Governance of EMU

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Ten years of EMU: a legal perspective

Introduction

- “Europe will not be created at a stroke or emerge fully formed; it will be created by tangible achievements whose first effect is to generate a spirit of solidarity”. Robert Schuman, Paris Conference, 9 May 1950, based on a memorandum prepared by Jean Monnet
- “At midnight tonight, the twelve national currencies of the euro area will cease to be legal tender. (…)[T]he citizens of the euro area have been (…) the key actors in this major step in the history of European integration. The euro area economy will undoubtedly build on this achievement in the months and years to come”. Willem F. Duisenberg, ECB President, Press Release 28 February 2002

Introduction

I thank Antonio Sainz de Vicuña and the Legal Committee of the European Central Bank for inviting me to take part in this important conference:

Happy Birthday!!

- Monetary union is considered to be one of the European Union's greatest **successes**. The celebration of the first ten years of the European Central Bank is a fitting tribute to the emergence and rise of a strong currency, the euro, and to the strength its institutional framework.
  - The euro is now a globally established currency for over 320 million people in sixteen EU Member States (Eurosystem) – the latest Slovakia. As an international reserve currency its use has been steadily growing. By the first half of 2008, 'the euro accounted for 27% of official foreign reserves; the dollar's share fell from 71.2% to 62.5%' (FT 16 Dec 2008). 'In 2006 the total value of euro notes in circulation overtook that of dollar bills' (FT 31 Dec 2008).
- **There are, however, some clouds in the horizon, some inconsistencies or asymmetries in the institutional design, and then, of course, there is the inherent complexity of the ESCB and the multiplicity of actors involved in the governance of EMU.**

Outline of the presentation

- The ECB is an independent institution (article 108 EC Treaty) in the performance of the tasks assigned to it by the Treaty (Article 105). The ECB is also a creature of Community law, which 'falls squarely within the Community framework' (OLAF case). Taking this into account,
- I will first discuss the complexity (multi-layered structure) of the ESCB and the multiplicity of actors concerning the internal and external governance of EMU (understood as Economic and Monetary Union)
- I will then discuss the three asymmetries (or inconsistencies) that complicate the governance of EMU and its institutional structure
  - Monetary policy – fiscal policy
  - Monetary policy – financial supervision (in the context of the pursuit of 'financial stability').
  - Internal and external aspects of monetary stability
- I will finish my presentation with a reference to some clouds in the horizons and current developments, and yet a note of optimism against the present gloom.

Complexity

- The European System of Central Banks is a complex central banking system. This complexity is multi-layered.
  - First, there is the structural complexity, which is a permanent feature of the system. The ESCB is composed of the ECB and the NCBs.
  - Secondly, for a transitional period of unknown duration there is the division between the ‘ins’ (member states whose currency is the euro) and the ‘outs’ (member states not participating in the single currency or ‘member states with a derogation’ according to the language of the Treaty).The NCBs of the ‘ins’ and the ECB constitute the Eurosystem.
  - Thirdly, the NCBs, in turn, are also characterised by a duality. On the one hand they are an integral part of the ESCB (operational arms of the ESCB), when carrying out operations that form part of the tasks of the ESCB. On the other hand, they are also national agencies when performing non-ESCB functions. For these reasons, while the law governing the ECB is solely EC law, the laws governing the status of the NCBs emanate not only from EC sources, but also from their respective national legislation (though such legislation needs to be compatible with Community law before the adoption of the euro).

