU in this present was not the first attempt of the member states to reach this level of integration. The Zollverein or German Customs Union was an early form of economic integration among German states that was formed to manage tariffs and economic policies. The preparatory talks had started after the Napoleonic wars and its first form formally came into being on 1 January 1834. By 1866 it included most of the German states. It gives us an important model since this was presumably the first time in European history when independent states had accomplished a full economic union for a long period without the simultaneous creation of a political federation or union. This asymmetric structure changed when the German states formed also a political union founding the unified German Empire in 1871 that assumed the control of the customs union. It is worth to mention that the territorial scope of the economic and political union was not identical. Not every state within the Empire was part of the Zollverein until 1888 (the two exemptions were the city-states of Hamburg and Bremen). On the other hand Luxembourg remained in the Zollverein until 1919 although it was not part of the German Empire. The economic and customs union however led to a monetary union after the establishment of the political integration of the German states. The common currency of the German Empire was introduced in 1873.

Another example of early European monetary integration although from the age of the metallic standard monetary system was the Latin Monetary Union (LMU). The LMU attempted to unify several European currencies - still made of gold and silver - that could be used in all the member states. It aimed to facilitate trade between its member states by setting the standards by which gold and silver currency could be minted and exchanged. Along these lines a trader could accept the currency of another member state in a cross border transaction without risk since it could be converted back to a comparable amount of own domestic currency of the trader. The LMU was established in 1865 by France, Belgium, Luxembourg, Italy and Switzerland. The participating member states fixed the silver and gold standard of their national currencies. Three years later Spain and Greece, in 1889 Romania, Bulgaria, Venezuela, Serbia and San Marino joined to the union. This monetary integration was based on the metallic standard of the currencies. It did not introduce common economic policies or a common currency; it neither led to a political union. Finally the First World War and already the prior political turbulences brought the LMU to its end although it was broken up "de jure" only in 1927. The Scandinavian Monetary Union of Denmark, Norway and Sweden between 1875 and 1914 followed the same pattern.

The 'Great War', the new countries and the harmful economic effects of these changes set back the economic integration among the European nations. Despite all that the basic idea of customs union or monetary union did not vanish. Belgium and Luxembourg established an economic and monetary union (Union économique belgo-luxembourgeoise / UEBL) in 1921 that already started to work from the next year. Under the terms of the treaty, the economic frontier was lifted and the Belgian and the Luxembourgian franc were set at a fixed parity. The latter step was facilitated by the fact that both currencies were members of the LMU. This union was the forerunner of the Benelux cooperation and a kind of model for the European Economic Community. But the idea that the future of the continent depends on whether the European nations could turn their economic separation into cooperation or even integration was not limited to the smaller and Western European countries. Elemér Hantos, Hungarian "rapporteur" at the Economic Committee of the League of Nations prepared plans for creating an economic union among the Central European nations along the river Danube. In 1929 even Gustav Stresemann – that time the foreign minister of Germany – raised the question of a European currency in the League of Nations.

Unfortunately later that year with the 'Black Friday' of the New York Stock Exchange an unprecedented global financial and economic crises started. It caused enormous economic turmoil all over the world, wave of business bankruptcies and an extreme level of unemployment. These sudden changes of the global economy completely abolished the chance of the economic and monetary integration among the European states. They responded to the crisis with a policy of 'beggar-thy-neighbour', taking deflationary measures to boost export competitiveness and introducing tariff barriers for products imported from abroad. This policy made the economic crisis worse. While in the short term it was beneficial to the state concerned, in the long term it had serious economic consequences: inflation, falling demand, rising unemployment and slower growth in world trade. And the disastrous economic consequences led the societies of Europe to harmful social and political situations and finally to the Second World War.

The Second World War was still going on in Europe when the Allied Powers already started the reconstruction of the European and global economy. The bad experiences of the post crisis measures redirected the focus of the economic philosophy of the governments towards the cooperation and integration again. Since the European economies were ruined by the war the procedure was led by the United States. In 1944, while the Second World War was still laying waste to Europe, a conference on the restructuring of international financial and monetary relations took place at Bretton Woods in the United States. Over forty countries participated: on 22 July 1944 they signed the Bretton Woods Agreements. These agreements laid down the rules and procedures governing the world economy and established the International Bank for Reconstruction and Development (IBRD), a component of the World Bank and the International Monetary Fund. Furthermore, the Bretton Woods Agreements put in place the gold standard monetary system. This system provided stable exchange rates based on gold which became the reference standard. Only the US dollar remained convertible into gold and the other currencies were indexed to the dollar.

2. From the Schuman Plan to the Werner Plan

The world underwent profound changes after the Second World War. The experiences of war gave rise to the awareness that international cooperation was crucial to solve the problem of the individual economies. Europe faced several challenges: how to find its place in the new world order, how to rebuild the economies, how to avoid a new armed conflict among the European states. The new answers were cooperative already. The Belgium-Luxembourg Economic Union gave a model to the Benelux (Netherlands–Belgium–Luxembourg) Customs Convention (or London Customs Convention) signed in 1944 by the three governments all in exile during the war. The Convention came into force in 1948 and lasted until 1960 when it was developed into a stronger form of integration, the Benelux Economic Union. This cooperation later gave a great inspiration to a European integration of a larger scale.

The European economic integration started by the visionary Schuman Plan (1950). The founding Treaties established the integration of the steel and coal sectors of the six founding member states (France, Germany, Italy and the Benelux; 1951 Treaty of Paris, European Coal and Steel Community, ECSC). But the first step was soon followed by others. The Dutch minister of foreign affairs Johan Beyen proposed a Benelux-like integration for the Six. The plan had the full support of all the Benelux and the intergovernmental conference of Messina in 1955 already decided to prepare a stronger integration. The blueprint of the next steps was outlined in the Spaak[94] report and the member states after long negotiations in Val Duchesse (Belgium) agreed the integration of nuclear sector and a broad integration of the European Market (1957 Treaty of Rome, European Atomic Energy Community, Euratom and European Economic Community, EEC). The new institutions functioned well and the customs union among the member states was realised even one and the half year earlier than it was planned. In the meantime – although the Economic and Monetary Union is the most ambitious of the European Union's current policies – it was not even mentioned as an objective in the founding treaties in the 1950s.

Regarding the monetary policy the ideas for the development were rather different. As we see the founding treaties did not mention it among their goals. The Spaak report mentioned the "stability" and an "economic region established on common bases" but this was far from the idea of a common currency.

The problem of convertibility was solved by other intergovernmental means. The European Payments Union (EPU, 1950-1958) was an organization to reduce the harmful effect of the lack of USD reserves and convertibility of the currencies. The EPU accounted for trades but did not transfer money until the end of the month. The EPU was a general success with trade levels more than doubling during its duration. By its close in 1958 the convertibility of currency no longer needed permissions in European countries. It was replaced by the multilateral settlement system of the European Monetary Agreement (EMA) that was administered by the OECD. The EMA finally was terminated in 1972 as its aims were largely replaced by the International Monetary Fund.

On the other hand the Action Committee for the United States of Europe (ACUSE), a pressure group created by Jean Monnet in 1955, proposed federative proposals for

94 Paul Henri Charles Spaak (1899 – 1972), Belgian politician and statesman, who served among others as Prime Minister of Belgium, as the first president of the Common Assembly of the European Coal and Steel Community (1952–1954). The first building of the European Parliament in Brussels was named after him.

the further development. The new customs union started to produce new common income for the EEC as the customs duties became common. And as the customs union needed a minimal level of coordination of other aspects of economic policies, also the Treaty of Rome mentioned that the member states shall regard their pro-cyclical policies as a matter of common concern and they shall promote coordination of the policies of member states in the monetary field to the full extent needed for the functioning of the common market (Articles 103 and 105). To achieve this aim a Monetary Committee of ministers of finance, governors of central banks and members of the Commission with advisory status was set up.

As the European economic integration achieved its first successes and as the possibility of the UK membership emerged, the idea of a development on monetary integration appeared on the agenda. In the Marjolin[95] Memorandum (24 October 1962) the European Commission proposed an action plan to achieve irrevocably fixed exchange rates, a common foreign-exchange reserve, consultation on monetary issues, mutual balance of payment assistance and the liberalisation of capital movement. No action was taken on this report but it indicated clearly the way of the long term development.

The lack of fixed exchange rates among the member states generated practical problems. With the devaluation of the French franc by 11.1% parallel to the rate increase of the German mark by 10% put a strong pressure on the system of direct payment of the Common Agricultural Policy. To avoid the further deterioration of the situation the member states introduced the European Unit of Account (EUA). It was a basket of European currencies, originally designed to have the same value SDR[96] of the IMF. In practice the CAP prices were determined in EUA (called the "green rates") by the Commission. This new system did not solve the problem of the CAP payment in the short term, but the EUA became the predecessor of the ECU and so the future euro.

As we have seen it earlier, the first proposals towards the monetary integration by the Commission were not successful. But the difficulties experienced in the course of the functioning the common policies inspired new attempts to solve the shortcomings. The Barre[97] plan proposed the coordination of economic policies and monetary cooperation within the Community, which was seen by the Commission as an original and complex economic entity consisting of national and Community elements. It is important that from the Commission's point of view incompatibility between policies or strategies could jeopardise the customs union because of the growing interdependence between the member states' economies. In this proposal the Commission called for increasing integration of Europe's economies and recognised

95 Robert Marjolin (1911 –1986) was a French economist and politician, member of the first European Commission (Hallstein Commission) with responsibility for the economics and finance portfolios.

96 Special drawing rights (SDRs) are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund (IMF).

97 Raymond Barre (1924–2007), French politician and economist, prime minister, 1967 – 1973 European Commissioner for Economic & Financial Affairs.

the need for an alignment of economic policies and monetary cooperation. Later this paper was followed by the second Barre plan that among others laid down clearly that economic coordination and monetary solidarity was inseparable from each other.

The proposals of the Commission and the practical needs for development in economic policy convinced the member states too. The goal of achieving some form of monetary union was first set at a summit meeting of the heads of state and government (informal predecessor of the European Council) in The Hague in December 1969. This summit was rather important because as one of the first summits after the resignation of de Gaulle it had such strategically important issues on its agenda like the political union, the monetary union and the first enlargement of the EC. Based on the decisions regarding monetary questions reached on the Hague summit, two months later the EC finance ministers agreed that the EMU objective should be the adoption of a single currency and commissioned the Luxembourg prime minister, Pierre Werner to submit a blueprint for how this might be achieved.

3. From the Werner plan to the European Monetary System

At the summit in The Hague in December 1969, the heads of state and government defined a new objective of European integration: Economic and Monetary Union (EMU). A high-level group chaired by Pierre Werner, Prime Minister of Luxembourg, was thus given the task of drawing up a report on how this goal might be reached by 1980.

The Werner group submitted its final report in October 1970. It envisaged the achievement of full economic and monetary union within ten years according to a plan in several stages. The ultimate goal was to achieve full liberalisation of capital movements, the total convertibility of member states' currencies and the irrevocable fixing of exchange rates. The report therefore envisaged the adoption of a single European currency as a possible objective of the process, but did not yet regard it as a goal in itself. Furthermore, the report recommended that the coordination of economic policies be strengthened and guidelines for national budgetary policies drawn up.

In March 1971, although being unable to agree on some of the key recommendations of the report, the Six gave their approval in principle to the introduction of the EMU in several stages. The first stage, involving the narrowing of currency fluctuation margins, was launched on an experimental basis and did not entail any commitment regarding the continuation of the process. The collapse of the Bretton Woods system and the decision of the US Government to float the dollar in August 1971 produced a wave of instability on foreign exchanges which called into serious question the parities between the European currencies. The EMU project was brought to an unexpected halt. In March 1972 the Six attempted to give fresh momentum to monetary integration by creating the "snake in the tunnel": a mechanism for the managed floating of currencies ("snake") within narrow margins of fluctuation against the dollar ("tunnel").

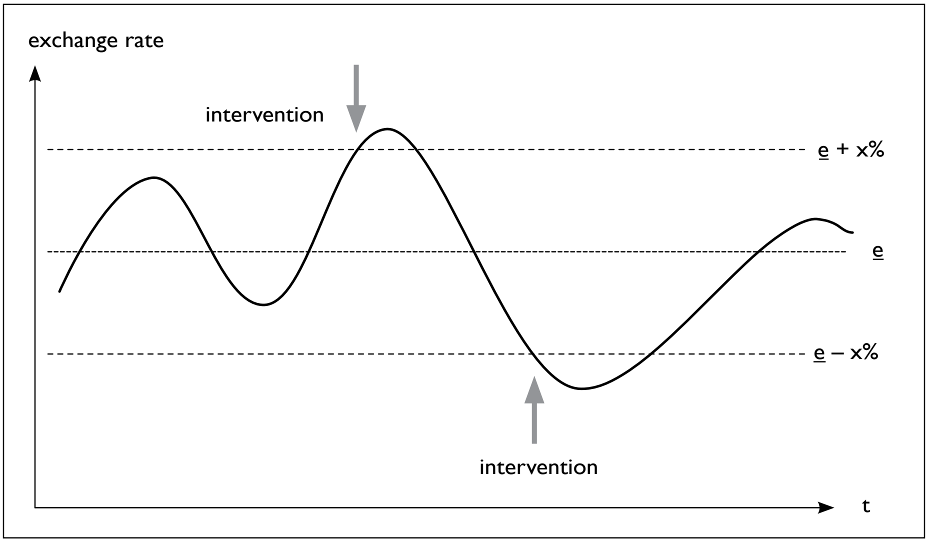


Figure 1: "Snake in the tunnel"

However, the first major initiative towards EMU, the new currency management system was quickly hit by serious problems generated successively by acute dollar instability in the wake of the Vietnam war, the 1973-74 oil crisis and the continuing recession of the mid-1970s. The "snake" system lost most of its members in less than two years and was finally reduced to a "DM" area comprising Germany, the Benelux countries and Denmark. Thus the attempt to create a monetary union by 1980 had to be abandoned.

After a period of stagnation the idea of a closer monetary integration was re-launched by the president of the Commission, Roy Jenkins in October 1977. The idea had a great support from the French president Giscard d'Estaign and the German chancellor Helmut Schmidt, both of whom had been finance ministers at the time of the Werner report. In July 1978 the summit in Bremen took a decision on the introduction of the European Monetary System (EMS) that was more ambitious than the former "snake in the tunnel" system and gradually emerged as a source of stability and a framework for discipline within the European economy. Another decision was the introduction of the ecu (the acronym of "European Currency Unit"[98] but also the name of a French gold coin from 1266[99]), the successor of the EUA. The summit also decided that the exchange rate policy towards third countries should be managed on Community level.

98 ISO 4217 currency code: XEU.

99 The "***écu***" may refer to one of the medieval French coins. The first *écu* was a gold coin ("*écu d'or*") minted during the reign of Louis IX of France, in 1266. The name comes from the Latin "scutum", like in the case of the Portuguese escudo, that means shield, because the design of the coin included a shield bearing a coat of arms. The value of the *écu* varied considerably over time, and silver coins ("*écu d'argent*") were also introduced.

The decision of the heads of state and government entered into force by 1979. The creation of the European Monetary System (EMS) was based on the concept of fixed, but adjustable exchange rates. The currencies of all the member states, except the United Kingdom, participated in the exchange-rate mechanism. The principle was easy. Exchange rates were based on central rates against the ecu, which was a weighted average of the participating currencies (a "basket of currencies"). A grid of bilateral rates was calculated on the basis of these central rates expressed in ecu, and currency fluctuations had to be contained within a margin of 2.25 % either side of the bilateral rates (with the exception of the Italian lira, which was allowed a margin of 6 %). Over a ten-year period, the EMS did much to reduce exchange-rate variability. The flexibility of the system combined with the political resolve to bring about economic convergence, achieved sustainable currency stability.

The most important instrument of the EMS was the European exchange rate mechanism (ERM). The central exchange rate of the system was fixed in ecu. A grid (known as the Parity Grid) of bilateral rates was calculated on the basis of these central rates expressed in ecu, and currency fluctuations had to be contained within a margin of 2.25% on either side of the bilateral rates as it was mentioned above. This is similar to the "snake in the tunnel" concept. But in the new mechanism if the rate leaves the narrower margin of +/-1.7% it means a warning signal for correction. (That is why this new system is called the "rattle snake in the tunnel"). To facilitate the correction the ERM provided unlimited very short term (45 days) credit line to the member states.

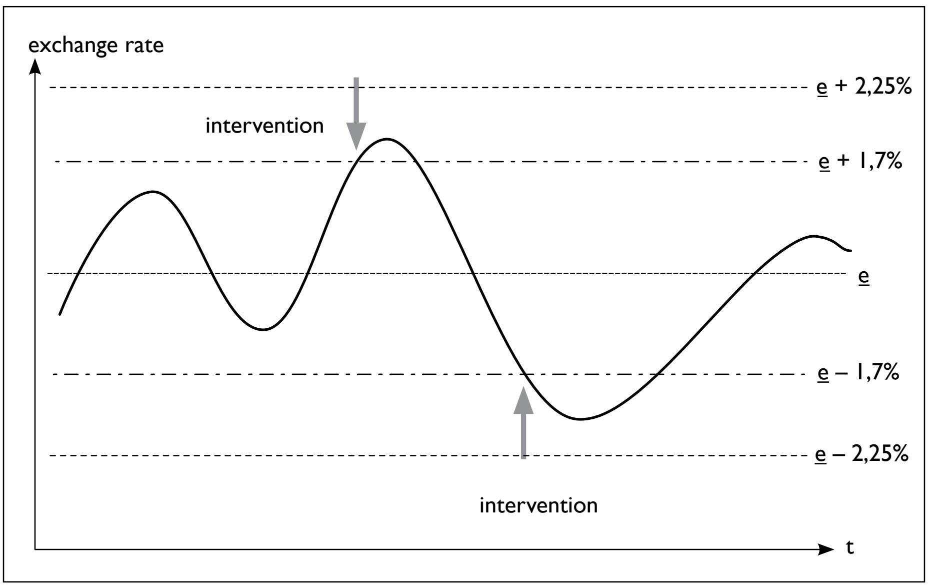


Figure 2: "Rattlesnake in the tunnel"

4. Preparation of the European Monetary Union

As Commission president from January 1985, former French minister of finance, Jacques Delors sought consciously to generate support for a revival of economic and monetary union as a keynote Community policy, amendments introduced to the treaty by the 1986 Single European Act (SEA) made reference to the EMU for the first time in a treaty text. Although the EMU was primarily a political project, Delors took care to justify it firmly in economic terms. With the adoption of the single market programme in 1985, it became increasingly clear that the potential of the internal market could not be fully exploited as long as relatively high transaction costs linked to currency conversion and the uncertainties linked to exchange-rate fluctuations, however small, persisted. Moreover, many economists denounced what they called the "impossible triangle": free movement of capital, exchange-rate stability and independent monetary policies were incompatible in the long term.

In June 1988 the Hannover European Council set up a committee for identifying the "concrete stages" for a possible path to a single currency. The committee was led by Jacques Delors and its members were the governors of the national central banks. The conclusion of the Delors report of April 1989 proposed a three stage move to the EMU, underpinned by treaty changes. In particular, it stressed the need for better coordination of economic policies, rules covering national budget deficits, and a new, completely independent institution which would be responsible for the Union's monetary policy: the European Central Bank (ECB). The plan found favour with all the member states apart from the UK.

On the basis of the Delors report, the Madrid European Council decided in June 1989 to launch the first stage of the EMU, the full liberalisation of capital movements by 1 July 1990. In December 1989 the Strasbourg European Council called for an intergovernmental conference (IGC) that would identify what amendments needed to be made to the Treaty in order to achieve the EMU. The work of this intergovernmental conference led to the Treaty on European Union ("Maastricht Treaty"), which was formally adopted by the heads of state and government at the Maastricht European Council in December 1991.

The Treaty provides for the EMU to be introduced in three stages:

- Stage 1: (from 1 July 1990 to 31 December 1993): the free movement of capital between member states.
- Stage 2: (from 1 January 1994 to 31 December 1998): convergence of member states' economic policies and strengthening of cooperation between member states' national central banks. The coordination of monetary policies was institutionalised by the establishment of the European Monetary Institute (EMI), whose task was to strengthen cooperation between the national central banks and to carry out the necessary preparations for the introduction of the single currency. The national central banks were to become independent during this stage.

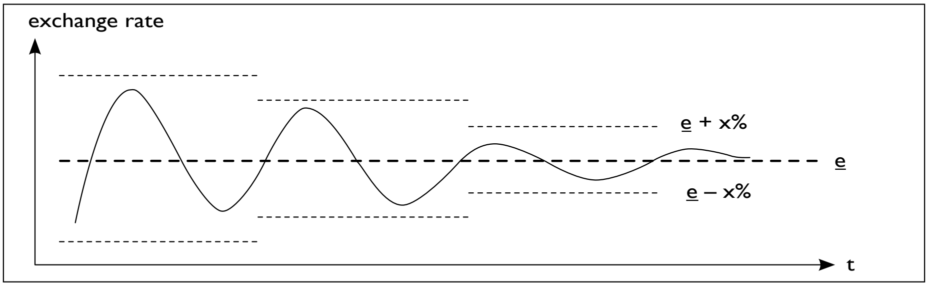


Figure 3: Narrow the exchange rate band

- Stage No 3: (since 1 January 1999): the gradual introduction of the euro as the single currency of the member states and the implementation of a common monetary policy under the aegis of the European Central Bank (ECB). Transition to the third stage was subject to the achievement of a high degree of durable convergence measured against a number of criteria laid down by the treaties. The budgetary rules were to become binding and a member state not complying with them was likely to face sanctions. A single monetary policy was introduced and entrusted to the European System of Central Banks (ESCB), made up of the national central banks and the ECB.

The euro convergence criteria ("Maastricht criteria")
The period taken into consideration is the year preceding the examination of the situation in the member state concerned.

Price stability: inflation rate of the member state concerned must not exceed by more than 1.5 percentage points that of the three best-performing member states in terms of price stability during the year preceding the examination of the situation in that member state.

Government finances: the member state concerned must comply with budgetary discipline on the basis of the following two criteria (interpretation in trend terms is acceptable):

- The annual government deficit: the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding financial year;
- Government debt: the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding financial year.

Exchange rates: the member state concerned must have participated in the exchange-rate mechanism (currently ERM II) without any break during the two years preceding the examination of the situation and without severe tensions. In addition, it must not have devalued its currency on its own initiative during the same period.

Long-term interest rates: the nominal long-term interest rate must not exceed by more than 2 percentage points that of, at most, the three best-performing member states in terms of price stability.

The first two stages of the EMU have been completed. The third stage is currently underway. In principle, all EU member states must join this final stage and therefore adopt the euro (Article 119 of the TFEU). However, some member states have not yet fulfilled the convergence criteria. These member states therefore benefit from a provisional derogation until they are able to join the third stage of the EMU. Furthermore, the United Kingdom and Denmark gave notification of their intention not to participate in the 3rd stage of the EMU and therefore not to adopt the euro. These two member states therefore have an exemption ('opt-out') with regard to their participation in the EMU. The exemption arrangements are detailed in the protocols relating to these two countries annexed to the founding Treaties of the EU. However, the United Kingdom and Denmark reserve the option to end their exemption and submit applications to join the 3rd phase of EMU. In 2014 18 of the 27 member states of the EU have joined the third stage of EMU and therefore have the euro as a single currency.

5. Practical introduction of the euro

The Madrid European Council decided in December 1995 on the name of the common currency and the practical details of the introduction. The name of the common currency was changed from the ecu to 'euro' (ISO 4217 code: EUR) with a common orthography (only exceptions are the languages with non-Latin alphabets like the Greek ευρώ and the Bulgarian евро). The euro is divided into 100 cents (or euro-cents). In Community legislative acts the plural forms of the euro and the cent are spelled without the s, notwithstanding normal English usage. The name of (euro) cents has many non-official local variations such as the 'centime' in France etc.

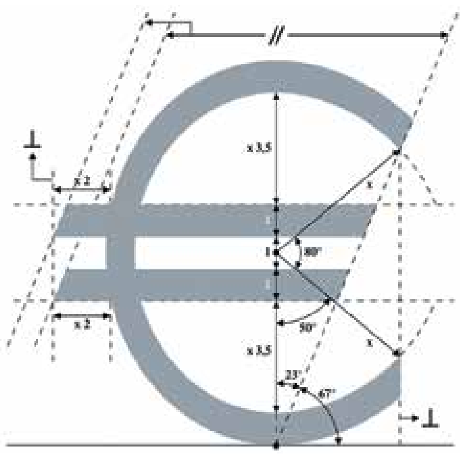


Figure 4: The euro symbol according to ISO standards The two parallel lines aim to emphasise the stability of the currency.
source: ECB, © European Community

The Council concluded that the banknotes would have a common design while the coins would have a common side and a national one. The production of the euro coins and notes needed 15 banknote prints and 16 mints. The starter quantity of banknotes was 15 billion pieces accompanied by 52 billion coins.

The convergence report of the EMI in March 1998 found that 11[100] out of the 15 member states fulfilled the convergence criteria. Greece and Sweden failed to fulfil at least one criterion while Denmark and the United Kingdom had an opt-out. The final decision on the participants and the irrevocable fixing of the exchange rates was made on 2 May 1998.

€	Currency
1	BEF 40.3399 (Belgian francs)
1	DEM 1.95583 (Deutsche Mark)
1	EEK 15.6466 (Estonian kroon)
1	IEP 0.787564 (Irish pound)
1	GRD 340.750 (Greek drachmas)
1	ESP 166.386 (Spanish pesetas)
1	CYP 0.585274 (Cyprus pound)
1	FRF 6.55957 (French francs)
1	ITL 1936.27 (Italian lire)
1	LVL 0.702804 (Latvian lats)
1	LUF 40.3399 (Luxembourg francs)
1	MTL 0.429300 (Maltese lira)
1	NLG 2.20371 (Dutch guilders)
1	ATS 13.7603 (Austrian schillings)
1	PTE 200.482 (Portuguese escudos)
1	SIT 239.640 (Slovenian tolars)
1	SKK 30.1260 (Slovak koruna)
1	FIM 5.94573 (Finnish markkas)

Table 1: Fixed euro conversion rates

100 Austria, Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

On 1 July 1998 the European Central Bank started to work and finally the euro was introduced on 1 January 1999 as an accounting currency. Greece made great efforts to join to the eurozone before the physical euro would enter into circulation. The Greek ambitions reached their aim on 1 January 2001 (however, later some of their efforts turned out to be false). The euro banknotes and coins entered into circulation on 1 January 2002 while they became the only currency of the eurozone on 1 July 2002 at the latest. Comparing the different introductions of the euro since 1999 there are two scenarios. The 'Madrid type' scenario gave three years of preparation and a relatively long double currency period. This scenario was used by the 'founders' of the eurozone. On the other hand the later introductions were managed along the 'big bang' scenario when the euro became an accounting currency and a physical one simultaneously and the period of the double use of the currencies was short.

The Commission and the ECB prepares a convergence report every two years about the member states with derogation. But each member state may require a convergence report if it wants to join the eurozone. The first requirement is participation in the exchange rate mechanism (ERM II) started at least two years before the designed date of the introduction of the euro. On the basis of a positive report on the fulfilment of the criteria in the reference period the Commission and the ECB submit their opinion in May of the year before (n-1) the designed introduction. The European Parliament decides on the opinions on June year n-1 while the formal decision of the Council takes place in July. All the introductions of the euro took place in 1 January so far. The institutions usually have had the same opinion about the candidates except the case of Lithuania in May 2006 when the Commission refused to support the application as the country's inflation rate was still 0.1% points above the level of the required convergence criteria. The number of member states using the common currency is increasing. Since 2002 Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011) and Latvia (2014) joined to the eurozone (up till now).

The preparation of the EMU was interrupted by the ERM crisis of 1992. There were several reasons that led to the destabilisations of the exchange rate mechanism. The differences between the nominal and real exchange rates increased in the early 1990s. This led to real overvaluation of the European currencies against the German mark. In the meantime the financial and national institutions were not prepared properly to the free movement of capital that was introduced in 1990. There was also a cyclical asynchrony between the boom in the German economy and the recession of the other member states. Because of the signs that the currencies of other member states started to weaken the currency market, investors started to change to German mark. As a result of these swift changes in the currency market the Italian lira, Spanish peseta and pound sterling could not retain their rates and had to leave the ERM. The next year the turbulent market developments had continued and the existence of the ERM got under strong pressure. Finally in August 1993 the member states agreed to retain the ERM but with a much wider margin of ±15%.

The wide margins of the ERM made the mechanism sustainable but were not effective enough for the requirements of the EMU. Therefore together with the third stage of the EMU a new European Exchange Rate Mechanism (ERM II) entered into force for non-eurozone member states. It also serves as a preparatory phase for the candidates to fulfil the exchange rate criteria. The anchor of the mechanism is the euro. There is no grid of bilateral rates but currencies in the ERM II are floating with respect to a central rate against the euro ("hub and spokes system"). The widest allowed margin is ±15% but the national currencies become part of the ERM II at dates to be agreed. Currently there are two currencies in the ERM II. The Danish krone entered to mechanism in 1999. Its nominal band is ±2.25% but the actual is less than 1%. The other member is the Lithuanian litas since February 2002. The litas has a nominal band of ±15% but it is pegged to euro in practice.

The euro is the common currency of the EU. Some other member states (currently Denmark and Lithuania) pegged their currency to the euro via ERM II while it is possible to peg it on a voluntary base as well (like in the case of the Bulgarian leva). The euro has important positions in the global financial market. The euro is the second largest reserve currency as well as the second most traded currency in the world after the US dollar. But the eur is also used as a currency by third countries as well. This euroisation has different types. Some countries (Monaco, San Marino and Vatican) use the euro as their official currency by virtue of specific monetary agreements with the EU. They may issue their own euro coins within certain quantitative limits. Practically in these cases the euro inherited the role of the former national currency of member states (French franc, Italian lira). In other cases currencies of former colonies are managed by monetary agreements (e.g. CFA[101]-franc, the Cape Verde escudo). Finally there are countries that introduced the euro as their own currency by a unilateral decision without any agreement like Montenegro and Kosovo. On the whole as of November 2013, with more than €951 billion in circulation, the euro has the highest combined value of banknotes and coins in circulation in the world, having surpassed the US dollar.

101 Communauté Financière d'Afrique.

IV. Monetary policy in the Economic and Monetary Union

1. Overview

Monetary policy in the Economic and Monetary Union is a matter of common concern. Countries participating in the common currency transpose their sovereignty in this area to European level. The institutional setup, as well as rules and procedures of monetary policy are regulated by the Treaty on the Functioning of the European Union (TFEU) and the Protocol No. 4 attached to it, on the basis of the relevant parts of the Treaty on the European Union (TEU). Therefore, the following chapter will present this system based on the TFEU provisions[102].

First of all, Title I Article 3 of the TEU stipulates that “the Union shall establish an economic and monetary union whose currency is the euro.” This is the basic provision in the primary legislation.

Also in the TEU, Title III Article 13 names the European Central Bank (ECB) among the institutions of the European Union. Since its establishment in 1999 the ECB is the central bank for Europe’s single currency, the euro. The ECB is based in Frankfurt am Main, Germany.

In the chapter on monetary policy, Articles 127-133 of the TFEU define the fundamental characteristics of monetary policy. The Treaty refers here to the European System of Central Banks (ESCB). The ECB, together with the national central banks (NCBs) of all EU countries constitute the ESCB. The Treaty sets the major tasks of the ESCB with reference to the Statute of the ESCB and the ECB laid down in Protocol No 4. The Statute contains the rules and procedures, based on the relevant articles of the TFEU.

In the institutional part of the TFEU Articles 282-284 define the European Central Bank and the European System of Central Banks. In this part of the Treaty the institutions of the ESCB are also listed, their roles and characteristics are outlined in Protocol No 4.

We have to make a distinction here between the ESCB and the Eurosystem. In the ESCB the ECB and the NCBs of all EU countries are represented. However, the Eurosystem is comprised of the ECB and the NCBs of the member states whose currency is the euro. The common monetary policy is interpreted in the context of the Eurosystem. Member states outside it conduct their own monetary policy.

As we saw earlier, the TFEU defines the fundamentals of the common monetary policy in general, the attached Protocol No. 4 on the Statute of the European System of Central Banks and of the European Central Bank gives us all the details.

102 Relevant texts from the TFEU and from the official website of the European Central Bank (http://www.ecb.europa.eu/home/html/index.en.html) are used for this chapter.

2. Objectives of the monetary policy

The primary objective of the ESCB is to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

According to Article 3 of the TEU, as one of its key objectives, the European Union shall work for the sustainable development of Europe based on balanced economic growth and price stability, and a highly competitive social market economy, aiming at full employment and social progress. Consequently, price stability is not only the primary objective of the ESCB's monetary policy, but also an objective of the European Union as a whole. Thus, the TFEU establishes a clear hierarchy of objectives making it clear that price stability is the most important contribution that monetary policy can make to achieving a favourable economic environment and a high level of employment.

3. Tasks of the ECB

3.1 Basic tasks to be carried out through the ESCB

- Define and implement the monetary policy of the Union. The European Central Bank aims to keep inflation below, but close to, 2% over the medium term.
- Conduct foreign-exchange operations. The Eurosystem may decide, where necessary, to conduct foreign exchange interventions. The Eurosystem may conduct such interventions either on its own, unilaterally, or as part of a coordinated intervention involving other central banks. Interventions may be carried out either directly by the ECB or by NCBs acting on behalf of the ECB.
- Hold and manage the official foreign reserves of the member states. The ECB's foreign reserves ensure that the ECB has sufficient liquidity to conduct foreign exchange operations if needed. The objectives for the management of the ECB's foreign reserves are, in order of importance: liquidity, security and returns. The ECB's foreign reserves portfolio consists of US dollars, Japanese yen, gold and special drawing rights[103]. The composition of the reserves changes over time, reflecting changes in the market values of invested assets, as well as the ECB's foreign exchange and gold operations.

103 Special drawing rights (SDRs) are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund (IMF).

- Promote the smooth operation of payment systems. The Eurosystem has the statutory task of promoting the smooth operation of payment and settlement systems. It provides payment and securities settlement facilities, operating a large-value payment system in euro (TARGET-2 system).

3.2 Further tasks of the ESCB also defined by its statute

- The ECB has the exclusive right to authorise the issue of euro banknotes within the euro area. Legally, both the ECB and the NCBs of the euro area have the right to issue euro banknotes. In practice, however, only the NCBs physically issue and withdraw euro banknotes. The ECB does not have a cash office and is not involved in any cash operations. As for euro coins, the sole legal issuers are the euro area countries.
- In order to undertake the tasks of the ESCB, the ECB, assisted by the national central banks, collects the necessary statistical information either from the competent national authorities or directly from economic agents. For these purposes it cooperates with the Union institutions, bodies, offices or agencies and with the competent authorities of the member states or third countries and with international organisations. The ECB has primary responsibility for monetary and financial statistics, statistics on the international reserves of the Eurosystem, and statistics on the nominal and real effective exchange rates of the euro.
- The Eurosystem contributes to the smooth conduct of policies by the competent authorities as regards the prudential supervision of credit institutions and the stability of the financial system. It is worth noting that from November 2014 the ECB will be the general supervisory authority in the Eurosystem and in the EU member states that are outside the Eurosystem but participating in the banking union. Thereby the ECB will be charged with new tasks and competencies (see Chapter VIII. for details).
- International and European cooperation of the ECB means maintaining working relations with relevant institutions, bodies and fora, both within the EU and at the global level, in respect of the tasks entrusted to the Eurosystem. The ECB and national central banks may establish relations with central banks and financial institutions in other countries and, where appropriate, with international organisations. They also may acquire and sell all types of foreign exchange assets and precious metals and conduct all types of banking transactions in relations with third countries and international organisations.
- The ECB has advisory functions as well. It shall be consulted on any proposed Union act in its fields of competence, and by national authorities regarding any draft legislative provision in its fields of competence. The ECB may submit opinions to the Union institutions, bodies, offices or agencies or to national authorities on matters in its fields of competence.

4. Independence

Independence has been a key factor of monetary policy in the past decades in modern market economies. In the European Union its importance is clearly recognised, the principle of the ECB's independence is established in the TFEU. The reason of central bank independence is that a central bank too susceptible to political direction or pressure may encourage economic cycles (as politicians may be tempted to boost economic activity in advance of an election) to the detriment of the long-term health of the economy and the goal of price stability.

Institutional independence is the first aspect of independence. When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a member state or from any other body. The Union institutions, bodies, offices or agencies and the governments of the member states should respect this principle and should not seek to influence the members of the decision-making bodies of the ECB or those of the national central banks in the performance of their tasks.

Financial independence is the second aspect. The Eurosystem is prohibited from granting loans to EU bodies or national public sector entities. This further shields it from any influence exercised by public authorities. Any type of credit facility with the ECB or with the national central banks in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states is prohibited, just as the purchase of debt instruments directly from them by the ECB or national central banks.

The ESCB is functionally independent. The ECB has at its disposal all instruments and competencies necessary for the conduct of an efficient monetary policy and is authorised to decide autonomously how and when to use them.

The personal independence of the ESCB means that governors of NCBs and members of the Executive Board have security of tenure:

- NCB governors have a minimum term of office of five years;
- members of the Executive Board of the ECB have a non-renewable term of office of eight years;
- members in both categories can be removed from office only in the event of incapacity or serious misconduct;
- the Court of Justice of the European Union is competent to settle any disputes.

The ECB has legal personality, enjoys in each of the member states the most extensive legal capacity, may acquire or dispose of movable and immovable property and may be a party to legal proceedings.

The ECB ensures that the tasks conferred upon the ESCB are implemented either by its own activities pursuant to their statute or indirectly, through the national central banks.

In the field of international cooperation the ECB decides how the ESCB shall be represented. The ECB and, subject to its approval, the NCBs may participate in international monetary institutions.

5. Accountability

According to the Statute of the ESCB and the ECB, the ECB is required to publish quarterly reports on the activities of the ESCB as well as a consolidated weekly financial statement. In addition, the ECB has to prepare an annual report on the activities of the ESCB and on the monetary policy of the previous and the current year. The Annual Report is addressed to the European Parliament, the EU Council, the European Commission and the European Council. Besides that, the ECB produces a wide range of other task-related publications.

In holding the ECB to account the European Parliament plays a key role. The president of the ECB regularly reports on the ECB's monetary policy and its other tasks at his hearings before the European Parliament's Committee on Economic and Monetary Affairs (ECON), which take place quarterly. Beyond that, the ECB replies to written questions by MEPs, which are published together with the ECB's answers in the Official Journal of the EU and on the ECB's website. As part of the ECB's reporting obligations, the president also appears before the plenary session of the Parliament to present the ECB's annual report, on which the Parliament, as a rule, adopts a resolution.

6. Jurisdiction

The ECB has the right to adopt legal acts. It can make regulations to the extent necessary to implement the tasks defined in the TFEU, as well as take decisions necessary for carrying out these tasks. These are binding outside the Eurosystem too. Within limits the ECB is entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions.

The ECB has the power to issue intra-Eurosystem binding legal acts as well, such as guidelines and instructions, to ensure that decentralised operations are carried out consistently by the NCBs.

The ECB can also make recommendations and deliver opinions and may decide to publish them.

The acts or omissions of the ECB shall be open to review or interpretation by the Court of Justice of the European Union in the cases and under the conditions laid down in the TFEU. The ECB may also institute proceedings. The Court of Justice of the European Union has jurisdiction in disputes between the ECB and the NCBs if the ECB finds that an NCB fails to fulfil its obligations under the TFEU, as well as between the ECB and its servants.

Disputes between the ECB, on the one hand, and its creditors, debtors or any other person, on the other, are to be decided by the competent national courts.

7. Organisation of the ESCB

The decision making bodies of the ECB are the Governing Council and the Executive Board. The third body is the General Council which can be regarded as a transitional body, since it will terminate its operation once every EU member state joins the eurozone.

7.1 The Governing Council

The Governing Council is the main decision making body. It comprises the members of the Executive Board of the ECB and the governors of the national central banks of the member states whose currency is the euro. The president or, in his absence, the vice-president shall chair the Governing Council and the Executive Board of the ECB. The members shall exercise their voting rights in person. The proceedings of the meetings are confidential. The president or his nominee shall represent the ECB externally.

Voting in the Governing Council

Originally, each member of the Governing Council had one vote.

As from the date on which the number of members of the Governing Council exceeded 21 (from 2009 with the 16th eurozone member), each member of the Executive Board has 1 vote (altogether 6) and the governors have altogether 15 votes. The governors are divided into two groups according to the aggregate GDP of their country and the size of the financial sector (aggregate balance sheet of financial institutions). In the first group the 5 biggest countries have 4 rotating votes. In the second group the rest have 11 rotating votes.

Once the number of governors reaches 22, the governors will be allocated to three groups according to a ranking based on the above criteria. The first group will be composed of 5 governors and will be assigned 4 voting rights. The second group will be composed of half of the total number of governors and will be assigned 8 voting rights. The third group will be composed of the remaining governors and will be assigned 3 voting rights.

At the calculation the aggregate GDP at market prices weighs 5/6, the aggregate balance sheet weighs 1/6.

The Governing Council has to meet at least ten times a year; however it usually meets twice a month at the Eurotower in Frankfurt am Main, Germany.

The president of the Council of Ministers and a Member of the Commission may participate, without having the right to vote, in meetings of the Governing Council of the European Central Bank.

The president of the Council of Ministers may submit a motion for deliberation to the Governing Council of the European Central Bank.

At its first meeting each month, the Governing Council assesses economic and monetary developments and takes its monthly monetary policy decision. At its second meeting, the Council discusses mainly issues related to other tasks and responsibilities of the ECB and the Eurosystem.

The main responsibilities of the Governing Council are to adopt the guidelines and to take the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem and to formulate monetary policy for the euro area.

This includes decisions relating to monetary objectives, key interest rates[104], the supply of reserves in the Eurosystem, and the establishment of guidelines for the implementation of those decisions.

7.2 The Executive Board

The Executive Board comprises the president, the vice-president and four other members.

The members perform their duties on a full-time basis. The president, the vice-president and the other members of the Executive Board are appointed by the European Council, acting by a qualified majority, from among persons of recognised standing and professional experience in monetary or banking matters, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council. Their term of office is eight years and shall not be renewable. Only nationals of member states may be members of the Executive Board.

Presidents of the ECB

The first president of the ECB was the Dutch Wim Duisenberg (1 June 1998 – 31 October 2003). He took over the European Monetary Institution (the predecessor of the ECB) form its founder Alexandre Lamfalussy in 1997, then became the first ECB president. Previously he was the Dutch Minister of Finance and the president of De Nederlandsche Bank. According to a political agreement linked to the launch of the ECB he stepped down after 5 years in 2003 in favour of Jean-Claude Trichet.

The French Jean-Claude Trichet was the second president of the ECB (1 November 2003 – 31 October 2011) He was a former governor of the Banque de France.

On 1 November 2011 the Italian Mario Draghi took over the office as president. His term expires in 2019. Previously he was managing director of Goldman Sachs, executive Director of the World Bank and Governor of the Banca d'Italia.

104 See Chapter IV. on the ECB's main refinancing rate, which is held to be the main policy tool of conducting monetary policy and influencing financial markets.

Each member of the Executive Board present in person has the right to vote and has, for that purpose, one vote. The Executive Board acts by a simple majority of the votes cast. In the event of a tie, the President has the casting vote.

The Executive Board is responsible for the current business of the ECB. The Executive Board implements monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board gives the necessary instructions to NCBs. The Executive Board has responsibility for the preparation of meetings of the Governing Council.

The president of the European Central Bank shall be invited to participate in Council of Ministers meetings when the Council is discussing matters relating to the objectives and tasks of the ESCB.

The president of the ECB and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament.

7.3 The General Council

The General Council comprises the President of the ECB, the Vice-President of the ECB and the governors of all NCBs of the currently 28 EU member states. In other words, the General Council includes representatives of every EU member state, regardless of their participation in the eurozone.

The General Council can be regarded as a transitional body. It carries out its tasks on account of the fact that not all EU member states have adopted the euro yet.

Among others the General Council also contributes to:

- the ECB's advisory functions;
- the collection of statistical information;
- the preparation of the ECB's annual report;
- the establishment of the necessary rules for standardising the accounting and reporting of operations undertaken by the NCBs;
- the necessary preparations for irrevocably fixing the exchange rates of the currencies of the "EU member states with a derogation" against the euro.

In accordance with the Statute of the ESCB and the ECB the General Council will be dissolved once all EU member states have introduced the single currency.

7.4 National Central Banks

The national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. The main goals and the rules of independence of the ESCB Statute are applied to them as well. The Governing Council shall take the necessary steps to ensure compliance with the guidelines and instructions of the ECB, and shall require that any necessary information be given to it.

National central banks may perform functions other than those specified in the Statute unless the Governing Council finds that these interfere with the objectives and tasks of the ESCB.

The statutes of the national central banks shall be in line with the ESCB Statute and, in particular, shall provide that the term of office of a governor of a national central bank cannot be less than five years.

A governor may be relieved from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct.

7.5 ESCB Committees

The Committees assist the work of the decision-making bodies of the ECB, which can request them to provide any information in their fields of expertise in order to facilitate the decision-making process and the implementation of decisions.

Participation is usually restricted to experts of the Eurosystem central banks. However, the NCBs of the EU member states which have not yet adopted the euro take part in the meetings of a Committee whenever appropriate. Moreover, representatives of other competent bodies may also be invited.

The ESCB Committees

- The Accounting and Monetary Income Committee (AMICO) advises on all intra-Eurosystem issues relating to accounting, financial reporting and the allocation of monetary income.
- The Banknote Committee (BANCO) advises on all banknote policy-related matters and assists in the strategic planning of banknote production and issuance.
- The Committee on Controlling (COMCO) helps to apply and further develop the common Eurosystem-wide cost methodology.
- The Eurosystem/ESCB Communications Committee (ECCO) assists in external and intra-system communication policy.
- The Eurosystem IT Steering Committee (EISC) has been established with the mandate to steer continuous improvement in the use of IT within the Eurosystem.
- The Financial Stability Committee (FSC) helps the decision-making bodies to fulfil their tasks in the field of prudential supervision of credit institutions and the stability of the financial system.
- The Information Technology Committee (ITC) assists in the development, implementation and maintenance of IT networks and communications infrastructures which support the joint operational systems.
- The Internal Auditors Committee (IAC) develops common standards for auditing Eurosystem operations and audits joint projects and joint operational systems at the Eurosystem/ ESCB level.
- The International Relations Committee (IRC) assists in the performance of the ECB's statutory tasks with regard to international cooperation and acts as

a forum for exchanging views on matters of common interest in the field of international relations.
- The Legal Committee (LEGCO) provides legal advice for the fulfilment of the ECB's statutory task and prepares the legal acts for the operation of the Eurosystem.
- The Market Operations Committee (MOC) assists in the execution of monetary policy operations and foreign exchange transactions, including those related to the operation of ERM II, and to the management of the ECB's foreign reserves.
- The Monetary Policy Committee (MPC) mainly advises on strategic and longer-term issues relating to the formulation of the monetary and exchange rate policy and is responsible for the Eurosystem staff projections.
- The Organisational Development Committee (ODC) focuses on organisational analysis/development and advises on planning issues related to the Eurosystem, the Single Supervisory Mechanism and their functions.
- The Payment and Settlement Systems Committee (PSSC) advises on the operation and maintenance of TARGET2, the definition and monitoring of collateral settlement procedures, the Eurosystem's catalyst role in achieving the Single Euro Payments Area (SEPA), general payment systems policy and oversight issues and issues of interest for central banks in the field of securities clearing and settlement.
- The Risk Management Committee (RMC) helps the decision-making bodies to achieve an appropriate level of protection for the Eurosystem by managing and controlling the risks originating from its market operations.
- The Statistics Committee (STC) mainly advises on the design and compilation of statistical information collected by the ECB with the assistance of the NCBs.
- The Budget Committee (BUCOM) is composed of representatives of the ECB and the Eurosystem NCBs, which assists and reports directly to the Governing Council in matters related to the ECB's budget.
- The Human Resources Conference (HRC) was established in 2005 and includes the heads of personnel of all EU central banks.

Source: www.ecb.europa.eu

8. Monetary transactions of the ESCB

The operational framework of the Eurosystem consists of the following set of instruments:

- open market and credit operations,
- standing facilities,
- minimum reserve requirements for credit institutions.

8.1 Open market and credit operations

In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the NCBs may operate in the financial markets by buying and selling marketable instruments and conduct credit operations with credit institutions and other market participants.

The Eurosystem's regular open market operations consist of one-week liquidity-providing operations in euro (main refinancing operations, or MROs) as well as three-month liquidity-providing operations in euro (longer-term refinancing operations, or LTROs). MROs serve to steer short-term interest rates, to manage the liquidity situation, and to signal the monetary policy stance in the euro area, while LTROs (with a three-month maturity) aim to provide additional, longer-term refinancing to the financial sector.

As a reply to the financial crisis that broke out in 2008, the Eurosystem has begun to apply new, non-standard measures in this field. The ECB launched two covered bond purchase programmes (the CBPP, which ended in June 2010, and CBPP2, which ended in October 2012.) From 10 May 2010 to February 2012 it conducted interventions in debt markets under the Securities Markets Programme (SMP), which was terminated in September 2012. In August 2012 the ECB announced the possibility of conducting outright open market operations in secondary sovereign bond markets to safeguard an appropriate monetary policy transmission and preserve the singleness of the monetary policy. In September 2012 the ECB announced the technical features it had decided upon for such operations, named Outright Monetary Transactions (for the details see Chapter XI).

8.2 Standing facilities

The ESCB offers credit institutions two standing facilities. Marginal lending facility is offered in order to obtain overnight liquidity from the central bank, against the presentation of sufficient eligible assets. Deposit facility is offered in order to make overnight deposits with the central bank. These instruments are used in a decentralised manner via the NCBs.

8.3 Minimum reserves

The ECB requires credit institutions established in the euro area to hold deposits on accounts with their national central bank. These are called 'minimum' or 'required' reserves. This helps the ECB to influence the liquidity in the economy. If the ECB requires higher reserve level, the quantity of liquid money is decreasing in the financial sector.

9. Financial provisions of the ESCB

9.1 Financial accounts and auditing

The financial year of the ECB and national central banks begins on the first day of January and ends on the last day of December. The annual accounts of the ECB are drawn up by the Executive Board, in accordance with the principles established by the Governing Council. The accounts are approved by the Governing Council and are published thereafter.

