2. Response by the authorities: actions and institutions

The European authorities continued their efforts to deal with the financial tensions in the euro area and to remedy the institutional failings and macroeconomic imbalances. The Eurosystem extended its non-standard measures for safeguarding the transmission and singleness of monetary policy by granting very long-term liquidity and announcing that Outright Monetary Transactions would be conducted if necessary, subject to stringent conditions. In a context of economic weakness and receding inflationary pressures, it cut its key interest rates in July. In parallel with the establishment of the permanent stability mechanism, the implementation of the adjustment programmes for Greece, Ireland and Portugal continued, and a new programme was set up for the recapitalisation of the Spanish banking sector. In addition, the economic governance of the EU and of the euro area was strengthened in regard to both fiscal policies and macroeconomic imbalances. Finally, the EU Heads of State or Government laid the foundations for the completion of EMU, providing in particular for the creation of a genuine banking union. In these circumstances, it was decided to establish a single supervisory mechanism comprising the ECB and the competent national authorities. It will become operational during 2014.

2.1 Eurosystem monetary policy

Weakening of financial tensions and economic stabilisation at the beginning of the year

Against the backdrop of acute tensions in various segments of the euro area financial markets, the ECB Governing Council had approved a major package of new enhanced credit support measures at its meeting on 8 December 2011. They were intended among other things to alleviate the consequences of financial market fragmentation for private sector financing conditions, and to ensure that the key interest rate cuts in November and December 2011 were effectively transmitted to the real economy.

First, the Governing Council had announced that it would conduct two three-year longer-term liquidity providing operations. Second, it had extended the range of assets eligible as collateral for Eurosystem loans by lowering the minimum rating required for certain asset-backed securities (ABS), and by authorising national central banks to accept temporarily as collateral certain credit claims which met specific eligibility criteria. Third, it had reduced the reserve requirement ratio from 2 to 1 % with effect from the reserve maintenance period beginning on 18 January 2012. Finally, it had agreed to suspend the fine-tuning operations hitherto conducted on the last day of each reserve maintenance period.

The two three-year longer-term operations aimed to guarantee banks access to stable longer-term financing, so that they would not suddenly reduce their leverage on account of funding difficulties. While such a reduction is in itself desirable since it restores conditions conducive to the soundness of the banking sector, a hasty debt reduction process – which generally involves fire sales of assets or credit restrictions – is liable to be detrimental to the financial markets and to damage the economy as a whole. The extension of the list of eligible collateral for Eurosystem lending was intended to facilitate access to those loans for the banks. Finally, the reduction in the reserve requirements alleviated the banks' consolidated

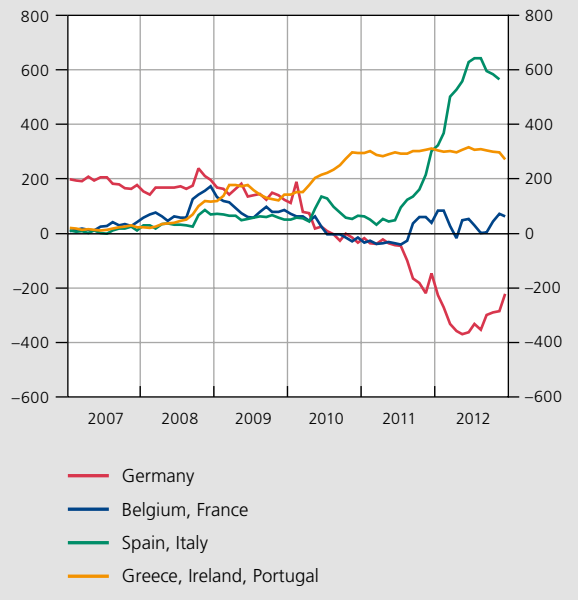
liquidity needs by around € 100 billion. It should be noted that the reserve requirements are no longer necessary as a tool for stabilising short-term money market rates in a situation characterised by a global liquidity surplus. This has proved to be the case since the introduction, on 15 October 2008, of fixed-rate tender procedures with full allotment of the bids.

The two three-year refinancing operations were undeniably the most important measure. The tenders took place on 21 December 2011 and 29 February 2012 respectively, in the form of fixed-rate tenders for an unlimited amount, the interest rate being equal to the average rate on the main refinancing operations over their life. These two operations also offered an option of early repayment after one year, in order to give banks ample flexibility and facilitate the management of their liabilities. The Eurosystem allotted € 489 billion in the first operation and € 530 billion in the second. Since these operations partly substituted for others which were reaching maturity, the net injection of liquidity amounted to € 210 and € 311 billion respectively. These relatively high figures show that the banks considered the terms attractive in comparison with those prevailing on the money market or the bond market. The December operation attracted 523 institutions, while 800 took part in the one in February. Among these were many small banks which generally play a key role in lending to SMEs. This was therefore seen as a positive outcome, owing to the heavy dependence of SMEs on bank financing and their importance for the euro area economies, where they account for almost three-quarters of private sector employment.

Financing considerations greatly influenced the banks' bidding, as the amounts borrowed covered most of their funding needs for the next three years. Owing to the increasing segmentation of financial markets along national borders, it was mainly banks based in the countries regarded as more financially fragile that encountered funding problems or feared that they might do so. On the balance sheets of the national central banks (NCBs) of the countries concerned, the cross-border outflows of liquidity which accompanied these problems led to a decline in the assets held by commercial banks and, subsequently, to an increase in liabilities under the TARGET2 payment system. As they faced a private funding drought, the commercial banks then turned to their respective national banks for refinancing. Thus, the liquidity supplied by the Spanish and Italian central banks expanded considerably via the three-year operations, while the Greek, Portuguese and Irish central banks had already had to cater for increased demand for refinancing from the banking sector at an earlier stage in the crisis.

CHART 19 NET BORRROWING [1] BY BANKING SECTORS FROM NATIONAL CENTRAL BANKS

(outstanding amounts, monthly data in € billion)



Source : NCBs.

(1) Difference between amounts lent by the NCBs to the resident banking sector and amounts deposited by resident banking sectors with the NCB.

Conversely, commercial banks in the countries perceived as financially sound recorded a cross-border inflow of liquidity, reflected in the TARGET2 claims which the national central banks of those countries record on their balance sheets. That inflow enabled the resident commercial banks to reduce their recourse to central bank refinancing, and some central banks – such as the Deutsche Bundesbank – even found that counterparties placed more liquidity with them than they were lending to the banking sector.

This situation illustrates the increased intermediation role played by the Eurosystem during the crisis – the banks using the Eurosystem to obtain refinancing or to place their liquidity surplus, rather than lending to one another – with the corollary of the expansion of its balance sheet [1].

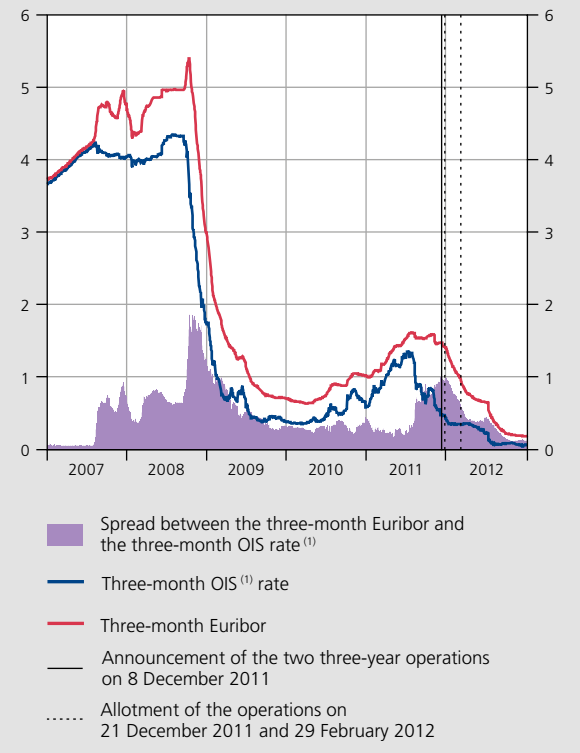
Implementation of the measures passed in December 2011 and, in particular, the provision of abundant liquidity via the three-year operations, had a calming effect on many market segments. On the money market, risk premiums fell sharply. After having reached 100 basis

(1) For more details, see Boeckx, J. (2012), "What is the role played by the Eurosystem during the financial crisis?", NBB, *Economic Review*, September, 7-29.

points at the beginning of December 2011, a level comparable to that prevailing early in 2009 at the onset of the crisis, the spread between the three-month Euribor and the three-month OIS interest rate shrank to around 40 basis points at the beginning of April 2012. In addition, the three-month Euribor became much less volatile, even though activity on the interbank market remained very limited. On the one hand, the three-year liquidity-providing operations had substantially reduced the banks' refinancing needs, while on the other hand the ongoing balance sheet adjustment processes, the concern over counterparty credit risk and, in the context of abundant excess liquidity, the low opportunity cost of using the Eurosystem's deposit facility continued to depress the volume of trading. On the bond market, the improvement in sentiment led to a fall in the risk premiums which banks in the euro area had to pay, and a cautious revival in their medium- and long-term issuing activity.

The easing of the banks' funding conditions also benefited the markets in sovereign bonds, where yields declined sharply and spreads in relation to the German Bund narrowed on the whole, particularly for maturities of less than three years. These developments generally result from the various interconnections between the financial sector and the public sector. More specifically, they are also due to the use by the banks – particularly those in Italy and Spain – of liquidity borrowed via the three-year operations to fund the purchase of sovereign bonds of their respective countries. While this last development helped to reduce the financing costs of those countries, it also strengthened the links between sovereign risks and banking risks, and therefore made the banks in those countries more vulnerable to a liquidity or solvency crisis concerning domestic public finances.