Multiplicity of actors

- Though the ECB is the main actor in the M of EMU, the governance of EMU (Economic and Monetary Union) is characterized the co-existence of <u>many actors with different roles</u>: Ecofin, European Commission, European Parliament, Economic and Financial Committee (EFC), Eurogroup (and others such as the Economic Policy Committee, EPC) as well as national authorities. The inter-play between these various actors faces additional challenges with the <u>enlargement of the EU and the euro-area</u>.
- There are also multiple fora for cooperation (in particular with regard to the European Financial Architecture) such as the Lamfalussy Committees, the Financial Services Committee and the Joint Task force on crisis management.
- The problems of relying upon multiple actors and the existence of a multi-layered system of representation in the Community with regard to the internal and external governance of EMU matters present a picture of bewildering complexity, that René Smits will be further discussing tomorrow, with the involvement of the President of the European Council, President of the Commission, Ministers of Finance, President of the EU Council, ECB President and the President of the Eurogroup, as well as the fixed and rotating presidencies of the different Council formations.
- Against this multiplicity of actors, some commentators have proposed a <u>unified European treasury and economic department</u> for the E of EMU (President Sarkozy has argued that the euro needs two parents…). Need for a centre for economic decision.

A note on Ecofin, the Commision and the European Parliament in the context of the governance of EMU

- The Council of Ministers in the configuration of the Ministers of Economy and Finance (The Ecofin Council), the Commission (in particular the Commissioner for Economic and Monetary Affairs, but also the DGs in charge of internal market and competition) and the European Parliament and the Council of Ministers are the European **institutions** with which the European Central Bank must keep a <u>constant dialogue</u> with regard to the governance of EMU.
- By analogy with the relationship at the national level between an independent central bank and the executive and legislative branches of the government, the independent ECB also needs to <u>**co-ordinate**</u> its policies with those holding legislative and executive power at the EU level. As well, the institutional <u>**accountability**</u> of the ECB to Ecofin and to the European Parliament (as well as to the European Court of Justice) is a fundamental element that cannot be ignored.
- The Commission guarantees that the strategic orientation of the EU proceeds through a steady course through the various presidencies (eg the processes launched under the French Presidency continue through the Czech Presidency).

Ecofin

- The Economic and Financial Affairs Council is one of the oldest configurations of the Council. It meets once a month. It is commonly known as the Ecofin Council, or simply "Ecofin" and is composed of the Economics and Finance Ministers of the Member States. In the conclusions of the Luxembourg European Council of December 1997, it was explicitly stated that the **ECOFIN Council was 'the center for the coordination of the Member States' economic policies**'.
- Under Article 113(2) of the EC Treaty, the ECB President is invited to participate in meetings of the Ecofin Council whenever matters related to the objectives and tasks of the ESCB are discussed.
- Ecofin covers EU policy in a number of areas including: economic policy coordination, economic surveillance, monitoring of Member States' budgetary policy and public finances, the euro, financial markets and capital movements and economic relations with third countries. It decides mainly by qualified majority, in consultation or co-decision with the European Parliament, with the exception of fiscal matters which are decided by unanimity.
- When the Ecofin Council examines dossiers related to the euro and EMU, the representatives of the Member States whose currency is not the euro do not take part in the vote of the Council .
- The Commissioner for Economic and Monetary Affairs attends the meetings of Ecofin as well as of the Eurogroup and of the ECB's Governing Council.

A note on EFC

- According to Article 114(2) of the EC Treaty, on 1 January 1999, the Economic and Financial Committee (EFC) replaced the Monetary Committee.
- The EFC prepares the ECOFIN Council's meetings, drafts opinions for the ECOFIN council and for the Commission and keeps the economic and financial situation of EU Member States under review. The EFC's secretariat comes under the Commission's Directorate General for Economic and Financial Affairs (DG ECFIN).
- Since 2003, the meetings of 'full EFC' review the economic situation, issues of financial stability and questions concerning the IMF. There are also smaller 'restricted EFC' meetings. The EFC also meets in a specific format, the Financial Stability Table twice a year. The composition in this format is that of a 'full EFC', enlarged to presidents of Committee specialized in the supervision of the financial sector, etc.
- The EFC has set up specialised working groups or sub-committees, including:
  - The EFC Committee on IMF related questions (SCIMF)
  - The Eurogroup working group, which prepares meetings of the Eurogroup, etc.
- **Though the Economic and Financial Committee remains the main source of advice for the EU Council and the Commission on financial affairs**, the Ecofin council established the Financial Services Committee or FSC in a decision of 18 February 2003, to focus on financial regulatory issues and to co-ordinate the work of the Lamfalussy Committees. The level three Committees report to the FSC with regard to supervisory convergence. The FSC reports to the EU Economic and Financial Committee (EFC) in order to prepare advice to the Council (ECOFIN). The Committee on Economic and Monetary Affairs (EMAC) of the European Parliament also plays a relevant role in issues of EU financial supervision.

