European Commission

POST-TROIKA

What next for Ireland?

#PostTroika

Economic Governance post-Troika
- Implications for Ireland

John McCarthy

28 March 2014

An Roinn Airgeadais
Department of Finance

Sea-change in economic governance since the onset of the crisis

- Crisis exposed serious design flaws in the monetary union
  - centralised monetary policy / decentralised fiscal policy
  - ‘free-rider’ problem / spill-over effects
  - implementation gaps
- Key policy response = retrofitting EMU with appropriate tools
- Enhanced governance = European Semester
  - (1) better co-ordination
  - (2) strict application of fiscal rules
  - (3) widening the scope of surveillance
  - (4) addressing implementation deficits
- What does this mean for economic and budgetary policy in Ireland?

(1) Better co-ordination of policies

- Co-ordination of MS budgetary and economic policies
  - synchronised timetables for fiscal and economic policies
  - rationale: internalise EU impact of domestic policies

- Semester agreed in 2010, first implemented in 2011
  - Ireland exempt…until this year
  - common budgetary timeline for euro area MS is a key element (2-pack)

- Implications for IE:
  - April: Stability Programme Update (DoF) / National Reform Plan (DoT)
  - June: Council endorses 'tailored' policy advice (=CSRs) to MS
  - October: Draft Budgetary Plan (DoF)

(2) Strict application of fiscal rules

- Strengthened Stability and Growth Pact
- SGP encompasses rules for the fiscal deficit, expenditure and debt

  - objective = ensure budgetary discipline in MS
  - two regulations / arms
- preventive arm (art. 121 – economic policies of common concern)
  - concept of MTO = balanced budget over the economic cycle
  - anchor : structural terms to allow automatic stabilisers operate
  - MS at or on adjustment path towards MTO
  - stability programme must show how MTO is achieved / path
- corrective arm (art. 126 – avoid excessive deficits)
  - MS required to bring deficit below 3% of GDP in timely manner
  - MS required to rapidly bring debt ratio to 60% of GDP (1/20th rule)
- "Fiscal Compact" (all MS except UK and CZ)
  - to increase national ownership

Implications of fiscal rules for Ireland

Corrective arm of the Pact (2009-2015)

- need to correct the excessive deficit by 2015

Preventive arm of the Pact (2016-)

- requirements of preventive arm apply from 2016 onwards
- need to make ‘rapid progress’ towards our MTO
  – for Ireland we will have to achieve MTO by 2018 (‘fiscal compact’)
- structural primary surplus of c. 4 per cent of GDP p.a. needed over medium term
  – should be sufficient to comply with debt-correction rule (1/20th rule)
- expenditure rule
  – capping expenditure (net of discretionary measures) below avg. potential growth

Institutional reforms (two-pack and EU / IMF programme)

- IFAC will have important role

(3) Widening the scope of surveillance

- **Economic imbalances also matter**
  - macroeconomic imbalances procedure
    : preventive arm (monitoring)
    : corrective arm (EIP)
  - purpose = detect, prevent and correct macroeconomic imbalances

- **Monitoring: annual alert mechanism report (November)**
  - scoreboard of 11 key indicators
    : internal (credit growth, debt) and external imbalances (BoP)
    : thresholds for each variable

- **In-depth reviews (IDR)**
  - analytical base for dialogue between MS and Comm re. policies

Implications for Ireland

Indicator	Threshold %	2012 %	2008 %
Competitiveness			
% change (5 years) in Export Market Shares	**-6%**	-16.3%	-21.2%
% change (3 years) in Nominal ULC	+12%	-10.4%	+6.1%
% change (3 years) in REER	**+/-5%**	-12.2%	7.3%
External imbalances			
3 year average of Current Account balance as % of GDP	-4/+6%	2.3%	-4.8%
Net International Investment Position as % of GDP	**-35%**	-112%	-76%
Internal imbalances			
% y-o-y change in Deflated House Prices	+6%	-11.7%	-8.4%
Private Sector Credit Flow % of GDP (consolidated)	14%	-1.6%	19.9%
Private Sector Debt as % GDP (consolidated*)	**133%**	306.4%	257%
% y-o-y change in Total Financial Sector Liabilities	16.5%	-0.7%	6.5%
General Government Debt as % of GDP	**60%**	117.4%	44%
3 year average of Unemployment Rate	**10%**	14.4%	5.2%

Source: European Commission

Note: Red shading indicates indicator value in excess of threshold ‘flashing’.
* On a consolidated basis excluding intra-sector liabilities such as inter-company loans

(4) Addressing implementation deficits

- **Weak implementation of SGP in first decade of EMU**
  - reform of the Pact in 2004 / 2005
  - further reform in 2011 (the '6-pack')
  - and in 2013 (the '2-pack')
- **Reinforce compliance / enforcement mechanisms**
- **Introduced financial sanctions for non-compliance**
  - 'sanctions regulation' (part of '6-pack')
  - sanctions in both preventive and corrective arms
    : earlier stage / progressive basis
  - quasi-automatic (rQMV)
- **Financial sanctions in MIP also**
- **Enhanced credibility**

In summary…..

In-Depth Review

- March – imbalances exist and policies must be cognisant of this

Stability Programme Update

- published in mid-April
- assessed in May / June
- CSRs – fiscal and structural (NRP)

Draft Budgetary Plans

- published in mid-October
- assessed by Eurogroup in November

Irish Fiscal Advisory Council

Post-Troika: What's Next for Ireland

The Future of Ireland's Economic Governance

John McHale
National University of Ireland, Galway
Irish Fiscal Advisory Council

March 28th, 2014

Conference organised by the European Commission Representation in Ireland in conjunction with the Dublin Chamber of Commerce, Aviva Stadium Conference Centre

Irish Fiscal Advisory Council

Overview

- Achievements in crisis resolution
- Fiscal governance, crisis resolution, and crisis prevention

Crisis resolution

- Property bubble bursts → Adverse feedback loops → Lost creditworthiness

- Crisis resolution strategy:
  - Adjustment with (conditional) assistance
  - Avoid default

- Necessary conditions for strategy to work
  - Economic and political feasibility of adjustment
  - Reasonable underlying growth potential
  - Adequate lender-of-last-resort support

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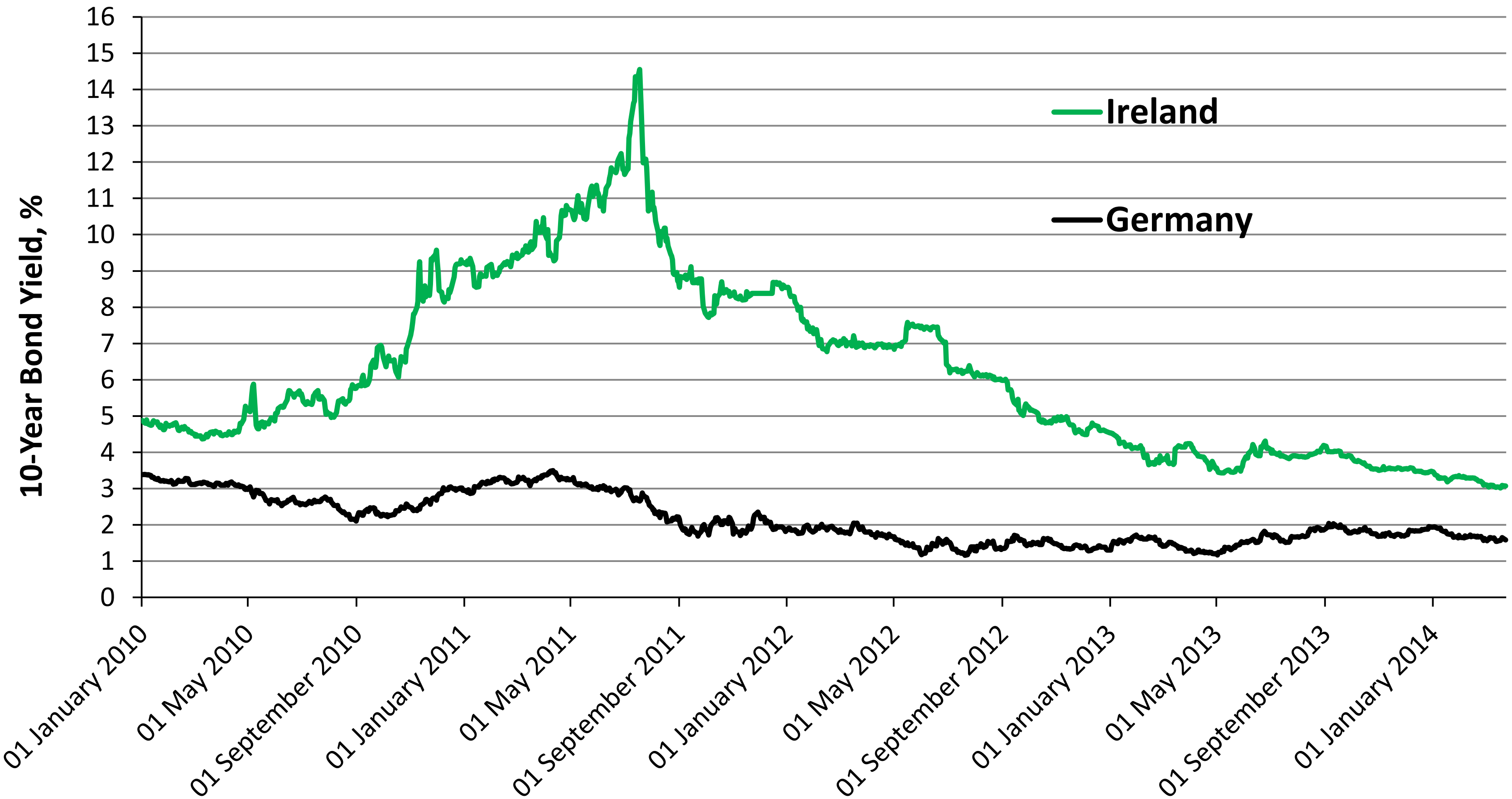
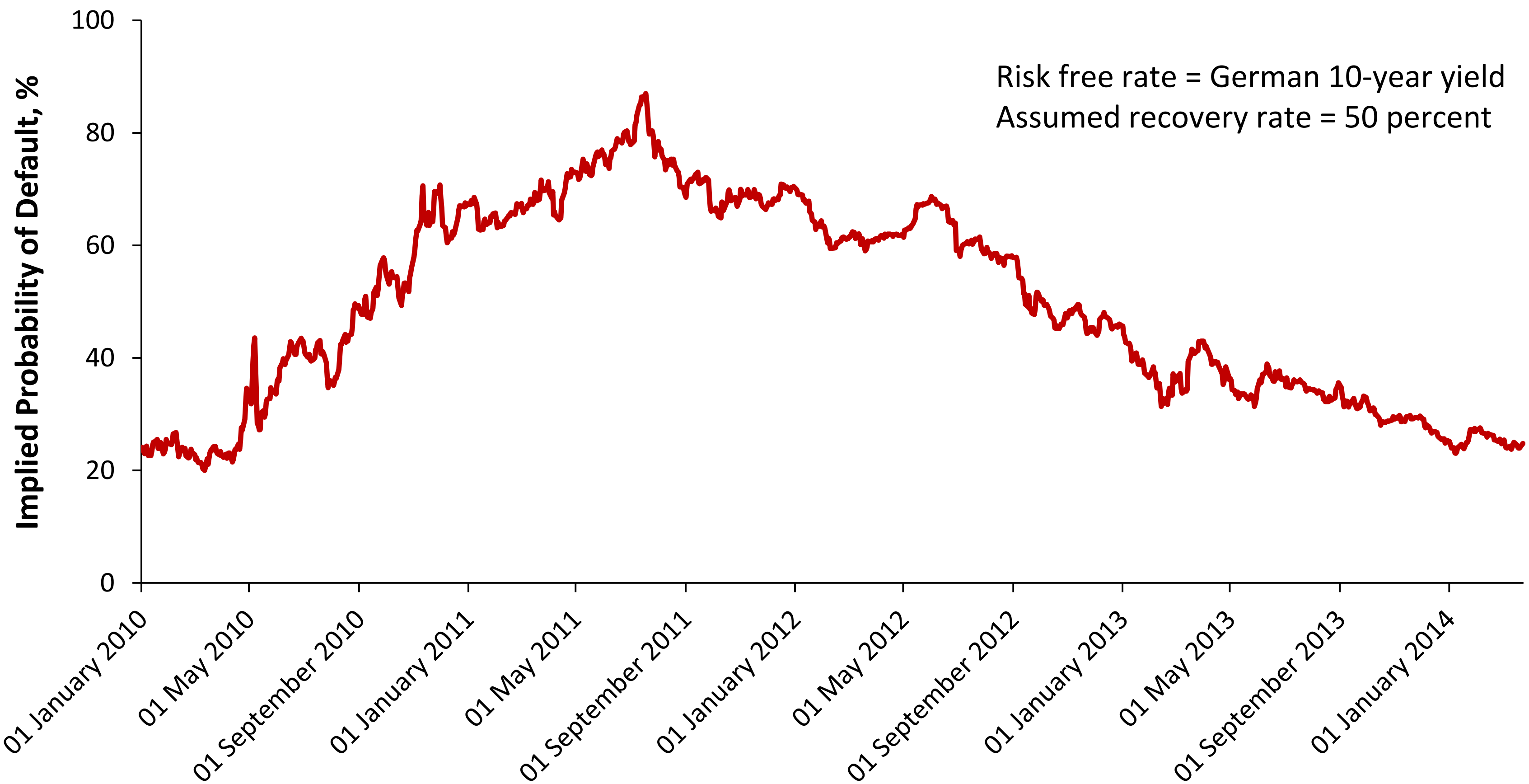
Achievements in crisis resolution



Source: Datastream

Implied probability of default (10-year horizon)



Source: Datastream and IFAC calculations

Significant risks remain

- Growth risks
  - Domestic: Uncertain dynamics of balance sheet recession
  - International: Trading partner growth
- Banking-related risks
- External risks
  - Contagion
  - European policy

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Economic governance for crisis prevention

Value of a strong fiscal framework

- Standard argument for the European framework:
  - Necessary for effective functioning of monetary union
- But a weak reed for public support
- *National* value of a strong fiscal framework
  - Avoid boom-bust cycles
  - Put debt on path to safer level
  - Credibility → Sustained creditworthiness given high debt levels

Complementary European and national frameworks

Effectiveness of **European** Fiscal Framework

Effectiveness of **National** Fiscal Framework

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European framework

- Reinforced *Stability and Growth Pact*
  - Preventive arm
    - Structural balance
    - Expenditure benchmark
  - Corrective arm
    - 3-percent deficit rule
    - 1/20th debt rule

- Unnecessarily complex?

