A Single Market Without a Single Currency?

Financial Market Reform in Euroland - A View from the European Parliament

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Dear Ladies and Gentlemen,

It is an honour for me to stand before you today to present to you a European view on one of the most pressing issues of our time: What were the roots of the financial and the euro crises? Which measures are being discussed in Germany and Europe to prevent such crises in the future? And finally, how can we work together at the global level for a sustainable world economy?

The financial crisis that hit the global economy since the summer of 2007 is without precedent in post-war economic history. It created the deepest recession of the European economy since 1930. In 2009, the Gross Domestic Product (GDP) shrinked by some 4%. This was the sharpest contraction in the history of the European Union. Finally, in the third quarter of 2009, the economic recession came to an end in the EU, in large parts thanks to the exceptional crisis measures put into place under the European Economic Recovery Plan[1], which had been launched in December 2008.

As you know, the crisis had **multiple causes**:

Innovation in structured financial products, willingness by lenders to take excessive risks, low interest rates and the greed of investors for ever higher yields, coupled with their belief that Credit Rating Agencies' ratings come close to recommendations, allowed

[1] The Recovery Plan included a fiscal stimulus of around 1.5% of EU GDP or 200 billion euros, within both national budgets (around €170 billion, 1.2% of GDP) and EU and European Investment Bank budgets (around €30 billion, 0.3% of GDP). The fiscal stimulus was complemented by proposals to speed up structural reforms and by "smart investment" measures at both European and national level.

complex investment products to be sold to an extremely wide range of investors.

The repackaging of credits, the increased complexity of products and the lengthened intermediation chain made it more difficult, sometimes impossible, to clearly evaluate the nature and magnitude of the risk involved and identify those who bear it.

Via off-balance Special Purpose Vehicles, banks could invest in such products without fulfilling the necessary capital requirements. The mutual distrust between banks eventually led to a liquidity crisis, which had to be addressed by economic stimulus packages and financial aid to support banks that were "too big to fail" across the world.

In the EU, the economic recovery measures led to **enormous increases in public spending**. At the same time, as another consequence of the crisis, EU countries faced a sharp decrease in tax revenues. All this combined created huge public budget deficits and rising public debts. The worst deficits can be found in the so-called PIIGS states (Portugal, Ireland, Italy, Greece and Spain), which already had been struggling with high public spending for many years.

As you are all well aware, **Greece marked the beginning of the euro crisis**. In order to get access to credit on the international capital markets through government bonds, Greece had to accept the highest interest rates since the introduction of the euro. This increased the country's payment obligations and reduced its credit-rating even further. So we had a vicious circle, which ultimately threatened the country's solvency in spring 2010.

The Greek crisis became a euro crisis, as it led to rapid shift in currency relations, with investors massively pulling out of the euro. Ultimately, following the plea for support by the Greek government, on 9 May EU Member States agreed on a **750 billion euro emergency rescue plan** to save Greece from insolvency and from pulling down the rest of the euro zone with it. In total, loans worth 500 billion euros were guaranteed by the EU via the new European Stabilization Mechanism. In addition, loans worth 250 billion euros were made available by the IMF.

In spite of the success of these exceptional short term measures, recovery from both crises will be slow and painful. The financial and euro crises made clear that **both the current financial system and the European Monetary Union need to be reformed**.

Last week, the US Congress adopted President Obama's financial reform package, bringing the biggest changes in banking regulation since the world financial crisis in the 1920.

What is being done in Europe to reform the financial markets?

The Free Democratic Party in the European Parliament has requested a reform of financial market regulation and financial supervision along the following four guidelines and principles:

- First, **transparency**: There has to be more transparency on the market. For instance, too many Credit Default Swaps (CDS) are traded over the counter, and not on the public trade market.
- Second, **responsibility**: All market participants must take responsibility for their actions and take corrective measures.
- Third, **sustainability**: Market stability must be restored on a sustainable and long-term basis, without hampering growth and innovation. Here we need above all stronger cooperation of supervisory bodies.
- And fourth, **investor protection**, which must be improved at European and national level.

In the following section of my speech, I will try to translate these general principles into more concrete proposals.

For **financial market supervision**, this means in concrete terms:

Supervisory bodies must collaborate more internationally and exchange information in order to recognise systemic risks at an early stage. This holds for the collaboration between European supervisors and the European Central Bank, but also for national supervisors and their national central banks.

In the mid-run, we need a **European Supervisory Authority**, which should work as a decentralised supervision system, much like the European System of Central Banks. Such a European Supervisory Authority should directly supervise cross-border financial activities in the EU.