A note on the Eurogroup

- The Eurogroup was established as an **informal body** in the Luxembourg European Council of December 1997, **to bring together the financial ministers of the countries adopting the euro and the Commissioner for Economic and Financial Affairs**. Since 2005 it has been chaired by a President which is elected for two years. The ECB is invited to participate in the meetings of the Eurogroup 'when appropriate'. The Eurogroup is not a decision-making body. The Council (Ecofin) takes the decisions, but in certain matters only the euro area members participate in the vote.
- The Eurogroup, meets normally before the Ecofin meeting and deals with issues relating to the Economic and Monetary Union (EMU). It is an informal body that is not a configuration of the Council. It can thus be described as an informal "economic government" of the euro area, meant to enhance the dialogue and to develop closer co-ordination of economic policies within the euro area.
- The Eurogroup finds formal recognition in the Treaty of Lisbon. It was also formally recognised in the proposed EU Constitutional Treaty (Article III-195) and in the Protocol on the Euro Group as an informal meeting of the ministers of finance of the Member States whose currency is the euro together with the Commission to discuss 'questions related to the specific responsibilities they share with regard to the single currency'.
- Need for a permanent structure. During France's six-month EU Presidency, Nicholas Sarkozy highlighted the need for a "unified economic government" of the Eurogroup, calling for more regular coordination meetings at head of state and government level, such as the extraordinary Eurogroup meeting held in Paris on Sunday 12 October 2008 (to which PM Gordon Brown was invited).

The three asymmetries (sources of tension) in the governance of EMU

- First inconsistency or asymmetry: monetary policy is centralised (exclusive competence) while fiscal policy is decentralised
- Second inconsistency or asymmetry: monetary policy is centralised while financial supervision is decentralised. The clarity that surrounds the legal framework concerning the price stability mandate contrasts with the lack of clarity concerning the pursuit of financial stability.
- Third asymmetry: the internal and external dimensions of monetary stability

Monetary policy – fiscal policy

- The advent of monetary union took place without a corresponding transfer of fiscal powers to a supra-national authority. Jean-Victor Louis has talked today about the E and the M of EMU. The M is the strong part of EMU; the E is the weak part of EMU (Lamfalussy, *The Guardian*, 16 August 2003).
  - Remember Article 105.1 of the EC Treaty: the secondary objective, the support of the **general economic policies in the Community,** is to be pursued without prejudice to the primary objective, ie price stability (influence of Article 12 of the Bundesbank Law, which was referred to by K.Stern as the 'squaring of the circle')
- The term economic union is indeed a bit of a misnomer. In much of Europe today (ie, in the euro-zone) there is one currency, one monetary policy and one central bank. The reality of 'oneness' is conveyed by the term of monetary union. Economic union is, in fact, **economic policy co-ordination**, since Member States – participating or not in monetary union – are still in charge of their fiscal policies (subject to Community rules) and retain other important national prerogatives with regard to their economic policies.
- This is particularly relevant with regard to the fiscal costs of banking crises. In the absence of an ex-ante formula/agreement, the *ex-post* allocation of the fiscal burden of the fiscal costs of recapitalising a pan-European financial institution remains a most controversial issue. The problem at the EU level is that the ECB has no European fiscal counter-part, which means that the relevant fiscal authorities are by definition at the national level.