- But generally takes us in the direction we need to go

National framework

- Usefully summarised in the Medium-Term Budgetary Framework document

- Key elements
  - Budgetary Rule [Fiscal Responsibility Act]
  - Medium-Term Expenditure Ceilings [Ministers and Secretaries (Amendment) Act 2013]

- Role of IFAC
  - Assess compliance with Budgetary Rule
  - Endorsement of macroeconomic forecasts underlying budgets and medium-term plans
  - Assessment of macro/fiscal projections and fiscal stance

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Fiscal policy stance

- Stay on track to exit the EDP on schedule
  - 2.9 percent deficit target for 2015
    - No safety margin allowed for in Budget 2014
  - Based on €2 billion of adjustments in Budget 2015
  - Mixed recent economic data

- Follow the rules of the preventive arm of the SGP post-2015
  - Most difficult phase of adjustment should be over
  - But still challenging given underlying spending pressures
  - Should put debt on a firm downward path
  - Should allow some flexibility in the face of economic shocks

The Future of Ireland's Economic Governance

A View From the Cheap Seats

Stephen Donnelly TD

28th March 2014

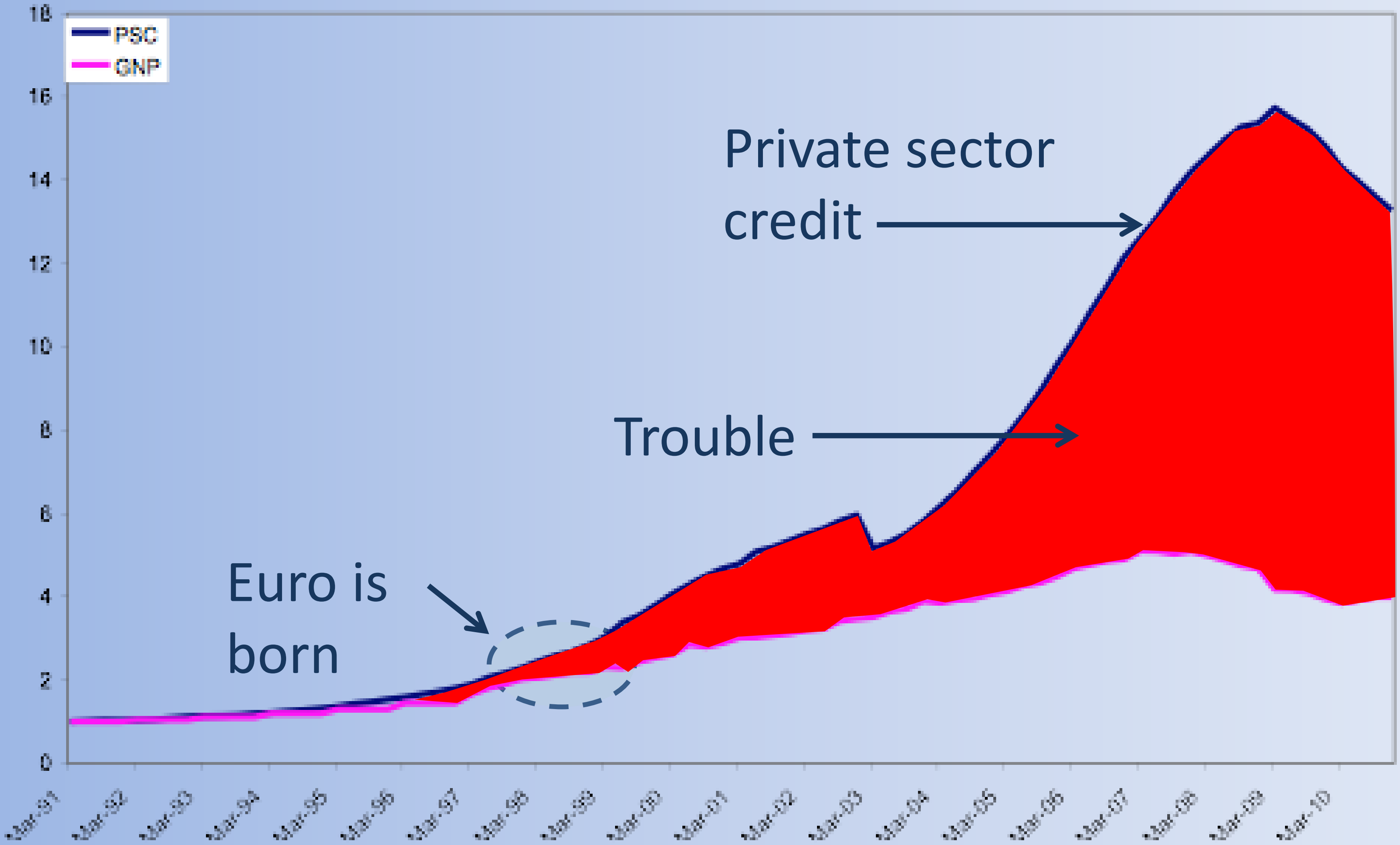
Economic (mis)management

What did the Dáil (not) do?

What should the Dáil do?

How can we make that happen?

A tsunami of foreign capital…



…crashed through weak institutions

1

AIB

Bank of Ireland

Irish Nationwide

EBS Building Society

Anglo Irish Bank

2

3

4

The (theoretical) role of Dáil Éireann

Article 28

4. 1° The Government shall be responsible to Dáil Éireann.

4. 4° The Government shall prepare Estimates…for each financial year, and shall present them to Dáil Éireann for consideration.

Instead, the Dáil failed…

…to call the banking risk

…to call the asset bubble

…to stem rising public expenditure

…to demand proper budgetary data

…to retain control of key spending decisions

Parliamentary governance in numbers

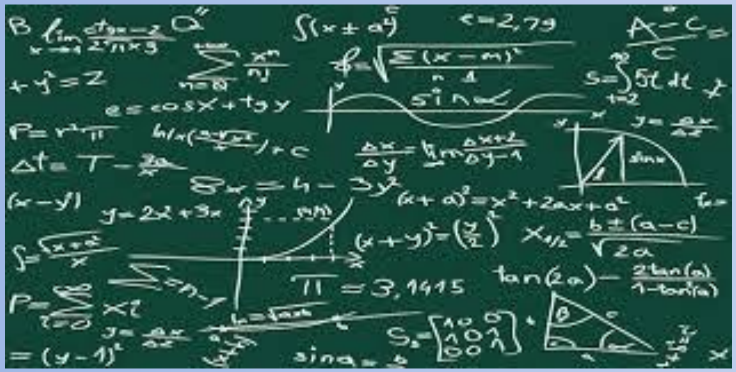
Scrutiny of legislation	2^{nd} last
Time on budgets	0 / 10
Data on budgets	0 / 10
Capacity on budgets	2^{nd} last
Vote after spend	1

Parliamentary governance in action

Some things are improving

- Stability Programme Update
- October budgets
- IFAC

But there’s lots more to do



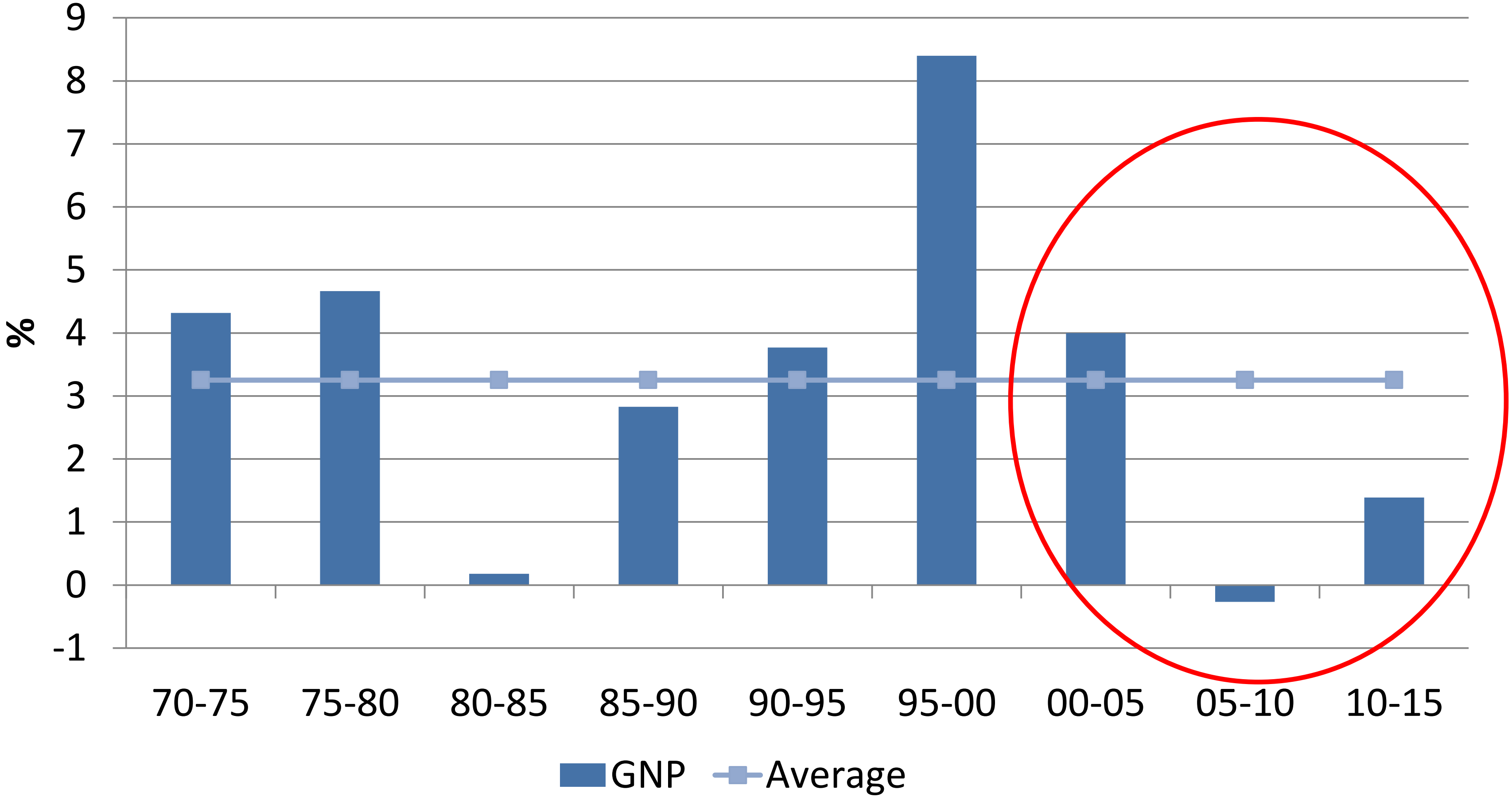
‘Post Troika (PT) Ireland’

Frances Ruane

Where to from here ?

- Historical growth path
- Troika Focus
- PT Realistic Assessment
- Beyond the short-term
- Future focus towards new strategy

