MINISTRY OF FINANCE

Improving the resilience of Europe's Economic and Monetary Union

Ministry of Finance publications – 37b/2015

Economic Policy

MINISTRY OF FINANCE

Improving the resilience of Europe's Economic and Monetary Union

Ministry of Finance publications –37b/2015

Economic Policy

MINISTRY OF FINANCE
PO Box 28 (Snellmaninkatu 1 A) FI-00023 GOVERNMENT
FINLAND
Tel. +358 295 16001
Internet: www.financeministry.fi
Layout: Government Administration Department /
Information Support and Publications Unit / Anitta Türkkan

Helsinki 2015

Description page

Publisher and date	Ministry of Finance, November 2015
Author(s)	Suvanto Antti et al.
Title of publication	Improving the resilience of Europe's Economic and Monetary Union
Parts of publication/ other versions released	The publication´s language versions: English: Improving the resilience of Europe´s Economic and Monetary Union (37b/2015)
Publication series and number	Ministry of Finance publications 37b/2015
Distribution and sale	The publication can be accessed in pdf-format at www.vm.fi/julkaisut.

ISBN 978-952-251-733-3 (PDF) **ISSN** 1797-9714 (PDF)	**No. of pages** 92	**Language** English

Abstract

The financial crisis has shown that the basic structures of the Economic and Monetary Union do not sufficiently support the stable development of the economy and financial markets in the eurozone. The development of the EMU was discussed in the Five President's Report ”Completing Europe's Economic and Monetary Union” published in the summer of 2015. The aforementioned report provides an outline for the discussion on the development of the EMU in the years to come. This expert report outlines two alternative visions for the development of the EMU's basic structures. These are as follows: the EMU based on centralised governance and the EMU based on market discipline. Each of the two visions forms an internally consistent model in which the relationship between power and responsibility is realised in the way required by legitimate decision-making and thus creates a foundation for democratic acceptability. Neither of these visions restricts the possibilities for deeper integration. Both visions enable the transfer of power to the Union insofar as is deemed justifiable. This report evaluates the ideas proposed for the further development of the EMU in relation to the two aforementioned EMU visions.

Foreword

There is broad consensus that Economic and Monetary Union (EMU) has basic design flaws. There is less agreement on how EMU should be developed. In which areas should integration be deepened, in which is it unnecessary or even inappropriate? There is not necessarily just one correct answer to these questions.

In any case, the European Union should be developed so as to best support economic and political stability in Europe. A stable operating environment provides a foundation for profitable business activity, investment appetite and, by extension, economic growth. Stable economic growth is a prerequisite for economic prosperity and lays the foundations for successful Economic and Monetary Union. It is also vital to ensure that decisions on matters of common interest are made democratically and are widely supported.

Further development of EMU was dealt with in the Five Presidents' Report 'Completing Europe's Economic and Monetary Union', published in summer 2015. The European Council is scheduled to take stock in October of discussions conducted concerning the Report. It is important that Finland's domestic policy formulation be based on careful analysis and open debate.

In August, Finland's Minister of Finance, Alexander Stubb set up a working group to assess further development needs in respect of European Economic and Monetary Union. The working group was mandated to formulate for Finland an expert view of such development needs as a basis for discussion. The working group was expected to focus particularly on those policy areas for which concrete proposals are to be made in the near term, but it was also permitted to exercise its discretion in expressing an opinion on longer-term issues, where it considered this necessary.

Invited to the working group were Antti Suvanto, Adviser to the Board, Bank of Finland, as chairman, and, as members, Kare Halonen, State Secretary, EU Affairs, Prime Minister's Office; Tuomas Pöysti, Auditor General, National Audit Office of Finland; Tuomas Saarenheimo, Permanent Under-Secretary, Ministry of Finance; Suvi-Anne Siimes, Managing Director, Finnish Pension Alliance TELA; Teija Tiilikainen, Director, Finnish Institute of International Affairs; Vesa Vihriälä, Managing Director, Research Institute of the Finnish Economy ETLA; and Tuomas Välimäki, Head of Department, Bank of Finland. The secretaries to the working group were Pauli Kariniemi, Financial Counsellor, Ministry of Finance, and Päivi Leino-Sandberg, Docent, Academy Research Fellow, University of Helsinki.

Finland has witnessed a lively debate on the further development of EMU. Experts from various fields have presented interesting, even critical assessments. Examples include a joint report by ETLA and the Finnish Institute of International Affairs entitled *EU:n suunta – Kuinka tiivis liitto?* [summary in English 'The EU's course – How deep a union?']; a book produced by the EuroThinkThank group under the guidance of Vesa Kanniainen entitled *Euron tulevaisuus – Suomen vaihtoehdot* [adaptation in English entitled *The Future of the Euro – The Options for Finland*]; a book by Kaarlo Tuori and Klaus Tuori focusing on constitutional aspects and entitled *The Eurozone Crisis, A Constitutional Analysis*; an official report in Finnish only by the Ministry of Finance entitled *Vakaampi talous- ja rahaliitto* ['A more stable Economic and Monetary Union']; and an extensive paper by Martti Hetemäki in Finnish entitled *Eurokriisin syyt ja euroalueen tulevaisuus* ['The causes of the euro crisis and the future of the euro area'] and published in the Finnish-language journal Kansantaloudellinen aikakauskirja ['Finnish Economic Journal']. The latest in this series of national opinions is the report just published by the Finnish Business and Policy Forum EVA entitled *Kun paha päivä koittaa* ['When the rainy day comes'], authored by Vesa Vihriälä, one of the members of our working group.

The working group organised three consultations with European experts. Those heard were Taneli Lahti, Head of Cabinet, European Commission; Arnaud Mares, Advisor to the Executive Board of the European Central Bank; and Klaus Regling, Managing Director of the European Stability Mechanism. They provided the working group with valuable information and useful insights.

In performing its work, the working group assessed the ideas presented for the further development of EMU relative to the two EMU visions. A certain proposal may be a natural component of one vision, but poorly compatible with another. It is therefore important that, both in Europe and here in Finland, we can reach a common understanding of the direction the development of Economic and Monetary Union should take. Otherwise, decisions will be taken piecemeal, without a clear idea of where we are going. But it is also advisable to be ready to respond to circumstances that can emerge irrespective of the vision, if it turns out to be unsuited to changing situations.

Having completed its work, the working group respectfully submits its report to the Ministry of Finance.

Helsinki, 18 September 2015

Antti Suvanto

Kare Halonen

Tuomas Pöysti

Tuomas Saarenheimo

Suvi-Anne Siimes

Teija Tiilikainen

Vesa Vihriälä

Tuomas Välimäki

Pauli Kariniemi

Päivi Leino-Sandberg

Executive summary

EMU contains basic design flaws

The purpose of the European Union is to foster economic and political stability in Europe. A stable environment provides the prerequisites for successful business activity, a willingness to invest and, ultimately, economic growth. Stable growth is the basis of the welfare of European citizens and forms the foundation of effective Economic and Monetary Union. It is also important to ensure that decision-making on matters of common interest is democratically accountable and enjoys wide support. The financial crisis showed that the basic structures of EMU do not provide sufficient support for financial market stability and hence stable economic developments.

This report outlines two alternative visions for the further development of EMU: an *EMU based on centralised governance* and an *EMU based on market discipline*. Each of the two visions forms an internally consistent model in which the relationship between power and responsibility is realised in the way required by legitimate decision-making and thus creates a foundation for democratic acceptability. However, in the case of the first model, due to the scope of the supranational power it involves, it is politically a more demanding task to create institutional structures and mechanisms that would establish democratic legitimacy.

Many of the influential opinions expressed in the debate on the future of EMU do not fit clearly into either of these two visions. In practical politics, policy formulation and the logic of integration are largely influenced by factors other than the internal coherence of a chosen vision. It is realistic to assume that the future development of EMU will not (as it has not in the past) be distinctly influenced by one single vision; rather, it will be a combination of different elements of several visions. At the same time, it is important to recognise that such hybrid models typically involve contradictions that weaken the legitimacy of decision-making and hence the effectiveness of the system.

Centralised governance entails mutual responsibility for the risks and stability of Member States

In an *EMU based on centralised governance*, the basic elements are strengthened supervision and control of Member States' fiscal and economic policies at the level of the Union, and thereby also increasing mutual responsibility for Member States' risks and stability.

This vision requires that the Union has the capacity to effectively control Member States' fiscal and economic policies. When considering the viability of this vision, a critical question is whether the Union's supranational power, which the vision inherently involves, could be exercised in a manner that enjoys adequate democratic legitimacy. If done successfully, the risk-sharing mechanisms and better consideration of the euro area as a whole afforded by this vision could yield beneficial end-results for all Member States. On the other hand, if the legitimacy of the Union's power becomes questionable during this process, the policies of the Member States will not be amenable to effective control. This could result in growing fiscal transfers between Member States and exacerbate political divisions.

In an EMU based on market discipline, Member States are responsible for their own economic policies and their consequences

An *EMU based on market discipline* builds on each Member State's full ownership of its own economic policies and their consequences. In this vision, the Union will gradually cede the aim of controlling and preventing mistakes in the economic policies that fall within the competence of each Member State.

In this vision, power and responsibility clearly lie at the national level, and thus the issues relating to the legitimacy of decision-making would be resolved naturally through national democratic institutions. Member States' economic and fiscal policies are constrained by their national fiscal policy rules and, ultimately, by market discipline. The role of fiscal policy in stabilising economic cycles remains modest, unless instruments are created specifically for this purpose at the level of the euro area budget.

An EMU of market discipline could also entail mutual responsibility, but it would primarily be risk sharing between citizens and businesses implemented through joint institutions, rather than mutual responsibility between Member States per se. A Single Resolution Mechanism in which the euro area's banks are paying into an insurance pool to cover the cost of crisis resolution in the euro area is one example of such a risk-sharing arrangement compatible with this vision.

Market discipline would have to be supported by a credible possibility of orderly debt restructuring for an over-indebted Member State. At present this may be challenging because, with many highly indebted Member States, a debt restructuring of one could easily lead to widespread contagion and risk a systemic crisis in the euro area. Therefore, an EMU of market discipline would require a long transition period during which the overall level of public debt would be reduced and procedures and institutions for orderly debt restructuring established.

Neither vision would restrict the scope for deepening integration

In the debate on the future of EMU, any reference to market discipline is often linked to a negative view of deepening integration in the euro area. Conversely, enhanced coordination of fiscal and economic policy is often seen as a central aspect of the euro area's development towards a federal system.

However, the choice of one of these two visions for EMU is not a statement for or against European integration or evolution towards a federal Europe. A well-functioning EMU based on market discipline requires enhanced centralised competence and risk-sharing, at least where the prevention and management of financial crises are concerned, but it would also provide opportunities for developing other types of federal structures. The USA is an example of a country where a federal structure is combined with strong market discipline for individual states.

Nevertheless, an EMU based on centralised governance would be more likely to lead to closer integration and provide less room for purely national, sovereign decision-making than an EMU based on market discipline.

No short-term alternative to rules-based coordination

The debate on EMU has focused a great deal on various proposals for strengthening the coordination of Member States' economic and fiscal policies. How these proposals are viewed depends on the choice between the two EMU visions described above.

If the intention is to strengthen centralised governance, the focus should be on enhancing implementation. On the other hand, if the objective is to strengthen market discipline, the direction would be more towards simplifying the rules framework and its gradual reduction. However, in the short term, no realistic alternative exists to some type of rules-based coordination of Member States' fiscal policies.

Flexible structures support the stability of EMU

Structural economic reform in the Member States is of common interest to the euro area. The more flexibly Member States can adjust to economic shocks, the better EMU can function. Enhancing the performance of product and labour markets and the public sector would enhance EMU's stability. Improving the internal market and removing the remaining obstacles to its smooth functioning would boost Europe's competitiveness and economic growth.

There has been a lot of debate on the promotion of structural reforms in Member States. Attempts have been made to accelerate the reforms through country-specific recommendations and peer reviews. The practical impact has been limited, and it is not clear whether the euro area has the capacity for more effective coordination. The creation of a binding centralised governance approach to promote structural convergence does not seem viable, as it would be impossible to enforce any policy recommendations in practice.

Banking Union reduces the likelihood of crises as well as their costs

The completion of Banking Union and the creation of a Capital Markets Union are compatible with both visions. Financial union can be seen as an important prerequisite to a well-functioning EMU based on market discipline, since it will reduce the need for fiscal stabilisation mechanisms and in extreme circumstances improve the likelihood of an orderly restructuring of a highly indebted Member State's sovereign debt. On the other hand, Banking Union is also compatible with the vision of an EMU of central governance.

From the point of view of the objectives of Banking Union, a European deposit insurance scheme would be a logical step. However, to ensure a level playing field it is first necessary to put the different banking sectors on an equally sound footing and to harmonise the ex ante funding levels in national deposit insurance schemes.

A well-functioning capital market serves as a buffer against country-specific shocks

Key objectives of the Capital Markets Union include the diversification of funding sources for SMEs, reducing the predominant role of banks on the financial markets, reducing home bias and promoting diversification of investments.

Reducing the predominance of banks in European financial systems will reduce vulnerability to shocks, as highly leveraged indirect financing is replaced by direct capital market financing. Well-functioning and diversified capital market financing can serve as a buffer against country-specific shocks. This will, in turn, help to reduce the need for fiscal stabilisation instruments.

The ESM could support market discipline

In principle, the European Stability Mechanism (ESM) is compatible with either of the two visions for EMU. However, if the objective is specifically to create an EMU based on market discipline, it is essential to ensure that ESM funding available to Member States is strictly limited to addressing liquidity problems. Solvency problems should be addressed by orderly debt restructuring where necessary.

In an EMU based on market discipline, the central role of the ESM is to limit contagion effects; i.e. to prevent the debt problems of an individual Member State from resulting in widespread contagion and a systemic crisis. Effective limitation of contagion reduces the costs of a Member State's debt restructuring, promotes investor responsibility and hence supports market discipline.

Contents

1 Background

Discussions on the further development of Economic and Monetary Union began in June 2012, when Herman Van Rompuy, then Chairman of the European Council, presented a report on deepening EMU to the Heads of State or Government. In the autumn of the same year, the Commission published a communication on the development of Economic and Monetary Union (a Blueprint document). Both reports were divided into four sub-areas: financial markets, fiscal policy, economic policy and democratic legitimacy. They included proposals for short-, medium- and long-term measures.

The December 2014 European Council agreed that Jean-Claude Juncker, President of the Commission, in close cooperation with Donald Tusk, President of the Euro Summit; Jeroen Dijsselbloem, President of the Eurogroup; Mario Draghi, President of the European Central Bank; and Martin Schulz, President of the European Parliament would report in their personal capacities on the development of EMU at the latest to the June 2015 European Council. The report 'Completing Europe's Economic and Monetary Union' was published on 22 June 2015. The June 2015 European Council took note of the Report and urged the Council to review it without delay.

The Five Presidents' Report includes both short- and long-term proposals. Stage 1 (1 July 2015 – 30 June 2017) entails boosting competitiveness and structural convergence, achieving and maintaining responsible fiscal policies at national and European level and enhancing democratic accountability. The short-term aim is to strengthen convergence among euro area countries by developing the current governance framework for economic policy. In Stage 2, the aim is to agree on measures to complete the economic and institutional architecture of Economic and Monetary Union by 2025.

According to the programme of the Finnish Government of Prime Minister Juha Sipilä, the Union needs to be reformed and its functioning improved, while amendment of the Treaties is not currently topical. The Government programme states that Finland respects common rules, expecting other Member States to do so too. The emphasis of Finland's EU policy is on promoting economic growth and employment. To this end, structural reforms aimed at improving competitiveness and research, development and innovation activities are of the essence. The European Union must focus on the most vital issues, and there is no need to deepen integration in all policy areas. The Government evaluates all EU regulation from the viewpoint of economic growth, competitiveness and employment and expects EU institutions to adopt corresponding approaches. The Union should not be assigned direct powers to levy taxes.

According to the Government programme, Finland is committed to promoting euro area stability as a member of Economic and Monetary Union. Finland's aim is a rules-based and effective euro area where each Member State has primary responsibility for its own economic policy. Similarly, each Member State is responsible for its own debts. The Government seeks to restore the credibility of the 'no bail-out' rule. EMU should not be developed through a deepening of economic coordination that would lead to a broadening of joint liability. The Government supports a strong Banking Union based on the bail-in principle and its further development. In order to strengthen compliance with the rules, economic policy coordination should be simplified, and Member States' ownership of economic policy must be ensured.

Finland's previous positions regarding EMU development are based, in particular, on the parliamentary Grand Committee statement SuVL 4/2012 vp and report SuVL 1/2014 vp. Of these, the first concerns EU institution proposals submitted in 2012 for the further development of EMU and Banking Union. At that time, the Finnish Parliament considered six-pack and two-pack legislation sufficient in the near term and warned not to look at economic policy only via debt sustainability, ignoring other economic policy objectives, such as employment, growth and social stability. Parliament stressed the responsibility of national parliaments for their own countries' budgets and the significance of civil rights, democracy and transparency. It would be premature to decide on actions addressing Member States' budgetary policies. Even partly mutualised debt would be economically harmful and in breach of the Treaties. Parliament was negatively disposed towards a common euro area budget, the creation of own funds for the euro area and the appointment of a euro area 'Minister of Finance'.

In its report (SuVM 1/2014 vp) on the Government's EU policy analysis, the Grand Committee reiterated its opinion that the current arrangements for economic policy coordination, if effectively implemented, would also provide a sufficient basis for the sustainable long-term operation of EMU. The Committee encouraged simplification of the framework for economic policy coordination, considering the key principles of Banking Union appropriate, but emphasising that single banking supervision and the single resolution mechanism did not mean joint guarantees. Making reference to pressures for joint liability and integrated fiscal policies, the Committee underlined that Finland, together with other countries with similar opinions, should strive for an option based on the current Treaties. The Committee considered that the credibility of the 'no bail-out' rule should be strengthened by setting up a set of rules to ensure the imposition of losses from sovereign insolvency on investors. Risk assessments of sovereign debt securities should be based on objective risk analyses. Moreover, tools for an orderly restructuring of private sector debt should be elaborated to safeguard euro area stability and to remove barriers to economic growth. The Committee emphasised that, although regulation within the Union law is primary, Finland is also openly disposed to intergovernmental agreements as a means of developing Economic and Monetary Union. The Committee also paid attention to the ECB's activities and the evolution of its tasks, voicing concern about Finland's total commitments, and their effects, arising from crisis management in connection with stability mechanisms.

2 Structural problems and visions of Economic and Monetary Union

2.1 General considerations

As its name suggests, EMU was designed to create economic and monetary union for Europe. Monetary union became a reality in January 1999 with the start of the single monetary policy. The establishment of economic union remained incomplete. In addition to the single market programme, it was mainly represented by the Stability and Growth Pact adopted in 1997 and aimed at ensuring fiscal discipline in euro area Member States so as not to pose a threat to monetary stability. These rules were supplemented later, but key economic policy decisions are still made at national level.

Safeguarding price stability in the euro area as a whole was defined as the primary objective of the single monetary policy. For this reason, the ECB's macroeconomic analysis is mainly focused on euro area-wide economic activity and inflation. Procedures were put in place for the monitoring of developments in public sector debt, but private sector debt was not monitored with the same care. Nor was adequate attention paid to cross-border differences and the resultant imbalances and tensions. Procedures for limiting macroeconomic imbalances were not established until a few years ago.

The years of financial and euro area crises showed that there were shortcomings ('design flaws') in the basic structures of Economic and Monetary Union. The crisis shook up the global financial markets, but only in the euro area did it escalate into a systemic, protracted sovereign debt crisis. The institutional structure of EMU defined in the Treaties was based on commonly agreed fiscal rules and elements supporting market discipline ('no bail-out' clause, prohibition of monetary financing by central banks).

Neither the fiscal rules, fiscal peer pressure between Member States nor market discipline were able to prevent the accumulation of excessive public debt in euro area countries. Nor could EMU's regulatory framework curb private sector indebtedness, housing market overheating or banking sector growth and excessive use of leverage. The realisation of the hidden liabilities from the banking sector in some Member States called the sovereigns' credit ratings into question, barring their access to market funding.

If, at the height of the crisis, efforts had been made to address bank and sovereign debt problems purely via the bail-in tool, there would have been a major risk of a broad-based collapse of the European banking sector. The consequences of such a meltdown for the real economy would have been devastating for all Member States, irrespective of the initial condition of a country's banking sector or government budgetary positions. No instruments were available for a quick reorganisation of interdependent banks. Nor were tools in place for carrying through sovereign debt restructuring without triggering a new banking crisis. In such a situation, euro area policy-makers opted for the path of financial support programmes. The decision meant increasing mutual exposures between euro area Member States, thus entailing a higher degree of joint liability.

During the course of the crisis, the ECB has also seen it necessary to implement non-standard measures. The measures initially focused on safeguarding bank liquidity in circumstances where interbank markets were severely disrupted. Credit operations with long maturities were launched at the end of 2011 in an attempt to ward off an impending credit crunch. The covered bond purchase programme was designed to boost secondary market operations in this market segment of key importance for housing finance. The aim of the securities markets programme was to secure the transmission of monetary policy in certain distressed countries. The possibility of conducting outright monetary transactions was announced with a view to reducing risk premia related to a potential break-up of the euro area. An expanded asset purchase programme was embarked upon at the beginning of 2015. The programme was aimed at minimising the risk of deflation, supporting economic growth and strengthening inflation expectations.

Box 1

Market discipline and euro area countries

Market discipline means pressure exercised by market pricing on the behaviour of securities issuers for the purpose of imposing financial discipline.

Market discipline in the capital markets operates via share and bond prices. As the outlook for a listed company weakens, the value of its shares decreases and the risk premium on its bonds increases. It may be necessary for the company to reassess its business model in order to restore market confidence. If the corrective measures available are inadequate, the company may apply for debt restructuring or its creditors may file a bankruptcy petition against the company. In both cases, a solution under court oversight will be sought to provide optimal safeguarding of creditor interests.