CHART 20 THREE-MONTH INTEREST RATES
(daily data)



Sources: ECB, Thomson Reuters Datastream.
(1) The fixed rate paid by the counterparty of an interest rate swap contract receiving the overnight interest rate (Eonia) for a period of three months.

The favourable impact of the three-year liquidity-providing operations on banks' funding conditions was also evident in the results of the euro area bank lending survey. In the first quarter of 2012, the banks reported a marked improvement in their access to wholesale financing, especially in regard to the money market and the bond market. Moreover, there was considerable attenuation of the tightening of credit standards which banks applied to both non-financial corporations and households, the main factor being a reduction in balance sheet constraints.

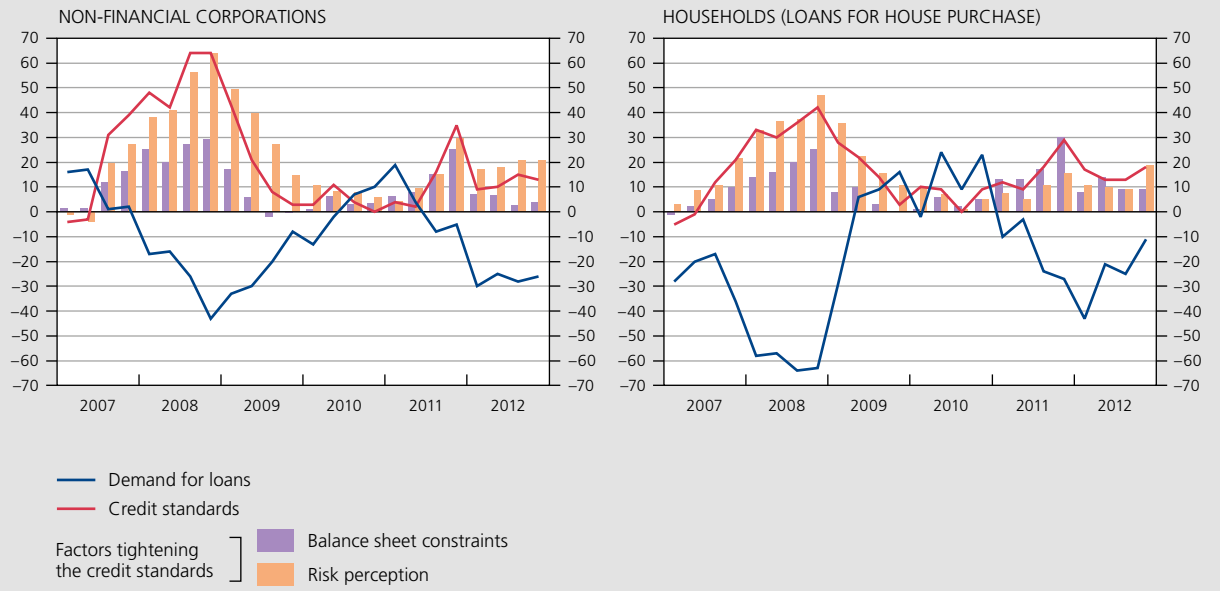
While the reduction in financing costs and balance sheet constraints helped to avoid a sharp contraction in lending to the non-financial private sector, this lending nevertheless maintained the downward trend which had begun in mid-2011. Bank lending to households and non-financial corporations was still inhibited, in particular, by a continuing high risk perception and by the sluggishness of demand, reflecting the anaemic economic activity and the ongoing process of balance sheet adjustment in the non-financial sector.

Another effect of the three-year refinancing operations was to swell the liquidity surplus in the euro area banking system by an unprecedented amount. While that surplus had expanded strongly in the second half of 2011 to reach around € 300 billion just before the first three-year operation, it exceeded € 800 billion immediately after the second operation at the beginning of March 2012. In that context, the overnight interbank market rate Eonia hovered at very low levels, close to the deposit facility rate.

The liquidity surplus is equivalent to the difference between the outstanding amount of transactions leading to an expansion of liquidity – namely the refinancing operations, the purchases of securities for monetary policy purposes and the use of the marginal lending facility – and the sum of the outstanding amount of liquidity-absorbing transactions and the consolidated liquidity need of the

CHART 21 EUROSYSTEM BANK LENDING SURVEY IN THE EURO AREA [1]

(quarterly data)



Source: ECB.

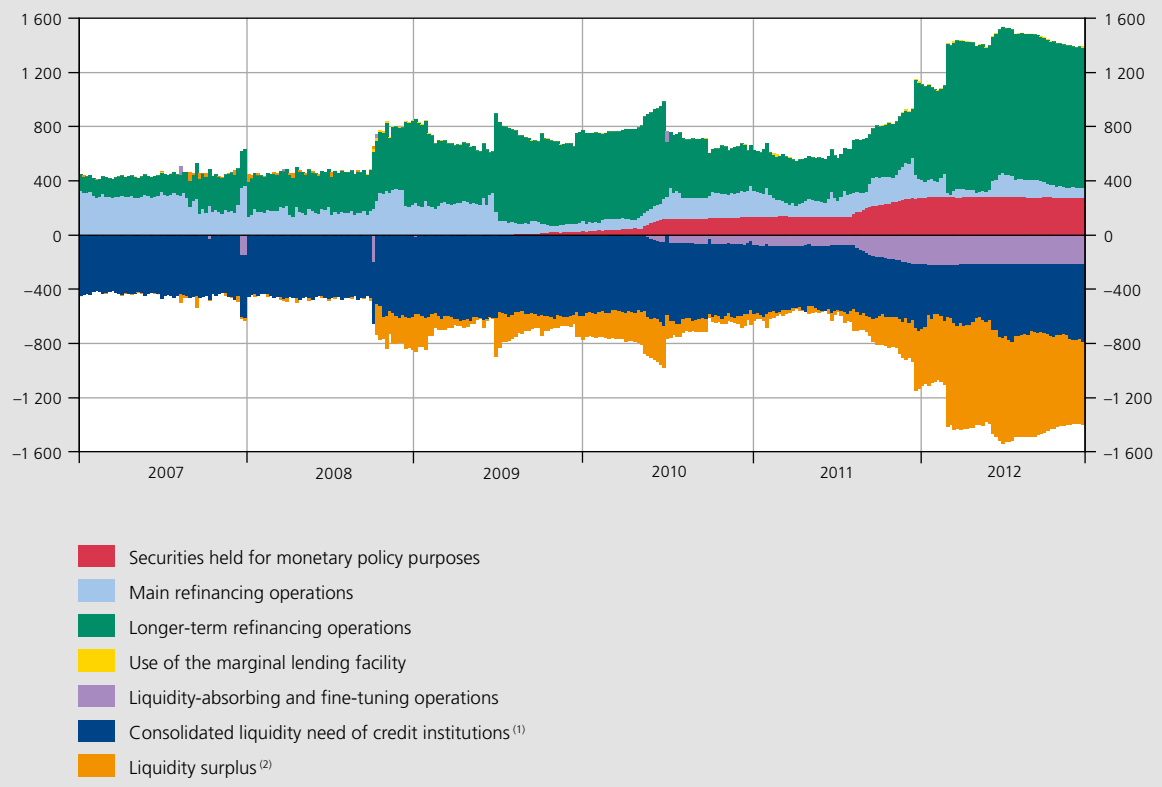
(1) Net percentages of replies from banks to the Eurosystem's bank lending survey indicating the degree of tightening (+) or easing (–) of credit standards and the movement in demand for loans.

banking system on the basis of autonomous factors and the reserve requirements. It corresponds to the sum of the amounts placed in the deposit facility and on current accounts in excess of the reserve requirements. An increase in the liquidity surplus expands the monetary base, but in reality it is almost the automatic corollary to the massive expansion in liquidity provided by the Eurosystem. It testifies to the greater intermediation role played by the Eurosystem within the euro area banking system, but says nothing about how the banks use the borrowed funds. As explained in more detail in box 2, an expansion of the monetary base does not directly threaten price stability.

In parallel with the easing of financial tensions at the beginning of 2012, signs that economic activity was stabilising, albeit at a weak level, gradually emerged. Although the outlook was still subject to downside risks in a persistently uncertain environment, real GDP growth was expected to gradually pick up during the year. Inflation measured by the HICP, after having reached 3 % in October-November 2011, gradually subsided. At that point, the expectation was that annual inflation rates would fall below 2 % from the beginning of 2013, while the monetary analysis did not reveal any medium-term inflationary pressure. In that context, the ECB Governing Council considered that the level of the key interest rates remained appropriate, following the two cuts of 25 basis points each, in November and December 2011 respectively, and therefore held the central key rate at 1 %.

CHART 22 LIQUIDITY IN THE EUROSYSTEM

(outstanding amounts, weekly data in € billion)



Source : ECB.

(1) Liquidity need due to "autonomous factors" such as demand for banknotes and reserve requirements.

(2) The liquidity surplus is equivalent to the difference between the outstanding amount of transactions leading to an expansion of liquidity – namely the refinancing operations, purchases of securities for monetary policy purposes and the use of the marginal lending facility – and the sum of the outstanding amount of liquidity-absorbing operations and the consolidated liquidity need of the banking system. It corresponds to the sum of the amounts placed in the deposit facility and on current accounts in excess of the reserve requirements.