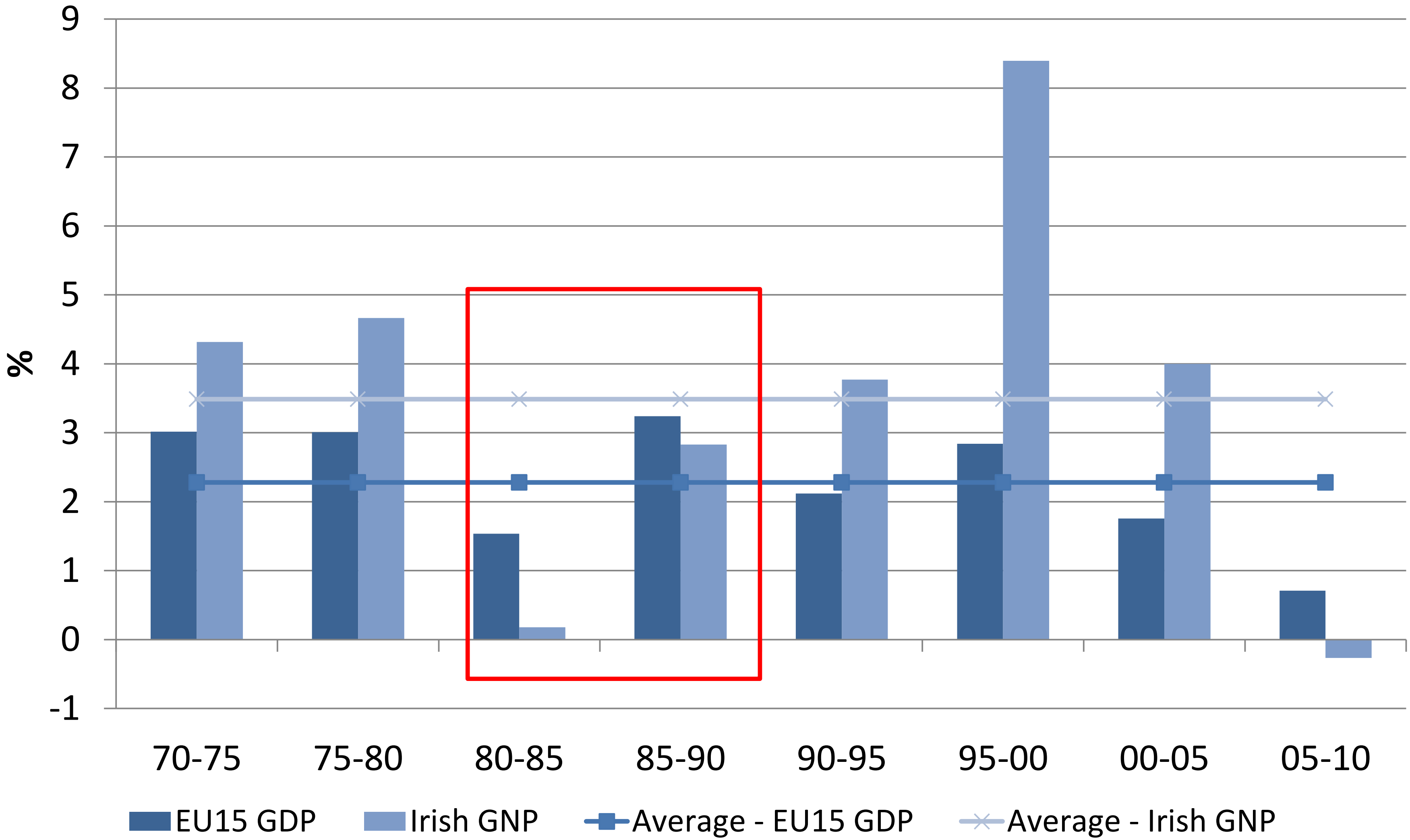
Irish GNP Growth 1970 – 2015



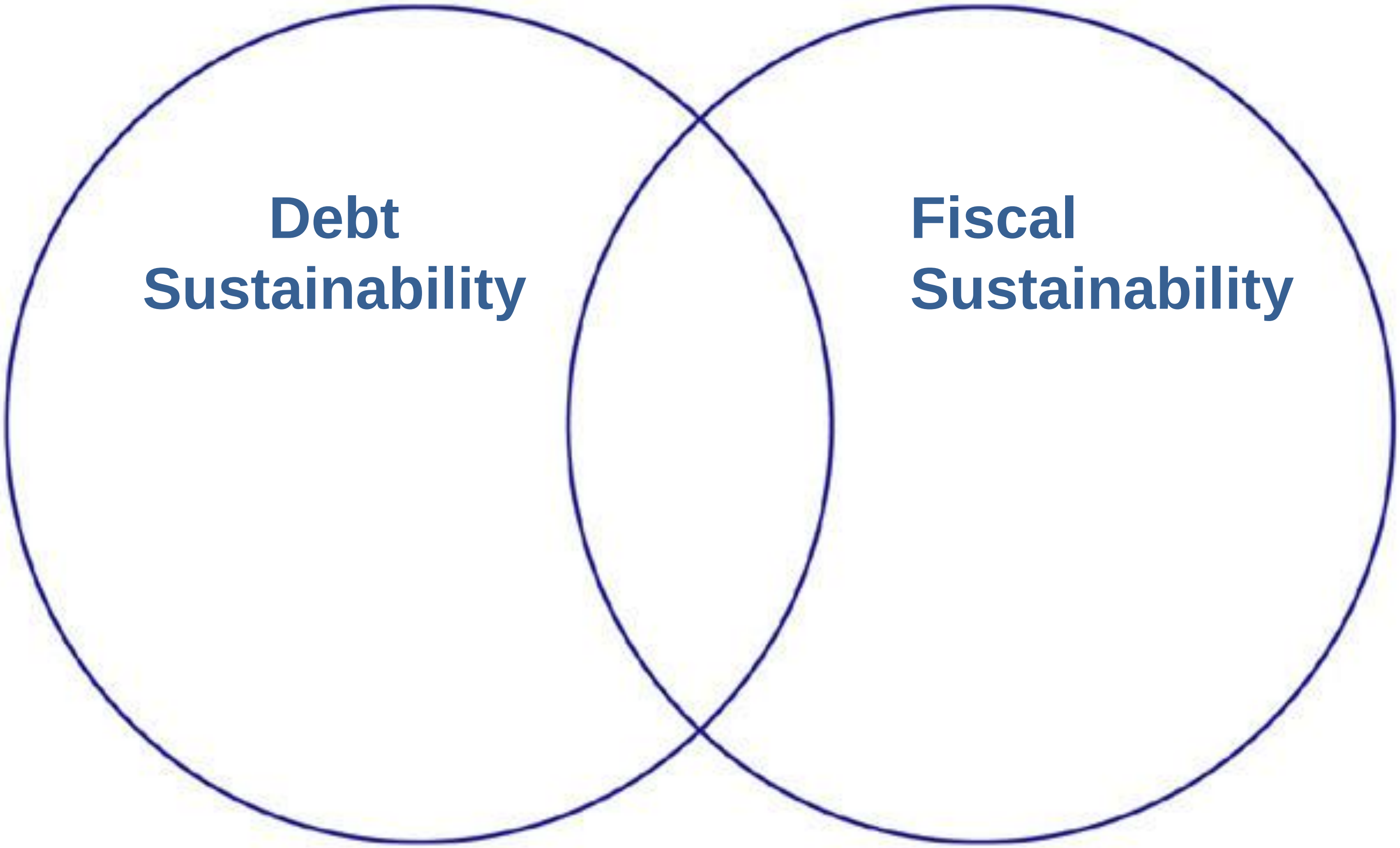
Average Annual Volume Growth Rates in Irish GNP ***Source: CSO and Recovery Scenario from MTR13***

-

Ireland and EU-15 Growth 1970 – 2010



Troika Focus 2010-2013



Troika noted dearth of evidence/analysis in some important areas

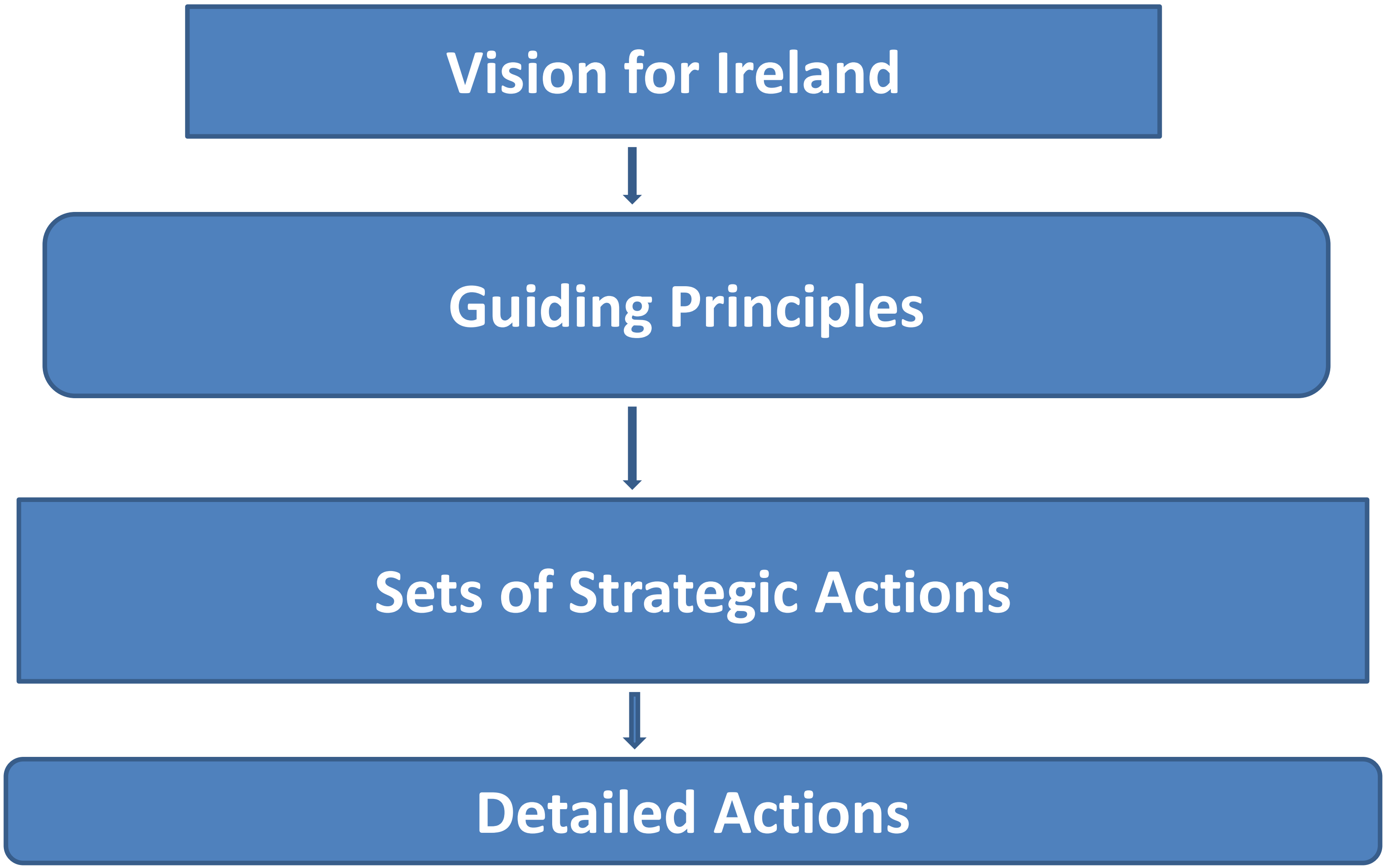
PT: Realistic Assessment of Ireland Inc

Our International reputation is vital

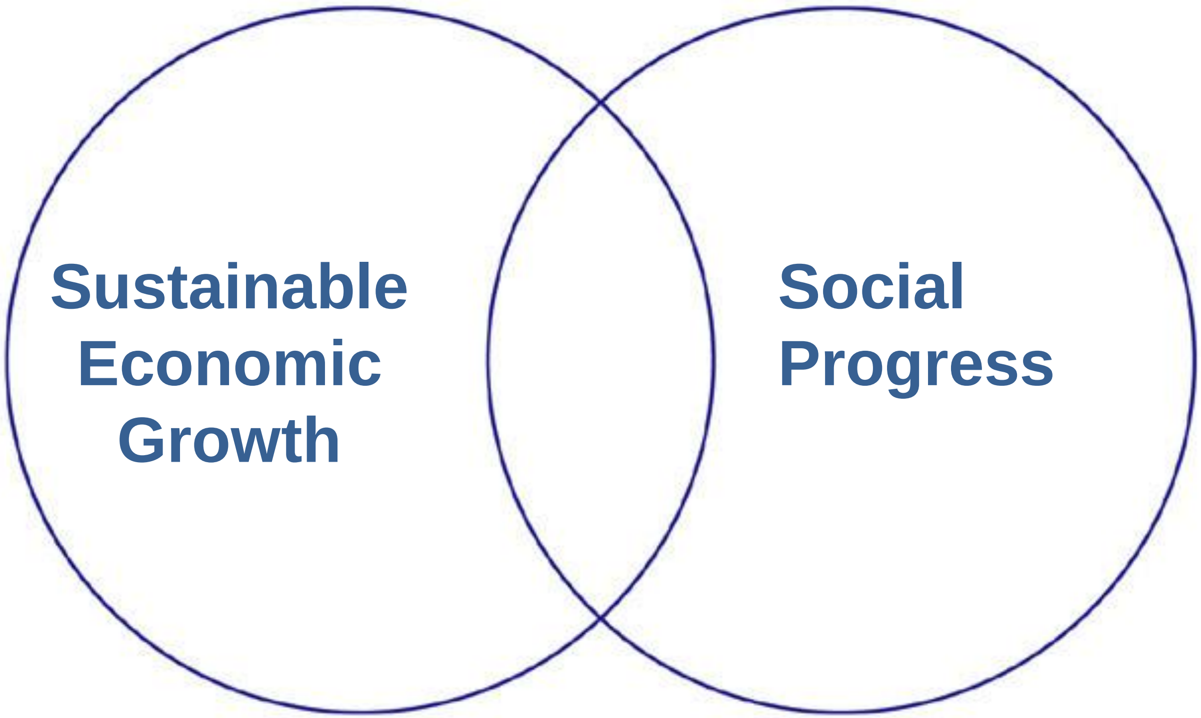
Support and develop: e.g., *SMEs*	**S**	**O**	Risk of lost opportunities: *e.g. trade strategy*
Failure to address known weaknesses: e.g. *Silos; skills gaps*	**W**	**T**	Prepare to identify and mitigate: e.g. *EU; climate*

We can't afford to make mistakes ...

We must plan for beyond the short-term



Policy Focus 2014 – More than Growth!