In connection with sovereign states, it makes sense to talk about market discipline only when borrowing takes place in a currency whose issuance the country does not control. In principle, debt denominated in the country's own currency can always be covered via the central bank. As euro area countries do not control the issuance of the euro, the euro is in this sense comparable to a foreign currency.

Even in cases where sovereign debt is in a foreign currency, market discipline has not always operated in a consistent or predictable manner. Markets have often been slow to identify hidden debt problems and have allowed government borrowing to continue for quite a long time before risk premia have begun to rise. After the markets have finally woken up, the response has often been dramatic, leading to a sudden halt to finance. A seemingly calm situation has translated into an acute crisis so fast that the government has in practice had no time to correct its policy.

A number of reasons can be identified for an imperfect functioning of market discipline in connection with (notably euro area) governments. In the first place, governments have no access to tools comparable to debt restructuring or bankruptcy to enable an orderly debt restructuring with safeguards for creditor interests. There is no court that would assume responsibility for a sovereign state's debt restructuring and guarantee an orderly and equal process that maintains the state's debt-servicing capacity. Therefore, sovereign debt restructuring is typically a chaotic, politically coloured process marked by coordination problems between creditors. As a consequence, sizeable damage is often caused to the economy and debt-servicing capacity of the affected country.

As no institutions for an orderly debt restructuring exist, expectations of government access to liquidity begin to steer market pricing. If investors assume a future tightening in the availability of finance for a country, the rational response is to seek to sell their holdings of the country's government bonds before the problems come to a head. This results in multiple equilibria, where negative expectations become self-fulfilling and market sentiment may lead to major changes in risk premia without a direct link to the country's economic fundamentals.

The rapid escalation of debt problems in the euro area has been further heightened by the bank-sovereign nexus. A government's funding problems have promptly led to deterioration in the condition of the country's banking sector and a drying-up of lending. As a result, the country's productive activity has been disrupted and, by extension, the government's debt-servicing capacity continues to weaken.

Finally, in the case of euro area countries, in particular, financial support packages have provided private creditors with an opportunity to offload their risks. Market pricing has largely been guided by market expectations of the availability of external financial assistance. Through this channel, political changes in distressed countries and countries providing finance have influenced market behaviour.

Thus, creating operational conditions for consistent market discipline in the euro area would require significant institutional reforms. These are discussed in more detail in other sections of this report.

Box 2

Joint liability

The programme of Prime Minister Sipilä's Government underlines Member States' responsibility for their respective economic policies and debts. The programme also states that stronger economic coordination must not lead to a deepening of joint liability. The wording of the Government programme is a reflection of the widespread negative attitudes observed in domestic debate towards increasing joint liability at European level.

Meaningful analysis of questions related to joint liability requires a clarification of the term. Joint liability may mean very different things, and Finland's interest is not necessarily the same in respect of the different forms of joint liability.

Joint liability may mean either **insurance-type risk-sharing** or **systematic fiscal transfers**.

Insurance-type joint liability is basically priced in such a way that each party bears the portion of the costs that corresponds to the protection it receives. An effective insurance-type system benefits all its participants and involves no (ex ante) fiscal transfers.

When joint liability takes the form of systematic fiscal transfers, wealth is typically transferred from those who have more to those who are in the greatest need. Such transfers are, for example, governments' internal income equalisation or development aid. The more extensive such joint liability is, the greater supportive experience of solidarity and cohesion between the fiscal transfer parties is required.

In many cases, the concrete forms of joint liability cannot be clearly assigned to either of these categories or include elements of both. In devising mainly pure insurance-type arrangements, consideration must be given to the fact that insurance activity almost always offers an opportunity for moral hazard, i.e. malpractice as a result of which payments intended as insurance-type compensation change into systematic fiscal transfers.

European joint liability could be implemented at different levels: between citizens, companies or Member States. The level of joint liability is of great significance in terms of the ability to control moral hazard.

The Single Resolution Fund included in Banking Union and a potential common deposit insurance scheme constitute, by their very nature, joint liability between European companies. In this context, to prevent malpractice, a comprehensive supervisory and regulatory framework has been set up, with the relevant independent authorities and courts of law assuming responsibility for its enforcement. It is reasonable to assume that, over time, this framework will safeguard an equal operation of joint liability mechanisms in accordance with the insurance principle.

In connection with joint liability arrangements between EU Member States, it is more difficult to eliminate risks relating to malpractice. As long as the Member States are sovereign states, they can ultimately make a unilateral decision on withdrawing from their agreements and commitments. If a Member State's political dynamics causes it to take action that is in conflict with the rules established for safeguarding joint liability, the EU will have limited scope for remedying the situation. This renders joint liability systems between governments inherently fragile.

2.2 Two visions of EMU

Debate about the further development of EMU relates to repair of the above 'design flaws'. Finland should have a national view of the direction in which Economic and Monetary Union is to be developed. Such a vision is needed in order for us to formulate a consistent opinion on the individual proposals made in e.g. the Five Presidents' Report on EMU development.

Finland has traditionally supported strict EU-level rules-based governance of Member States' fiscal policies. On the other hand, in Finnish debate there has been a widely shared view that each Member State is liable for its own debts (the 'no bail-out' principle) and that market discipline should guide policy-makers' behaviour. Both of these elements are also incorporated into the EMU statement in the present Government programme.

Box 3

What is the 'no bail-out' principle?

The 'no bail-out' principle refers to the Maastricht Treaty provision (TFEU, Article 125) stating that the Union and its Member States shall not be liable for or assume the financial commitments of other Member States. Moreover, the prohibition on monetary financing (TFEU, Article 123) prohibits the European Central Bank and national central banks from financing governments.

The purpose of the provision was, in addition to preventing the Member States and markets from relying on fiscal transfers and joint liability between governments, to encourage the markets to keep governments in check by pricing their debt according to the credit risks involved. The European Court of Justice has interpreted the provision in dealing with ratification of the Treaty establishing the European Stability Mechanism in case C-370/12: Thomas Pringle v the Government of Ireland. The Court of Justice emphasised that it was apparent from the preparatory work relating to the Article that its aim was to ensure that Member States follow a sound budgetary policy so that they 'remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline'.

There is, however, a certain tension, difficult to reconcile, between strict centralised governance of Member States and market discipline. The more extensive governance the EU exercises over Member States' fiscal and economic policies, the more responsibility it has to assume for the policy consequences. Accordingly, tight centralised governance of Member States and the 'no bail-out' principle should be seen as components of two different EMU visions. These can help outline the choices facing Finland and the euro area in the coming years.

In an EMU based on centralised governance and joint liability, EU Member States, through their fiscal and economic policy coordination, together aim at forestalling negative externalities from one Member State's unsustainable policies, safeguarding the stability of Economic and Monetary Union and improving the fiscal policy stance of the euro area as a whole. Member States' fiscal and economic policy autonomy would be subjected to centralised governance to a larger extent than at present.

Centralised governance may take highly divergent forms. On one hand, it may mean tightening the fiscal and economic policy rules for Member States and the supervision of their enforcement. In such a case, Member States would be formally responsible for their own policies, but the rules would increasingly restrict their actual freedom of manoeuvre. On the other hand, centralised governance may mean discretionary decisions at euro area level, going beyond the interpretation of the rules. This sort of centralised decision-making would bring with it over time increasing responsibilities for the consequences of common governance and, through that channel, joint liability among the Member States. In practice, the implementation and effectiveness of this model would require a strengthening of the EU's economic policy competence and thus a Treaty amendment, too.

It should be noted that the link between power and responsibility operates both ways. The more Member States share risks among themselves, for example, through mutual loan arrangements, the more there is a need for centralised decisions in order to control moral hazard.

Box 4

The link between centralised governance and joint liability

One of the central themes of this report is the link between centralised governance of Member States' policies and Member States' joint liability.

The EU's endeavour to steer Member States' fiscal and economic policies is, by nature, the wielding of power. As is normally the case with legitimate exercise of power, it also inevitably involves an assumption of responsibility. The more comprehensive the centralised governance based on Member States' rules and/or discretion is, the more obvious it is that this entails a transfer of policy ownership from Member States to the Union and the clearer it becomes that the responsibility is to be borne jointly.

The link works both ways. If the risks of Member States are to be shared, for example via mutual loans or counter-cyclical arrangements, centralised decision-making will be needed to control the moral hazard involved. Academic research shows that the formulation of market expectations of the degree of joint liability in times of crisis is closely dependent on the extent to which a federal government seeks to control the policies of the individual states in a federal system.[*]

In present-day federal states, the link between centralised governance and liability is clearly visible. In those federal systems (or countries resembling federal states) such as Germany and Spain, where the federal states, or provinces, are subject to centralised governance, the federal level also carries ultimate responsibility for the individual states' financial problems. This expectation of joint liability is very clearly expressed in, for example, credit rating agencies' assessments of individual states' credit standing.

In other federal systems (the United States, Canada and Switzerland) the 'no bail-out' principle is strongly established, and the markets or rating agencies do not expect the federal government to come to the rescue of individual states encountering difficulties. These federal systems do not typically pursue centralised coordination of individual states' policies. In contrast, individual states have imposed on themselves very strict rules for their own borrowing.

The link between rules and surveillance, on one hand, and risk-sharing and joint liability, on the other hand, has characterised the management of the euro crisis and discussions on the further development of EMU. Establishing a framework of stricter coordination and governance within EMU is widely seen as a cornerstone on which systems of risk-sharing and joint liability between Member States can be built. The President of the European Commission, Jean-Claude Juncker, brought this link clearly to the fore in addressing the European Parliament in his speech concerning the state of the Union in September 2015: '*Some say we need a government of the euro. Others say we need more discipline and respect of the rules. I agree with both: we need collective responsibility, a greater sense of the common good and full respect and implementation of what is collectively agreed.*'

[*] Rodden, J., 'The Political Economy of Federalism,' in the book by Weingast, B. and Wittman, D., eds., *Oxford Handbook of Political Economy*, Oxford University Press 2006 and Rodden, J., 'Can Market Discipline Survive in the U.S. Federation?', in Nadler, D. and Petterson, P.E., (eds.) *The Global Debt Crisis*, Brookings Institute Press 2014.

When operating as planned, the different models of centralised governance may produce a good overall outcome. Operating optimally, a jointly steered fiscal policy would serve to smooth cyclical fluctuations at the level of the euro area and also the differences in such fluctuations between Member States. Shared risk diversification among Member States would be implemented in such a way as to reduce the likelihood of sovereign financial crises.

The main challenge in such an EMU would be the uncertainty relating to the functioning of its structures. Experiences of the actual potential of EU governance to impact on Member States' policies have not been encouraging to date. There is an apparent danger that compliance with the rules becomes politically impossible for national policy-makers. Alternatively, the rules need to be interpreted very loosely in practice. Many of the structures of this vision are, in effect, untested and created as substitutes for conventional federal state structures (e.g. the federal budget, the power to levy and collect taxes, direct economic competence) that have so far not been considered as being politically feasible in the context of the EU.

Another type of alternative is, in principle, offered by an **EMU based on market discipline**. In such an EMU, governance of EU Member States' policies is not binding, but would mainly take the form of peer pressure and the sharing of best practices. Member States would themselves be responsible for the contents and consequences of their own policies. Member States could be expected to have in place possibly harmonised rules with national ownership based on spending limits and debt sustainability objectives. In the event of potential over-indebtedness in a Member State, the primary solution would be debt restructuring, and any EU financial assistance would be strictly limited to the management of liquidity problems. Market discipline would maintain incentives for the Member States to pursue disciplined policies and structural reforms.

An EMU based on market discipline would be built on the existing division of economic policy competence between the Union and the Member States. The legitimacy of decision-making would be mainly based on national-level arrangements. Functioning optimally, this EMU would significantly reduce problems related to moral hazard, and the risk of financial support packages undermining the integrity of the EU could be minimised.

This model also includes numerous practical challenges, at least in the short term. Creation and maintenance of a credible 'no bail-out' rule and, by extension, effective market discipline necessitate the pursuit of consistent policies and a readiness to accept, at least initially, considerable risks to financial stability. Enabling an orderly debt restructuring for a euro area country requires development of supportive institutions and the creation of an effective Banking Union. On account of the current high levels of debt in many Member States, euro area fiscal policy would at least initially – possibly permanently – be procyclical. In addition, the high debt levels would set restrictions on the speed at which migration to a system based on market discipline could take place without serious shocks to financial stability.

Many of the powerful views presented in discussions on the further development of EMU cannot be clearly accommodated into either of these visions. Practical formulation of political positions and the logic of integration are largely guided by factors other than the internal consistency of the target vision. It is, in fact, realistic to assume that, going forward, there will also be no single clear-cut vision to guide the further development of EMU. Instead, development will be based on a combination of elements from both visions. But we should acknowledge that such hybrid models typically encompass contradictions capable of weakening the legitimacy of decision-making, and hence the effectiveness of the system. It would therefore be warranted to keep the target vision for EMU development as consistent as possible.

The choice between these two EMU visions is not a statement in favour of or against European integration or evolution towards a federal system. Integration can proceed and federal structures can be created in the same manner and within the framework of both an EMU based on centralised fiscal and economic policy governance and an EMU based on market discipline.[1] In both cases, integration can continue to develop to the extent desired. For example, Banking Union and the related centralisation of decision-making regarding banks can be deemed necessary especially in an EMU based on market discipline, but these are also natural components of an EMU based on centralised governance. Similarly, both visions allow transfers from Member States to the Union of social policy instruments related to income equalisation between citizens (e.g. unemployment benefits). How far this type of evolution towards a federal system is to proceed is a political decision largely independent of the EMU vision targeted. The difference between the visions is related to the extent EU governance is considered necessary and possible in respect of fiscal and economic policies, currently falling within the remit of Member States' competence and financed nationally, and to the effects this would have on the division of competence between the Union and the Member States.

This report seeks to evaluate, to the extent deemed relevant, the proposals for the further development of EMU relative to the target EMU vision. A certain proposal may be a natural component of one vision but poorly compatible with the other.

---

[1] There are examples of both models in existing federal systems. The United States, Canada and Switzerland are federal systems essentially based on market discipline, whereas the role of centralised governance is vital in Germany and Spain.

Many of the proposals reviewed are derived from the Five Presidents' Report containing reform proposals that will constitute an essential element of near-term discussions. The Report's proposals are divided into four sub-areas: financial market policy, fiscal policy, economic policy and democratic legitimacy and accountability. Many of the Presidents' proposals are more naturally related to the first EMU vision of centralised governance; others suit both visions.

Experiences of the crisis showed that strengthening EMU's financial stability and shock-absorbing capacity is an indispensable prerequisite for safeguarding the sustainability of Economic and Monetary Union. For this reason, Banking Union has also been one of the spearhead projects for further development of EMU and, despite challenges, has gained the necessary political support. Completing Banking Union and creating a Capital Markets Union are economically feasible ways of remedying some of the shortcomings of Economic and Monetary Union and promoting risk-sharing mechanisms that improve the resilience of the system. The completion of Banking Union helps to guarantee that the value of euro cash or deposit holdings does not depend on their location within the participants in Economic and Monetary Union. Banking Union includes an insurance-type joint liability. An effective insurance-type system, if correctly priced, benefits all participants, involving no (ex ante) fiscal transfers.

In contrast, partial transfer of economic and fiscal policy decision-making to the sphere of the Union's competence would not appear to be a necessary precondition for effective Economic and Monetary Union. It is, however, possible that, going forward, a strengthening and broadening of the EU's competence in the area of economic and fiscal policy, too, will be seen as useful. Both an EMU based on centralised governance and an EMU based on market discipline are consistent with such federal developments. In both models there would be better chances of stabilising the Union's economic development if the common EU budget were larger. A higher EU-level share in general government revenue and expenditure would reduce tensions related to the rules-based features in a model based on centralised governance. Meanwhile, a model based on market discipline, together with a significant Union-level budget, would shape the system towards the US version, where the federal level assumes joint liability for the federal budget and the individual states are independently liable for both their expenditure and their financing.

3 Financial Union

3.1 Completing Banking Union

Banking Union has been the fastest-advancing area in the process of completing EMU. The objectives behind the establishment of Banking Union have been in the short term to stabilise the financial markets, and in the longer term to contribute to an effective functioning of the markets and to breaking bank-sovereign negative feedback loops in the euro area.

This bank-sovereign nexus was the main reason why the financial crisis translated into a protracted sovereign debt crisis in the euro area, in particular. In those countries where the problems were a legacy from uncontrolled growth in bank lending and weak risk management, the home state had to prevent the banking sector's systemic collapse by providing sizeable public financial support. In other countries where the problems stemmed from excessive government debt, the country's domestic banks had to safeguard their home state's access to finance. The outcome in both cases was the same: both the banks and the governments were brought to the brink of meltdown, and the problems had to be sorted out by external financial support.

From the perspective of financial stability and a single financial market, Banking Union is a justified component of any vision for EMU. As long as the stability of a country's banking sector is the responsibility of the home state, an orderly restructuring of sovereign debt is not a realistic option. Allowing sovereign insolvency would mean the collapse of the country's entire banking system, the termination of financial intermediation and serious consequences for the functioning of the economy as a whole and the well-being of the country's citizens. In such a situation, both economic, political and human aspects would all render external financial support almost indispensable. Effective Banking Union has the potential to break this logic of interdependence and to facilitate orderly sovereign debt restructuring in the euro area.

The legislation concerning the basic Banking Union architecture has been approved, and the implementation of Banking Union is mainly advancing as agreed. The main elements of Banking Union currently include:

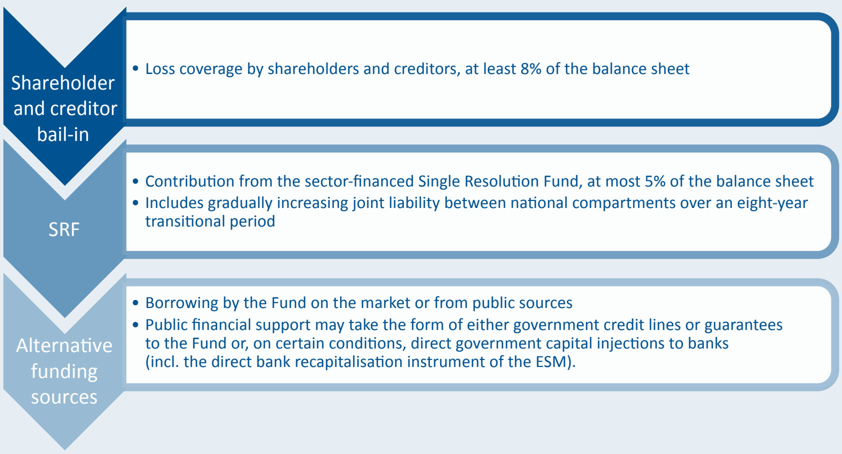
1. the Single Rulebook;
2. the Single Supervisory Mechanism (SSM);
3. the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF);
4. the ability of the European Stability Mechanism (ESM) to provide direct bank recapitalisation.

Alongside these already agreed elements, the Five Presidents' Report also proposes the launching of a common deposit insurance scheme for the Member States participating in Banking Union. To date, progress in deposit insurance has only been made in the harmonisation of national deposit insurance schemes.

Box 5

Burden-sharing in bank resolution within Banking Union

The aim of the Bank Recovery and Resolution Directive (BRRD) has been to fundamentally reform the burden-sharing related to the costs of banking crises. The basic principle is that, in the event of a bank resolution, the bank's losses and recapitalisation are to be covered through the application of the bail-in tool, i.e. by writing down the bank's share capital and, if necessary, converting the bank's creditor claims into equity. Moreover, the Member States participating in Banking Union have established a Single Resolution Fund (SRF), to be adopted stepwise during an eight-year phase-in period. The SRF is to be funded through risk-adjusted levies on the sector. The Fund's target level is approximately EUR 55 billion (i.e. 1% of covered deposits) by the end of 2023. The Fund will serve as a secondary buffer, after bail-in, for covering the costs of crisis management. Any government financial support either to the Fund or, on certain additional criteria, directly to banks, is but a means of last resort in covering the costs of a crisis. However, it should be noted that, in the event of a broad-based systemic crisis, the legislation also enables precautionary public recapitalisation in respect of financially sound banks prior to resolution measures and the related bail-in procedure. The new legislative framework is designed to promote market discipline in bank resolution and to safeguard taxpayer interests in banking crises.



Box 6

Structure and present condition of the Finnish banking sector

Finnish banks operate on the fringes of Banking Union

In Finland, the banking sector accounts for the bulk of financial intermediation between the different sectors of the economy. Relative to the size of the economy, the size of the banking sector approaches the EU average (about 300% relative to GDP). Of the three largest banks, two are subsidiaries of foreign banks, and the links to other Nordic countries, in particular, are close. The location of banks' parent groups outside the Banking Union countries means the groups can transfer to Finland operations they wish to keep within the framework of Banking Union. On the other hand, decisions on a banking group's entire organisational structure and the company form of the bank operating in Finland may, in part, be made on the basis of the benefits and costs that operation in a Banking Union country entails. In summer 2015, Nordea Group announced its intention to transform its subsidiaries in Finland and other Nordic countries into branches. Following such a change, the supervision and resolution of the Group would move entirely to Sweden, beyond the reach of Banking Union institutions.

Banking sector highly concentrated

By international standards, the Finnish banking sector is exceptionally concentrated. There are currently 11 deposit banks or banking groups operating in Finland. Two of these actors, OP Group and Nordea Bank Finland, account for around 60–70% of deposits and the loan stock. Finnish banks are applying the model of financial conglomerates. They provide a wide spectrum of investment and asset management services. They also have close links with the insurance sector. Some banks have insurance companies of their own, while others market insurance services in cooperation with independent insurance providers.