The accounts of the ECB and national central banks are audited by independent external auditors. The auditors have full power to examine all books and accounts of the ECB and national central banks and obtain full information about their transactions.

9.2 Capital of the ECB

The capital of the ECB comes from the NCBs of all EU member states and amounts to €10,825,007,069.61 (over 10,8 billion euros)[105]. The NCBs' shares in this capital are calculated using a key which reflects the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting. The ECB adjusts the shares every five years and whenever a new country joins the EU. The adjustment is made on the basis of data provided by the European Commission.

105 As of 1 January 2014.

Euro area NCBs' contributions to the ECB's capital	
National central bank	**Capital key %**
Nationale Bank van België/Banque Nationale de Belgique (Belgium)	2.4778
Deutsche Bundesbank (Germany)	17.9973
Eesti Pank (Estonia)	0.1928
Central Bank of Ireland (Ireland)	1.1607
Bank of Greece (Greece)	2.0332
Banco de España (Spain)	8.8409
Banque de France (France)	14.1792
Banca d'Italia (Italy)	12.3108
Central Bank of Cyprus (Cyprus)	0.1513
Latvijas Banka (Latvia)	0.2821
Banque centrale du Luxembourg (Luxembourg)	0.2030
Central Bank of Malta (Malta)	0.0648
De Nederlandsche Bank (The Netherlands)	4.0035
Oesterreichische Nationalbank (Austria)	1.9631
Banco de Portugal (Portugal)	1.7434
Banka Slovenije (Slovenia)	0.3455
Národná banka Slovenska (Slovakia)	0.7725
Suomen Pankki – Finlands Bank (Finland)	1.2564
Total	**69.9783**

Table 1: Euro area NCBs' contributions to the ECB's capital
Source: www.ecb.europa.eu

The EU's non-euro area NCBs are required to contribute to the operational costs incurred by the ECB in relation to their participation in the ESCB by paying up a small percentage of their share in the ECB's subscribed capital.

Non-euro area NCBs' contributions to the ECB's capital	
National central bank	**Capital key %**
Българска народна банка (Bulgarian National Bank) (Bulgaria)	0.8590
Česká národní banka (Czech Republic)	1.6075
Danmarks Nationalbank (Denmark)	1.4873
Hrvatska narodna banka (Croatia)	0.6023
Lietuvos bankas (Lithuania)	0.4132
Magyar Nemzeti Bank (Hungary)	1.3798
Narodowy Bank Polski (Poland)	5.1230
Banca Națională a României (Romania)	2.6024
Sveriges Riksbank (Sweden)	2.2729
Bank of England (United Kingdom)	13.6743
Total	**30.0217**

Table 2: Non-euro area NCBs' contributions to the ECB's capital
Source: www.ecb.europa.eu

The income accruing to the NCBs in the performance of the ESCB's monetary policy function is allocated at the end of each financial year. An amount to be determined by the Governing Council, which may not exceed 20% of the net profit, is transferred to a general reserve fund. The remaining net profit is distributed to the shareholders of the ECB in proportion to their paid-up shares. The non-euro area NCBs are not entitled to receive any share of the distributable profits of the ECB, nor are they liable to fund any losses of the ECB. In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB.

10. Provisions on secrecy and transparency

Members of the governing bodies and the staff of the ECB and the national central banks are required, even after their duties have ceased, not to disclose information of the kind covered by the obligation of professional secrecy.

Besides secrecy, transparency is also a key factor of the ECB's activity. Transparency means that the central bank provides the general public and the markets with all relevant information on its strategy, assessments and policy decisions as well as its procedures in an open, clear and timely manner.

While the minutes of the Governing Council's meetings are not published, the monetary policy decisions are explained in detail at a press conference held shortly after the first meeting each month. The president, assisted by the vice-president, chairs the press conference.

Transparency helps the public to understand the ECB's monetary policy. Better public understanding makes the policy more credible and effective. Regular communication about a central bank's assessment of the economic situation is particularly useful. It is also helpful for central banks to be open and realistic about what monetary policy can do and, even more importantly, what it cannot do.

The ECB publicly announces its monetary policy strategy and communicates its regular assessment of economic developments. This helps the markets to understand the systematic response pattern of monetary policy to economic developments and shocks. It makes policy moves more predictable for the markets over the medium term. Market expectations can thus be formed more efficiently and accurately. Quarterly reports on the activities of the ESCB as well as the weekly financial statement together with the annual report all serve this purpose.

11. Assessment of the ECB's monetary policy

The ECB outlines the key characteristics of a successful monetary policy as the following[106]. The ECB, like other central banks, faces considerable uncertainty about the nature of the economic shocks hitting the economy, the reliability of economic indicators and the effects of the monetary policy transmission mechanism, among other factors. For its monetary policy to be successful, various conditions need to be met:

- It requires properly functioning money markets if its transmission mechanism is to work. An effective transmission depends on the behaviour of banks and on their willingness to ensure smooth exchanges of liquidity in the interbank market. Dysfunctional money markets can weaken the influence of monetary policy on the outlook for price stability;
- The policy needs to be forward-looking and pre-emptive. Changes in policy today will only affect the price level after a number of quarters or years. So a central bank needs to ensure that the impact of the decisions and actions it takes today will maintain price stability in the future;
- It should have a medium-term orientation to avoid excessive activism and the introduction of unnecessary volatility into the real economy. Monetary policy cannot prevent some short-term volatility in inflation rates, caused, for example, by changes in international commodity prices;
- It should firmly anchor inflation expectations. To that end, a central bank should specify its goal, elaborate and keep to a consistent and systematic method for conducting monetary policy, and communicate clearly and openly. These help it to be credible, which is essential if it is to influence the expectations of businesses and households.
- Monetary policy has to be broadly based and take into account all relevant information in order to understand the factors affecting the economy.

106 ECB website (http://www.ecb.europa.eu/home/html/index.en.html)

Of course we may put the question, whether the ECB has met these conditions during the first 15 years of its operation. When doing so it is worth dividing this one and a half decade into a pre-crisis period and a crisis period starting in 2007-2008. The first period was definitely a challenge because a new establishment and institutional system had to be created. The second period, however, was an even bigger challenge. The most severe crisis of the post war era has tested the readiness and the professional capacity of the EMU institutional framework, with a key role of the ECB in it. For the crisis period and the ECB's role in it see Chapter XI. For the assessment of the first period we can rely on numerous studies and researches. Most of them paint an overall positive picture acknowledging, that the ECB could take over the role of the central bank well and was able to build a credible monetary policy.

Assessment of the ECB' activity

Artis[107] states in his study of 2002 that "in nearly three years of full-scale operation, the ECB has established itself as a significant institution. Despite a number of criticisms, some of them legitimate, the ECB has performed creditably in this period. Unemployment has fallen across the Euro-area and it has been tolerant of breaches of its own target ceiling on inflation. This has drawn the sting of anticipatory criticism that the ECB would err on the side of rigour to establish itself as the Bundesbank's successor." He adds, that "it is also true that the ECB has been quite lucky, thus far, in the macroeconomic conjuncture it has inherited: the most obvious problems have been ones related to intra-area adjustment where some smaller countries have experienced problems of 'excess' output growth and inflation."

Bordes and Clerc[108] evaluate that "the price-stability oriented monetary policy strategy adopted by the European Central Bank can be qualified as a mixed or hybrid strategy: it aims to anchor medium term inflation expectations, by ensuring that they stay within a narrow range between 1.7% and 1.9%, while also attempting to restrict long-term price-level uncertainty."

In the view of Dominguez[109] "the European Central Bank came into being during a particularly volatile period for global financial markets and has succeeded in creating a stable eurozone money market. Criticisms of the European Central Bank come from both directions: both that it has run an overly loose monetary policy and allowed inflation to exceed the bank's stated targets, and also that it has run an overly tight monetary policy without sufficient attention to unemployment rates and economic growth. But on both sides, the complaints are only mild ones. Overall, the ECB deserves good marks for its performance to date."

107 Mike Artis: *The Performance of the European Central Bank*, in: International Review of Applied Economics, Vol. 16, No. 1, 2002

108 Christian Bordes - Laurent Clerc: *Price stability and the ECB's monetary policy strategy*, in: Journal of Economic Surveys Volume 21, Issue 2, pages 268–326, April 2007.

109 Kathryn M. E. Dominguez: *The European Central Bank, the Euro, and Global Financial Markets,* in: Journal of Economic Perspectives -Volume 20, Number 4, Fall 2006, Pages 67–88.

De Haan, Amtenbrink and Waller[110] examined the transparency and credibility of the ECB. They find – with some criticism – that in this respect "the ECB ranks more highly than the Federal Reserve and has the same ranking as the Bank of England if publication of minutes and voting behaviour is not included. Our evidence on financial market expectation as implied by the price of three-month Euribor futures indicates that most ECB policy decisions were in line with financial market expectations. Nevertheless, our survey evidence on transparency and credibility suggests that the ECB is not perceived as very transparent and credible. As the ECB is a new institution, it simply may take time before financial markets and the public at large feel that they understand its policies. Still, we feel that the ECB can improve on its transparency by changing its monetary policy strategy that seems somewhat difficult to understand."

Crowley and Lee[111] investigated in 2008 "the extent to which the ECB has responded to changing economic conditions of individual euro area member states versus the euro area as a whole." They found "substantial disparities across countries, reflecting the extent of heterogeneity among the national economies inside the euro area." They concluded that "the ECB policy rule best fits the economic conditions of the largest member state, Germany." Some smaller economies whose economic performance was similar to that of Germany were also found to have similar position. "On the other hand, had other euro area member states followed their own policy rule, then their interest rates would have been quite different from those predicted by the ECB policy rule." As a consequence "the extent of heterogeneity across national economies within the euro area entails a challenge for delegating the responsibility of monetary policy to the ECB. Since economies of euro area countries have been quite unsynchronized, ECB policy actions, which might be adequate for the euro area as a whole, might have been too loose for such faster growing countries as Greece and Ireland but too tight for slower growing countries, such as France."

110 Jakob De Haan - Fabian Amtenbrink - Sandra Waller: *The Transparency and Credibility of the European Central Bank*, in: Journal of Common Market Studies Volume 42, Issue 4, pages 775–794, November 2004.
111 Patrick M. Crowley - Jim Lee: *Do All Fit One Size? An Evaluation of the ECB Policy Response to the Changing Economic Conditions in Euro Area Member States* (2008) http://research.stlouisfed.org/conferences/integration/Crowley-Lee-paper.pdf.

A similar study by Srivangipuram[112] from 2012 examines "how well the European Central Bank's interest rate decisions 'fit' each of the member states. A basic Taylor rule[113] was used to calculate the 'optimal' rates for each of the individual countries in the euro area. The data for these countries highlighted the changing magnitudes and directions of the stress levels of each of these, with many peripheral countries experiencing larger stress levels than core countries such as Germany, France, and the Netherlands. The differences in economic fundamentals between the euro area countries have implications on various additional economic issues such as competitiveness and debt dynamics. These issues, and the implications of the ECB's interest rate decisions, were explained with regards to the multiple crises affecting the eurozone."

112 Tejasvi (TJ) Srivangipuram: *Monetary Policy in the eurozone: Evaluating the European Central Bank's interest rate decisions and the needs of member states using a Taylor rule* (2012) http://econ.berkeley.edu/sites/default/files/Srivangipuram.pdf.

113 Taylor rule is a monetary-policy rule that stipulates how much the central bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions.

V. Economic policy coordination I – narrow sense

1. The origins of economic policy coordination

Coordination of economic policies in the member states is very closely linked to the creation of the Economic and Monetary Union (EMU), although certain limited steps had already been taken before the Maastricht Treaty came into force. The first steps were aiming mostly at monetary cooperation in the '60s. Further steps were taken from 1973 with the European Monetary Cooperation Fund and with the European Exchange Rate Mechanism (ERM). These instruments were created to stabilise the exchange rates of the member states. Besides the monetary part – although in a more limited way – the fiscal cooperation also commenced to operate in the '70s. Finance ministers in the Ecofin formation of the Council regularly overviewed those general fiscal priorities that were essential for the sake of the enhancing monetary cooperation. This cooperation led then to the Delors Plan and to the creation of the EMU in the beginning of the '90s, with common monetary policy but only a limited level coordination concerning national fiscal policies.

With the EMU, the rules of economic policy coordination were incorporated in the Maastricht Treaty. By this step the level of coordination was enhanced, but remained still quite limited, concentrating mostly on the deficit and debt rules. At this time these were held to be essential for the sake of the new common currency, the euro. As a consequence, the shape of the EMU has become unbalanced, because monetary policy got into the full competence of the ESCB in the eurozone, meanwhile the fiscal part of the economic policy remained in national competences, with only a certain level of coordination as laid down in the Treaty.

It was of course obvious, that in a monetary union the synergy between monetary and fiscal policy is essential. Since we have one monetary policy and numerous fiscal policies in the euro area, these latter require strong coordination in order to avoid negative spillover effects. The limited scope of the fiscal rules in the Treaty however proved to be insufficient in practice, especially after the financial crisis broke out in 2008. This chapter will outline the accelerating evolution of economic policy coordination, but we have to start presenting Treaty provisions, because they constitute the legal base of new rules and instruments and they have remained almost unchanged since their adoption[114].

As a basic principle, Article 120 of the TFEU lays down, that member states have to conduct their economic policies with a view to contributing to the achievement of the objectives of the Union, as defined in Article 3 of the TEU. According to Article

114 A limited amendment of the Article 136 of the TFEU entered into force in 2013 related to the creation of the ESM.

121 of the TFEU they have to regard their economic policies as a matter of common concern and have to coordinate them within the Council (Ecofin[115]).

Also in this Article the TFEU stipulates that on a recommendation from the Commission the Council formulates guidelines of the economic policies of the member states and of the Union and reports its findings to the European Council which discusses them. On this basis the Council adopts a recommendation. After the crisis this process has been significantly widened by the European semester (see later in this chapter).

Entitled by the TFEU (Article 121), the Council monitors economic developments in each of the member states and in the Union as well as the consistency of economic policies with the guidelines. For the purpose of the multilateral surveillance, member states forward information to the Commission about important measures taken by them in the field of their economic policy and other related information as they deem necessary.

During this process the Commission may address a warning and the Council may address recommendations (on the Commission's proposal) to the member state concerned, when they find that the guidelines are jeopardised. However, no sanctions are applied here in case a member state neglects these recommendations.

It is another important element of the rules, that the European Parliament must be reported to on the results of multilateral surveillance.

1.1 The origins of the excessive deficit procedure – Creation of the stability and growth pact

The cornerstones of the multilateral surveillance are the criteria on general government deficit and public debt as laid down in the Treaty among the so called Maastricht convergence criteria (see Text box 1). The criterion on deficit has always been the key figure. From the birth of the EMU on it has been used to evaluate the quality of public finances[116], and the principle of avoiding excessive deficit is set in the TFEU (Article 126). Moreover, the whole excessive deficit procedure[117] is regulated by Article 126, which is completed by the stability and growth pact (SGP)[118] originally incorporated in two regulations (1466/97/EC and 1467/97/EC). TheTFEU sets the consecutive steps to be followed during the process, which provisions stayed in force even after the general reform of the SGP in 2011.

115 Economic and Financial Affairs Council.

116 This approach has been challenged after the crisis which provoked a radical reform of the whole system of economic policy coordination.

117 The excessive deficit procedure will be outlined later in this chapter.

118 The SGP was born in 1997 on the initiative of the German government with the aim to introduce a preventive element in the system.

Maastricht convergence criteria

Adopting the single currency is a milestone in a member state's economy. It has to comply with numerous criteria in order to fix irrevocably its exchange rate and transfer its monetary policy to the European Central Bank. These criteria were agreed upon in 1991 by signing the Maastricht Treaty, therefore they are called Maastricht criteria.

In addition to meeting the economic convergence criteria, a euro area candidate country must make changes to national laws and rules, notably to the governing its national central bank and other monetary issues, in order to make them compatible with the Treaty. In particular, national central banks must be independent, just as monetary policy decided by the European Central Bank is also independent.

The four convergence criteria are regulated by Article 140 and Protocol no. 13 of the TFEU:

1 Price stability

A member state shall have a price performance that is sustainable and an average rate of inflation observed over a period of one year before the examination that does not exceed by more than 1.5 percentage points that of the three best performing member states in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions.

2 Fiscal discipline

The criteria require the soundness of fiscal policy (under Article 126 of the TFEU), meaning that at the time of examination the member state is not subject to a Council decision under Article 126(6) of the TFEU – saying that an excessive deficit exists.

3 Exchange rate developments

According to this criterion, a member state has to respect the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the time of examination. In particular, the member state shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period.

4 Long-term interest rate developments

The average nominal long-term interest rate shall not exceed by more than two percentage points that of the three best performing member states in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

Source: European Central Bank; http://www.ecb.europa.eu/ecb/orga/escb/html/convergence-criteria.en.html

In the first decade of the EMU the focus was solely set on the deficit figures of the member states, the debt criterion was treated more loosely. The Commission and the Council started the procedures in case of some countries, still, the application of the 'punishing instruments' has never taken place. Moreover, despite a quite favourable economic situation in the early 2000s, the SGP was often criticised to be too rigid, not taking into account the economic cycles and the special characteristics of different member states.

The critical voices culminated in 2003-2005 which led to a controversial reform of the SGP that made the system more flexible and soft.

In November 2003 the Commission proposed a recommendation on the excessive deficit for both Germany and France. Nevertheless, in the Ecofin of 25 November the proposal did not get the qualified majority, mostly due to the intense intervention of Germany and France. The procedure stopped, some countries however found this unjust and asked the European Court of Justice (ECJ) for its opinion. The Court decided[119] that the Commission had been right and the procedure should continue, as of 25 November 2003.

To bring down the deficit both countries got a deadline of 2005, but in parallel with the legal procedure the Commission started to elaborate the revision of the SGP rules, acknowledging that more flexibility should be applied during the procedures.

As a result of this revision, after a long debate, the two SGP regulations were amended in 2005, allowing a more flexible approach in "bad times" (in exchange in "good times" a more active fiscal consolidation was required) and the deadlines for the adjustments were extended. Even the result of structural reforms could be taken into account during adjustments (and a special paragraph allowed Germany to take into account the costs of the country's reunification, well 15 years later). These modifications clearly eased the previous rigour. Some additional rules were also added to the amendments like the reinforcement of the statistical services, the involvement of the national parliaments in the SGP procedures or the principle that the debt criterion should be taken seriously. Nevertheless, these rules could not counterbalance the sentiment that the SGP was watered down in 2005. As we will see, it did not pay off. As the financial crisis broke out in 2008, the radical reform of the economic policy coordination was required, including that of the rules of the SGP.

1.2 Institutional setup of the economic policy coordination

When creating the EMU the institutional system of economic policy coordination was also strengthened. The major player in the economic policy coordination is the Council (in the composition of economic and finance ministers, as generally called the Ecofin). As outlined earlier, the TFEU gives explicit powers to the Council to conduct this work. The Ecofin generally meets every month, in case of necessity extraordinary meetings are convened.

Since 1998, upon the decision of the European Council of December 1997, the Eurogroup is a meeting of the finance ministers of the euro area. Their meeting is informal and restricted to issues related to the common currency. The Eurogroup is

119 Judgement C-27/04 of 23 July 2004.

chaired by the president who is elected by the members for two and a half years. The ministers always meet a day before the meeting of the Ecofin. They communicate their decisions via press and document releases. The Eurogroup was formalised by a protocol attached to the Lisbon Treaty.

As a response to the crisis, on the initiative of the French president Nicolas Sarkozy, the Euro Summit (heads of state and government of eurozone countries) came into being in 2008. With the Treaty on Stability, Coordination and Governance[120] (TSCG) the Euro Summit was formalised, stating that at least twice a year it should meet under the leadership of a permanent president[121]. Still, after 4 meetings in 2011 and 3 meetings in 2012 the Euro Summit met only once during 2013. Hence, the creation of the Euro Summit does not endanger the leading role of the European Council in setting the main priorities and directions of economic governance.

In order to support the work of the Ecofin Council a very important preparatory body, the Economic and Financial Committee (EFC) was established on the basis of the Maastricht Treaty. The EFC is composed of senior officials from national administrations and central banks. Its role is to discuss the economic and financial issues arising in the EMU. The EFC was preceded by the Monetary Committee, whose role was to promote policy coordination of the policies of the member states to the extent needed for the functioning of the internal market.

Under Article 134 (2) and (4) of the TFEU the EFC's tasks are:

- to keep under review the economic and financial situation of the member states and of the Community and to report regularly to the Council and the Commission on this subject, in particular on financial relations with third countries and international institutions;
- to contribute to the preparation of the work of the Council, particularly as regards recommendations required as part of multilateral surveillance and decisions required as part of the excessive deficit procedure.

The Economic Policy Committee (EPC) also assists the Ecofin Council by providing economic analyses and opinions on methodologies and by contributing to the drafting of policy recommendations, particularly on structural policies. The EPC has a significant role in the European semester (see below). The EPC was established by Council Decision 2000/604/EC. By producing reports, the EPC supports also the work of the EFC. It focuses in particular on:

- the functioning of goods, capital, services and labour markets (developments as regards wages, productivity, employment and competitiveness);
- the role and efficiency of the public sector and the long-term sustainability of public finances;

the economic implications of specific policies, such as those relating to the environment, research, development and social cohesion.

120 TSCG is an Intergovernmental Treaty and is not part of the EU law, details can be found later in this chapter.

121 In 2012 the president of the European Council, Herman Van Rompuy was elected to be the president of the Euro Summit until the end of his term as EC president.

The governance of the EMU

- The **European Council** – sets the main policy orientations for the EU
- The **Euro Summit** – focuses on euro area issues based on the TSCG
- The **Council** (Ecofin) – coordinates EU economic policy-making and decides on issues related to it
- The **Eurogroup** – coordinates policies of common interest for the euro-area member states
- The **Economic and Financial Committee** (EFC)– helps and prepares the work of the Ecofin
- The **Economic Policy Committee** (EPC) – prepares the work of the Ecofin as regards the coordination of member state and EU economic policies
- The **member states** – set their national budgets within agreed limits for deficit and debt, and determine their own structural policies involving labour, pensions and capital markets
- The **European Commission** – monitors performance and compliance, prepares legislative proposals
- The **European Central Bank** – sets monetary policy, with price stability as the primary objective
- The **European Parliament** – shares the job of formulating legislation with the Council

2. Overhaul of the economic policy coordination

After the short introduction to the birth of economic policy coordination, let us take a look at the reform steps, which resulted in the complete overhaul of the economic governance framework, a significant reform in order to tackle the challenges posed by the roots of the crisis. Therefore this chapter focuses on the current, post-crisis setup of the regulatory environment. Chapter XI presents the main roots of the current crisis and focuses on part of the measures taken in order to find solutions for the challenges. In general, the crisis revealed that there are serious systemic flaws in the design of the EMU. Finding answers required a twofold approach:

- "Firewall building": The contagion of the crisis required an effective firewall to contain the tensions and separate countries already at the edge of collapse from the others which are still able to finance themselves on the markets. These measures are detailed in Chapter XI.
- "Systemic reconstruction" was necessary to overhaul the economic governance framework of the EMU in order to prevent the occurrence of the weaknesses, which were presented above. The main goal is to make the governance framework more effective and credible.

Table 1 provides a general overview about the response measures and their goals.

Firewall building	Systemic reconstruction
Goals	
• ease market tensions • enhancing credibility • preserve the stability of the euro area	
• avoid contagion • enhancing the crisis resistance capacity • create an effective crisis resolution mechanism	• reinforcing the fiscal surveillance framework • broadening the surveillance in order to identify macroeconomic challenges • better coordination of growth enhancing structural reform and economic policies • tackle the lethal interdependence of the banking sector and sovereigns • (institutional element to improve governance of the euro area)
Tools and measures	
• temporary crisis resolution framework (GLF, EFSF, EFSM) • permanent European Stability Mechanism • strengthening the lending capacity of the IMF • (ECB steps to ease the tensions on the sovereign debt markets) • monitoring the implementation of the policy conditionality by the Troika	• European semester • 'Six pack' • 'Two pack' • Euro Plus Pact • TSCG • process towards a genuine EMU

Table 1: A twofold approach towards the crisis management in the EU
Source: Authors

The goals and measures are presented in different chapter: Chapter XI presents the measures adopted in order to tackle the short-term challenges with the aim of "firewall-building". This chapter focuses on the economic governance and coordination[122], the 'systemic reconstruction' part of the crisis management. Chapter X introduces the longer-term reform procedure started in 2012, which aims to realize the genuine Economic and Monetary Union. The reform steps in order to overhaul the systemic framework had five main aims, of which three are discussed in this chapter in the framework of economic coordination. As presented in Table 1:

122 Chapter VI. presents the economic policy coordination in the broad sense (the economic and social policy aspects of the coordination). This chapter focuses only on the economic aspect of the coordination (the so called economic governance).

- Reinforcing the fiscal surveillance framework, thus reinforcing the stability and growth pact and supplementing it with additional requirements for the euro area member states (MSs).
- Broadening the surveillance in order to identify macroeconomic challenges, which meant the elaboration of a completely new approach and procedure.
- Better coordination of growth enhancing structural reforms and economic policies, the move from soft coordination methods to more binding rules.
- Tackle the lethal interdependence of the banking sector and sovereigns, which means the shift from national financial supervision and financial crisis resolution exercises to European scale. This latter goal is discussed also in Chapter X as a key part of the procedure to establish a banking union.
- Institutional element to improve governance of the euro area.

In connection to the first three objectives another partial goal can be identified: the formulation of a surveillance framework for MSs under financial assistance from the EFSF/ESM. The crisis brought an exercise for monitoring the implementation of the macroeconomic policy conditionality; however, it was not regulated properly (see details in Chapter XI). This need was met by the second regulation of the 'two pack'.

The following table provides an overview about the reform steps, which are indicated according to their order of adoption.

	Published	Adoption	Entry into force
European semester	Conclusion of the EC of 17 June 2010 COM recommendation of 30 June 2010	7 September 2010 – Ecofin 16 September 2010 – EC reinforcement	in legal terms: as a part of the 'six pack': 1175/2011/EU, 13 December 2011
'Six pack'	29 September 2010 COM	4 October 2011 Ecofin	13 December 2011
Euro Plus Pact	January 2011 French-German initiative	24-25 March 2011 EC	25 March 2011
TSCG	8-9 December 2011 EC	1-2 March 2012 EC	1 January 2013
'Two pack'	23 November 2011 COM	5 March 2013 Ecofin	30 May 2013

Table 2: Overview of the steps to reform economic governance
Source: Authors

Figure 1 shows which reform steps served which goals.

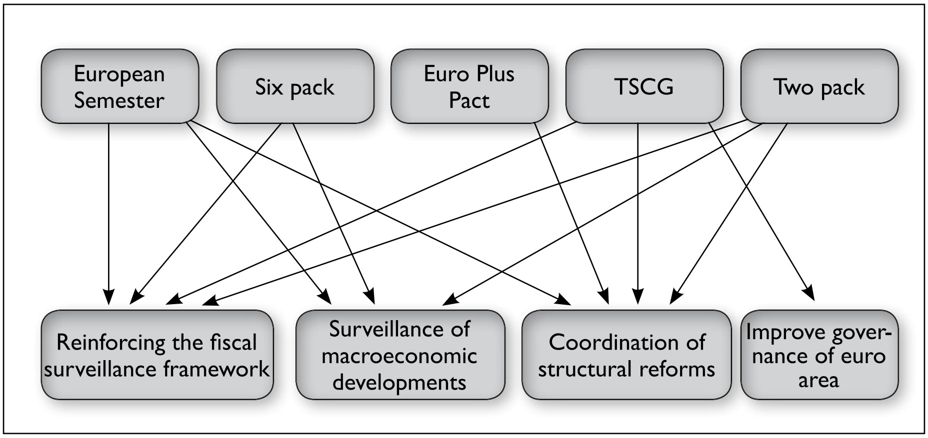


Figure 1: Overview of the reform steps and goals
Source: Authors

The reform steps taken in order to serve the above mentioned goals vary in numerous aspects. First, not all of the reform steps serve all of the goals. Second, the majority of reforms includes rules and requirements for euro area MSs. Non-euro are countries are not obliged to apply the rules until the introduction of the euro. Third, the legal nature of the reform steps is also varied. There is secondary legislation (such as the European semester, the 'six pack', the 'two pack') and measures outside the EU legislative framework: such as intergovernmental political agreement (euro plus pact) and international treaty (TSCG).

As indicated, the rules of the economic coordination framework do not apply equally to all of the MSs. There are two main axes, along which we can differentiate the countries[123]:

- MSs of the euro area and countries outside the euro area. The majority of the new rules are solely applicable to the first group.
- MSs under excessive deficit procedure (in the corrective arm) and MSs in the preventive arm.

It is an additional element to fragmentation that not all of the MSs adopted those decisions which were approved outside the EU legislative framework.

Keeping the above in mind, Table 3 provides an overview about the MSs the reform step measures.

123 Németh, Anita; Tóth Szabolcs: *Pillanatfelvétel az európai gazdasági kormányzás reformjáról;* Európai Tükör, XVII., No. 2, 2012. Winter.

	European semester	'Six pack' (policy part)	'Six pack' (enforcement)	'Two pack'	Euro Plus Pact	TSCG	under EDP[124]	
AT	■	■	■	■	■	■	■	**euro area (EU18)**
BE	■	■	■	■	■	■	■	
CY	■	■	■	■	■	■	■	
DE	■	■	■	■	■	■		
EE	■	■	■	■	■	■		
ES	■	■	■	■	■	■	■	
FR	■	■	■	■	■	■	■	
GR	■	■	■	■	■	■	■	
IE	■	■	■	■	■	■	■	
IT	■	■	■	■	■	■		
LU	■	■	■	■	■	■		
LV	■	■	■	■	■	■		
MT	■	■	■	■	■	■	■	
NL	■	■	■	■	■	■	■	
PT	■	■	■	■	■	■	■	
SF	■	■	■	■	■	■		
SI	■	■	■	■	■	■	■	
SK	■	■	■	■	■	■	■	
BG	■	■			■	■		**non-euro area**
CZ	■	■					■	
DK	■	■			■	■	■	
HR	■	■					■	
HU	■	■				■		
LT	■	■			■	■		
PL	■	■			■	■	■	
RO	■	■			■	■		
SE	■	■				■		
UK	■	■					■	

Table 3: Member states' participation in EU-level economic policy reform measures
Source: Németh and Tóth 2013

124 MSs under excessive deficit procedure on 20 April 2014.

First, we introduce the different reform steps in general, thereafter we analyse the goals in details.

2.1 An introduction to the reform steps

2.1.1 European semester

The European semester is the first phase of the EU's annual cycle of economic policy guidance and surveillance. It was first approved by heads of state and government on June 2010. Then it was included in Regulation 1175/2011/EU, which amended the original regulation of the preventive arm (1466/97/EC).

2.1.2 'Six pack'

The 'six pack' consists of six legislative elements (5 regulations and one directive):

- Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies;
- Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure;
- Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area;
- Directive 2011/85/EU on requirements for budgetary frameworks of the member states;
- Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances;
- Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

The whole legislative package entered into force on 13 December 2011 and applies to all MSs. However, the enforcement measures (sanctions) apply only to euro area MSs. the 'six pack' does not only cover fiscal surveillance, but also macroeconomic surveillance under the new macroeconomic imbalance procedure. In the fiscal field, the 'six pack' strengthens the stability and growth pact (SGP).

2.1.3 'Two pack'

The 'two pack' entered into force in 30 May 2013 and applies only to euro area MSs. It consists of two regulations:

- Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the member states in the euro area;

- Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of member states in the euro area experiencing or threatened with serious difficulties with respect to their financial stability;

In general, the first regulation strengthened further budgetary surveillance for MSs of the euro area by creating a common budgetary timeline, which complements the rules of the preventive arm of the stability and growth pact. Moreover, common budgetary rules at the national level shall be monitored by independent institutions. The second regulation introduces the enhanced surveillance for those countries that receive European stability mechanism (ESM) financial assistance and sign a macroeconomic adjustment programme as a precondition. This enhanced surveillance substitutes the other surveillance procedures.

2.1.4 Treaty on Stability, Coordination and Governance (TSCG)

TSCG is an intergovernmental treaty signed by 25 MSs (Czech Republic, United Kingdom did not sign, Croatia has not signed yet after accession). It is not part of the EU acquis, since some of the rules included in the TSCG would have required the amendment of the TFEU. The provisions of the TSCG apply only for euro area MSs, but non-euro area MSs can join on a voluntary basis. The TSCG includes a fiscal compact, which introduced a kind of "debt brake" to be included in the national law possibly on constitutional level. The TSCG also has provisions on the coordination of major structural reforms, coordinated debt issuance and the governance of the euro area.

2.1.5 Euro plus pact[125]

To give further impetus to the governance reforms, the Euro plus pact, signed in March 2011, commits signatories to even stronger economic coordination for competitiveness and convergence, also in areas of national competence, with specific goals agreed on and reviewed on a yearly basis by heads of state or government.

3. Elements of the economic policy coordination

After this short overview, let us turn now to the main elements of the economic policy coordination, which are:

- surveillance and coordination of fiscal policies;
- surveillance and correction of macroeconomic developments;
- coordination of structural policies and reforms.

125 http://ec.europa.eu/economy_finance/economic_governance/index_en.htm.

3.1 Surveillance and coordination of fiscal policies

As seen earlier, during the inception of the EMU, important safeguards were enshrined in the Maastricht Treaty to prevent fiscal profligacy and to ensure fiscal discipline. These main principles are[126]:

- the prohibition of monetary financing of government deficits via central banks;
- the prohibition of privileged access to financial institutions by the public sector;
- the no-bailout principle;
- the requirement to avoid excessive deficit and debt, which took the form of the stability and growth pact and the supervision and coordination of national fiscal policies.

Another important institutional element was tied to the convergence criteria. To meet the fiscal targets is an important precondition of eligibility for membership of the euro area.

In general, regulation and coordination of national fiscal policies have two main arms:

- Preventive arm to ensure that fiscal policy is conducted in a sustainable manner over the cycle and prevent the formulation of excessive deficit situation.
- Corrective arm to ensure that MSs take corrective action to restore sustainable fiscal situation when excessive deficit situation arises.

As mentioned earlier, before the crisis, mainly the stability and growth pact – adopted in 1997 – regulated the fiscal governance in the EMU. It was established to safeguard sound public finances, based on the principle that economic policies are a matter of shared concern for all member states[127]. This rule-based framework for the coordination of national fiscal policies consists of two regulations:

- Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
- Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure

Due to the preparation for introducing the common currency, fiscal situation improved significantly in MSs. Average deficit improved by 3 percentage points from 1992 to 1998. Public debt also started to decline in the second half of the 90's. After the introduction of the euro however, consolidation fatigue kicked in. The first ten years can be considered as "wasted" good times, even though a mild economic downturn due to the dotcom crisis dampened growth[128].

The above mentioned 2005 reform made the SGP more flexible and easier to enforce. However, the compromise reached did not fully water down the SGP and did

126 Schucknecht, Ludger et al, 2011: *"The stability and growth pact, crisis and reform"* Occasional Paper Series, no. 129, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp129.pdf.

127 http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm.

128 Schucknecht, Ludger et al, 2011: *"The stability and growth pact, crisis and reform"* Occasional Paper Series, no. 129, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp129.pdf.

not mean the full erosion of the basis of the economic policy coordination, even if big changes were accepted.[129]

In light of the SGP reform, it is not very surprising that the period between the launch of the euro and the eruption of the financial crisis could not bring the necessary budgetary consolidation in a number of MSs, even amid favourable economic conditions (at least in some member states). The implementation of the reformed pact was lenient; the deadlines for ending the excessive deficit situation were extended numerous times and thus limiting the required adjustment reforms.[130]

The legal framework for the coordination of fiscal policies is based on main TFEU provisions:[131]

- Article 121 of the TFEU (ex Art. 99 TEC) – multilateral surveillance, regulating the preventive arm;
- Article 126 of the TFEU (ex Art. 104 TEC) – regulating the corrective arm with the excessive deficit procedure (EDP);
- Protocol (No 12) on the excessive deficit procedure annexed to the TFEU;
- Article 136 of the TFEU – specific economic policy guidelines for the euro area to strengthen coordination and surveillance of budgetary discipline, in accordance with the relevant procedures from Articles 121 and 126.

3.1.1 The preventive arm[132]

The preventive arm aims to ensure sound budgetary policies over the medium term by setting parameters for member states' fiscal planning and policies during normal economic times. Compliance with the preventive arm's provisions should ensure that the Treaty's limits (3% of GDP for the general government deficit and 60% of GDP for gross debt, where debt above the limit must be diminishing at a satisfactory pace) are not breached over a normal economic cycle.

The preventive arm is based on Article 121 of the TFEU and regulated in Regulation 1466/97/EC, which was recently reformed with Regulation 1175/2011/EU. The 'two pack' package also contributed to the strengthening of this arm.

Medium term objective

The key element of the preventive arm is the so called medium term objective (MTO), which is defined in structural deficit[133] terms. It is a key indicator of budget

129 Hetényi, Géza: *A Gazdaságpolitikai koordináció* (in: Az Európai Unió gazdasága – Minden, amit az EU gazdasági és pénzügyi politikáiról tudni kell. Szerk: Marján, Attila, HVG Kiadó Rt, Budapest, 2005).

130 Schucknecht, Ludger et al, 2011: *"The stability and growth pact, crisis and reform"* Occasional Paper Series, no. 129, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp129.pdf.

131 http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm

132 http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm.

133 Structural deficit means that the general government balance is adjusted with cyclical factors and one-off measures.

sustainability, therefore it is a cornerstone of the preventive arm. The MTO pursues the following objectives[134]:

- It provides a safety margin with respect to the 3% deficit limit.
- Ensures rapid progress towards sustainability.
- Allows room for budgetary manoeuvre.

All member states must reach their MTOs or be on an appropriate adjustment path towards it, with an annual improvement of their structural balance of 0.5% of GDP as a benchmark. The main rule is that the MTO is differentiated to take into account country specific factors, but it shall be determined to ensure a healthy underlying budgetary position. MTOs are updated every three years or more frequently if a member state has undergone a structural reform significantly impacting its public finances. The rules are stricter for euro area MSs, but even within this group, the rules differentiate among countries with lower and higher debt to GDP positions. For MSs where the debt to GDP ratio is above the 60% limit, the TSCG sets an MTO of maximum -0.5% of GDP. Where debt position is more favourable (under the 60% limit), the TSCG allows a slightly bigger MTO of -1% of GDP.

As seen, MSs have to be at their MTO or be on a sufficient adjustment path towards it. The country specific MTOs and this adjustment path must be included in the stability or convergence programmes (see later for details).

There are some further general rules about the requirements of the correction path:

- There is a cyclical component in the correction path. For all countries, a higher adjustment is required in good economic times in order to have more flexibility in bad times.
- Member states faced with a debt level exceeding 60% of GDP or with pronounced risks to overall debt sustainability are required to adjust faster towards the MTO. Faster adjustment to the MTO ensures debt sustainability and accelerated decrease in debt level.
- The TSCG includes an additional rule for euro area MSs. They have to create a correction mechanism in case of significant observed deviations from the medium-term objective or the adjustment path towards it, which has to be triggered automatically.

The expenditure rule[135]

The analysis of the MTO and the adjustment path towards is complemented by an analysis of the growth rate of expenditure as well. Government expenditure has to be assessed net of discretionary revenue measures. The rule compares the growth

134 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf.

135 http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm.

of the expenditure to a medium-term reference rate of potential GDP growth[136] and requires compensating excessive expenditure growth with discretionary revenue measures. In more details, the rule divides the MSs into two groups:

- if a country is at its MTO, any excess growth of new expenditure over the medium-term reference rate of potential GDP growth must be matched by discretionary revenue measures;
- if a country is on its adjustment path (not reached its MTO yet) it must contain its net expenditure growth at a rate lower than medium-term potential GDP growth, again unless matched by discretionary revenue measures.

This ensures a gradual strengthening of the underlying budget balance. The information to allow an assessment of these objectives is also provided in the MSs' stability and convergence programmes.

Stability and Convergence Programmes[137]

The preventive arm of the stability and growth pact requires member states to submit stability or convergence programmes (SCPs) to the European Commission every spring. Stability programmes are submitted by euro area member states, while convergence programmes, which also contain monetary strategies, are submitted by non-euro area member states. The main function of the SCPs is to allow the Commission and the Council to assess whether member states have reached their MTOs or are on an appropriate adjustment path towards them, including an assessment of compliance with the expenditure benchmark. Consistency in member states' plans with the policy guidelines adopted at the European level is also examined. The programmes are submitted annually in April and assessed as part of the European semester, so that policy advice on fiscal policy planning is provided before key decisions are taken on national budgets for the following years. Guidelines on the content and format of the stability and convergence programmes are covered by a code of conduct. SCPs contain:

- An MTO representing a budgetary position that safeguards against the risk of breaching the 3% of GDP threshold of the TFEU and ensures the long-term sustainability of public finances; the adjustment path towards the MTO (the year-by-year target effort until it is achieved) and the expected path of the debt ratio;
- The underlying economic assumptions (growth, employment, inflation and other important economic variables);
- A description and assessment of policy measures to achieve the programme objectives;

136 The potential output shows the size of the output (GDP) that an economy can produce at a constant inflation rate. Although an economy can temporarily produce more than its potential level of output, that comes at the cost of rising inflation. Potential output depends on the capital stock, the potential labour force (which depends on demographic factors and on participation rates), the non-accelerating inflation rate of unemployment, and the level of labour efficiency. The Economic Policy Committee (EPC) provides a calculation method of this reference value. This is based on regularly updated forward-looking projections and backward looking estimates.

137 http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm.

- An analysis of how changes in the main economic assumptions would affect the budgetary and debt position;
- If applicable, the reasons for a deviation from the required adjustment path towards the medium term budgetary objective;
- Information covering a multi-annual timeframe including: one year of budgetary execution, the current budgetary year, and plans for the three following years.

Member states' convergence programmes should be based on the most likely macro-fiscal scenario or on a more prudent scenario. With the entry into force of the 'two pack', stability programmes submitted by euro area member states should be based on independent macro-economic forecasts, i.e., forecasts produced or endorsed by an independent body. The macroeconomic and budgetary forecasts are compared with the most recently updated Commission forecasts and, if appropriate, those of other independent bodies. Significant differences between the chosen macro-fiscal scenario and the Commission's forecast should be described with reasoning, in particular if the level or growth of external assumptions departs significantly from the values retained in the Commission's forecasts.

As part of multilateral fiscal surveillance, the Commission conducts both an ex-ante assessment for the current and forthcoming years and an ex-post assessment for the previous year based on each member state's stability or convergence programme. The ex-ante assessment allows for pointing out risks that a member state does not comply with the requirements of the preventive arm, while the ex-post assessment includes identifying actual or expected significant divergences from the requirement (i.e., the attainment of the medium-term budgetary objective or progress on the appropriate path towards it). The in-year and ex-ante assessments aim to inform the policy debate and provide guidance to countries. The ex-post assessment may lead to a Council decision establishing the fact of a significant deviation from the adjustment path to the MTO which may then lead to the imposition of an interest-bearing deposit for euro area member states.

Monitoring in the preventive arm[138]

Monitoring in the preventive arm is based on Article 121 (3) and (4) of the TFEU. The steps taken are not as explicit as in the case of the excessive deficit procedure, the details can be found in the amended Regulation 1466/97/EC.

As part of the multilateral fiscal surveillance, the Commission conducts both an ex-ante assessment for the current and forthcoming years and an ex-post assessment for the previous year based on each member state's stability or convergence programme. The ex-ante assessment includes an examination of the MTOs presented by member states in their stability and convergence programmes, focusing on whether a) the MTO is appropriate, b) the country is at the MTO or if the adjustment path towards it is

138 http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm

appropriate, considering the cyclical conditions and the sustainability risks, and c) the economic assumptions on which the programme is based are plausible.

In case a significant deviation from the adjustment path towards the MTO is observed, the Commission addresses a warning referred to the member state concerned. Within 1 month after the warning, the Council adopts recommendations for the necessary policy measures and sets a deadline of 5 months for addressing the deviation[139]. If a MS fails to act, the Commission recommends the Council to adopt a decision that no effective action was taken. The Council adopts this decision with qualified majority voting. However, if the Council does not adopt the decision, the Commission recommends to the Council again that no effective action was taken. In this second case, the decision shall be deemed to be adopted by the Council unless it decides, by simple majority, to reject the recommendation within 10 days of its adoption by the Commission (reversed qualified majority voting).

According to Regulation 1173/2011/EU, a Council decision on no effective action triggers sanctions only for MSs in the euro area. Within 20 days, the Commission shall recommend the Council to adopt a further decision that requires the MS concerned to lodge an interest bearing deposit amounting to 0.2% of its GDP in the preceding year. The Council can reject the proposal by qualified majority voting, otherwise the decision shall be deemed adopted.

Assessment of draft budgetary plans for euro area MSs

The 'two pack' regulation on common provisions for monitoring and assessing draft budgetary plans (473/2013/EU) introduces an additional step in the ex-ante monitoring of budgetary policies for euro area member states. Namely, the 'two pack' establishes a common budgetary timeline for euro area member states which requires that these member states submit draft budgetary plans to the Commission by October 15 every year, prior to the adoption of the budget.

The Commission will provide two assessments:

- an opinion on each member state's plan and
- an overall assessment of the budgetary situation and prospects of the euro area as a whole.

This exercise mirrors the horizontal assessment of stability and convergence programmes taking place in spring, but with a focus on the forthcoming year rather than on medium-term fiscal plans. The Commission opinion on euro area member states' plans will be based on the requirements of the SGP – in particular the country-specific recommendations issued under the preventive arm at the end of the European semester and the need to comply with the MTO requirements. For countries under an EDP, progress towards meeting the obligations stemming from the recommendations issued to the member state will be a central aspect of the assessment. If the Commission identifies particularly serious non-compliance with the European budgetary policy obligations, it can ask for a new plan to be submitted.

139 The deadline shall be reduced to 3 months if the Commission, in its warning, considers that the situation is particularly serious and warrants urgent action.

In the ex-post assessment, the Commission determines whether a member state has made sufficient progress towards the MTO compared to the benchmark of an annual improvement of the structural balance equal to 0.5% of GDP. This assessment is further on compliance with the expenditure benchmark. If the Commission finds evidence of significant deviation from the MTO or the adjustment path towards it – which is a conclusion based on an objective, numerical criteria – the Commission shall address a warning to the member state concerned, which is followed by a Council recommendation within one month. If not respected, this can be followed, in the case of euro area member states, by a sanction equal to an interest-bearing deposit of 0.2% of GDP as a rule.

Quality of the fiscal framework of MSs

In order to ensure fiscal discipline, it is indispensable to strengthen the fiscal framework of member states. Therefore it is an important goal of the reforms as well. One of the most important development is that the rules of the TSCG's fiscal compact has to be included in the national law of the euro area member states preferably on constitutional level (or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes). The aforementioned automatic correction mechanism shall be elaborated on the basis of common principles of the European Commission.

The 'six pack' also included provisions to set the basic requirements for budgetary frameworks of the member states (Directive 2011/85/EU). The rules laid down in the directive had to be implemented in national law until the end of 2013. The main provisions of the directive are the following:

- Member states shall ensure timely and regular public availability of fiscal data for all sub-sectors of general government (Art. 3).
- Member states shall ensure that fiscal planning is based on realistic macroeconomic and budgetary forecasts using the most up-to-date information. Budgetary planning shall be based on the most likely macrofiscal scenario or on a more prudent scenario. The macroeconomic and budgetary forecasts shall be compared with the most updated forecasts of the Commission and, if appropriate, those of other independent bodies. The requirement of independence is explicit for euro area countries according to the 'two pack'. Moreover, the application of independent macroeconomic forecasts is also required in the case of euro area member states. ('Two pack' Regulation 473/2013/EU).
- Significant differences between the chosen macrofiscal scenario and the Commission's forecast shall be described with reasoning, in particular if the level or growth of variables in external assumptions departs significantly from the values contained in the Commission's forecasts. (Art. 4).
- The Directive requires each member state to put in place numerical fiscal rules which are specific to it and which effectively promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon for the general government as a whole. (Art. 5).
- Member states shall establish a credible, effective medium-term budgetary framework providing for the adoption of a fiscal planning horizon of at least 3 years, to ensure that national fiscal planning follows a multiannual fiscal planning perspective.

Coordination of debt issuance
The TSCG and the 'two pack' requires the euro area MSs that the euro area MSs shall report ex-ante on their public debt issuance plans to the Council of the European Union and to the European Commission, with a view to better coordinating the planning of their national debt issuance. It is important to note that it does not mean the issuance of commonly backed debt (like eurobonds for example).

3.1.2 The corrective arm[140]

The corrective arm of the fiscal surveillance ensures that member states adopt appropriate policy responses to correct excessive deficits. Excessive deficit occurs, when a country's government balance breaches the Maastricht reference criteria included in Protocol 12 of the TFEU. According to this Protocol:

- government deficit limit is 3% to gross domestic product at market prices;
- government debt limit is 60% to gross domestic product at market prices.

When these limits are breached, the aim of the economic governance framework is to effectively correct the excessive deficit and debt situation on a sustainable basis and thus normalise the budgetary situation. the excessive deficit procedure is a key tool to serve this goal. Main features of the mechanism are regulated in primary law in Article 126 of TFEU. Detailed rules are in Regulation 1467/1997/EC (SGP), which was recently reformed by Regulation 1177/2011/EU as a part of the 'six pack' reform package and further strengthened by Regulation 473/2013/EU as a part of the 'two pack' reform package. Since the SGP concentrated mainly on the headline deficit and the debt criterion was neglected, a key element of the reform was that it introduced an operationalized debt criterion, which requires a set debt reduction path (see later in details).

The Excessive Deficit Procedure
The excessive deficit procedure was significantly reinforced due to the reform process, new sanction elements were attached to the different steps in the procedure. Moreover, the adoption of these sanctions is more automatic with the introduction of the reversed qualified majority voting scheme. In order to have a clearer view about the different steps of the EDP procedure, we should follow Figure 2.