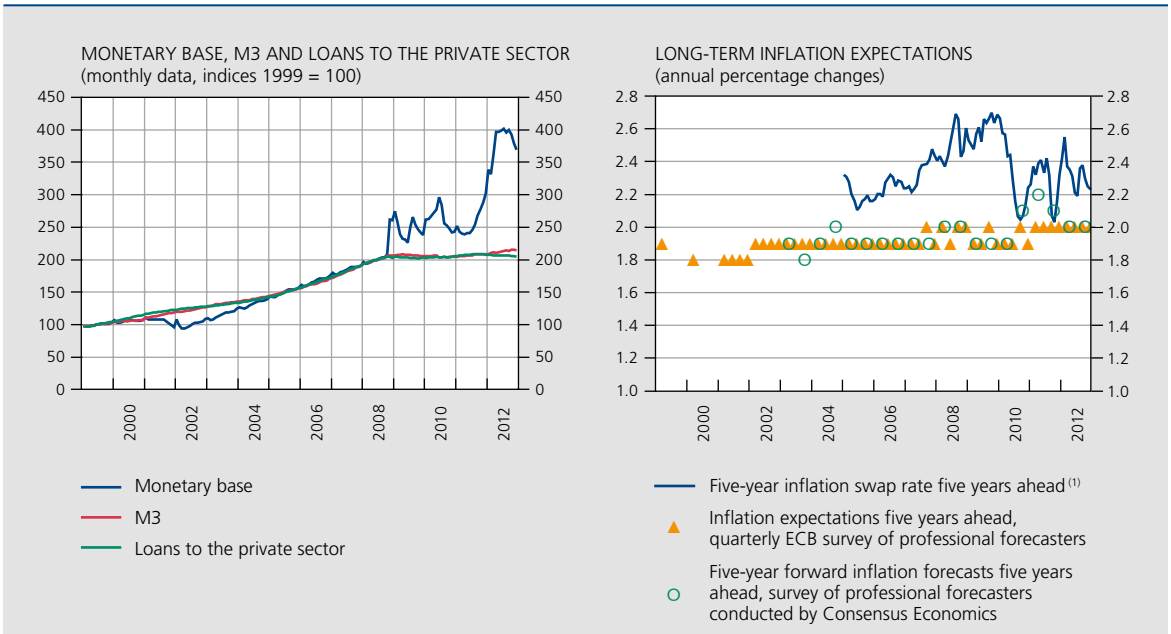
Box 2 – Does the strong growth of the Eurosystem balance sheet represent a threat to price stability ?

The level of the monetary base, which corresponds to money in its most liquid form – i.e. money that can only be created by the central bank and therefore comprises banknotes in circulation and reserves that banks hold with the central bank, either on their current account or on the deposit facility – has risen considerably in the euro area since the eruption of the economic and financial crisis. That is due to the intermediation role that the Eurosystem has had to play on the interbank markets. On the one hand, solvent banks facing liquidity problems can obtain refinancing from the Eurosystem on attractive terms against appropriate collateral. On the other hand, stronger banks can place their liquidity surplus with a secure counterparty, the central bank. The Eurosystem's lending to the banks therefore exceeded the consolidated liquidity need of the banking sector, creating a – currently very large – liquidity surplus on the money market, which took the form of recourse to the deposit facility and amounts held on current account in excess of the reserve requirements.

When the tensions on the sovereign bond markets grew worse – with repercussions on the financing conditions of the resident banking sectors of the countries concerned – this intermediation role increased further, notably following the decision to allow banks to turn to the central bank for refinancing, in December 2011 and February 2012, for a three-year term and at an attractive rate.

The associated expansion of the monetary base may raise questions about the risk of excessive lending or a derailment of inflation. Although a close correlation has been evident in the past between movements in the monetary base, lending and the broad money supply M3, the first variable is nevertheless not a major determinant of the latter two. In fact, the Eurosystem systematically ensures that banks have the liquidity they need. Previously, it used to match its provision of liquidity to the consolidated liquidity need of the banking sector and since 15 October 2008, following the malfunctioning of the interbank market, it has met all requests for liquidity from individual banks at a fixed interest rate. In this way, commercial bank lending is not constrained by the availability of central bank reserves.

MONETARY BASE, M3, LOANS TO THE PRIVATE SECTOR AND LONG-TERM INFLATION EXPECTATIONS IN THE EURO AREA



Sources: Thomson Reuters Datastream, Bloomberg and own calculations.
(1) Implicit inflation rate derived from swaps covering the inflation risk in the euro area, for a period of five years beginning five years after the conclusion of the contract.

In reality, individual banks weigh up the risks and returns when deciding to lend to the real economy. For a commercial bank, the liquidity surplus that it holds with the central bank is a secure and highly liquid asset, compared to loans to the real economy, but it yields a penalising interest rate since it is always remunerated at less than the market rate. However, during the crisis, the banks preferred this asset to alternative use of their liquidity offering higher remuneration but entailing a risk. Lending and the money supply in the broad sense therefore remained flat while the monetary base expanded considerably. Yet this does not necessarily imply that the measures taken by the ECB Governing Council did not have a positive influence on lending. In fact, negative

supply factors would probably have depressed lending even further if the banks facing a liquidity shortage had been unable to turn to the central bank for refinancing.

As the expansion of the monetary base did not speed up the expansion of lending, a fact which is also attributable to the relatively weak demand for loans in a sluggish growth environment, there seems little risk at present of inflation becoming derailed. The generally moderate pace of inflation, and particularly underlying inflation, bears that out. Moreover, long-term inflation expectations have always remained at levels compatible with price stability. That is true not only for the forecasts derived from surveys of professional forecasters, but also for those based on financial products such as inflation swaps. Although the latter are close to their historical average, the risk premiums which they include could blur the signal relating to true inflation expectations, especially in a context of financial turbulence. These readings must therefore be interpreted with caution.

However, vigilance is required to ensure that the expansion of the central bank balance sheet does not lead to a derailment of inflation or a weaker anchoring of inflation expectations. Even if financial stability considerations mean that the Eurosystem must continue to play a major intermediation role – which is reflected in a voluminous central bank balance sheet – the Governing Council still has the means for tightening the monetary policy stance should upside risks to price stability emerge. A first option for the Eurosystem would then be to offer term deposits or to issue debt instruments, generally better remunerated than the deposit facility. These tools could absorb a substantial part of the liquidity surplus, currently depressing the overnight interest rate. During the year under review, that rate in fact stood at levels close to the amount paid on the deposit facility. Another option would be to modify the interest rate corridor, e.g. by increasing it or by raising only the remuneration on the deposit facility. In that case, the overnight rate would also rise.

If this increase in the overnight rate were to be reflected – albeit only partially – in the rates offered to retail customers, that would curb demand for loans from households and businesses. In regard to the credit supply, the increase in remuneration of assets held with the central bank – be it in the form of term deposits, debt instruments or use of the deposit facility – tends to reduce the opportunity cost of holding surplus liquidity with the central bank. These two effects may moderate lending and hence inflation. These mechanisms should therefore enable the Eurosystem to continue to guarantee price stability in the medium term, despite a large balance sheet.

Resurgence of financial tensions against the backdrop of deteriorating economic prospects

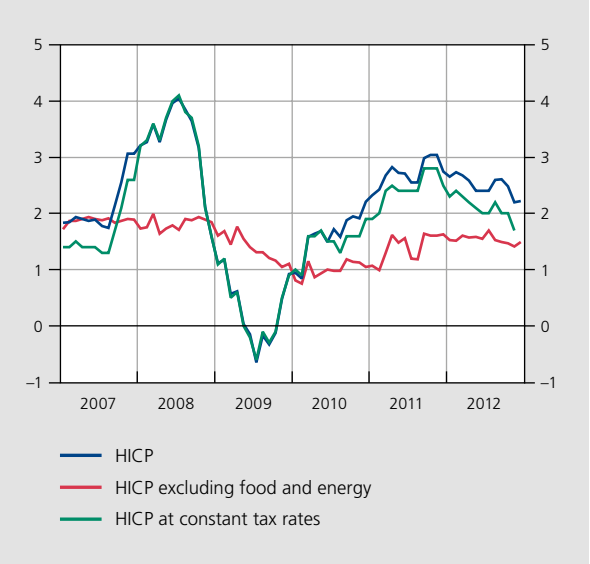
The relative optimism which had prevailed in the euro area in the initial months of the year under review nevertheless began to evaporate in the early spring, both on the financial markets and in regard to economic activity.

Following zero GDP growth in the first quarter, the signs of an economic slowdown proliferated from May onwards, and in an environment of mounting uncertainty the economic prospects were steadily revised downwards. Inflation continued to fall, dropping to 2.4 % between May and July despite the upward pressure from high energy prices and increases in indirect taxation in some countries. In the context of weak growth and firmly anchored inflation expectations, the inflationary pressures over the horizon relevant for monetary policy had eased.

In line with contained inflationary pressures, the monetary dynamics remained moderate. As is evident from the results of the Eurosystem's bank lending survey, credit standards were constantly tightened, essentially reflecting the high risk perception, while balance sheet constraints diminished somewhat. Furthermore, the gloomy outlook for GDP and the ongoing process of balance sheet adjustment continued to weigh on a constantly shrinking demand for loans, on the part of both households and firms. Although the general situation in the euro area still masked significant disparities between countries, the annual growth rate of lending to the non-financial private sector therefore declined further, driven down by a marked contraction of lending to non-financial corporations. The growth of the monetary aggregate M3 gathered pace slightly to 3.9 % in October, against 2 % in January. The divergence between the movement in M3 and that in lending to the private sector is due largely to

CHART 23 INFLATION IN THE EURO AREA

(percentage changes compared to the corresponding period of the previous year; monthly data)



Sources: EC, ECB.

an increase in claims by euro area banks on governments, but also to a general preference for more liquid assets in an uncertain economic environment with low interest rates. That preference led to a fall in longer-term financial liabilities, and was also reflected in the movement in the components of M3. The annual growth of the narrow aggregate M1 accelerated considerably from May onwards, propelled by a shift from short-term deposits included in M2-M1 to overnight deposits. Conversely, after having pursued an upward trend until July, the change in marketable instruments, likewise included in M3, became negative following a sharp fall in holdings of short-term debt securities issued by MFIs and repurchase agreements.