In September 2009, the European Commission submitted a legislative proposal to create three new European authorities[2] and a European Systemic Risks Board, which is to act as an early warning system within the ECB. The FDP in the EP considers these proposals as going into the right direction. However, in the view of the European Parliament, they don't go far enough. We would prefer a more encompassing reform, resulting in the creation of a European Supervisory Authority, as outlined before. However, the Member States only want to limit this new authority to the supervision of rating agencies. The negotiations have been difficult and are still ongoing.

With regard to **banks**, we ask the following:

Banks must be able to go bankrupt, if they do not constitute a systemic risk. **Reckless risk-taking must be punished**; otherwise we have a "moral hazard" problem.

Banks should be prepared for crisis situations with **emergency plans**, which would also enable the quick separation of certain parts of the bank.

The **remuneration system** needs to be more long-term oriented and transparent.

[2] European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority.

Risk management needs to be improved. Off-balance sheet activities must be limited. Banks should stick to their business model (for example, a bank specialised on financing small and medium-sized businesses should not act like an investment bank).

At the same time, all providers of services that are similar to a bank must be regulated as a bank.

Furthermore, the **Capital Requirements Directive (Basel II)**[3] needs to be revised and the new rules must be implemented both in the EU and the USA, in order to prevent unfair competition.

In parallel to the international Basel III negotiations, the Commission submitted its own **legislative proposal** in July 2009, increasing capital requirements for the trading book and for re-securitisations. Furthermore, banks are required to have sound

[3] The original Basel Accord was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel I, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.
Basel II is a revision of the existing framework, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices. It affects banks and building societies and certain types of investment firms.
The new framework consists of three 'pillars'. Pillar 1 of the new standards sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and must take action accordingly. The aim of Pillar 3 is to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.
The new Basel Accord has been implemented in the European Union via the Capital Requirements Directive (CRD). The CRD came into force on the 1 January 2007, with firms applying the advanced approaches from 1 January 2008.

remuneration practices that do not encourage or reward excessive risk-taking.

On 7 July 2010, European Parliament and Member States adopted the new directive. From 2011, banks must strictly tie manager bonuses to their basic salaries.[4] The biggest part of the bonuses may only be paid after three to five years, when the transactions of the manager have proved to be successful. If the bank gets into financial difficulties, bankers will be liable with their bonuses that have not yet been paid to them.

In addition, the Commission is working on proposals to harmonise insolvency law in the different Member States, going hand in hand with a cross-border crisis management system for the banking industry. Such a **pan-European insolvency mechanism** would allow the profitable structures to survive and the remaining parts of the company to declare bankruptcy.

Finally, **rating agencies** should become **more transparent**, adapt their assessments more **quickly** and provide **clear information on their methodology**. It has to be clear what a rating means.

We have to discuss inherent **conflicts of interest**, when agencies perform consulting and rating services at the same time.

In April 2009, the EU adopted a **regulation on credit rating agencies**, which is supposed to tackle all these points. From

[4] There is no general upper limit for bonuses. But the EU will produce strict guidelines in order to prevent disproportionate bonuses.

January 2011, all credit rating agencies will have to register with the European Securities and Markets Authority. Supervision is to increase in general, but supervisory authorities will not be allowed to influence the content of credit ratings. New rules are to prevent conflicts of interest and to ensure increased transparency as well as the stable quality of credit ratings.

Overall, the FDP has supported the compromise. However, the new regulation also makes it more difficult for small rating agencies to access the European market, which strengthens the oligopoly of the "big three" agencies (S&P, Moody's, Fitch).

In fact, this oligopolistic structure should be broken. The EU should therefore swiftly go about the **creation of an independent country rating** of its own. The FDP in the EP would like to make sure that country ratings are carried out in the most reliable way. Therefore the oligopoly of the three private rating agencies should be complemented by a **European Rating Foundation**, which would work similarly to the German Stiftung Warentest. This EU Rating Foundation, which would be limited to country rankings, would foster competition with and between the established rating agencies. It would be independent of the ECB and political influence by the Commission or Member States. The foundation should also be financially independent, financing itself by selling its ratings to investors. In the future, it should be mandatory for government bonds of EU Member States to have two ratings, one of them from the European Rating Foundation.

Now I have spoken a lot about initiatives for financial market reform in the EU. However, financial markets all over the world are more interconnected than any other markets. Therefore, if we really want to prevent another crisis from happening, we need to reach **international agreements on financial market reform**.

The most important forum for global reform is the **G20**, which unites the 20 leading industrial and emerging economies. On the G20 summit last June, all countries agreed to "lead world-wide growth on a sustainable path".

However, the US and Europe revealed **different positions in the question how stable growth can be aligned with the consolidation of public budgets**. The US and some emerging countries warned of strict saving policies and asked for more economic stimulus measures to increase demand especially in export nations, like Germany. By contrast, European countries made clear they are in a transition to consolidate their budgets after spending billions of euros on the crisis.