140 Németh, Anita; Tóth Szabolcs: *Pillanatfelvétel az európai gazdasági kormányzás reformjáról;* Európai Tükör, XVII., No. 2, 2012. Winter.

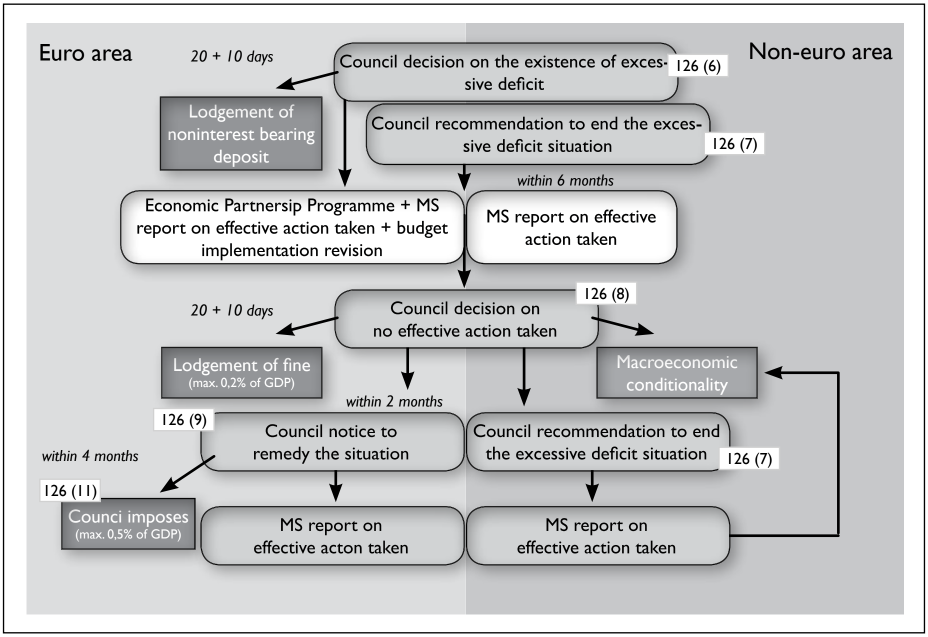


Figure 2: An overview of the excessive deficit procedure
Source: Authors

The European Commission is responsible for monitoring the fiscal developments and the stock of government debt in MSs with a view to identifying gross errors. In particular it examines compliance with budgetary discipline on the basis of the aforementioned deficit and debt criteria[141] (Article 126 (2) of the TFEU). Nevertheless, the 3% deficit limit cannot be considered excessive, if the deficit level declined substantially and continuously and reached a level that comes close to the reference value or the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

If a member state breaches the criteria or there is a risk of excessive deficit, the Commission prepares a report and addresses an opinion to the member state concerned and shall inform the Council accordingly. On the basis of the proposal of the Commission, the Council decides (under Article 126(6) of the TFEU) if an excessive deficit situation exists.

This decision may trigger a sanction for euro area member states. According to the regulation 1173/2011/EU, after 20 days of the Council decision under 126(6), the Commission shall recommend that the Council require to lodge with the Commission

141 Non-compliance with the debt criteria does not trigger automatically the establishment of the existence of the excessive deficit. A whole range of relevant factors has to be taken into account.

a non-interest bearing deposit amounting to 0.2% of the GDP in the preceding year of the member state concerned, if:

- the member state lodged interest bearing deposit in the preventive arm;
- particularly serious non-compliance with the budgetary policy obligations is identified by the Commission report.

The decision requiring the lodgement shall be deemed adopted by the Council unless it decides by a qualified majority to reject it within 10 days (reversed qualified majority voting). If a member state already lodged an interest bearing deposit in the preventive arm, it shall be converted to non-interest bearing deposit.

In case of a decision under 126 (6) of the TFEU, euro area member states also have to present an economic partnership programme describing the policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit (according to the 'two pack', Regulation 473/2013/EU). The Council, acting on a proposal from the Commission, shall adopt an opinion on the economic partnership programme. This economic partnership programme has to be presented along with the report on effective action taken (see next paragraph). Moreover, euro area member states have to comply with additional reporting requirements as well (see text box 3).

Additional reporting requirements for euro area member states under EDP

When the Council makes a decision under 126(6) of TFEU about the existence of excessive deficit, the euro area member state concerned is a subject to additional reporting requirements (according to Regulation 473/2013/EU):

- The member state has to carry out a comprehensive assessment of in-year budgetary execution for the general government and its subsectors. The results have to be included in the report about the effective action taken.
- The member state shall report regularly to the Commission and to the economic and financial committee about the in-year budgetary execution, the budgetary impact of discretionary measures taken on both the expenditure and the revenue side, targets for the government expenditure and revenues, and information on the measures adopted and the nature of those envisaged to achieve the targets. This report has to be prepared in every six months.

On the basis of the recommendation of the Commission, the Council adopts recommendations under Article 126(7)) in order to bring the excessive deficit situation to an end within a given period. In its recommendation, the Council shall request that the member state achieve a minimum annual improvement of at least 0.5% of GDP in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation. Member states have to take effective action to reduce the deficit and meet the deadline of six months after the Council decision. Within the six months deadline, the member state concerned shall report to the Council and the Commission on its action taken.

The Council decides whether effective action was taken by the member state (under Article 126(8) of TFEU). If no effective action was taken the procedure continues in two possible ways, depending on the membership of the euro area.

Further steps for euro area countries

First of all, the decision under Article 126 (8) may trigger a sanction for euro area MSs. Within 20 days, the Commission shall recommend the Council to impose a fine amounting to 0.2% of the member state's GDP in the preceding year. The decision imposing a fine shall be deemed adopted by the Council unless it decides by a qualified majority to reject it within 10 days (reversed qualified majority voting). If a euro area MS has lodged a non-interest bearing deposit with the Commission, this non-interest bearing deposit shall be converted into the fine.

If no effective action is taken within the deadline and the euro area MS persists in failing to put the recommendations of the Council into practice, the Council may decide to give notice (under Article 126(9)) to the euro area member state to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation. The Council has to take the decision about giving Article 126(9) notice no later than two months after the Article 126(8) decision of the Council on no effective action taken. Following a Council notice under Article 126(9), the member state concerned shall report to the Council and the Commission on action taken in response thereto.

If a euro area MS fails again to take effective action and fails to comply with the notice under Article 126 (9), the Council may decide under Article 126 (11) of the TFEU to apply a fine, as a rule. However, the Council may decide to supplement the fine by other measures listed under Article 126 (11) of the TFEU[142].

According to regulation 1177/2011/EU, the amount of the fine – under Article 126 (11) of TFEU – shall comprise a fixed component equal to 0.2% of GDP, and a variable component. The variable component shall amount to one tenth of the absolute value of the difference between the balance as a percentage of GDP in the preceding year and either the reference value for government balance or, if non-compliance with budgetary discipline includes the debt criterion, the government balance as a percentage of GDP that should have been achieved in the same year according to the notice issued under Article 126(9) of TFEU. However, no single fine shall exceed 0.5% of GDP.

Further steps for non-euro area countries

If no effective action is taken by the non-euro area MS under Article 126(8) of TFEU, the Council may decide on further recommendations under Article 126 (7) and set a new deadline to correct the excessive deficit. The possibility of imposing a fine is not provided for non-euro area countries; nevertheless, they can be also subject to certain corrective measures in another type of legal procedure. The so called macroeconomic

142 The Council may require from the member state concerned to publish additional information, to be specified by the Council, before issuing bonds and securities; or it may invite the European Investment Bank to reconsider its lending policy towards the member state concerned.

conditionality, linked to cohesion policy, is applied for both euro area and non-euro area countries. The previous rules limited to the cohesion fund and with no specified sanction levels were significantly amended from 2014, as a result of the negotiations of the 2014–2020 multiannual financial framework (MFF) of the EU.

Macro-economic conditionality

The macro-economic conditionality means that the European cohesion policy funding is dependent on the member states' compliance with the economic policy procedures (excessive deficit procedures (EDP), excessive imbalances procedure (EIP), programme under balance-of-payment (BoP) facility, European Stability Mechanism (ESM) and moreover, with the relevant country specific recommendations

- The decision on the multiannual financial framework of 2014-2020 strengthened the conditionality in three aspects:
- besides the commitments, payments also can be suspended wholly or partly;
- besides the cohesion fund, commitments and payments of the European regional development fund (ERDF), the European social fund (ESF), the European agricultural fund for rural development, and the European maritime and fisheries fund also may be suspended;
- the maximum amount of the suspension has been fixed (max. of 1% of nominal GDP can be suspended if the MSs breach the EDP and max. 0.5% of GDP in the case of EIP).

The decision to suspend payments shall be made by the Council, on a proposal from the Commission; the decision to suspend commitments automatically adopted by the Council, unless it rejects such a proposal by qualified majority (RQMV).

Taking into account adverse economic situations

In case unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that notice, the Council may decide to give either revised recommendations under 126 (7) or revised notice under 126 (9). This was the case during the recent crisis as well. Since unfavourable economic developments occurred in a lot of cases, the deadline set under 126 (7) was revised in numerous cases.

The debt reduction benchmark

Although a debt criterion was also set in the TFEU, it was neglected before the crisis. As seen earlier, the former SGP could not ensure the sufficient debt reduction. According to the criterion a MS complies with the rules, if the government debt to GDP ratio does not exceed the 60% reference value. In case of a debt stock over 60%, the ratio has to be sufficiently diminishing and approaching the reference value at a satisfactory pace. Elaborating the meaning of the "satisfactory pace" was an important element of the reforms, a numerical benchmark for the debt reduction was created. It is also regulated by Regulation 1177/2011/EU and was later reinforced by the fiscal compact as well. The numerical benchmark has a backward-looking and a forward-looking approach.

According to the backward-looking approach of the numerical benchmark, when government debt to GDP exceeds the 60% reference value, the ratio of the government debt to gross domestic product (GDP) shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace if the differential with respect to the reference value has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data is available. The requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which the data is available.[143]

Debt reduction benchmark – an example

The Commission presented a formula to calculate the sufficient debt reduction path. For the backward looking approach, let us apply the rules on an ex-post basis in the case of Belgium for the period of 2004-2006. Belgium is a good example, since the debt to GDP ratio is well above the 60% reference rate (it was above 90% in 2004) and the country could decrease significantly its debt to GDP ratio in the period. According to the formula of the Commission, the benchmark debt ratio for 2007 should have been 88.17%. Since the actual debt ratio was 84%, Belgium complied with the rule.

The computed formula for the backward looking approach:

$$debt_{07} = 60\% + \frac{0{,}95}{3}(debt_{06} - 60\%) + \frac{0{,}95^2}{3}(debt_{05} - 60\%)\frac{0{,}95^3}{3}(debt_{04} - 60\%)$$

For the forward looking approach, let us consider the case of Hungary as an example, even if the debt reduction benchmark can be applied only from 2016. If we apply the rule for the period 2013-2015, the required debt level in 2015 shall be 77.06%.

143 It is important to note that the rule cannot be applied instantly after entry into force of the Regulation. There is a temporary debt rule for MS under EDP: For a member state that is subject to an excessive deficit procedure on 8 November 2011 and for a period of three years from the correction of the excessive deficit, the requirement under the debt criterion shall be considered fulfilled if the member state concerned makes sufficient progress towards compliance as assessed in the opinion adopted by the Council on its stability or convergence programme.

3.2 Surveillance and correction of macroeconomic developments

As we have seen above, the reform of economic governance also aimed to broaden the surveillance procedure horizontally from budgetary situations to macroeconomic developments. Its rationale lied in the eurozone crisis enfolding from 2010. The crisis revealed that unsustainable macroeconomic developments had been hidden by the common currency. Greater financial and economic integration lowered the currency risk in periphery countries. Thus, financial deregulation and liberalization, convergence of the long-term interest rates contributed to large inflows of capital into member states of euro area periphery. The capital was flowing towards countries where higher returns were expected due to higher growth prospects. This led to asset price bubbles (real estate, commodities) and excess consumption instead of encouraging the economic adjustment. The losses in the financial sector driven by the burst of bubbles finally caused huge fiscal deficits and unsustainable budgetary situations. (See Chapter XI for details.)

Turbulences in Ireland and Spain, for example, were driven by credit and housing bubbles. Prior to the crisis, these countries performed well as they pursued sound budgetary policies with budgetary surplus and low public debt. But financial difficulties, caused by 'cheap capital' inflows, led to serious macroeconomic imbalances such as huge losses in export competitiveness, economic downturn, huge budgetary deficits, and deterioration of financing conditions, thus leading to the need for an external financial assistance programme. The vulnerability of these countries enhanced the risk to proper functioning and financial stability of the EMU. Therefore, in order to prevent evolution of similar imbalances in the future, there was a need to broaden the surveillance procedure to macroeconomic developments. The new surveillance and enforcement mechanism were set up in December 2011 as part of the above detailed 'six pack' legislation. (See Table 4 for a reminder about the elements of the legislation.) The surveillance procedure is based on the Regulation (EU) No 1176/2011 and Regulation (EU) No 1174/2011.

Legislation	Amends	Subject	Member states concerned
Regulation 1175/2011	Regulation 1466/97	Budgetary discipline: medium-term objective	EU
Regulation 1177/2011	Regulation 1467/97	Budgetary discipline: excessive deficits	EU
Regulation 1173/2011		Budgetary discipline: enforcements / sanctions	Euro area
Regulation 1176/2011		Macroeconomic surveillance	*EU*
Regulation 1174/2011		Macro-economic surveillance: enforcement / sanctions	Euro area
Directive 2011/85		Budgetary frameworks	EU

Table 4: Macroeconomic surveillance in the 'six pack' legislation
Source: Authors

The new macroeconomic imbalance procedure (MIP)[144] aims to identify potential risks early on, to prevent the emergence of harmful macroeconomic imbalances, and to correct the imbalances that are already in place. The design of the MIP, which is based on Article 121(6) of the TFEU, follows the implicit logic of the stability and growth pact (SGP) with a 'preventive' arm and a stronger 'corrective' arm for more serious cases as follows.

The objective of the MIP (see Figure 3) is to identify macroeconomic imbalances at the early stage of their emergence so that necessary policy actions can be taken in due time and thus prevent the development of severe imbalances which are damaging for the member state concerned and risk jeopardising the functioning of the EMU. The procedure relies on an alert mechanism identifying member states which show signs of potential emerging macroeconomic imbalances that require in-depth analysis. The alert mechanism consists of an indicator-based scoreboard (see *Box 7*). The scoreboard is published by the Commission in the alert mechanism report (AMR) that marks the starting point of the annual cycle of the MIP in autumn. For each indicator, alert thresholds have been defined to detect potential imbalances. The scoreboard and the thresholds are not applied mechanically, as the scoreboard is complemented by an economic reading (i.e. a 'flash' for an indicator does not lead to an automatic conclusion that an in-depth review is warranted). The alert mechanism is thus a 'filter' to identify countries and issues for which more country-specific in-depth analysis is required. The Commission decides for which countries it will prepare the analysis on the basis of the Council discussions.

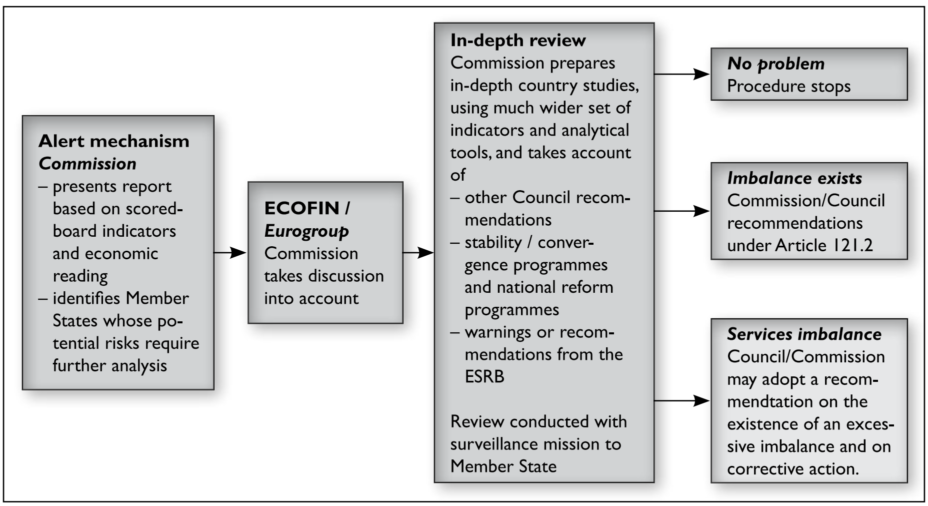


Figure 3: Overview of the macroeconomic imbalance procedure (MIP)
Source: European Commission

144 http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm.

The in-depth reviews (IDRs) aim at assessing the extent of the potential imbalances. These IDRs are based on solid economic reasoning and take into account the broad economic context. Economic spillovers in an EU context are taken into consideration, whether negative or positive. The degree of adjustment capacity of the member state to revert the imbalance is of crucial importance when assessing the potential for wider negative implications. The in-depth reviews are made public. If, on the basis of this analysis, the situation is considered unproblematic, the Commission will not propose any further steps. If the Commission, however, considers that macroeconomic imbalances exist, it will come forward with proposals for preventive policy recommendations for the member state(s) concerned under Article 121(2) of the TFEU ('preventive' arm). These are embedded in the integrated package of country-specific recommendations which the Commission puts forward in May/June in the context of the European semester.

The indicators of the scoreboard

The scoreboard in the alert mechanism report of 2014 contained the following eleven indicators and indicative thresholds, covering the major sources of macroeconomic imbalances:

To identify external imbalances:

- 3 year backward moving average of the current account balance as a percentage of GDP, with thresholds of +6% and -4%
- Net international investment position (NIIP) as a percentage of the GDP, with a threshold of -35%

Competitiveness indicators:

- 3 years percentage change of the real effective exchange rates based on the harmonised index of consumer prices (HICP)/consumer price index (CPI) deflators, relative to 41 other industrial countries, with thresholds of -/+5% for euro area countries and -/+11% for non-euro area countries
- 5 years percentage change of export market shares measured in values, with a threshold of -6%
- 3 years percentage change in nominal unit labour cost, with thresholds of +9% for euro area countries and +12% for non-euro area countries

To identify internal imbalances:

- Year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%
- Private sector credit flow in % of GDP with a threshold of 15%
- Private sector debt (consolidated) in % of GDP with a threshold of 133%
- General government sector debt in % of GDP with a threshold of 60%
- 3-year backward moving average of unemployment rate, with a threshold of 10%
- Year-on-year changes in total financial sector liabilities, with a threshold of 16.5%

However, if the Commission considers that there are severe or excessive imbalances that may jeopardise the proper functioning of the EMU, it may recommend to the Council to open an excessive imbalance procedure (EIP) which falls under the 'corrective' arm of the new procedure. In this case, the Council may adopt a recommendation asking the member state to present corrective actions within a specified deadline. Then the member state is obliged to present a corrective action plan (CAP) setting up a roadmap to implement corrective policy actions. The CAP should be a detailed plan for corrective actions with specific policy measures and implementation timetable. After submission of the CAP by the member state, the Council assesses the CAP with two possible outcomes:

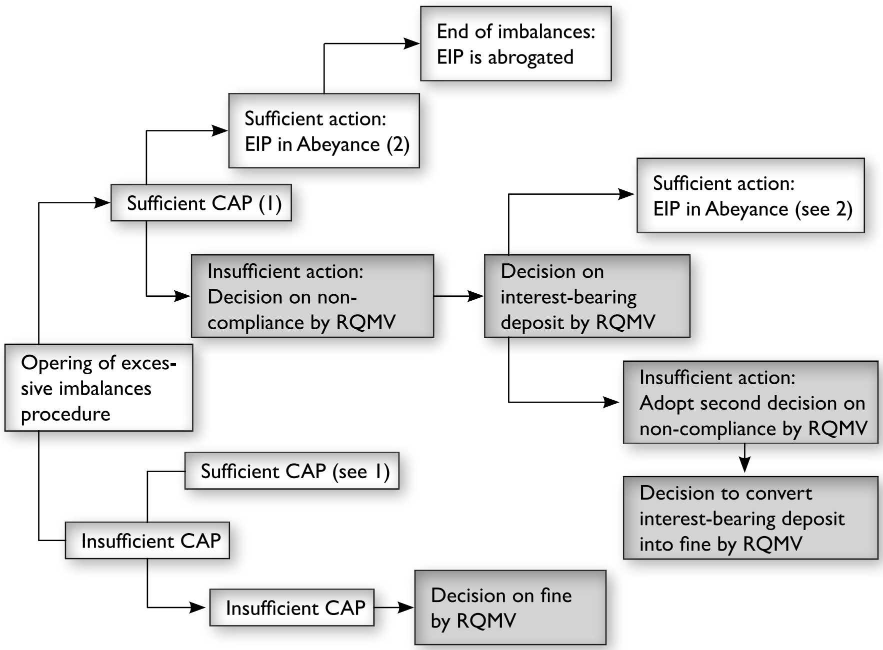
- If the Council considers the CAP to be insufficient, the Council adopts a recommendation to the member state to submit a new CAP. If the new CAP is still considered to be insufficient, a fine (0.1% of GDP) can be imposed (with reversed qualified majority voting, RQMV[145]) for having failed twice in a row to submit a sufficient CAP. Thus the member state cannot stall the procedure by not presenting a good CAP.
- If the Council considers the CAP to be sufficient, it will endorse the CAP through a recommendation that lists the corrective actions and their implementation deadlines.

Then the Council assesses whether or not the member state has taken the recommended actions according to the set deadlines. Two outcomes are possible:

1) If the Council considers that the member state has not taken the recommended corrective actions, it will adopt a first decision establishing non-compliance together with a recommendation setting new deadlines for taking corrective action. In this case, the enforcement regime established by the regulation comes into play. It consists of a two-step approach. The first decision declaring non-compliance with the issued recommendation allows the Council to impose an interesting-bearing deposit (0.1% of GDP). After a second decision by the Council declaring non-compliance, the Council can take the decision to convert the deposit into an annual fine. These decisions are taken with RQMV. When the second Council decision confirms compliance, the Council can put the procedure in abeyance. (*Box 8* summarizes the sanctions under EIP.)

2) If the Council considers that the member state concerned has taken the recommended correction actions, but imbalances are not yet corrected, the procedure will be placed in abeyance. The member state continues to be subject to periodic reporting. If the Council considers that the member state concerned has taken the appropriate actions and the member state is no longer experiencing excessive imbalances, the EIP will finally be closed (see Figure 4).

145 In the RQMV decision-making process a decision is deemed to be adopted unless the Council decides by qualified majority to reject the proposal. This semi-automatic decision-making procedure makes it very difficult for member states to form a blocking majority.



Notes: CAP – corrective action plan; EIP – excessive imbalances procedure; RQMV – Reverse qualified majority voting

Figure 4: Overview of the macroeconomic imbalance procedure's corrective arm
Source: European Commission

Sanctions in the excessive imbalances procedure (EIP)
The new surveillance procedure introduced effective enforcement measures for euro area member states if they repeatedly fail to meet their obligations. The following sanctions can be imposed:

- An interest-bearing deposit (0.1% of GDP) can be imposed after the first failure to comply with the recommended corrective action;
- After a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP);
- Sanctions can also be imposed for failing twice to submit a sufficient corrective action plan.

For the purpose of assessing the macroeconomic situation and potential risks in the member states, the Commission may carry out on-site missions. In the case of member states which are subject of a recommendation about existence of an excessive imbalance position the Commission may undertake enhanced surveillance missions.

So, the Commission has a stronger role in this enhanced surveillance procedure as regards assessments that are specific to each member state, monitoring, on-site missions, recommendations and warnings.

A case study: Hungary's performance in macroeconomic developments
In its AMR analysis of 2013, the Commission identified that macroeconomic imbalances have built up over the past years in Hungary. As Table 5 shows, four indicators exceed the indicative threshold, namely the Net International Investment Position (NIIP), the export market share, the government debt and the unemployment rate. The NIIP raised concerns, due to its still highly negative level and high short-term external rollover needs, but a continuous improvement is projected. In the Commission's assessment the Hungarian export performance has weakened during the past few years. Large FDI investments in the automobile industry in 2012-2013 might improve somewhat Hungary's lacklustre export performance, but these new capacities will not suffice to turn it around in a sustainable manner. Despite a recent slowdown in deleveraging, indebtedness of households and non-financial corporations also remains a key vulnerability. The public debt level has declined (due to one-off capital transfers), but remained high and is forecasted to be corrected only at a very slow pace. According to the Commission's analysis these imbalances are not excessive, but require monitoring and decisive policy actions. However, a faster decline of Hungary's imbalances is hindered by a relatively low growth potential.

Indicator	Threshold	2012	2011	2010
Current Account Balance (as % of GDP)	+6/-4	0,6	0,6	-2,1
Net International Investment Position (as % of GDP)	-35	***-103***	***-105,9***	***-112,5***
Real Effective Exchange Rate (% change)	+/-11	-1,2	-3,3	-0,5
Export Market Share (% change)	-6	**-17,8**	-2,8	1,4
Nominal Unit Labour Cost (ULC) (% change)	12	4,4	3,7	3,9
Change in Deflated House Prices (%)	6	-9,2	-4,1	-6,7
Private Sector Credit Flow (as % of GDP)	15	-6,1	6,4	-18,7
Private Sector Debt (as % of GDP)	160	*131*	***167***	155
General Government Debt (as % of GDP)	60	***80***	***81***	***81***
Unemployment Rate (%)	10	***11***	***10,7***	9,7
Change in Total Financial Sector Liabilities (%)	16,5	-8,3	-2,6	-

Table 5: Hungary's scoreboard indicators
Source: European Commission

3.3 Coordination of structural policies and reforms

As presented previously, prior to the crisis, the levels of coordination were quite limited. Thus, besides strengthening the fiscal and macroeconomic surveillance procedures, the reform of the EMU had a third focus: the enhancement of economic coordination for competitiveness and convergence among member states, which means a real move beyond 'soft coordination'.

Areas that fall under national competence such as employment and social policies[146] and taxation[147] are crucial for increasing the competitiveness of member states and ensuring balanced economic growth. Competitiveness is essential to produce higher levels of income for citizens, and to preserve the European social models. But enhancing coordination in these fields is a politically sensitive question among member states, so the agreement has not been achieved according to the traditional means of policy-making in the EU, the so-called Community method. It has taken the form of intergovernmental political agreement (euro plus pact) and international treaty (TSCG) relying on the obligatory participation of euro area member states and on voluntary cooperation of other member states.

To this end, twenty-three[148] member states, including six outside the euro-area (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania), signed the Euro Plus Pact[149] in March 2011.

The euro plus pact builds on the existing framework of economic priorities agreed at EU level under the Europe 2020 Strategy for "smart, sustainable and inclusive" growth. The strategy sets targets in the fields of employment, innovation, climate and energy, education and social inclusion. Participating member states agreed on five objectives: i) foster competitiveness, ii) foster employment, iii) contribute further to the sustainability of public finances, iv) reinforce financial stability and v) enhance tax policy coordination. Table 6 gives an overview of the objectives.

146 According to Article 5 of TFEU: "2. The Union shall take measures to ensure coordination of the employment policies of the member states, in particular by defining guidelines for these policies. 3. The Union may take initiatives to ensure coordination of member states' social policies."

147 The majority of direct taxation policies fall under national competencies. The EU only limits some aspects of indirect taxation (the level of variation allowed for VAT rates).

148 For different reasons the Czech Republic, Hungary, Sweden and the United Kingdom did not sign the pact.

149 The original plan (called Competitiveness Pact) was announced by Germany and France in February 2011.

Foster competitiveness	Monitor wages and productivity trends
	Measures to increase productivity
Foster employment	Labour market reforms
	Life-long learning
	Tax reforms to raise labour participation
Enhance the sustainability of public finances	Pensions, health care and social benefits
	National fiscal rules
Reinforce financial stability	National legislation for banking resolution
	Regular bank stress tests
Structured discussion on tax policy issues	

Table 6: Overview of objectives of euro plus pact
Source: European Commission

The pact commits signatories to achieve these goals with concrete national commitments. The pact requires the heads of state and government to make their own annual commitments to specific targets and measures ('action programmes'). The choice of the specific policy actions necessary to achieve the common objectives, however, remains the responsibility of each country taking into account its specific challenges. In light of the need to ensure consistency and to avoid overlap with the European semester, the euro plus pact commitments are anchored in the European semester and presented in the national reform programmes (NRPs) and stability and convergence programmes (SCP). The commitments are monitored and assessed by the Commission and the Council within the context and timing of the economic surveillance under the European semester. Each year progress towards the common objectives is reviewed by the heads of state or government.

With regard to the sustainability of public finances and reinforcing the financial stability, the pact laid down potential measures, but since its adoption. Regarding national fiscal rules, as we mentioned above, Article 3 of the fiscal compact (TSCG) sets out the 'balanced budget rule' applied in national law of binding force (preferably constitutional). Furthermore, the comprehensive reform of the EU framework for financial sector supervision and regulation has been realized during the concept of building up the 'banking union' (see Chapter VIII for details.)

As regards the tax policy coordination, the euro plus pact emphasized that direct taxation remains a national competence. However, pragmatic coordination of tax policies is a necessary element of stronger economic policy coordination. Particular attention should be paid to how tax policy can support economic policy coordination and contribute to fiscal consolidation and growth. In this context, member states engage in structured discussions on tax policy issues, notably to ensure the exchange of best practices, avoidance of harmful practices and proposals to fight against fraud and tax evasion. Thus, the Council of economy and finance ministers plays key role as they discuss and report regularly on progress made in structured discussions on the coordination of tax policies.[150]

The second 'pillar' of the economic policy coordination was introduced by the TSCG. Title IV of the TSCG sets out further actions towards a more closely coordinated economic policy to enhance convergence. Article 11 introduced the new practice of ex-ante discussion and coordination of major economic policy reform plans among participating member states and institutions of the EU. Such coordination covers only key economic policy reform plans, such as reforms in product, services, labour market, tax and financial markets, at an early stage before the measures are adopted. Coordinated reforms across member states can help communicate the broader welfare effects of structural reform. Benchmarking, mutual learning and the exchange of best practices – based on individual examples or a horizontal overview of implemented reforms – can be helpful. In near term, EU decision-makers intend to apply the ex-ante coordination among all member states as an integral part of the EU legal framework[151]. The concept of ex-ante coordination of plans for major economic policy reforms has been also appeared in the work towards a genuine EMU (see Chapter X for details).

3.4 Economic and budgetary surveillance of euro area 'programme-countries'

After the overview of the elements of the economic policy coordination, let us shortly reflect on the case of MSs under financial assistance, where the surveillance framework is much deeper and broader.

EU financial assistance conditionality, in the years of the eurozone crisis, has been heavily criticised both on procedural and substantive grounds. First, conditions of the loan were drafted behind closed doors by the atypical tripartite institution, the Commission-ECB-IMF 'Troika', and parliamentary control of conditionality was extremely weak. Second, economists argued that the programmes focused on austerity, hurting the prospects of recipient countries to return to growth, and imposing cuts that undermine access to vital public services, such as healthcare and education.[152]

Therefore, there was a need to set up an EU framework for drafting conditions for countries receiving financial assistance. The new, comprehensive and better aligned mechanism of 'economic surveillance' was created for member states in the euro area threatened with or experiencing serious difficulties with respect to their

150 Chapter VI. gives an overview of the other objectives of the pact (regarding employment and social policy).

151 The TSCG foresees the incorporation of its content into the legal framework of the EU by 1 January 2018 at the latest.

152 Ioannidis, Michael: *EU Financial Assistance Conditionality after 'Two Pack'*. Goethe University Frankfurt – Faculty of Law, February 20, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2398914.

financial stability, those in receipt of financial assistance, and those that are in the process of exiting such assistance, by entering into force of 'two pack' (Regulation (EU) No 472/2013). The regulation has two main objectives: i) to prevent contagion of financial difficulties and to allow EU institutions to intervene before a formal request by requiring all necessary information and indicating reform measures; and ii) to set economic policy conditions to the assistance, consistent with the existing surveillance mechanisms foreseen by EU law. Member states asking for financial assistance have to agree on a memorandum of understanding – drawn up outside the EU framework – and draft a macroeconomic adjustment programme – which is now foreseen by secondary EU law.

The surveillance of the budgetary policy of these euro area member states builds on but goes further than the requirements for member states under an excessive deficit procedure (EDP). The strength of the monitoring and the surveillance increases in line with the severity of the difficulties encountered and with the nature of the financial assistance received. Regulation 472/2013/EU defines three types of economic surveillance: enhanced surveillance, programme-based surveillance, and post-programme surveillance. The differences in the intrusiveness of these types of surveillance reflect differences in conditionality, which might range from a full-fledged macroeconomic adjustment programme to continuous respect of pre-established eligibility conditions. Enhanced surveillance is the least intrusive form of surveillance, whereas programme-based surveillance is the most demanding, requiring the preparation of a full-fledged macroeconomic adjustment programme. Member states subject to a macroeconomic adjustment programme are exempted from submitting a stability programme. Post-programme surveillance largely coincides in its content and intrusiveness with enhanced surveillance. A member state will be under post-programme surveillance until it has repaid at least 75% of the financial assistance received.[153]

4. The frame of the economic policy coordination process: the European semester[154]

In order to streamline the surveillance process and to better align the goals of national budgetary, macroeconomic, growth and employment policies, there was a need to synchronize the timetables of these procedures under the umbrella of the so called European semester. The European semester is the annual cycle of economic and fiscal

153 Ioannidis, Michael: *EU Financial Assistance Conditionality after 'Two Pack'*. Goethe University Frankfurt – Faculty of Law, February 20, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2398914.

154 Based on http://www.consilium.europa.eu/special-reports/european-semester. Chapter VI. presents the semester from social and employment perspective.

policy coordination. It was first approved by the heads of state and government on June 2010, and the first cycle took place in 2011 under the Hungarian Presidency of the Council of the EU. Then it was included in the 'six pack' (Regulation 1175/2011/EU[155]). Its main focus is on the six-month period from the beginning of each year, hence its name – the semester. During the cycle all member states align their budgetary and economic policies with the goals and rules agreed at the EU level. Therefore the semester has a threefold objective:

- to enhance structural reforms, focusing on promoting growth and employment in line with the Europe 2020 Strategy;
- to ensure sustainability of public finances in line with the stability and growth pact;
- to prevent excessive macroeconomic imbalances in the EU.

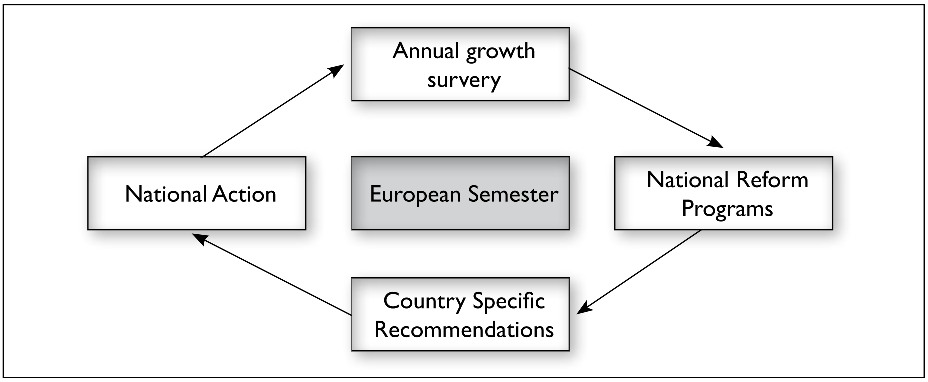


Figure 5: The simplified process of the European semester
Source: European Commission

The European semester's annual cycle covers four phases (Figure 5 and 6 provide an overview about the cycle):

- The preparatory phase (from November to end of December): analysis of the situation and follow-up to the previous year.
- First phase (from January to March): policy guidance at the EU level.
- Second phase (from April to June): country-specific objectives, policies and plans.
- Third phase (from July): implementation of recommendations.

155 Section 1-A of Regulation 1175/2011/EU includes the elements of the multilateral surveillance cycle.

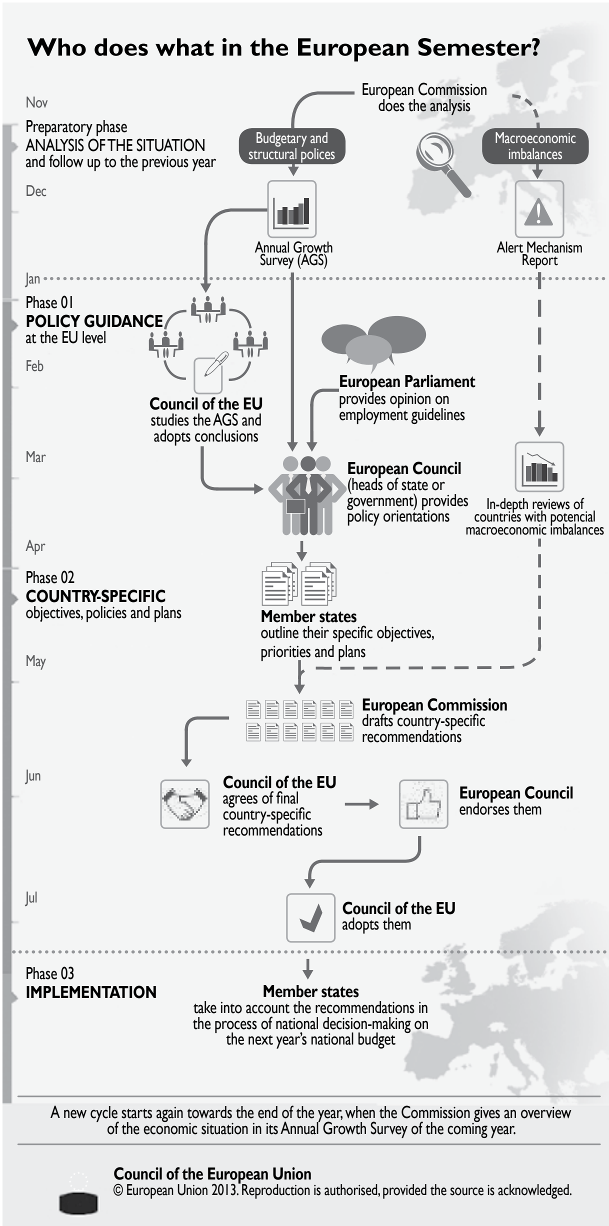


Figure 6: Overview of the European semester
Source: Council of European Union

4.1 The preparatory phase

The European semester starts with the publication of the annual growth survey (AGS) and alert mechanism report (AMR) by the Commission in November for the coming year. The AGS presents the Commission's view of EU policy priorities for the next year. The Commission identifies the main challenges facing the Union and the euro area, and gives strategic guidance on policies. The member states are invited to take them into account when designing their economic policies for the coming year. In the AMR, as above mentioned, the Commission reviews macroeconomic developments in individual EU countries.

The new rules of the 'two pack' regulation are also incorporated into the European semester cycle. In line with the new common budgetary timeline, euro area member states are required to submit draft budget plans to the Commission by 15 October each year. Budgets have to be adopted by national parliaments by 31 December each year.

Phase 1

In the beginning of the year, the Council of the EU debates the AGS, formulates orientations and adopts conclusions. As the semester has implications for a range of policies, therefore the Council discusses it in its various configurations[156]. Based on the AGS and the Council's conclusions, the European Council of March provides policy orientations. The member states are invited to take into account these orientations when preparing their national stability or convergence programmes and national reform programmes which outline their budgetary policies and policies promoting growth and competitiveness.

Based on the AMR, the Commission conducts in-depth reviews (IDR) of macroeconomic imbalances in those member states where the risk of such imbalances was perceived to be high and publishes the result of IDRs in March. Such reviews help to identify whether potential macro-economic imbalances exist, and if they exist, their exact nature and scope.

Phase 2

The member states submit their policy plans, preferably by 15 April and at the latest by the end of April: i) stability and convergence programmes (SCPs)[157] outlining the member states' medium-term budgetary strategy and ii) national reform programmes (NRPs)[158] outlining member states' structural reform plans, focused on promoting growth and employment.

156 The Employment, Social Policy, Health and Consumer Affairs Council (EPSCO), and the Economic and Financial Affairs Council (Ecofin) has leading role.

157 Member states that benefit from financial assistance which is coupled with an economic adjustment programme, are not required to submit stability programmes, and are not subject to a possible in-depth review (IDR) on macroeconomic imbalances.

158 All member states have to submit their NRP, which presents the country's policies and measures to sustain growth and jobs and to reach the Europe 2020 targets.

In May the Commission evaluates these policy plans and presents draft country-specific recommendations (CSRs). Recommendations regarding the macroeconomic imbalances procedure (MIP) can be also proposed by the Commission together with the CSRs aimed at the countries concerned for the purpose of correcting the imbalances (or this can be done at the same time as the in-depth review is released). In June the Council of the EU discusses the draft and agrees on final CSRs. They are then presented to the European Council of June for endorsement and member states are invited to implement them.

Phase 3

The member states start to implement the recommendations in July. They are invited to take into account the CSRs in the process of national decision-making on the next year's national budget which will enable them to carry out policies as envisaged. The member states inform the Commission about their implementation. In the end of the cycle the Commission starts taking into account the progress achieved by individual countries in implementing the recommendations. The Commission holds regularly bilateral consultations with all EU member states (in the 2014 semester three times in the cycle, previously less or none) about the progress achieved regarding the implementation of previous CSRs. The cycle starts again towards the end of the year, when the Commission gives an overview of the economic situation in its AGS for the coming year.

VI. Economic policy coordination II - broad sense

This chapter deals with a policy area which is beyond the legal accountability of member states, discussing employment and social policy issues as well where continuous small steps in most cases taken by political decisions and not by legally binding regulations may and indeed d lead to new political, institutional and legal dimensions of the European integration.

1. Historical background

1.1 What has and has not been achieved by the Maastricht Treaty

The Copenhagen European Council of 22-23 June 1993 was prepared under dramatic circumstances. By the end of 1993 the basic building blocks of a successful internal market have been achieved; the customs union has already been accomplished and by the adoption of the Single European Act the basis of creating the legal framework of the European single market has been laid down. After the long awaited successful Danish referendum in May 1993 on the Treaty of Maastricht, the Economic and Monetary Union (EMU) could become operational from 1 December 1993. The Maastricht Treaty has been a very important milestone on the road towards the European integration. Not only by creating the perspective and the institutional setup of the common currency but also by signalling the clear limits of member states' willingness in transferring competences on the EU. The principle of subsidiarity, incorporated into the Maastricht Treaty[159], limits the European Union to act only if and in so far as the objectives of the proposed action scale or the effects of the scale cannot be sufficiently achieved on a national, regional and local level but can rather be better achieved at Union level by the reason of the scale or effects of the proposed action. Until the end of 1992 the single market delivered tangible results.[160] 70 million customs documents have been withdrawn, 3% on savings on international transport has been saved, three times more company mergers and acquisitions have been pursued in the Community's territory, twice as much European companies have been involved in global mergers and acquisitions, trade in sectors previously sheltered from competition has been doubled, investment in the Community rose by one third between 1985 and 1990, nine million extra jobs were created and 0.5% extra growth was produced each year.

159 Art 5 (3) TFEU.

160 Growth, competitiveness, employment. The challenges and ways forward into the 21st century. White Paper. Commission of the European Communities. COM(93)700. 5 December 1993.

The single market, the single currency and the Economic and Monetary Union, as enshrined in the Maastricht Treaty, was thought to be efficient against global economic shocks like the oil shocks in the 1970s. In spite of this the entry into force of the Maastricht Treaty was questioned by the first unsuccessful referendum in Denmark. Besides, the Maastricht Treaty could not even enter into force in its entirety since some countries asked for derogation of entering into the third phase of the European Exchange Rate Mechanism while the Treaty's social provisions have been opted out by the UK. It became clear that member states are not unequivocally supportive of quick steps towards conferring competencies on the Union in further policy areas. Although the Maastricht Treaty has stipulated that member states' economic policies should be coordinated by means of broad economic policy guidelines and employment guidelines proposed by the Commission and adopted by qualified majority voting by the Council on the basis of which the Council adopts recommendations to the member states. At the same time, economic figures have become more and more worrisome. The potential growth rate (per year) of the EU has shrunk from around 4% in 1970s to 2.5%. Unemployment has been steadily rising from cycle to cycle and the investment ratio has fallen by 5%. The EU's competitive position towards the USA and Japan has worsened as regards employment, export market shares, R&D&I investments and their incorporation into goods brought into the market. Member states were particularly severely hit by unemployment; cyclical unemployment increased by 0.5% a year. Despite of the growing economy unemployment rate stood at 12% as a clear signal for structural, partly technological unemployment, half of which is long-term unemployment. In addition to the worsening data there were foreseeable changes in the global economy which would result in the worsening competitive position of the European Union supposing a no-policy-change. For example the emergence of new competitors, population ageing, shifting the growth potential from industry to technologies, jobs and skills, the interdependence of financial and capital markets which are enabled by new technologies. Jacques Delors, the ambitious president of the European Commission presented an impulsive speech at the June '93 Copenhagen European Council.[161] He suggested that the European Union should

- get back on the road to convergence, which will boost growth and create jobs throughout the Community;
- provide national policies and business strategies with a credible, clear and comprehensible perspective and to this end, make the single market productive;
- pursue an open trade policy;
- aim to increase cooperation in the field of R&D and to increase R&D-related spending on 3% of GDP;
- create more efficient network of transport and telecommunications infrastructure, making easier the exercise of the four freedoms in the single market;

161 Conclusions of the Presidency - Copenhagen, June 21-22 1993. http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/72921.pdf. Downloaded: 19 April 2014.

- enhance the share of employability by promoting lifelong learning and atypical work contracts (part-time work, distance work) and
- enhance the level of employment by promoting active labour market policies.

The Council invited the Commission to present a white paper on the proposed measures on a medium-term strategy for consideration at its meeting of December 1993. The White Paper elaborated by the Commission chaired by Jacques Delors and presented to the 10-11 December Brussels European Council proposed wide-ranging solutions of three elements: the creation of a macroeconomic framework to support market forces, increasing the competitiveness of European economy and structural changes in the labour market. The White Paper[162] was welcomed by the Brussels European Council of 10-11 December 1993 which adopted an action plan both for the Community and the member states concerning growth, competitiveness and employment.[163]

By the beginning of the 1990s it became evident that:

- member states are not willing to coordinate their economic policies in a legally binding way (the Court did and still does not have jurisprudence over issues arising from Article 126 of the TFEU);
- member states take on the responsibility of committing themselves to the Maastricht criteria;
- as employment is not a Community policy and social policy is only coordinated at a Community level as far as it is necessary to promote equal protection of workers throughout member states, the legal basis is missing even to use soft tools of coordination in the economic policy areas falling outside the Maastricht criteria.

It was only the Treaty of Amsterdam which could create the previously missing legal basis for an economic coordination in a broader sense by including employment in it and consolidating its social policy provisions.

1.2 The European employment strategy

The disappointment caused by the lack of reference to employment in the Treaty on the European Union and the initiative to combat unemployment mounted at the Essen European Council of 9 and 10 December 1994, which drew up short and medium-term lines of action on employment. The summit's conclusions[164] stated that reducing unemployment is one of the priority tasks of the European Union and highlighted

162 Growth, competitiveness, employment. The challenges and ways forward into the 21st century. White Paper. Commission of the European Communities. COM(93)700. 5 December 1993.

163 Presidency conclusions. 10 – 11 December 1993. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/82736.pdf.

164 European Council meeting on 9 And 10 December 1994 in Essen. Presidency Conclusions http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/00300-1.EN4.htm.

the structural origins of much of the European unemployment and the crucial role of meaningful dialogue between the social partners and policy-makers with a view to resolving this problem. The European Council also defined five priority strands for member states' employment policies:

- promoting investment in vocational training so workers can adapt to technological developments throughout their working life;
- increasing employment during periods of growth (through more flexible work organisation, a wage policy designed to encourage job-creating investments and the encouragement of initiatives at regional and local level);
- reducing non-wage labour costs to encourage hiring unqualified workers in particular;
- improving the effectiveness of labour market policy by a better definition of measures to raise wages and by regularly evaluating the effectiveness of labour market policy instruments;
- improving measures to help groups which are particularly hard hit by long-term unemployment e.g. young people leaving school without qualifications, elderly workers and women.

The Turin European Council of 25 March 1996 welcomed[165] the "Action for employment in Europe: a confidence pact" of the Commission with a commitment to the struggle against unemployment in medium and long term. The European Union has also taken numerous job creation measures under the structural funds and the European social fund. The Council urged the member states to prioritise these issues at the Intergovernmental Conference starting in 1996 on the revision of the Treaty of Maastricht. Following difficult negotiations a consensus finally emerged on the precedence of national policies and the rejection of large-scale spending programmes. The addition of a new chapter on employment in the Treaty establishing the European Community is the fruit of these negotiations. By including employment in the Community policies (a new Title VIII of the EC Treaty, currently Title IX TFEU) and putting it on the agenda of every European Council, the Treaty of Amsterdam, which entered into force on 1 May 1999, allows the development of Community employment initiatives and the creation of a consistent policy at European level. Promoting employment has become one of the objectives of the European Union and a "matter of common concern" for the member states.[166] The new objective is to achieve "a high level of employment" without weakening the competitiveness of the European Union.[167] To achieve this objective a new power has been vested in the Union, supplementary to that of the member states, concerning the preparation of a "coordinated strategy" for employment. The core of this strategy consists of common guidelines (called employment guidelines) adopted for the first time by the extraordinary Luxembourg European Council (Job Summit) of 20-21 November 1997.

165 Turin European Council 29 March 1996. Presidency Conclusions http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/032a0001.htm.

166 Article 2 of the EC Treaty.

167 Article 2 of the EU Treaty.

1.3 Social Policy

The Treaty of Amsterdam was decisive not only from the point of view of the inclusion of the employment policy into the Treaty but also because it has merged the former Treaty references:

- the EC Treaty, which contains provisions applicable to all member states, concerning social policy coordination as regards working conditions and
- the Social Agreement annexed to the Social Protocol[168] by the Treaty of Maastricht

into a single social policy chapter referring to the European Social Charter signed at Turin on 18 October 1961 and to the 1989 Community Charter of the Fundamental Social Rights of Workers.

Article 151 of the TFEU[169] reaffirms that social policy is a competence shared by the European Community with the member states. The objectives of the European Union's social policy are the promotion of employment, the improvement of living and working conditions, adequate social protection, social dialogue, the development of human resources to ensure a high and sustainable level of employment and the integration of persons excluded from the labour market.