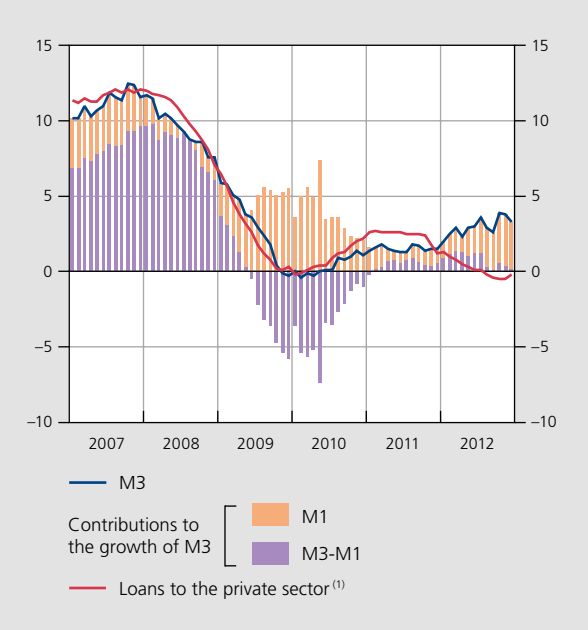
In June and July, in a context of further heightening of tensions on the sovereign debt markets, deteriorating economic prospects and moderate inflationary pressures, the ECB Governing Council adopted a number of new standard and non-standard monetary policy measures aimed at supporting both bank funding and economic growth.

On 6 June, the Governing Council thus announced that it would continue to conduct its refinancing operations in the form of fixed-rate tender procedures with full allotment for as long as necessary, and at least until 15 January 2013. For the main refinancing operations and the special-term refinancing operations with a maturity of one maintenance period – or about one month – the rate applied would always be the central key rate prevailing at the time of the allotment. For longer-term operations it would correspond, as previously, to the average rate on the main refinancing operations over the life of the operation concerned. On 20 June, in order to further improve the access of the banking sector to the Eurosystem's liquidity-providing operations, the Governing Council decided to extend once again the list of eligible collateral for the Eurosystem refinancing operations by lowering the rating threshold and amending the eligibility criteria of certain types of ABS.

On 5 July, the Governing Council opted to relax its monetary policy stance further by a 25 basis point cut in its key interest rates. In so doing, it considered that the worsening outlook for economic growth and the mounting uncertainty would restrain inflationary pressures and that, under these conditions, a reduction in the key interest rates was justified in order to fulfil its mandate of maintaining price stability in the medium term. That decision took the key interest rates to historically low levels of 0.75 % for the central key rate, 0 % for the deposit facility rate and 1.5 % for the marginal lending facility rate. On the money market, it triggered a fall in the Eonia

CHART 24 M3 AND LOANS TO THE PRIVATE SECTOR IN THE EURO AREA

(percentage changes compared to the corresponding month of the previous year unless otherwise stated, seasonally adjusted data)

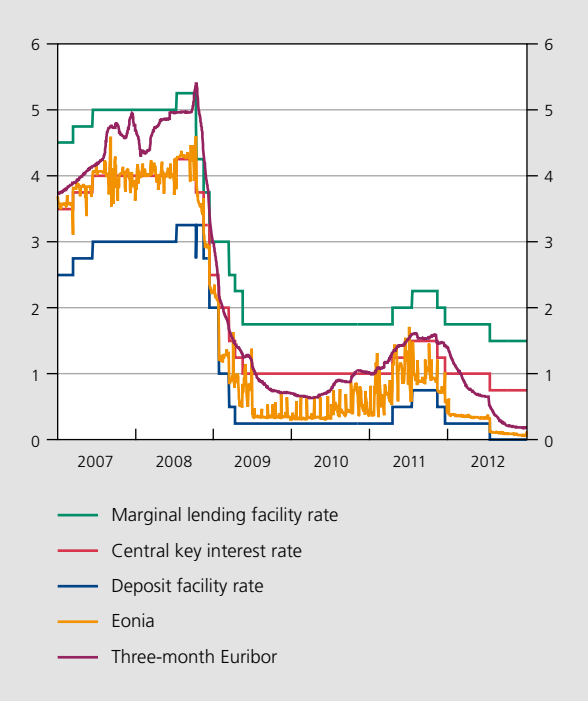


Source: ECB.

(1) Households, non-financial corporations, insurance companies, pension funds or occupational pension institutions and other non-monetary financial intermediaries. Data adjusted for securitisation.

CHART 25 KEY INTEREST RATES AND MONEY MARKET RATES IN THE EURO AREA

(daily data)



Sources: Thomson Reuters Datastream, ECB.

overnight rate which declined steadily to less than 10 basis points, a yield close to that on the deposit facility, in the context of a still large liquidity surplus. The cut in the remuneration on the deposit facility, reduced to the same level as that on amounts held on current account in excess of the reserve requirements (which are not remunerated), also removed the financial incentive for banks to transfer their excess liquidity to the deposit facility. Consequently, the sums placed in that facility declined considerably, while at the same time the sums held on current account increased. However, following the interest rate cut, there was no fundamental change in the liquidity surplus. During the autumn, it nevertheless contracted somewhat following the announcement of new non-standard monetary policy measures, namely the Outright Monetary Transactions (OMT).

Serious disruption on the sovereign bond market and Outright Monetary Transactions

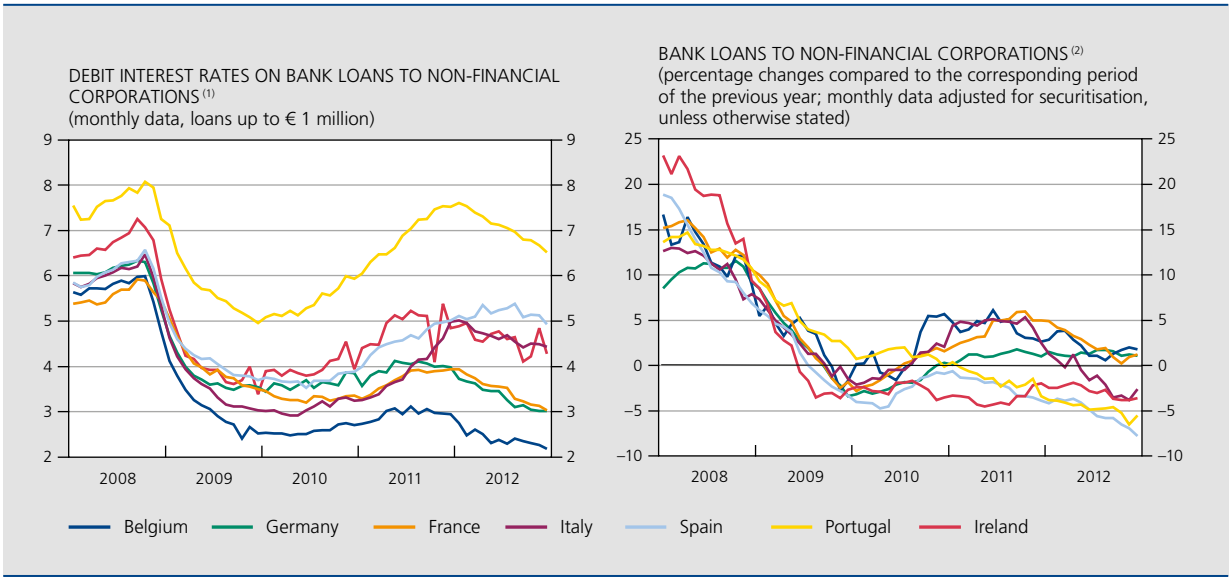
Despite the progress made at the summit of Heads of State or Government on 28 and 29 June with a view to extricating the euro area from the crisis, the borrowing costs of the Spanish State and, to a lesser extent, the Italian State rocketed in July, reaching levels which could not be justified by the economic fundamentals of those countries. Driven by the growing fears of investors regarding a possible reversibility of the euro – caused by a country leaving the euro area – short-term bond yields soared, resulting in a flattening of the yield curve. These unprecedented tensions considerably increased the fragmentation of euro area financial markets along national borders. They therefore placed a further heavy burden on financing conditions for a number of national banking sectors and were reflected in the credit standards and commercial banks' interest rates offered to the private sector. Thus, the cut in the key interest rates decided in July in response to the weakness of economic activity was not passed on uniformly in all euro area countries. In some of them it was reflected directly in the rates offered to households and businesses, whereas in others the rates which banks charged did not really change, or they even increased.

These developments threatened to drag the economies of several countries into a negative spiral and generate a situation of systemic instability, with risks to medium-term price stability in the euro area. In that context, and to prevent serious distortions in sovereign financing costs from hampering the functioning of the credit markets in the euro area to the point where they jeopardised the transmission and singleness of its monetary policy, the Governing Council announced at its meeting on 2 August that it might conduct outright open market operations. The rules governing these purchases on the sovereign debt market – in the meantime referred to as Outright Monetary Transactions (OMTs) – were drawn up on 6 September.