Further, the USA, Germany and France **failed to reach an agreement on a universal bank levy** to make banks pay for the cost of the financial crisis. Canada, Japan and Brazil, whose banks needed no public aid during the crisis, could not be convinced to impose a levy on their banks. However, EU countries are now planning to go ahead with a European bank levy. Of course, it is now to fear that such a unilateral levy could lead to a loss of competitiveness of the European banking sector, since banks could just leave to other countries that do not have a levy in place.

Another blow to European ambitions, the final document made **no reference to a financial transaction tax**, killing any chance of bringing in such a measure on a global scale in the near future. The FDP in the EP rejects a financial transaction tax, but supports a **financial activity tax**, which is limited to high-risk transactions.

From these examples, we can see that there is **still a long way to go** until a comprehensive global reform of financial markets can be reached.

Now let us turn from the financial crisis to the **euro crisis**.

We need a new basis for the Economic and Monetary Union (EMU). In principle, the crisis has shown that a uniform monetary policy is only possible in the long term if also economic policies are coordinated with other euro zone members.

On the first view, the euro crisis seems to confirm the critics of the common European currency, who have never believed that this could work. Some politicians in Germany have even demanded the re-introduction of the Deutsche Mark. Nevertheless, **the euro has brought the EU considerable economic advantages**. In order to recall what is at stake here, let's go back for a moment to its underlying assumptions.

What are the advantages of a common European currency?

First of all, **price stability**. Since the end of World War II, Germany has always been a champion of stability-oriented fiscal policy. The German Bundesbank enjoyed an excellent reputation its success in the fight against inflation in Germany. This thinking was transferred to the ECB, which is also located in Germany. In the first ten years of the EMU, the ECB was even more successful than its predecessor. Since the introduction of the euro, the inflation rates have decreased in all euro zone countries.

Second, a **more stable exchange rate with the dollar**. Since spring 2002, the euro has almost continuously risen against the dollar. Only the Greek crisis led to a devaluation of the euro. Nevertheless, most euro zone countries enjoy more stable exchange rates compared to before because short-term currency fluctuations have become less frequent.

Third, **a boost for economic growth**. The euro boosts cross-border trade of products and services in the internal market, because it saves costs for currency exchange and prices are easier to compare. Furthermore, businesses no longer need to hedge against changing exchange rates. In Germany and some other countries, this created a one-off growth boost of about 2%.

Fourth, **a boost for foreign trade**. Thanks alone to the euro, exports within the euro zone have increased by around 5%, especially because some companies, which had never exported goods to other EU countries, finally dared to enter the export business.

Fifth and finally, **protection from currency crises**. Especially Southern European countries, whose credit rating has suffered most in the financial crisis, were lucky to have the euro. If Greece, Spain and Portugal had still had their national currencies, these would have come under enormous pressure to devaluate. Since these countries would have borrowed mostly in foreign currencies, their debt would have become even more threatening.

Before we look at the proposals for reforms in more detail, we should have a look at **how the EMU works at the moment**.

At the moment, **16 out of 27 EU countries are members of the euro zone**. Eleven countries have not yet introduced the Euro, but have the obligation to do so according the EU Treaty, except from Great Britain and Denmark.

In order to join the monetary union, a candidate country must fulfil the **convergence or Maastricht criteria,** adopted in 1991. This is to ensure a similar, stable economic development of the participating countries. The following conditions to be fulfilled:

- The country must prove a high degree of price stability,[5]
- The financial situation of the government must be sustainable,[6]
- The exchange rate must be stable,[7]

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[5] The inflation rate may only be 1,5 percentage points above the average inflation rate of the three most stable euro zone countries

[6] The yearly deficit of the public budget may not be higher than 3 percent of the GDP, and the total government debt may no exceed 60 percent of the GDP.

- and the interest rates for long-term credits should be similar.[8]

However, as you know, Greece joined the euro zone in 2001 on the basis of fake statistics, as we learned later on. But also Belgium and Italy had clearly missed the debt criteria with quota of more than 100%. Letting them join the monetary union was ultimately a political decision.

In addition to the Maastricht criteria, the **Stability and Growth Pact (SGP)** of 1999 was intended to ensure that the Member States maintain budgetary discipline after the single currency has been introduced. The Stability and Growth Pact opens the way for the Council to penalise any participating Member State that fails to take appropriate measures to end an excessive deficit (the **"excessive deficit procedure"**). Initially, the penalty would take the form of a non-interest-bearing deposit with the Community, but it could be converted into a fine if the excessive deficit is not corrected within two years.