Monetary stability – internal and external dimension

- The ESCB is entrusted by the EC Treaty with sole responsibility for monetary policy, which is an exclusive Community competence (albeit geographically limited to the Member States that have adopted the euro). Despite the indissoluble link that exists between a single monetary policy (geared towards internal price stability) and external monetary relationships, in the euro area the responsibility for the latter is divided between the Council and the European Central Bank (shared competence) under a notoriously unclear set of Treaty provisions (Article 111).
  - Monetary policy *lato sensu* refers to both interest rate policy and exchange rate policy.
  - Monetary policy *stricto sensu* refers to interest rate policy (Article 111 and 105.2 EC Treaty).
- While the voice of the ECB with regard to monetary policy is a 'single voice', the Council represents many voices, the views of all the Member States. This adds an extra layer of complexity to the conduct of exchange rate policy in Europe.

Who is ‘Mr Euro’?

- As a result of the sharing of competences between the Council and the ECB in the field of exchange rate policy, the answer to this question is not clear. Some argue that a single external voice for the euro is needed both to defend its value on international exchange markets and to influence decisions on a wide range of international macroeconomic policy issues, (normally in the G7 or the IMF) such as international policy coordination on fiscal, monetary and exchange rate policy, the construction of a new international financial architecture and the management of international financial crises.
- Some have spoken of the President of the Eurogroup as Mr Euro, while this denomination has also been appropriated in some occasions by the President of the ECB. My friend and colleague René Smits, who will be talking about the international representation of EMU tomorrow, stated in 2005: ‘The Eurogroup president may strive to call himself “Mr Euro” - an epithet that only comes naturally for the ECB President in view of the central competences for the management of the euro with which the central bank is entrusted, certainly in the absence of formal exchange-rate agreements or formal orientations from the Council’.
- Under the EC Treaty, both the ECB and the Council speak for the euro. The former is a single voice, the latter represents the voices of all member states.

Who is Mr Euro?

- According to Chiara Zilioli and Martin Selmayr, ‘One may even observe a certain competition between the Community institutions, the Member States, the European Central Bank and some national central banks to assume the role of “spokesman” for the euro area. The danger involved in such a competition is that a situation could arise which is only too familiar from the field of the common foreign and security policy: a situation in which our American counterparts would still be asking whom they should call in Europe’.
- The ECB President, Jean-Claude Trichet was quoted in *Financial Times,* 17 September 2004, saying: As far as the currency is concerned, I am evidently Mr Euro’. At an ECB Press Conference on 4 March 2004 (www.ecb.int/pressconf/2004) Mr Trichet received the following question: ‘The European Central Bank is supposed to be the key spokesman for the euro, but over the last few weeks there has been a lot of noise from finance ministers and Heads of State. [Chancellor] Schröder was in Washington and talked to [President] Bush about the euro – does this bother you in any way as Mr Euro?’ And this was his answer: ‘We have a system which is very clear. The Governing Council of the European Central Bank takes a number of decisions. The President of the ECB is the “porte parole” or spokesperson of the institution, which has the unique and extraordinary responsibility of having to run a monetary policy, a single monetary policy, for 306 million citizens belong to 12 different economies and countries. On the side of the executive branches we have an organisation called the “Eurogroup”, which is the college of the 12 ministers of finance of these countries, the members of the euro area, and we have a president of the euro area, which is currently Charlie McCreevy, the Irish finance minister, and we also have the Commission, of course. So the equivalent of the executive branch is the combination of the President of the Eurogroup and the role of Pedro Solbes and the Commission. We have an organised system, and when we were together in the United States for the Boca Raton meeting, I was, if you like, the equivalent of Alan Greenspan and Charlie McCreevy was opposite [Treasury] Secretary Snow. That’s the organisation of Europe, and I believe that it is a good organization.’

IMF membership and obligations (I)

- A major problem in the external governance of EMU stems from the international obligations of EU Member States, in particular those arising from IMF membership.
- Under the Fund's Articles of Agreement (Article II, section 2), only 'countries' are allowed for membership. Member States that have adopted the euro remain individual members of the IMF, despite the fact that the area of jurisdiction of the euro is clearly supra-national. The membership of the Community/Union (or of the ECB) would need an amendment of the Articles. The euro area as such is not able to appoint a Governor or elect Executive Directors in the IMF, even though in December 1998, the ECB was granted observer status at selected Executive Board meetings.
- The national/supra-national dichotomy presents a challenge for the Member States of the euro area.