Banking sector weathered the crises relatively unscathed

The Finnish banking sector weathered the financial and euro area debt crises relatively unscathed. The growth rate of bank loans remained positive, albeit much slower than in the pre-crisis years. Of Finnish banks' assets, just under half are loans granted to households and non-financial corporations. Bank balance sheets are boosted by fairly large trading portfolios. This is due to the wide scope of Nordea's operations concentrated in Finland. In contrast, unlike in many other euro area countries, only a few per cent of Finnish banks' assets are held in public sector debt securities. Compared with many other euro area countries, the volume of banks' non-performing loans has been low and profitability has remained good.

Banks' corporate loan portfolio is broadly diversified across the different sectors of the economy, but housing loans present a clear risk exposure on bank balance sheets. Therefore, the banking sector is vulnerable to shocks in housing prices or households' debt-servicing capacity. On the other hand, from the banks' risk management viewpoint, the interest rate risk is transferred to households, as in Finland, contrary to many other euro area countries, interest rates on housing loans are mainly tied to short-term money market rates.

Banks well capitalised, but dependent on market funding

The capital adequacy of the Finnish banking sector is good. At the end of March 2015, the ratio of own funds to risk-weighted assets was 16.6%, well above the minimum requirement. The quality of own funds is also high, with the bulk consisting of earnings retained. Nor do Finnish banks carry deferred tax assets, deriving from earlier losses, on their balance sheets. The leverage ratio, i.e. equity to non-risk-weighted total assets, was 4.6% at the end of March 2015. The

Basel Committee on Banking Supervision has proposed a 3% minimum leverage ratio requirement, but no binding minimum requirement for the leverage ratio has yet been adopted at EU level.

With regard to funding, Finnish banks are highly dependent on market funding. The loan-to-deposit ratio in Finland is, after Sweden and Denmark, the highest in the EU, at slightly below 130%. Although this indicator for the banking sector's structural risk has diminished in recent years, it is still relatively high by international standards. The average ratio of euro area banks was 112% in summer 2014. Dependence on market funding makes Finnish banks and their Nordic parent banks vulnerable to disruptions on the international financial markets.

3.1.1 Single Rulebook

The Single Rulebook lays the basis for banks' equal treatment within Banking Union and, more broadly, within the EU as a whole. The Single Rulebook includes bank capital requirements (CRD4/CRR), a comprehensive set of recovery and resolution tools with the related bail-in provisions (BRRD) and the harmonised Deposit Guarantee Scheme (DGSD). The legal acts concerning the reform of prudential regulation entered into force as from the beginning of 2014. The legal acts concerning recovery and resolution tools and deposit insurance are due to become effective in 2015–2016. However, the national transposition of resolution legislation and the approval procedures for the intergovernmental agreement on the Single Resolution Fund (SRF agreement) are still pending in most Member States.[2] In addition, based on the Commission's proposal, the Council reached consensus on structural banking reform in June 2015. The matter is, however, still under review by the European Parliament.

National application of the Single Rulebook still involves certain challenges that need to be addressed in the immediate years ahead in order to achieve a level playing field for banks. Despite the Single Rulebook and single supervision, Member States continue to have a significant degree of national discretion in the regulation of banks' financial position. According to the ECB, in regulating capital adequacy and liquidity, Member States and their supervisors have access to more than 150 national options, the application of which places banks operating within Banking Union in unequal positions. Some of the national options are transitional provisions and thus temporary, while others are permanent. For example, as regards the quality of bank equity, the transitional provisions in the EU Capital Requirements Directive enable differing treatments for certain Common Equity Tier 1 Capital instruments and deferred tax assets. Similarly, there are national differences in the regulation of financial reporting, particularly between listed and unlisted banks. The Deposit Guarantee Scheme Directive allows national discretion on a number of issues. The Five Presidents' Report emphasises the need to address the margin for discretion at national level to ensure a level playing field for banks within Banking Union.

[2] Finland has implemented the legislation, approving the intergovernmental SRF agreement at the end of 2014.

The working group considers it important to resolutely continue regulatory harmonisation in the area of banks' financial position and financial reporting under Banking Union. The ECB has the possibility to restrict national options provided this falls within the supervisory mandate. In addition, removal of national differences is also important at legislative level. Detailed regulation and related national discretion could be reduced if bank leverage ratio requirements were substantially higher.

Under Banking Union, there would also be a case for at least banking groups under ECB supervision to issue their financial statements in accordance with the International Financial Reporting Standards (IFRS/IAS). For the sake of a level playing field between banks having different company forms and located in different Member States and the comparability of financial institutions' financial statements, it would be preferable if all authorised financial sector enterprises were required to issue their financial statements in compliance with the IFRS/IAS.

3.1.2 Treatment of sovereign risk in banking regulation

One of the most important channels for the bank-sovereign nexus runs through the home state's debt securities held on bank balance sheets. In many euro area countries, almost all sovereign debt securities on bank balance sheets are instruments issued by the home state. The home state's debt securities constitute a particularly significant risk exposure in those euro area countries that encountered difficulties during the debt crisis.

Current banking regulation places no specific restrictions on banks for the purchase of their home state's debt securities issued in the home state's own currency. Instead, such purchases are actually encouraged by the risk-free treatment of government bonds in risk-based prudential regulation and by the reformed liquidity regulation. The structural banking reform also proposes the exclusion of trading in sovereign debt securities from the restrictions. This has, in fact, been reflected in increasing holdings of government bonds on the balance sheets of certain euro area banks. Meanwhile, the preferential treatment of government bonds has contributed to hampering corporate sector access to finance in several euro area Member States.

The situation has also been reflected in the management of the euro area debt crisis. For example, in connection with Greece's financial assistance programmes, it has not been possible to make a distinction between government and bank financing. The government has, in part, been financed by banks, and the banks have incentives to continue to finance the government despite its weakening budgetary position. The banks' calculated capital positions will improve if they exchange corporate bonds with high risk weights for risk-free government bonds. As long as the credibility of deposit insurance depends on the government's liquidity position, banks will also have a clear interest in continuing the provision of finance to their home state.

In the present situation, the treatment of sovereign debt as risk-free investment poorly corresponds to the actual risk involved in the investments. The debt restructuring in Greece showed that an EU country's sovereign debt is truly a risky investment. Significant (albeit narrowing since 2012) government bond spreads point to the same phenomenon. This should be reflected in regulation.

The Five Presidents' Report pays attention to this problem, proposing that the treatment of sovereign risk in bank capital requirements be reviewed, for example by setting large exposure limits on sovereign risk, too.

> *In the working group's view, euro area countries' sovereign debt should not be treated as a categorically risk-free instrument.*[3] *Such prudential treatment does not eliminate the credit risk related to the debt instruments, but rather creates an illusion of non-existence of risk. Another aspect worthy of note is that the credit risk involved in debt securities issued by states participating in Monetary Union is higher than the credit risk of those states that have currencies of their own and therefore can 'inflation tax' their debts, if necessary. The regulation of sovereign debt risk treatment has reinforced the link between banks and their home states, although the announced goal was to weaken it.*
>
> *Sovereign credit ratings should be taken into account in capital adequacy and liquidity regulation. Moreover, as for euro area banks, limits on large exposures should also be applied to debt instruments issued by their respective home states. On account of the large number of euro area countries, it is easy for banks to diversify their euro-denominated sovereign debt investments among different issuers. Accordingly, extension of large exposure limits to cover sovereign debt would have more minor implications for euro area banks than for banks operating in the currency area of a single country. Meanwhile, the diversification triggered by large exposure limits would also be helpful in weakening bank-sovereign negative feedback loops.*

3.1.3 The role of public backstops under Banking Union

As part of the creation of the Single Resolution Fund, it will be necessary to take a stand on the type of public backstops needed to safeguard the adequacy of the Fund's financial resources. Immediate decisions should be taken on arrangements for the transitional period, i.e. the period from the beginning of 2016 to the end of 2023. During the transitional period, the Fund will not have reached its full size, and the ultimate responsibility for resolution funding will lie with the Fund's national departments. Permanent arrangements apply to the period beyond 2024, after the Fund will have reached its full size and national components will have been fully merged into one single fund. The need to take decisions on permanent arrangements will not arise until towards the end of the transitional period. On the other hand, the Five Presidents' Report proposes a permanent arrangement, to be already established in the near term, in the form of a credit line from the European Stability Mechanism (ESM) to the Single Resolution Fund.

---

3 Central bank deposits are truly risk-free investments for banks.

The issue of public backstops can be approached from the angle of the following three questions:

1. Is a public backstop needed to support bank resolution?
2. Which would be the most appropriate institution to grant such a backstop?
3. What kind of decision-making process is needed for granting backstop financing?

The setting-up of a public backstop for the Single Resolution Fund is motivated by the fact that it would bring credibility to the resolution process. In the absence of sufficient funds for orderly resolution, the resolution authority may find it necessary to adopt a resolution strategy that is less appropriate for financial stability. On the other hand, it is also clear that, in the event of an extensive systemic crisis affecting the financial system as a whole, the pre-financing of the Fund would not be enough to stabilise potential market panics.

The new resolution powers and more stringent capital requirements can be expected to significantly reduce the likelihood of a need for public financial support. It is, nevertheless, possible that, in the event of a broad-based systemic crisis, the financing needed for resolution will at least temporarily exceed the financial capacity of the Single Resolution Fund. This risk will be particularly relevant in the immediate years ahead, when the Fund will not yet have had time to accumulate significant levels of ex ante funds. In such a case, the only practical alternative to supplementary funding is public financial assistance.

It could, however, be argued that a clear budgetary constraint would provide resolution authorities with incentives to opt for a resolution strategy based on the bail-in tool and designed to minimise the need for external funding. Such an approach would reduce disincentives related to public subsidies and would promote responsible activity within the financial system.

However, it may be difficult for a government to adopt a credible commitment to always refrain from supporting the stability of the banking sector with public money. In an acute crisis and in the face of major financial damage, political disapproval of bank support normally fades and the means to grant public assistance can be made available. In practice, confidence in the financial system is also based on the factual role of the government and/or central bank as lender and guarantor of last resort.

If credible commitments not to support resolution with public funds cannot be made, it is warranted to define predictable and effective procedures for granting such support. The worst alternative is an improvised solution with unpredictable outcomes and prone to technical problems. In any case, the EU's new resolution framework restricts the scope for using public support, and it is no longer possible to artificially underpin the operation of non-viable banks with public funds.

The need for public backstops will be greatest during the transitional period and particularly in the first years of operation of the Single Resolution Mechanism. In those years, differences in banking regulation and crisis vulnerability across countries will also be at their largest. Although, from the perspective of breaking the bank-sovereign nexus, there would be a case for a common backstop with joint liability to be in place already in the transitional period, this would not yet be a system based on insurance-type, equal joint liability.

The risk of systematic fiscal transfers involved in the arrangement would be significant. For Finland, a more desirable option would be a transitional arrangement where each Member State safeguards the adequacy of funds used for the resolution of its own banks during the transitional period.

The situation will be different for the permanent arrangement due to enter into force at the beginning of 2024. An eight-year horizon makes it impossible to foresee the future strength of the banking sectors in different countries. Differences in supervision and regulation should also have vanished by then. It would be justified to have a common backstop in operation by that time, for example a system based on the European Stability Mechanism (ESM) or the European Financial Stabilisation Mechanism (EFSM).[4] The funding for the EFSM is guaranteed from the EU budget.

From the perspective of the decision-making procedure, a key question is whether the EU's Single Resolution Board (SRB) should be mandated to independently decide on the use of Member States' budgetary funds for bank resolution or whether public financial assistance provided by a Member State should always require a separate decision made in accordance with the applicable national procedure.

For example, the Commission has proposed that Member States should give legal commitments (in Finland's case, up to a maximum amount of just over EUR 1 billion) to provide support from their government budgets for the resolution of their own banks, upon request from the European resolution authority. In practice, this would mean extensive delegation of decision-making powers regarding Member States' budgetary funds to the Single Resolution Board. The rationale for the proposal is that separate decision-making procedures in Member States would call the adequacy and speed of resolution funding into question.

Extensive delegation of budgetary authority to the Single Resolution Board in connection with bank resolution would be unusual, not only for Finland's domestic use of public funds, but also by international standards. As far as is known, there is no such automatic system as described above in any country outside those participating in Banking Union, not even in those countries that have no pre-funded funds. In some countries, the allocation of public funds for resolution purposes is decided by the parliament (the United Kingdom); in others, such decision-making is delegated to the government (the United States). It is difficult to see that the delegation of the use of public funds beyond the reach of political decision-making would be an essential element of an effective resolution framework.

4 The European Financial Stabilisation Mechanism (EFSM) is based on a Council Regulation, and it is the only instrument formally activated within European Union law for the resolution of an acute crisis. Through the EFSM, the Commission is allowed to borrow on the market under an EU budget guarantee. The mechanism has provided distressed countries with conditional loans. All EU Member States participate in the arrangements via the EU budget.

The working group considers it justified to agree in advance on the procedures enabling the provision of public funds to safeguard the adequacy of funding for bank resolution.

Given that differences in risks within different countries' banking sectors are set to remain significant in the immediate years ahead, a rapid transition to a common backstop could lead to systematic fiscal transfers between the countries. As this is not deemed acceptable, it is advisable to fund the backstop from national sources in the near term.

In so far as backstops are funded nationally, the working group deems it necessary to have a procedure in place where the use of Finland's budgetary funds as safeguards for the resolution of Finnish banks requires a separate political decision at national level. The ability to take such decisions rapidly, if required, should be secured by delegating the relevant decision-making powers, for example to the government.

In the long term, once the initial differences between different banking sectors have evened out, it will be necessary to decide on whether the costs of bank resolution can be borne jointly within the context of Banking Union. Supplementary funding for the Single Resolution Fund could be sourced e.g. via the ESM, or possibly the EFSM.

3.1.4 Direct bank recapitalisation instrument of the European Stability Mechanism

In June 2012, euro area Heads of State or Government agreed that, following the establishment of effective single banking supervision, the European Stability Mechanism (ESM) could be allowed to recapitalise banks directly, without an intermediary role for the state.[5] After lengthy negotiations, the Eurogroup finally reached a decision on the operational framework of the direct bank recapitalisation instrument in June 2014. A precondition for the use of the instrument is that the bank is under ECB supervision. The instrument enables recapitalisation of systemically important viable banks as a means of last resort for safeguarding Europe-wide financial stability in a situation where the creditworthiness of the home state is under threat.[6]

The use of the direct recapitalisation instrument is always decided unanimously, on a case-by-case basis. The instrument cannot be activated until an extensive bail-in of the bank's shareholders and creditors has first taken place in accordance with the Bank Recovery and Resolution Directive (at least 8% of the bank's balance sheet). In addition, the Single Resolution Fund must have participated in the recapitalisation (5% of the bank's balance sheet). If, even after these measures, the bank is still in need of additional capital, the remaining senior liabilities will first be converted into equity, and thereafter the ESM may participate in the recapitalisation. The bank's home state is also required to participate in the recapitalisation alongside the ESM. As equity investments are generally riskier than loans to governments, the capacity of the instrument is limited to EUR 60 billion by decision of the ESM Board of Governors.

---

5 Before this, the range of ESM instruments only included a possibility for the ESM to recapitalise banks indirectly, whereby the ESM provides a loan to the government, with the latter also assuming ultimate responsibility for the loan repayment.

6 The direct recapitalisation instrument cannot be used for precautionary recapitalisation.

The outcome of the negotiations on the terms and conditions of the direct recapitalisation instrument largely met Finland's goals for the negotiations. In contrast, many other parties have considered the agreed terms and conditions too strict and seen them as practically preventing the use of the instrument in cases other than exceptional circumstances. The Five Presidents' Report also proposes a review of the terms and conditions of the recapitalisation instrument, while not specifying how they should be revised.

> *In the working group's view, the ability of the ESM to also directly recapitalise banks placed under resolution constitutes an important element of the Single Resolution Mechanism. According to the new Bank Recovery and Resolution Directive, public recapitalisation of banks is only to be used as a means of last resort for bank resolution, after contributions from the bail-in tool and the Single Resolution Fund. Consequently, the terms and conditions of the ESM direct recapitalisation instrument cannot be treated separately from bank resolution legislation. The working group sees no need to review the new bank resolution legislation.*

3.1.5 European Deposit Insurance Scheme

The Five Presidents' Report proposes the launching of a European Deposit Insurance Scheme (EDIS) for the Member States participating in Banking Union. According to the Report, such a common deposit insurance scheme would further help address bank-sovereign negative feedback loops and strengthen the resilience of the financial system. A common fund would prevent the value of depositor holdings from depending on the credit rating of the bank's home state, as their repayment would be guaranteed jointly. Every deposited euro would thus have the same value throughout the euro area (up to the deposit protection limit).

A common deposit insurance fund would also be significantly larger than national funds, which would reduce the likelihood of tax payers having to bear the costs of the problems of an individual bank. A larger fund can therefore be seen as limiting Member States fiscal risks, notably in Member States like Finland that have a concentrated banking sector. On the other hand, it is clear that, especially in systemic crises, the credibility of a common deposit insurance scheme would require a public backstop as a complement to pre-funding.

In 2010, the Commission already proposed at least three different structural alternatives for the implementation of common deposit insurance: [7]

1. a single entity acting as a pan-EU scheme, replacing the existing national schemes
2. an additional scheme at EU level, supplementing the existing national schemes
3. a network of existing national schemes, including a mutual borrowing facility vis-à-vis other national schemes.

---

[7] COM (2010) 369 final.

The Five Presidents' Report proposes restriction of membership in the common deposit insurance scheme so as to cover the Member States participating in the Banking Union, instead of all 28 Member States.

Finland has opposed the development of a common deposit insurance scheme. The motivation for Finland's stance has been an assessment of Finnish banks' current low probability of default compared with other Member States, meaning that the banks would be unlikely to benefit from a common scheme, at least in the near term. Different levels of funding across the Member States have also caused concern in Finland.[8] Another reason behind Finland's stance has been that common deposit insurance would lead to a de facto obligation to jointly guarantee deposits of all bank customers up to EUR 100,000 throughout the Banking Union.

However, in assessing the fiscal risks involved in deposit insurance, it should be noted that Finland's own national pre-funding (slightly over EUR 1 billion) is in practice enough to cover only the claims of the depositors of the smallest banks. As for more significant banks, supplementary financing to reimburse deposits would likely be needed, meaning that the pressure for using public funds would be considerable. This could also affect Finland's sovereign credit rating in the case of the largest banks.

Worthy of note is that the new Bank Recovery and Resolution Directive led to a strengthening of the priority of deposits covered by deposit insurance relative to other bank creditor claims. According to the new order of priority, a deposit guarantee fund will incur costs only if the write-down of shares, senior liabilities and uncovered deposits is not enough to cover bank losses. This reform significantly restricts the risk associated with deposit insurance.

Common deposit insurance has been a controversial element in the establishment of Banking Union. The working group does, however, consider that common deposit protection based on an insurance-type arrangement would be a consistent element of Banking Union. A safety net provided by common deposit insurance would most benefit small and concentrated banking systems with strongly correlated banking risks among different actors. Against this background, Finland would be one of the main beneficiaries of the completion of Banking Union. Common deposit insurance would also facilitate the handling of bank problems separately from the state.

In the working group's view, common deposit insurance cannot be launched on an equal basis until we can justifiably state that Member States' funding levels have converged, all countries exercise uniform banking supervision and the Single Rulebook and financial reporting regulations are genuinely harmonised.

A prerequisite for common deposit insurance is the elimination of excessive home-state risks from bank balance sheets. This can be achieved by removing the preferential treatment of sovereign exposures from prudential regulation and by setting large exposure limits relative to the risks of a single issuer.

---

8 However, Finland's situation with regard to the funding level has been different since the beginning of 2015, as the revised legislation on deposit insurance provided for the levying of contributions for a new deposit guarantee fund to start from the minimum level permitted by the Directive.

The working group considers that deposits should enjoy absolute protection up to an agreed limit. On the other hand, it can be asked whether the current limit of EUR 100,000 is excessively high for full protection. The coverage of common deposit insurance should also be re-analysed. In addition to the maximum amount of deposit protection, we may also pose the question as to whether the protection should to any extent cover e.g. fixed-term deposits with long maturities.

Common deposit insurance also needs to be supported by a common fiscal backstop. In this respect, the situation is the same as with the Single Resolution Fund.

3.1.6 ECB collateral policy and emergency liquidity assistance by national central banks

The Eurosystem implements the single monetary policy by, among other things, granting collateralised loans to financially sound banks. Central banks are not allowed to grant credit to financial institutions without adequate collateral. Banks' main collateral assets consist of debt securities, which are valued daily by the Eurosystem for collateral purposes. Eurosystem central banks are responsible for the risks involved in monetary policy operations, as a rule in the proportion determined by the ECB's capital key.

However, Eurosystem national central banks can also grant credit to banks in exceptional situations via channels other than monetary policy operations (emergency liquidity assistance, ELA). The central bank providing such credit decides on its terms and conditions and assumes responsibility for the risks involved in accordance with jointly agreed principles. But the Governing Council of the ECB may restrict the amount of emergency liquidity assistance available to banks, the collateral used in the relevant transactions and collateral haircuts if such assistance is deemed to be in contradiction with Eurosystem monetary policy or if it were to jeopardise the financial independence of the relevant national central bank. This was the case in Greece in summer 2015, when negotiations on further EU/IMF financial support collapsed. Meanwhile, the drying-up of emergency funding led to the closure of Greek banks, the imposition of withdrawal limits on deposits and restrictions on capital movements.

With the largest banks placed under direct single supervision within the sphere of Banking Union, the ECB's collateral policy and the emergency liquidity assistance provided by national central banks may become subject to review in discussions on the further development of Economic and Monetary Union.

Under the current framework, emergency liquidity assistance is officially granted at the risk of national central banks. In extreme circumstances, the risk-bearing capacity of a national central bank may be compromised.