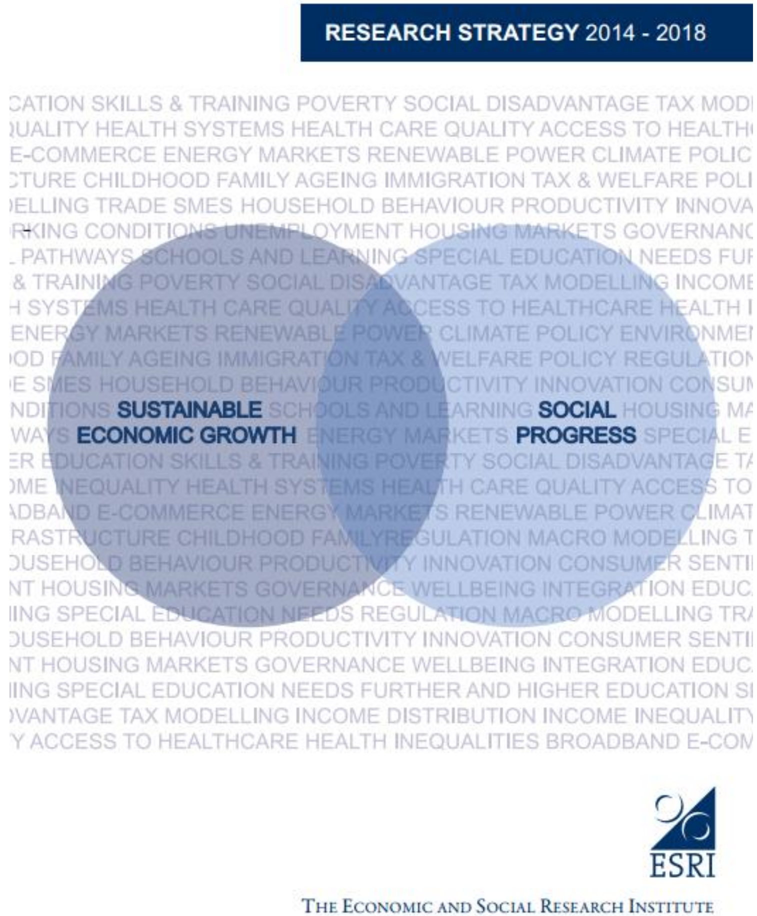


To realise these objectives we need to use all our analytical and creative skills across all domains…

ESRI's Role as a Stakeholder

To provide evidence, through analysis of robust data, that can inform public/business/ government about

- economic processes
- social change
- implications of events
- implications of existing policies
- implications of proposed policies



Post Troika: What Next For Ireland

A Stakeholder Perspective

David Begg, General Secretary
Irish Congress of Trade Unions

Dublin, 28th March, 2014

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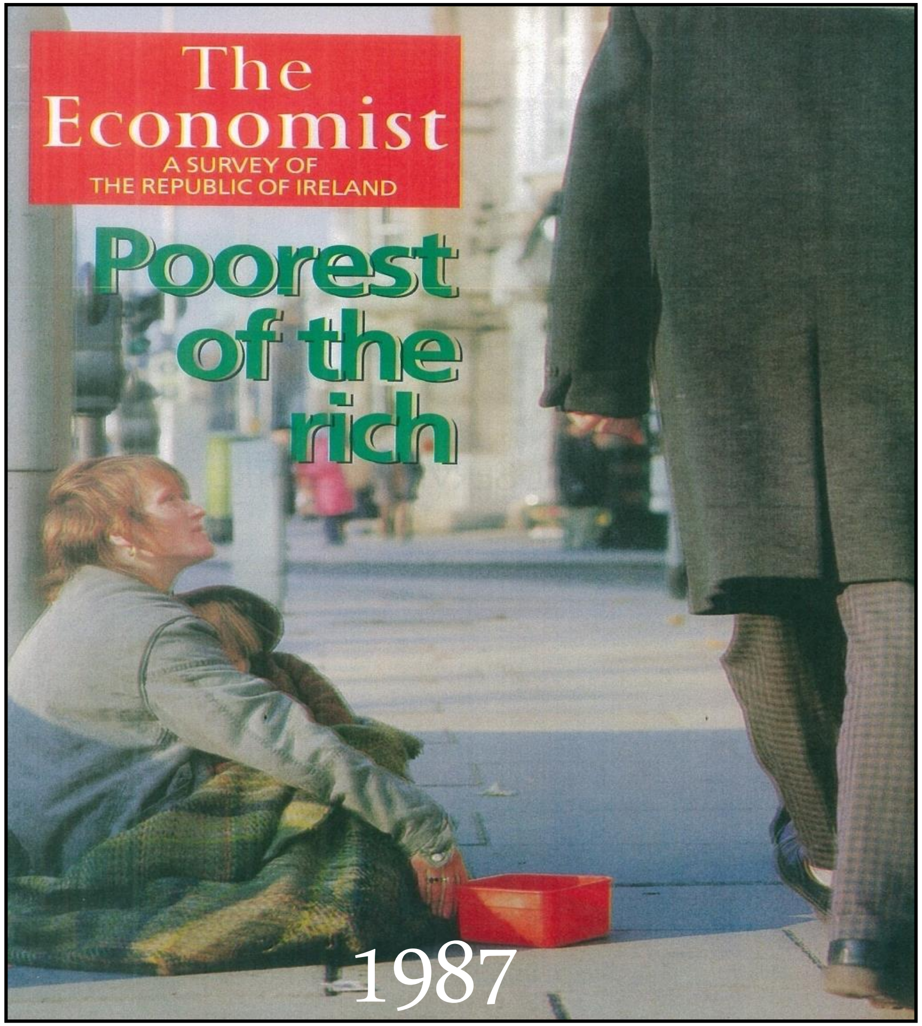

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The Troika Comes to Town

Ajai Chopra, deputy director of the European department of the International Monetary Fund, and an unidentified colleague pass a beggar as they make their way to the Central Ban of Ireland for crucial talks with the Government in Dublin yesterday. Photograph: Peter Morrison/AP

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Core Propositions

1. Ireland's future is highly contingent on how policy unfolds in Europe
2. The financial crisis and its management exposed a weakness of political legitimacy in the EU and its institutions……scale of which we will see in June
3. Experience of the last five years points to the difficulty of operating a currency union without a fiscal and political union
4. EMU is structured such that, in the event of an exogenous shock, the burden of adjustment falls disproportionately on labour markets.

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The European Semester – A Social Policy Context

- In the mid-1990s, 13 of the 15 EU Governments were Social Democratic – most were out of office by the early 2000s
- A 1997 initiative by the Dutch Presidency led to the Amsterdam Treaty and the European Employment Strategy (EES)
- This was embodied in the Lisbon Agenda in 2000 Article 3 of which commits the EU to a 'Social Market Economy' with high employment, universal social protection, and effective anti-poverty policy
- This commitment was weakened in the 2005 review
- But substantially reinstated in the 2010 replacement for the Lisbon Agenda, the European 2020 strategy, which includes the European Semester

What credibility does the social dimension have following the Troika and riots in European capitals?

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Why Ireland's Future is Highly Contingent

- Recent good employment and financial market performance

But

- Not exactly escape velocity

And

- Potential deflation and low growth in EU could make already difficult debt problem worse

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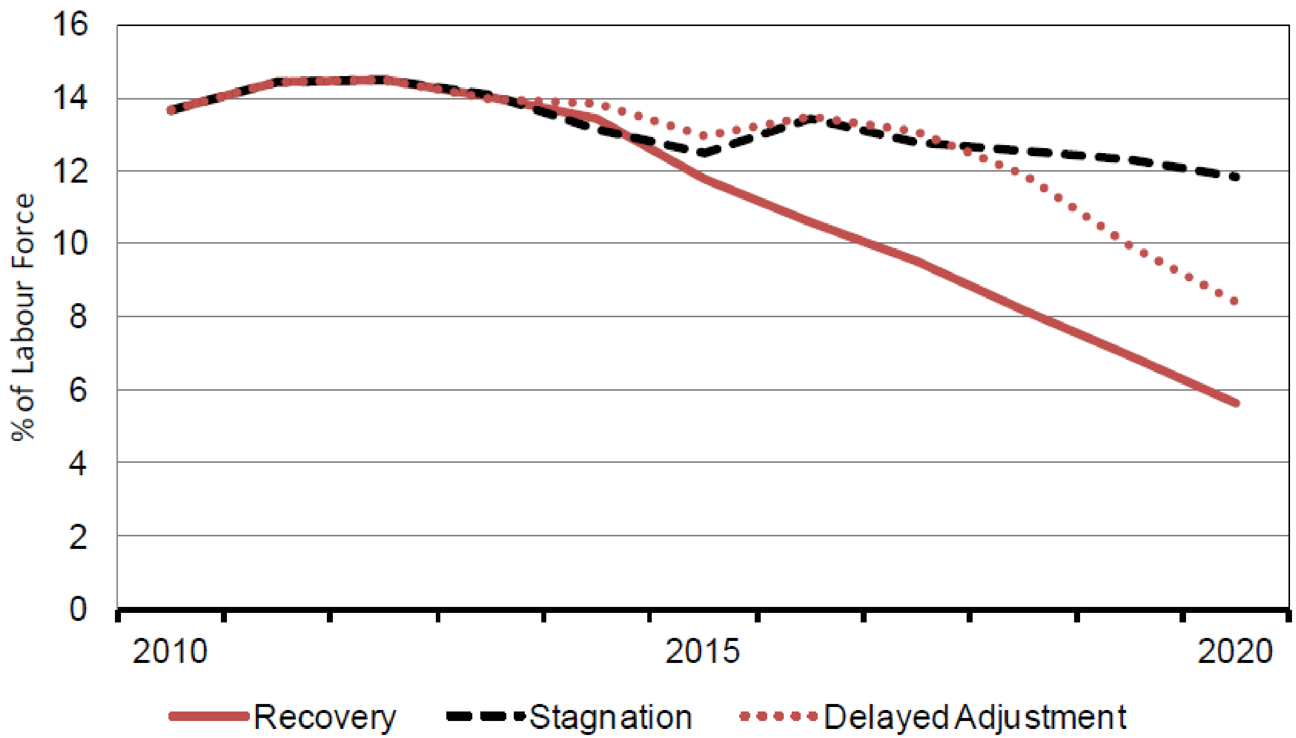
Unemployment Rate (ILO) Under Three Different Scenarios for Ireland



Source: ESRI Medium Term Review 2013-2020 P. 35

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Dilemmas for Europe

- Era of permissive consensus for deepening integration is over
- Rise of political populism likely to have chilling effect on mainstream
- Emergence of new kinds of social risk compounded by ageing demographic
- Asymmetric power of ECB. Diversity of welfare systems and national focus presents collective action problem for social policy

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Dilemmas for Ireland

All of the above plus:

- Structural unemployment compounded by a secular trend tending to ‘hollow out’ labour market
- Weakened labour market institutions
- Strategic vulnerabilities in our industrial policy (indigenous v modern imbalance, tax v FDI, innovation v R&D)
- Uncertainty about Britain’s future in Europe
- As an LME, is it sustainable for Ireland to remain an outlier in a Eurozone of social market economies?

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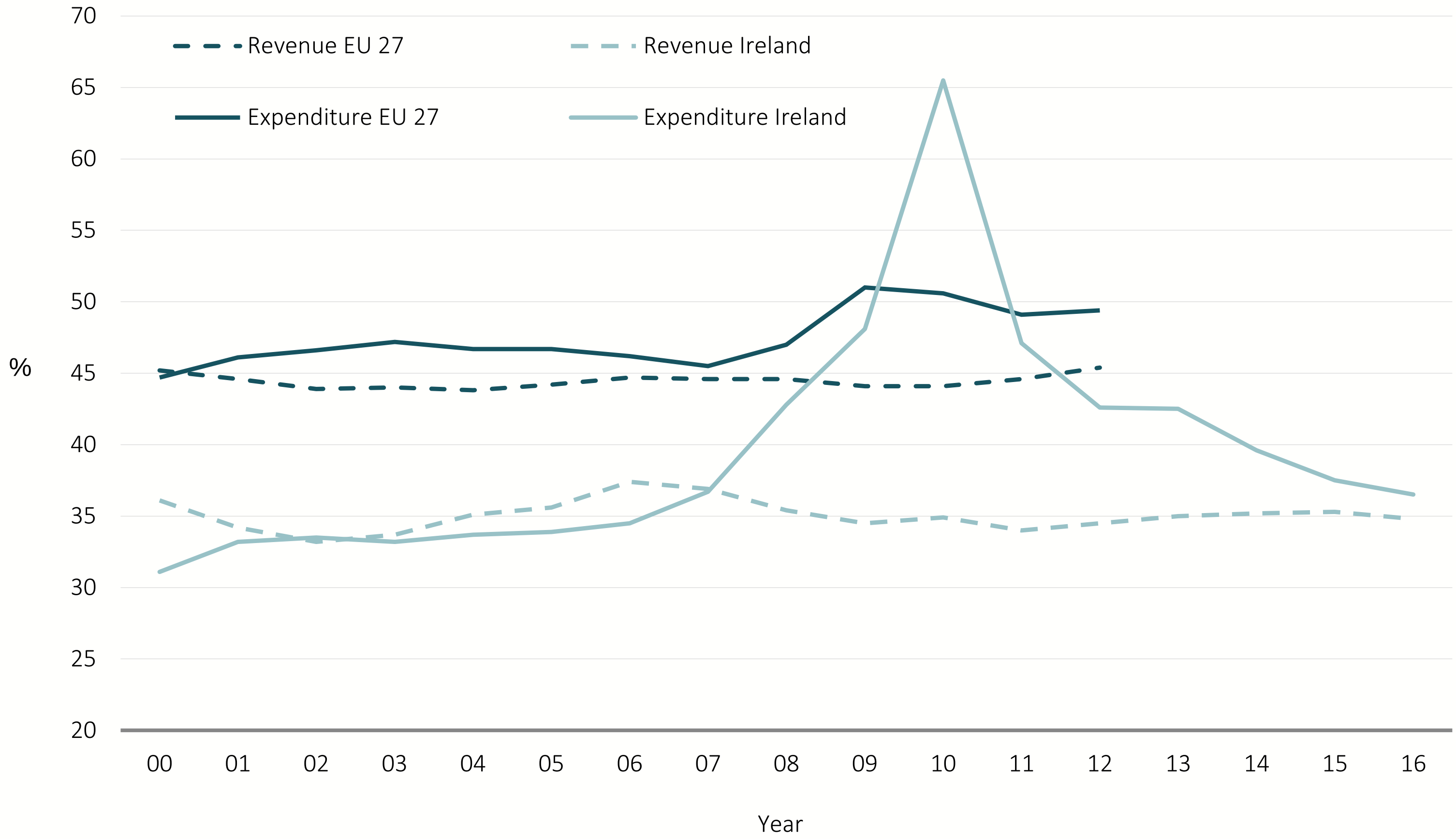
General government revenue and expenditure: Ireland and EU 27



Sources: a) Eurostat (2014), Government finance statistics. Available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/data/database
b)Irish Stability Programme Update (2013) Table A1.1: General government budgetary forecasts 12-16.

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What is to be done?