IMF membership and obligations (II)

- The differentiated integration with regard to monetary policy and exchange rate policy, the asymmetries between monetary and fiscal policy, and between monetary policy and financial supervision further complicate the obligations of IMF membership for EU Member States as well as the governance of EMU.
  - Implications for IMF surveillance. Regular consultations with members continue to be held with individual countries. However, an Article IV consultation with a member cannot be completed without the Fund having had an opportunity to assess monetary and exchange rate policies. Therefore, discussions with representatives of the relevant EU institutions are needed as part of the Article IV consultations with individual euro-area countries. These discussions, and consideration by the IMF's Executive Board of the monetary and exchange rate policies of the euro area are, as a practical matter, held separately from those with individual euro-area countries, but are considered an integral part of the Article IV process for each member.
  - Implications for the SDR. Prior to EMU, the SDR basket included the currencies of the five IMF members with the largest exports of goods and services (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). Since the advent of EMU, the euro has replaced the currency amounts of the deutsche mark and the French franc in the SDR valuation basket.
  - Implications for the Holding and Management of Foreign Reserves (a basic ESCB task according to Article 105.2 EC Treaty). As part of their membership responsibilities, Member States hold reserve positions with the IMF (Article 31 ESCB Statute). However, the discretion that a Member State of the euro-area retains in managing its foreign reserve assets is limited: part of the assets have been transferred to the ECB (Article 30 ESCB Statute), and transactions above certain limits involving foreign assets that are retained by a country are subject to ECB approval. Article 30.5 states, 'The ECB may hold and manage IMF reserve positions and SDRs and provide for the pooling of such assets'.

Monetary policy and prudential supervision

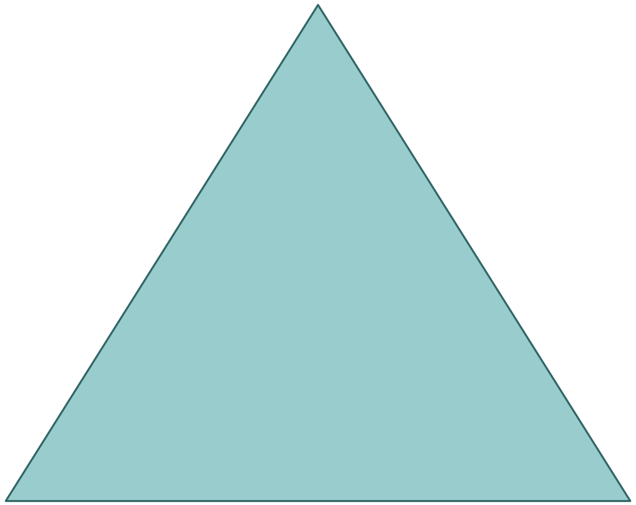
- The abandonment of the coincidence between the area of jurisdiction of monetary policy and the area of jurisdiction of banking supervision is a major novelty brought about by the advent of EMU, as Tommasso Padoa-Schioppa has pointed out. Since the launch of the euro in January 1999, the European Central Bank is in charge of the monetary policy of the countries which have adopted the single currency, while responsibility for supervision remains decentralised. This change has coincided with the transfer of supervision away from the central bank in some countries, like the UK, with the creation of a single regulator.
- Monetary policy and banking supervision – MP is transmitted through the financial system. Perhaps we have gone too far in separating MP and BS?
- The sense of 'permanence' and 'irrevocability' that is associated with monetary union is absent in financial supervision.
- <u>There is an inevitable tension in the current EU institutional structure</u>, that affects the governance of EMU : a national mandate in prudential supervision, combined with a single European currency and a European mandate in the completion of the single market in financial services
- This tension has been evidenced in the current financial crisis, leading to calls for reform, with a number of proposals currently being considered in different fora (including the committee chaired by De Larossiere) : granting a supervisory role to the ECB (via Article 105.6 of the EC Treaty), creating a European System of Financial Supervisors, enhancing and upgrading the Lamfalussy Committees, in short creating a EU wide supervisory body.