Transferring the responsibility for emergency liquidity assistance away from national central banks to the ECB would enable the Governing Council of the ECB to directly influence the ELA amount and its terms and conditions by simple majority instead of the currently required qualified majority.

The working group holds that, in the context of Banking Union, it would be logical to transfer the task of granting emergency liquidity assistance away from national central banks to the ECB in respect of banks subject to single supervision. At the same time, the definition of ELA terms and conditions would be taken over by the ECB, and ELA risks would be shared within the Eurosystem in the same way as in monetary policy credit operations.

3.1.7 Institutional aspects within Banking Union

The institutional structure and legal basis of Banking Union involve several issues (between the Member States, the Commission and the European Parliament) open to interpretation. There is no express legal basis for Banking Union in the Treaties. A key element on which Banking Union is based is the transfer to the ECB of tasks in the area of prudential supervision: this binds Banking Union, in practice and in principle, to Economic and Monetary Union, although non-euro area countries may also be Banking Union participants.

Competence regarding single banking supervision is based on the specific provision requiring unanimous Council decisions in paragraph 7 of Article 126 of the Treaty on the Functioning of the European Union (TFEU). The decision on establishing the Single Resolution Mechanism was made on the basis of, in part, single market regulation (TFEU, Article 114), in part, a separate intergovernmental agreement. Although single market cooperation in principle applies to all EU Member States, the scope of application of the Single Resolution Mechanism is limited to cover the Member States participating in single supervision. The legal basis applied has been seen as preventing at least in theory any fiscal effects on Member States from decisions taken within the Single Resolution Mechanism. The questions related to the adequacy of the legal basis in connection with common deposit insurance are the same as those concerning the limits of the legal basis of the Single Resolution Mechanism. The operation of the ESM is based on a separate intergovernmental agreement, even if Article 136 of the TFEU has been supplemented with the relevant provision.

The question of the borders of Banking Union is of key importance for Finland given the Nordic dimension of our banking sector. Debate on the role of single banking supervision as part of the ECB may gain new momentum if, for example, Denmark decides to join Banking Union. From this perspective, subjecting the decision-making powers on banking supervision to the Governing Council of the ECB may become a sore point.

The basic solutions concerning Banking Union will come under review in the near future. The SSM and SRM Regulations include revision clauses making reference to a review of their institutional roles no later than the end of 2018. The SRF agreement contains provisions under which the Member States are committed to transfer, no later than 10 years after the entry into force of the agreement, regulation concerning the Fund to the framework of Union law, in compliance with the provisions of the Treaties and, if necessary, via amendments to the Treaties. Furthermore, in April 2013, ECOFIN Council ministers adopted a declaration stating that the Member States were ready to review constructively any Treaty amendments that ensure the separation of the ECB's banking supervisory tasks from monetary policy decision-making. The Five Presidents' Report also mentions the integration of the agreement on the European Stability Mechanism (ESM) into the framework of EU law.

In the negotiations on Banking Union institutions, Finland has underlined the separation of the ECB's banking supervisory tasks from monetary policy decision-making and the importance of securing as independent a status as possible for the SRB in resolution decisions. Germany, in particular, has repeatedly proposed that the Treaties be supplemented with a specific legal basis for Banking Union. Incorporation of such a specific legal basis would reduce the possibility of Banking Union's legal status being open to interpretation. On the other hand, the incorporation of a specific legal basis would also create pressure for extending the competence of the Union. The current interpretation of the limits of the Union's competence has been in line with what Finland deems acceptable and appropriate.

For the sake of clarity in the division of competence, the incorporation into the Treaties of a specific legal basis for Banking Union should be reviewed as part of any future Treaty amendments, especially if it were to contribute to the participation of non-euro area countries in Banking Union.

3.2 Launching the Capital Markets Union

The free movement of capital is a key part of the internal market of the European Union. Barriers to the cross-border movement of capital are due to, for example, differences in national legislation, taxation and supervisory practices. Currently, three-fourths of financial intermediation in Europe is bank credit intermediation, and therefore investment and economic growth are too dependent on the banking sector's ability to provide credit. Increasing the role of the capital markets alongside a banking sector that is strongly dependent on leverage would improve financial stability and thus enhance the smooth functioning of Economic and Monetary Union. A more versatile system of financial intermediation would decrease the interdependence of the national banking sector and public finances. The diversification of company ownership across borders, which would be supported by an effective Capital Markets Union (CMU), would decrease, via capital income and value changes in investment assets, the spillover effects that cyclical shocks have on Member State economies. Via a number of channels, the Capital Markets Union would thus dampen cyclical fluctuations in the euro area and increase the role of private investors in European risk-sharing. [9]

The President of the European Commission, Jean-Claude Juncker issued in July 2014 a proposal for developing a Capital Markets Union that would include all the 28 Member States of the European Union. The aim was to increase the diversity of European financial markets. The key objectives of the Capital Markets Union are to improve access to equity and debt finance by SMEs, in particular, and promote their listing as well as to diversify and deepen the capital markets in the EU, with the consequent improved market liquidity brought by the latter. This would enable the channelling of capital to investments with a

9 According to recent estimates, in the United States, the diversification of private risk via the capital markets is the most important mechanism for smoothing asymmetric shocks among US states, and in this context, its importance is multiple to that of the federal budget.

higher return and a reduction in business costs. In February 2015, the Commission issued a Green Paper, proposing the building of a Capital Markets Union by 2019. In parallel to the Green Paper, the Commission launched a public consultation, the purpose of which was to improve the targeting of measures. In autumn 2015, the Commission published a Communication on the legislative proposals and other proposals expected to be adopted in the medium and longer term. Building a Capital Markets Union is one of the flagship projects of Juncker's Commission.

Achieving the goals of the Capital Markets Union requires a variety of policy measures on the financial markets at EU and national levels. Some of the goals of the Capital Markets Union would be accomplished through judicial cooperation. Even though the Capital Markets Union is, in principle, an EU-wide initiative, the United Kingdom, Ireland and Denmark have special arrangements with respect to judicial cooperation that enable them to exclude themselves from initiatives in these fields. A further challenge is created by differences in the level of market development across Member States. Targeting the measures requires deeper analysis, and work on this is due to start in autumn 2015. Some of the measures can be implemented swiftly, but others, e.g. those concerning taxation as well as insolvency law, company law, and the development of EU-level supervision, are strongly opposed by a number of Member States.

A Capital Markets Union does not necessarily always require the issuing of new EU legislation that is binding in all circumstances and generally applicable. Its objectives can be promoted also by alternative, non-regulatory and less stringent measures that take into consideration the special characteristics of national markets. Measures at EU level can enhance the cross-border availability of information and cooperation between authorities, and they can also involve issuing to market participants recommendations on practices that they can introduce. One alternative is to consider pan-European opt-in regulatory models (the '29th regime') that financial market participants can introduce if they have cross-border operations. On the other hand, development of such models has been slow thus far, and their use (e.g. the 'European Company') has been rare. Another alternative is to apply voluntary industry standards.

The EU-level measures to be implemented in the short term include reviewing the Prospectus Directive, developing a transparent and standardised securitisation model and measures to develop alternative funding options. In addition, the Council of the European Union adopted in June 2015 conclusions proposing measures to enhance liquidity and market making, improve cross-border investment in corporate debt and equity securities, increase investment capacity in the EU and remove barriers to marketing and growth of investment funds and their cross-border operations.

The effective removal of barriers to the movement of capital will, however, require the setting of ambitious goals in the more difficult policy areas, too, e.g. in insolvency, securities and company law, and in taxation. In the area of private law, the competence of the European Union is currently restricted to matters of cross-border effects. In the area of taxation, legislation can be harmonised by a unanimous decision taken by the Council of the European Union insofar as it is necessary for the realisation of the Internal Market and for ensuring its functioning as well as for preventing competitive distortions. Thus far, progress in these fields has been slow, and Finland, too, regards the restrictions imposed by the Treaties as justified. However, the debate on Capital Markets Union has repeatedly underlined that the harmonisation of insolvency law to cover, at a minimum, the entire financial sector, and the harmonisation of tax treatment in Member States are key prerequisites for the functioning of the Internal Market. Promotion of the objectives of Capital Markets Union also entails that the regulatory instruments aimed at enhancing financial stability are extended outside the banking sector to apply also to shadow banking and the market infrastructure.

Even though the development of a Capital Markets Union is not first and foremost about the centralisation of supervision, the authorities will also have to consider ways of eliminating differences in national supervisory cultures. A more extensive centralisation of supervision may be justified and appropriate in some situations, e.g. if the activities of the supervised entities involve systemic risks or generate externalities. Situations like this may arise if the number of European market participants (credit rating agencies, central counterparties, central securities depositories) is small. In contrast, centralisation of supervision may not be appropriate if the number of national market participants is large or if they are small in size. Effective supervision may also require the strengthening of the powers of the European Supervisory Authorities as supranational supervisory authorities. If supervision is centralised, however, steps must be taken to ensure that national competent authorities retain an adequate degree of influence and access to information.

The working group considers the development of a Capital Markets Union an important element for building a more stable Economic and Monetary Union. We take the view that developing a Capital Markets Union must apply first and foremost to the entire EU internal market, and not only to euro area countries. The working group also notes that a well-functioning Capital Markets Union could become, together with Banking Union, the most significant countercyclical factor that would also enable the cross-border distribution of private sector risks within Economic and Monetary Union. Ambitious goals should therefore be set for the development of the Capital Markets Union, and reforms on taxation and insolvency law should be approached with an open mind.

The working group takes the view that if financial intermediation shifts from an excessively large but regulated banking sector to a capital market that is underdeveloped and less regulated, the ability of the authorities to safeguard financial stability must remain at an adequate level. Financial stability can be promoted, e.g. by creating macroprudential instruments that apply to non-banks, harmonising statistical requirements and creating incentives for the use of regulated marketplaces.

3.3 Macroprudential policy in the euro area

The euro crisis showed that Economic and Monetary Union has basic structural flaws. EMU's framework of rules focused on the public finances. It ignored the rapid growth of private sector debt, housing market overheating, the growth of the banking sector and its excessive use of leverage. The realisation of hidden liabilities from the banking sector, to be borne by the home Member States in Ireland, Spain and Cyprus, put the creditworthiness of these countries into question, excluded them from market finance and brought them under the scope of external financial assistance. These challenges related to excessive debt levels in the private sector can be addressed by developing macroprudential policy measures. Another tool for solving these problems is the Macroeconomic Imbalance Procedure (MIP), which is discussed in more detail in chapter 4.

The Five Presidents' Report pays attention to potential new risks developing in the banking sector. It proposes the strengthening of macroprudential institutions, building on the role and powers of the European Systemic Risk Board (ESRB), while maximising its synergies with the ECB.

The objective of macroprudential policy is to reduce, in individual Member States, systemic risks to financial stability and to strengthen the banking sector's resilience against these risks. The national macroprudential authority in Finland is the Financial Supervisory Authority (FIN-FSA), and the FIN-FSA Board takes the decisions on the use of macroprudential tools. Before a final decision is taken, the ECB is requested to issue an opinion on the preliminary decision taken by the Board. In addition, the European Systemic Risk Board (ESRB) issues recommendations on macroprudential policy measures in the EU.

Systemic risks to financial stability often involve macroeconomic imbalances, e.g. a rapid rise in household or corporate debt and asset prices. Now that the Macroeconomic Imbalances Procedure has been introduced in the EU, it would make sense for the macroprudential supervisors and the Commission to have a uniform picture of the possible build up of imbalances.

3.3.1 The macroprudential toolkit within Banking Union

The key macroprudential instrument in EU legislation, and mandatory to all banks, is the countercyclical capital buffer. Other macroprudential instruments included in EU legislation are the additional capital buffer requirement imposed on systemically important banks, and the discretionary systemic risk buffer.

Another tool considered as a macroprudential instrument is the supervisory authority's right to impose stricter risk weights on mortgage loans, where necessary, than the harmonised requirement provided by the EU's Capital Requirements Regulation (CRR). According to Article 458 of the CRR, the supervisory authority of a Member State can also on national macroprudential grounds apply to credit institutions capital adequacy and liquidity requirements that are stricter than the harmonised requirements, as well as certain other requirements as provided in the aforementioned article.

The macroprudential toolkit also includes instruments that restrict the size as well as the terms and conditions of bank loans. These tools can, at least in principle, be used on a permanent basis or they can be discretionary countercyclical instruments. Recommendations by the ESRB list, as possible tools, limits on the loan-to-value ratio for housing and other credit, the debt-to-income ratio and the debt-service-to-income ratio. These tools have not been harmonised at EU level. Of these instruments, to date only the limit on the loan-to-value (LTV) ratio for housing loans has been transposed to Finnish legislation. The LTV requirement will be applied as of 1 July 2016.

EU-level harmonisation of macroprudential tools is inadequate and the toolkits differ significantly across countries. The European Commission is expected to assess in 2016 whether the provisions on macroprudential tools included in the Capital Requirements Regulation and the Capital Requirements Directive are adequate for mitigating systemic risks.

3.3.2 Macroprudential institutions

The European Commission published in August 2014 review reports on the operation of the European System of Financial Supervision (ESFS) and of the mission and organisation of the European Systemic Risk Board. In October 2014, the Council of the European Union adopted conclusions on the matter, emphasising the need to enhance the proactiveness, transparency and independence of the ESRB's operations as well as the efficiency of its decision-making. The Council did not propose that the mandate and powers of the ESRB be extended; instead the ESRB should remain an authority issuing only recommendations and warnings.

The Council's conclusions were well in line with Finland's views on the matter. In discussions, Finland has emphasised, in particular, proactive interaction with the entities subject to the recommendations and warnings being prepared, raising the organisational identity and independence of the ESRB, including the appointment of a separate Managing Director, as well as including the national macroprudential authorities in the ESRB's decision-making process. The Five Presidents' Report does, however, go a step further and highlight the need to strengthen the powers of the macroprudential institutions and the ESRB within Economic and Monetary Union. Nevertheless, the report does not specify how, for example, the powers of the Supervisory Board of single banking supervision or that of the ESRB should be changed in relation to the national macroprudential authorities.

> *The powers and toolkit of the macroprudential authorities should be extended and harmonised in the Member States participating in Economic and Monetary Union. At the same time, it would be useful to clarify the relationship between the macroprudential policy of the Member States and the Macroeconomic Imbalance Procedure.*

4 Economic and Fiscal Union

4.1 Significance of centralised governance of economic and fiscal policies

4.1.1 General remarks

As a rule, economic and fiscal policies in the Member States participating in Economic and Monetary Union fall within the competence of the Member States themselves. However, when EMU was created it was already understood that one Member State's fiscal policy mistakes could lead to considerable adverse externalities in the other participating Member States. For this reason, the Treaty obliges Member States to coordinate their economic policies within the Council and regard them as a 'matter of common concern'. In addition, steps have been taken to control externalities with rules that guide fiscal policies. Such rules have constituted a key element of EMU's framework of Treaties from the outset. Besides fiscal rules, economic discipline is underpinned by the 'no bail-out' clause in Article 125 of the TFEU and the prohibition of monetary financing.

The financial and debt crises showed that focusing exclusively on fiscal policy drew attention from major channels of externalities. In some countries – such as Ireland, Cyprus and Spain – the seemingly stable fiscal position masked serious imbalances in general economic developments and problems in the banking sector which, when they came to a head, also led to a drastic deterioration in the public finances.

In recent years, the euro area economic and fiscal governance frameworks have been strengthened on the basis of the lessons learned from the crisis. Coordination has increased in terms of objectives and procedures. The rules for procedures in the field of economic policy were revised and supplemented in 2011 with a set of legislative measures, known as the 'six-pack', which not only pertains to the Stability and Growth Pact (particularly the practical application of the debt criterion, strengthening of the preventive arm and reinforcement of the sanctions system), but also to national budgetary frameworks and macroeconomic imbalances.

In addition to budgetary policies, current EU procedures also cover economic policies in Member States in a broader sense as well as factors affecting macroeconomic imbalances. Macroeconomic imbalances refer to, for example, large imbalances in the current account, excessive indebtedness in the private sector or an excessive rise in property prices. Imbalances may arise in one country, but their correction can cause disruptions in other countries, too.

At the same time, the EU governance system has become more detailed in nature. In fact, the procedures for economic policy coordination have already diverged between the euro area and non-euro area Member States to the extent that euro area countries are subject to more stringent rules. 2013 saw the adoption of the 'two-pack' Regulations applicable to euro area Member States which pertain, on one hand, to budgetary surveillance and, on the other hand, to euro area countries that are experiencing serious difficulties and requesting or already receiving financial assistance. Such countries are put under 'enhanced surveillance'.

In assessing the functioning and development needs of the euro area coordination framework, three aspects should be considered:

1. Enforcement. Can rules imposed by the EU or discretionary governance steer Member States' economic and fiscal policies in a reliable manner? What happens if there is non-compliance with the rules?
2. The effectiveness of the rules in achieving the desired effects. Is centralised governance of Member States' economic and fiscal policies the most effective method for controlling externalities stemming from unsound policy?
3. Impact on the division of powers and responsibilities. How does centralised coordination affect the ownership of policy and the division of responsibilities in the event of any problems?

4.1.2 Enforcement of the rules

Reliable implementation of the rules has been seen as a problem throughout the history of Monetary Union. The convergence criteria specified in the Maastricht Treaty were interpreted loosely, and several countries whose debt-to-GDP ratio markedly exceeded the Treaty's benchmark were admitted to Monetary Union. When the application of the rules to Germany and France led to politically difficult debates in 2003, the rules were amended. Even though the deficit and debt criteria in many countries exceeded the thresholds of the Stability and Growth Pact (SGP) for a protracted period and to a significant degree, no sanctions were imposed.

In the reforms of recent years, the rules framework has been extended from the surveillance of general government risk limits to more comprehensive promotion of responsible policy. The preventive arm of the SGP and the Macroeconomic Imbalance Procedure (MIP) aim to prevent problems in public finances and the macro economy well before they evolve into an acute stability risk. At the same time, the aim has been to reinforce the credibility of sanctions by strengthening the Commission's powers to initiate sanction procedures against euro area countries.

The new sanction frameworks have increased the number of indicators and the complexity of procedures, thus eroding transparency. The framework has been applied with more interpretation, which has increased the risk of politicised decision making. The Commission acts in the procedures as both a political actor and as a body overseeing implementation of the Union's legal provisions.[10] The first experiences on the application of the new rules have not been very promising. The framework is regarded as incoherent and unpredictable. Increasing the Commission's powers does not seem to have led to stricter implementation, either. Not a single sanction procedure has yet been launched under either rules-based or discretionary coordination.

Problems with implementation are often related to the ownership of EU-level decisions in the Member States. In situations where a Member State has found it difficult to implement the rules, there has often been a broad understanding in the country that a strict interpretation of the rules would necessitate unreasonably tight economic policy. There has often been a clear risk that strict implementation of the rules could ignite a political crisis in the country and strengthen anti-EU political movements. The government may have lacked not only the political will but also sufficient parliamentary support to implement the required measures.

It is understandable that, in such a situation, a country seeks to find a compromise by interpreting the EU rules. It is difficult to change such an arrangement in practice, and the problem cannot be resolved by adding more rules. However, creative interpretation of the rules affects their credibility. For this reason, the rules should be designed so that their credibility is maintained even when objectives set at EU level are not followed at national level for one reason or another. In this respect, the management of fiscal policy necessitates an adequate balance between rules-based governance and decision-maker's discretion in each situation.

4.1.3 Effectiveness of rules in achieving the desired effects

Effective implementation of the rules framework alone does not guarantee sound economic and fiscal policies in the Member States. The rules must be such that they are considered to be sensible. In other words, they must be able to adequately summarise the key elements of sensible economic policy. This is particularly challenging, since there are many situations in which the implementation of rules also involves discretion.

It would be beneficial for the credibility of the rules if they were as concrete and unambiguously measurable as possible. It is, however, challenging to determine simple and unambiguous indicators that would steer in the right direction. The more comprehensive centralised governance is, the more difficult it is to specify clear rules, so that the rules framework will inevitably become complex. Just setting the right fiscal stance with respect to the business cycle necessitates an understanding of various unobservable variables, for the evaluation of which economic research does not give an unambiguous solution. When we move on to a broader assessment of economic policy, there is even more room for interpretation in the identification of risks. Designing a rules framework is always a compromise between clarity and sophistication.

---

10 Commission President Jean-Claude Juncker strongly defended the Commission's role as a political actor in his speech of 9 September 2015 on the state of the Union: 'Where the Treaties talk about the Commission, I read this as meaning the Commission as an institution that is politically led by the President and the College of Commissioners.'

At its best, centralised rules-based governance can mitigate the problems with coordination and moral hazard that decentralised fiscal and economic policies produce in the environment of a single currency. On the other hand, the ability of rules-based governance to take account of diverging circumstances or react to new phenomena is, as a rule, poorer than that of discretionary policy.

The need for rules can be reduced by mitigating the externalities associated with the single currency. During the debt crisis, it became evident that one of the key channels of externalities came via the banking sector. Deterioration of the economic situation in a Member State led to increased lack of confidence towards its banking sector. This resulted in capital flight and strong indebtedness of the country's banking sector vis-à-vis the ECB. One of the purposes of Banking Union is to eliminate this channel of externalities as exhaustively as possible. The externalities associated with Member States' indebtedness, in turn, can be mitigated by creating a well-functioning framework for an orderly restructuring of government debt.

There are many reasons why transition to a system based purely on market discipline cannot be deemed realistic at this stage of EMU. Procedures and institutions for the rescheduling of debt have not yet been created. Banking Union has not yet progressed to the point where the problems of banks and sovereigns could be effectively separated from each other. There will in any case still be some kind of a connection between sovereigns and banks. Citizens and businesses of a defaulting country also encounter repayment difficulties, which is reflected in the position of the country's banks. Furthermore, the EU budget does not level off economic cycles in Member States to the same extent as e.g. the federal budget in the USA. At least in the short term, rules-based governance – even with all its flaws – is an inevitable part of the EMU architecture.