1.4 Coordination of economic policies after the Treaty of Amsterdam entered into force

Every year conclusions on the employment situation in the Community were adopted by the European Council on the basis of the annual report prepared by the Council of the European Union and the Commission. Based on these conclusions the Commission proposed employment guidelines[170] so member states' employment measures were compatible with the major economic guidelines laid down under the monetary union (Article 99 of the TEC, currently Article 121 of the TFEU) which were then adopted by qualified majority voting. The background analysis of national measures has been prepared by permanent advisory bodies of the Commission: the Employment Committee and the Social Protection Committee.

Member states had to take employment guidelines into account in their employment policies. The Council then examined the annual reports submitted by the member states and if it was necessary, acting on a proposal from the Commission, addressed a recommendation to the member state concerned.

Country-specific recommendations were similar to the ones on economic policy but

168 The United Kingdom is not a signatory of this protocol.
169 Article 136 of the EC Treaty.
170 The first employment guidelines were adopted by the 20-21 November 1997 Luxembourg extraordinary council devoted to employment issues.

- in contrast with the provisions on Economic and Monetary Union the Treaty did not prescribe any macroeconomic objectives to be achieved along the lines of the economic convergence criteria;
- no penalties were imposed on member states that fail to comply with the Council's recommendations;
- the Treaty did not state either that these recommendations have to be published.

The 3-4 June 1999 meeting of the European Council in Cologne[171] set up

- the Cardiff Process covering macroeconomic coordination, the comprehensive structural reform and modernisation to improve the innovative capacity and efficiency of the labour market and the markets in goods, services and capital;
- the Cologne Process for the coordination of economic policy and improvement of mutually supportive interaction between wage developments and monetary, budget and fiscal policy through macro-economic dialogue aimed at preserving a non-inflationary growth dynamic;
- the Luxembourg Process concerning the further development and better implementation of the coordinated employment strategy to improve the efficiency of the labour markets by improving employability, entrepreneurship, adaptability of businesses and their employees and equal opportunities for men and women in finding gainful employment.

1.5 The Lisbon Strategy

On 23 and 24 March 2000 the heads of state and government agreed on a new strategic goal for the European Union in order to strengthen employment, economic reform and social cohesion as part of a knowledge-based economy. It seemed that the reforms gradually introduced had been paying off; the Union enjoyed economic growth of about 3.5% in 2000, 2.5 million jobs were created which mostly improved the employment rate of women. Unemployment has fallen to the lowest level since 1991 it stood at 8.7%[172] in 2000. The economic fundamentals in the EU remained sound. Price stability has been maintained (HCPI: 2.19% in 2000)[173], public finances have been restored and the EU had a potential growth rate of 3%. Yet, the new competitors were emerging in the global markets, the demographic challenge and the projected rise of the old age dependency ratio seemed to be as alerting signs for decision-makers. The foreseen common actions were underpinned by the TEC and TEU as amended by the

171 Presidency conclusions. Cologne European Council of 3 and 4 June 1999. http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/kolnen.htm.

172 Eurostat data. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Unemployment_rate,_2000-2011_(%25).png&filetimestamp=20120502100338.

173 See Eurostat data: http://www.inflation.eu/inflation-rates/europe/historic-inflation/hicp-inflation-europe-2000.aspx.

Amsterdam Treaty which created the legal basis for a broadly based economic policy coordination of mid-term competitiveness reforms.

1.5.1 Goals

By adopting the Lisbon Council Conclusions the heads of states and governments agreed that Europe's economy needs to be modernized to reach the overall goals:

1) Preparing the transition to a knowledge-based economy and society for all to
   - *a)* create an information society (the adoption of several e-directives e.g. copyright, e-commerce, e-money, etc., the modernization of the telecom sector, providing internet access for schools, electronic access to main public services);
   - *b)* establish a European Research Area (developing appropriate mechanisms for networking national and joint research programmes, improving the environment for private investment, high-technology start-ups, removing barriers from the free movement of researchers, adopting the regulation on the Community Patent);
   - *c)* create a friendly environment for starting up and developing innovative businesses, especially SMEs (lowering the costs of doing business and removing unnecessary red tape);
   - *d)* perform economic reforms for a complete and fully operational internal market (liberalization of services, liberalization of gas, electricity, postal and transport services; making public procurement regime more suitable for SMEs, ensuring on-line government procurements and reducing the general level of state aids);
   - *e)* ensure efficient and integrated financial markets (facilitating the widest possible access to investment capital, implementing the Financial Services Action Plan and the Risk Capital Action Plan, adoption of the directive on take-over bids);
   - *f)* coordinate macroeconomic policies (ensuring the long-term sustainability of public finances, alleviating tax pressure on labour, redirecting public expenditure to support R&D, innovation and information technologies).

2) Modernizing the European social model by investing in people and building an active welfare state
   - *a)* modernizing education and training for living and working in the knowledge society (increasing substantially the capital increased in human resources, reducing the number of early school-leavers by half, defining new learning skills to be provided through lifelong learning, fostering the mobility of students and developing the common CV-format);
   - *b)* developing an active employment policy for more and better jobs (improving employability, reducing skill gaps, giving priority to lifelong learning, increasing employment services, fighting against discrimination and furthering all aspects of equal opportunities);
   - *c)* modernizing social protection so that it would support the knowledge-based economy;
   - *d)* promoting social inclusion (mainstreaming the promotion of member states' employment, education and training, health and housing policies in the completion of the structural policies).

3) Providing a more systematic and coherent governance system through
   a) a better coordination and streamlining of the Cologne, Cardiff and Luxembourg processes (broad economic policy guidelines focusing on medium-term objectives, enhance ownership by devoting the Spring Councils to economic issues);
   b) implementing a new open method of coordination by fixing guidelines, benchmarks and timetables and periodic monitoring, evaluation and peer review.

Detailed commitments have been made at the various European Council meetings afterwards. The Feira European Council[174] adopted the charter for SMEs, endorsed the review of the single market strategy and the Europe action plan and endorsed the broad economic policy guidelines which enhanced synergies between the Cardiff, Cologne and Luxembourg Processes.

The Nice European Council[175] adopted the European social agenda which defines specific priorities for action around six strategic orientations in all social policy areas. The conclusions emphasized the characteristics of the European social model, at the insistence of France: "This Agenda constitutes a major step towards the reinforcement and modernisation of the European social model, which is characterised by the indissoluble link between economic performance and social progress." The Stockholm European Council[176] set the employment targets to achieve an overall employment rate of 67% and 57% for women until 2005 and to increase the employment rate of older persons to 50% by 2010. The Summit also approved a 1.5% of transposition deficit concerning the implementation of single market directives. The Göteborg Council[177] of 15-16 June 2001 agreed on a sustainable development strategy and added an environmental dimension to the Lisbon process. The Barcelona Council[178] called on member states to meet the transposition deficit target of 0% in the case of directives whose implementation is more than two years overdue. The Barcelona Council also set the investment target of 3% of GDP, while the informal Competitiveness Council of April 2008 in Brdo decided to launch the Ljubljana process aiming at creating the European Research area.

174 Presidency Conclusions. Santa Maria da Feira European Council 19 and 20 June 2000. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/00200-r1.en0.htm.

175 Presidency Conclusions Nice European Council Meeting 7, 8 And 9 December 2000. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/00400-r1.%20ann.en0.htm.

176 Presidency Conclusions. Stockholm European Council 23 and 24 March 2001. http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.%20ann-r1.en1.html.

177 Presidency conclusions. Göteborg European Council of 15-16 June 2001. http://ec.europa.eu/smart-regulation/impact/background/docs/goteborg_concl_en.pdf.

178 Presidency conclusions. Barcelona European Council Barcelone, 15-16 March 2002. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/71025.pdf.

1.5.2 Governance under the first cycle of the Lisbon Strategy

The reporting under the stability and growth pact and under the Lisbon Strategy had separate procedures and timetables. Ultimate decisions and endorsements were made by the European Council but as a general rule every Council formation prepared key issues papers summarizing the ministers' views on Lisbon-related questions. The work began in working party meetings at expert level the findings of which were approved by the COREPER and then by the Council. The contributions of various Council formations (key issues papers) were channelled to the European Council which summarized the decisions in Council Conclusions guided by the rotating presidencies. As there has been no legal basis for member states' legal accountability concerning their employment and social actions, national policies were evaluated in the framework of the open method of coordination (OMC) introduced by the Treaty of Amsterdam. As the 20-21 November 1997 Luxembourg extraordinary council adopted the employment guidelines member states could start their Employment OMCs. Member states hosted their partners during the missions then the findings of the examinations were merged into a report, which served as basis of the discussions of the EPSCO ministers in parallel with the findings of the EMCO[179] analysis of Eurostat data. As regards social policy, the OMC was not operational until 2003 because benchmarking in the social area was a heavily controversial topic among member states. In the social field the SPC[180] prepared analysis on the basis of Eurostat data. In short, the strategy was guided by a bottom-up way just like the legislative decision-making process which, together with the varying approach of the rotating presidencies, resulted in the lack of strategic breakthroughs.

1.5.3 The midterm review of the Lisbon Strategy

The report of the High Level Group

The report[181] by Wim Kok on the evaluation of the Lisbon Strategy acknowledged the positive outcomes but also major shortcomings. The reforms delivered by member states did not seem enough to reach the goals.

- Some steps were taken to enhance the level of employment. The employment rate of 62.5% in 1999 had risen to 64.3% by 2003. Seven member states seemed to achieve the 67% goal set for 2005. The employment rate of women went up to 56% by 2003 and some member states could also raise the employment level of elderly which reached 41.7%.

179 Art 130 TEC, currently Art 150 TFEU.

180 Art 144 TEC, currently Art 160 TFEU.

181 Facing the challenge. The Lisbon Strategy for growth and employment. Report from the High Level Group chaired by Wim Kok. http://ec.europa.eu/research/evaluations/pdf/archive/fp6-evidence-base/evaluation_studies_and_reports/evaluation_studies_and_reports_2004/the_lisbon_strategy_for_growth_and_employment__report_from_the_high_level_group.pdf.

- Important steps were taken towards the goals of spreading ICT in public services and the use of internet at schools. Twelve member states reached the goals concerning household internet penetration.
- Nevertheless, net job creation slowed down considerably and the risk of not reaching the 70% goal by 2010 was apparent. The R&D spending goal of 3% was exceeded by only two countries while private R&D spending of 2% of GDP equivalent has also been reached by these two countries.
- Only five countries have reached the 1.5% transposition deficit target of Stockholm.
- There were not major steps taken in the decoupling of economic performance from harmful environmental impacts. The volume of traffic was rising more rapidly than GDP and congestion, pollution and noise level was worsening. Most European countries were below their Kyoto targets.
- The emergence of coordinated reforms has never been more urgent than before.
- As a result of declining birth rates and rising life expectancies, the working age population (aged 15-64) was projected to be 18% smaller by 2020 than in 2003 and the persons aged 65 and over will increase by 60%. The average ratio of persons in retirement would double from 24% to almost 50% by 2050, varying from 36% in Denmark to 61% in Italy. The pure impact of ageing population would be to reduce the potential growth rate from 2-2.25% in 2003 to 1.25% by 2040. The increased pension and health care system spending will demand public spending to be raised by 2% by 2050.
- The enlargement would increase EU population by 20% while GDP only by 5%, reducing the output per head by 12,5%. The average employment rate would lower by almost 1.5%. Though output and productivity growth of the new member state is constantly higher than that of the EU15. When they replace their ageing technologies to new ones, they will jump in their technological capacity. Nevertheless, as they attract inward investment by their low wage and tax rates, their growth strategies are likely to be a source of growing friction.
- Europe's economy is growing less than that of the USA. From the mid-1970s, EU GDP per capita (in PPS) has stabilised at around 70% that of the USA, since 1996, the average annual growth in the EU output per head has been 0.4% below that of the US. At the same time EU productivity growth rate averaged 1.4% as opposed to 2.2% recorded for the US.

Therefore, the high level group has proposed actions both regarding the focusing of the diversity of goals and of reforming the governance structure. On the one hand, the group has proposed to concentrate on five goals:

- the knowledge society (increasing R&D spending and attracting researchers),
- the internal market (adoption and timely and proper transposition of directives),
- the business climate (reducing administrative burden, improving the quality of legislation and facilitating start-ups),
- the labour market (developing LLL an active ageing strategies and performing coordinated labour market reforms),

- environmental sustainability (spreading eco-innovation which leads to sustained improvement in productivity).

On the other hand, the HLG suggested that ownership should be strengthened by

- the European Council taking lead in progressing the strategy,
- member states preparing national programmes which they commit themselves to,
- the Commission reviewing, reporting and facilitating the progress,
- the EP being active in monitoring,
- the European Social Partners being actively involved.

Changes implemented: refocusing on growth and jobs

Based on the report of the high level group the European Commission has proposed the mid-term review of the strategy[182] suggesting that the EU and the member states should concentrate on more growth, more and better quality jobs and the implementation of the Strategy should be governed more efficiently.

In order to achieve more growth member states must focus their efforts on the reforms agreed as part of the strategy and pursue stability-orientated macroeconomic policies and sound budgetary policies. In order to create more and better quality jobs the Commission has proposed to review the European employment strategy in 2005. The goal was to attract more people to the employment market and modernize social protection systems, to improve the adaptability of the workforce and business sector, increase the flexibility of the labour markets and to invest more in human capital by improving education and skills. Moreover, the Commission's new proposal concerning the financial framework for the period 2007-2013 reflected a switch of emphasis in favour of growth and employment. Better governance of the strategy would be crucial in monitoring the implementation. Therefore, the Commission has proposed a simplified coordination which has been approved by member states of the spring European Council[183], which has also adopted the European youth pact and the Council's report on "Improving the implementation of the stability and growth pact", reforming both the SGP's preventive and corrective arm.[184] The national programmes concerning the Lisbon strategy were to be presented in a format bringing together three coordination methods, the Luxembourg, the Cardiff and the Cologne process. Member states were required to prepare their national reform programmes for attaining the strategy objectives and to appoint a national coordinator (Mr or Ms Lisbon) for monitoring the Strategy implementation. They reported about the implementation of the strategy to the Commission every year and at the beginning of every three-

182 A new start for the Lisbon Strategy. Working together for growth and jobs. Communication to the Spring European Council. Brussels, 2.2.2005. COM(2005) 24 final.

183 Presidency Conclusions. European Council Brussels 22 and 23 March 2005. Brussels, 23 March 2005

184 The commitments of the European Council concerning the SGP-reform have been incorporated by the Council Regulation (EC) No 1055/2005 of 27 June 2005, amending COUNCIL REGULATION (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

year cycle they present their new reform programmes. The implementation of the Lisbon Strategy was carried out via the open method of coordination, i.e. voluntary coordination of the member states' policies in the areas where the EU does not have exclusive competences. Emphasis was placed on the exchange of good practices and experiences between the member states with the Commission's surveillance role. The Commission prepared an overview of attaining the Lisbon objectives every year which was included as part of the report to the Spring European Council. At the same time the Commission prepared country-specific recommendations for the member states regarding the implementation of national reforms in line with the Lisbon Strategy.

The integrated guidelines

The broad economic policy guidelines (under Art 99 TEC)[185] and the employment guidelines (Art 148 TEC)[186] were merged into a single guidance document[187] of 24 Integrated Guidelines. Macroeconomic policies were to support growth and jobs by respecting medium-term budgetary objectives avoiding pro-cyclical fiscal policies; by reducing public debt, to reinforce pension, social security and health care systems and increase labour market participation; by redirecting public expenditure towards growth-enhancing categories, by adapting tax structures in order to strengthen growth potential. Mechanisms were to be put in place in order to assess the relationship between public spending and the achievement of policy objectives aimed at ensuring the coherence of the reforms; by promoting nominal wages and labour cost developments consistent with price stability and the trend in productivity over the medium term; by pursuing labour and product market reforms that increase growth potential and reinforce the macroeconomic framework by increasing flexibility, factor mobility and adjustment capacity in labour and product markets in response to globalisation, technological advances, demand shift and cyclical changes. Investment in human capital was to be increased.

At the same time microeconomic reforms were to raise Europe's growth potential by increasing investment in R&D to 3% of GDP by 2010, improving framework conditions to ensure that companies operate in a sufficiently competitive and attractive environment. The reforms also aimed to raise the growth potential by developing public-private partnerships, developing and strengthening centres of excellence of educational and research institutions, improving the transfer of technologies between research institutes, and focusing on improvements in innovation support services, in particular for the dissemination and transfer of technology. Furthermore, they tried to assist by the creation of innovation poles bringing together research institutes and universities, encouraging the widespread use of ICT in public services, small and medium-sized enterprises and households, establishing attractive framework conditions for manufacturing and enhancing competitiveness factors in response to the challenges

185 Currently Article 212 of TFEU.
186 Currently Article 148 of TFEU.
187 Council Decision 2005/600/EC of 12 July 2005 on guidelines for the employment policies of the member states.

of globalisation. The reforms also meant to help by giving priority to energy efficiency and the development of sustainable energies, in particular renewable energies, and by promoting the rapid spread of environmentally friendly technologies, speeding up the transposition of internal market directives and giving priority to removing the regulatory and trade barriers that hinder competition, by reducing the administrative burden on enterprises, particularly SMEs and start-ups, and simplifying tax systems and reducing non-wage labour costs.

The governance system of the renewed strategy
Two three-year cycles were established: 2005–2008 and 2008–2011. After the first cycle the Commission prepared a strategic report to serve as a basis for continuing the process in the second cycle. The Integrated Guidelines were re-examined but remained unchanged in the last cycle of the renewed strategy. Taking into account the Integrated Guidelines and the schedule proposed by the European Commission, the member states wrote their respective three year national reform programmes[188] (NRP) in the light of their specific conditions. The NRPs for the first cycle were prepared by the end of 2005, for the second cycle by the end of 2008. The employment OMC has been supplemented by the streamlined social OMC, already using social indicators agreed by the SPC-members. The bottom-up approach of the governance model has remained the same as before.

The evaluation of the strategy
As the Commission has stated in its evaluation document[189], the main targets (70% employment rate and 3% of GDP spent on R&D) will not have been reached. The EU employment rate has been raised to 66% in 2008 from 62% in 2000 but the crisis had negative effects of the change of trends in employment. The productivity gap with leading industrialised countries could not be closed: R&D spending improved only marginally (from 1.82% in 2000 to 1.9% in 2008). The overall conclusion was that the success of the Lisbon Strategy was the strategy itself; member states' acknowledgements that Europe needed coordinated reforms in areas outside the SGP performed in coherence with the reformed SGP. The Lisbon strategy focused on the right structural reforms which even partially performed made the EU economy more resilient (facilitated the quick adoption and swift implementation of the european economic recovery plan) and the earmarking of structural funds helped to mobilise considerable investments (over €228 billion during the programming period 2007-2013). The adoption of the third energy package and the services directive and the setup of the European Institute of Technology are important and tangible results of the peer pressure represented by the strategy. However, it could not focus on critical elements which played a role in the crisis; the robust supervision and systemic risk in financial

188 For the national reform programmes see: http://ec.europa.eu/archives/growthandjobs_2009/documentation/idex_en.html#national.

189 Lisbon Strategy evaluation document. Commission Staff Working Document. Brussels, 2. 2. 2010. SEC(2010) 114 final.

markets, speculative bubbles and credit-driven consumerism which accounted in high current account deficits. Macro-economic imbalances and competitiveness problems were not adequately addressed in the surveillance of member states' economies carried out through the SGP and the Lisbon Strategy which tended to operate in parallel rather than complementing one another. Although the open method of coordination proved to be a useful tool for coordination, the governance and the ownership of the strategy have not improved sufficiently even after the midterm review because there were no political and legal consequences of the lack of implementation. Moreover, in absence of proper and targeted communication the necessity of the strategy was not explained which resulted in the lack of awareness and public support.

2. The Europe 2020 Strategy

Having seen the weaknesses of the strategy and intending to correct the main failures of its predecessor, the Commission's proposal on the Europe 2020 Strategy[190], which was endorsed by the European Council of 25 and 26 March 2010[191], mainstreams fundamental economic social and environmental objectives both at EU level (through the use of funding programmes and policy initiatives) and in the context of national reforms. The strategy continues to promote growth based on knowledge and innovation, aiming at high employment but still delivering social cohesion and in a sustainable perspective both in competitive and environmental terms.

2.1 Numerical targets

The goals of the strategy are reflected in the five measurable targets approved by the European Council of March[192] and June 2010[193]:

- 75% employment rate for the 20-64 age group;
- 3% of GDP investment rate in R&D;
- 20/20/20 climate and energy targets (the reduction of greenhouse gas emissions by at least 20%, a share of final energy consumption coming from renewable energy sources increased to 20% and an energy sufficiency of 20%);

190 Europe 2020. A Strategy for smart, sustainable and inclusive growth. Communication from the Commission. Brussels, 3.3.2010. COM(2010) 2020 final.

191 From 1 January 2009, by virtue of the Treaty of Lisbon, the European Council is chaired by its standing president and it is seated in Brussels.

192 European Council Conclusions. 25/26 March 2010. Brussels, 26 March 2010. EUCO 7/10. CONCL 1.

193 European Council Conclusions. 17 June 2010. Brussels, 17 June 2010. EUCO 13/10CO. CONCL 2.

- improving the education levels (a reduction of school drop-out rates to under 10%, and increase the share of the population aged 30-34 having completed tertiary or equivalent education over 40%);
- reduction of the number of people living in poverty by 20%.

The member states, having consulted the Commission, had to translate these targets to national goals in a way that they should be realistic but needing considerable efforts to be fulfilled.

2.2 Tools of implementation

2.2.1 Flagship initiatives

The way of achieving the measurable targets is specified in a series of actions and policies published as part of 7 flagship initiatives.

Flagship initiative "Agenda for new skills and jobs", consisting of 13 key actions accompanied by several support elements, was focussing on employment including the issues of flexicurity, skills, working conditions and job creation. It set up four major priorities:

- to help the European labour markets function better by the use of flexicurity policies,
- to endow people with skills adapted to labour market needs,
- to improve working conditions and
- to promote job creation.

Flagship initiative "Youth on the move" covers education and employment and is intended to enhance the performance of education, address the challenges young people face on the labour markets and facilitate the transition from school to work. Its priority areas are:

- supporting the acquisition of skills through learning,
- encouraging mobility,
- promoting the participation of young people in higher education and
- support youth employment.

Flagship initiative "Innovation union" is a package of 34 legislative and non-legislative actions with a focus on creating an innovation-friendly environment within the EU.

Flagship initiative "Digital agenda for Europe" is a group of 101 actions grouped by 7 pillars aimed at achieving a competitive digital single market.

Flagship initiative "Industrial policy for the globalisation era" is a set of 70 key actions (including innovative financing tools) aiming at enhancing the competitiveness of the European industry. It puts emphasis on the combination of innovation, diversification and sustainability to encourage the setting up and development of SMEs.

Flagship initiative "Resource-efficient Europe" supports the shift towards a resource-efficient and low-carbon economy by decoupling growth and resource use and provides a long-term framework for embedding resource efficiency in the design of energy, transport, industry agriculture policies and so on.

Flagship initiative "The European platform against poverty and social exclusion" identifies the tasks for the Commission and of the member states in combatting poverty and social exclusion by 64 actions.

2.2.2 Integrated Guidelines

The broad economic policy guidelines and the employment guidelines, just like in the second cycle of the Lisbon Strategy, are merged into a single document called integrated guidelines. Since the Council of the European Union has a thematic working method, Guidelines 1-6 (the broad economic policy guidelines under Article 121 of the TFEU) were adopted by the Ecofin Council on 13 July 2010 in the form of a Council recommendation[194], while the employment guidelines (under Art 148) were adopted by the EPSCO Council in a form of a Council Decision[195] on 21 October 2010, only after having consulted the European Parliament. The integrated guidelines remain unchanged until the end of 2014 and will be revisited in 2015 in the framework of the general revision of the strategy.[196]

The Europe 2020 Integrated Guidelines

(1) Ensuring the quality and the sustainability of public finances.
(2) Addressing macroeconomic imbalances.
(3) Reducing imbalances within the euro area.
(4) Optimising support for R&D and innovation, strengthening the knowledge triangle and unleashing the potential of the digital economy.
(5) Improving resource efficiency and reducing greenhouse gases.
(6) Improving the business and consumer environment, and modernising and developing the industrial base in order to ensure the full functioning of the internal market.
(7) Increasing labour market participation and reducing structural unemployment.
(8) Developing a skilled workforce responding to labour market needs, promoting job quality and lifelong learning.
(9) Improving the performance of education and training systems at all levels and increasing participation in tertiary education.
(10) Promoting social inclusion and combating poverty.

194 Council Recommendation on broad guidelines for the economic policies of the member states and of the Union. Brussels, 7 July 2010. http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2011646%202010%20INIT.

195 Council Decision of 21 October 2010 on guidelines for the employment policies of the member states (2010/707/EU).

196 European Council Conclusions, 20/21 March 2014. Brussels, 21 March 2014. point 2.

2.2.3 Accompanying instruments

The implementation of the strategy is supported by measures accomplishing the single market by exploiting possibilities of the EU budget and of the new capacity of the European Union's legal personality deriving from the Lisbon Treaty.

The basic regulations and directives concerning the single market were adopted since directive 2004/38/EC on the free movement of persons and directive 2006/123/EC on the internal market services, as previously heavily debated directives have already been in force since then. Further proposals of the Commission regarding financial and digital services, labour law proposals have been mentioned in the Single Market Act I[197] while transport and digital services, proposals concerning social entrepreneurship and improving the business environment have been incorporated into the Single Market Act II[198] packages of the Commission. Both communications of the Commission were based on the proposals of the two times former Commissioner professor Mario Monti.[199]

Furthermore, the implementation of the strategy is supported by measures exploiting possibilities to improve the effectiveness and efficiency of the EU budget through stronger prioritisation and through better alignment of EU expenditure with the goals of the Europe 2020 to address the fragmentation of EU funding instruments by designing new financing instruments with the involvement of the European Investment Bank and the European Investment Fund and by regulatory dialogues in new areas such as climate and green growth.

At last, the EU's legal personality will enable the Commission and the High Representative to act more efficiently than before in high-level strategic dialogues with key partners, to discuss strategic issues and in reinforcing the Transatlantic dialogues with the US, the High Level Economic Dialogue with China and deepen its relationship with Japan and Russia. Under regulation 1219/2012/EU[9] the Commission can authorize under certain conditions member states to negotiate and conclude BITs with countries with which the EU does not plan to negotiate in the near future. Concerning countries of common interests, the Commission has the right to set common guidelines in concluding free trade agreements so as to maintain the approximate net positive income of €75 billion per year.

2.2.4 Governance

The inefficient governance model of the Lisbon strategy had been heavily criticized therefore, important reforms has been taken in this context. The first plans of the

197 Single Market Act I. Twelve levers to boost growth and strengthen confidence "Working together to create new growth". Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions. 13. 14. 2011. COM(2011)0206 final.

198 Single Market Act II. Together for new growth. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Brussels, 3.10.2012. COM(2012) 573 final.

199 A new strategy for the single market at the service of Europe's economy and society. Report to the President of the European Commission Jose Manuel Barroso by Mario Monti. 9 May 2010.

Commission to sanction non-performing member states have soon been outvoted. However, important steps have been taken which were based on the new legal and institutional setup which entered into force on 1 December 2009. The bottom-up approach has been reverted; the European Council is clearly in charge of driving the process on the basis of the Commission's proposals. The permanent President of the European Council and its team is a very important player of the process ensuring the possibility of high level political dialogues before the difficult decisions. Besides, the European Commission has a much stronger role as well since it has the privilege of

- preparing each November the annual growth survey (AGS) defining the Union's goals for the following year,
- evaluating each member state's NRP in the context of the AGS and of the Council's guidance adopted in the form of council conclusions,
- proposing country specific recommendations for each country, if it deems necessary to align the NRPs with the EU's goals. Country-specific recommendations as such were tools used during the second cycle of the Lisbon Strategy. Under the Europe 2020 Strategy they are currently adopted by reverse majority voting (i.e. qualified majority of member states are able to change the recommendations proposed by the Commission). Furthermore, recommendations are endorsed by the June European Council, reflecting this way the highest possible level of commitment towards their implementation.
- based on its new capacity under Article 121(4) of the TFEU to issue 'policy warnings' if a member state fails to deliver on objectives defined in the Broad Economic Policy Guidelines (Guidelines 1-3 of the Integrated Guidelines).

The governance framework of the strategy is the European semester (dealt with separately in Chapter V), which starts with the publication of the AGS and ends with the adoption of the country specific recommendations. the integrated guidelines serve for the basis of both the annual growth survey and the member states' NRPs. Since NRPs must be prepared by the member states in parallel with the convergence or growth programmes, the reporting system is also better coordinated with the stability and growth pact reporting system, ensuring that member states' macroeconomic reforms are better coordinated with the thematic initiatives expected to be driven by the Europe 2020 Strategy.

2.3 The coordination in the employment and social and in the microeconomic fields

From the very beginning of the European Integration, economic reform programmes were accompanied by legislative packages. This is not an outstanding phenomenon since the European Union's main distinctive feature is its legislative and judiciary power. So it is evident that measures falling under the legislative competency of the EU are put through the legislative process with the result of legally binding and enforceable acts. These measures are usually packaged by the Commission with a view of endorsement by the European Council. The actual legislative proposals are then adopted by the relevant procedure and must be transposed by the member states. The latest packages of the Commission were the Single Market Acts of 2011 and 2012 proposing twelve measures for negotiation and adoption respectively. However, the attainment of the goals of the strategy needs a lot of measures falling outside the EU's competence; therefore, the Commission is guiding member states via soft tools: recommendations (Youth Guarantee[200]) and communications (the employment package of 2012[201]) and channelling financial resources to insist on implementing them in a mutually agreed way. A good example for this is the obligation to allocate 23% of cohesion spending on projects promoting employment and to include implementing measures (such as the preparation of a strategy concerning early childhood education or life-long learning) as ex-ante conditionalities of the operative programmes of member states.

2.4 The examination and analysis of indicators as a basis of giving guidance for member states in the form of Country-Specific Recommendations

2.4.1 Microeconomic coordination (Guidelines 4-6)

Optimising support for R&D and innovation, strengthening the knowledge triangle and unleashing the potential of the digital economy (Guideline 4)
Member states have to review their national R&D and innovation systems, ensuring effective and adequate framework conditions for public investment within the budgetary consolidation strategies under the stability and growth pact, and orienting them towards higher growth while addressing, where appropriate, major societal challenges (including energy, resource efficiency, climate change, biodiversity, social and territorial cohesion, ageing, health, and security) cost-effectively. In particular, public investment should serve to enhance private R&D financing. The reforms should foster excellence and smart specialisation, promote scientific integrity, reinforce cooperation between universities, research institutes, public, private and third sector players, both domestically and internationally and ensure the development of infrastructures and networks that enable knowledge diffusion. The governance of research institutions should be improved to make national research systems more cost-effective and productive. To this end, university-based research should be modernised, world-class infrastructures developed and made accessible, attractive careers and the mobility of researchers and students should be promoted. Funding and procurement schemes

200 Council recommendation of 22 April 2013 on establishing a Youth Guarantee. 2013/C 120/01.

201 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. Towards a job-rich recovery. Strasbourg, 18.4.2012. COM(2012) 173 final. {SWD(2012) 90 final}, {SWD(2012) 92 final}, {SWD(2012) 93 final}, {SWD(2012) 95 final}, {SWD(2012) 96 final}, {SWD(2012) 97 final}, {SWD(2012) 98 final}, {SWD(2012) 99 final},{SWD(2012) 100 final}.

should be adapted and simplified, helping to facilitate cross-border cooperation, knowledge transfer and merit-based competition, building on synergies and achieving greater value.

Improving resource efficiency and reducing greenhouse gases (Guideline 5)
Member states and the EU have to promote the decoupling of economic growth from resource use, turning environmental challenges into growth opportunities, implement the necessary structural reforms to be successful under increasing global carbon and resource constraints in creating new business and employment opportunities and increase resource efficiency. The EU and member states should speed up the creation of an integrated and fully functioning internal energy market to enable gas and electricity flows without bottlenecks. Member states should reduce emissions and better adapt to climate change, support sustainable growth and jobs and resource efficiency in a cost-effective manner, incentivise the use of renewable energy and low-carbon climate-resilient technologies, a shift to more environmentally-friendly and interconnected modes of transport and promote energy savings and eco-innovation. Member states should phase out environmentally harmful subsidies.

Improving the business and consumer environment, and modernising and developing the industrial base in order to ensure the full functioning of the internal market (Guideline 6)
While ensuring the protection of consumers, predictable framework conditions for business should be set up ensuring well-functioning, open and competitive goods and services markets. In particular, actions should aim for the deepening the single market and regulation system, notably in the financial sector, as well as the promotion of a level playing field in financial markets at global level, the effective implementation and enforcement of single market and competition rules, and developing the necessary physical infrastructure, also with a view to reducing regional disparities.

The implementation of these guidelines is evaluated through the examination of a large number of product market and performance indicators:

- performance indicators (labour productivity in total economy, labour productivity in manufacturing, labour productivity in electricity, gas, steam and air conditioning supply, labour productivity in the construction sector and the total number of patent applications);
- policy indicators (the days of enforcing contracts, time to start business, R&D expenditure in GDP%, tertiary education attainment, total public expenditure on education, the intensity of overall product market regulation, the intensity of product market regulation in the retail sector and in the network industries) and
- green growth performance indicators (macroeconomic, sectoral and energy security).

In the field of microeconomic coordination, the Commission is insisting on member states to transpose them in time and to implement the adopted legislation, to speed up the infringement procedures and to comply the ECJ's ruling in the shortest possible time. The Commission is also preparing communication instruments: every year a competitiveness report, an Innovation Scoreboard and an Industrial Performance

Scoreboard is published, twice a year a single market scoreboard is prepared and each November, a single market integration report is attached to the annual growth survey. On the other hand, member states' performance regarding these guidelines is evaluated by the Commission.

2.4.2 Employment and social affairs, education, health (Guidelines 7-10)

The "old" model of employment and social OMC has remained, meaning that member states evaluate each other's performance and share their best practices via peer review visits. The findings of the reviews are incorporated into a report presented to the March EPSCO and European Council.

On the other hand, the numeric targets of the Europe 2020 Strategy require detailed analysis and evaluation of member states' performance. Deriving from Article 148 of the TFEU, the EPSCO Council preceding the actual European Council give policy briefing in employment and social policy issues to the Ecofin and the European Council. The basis of the documents prepared by the EPSCO and the Ecofin is the qualitative and quantitative analysis carried out on the basis of the NRPs. The goal of the policy coordination is to get close to the numerical targets of the Europe 2020 Strategy:

- raising the employment rate by 75% until 2020;
- attaining that 40% of the 30-34 years old population have a higher education degree;
- reducing the share of early school-leavers (28-24 years) under 10%;
- reducing the number of people living in poverty by 20 million, with the sub-indicators:
    - at risk of poverty or social exclusion rate (the sum of persons who are: at-risk-of-poverty or severely materially deprived or living in households with very low work intensity as a share of the total population);
    - severe material deprivation rate (share of population living in households lacking at least 4 items out of the following 9 items: i) to pay rent or utility bills, ii) keep home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) a week holiday away from home, or could not afford (even if wanted to) vi) a car, vii) a washing machine, viii) a colour TV, or ix) a telephone);
    - share of population (aged 0-59) in very low work intensity households (people aged 0-59, living in households, where working-age adults (18-59) work less than 20% of their total work potential during the past year).

Employment guidelines which have to be taken into consideration when preparing NRPs are the following:

Increasing labour market participation of women and men, reducing structural unemployment and promoting job quality (Guideline 7)

In order to meet the 75% employment objective, member states have to promote the labour market participation of young people, older and low-skilled workers and legal migrants. Therefore, national policies must in particular promote the principles of flexicurity, worker mobility and work-life balance. Member states must make employment more attractive, particularly for the low-skilled, while ensuring that labour costs are consistent with price stability and productivity trends. Member states must promote self-employment and entrepreneurship. They must foster job creation, including in the areas of care and green employment.

Developing a skilled workforce responding to labour market needs and promoting lifelong learning (Guideline 8)
Member states must extend the capacity of education and training systems and foster their adaptation to societal trends towards a low-carbon and resource-efficient economy. In this perspective, measures taken must ensure quality of early education and lifelong training opportunities. Training must be open both to low-skilled and highly skilled workers, and be organised in cooperation with social partners and enterprises. Member states, through systems for recognising acquired competencies, should also encourage labour mobility.

Improving the quality and performance of education and training systems at all levels and increasing participation in tertiary or equivalent education (Guideline 10)
By 2020, early school leaving is to be reduced to less than 10% and at least 40% of the 30-34 year-old population is to have completed tertiary or equivalent education. This target means investing in the quality of education and training systems, by adapting teaching methods to societal trends and making employability a priority. Member states must also promote lifelong learning, including through non-formal methods. They must also foster the international mobility of teachers and learners, the development of qualification frameworks enabling flexible learning pathways, and partnerships with enterprises.

Promoting social inclusion and combating poverty (Guideline 10)
In order to exempt 20 million people from the risk of poverty and exclusion by 2020, member states should pay particular attention to the employment of those furthest away from the labour market but must also combat in-work poverty. National policies must provide guarantees of access to affordable, sustainable and high quality services, including in the social sector. Member states should also aim to ensure that social protection and pension systems are modernised and viable and shall support the social economy and social innovation, fostering equal opportunities and combating discrimination.

Qualitative and quantitative assessment of employment and social trends is performed by the EMCO and SPC, involving the Commission. In March an employment performance monitor[202] and a social protection performance monitor[203] is drafted by EMCO and SPC respectively with in-depth review of both the EU and

202 Foundations and structures for a Joint Assessment Framework (JAF) including an employment performance monitor to monitor the employment guidelines under Europe 2020 Strategy.
203 Social protection performance monitor (SPPM) – methodological report by the Indicators Sub-group of the social protection committee. Social protection committee. 17 October 2012.

national level of dynamics. Analysis is provided on the basis of benchmarks approved as the joint assessment framework[204] and of the social indicators approved by SPC members. In addition, from 2014 on an employment and social scoreboard is attached to the document with the performance in the key indicators able to capture at an early stage developments that require specific attention in the context of the monetary union because of their severity and/or because they reflect divergences between countries that potentially undermine the well-functioning of the EMU. These indicators are:

- unemployment level and change;
- young people (aged 15-24 years) not in employment, education or training;
- changes in real gross disposable income of households;
- changes in the at-risk-of-poverty rate of the working age population;
- inequalities (S80/20 ratio).

From 2011 on a Joint employment report (JER) attached to the AGS is evaluating how member states have implemented the CSRs and describing the employment and social developments regarding the common Europe 2020 goals: the EU-wide unemployment and activity rate, labour market mismatches, problems in labour taxation, labour market segmentation, active labour market policies, gender equality, work-life balance, social security systems and lifelong learning strategies, the situation concerning early school leavers and high level education, the inclusivity of labour markets, the sustainability of social protection systems, the steps taken towards inter-generational transmission of poverty, the proposed measures in order to achieve the goals and so on..

Besides the aforementioned indicators more than 20 employment and 17 social indicators are being examined to help analysis for evidence based policy-making and multilateral surveillance. On basis of these data published in a structured way by Eurostat, the Commission is proposing CSRs[205], which are at the moment not legally, but politically binding documents, as adopted by the European Council.

2.5 The results so far

How did member states succeed in reaching the numerical targets?[206]

1) In order to reach the 75% target concerning the employment rate 16 million more people should be employed than today. The aggregate of national target is 74%, so the EU target could not be reached even if every member

204 Foundations and structures for a joint assessment framework (JAF) including an employment performance Monitor to monitor the employment guidelines under Europe 2020 Strategy.

205 http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm.

206 For a detailed analysis of both EU and national level developments see: Taking stock of the Europe 2020 Strategy for smart, sustainable and inclusive growth. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. Brussels, 5.3.2014. COM(2014) 130 final.

states could reach its national goal. The EU level employment rate of aged 20-65 was 68.5% in 2010 and 68.4% in 2012. Active labour market policies (helping unemployed to get jobs) should be used in a more efficient way by member states.

2) Projections show that 2.2% of the GDP will be invested into R&D by 2020, so the 3% target will definitely not be met. The aggregate of national targets would only amount at 2.6%. Progressing more rapidly towards the 3% target needs faster structural change towards more knowledge-based economic activities.

3) There is a better chance to achieve the climate/energy targets:

a) It is projected that by 2020 greenhouse gas emission will lessen by 18% which means that by 2020 greenhouse gas emission will reduce by 24% of the level of 1990.

b) Increase the share of renewable energy in final energy consumption to 20%. Based on the latest trends the target within reach since the share of renewables in gross final energy consumption might approach 21% in 2020. From 7.5% in 2000 the share of renewables in gross final energy consumption increased to 8.5% in 2005 and 14.4% in 20124, i.e. 5.6 percentage points below the Europe 2020 target. The EU is now in the lead in terms of investment in renewables, there has been a rapid development in wind and solar energy.

c) Between 2000 and 2006, primary energy consumption has steadily increased, from 1617.8 Mtoe (million tonnes of oil equivalent) in 2000 to a peak of 1711.6 Mtoe in 2006. As of 2007, the onset of the crisis led to an almost uninterrupted fall in primary energy consumption, to 1583.5 Mtoe in 2012. Reaching the 2020 target would mean cutting primary energy consumption by a further 6.3% by 2020.

4) Educational targets:

a) The indicator of early school leavers has followed a steadily decreasing trajectory since 2000 and has declined from above 17% in 2008, to 15.7% in 2005 and 12.7% in 2012 in the EU. However, this remains 2.7 percentage points above the Europe 2020 target of 10%.

b) The goal to increase the share of the population aged 30-34 having completed tertiary education to at least 40% is within reach by 2020. With a rate of 22.4% in 2000, 27.9% in 2005 and 35.7% in 2012, corresponding to an increase of 13.3 percentage points in 12 years, the EU has significantly advanced towards its target and the number of tertiary graduates has rapidly increased. Only 4.3 percentage points separate the current EU performance from the 40% Europe 2020 target.

5) Lift at least 20 million people out of the risk of poverty or social exclusion. The years until 2009 were marked by a steady decrease in the number of people exposed to poverty or social exclusion. The lowest level was reached in 2009, with around 114 million people at risk of poverty or social exclusion, against more than 124 million in 2005. However, the crisis offset these positive developments and led to a rise in the values of the EU28 aggregates, with the number of people at risk of poverty or social exclusion increasing to more than 118 million in 2010, more than 121 million in 2011 and more than 124 million in 2012. Two sub-indicators, the share of people living in monetary poverty and in severe material deprivation has increased most rapidly, the letter one by 7.1 million people since 2010. Based on recent trends and according to the latest projections the EU target of reducing the number of people at risk of poverty or social exclusion to 96.4 million by 2020 is unlikely to be met and the indicator might remain close to 100 million.

2.5.1 Some more data behind the numerical targets[207]

The statistical data show that the EU is still behind its competitors in productivity gains. The gap between the EU-USA growth rates were widening: between 1995 and 2004, the average GDP growth rate in the US was 3.3%, 0.85% percentage points higher than that of the EU. Between 2004 and 2007, the EU started to grow faster (3%) than the US (2.5%), mostly linked to the growth rate of the 2004 accession round countries. After the outbreak of the crisis, recovery returned and performance of the EU improved in 2010-2011 but the sovereign debt crisis caused fall in the output again in 2012. Both the US and Japan suffered drops in output in 2009, but while the growth rate of Japan and of the EU seem to stagnate since 2011, the growth rate of the US is constantly increasing since 2009. The situation is even worse when the GPD per hour rate is taken into account; the US is definitely the forerunner with more than 130% of GDP per hour rate in 2013 compared to the situation in 1995, while both the EU and Japan stand on 120% . This is mainly caused by efficiency gap related to regulations, by lower investment in ICT and intangible assets. The efficiency gap in regulations is mainly deriving from the improper transposition and selective application of the Services Directive[208] which brings evident need for the ambitious implementation of the directive since more than 60% of both the EU's GDP and employment is coming from the services sector. The second important factor is the ICT, which could help reducing inefficiencies in the use of resources, but technical efficiency between the US and EU is narrowing because of the decline of the efficiency of the US. Intangible assets (R&D, human capital, etc.) are important sources of sustained long-term competitiveness. However, R&D spending in the USA is almost 1.5 times higher (2.7%) than in the EU (1.85%) which is due to underperformance in all sectors in the EU. The EU is also lagging behind in patenting and in the transmission of research results from the laboratory to the market. This process will in medium-term may cause problems by eroding current EU comparative advantages in medium-high technology industries such as pharmaceuticals, optical, electrical, medical and surgical

207 For more data see: Joint Employment Report. Accompanying the Communication from the Commission on Annual Growth Survey 2012. Brussels, 13. 11. 2013. COM(2013) 801 final.; Employment and Social Developments in Europe 2013.European Commission. 2013.; member states' industrial performance and the implementation of EU industrial policy. Industrial Performance Scoreboard. Edition 2013.; Towards a knowledge driven reindustrialisation. European competitiveness report 2013. European Commission, 2013.

208 The directive 2006/123/EC on the services in the internal market.

equipment, telecom and office equipment, accumulators and batteries, radio and TV. In key enabling technologies like industrial biotechnology and advanced materials, R&D intensity of EU manufacturing is 62% of that of the USA while between 1995 and 2011 Brazil, India and China all increased considerably their market shares in global value added exports of manufactures. R&D commercialisation is the less efficient where R&D investments are mostly done by the government. In order to maintain the EU's position in the global supply chain it is also vital to strengthen not only the services sector (representing roughly 60% of the GDP and employment) but also the manufacturing (representing around 15% of share in GDP) since it is not only decisive from the point of view of R&D absorption but also because there are important 'backward linkages' from manufacturing to services, in particular business services.

At the same time, the 2008 crisis had substantial negative effect on the EU's labour market. Employment rate of the EU between 2008 and 2013 was lower (EU: around 64%, US: around 67%[209]) and unemployment rate was higher (EU: 10.6%, US: 6.7%) than of the US and of the OECD average. However, the picture is very mixed when it comes to the numbers broken down by member states. Employment rate is 79.8% in Sweden, 76.5% in the Netherlands and 77.1% in Germany, while it is as low as 53.2% in Greece and 59.8% in Croatia and Italy. Unemployment rate in Greece is 27.5%, in Spain 25.8%, in Portugal 15.3%, while 5.3% in Germany, 6.5% in the Czech Republic and 6.8% in Denmark. Part-time jobs mean real alternative to join the labour market but in most cases (EU: around 70% in all countries, US: 60%) part-time workers only work part time because they have not been able to find a full-time job. While the average duration of unemployment in the USA is 6.3 months, it is 11.6 in the EU. Again, data vary from country to country: in Hungary it is 12.4 months, while in Finland it is only 3.6. While the real hourly minimum wages (in ppp) in 2013 was $7.1 in the US, in Estonia it was $2.9, in Slovakia and in the Czech Republic $3.3. Youth unemployment rate is 23.5% in the EU and long term (at least one year) unemployment rate is constantly rising, reaching 4.7% in 2012. Between 2008 and 2012 employment was hit harder (-2.4%) by the crisis than the GDP declined (-1.1%). Thanks to the working-time reduction policies in some member states, the number of working hours decreased only moderately (-1.6%), while hourly productivity made headway (+3.1%). The rise of part-time and temporary work contract in every member state shows how firms are trying to adapt to difficult conditions. It is interesting to see that in half of the member states real unit labour cost rose (e.g. in Estonia with over 2%) during 2012 while mostly in the eurozone periphery (e.g. in Greece with nearly 6%) it sharply declined. The crisis increased the migration within the EU (+22% over 2010-2012) while migration from third countries declined sharply (-9% from 2010 to 2012). Migration is particularly strong from the eurozone periphery (Spain, Portugal and Greece) to Germany, to the UK and to the Netherlands. The stabilizing effect of social spending on household incomes decreased after 2010. New jobs will be driven by new market exploitation of KETs and ICT, while possible new jobs will be catalysed

209 OECD: Labour Force Statistics.

by the ICT and the telecom sector and by the green economy, provided they will be skilled. Future skills needs move into the direction of higher educated and better skilled workers, while there are huge disparities among member states; the highest share of low-skilled workers live in Portugal (51%) while the lowest in Slovakia (4%). Undeclared work represents 2% to 30% of the GDP while the EU has an average of shadow economy of 14.3% of its GDP. The size and structure of social expenditure also varies from member state to member state. Romania has some 17% of social expenditure in its GDP share while Denmark some 10 pp. higher. Poland, Malta and Italy spend a lot on pensions; Ireland, Spain, Belgium and Finland have generous unemployment benefits, while Finland, Denmark, Ireland and Luxembourg provide the most family related expenditure. The number of people living at risk of poverty rate became much higher since 2008. The number of Europeans at-risk-of-poverty or social exclusion increased by 8.7 million to 25.1% of the EU28 population in 2012. The household disposable income is also declining in real terms in an uneven way among member states. The three countries most severely hit were Cyprus (-7%), Romania and Spain (-4.2%). The number of young people who are unemployed, not taking part in education or training increased by 2 pps to 12.9% by 2012. Early school leaving levels are gradually going down, now starting at 12.7%. In some member states (Bulgaria, Latvia, Romania, Estonia and Italy) access to healthcare system have become more difficult than in 2008.

2.6 The way forward

Since the beginning of the depression in 2008 it became clear that coordination measures at hand should be more binding and should be supplemented by long term measures. By 2008 the common currency was backed by a varying diversity of economic policies even within the eurozone. It was based on highly regulated and unified financial services and capital market with less unified single market of goods and services and, when compared to the US, with a moderate but uneven migration potential of persons. As result of the first set of the reform package, the basic requirements of the fiscal stability were adopted; financial regulatory bodies were set up on European level (the European Systemic Risk Board, the European Securities and Markets Authority the European Insurance and Occupational Pensions Authority) as result of the de Larosière report, the new governance cycle of the Europe 2020 Strategy was created and the so called 'six pack' and 'two pack' was adopted. Furthermore, using its new power under the Lisbon Treaty, the European Council created the legal possibility of bail-out for eurozone countries by its decision of 2011/199/EU[210].