We have to reimagine Ireland as a Northern European Social Market Economy. This involves:

- Broadly aligning tax revenue and public spending with European norms
- Recapturing the developmentalism of the 1994-2001 period……..completing the work begun by Mjoset (1992)
- Embracing the democratic corporatism of Europe's small open economies (Katzenstein, 1985)
- Immediately create a robust investment vehicle to develop infrastructure and create construction jobs (Duggan, 2013)
- Social investment as a productive asset (Hemerijck, 2013)

In short, Ireland needs a new development model – accepting the limitations of the policy space – to do what Gösta Rehn and Rudolf Meidner did for the Nordic region in the 1950s

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Post Troika Conference

Applying lessons learned

Pat McArdle

28 March 2014

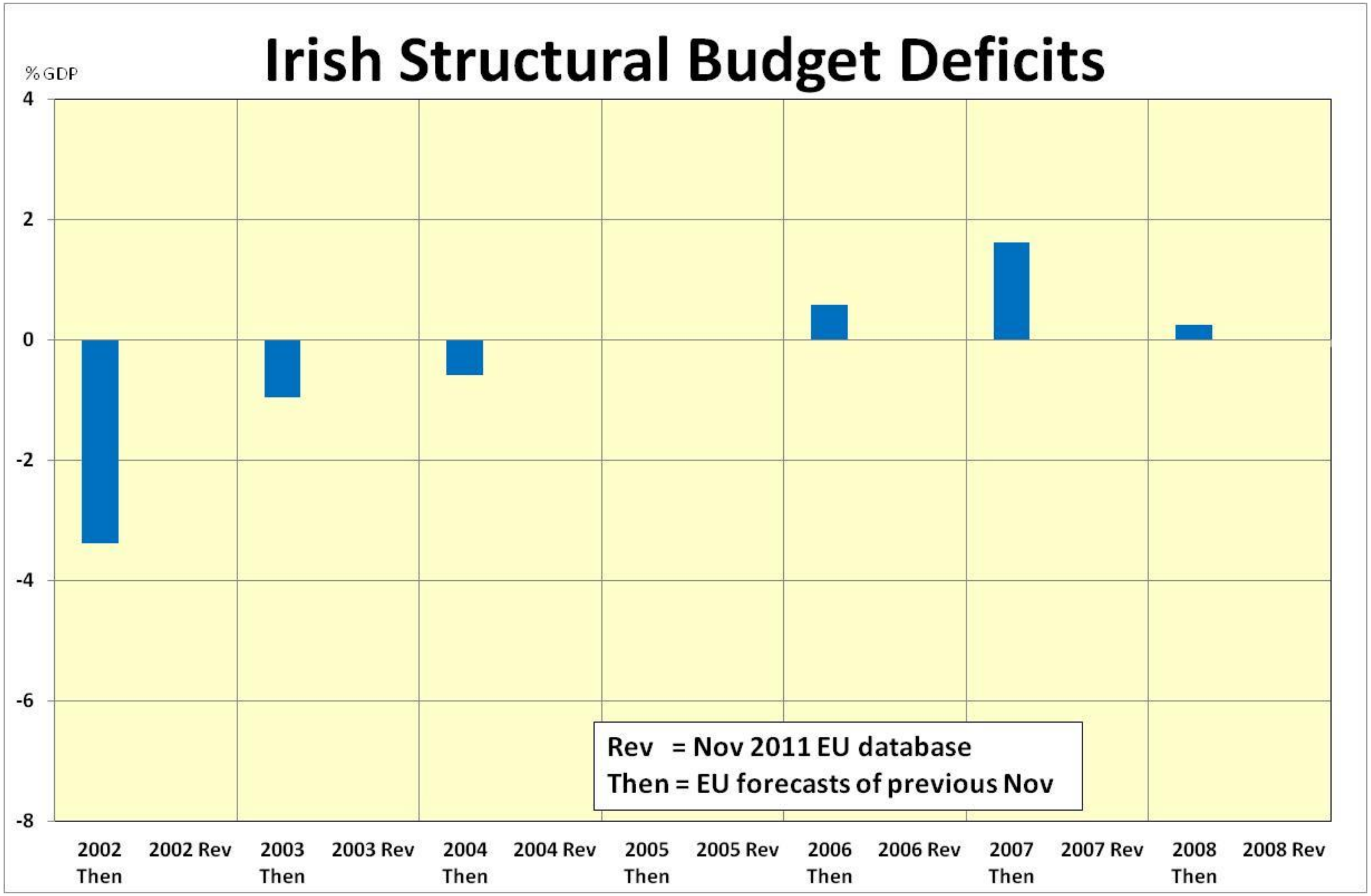
Why was this man famous?

Who is the odd one out!

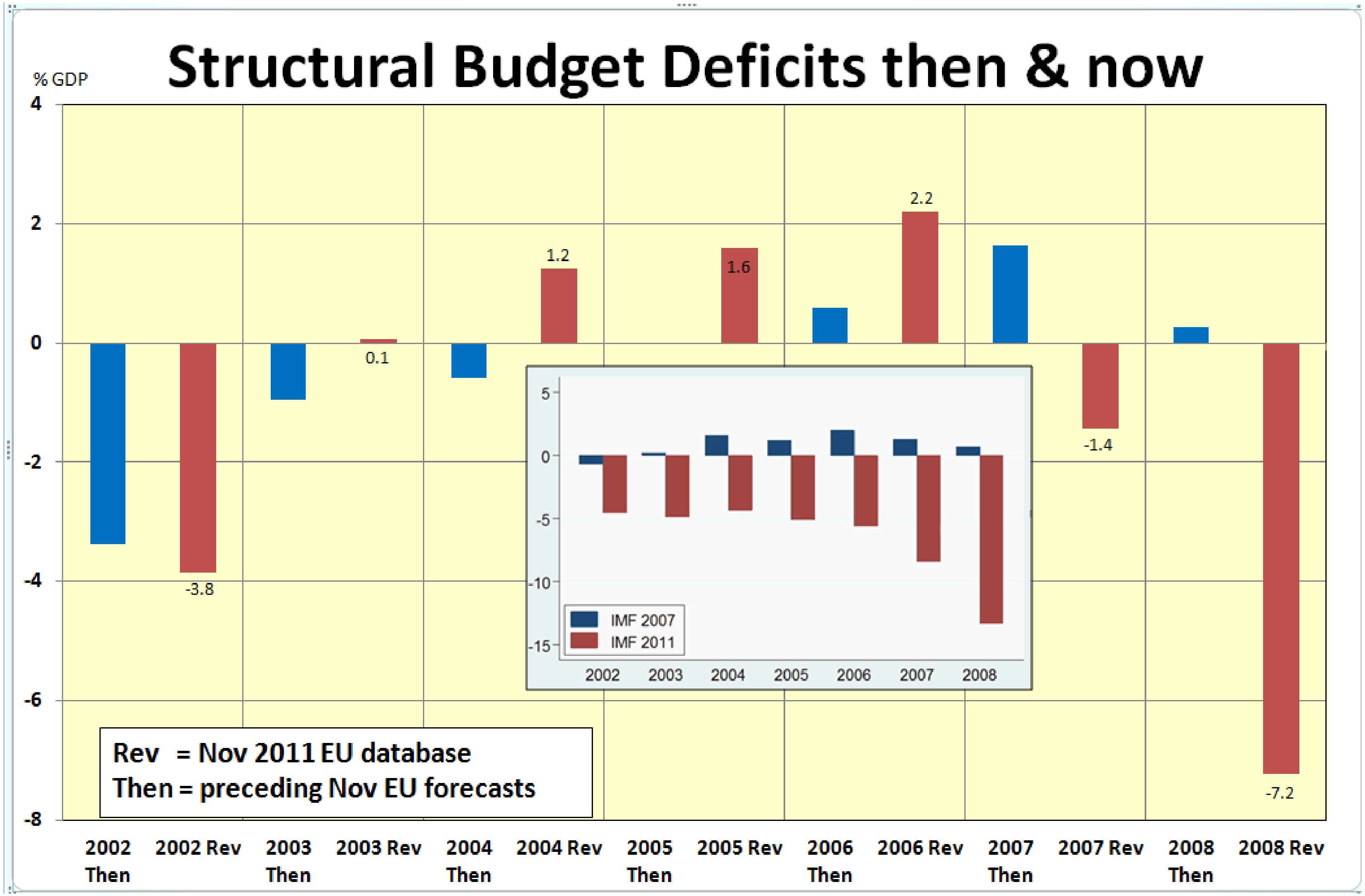
What is the common denominator?

- Fiscal policy was pro-cyclical before the crisis
- The major responsibility (for the crisis) lies with the directors and senior managements of the banks
- Principles based regulation = light touch regulation
- The bank guarantee was the worst financial decision ever
- Competition is always good
- The Department of Finance has been central to all that has gone wrong
- The (property) assets being acquired by NAMA from the banks are worthless
- The Irish people not the troika bailed out the State

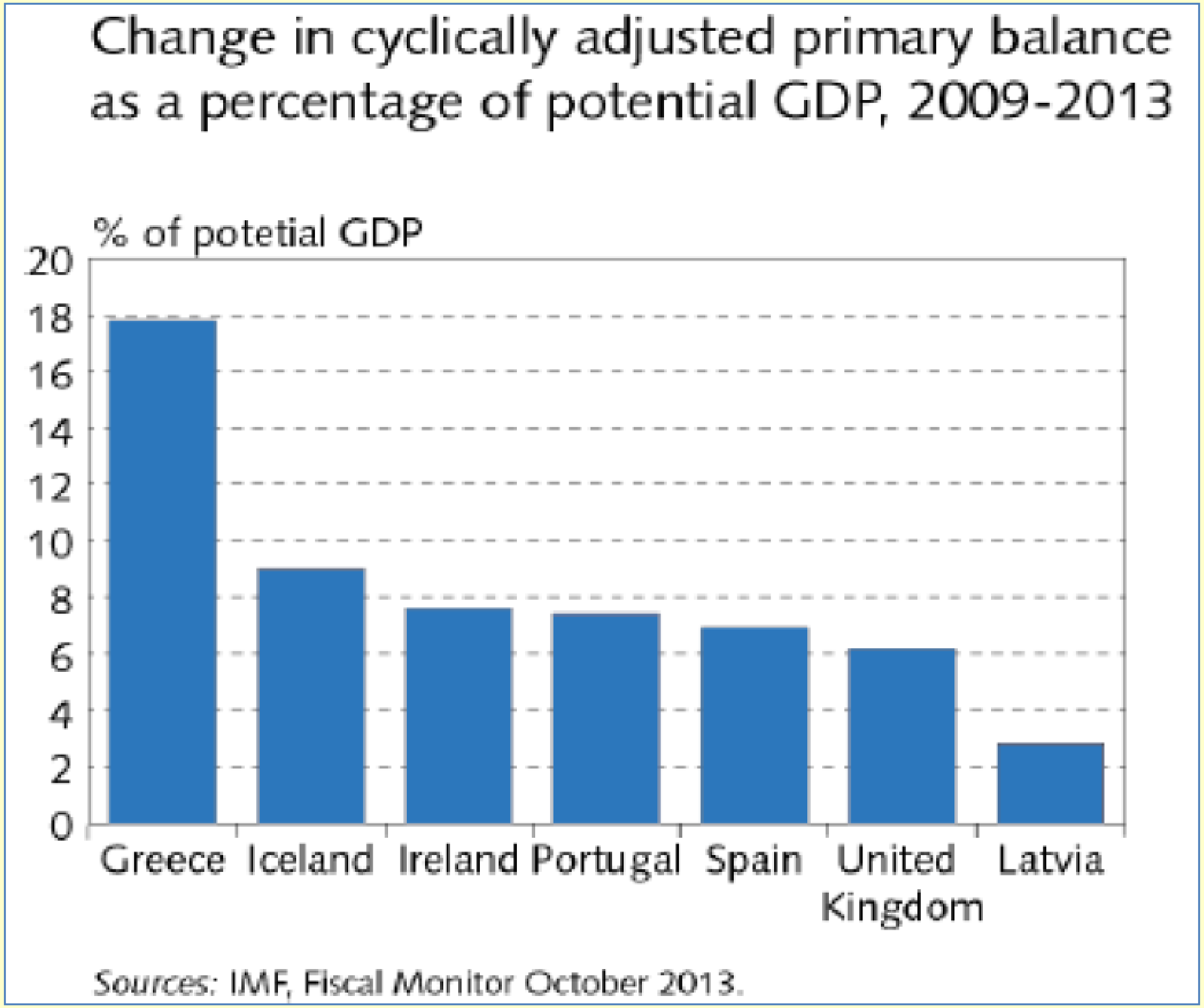
IRL did not have budget deficits



Until history was revised!