4.1.4 The impact of centralised governance on powers and responsibilities of the Union and the Member States

Problems with implementation do not mean that economic policy coordination would be pointless. The Commission's independent assessment of economic and fiscal policies generates valuable information in support of national policy. Publicity and the loss of influence related to the processes may encourage a Member State to pursue a more responsible policy.

However, coordination also has effects other than (potential) changes in Member States' economic and fiscal policies. As discussed in Box 4, the EU's endeavour to steer Member States' economic and fiscal policies is, by nature, the wielding of power, and as is normally the case with the legitimate exercise of power, it also inevitably involves an assumption of responsibility. The more comprehensive centralised governance based on rules and their interpretation is, the more obvious it is that centralised governance entails a transfer of political ownership from a Member State to the Union, and the greater the risk that the Member State's responsibility becomes blurred.

How we should respond to such a tendency is a political question. If there is a desire to continue towards tighter coordination and increased solidarity, it is important to ensure that the rules can genuinely be implemented. Otherwise, there is a risk that the systems designed for equal diversification of risks will in fact lead to systematic fiscal transfers.

4.2 Development needs in respect of fiscal policy coordination

As described above, the rationale behind EU-level decisions has been to steer national fiscal policies in a more binding manner. In practice, the Commission and the Council can not only set goals but also increasingly determine the means to achieve these goals. At present, the EU Budgetary Frameworks Directive and the Fiscal Compact also include provisions on national institutions and the obligation to set a medium-term budgetary objective (MTO). The MTO means a quantitative objective set for the reduction of a Member State's (structural) budget deficit. National legislation has been used to coordinate budgetary planning and enable faster identification of and responses to deviations.

The system does not seem to be bearing fruit at present. It does not guarantee realisation of and convergence with the reference values specified in the Treaties. Recent discussions have shown a broad understanding that the framework for economic policy coordination has become overly complex with its many rules, objectives and procedures. The rules have been deemed difficult or even impossible to apply from the perspective of economic policy. Complexity has increased due to the effort to reduce the procyclicality of the rules, which is, as such, a justifiable goal. In practice, the rules are still too procyclical and their ownership in national decision-making is weak. The results of coordination will remain scanty unless political leaders in the Member States regard EU guidance as useful and genuinely assume responsibility for its implementation.

Assessed more broadly, common fiscal rules are not an inevitable or essential part of the functioning of Monetary Union. As stated before, there are examples of well-functioning federations that have no such centralised rules; instead, the states making up the federation have, by themselves, strengthened their fiscal institutions to secure market confidence.

Hence, the extent to which it is possible and justifiable to intensify common rules and centralised governance of Member States depends on the type of EMU vision that we wish to promote in the long term. If the aim is to move towards broader risk-sharing between euro area countries, it is necessary to strengthen centralised governance (EMU based on centralised governance). On the other hand, if the aim is to promote an EMU that is founded on market discipline and investor responsibility (EMU based on market discipline), it is not necessary – or could even be detrimental – to strengthen centralised governance.

In any case, the credibility of Member States' fiscal policies in the EU has been quite consistently built on common rules, and a quick change of direction is not realistic or even desirable for the credibility of the framework. Regardless of the desired EMU vision, simplifying the set of fiscal policy rules and improving their acceptability and ownership in Member States would be justified in terms of the effectiveness of the rules.

The rules could be simplified and their ownership increased by setting only the key reference values at the level of the Union. In addition, it would be laid down in Union legislation that there should be sufficiently comprehensive and effective fiscal policy rules at the national level. It would then be the Commission's task particularly to assess whether the national rules of a Member State are sufficiently comprehensive and effective. The Commission's assessment would be the foundation for peer review in the Eurogroup and the Council. In this model, it would also be important to clarify the role between the Commission and the Council. The Commission should act as an expert in assessing matters related to the application of fiscal rules, while the Council would be responsible for political consideration. Hence, from the viewpoint of the Commission's role, important elements would be consistency and public and high-quality justifications of recommendations.

In practice, the most significant jointly monitored indicator in terms of the long-term sustainability of the public finances would be the total amount of public debt and developments in such debt. National fiscal policy rules could be required to create sufficient fiscal leeway in good times, whereas in bad times automatic stabilisers should be permitted to operate. In such a setting, Member States' fiscal policies would have a clear task of stabilising shocks to an individual Member State or only some Member States.

Box 7

Fiscal policy rules in the EU

EMU includes a common regulatory framework for the fiscal policies of Member States, which consists of a number of fiscal rules. The framework is designed for the management of adverse externalities relating to the sustainability of public finances, financial stability and economic growth in the euro area as a whole. The rules set by the EU are:

- The reference value set in Protocol No 12 annexed to the Treaty, according to which a Member State's general government deficit in nominal terms should not exceed 3% of GDP.
- The reference value set equally in Protocol No 12, according to which a Member State's general government debt should not exceed 60% of GDP.
- The medium-term objective (MTO) based on Council Regulations forming the foundation of the Stability and Growth Pact (SGP), according to which a Member State's general government structural balance, net of cyclical effects and one-off factors, should not exceed 0.5% of GDP. Member States have been obliged to transpose into national law such a rule on the structural deficit and the related automatically triggered correction mechanism with the Fiscal Compact. If there is no substantial risk to a Member State's fiscal sustainability, the Fiscal Compact states that the general government structural deficit may reach at most 1% of GDP.
- The debt criterion in line with the SGP, according to which a Member State must reduce the difference between the general government debt-to-GDP ratio and the 60% reference value imposed by the TFEU by at least 1/20 annually.
- The expenditure benchmark in line with the SGP, which determines the maximum permitted growth in public expenditure in order for a Member State to achieve its MTO. In calculating the expenditure benchmark, a convergence margin is deducted from the medium-term rate of potential output growth; if the MTO has already been reached, the required convergence margin is zero. Hence, the growth rate of real public expenditure would follow potential output growth. The expenditure benchmark is assessed on the basis of an imputed expenditure aggregate.

To enable consideration of cyclical effects and structural reforms, EU law also provides for deviations and how economic disturbances classified as temporary or interim, and exceptional circumstances, may be taken into account. The Commission has recently issued a communication on such flexibility elements.

In addition to these EU-level rules, the Fiscal Compact also requires Member States to incorporate a fiscal rule (set on the basis of structural balance) within their national legislation. Furthermore, the Budgetary Frameworks Directive 2011/85/EU requires Member States to put in place country-specific numerical fiscal rules covering all subsectors of general government and the national accounts in order to promote compliance with the objectives of the SGP.

Box 8

The Stability and Growth Pact and Finland

There have also been a few times when initiation of procedures against Finland has been under consideration. An excessive deficit procedure (EDP) was opened for Finland in 2010 due to an expected breach of the deficit benchmark. However, the actual figures showed that the deficit was under 3% and the EDP decision was abrogated. The Commission has assessed the fulfilment of the debt criterion in Finland in March 2013, May 2014 and February 2015. These reports concluded that Finland is in compliance with the debt criterion even though the 60% reference value will be exceeded in 2015 due to solidarity operations on the one hand and the cyclical position on the other. In spring 2015, however, it suddenly became apparent that the deficit had exceeded the benchmark of 3% in 2014 and would continue to be in excess also in the years ahead. The Commission's report of May 2015 concluded that Finland was in breach of both the deficit and the debt criterion. The Commission reassessed the situation after completion of the Government Programme and saw that full implementation of the adjustment measures in the Government Programme will be adequate to push the deficit below 3% in 2016. Hence, the deficit criterion can be deemed to be fulfilled. In its report on fiscal policy monitoring to the 2015 Parliament, the National Audit Office of Finland states that compliance with the fiscal rules embedded in the preventive arm of the SGP and the processes under the SGP have not ensured that Finland could meet the EU Treaties' general government reference values.

The economic literature and related debate have considered expenditure rules to be a positive element. Against this background, the EU regime for fiscal policy rules would contain the following components:

– A fiscal policy benchmark of the Union for a Member State's general government debt-to-GDP ratio and debt reduction for a period assessed to go beyond the business cycle, e.g. five years.

– Comprehensive and effective national rules for fiscal policy, the formulation of which would be left to each Member State. Such rules should, in line with the Budgetary Frameworks Directive, cover the whole of general government with all its subsectors. Furthermore, they should give sufficient leeway in terms of the stabilisation and sustainability of the economy and enable fulfilment of the Union's reference value for public debt. As a rule, national fiscal policy rules would be set as expenditure rules concerning the maximum amount of expenditure, and the key automatic stabilisers would operate outside the limit on maximum expenditure. Expenditure increases, funded by tax base changes, would naturally be possible. The system would resemble the central government spending limits procedure applied in Finland, but such that the limits would be set for all general government subsectors included in the national accounts, and the level of expenditure within the spending limits would be required to provide both long-term economic sustainability and adherence to the Union's reference values. The challenge of this system, however, is setting the correct level of spending permitted by the expenditure rule. The problem cannot be fully eliminated even with rules linked to e.g. developments in potential output; ultimately, it will always be a question of the decision-maker's overall assessment.

According to the working group's assessment, there is no realistic alternative to rules-based governance of economic and fiscal policies in the Member States of EMU, at least in the medium term. However, the rules framework should be simplified and its procyclicality eased, if possible. The framework could be simplified by focusing on a few reference values (mainly the debt ratio and spending limits) that would be laid down in national law. The Commission would monitor their enforcement.

However, the root causes of problems with the implementation of economic and fiscal policy rules – such as time-related inconsistencies concerning compliance with the rules – cannot be resolved easily. Even if the goal were an EMU based on centralised governance – which would probably necessitate fundamental changes in the relations between the EU and the Member States, and political integration – there is no reason to proceed with the creation of structures that increase solidarity among Member States until solutions have been found for enhancing implementation of the rules.

If the objective is an EMU based on market discipline, the focus should, over time, shift from greater centralised governance to more robust national fiscal policy institutions and rules frameworks as well as the creation of structures that support more efficient market discipline and reduce the need for centralised governance.

Comprehensive and effective national rules for fiscal policy are a useful part of various EMU visions, but they assume a pivotal role in an EMU based on market discipline, in which the need for centralised governance declines.

4.3 Development of economic policy coordination

4.3.1 Structural policy reforms: development of the MIP and a system of competitiveness authorities

The Five Presidents' Report emphasises Member States' interdependencies in the pursuit of growth. It is in each Member State's own and common interest to be able to effectively cushion economic shocks and modernise economic structures. The latter – e.g. product and labour markets – should underpin productivity growth. The aim is that economies could flexibly adapt when changes in the operating environment require a reallocation of resources.

This does not pertain to euro area countries alone, but to all EU Member States. For this reason, development of the internal market is a key element of structural policy. The creation of a Capital Markets Union, too, should facilitate the reallocation of resources from contracting to growing industries. Flexible product and labour markets as well as efficient and integrated capital markets would enable faster and less painful adjustment to change.

There has been a lot of discussion at EU level about the promotion of structural changes, but it has been difficult to find methods that would work. Practical efforts to speed up structural reforms have included country-specific recommendations and peer reviews, but these have produced only limited results.

The Five Presidents' Report suggests that the Macroeconomic Imbalance Procedure (MIP) should be used forcefully to promote structural reforms through the European Semester. The objective of the MIP is to monitor e.g. private sector indebtedness, current account dynamics and competitiveness in individual Member States. In the preventive arm of MIP, the Council discusses the position of Member States on the basis of the Commission's Alert Mechanism Report and country-specific in-depth reviews. An Excessive Imbalance Procedure (EIP) may be opened if a Member State is experiencing a macroeconomic imbalance that poses a risk to the functioning of Monetary Union. Whether an excessive imbalance exists in a Member State is confirmed by a Council recommendation. The first phase of the procedure is the Member State's corrective action plan, and the procedure may proceed to sanctions.

The MIP has a clear connection to macroprudential policy, too. For instance, both the MIP and macroprudential policy aim to prevent excessive household indebtedness, and it would make sense to ensure there are no contradictory requirements in the different parts of EU provisions. The MIP should take a position on the need to use macroprudential instruments to reverse the development of imbalances. The European Systemic Risk Board (ESRB), in turn, should provide information on systemic risks in the financial sector for preparation of the MIP.

The MIP can be seen as too strong an instrument for the promotion of structural reforms, since the corrective arm of the procedure escalates easily into sanctions. Structural reforms require planning, impact assessment and implementation, and measuring the concrete effects of the reforms is not easy. In practice, the development of EU-level incentives is difficult. There have also been discussions about the possibility of more binding EU governance, and the Five Presidents' Report implies this as a subsequent step. Fundamentally, the problem is that important structural reforms in Member States are deeply political by nature and necessitate a lot of dialogue and national ownership. Coercive EU-level governance is ill-suited to building such ownership.

The Five Presidents' Report also recommends the creation of a system of Competitiveness Authorities in the euro area to improve euro area competitiveness. It proposes that each euro area Member State create a national Competitiveness Authority in the next few years, tasked with tracking performance of measures and competitiveness policy. Such national bodies and the Commission would later establish a system of Competitiveness Authorities which would coordinate the activities of the national bodies.

National actors (such as the social partners) should consider the Competitiveness Authority's position as a guideline during wage negotiations. The Commission would coordinate the actions of national Competitiveness Authorities on an annual basis. The outcomes of coordination should be taken into consideration at EU-level, e.g. in decisions taken under the MIP and in connection with the initiation of an EIP.

The Five Presidents' Report does not define the precise content of the proposal. It emphasises productivity, employment, investment and expansion of trade on one hand, and wage developments in relation to productivity on the other. The same themes have been repeatedly highlighted, most recently in the Europe 2020 strategy (2010) and the Euro Plus Pact (2011).

Procedures, programmes and peer pressure already exist for the strengthening of productivity and modernisation of economies. Member States draw up National Reform Programmes each year and, based on these, the Council issues its country-specific recommendations. For this reason, one could ask why euro area countries would need yet another new procedure.

In the working group's opinion, it is justified to focus on structural reforms that promote economic flexibility, innovativeness and modernisation. Such measures increase productivity and, at the same time, strengthen the economies' ability to adapt to external disturbances and changes in the operational environment.

Structural reforms are best fostered by disseminating research findings on successful reforms and seeking out best practices. Besides national incentives, peer pressure is one method of promoting reforms. Binding EU rules for the promotion of structural reforms should be avoided because their effective implementation is practically impossible.

Instead of new procedures, one should consider more explicit linking of the EU's current instruments, such as structural funds and cohesion policy, to structural policy aimed at improving Member States' competitiveness.

The working group does not see a clear justification for the creation of a system of national Competitiveness Authorities. Such a system would introduce overlap with current monitoring and recommendation procedures, such as National Reform Programmes, the MIP and the Euro Plus Pact. To the extent that concrete methods for the promotion of structural reforms can be found, they can be used within the framework of the current procedures.

The working group is of the opinion that it is difficult to set up coordination related to differences in labour costs without being forced to interfere in the position of labour market organisations. The issue concerns a task where the role of government bodies is, all in all, very limited at present. Ways to comprehensively examine issues relating to employment and growth should be left to national discretion. At the EU level, the Commission is already able to assess these factors within the current procedures.

The working group is of the view that, in connection with the MIP, the situation should also be assessed from the viewpoint of macroprudential policy.

4.3.2 Development of the European Semester and formalisation of the convergence process

The Five Presidents' Report includes many proposals to strengthen, simplify and enhance the framework for economic policy coordination, highlighting the European Semester and ways to put its focus on essential issues:

- Country-specific recommendations should be made more concrete, and Member States' responsibility for the fulfilment of their commitments should be strengthened. Member States should be free to decide on the methods for achieving the goals.

- The European Semester should be developed by putting more emphasis on employment and social issues. In the longer term, deeper integration of national labour markets should be enhanced.
- Assessment should focus on peer analysis and best practices. The Eurogroup's participation in the renewed European Semester should be strengthened.
- The euro area level and the national level should be integrated better so that the European Semester would consist of two consecutive stages: the European stage and the national stage.
- In addition, the annual cycle of the European Semester should be supplemented with a stronger approach spreading over several years.

For the medium term, the Five Presidents' Report suggests stronger coordination of economic policies and formalisation of the convergence process. The process of convergence in economic policies refers to economic performance in a broader sense.

Box 9

What does economic policy entail?

At the general level, economic policy is considered to cover macroeconomic policy, which comprises monetary policy and fiscal policy. Macroeconomic policy seeks to influence macroeconomic goals, such as price stability, economic stability and sustainability of the public finances. The euro area shares a single monetary policy. Fiscal policy is a national domain, but steps have been taken to coordinate it with a common rules framework.

In addition to monetary and fiscal policy, economic policy includes microeconomic policy. This refers to measures aimed at influencing corporate and household behaviour. Such means include tax structures, income transfers and various public subsidies. Microeconomic policy can also be regarded as including all the measures related to economic incentives that strive to enhance productivity or economic performance in general. This is usually referred to as structural policy or structural reforms.

According to the Treaties on European Union, 'the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of 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 conducted in accordance with the principle of an open market economy with free competition.'

The Treaties' provisions stating that Member States should regard their economic policies as a matter of common concern mean, in practice, that they should refrain from economic policy measures that can cause adverse externalities in other Member States. In the logic of the Treaties, the majority of measures that are significant in terms of economic policy are formally excluded from the issues governed under the Treaties' chapters on economic policy.

The Fiver Presidents' Report discusses fiscal policy and economic policy separately. Fiscal policy refers to responsible budgetary policy. Economic policy covers all policy fields encompassed by the European Semester, including structural reforms aimed at boosting potential growth, job creation and utilisation of the opportunities offered by the Single Market.

Box 10

What convergence process?

The Maastricht Treaty specified the convergence criteria for Member States regarding EMU (Article 109j and the Protocol on the Convergence Criteria). According to Article 121 of the TFEU, the 'Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Union as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment.' The purpose of multilateral surveillance is to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States.

In the 2012 Blueprint for a deep and genuine EMU, the Commission suggested development of a comprehensive legal and financial framework for economic coordination, integration and real convergence. However, the plan has not moved forward.

According to the Five Presidents' Report, coordination of economic policies should become more binding, with standards defined in EU legislation. The common standards would focus on labour markets, competitiveness, the business environment, public administration and certain aspects of tax policy (such as the corporate tax base). The Report does not explain in more detail to what extent this would entail extending the competence of the EU. These areas are already partly covered by EU legislation and partly subject to national discretion. The Report does not justify the common interest (and hence also the interest to Finland) that could be gained from a potential transfer of competence. Any shift in decision-making could affect the ownership of structural policy. Extending the Union's competence does not necessarily ensure the success of a policy.

> *Many of the Single Market objectives listed in the Report have a clear connection with the functioning of EMU. However, a discussion about the development of EMU is not the best forum for the promotion of these objectives.*

4.3.3 Closer coordination of economic policies and changing the nature of competence

Stronger coordination of economic policy is fundamentally linked to the question of the Union's economic policy competence and the related implications. At present, the Union's competence in the field of economic policy does not fall under any of the main competence categories (exclusive, shared and supportive competence). The Treaties separately specify that the Member States have competence in economic policy and are obliged to coordinate it within the Council.

Box 11

On the constitutional boundaries of the EU's economic and fiscal competence

Underlying the definition of the Treaties' restricted competence in the field of economic policy are boundaries relating to the interpretation of Member States' national constitutions pertaining to budgetary sovereignty and the democratic coverage required by the execution of powers in economic and fiscal matters. The most famous of these interpretations is the view of the Federal Constitutional Court of Germany in connection with the approval of the Treaty of Lisbon. According to the Court's view, government revenue and expenditure are in the core of the exercise of democratic power, in which the possibilities to shift competence from the national level to the EU level is very restricted. In Finland, too, the Finnish Parliament has interpreted the question of budgetary sovereignty in a similar manner (e.g. opinion of the Grand Committee SuVL 4/2012 vp and several statements of the Constitutional Law Committee).

On the other hand, it must be noted that Member States' sovereignty in economic policy matters is already relative. If EU institutions were to exercise their powers based on the EU's regulatory framework to the full extent, this would have a substantial impact on Member States' room for manoeuvre. For example, it has been deemed difficult to reconcile the potential sanctions imposed on euro area countries for non-compliance with the legally non-binding recommendations of the coordination process and the current definition of the Union's economic policy competence. Strengthening the Union's competence in the Treaties has been justified by the need to increase legitimacy by clarifying the division of powers between the Union and its Member States, which would make the actual division of powers and responsibilities more transparent. However, an alternative option would be to cut back the Union's current legislation to better correspond to the current division of responsibilities under the Treaties.

In practice, the nature of EU competence dictates the impact of legislation adopted by the EU on Member States' possibilities to make decisions in the same matter. At present, the EU has very light competence in economic policy matters, restricted formally to the right to coordinate Member States' policies within the Council. For this reason, Member States currently have broad leeway in the field of economic policy. As a rule, the EU's competence in other policy fields is stronger and either excludes or materially limits Member States' room for manoeuvre.

According to the Five Presidents' Report, decision-making on policies of common concern between the EU and the national levels should be shared more, over time. For this reason, there should be a shift from a system of rules and guidelines for national economic policy-making to a system of further sovereignty sharing within common institutions. Implementation of the rules would be regularly monitored via country-specific recommendations and the MIP. The Member States should increasingly accept joint decision-making on issues relating to their national budgets and economic policies. Convergence based on a set of common benchmarks would also be a condition for some degree of public risk sharing and a Member State's right to benefit e.g. from a shock absorption mechanism set up for the euro area as a whole (see section 4.4.3).