210 European Council Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for member states whose currency is the euro (2011/199/EU).

As urgent measures in the financial turmoil two legal instruments were adopted during 2011-2012: The Euro Plus Pact, adopted by the 24-25 March 2011 European Council[211], with the goal of wider economic policy coordination. The contracting parties (the eurozone countries and Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) committed themselves to

- monitor wages, wage setting agreements and indexation, and productivity trends;
- ensure that wages settlements in the public sector support the competitiveness efforts in the private sector;
- adopt measures to increase productivity;
- increase productivity, such as further opening of sheltered sectors, removing red tape and improving the regulatory framework and improving education systems and promote R&D, innovation and infrastructure;
- remove unjustified restrictions on professional services and the retail sector;
- implement labour market reforms applying flexicurity;
- invest more into life-long learning;
- implement tax reforms to raise labour participation;
- reform pensions by aligning the pension system to the national demographic situation, and by limiting early retirement schemes and using targeted incentives to employ older workers;
- and reform their health care systems.

Member states signing the pact report their national measures in their National Reform Programmes. The Treaty on Stability, Coordination and Governance[212] mostly deals with budgetary and fiscal issues but its Article 11 has reference to the need of an ex-ante coordination of economic policy reforms. These instruments, as international agreements concluded by member states, are legally binding and enforceable by the ECJ under Article 273 of the TFEU.

The difficult global conditions, however, urged the EU leaders to elaborate a comprehensive package of long-time measures. It was clear that the absence of exchange rate adjustments requires efficient labour and product markets. This is essential to fight large scale unemployment, and to facilitate price and cost adjustments that are the key of competitiveness and growth. Therefore, promoting labour mobility across borders and addressing skills mismatch in the labour market were to be tackled urgently. As part of the initiative[213] made by the presidents of the European Council, the Commission, the eurozone and the European Central Bank, the economic policies of member states should be better coordinated to avoid excessive divergences. The basis of the measures

211 European Council Conclusions 24-25 March 2011. Brussels, 20 April 2011. EUCO 10/1/11 CONCL 3.

212 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union signed at Brussels on 2 March 2012.

213 Towards a genuine Economic and Monetary Union. Interim Report. European Council. Brussels, 5 December 2012.

proposed is that the EU's global competitiveness should be enhanced by remaining a highly attractive social market economy and by preserving the European social models.

- As proposed, the integrated budgetary and fiscal framework would be supplemented by an integrated economic policy framework, moving towards a deeper EU level coordination in employment and social affairs. The basic elements of the reforms are:
- the ex-ante coordination of national reforms (as suggested by the TSCG);
- deepening the social dimension of the EMU;
- the establishment of a contractual relationship among member states serving the goals of competitiveness and growth;
- the setting up of a solidarity mechanism.

The establishment of the social dimension of the EMU[214], the Alert Mechanism Report is extended by sub-indicators in order to give more detailed background of member states' economic and social movements. These indicators are:

- the participation (employment) rate;
- the long-term unemployment ratio;
- the youth unemployment rate (complemented by the proportion of young people who are not in employment, education or training (NEET));
- the 'at risk of poverty and social exclusion' rate (complemented by the three sub-indicators;
- the at-risk-of-poverty rate, the severe material deprivation rate and
- the proportion of persons living in households with low work intensity.

Besides, a new employment and social scoreboard is attached to the Joint Employment Report:

- the unemployment level and changes;
- the NEET rate (young people not in education, employment or training) and youth unemployment rate;
- the real gross disposable income of households;
- at-risk-of-poverty rate of working age population;
- inequalities (S80/S20 ratio).

Meanwhile the Employment Performance Monitor and the Social Protection Performance monitor remain the same as before.

Furthermore, the Commission takes the opportunity to draft proposals taking further steps to a common employment policy. Through legislative proposals aiming to modernize the EURES system it is trying to create a common European pool of job seekers and job offers. Besides, it also suggests that member states should consider the possibility of introducing an automatic or quasi-automatic anti-cyclical stabilizing instrument, a "basic unemployment insurance" in Europe. This financial instrument would substitute a part of the national insurance scheme helping member states to maintain their deficit commitments even when bubbles occur which result in mass

214 Strengthening the social dimension of the Economic and Monetary Union. Communication from the Commission to the European Parliament and the Council. Brussels, 2.10.2013. COM(2013) 690 provisoire.

redundancies like in the construction sector. The Commission is also insisting on the ex-ante coordination of national structural reforms. Both initiatives are in the discussion phase at the time of writing this chapter.

VII. Customs and taxation policy

1. Introduction

Customs and taxation have many common characteristics. Both are revenues of the budget but also economic policy instruments. Both of them are crucial regarding the creation of the single market. But there are significant differences in their nature so while the harmonisation of customs was the first great achievement of European economic integration the taxation has shown more limited progress in harmonisation and remained under the unanimous decision making of the member states. Hereinafter we try to give a short overview on this somehow similar but in the meantime different field of European integration.

2. History

Customs are duties levied upon imports from foreign countries or export to foreign countries. They are levied when the goods (or services) cross the custom border. The right to collect customs goes back to the ancient times when different entities had this privilege. Later the customs became national monopolies with the same aim. But as the industrial revolution made it clear the feudal custom rights could not be operable anymore (e.g. traders had to pay customs duty on the Weser-Elba waterway in every 12 kilometres or in the mid-19th century there were eight tolls payable at frontiers on goods being transported over the 240 kilometre from Milan to Florence). The Great Depression and later the post war period made it obvious that the European economy could not achieve sustainable growth with the existing national custom borders.

Abolition of custom borders can be the first step towards an economic integration. The first three levels of the classification of the economic integration[215] are (i) the preferential trading area where preferential access is given to certain products from the participating countries, that means reduction but not abolition of tariffs; (ii) free trade area which eliminates tariffs, import quotas and preferences on most (if not all) goods and services and (iii) the customs union which is composed of a free trade area with a common external tariff and the participant countries set up common external trade policy. Customs unions are recognised as "regional trading arrangements" within the World Trade Organisation (WTO) and their members are exempt from the requirements to accord "most favoured nation" treatment to non-members.

Already the Treaty of Rome stated that the Union shall comprise a customs union which shall cover all trade in goods and which shall involve the prohibition between

215 Balassa, B. *Trade Creation and Trade Diversion in the European Common Market.* The Economic Journal, vol. 77, 1967, pp. 1–21.

member states of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries. Furthermore, customs duties on imports and exports and charges having equivalent effect shall be prohibited between member states. To achieve these goals ambitious deadlines were set for progressive elimination of custom duties and quantitative restrictions (quotas) on the trade between member states (by 1970). Eighteen months ahead of schedule, the EEC's customs union was completed on 1 July 1968. Since then the customs and trade policy is a common policy of exclusive EU competence, managed by the European Commission and the customs revenues from the extra Community trade are resources of the common budget.

If we follow the international developments of customs and trade policy it becomes clear that as the result of the liberalisation of world trade the revenues from customs duties lost their budgetary importance. However, customs still serves as an economic or development policy instrument. The WTO negotiations aim at further decreasing the general level of customs and the EU is interested in this liberalisation. The trade agreements of the EU created a global system of preferential arrangements (e.g. Pan-Euro-Mediterranean, Western Balkan or autonomous preferential arrangements with overseas countries and territories). Another element of the global trade liberalisation is the Generalised System of Preferences (GSP) that was agreed at the United Nations Conference on Trade and Development (UNCTAD), and is a facility granted to developing countries ('beneficiary countries') by certain developed countries ('donor countries'). The GSP schemes are not negotiated with beneficiary countries but offered by the various donor countries, making the preferential treatment non-reciprocal. It is worth noting that the schemes are not uniform: goods complying with the conditions of the GSP of the EU, for example, will not necessarily comply with the GSP of another developed nation. The global and common EU trade policy is also taking into account other international obligations like antidumping measures.

Summary of key EU figures *(year 2012; 27 member states; source: Eurostat and DG Taxation and Customs Union)*	**Total (Extra-EU trade)**	**Import**	Export
Value (€)	€ 3.5 trillion	€ 1.8 trillion	€ 1.7 trillion
EU share in world trade (%)	15.5%	15.6% *(US = 15.8%, China = 12.3%)*	15.3% *(US = 10.9%, China = 14.5%)*
Quantity of goods (tonnes)	2.2 billion	1.6 billion	0.6 billion
Customs declarations (number of declarations)	261 million	139 million for import, 105 million for export and 17 million for transit	
Customs duty collected	€ 21.7 billion		
Customs duty transferred to the EU budget *(25% is for the administrative costs of the MSs)*	€ 16.3 billion		
Share of custom duty in the EU revenues	12.6%		

Table 1: European Union in the international trade (2012)
Source: European Commission

The centrepieces of the customs union acquis since 1993, the completion of the single market have been the comprehensive and directly applicable Community Customs Code that compiles the rules, arrangements and procedures applicable to goods traded between the EC and third countries. The Code is covering the scope, definitions, basic provisions and content of Community customs law. Its original form was the regulation 2913/92/EEC and the Code's implementing provisions were contained in the regulation 2454/93/EEC. Implementing powers are conferred on the Commission which is assisted by a Customs Code Committee. The latest amendments of the Code – Modernised Customs Code (MCC) – were introduced by Regulation 450/2008/EC. The MCC aimed at the adaptation of customs legislation to fit but also to govern the electronic environment for customs and trade. This Regulation entered into force in 2008 and was due to be applicable once its implementing provisions are in force and before June 2013 at the latest.

However, the Commission proposed in 2012 to recast the Modernised Customs Code (MCC) before this date due to the developments of the IT background, the new tasks from the Lisbon Treaty and some further need to legal adjustment. Moreover, the 'Community' Customs Code (MCC) was renamed into 'Union' Customs Code (UCC). It was adopted on 9 October 2013 as Regulation 952/2013/EU, entered into force on 30 October 2013 and repealed the MCC but its substantive provisions will apply only on 1 May 2016. In the meantime, the UCC-related Commission acts need to be adopted.

3. Measures and tools

The measures relating to EU customs tariff, commercial and agricultural legislation are collected in the TARIC (*Tarif Intégré de la Communauté*; French: Integrated Tariff of the European Community). This is the integrated Tariff of the European Union, a multilingual database for securing the uniform application of customs rules having an effect on the amount of customs duty payable (most notably rules of origin and duty rates) by all member states and gives all economic operators a clear view of all measures to be undertaken when importing into the EU or exporting goods from the EU. It also makes it possible to collect EU-wide statistics for the measures concerned.

An important tool of common customs and trade policy is the Combined Nomenclature or CN. When declared to customs in the Community, goods must generally be classified according to it. Imported and exported goods have to be declared stating under which subheading of the nomenclature they fall. This determines which rate of customs duty applies and how the goods are treated for statistical purposes. The CN is a method for designating goods and merchandise which was established to meet, at one and the same time, the requirements both of the Common Customs Tariff and of the external trade statistics of the Community. The CN is also used in intra-Community trade statistics. The CN is comprised of the Harmonized System (HS) nomenclature with further Community subdivisions. The Harmonized system is run by the World Customs Organisation (WCO).

The European Community has created the Binding Tariff Information (BTI) system as a tool to assist economic operators to obtain the correct tariff classification for goods they intend to import or export. Binding Tariff Information is issued on request to economic operators by the customs authorities of the member states. It is valid throughout the Community regardless of the member state which issued it. The main benefit to the holder is legal certainty with regard to tariff classification. This is important as tariff classification is the basis for determining customs duties, export refunds and the application of other related legal provisions (e.g. import/ export certificates). A BTI is generally valid for 6 years. However, in certain cases (e.g. the publication of a classification regulation, a change in the interpretation of the nomenclature at international level or any other possibility laid down by the provisions for the implementation of the Customs Code) a BTI may cease to be valid.

The preferential trade regimes of the EU could work only with the concept of origin. This means the „economic" nationality of goods in international trade. There are two kinds, non-preferential and preferential. Non-preferential origin confers an „economic" nationality on goods, determining which commercial policy measures (such as anti-dumping measures, quantitative restrictions) or tariff quotas apply to them. Preferential origin grants certain benefits (mainly reduced or zero duty rates) for goods traded between the countries concerned. Rules of origin are also used for statistical purposes.

Regarding the non-EU countries in Europe it should be mentioned that the EU has customs unions with the European microstates (Andorra, Monaco and San Marino) as well as with Turkey. Furthermore, Iceland, Norway and Liechtenstein (together with EU member states) are members of the European Economic Area, founded in 1994, which is a single market and a free trade area but not a customs union. However, these countries apply full cumulation between them, while the EEA is considered as a single territory, with a common "EEA originating status".

Hereinafter there is no possibility to examine all the trade agreements of the EU but the countries of the Western Balkan as countries with clear intention for accession should be mentioned. Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia and Kosovo participate in the Stabilisation and Association Process (SAP). Participation in SAP grants Western Balkans free access to the European Union market for almost all products. This treatment results from the implementation of the Stabilisation and Association agreements (in case of Albania, the Former Yugoslav Republic of Macedonia and Montenegro) or Interim agreements on trade and trade-related matters (in case of Bosnia and Herzegovina and Serbia). In case of Kosovo, preferences are granted on the basis of autonomous trade measures (ATMs).

4. Taxes

Taxes have a similar nature to customs to a certain extent as revenue of the budget collected on the base of the sovereignty and instrument of the national economic policy. But while customs are levied on the cross border movement of goods and services, taxes could cover all economic activities or even go far beyond that (e.g. life and death in the case of inheritance tax). Their effects can complement each other or taxes can substitute customs easily.

The word 'taxation' goes back to the Latin 'taxare' that means to estimate e.g. someone's wealth or the price of certain goods to assess to tax them. Taxes are important revenues of the government imposed by its fiscal sovereignty on natural and legal persons for financing the public spending. But they are not only a source of income but an instrument of the economic policy as well. The national economic policy could support preferred activities by a targeted tax regime while could roll back others by higher taxation. The most regular classification of taxes is based on the way as they are paid. Direct taxes are paid directly to the government (practically to the national tax authority) by the persons on whom it is imposed. On the contrary the indirect taxes are collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the consumer). The latter is built in the price of goods or services so it has a much stronger influence on the market and the free movement on it.

It is an important question who has the right to introduce taxes. In the modern world the taxation is a core element of the national sovereignty. The national governments have the right to organise the public finances; to impose taxes, duties, levies etc. The limits of the fiscal sovereignty are the limits of the national sovereignty but in some cases it can be extended beyond the fiscal sovereignty of other states (e.g. taxation of the income of its nationals earned abroad). On the other hand, the limitation of this fiscal sovereignty is possible in certain conditions with the appropriate legal framework. It means that on the one hand taxation is an exclusive right of the government but on the other it is transferable to lower levels of administration, to supranational institutions or can be restricted by international agreements.

The tax harmonisation can be a core element of an economic integration because the taxes can have similar effects like customs and so a custom union cannot function effectively without a certain level of common tax rules on goods and services. The taxation and particularly the indirect taxation with its influence on prices are important regarding the accomplishment of the internal market. The harmonised taxes could be the base of the revenues of the common budget and also could provide an effective tool for the common economic policy as well.

Hence the ambiguous position of the member states of the economic integration induced an active attitude towards the tax harmonisation. To achieve a real custom union the member states must harmonise their taxes with similar effect to the customs to avoid raising new fiscal barriers instead of the just removed custom barriers even if they do not intend to do so. Furthermore, certain steps of the completion of the single market need additional common tax measures if the existing national ones are against the desired developments. But on the other hand member states stick to their taxation rights because these are their main incomes and the most important national economic policy instruments after they transferred others, like monetary policy to the EU. Consequently we could say that tax harmonisation is dependent upon the realisation of the aims of the Treaty. As the custom union was finalised the first value added tax (VAT) directives were adopted. When the internal market was accomplished including the real free movement of goods the VAT rules for the internal market were introduced and the system of excise legislation was adopted. The latter was further developed towards energy taxation along the liberalisation of energy markets. The free movement of capital has induced harmonisation of tax measures on certain cross border capital transactions or on taxation on savings. But these steps of tax harmonisation always followed the development of the single market. On the contrary we can presume that all the mentioned general achievements of the economic integration would not be possible without the supplementary acts of tax harmonisation.

The first example of the above detailed nature of tax harmonisation is the (already repealed) third paragraph of Article 95 of the Treaty of Rome that requires the harmonisation of taxes but only in favour of the common market. This explains the main difference between the provisions of the Treaty on customs and taxation. Article 30 on customs prohibits imposing any new national custom duties. In contrast with this, Article 110 permits to impose any new national tax on import if the same duty is imposed on similar domestic goods.

Title "Capital and Payments"	
Art. 65(a) (ex 73d)	right of distinction between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested
Title "Taxation"	
Art. 110 (ex 95)	fiscal neutrality, prohibition of imposing different taxes on similar products
Art. 111. (ex 96.)	any repayment of internal taxation shall not exceed the internal taxation imposed
repealed art. (ex 97.)	transformation of the cumulative taxation systems to VAT systems
Art. 112. (ex 98.)	remissions and repayments in respect of exports may not be granted and countervailing charges in respect of imports may not be imposed
Art. 113. (ex 99.)	recommendation to harmonise the fiscal legislation
Title "General and Final Provisions"	
repealed (ex. 220.)	member states shall, so far as is necessary, enter into negotiations with each other (…) on the abolition of double taxation within the Community

Table 2: Main articles of the Treaty regarding taxation
(current articles and the former numbering by the Treaty of Rome)

The main principle of the Treaty on taxation matters is the principle of fiscal neutrality. No member state shall impose directly or indirectly on the products of other member states any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. Furthermore, no member state shall impose on the products of other member states any internal taxation of such a nature as to afford indirect protection to other products. This provision has direct effect[216], natural and legal persons can claim for abolition of the discriminative tax measures. This means not only prohibition of the discrimination between similar products but prohibition of the discrimination between non similar but competitive products as well. But the discrimination can materialise in very different ways and the Court of Justice gives us a broad interpretation of it. It could be established by definition of higher tax rate category for imported goods[217] or by different accountancy rules when not all phases of production and distribution are compared[218]. But also the sanctions can be discriminative[219] and it is important that taxation in other member states shall be taken into consideration[220]. However, this does not mean that member states may not apply such taxation measures that meet their economic policy goals, only the measures shall be neutral on export and import[221]. Member states also have the right of distinction between taxpayers with regard to their place of residence or with regard to the place where their capital is invested. This right of distinction is necessary to make possible the existence on treaties against double taxation.

The Treaty gives the legal base of the common legislation on taxation but retains the special legislative procedure on this field (the Council – acting unanimously after consulting the European Parliament – adopts provisions for the harmonisation). While the majority of the decision making of the single market is under ordinary legislative procedure by now, member states persist to retain their veto power over tax matters. The strategies of the European institutions always based on these provisions and the above detailed situation. The European Commission as the engine of the integration is trying to develop the single market among others by newer and newer tax proposals. The Council is discussing them at a slower pace and to reach the obligatory unanimity is always makes the debates longer and more complex. The European Parliament has only a consultative role while it has a clear intention to enhance its influence on this field because tax matters have direct impact on the European citizens.

The slow legislative procedure, the reserved approach of the member states and the frequently non-effective compromises for the consensus result in a not always coherent tax legislation that do not cover all the different areas of taxation. In the meantime the business actors must apply these rules and in the case of imperfect measures they can ask the European Court of Justice (ECJ) to clarify the situation. Hence the case law of the ECJ gives us clearer interpretation of the tax harmonisation than the secondary legislation by the Council itself.

There is a further institutional peculiarity of tax harmonisation that the member states have never intended to establish a common European tax authority. At the same time the increasing number of cross border transactions and the technical developments

216 European Court of Justice case C-57/65 Lütticke.
217 C-77/69.- Commission v Belgium.
218 C-42/83 Denkavit.
219 C-299/86 Drexl.
220 C-15/81 Schul.
221 C-140/79 Chemical Farmaceutici.

have boosted tax avoidance, evasion and fraud[222]. But without common institutions the cooperation of national tax authorities proved to be insufficient. With the harmful budgetary effects of the global crisis as a background the member states revised their earlier opinions and started to be more open towards developing the cooperation of tax administrations on a European and even on global level.

Regarding the different types of taxes the level of harmonisation is different. The indirect taxes have a direct impact on the price of the goods and services, therefore a direct impact on their free movement. That is why the harmonisation of indirect taxes is more developed. We can find framework measures and coherent horizontal rules. On the contrary, the harmonisation of direct taxes is concentrating on those elements that have single market components and leave the basic rules under national sovereignty.

4.1 Value added tax

The value added tax (VAT), a consumption tax extending to the whole chain of transactions was introduced first time in France in 1954 and became the basic type of consumption taxes within the EEC because VAT avoids the cascade effect of earlier sales tax (e.g. sales taxes) by taxing only the value added at each stage of production. The first VAT directives were adopted just before the customs union came into effect. But the framework of the common VAT rules was laid down by the 6th VAT directive in 1977[223]. This directive was amended several times so its recast had to be made in 2006 but the original principles of the common VAT rules are still present in the current EU VAT legislation (Directive 2006/112/EC[224]). The directive gives an indirect prohibition that the common VAT system shall not prevent a member state from maintaining or introducing taxes which cannot be characterized as turnover taxes. But the directive does not contain any list of the characteristics of turnover taxes. Without any support from the common VAT legislation we should turn to the ECJ for the definition. According to the European case law the value added tax is applied generally on transactions of supply of goods or services and is proportional to the price of these goods or services. It is applied at every stage of production and selling and finally it is applied on the added value of goods or services, the final amount of tax is paid by the final consumer[225].

222 Before the crisis the estimated budgetary loss of the member states because of fraud was estimated to 200-250 billion euro [Losonczi L.]. In June 2012 The Commission stated that the size of the European grey economy could be one fifth of the GDP that means 2 billion euro in total. [Commission Press Release IP/12/697 27/06/2012].

223 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment; OJ L 145, 13/06/1977, p. 1–40.

224 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax; OJ L 347, 11/12/2006, p 1 – 118.

225 E.g.: C-200/90, Dansk Denkavit, C-347/95 UCAL, C-318/96 SPAR, C-338/97 Pelzl, C-475/03 IRAP etc.

The common VAT system is in many ways very similar to the national ones just synchronises them for the needs of the single market. But there is a great difference. In the case of trader to trader transaction in the national market (both taxable ~ "business to business") the VAT paid in the price would be transferred to the national budget. But in the single market when the two traders are resident in different member states the VAT paid by the vendor in the price to the tax authority via the seller would be transferred to the national budget of the member state of the seller. This in turn would be against the interests of the member states with higher purchasing power because they would lose a good part of their VAT revenues. That is why one of the major differences between the national and common VAT system can be found in the intra-Community VAT rules. In the case of intra-Community transactions the VAT is paid by the vendor directly to the tax authority of its own member state instead of pay it in the price.

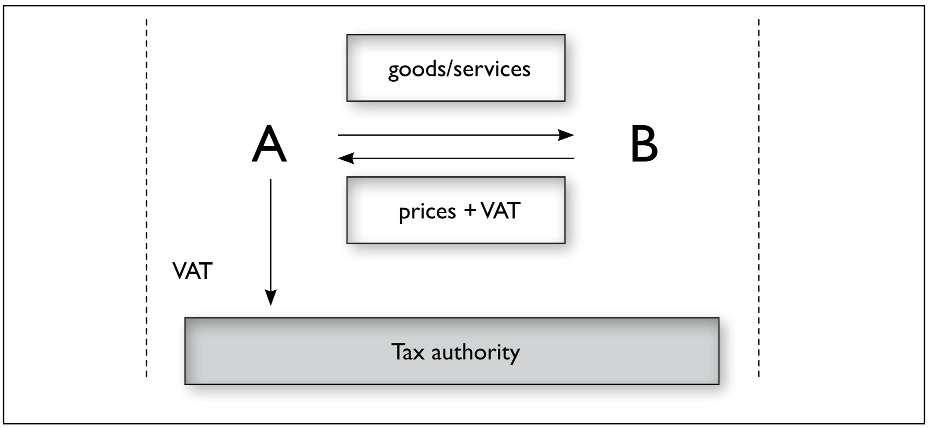


Figure 1: Business to business transaction in a national VAT system

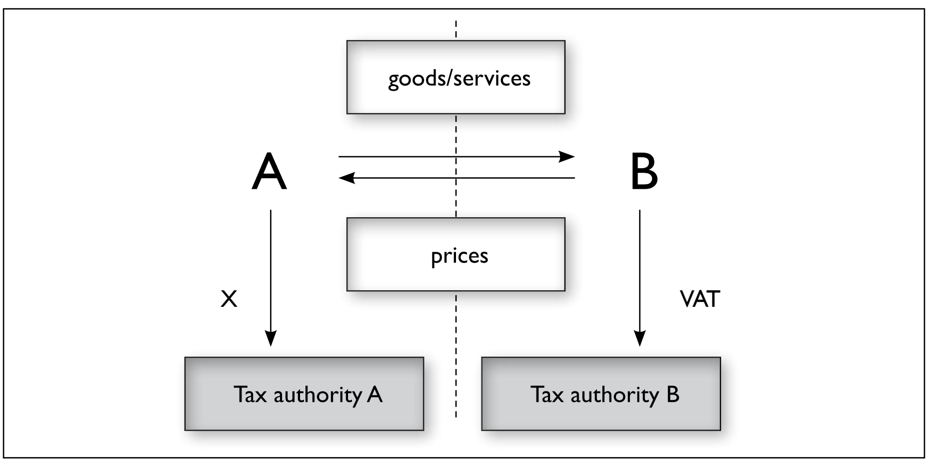


Figure 2: Business to business intra-Community VAT transaction

The common VAT system does not set common tax rates just intends to keep the national rates in an interval that makes the functioning of the single market effective. The tax rate must be defined as a percentage of the tax base. Member states can introduce one standard rate that is not lower than 15% and one or two reduced rates that are not lower than 5%. The goods and services to which the reduced rates may be applied are listed by the directive.

Member states	Rate (Standard)	Name
Austria	20%	German: Mehrwertsteuer / Umsatzsteuer
Belgium	21%	Dutch: Belasting over de toegevoegde waarde
		French: Taxe sur la Valeur Ajoutée
		German: Mehrwertsteuer
Bulgaria	20%	Bulgarian: Данък върху добавената стойност (Danăk vărhu dobavenata stojnost)
Cyprus	19%	Greek: Φόρος Προστιθέμενης Αξίας (Fóros Prastithémenes Axías)
Czech Republic	21%	Czech: Daň z přidané hodnoty
Croatia	25%	Croatian: Porez na dodanu vrijednost
Denmark	25%	Danish: Meromsætningsafgift
Estonia	20%	Estonian: käibemaks
Finland	24%	Finnish: Arvonlisävero
		Swedish: Mervärdesskatt
France	20%	French: Taxe sur la valeur ajoutée
Germany	19%	German: Mehrwertsteuer / Umsatzsteuer
Greece	23%	Greek: Φόρος Προστιθέμενης Αξίας (Fóros Prostithémenis Axías)
Hungary	27%	Hungarian: általános forgalmi adó
Ireland	23%	Irish: Cáin Bhreisluacha
Italy	22%	Italian: Imposta sul Valore Aggiunto
Latvia	21%	Latvian: Pievienotās vērtības nodoklis
Lithuania	21%	Lithuanian: Pridėtinės vertės mokestis
Luxembourg	15%	French: Taxe sur la Valeur Ajoutée
Malta	18%	Maltese: Taxxa fuq il-Valur Miżjud
Netherlands	21%	Dutch: Belasting toegevoegde waarde
Poland	23%	Polish: Podatek od towarów i usług
Portugal	23%	Portuguese: Imposto sobre o Valor Acrescentado
Romania	24%	Romanian: Taxa pe valoarea adăugată
Slovakia	20%	Slovak: Daň z pridanej hodnoty
Slovenia	22%	Slovene: Davek na dodano vrednost
Spain	21%	Spanish: Impuesto sobre el valor añadido
Sweden	25%	Swedish: Mervärdesskatt
United Kingdom	20%	English: Value Added Tax

Table 3: Standard VAT rates in the member states

The VAT directive also contains the common rules on subject matter and scope, taxable transactions, place of taxable transactions, chargeable events and chargeability of VAT exemptions, exemptions, deductions, obligations of taxable persons (e.g. obligation to pay, invoicing or accounting), special schemes and derogations.

The VAT had a well harmonised common legal framework in the early stage of the European integration so the VAT bases were comparable. Furthermore, this type of tax revenues is closely linked to the purchasing power of the member states concerned. Therefore a VAT-based own resource of the common budget was progressively set in place from 1970 onwards, with payments eventually starting in 1979, when a harmonised calculation base was introduced. The VAT-based payments derive from the application of a call rate to member states' VAT bases set according to harmonised rules. However, VAT bases are capped at 50% of GNI because VAT-based resource is seen as penalising the less wealthy member states where a higher share of income is spent on consumption.

The harmonised VAT base is calculated by the relevant member state that divides the total annual net VAT revenue collected by itself by the weighted average rate of VAT, i.e. an estimate of the average rate applicable to the various categories of taxable goods and services to obtain the intermediate VAT base. The intermediate base is subsequently adjusted with negative or positive compensations in order to obtain a harmonised VAT base pursuant to the common VAT legislation in force.

4.2 Common excise system

The excise duty is a tax on the sale of specific goods and the other main indirect tax in the member states. It is called duty because it has common roots with customs and in many countries it is administered by customs authorities. The name itself is presumed to come from the Latin 'accensare' that means 'to tax' and its origin goes back to traditional feudal monopolies. It is a source of revenue but also often serves economic, social or other political aims (e.g. public safety and health; environmental protection). According to the common rules it is obligatory to introduce it on three groups of goods, alcohols, mineral oils or energy products (motor fuels and heating fuels such as petrol and gasoline, electricity, natural gas, coal and coke) and manufactured tobacco products. But beyond these categories member states have the right to impose consumption tax similar to excise duty on other goods (e.g. gold, cars and perfumes).

The main aim of the common measures[226] on excise duty is to set up the common principles of taxation to ensure the free movement of excise goods in the single market but to retain the tighter control of these goods and to clarify the redistribution of

226 General arrangements: dir. 2008/118/EC (earlier: 92/12/EEC); rules of implementation: dir. 92/83/EEC (on alcohols), dir. 2011/64/EU (on tobacco products); tax rates: dir. 92/84/EEC (on alcohols), dir. 2011/64/EU (on tobacco product), rules on mineral oils were merged into the energy taxation legislation.

revenues between member states. The invention of the common excise system is to meet these challenges with the introduction of the tax warehouse system. Tax warehouse is a place where excise goods are produced, processed, held, received or dispatched under duty suspension arrangements by an authorised warehouse keeper in the course of his business, subject to certain conditions laid down by the competent authorities of the Member State where the tax warehouse is located. With this arrangement the free movement, the control and the distribution became possible even after the abolition of border controls among the member states. The common excise legislation defines only minimal tax rates on product-by-product base.

The common system of energy taxation[227] was developed from the excise duty on mineral oils but its scope is broader. It covers all energy products like mineral oils, coal, brick, coal, coke, natural gas, electricity, etc. The introduction of energy taxation was inspired by the development of the internal market its aim being the promotion of the liberalisation of the energy market. It is worth noting, however, that there is a proposal currently under discussion whose purpose is to redirect the aim of the common measures to promote energy efficiency and consumption of more environmentally friendly products. This would need to change the energy taxation to a two components duty partly based on CO_2 emissions, partly energy content.

In contrast with the indirect taxes the direct taxation is not well harmonised in the EU. Beyond the directives or regulations the acquis on direct taxes frequently uses softer instruments (e.g. recommendations or codes of conduct). The main aim of the adopted legal measures is promoting the creation of equal competition[228] and the elimination of harmful tax competition. The differences of taxation or the cross border element of a transaction within the EU should not influence the investment decisions. It is also an important element that member states should stop the erosion of tax their bases (when tax exemptions guaranteed to appeal investments permanently decrease the tax base) and should decrease the tax burdens on labour, especially with regard to the sensitive employment situation in the member states. But in general the direct taxation remains the sole responsibility of the member states; the common legislation is focused on taxation of certain cross border transactions. Due to the harmful consequences of the global downturn there are new proposals by the European Commission with a more comprehensive approach but they are heavily contested by the member states so the future of these ideas is not clear in the time of writing of this text.

Since there is no common tax authority in the EU the administrative cooperation between the national tax authorities are extremely important. These measures set up the framework for different form of information exchange and data protection. The cooperation has strong technical support by commonly developed IT instruments like VAT Information Exchange System (VIES) or the Excise Movement Control System (EMCS). As a consequence of the effects of the global economic downturn the

227 Energy taxation: dir. 2003/96/EC, amendment proposal: COM (2011) 169.

228 See: Parent and subsidiary directive 2003/123/EC (earlier: 90/435/EEC); Merger directive 2005/19/EC (earlier: 90/434/EEC); Directive on cross-border interest and royalty payment 2003/49/EC.

administrations of the member states are more and more ready to spread the cooperation to global level making the fight against fraud and tax evasion more effective. The recent meetings of the European Council adopted conclusions to enhance the anti-fraud and anti-avoidance activities of the EU. In the meantime the EU has started to harmonise its efforts to global frameworks (e.g. the FATCA of the USA).

VIII. Financial services policy

1. Definition

Financial services policy[229] should ensure secure and efficient financial markets and contribute to coherence and consistency between the different policy areas, such as banking, insurance, securities and investment funds, financial markets infrastructure, retail financial services and payment systems.

Financial markets are essential for the functioning of modern economies. Completing the single market in financial services is a crucial part of the Lisbon economic reform process, and essential for the EU's global competitiveness.

2. Financial markets and institutions

Financial market is an organisational framework where some sort of financial product is being traded.

2.1 Different types of financial markets

- Capital market: Primary markets deal with the trade of new issues of stocks and other securities, whereas secondary markets deal with the exchange of existing or previously-issued securities. Another important division is made in the capital market based on the nature of the security traded, i.e. stock market and bond market.
  - Bond market provides financing by bond issuance and bond trading.
  - Stock market provides financing by shares or stock issuance and by share trading.
- Commodity markets facilitate the trading of commodities.
- Money markets provide short term debt financing and investment.
- Derivatives markets provide instruments for the management of financial risk.
- Futures markets provide standardized forward contracts for trading products at some future date; see also forward markets.
- Insurance markets facilitate the redistribution of various risks.
- Foreign exchange markets facilitate the trading of foreign exchange.

229 The definition from the official website of the European Commission (ec.europa.eu/internal_market) is used in this chapter.

2.2. Types of financial institutions[230]

Monetary financial institutions (MFIs): Regulation ECB/2013/33 defines that MFIs are resident credit institutions and other resident financial institutions that receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account, to grant credits and/or make investments in securities. Regulation ECB/2013/33 defines MFIs as resident undertakings that belong to any of the following sectors:

- Central banks, i.e. national central banks of the EU member states and the European Central Bank;
- Credit institutions as defined in Article 4(1)(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms;
- Other deposit-taking corporations which are
  1) principally engaged in financial intermediation and whose business is to receive deposits and/or close substitutes for deposits from institutional units, not only from MFIs and for their own account, at least in economic terms, to grant loans and/or make investments in securities or
  2) electronic money institutions, as defined in Article 2(1) and (2) of Directive 2009/110/EC, that are principally engaged in financial intermediation in the form of issuing electronic money;
- Money market funds (MMFs), as defined in Article 2 of Regulation ECB/2013/33.

Investment funds (IFs): As Regulation (EC) No 958/2007 of the European Central Bank determines IFs are collective investment undertakings that: i) invest in financial and non-financial assets and ii) are set up under Community or national law.

Included within the definition of IFs are: i) undertakings whose units or shares are, at the request of the holders, repurchased or redeemed directly or indirectly out of the undertaking's assets; and ii) undertakings which have a fixed number of issued shares and whose shareholders have to buy or sell existing shares when entering or leaving the fund.

Financial vehicle corporations (FVCs): As Regulation (EC) No 24/2009 of the European Central Bank defines FVCs are undertakings set up under national or Community law which primarily:

- carry out securitisation transactions and which are insulated from the risk of bankruptcy or any other default of the originator; and which
- issue securities, securitisation fund units, other debt instruments and/or financial derivatives and/or legally or economically own assets underlying the issue of securities, securitisation fund units, other debt instruments and/or financial derivatives that are offered for sale to the public or sold on the basis of private placements.

230 Data and text from the official website of the European Central Bank is used in this chapter (http://www.ecb.europa.eu/stats/money/mfi/html/index.en.html).

2.2.1. The number of monetary financial institutions (MFIs) in the euro area

On 1 January 2014 there were 6,790 MFIs resident in the euro area, compared with 7,059 on 1 January 2013. In relative terms, the decrease was particularly pronounced in Cyprus (-26%), Greece (-17%), Luxembourg (-16%), Spain (-9%), Malta (-9%) and France (-7%). In absolute terms, Luxembourg (-70), France (-76), Spain and Cyprus (-36) were the main contributors to the net decrease of 269 units in the euro area. The financial crisis was an important driver of this process of market concentration. More on the roots of the crisis and on crisis management is presented in Chapter XI.

Since 2011 a substantial decrease in the number of money market funds has been recorded in the euro area (-658 units over three years), partly on account of their new statistical definition, which has been adjusted towards supervisory standards. In addition, the contraction in this sub-sector continued during 2013, most prominently in Luxembourg (-77) and France (-65).

Despite the enlargement of the euro area with the accession of Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011) and Latvia (2013), the number of MFIs in the euro area has decreased by 31% – or 3,066 institutions – since 1 January 1999. On 1 January 2014 Germany and France accounted for 42% of all euro area MFIs, approximately the same share as recorded on 1 January 2013.

On 1 January 2014 there were 8,746 MFIs resident in the EU, a net decrease of 330 units (-3.6%) since 1 January 2013. Compared with the situation on 1 January 1999, when there were 10,909 MFIs in the EU, there has been a net decrease of 2,163 units (-20%), despite the (net) addition of 1,608 MFIs on 1 May 2004, when ten new member states acceded, a further 72 MFIs on 1 January 2007, when Bulgaria and Romania joined the EU and the addition of 57 Croatian MFIs on 1 July 2013.

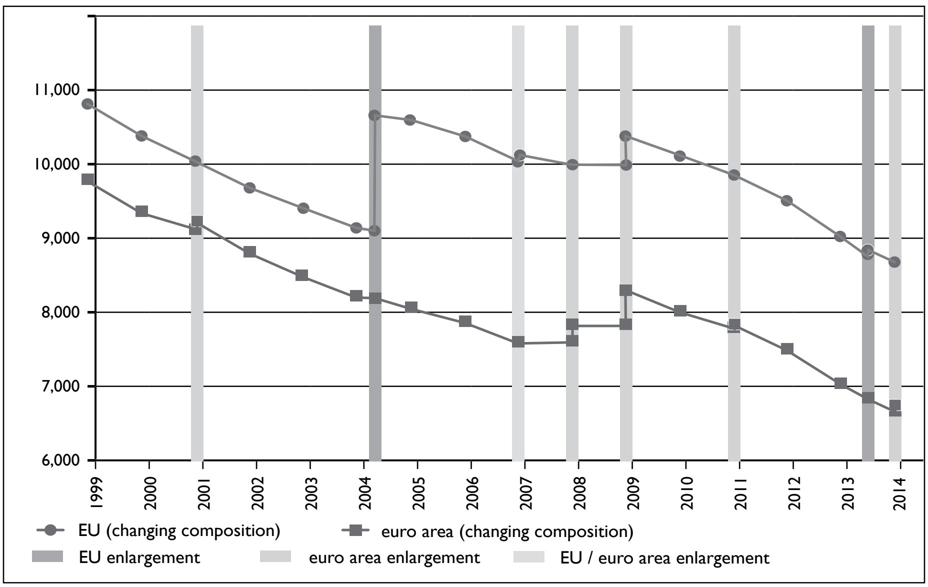


Figure 1: Number of MFIs in the EU and in the euro area
Source: http://www.ecb.europa.eu/press/pr/date/2011/html/pr110114.en.html

2.2.2. Structure of the MFI population

The vast majority of euro area MFIs are credit institutions (i.e. commercial banks, savings banks, post office banks, credit unions, etc.), which accounted for 87% of MFIs (5,909 units) on 1 January 2014, while money market funds accounted for 12% (816 units). Central banks (19 units including the ECB) and other institutions (46 units) together accounted for only 1% of the total number of euro area MFIs.

In the EU as a whole, credit institutions accounted for 88.3% of MFIs on 1 January 2014, while money market funds accounted for 10.8% (see Figure 2 below).

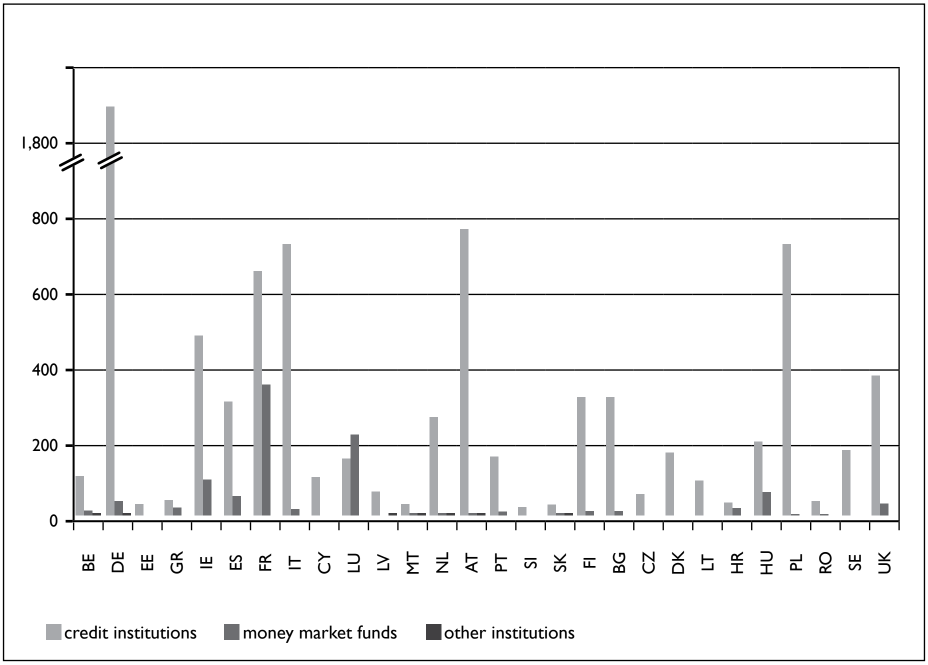


Figure 2: Number of MFIs in the EU (excluding central banks and the European Investment Bank)
Source: http://www.ecb.europa.eu/press/pr/date/2011/html/pr110114.en.html

2.3 Mergers and acquisitions

Mergers and acquisitions (M&As) are corporate actions, the consolidation of companies in order to help an enterprise or firm grow rapidly in its sector, without creating a joint venture or a subsidiary.

- Merger is a legal consolidation, a corporate action where two companies decide to combine their operations into one entity. (Company A + Company B = Company C);

- Acquisition means a corporate action where one company takes over another and the acquired company thus becomes a part of the acquiring (owner) company. Sometimes acquisitions occur without the consent of the acquired firm. (Company A + Company B = Company A).

2.3.1. Types of mergers and acquisitions

Type	Characteristic
Horizontal merger	Companies are in the same line of business, often competitors.
Vertical merger	Companies are in the same line of production (supplier–customer).
Conglomerate merger	Companies are in unrelated lines of business.

Table 1: Types and characteristics of mergers and acquisitions
Source: Mergers and acquisitions, CFA Institute

2.3.2. Mergers and acquisitions activity in Europe

Before the 1980s, only the United States experienced mergers and acquisitions activity. At European level, the construction of the single market, the introduction of the euro, globalisation, financial markets boom and existing liquidity led to an increase in mergers and acquisitions activity. EU firms have become important players in the global market of mergers and acquisitions[231]. The increased number of the mergers and acquisitions has formed the European banking structure and contributed to the higher concentration of the banking system.[232]

Since the 1980s, Europe has experienced three waves of mergers and acquisitions:

- The first M&A wave was after the construction of the single market (1987-1991).
- The next M&A wave took place in the late 90s (1997-2000).
- The last wave (2003-2007) ended with the outbreak of the financial crisis.

231 Vancea Mariana: *Mergers and Acquisitions waves from the European Union perspective*, 2013.
232 Éva Alíz Tóth: *Consequences of the process of the concentration of the European banking system M&As, performance, competition and banking crises*, 2012.

3. Legislative framework

3.1 Financial services action plan (FSAP) and the Lamfalussy process

The European financial market integration reform was started by the 'Financial services action plan' 1999-2005 (FSAP) adopted in 1999. In the action plan the Commission determines measures needed to harmonise the member states' rules on securities, banking, insurance, mortgages and other forms of financial transactions[233].

The complicated legislative process within the European Union also needed to be modified. The EU institutions agreed to such an accelerated process — the Lamfalussy process[234] — and began applying it to securities legislation in 2002 and to banking legislation in 2004[235].

The Lamfalussy process
The Lamfalussy process was launched in 2001 for the purpose of strengthening the European regulatory and financial sector supervision framework. It consists of four levels. It starts with the adoption of the framework legislation (Level 1) and detailed implementing measures (Level 2). For the technical preparation of the implementing measures, the Commission is advised by European Supervisory Authorities, made up of representatives of national supervisory bodies, which exist in three sectors: banking, insurance and occupational pensions and the securities markets. These authorities then contribute to the consistent implementation of Community directives in the member states, ensuring effective cooperation between the national supervisory authorities and convergence of their practices (Level 3). Finally, the Commission enforces the timely and correct transposition of EU legislation into national law (Level 4).

Source: www.europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/l32056_en.htm

233 Implementing the framework for financial markets: Action Plan.
234 Alexandre Lamfalussy, European economist and central banker.
235 Duncan Alford, *The Lamfalussy Process and the EU bank regulation: Another step on the road to pan-european regulation?*, University of South Carolina School of Law; University of South Carolina - Coleman Karesh Law Library, April 1, 2006, Annual Review of Banking & Finance Law, Vol. 25.

3.2 The Commission white paper on financial services 2005-2010

On December 2005 the Commission presented a policy paper on financial services. This paper presented the objectives of the European Commission's financial services policy over the next 5 years.[236]

The Commission's financial services policy priorities up to 2010

The objectives set out in the white paper.

- consolidate towards an integrated, open, competitive and economically efficient EU financial market;
- remove the remaining economically significant barriers;
- implement, enforce and continuously evaluate the existing legislation and apply the better regulation agenda to future initiatives;
- enhance supervisory cooperation and convergence in the EU;
- deepen relations with other global financial market places.

Source: WHITE PAPER, Financial Services Policy 2005-2010

3.3. The financial crisis and the 'de Larosière report'

After the outbreak of the financial crisis in 2008, the stabilisation of financial markets became a priority. Reforming financial markets regulation and strengthening the supervision of the financial sector in Europe have been the two main strands of work.[237]

The Commission stipulates that the experience of the financial crisis has revealed important failures in financial supervision, both in particular cases and in relation to the financial system as a whole. Current supervisory arrangements proved incapable of preventing, managing and resolving the crisis.

In November 2008, the Commission mandated a high level group chaired by Mr Jacques de Larosière[238] to propose recommendations to the Commission on how to strengthen the European supervisory system in order to rebuild trust in the financial system.

The final report presented by the de Larosière group on 25 February 2009 set out a plan for a new system of European financial supervision.[239]

236 Text from the Commission white paper on financial services is used in this chapter (www.ec.europa.eu/internal_market).
237 Data and text from the official website of the European Commission is used in this chapter (ec.europa.eu/internal_market).
238 Former managing director of the International Monetary Fund.
239 Communication from the Commission on European financial supervision.

3.4. Reforming the European financial supervision system (2009–2011)

The financial crisis in 2008 revealed important shortcomings in financial supervision. Nationally based supervisory models have lagged behind globalisation of financial markets in which many financial institutions operate across borders. The crisis also exposed shortcomings in the areas of cooperation, coordination, consistent application of EU legal framework and trust between national supervisors.[240] Therefore, based on the 'de Larosière report' and replying to the challenges of the financial crisis, the member states of the EU adopted the legislative background of a new financial supervisory framework in 2010. The European System of Financial Supervision (ESFS) came into effect on 1 January 2011. This chapter will present the system based on the regulations provisions establishing the ESFS.[241]

Macro-prudential Supervisory	Macro-prudential Supervisory
– European Systemic Risk Board (ESRB); – National macro-supervisory authorities	– European Securities and Markets Authority (ESMA); – European Insurance and Occupational Pensions Authority; – European Banking Authority (ENA); – National micro-supervisory authorities

Table 2: The European System of Financial Supervision

3.4.1 First pillar: European Systemic Risk Board (ESRB)

The ESRB regulation[242] (Chapter I, Article 3) stipulates that the Union needs a specific body responsible for macro-prudential oversight across its financial system, in order to identify risks to financial stability and, where necessary, issue risk warnings and recommendations for action to address such risks. The ESRB is established as a new independent body, with no legal personality. It shall have its seat in Frankfurt am Main.

240 Review of the new system of financial supervision (2013), p. 10-13. (http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507446/IPOL-ECON_ET(2013)507446_EN.pdf.

241 Relevant texts from the ESRB regulation, EBA regulation, ESMA regulation, EIOPA regulation are used in this chapter.

242 Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

3.4.2. Second pillar: The three European Supervisory Authorities (ESAs)

On 16 December 2010, the three regulations[243] establishing the EBA[244], the EIOPA[245] and the ESMA[246] entered into force. The ESAs are established as independent legal entities under European public law, distinct from the EU institutions. The 28 national supervisors are represented in all three supervising authorities. The authorities shall be represented by a chairperson.[247] The three EU authorities have similar powers and competences and were established as of 1 January 2011. The EBA, the ESMA and the EIOPA regulations (Chapter I, Articles 1-2) define the main role of the new financial supervisors. Their role is to contribute to the establishment of high-quality common regulatory and supervisory standards and practices. They bring together the actors of financial supervision at national level and at EU level, solve cross-border problems. The authorities monitor and assess market developments and cooperate closely with the ESRB.