‘Trilemma in financial supervision’

- One of the main economic arguments in favour of European Monetary Union was the need to solve the ‘inconsistent quartet’ of policy objectives: free trade, full capital mobility, pegged (or fixed) exchange rates and independent national monetary policies. The only long-term solution to this inconsistency was to complement the internal market with monetary union, thus abandoning national control over domestic monetary policies.
- With regard to financial supervision, it is difficult to achieve simultaneously a single financial market and financial stability while preserving a high degree of nationally based supervision (Thygesen), as evidenced with the crisis. Schoenmaker refers to these inconsistent objectives as the ‘trilemma in financial supervision’:
  - <u>a stable financial system,</u>
  - <u>an integrated financial market, and</u>
  - <u>national financial supervision.</u>

The trilemma of financial supervision

Stable financial system



Integrated financial market

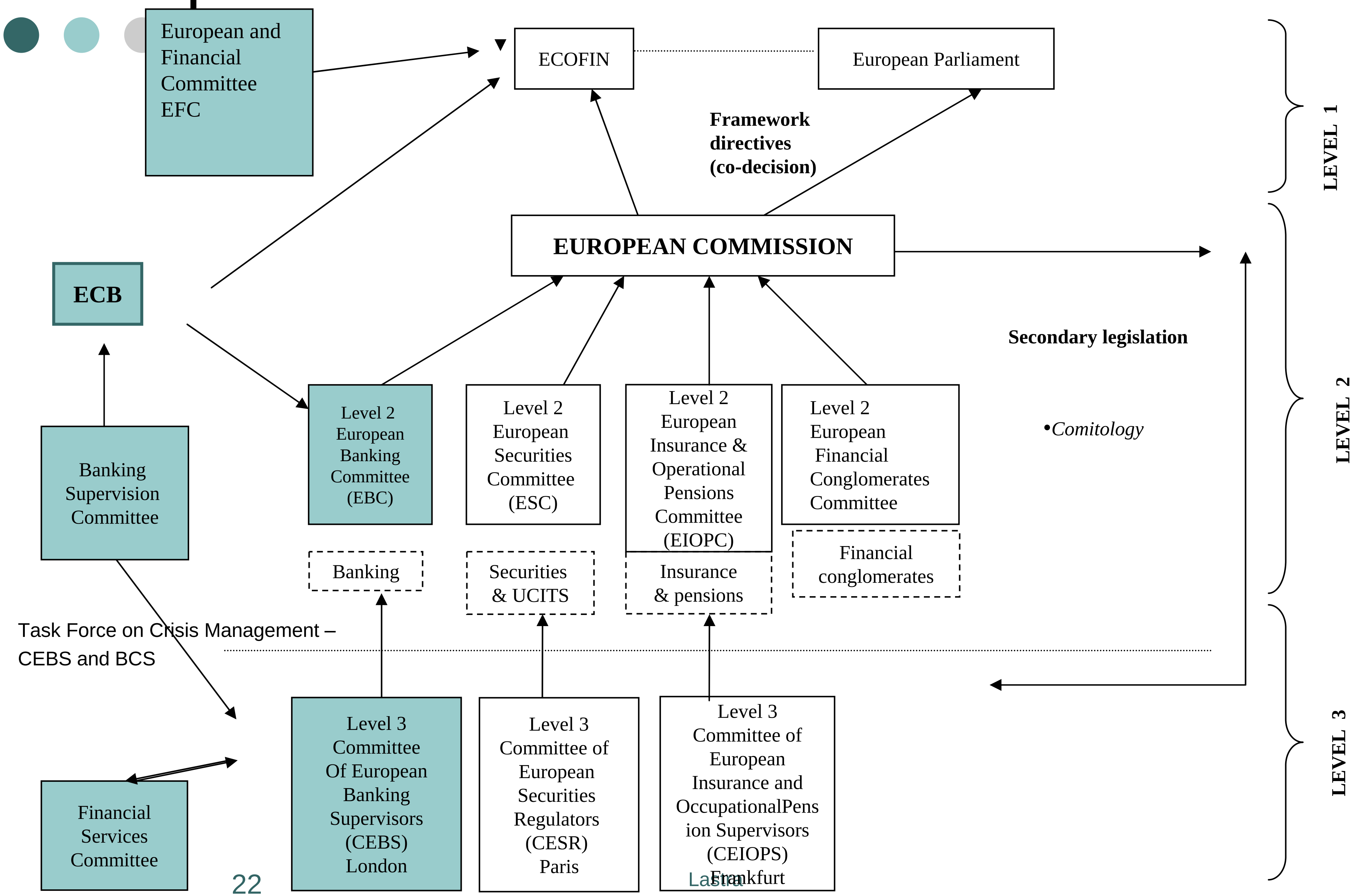
National financial supervision

Monetary stability and financial stability

- Twin mandate of central banks: monetary stability and financial stability. Central banks are best positioned to do monetary stability and 'macro-prudential' supervision. The crisis has shown the importance of financial stability. Reform in the UK and the US.
- The transfer of supervision away from the central bank (or the lack of supervisory responsibilites) effectively deprives the central bank of a major instrument to deal with financial stability (leaving it only with a LOLR).
- The main organizational challenge is to establish close and continuous communication and flow of information between the central bank and the supervisory agencies, especially in times of crises.
  - 'There is a dangerous asymmetry between, on the one hand, the integrated financial markets, and on the other, the fragmented national jurisdictions and supervisory authorities with domestic mandates', George Zavvos.

European financial architecture

Current design



European Financial Architecture – possible future design?

- Analogy FAs and UEFA – two sets of rules
- ECB in charge of LOLR and supervision of major pan-European systemically important financial institutions (Article 105.6 EC Treaty∗) with an ex-ante arrangement for fiscal burden sharing. This requires a rethinking of rules on deposit insurance and insolvency proceedings (liquidation and winding up).