The Irish fiscal adjustment was not exceptional



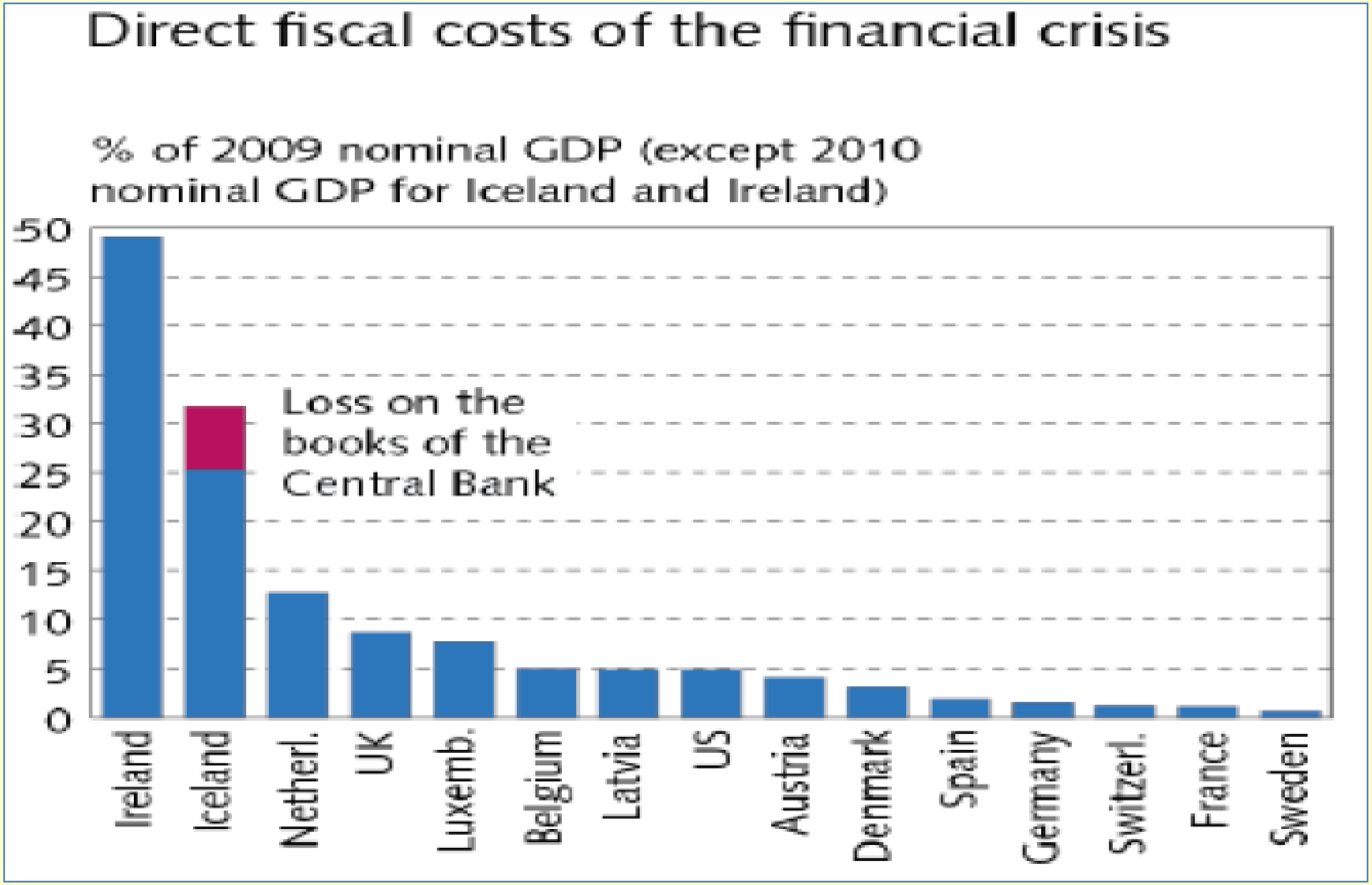
Neither were we the only ones to have a banking crisis

- Austria
- Belgium
- Cyprus
- Estonia
- Finland
- France
- Germany
- Greece
- Ireland
- Italy
- Luxembourg
- Malta
- Netherlands
- Portugal

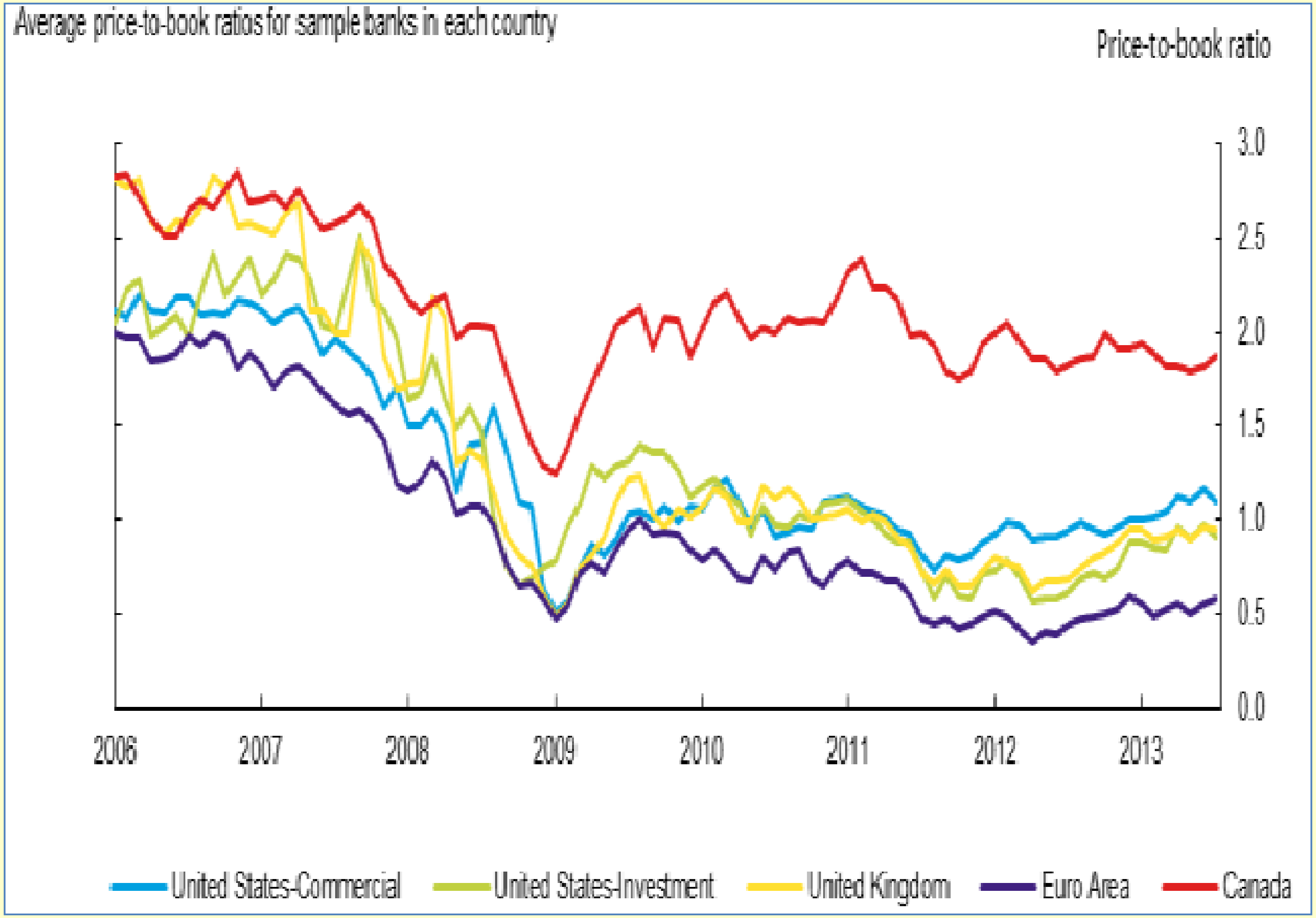
- Slovakia
- Slovenia
- Spain
- Bulgaria
- Czech Republic
- Denmark
- Hungary
- Latvia
- Lithuania
- Poland
- Romania
- Sweden
- UK

Source: IMF

Though Ireland's bust was bigger



Canada provides some useful lessons



Canada fared better because:

- they had learned from previous crises
- they had a strict but principles-based supervisory approach
- they had limits on bank leverage since the early 1980s
- they had multiple regulatory agencies
- they had a committee structure (FISC) to encourage communication and coordination across the various regulatory bodies
- mortgages must be insured against default when the loan-to-value ratio exceeds 80 per cent

The shakeout from unfettered competition

Number of service providers			
	1995	2006	2014
Mortgages	9	14	8
Current accounts	8	8	6
Credit cards	8	12	5
Personal loans	9	14	4
Source: IBF			

Private wages have not fallen

Labour costs per hour (ex agric, public admin)		
	Euro	**2008-13**
Germany	31.3	12.2%
Ireland	29.0	0.5%
Greece	13.6	-18.6%
Spain	21.1	8.7%
Latvia	6.3	7.1%
Portugal	11.6	-5.1%
UK	20.9	-0.3%
Source: Eurostat		

Impact of rules based regulation

Central Bank staff numbers			
	2007	2012	% change
Financial Regulator			
Consumer Protection	80.0	-	-100%
Banking Supervision	48.0	622.0	136%
Other	215.5		
Total Regulation	343.5	622.0	81%
Shared Services	300.0	469.5	57%
Central Bank	162.5	293.5	-14%
Currency services	179.0		
Other	6.0	9.0	50%
	991.0	**1,394.0**	41%
Source:Annual Reports			

Some lessons

- Regulatory failure was catastrophic, quality people are critical, excessive focus on rules, may still not have right structure
- ECB supervision but (too) much discretion remains with national supervisors & governance is too complex
- Watch sustainability of tax revenues (recent UK budget has some bad examples)
- Competitiveness is vital (we ignored this)
- Pay policy must be compatible with the exchange rate regime
- Balance of Payments is important (we now know)
- No tax incentives for sheltered activities

What is the common denominator?

- Fiscal policy was pro-cyclical before the crisis
- The major responsibility (for the crisis) lies with the directors and senior managements of the banks
- Principles based regulation = light touch regulation
- The bank guarantee was the worst financial decision ever
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Pat Mc Ardle

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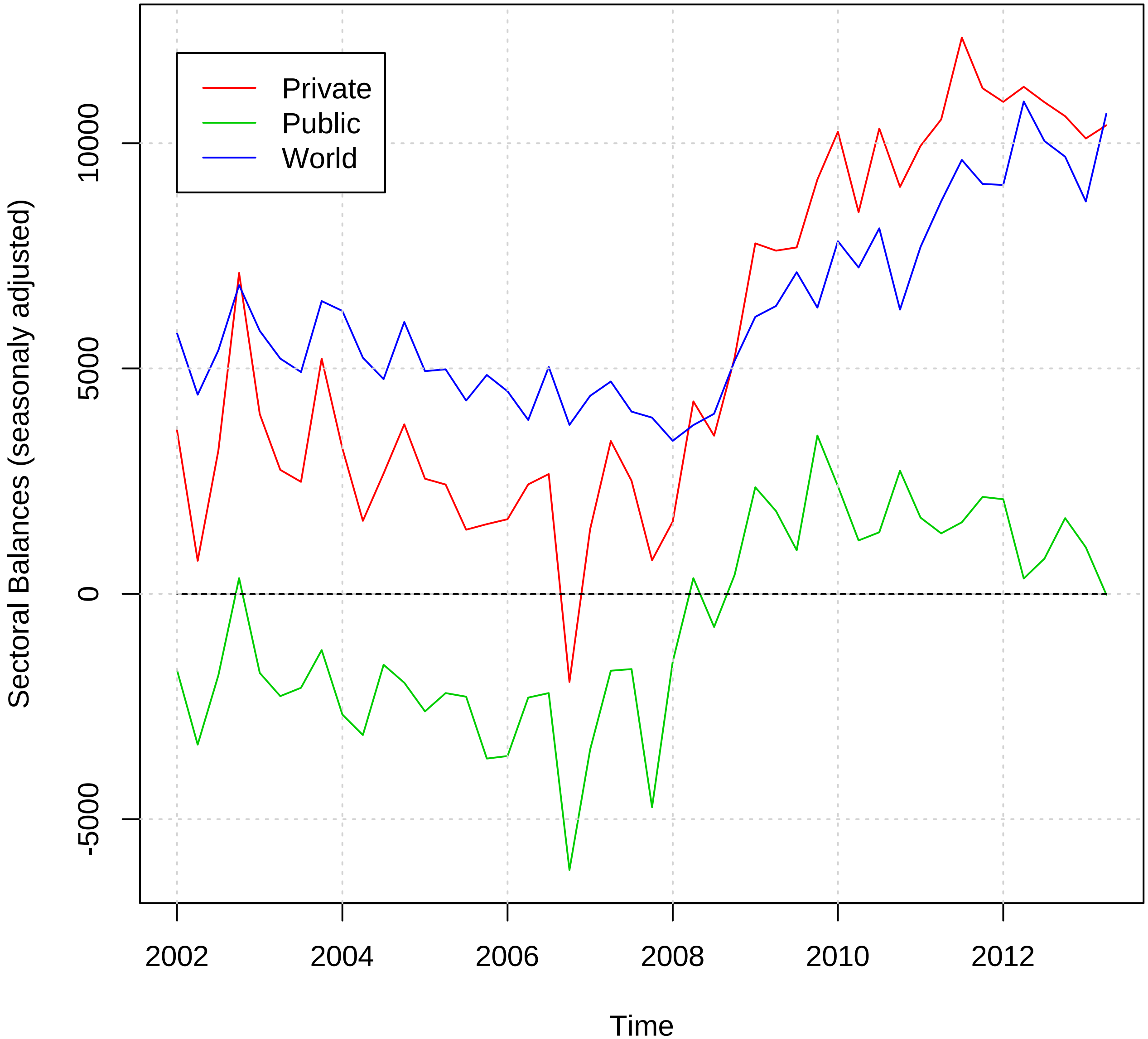
Governance Architectures in a Post-Austerity(?) Era