3.5 A comprehensive EU response to the financial crisis

After the outbreak of the financial crisis the member states had 27 different regulatory systems for banks and capital markets in place. Regulations were generally based on national rules without an effective pre-crisis framework. Since 2008 the European Commission has tabled around 30 proposals to create a safer and more effective financial sector.[248]

3.5.1 Building new rules for the global financial system

Over the last five years the EU and its global partners in the G20 played a key role in establishing a new global financial regulatory framework. The reforms improve

243 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010;2.
Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC.
Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

244 The EBA shall have its seat in London.

245 The EIOPA shall have its seat in Frankfurt am Main.

246 The ESMA shall have its seat in Paris.

247 2011-2016: Andrea Enria (EBA), Steven Maijoor (ESMA), Gabriel Bernardino (EIOPA).

248 A comprehensive EU response to the financial crisis – substantial progress towards a strong financial framework for Europe and a banking union for the eurozone, http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en.

the stability of the banking system through stronger prudential requirements and a framework for crisis management, as well as measures to strengthen the regulation of financial markets and infrastructures, especially through the compulsory trading and clearing of derivatives on well-regulated and transparent platforms.

The following Table will present the main pieces of European legislation linked to the G20 commitments, including three very significant regulations and directives on prudential requirements for banks, on deposit guarantee schemes and on bank resolution.[249]

Apr 2009	Hedge Funds & Private Equity (AIFMD)	Capital markets
July 2009	Remuneration & prudential requirements for banks (CRD III)	Banks
Sep 2010	Derivatives (EMIR)	Capital markets
July 2010	Deposit Guarantee Schemes (DGS)	Banks
Nov 2008 **June 2010** **Nov 2011**	Credit Rating Agencies	Capital markets
July 2011	Single Rulebook of prudential requirements for banks: capital, liquidity & leverage + stricter rules on remuneration and improved tax transparency (Credit requirements directive / Credit requirements regulation, CRD IV / CRR)	Banks
Oct 2011	Enhanced framework for securities markets (MiFID/R)	Capital markets
Oct 2011	Enhanced framework to prevent market abuse (MAD/R)	Capital markets
June 2012	Prevention, management & resolution of bank crises (BRRD)	Banks
Sep 2013	Shadow banking, including Money Market Funds	Capital markets
Jan 2014	Structural reform of banks	Banks
Jan 2014	Shadow banking: Increasing the transparency of securities financing transactions	Capital markets
2014	Prevention, management & resolution of financial institutions other than banks	Capital markets

Actions completed
Proposals presented by the Commission but not yet adopted by the co-legislator
Proposals to be presented by the Commission

Table 3: European legislation linked to the G20 commitments
Source: ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf

249 Financial reform at the service of growth Internal Market and Services, p. 2. (http://ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf).

Stronger prudential requirements and the 'single rulebook'

This chapter presents the first significant package linked to the G20 commitments from Table 3. The regulation and directive on capital requirements for banks (Capital Requirements Directive IV[250] and Capital Requirements Regulation[251]) implements the new global standards on bank capital (the Basel III agreement[252]) into the EU legal framework. The timely implementation features among the commitments taken by the EU in the G20. The rules apply from 1 January 2014.[253]

The new framework determines stronger prudential requirements for banks, requiring them to keep sufficient capital reserves and liquidity. Furthermore, these new rules will strengthen the requirements with regard to corporate governance arrangements and processes of banks. In addition, in order to tackle excessive risk-taking, the framework imposes tough rules on bonuses.

The CRD IV changes

CRD IV changes can be grouped into two areas:

capital reform

- Increase the quality of eligible capital;
- Increase the quantity of capital held by setting significantly higher minimum capital ratios and reducing pro-cyclicality by introducing new capital buffers;
- Increasing the capital requirements for counterparty;
- Credit risk including a new capital charge for potential mark-to-market losses on OTC derivatives (credit valuation adjustment, 'CVA');
- Introduction of a non-risk based leverage ratio to safeguard against built up of leverage in the system.

liquidity standards

- Liquidity coverage ratio (LCR) promotes short-term resilience by strengthening the liquidity risk profile to withstand a stress scenario and
- Net stable funding ratio (NSFR) aims to ensure that banks have stable funding in place to support operations during a stressed period of one year.

Source: KPMG Regulatory advisory CRD IV (2013)

250 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance.

251 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance.

252 Recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

253 Data and text from the official website of the European Commission is used in this chapter (http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en).

The European Council (2009) recommended establishing a single rulebook for financial institutions. The capital requirements directive and the capital requirements regulation cover the single rulebook, which sets out to harmonise fully the different regulatory standards across the European Union. The rulebook is a body of legislative texts, which ensures that there is good regulation everywhere, without loopholes, in order to guarantee a level playing field for banks and a real integrated single market for financial services.[254]

Directive on the deposit guarantee scheme (DGS)

The second important directive linked to G20 commitments is the directive on deposit guarantee scheme. In 2010 the European Commission proposed the second revision of the directive.[255] The new rules were designed to improve depositor protection and to maintain the confidence of depositors in the financial safety net.

Key elements of the directive[256], which should enter into force on 1 January 2015:

- A universal guarantee of deposits up to €100.000: The directive preserves the harmonised coverage level of €100 000 per depositor and per bank.
- Strengthened financing: through a significant level of ex-ante funding of 0.8% of covered deposits to be collected from banks over a 10-year period. A maximum of 30% of the funding could be made up of payment commitments.
- Faster access to repayment: Repayment deadlines will be gradually reduced from the current 20 working days to 7 working days.
- Better information for depositors.

Bank recovery and resolution directive (BRRD)

The third significant directive linked to G20 commitments is the directive on bank recovery and resolution. This proposal is the final measure in fulfilling the EU's obligation for better financial regulation.

The directive[257] is designed to provide 'adequate tools at European Union level to effectively deal with unsound or failing credit institutions'. It aims to make sure a bank or an institution can be resolved speedily and with minimal risk to financial stability. The rules will apply to both credit institutions and larger investment firms.[258]

254 A comprehensive EU response to the financial crisis: substantial progress towards a strong financial framework for Europe and a banking union for the eurozone (http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en).

255 The first amendment of the Directive on Deposit Guarantee Schemes was adopted in 2008.

256 Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

257 Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.

258 Key points from the EU Recovery and Resolution Directive (http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/RRP/EU%20Directive%20key%20points.pdf).

Resolution takes place if the preventive and early intervention measures fail to redress the situation from deteriorating to the point where the bank is failing or likely to fail. The directive determines (in Chapter III, Article 31) the main resolution powers and tools. The resolution authorities may apply the resolution tools either singly or in any combination.[259]

The main resolution tools

The main resolution tools are the following

- A sale of business tool which enables authorities to sell part of the business without shareholder consent.
- A bridge institution tool allows authorities to transfer all or part of the business to an entity owed by the authorities, which continue to provide essential financial services pending onward sale or entity wind down
- An asset separation tool enables the transfer of 'bad' assets to a separate vehicle or 'bad bank'.
- A bail-in tool allows equity and debt to be written down and is intended to ensure that most unsecured creditors of an institution bear appropriate losses.

To be effective, the resolution tools will require a certain amount of funding. If market funding is not available and in order to avoid resolution actions from being funded by the state, supplementary funding will be provided by resolution funds which will raise contributions from banks proportionate to their liabilities and risk profiles. The funds will have to build up sufficient capacity to reach 0.8% of covered deposits in 10 years. For maximum synergy, member states will even be allowed to merge the DGS fund and the resolution fund, as long as all the guarantees are in place to ensure that the scheme remains in position to repay depositors in case of failure.[260]

3.5.2. Establishing a safe, responsible and growth-enhancing financial sector in Europe

The European Union is working together with its global partners for global objectives, but member states have also been working to improve the stability and efficiency of the single market, which is essential to ensure the financial sector supports the real economy.[261]

Table 4 will show all the main European legislation linked to improve stability and efficiency of the single market, and the following subchapter presents the most important points in the banking union.[262]

259 Texts from the BRR Regulation are used in this chapter.

260 Data and text from the official website of the European Commission is used in this chapter (http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en).

261 Financial reform at the service of growth Internal Market and Services, p. 2. (http://ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf).

262 Financial reform at the service of growth Internal Market and Services, p. 2. (http://ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf).

July 2007	Risk-based prudential and solvency rules for insurers (Solvency II)	Insurance
Sep 2009	Establishment of the European Supervisory Authorities (for banking, capital markets, insurance and pensions) & the European Systemic Risk Board regulations	Single market
July 2010	Investor Compensation Schemes	Investors / Consumers
Aug 2010	Strengthened supervision of financial conglomerates	Banks / Insurance
Sep 2010	Short-Selling & Credit Default Swaps	Capital Markets
Dec 2010	Creation of the Single Euro Payments Area (SEPA)	Single market
Jan 2011	New European supervisory framework for insurers (Omnibus II)	Insurance
Feb 2011	Interconnection of business registers	Single market
Mar 2011	Responsible lending (mortgage credit)	Investors / Consumers
Oct 2011	Simplification of accounting	Capital Markets
Oct 2011	Enhanced transparency rules	Capital Markets
Nov 2011	Enhanced framework for audit sector	Capital Markets
Dec 2011	Creation of European Venture Capital Funds Investors	Investors / Consumers
Dec 2011	Creation of European Social Entrepreneurship Funds Investors	Investors / Consumers
Mar 2012	Central Securities Depositaries	Capital Markets
July 2012	Improved investor information for complex financial products (PRIPS)	Investors / Consumers
July 2012	Strengthened rules on the sale of insurance products (IMD)	Insurance
July 2012	Safer rules for retail investment funds (UCITS)	Investors / Consumers
Feb 2013	Strengthened regime on anti-money laundering	Single market
Mar 2013	Green paper on the long-term financing of the European economy	Single market
Apr 2013	Non-financial reporting for companies	Capital Markets
May 2013	Access to basic bank account / transparency of fees /switching of bank accounts	Investors / Consumers
June 2013	Creation of European long-term investment funds for investors	Investors / Consumers
July 2013	Revised rules for innovative payment services (cards, internet & mobile payments)	Single market
Sep 2013	Regulation of Financial Benchmarks (such as LIBOR & EURIBOR)	Capital markets
2014	Revised rules for occupational pension funds (IORP)	Pensions

Actions completed
Proposals presented by the Commission but not yet adopted by the co-legislator
Proposals to be presented by the Commission

Table 4: European legislation to improve the stability and efficiency of the single market
Source: ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf.

3.6 Banking union

Over the past decades, the Union has made progress in creating an internal market for banking services. The EU financial system became integrated, especially within the euro area, after the introduction of the single currency.[263] But there is a discrepancy between the integrated European banking market and largely national banking policies. Europe is heavily dependent on bank credit, much in contrast to the US, whether other forms of financial intermediation play a more important role.[264]

The Commission determines that in many member states, banking groups with their headquarters established in other member states hold a significant market share, and credit institutions have geographically diversified their business, within both the euro area and the non-euro area.[265] The outbreak of the financial and economic crisis has shown that the integrity of the single currency and the internal market may be threatened by the fragmentation of the financial sector. The euro zone crisis also highlighted the toxic interactions between weak banks and weak sovereigns. The negative feedback loops between individual Member State budgets and some of their banks are a threat to financial stability in the EU.

Types of economic crisis

- Balance of payments crisis: pre-crisis accumulation of large external debts, partly due to excess demand, partly due to loss in competitiveness, private capital outflow during the crisis;
- Banking crisis: significant asset deterioration due to output loss and asset price decline
- Sovereign debt crisis: permanent loss in previous booming sectors reduces tax revenue and output, bank rescue costs;
- Consequent growth crisis: the triple crisis above, along deficiencies in euro area level decision-making, led to output collapse and unemployment in southern Europe, which spilled-over to Northern Europe and outside the euro area.

Source: Zsolt Darvas, Bruegel, 2013

Creating an effective banking union is a cornerstone of the Commission's efforts towards a deeper economic and monetary union. The initiative to build a new supervisory and resolution framework was announced by the heads of state and government of the

263 A comprehensive EU response to the financial crisis: substantial progress towards a strong financial framework for Europe and a banking union for the eurozone. (European Commission - MEMO/14/244 28/03/2014).

264 *The neglected side of banking union: reshaping Europe's financial system,* André Sapir, Guntram B. Wolff, Bruegel, 2013. p.2.

265 ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf.

euro area in June 2012. The vision was further developed in the European Commission's blueprint[266] for Economic and Monetary Union in November 2012.

Goals of the banking union
- Break the vicious circle between banks and sovereigns
- Improve the quality of banking oversight, especially for cross-border banks
- Reduce the probability of bank failures and the costs to taxpayers
- Ensure consistency of supervisory practices
- Reverse financial fragmentation that started with the euro-crisis

Source: Zsolt Darvas, Bruegel, 2013

3.6.1. Key elements of the banking union

A banking union would be underpinned by a comprehensive and detailed single rulebook for financial services for the internal market as a whole and would be composed of a single supervisory mechanism and new frameworks for deposit insurance and resolution. In the banking union supervision and resolution of banks will move from the national to the EU level.

All euro area member states will automatically become part of the banking union. With a view to maintaining and deepening the internal market, the banking union is open to all non-euro area member states. Non-euro area countries may notify the ECB of their intention to join the banking union by establishing close cooperation between their competent authorities and the ECB.

	Entry	Exit
Eurozone	• automatically joining to the eurozone	• irrelevant
Non euro members	• close cooperation[267] 10 agreement with the ECB	• terminate the close cooperation with the ECB

Table 5: Entry and exit rules

Single supervisory mechanism (SSM)

As a first step towards a banking union, a single supervisory mechanism[268] should ensure that the Union's policy relating to the prudential supervision of credit

266 For more details about the European Commission's blueprint see Chapter V.

267 Close cooperation = adoption of the necessary legal framework, cooperation with the ECB, following the guidelines and performing the request of the ECB.

268 Council regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

institutions is implemented in a coherent and effective manner.[269] The SSM will cover all (approximately 6,000) banks in the euro area and in the participating member states. The new rules which apply from November 2014 entered into force on 4 November 2013.

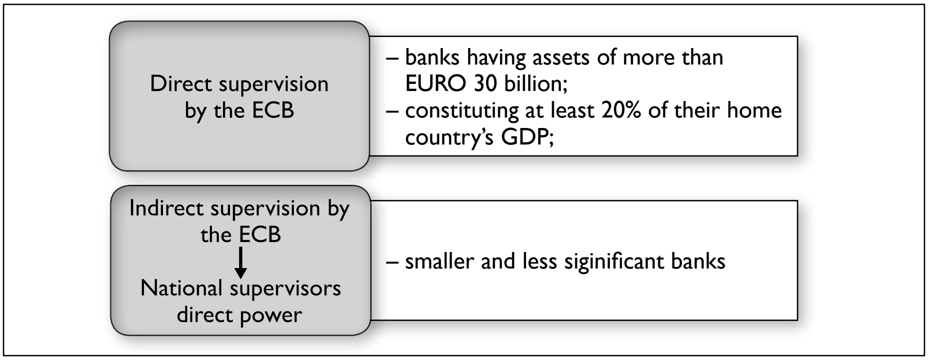


Figure 3: Scope of the SSM

The SSM regulation determines that specific supervisory tasks which are crucial to ensure a coherent and effective implementation of the Union's policy relating to the prudential supervision of credit institutions should be conferred on the ECB, while other tasks should remain with national authorities.

The ECB is responsible for:

- Authorising and withdrawing the authorisation of all credit institutions in the euro area;
- Assessing acquisition and disposal of holdings in banks;
- Ensuring compliance with all prudential requirements laid down in EU banking rules and set higher prudential requirements for banks.

There are several reasons why the ECB is best suited for carrying out banking supervision[270]:

- The ECB will ensure a truly European supervision mechanism that is not prone to the protection of national interests and which will weaken the link between banks and national sovereigns.
- The ECB's strong focus and expertise on financial stability will ensure that financial stability risks are sufficiently taken into account.
- The Treaty on the functioning of the European Union (TFEU, Article 127(6)) stipulates that supervisory tasks can be conferred on the ECB.
- The organisational principles laid down in the legislative package will ensure the separation of the ECB's monetary policy tasks from its supervisory tasks.

269 Texts from the Council Regulation is used in this chapter.
270 Data and text from the official website of the European Commission is used in this chapter (http://europa.eu/rapid/press-release_MEMO-13-780_en.htm?locale=en).

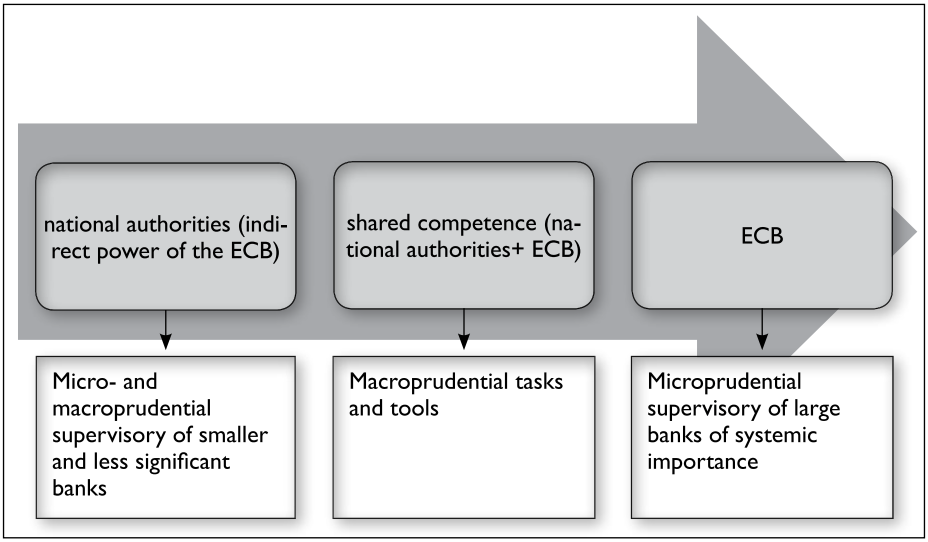


Figure 4: Application of supervisory tools

The ECB cooperates closely with the European banking Authority (EBA), which is responsible for the development of the Single Rulebook and the creation of a single supervisory handbook. The effectiveness of the single supervisory mechanism largely depends on the single rulebook.

Accountability provisions to ensure that ECB uses its supervisory powers in the most effective and transparent way

- ECB regularly reports to the EP and the Eurogroup, ministers of non-euro participating member states;
- The chair of the Supervisory Board may be requested to testify at the EP;
- ECB answers in writing questions raised by national parliaments;
- Chair or other members of the Supervisory Board can be invited by national parliaments.

In the meantime, the European Central Bank is actively preparing to take up its new role of supervisor. In 2014 the ECB carried out a comprehensive assessment of all banks which will be under its direct supervision and the balance sheets of those banks. In parallel it is recruiting high quality supervisory staff[271] and building up a new supervisory structure that integrates national supervisors before it commences its activities.

271 Danièle Nouy has been appointed as first chair of the single supervisory mechanism board.

Main features of the single supervisory mechanism (SSM)

- It confers supervision powers on the ECB for the banks of the euro area, the authorisation of all banks in Europe, the monitoring of the supervision exerted by national supervisors on less significant banks;
- The ECB shall ensure the coherent and consistent application of the single rulebook in the euro area.

Single resolution mechanism (SRM)
The single resolution mechanism complements the single supervisory mechanism: it is set to centralise key competences and resources for managing the failure of any bank in the euro area and in other member states participating in the banking union. The legal basis for the SRM is Article 114 of the Treaty on the Functioning of the European Union (TFEU), which provides for the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the single market.

The SRM regulation would ensure that if a bank subject to the single supervisory mechanism faces serious difficulties, its resolution can be managed efficiently. In case of cross-border failures, it would be much more efficient than a network of national resolution authorities and risks of contagion would be avoided more easily. The single resolution mechanism would be directly responsible for the resolution of all banks in member states participating in the single supervisory mechanism (about 6,000).

The single resolution mechanism would be governed by a piece of EU legislation and an international agreement: a single resolution mechanism regulation covering the main aspects of the mechanism and an inter-governmental agreement (IGA) related to some specific aspects of the single resolution fund (SRF).

The SRM regulation must be fully in line with the bank recovery and resolution (BRR) directive which determines the rules for how EU banks in difficulties are restructured, and how costs are allocated to the banks' shareholders and creditors. But the BRR directive would rely on a network of national authorities and resolution funds to resolve banks. While this network would be a major step forward to minimising different national approaches and fragmentation of the single market, it would not be sufficient for member states who share the common currency or are supervised by the European Central Bank in the banking union. Going beyond the requirements established in the bank recovery and resolution directive, the aim of the SRM is to create a coherent, swift and decisive centralised decision-making architecture (with a perspective extending to all member states in the banking union), as well as to provide a resolution fund pooling and mutualising member states' contributions.[272]

272 Data and text from the official website of the European Commission is used in this chapter (http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en; http://europa.eu/rapid/press-release_MEMO-13-675_en.htm?locale=en).

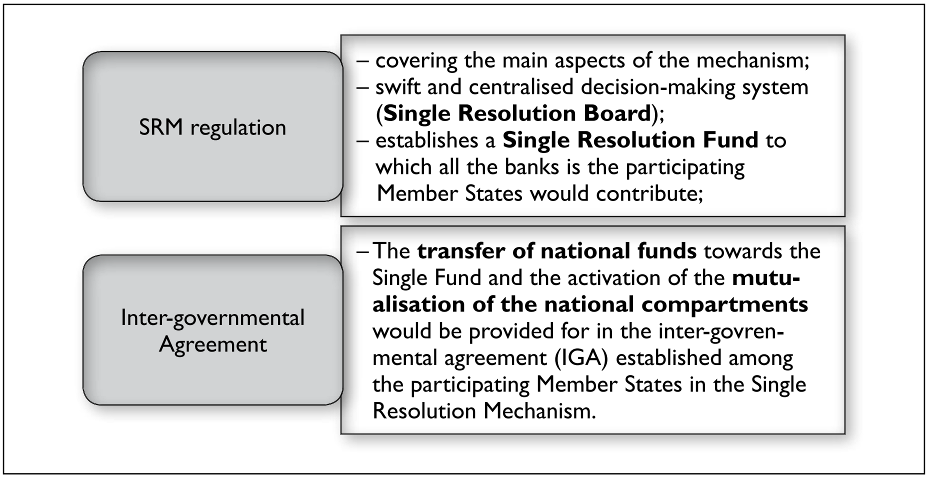


Figure 5: Legal background of the SRM

From January 2016 the resolution fund has a target level of about 1% of covered deposits of the banking union's banks over an 8 year period (this would amount to circa €55 billion). During this transitional period, the single fund would comprise national compartments, the resources of which would be progressively mutualised over a period of 8 years, starting with 40% of these resources in the first year.[273]

The single resolution mechanism would enter into force on 1 January 2016, whereas bail-in and resolution functions would apply from 1 January 2016.[274] Member states outside the euro zone which join the single supervisory mechanism will also join the single resolution mechanism.

3.6.2 Bank recapitalisation and EU backstops

The Council clarified on 15 November 2013 the order of the backstops in case capital shortfalls are identified for banks of the banking union. In a first instance, banks should raise capital in the market or raise capital from other private sources. Should this not be sufficient, public money could be engaged at national level in line with state aid rules and if needed, through the provision of a public backstop. In the first instance, national frameworks will be activated. In the second instance, if national backstops are not sufficient, instruments at the European level may be used, including the European stability mechanism.

Finally, discussions are ongoing to explore how equivalent support mechanisms can be established for non-euro area members willing to join the banking union.

273 A comprehensive EU response to the financial crisis: substantial progress towards a strong financial framework for Europe and a banking union for the eurozone (http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en).

274 As specified under the Bank Recovery and Resolution Directive.

State aid rules

The European Commission has adapted its temporary state aid rules for assessing public support to financial institutions during the crisis. A European Commission's communication sets out the up-dated EU crisis rules for state aid to banks during the crisis from 1st August 2013.

The main changes include strengthened burden-sharing: banks are required to work out a sound plan for their restructuring or orderly winding down before they can receive recapitalisations or asset protection measures. Moreover, in case of capital shortfalls, bank owners and junior creditors are now required to contribute as a first resort, before banks can ask for public funding. The rules will be revised as necessary. In particular, they may need to be adjusted in light of the evolution of the EU regulatory framework for banking.

Part Two:
Political Economy

IX. Relevance of the European single currency – a political economy view

Four decades ago, in 1966, a member of the European Parliament said that Europe would become tangible for Europeans the moment when they held a pan-European coin in their hands with the figure of a young lady riding on a bull. Although, in the end, the euro coins bear a different image on them – only Greece has coins with the lady on the bull – it does not diminish the symbolic value of the single currency. Some prophecies date from even earlier. The illustrious British weekly *The Economist* predicted in an op-ed piece 120 years ago that "one day Europe – but not Britain – will have a single currency". The British pound is the oldest western currency, with a much longer history than most of its European counterparts. The pound sterling and its predecessors have been in use for 1,300 years; which explains the British public's emotional attachment to the pound and their reluctance to let go of their beloved currency and join the monetary union.

Let us first clarify what we mean by monetary union. Contrary to popular belief, it does not necessarily mean a common currency, even though the euro is a tangible result of the European monetary union. The minimum requirements of a monetary union are set exchange rates of the participating currencies.

In a full monetary union, the other extreme, participating currencies disappear and are replaced by a single currency managed by a common central bank. This is the scenario currently being played out in Europe. The main advantages of a monetary union are a reduced exchange rate risk (as companies and citizens can be certain that the exchange rates remain unchanged) and no more exchange costs. The biggest disadvantage is that participating countries lose some of their key policy instruments for regulating the economy by delegating their right of making monetary policy and setting interest rates to a central body – in our case the European Central Bank in Frankfurt.

Relinquishing a country's sovereignty for a monetary union is by no means a novel phenomenon; in 1867 the UK, France and the USA – the three leading powers of the time – had already contemplated the idea of introducing a single world currency. The idea was soon abandoned as unrealistic. Monetary unions have come and gone on all continents. The four colonies of New England, on the east coast of the current USA, established one in 1750 by recognising each other's currencies. A more noteworthy one was the Latin Monetary Union of the late 19th century, created on France's initiative between the countries of Belgium, Bulgaria, Greece, France, Italy and Switzerland. This franc-zone (somewhat similar to what was in effect the informal deutschmark-zone in the 1960s and '70s), was characterised by the dominance of one strong currency. The Latin Monetary Union (LMU) had a single currency but lacked a common or coordinated monetary policy. Officially the LMU ended in 1926, but its practical significance disappeared long before that as the Anglo-Saxon world gradually switched to the so-called gold standard system. The Scandinavian Monetary Union, founded by Denmark, Norway and Sweden in 1873, also proved to be a short-lived experiment. Some monetary unions evolved as nation states emerged, for example that of the Austro-Hungarian Monarchy, or the

Prussian-dominated one created by Bismarck for the North German Confederation and the creation of its customs union (Zollverein). Under pressure from Bismarck, and after full German unification in 1871, Germans using dozens of different currencies accepted the Goldmark as sole legal tender even though the Reichsbank did not have exclusive competence to print money. Bismarck's monetary union was very stable, outliving the Great Depression and two world wars. The reason for its stability was simple: behind the currency was an increasingly united state. Another, oft forgotten monetary union between Belgium and Luxembourg has been in existence since 1921 and was only "overwritten" by the introduction of the euro.

The introduction of the euro was primarily politically motivated, symbolic of the spirit of European unity, with some finer considerations in the background: by pooling their monetary policy competences in a common bank, France and the Netherlands increased their independence from the German Bundesbank, which used to dictate European monetary policy (not by force but rather by market realities). On the other hand, by relinquishing the Bundesbank's hegemony in monetary policy, Germany made a *beau geste* towards European countries anxious about its reunification. The symbolic move of giving up the D-mark, one of the most successful currencies of all time, served to demonstrate Germany's European-ness.

Nobel laureate Canadian economist Robert Mundell from 1998 said: "The euro will probably challenge the dominant position of the dollar, making it the single most important development in the international monetary system since World War I, when the dollar took over the pound's role as the leading reserve currency."[275] Will his prophecy ever come true?

Since the euro was introduced, the world economy has undergone major changes, and the trends suggest that the unipolar global monetary system based on the dollar's absolute hegemony is shifting towards a bipolar system. To put it in plain language: the euro has appeared as a competitor to the dollar. When it was introduced, the euro became the number two reserve currency overnight, and has gradually been gaining in strength as such. All this time, the US economy has accumulated vast debts vis-à-vis the rest of the world (not least China) and has thus weakened astonishingly. The US current account deficit is double (6%) the historic high recorded during the years of the arms race under Reagan in the '80s. The United States has turned from the world's biggest lender to the world's biggest debtor, which shaved off about half of the dollar's value (against the euro) in just a few years.

The international clout of a currency is determined not solely by its role as a reserve currency. A clear indication of the euro's worldwide acceptance is its share in the international bond market (i.e. in the market of non-bank loans), where it already stole the show in early 1999 when – for a brief period – most bonds were issued in euros and not dollars. In the years prior to the euro's introduction, the situation was just the opposite: European currencies struggled to maintain their position, naturally competing against each other, while the dollar gained ground to the detriment of the yen. With the

275 Posen, S. Adam, ed.: *The Euro az Five: Ready for a Global Role?* Special Report p18. Washington DC. Institute for International Economics.

introduction of the euro, the dollar had a new competitor to face, one which has been advancing with giant strides. For non-eurozone issuers the rule of thumb, however, is the following: when the target investors are European, the bonds are issued in euro, when it is a global issue (including Europe) the dollar is preferred. This rule has been changing slowly but surely. The key questions that experts and market actors were trying to predict in the run-up to the creation of the eurozone were: 1) whether the euro's role in currency markets would be bigger (and if so, by how much?) than the combined role of participating currencies before its introduction; 2) whether it would outperform the late Deutschmark. The years since have shown that the answer is – not really; the weight of the euro in currency markets is similar to what the D-mark used to have.

Countries with close trading or institutional ties with the eurozone generally use the euro as their key currency for influencing exchange rates, invoicing and payments (in addition to their own currencies, of course). Lebanon, Egypt and Israel all opted for euro-based loans in the international money market. Nevertheless, on the international scene, the euro still only plays a fundamentally regional role. It serves as a secondary currency in central and South-Eastern Europe and in parts of the Balkans and the Mediterranean, which is only logical as the Deutschmark, and to a lesser extent the Austrian schilling or the French franc, used to play the same role.

The US dollar has twice the share of the euro in currency transactions, and maintains its role as the currency of choice for invoicing in international trade, especially in the oil business. In EU-US trade relations, the dollar is used for settling accounts in 80% of bilateral trade.

Europe is far from being unified, both culturally and economically. Europe's markets are not uniform, which impairs its international clout. However, this is not the main obstacle preventing the euro from becoming the world's leading currency. The real stumbling-block is that it is a currency without a country.

Politics are just as important as economics – if not more important – in positioning a currency on the global scene. Eurozone members are yet to sing from the same hymn sheet internationally, especially at forums such as the G7 or the IMF. The euro is a currency created by politicians but lacking a political image.

The "growth versus balance" question is not unique to Europe; the USA faces the same dilemma. In his essay of 2005[276], Daniel Griswold, research fellow at the Cato Institute, went as far as to argue that, in the light of historic experience, the current accounts imbalance was a precondition to the growth of the US economy. Griswold analysed economic figures from the past two and a half decades and concluded that the growing deficit regularly yielded increased growth and employment. In comparison with the record US deficit of 620 billion, in 2004 Germany accumulated a global surplus of USD 200 million, but with an unemployment rate of over 11%. (The last time the US saw such a high unemployment rate was in 1982, when it had a negligible 5 billion USD deficit.) The USA, as the world's strongest economic power and the holder of the number one global currency, is in many respects in a different position

276 Daniel Griswold: *Bad Neas ont he Trade Deficit Often Means Good News ont he Economy.* p. 1-3. Free Trade Bulletin, no 14. 14, January 11, 2005.

from Europe, especially since Europe is troubled by the peculiar situation of the two arms of economic policy moving to different beats. Monetary policy – i.e. the setting of interest rates (with a direct impact on economic growth and unemployment) – is made in Frankfurt by the European Central Bank, with the governments having no say whatsoever. The strings moving the other arm of economic policy, budgetary policy (i.e. what the state spends money on) are in the hands of the 28 governments. The European Commission is caught in between, trying to coordinate and orientate national budgetary policies by sanctioning member states that overspend and allow their budgetary deficit to exceed 3% of GDP.

How the rules supposed to guarantee fiscal stability in the euro area can be enforced and reinforced is a critical issue. News are regularly coming from Brussels about the stability pact and its bodyguard, the excessive budgetary deficit procedure. This is no coincidence: at any given time as many as a dozen member states – some already in the eurozone – are in violation of the budget deficit ceiling.

The rules of the stability pact were proposed by Germany, wary of member states with poorer economic track records. Germany had to convince its citizens that the euro would be just as hard a currency as the D-mark was, and would not be jeopardised by other euro area countries under any circumstances. Essentially, the pact is a complex supervisory system to prevent crises through member states constantly keeping an eye on each other, with the excessive deficit procedure acting as a deterrent. The pact was born as a compromise between Germany and France. The Germans managed to realise their pet project and have their pact adopted, but the sanctions (fines) for offenders finally agreed upon were not quite the deterrent originally envisaged. Firstly, sanctions are not automatic, but depend on the discretionary decision of ministers of finance. Secondly, the time until the deposit becomes a fine is so long that it hardly forces governments to make the necessary corrections. Countries afraid of being sanctioned thus have time to explain the reasons behind their deficit and avoid being fined. The sanctions foreseen in the pact have never really been applied in practice; the two big eurozone economies of France and Germany got off cheap, which largely discredited the pact. People started questioning the point of having the pact and whether its rules could be enforced. The problems surrounding the stability and growth pact are often traced back to the Maastricht convergence criteria, which – for the sake of simplicity and clarity – set objectives that disregarded real economic processes. The key shortcoming of the pact, critics say, is its inability to respond to changing economic circumstances in a flexible manner. This rigidity is most apparent during recession or years of stagnation, when the pact leaves little room for manoeuvre to stimulate the economy as such measures could temporarily increase the budget deficit.

"The euro is nothing more than a system of fixed exchange rates covered by a glossy coat of political paint. The malfunctioning rules of the euro area unite countries that would otherwise be economically incompatible and which could easily be wrecked by a handful of global hedge funds. The luck of the euro is that – for the time being – it is not in the interest of hedge funds to do so".[277] Such views are easy to come across in the

277 In: Attila Marján: *Europe's Destiny*, 2010. p. 243

European – especially the British – press. The euro will disappear – American financial investors say. Are all of these opinions nonsensical, or is there some truth in it?

Historical experience shows that monetary unions are successful when they have among their members at least one economic power-house acting as the engine. Central institutions are also needed to control and enforce the rules. The most successful ones are preceded by a political union, as in the case of the USA, the UK or Germany. Price and wage flexibility is a fundamental criterion, so that wages can be limited in poorly performing regions, just as inter-regional transfers can be useful. Fixing and applying criteria on economic convergence also prove to be necessary. In the eurozone, we can hardly talk about real flexibility of labour markets, just as we cannot talk about a political union either. The EU budget is not designed for major income transfers either, as it only disposes of 1% of GDP. The eurozone meets all of the remaining conditions. The US federal budget is around EUR 3.3 trillion, compared with the EU "federal" budget of roughly 120 billion euros, a good part of which is transferred to non-eurozone countries. The difference between the internal transfer capabilities of the two monetary unions is obvious. On the other hand, in the absence of a European identity, it is much harder to convince a German factory worker of the benefits of financially supporting Portuguese fishermen than to explain to a Californian why it is important to help the good people of Utah.

One can observe serious shortcomings in the operation of the European monetary union. These are partly caused by the imperfections of the institutional setup, and partly due to the increasing disparities within the euro area in terms of inflation, productivity, and growth rate. (The fact that Spain has accumulated a 9% current account deficit while Germany has a 9% surplus, also speaks volumes.) The gaps are growing, even though they should be diminishing, as we have seen. To make things worse, Europe is losing ground versus the US in terms of competitiveness. Both problems can be traced back to the same roots: the unwillingness of certain member states to carry out the necessary reforms and push ahead with modernisation. Prior to the introduction of the euro, governments were all for reforms as their participation in the single currency was at stake. Italians even had to pay a one-off 'euro levy' and they did not take to the streets in protest. As soon as people had the euro notes in their hands, the purse-strings came loose again. With the disappearance of national currencies, depreciation is no longer a monetary policy option; the only instrument governments have at their disposal is to dismantle labour market obstacles and allow competition in all sectors, in other words to strengthen competitiveness through exposure to market forces.

At the time of the creation of the monetary union, it was generally believed that the success of the euro would hinge on two things. First and foremost on the reform of European markets: dismantling the welfare and bureaucratic rules that prevent the economy from unleashing its potential. Secondly, on building stronger political integration. The first is important because countries changing over to the euro lose the option of depreciating their national currency but must remain able to respond flexibly to changes in the world around them. The second is important because a successful stability-oriented economic policy requires social and political legitimacy. When preparing the introduction of the single currency, political union was temporarily taken off the agenda – in order to prevent national governments from exerting political pressure – the Central Bank was given full independence: nobody can just walk into the eurotower in Frankfurt to do a bit of lobbying. As a complementary measure, the stability pact was adopted with the aim of reining in member state overspending. As we can see, the institutional framework is built on mutual distrust: Community institutions without political legitimacy act as the guardians of economic stability vis-à-vis the politically legitimate member states that are not to be trusted. The question is, how long can this arrangement be maintained, when will the steam blow the lid off and who will get scalded when it does? One potential solution – call it an escape route, if you will – is to continue with political integration. But an even more pressing question is, if political integration continues, what will it mean for managing the economies of the eurozone: stability or a spending spree? Despite all of these difficulties, I believe that political integration should not be rushed only for the survival of the monetary union; the euro can wait for slower political integration, but not for slow market integration.

As the world's most powerful banker, US Federal Reserve Chairman Ben Bernanke wrote, "we must accept the eurozone for what it is: a bold political project, which is not your textbook optimum currency zone, but works nonetheless, and as such cannot be judged by solely economic aspects but as part of the whole European project."[278]

The euro was created by politics – and what a good deed it was. Politics must also help preserve it, but not by taking the easy way out and exercising direct political control over exchange rate policy; instead, focus needs to be on completing internal market integration and agreeing to a higher degree of coordination of member-state economic policies. As André Sapir and Jean Pisani-Ferry put it: the euro area needs fewer routine procedures and more ability to act in times of real crises[279]. The eurozone's approach to economic changes and political changes (such as enlargement) is still very legalistic, and still has no international strategy and proper representation in fora like the IMF. More profound economic coordination need not mean full harmonisation as that would impair the members' ability to conduct an economic policy best suited to their own conditions and economic cycles. And certainly should not mean the hindering of the Central Bank's functioning, but coordination of structural reforms. The euro is not only an important symbol and an economic stabiliser, but should also be the stepping-stone to more coherent European action on the international scene. It is not only the driving force behind economic integration, but also enhances European identity and reinforces Europe's global role. As Ottmar Issing puts it: *Der Euro* "is still an experiment whose outcome seems likely to remain uncertain for a considerable time to come."[280]

The eurozone experienced its deepest crisis as from 2008. The European Commission, the European Central Bank and member states had to put in place a series of policy reforms to save the common currency and to get eurozone economy back on track. It

278 In: Attila Marján: *Europe's Destiny*, 2010. p. 239.

279 Pisani-Ferry, Jean, et al.: *Coming of Age: Report on the Euro Area*, Bruegel Blueprint 4. p.4. 2008, Brussels

280 Ottmar Issing: *Europe: Common Money – Political Union?* p. 6. European Central Bank, 1999.

became obvious that the political and economic structure behind the currency union was insufficient and needed a significant overhaul and reinforcement. This recognition helped pave the way to a genuine economic union and gave a new impetus to plans to get closer to a European political union. The crisis and European crisis management efforts shall be analysed in detail in subsequent chapters.

X. Economic policy reforms

1. Overview

During the economic and financial crisis beginning in 2008, weaknesses of the initial design of the Economic and Monetary Union (EMU) became obvious. The EMU structure is characterised by asymmetry as it is a real monetary union with a common currency, but the economic pillar of the EMU lagged behind as fiscal policies are conducted at national level. The crisis underlined that in the absence of strong fiscal cooperation, EMU is not a real economic union as sufficient fiscal transfers to tackle efficiently the tensions stemming from asymmetric shocks are not available. As we can see in Chapters V and XI the European Union has taken several measures to address these weaknesses and to improve the governance of the EMU. But the crisis also highlighted that the EMU is facing a fundamental challenge and needs to be strengthened further to ensure economic and social welfare in the long run. Therefore, in the course of 2012, a European debate was launched on how to achieve a more deeply integrated EMU in the future.

The vision was presented first by Herman Van Rompuy, President of the European Council on the summit of 28-29 June 2012. His report[281] named 'Towards a Genuine Economic and Monetary Union' set out four 'building blocks' for the future EMU: an integrated financial framework (the so called banking union), an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability[282]. As the June summit invited him, President van Rompuy presented a specific and time-bound roadmap for the achievement of a genuine EMU in December 2012. Parallel to this, the European Commission published its views in the 'Blueprint for a deep and genuine EMU' in November 2012. The report and the blueprint also identified the actions required in the short, medium and long term to arrive at a genuine EMU on a permanent basis, from stronger policy coordination to fiscal capacity to greater pooling of decisions on public revenue, expenditure and debt issuance.

The political vision is based on the following key principles. First, during the process, the integrity of the European Union needs to be preserved. Second, the deepening of the EMU should primarily and fully exploit the potential of EU-wide instruments, without prejudice to the adoption of measures specific to the euro area. Whenever legally possible, measures targeted at the current members of the eurozone should be open for participation of other member states. Third, the deepening of the EMU should be done within the institutional and legal framework of the TEU and

281 In close cooperation with the Presidents of the Commission, Eurogroup and European Central Bank.

282 The process has been completed with measures to enhance the social dimension of the EMU (see Chapter VI.)

TFEU[283] (hereafter the Treaties). Steps should primarily be made through secondary legislation. Amendment in the Treaties should be contemplated only where and when necessary and after a careful preparation. Therefore, the first priority was to create the elements of the banking union in 2012-2013. This process is almost completed as a single supervisory mechanism is agreed upon and it is to operate from November 2014, putting in place the architecture for coordinated financial supervision in the eurozone. Building on this, a single resolution mechanism will be established to be able to effectively stabilise the financial sector.

In this chapter, we present the four 'building blocks', namely the vision outlined by the Commission and president Van Rompuy towards a full banking, economic, fiscal and political union[284] and the progress achieved so far. The following subchapters are built up in chronological order, but all of the 'building blocks' are closely connected (especially the economic and the fiscal union). *Table 1* gives a general overview about the elements of 'building blocks' and their timing. Stage I contains the short term measures from 2012 to 2014. Stage II covers the medium term measures from 2014 to 2017. Stage III refers to the long term vision. The 'building blocks' of the EMU in the medium and long term go beyond what is possible under the current Treaties, therefore, many elements of the planned new structure are just theoretical considerations, with no concrete steps taken and no agreements made in most cases of medium and long term views.

283 Treaty on the European Union (TEU) and Treaty on the Functioning of the European Union (TFEU)

284 The emphasis of this chapter is on the economic and fiscal union. Chapter VIII details the banking union.

	Stage I (short term, mostly completed)	Stage II (medium term: 2014-2017)	Stage III (long term: beyond 2017)
Integrated financial framework (banking union)	Single Supervisory Mechanism Single Rulebook ESM direct bank recapitalization Single Resolution Mechanism (all agreed)		Full banking union*
Integrated economic framework	Ex-ante discussion of major economic policy reforms Creation of a Convergence and Competitiveness Instrument (CCI)	Deeper coordination in the fields of taxation and employment*	Full economic union*
	Continuous implementation of the European Semester		
Integrated budgetary framework	Agreement of 'two pack' Financial support in the CCI	Setting-up of a redemption fund* Issuance of Eurobills*	Full fiscal union* Creation of a central budget with a stabilization function (proper fiscal capacity)*
	Continuous implementation of 'six pack', 'two pack' and Treaty on Stability, Coordination and Governance (TSCG)		
Political accountability	Smooth progress on democratic legitimacy and accountability		Full political union*

Table 1: The overview of steps towards a genuine Economic and Monetary Union (EMU)
Source: Authors own construction based on 'Blueprint for a deep and genuine EMU' and report on 'Towards a Genuine Economic and Monetary Union'
*Note: *Amendment of the Treaties is needed*

2. Integrated financial framework[285]

Creating an effective banking union is a cornerstone of the EU's efforts towards a deeper economic and monetary union. The initiative to build a new supervisory and resolution framework was announced by the heads of state and government of the euro

285 For more details on the banking union, see Chapter VIII.

area in June 2012. The vision was further developed in the European Commission's blueprint for economic and monetary union in November 2012. The banking union is to be underpinned by a comprehensive and detailed single rulebook for financial services for the internal market as a whole and to be composed of a single supervisory mechanism and new frameworks for deposit insurance and resolution. In the banking union supervision and resolution of banks will move from the national to the EU level.

All euro area member states will automatically become a part of the banking union. With a view to maintaining and deepening the internal market, the banking union is open to all non-euro area member states.

3. Integrated economic policy framework

3.1 Rationale

The fact that member states' economic policies are a matter of common concern (in accordance with the Treaties) has been highlighted by the sovereign debt crisis, especially in the euro area. The crisis has shown that the unsustainable economic policies, slow or weak implementation of structural reforms of some euro area countries can cause economic spillover effects on other members of the EMU. Therefore, an integrated economic policy framework is necessary to guide the policies of member states at all times towards strong and sustainable economic growth to produce higher levels of growth and employment. Closer coordination of economic policies will help detect economic vulnerabilities at an early stage, and allow for their timely correction. To achieve this aim, it is essential to increase the level of commitment, ownership and implementation of economic policies and reforms in the euro area member states.

3.2 Short-term steps

3.2.1 Ex-ante coordination of major structural reforms

The current EU economic surveillance framework already provides a basis for economic policy coordination. This framework, however, does not provide for systematic ex-ante coordination among the member states of national plans for major economic policy reforms. The concept of ex-ante coordination was introduced by the Treaty on Stability, Coordination and Governance in the EMU (TSCG, or 'fiscal compact' in brief). Article 11 of the TSCG provides that "With a view to benchmarking best practices and working towards a more closely coordinated economic policy, the contracting parties ensure that all major economic policy reforms that they plan to undertake will be discussed ex-ante and, where appropriate, coordinated among themselves". It would be incorporated into the legal framework of the EU by 1 January 2018 at the latest, according to the TSCG. To that end, the European Commission issued a communication on ex-ante coordination in March 2013, and intends to come up with a concrete legislative proposal.

The ex-ante discussion of major reform plans would allow the Commission and member states to assess the potential spillover effects of national action, comment on the plans or suggest changes before final decisions are taken at national level. The Commission considers that ex-ante coordination should concern only major national economic reform plans in the area of competitiveness, employment, market functioning, tax systems, financial stability and fiscal sustainability. According to the current considerations, this framework would have a binding nature for euro area member states, because of stronger interdependence between euro area countries, but other member states would be able to participate on a voluntary basis.

The discussion of the reforms would be the integral part of the European Semester process. Participating member states would submit information about their major economic reform plans to the Commission for example in their National Reform Programme (or at another time during the year). The Commission would assess the plan and deliver an opinion on it. The assessment of the Commission would pay particular attention to the impact the reform would have on the functioning of the euro area and to possible spillover effects on other member states. These plans would then be discussed by the Council and the Eurogroup. The Commission and the Council can suggest modifications to the national reform plan where they could be justified by the expected effects on other member states and the functioning of the EMU.

3.2.2 Supporting the implementation of structural reforms

In order to increase national commitment and to facilitate and provide support for the timely implementation of structural reform plans as mentioned above, there is a need to set up a Convergence and Competitiveness Instrument[286] (CCI). This instrument would combine deepening integration of economic policy through mutually agreed contractual arrangements (hereinafter contracts) with a solidarity mechanism. Figure 1 shows the two legs of the instrument. The consultations on this contract among member states have started in spring 2013[287]. Member states agree with the main features of the contract:

- The new system would also build on the existing EU surveillance framework, namely the European Semester.
- The mechanism would be mandatory for euro area member states and voluntary for the others.
- The contracts would be negotiated and mutually agreed between the member state and the Commission, before being submitted to the Council for approval.
- The National Reform Programme submitted by each member state will be the basis for the contracts, also taking into account the Country Specific

286 The Commission calls it 'Convergence and Competitiveness Instrument', while the European Council refers to it as 'contractual arrangements and associated solidarity mechanism' or more recently 'Partnerships for Growth, Jobs and Competitiveness'.

287 Debates were held in European Council meetings and its preparatory Sherpa meetings.

Recommendations (CSRs) and the economic policy priorities identified by the European Council.
- The system would support the structural reforms of member states in areas which are crucial for growth, competitiveness and jobs.
- The contracts would cover a broad range of measures, including the performance of labour and product markets, the efficiency of the public sector, as well as research and innovation, education and vocational training, employment and social inclusion.
- The reforms could be supported by temporary, targeted and flexible financial incentives, on a case-by-case basis, helping investment in growth and job-enhancing policies. (See section 4.2. below about the budgetary implications of the contract.)

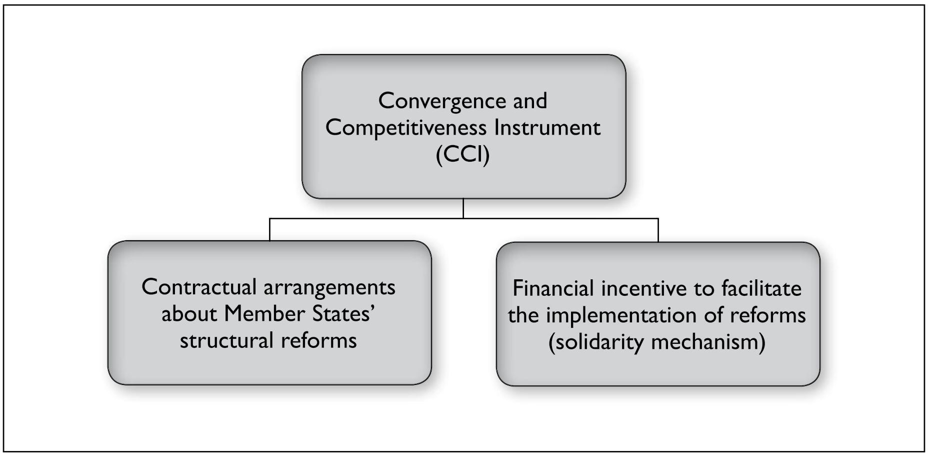


Figure 1: The design of the Convergence and Competitiveness Instrument (CCI)
Source: 'A Blueprint for a Deep and Genuine Economic and Monetary Union – Launching a European Debate', COM(2012) 777 final

3.3 Medium and long term steps (deeper coordination in the fields of taxation and employment)

An effective monetary union requires a far more centralized tax system. In addition, well-functioning labour markets and labour mobility in particular have significant importance for adjustment capacity within the euro area. Furthermore, tax and employment policy can support economic policy coordination and contribute to fiscal consolidation and growth. The Commission highlights that based on the experience to be gained with the structured discussions and ex-ante coordination of these issues, deeper coordination in the field of tax systems and employment is worth considering in the future, in the context of a Treaty change providing scope for legislation. The

Commission also argues that these possible changes would provide the basis for developing a proper fiscal capacity for the euro area to support structural reform on a large scale as well as for enabling forms of debt mutualisation to facilitate the solution of the problems of high debt and financial segmentation that are among the legacies of the crisis.