The proposal for pooling of sovereignty (and at the same time the sharing of competence) between the EU and the Member States would fundamentally change the division of responsibilities between these parties in the field of economic policy. The proposal would probably mean the transfer of economic policy into an area of shared competence between the Union and the Member States. A key feature of shared competence is that a Member State can exercise its competence only to the extent that the Union has not exercised its legislative powers.[11] In practice, this would mean strengthening the Union's possibilities to regulate Member States' economic policies. This would mean that, to the extent that the EU exercises its competence, the Member States would not be able to regulate their own economic policies.

The scope of the Union's economic policy competence, i.e. which issues the EU's competence would cover, could be recorded in the Treaties in several different ways. It would be necessary to define, for example, what is meant by the economic policy of the Union and over which issues of the Union's economic policy Member States would transfer their competence to the Union. Union competence could be strengthened e.g. by tightening the rules on fiscal and economic policies in the Member States and the monitoring of their implementation, or by transferring sovereignty relating to the content of economic policy to the euro area level. In these issues, decision-making would be transferred from national to EU institutions. Such a change to the Treaties would be a precondition for an EMU based on centralised governance, and for transferring a greater share of Member States' autonomy in fiscal and economic policies under centralised steering by EU institutions.

The proposal to strengthen the Union's economic policy competence can be justified particularly by the insufficiency of Member States' measures for structural reforms and disciplined economic policy, so that the responsibility for these policies should be transferred to the EU level. Consequently, the Union would be able to use strong legislative measures in the exercise of economic policy competence. At the same time, it could be considered whether justifications for competence in e.g. structural policy and objectives related to other economic policies should be added to the rules pertaining to economic policy.

If it was deemed desirable to dismantle the current particular nature given to economic policy, it would be logical to eliminate the current restrictions to the Commission's infringement procedure (Art. 258 TFEU) and enforcement actions (Art. 259 TFEU), so that the application of economic policy rules could also be considered in the EU Court of Justice. Although the nature of competence does not dictate the applicable decision-making procedure, EU institutions' role and competence in decision-making, too, would probably need reassessment if the EU's competence in economic policy were strengthened and contractual arrangements made outside of EU laws brought under the institutional frameworks of the Treaties (see section 5).

11 In principle, however, it would be possible to incorporate special provisions concerning economic policy within the Treaties. See also e.g. the provisions on development cooperation, research and space, according to which the fact that the Union exercises its competence does not result in Member States being prevented from exercising theirs; these are parallel by nature.

Even though the Five Presidents' Report discusses issues on a very general level, it is clear that, to implement its recommendations, the Union's economic policy competence would need to be redefined in the Treaties at least in respect of euro area countries. Realisation of the proposals in the Report would also necessitate application of the procedure for amending the Treaties, since the change would extend the Union's competence.

To be accepted, the change would need to fulfil the criteria pertaining to the division of budgetary powers discussed in constitutional debates in the Member States. Constitutional courts in several Member States would probably assess the implications of the changes to each Member State's budgetary sovereignty and whether the EU system would provide for the adequate democratic coverage required by economic and fiscal competence. The presented changes would also create major challenges to the legitimacy of decision-making and effective implementation of decisions in Member States. Experiences to date have emphasised the need to ensure Member States' strong ownership of economic policy decision-making. Hence, it would be difficult to reconcile an increase in the Union's responsibilities with strong ownership at the national level. Increasing the Union's competence would scarcely resolve the fundamental problem that it is difficult to force Member States to comply with rules agreed at the level of the Union.

Strengthening the Union's competence in the field of economic policy would also necessitate reassessment of the situation of non-euro area countries. The current fiscal policy rules of the Treaties principally pertain to all Member States, but euro area countries are subject to more stringent rules in some respects. For non-euro area countries, it is more difficult to find justifications for strengthening the Union's economic policy competence. In such a case, the change would probably deepen the current diverging trend between the euro area and non-euro area countries.

An EMU based on market discipline, in turn, would largely build on the current division of competence between the Union and the Member States. Realisation of such an EMU would necessitate the reduction of rules to clarify the division of responsibilities between the Union and its Member States.

This would not require amendments to the Treaties, but could be achieved by making changes to the secondary legislation of the Union.

Widening the scope of the EU's competence would in practice necessitate changes to the Treaties. To open a fruitful discussion, we should first define the common interest that could be achieved by competence changes.

4.4 Formulation of a European Fiscal Policy

4.4.1 European Fiscal Board

The Fiscal Compact requires Member States to set up independent fiscal councils to analyse fiscal sustainability and the fiscal stance. In Finland, this task has been conferred upon the National Audit Office. The provisions of the Fiscal Compact have been loosely implemented in many Member States.[12] The regulatory level chosen does not ensure that fiscal policy objectives will take priority over other objectives: the national fiscal councils do not have sufficient independence, their tasks have not been defined in sufficient detail, or the re-examination of objectives is not sufficiently automatic. In the case of Finland, the Commission has raised similar concerns over implementation of the Fiscal Compact.

The Five Presidents' Report proposes the creation of a European Fiscal Board. This would coordinate and supplement the work of the independent national fiscal councils. It would provide an independent assessment, at European level, of how budgets and their execution perform against the objectives and recommendations set out in the EU fiscal governance framework and would encourage the adoption of a euro area-wide fiscal policy perspective in national fiscal policies.

The tasks outlined for the European Fiscal Board are similar to many of the responsibilities of the Commission under the existing coordination framework. However, the Board would only have an advisory role and would not be entrusted with the current powers of the Commission and Council to propose and impose sanctions. Hence it is not clear how such a construct would improve fiscal policy coordination across Member States. In fact, the proposal may rather reflect a lack of confidence in the discretion used by the Commission. However, the establishment of a Fiscal Board is not a solution to this problem.

National fiscal councils already have their own internal network in place, with such useful activities as information sharing and promotion of common calculation methods. The network does not have any executive powers. The promotion and support of a framework for information sharing between national fiscal councils would, as such, be useful. If this were to be the Board's mission, it would be a clear argument in favour of the proposal. Many national fiscal councils have rather limited resources. Well-structured cooperation would deliver improvements in the quality and effectiveness of the operations of national institutions, with cost efficiencies.

> *The working group takes the view that it is questionable whether an advisory European Fiscal Board would produce any added value in addition to the current responsibilities of the Commission and the existing network of national fiscal councils. As currently outlined, the tasks of the proposed Board remain unclear. It may be justified to strengthen the network of fiscal councils and their cooperation to bolster the national role of the fiscal institutions.*

---

12 A compendium with details of the methods of enforcement of individual Member States is available from the database http://eurocrisislaw.eui.eu/topic/fiscal-compact/.

4.4.2 Creation of a euro area Treasury

According to the Five Presidents' Report, the creation of a euro area Treasury should be considered in the longer term. The report underlines that this would by no means mean centralisation of all aspects of revenue and expenditure policy; Member States would continue to decide on taxation and the allocation of budgetary expenditures consistent with national preferences and policy choices. However, the report states that some decisions would increasingly be made collectively while at the same time ensuring democratic legitimacy and accountability.[13]

In principle, the EU already incorporates some features of such a scheme, especially within the 'own resources' system. This is revenue that is granted to the Union under Article 311 of the TFEU to finance the EU budget. It belongs to the Union and is collected by the authorities of Member States and forwarded to the Union. The creation of a Treasury would probably amount to an expansion and institutionalisation of such a scheme based on a separate budget, although the report does not include a clear proposal to this effect. The report does not specify which decisions would be transferred to the EU level, how large the budget would be or what use would be made of the tax revenue. One of the key issues of the scheme is what income transfers it would involve. This is not specified in the report.

The proposal may be seen as a response to the past debate on eurobonds, a debt redemption fund and eurobills. The report of the Commission's Expert Group completed in March 2014 notes that both a debt redemption fund and eurobills would have merits in stabilising government bond markets and supporting financial stability and integration.[14] However, both would involve economic, fiscal and moral hazard risks. The Expert Group therefore recommended against taking any action until some experience had been gained of the new economic governance framework. In any case, adoption of the measures would require revision of the EU Treaties or intergovernmental arrangements.

Basically, the discussion boils down to the division of competencies between the Union and Member States for the use and finance of public funds, the latter referring to taxation. In many federal states, the central administration has the power to levy taxes. The evaluation of proposals that advocate limited tax-levying power for the EU should focus on the proposed uses of such tax revenue. Union-wide or euro area-wide taxes could be used to collect funds e.g. for potential income transfers of an insurance type, such as a single European unemployment security scheme or other cyclical stabilisation schemes (see the subsection below).

Joint liability between Member States might be easier to accept if the relevant funds were not to be channelled through national budgets. However, there are also some constitutional aspects of key importance to national sovereignty attaching to taxation rights. The power to levy taxes could be justifiable if the tax revenue were used to finance the production of

13 The establishment of a Treasury for the management of joint resources was also included in the 2012 Blueprint, which proposed the establishment of a new budgetary authority to manage joint resources. The Blueprint also proposed the introduction of the position of Minister of Finance.

14 See the Expert Group's final report adopted in March 2014, available online at http://ec.europa.eu/economy_finance/articles/governance/pdf/20140331_report_en.pdf.

public goods viewed as important by EU citizens, such as border control and security. Key considerations in terms of the acceptability of taxation rights are not only the method of collection or purpose of the taxes but also the results delivered by the use of the tax revenues.

> *The proposal for a euro area Treasury is unspecific and an evaluation of the proposal would warrant greater insight into the kind of tasks to be assigned to such an administrative body. However, the assumption is that the primary purpose of such a body would be to offer a natural setting for those fiscal responsibilities that would possibly later be transferred to the Union.*
>
> *Given that there is scarcely any political realism in a substantial increase in the direct fiscal responsibilities of the Union or the assignment of taxation rights, even if limited, to it at this juncture, the stability of Monetary Union would benefit more from a discussion of the harmonisation of the taxes that are key to the operation of the Single Market and the Capital Markets Union.*

4.4.3 Cyclical stabilisation mechanism

The Five Presidents' Report proposes the establishment of a fiscal stabilisation function for the euro area. The report is rather vague with respect to both the objectives and implementation of such a function. However, it allows the conclusion that the purpose of the function would be to act both as a regulator of euro area-wide public demand and, potentially, also as a cushion against shocks facing Member States.

The report notes that the stabilisation function could initially build on e.g. the European Fund for Strategic Investments. The function should not lead to permanent transfers between Member States or be conceived as a way to equalise incomes between them. The stabilisation function should neither undermine the incentives for sound fiscal policy-making at the national level, nor the incentives to address national structural weaknesses. It should not be an instrument for crisis management, i.e. it is not intended to take over the role of the ESM. It should be open and transparent vis-à-vis all EU Member States. Access to the stabilisation function would be conditional on adherence to the convergence criteria. The report underlines that the stabilisation function should be developed within the framework of the EU, to guarantee consistency with the existing EU fiscal framework and coordination measures. This would probably require an amendment of the Treaties.

When assessing the need for a cyclical stabilisation mechanism in the context of Economic and Monetary Union, at least the following three questions arise:

- Could the euro area as a whole pursue a more accommodative fiscal policy, especially with interest rates close to zero?
- Are there any barriers to the exercise of fiscal stabilisation by individual euro area countries? If so, can they be removed?
- What are the costs and benefits of cross-border stabilisation mechanisms in the euro area?

Before the current crisis, monetary policy was believed to be a more effective instrument of cyclical stabilisation at euro area level than fiscal policy. Furthermore, the so-called automatic stabilisers of fiscal policy were presumed to be a relatively effective source of cyclical stabilisation at national level. With interest rates close to zero, the scope of monetary policy to pursue cyclical stabilisation is more limited, whereas the multiplier growth effect of fiscal policy is higher than usual in a zero-interest rate environment. This being so, a strong tightening of fiscal policy may even have a negative impact on the debt-to-GDP ratio, through a contraction in total output.

Decentralised fiscal policy has not provided the best possible support to the financial stability of the entire currency area. Hence, it would, in principle, be beneficial if the euro area as a whole would be better equipped to foster growth by coordinating the fiscal policies of Member States. Efficient implementation of euro area-wide fiscal policy coordination is, however, difficult under the current division of competencies, unless Member States find it to be in their own interest.

In the absence of national monetary policies, fiscal stabilisation is of greater significance to individual Member States than to the euro area overall. This has also been recognised in the EU Treaty Framework. The Stability and Growth Pact provides for cyclical stabilisation, as the Pact is designed to ensure the fiscal sustainability of Member States and permits a temporary breach of its own 3% deficit threshold. By contrast, the Pact sets a constraint on the cyclically adjusted structural deficit.

Another key constraint on the exercise of active fiscal policy, besides the regulatory framework, is delivered by the market. If investor confidence in the creditworthiness of an individual euro area country is compromised, the price of market funding, i.e. the interest rate charged, may increase to the point of expectations of the country facing financial distress becoming self-fulfilling. In such a situation, the Member State will lose its ability to pursue fiscal stabilisation and will have to adopt a pro-cyclical policy. In its present form, the financial assistance provided by the ESM can bring some relief to the increase in the interest expenditure of a Member State perceived as vulnerable, but the assistance is always conditional on the adoption of fiscal consolidation measures.

A single EU or euro area budget and related fiscal transfers would present one possible approach not only to the regulation of euro area-wide demand but also to cross-border cyclical stabilisation within Economic and Monetary Union. In other currency unions, such as Germany or – to a lesser extent – the United States, the federal budget serves this purpose between the inhabitants of federal states. Given the reluctance to expand the budget of the EU or euro area and the prohibition against fiscal transfers between Member States, the Five Presidents' Report proposes the establishment of a separate fiscal stabilisation function for the euro area. According to the report, the fiscal stabilisation mechanism would help Member States overcome cyclical slumps and might, in fact, rescue a Member State from having to rely on external emergency assistance.

The fiscal stabilisation mechanism outlined in the report could, in principle, be beneficial to Economic and Monetary Union. If and when there is no readiness to adopt a single fiscal policy for the euro area, economic justification may be found for separate mechanisms of cyclical stabilisation that serve to absorb asymmetric external shocks.

Countries like Finland, where the economy has traditionally been more cyclically sensitive than the euro area average, would reap the greatest benefits from the stabilisation mechanism outlined in the report. To avoid the stabilisation mechanism resulting in fiscal transfers or permanent equalisation of income across Member States, activation of the mechanism should be based on clear, pre-defined rules, rather than political discretion.

The design of an effective cyclical stabilisation scheme involves two problems of principle. The real-time cyclical conditions of Member States cannot be defined unambiguously and, what is more, there would be an apparent danger of politically motivated interpretation of the rules. Application of the rules would be difficult e.g. in a context where the deceleration in growth believed to be a cyclical bump is with time revealed as a more permanent structural problem. According to the Five Presidents' Report, access to the fiscal stabilisation function would be conditional on adherence to convergence criteria to be defined at EU level. The report fails to indicate in what way compliance with new binding criteria could be expected to be superior to past compliance with numerous previous EU economic policy rules, the implementation of which has been wanting and enforcement painful.

The working group takes the view that the primary objective should be to enhance the operation of private risk sharing and cyclical stabilisation within Economic and Monetary Union. A well-functioning Banking Union and Capital Markets Union are key to ensuring this.

As well as monetary policy measures, fiscal policy measures should be harnessed as a means towards cyclical stabilisation. Efficient implementation of euro area-wide fiscal policy coordination is difficult in the present situation. Instead, it would be important to allow the automatic stabilisers of Member States to operate fully also in conditions of monetary union. One step in this direction could be the substitution of a spending limits framework for the structural deficit criteria. This would strengthen the operation of automatic stabilisers also in good times.

The working group finds the economic arguments of the potential benefits of a rules-based stabilisation mechanism between Member States to be valid in principle. Schemes that alleviate the effects of short-lived asymmetric economic shocks should, in fact, not be ruled out in advance from the future toolkit of Economic and Monetary Union. However, insurance-type schemes should not be allowed to result in permanent unilateral fiscal transfers and should not undermine Member States' incentives to exercise fiscal discipline.

4.4.4 European Stability Mechanism (ESM)

With the establishment of the European Stability Mechanism (ESM), a permanent crisis management mechanism was created for euro area countries. The ESM builds on a new Treaty provision (Article 136(3) of the TFEU) that stipulates that euro area Member States may set up a stability mechanism that is activated when necessary for ensuring the financial stability of the euro area as a whole. The amendment of the Treaty demonstrates that, unlike previous mechanisms, the ESM is conceived as an integral part of the permanent architecture of EMU. The same article provides that strict conditionality shall apply to the provision of financial assistance under the ESM.

The mandate of the ESM is to raise funds and grant financial assistance to ESM members suffering from, or threatened by, serious financial difficulties. The provision of financial assistance is conditional on it being indispensable to safeguarding the financial stability of the euro area as a whole and of individual Member States. At the same time, the availability of financial assistance may raise moral hazard issues that undermine both the incentives of euro area countries to pursue a responsible economic and fiscal policy and the incentives of investors, thus eroding market discipline.

In order to contain Member States' incentive problems, the provision of financial assistance is, therefore, always accompanied by broad economic policy conditionality. Obviously, the conditions defined by the providers of assistance inevitably imply significant curtailment of the economic policy sovereignty of the beneficiary country.

The Five Presidents' Report does not address the mandate, mission or effectiveness of the ESM. It does not make any concrete proposals for the development of the ESM. Rather than discussing issues of content, the report proposes integration of the ESM Treaty with the EU Treaties in the medium term. This issue is discussed in chapter 5, below.

An issue more relevant to the development of EMU than the legal status of the ESM Treaty relates to the mandate and mission of the ESM. Considering the reluctance to introduce reliance on fiscal transfers between Member States, the funding to sovereigns provided by the ESM should be more strictly confined to the management of liquidity problems alone. This means provision of temporary finance to a Member State requesting assistance, for the duration of an economic adjustment programme. At the same time, however, agreement should be reached on the procedures to be observed in the event of the country facing problems of solvency, not liquidity.[15] In practice, this means putting in place procedures and institutions that facilitate the performance of sovereign debt restructuring (see section 4.5, below).

The need to differentiate between liquidity problems and solvency problems was, of course, recognised already in the negotiations on the establishment of the ESM. The preamble clause 12 of the ESM Treaty reads: 'In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme.' The ESM Treaty also requires inclusion of standardised collective action clauses (CAC) in all new euro area government bonds as of 1 January 2013, to facilitate the process of debt restructuring. With the introduction of CACs, a decision taken by a qualified majority of creditors on the restructuring of the bonds of a debtor country or of an individual issue is now binding on all creditors. In some assessments, however, euro area CACs have been claimed to have little effect in their current wording, as a successful implementation of comprehensive debt restructuring requires that the creditors hold a majority of all individual debt instruments (see 4.5 below).

15 Assessments of debt sustainability are always surrounded by uncertainty. In practice, this uncertainty often results in the entertainment of hopes that the debt crisis is only a liquidity problem that can be addressed by the provision of bridging finance. However, if the income development of the debtor is weaker than expected, it must in the end be admitted that the reasons for the problem lie deeper and the solvency of the debtor must be restored by other means, such as debt restructuring.

However, debt restructuring has not been set as a precondition in the ESM financial assistance programmes adopted so far. In the cases of Spain and Cyprus, the vulnerabilities and, hence, the financial relief were concentrated on the banking sector. In the context of the third financial assistance programme for Greece, the potential need for debt restructuring was clearly brought to the fore, but the situation was different in that most of the public debt of Greece was already held by official sector creditors. This has understandably resulted in some lack of appetite in debt restructuring on the part of Member States. Overall, it must be recognized that debt restructuring as such does not necessarily completely wipe out the need for external financial assistance, but it does reduce the scale of external assistance and domestic adjustment necessary and, above all, improves the prospects of success for the programme.

The discussion on the mission and mandate of the ESM has also addressed the role of the ESM in Banking Union. As stated above in the section on Banking Union, the ESM's financial assistance toolkit at present allows for the direct recapitalisation of banks as well as stability support to Member States. In addition, Member States may take advantage of the ESM's loans for indirect bank recapitalisation during the initial transition period to the Single Resolution Fund (SRF) as a bridging finance mechanism for the national contribution to the fund. In contrast, the role of common backstop for the Single Resolution Fund foreseen for the ESM in the Five Presidents' Report would require an amendment of the ESM Treaty.

> *The working group takes the view that the ESM is a useful instrument for strengthening the shock resilience of the euro area. A key aspect of the ESM's stability support to Member States concerns its confinement to the management of liquidity problems. In the case of solvency problems, the distressed Member States' debt should be restructured. The role of the ESM as the last resort of funding in crisis will gain importance as the emphasis in crisis resolution for banks and sovereigns moves to bail-in and debt restructuring.*
>
> *The working group finds it natural that economic policy conditionalities are attached to the financial assistance provided by the ESM. The threat of curtailments in sovereignty also serves to encourage Member States to pursue a fiscal policy that reduces the potential need for assistance.*

4.5 Market discipline and sovereign debt restructuring mechanisms

According to the no bail-out clause of the Maastricht Treaty, the Union or a Member State cannot be liable for or assume the financial commitments of another Member State. In addition, the ban on central bank financing prohibits the European Central Bank and national central banks from funding governments. These provisions were designed to prevent Member States and markets from relying on intergovernmental fiscal transfers and solidarity or the central bank as a source of finance. Another purpose was to encourage market discipline by adopting a credit-risk based approach to the pricing of government debt.

The operation of market discipline has not been effective in the euro area. Following the establishment of the euro, government bond yields converged across the euro area irrespective of the consideration given by individual euro area countries to the sustainability of their public finances. This situation, which was conducive to borrowing, prevailed until the outbreak of the global financial crisis. In response, the public debt of many euro area countries surged despite a broad expansion of the tax base driven by rapid growth. This was especially true of Greece and Portugal.

The global crisis exposed the vulnerability of the funding structures of both private and public sectors. Markets rapidly changed their perception of the solvency of non-financial corporations and banks, as well as sovereigns. The government bond yields of Greece, Ireland, Portugal and, to a lesser extent, Spain and Italy rose markedly compared with the government bond yields of countries believed to be safe, such as Germany or Finland. Market discipline was set in operation, but too late. In some situations, market reactions were clearly driven by factors other than those directly related to a weakening of the country's fundamentals. Investors responded strongly to changing expectations of the probability of external financial assistance and of the general availability of funding.