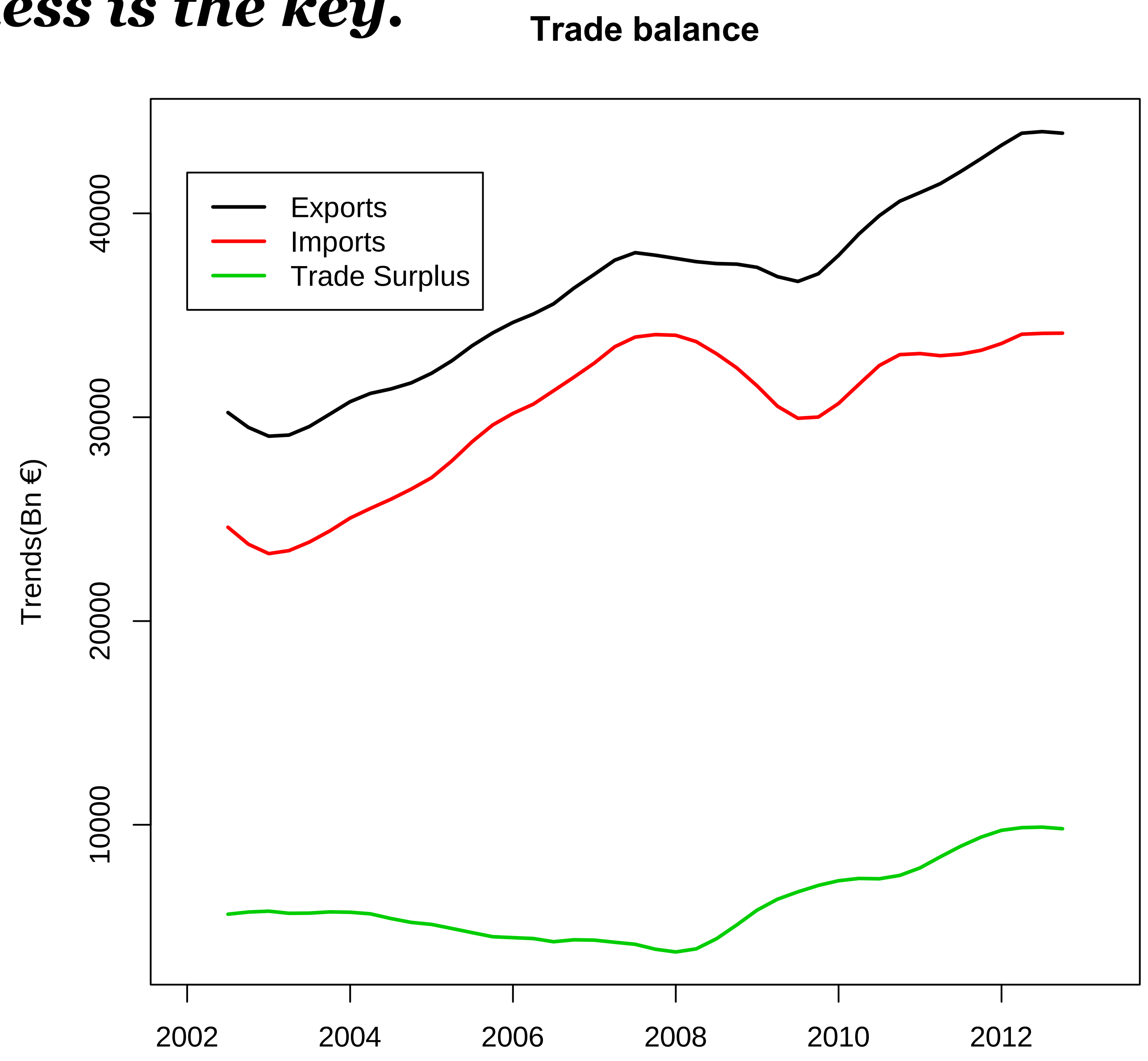
Vincent O'Sullivan & Stephen Kinsella

University of Limerick

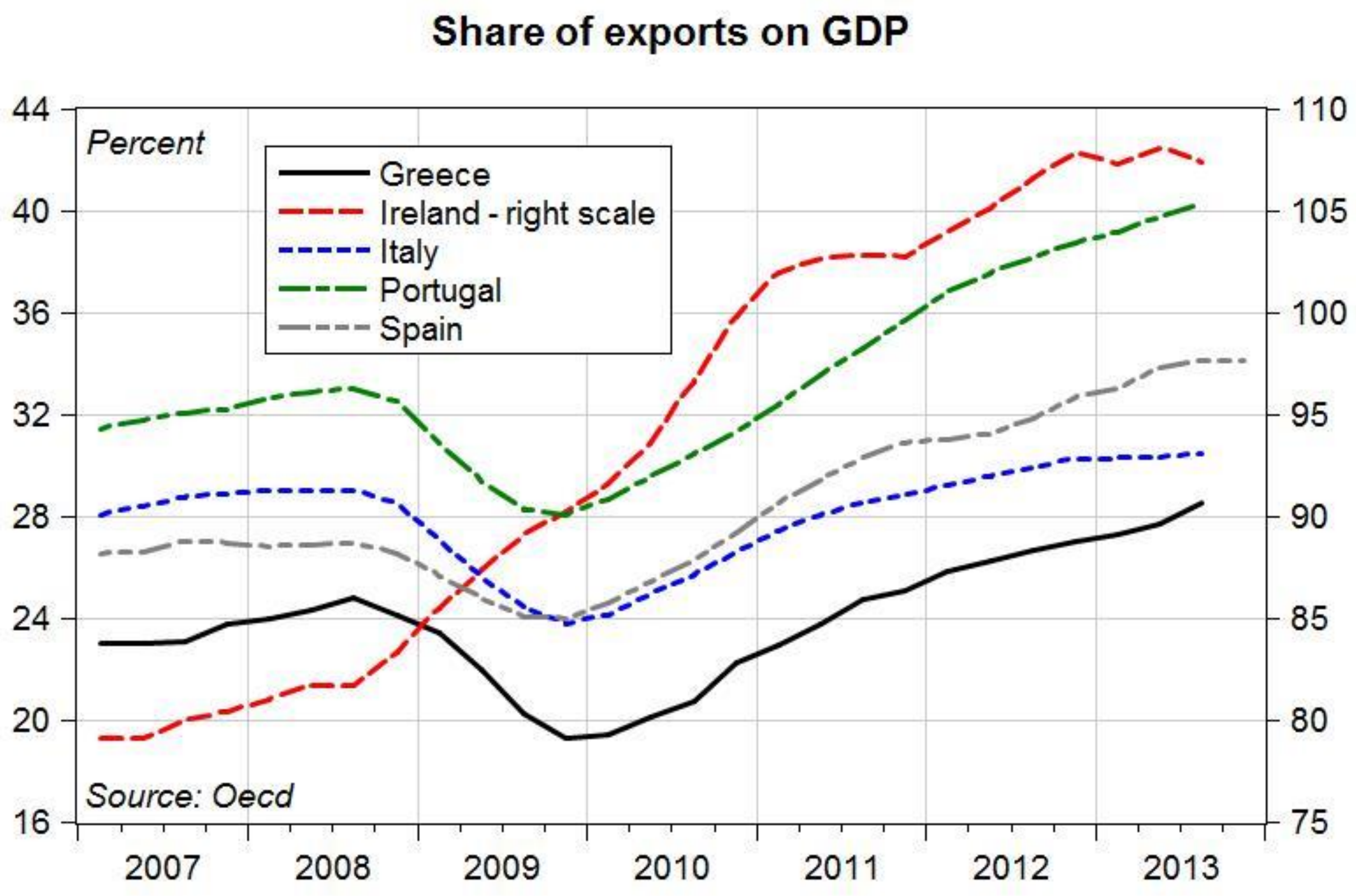
Poster Child for Austerity?



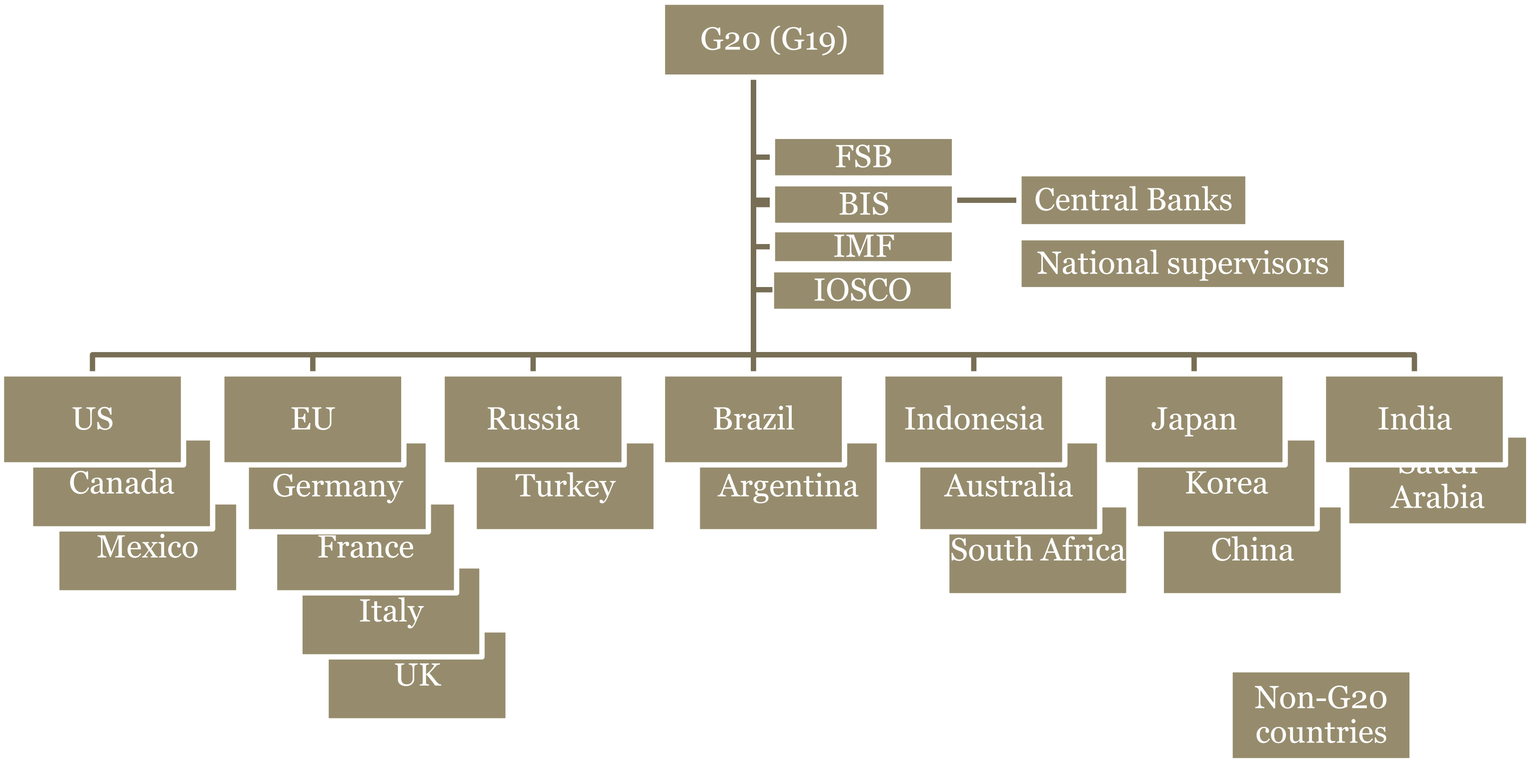
Openness is the key.



Austerity predicated on openness won't work as well elsewhere



New global regulatory architecture



Regulatory reform

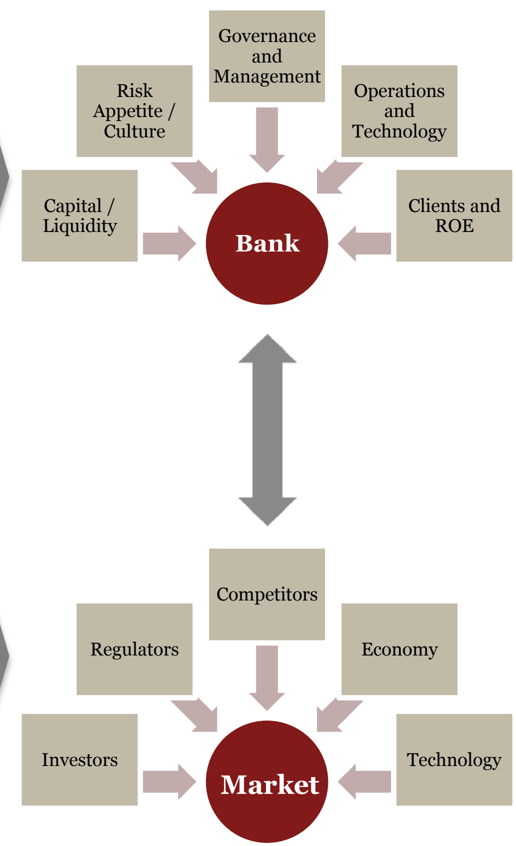
2009 G20 commitment introduced a significant global agenda

Too big to fail	Recovery and resolution
	Segregation
Prudential regulations	Governance
	Capital / liquidity / leverage
Market reform	Transparency
	Market structure / integrity
	OTC derivatives reform
	Investor protection and choice

Resulted in a multitude of regulations

- **Dodd-Frank Act**
- **MiFID II**
- **EMIR**
- **Basel III / CRD IV**
- **Short-Selling and CDS**
- **AIFMD**
- **MAR**
- **Securities Law Directive**
- **Solvency II**
- **PRIPS**
- **Central Securities Depositories**
- **FATCA**