4. Integrated budgetary framework

4.1 Rationale

In the past few years, significant improvements have been made in order to reinforce the fiscal surveillance framework. With the 'six pack', the stability and growth pact was strengthened. Since December 2011 there is greater focus on the prevention of budgetary imbalances, on debt developments and on better enforcement mechanisms. The 'two pack', entered into force in May 2013, further reinforced the coordination and control of national budgets. By signing the 'fiscal compact', certain member states have legally underlined their commitment to balanced budgets.[288]

Despite these decisive steps to move towards fiscal union, the progress is far from over. The EMU needs to be deepened further in the medium term, because there is no centralised fiscal policy. A firm monetary union requires a common risk-sharing mechanism. In the euro area adjustment to country-specific economic shocks is inadequate (as labour mobility is low, the capital flow fluctuations can undermine financial stability, etc.), therefore fiscal risks should be shared among the euro area member states. Setting-up a shock absorption mechanism, like a centralised fiscal capacity, can help to prevent contagion across the euro area.

4.2 Short-term steps

The initial step towards a central fiscal budget would be a solidarity instrument that helps implementing member states' structural reforms through financial incentives in the form of the above mentioned mutually agreed contracts. This solidarity instrument would be the financial leg of the above mentioned Convergence and Competitiveness Instrument (CCI). The 'solidarity mechanism' through a contract may offer a solution of shock absorption, through an insurance-type mechanism in the long term. There is no final agreement on this mechanism, but regarding the main principles, the member states reached an agreement at the European Council meeting in December 2013:

288 These developments are addressed in detail in Chapter V.

- Any financial support agreement associated with contracts will have a legally binding nature.
- The mechanism would not entail obligations for the member states not participating in the system.
- As this financial support would be limited and temporary in nature, it should be treated separately from the Multiannual Financial Framework (MFF) regulation.
- The instrument should not become an income equalisation tool.
- It should respect the budgetary sovereignty of the member states.

Illustrative example for the operation of the Convergence and Competitiveness Instrument (CCI)

Due to the crisis, the unemployment rate in Spain has reached record high levels (26.4% in 2013). In order to tackle high unemployment and ease labour market tensions, the Spanish government intends to implement structural reform in the labour market to reach higher internal flexibility. Therefore, Spain submits a contractual arrangement proposal including concrete policy actions and a timetable for those actions. The Commission discusses and mutually agrees with Spain on the content of the arrangement, and then the Council approves it. To facilitate the efforts and the commitment of Spain, the labour market reform could be supported by financial incentives. For example, training programmes could be financed in part through support provided under the CCI. If Spain does not meet the contractual arrangements, the financial support can be withheld.

Further work is necessary as regards the nature (e.g. loans, grants or guarantees), institutional form and the volume of support in solidarity mechanisms. The president of the European Council was invited to carry this work forward and to report to the October 2014 European Council "with a view to reaching an overall agreement".

Regarding the nature of support, some proposals emerged during the debate. The Commission suggested that the solidarity mechanism would be included in the EU budget as external assigned revenues, and be financed either by direct contributions (e.g. GNI key) or by new own financial resources. But these grants necessarily imply some pooling of common fiscal resources and transfers, therefore, it also emerged that the financial assistance could take the form of loans at a lower interest rate than the market rate of most beneficiary member states.

Vanden Bosch[289] argues however that the form of this financial support should not be limited to loans, and should include the possibility for grants. He finds that the incentive effect of such loans is questionable because limited number of countries

289 Vanden Bosch, Xavier (December 2013): "Contractual arrangements: the overlooked step towards a fiscal union", European Policy Brief, Royal Institute for International Relations, http://www.egmontinstitute.be/wp-content/uploads/2013/12/EPB18.pdf.

would request such support at around 2% interest rate as programme countries[290] are excluded. Moreover, he considers that loans would not fit the rationale of contractual arrangements being used as an intermediary step towards a fiscal union.

4.3 Medium term steps

This chapter presents the medium term plans about building an integrated budgetary framework. Although the work on the above presented Convergence and Competitiveness Instrument (CCI) started both on a technical and a political level, there was no discussion on the following proposals until the completion of this book. These are just theoretical considerations, and in some cases they do not have support among member states.

4.3.1 Transition towards a fiscal capacity

Building on the future experience of the solidarity mechanism (through a Convergence and Competitiveness Instrument), a proper fiscal capacity for the euro area should be established in the medium to long term. In this transitional period towards establishing this automatic stabilisation function, limited, temporary and flexible financial incentives could be provided to member states to promote structural reforms. Thus, successfully implemented reforms specified in the above mentioned contractual arrangement could also serve as a criterion for participating in the fiscal capacity mechanism established in the long run. This would provide countries with a strong additional incentive to implement sound economic policies before and after they join the shock absorption mechanism.

4.3.2 Setting-up of a redemption fund

The spread of the financial crisis to sovereign debt markets and the development of negative feedback loops between banks and sovereigns have resulted in a broader fragmentation of the euro area financial system in 2010. The build-up of the vulnerabilities was partly due to the insufficient respect of public debt rules laid down in the Stability and Growth Pact (see Chapter V for details). In order to tackle the sovereign debt crisis and to reduce the huge government debt of the member states in an effective and credible way, some ideas emerged to introduce debt mutualisation in the medium to long term. The Commission has already proposed two forms of debt mutualisation: i) a redemption fund and ii) the eurobills.

290 Programme countries that benefit from the EU crisis resolution mechanism (EFSF/ESM). For details on these mechanisms, see Chapter XI.

The concept of a collective redemption fund was first presented in 2011 by the German Council of Economic Experts[291]. The redemption fund aims to bring the public debt of the euro area member states to sustainable levels by lowering the financing costs. The framework would operate as follows:

- The member states' government debt would be divided into two parts: i) the debt under 60% of the GDP would remain the member states' responsibility, ii) while the debt above the 60% of the GDP would be transferred and pooled into a fund. Member states would be obliged to autonomously redeem the transferred debt over a special period of time (e.g. 25 years).
- The fund would finance itself by issuing its own bonds, which would ideally be backed by a joint guarantee of all euro area member states. The joint and several guarantees on the fund's bonds would result in a relatively low cost of financing for participating member states thereby easing their overall debt-servicing burden.
- This risk of moral hazard would need to be addressed by commitments by member states in the area of economic governance. As a pre-condition for participating in the scheme, a path for budgetary consolidation and structural reform would be laid down for each member state.
- The scheme has several challenges: i) incentives would need to be created for high-credit quality member states, ii) the market-disciplining effect would be substantially weakened, iii) a limited duration of the scheme would reduce market liquidity towards the end of the scheme.

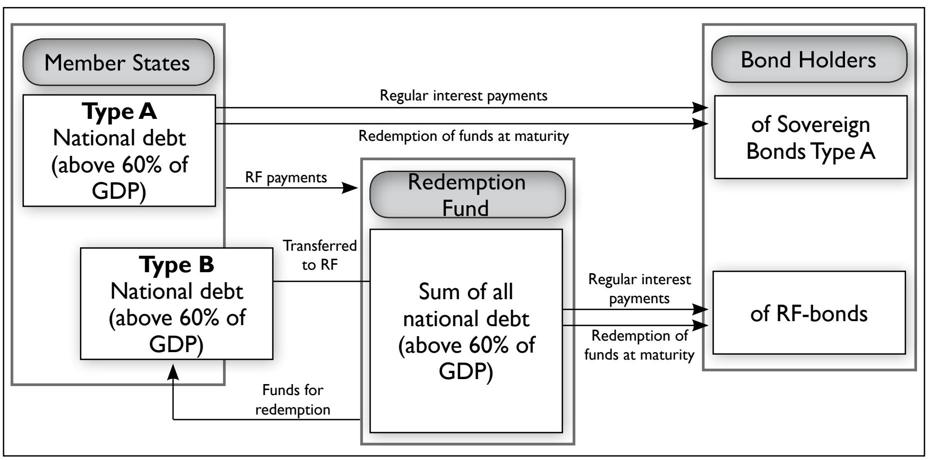


Figure 2: Scheme of the European redemption fund
Source: Blueprint

291 The German Council of Economic Experts is a group of economists set up in 1963 to advise the German government and Parliament on economic policy issues. The Council has five members which are nominated by the federal government and appointed by the president of Germany. In 2011, the Council proposed a plan for the issuance of collectivised European debt.

Despite the benefits, the idea of debt mutualisation has had a cold reception, particularly in Germany. For example, Claudia Buch, a member of the German Council of Experts, emphasised that the redemption fund was never designed as a long-term mutualisation tool and conceded that there is much less urgency for the debt redemption pact with ECB's Outright Monetary Transactions (OMTs) in place and interest rates having narrowed.

4.3.3 Issuance of short-term eurobills

Before the crisis, for more than a decade, movements in sovereign debt markets had been highly synchronized across euro area countries, member states could borrow at almost equal conditions. However, with the onset of the eurozone sovereign debt crisis, credit risk spreads have diverged. Government bonds issued by countries of the euro area periphery[292] have been traded at considerably higher yields, with negative consequences for the sustainability of public finances. This segmentation of credit risk has caused financial fragmentation in the euro area.

The second instrument to stabilise these volatile government debt markets suggested by the Commission is the so called 'eurobills' (also known as 'eurobonds'). This would mean common issuance by euro area member states of short-term government debt with a maturity of up to 1 to 2 years. It would constitute a powerful instrument to foster the integration of euro area financial markets and against financial fragmentation, reducing the negative feedback loop between sovereign and banks, while limiting the moral hazard. Eurobills could gradually replace existing short-term debts, and would not expand the amount of euro area national short-term debt. The eurobills would also help greatly for the conduct of monetary policy in the euro area, as the transmission channels would be strengthened and harmonised. The short-term nature of such bills makes it possible to adjust the funding schemes quickly to national fiscal behaviour, thereby setting incentives for fiscal discipline.

To develop any of the two financial instruments, amendments to the Treaties would be required because joint and several guarantees by the participating member states are essential for these operations.

4.4 Long-term steps

4.4.1 A proper fiscal capacity – a central eurozone budget

A central budget for the euro area providing for a 'fiscal capacity' with stabilization and shock absorption function should be created gradually in the long run. The Commission indicated that the main purpose of a central budget would be to provide necessary stabilisation. However, president Van Rompuy's long term vision involves a 'fiscal capacity' to facilitate adjustment to economic shocks. Apart from the phrasing

292 Cyprus, Greece, Ireland, Italy, Portugal and Spain.

and timing[293], the purpose and the functioning of the two proposals would be the same.

Scope

Setting up common risk-sharing tools can contribute to:

- supporting adjustment to asymmetric shocks;
- preventing contagion across the euro area and beyond;
- stronger economic integration and convergence and
- avoiding permanent transfers over the cycle.

It is commonly believed that there is a need for a stabilisation mechanism because few countries save enough money in the good times to have then enough cash available in the bad times to stabilise their economies. Wolff[294] also argues that most monetary unions tended to have "some mechanism that temporarily helps to smooth such big shocks". He found that "a monetary union like the euro area requires a common budget in order to i) provide a temporary but significant transfer of resources in case of large regional shocks; ii) have an instrument to counteract severe recessions in the area as a whole in situations in which monetary policy is less powerful and fiscal policy becomes more powerful, and iii) provide public goods for the area to ensure financial stability". He added that a centralised stabilisation mechanism was also needed because "with decentralised fiscal policies the euro area-wide stabilisation that will be offered will be less than optimal because basically everybody hopes that their neighbour is doing the stabilisation".

The report of Van Rompuy states that the design of a future 'fiscal capacity' should rest on a number of guiding principles:

- Elements of fiscal risk-sharing related to the absorption of country-specific shocks should be structured in a way that they do not lead to unidirectional and permanent transfers between countries, nor should they be conceived as income equalisation tools. Over time, each euro area country, as it moves along its economic cycle, would in turn be a net recipient and a net contributor of the scheme.
- Such a function should neither undermine the incentives for sound fiscal policy making at the national level, nor the incentives to address national structural weaknesses. Appropriate mechanisms to limit moral hazard and foster structural reforms should be built in the shock absorption function. Linking it tightly to compliance with the broad EU governance framework, including possible arrangements of a contractual nature, should be envisaged.
- The 'fiscal capacity' should be developed within the framework of the EU and its institutions. This would guarantee its consistency with the existing rules-based EU fiscal framework and procedures for the coordination of economic policies.

293 President Van Rompuy would implement the instrument after 2014, while the Commission even later, beyond 2017.

294 Wolff, Guntram (December 2012): *A Budget for Europe's Monetary Union, Bruegel Policy Contribution*, 2012/22, http://www.bruegel.org/publications/publication-detail/publication /762-a-budget-for-europes-monetary-union/.

- The 'fiscal capacity' should not be an instrument for crisis management, as the European Stability Mechanism (ESM) has already been established for that purpose. By contrast, the fiscal capacity's role should be to improve the overall economic resilience of the EMU and euro area countries. It would contribute to crisis prevention and make future ESM interventions less likely.
- The design of the 'fiscal capacity' should be consistent with the principle of subsidiarity, and its operations transparent and subject to appropriate democratic control and accountability. Equally, it should be cost-effective and not lead to the undue development of costly administrative procedures or unnecessary centralisation. It should not lead to an increase in expenditure or taxation levels."

Resources

The budget should be autonomous in the sense that its revenues would rely on national contributions, own resources, or a combination of both. It should be effective and provide sufficient resources to support important structural reforms in a large economy under distress. In a longer term perspective it could eventually resort to borrowing, a key aspect of a future fiscal capacity. Therefore, the 'fiscal capacity' would require amending the Treaties.

Options

According to plans of the Commission and President Van Rompuy, a 'fiscal capacity' could take the form of a mutual insurance-type system between euro area countries to absorb shocks and smooth out business cycles – ensuring economic stability of the Union as a whole. The size of the autonomous budget would depend on the magnitude or range of the stabilisation function envisaged, on the depth of integration desired and on the willingness to enact accompanying political changes.

Options for a 'fiscal capacity' – the researchers' views

Various think-tank studies examined the possible options of euro area fiscal stabilization schemes. All of them agree that a monetary union, like the euro area, requires a budget in case of shocks and as a backstop to the banking union. Guntram Wolff[295] proposed that a European budget equal to two percent of euro-area GDP would be a good start in providing relief and, hence, imparting resilience to distressed economies. He finds that the four main options for stabilisation of regional shocks to the euro area are: i) unemployment insurance, ii) payments related to deviations of output from potential, iii) the narrowing of large spreads, and iv) discretionary spending.

295 Wolff, Guntram (December 2012): A Budget for Europe's Monetary Union, Bruegel Policy Contribution, 2012/22, http://www.bruegel.org/publications/publication-detail/publication/762-a-budget-for-europes-monetary-union/.

Jean Pisani-Ferry[296] also identified four options for a fiscal capacity. These are (i) a federal budget with unemployment benefit schemes and corporate taxes shifted to euro-area level; (ii) a support scheme based on deviations from potential output; (iii) an insurance scheme via which governments would issue bonds indexed to GDP, and (iv) a scheme in which access to jointly guaranteed borrowing is combined with gradual withdrawal of fiscal sovereignty.

4.4.2 Issuance of long-term eurobonds

Based on the experience of short-term eurobills, a really deep fiscal integration would create the conditions for a common issuance of long-term government debt through long-term stability bonds as set out in the Commission's 2011 green paper. The main difference among eurobills and stability bonds is the maturity: while eurobills would be only short-term bonds issued with a maturity of 1 or 2 years, stability bonds would substitute the national long-term government debt issuance.

The Commission lists three approaches for common issuance of stability bonds, based on the degree of substitution of national issuance (full or partial) and the nature of the underlying guarantee (joint and several or several):

- The full substitution by stability bond issuance of national issuance, with joint and several guarantees. This approach would have strong potential positive effects on stability and integration, but it would pose a relatively high risk of moral hazard (by abolishing all market pressure on member states), and it might need significant amendments of the Treaty.
- The partial substitution by stability bond issuance of national issuance, with joint and several guarantees. Stability bonds under this option would only cover parts of national financing needs. Therefore, member states would continue issuing their own bonds, although at an accordingly lower volume due to the parallel issuance of stability bonds. Hence, member states would still need to tap financial markets on their own and would be subject to market and financing conditions that would vary across member states and might reflect their different credit quality. The risk of moral hazard would also exist under this option but in a more reduced form, as market conditions specific for each member state would only apply to the national issuance part of debt financing. As this approach would only partly cover financing needs of member states, under this approach, as under the third one, one would have to decide about the specific volume or share of financing needs for a member state to be provided by the issuance of stability bonds.
- The partial substitution by stability bond issuance of national issuance, with several but not joint guarantees: This option would have only smaller effects on stability and integration, but the risk of moral hazard for the conduct of economic and fiscal policies in member states would seem very limited. This

296 Pisani-Ferry, Jean, Erkki Virhiälä and Guntram B. Wolff (January 2013): *'Options for a Euro-Area fiscal capacity', Bruegel Policy Contribution*, 2013/01 http://www.bruegel.org/publications/publication-detail/publication/765-options-for-a-euro-area-fiscal-capacity/

option would be relatively rapidly deployable, as the need for measures to counteract such moral hazard would be limited and as the instrument seems fully compatible with the Treaty.

An alternative approach to reach the genuine EMU

Ashoka Mody[297] proposed an alternative way to a more perfect economic union. His 'Schuman compact' is based on the idea that the fact that EU countries have been unwilling to surrender national fiscal sovereignty and centralised surveillance by supranational institutions cause political frustration and does not result in solidarity. In his decentralised approach, Mody argues for a model which extends the fiscal compact with a compact on enforcement of sovereign debt restructuring and a banking compact. The sovereign debt compact would create a credible "no bailout" regime to minimise the risk of excessive future sovereign borrowing as private lenders bear losses. The banking compact would encourage downsizing the enormous banking system while bolstering viable banks.

5. Political accountability

As all these proposals imply deeper integration, creating a deeper and genuine EMU needs to go hand in hand with developing a strong political union. Thus, improving the democratic legitimacy and accountability is essential during all stages of the process.

In short term, the parliamentary debate on economic policy coordination in the European Semester[298] should be reinforced as the application of the economic dialogue in the European Parliament (EP) introduced by the 'six pack'[299] should be broadened. For instance, debates could be held in the Parliament on the annual growth survey (AGS) and on the country-specific recommendations (CSRs). But the economic dialogue is not enough to respond to broader questions about the democratic accountability towards European citizens. There needs to be also more and closer cooperation between national parliaments and the EP in the future.

In longer term, the EP would have the possibility of adapting its internal organisation to a stronger EMU. It could set up a special committee on euro matters, an "EMU

297 Mody, Ashoka (2013): 'A Schuman Compact for the Euro Area'. Bruegel Essay and Lecture Series. http://www.bruegel.org/publications/publication-detail/publication/802-a-schuman-compact-for-the-euro-area/.

298 For more details on European Semester, see Chapter V.

299 The new provisions allow the Parliament to conduct economic dialogues with member states, in particular when they are in breach of EU rules. These provisions allow for a national government to be held to account in public at the European level for any failure to respect their European obligations.

sub-committee"[300] in charge of scrutiny and decision-making in the eurozone. The proposal has already emerged in the Committee on Economic and Monetary Affairs (EP ECON). At the same time, the idea of strengthening the informal Eurogroup also emerged by making it responsible for decisions concerning the eurozone.

300 The European Parliament already has two sub-committees – on human rights, and on security and defence – both linked to the foreign affairs committee.

XI. Euro crisis and crisis management

1. From subprime crisis to euro crisis

The experience of the first ten years of the Economic and Monetary Union (EMU) suggested that the project might be successful against all the prior negative voices in the academic debate. The euro turned out to be a stable currency with a strong international reserve role on the basis of the former Deutsche Mark. But shortly after the introduction of the euro, an external shock immediately tested the resistance of the system. The so called "dotcom" bubble burst in the U.S. in 2001. Experience showed that the new setup can withstand these developments better than the "constructions" before, like the European Monetary System[301]. After a short deceleration in the economic activity due to the "dotcom" crisis, growth picked up from 2006 until the financial crisis – which started to unfold from the summer of 2007 in the United States – slowly spilled over to the euro area. The financial crisis caused a downturn in real economy, the markets started to focus on country specific factors like financial imbalances, debt sustainability, lack of competitiveness, etc. This shift in market perception caused higher sovereign spreads for a growing number of countries, which lost their ability to refinance the maturing debt from the market. These developments led to a full-blown euro crisis, which affected most seriously the periphery of the euro area; however, all of the member states (MSs) faced challenges.

In this context, it is worth to analyse how the subprime crisis lead to a debt crisis in the euro area.

According to Mody and Sandri[302] , three different stages can be identified. But first of all, let us take a closer look on the causes of the so called subprime financial crisis in general.

Subprime lending in the housing sector was booming in the US before 2007 due to the "cheap" money, the financial innovations and the constantly rising real estate prices. Mortgage-backed securities were considered to be a good investment opportunity. Meanwhile, a small economic shock triggered a slow decrease in housing prices, which resulted in negative equity for a growing number of debtors. The rise of non-performing loans made the value of mortgage-backed securities decrease, which resulted in huge losses for the investors trading with them. This marked the first stage, which started in July 2007 and lasted until March 2008, when Bear Sterns, an American investment

301 For a detailed description about the European Monetary System see Chapter IV.

302 Mody, Ashoka, and Damiano Sandri. 2012. *„The eurozone crisis: how banks and sovereigns came to be joined at the hip."* Economic Policy 27, no. 70: 199-230.

bank[303] was bailed out. The unfolding tension in the US financial markets spilled over to Europe due to highly integrated global financial markets. At this stage, no country differentiation in risk perception could be observed among euro area MSs, a change in sovereign spreads in the euro area reflected global rather than domestic factors.

The rescue of Bear Sterns constituted an important milestone and marked the beginning of the second stage, during which the crisis got a distinctive European dimension.[304] This period ended at the end of 2008, early 2009. (The authors mark the end with the nationalisation of the Anglo Irish Bank in January 2009[305]). Market sentiment changed over this period since domestic financial developments came into spotlight. Direct and indirect effects of financial stress started to reflect in sovereign spreads since financial turmoil undermines growth by contracting credit supply and curbed investment. Therefore it affects the future debt dynamics of a country. Moreover, the potential losses on banks' balance sheets are potentially absorbed by the government in order to safeguard the stability of the financial system. This results in a high contingent liability for the public sector. Data show that due to these developments, stress in the financial sector was followed by a rise in sovereign spreads with a few weeks delay. Moreover, since the fiscal space is an important factor in the crisis management capacity and competitiveness and future potential growth is an important indicator of the crisis resistance, fiscal and economic developments also came into spotlight besides the financial developments. A moderate divergence in the euro area spreads started during this stage.

The third stage started with the nationalisation of the Anglo Irish Bank, which pointed out how significant might be the burden of rescuing the financial sector on public finances. Financial stress no longer preceded the rise in sovereign stress, the two moved simultaneously. A vicious circle of financial and sovereign shocks emerged, mutually reinforcing each other. The large cost of nationalisation put the ability of sovereigns to shore up the financial sector in question. Fiscal sustainability became also an independent driver of the crisis. The financial sector was hurt, too when greater stress on the sovereign was revealed. Analysis suggests that financial shocks had a more severe impact on sovereign spreads where growth prospects are low and the debt-to-GDP ratios are higher. The divergence in the euro area sovereign spreads intensified,

303 Two giant hedge funds of Bear Sterns collapsed, which were specialized in mortgage-backed securities, resulting a serious funding problem. This event triggered a credit crunch in the Wall Street and Bear's stock was in a free fall by/from March 14, 2008. JPMorgan Chase and the US federal government teamed up on a rescue package. (http://www.businessweek.com/stories/2008-03-14/bear-stearns-big-bailoutbusinessweek-business-news-stock-market-and-financial-advice).

304 Mody, Ashoka, and Damiano Sandri. 2012. „The eurozone crisis: how banks and sovereigns came to be joined at the hip." Economic Policy 27, no. 70: 199-230.

305 A property bubble collapsed in Ireland in September 2008 due to the global financial tensions which created huge losses in the Irish banking sector. To cool down the tension and to avoid capital flight, the government issued a – then highly debated – blanket guarantee for banking assets. The Irish government nationalised Anglo Irish Bank after the collapse of its share price accelerated and large scale deposit withdrawal occurred, which endangered the whole Irish banking system.

which massively increased the refinancing of the maturing debt. This puts an additional pressure of the budget of the MSs. Figure 1 shows the divergence in the long term interest rates. It is clear that January 2008 marked the start of the divergence, which then intensified from January 2009.

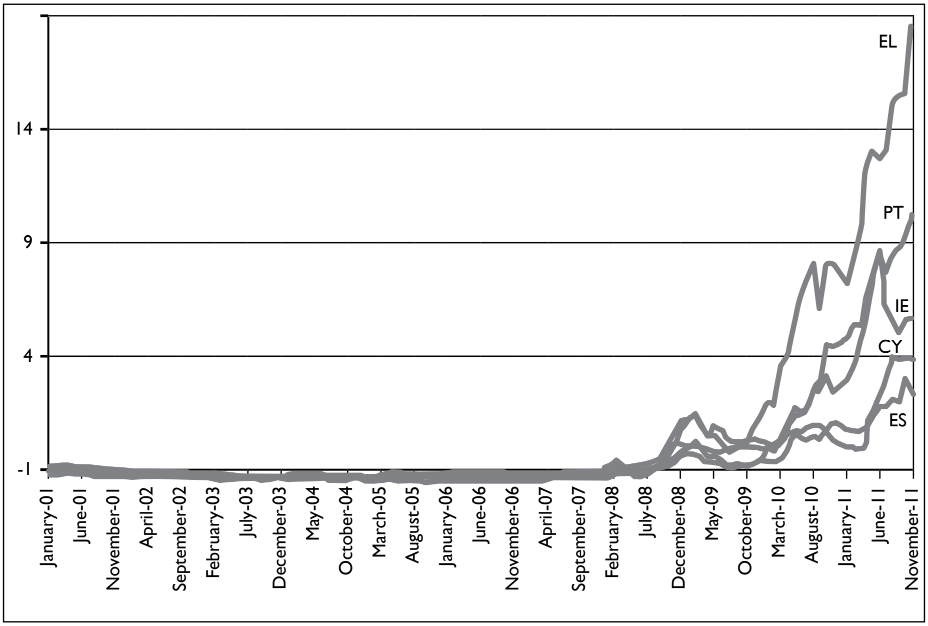


Figure 1: Divergence from the German long-term interest rates in selected euro area MSs (pp., %)
Source: ECB

The unfolding euro crisis hit all the MSs of the EU, but the most serious problems emerged on the periphery (often referred to as PIGS[306] countries) of the euro area. Consequently, countries lost market access and asked for international financial assistance: Greece (May 2010), Ireland (December 2010), Portugal (April 2011), Spain (July 2012), Cyprus (March 2013).

2. The roots of the crisis

As we have seen, because of the transatlantic banking crisis the market focus turned to the vulnerability of the domestic financial sector, the fiscal space and the competitiveness of the euro area MSs, which led to bailouts and a euro crisis. Before

306 PIGS=Portugal, Ireland, Greece, Spain. Cyprus was not included at first.

turning to the detailed analysis of the crisis response and the different bailouts, let's focus on the roots which led to a prolonged euro area crisis and the reason why the issue of competitiveness and fiscal situation arose in the first place. Based on the work of Darvas[307], the major roots of the euro crisis could be identified as follows:

- Inability to ensure fiscal discipline and the failure of the Stability and Growth Pact (SGP);
- No coordinated fiscal capacity to mitigate external shocks;
- Negative feedback between fiscal consolidation and growth;
- The build-up of credit bubbles and the neglect of private sector vulnerabilities;
- Lack of effective tools to foster structural reforms;
- No available crisis resolution mechanism for the euro area;
- The strong interdependence of banks and sovereigns;
- Lack of lender of last resort for sovereigns;
- Interdependence among member states and contagion;
- Executive and democratic deficit.

2.1 The failure of the Stability and Growth Pact (SGP)

The SGP was supposed to constitute the second, economic and fiscal pillar of the EMU. The objective of the rule-based mechanism was to ensure the fiscal discipline and to avoid the occurrence of "free rider" behaviour of a MS. However, the enforcement of the SGP was compromised already before the crisis (as shown in Chapter V.)

In light of the SGP reform, it is not very surprising that the period between the launch of the euro and the eruption of the financial crisis could not bring the necessary budgetary consolidation in a number of MSs, even amid favourable economic conditions (at least in some member states). The implementation of the reformed Pact was lenient; the deadlines for ending the excessive deficit situation were extended numerous times and thus limiting the required adjustment reforms.[308] Figure 2 shows the debt developments in the euro area in selected MSs. Only Cyprus, Ireland and Spain were able to reduce the debt level[309].

307 Darvas, Zsolt. 2012. *"The euro crisis: ten roots, but fewer solutions."* Bruegel Policy contributions http://www.bruegel.org/publications/publication-detail/publication/755-the-euro-crisis-ten-roots-but-fewer-solutions/.

308 Schuknecht, Ludger et al. 2011. *"The Stability and Growth Pact, crisis and reform"* Occasional Paper Series, no. 129, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp129.pdf.

309 These were the countries where the crisis hit not because of the initial fiscal weaknesses but through the imbalances in the private sector.

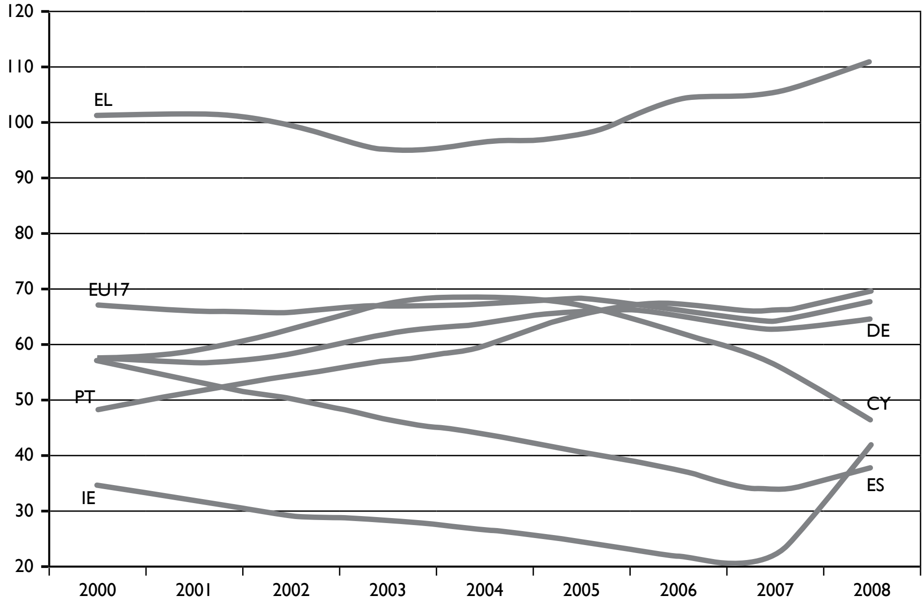


Figure 2: Debt developments in selected MSs (% of GDP)
Source: Eurostat

The situation of Greece in the context of the 3% deficit limit is even more complex. In 2003, the Eurostat concluded that the country never met the convergence criteria, the deficit data was manipulated by the Greek authorities. In 2003, the actual deficit in terms of GDP exceeded the 5%. Moreover, another massive statistical misreporting became apparent in 2009, which had a key role in the Greek crisis.

2.2 No coordinated fiscal capacity to mitigate external shocks

As a result of the structure of the EMU, the fiscal policy of the MSs is coordinated but there is no central authority to manage the overall fiscal stance of the euro area. member states are managing their own fiscal policies, which are deemed appropriate for their own economies, according to their own fiscal stance. However, these fragmented fiscal positions cannot be allocated to measure the fiscal stance of the euro area as a whole.[310]

310 Darvas, Zsolt. 2012. *"The euro crisis: ten roots, but fewer solutions."* Bruegel Policy contributions http://www.bruegel.org/publications/publication-detail/publication/755-the-euro-crisis-ten-roots-but-fewer-solutions/.

According to the theory of optimal currency areas[311], fiscal transfers with appropriate size are necessary to prevent adverse economic developments.[312] But the Multiannual Financial Framework (MFF), which is the seven-year budgetary framework of the EU, is only 1% of the GNI of the EU.[313] This size does not provide the possibility of significant transfers and it is not an appropriate tool to smooth the economic cycle and to ease the severe economic downturn in certain member states. Moreover, goals and functions of the MFF are also different from the "traditional budgets".

2.3 Negative feedback between fiscal consolidation and growth

Since the good economic times were wasted in a lot of countries to conduct rigorous fiscal consolidation, the crisis has hit while there was an extremely narrow room for manoeuvre. The lack of fiscal capacity compromised the government's ability to stabilise the distressed financial sector. Moreover, the unsustainable budgetary developments posed an imminent stress for the domestic financial sector as well. The missed fiscal consolidation effort had to be made under financial stress, contracting economic activity, lost competitiveness and low growth prospects. A vicious circle of fiscal consolidation and economic contraction occurred – the economic downturn increased the pressure on the expenditure side, since it turned on automatic stabilisers (e.g. unemployment benefits). Meanwhile, the sluggish economic activity decreased tax revenues and thus the revenue side. The initially narrow fiscal room of manoeuvre dampen the availability of anti-cyclical Keynesian[314] policies. These further undermine the economic activity.

311 An extensive academic literature exists about the optimal currency areas, which originated from the debate about the fix and flexible exchange rates (Palánkai et al. 2011).

312 Palánkai, Tibor, et al. 2011. *A globális és regionális integráció gazdaságtana* (Budapest: Akadémiai Kiadó 2011.

313 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0884:0891:EN:PDF.

314 According to the ideas of John Maynard Keyn es, the impact of recessions can be mitigated by increased government spending in an anti-cyclical way and by reducing interest rates.

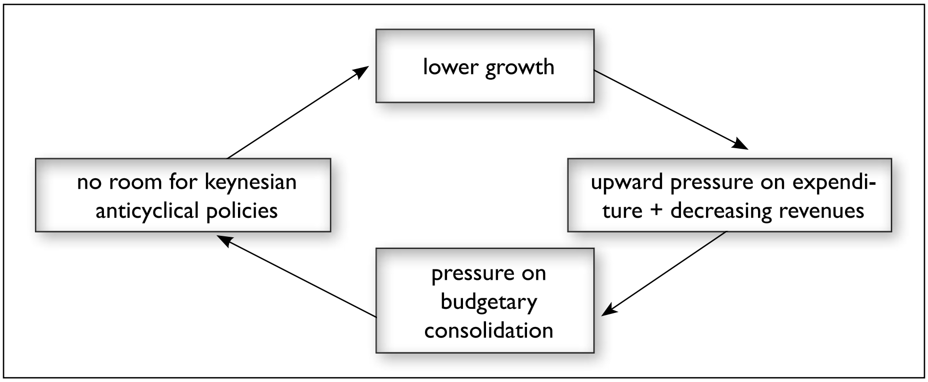


Figure 3: The vicious circle of low growth and consolidation
Source: author's own construction

2.4 Neglect of private sector vulnerabilities

Prior to the crisis, economic growth in certain countries was boosted by unsustainable economic developments. The convergence of the long-term interest rates, the liberalisation of the capital markets and the accommodating global financial developments provided "cheap money" for the euro area MSs. The capital was flowing towards countries where higher returns were expected due to higher growth prospects. This led to the build-up of bubbles both in private and public sector. Credit and housing bubbles were blown in Ireland and Spain and excessive public spending occurred in Greece. Nevertheless, the focus of the economic surveillance fell solely on fiscal developments, mainly on the 3% deficit criteria.

Missed structural reforms (see the following point) and lack of response to the adverse macroeconomic developments such as higher inflation, rapid appreciation of the real effective exchange rate and rising unit labour costs compared to the relatively low growth in productivity, undermined competitiveness and export performance. This resulted in external imbalances, high and excessive current account deficits (in Greece, Spain, Portugal and Cyprus).

2.5 Lack of effective tools to foster structural reforms

There were no effective mechanisms and rules to foster growth and competitiveness enhancing structural reforms. Some countries like Germany made significant structural reforms in the early 2000s, but others could not adjust.[315] The practice of promoting important structural reform was soft and lacked enforcement. The major structural reforms were not appropriately coordinated. Moreover, MSs would undertake reforms only with the smallest social resistance and do not have a broad vision about the modernisation process in most of the cases. The implementation of major economic reform programmes is undoubtedly challenging since the costs arise immediately and this hurts many interests. However, the benefits come only on a wider timescale and identifying the beneficiary groups is mostly puzzling.[316] We also have to take into account that the majority of these policy areas falls under the competence of the MSs (e.g. labour market reforms, tax policy, pension system, etc.).

The Lisbon Strategy, which was approved in 2000, was supposed to foster the competitiveness of the European Union with the ambitious aim of becoming the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion until 2010. It was based on the realisation that, in order to enhance its standard of living and sustain its unique social model, the EU needed to increase its productivity and competitiveness in the face of an ever fiercer global competition, technological change and an ageing population. In spite of re-launching the strategy in 2005 with the aim of reform its governance structure, the Lisbon Strategy could not achieve its goals. However – according to the Commission's evaluation – it would be too simplistic to conclude that the strategy failed because the targets (employment, R&D expenditure) were not met. The merit of the process is that it has broken new ground by promoting common actions to address the EU's key long-term challenges.[317]

2.6 No available crisis resolution mechanism

This issue also relates to the previous question of optimal currency areas and necessary fiscal transfers to mitigate the adverse economic developments. As we have seen, such fiscal capacity is not available for member states. An important safeguard against fiscal profligacy is the no-bailout principle, which is incorporated in the Article 125 of the TFEU: *"The Union shall not be liable for or assume the commitments of central*

315 Darvas, Zsolt. 2012. *"The euro crisis: ten roots, but fewer solutions."* Bruegel Policy contributions http://www.bruegel.org/publications/publication-detail/publication/755-the-euro-crisis-ten-roots-but-fewer-solutions/.

316 Marján, Attila, and Buda, Lorina. 2014. *"Az EU és a „programországok" válságkezelésének értékelése."* MKI Tanulmányok 2014/05, http://www.kulugyiintezet.hu/pub/displ.asp?id=MLGCLT.

317 European Commission. 2010. *"Lisbon Strategy evaluation document"* Commission Staff Working Document, http://ec.europa.eu/europe2020/pdf/lisbon_strategy_evaluation_en.pdf.

governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project." The main goal of the clause along with the requirement of avoiding excessive deficit is to prevent "free rider" behaviour. However, the sovereign debt crises in several euro area countries came as a surprise with no available euro area mechanism. Only the IMF was available for possible financial assistance for euro area countries.

It is important to note that a crisis resolution framework was available for non-euro area member states under the balance of payments assistance (based on Article 143 of the TFEU). Under this arrangement, the EU can provide financial assistance for non-euro area MSs if they face serious imbalances and difficulties in their balance of payments and the external financing ability is compromised. Although the framework of medium-term financial assistance allows providing loans solely by the EU, recent practice shows that the assistance is usually extended in cooperation with IMF and other international institutions or countries[318].

2.7 The strong interdependence of banks and sovereigns

Some hints about the linkages between the financial sector and the sovereign were already presented at the beginning of this chapter. In general, the financial sector and the sovereign are interlinked in two ways.

First, in some euro area countries the size of the banking sector compared to the GDP is huge. The possible losses of the banking sector, as a result of a financial shock, might create an unmanageable burden for the government. A serious shock may be reflected in the increasing sovereign spreads.

Second, a special European continental phenomenon is that MSs are characterised by large size of government debt held in their domestic banks' balance sheets, which even increased as a result of the crisis. It is clearly larger than in the UK or in the US where banks were not major buyers of government papers. As a consequence, any concern about sovereign solvency was bound to have major consequences for banks.[319] If doubts arise about the sustainability of public debt developments, it has serious effect on the soundness of the domestic financial system.

318 Hungary, Romania and Latvia got financial assistance from this framework because of the financial crisis.

319 Merler, Silvia and Jean Pisani-Ferry. 2012. *"The simple macroeconomics of North and South in EMU"*, Working Paper 2012/12, Bruegel. http://www.bruegel.org/download/parent/740-the-simplemacroeconomics-of-north-and-south-in-emu/file/1603-the-simple-macroeconomics-of-north-andsouth-in-emu/.

2.8 Lack of lender of last resort for sovereigns

A central bank can in principle act as a lender of last resort for the sovereign, which simply means that it can print money and buy sovereign bonds, thus decreasing the pressure on sovereign bond market. Nevertheless, the European Central Bank avoided this role since its main focus fall in price stability and the prohibition of monetary financing. This is a basic principle to avoid fiscal profligacy.

2.9 Interdependence among member states and contagion

Economic and financial interdependence could be considered as a natural phenomenon on a single market where capital, goods, services and persons can "flow" freely. The crisis revealed how deep these linkages are. The fact that the financial stress spilled over overlaps with the majority of factors identified above. Even before Greece got to the edge of collapse, investors started to differentiate among countries. As seen at the second stage of the unfolding crisis, competitiveness, growth prospects and initial indebtedness came also into account. The recalculation of debt developments turned the focus on other vulnerable countries on the periphery. The spreads started to collate in these countries as stress in one country spilled over to the others. Contagion effect was intensive on the periphery but it had affected the core countries as well through three main factors: i) the stress put the viability of the euro in question, ii) losses arose in the banking sector of the core countries as well and iii) economic contraction spilled over to partner countries through trade links.

2.10 Executive and democratic deficit

As shown in Chapters IV-V. the governance of the EMU requires a highly complex structure, since the competences of the member states and the EU institutions are very different in various policy areas. Formulating the monetary policy – the first leg of the EMU – is the ECB's main responsibility but in every other major questions the member states have the key role. Therefore, the capacity of making immediate and effective decision is sometimes compromised. For this reason, one could add the governance aspect to the current crisis, too. In most cases the response of the European policymakers has been partial, inadequate and belated, undermining the ability for an effective crisis management.[320]

320 Darvas, Zsolt. 2012. *"The euro crisis: ten roots, but fewer solutions."* Bruegel Policy contributions http://www.bruegel.org/publications/publication-detail/publication/755-the-euro-crisis-ten-roots-but-fewer-solutions/.

3. Crisis management

After a short overview about the key factors which led to the euro crisis, let us focus on the measures taken in order to find a solution to the presented challenges. The crisis revealed that there are serious systemic flaws in the design of the EMU which required a twofold approach:

- "Firewall building": The contagion of the crisis required an effective firewall to contain the tensions and separate countries which were already at the edge of collapse from the others, which are still able to finance themselves on the markets.
- "Systemic reconstruction": It is necessary to overhaul the economic governance framework of the EMU in order to prevent the occurrence of the weaknesses which were presented above. The main goal is to make the governance framework more effective and credible.

Table 1 provides a general overview about the response measures and their goals.

<table>
<tr><th>Firewall building</th><th>Systemic reconstruction</th></tr>
<tr><td colspan="2">Goals</td></tr>
<tr><td colspan="2">• ease market tensions
• enhance credibility
• preserve the stability of the euro area</td></tr>
<tr><td>• avoid contagion
• enhance the crisis resistance capacity
• create an effective crisis resolution mechanism</td><td>• reinforce the fiscal surveillance framework
• broaden the surveillance in order to identify macroeconomic challenges
• improve coordination of growth enhancing structural reform and economic policies
• tackle the lethal interdependence of the banking sector and sovereigns
• improve the governance of the euro area</td></tr>
<tr><td colspan="2">Tools and measures</td></tr>
<tr><td>• temporary crisis resolution framework (GLF, EFSF, EFSM)
• permanent European Stability Mechanism
• strengthening the lending capacity of the IMF
• (ECB steps to ease the tensions on the sovereign debt markets)
• monitoring the implementation of the policy conditionality by the Troika</td><td>• European Semester
• 'Six pack'
• 'Two pack'
• Euro Plus Pact
• TSCG
• process towards a genuine EMU</td></tr>
</table>

Table 1: A twofold approach towards the crisis management in the EU
Source: Author's own construction

This chapter focuses on the 'firewall building', Chapters V and X provide an overview about the systemic reform steps.

The main goal of these measures was to avoid the collapse of countries in the euro area or even of the euro area itself. This meant the prevention of contagion and enhancing the crisis resistance capacity of the euro area. The lack of an available crisis resolution framework called for setting up a new system in order to meet the aforementioned goals.

In the wake of the Greek crisis an effective mechanism was not available. Therefore, on 2 May 2010 euro area MSs approved bilateral loans, which were pooled and disbursed by the Commission under the Greek Loan Facility (GLF). Shortly after the decision on 9 May 2010 the Ecofin Council decided about a temporary crisis resolution framework with two main elements:

- European Financial Stability Facility (EFSF)
- European Financial Stability Mechanism (EFSM)

The IMF played a key role in this temporary system, since it provided co-financing and expertise in crisis resolution.

3.1 The European Financial Stability Facility (EFSF)

The EFSF is a company (*société anonyme*) which was set up under Luxembourg law on 7 June 2010 as part of the May 2010 package. The EFSF's objective is to preserve financial stability of Europe's monetary union by providing temporary financial assistance to euro area member states if needed.

Euro area member states provided guarantees for EFSF issuance up to a total of €440 billion on a pro rata basis.[321] This meant an effective lending capacity of €250 billion, which was then increased to €440 billion on June 2011 with a total guarantee level of €780 billion[322]. The EFSF raised funds on the financial markets by issuing bonds or other debt instruments.

The EFSF became operational in August 2010 as a temporary measure. The EFSF may not enter into new programmes since 1 July 2013 but it still continues to service existing commitments thereafter until the outstanding loans are paid back. The shareholders of the EFSF are the euro area member states based on their guarantee commitments which are calculated in accordance with their share in the paid-up capital of the European Central Bank.

The EFSF originally enjoyed the highest (AAA) credit rating, which made it possible for the EFSF to raise money on financial markets with more favourable conditions and channel these cheaper funds to the MSs in need. However, in January 2012 it was

321 http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/misc/114977.pdf.

322 The countries under financial assistance programme are not contributing to the guarantees (Greece, Ireland, Portugal and Cyprus). The adjusted amount of guarantees was €724.47 billion on 30 April 2013.

slightly downgraded since two of its major guarantors (Austria and France) lost their ratings as well.

In order to fulfil its mission, the EFSF was authorised to[323]

- issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries in financial difficulties
- intervene in the debt primary market
- intervene in the debt secondary markets
- act on the basis of a precautionary programme

3.1.1 Loan operations

In the period of its operation the EFSF committed loans in the sum of €200 billion to Portugal (€26 billion), Ireland (€22.5 billion) and Greece (the second adjustment programme, €144.7 billion). The majority of this sum is already disbursed. Table 2 includes the disbursed and the remaining available funds.

	Disbursed	Remaining amount available	Max. total
GR	133,6	10,1	**144,6**
IE	17,7	0[325]	**22,5**
PT	24,8	1,2	**26**

Table 2: Financial assistance from the EFSF as of 19 December 2013 [324]
Source: EFSF

The maturity of the loans was decided on a case-by-case basis. At the euro zone summit of 21 July 2011 it was agreed that maturities would be extended from the current average of 7.5 years to a minimum average of 15 years and up to 30 years.

3.2 European Financial Stability Mechanism (EFSM)[325]

The EFSM is a significantly different instrument from the EFSF. It reproduces for the EU 27 the basic mechanics of the existing Balance of Payments Regulation for non-euro area member states. The EFSM was established by Council Regulation 407/2010 on 11 May 2010 on the basis of Article 122(2) of the TFEU, which foresees the possibility of granting Union financial assistance to a Member State in difficulties or

323 www.efsf.europa.eu/attachments/EFSF FAQ 2014-03-03.pdf.
324 Ireland exited the programme and is not able to call down funds.
325 http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm.

seriously threatened with severe difficulties caused by exceptional occurrences beyond its control.

The EFSM, like EFSF, was set up on a temporary basis. Six months after this Regulation entered into force the Commission had to review whether the exceptional circumstances, which justified the establishment of the EFSM, remain. It concluded that the exceptional events and circumstances still exist and the EFSM should therefore be maintained.

Under the EFSM the Commission is allowed to borrow up to a total of €60 billion in financial markets on behalf of the Union under an implicit EU budget guarantee. The Commission then lends on the proceeds to the beneficiary Member State. This particular lending arrangement implies that there is no debt-servicing cost for the Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission. The EU budget guarantees the repayment of the bonds in case of default by the borrower. The European Commission is empowered to contract borrowings on behalf of the European Union for the purpose of funding loans made under the EFSM.

Under the EFSM the borrower is the European Union. The EU enjoys an AAA credit rating from the major rating agencies which ensures favourable borrowing conditions. The Commission is the institution that manages the borrowing on behalf of the EU. The Commission's role in this respect is comparable to a government finance agency contracting borrowing on behalf of the country.

The EFSM provides assistance to member states where:

- a Member State is experiencing, or is seriously threatened with, a severe financial disturbance;
- the financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned.

The EFSM provided complementary financing for the Irish (€22.5 billion) and Portuguese (€26 billion) package. €21.7 billion was disbursed for Ireland and €22.1 billion for Portugal.