The OMTs were designed to be fully compatible with European law and, in particular, with the prohibition of monetary financing set out in Article 123 of the Treaty on the Functioning of the EU. In particular, this article prohibits the purchase of public debt instruments on the primary market. In that context, it was therefore specified that the OMTs would be conducted exclusively on the secondary market, subject to strict conditions, and only if they are warranted from a monetary policy perspective and to the extent deemed necessary to ensure medium-term price stability. The modalities governing the OMTs were also defined so as to guarantee their effectiveness.

First, the OMTs are subject to strict conditionality in order to maintain the incentives for governments to implement the essential adjustments to strengthen competitiveness and to progress towards a sustainable fiscal path. This means that such transactions can only be initiated after activation by a Member State of an EFSF or ESM programme

CHART 26 BANK FINANCING OF NON-FINANCIAL CORPORATIONS IN THE EURO AREA



Sources: ECB, NBB.
(1) Rates offered on new loans, taking all maturities together.
(2) All maturities together, data not adjusted for securitisation before February 2010. The data relating to Italy are not adjusted for securitisation.

accompanied by strict and effective conditionality, providing for the possibility of EFSF or ESM primary market purchases of securities. However, the Governing Council will retain full discretion over the decision to conduct the transactions, a decision to be based solely on monetary policy considerations. The transactions will be suspended during the programme assessment period, and will be terminated in the event of non-compliance with the programme or once the transactions have achieved their objectives. Second, the OMTs are intended for future cases of adjustment programmes, although they can also be considered for countries already under a programme, provided those countries regain bond market access. Third, the OMTs focus on the short part of the yield curve, and in particular on sovereign bonds with a residual maturity of between one and three years. This aspect emphasises that these are transactions in the monetary policy domain and that they essentially aim to depress the reversibility premiums which mainly emerge over that horizon. Fourth, there are no *ex-ante* quantitative limits, which indicates the Eurosystem's commitment to do everything possible within the confines of its mandate to safeguard the euro's future and its soundness. Fifth, in regard to bonds which the Eurosystem purchases under the OMTs, it will accept the same treatment as private or other creditors. The sixth and final point is that the liquidity generated by these transactions will be fully sterilised so as not to affect the aggregate level of liquidity in the banking system. In a desire for great transparency, it is also planned to publish the total OMT holdings, their average duration, their market value and the breakdown by country.

After having decided the OMT arrangements, the Governing Council terminated the Securities Markets Programme (SMP) which had been adopted in May 2010 following the first severe tensions caused by the sovereign debt crisis. The SMP's specific aim was, via purchases of public debt securities on the secondary market, to restore the smooth functioning of the market segments subject to malfunction in the context of the crisis, and thus to safeguard the proper transmission of the monetary policy signal. Although the SMP did support the transmission of monetary policy, it did not offer any incentives for governments to adjust their economic policies and, despite its scale, it did not succeed in permanently stabilising the situation on the sovereign debt markets. Moreover, the SMP had some counter-productive effects, owing to its temporary nature, its lack of transparency and the perception that the Eurosystem had preferential status with regard to the securities purchased.

Waning financial tensions, sluggish economic activity and contained inflationary pressures at the end of the year

Even without having been activated, the OMTs have brought a fundamental change in the market mood. Just

the announcement of possible potentially unlimited purchases of sovereign bonds did much to ease the financial tensions, especially on the public debt markets of the countries giving rise to the greatest concern, such as Italy and above all, Spain. In those countries, the announcement also led to a reduction in the bank interest rates offered to the private sector and, more generally, restored the confidence of foreign investors who had fled the euro area en masse during the summer. Finally, the announcement of the OMTs seems to have acted as a catalyst for the gradual reduction of recourse to Eurosystem liquidity since the beginning of September.

In that context, the Governing Council decided to leave the ECB key interest rates unchanged, despite the successive downward revisions of the growth forecasts in September and December. It considered that the accommodative stance of ECB monetary policy, backed by the improvement in market confidence resulting from the adoption of the OMTs, would support economic activity and that, in an environment featuring still moderate monetary expansion, inflation should remain compatible with medium-term price stability. At its meeting on 6 September, in order to guarantee the banks' access to liquidity and to continue fostering an appropriate transmission of monetary policy, the Governing Council agreed to suspend the application of the minimum credit rating threshold for certain securities issued or guaranteed by the central government of programme countries and of those eligible for the OMTs, and to accept as collateral debt instruments denominated in US dollar, pound sterling or Japanese yen provided they were issued and held in the euro area. In reality, this last decision reintroduced a measure which had applied between October 2008 and December 2010. In addition, at its 6 December meeting, the Governing Council decided to continue conducting the fixed-rate tender procedures with full allotment for as long as necessary and at least until 9 July 2013 for all its operations, on the same terms as those already in force. Finally, on 13 December, the Governing Council announced its decision to extend until 1 February 2014 the existing liquidity swap lines between the ECB and the Federal Reserve, the Bank of Japan, the Bank of England, the Swiss National Bank and the Bank of Canada. It also announced that, until further notice, it would continue to provide liquidity in dollars through operations with a duration of between 7 and 84 days.

Overall, the monetary policy decisions of 2012 played a crucial role in supporting the credit markets and the real economy in the euro area. During the year under review, the Governing Council constantly reaffirmed its determination to preserve the singleness of monetary policy and thus ensure the effective transmission of that policy in all the euro area countries. However, it systematically repeated that it was acting strictly in accordance with its mandate to maintain price stability in the medium term, and that its monetary policy decisions were taken totally independently. The measures taken, and particularly the OMTs, are intended to help solve the problems affecting the monetary policy transmission mechanism and restore confidence, but the problems are due essentially to the conduct of inappropriate economic policies in a number of countries. In these circumstances, and confronted by the obvious limits of monetary policy, the Governing Council repeatedly called for the resilience of the banks to be strengthened. It also asked the euro area authorities to persevere resolutely with the fiscal consolidation and structural reforms aimed at strengthening competitiveness, the economy's adjustment capacity, and growth. Finally, it also called for the completion of EMU.

2.2 Actions of the European authorities

Already in the first half of 2010, the European authorities and the IMF had adopted a series of measures to halt the sovereign debt crisis that was spreading across the euro area. At first, the crisis was largely regarded as a problem concerning public finances that was confined to certain Member States, particularly Greece. However, it soon became obvious that there was a need to establish powerful emergency financing mechanisms to prevent contagion between Member States.

At the same time, it also rapidly became apparent that the coordination of economic policy within the EU needed thorough reform, as the existing framework was proving incapable of providing a satisfactory response to the growing divergence within the euro area. The primary objectives of the major reform of economic governance launched in 2010 are the strengthening of fiscal discipline and the early identification and, if necessary, correction of other macroeconomic imbalances. The aim is to avoid any further disruption of the economy of certain Member States, which could again threaten the stability of the euro area as a whole.

On these two fronts, the reinforcement and implementation of the measures adopted earlier continued in 2012. They took the form of decisions on the programmes of certain countries in difficulty and the application of the new macroeconomic surveillance framework. In addition, to further strengthen the stability of the euro area, the Heads of State or Government of the euro area decided in mid-2012 that it was imperative to break the vicious circle of contagion between banks and sovereigns.

Establishment of the permanent stability mechanism

In response to the increasing mistrust of the financial markets regarding the sustainability of the Greek public debt, Greece had already been granted bilateral emergency financing of € 110 billion for a three-year period in May 2010, of which € 30 billion was borne by the IMF.

To avoid contagion between Member States, it had also been agreed to set up the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), with financing resources totalling € 500 billion. These mechanisms, established for a three-year period, aimed to grant conditional financial assistance to countries having difficulties in raising finance. The IMF was closely involved, contributing € 250 billion and helping to design the loan conditions and monitor the rescue plans. These mechanisms offer financial assistance to Member States suffering severe financing problems, thus safeguarding the financial stability of the euro area as a whole. However, this assistance is only temporary and is only granted subject to appropriate, strict conditions. It gives the Member State in distress the time needed to consolidate its public finances and implement the structural reforms aimed at restoring competitiveness and laying the foundations for sustainable growth, thus eliminating the macroeconomic imbalances which were the underlying cause of its financing problems.

At the end of October 2010, the European Council considered that it was necessary to establish a permanent mechanism to safeguard the financial stability of the euro area as a whole. Originally, this new device, the European Stability Mechanism (ESM), was to take over the role of the EFSF and the EFSM from July 2013, but in December 2011 the euro area Heads of State or Government decided to bring forward the date for its entry into force. A revised version of the Treaty establishing the ESM was signed by the euro area Member States on 2 February 2012. However, the ratification process was delayed, notably because appeals were lodged with the German Constitutional Court, which did not give the go-ahead until September. After the Treaty had been ratified by all the euro area Member States, the ESM was inaugurated on 8 October 2012.

The ESM has capital of € 700 billion provided by the euro area Member States, comprising € 80 billion in paid-in capital and € 620 billion in callable capital. The ESM can thus offer effective financing capacity of € 500 billion. In March 2012, the ceiling for the joint lending capacity of the ESM and the EFSF was raised to € 700 billion. That figure covers the almost € 200 billion lent by the EFSF – which remains active for the existing programmes for Ireland, Portugal and Greece – and the € 500 billion corresponding to the new financing capacity of the ESM.

The activities of the ESM will be the same as those of the EFSF. Subject to strict conditions, it can provide stability support for its members beset by serious financing difficulties. It can also grant precautionary financial assistance. The government bonds of ESM members subject to a macroeconomic adjustment programme or a precautionary programme can be purchased on the primary market.