However, there is **no fixed rule** concerning these penalties: they are **subject to assessment of the circumstances by the Council**. In March 2005, the European Council, under the pressure of France and Germany, **relaxed the rules**. The ceilings of 3% for budget deficit and 60% for public debt were maintained, but the

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[7] The national currency may not go beyond the margin of deviation of the European Monetary System (2,25%) for at least two years before the examination of the application.

[8] The interest rates for long-term credits may not be more than 2 percentage points above the interest rates of the three countries with the highest price stability.

decision to declare a country in excessive deficit can now rely on certain parameters.[9]

It is clear that the **EMU needs to be reformed in order to prevent future crises** like the one caused by Greece. The **FDP in the EP asks for four concrete measures** in this respect:

- First, the **European Commission must receive the necessary competences and rights** to work as a hub and to be able to implement tough sanctions.
- Second, **compliance with the SGP must be enforced on the basis of revised rules**, which put **more emphasis on the factor competitiveness**. Control of compliance needs to be improved and tightened through **tough sanctions**. Such sanctions could range from "naming and shaming" over warnings and withdrawal of voting rights in the Council to the blocking of EU money from agricultural, structural or cohesion funds to which the Member State is entitled.
- Third, the Commission should receive more rights in order to be able to **give recommendations to Member States already at the formulation of their economic policies and draft budgets**. Competitiveness needs to become a central element of Member States' economic policies.
- Fourth, we also need a **direct crisis resolution mechanism**, which comes into action in cases like Greece. A **European Monetary and Stability Fund (EMSF)** could work as a last

[9] The behaviour of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures.

resort to stabilize the European monetary system. The objective is **not a bail-out**, which would be in contradiction to the EU Treaty. Financial support by the EMSF would not mean the take-over of debt, but merely a temporary credit.

However, this idea to set up a lender of last resort, which has found the support of the German government, has attracted **critics from the ECB and the French government**. Many questions are still open, including who would pay into the fund and how independent it would be from the Commission.

Another divergence between the German and the French governments was the question **how European economic governance should be organised in the future**. While Mr Sarkozy was in favour of a permanent "Directorate" of the 16 euro zone countries with its own secretariat, Merkel was for an inclusion of all 27 Member States. As a compromise, only in emergency situations the euro zone countries can meet on an exclusive basis, and they will not get their own secretariat.

On 30 June 2010, **the European Commission made several proposals to reform the SGP**. However, the proposed measures appear to represent the lowest common denominator between the Member States and do not require any changes to the EU Treaty.

According to the proposal, Member States should **coordinate their national budgets** in a structured manner in the first semester of each calendar year, the so-called "European Semester". This process is supposed to start already in January 2011.

Furthermore, **Member States should be forced to comply with the SGP by quicker sanctions**. If a country fails to comply with the 3% deficit or 60% debt criteria, it risks loosing its subsidies from the EU budget. Nevertheless, fishers and farmers would still be entitled to their subsidies, but they would have to be paid from the national budget.

If a Member State fails to make progress on the consolidation of its budget, it will have to leave a **deposit** with the EU. As soon as the Member State recovers, the money is paid back with interest.

In addition to **budget surveillance**, the Commission also plans to introduce **macro-economic surveillance**. An early warning system is going to assess indicators like trade balance, competitiveness, inflation, private debt and real estate prices. In most serious and confirmed cases, the Commission would make **country-specific recommendations** and could also propose placing a Member State in an “excessive imbalances position”. For euro zone countries, an **enforcement mechanism in the case of serious and repetitive breach of recommendations** could be envisaged.

Unfortunately, the Commission proposal did not take up the further-going proposal by the German Minister of Finance, Wolfgang Schäuble, and the ECB to start deficit procedures automatically, in order to exclude non-compliant states from the decisions on sanctions. This was to avoid that "sinners judge over sinners".

Also the proposal to temporarily withdraw voting rights in the Council from non-compliant countries, which the German Chancellor Angela Merkel and also President Sarkozy had advocated at the European Summit two weeks before, was dropped.

Nevertheless, the Commission's reform proposal addresses many of our requests and is a step forward into the right direction. At least we can expect the reform of the SGP to be adopted still this year, since it seems to be based on a general consensus between Member States.

In **conclusion**, financial market reform is an extremely difficult task, both at the European, and even more so at the global level. Although some important first steps have been taken, a lot remains to be done.

The same holds for the reform of the European Monetary Union. We cannot afford to lose the advantages of the euro. Therefore we have to use all our energy and political will now to get the job done, while the window of opportunity is still open.

A crisis can be defined as a "crucial or decisive point or situation, or a turning point". In the case of the European Union, there are two clear options: Either the Union breaks apart, or it emerges from this crisis united stronger than ever. I believe in the latter option.

Thank you very much for your attention.