Ultimately, five euro area countries drifted into a situation where they were no longer able to raise market funding to service their debts and cover their deficits. For fear of the consequences of the default of a euro area country, arrangements for financial assistance were put in place.

For Greece, the liquidity support was in the end not sufficient, but the country's public debt had to be restructured. Consequently, the credit risks taken on by the creditors were at least partly realised in the case of Greece. The delayed acknowledgement of the actual state of insolvency and the insufficiency of the debt relief provided in the debt restructuring process of 2011/2012 has caused Greece major losses of production and employment and has also sustained uncertainty overall.

There are two solid arguments for the concern about the consequences of debt restructuring.[16] Firstly, the banking system has been highly vulnerable to haircuts on sovereign debt, given the large volume of domestic government bonds in banks' asset portfolios. Consequently, reductions in debt would be likely to generate major losses for banks and trigger a systemic banking crisis, with cross-border contagion effects. Secondly, considering that there are no predefined procedures in place for debt restructuring, the process can be expected to become prolonged and give rise to a host of legal disputes. Legal disputes sustain uncertainty, which spills over to other countries and is highly detrimental to the revival of economic growth in a crisis.

If the aim is to move towards a vision of EMU based on market discipline, it is necessary to mitigate the risk of catastrophic consequences resulting from the debt restructuring of a euro area country. In principle, there are at least four approaches to such risk mitigation: (1) ensuring that there are credible firewalls in place to support the liquidity of other countries, (2) reducing banks' exposure to sovereign risks, (3) putting in place clear, predefined,

---

[16] A number of assessments suggest that opposition to debt relief for Greece has also been motivated by less valid reasons (such as protection against losses of large individual German and French banks) or are merely an expression of the ideological view that a euro area country cannot leave its debts unpaid.

swift and legally binding procedures for sovereign debt restructuring, and (4) promoting cross-border banking in the euro area.

Under these conditions, investors will not be able to count on the other Member States to bail out a country whose solvency is seriously compromised in the face of payment difficulties. In addition, explicit recognition of a debt restructuring as an option in crisis management, together with clear predefined procedures, are likely to provoke an earlier reaction from investors to the risks associated with sovereign debt management. This will leave the country time to implement corrective measures before the risks increase to a point where investors will require very high risk premia.

So far, only the first point has been relatively successfully addressed, with the creation of the European Stability Mechanism and the stability-enhancing measures taken by the ECB. The conditions for cross-border banking have also strengthened in response to the launch of Banking Union. By contrast, no measures whatsoever have been taken to contain banks' sovereign risks. Similarly, the efforts devoted to facilitating sovereign debt restructuring have remained limited in relation to the challenges of the task. The Five Presidents' Report makes a cautious reference to the reduction of banks' exposures to sovereign risks, but completely disregards the issue of a sovereign debt restructuring mechanism. This is a major shortcoming of the report. As was noted above, a sovereign debt restructuring mechanism can be regarded as a condition for appropriate market pressure and, in certain cases, the restoration of fiscal sustainability.

When a country runs into solvency problems, the contractual terms of its government bonds largely define the scope available for debt restructuring based on negotiation, especially where the bonds have been issued under legislation other than the national legislation of the distressed country, which thus has no recourse to the legislative process to change the contractual terms.

Where insolvency procedures have not been sufficiently provided for in the contract, this has often rendered the negotiation of orderly debt restructuring impossible, resulted in years of legal proceedings and delayed the country's return to the international capital markets. As a rule, sovereign insolvencies cause major macroeconomic losses in the country itself and instil fears of the financial problems also having contagion effects on other countries. However, the extent of the losses and the risk of contagion depend on how well the unsustainable debt burden is managed.

Finland has advocated the formulation of rules and procedures that support orderly restructuring of debt. In the absence of predefined and legally binding procedures, the debt restructuring process may be problematic in many respects. First of all, the process will stretch on as the debtor countries, on one hand, put off the restructuring, while, on the other hand, negotiations will be long drawn-out in the absence of clear rules of conduct. Meanwhile, a run of capital from the distressed country gets underway, further hampering economic developments. Secondly, even if a large majority of creditors were to be in favour of granting relief to the debt burden, some creditors may refuse it and instigate long and potentially successful legal proceedings (hold-out). This will sustain uncertainty in the long term and weaken the debtor country's prospects of returning to the bond markets, and may even result in renewed insolvency.

For these reasons, proposals for as orderly schemes of sovereign debt restructuring as possible have been made. Efforts to introduce arrangements based on international law have failed.[17] In the absence of this option, there have been attempts at solving the hold-out problem by inclusion of collective action clauses (CAC) in bond terms, under which the majority of creditors have the right to take a decision on the reduction of the debt burden that is binding on all creditors. To facilitate the process of debt restructuring, the terms and conditions of all new euro area government bonds issued since the beginning of 2013 include harmonised CACs (see 4.4.4 above). However, the CACs have little effect, as they provide for successful debt restructuring only if the creditors hold a majority of all individual debt instruments.

The euro area crisis has sparked proposals for an EU- or euro area-wide debt restructuring mechanism. A debt restructuring mechanism based on EU law should also be easier to implement than a global scheme. The proposals foresee an integration of the scheme with the ESM.[18] Drawing on international experience, the IMF, too, in cooperation with market participants, has drafted a new and better set of model clauses for inclusion in globally issued new government bonds. The clauses restrict the possibilities of holders of individual bond series to opt out of a debt restructuring plan negotiated by a majority of creditors. These new clauses would significantly improve the prospects of a orderly process of debt restructuring. The first issuances of bonds containing the new clauses have been successful. EU countries have not yet embarked on discussions on the inclusion of the new clauses in their own securities.

The UN General Assembly has also addressed the need for a separate international law framework to facilitate sovereign debt restructuring. Still, the creation of a global debt restructuring mechanism does not appear likely this time, either.

There are several factors underlying the operability of a debt restructuring mechanism. They relate primarily to the launch of the process and the related suspension of interest and amortisation payments for the duration of the decision-making process. Decision-making must be swift, preventing aggravation of the financial situation of the distressed country due to a run on capital. Considering that debt sustainability is a function of many factors, decision-making can hardly be based on one single triggering indicator, such as the debt-to-GDP ratio. However, experience has shown that a high degree of discretion easily results in deferral of decisions. It is also important to ensure that creditors who are discontented with the restructuring plan are not able to take legal action to prevent or delay the process.

---

17 In 2002, the Vice President of the IMF, Anne O. Kruger, proposed a statutory sovereign debt restructuring mechanism, primarily modelled on the Argentinian default experience. This proposal, known as the Sovereign Debt Restructuring Mechanism (SDRM) and built on an expansion of the IMF Treaty, did not, however, get the support of 'creditor countries', notably the United States, and thus came to nothing.

18 Buchheit et al. propose one possible construct for this connection. The basic idea of the proposal is that Member States with a level of public debt below 60% of GDP are provided financial assistance by the ESM without any preconditions of fiscal consolidation or debt restructuring. Such assistance would probably be in little demand, as lightly-indebted countries, as a rule, always have access to credit at a reasonable price. When the level of public debt is between 60% and a defined upper threshold (such as 90%), the ESM will, as currently, offer financial assistance on condition that the Member State agrees to put in place necessary budgetary consolidation measures and structural reforms. Debt restructuring is not a condition, unless suggested by a debt sustainability analysis of the level of debt. However, the availability of financial assistance to countries with debt levels above 90% of GDP is conditional on the restructuring of debt to fall clearly below the upper threshold. See Buchheit, L. A. et al., Revisiting Sovereign Bankruptcy, Committee on International Economic Policy and Reform, Brookings Institute 2013.

The third important issue is to protect other countries against suffering a loss of confidence in response to the debt restructuring of one euro area country. To ensure this, countries whose debts are assessed to be on a sustainable footing should receive such financial assistance as to render speculation futile. Integration of the debt restructuring scheme with the existing financial assistance facility of ESM would provide a natural starting point for this. It is vital to prevent the debt restructuring of a sovereign from putting the functioning of the banking system at risk, as has been the case in the past. Here, mitigation of banks' sovereign risks plays a key role.

The introduction of a debt restructuring mechanism is a major issue. Under the prevailing high levels of debt, restructuring of the debts of one country involves a major risk of contagion to other highly indebted countries. Seeking recourse to debt restructuring would, therefore, be a risky solution at the current juncture. Debt restructuring can be adopted as the preferred course of action only when the debt sustainability of the majority of Member States has been placed on a secure footing and markets basically treat the debt problems of individual countries as isolated cases. Therefore, a transition period must be provided for, in the course of which Member States must reduce their debt levels. This will ensure that the introduction of the scheme will not induce systemic panic reactions.

If a safe transition period is found to be too long, the prospects of adopting exceptional measures to reduce debt levels should be considered.[19] Implementation of such exceptional measures is difficult in many respects. One key question is how binding commitments can be imposed on Member States to permanently direct their income flows to the discharge of such undertakings. As long as Member States can unilaterally decide to terminate such arrangements, the credibility of the scheme would be questionable and the moral hazard evident.

> *It is a necessary prerequisite for an EMU based on market discipline that it provide for the restructuring of sovereign debt in the extreme case of the insolvency of a Member State. Even if other measures were to be taken to keep the probability of such a situation to a minimum, it cannot be ruled out completely. In such case, it would be commendable to provide for swift restructuring of private debts consistent with predefined procedures, rather than improvise. In addition to the crisis management benefits gained, awareness of the availability of a feasible debt restructuring option would enhance market discipline.*
>
> *The working group finds that financial assistance from the ESM should be made conditional on debt restructuring if the Member State requesting assistance suffers from a solvency problem rather than a pure liquidity problem. Effective implementation of debt restructuring is likely to be best ensured if founded in law and based on a debt restructuring mechanism integrated with the ESM. In the opinion of the working group, a study on the establishment of such a mechanism should be launched as part of the EMU development initiatives.*

---

19 Corsetti et al. (2015) propose various approaches, mainly based on a separate fund buying the debts of Member States and financing the purchases with perpetual bonds collateralised by some flow of income from Member States (value added tax or monetary income of the central bank). The exchange of debts for instruments more akin to shares (GDP-related bonds) is one option addressed. Corsetti G. et al., A New Start for the Eurozone: Dealing with Debt, Center for Economic Policy Research 2015.

Another condition for safe implementation of debt restructuring is ensuring that it will not lead to the collapse of the banking system. Consequently, mitigation of banks' sovereign risks constitutes a vital part of the development of EMU.

5 Democratic legitimacy and accountability

5.1 Ensuring the legitimacy of economic policy decision-making

5.1.1 Prerequisites for democratic legitimacy

The difficult decisions on euro area crisis management have divided the euro area countries and triggered the need to assess the legitimacy and accountability of the EU and euro area economic policy coordination and decision-making. This is also one of the questions raised in the Five Presidents' Report and in earlier reports on the development of EU institutions and Economic and Monetary Union. Discussion on democratic legitimacy and accountability often focuses on the role of the EU institutions and on whether decision-making and its democratic oversight should take place on the EU level or lie with Member States. An analysis of democratic mechanisms, the legitimacy of the exercise of power as well as accountability is, however, more extensive.

A functional institutional framework for economic policy requires legitimacy in the exercise of power and an adequate level of trust by citizens in the institutions exercising power. This includes questions regarding the separation of powers and controls on the use of power (checks and balances). Trust and legitimacy, as well as control arrangements, also have an impact on the activities of individual economic agents (citizens, companies) and political institutions. In general, institutional arrangements based on a high level of trust enable decision-making that is economically effective, and are in themselves legitimate. Ultimately, trust is also the basis of tax compliance by companies and private citizens.

Box 12

What is the legitimacy of decision-making?

The legitimacy of the exercise of power traditionally requires that

- the exercise of power is compatible with society's norms and moral standards;
- the exercise of power is based on constitutional institutions and procedures;
- the results of the exercise of power are considered beneficial to society.

The legitimacy problems of EMU are essentially linked to the challenges of the Treaty-based separation of power between Member States and the EU in economic and fiscal policy. EMU is a combination of federal-type centralised governance and shared sovereignty by the Member States.

Under the EU Treaties, economic and fiscal policy fall within the competence of the Member States, but, in practice, the EU steers and regulates in many ways the public finances and macroeconomic developments in euro area countries. The institutional forms and political guidelines of this exercise of power remain unambiguous, and it is not granted legitimacy in the standard political process of the EU or its Member States. This has an impact on the legitimacy of EU-level regulation and hence on Member States' willingness to implement common rules.

Safeguarding the outcome of the exercise of power within EMU is hampered by the fact that the costs and benefits of the decisions are often distributed very unevenly. This may easily cause tension and conflict.

A key question in the development of EMU involves the role of the general public, i.e. to what extent the public and tax-paying companies are direct recipients of the benefits generated by EMU and the payers of its costs, and to what extent this role is realised via the Member States. Accountability as a political or legal principle, in turn, is based on the balance of power and responsibility: the exercise of power involves responsibility to those on behalf of whom power is exercised and who are subject to the exercise of power. Accountability is also based on the disclosure of correct and adequate information to support participation and to enable assessment of the exercise of power. For ensuring disclosure, there are various supervisory procedures. If the Union produced public goods and generated other benefits directly for companies and the public, the exercise of power between the citizens and the Union would become closer. In a situation like this, the Union would be directly responsible for providing certain public services, by e.g. ensuring the realisation of certain social rights. This could create legitimacy and a relationship based on trust between the Union and its citizens, which would also support tax compliance.

The debate on euro area governance and democratic legitimacy is closely linked to the above-mentioned debate on the nature and the broadening of the scope of the EU's competence in economic policy. Changing the nature of competence has been justified in particular by the aim to clarify the division of competence so that de facto competence is executed by those upon whom the task has been conferred by the Treaties. The minimum guarantee for democratic legitimacy is compliance with the Treaties. It is clear that EMU must be developed so that it is compatible with the Treaties.

There are no easy or perfect solutions to the legitimacy of decision-making within EMU. As a political system, the European Union is a hybrid, with a channel of democratic legitimacy and accountability on both the national and EU levels. In the alternatives that have been discussed on the future of EMU, the hybrid form of EMU will remain. It is therefore essential to find the best possible balance between national and EU-level solutions.

5.1.2 Legitimacy of the institutional structures of Economic and Monetary Union

In addition to the need to clarify the basis of the separation of power and the division of competence between the Union and its Member States, there has been calls for simplifying and consolidating the institutional structures of the EMU, in the first place within the framework of the EU Treaties, and secondly under the Eurogroup. Section 5 of the Five Presidents' Report discusses democratic accountability, legitimacy and institutional strengthening. The Report states that greater responsibility and integration at EU and euro area level means that the new powers should be shared better while at the same time increasing the transparency of decision-making.

The Report notes that, in the short term, the Eurogroup's presidency and the means at its disposal may require reinforcement. The external representation of the euro area should be consolidated. In the longer term, a full-time presidency of the Eurogroup with a clear mandate should be considered. According to the Report, decision-making at euro area level should be strong, but this is not discussed in more detail. As concrete steps towards more democratic accountability and legitimacy, the Report lists the strengthening of the role of the European Parliament and the national parliaments, as well as enhanced and closer dialogue between the European Parliament and the Council, the Commission and the Eurogroup.

The implementation of democratic legitimacy depends on which level power is executed at. If EMU is developed in the direction envisaged in the centralised governance model, it is important to find means that are adequately strong for the EU-level realisation of democratic legitimacy and accountability, the prerequisites for the power to govern. If economic policy decision-making was transferred to the Union's normal competence framework, we consider it justified to also strengthen the powers of the European Parliament as part of the reinforcement of democracy in decision-making. As part of the 'normalisation' of economic policy competence, the discussion will also involve the status of not only the Eurogroup and the Council, but also that of the Commission and the Court of Justice of the European Union. On the other hand, it is not clear whether the status of e.g. the Eurogroup in the centralised coordination model would have to be significantly different from its current status, even if the framework for economic policy rules were tightened only in the euro area. The Council can already now take decisions in the composition of euro area countries.

Transferring economic policy decision making to the competence of the Union is not merely a legal technicality. It would transfer policy ownership crucially to Union bodies and reduce the policy ownership of the Member States. In such a situation, it is important to assess whether the conditions for the legitimacy of decision-making are fulfilled in the Union's exercise of power. Otherwise elements will be created that encourage moral hazard or reduce legitimacy. The transfer of economic policy to the shared competence of the

Union could, however, depending on the issue, benefit from utilisation of the EU's institutional arrangements and its legitimacy and accountability.

The nature of competence does not automatically define the institutions' competence or the decision-making procedures. The European Parliament has in its previous opinions (in 2012) considered that decisions on economic policy issues within the competence of the Union should be taken in the ordinary legislative procedure, in which laws are adopted jointly by the European Parliament and the Council. The European Parliament already participates now in the adoption of rules concerning the multilateral surveillance procedure. However, the EU Treaties also allow for other types of decision-making procedures. The Council can take decisions in other procedures and unanimously, and in principle national Parliaments can also be involved in decision-making.[20] At the same time, many economic policy decisions are not taken in the legislative procedure, instead they involve the implementation of rules, which under the Treaties is the responsibility of the Member States and the Commission or Council, and not that of the European Parliament. Hence, changing the nature of the EU's competence or extending its scope does not automatically result in one specific decision-making model. The strengthening of competence or extending its scope will, however, make demands on how to guarantee the democratic legitimacy of decision-making.

Reinforcement of democracy at EU level is usually linked to the need to strengthen the status of the European Parliament. In the discussion on a deeper EMU, strengthening the role of national parliaments at EU level and their close cooperation with the European Parliament have been proposed as key measures for enhancing the democratic scrutiny of the exercise of power within EMU. Joint meetings with parliamentary representatives have been organised since 2012, initially in connection with the European Semester, which is a cycle of economic policy coordination, and subsequently also within the budgetary process defined in the Fiscal Compact. These joint meetings between the national parliaments and the European Parliament – which do not have actual competence – are not an answer to fundamental questions on the bases of legitimacy.

Both the Five Presidents' Report and European discussion in general address the development of the status of the European Parliament and the national parliaments as if they were parts of the same entity. Their tasks and principles of operation do, however, differ crucially. National parliaments act in accordance with the principles of parliamentarianism, and first and foremost they seek solutions that are nationally legitimate. In parliamentarianism, power and responsibility is based on the government/opposition constellation and voters' opportunity to influence it. The European Parliament lacks this type of constellation, and the Commission is not a political government that is accountable to the European Parliament and hence to European voters.

---

[20] See e.g. Article 218(8) of the TFEU, under which the European Council is to act unanimously for the agreement on accession of the Union to the European Convention for the Protection of Human Rights and Fundamental Freedoms. The Council's decision concluding this agreement is to enter into force after it has been approved by the Member States in accordance with their respective constitutional requirements. A decision, as referred to in Article 311 of the TFEU and adopted unanimously by the Council, laying down the provisions relating to the system of own resources of the Union cannot enter into force until it is approved by the Member States in accordance with their respective constitutional requirements.

It is also difficult to imagine that national parliaments could have de facto power outside a national system created under a national constitution. In addition, the roles and competence of national parliaments differ significantly across EU countries. For these reasons, the role of the national parliaments – and their relationship with their governments – at the non-national level is not unproblematic. The EU-level role of national parliaments in economic and fiscal policy cannot be strengthened much from its current role, which is based on dialogue and exchange of information. Designating EU-level tasks to national parliaments with the help of EU law confuses the already complicated institutional framework of the Union and blurs the relationships of powers and responsibilities. Even though it is naturally useful to develop forms of cooperation, they do not affect the duties and accountability of parliaments, and therefore they have a very limited impact on the functioning of democracy.

The realisation of democratic legitimacy (and hence stronger ownership) via national parliaments would be further reinforced if fiscal policy rules set at EU level were to be simplified so that only the most important benchmarks would be set at Union level and other rules would be imposed mainly at national level. Compliance with these other rules would be monitored mainly by national fiscal policy institutions. National parliaments are, however, first and foremost responsible for their national budgets and taxation. As long as economic or fiscal policy power is not to a significant extent shifted to EU level, it is justified that they also participate in the formation of national positions when economic policy decisions are taken in the EU. The role of national parliaments in EU-level decision-making should, however, be strengthened at the national level and in accordance with national constitutional requirements. In Finland, the Grand Committee participates in the preparation of meetings of the Ecofin Council, the Eurogroup and the decision-making bodies of the ESM.

In an EMU based on the current division of competence, too, the European Parliament has a role in ensuring the legitimacy of decision-making. When the EU-level exercise of power is no longer purely intergovernmental, it also slides out of the reach of national parliaments. The key task of the European Parliament in the field of economic policy is to oversee that the European Commission effectively and independently monitors compliance with the rules. The status of the European Parliament has in recent years been reinforced, particularly its role as overseer of the tasks of the European Commission in the framework of the European Semester. The European Parliament also has the right to obtain information and engage in dialogue with other Union institutions important to economic and fiscal policy. However, actual decision-making falls outside the scope of democratic supervision. For example, the European Parliament does not participate in the appointment of the Governing Council of the European Central Bank, and nor does the Parliamentary Supervisory Council that oversees the operations of the Bank of Finland.

The problem with supervision of the Commission is that its activities simultaneously involve judicial discretion, expert authority activities and political discretion by a political institution. Current surveillance mechanisms and forms of parliamentary participation do not adequately identify the combination of these tasks. A combination of expert power and political power often leads to a situation in which solutions slide into the scope of political power. The key question in such a situation is not the role of the European Parliament, but the Commission's double role as, on one hand, an independent supervisor and assessor of

Union law and economic policy results and rules, and, on the other hand, an institution that participates in economic policy coordination and exercises political discretion. The key in the accountability of expert assessment is the disclosure, justification and validity of the assessment, and keeping the assessment within the limits of the law. The accountability of political discretion, in turn, is based on parliamentarism and the supervision of parliamentarism in the Government/opposition constellation, and alternatively on a strict separation of powers, an example of which is the US federal government decision-making process. In terms of accountability, clarification of the division of tasks and the relationship between the Commission and the Council is therefore a key question in matters related to economic policy coordination and assessment.