TABLE 3 INSTITUTIONAL STRUCTURE OF THE EUROPEAN STABILITY INSTRUMENTS

	European Stability Mechanism (ESM)	European Financial Stability Facility (EFSF)
Legal structure	International financial institution under international law	Private company under Luxembourg law
Duration	Permanent	Temporary
Capital structure	Authorised capital of € 700 billion comprising paid-in capital of € 80 billion and callable capital of € 620 billion	Supported by guarantees of euro area Member States amounting to a maximum of € 780 billion
Contribution to capital against guarantee system	Application for or receipt of financial assistance does not affect the obligation to contribute to the paid-in capital	Member States can "step out" of the guarantee system when they apply for financial assistance
Maximum lending capacity	€ 500 billion	€ 440 billion
Creditors' rights	Preferred creditor status[1]; only junior to IMF	On an equal footing with other creditors *(pari passu)*

Source: ESM.
(1) However, the Eurogroup decided not to grant preferred creditor status in respect of the transfer to the ESM of the assistance to Spain for the recapitalisation of the banks.

Moreover, the ESM can intervene on the secondary market in its members' government bonds. Finally, financial assistance may be granted in the form of loans to the government of an ESM member for the specific purpose of recapitalising its financial institutions. On 29 June 2012, wishing to break the vicious circle between banks and the public sector, the Heads of State or Government of the euro area declared that, when a single supervisory mechanism has been created for the euro area banks, the ESM could have the possibility to recapitalise banks directly, instead of via the government. However, that possibility would be subject to appropriate conditions. The European Councils in October and December 2012 instructed the Eurogroup to draw up the operational framework, including the definition of legacy assets, which will guide the direct recapitalisation of the banks. That framework will in practice define the scope within which the ESM will be able to fund the recapitalisation of the banks.

Moreover, from 1 March 2013, the financial assistance granted under new programmes will be subject to ratification of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union by the Member State concerned, and its transposition into national law by the stated deadline.

The ESM will therefore grant conditional financial assistance largely on the same lines as the EFSF. Nonetheless, as shown in the table above, there are some essential differences between the two mechanisms in terms of the institutional structure.

Follow-up of the Greek, Irish and Portuguese economic adjustment programmes and the recapitalisation programme for the Spanish banking sector

Greece

The concern about the sustainability of Greece's public finances which had triggered the sovereign debt crisis in the euro area continued to fuel turbulence on the financial markets. During the course of 2011, it became increasingly obvious that Greece would not be able to return to the financial markets for its long-term financing as early as 2012, as expected in the first adjustment programme, so that speculation about a possible restructuring of the Greek public debt intensified. That was the context in which the Heads of State or Government of the euro area had already taken certain decisions, in July and October 2011, on a second assistance programme, while the financial sector had stated that it was prepared to set up a voluntary exchange of Greek sovereign debt bonds.

In February 2012, in accordance with those decisions, the Eurogroup concluded an agreement with Greece on the measures which form the basis of its second economic adjustment programme, the purpose of which was to cut the Greek public debt to 120.5 % of GDP by 2020, a level regarded as sustainable. Greece also concluded an agreement with the private sector concerning a voluntary bond exchange (private sector involvement – PSI). Since these measures were insufficient to achieve the said public debt target, the Eurogroup decided to grant additional official support, among other things via a further retroactive cut in the interest rate on the bilateral emergency financing granted in May 2010. As for the voluntary bond exchange by the private sector, the 95.7 % participation rate was sufficient for the exchange to go ahead. The face value of the Greek public debt held by the private sector was devalued by 53.5 %. This haircut entailed the exchange of the existing debt against new government bonds – with a maturity of 30 years and coupons of 2 to 4.3 % – with a face value of 31.5 % of the existing debt, and against securities issued by the EFSF – with a maturity of maximum two years – amounting to 15 % of the existing debt. In addition, there was compensation for unpaid accrued interest, and the private creditors also acquired debt securities linked to Greek GDP.

Next, on 14 March, the Eurogroup approved the financing of Greece's second economic adjustment programme. The financial assistance runs until 2014 and comes to a total of around € 164 billion. This figure includes the contribution of € 30 billion by the EFSF to facilitate the PSI operation, and new emergency financing of € 100 billion, which had already been agreed in October 2011, plus the undisbursed amounts under the bilateral emergency financing of May 2010 which was discontinued at the start of the second programme. Out of this total, € 144.7 billion will be granted by the EFSF and the rest by the IMF. This last contribution comes under the arrangement under the Extended Fund Facility, concluded with the IMF in March 2012, which covers a four-year period and amounts to a total of € 28 billion. Of this funding, € 75.6 billion was allocated under the first tranche, from March to June 2012, € 74 billion of which came from the EFSF.

In mid-October 2012, the Troika – i.e. the team of experts from the EC, the ECB and the IMF responsible for monitoring the programme – completed its assessment of the progress made as a result of the economic adjustment programme. That analysis confirmed that the adjustment programme had to be revised in view of the deeper than expected recession in Greece and the delays accumulated in implementing the programme. More particularly, it had become evident that the planned budget path and the target of cutting the public debt to around 120 % of

GDP in 2020 were no longer realistic. Greece asked for a two-year postponement of the deadline for achieving its budget targets. In order to improve the sustainability of its public debt, Greece would buy back government bonds which it had issued. If this operation were successful, the euro area Member States would be prepared to consider a number of additional initiatives with the same goal.

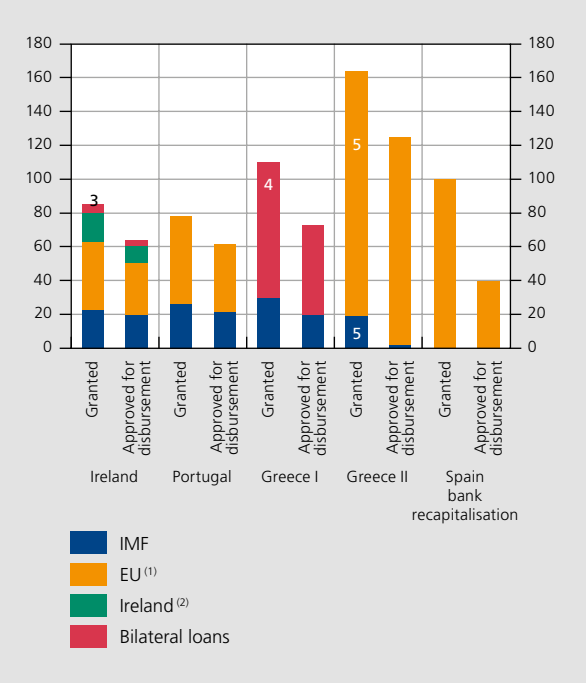
At the beginning of December, Greece therefore launched a buy back operation relating to its government securities, reducing its public debt by around € 21 billion. On 4 December the Ecofin Council decided to grant Greece an additional two years to enable it to correct its excessive public deficit: this means that Greece has until 2016 instead of 2014 to cut the deficit below 3 % of GDP. On 13 December the Eurogroup approved the disbursement of the second instalment, amounting to € 49.1 billion, of the emergency financing granted by the EFSF, a large part of which was intended to cover the recapitalisation of the banks and the cost of their resolution. Full implementation of the revised adjustment programme, the debt buy back operation and the initiatives of the euro area Member States should ensure that the Greek public debt does not exceed 124 % of GDP in 2020.

Ireland

After the Irish government had formally requested international assistance, an aid package running until 2013 was approved in December 2010 for a total of € 85 billion. It included in particular the use of internal funding sources amounting to € 17.5 billion, partly in the form of a loan financed by the Irish National Pension Reserve Fund, and international aid worth € 67.5 billion. The recapitalisation and restructuring of the Irish banking sector are key elements of the economic adjustment programme. Successive assessments of the adjustment programme linked to the financial support indicated that it was being resolutely implemented, achieving significant progress in fiscal consolidation and banking sector restructuring, as well as structural reforms to promote growth. The successive funding tranches were paid out so that, at the end of the third quarter of 2012, around € 55 billion, or 81.5 % of the total international support of € 67.5 billion, had been allocated. The confidence of the financial markets began rising again. Thus, in mid-2011, the yield on the Irish public debt on the secondary market had begun to fall, and the decline continued in 2012. In addition, during the summer of 2012, the Irish debt management agency was again able to raise finance on the markets, albeit to a limited extent, first by issuing Treasury bills, and then longer-term debt instruments.

CHART 27 FINANCIAL ASSISTANCE IN THE EURO AREA

(situation at the end of 2012, € billion)



Sources: EC, EFSF, ESM, IMF.

(1) EFSM, EFSF and ESM. The financial assistance for Spain was transferred from the EFSF to the ESM.

(2) Treasury and National Pension Reserve Fund.

(3) Bilateral loans from the United Kingdom, Denmark and Sweden.

(4) Bilateral loans from euro area countries.

(5) Including undisbursed amounts under Greece I.

Portugal

In May 2011, the IMF and the EU had granted Portugal financial assistance amounting to € 78 billion up to mid-2014. According to the reviews of its implementation, the adjustment programme is on track and the reforms have been generally carried out as agreed. Portugal has made clear progress in correcting its macroeconomic imbalances, especially in external adjustment. However, this faster-than-expected rebalancing of the Portuguese economy favouring economic activity geared more towards exports has put additional pressure on public finances, and that pressure was felt to be beyond the Portuguese government's control. It was considered that the one-year postponement to 2014 of the deadline for bringing the public deficit back below 3 % of GDP would enable the government to adopt new structural fiscal measures while alleviating the short-term economic and social costs of restoring sound public finances. At the beginning of October 2012, it was therefore decided to revise the budget targets set in the financial assistance agreement for Portugal: the public deficit could be 5 %

of GDP, rather than 4.5 %, in 2012 and 4.5 % of GDP instead of 3 % in 2013. However, in 2014, the deficit must not exceed 2.5 % of GDP. At the end of 2012, € 61.5 billion, or just under 79 %, of the financial assistance totalling € 78 billion had already been disbursed. After having peaked at the end of January 2012, the yield on the ten-year government debt declined gradually throughout the year.