3.3 The European Stability Mechanism

Shortly after the setup of the temporary crisis resolution framework it became obvious that a permanent tool is required for the effective crisis management and to avoid contagion. On the 28-29 October 2010 European Council meeting the heads of state and government agreed to establish a permanent crisis management mechanism to safeguard financial stability in the euro area as a whole. Political consensus on the ESM was reached at the meeting of the European Council on 16-17 December 2010, when it was agreed to amend Article 136 of the Treaty via the simplified revision procedure.[326]

326 European Central Bank. 2011. "The European Stability Mechanism." ECB Montly Bulletin, July 2011 https://www.ecb.europa.eu/pub/pdf/other/art2_mb201107en_pp71-84en.pdf?949be656fa5e93425de7b4bffded7c75.

The 25 March 2011 European Council meeting adopted the decision to add a new paragraph: "The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

The international treaty to establish the ESM was signed on 11 July 2010. Shortly after this the European Council of 21 July 2011 adopted measures to improve the effectiveness of the EFSF and of the newly established ESM and address contagion increased the flexibility[327]. Thus the amendment of the treaty establishing the ESM was required. Unlike EFSF, ESM is an international financial institution based in Luxembourg under public international law. Its members are the euro area countries. If a Member State introduces the euro it will be admitted as an ESM member and receives shares in exchange for its capital contributions (Article 2 of ESM Treaty).

The purpose of the ESM is to mobilise funding and provide stability support for euro area member states, however there are several key preconditions to be met (Article 3 of ESM Treaty):

- The support is provided under strict conditionality which may range from a macroeconomic adjustment programme to continuous respect of pre-established eligibility conditions.
- The beneficiary is experiencing or threatened by severe financing problems.
- If the support is indispensable and all the other stabilization tools are ineffective.

3.3.1 Capital structure

The authorized capital (Article 8 of ESM Treaty) of the ESM is €701,935.3 billion, which is divided into shares with a nominal value of €100,000 each. The contribution key is based on the ECB capital contribution with a correction mechanism (see Table 3). The three biggest contributors are Germany, France and Italy representing €458.12 billion capital (65% of the authorized capital).

The authorized capital is divided into paid-in and callable capital. The initial value of paid-in capital is €80 billion and was paid in five instalments. The last was made in April 2014. Since Latvia introduced the euro on 1 January 2014, it will pay its paid-in capital in five annual instalments of €44.24 million each. Callable capital may be called in to restore the level of paid-in capital if the latter is reduced by the absorption of losses. Furthermore, paid-in capital is not available for lending operations because it is invested in high quality liquid assets.[328]

327 https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf.
328 http://www.esm.europa.eu/pdf/2014-03-13%20ESM%20Factsheet.pdf.

ESM Member	ESM Key (%)	No. of Shares	Capital subscription (€)	Paid-in capital (€)
Austria	2.7757	194 838	19 483 800 000	2 226 720 000
Belgium	3.4675	243 397	24 339 700 000	2 781 680 000
Cyprus	0.1957	13 734	1 373 400 000	156 960 000
Estonia	0.1855	13 020	1 302 000 000	148 800 000
Finland	1.7924	125 818	12 581 800 000	1 437 920 000
France	20.3297	1 427 013	142 701 300 000	16 308 720 000
Germany	27.0716	1 900 248	190 024 800 000	21 717 120 000
Greece	2.8089	197 169	19 716 900 000	2 253 360 000
Ireland	1.5878	111 454	11 145 400 000	1 273 760 000
Italy	17.8643	1 253 959	125 395 900 000	14 330 960 000
Latvia	0.2757	19 353	1 935 300 000	221 200 000
Luxembourg	0.2497	17 528	1 752 800 000	200 320 000
Malta	0.0729	5 117	511 700 000	58 480 000
Netherlands	5.7012	400 190	40 019 000 000	4 573 600 000
Portugal	2.5023	175 644	17 564 400 000	2 007 360 000
Slovakia	0.8217	57 680	5 768 000 000	659 200 000
Slovenia	0.4264	29 932	2 993 200 000	342 080 000
Spain	11.8709	833 259	83 325 900 000	9 522 960 000
Total	**100**	**7 019 353**	**701 935 300 000**	**80 221 200 000**

Table 3: Capital contributions of ESM members
Source: http://www.esm.europa.eu/about/governance/shareholders/index.htm

The ESM has a wide-range of flexible financial tools to meet its purposes (Article 14-18 of ESM Treaty):

- precautionary financial assistance
- financial assistance for the recapitalisation of financial institutions of an ESM member
- loans
- primary market support facility - the ESM may purchase government bonds of an ESM member on the primary market in order to maximise the cost efficiency of the financial assistance
- secondary market support facility – the ESM may purchase government bonds of an ESM member on the secondary market on the basis of an analysis of the ECB recognising the existence of exceptional financial market circumstances

The pricing of the financial assistance provided by the ESM to beneficiary member states is several times lower than the cost of comparable borrowing via financial markets. There is no single interest rate that is applied to loans for beneficiary member states. The ESM passes on to beneficiary countries its cost of funding (issuing bonds and bills) which is variable. In addition, there are small fees to cover ESM's operational costs and a margin which reflects the varying risk profile of financial assistance instruments.

The cost of loans and other types of financial assistance is determined separately for each tranche of loan or assistance. The interest is paid by the beneficiary Member State on an annual or semi-annual basis and the principal (the amount borrowed) is repaid in full at maturity, i.e. the date of final repayment. The maturity varies between each tranche of loan or assistance.

The private sector may also participate in financial assistance on an ad-hoc basis. As of 1 January 2013 collective action clauses[329] shall be included in all new euro area government securities with maturity above one year in a way which ensures that their legal impact is identical.

3.3.2 Governance of ESM

The governance of the ESM consists of the Board of Governors, the Board of Directors, a Managing Director and the Board of Auditors.

The Board of Governors is the main decision making body. Each ESM Member shall appoint a governor and an alternate governor. The governor is the member of the government who has responsibility for finance. The Board of Governors is chaired by the president of the Eurogroup. The Member of the European Commission in charge of economic and monetary affairs and the president of the ECB, as well as the president of the Euro Group (if not chairperson or governor) may participate in the meetings of the Board of Governors as observers[330].

Each governor appoints one director and one alternate director from among people of high competence in economic and financial matters. The Member of the European Commission in charge of economic and monetary affairs and the president of the ECB may also appoint one observer each. The Board of Directors ensures that the ESM is run in accordance with its Treaty and by-laws. It takes decisions as provided for by the ESM Treaty or decisions delegated to it by the Board of Governors. Decisions are taken by qualified majority, unless otherwise stated by the ESM Treaty. The Board of Directors meetings are chaired by the ESM managing director.[331] The managing director of the ESM is appointed by the Board of Governors for a term of 5 years.

The Board of Auditors is an independent body composed of five members appointed by the Board of Governors. It shall inspect the ESM accounts and verify that the operational accounts and balance sheet are in order.[332]

3.3.3 ESM in operation

The ESM became operational in October 2012. According to decision to boost the capacity of the EFSF/ESM firewall until 1 July 2013 the EFSF and the ESM was operating in parallel with a combined effective lending capacity of €750 billion. The

329 Collective action clause became an important feature in issued government bonds. If a debt restructuring occurs, it prevents the possibility that a minority of bondholders could block an agreement.
330 http://esm.europa.eu/about/governance/board-of-governors/index.htm.
331 http://esm.europa.eu/about/governance/board-of-directors/index.htm.
332 http://esm.europa.eu/about/governance/board-of-auditors/index.htm.

ESM took over the functions of the EFSF along with its staff. Since its inauguration the ESM entered in financial assistance operation two times, in the case of Spain and Cyprus. For the recapitalisation of the banking sector, Spain got €100 billion financial assistance, of which €41.333 billion was disbursed with an average maturity of 12,2-12,5 years. On 31 December 2013 the ESM financial assistance programme for Spain expired.[333] On 25 March 2013 the Eurogroup approved a package of financial assistance for Cyprus of up to €10 billion in order to stabilize the banking sector. As of 19 December 2013 €4.6 billion was disbursed with a weighted maturity of 14.86 years.

The provided overview shows that various tools were created to tackle the challenges and avoid contagion in the euro area. The following table summarizes the main characteristics of these measures.

333 http://esm.europa.eu/assistance/spain/index.htm.

	Euro area loans to Greece (GLF)	European Financial Stabilisation Mechanism (EFSM)	European Financial Stability Facility (EFSF)	European Stability Mechanism (ESM)
Legal/ institutional form	Intergovernmental agreement	EU mechanism	Private company owned by euro area countries	Intergovernmental organisation
Capital structure	None, bilateral loans pooled by the European Commission	Guaranteed by EU budget (i.e. all EU Member States)	Guarantees and overguarantees from euro area countries	€80 billion paid-in capital and €620 billion callable capital (payment of initial shares by euro area countries to be made in five annual instalments of 20% of the total amount)
Lending capacity	€80 billion	€60 billion	€440 billion	€500 billion
Instruments	Loans	Loans, credit lines	Loans, bond purchases on the primary market	Loans, bond purchases on the primary market
Duration	Until repayment	Until the end of June 2013	Until the end of June 2013. Will also remain operational thereafter until all outstanding liabilities are repaid	Permanent mechanism from the beginning of July 2013 onwards
Main decision-making bodies	Eurogroup	Ecofin Council, acting by qualified majority voting on proposal from European Commission	Eurogroup/EFSF Board of Directors	Eurogroup/ESM Board of Governors and ESM Board of Directors
Legal basis Financing	Intergovernmental decision and Treaty Article 136	Treaty Article 122 (a Member State facing "exceptional occurrences beyond its control")	Intergovernmental decision	Intergovernmental treaty linked to amended Treaty Article 136

Table 4: A general overview about the temporary and permanent crisis resolution frameworks
Source: ECB

3.4 The role of the IMF financing

As a key part of efforts to overcome the global financial crisis, the group of twenty industrialized and emerging market economies (G20) agreed in April 2009 to increase borrowed resources available to the IMF (complementing its quota resources) by up to $500 billion, which tripled the total pre-crisis lending resources of about $250 billion, to support growth in emerging market and developing countries.

In April 2012 the International Monetary and Financial Committee[334] (IMFC) and G20[335] Finance Ministers and Governors jointly agreed to further enhance IMF resources through a new round of bilateral borrowing. Pledges were made by 38 members or their central banks, currently amounting to $461 billion. As of the end of February 2014 33 agreements for a total of $436 billion have been finalized.[336]

The IMF provided significant funds for financial assistances in the euro area. Table 5 indicates the participation of the IMF through the Extended Fund Facility[337] in the programs for euro area MSs.

			Amount agreed (billions)		Undrawn balance (billions)	
Member	Effective Date	Expiration Date	Euros (billions)	As percent of Quota	Euros (billions)	As percent of Quota
Cyprus	5/15/13	5/14/16	1.02	563.2	0.93	516
Greece	3/15/12	3/14/16	27.2	2,158.8	18.95	1504
Ireland	12/16/10	12/15/13	22.3	1,547.9	1.44	100
Portugal	5/20/11	5/19/14	27.1	2,305.7	4.62	393

Table 5: IMF contribution to financial assistances
Source: IMF calculations

334 The IMFC is responsible for advising and reporting to the IMF Board of Governors as it manages and shapes the international monetary and financial system.

335 The Group of Twenty (G20) is a group of twenty major advanced and emerging economies. The group started in 1999 as a meeting of Finance Ministers and Central Bank Governors in the aftermath of the Asian financial crisis. In 2008 the first G20 Leaders Summit was held to deal with the global financial crisis. G20 leaders have met eight times since 2008 and there is now a Leaders Summit each year.

336 https://www.imf.org/external/np/exr/facts/changing.htm.

337 When a country faces serious medium-term balance of payments problems because of structural weaknesses that require time to address, the IMF can assist with the adjustment process under an Extended Fund Facility (EFF). Compared to assistance provided under the Stand-by Arrangement, assistance under an extended arrangement features longer program engagement—to help countries implement medium-term structural reforms—and a longer repayment period.

3.5 Policy conditionality and the implementation of the programmes

Each financial assistance programme is based on strict policy conditionality which is tailored to the challenges of each affected MS and forms a macroeconomic adjustment programme. The detailed programme is included in a Memorandum of Understanding signed by the lenders and the representatives of the Member State. The representatives (the prime minister, the minister of finance and the central bank governor) also sign a so called letter of intent which includes the policy measures they are committed to. The macroeconomic adjustment programme contains numerical benchmarks to help monitoring the implementation.

The so called Troika (representatives of the European Commission, the European Central Bank and the IMF) played a key role in the crisis management of the crisis hit euro area MSs. The Troika conducts a quarterly mission at the program country and assesses the implementation in review reports. In this assessment the Troika concludes that the conditions for disbursing the next tranche of the financial assistance are met.

This practice is unique since the IMF does not play a single role in the financial assistance like in the case of the Asian financial crisis in the 90s but acts as a partner of the two European institutions. The involvement of the IMF was straightforward during the first bailouts. There was not enough money, no expertise and no staff for financial assistance at disposal to successfully implement the macroeconomic adjustment programmes.[338]

The EU-IMF cooperation has some special aspects. Both parties provide financial assistance following their own interests, rules and logic. Regarding the EU, the focus is on the phrase "if indispensable". The financial assistance from the EFSF/ESM is the last available option which follows the path set by the no bailout clause. The IMF prefers the precautionary measures which prevents the build-up of more serious tensions. The IMF is a completely independent actor in the bailouts; on the contrary, the Commission cannot be considered as independent but as an internal agent. In most of the cases the IMF provides the majority share of financial assistance (e.g. non euro area countries like Hungary and Romania). However, in the programs for euro-area MSs the share of the IMF shrank to one third.

338 Marján, Attila, and Buda, Lorina. 2014. *"Az EU és a programországok válságkezelésének értékelése."* MKI Tanulmányok 2014/05, http://www.kulugyiintezet.hu/pub/displ.asp?id=MLGCLT.

3.6 The role of ECB in crisis management[339]

As it is presented in Chapter IV the ECB's main goal is to maintain price stability but the crisis revealed the necessity of applying a series of non-standard measures as well. After the Lehmann bankruptcy the aim of the ECB was to continue preserving price stability, to stabilize the financial situation and to limit the fallout on the real economy.

As a standard measure the ECB rapidly reduced the interest rates to historically low levels as the crisis unfolded. Until May 2009 the main refinancing rate was brought down to 1%.

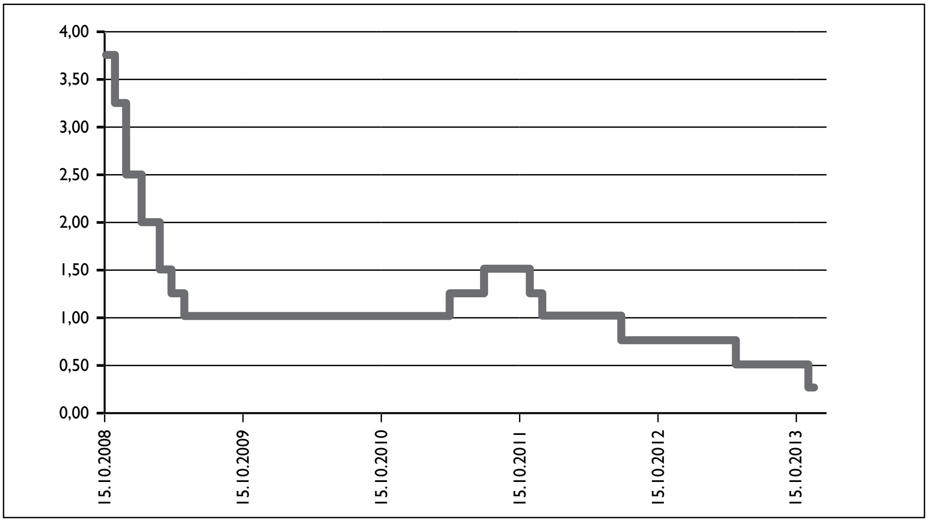


Figure 4 - Main refinancing rate of ECB (%)
Source: ECB

As non-standard measures the ECB introduced fixed-rate full allotments, the extension of the maturity of long term refinancing operations, the extension of eligible collaterals, currency swap agreements and covered bond purchase programme. Although it is one of the ECB's monetary policy instruments since 1999, outright purchases remained unused until June 2009 when the ECB started its first covered bond purchase programme.

However, as the tensions rose on sovereign debt markets and the secondary markets for some government bonds began to dry up completely from the beginning of 2010, the ECB had to introduce further non-standard measures. To help calm down the markets and support the better functioning of the monetary policy transmission mechanism, the ECB established the Securities Markets Programme (SMP) in May 2010 in which the ECB acquired government debt securities on the secondary

339 This section mainly relies on the work of Cour-Thimman and Winkler 2013.

markets.[340] Even though the SMP was primarily used for monetary policy purposes it also provided time for governments to find durable solution to the crisis and restore the sustainability of public finances. When the bond market of Italy and Spain risked becoming dysfunctional in August 2011, the program was activated again with a clear aim to ease the tensions on sovereign debt markets. About €220 billion of bonds (par value, excluding redemptions) were acquired from 2010 to early 2012.[341] The SMP was terminated in September 2012 as the new Outright Monetary Transactions (OMT) programme started (see details later). An ECB study concluded that in addition to a large and economically significant announcement effects the ECB's repeated interventions had an impact of approximately -1 to -2 basis points (in Italy) and up to -17 to -21 basis points (in Greece) at a five-year maturity per €1 billion of purchases across euro area countries[342].

During autumn 2011 the euro area banking system came increasingly under strain due to the depressed sovereign debt markets which weakened bank balance sheets. Markets questioned the viability of banks in numerous euro area countries and the interbank market became dysfunctional. As a stabilisation initiative the European Banking Authority agreed to raise Core Tier 1[343] capital ratio to 9%, which created an additional capital need of over €100 billion to be raised within less than a year. Therefore a package was announced by the ECB in December 2011. This included two long term refinancing operations (LTRO) with low interest rates and a maturity of 3 years each and the reduction in the reserve ratio from 2% to 1%. Around €1 trillion was allotted during the two LTROs. Nevertheless, bank funding costs were continuously pushed up by continued tensions in sovereign debt markets with a further pressure on banks' balance sheets.

In order to ease the tensions the ECB announced the Outright Monetary Transactions (OMT) programme in August 2012 which meant an important turning point in the context of the euro crisis. OMT provides unlimited intervention on the secondary sovereign debt markets for countries under EFSF/ESM programme in order to preserve the primacy of the ECB's price stability mandate and to ensure that governments retain the right incentive to implement required fiscal adjustments and

340 As seen in Chapter IV, monetary financing is strictly prohibited. If we look at the bond purchase programmes, we can see: i) that the primary aim is to maintain the proper functioning of the monetary transmission mechanism ii) the mechanisms operate only on the secondary markets. Consequently the risk of monetary financing is limited.

341 https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1587.pdf.

342 Eser, Fabian, and Schwaab Bernd. 2013. *„Assessing asset purchases withon the ECB's Securities Markets Programme."* ECB Working Paper Series, no 1587 https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1587.pdf

343 Tier one capital is the best form of bank capital - the money that the bank has in its coffers to support all the risks it takes: lending, trading and so on. Tier one is essentially top-notch capital, with core tier one a subset comprising the best of the best. The Basel Committee on Banking Supervision, whose Basel III rules form the basis for global bank regulation, is focused on the core tier one ratio, which, like the Americans, it refers to as the equity tier one ratio. It essentially will consist of only equity and retained profits. Source: http://lexicon.ft.com/Term?term=core-tier-one-capital

structural reforms. As was the case with the SMP the liquidity created through OMTs will be fully sterilised.[344] Following a thorough assessment the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate. The OMT was a clear step towards a lender of last resort role which was demanded earlier by the markets.[345] The single fact of its existence had greatly calmed financial markets.[346] The following graph clearly shows that the introduction of the OMT had a significant effect on calming the markets; it was an important milestone in the sovereign debt crisis.

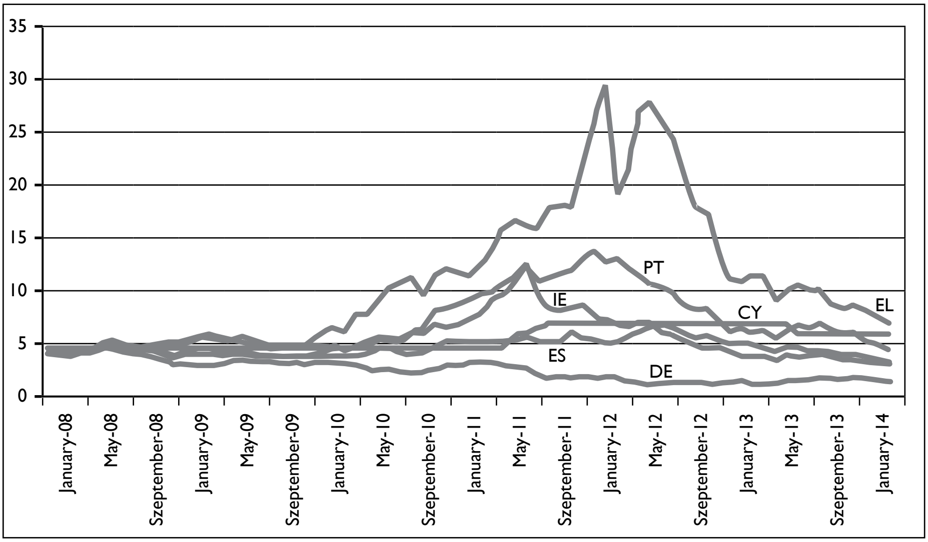


Figure 5: Long-term interest rates (%)
Source: ECB

Besides acting independently to resolve the crisis, the ECB is also the member of the Troika (as shown earlier). However, this role of the ECB adds to the confusion. It is not clear in what extent the ECB shoulders the responsibility for the decisions made by the Troika. Furthermore, ECB often hits a much stricter tone than the European Commission and the IMF and prefers the price stability over the long term sustainability of the budgetary situation.[347]

344 http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html
345 http://www.economist.com/blogs/freeexchange/2012/09/ecbs-new-bond-purchase-programme
346 http://lexicon.ft.com/Term?term=outright-monetary-transactions-OMT
347 Marján, Attila, and Buda, Lorina. 2014. *"Az EU és a „programországok" válságkezelésének értékelése."* MKI Tanulmányok 2014/05, http://www.kulugyiintezet.hu/pub/displ.asp?id=MLGCLT.

4. The crisis in the periphery - Case studies

Although the challenges in the PIGS countries are varied, some common roots can be identified. The introduction of the euro led to the convergence of the long-term interest rates. The financing costs for most of the countries significantly decreased, and the spreads moved in a narrow path (Figure 5). The sovereign spreads in the euro area converged to a much greater degree than economic prospects.[348]

The market did not differentiate the euro area MSs in terms of sovereign spreads. The cheaper financing on the demand side and the liberalised capital markets on the supply side led to a significant inflow of capital in the periphery, which led to the build-up of credit bubbles both in the private and the public sector (as seen at the list of roots). The capital inflow and the booming domestic demand was the basis of the economic growth and concealed the adverse macroeconomic developments. The economic prosperity lifted the pressure from structural reforms as well.

We can identify two main groups regarding the countries on the euro area periphery which were severely hit by the crisis and were forced to ask for some kind of financial assistance. The first group consists of uncompetitive countries where the tensions stemmed from mainly the imbalances in the public finances (Greece and Portugal). The second group of countries includes MSs where the imbalances occurred mainly in the private sector in the form of credit bubble (Ireland, Spain and Cyprus).

4.1 Greece

In Greece, the economic growth prior to the crisis was driven by a twofold demand shock. Both the private and the public consumption were boosted by 'cheap money'. The inflation was constantly higher due to booming domestic demand and the continuous increase in wages caused an appreciation of around 20% of the real effective exchange rate from 2000 to 2009. Since the wage increase far exceeded the improvement in productivity, the unit labour cost rose sharply. These factors further undermined the competitiveness which was clearly shown in loss of export market share and in highly negative trade balance. Consequently, the current account deficit peaked over 16% in 2008.[349] The most alarming problems of the Greek economy were the underperforming education system, the ineffective governance, corruption, poor revenue administration, tax evasion and unfavourable business environment.[350]

348 Mody, Ashoka, and Damiano Sandri. 2012. *„The eurozone crisis: how banks and sovereigns came to be joined at the hip."* Economic Policy 27, no. 70: 199-230.

349 Tóth, Szabolcs. 2014. *„A görög válság és válságkezelés."* Európai Tükör 19 no. 2, 2014 április.

350 Oltheten, Elisabeth, Theodore Sougiannis, Nickolaos Travlos, és Stefanos Zarkos. *„Greece in the Eurozone: Lessons from a decade of experience."* The Quarterly Review of Economics and Finance, 2013: 317-335.

The Stability and Growth Pact failed to ensure sound public finances. As it was revealed Greece manipulated fiscal data in order to meet the Maastricht criteria and the budget deficit was way over 3 percent limit. Despite the economic prosperity, the initially high debt level was not put in a sustainably decreasing path. The economic downturn in 2009 hit an uncompetitive, highly indebted economy with an extremely narrow room for manoeuvre. After the elections in autumn 2009 the new government revealed that the deficit figures were yet again manipulated and the actual deficit would be much higher; it reached 15.7% of GDP. The Greek credit rating was downgraded several times and as default risks rose sharply, Greece lost its ability to refinance its maturing debt over spring 2010. Consequently, Greece asked for international financial assistance on 23 April 2010.

For the first time in history of the euro area a member country was threatened by a disorderly default. The lack of crisis resolution mechanism called for "improvisation". The euro area MSs agreed in bilateral loans amounting €80 billion[351] which was supplemented by €30 billion from the IMF. The bilateral loans were pooled and disbursed by the Commission in the framework of the Greek Loan Facility. The Greek package included strict economic policy conditionality, a macroeconomic adjustment programme. The implementation of the programme was closely monitored by the Troika (the representatives of the IMF, ECB and the Commission). This setup served as a template during the following bailouts. The lack of tools to tackle contagion led to the setup of a temporary crisis resolution framework.[352]

The overarching objective is to durably restore Greece's credibility for private investors. The short-term objective of the Greek adjustment programme was to urgently consolidate the fiscal imbalances on a sustainable manner and to implement policies in order to maintain the stability of the financial system. The medium-term programme objective is to improve competitiveness and alter the economy's structure towards a more investment- and export-led growth model.[353]

It became obvious already in the summer of 2011 that Greece won't be able to access the markets in 2013. Therefore a supplementary financial assistance programme was necessary. Since the debt path became unsustainable due to the crisis, the debt restructuring and the private sector involvement (PSI) was a necessary precondition of the second bailout package. On a voluntary basis the debt holders needed to accept a swap of bonds with a nominal haircut of 53.5%.[354] Out of a total of €205.6 billion in bonds eligible for the exchange offer, approximately €197 billion or 95.7% have been exchanged.[355] The agreement on debt swap made it possible to approve the second

351 Slovakia decided not to participate in the package.

352 The European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM), find the details in the next section.
Tóth, Szabolcs. 2014. *"A görög válság és válságkezelés."* Európai Tükör 19 no. 2, 2014 április.

353 The Economic Adjustment Programme for Greece: http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf.

354 http://www.ft.com/intl/cms/s/0/cd8953dc-5ee1-11e1-a087-00144feabdc0.html#axzz2yEFSMfZN.

355 http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/.

programme, which foresees €164.5 billion (€130 billion new funding) until the end of 2014 from the EFSF and the IMF. Altogether a sum of €210 billion is expected to be disbursed. Table 6 provides an overview of the characteristics of the two programmes.

	First programme	Second programme
Financing	Bilateral loans from euro area MSs (except SK, PT, IE) pooled in the Greek Loan Facility (GLF) and IMF	EFSF and IMF
Scope	€110 billion	€164.5 billion (130 billion new funding)
Period	2010-2013	2013-2015
Conditionality	Strict policy conditionality, implementation of a macroeconomic adjustment programme	
Method of financing	Tranches are disbursed on a quarterly basis	
Monitoring	Troika (COM + IMF + ECB)	
Assistance for implementation	Task Force for Greece (2011.07.)	

Table 6: The overview of the Greek programmes[356]
Source: Tóth 2014

To help the belated and controversial implementation of the adjustment programme, the Commission decided to set up the Task Force for Greece on July 2011. The main objectives of the Task Force are:

- to identify and coordinate the technical assistance that Greece needs in order to meet the terms of the EU/IMF adjustment programme. This is done in close cooperation with Greece and benefiting from input from other member states;
- to assist the relevant Greek authorities in defining the details of the kind of technical assistance to be provided; and to recommend legislative, regulatory, administrative and if necessary (re)programming measures for an accelerated take-up of EU funds, focussing on competitiveness, growth and employment.

Even though important results could be achieved in consolidating the fiscal situation and recapitalizing the banking sector, programme implementation in several areas is slow and inadequate. The biggest challenges arise in the reform of the public sector, the fight against corruption, the reform of the energy market and judiciary system.[357]

The second Greek programme ends in 2015 but it is still possible that Greece might need a third programme since there might be a financing gap.

356 http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/index_en.htm.
357 Tóth, Szabolcs. 2014. *"A görög válság és válságkezelés."* Európai Tükör 19 no. 2, 2014 április.

4.2 Ireland

Ireland enjoyed buoyant growth in the 'Celtic tiger' period. However, the base of the prosperity before the crisis was mainly the property and credit bubble due to the "cheap money" which was flowing into the country. As a side effect of the financial meltdown in September 2008 the property bubble burst generating huge losses in the financial sector. The Irish government stabilized the financial system by nationalizing the Anglo Irish Bank which started a new phase in the crisis. The burden of the financial sector, the imbalances in the external trade and the contraction of the real economy imposed a huge burden on the public finances causing a 32 percent deficit in terms of GDP. The Irish government asked for international financial assistance on 21 November 2010. The agreement was formally adopted on 7 December 2010 at the Eurogroup/Ecofin meeting in Brussels. The Economic Adjustment Programme for Ireland includes a joint financing package of €85 billion with contributions from the EU/EFSM (€22.5 billion), euro area member states/EFSF (€17.7 billion), bilateral contributions from the United Kingdom (€3.8 billion), Sweden (€0.6 billion) and Denmark (€0.4 billion) as well as funding from the IMF (€22.5 billion). Moreover, there is an Irish contribution through the Treasury cash buffer and investments of the National Pension Reserve Funds (€17.5 billion).[358]

The objectives of the adjustment programme were:

- immediate strengthening and comprehensive overhaul of the banking sector;
- ambitious fiscal adjustment to restore fiscal sustainability, correction of excessive deficit by 2015;
- growth-enhancing reforms, in particular on the labour market to allow a return to a robust and sustainable growth.

In December 2013 Ireland exited from the three-year adjustment programme due to a successful consolidation of the current account balance and the fiscal position. The unemployment rate decreased; however, the financial sector imbalances and possible unfavourable growth prospects may undermine the positive attitude. Ireland will start to pay back the disbursed funds from 2029.[359]

4.3 Portugal

Like Greece Portugal was also hit by the financial crisis due to the lack of sound fiscal discipline and the huge private indebtedness. Moreover, the country is facing structural challenges, low competitiveness and growth prospects since its EEC accession.[360]

358 http://ec.europa.eu/economy_finance/assistance_eu_ms/ireland/index_en.htm.

359 Marján, Attila, and Buda, Lorina. 2014. *"Az EU és a „programországok" válságkezelésének értékelése."* MKI Tanulmányok 2014/05, http://www.kulugyiintezet.hu/pub/displ.asp?id=MLGCLT.

360 Marján, Attila, and Buda, Lorina. 2014. *"Az EU és a „programországok" válságkezelésének értékelése."* MKI Tanulmányok 2014/05, http://www.kulugyiintezet.hu/pub/displ.asp?id=MLGCLT.

During the Hungarian Presidency of the Council in 7 April 2011 Portugal requested financial assistance from the EU, the euro area member states and the International Monetary Fund (IMF). The economic adjustment programme for Portugal includes a joint financing package of €78 billion (€26 billion by the EU/EFSM,€26 billion by the Euro area/EFSF and about €26 billion by the IMF). It contains reforms to promote growth and jobs, fiscal measures to reduce the public debt and deficit and measures to ensure the stability of the country's financial sector.

The aid is provided on the basis of a three-year policy programme for the period 2011 to mid-2014. The economic adjustment programme includes:[361]

- structural reforms to boost potential growth, create jobs and improve competitiveness;
- a fiscal consolidation strategy, supported by structural fiscal measures and better fiscal control over public-private-partnerships and state-owned enterprises, aimed at putting the gross public debt-to-GDP ratio on a firm downward path in the medium term and reducing the deficit below 3% of GDP by 2014;
- a financial sector strategy based on recapitalisation and deleveraging with efforts to safeguard the financial sector against disorderly deleveraging through market based mechanisms supported by backstop facilities.

Portugal is supposed to exit the bailout programme during 2014. According to the assessment of the Troika amid signs of a recovery in economic activity the programme's implementation remains broadly on track.[362]

4.4 Spain

The main problems in Spain were similar to Ireland's. Macroeconomic imbalances emerged and the property bubble burst as a result of the crisis. Huge losses were identified in the banking sector which put the sustainability of public finances in question, too. Amid the economic contraction and the worsening employment situation it seemed to be too high a burden. In order to avoid the loss of market access Spain requested financial assistance on 25 June 2012. The main conditionality is bank-specific but Spain needs to honour its commitments under the excessive deficit procedure and regarding structural reform, with a view to correcting macroeconomic imbalances in the framework of the European semester. The agreement was endorsed by the Eurogroup meeting in Brussels on 20 July 2012.

The financial assistance was provided for the period from July 2012 to December 2013. The restructuring of the banks receiving public support under the State aid rules is expected to take up to five years.

361 http://ec.europa.eu/economy_finance/assistance_eu_ms/portugal/index_en.htm.
362 http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp171_en.pdf.

The bank-specific conditionality has three main components:

- a comprehensive diagnostic as regards the capital needs of individual banks based on a comprehensive asset quality review and valuation process and bank-by-bank stress tests;
- the segregation of impaired assets from the balance sheet of banks receiving public support and their transfer to an external Asset Management Company;
- the recapitalisation and restructuring of viable banks and an orderly resolution of ultimately non-viable banks with private sector burden-sharing as a prerequisite.

The European Commission in liaison with the ECB and EBA has been verifying at regular intervals that the policy conditions attached to the financial assistance are fulfilled through missions and regular reporting by the Spanish authorities on a quarterly basis. The Spanish authorities have also requested technical assistance from the IMF to support the implementation and monitoring of the financial assistance with regular reporting. The role and involvement of the IMF in the programme is specified in separate Terms of Reference (ToR).

The loans have been provided to the Fondo de Reestructuración Ordenada Bancaria (FROB), the bank recapitalisation fund of the Spanish government, and then channelled to the financial institutions concerned. The funds were disbursed in two tranches amounting to €41.3 billion ahead of the planned recapitalisation dates pursuant to the roadmap included in the Memorandum of Understanding and no further disbursements are currently foreseen.

The assistance was disbursed in the form of debt securities issued by the ESM for this purpose. They comprised 2- and 10-month bills as well as floating rate notes (FRNs) with a maturity between 18 months and 3 years.

4.5 Cyprus

Probably it is not completely a mistake if one argues that the Cypriot bailout package is one of the most debated. It also differs significantly from other financial assistances in several aspects.

In the last decade Cyprus was increasingly facing serious challenges in terms of unsustainable external and internal macroeconomic imbalances such as the erosion of its international competitiveness, the deterioration of public finances, the oversized banking sector, the accumulation of private sector debt and the significant increases in the property prices. While some imbalances have emerged only following the sharp recession and the collapse of the domestic credit boom, others have been building up over the past decade. Amidst concerns about the sustainability of its public finances and a weakened financial sector the Cypriot authorities requested financial assistance from euro area member states and the IMF on 25 June 2012.[363] However, as a result of extensive negotiations, the package was only agreed on 25 March 2013.[364] The financial package covers up to €10 billion; the ESM provides up to €9 billion, and the International Monetary Fund (IMF) is expected to contribute around €1 billion.

The Cypriot programme includes a key and highly debated conditionality element, the burden-sharing of the private sector the so called bail-in of depositors in restructuring the two biggest banks: Bank of Cyprus (BoC) and Cyprus Popular Bank (Laiki).[365] The BoC was capitalised through the full contribution (bail-in) of the shareholders and bondholders of the bank and through the conversion of 47.5% of uninsured deposits (over €100,000) into equity. The resolution of Laiki minimised the use of taxpayers' money with a full bail-in of equity shareholders and bondholders and a partial bail-in of uninsured depositors. All deposits under €100,000 were fully protected. As a result, Laiki was split in two units. While all uninsured deposits were kept in a legacy unit (Legacy Laiki), the insured deposits were transferred together with certain assets and liabilities to the BoC. In exchange for the positive net asset position transferred the Legacy Laiki received shares of the BoC.

The economic adjustment programme will address short- and medium-term financial, fiscal and structural challenges facing Cyprus. The key programme objectives are:

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls in line with the political agreement of the Eurogroup of 25 March 2013;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible particularly through measures to reduce current primary expenditure and maintain fiscal consolidation in the medium-term particularly through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector;
- to implement structural reforms to support competitiveness as well as sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances particularly by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

363 http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp149_summary_en.pdf.

364 It was the second agreement among Cyprus, the EU and the IMF. The first agreement on 16 March 2013 was voted down by the Cypriot parliament. The uncertainties led to significant market turbulence in Cyprus.

365 http://esm.europa.eu/pdf/FAQ%20Cyprus%2018092013.pdf.

Closing remarks: European economic integration in political perspective

Economy and politics walk hand in hand in the process of European integration. This has been clearly seen during the years of the euro crisis. During the worst crisis ever experienced by the EU as from 2008, the euro was not seen as the solution, rather than the source of the problem. But in fact, the lesson from the recent malaise is that the policy system behind the common currency needs significant reinforcement.

The euro is one of the most sophisticated results of the process of modern European integration. It is also a symbol of peaceful collaboration between European countries, which has been accompanied by, or has resulted in, unprecedented levels of peace, stability and prosperity in Europe.

In order to restore confidence in the single currency zone, a high-level fiscal union must be created, which will require further measures of economic integration, such as the creation of a European finance minister, a far bigger EU budget, and an effective bank supervisory authority at euro-zone level. Not all members will be able or willing to go that far in the medium term. A two-speed Europe has already come into existence in reality with the UK's decision to stand aside. Nevertheless, the dynamics of integration is uncertain. This is partly because the alliance between the 18 current members of the euro zone is not a stable formation per se; for many of them, the bar will be set too high, and they will not be able to accept the degree of harmonisation needed. An additional factor is that integration is to proceed on an intergovernmental – rather than supranational – basis, and there will be a need to clarify the roles of the EU bodies, in particular that of the European Commission.

Despite its undoubted successes, modern European integration is – in historical terms – a fragile construct. The main reason for this is the absence of a precise self-definition. Europe is still a nascent formation, consisting of political compromises, a common system of law, a common economic zone, and a collection of political and institutional responses to crises. Although the peoples of Europe have lived side by side for thousands of years, they do not share traditions, living myths, a common identity or language; nor do they project a single image towards the outside world. The political class and the intellectual elite are just as divided: some want more Europe, while others think that even the present level of cooperation is far greater than desirable. The underlying reason is that no one has a clear picture of the function, goal and future development of the EU; there is no agreed vision.

The federalism school sets out the ultimate (political) goal and plans the necessary constitutional steps in this direction. In contrast, functionalism proceeds step by step in the form of concrete – mostly economic – measures. Federalism would like to concentrate the power of the nation-state in the hands of integration, while functionalism seeks to combine the activities of states at a higher international level. Federalism would like to curtail state sovereignty and it condemns nationalism. The aim of federalism in its pure form is to unify states by constitutional means, whereas functionalism seeks to develop a framework for economic and social welfare through the cooperation of participating member states and shared organisations. In federalist ideology, governments and states are considered the central actors of integration, whereas for functionalists this role is fulfilled by organisations at the 'sub-governmental' level, i.e. economic actors and interest groups. Legal regulation has a central role for the federalist school (which has a more uniform doctrine than functionalism with its numerous branches). In contrast, functionalism considers legislation to be simply one means of integration.

Federalists believe that the time has come to establish a political union, or the alternative is a collapse of the integration project brought about by the euro crisis. Others claim that political union is not only unnecessary but also impossible in Europe. Many member states, much of public opinion and of the European cultural elite reject the idea of a political union. In addition, Europe is not yet prepared mentally for such a union. There are three reasons for this. First, the lack of common European traditions, identity and language. Second, the member states having extremely divergent visions for the European Union and holding a variety of opinions on what is the ideal economic and social model. Third, it is a physical impossibility to create a unified political union out of a Europe that has 28 members and is expected to expand continuously. Consequently, the result is a multi-speed Europe.

The UK is distancing itself from integration, thereby creating a good pretext for the German-French duo to press on with establishing Core Europe while avoiding the EU-28. For eurozone key countries surrendering more of their sovereignty will be far less painful than a euro meltdown. Chancellor Merkel seriously believes that the demise of the euro would be the downfall of the EU.

By creating the euro (which was in many – especially in economic – respects either an irresponsible enterprise or a visionary act, depending on one's perspective), Europe crossed the Rubicon: it pushed integration to a point of no return where it either presses on with a fiscal and political union or must bear the dire economic and social consequences of a break-up of the common currency.

Euro-related challenges are not only factors: Europe at the beginning of the 21st century is facing not only a financial crisis but also a political crisis (caused in part by the economic crisis). It is a political crisis in the sense that the political institutions established after World War II, including those of the EU, have lost the confidence of the electorate. Society and the economy are undergoing rapid change. For many, such change is an opportunity, but for even more people it is a threat. This undermines society's confidence and leads to the chronic rejection of political institutions and a widening of the chasm between the elite and the man in the street. The welfare model that was designed to prevent a repetition of the disastrous social problems of the interwar period is now in a crisis, thereby jeopardising the social peace that was based on keeping the middle-classes satisfied. This in turn has added to economic and social tensions caused by immigration and to a hysterical fear of globalisation. In the view of many, globalisation – or as the anti-globalists call it: the unbridled competition of dog-eat-dog capitalism – finds embodiment in the European Union. It is therefore not accidental that there is a growing rejection of European integration, accompanied by a general rejection of the political mainstream.

Crises are inherent to capitalism, but the crisis that began in 2008 has several unique features. The first is its rapid spread in the financial sectors of the developed world, which was due to the unprecedented interconnectedness of the world's financial markets. Many have drawn comparisons between the current crisis and that of 1929. True, at that time too, an irresponsible deluge of credit had caused economic bubbles, but the crisis was one of over-production. In other words, the problems of the 1930s originated in production, i.e. the real economy. In contrast, the crisis of 2008 originated in the financial sector. There were no problems with the foundations of the real economy until they were rocked by the financial meltdown. But the most important feature of this crisis is that – contrary to previous ones in the second half of the 20th century – it is a crisis of the West. The scenario is not that of a collapsing emerging economy (Argentina, Mexico, Russia, East Asia) that has proved itself incapable of implementing the operating principles of Western liberal capitalism. On the contrary, the rest of the world remains relatively stable while the economy of the West (USA and EU) seems to be cracking. Ground zero of the financial crisis was in the United States, the key archetypal capitalist actor. However, by 2011, the eurozone had become the real focus of the crisis. China, Japan, and the United States are keeping a watchful eye on the success (or failure) of Europe's crisis management, while drawing up various strategic scenarios. Thus the crisis has crossed the Atlantic, and made the leap from the financial sector to the real economy, affecting in particular national budgets. Act two of the current crisis centres on unsustainable national budgets. This explains why, in Europe, a rescue is needed not only for the banks but also for the member states.

Clearly, the present crisis is one of the most serious ones in the history of European integration. It is fundamentally a political crisis rather than a purely economic one. It is the consequence of a downward spiral of political and economic problems that mutually reinforce each other. At its centre lies a weakness of political vision in the EU and in the eurozone. In economic terms, Europe is better placed than the USA; yet it is the eurozone that has become the epicentre of the crisis. History teaches us that monetary unions are unsustainable without political coordination and a fiscal union: a major economic crisis has now made this painfully clear to the eurozone too.

In the history of European integration, crises have acted as the triggers of major political and institutional changes. Europe and the EU face many external and internal challenges, the scale of which has grown in recent decades (greater international competition, a whole series of demographic, social and budgetary problems). Member states have often made feeble and belated responses to such challenges with delayed reforms and poor management of immigration and demographic trends. At the same time the European Union has not been more robust either (see weak and eventually failed policy visions as the Lisbon programme, diplomatic and geopolitical difficulties due to the lack of a common EU position, years of impasse after the failed European constitutional project, etc.)

The question is whether the present crisis, which threatens the existence of the most important achievement of European integration – the common currency – will lead to a 'quantum leap' towards closer political integration and a multi-speed Europe. It may indeed result in any of the two.

In the medium term, the whole of Europe must prepare itself for a decade of sluggish economic growth. The gap in economic, social and political development within the eurozone will only widen unless there is a major change of direction in the integration process. In the long term, the European welfare state is unsustainable in its present form (cf. ageing and shrinking populations, budgetary over-extension, an increasing competitive disadvantage vis-à-vis Asia). For this reason alone, it would seem sensible to pool European resources and to aim for a common European political and geopolitical agenda. But that will be the result of economic necessity rather than rationality.

A lot of discussion is taking place about political union. But one thing has to be clear: not any form European political union should or could mean the formation of a regional world government or the elimination of Europe's nation states. The nation state is a European invention, and Europe's nations will never be dissolved into an all-embracing pan-European political unity – if for no other reason than because for Europeans a sense of European identity barely exists, and Europe does not have a common language like the United States does. Political union could mean closer political integration, a real common foreign policy, a real European (or eurozone) president, real European parliamentary elections, a real (perhaps eurozone) budget, and a truly common economic policy. It could also mean unified European representation (a single seat and a single voice) in international organisations as well as stronger pan-European symbolism in daily life. The euro would still not be backed by a real country, but there would be regional integration with a far stronger political profile.

Currently, the key question concerning the future of European integration is whether or not a currency without a country is viable. The European Union has tried to establish a monetary union without a political union, but it has become increasingly clear that both are needed – or neither. Some thought that this ambiguous situation would lead to a great crisis, forcing the EU to establish closer political integration. That is to say, what cannot be achieved through nice words, will happen under pressure – as has been the case so many times before. Angela Merkel has a point saying that if the present crisis leads to the end of the euro, this would result in the collapse of European integration as a whole, at least in its present form[366].

Not only is the common currency without a country; it also has no backing in the form of political institutions or even the basic foundations of economic integration. The EU barely has a budget: in a modern market economy, the budget amounts to 40-50 percent of GDP, while the EU budget amounts to just one percent of European GDP. Moreover, money is not spent on things that a "normal" budget would target, but for very different purposes, such as farm subsidies – which still account for almost every second euro spent. These factors add up to a budget ill equipped to make significant transfers between eurozone members at different levels of development and in different stages of the economic cycle. An even more important deficiency of the eurozone is

366 http://www.spiegel.de/international/germany/if-the-euro-fails-europe-fails-merkel-says-eu-must-be-bound-closer-together-a-784953.html

its lack of a common economic policy and the cumbersome decision-making with unanimity required, for instance, to adopt common fiscal rules.

A closer union in fiscal and economic policy terms - a European finance minister, eurobonds, common financial supervision, a closely coordinated economic policy - seems inevitable, as does, in certain respects, a political union. All this will require a new treaty, an amended ECB statute, and above all political will. Closer integration may certainly be envisaged in the form of a multi-speed union. A radically different European space is appearing before our very eyes. And in this new space the role of Europe's major powers will change, and there will also be a shift in the relative clout of countries. Germany may be the greatest beneficiary of the reshuffle with its new-found regional primacy. German political elite supports closer integration, which will help mitigate fears of German hegemony, but the German-French tandem will no longer be regarded as a partnership of equals. History (and necessity) has made the economy – and the common currency – the driving force of federalism, rather than political institutional development or the construction of a European cultural identity, which would have favoured the French. The French wanted the euro – and the whole process of integration – as a means of keeping the Germans in check, but in reality the opposite happened. The principles of France's European policy – the multiplication of French power and capacities at the European and global level coupled with categorical inter-governmentalism – have been sorely wounded.

Historically speaking, hostility, rivalries and war are the norm on the European continent; periods of peaceful co-existence are the exception. Also, in historical terms, modern European integration (voluntary cooperation between sovereign states, based on the respect for common laws, and which was launched after World War II with a strengthening of economic and commercial relations but with the primary purpose of pacifying Germany) is a vulnerable formation. As a consequence, peace and solidarity on the European continent may soon be replaced by growing hostility – if the economic situation deteriorates and becomes crisis-ridden in a geopolitical milieu that is increasingly unstable. The fate of the boldest achievement and symbol of EU integration – the common currency – is intertwined with the fate of integration as a whole: an anarchic collapse of the euro would be accompanied by the break-up of the EU and political paralysis in Europe. The euro is fundamentally a political and symbolic creation; in its present form, it does not have firm economic foundations. In light of the above it is in the interest of the EU to save the euro by establishing a strong economic union. With its present architecture, rules and stakeholders (whether they are the EU-28, the EU-26 or the EU-18), the European Union is incapable of moving forward at the right speed and depth. In addition, European public opinion gives a cool reception to any initiative coming from above, from Brussels. The European Union – it seems - faces two possible scenarios in the long term. Under the first scenario, it passively allows the centrifugal forces (markets, member-state sabotage, public disinterest) to break it up or it ceases to exist in its present form, with the unplanned termination of the euro. All of this would be temporarily accompanied by an extremely grave crisis. Under the second scenario, in the extended lands of Charlemagne a new intergovernmental treaty may be adopted, resulting in strong economic policy integration and preserving the euro. The second and third groups of countries could join later based on new conditions (which would be far stricter than they are today). The historical and European lesson is that regional integration projects are far from everlasting, and often the temporary break-up of a poorly designed form of integration is the key to a restructured formation that guarantees long-term survival.

The founding fathers of modern Europe wanted a political union to avoid war. They could not get it, so a Europe of trade was decided to be built up. But this building grew too high, or rather, too thin. Sixty years on, in the middle of a serious crisis, European integration lacks direction but at least EU institutions and member states make serious efforts to guarantee the longevity of the Economic and Monetary Union.

Index

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