Even though the clarity of rules related to decision-making is important for the legitimacy of decision-making, atypical solutions, e.g. the definition of competence in an exceptional manner or the special roles of institutions in certain policy areas, are not automatically a sign of inadequate democratic legitimacy. Accountability can be realised in many ways. Legitimacy depends not only on who takes the decisions, but also on whether adequate time has been reserved for processing and discussion of said decisions, and on whether justification for them has been provided and is comprehensible.

The discussion on the inadequate democratic legitimacy of decision-making within Economic and Monetary Union must be taken seriously. An assessment of the options for the development of EMU must also take into consideration the impact of the options on the legitimacy of decision-making. Several of the Five Presidents' Report proposals for developing EU-level decision-making could, if realised, create major challenges, in particular for EU-level democratic legitimacy. The stronger the euro area-level exercise of power in economic and fiscal policy becomes, the higher the importance of the democratic control of this exercise of power. Against this background, the proposals included in the Five Presidents' Report for strengthening the legitimacy of economic and fiscal policy are modest.

5.2 Intergovernmental agreements or EU law?

The Five Presidents' Report refers to non-Treaty intergovernmental arrangements that were created during the crisis and need to be integrated into the legal framework of the European Union. This is seen primarily as part of strengthening the democratic legitimacy of EMU. A significant part of the new arrangements created during the financial crisis, e.g. the European Stability Mechanism (ESM), the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, and the Single Resolution Fund (SRF) in the banking union, were established outside the EU Treaty and its institutional framework.

Finland has sought to find solutions to the development of Economic and Monetary Union primarily within the framework of the current Treaty, but it has also kept an open mind on intergovernmental arrangements outside the Treaty. The key objective of the previous solutions has been to achieve legally binding solutions that can be implemented sufficiently quickly.

Box 13

Provisions of agreements concluded outside the framework for EU law, and their inclusion in the Treaties

The European Stability Mechanism (ESM) is based on an intergovernmental agreement between Member States. The Treaty establishing the European Stability Mechanism (ESM Treaty) does not include actual clauses on reassessment. It is subject to interpretation whether the EU would have had the competence to establish the ESM without amendments to the Treaties. The ESM Treaty has been contested in several national constitutional courts, and the case has also been heard by the Court of Justice of the European Union, but, in its current form, the ESM Treaty has been found legally binding (Case C-370/12 Pringle).

According to Article 16 of the **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union**, on the basis of an assessment of the experience with its implementation, the necessary steps are to be taken to incorporate the substance of the Treaty into the legal framework of the European Union within five years, at most, of the date of entry into force of the Treaty (1 January 2013). According to the preamble of the Treaty, the primary method of incorporating it is to amend the EU Treaties. In the Government Bill (HE 155/2012) on the Treaty, one alternative are the measures specific to those Member States whose currency is the euro, as referred to in Article 136 of the Treaty on the Functioning of the European Union, or enhanced cooperation as referred to in Article 20 of the Treaty on the European Union. The provisions on enhanced cooperation cannot, however, be used for extending the competence of the EU; the exercise of EU competence requires an appropriate legal basis provided by the EU Treaties. The relationship of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union to EU competence is subject to interpretation because it has been considered unclear whether the Treaty has clear additional value in relation to the obligations already included in the EU Treaties and secondary law. However, the incorporation of Article 3, at least, is considered as requiring changes to the Treaties. The rules included in Article 3 relate to rules set out in the Protocol on the excessive deficit procedure, and the Article includes specific rules for amendment of the rules.

Under Article 16 of the **Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund**, the Single Resolution Board is to assess implementation of the Agreement within two years of the date of its entry into force, at the latest, and every 18 months thereafter. Within ten years of the date of entry into force of the Agreement (objective 1 January 2016), at the latest, the necessary steps must have been taken, in accordance with the TEU and the TFEU, with the aim of incorporating the substance of the Agreement into the legal framework of the Union. The Agreement does not include provisions on how said incorporation will take place in practice.

The resolution on the **Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund** was based on the differing views of the institutions and the Member States on the appropriateness of the legal basis (Article 114 of TFEU) of the SRM Regulation. In terms of adequate legal basis, a particularly problematic question was whether the EU has the competence to regulate the transfer of contributions raised from credit institutions to the Single Resolution Fund, and certain issues related to the functioning of the Fund. The Member States decided to incorporate these issues into a separate intergovernmental agreement that complements the SRM Regulation and the BRR Directive, and in agreeing on which the Member States exercised their national powers. Incorporation of some parts of the agreement into the SRM Regulation could be possible based on EU law. The final agreement will deal particularly with two issues: the transfer of contributions and the order in which the costs are covered, particularly the functioning of the national compartments in the transitional period. From the perspective of the division of competence, the more problematic issue, i.e. the fixing and levying of contributions, is determined by the SRM Regulation and the delegated and implementing acts.

As the division of competence concerning conclusion of the Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund is subject to interpretation, it is also unclear what it would require to incorporate the substance of the Agreement into the legal framework of the Union. Some Member States have considered that this would require changes to the Treaties. Other Member States and the Commission, however, take the view that the Agreement will no longer be needed when the transitional period has ended and the national compartments have been merged. The Five Presidents' Report proposes that the Intergovernmental Agreement on the Single Resolution Fund (the Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund) be integrated into the framework of EU law by June 2017.

The Euro Plus Pact, which is also mentioned in the Five Presidents' Report, is not an actual intergovernmental agreement but a political declaration by the Heads of State and Government of the Member States that signed the Pact, on common goals and measures to promote, in particular, structural reform. It is non-binding, and therefore its relationship to the competence of the EU has not been defined. Application of the Pact has been minor. The Five Presidents' Report proposes that relevant parts of the Euro Plus Pact be integrated into the framework of EU law by June 2017. In terms of its contents, the Pact is related to the objectives to make the convergence process official, and incorporation of the Pact would probably also affect the competence of the Union.

Solutions made outside the framework of EU law are not a problem in principle, if the decision-making process is planned so that national parliaments' capacity to exert influence is ensured. In terms of the legitimacy of decision-making, the solutions become a problem if they distort the framework of competence and blur the compatibility of solutions with the EU Treaties.

Incorporating the agreements into the legal and institutional framework of the Treaties can be justified by the need to maintain the clarity and consistency of the exercise of power and the set of norms related to Economic and Monetary Union. On the other hand, there are no clear legal grounds why the agreements should absolutely be incorporated into the framework of EU law. Also, in activities taking place outside the official framework of EU law it is possible to take into consideration the requirements for democratic accountability and legitimacy. The key question concerning the agreements is the same as in all economic policy decision-making and relates to the need to ensure that power and responsibility for the decisions are at the same level.

Incorporating the agreements into the framework of EU law would probably also have an impact on e.g. the rules on decision-making to be applied and the ownership of the solutions, and thereby it would also have an economically significant impact on the activities of Member States. On the other hand, incorporation into EU law does not automatically produce any specific institutional solutions. For example, the institutional solutions of the Single Resolution Mechanism are already included in EU law. Incorporation of the Treaty establishing the ESM into the framework of EU law would not automatically mean giving up the requirement for unanimity or the separate decision-making and governance structures of the stability mechanism, even if in principle it is possible to integrate them more tightly into the general EU framework. Incorporation of the agreements would, however, create pressure to abandon the requirement for unanimity and to simplify the decision-making processes, and this is indeed considered one of the key objectives of incorporation.

5.3 Deeper EMU challenges the integrity of the EU

In the development of EMU, the objective has been to avoid negative spillover effects to the integrity of the Union or its institutional framework. Enhanced cooperation between euro area countries was for a long time built by means of political arrangements that were integrated into the legal and institutional framework of the Union. The Treaties are built on the assumption that, in time, all Member States will join the euro area. This does not apply to the United Kingdom and Denmark, who have a permanent exemption from participating in the euro area, as detailed in the Protocols annexed to the Treaties.

Box 14

What is flexible or differentiated integration?

Flexible or differentiated integration refers to possibilities created within the EU system to deepen cooperation without all Member States participating in it. The Third Stage of Economic and Monetary Union, or Schengen cooperation related to the freedom of movement, are more extensive examples of areas of cooperation in which not all Union Member States are participating. The EU Treaties create rules for the introduction of similar enhanced cooperation within the framework of the Union's areas of single competence. This possibility has been used, e.g. within the context of the European patent system or in the regulations on international divorce. Differentiated integration has been used to introduce flexibility into an enlarging Union in which it is increasingly difficult to find a common view on the role of the Union. At the same time, the aim has been to foster the integrity of the Union and its institutional and legal system.

Decisions on the deepening of EMU, taken as a result of the economic crisis, started a new chapter in the divergence between the euro area and the other EU Member States. Tighter regulation and coordination of economic and fiscal policies – as well as Banking Union and the establishment of the ESM – resulted in a considerable divergence of obligations between euro area and non-euro area countries. In practice, euro area countries are subject to a stricter framework for economic policy coordination that also includes the possibility to impose sanctions. In addition, Banking Union and the ESM cover only euro area countries, while the Treaty on Stability, Coordination and Governance in Economic and Monetary Union was ratified by all EU Member States with the exception of two. The Euro Plus Pact was not signed by the Czech Republic, Hungary, Sweden or the United Kingdom, or Croatia, which joined the EU later. Even though the Capital Markets Union would in principle cover all EU Member States, many of the initiatives that are key to its implementation (company law, insolvency law) fall within the scope of judicial cooperation, which also includes special arrangements.

The larger responsibilities and tighter obligations of the euro area countries have on one hand also encouraged institutional divergence, in which the unofficial decision-making forums initially designed for the euro area have expanded and turned into actual decision-making bodies. The aim has been to avoid divergence by leaving the majority of the new EU-level obligations open for non-euro area countries, and by maintaining an adequate connection between the Eurogroup and the actual Union institutions. In the longer-term visions for EMU, divergence will grow further. The visions are based mainly on the expansion of the economic and fiscal policy powers exercised within the framework of the euro area. This further underlines the need to create for the euro area its own decision-making and governance mechanisms, as well as the need to separate out the democratic supervision taking place within the framework of the Union. Political proposals have already been made for changing the structure of the European Parliament and the European Commission so that they would have their own composition for matters within the decision-making powers of the Eurogroup. This would be a logical institutional development for many of the proposals presented in this report. This type of arrangement would mean dividing the institutional system of the Union, and its consequences for the functioning of the Union are difficult to anticipate. Another cause for concern is that divergence within EMU could have direct spillover effects to other policy areas, e.g. the internal market.

Since publication of the Five Presidents' Report, the possibility of divergent integration within the euro area has also been discussed. Only some euro area countries are known to be ready to proceed according to the proposals presented in the Report. This could create a situation in which some euro area countries introduce enhanced cooperation.

Maintaining the internal cohesion of the Union is an increasingly important goal in the assessment of the development of EMU. For Finland, the most important issue is to ensure the effective functioning of the euro area, and in some situations this may mean a stronger divergence of the euro area from the general framework of the Union. The integrity of the Union is part of the objective concerning the clarity of the functioning of the Union, but fostering integrity is not necessarily an end in itself. On the other hand, divergence can also create concrete problems, which in the case of Finland is most evident in the context of Banking Union. Democratic accountability can, however, be realised through a variety of mechanisms, despite possible significant differences in the obligations and position of Member States.

6 Conclusions

The financial crisis showed that there have been flaws in the basic design of Economic and Monetary Union. This report has outlined two alternative visions for the further development of EMU.

An *EMU based on centralised governance* would serve to strengthen fiscal and economic policy coordination between Member States. At the same time, joint liability for risks and stability in the Member States would increase. This vision requires of the European Union an ability to ensure effective governance of Member States' fiscal and economic policies. If this is to succeed, the risk-sharing mechanisms and better consideration of the euro area as a whole, as outlined in the vision, can yield the best outcome for all Member States. In contrast, if the governance of Member States' policies fails, we may witness an outcome of increasing fiscal transfers and deepening political conflicts between Member States.

An *EMU based on market discipline* is, in turn, predicated on Member States' responsibility for their own economic policies and their consequences. In this vision, the Union gradually abandons its efforts to pursue joint governance of Member States' economic policies and to prevent the related policy errors. Responsibility for each Member State's disciplined policy is clearly at national level, supported by market discipline and national fiscal policy institutions. In an EMU based on market discipline, the role of fiscal policy remains more modest in smoothing out cyclical fluctuations. Nor is creating conditions for effective market discipline void of risks in respect of heavily indebted euro area countries. This would at least require a long transition period and sizeable institutional reforms that would enable an orderly debt restructuring for Member States encountering problems.

Neither of the visions hinders the scope for deepening integration. Both could provide the Union with direct competence to the extent deemed warranted. This report has assessed the ideas presented for the further development of EMU relative to the above EMU visions. A certain proposal may be a natural component of one vision, but poorly compatible with the other. But an individual proposal may accord with both visions.

Financial union

The major common interest of the Member States participating in Economic and Monetary Union relates to financial stability. The establishment of a financial union enables the equipping of Economic and Monetary Union with insurance-type risk-sharing and private-sector equalisation mechanisms. According to the working group's assessment, completing Banking Union is an important prerequisite for a stable Monetary Union and in line with Finland's interests, irrespective of the type of EMU vision targeted. Banking Union is expected to improve supervision of large banks, thus enabling the devising of comprehensive common rules for bank resolution in crisis situations. Effective Banking Union would also facilitate the handling of bank problems separately from the state. At its most effective, it would also lower the threshold for sovereign debt restructuring.

The working group takes the view that common deposit insurance would also belong to a consistent overall structure for Banking Union. A safety net provided by common deposit insurance would most benefit small and concentrated banking systems, as in Finland, with strongly correlated banking risks among different actors.

However, migration to common deposit insurance on an equal basis would require significant changes in the regulatory framework and in the balance sheet structures of many banks. Such requirements would include that banking supervision has been brought onto a steady path, with major options and national discretions in the Single Rulebook removed, financial reporting regulations genuinely harmonised and ex ante funding for deposit insurance in participating Member States at the same level. Similarly, changes in the treatment of sovereign exposures on banks' balance sheets should be a prerequisite for common deposit insurance. In connection with common deposit insurance, the lowering of the maximum amount of deposit protection from the current EUR 100,000 should also be considered. Common deposit insurance would additionally need to be supported by a common public backstop.

The working group deems it advisable to agree for Banking Union in advance on the procedures enabling the use of public funds to ensure the adequacy of funding for bank resolution. Given the initial differences in banking sectors, it is logical to have national backstops in place during the transition period. The working group also sees no problems in a process whereby ultimate decisions on the use of public funds in resolution requires a separate political decision at the national level. Even so, conditions should be in place that enable such decisions to be taken rapidly, if required, by delegating the decision-making, e.g. to governments. Any permanent backstop created upon termination of the transition period should be a common arrangement based, for example, on the financing capacity of the ESM or the EU budget via the EFSM.

The working group sees no specific grounds for amending the agreed terms of the direct recapitalisation instrument of the ESM. According to the new Bank Recovery and Resolution Directive, public direct recapitalisation of banks is only a last resort tool in bank resolution, after contributions from the bail-in tool and the Single Resolution Fund. This is reflected in the terms and conditions of the recapitalisation instrument.

In the view of the working group, ambitious objectives, to the extent possible, should be set for the development of Capital Markets Union, and Finland should also be openly disposed towards reforms in taxation and insolvency legislation. Meanwhile, the working group underscores that, if financial intermediation moves from the regulated banking sector to less regulated capital markets, it will be necessary to ensure that the authorities' ability to safeguard financial stability remains adequate.

The working group considers that the powers and tools of macroprudential institutions need to be harmonised and broadened in the countries participating in Economic and Monetary Union. At the same time, it would be useful to agree on information exchange between Member States' macroprudential policies and the macroeconomic imbalance procedure.

Economic and fiscal union

The attitude adopted to the proposals for strengthening the economic and fiscal policies of Member States depends on the choice between the two above mentioned visions of EMU. If stronger centralised governance is opted for, more efficient enforcement should be at the core of the measures taken to improve coordination. However, the basic reasons underlying the problems of enforcement, such as the time inconsistencies of regulatory compliance, are not easily resolved. This would probably require fundamental changes in the relations between the EU and euro area countries, and in political integration.

However, if the aim is to underpin market discipline, the natural way forward is to strengthen national fiscal institutions and simplify and gradually trim the EU level fiscal rules framework. The fiscal framework could be simplified by focusing on a few reference values (notably the debt-to-GDP ratio and the spending limits framework) that would be regulated in national law and monitored by the Commission.

The working group finds it justified to focus attention on structural reforms that foster economic flexibility, innovation and modernisation. Such reforms would increase productivity, while at the same time enhancing the flexibility of economies to respond to external shocks and changes in the operating environment. Structural reforms are best promoted by sharing research findings necessary for the successful implementation of reforms and by seeking best practices. As well as national incentives, peer pressure is another way of encouraging reform. The construction of binding EU rules to promote structural reforms should be avoided, as their effective enforcement is practically impossible.

The working group sees no clear grounds for the establishment of a system of national competitiveness authorities. Such a system would overlap with the monitoring and recommendation procedures already in place, such as national structural reform plans, the Macroeconomic Imbalance Procedure and the Euro Plus Pact. Instead of introducing new schemes, consideration should be given to closer integration of current EU instruments – such as Structural Funds and Cohesion Policy – with structural policy designed to improve the competitiveness of Member States.

The coordination of national differences in labour costs is difficult without interfering in the role of the social partners. This is an area where governments overall have a limited role to play at present. The approaches available to comprehensive examination of employment and growth related issues should be left to national discretion. At EU level, the existing procedures already allow the Commission to review these factors.

The creation of common fiscal institutions for the euro area (European Fiscal Board and Treasury, euro area budget and even limited taxation rights) is equally possible in the vision of EMU based on centralised fiscal and economic governance and in the vision of EMU based on market discipline. However, creation of these institutions would require political consensus on the benefits and merits of the transfer of fiscal competence from Member States to the euro area.

Considering that there is little political realism in a transfer of competence to Union level, the working group finds it questionable whether an advisory European Fiscal Board would produce any added value in addition to the current responsibilities of the Commission and the existing network of fiscal councils. As currently outlined, the tasks of the proposed Board remain unclear.

Under the current division of competence, there are benefits to be gained from a discussion of the harmonisation of the taxes that are key to the operation of the Single Market and Capital Markets Union.

As well as monetary policy measures, fiscal policy measures should be harnessed as a means towards cyclical stabilisation. Efficient implementation of euro area-wide fiscal policy coordination is, however, difficult in the present situation. Instead, it would be important to allow the automatic stabilisers of Member States to operate fully also in conditions of monetary union. One step in this direction could be the substitution of a spending limits framework for the structural deficit criteria. This would strengthen the operation of automatic stabilisers in good times as well as bad.

The working group finds the economic arguments of the potential benefits of an insurance-based stabilisation mechanism between Member States to be valid in principle. Schemes that alleviate the effects of short-lived asymmetric economic shocks should, in fact, not be ruled out in advance from the future toolkit of Economic and Monetary Union. However, insurance-type schemes should not be allowed to result in permanent fiscal transfers and should not undermine Member States' incentives to exercise fiscal discipline.

The working group takes the view that the ESM is a useful instrument for strengthening the shock resilience of the euro area. Potential ESM financial assistance to sovereigns must be confined to the management of liquidity problems. In the case of solvency problems, the solution should be debt restructuring. The role of the ESM as the last resort of funding in crisis will gain importance as the emphasis in crisis resolution for banks and sovereigns moves to bail-in and debt restructuring. ESM financial assistance is accompanied by economic policy conditionalities that curtail the economic policy sovereignty of the beneficiary country. The threat of curtailments in sovereignty also serves to encourage Member States to pursue a fiscal policy that reduces the potential need for assistance.

It is a necessary prerequisite for an EMU based on market discipline that orderly sovereign debt restructuring is possible in the extreme case of default by a Member State. Even if other measures were taken to keep the probability of such a situation to a minimum, it cannot be ruled out completely. In such a case, it would be commendable to provide for a swift restructuring of private debts consistent with predefined procedures, rather than to improvise. In addition to the crisis management benefits gained, awareness of the possibility of a orderly debt restructuring option would enhance market discipline.

The working group finds that financial assistance from the ESM should be made conditional on debt restructuring if the Member State requesting assistance suffers from a solvency problem rather than purely a liquidity problem. Effective implementation of debt restructuring is likely to be best ensured if founded in law and based on a debt restructuring mechanism integrated with the ESM. In the opinion of the working group, a study on the establishment of such a mechanism should be launched as part of the further EMU development initiatives.

Another condition for safe implementation of debt restructuring is ensuring that it will not lead to the collapse of the banking system. Therefore, mitigation of banks' sovereign risks constitutes an integral part of the development of EMU.

Measures strengthening the democratic legitimacy of Economic and Monetary Union should be assigned a prominent role in the development of EMU. In order to ensure sufficient democratic approval of the exercise of economic and fiscal policy by the Union, an EMU based on centralised governance requires more demanding and comprehensive approaches to consolidation of the EU-level democratic mechanisms than an EMU based on market discipline. In the case of both models, a clear division of powers between the Union and Member States and the consistency of powers and responsibilities are essential prerequisites for the legitimacy of the exercise of powers.

MINISTRY OF FINANCE
Snellmaninkatu 1 A
PO BOX 28, 00023 Government
Tel. +358 295 160 01
Fax 09 160 33123
www.financeministry.fi

ISSN 1797-9714 (pdf)
ISBN 978-952-251-733-3 (pdf)

November 2015