Spain

During 2012, Spain too ended up resorting to external financial assistance. However, this aid which is intended strictly to support the process of recapitalising and restructuring Spanish financial institutions, was very different from that granted to the countries mentioned above. Originally, the bubble that had developed on the Spanish property and construction market up to 2008 had been fuelled and encouraged by rapid expansion of banking sector lending. After that bubble had burst and the economic recession had set in, many Spanish banks recorded large stocks of problematic property-related assets on their balance sheet, raising doubts over the adequacy of their capitalisation, especially in the case of the savings banks (*cajas*), and making it increasingly difficult for them to raise finance on the markets. In response to the growing fragility of banks' balance sheets, the Spanish authorities had intervened already in 2009, establishing a programme of reforms to recapitalise and restructure the banking sector. Despite this initiative, the government had to step in again in May 2012, partially nationalising Bankia by taking on 45 % of its capital; this sparked a loss of confidence in other banking institutions and, more generally, doubts about the viability of the sector as a whole. Apart from these concerns, public finances also gave rise to much anxiety from the end of 2011, following serious budget slippages in that year and the delayed adoption of the 2012 budget at the end of March, although the latter did introduce an ambitious package of reforms concerning fiscal consolidation. In a climate of mixed messages from the Spanish and European authorities and episodes of political uncertainty, the markets steadily lost confidence in Spain's ability to keep a grip on its public finances. In July, the Ecofin Council did actually grant an extra year for correcting the excessive deficit.

This context generated adverse mutual interactions between the various fears concerning the stability of the financial sector, the viability of public finances and the deteriorating cyclical conditions, as testified by the surge in interest rates on Spanish government debt securities from March 2012. Although Spain still had access to the markets, its financing costs had nevertheless reached record levels, and it had become obvious that recourse to sufficiently substantial external assistance to provide a credible safety net was necessary to restore the viability of the Spanish banking sector: on 25 June 2012, the government thus submitted an official application for EFSF assistance.

On 20 July, the Eurogroup agreed to that assistance, which was spelt out in a memorandum of understanding and subject to conditionality specifically concerning the financial sector. The amount of the financial aid, which covers the capital requirements of the banks concerned while including a safety margin, was provisionally set at € 100 billion. The stress tests which the Spanish government commissioned in June and September 2012 from external consultants, using both a top-down and a bottom-up approach, made it possible to determine and specify the total financing needs. They fell respectively within a range of € 51-62 billion and € 54-59 billion, and were thus covered by the planned budget. In addition, the funding is to be granted in the form of loans paid out in several tranches to the Spanish fund for the orderly restructuring of the banks, acting as the government's agent, which then allocates the funding to the financial institutions concerned. On 3 December, after having examined the progress of the Spanish aid programme, the Eurogroup welcomed the ESM's decision to authorise payment of the first tranche in the programme, amounting to € 39.5 billion. These initial funds were meant for the hardest hit financial institutions whose restructuring plans had been approved by the EC in November.

Cyprus also requested financial assistance from the European emergency funds and the IMF in June 2012. That application was still in negotiation at the closing of this report.

Enhancing economic governance

Among other things, the euro area crisis showed that the institutional architecture of EMU had been unable to prevent the formation of imbalances in some countries. Events obliged the leaders of the EU, and more particularly those of the euro area Member States, to strengthen economic governance. Whereas coordination used to concern mainly fiscal policy, it has now become more general. In November 2011, on the basis of the report by the Van Rompuy task force and the EC's proposals, the European Parliament and the Council had thus adopted a set of six proposals – five Regulations and one Directive – known as the Six Pack, based essentially on two pillars. The first – the fiscal pillar – strengthens the Stability and Growth Pact (SGP), which was itself reformed in 2005, to ensure closer surveillance and better monitoring of the

sustainability of public finances. The second pillar is intended to prevent other macroeconomic imbalances and to correct them if necessary, in order to avoid the risk that their unwinding may lead to a sudden deterioration in public finances and threaten the economic and financial stability of the country concerned, and of the euro area as a whole[1].

Better surveillance of fiscal policy

During the year, the fiscal pillar rules and their binding character were further reinforced. Thus, in the margins of the European Council at the beginning of March, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) was signed by the EU Member States excluding the Czech Republic and the United Kingdom. By opting for an international treaty, the signatories were able to maximise the coordination of their economic policies without having to go through the long process of amending the Treaty on the Functioning of the European Union (TFEU). Apart from some general provisions on the coordination of economic policies and improvements in competitiveness, the TSCG primarily comprises binding fiscal rules known as the "Fiscal Compact", which apply only to the euro area Member States.

The Fiscal Compact reiterates three key provisions of the SGP. First, there is the rule whereby the government budget must be in balance or in surplus. That rule is respected if the annual structural budget balance meets the country-specific medium-term objective (MTO) defined in the SGP. The lower limit is a structural deficit of 0.5 % of GDP; that limit increases to 1 % of GDP if the public debt is less than 60 % of GDP. Next, it restates the debt reduction rule under the SGP: a public debt of more than 60 % of GDP must be reduced each year by, on average, one-twentieth of the difference between the actual debt level and 60 % of GDP. Finally, it contains the SGP provisions defining the exceptional circumstances under which a deviation from the targets is permissible.

However, the Fiscal Compact also tightens up the fiscal rules of the Six Pack. For one thing, the targets must be enshrined in the constitution or at a comparable level, otherwise the Member State concerned may be summoned before the EU Court of Justice and be subject to a fine of up to 0.1 % of GDP. There must also be rapid convergence towards the medium-term objective on the basis of a timetable to be established by the EC, and an automatic correction mechanism must be triggered in the event of a significant deviation from the MTO; the EC laid down the principles for this on 20 June in the year under review. Also, the euro area countries undertake always to accept an EC recommendation on the existence of an excessive public deficit unless a qualified majority votes against it. Other measures require countries subject to an excessive deficit procedure to set up an economic and fiscal partnership programme detailing the structural reforms needed for an effective and durable correction of their excessive deficit. The Member States also promise to improve the coordination of national debt issuance via ex ante reporting to the EC and the Council.

In addition, the TSCG provides for enhancement of the governance of the euro area, including regular euro area summits. Twelve euro area countries, but not Belgium, ratified the Treaty before the end of the year under review, and it entered into force on 1 January 2013.

Like the TSCG, the Two Pack is intended to reinforce compliance with the SGP by euro area countries, via two Regulations which the EC proposed on 23 November 2011.

The first proposal for a regulation reinforces the preventive arm of the SGP by introducing more detailed monitoring and more specific assessment of draft budgets that euro area Member States must submit to the EC before 15 October, including the independent macroeconomic growth forecasts on which they are based and the detailed objectives per sub-sector. In the case of serious defects, the EC may require a revised draft budget. If necessary, it will issue an opinion which will be published, then discussed by the Eurogroup and submitted, on request, to the parliament concerned. The Member States must also have budget rules stated in figures, specifying their medium-term objectives and preferably anchored in the constitution, and an independent fiscal institution to monitor the application of these rules. This means that the similar TSCG provisions will be transposed into European legislation. Member States with an excessive deficit will be subject to even closer surveillance, notably by the submission to the EC and the Economic and Financial Committee of reports on the implementation of the budget during the year, and on the impact of discretionary measures on the budget. If there is a danger that a Member State may not meet its obligations under the excessive deficit procedure applicable to it, the EC may recommend additional measures and make those recommendations public.

(1) E. De Prest, H. Geeroms and G. Langenus (2012), "New developments in the economic governance of the European Union", NBB, Economic Review, June, 103-123.

TABLE 4 OVERVIEW OF THE NEW EU GOVERNANCE FRAMEWORK

	Six Pack	TSCG[1]	Two Pack
What?	5 EU Regulations and 1 EU Directive	International treaty	2 EU Regulations (in negotiation)
Who?	EU Member States (with some differentiation between euro area countries and others)	EU Member States except the Czech Republic and the United Kingdom, fiscal and economic rules applicable specifically to euro area Member States	Euro area Member States
Date of entry into force	13 December 2011	1 January 2013)	Target date: 2013
Content	• Enhanced fiscal surveillance (including the operational debt criterion) • Minimum requirements for national fiscal frameworks • Prevention and correction of other macroeconomic imbalances • New, more automatic decision-making procedures	• Restriction of the structural deficit, preferably enshrined in the constitution; automatic correction mechanism • In principle, euro area countries must accept the EC's recommendations on excessive deficits[2] • Role of the European Court of Justice • Greater economic policy coordination • Euro area summits	• Even closer fiscal supervision and coordination in the euro area • Compliance with binding fiscal rules of a constitutional nature monitored by independent national institutions • Precise timetable for the annual budget, with prior examination by the EC • Stricter surveillance for countries subject to financial problems (automatic if assistance is granted)

Source: NBB.
(1) The term Fiscal Compact is often used to refer to fiscal rules included in the TSCG.
(2) The euro area countries undertake to accept any EC recommendation on the existence of an excessive deficit, unless a qualified majority votes against it.

The second draft Regulation in fact transposes the current approach regarding "programme countries" – i.e. countries receiving financial assistance – into secondary legislation. In particular, it implies enhanced surveillance by the EC and the ECB and technical assistance, on the understanding that other euro area countries confronted by serious financial stability problems may also be subject to such surveillance and assistance.