- National Central Banks and/or national supervisory authorities in charge of supervision of national financial institutions (micro-prudential supervision) working - together with national fiscal authorities - under a European System of Financial Supervisors, structurally similar to the ESCB (Dirk Schoenmaker has proposed such a system).
  - Most recent ‘convert’: Howard Davies (FT January 13, 2009), *Europe’s Banks need a Federal Fix*

∗Reference to insurance undertakings is obsolete

Clouds in the horizons and other developments

- The crisis and the lack of European-wide uniform response.
- Compliance with state aid and fiscal rules?
- Are the banks too big to rescue? (Martin Wolf, FT 23 Jan 2009) – Icelandic banks but others too.
- Widening of bond yields between Germany, and countries like Spain or Greece (which have been recent downgraded by Standard & Poor's)
- Nationalism, 'financial isolationism' and protectionism
- President Obama (20 January 2009): 'The crisis has reminded us that without a watchful eye the market can spin out of control'.

Yet, it is important to point out the **rise in popularity of the euro** for Hungary, Denmark and even a non EU member: Iceland (the problems of small countries with their own currencies and a banking system that is too large to be bailed out by national authorities….(Buiter and Sibert, 2008). As Lorenzo Bini-Smaghi pointed out: it is better to be in a large ship than in a small vessel.

Even in the UK the debate has re-opened… *Why the British may decide to love the Euro (FT, 17 Nov 2008, by Wolfang Munchau).*

Concluding observation

- The structural and functional duality of the ESCB, its organizational complexity, the multiplicity of actors in an enlarged EU/euro-area, the mix of centralised and decentralised responsibilities, and the novelty of a truly ‘independent institution’ within the Community’s institutional structure make the governance of EMU a complex matter.
- However, the Cassandras of EMU have been proven wrong so far: though complex, the institutional foundations of monetary union, the euro and the ECB, are truly a success story for the EU. And on this positive note, I would like to say thank-you again and happy 10th birthday ECB!

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