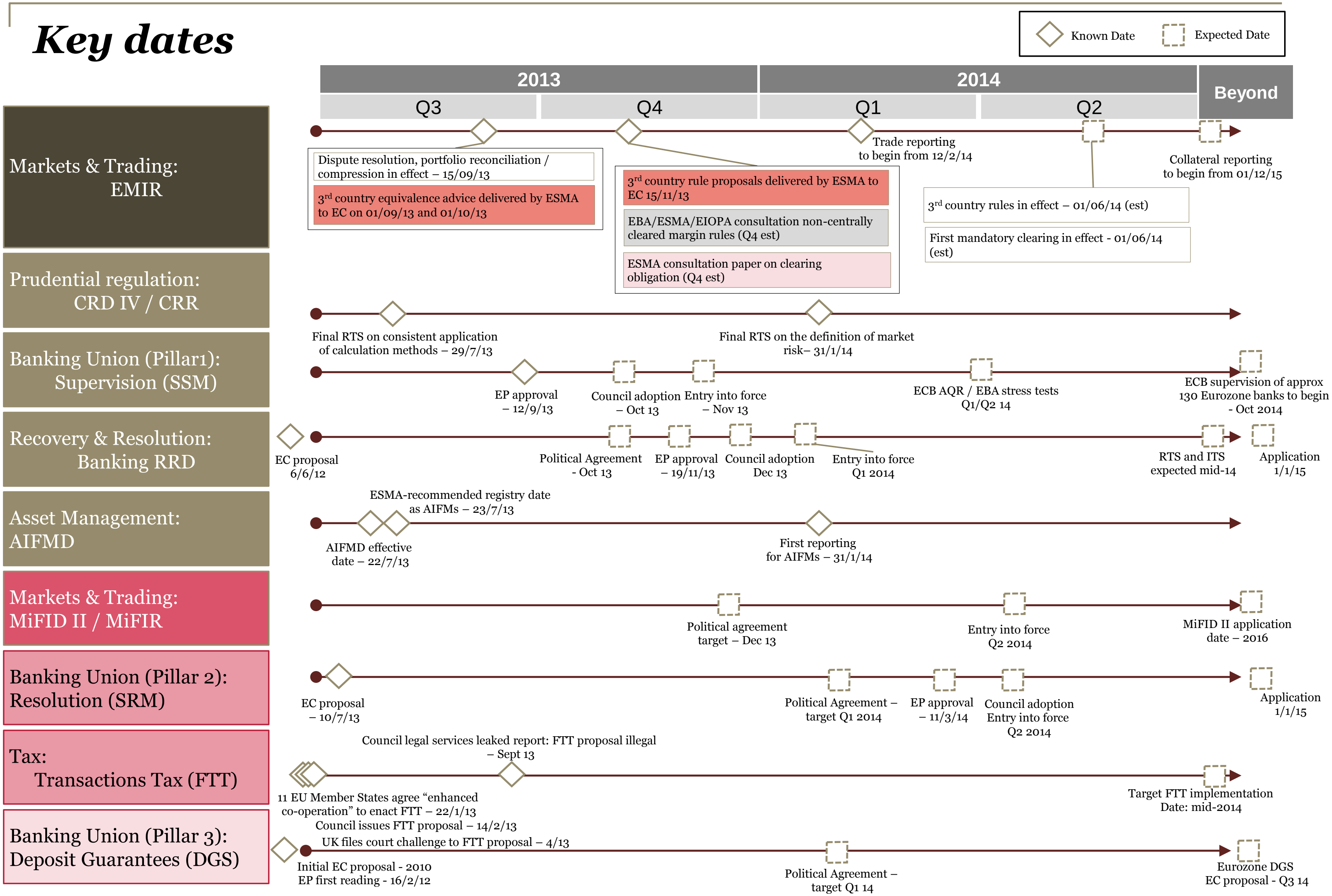
Triggering a multi-faceted impact on banks and market



And a number of changes in the global financial markets

- Unprecedented number of financial regulatory reforms
- Significant ambiguity in potential outcomes and impact
- Uncertain degrees of international regulatory convergence
- Significant focus from banks on compliance and impact assessment

Key dates

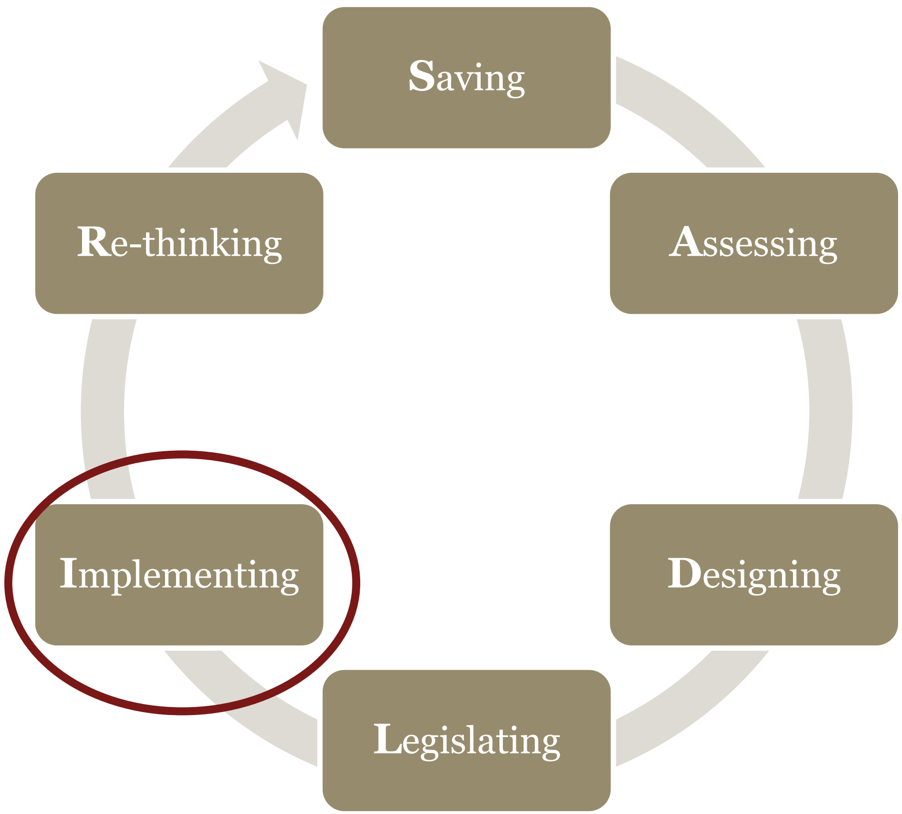

Known Date
Expected Date
2013
2014
Beyond
Q3
Q4
Q1
Q2
Markets & Trading: EMIR
Dispute resolution, portfolio reconciliation / compression in effect – 15/09/13
3rd country equivalence advice delivered by ESMA to EC on 01/09/13 and 01/10/13
3rd country rule proposals delivered by ESMA to EC 15/11/13
EBA/ESMA/EIOPA consultation non-centrally cleared margin rules (Q4 est)
ESMA consultation paper on clearing obligation (Q4 est)
Trade reporting to begin from 12/2/14
3rd country rules in effect – 01/06/14 (est)
First mandatory clearing in effect - 01/06/14 (est)
Collateral reporting to begin from 01/12/15
Prudential regulation: CRD IV / CRR
Final RTS on consistent application of calculation methods – 29/7/13
Final RTS on the definition of market risk– 31/1/14
Banking Union (Pillar1): Supervision (SSM)
EP approval – 12/9/13
Council adoption – Oct 13
Entry into force – Nov 13
ECB AQR / EBA stress tests Q1/Q2 14
ECB supervision of approx 130 Eurozone banks to begin - Oct 2014
Recovery & Resolution: Banking RRD
EC proposal 6/6/12
Political Agreement - Oct 13
EP approval – 19/11/13
Council adoption Dec 13
Entry into force Q1 2014
RTS and ITS expected mid-14
Application 1/1/15
Asset Management: AIFMD
ESMA-recommended registry date as AIFMs – 23/7/13
AIFMD effective date – 22/7/13
First reporting for AIFMs – 31/1/14
Markets & Trading: MiFID II / MiFIR
Political agreement target – Dec 13
Entry into force Q2 2014
MiFID II application date – 2016
Banking Union (Pillar 2): Resolution (SRM)
EC proposal – 10/7/13
Political Agreement – target Q1 2014
EP approval – 11/3/14
Council adoption Entry into force Q2 2014
Application 1/1/15
Tax: Transactions Tax (FTT)
Council legal services leaked report: FTT proposal illegal – Sept 13
11 EU Member States agree "enhanced co-operation" to enact FTT – 22/1/13
Council issues FTT proposal – 14/2/13
UK files court challenge to FTT proposal – 4/13
Target FTT implementation Date: mid-2014
Banking Union (Pillar 3): Deposit Guarantees (DGS)
Initial EC proposal - 2010
EP first reading - 16/2/12
Political Agreement – target Q1 14
Eurozone DGS EC proposal - Q3 14

Keeping on track

- Complexity is a challenge.
- Pace of regulatory change unprecedented.
- New tools and new rules which are untested.
- Less time for impact assessment or planning.
- Lots of unknown unknowns.

- Agreeing the “details” is proving difficult.
- Timetables for implementing G20 commitments slipping.
- Memory of the crisis fading?

Regulatory Lifecycle



Saving: capital injections, restructuring, monetary policy, bans on certain activities in the immediate aftermath of the crisis

Assessing: as financial systems stabilises, the blame game begins: Regulator? Banks? Fiscal/monetary policy?

Designing: Policy makers start outlining grand plans (more regulation, additional powers, institutional restructuring, more intensive supervision) to prevent/mitigate crises from occurring again

Legislating: Detailed legislative proposals are developed which proves tricky and laborious for regulators. Filling gap in the regulator system is difficult; addressing weaknesses in the previous regime, a real challenge. Lobbying from financial firms starts to pick up pace; political commitment starts to wane

Implementing: Regulations are implemented; industry cry over the costs, concerns about the impact on the real economy start to come to the fore

Re-thinking: Questions about growth versus stability, what about competition in the financial system and the benefits of innovation? Regulations start to be watered-down, supervision of banks is relaxed, banks given freedom to start taking bets again…….

From prudential to conduct: regulators shifting their focus towards culture

Role of leadership

Are leaders encouraged to:

- role model the right behaviours
- build a culture of integrity and trust
- condone inappropriate attitudes and behaviours
- create an environment for effective challenge

Ethical framework

Does a framework exist which places ethics at the centre of the organisation and :

- supports the concept of 'doing the right thing' for customers/clients, employees and communities
- governs how decisions are made
- balances values with profit generation at all costs

Cultural translation

What mechanisms are in place to ensure desired values and behaviours are:

- interpreted consistently by all levels of management
- consistently applied across divisions, functions & front-to-back processes
- Enforced by reward structures

Control framework

Does the control framework:

- reinforce the desired culture and behavioural outcomes
- encourage collaborative working
- enable effective challenge and reporting of 'bad news'
- support an effective balance of individual and collective responsibility

Reward

Are individuals and teams:

- rewarded for doing the right thing
- incentivised for good behaviour and poor behaviours dis-incentivised
- recognised for "the how" (behaviours) as well as "the what" (targets and outcomes)

Clarity of expectations

Is there a clear and consistent

- view of what behaviours are expected across front-to-back process
- understanding on what personal responsibility means
- view of responsibilities between functions i.e. hand-offs

What is conduct risk?

Wholesale Conduct Risk

The risk that products, services and activities deliver ***poor outcomes*** to:

- ***the market***;
- ***counterparties*** and clients; and
- ***end users*** of the market.

Retail Conduct Risk

The risk that products and services deliver ***poor outcomes to customers***.

Regulator concern

Sales/distribution of:

- Mortgages
- Investment products
- Derivatives/hedges
- Insurance

LIBOR and other benchmarks

Foreign exchange market practices

Multiple and repeated concerns have caused investigators to focus on organisational ***culture***

Fallout from more regulation

Arbitrage
Asset quality
Balance sheets
Capital
Collateral
Complexity
Competition
Contagion
Culture
Debt/Equity
Deleveraging
Environment

Costs
Profitability
Relationships
Resources
Restructuring
Risk Management
Shadow Banking
Strategy
Training

Summary

Ireland shouldn’t be held up as a poster child for austerity, rather we are a special case because of our institutional and industrial structures.

Imposition of similar rule sets unlikely to achieve similar aims.

New global governance architecture is unprecedented in scale, scope, and complexity.

Potential pitfalls involve pooling of risk in unforeseen areas of the system, the law of unintended consequences writ-large.

European Commission

Good governance: applying lessons learned in the EU

John Berrigan, DG ECFIN

Outline of presentation

- Anatomy of the global financial crisis
- Why the euro-area?
- Reinforcing EMU in response to the crisis
- Key challenges

Anatomy of the crisis

- Phase 1: US mortgage market
- Phase 2: Global financial system
- Phase 3: Global economy
- Phase 4: Sovereign debt markets
- Phase 5: Currency

Anatomy of the crisis

- Crisis not confined to euro area (e.g. US, UK, Iceland)
- Mixed fortunes within the euro area (periphery vs. core)
- Varying crisis characteristics across periphery:
  - *high growth vs. low growth*
  - *from banks to sovereign*
  - *from sovereign to banks*
- Vulnerabilities from EMU construction

Why a euro-area crisis?

- EMU a unique construction: single monetary policy with decentralised fiscal/structural policies
- Removed devaluation as means to avoid reform, but also as means to absorb severe shocks
- Specific construction ensured cost of "non-reform" could not be shifted to supra-national level
- Assumed economic discipline would necessitate convergence in national political preferences

Why a euro-area crisis?

- Pre-conditions for the effective functioning of EMU did not materialise
  - *Member State compliance with a comprehensive rules-based policy coordination framework*
  - *Financial-market discipline to incentivise policy co-ordination*
  - *Integrated financial-stability architecture to validate capital flows*
  - *Capacity to pool fiscal resources (in support of monetary policy) in response to specific shocks, notable financial shocks*

Why a euro-area crisis?

- Substantial cross-border financial flows in pre-crisis period
- Mispricing of risk and misallocation of resources
- Accumulation of economic/financial imbalances in periphery
- Sharp financial reversal as crisis hit
- Fragmentation of financial system and redenomination risk

Reinforcing EMU

- Medium-term dimension of EA crisis response focused on reinforcing the EMU construction
  - *Economic surveillance re-organised more efficiently - EU Semester*
  - *Policy co-ordination framework strengthened and expanded*
  - *Crisis management instruments established - EFSF/EFSM/ESM*
  - *Financial-stability architecture completed – Banking Union*

Key challenges: *Policy environment*

- Inconsistency in market discipline
- Residual economic and financial imbalances
- Low growth-low inflation environment
- Financial fragmentation

Key Challenges: ***Policy implementation***

- Differential perspectives of crisis
- Political constraints on crisis management
- Short-term flexibility vs. long-term credibility
- Time consistency

Thank you for your attention

Presentation by John Berrigan,
European Commission
28 March 2014

European Commission