On 13 July, the European Parliament made substantial amendments to these two draft Regulations, in order to consolidate their binding character and strengthen the role of the EC and the European parliamentary assembly. In particular, the Parliament wanted the scope of the first draft Regulation extended to cover all economic policy. Although the European Council on 18 and 19 October pressed for an agreement to be reached before the end of 2012, the discussion was still going on in the "trialogue" (Council, Commission and European Parliament) when this Annual Report went to press.

Better coordination of economic policy

From the economic policy perspective, the European Semester, organised for the first time in 2011, has gained importance since the entry into force of the Six Pack. It aims to establish closer coordination and lasting convergence between the economies. On the one hand, it incorporates European supervision of structural economic policy on the basis of the broad economic policy guidelines and the employment guidelines; it also incorporates surveillance of macroeconomic policy, more specifically in regard to public finances, under the enhanced SGP, and the prevention and correction of macroeconomic imbalances.

The Annual Growth Survey, approved by the spring European summit, identifies the main economic challenges for the EU and defines the policy priorities. In April each year, Member States are therefore required to submit to the EC both their stability or convergence programmes and their national reform programmes, which are then

assessed by the EC and the Council. That assessment results in a series of recommendations addressed to each Member State and to the euro area as a whole; they are endorsed by the Heads of State or Government towards the end of June before being approved by the Council, and that concludes the European Semester.

Under the Six-Pack rules, Member States which disregard the recommendations addressed to them are subject to new recommendations and a warning, or even sanctions. However, the Six Pack also allows recommendations to be made outside the timescale of the European Semester. The importance of recommendations made in the context of the European Semester was again emphasised at the European summit on 29 June 2012, when it was decided to make the financial assistance granted under the EFSF/ESM conditional upon compliance with those recommendations.

The legislative initiatives of the past two years are the most far-reaching since the introduction of the euro. The Two Pack supplements the Six Pack, and the European Semester is an important step in the right direction, heading towards more logical and coherent recommendations. The peer pressure for approval of the recommendations is also reinforced by the Council which applies the principle of following the EC's recommendations and proposals or explain its position publicly ("comply or explain" principle). On the other hand, the choice of recommendations is not always clear, and there is insufficient prioritisation; also, the objectives are sometimes too vague. The recommendations made do not always take adequate account of possible contagion effects between euro area Member States, and do not differentiate sufficiently between countries. For instance, at the end of May 2012, twelve Member States were subject to an in-depth assessment under the macroeconomic imbalances procedure, though their performance according to the "scoreboard" indicators was quite different, and in the end no imbalance was classed as excessive in these countries, whereas the vulnerability of Cyprus and Spain had become obvious during the year.

2.3 Adaptation of the European institutions

Though the legislative initiatives of the past two years represent significant progress, the interdependencies between the financial, real and fiscal spheres require the implementation of additional measures to continue the process towards a more integrated Economic and Monetary Union. With that in mind, at the European Council on 13 and 14 December 2012, the President, Herman Van Rompuy, presented his final report entitled "Towards a genuine Economic and Monetary Union". The Heads of State or Government concluded by agreeing on the basis for the completion of EMU, together with a timetable.

The Heads of State or Government decided to persevere with the introduction of an integrated financial framework, also known as a "banking union". This includes the single supervisory mechanism for credit institutions, agreed by the Council members at their meeting on 12 December 2012, and the single resolution mechanism funded by the financial sector. The President of the European Council was also instructed to propose, by mid-2013, any measures and a roadmap for achieving closer economic policy coordination. The main instrument available for this purpose is the conclusion, between Member States and EU institutions, of "competitiveness and growth contracts" based on financial solidarity mechanisms. Democratic legitimacy should be reinforced by closer involvement of the European Parliament and national parliaments, which will be able to cooperate better in developing an integrated economic and fiscal policy.

Establishment of a single supervisory mechanism for banks in Europe

During the year under review, the discussions took a practical turn, mainly as regards banking supervision. The sovereign debt crisis in the euro area in fact highlighted the close links between the public sector and the banking sector. In a monetary union, if there is no European safety net, the weaknesses of the banking system can have a more rapid adverse effect on the public finances of the Member States. Such a safety net is inconceivable without a single supervision system. Conversely, Member States' fiscal problems can have a profound impact on the financial situation of domestic credit institutions. As explained in the 2011 Report, numerous measures and reforms to ensure lasting reinforcement of the euro area's financial system have already been adopted since the eruption of the financial crisis. For instance, a significant tightening of the prudential rules is in progress, which involves in particular the transposition of the Basel III agreements at European level (CRD IV). Apart from these reforms aimed at making the financial system more resilient, coordination between supervisory authorities was strengthened at European level, and a new institutional framework was set up on 1 January 2011 with, for example, the creation of the European System of Financial Supervision (ESFS), comprising the European Systemic Risk Board (ESRB), a European macroprudential supervision body, and the European Supervisory Authorities (ESAs) responsible for improving microprudential supervision in Europe in the three sectors: banking, insurance and securities markets.

However, the scale and duration of the current sovereign debt crisis showed that these measures were not sufficient. To resolve the crisis and safeguard the euro, it was therefore essential to break the link between sovereign debts and bank debts. In that context, at the euro area summit on 29 June 2012, the EU Council decided to set up a single supervisory mechanism comprising the ECB and the competent national authorities. At this summit, the Heads of State or Government also agreed on the scope for direct intervention by the ESM in European banks subject to common supervision. The new single supervisory mechanism should also help to reduce the market fragmentation. In addition, it should guarantee the uniform and coherent application of the prudential rules and supervision techniques to all credit institutions in order to boost public confidence in the system and ensure a level playing field between institutions.

In that sense, the introduction of a single supervisory mechanism is a key step in the continuing construction of Economic and Monetary Union. At the summit last December, on the basis of a draft EC text dated 12 September 2012, the Heads of State or Government agreed on a proposal for a Regulation defining the regulatory framework for this mechanism. The Regulation will enter into force early in 2013, and the single supervisory mechanism (SSM) for banks will be operational by no later than 1 March 2014, or one year after the adoption of the Regulation. Section II. A. 2 in the prudential part of this Report describes its provisions in more detail.

The SSM will take on the supervision of all euro area credit institutions, numbering over 6 000 [1]. The agreement also makes provision for countries not belonging to the euro area to join this mechanism.

The ECB's new responsibilities will be supported by the collaboration, expertise and knowledge of the national supervisors. Initially, the national authorities will retain direct competence for supervising smaller institutions.

The supervision tasks carried out by the ECB will include decisions on the grant and withdrawal of banking licences, the conduct of stress tests, and the surveillance of financial conglomerates. In addition, the ECB will have to monitor compliance with the prudential rules laid down by European acts, and the adequacy of a credit institution's internal capital in relation to its risk profile. It will also be able to impose sanctions on institutions which fail to meet the prudential requirements, and will have to help draw up recovery plans if an institution no longer complies with the minimum prudential rules, or is at risk of non-compliance. In order to fulfil its new responsibilities, the ECB will have access to all the information that it needs, and may, in particular, carry out inspections in financial institutions.

Monetary policy will be kept separate from financial supervision. This new mission therefore does not alter in any way the ECB's primary mandate, namely the maintenance of price stability.

This transfer of powers makes it all the more important to establish a single rulebook. The European Banking Authority (EBA) will remain the competent authority here. There must be close collaboration between that institution and the ECB. The Heads of State or Government also accepted the proposal for an amendment by the EC of the EBA Regulation, modifying the voting procedures in this institution; the proposal respects a balance between member countries and those not belonging to the SSM.

The text also states that the ECB will be jointly responsible with the national authorities for the implementation of certain macroprudential instruments provided for in European acts. This concerns in particular the countercyclical buffer, the systemic buffer and the specific capital requirements for loans relating to the property sector. In order to guarantee a coherent, optimal macroprudential policy, the use of these instruments should be differentiated across countries depending on the macroeconomic conditions and specific risks. Other instruments, such as the loan-to-value or debt-to-income ratios, will remain within the competence of the national authorities. Very close collaboration between the competent national authorities and the ECB will be vital, especially as, in the absence of fiscal union, it is very largely the Member States that would bear the financial consequences of a systemic crisis. As explained in the part of the Report concerning prudential policy, discussions are in progress in Belgium on setting up an institutional structure to coordinate macroprudential policy at national level.

The establishment of a banking union is a vital step in the continuing process of European integration. However, it requires the implementation of other fundamental elements. The single supervisory mechanism cannot be coherent and optimal unless a single resolution authority and a common deposit guarantee system are also set up. In the context of common banking supervision, and taking account of the size of cross-border groups in Europe, the absence of a central resolution authority could again destabilise confidence and strengthen the link between bank debts and public debts. In a crisis period,

(1) According to an ECB census, there are in fact 4 194 credit institutions, not counting those included in the consolidated statements of their parent company.

it is essential to be able to take prompt, convincing action. In these circumstances, a central authority would be more effective than a multitude of national authorities. A mechanism of this kind should limit the negative externalities resulting from individual national measures, such as those seen at the time of the resolution of large European cross-border groups during the financial crisis. That is the context in which the Heads of State or Government asked the EC to draft a legislative proposal on the subject during 2013, and to speed up the discussions on the proposal for an EC Directive on the establishment of a framework for the recovery and resolution of failing credit institutions and investment firms, and on a deposit guarantee fund, in order to reach agreement before June 2013. Another question that arises here concerns sharing the financial burden of such actions.