The euro-zone at cross roads.

Speech by Carlo Trojan, former Secretary General of the European Commission, at the Enlarged Council Meeting of the International Fertilizer Industry Association (IFA), Rome 28 November 2012.

Ladies and Gentlemen,

It is a great pleasure for me to address today's IFA's Enlarged Council Meeting. I have been asked to give you my views on the present euro-crisis, its impact on industry and the perspectives for euro-zone restoration.
The financial stability of the euro-zone and the economic outlook of the EU as a whole are of crucial importance for the industry at large. The EU with its 500 million citizens is still the largest economic area in the world, the largest trading partner and largest provider of foreign investment. As the second largest exporter in the world of agricultural products the EU is of particular importance to the fertilizer industry. Persistent fiscal imbalances, the sovereign debt crisis, the fragility of the banking sector and the inadequate response of the EU financial and economic governance have undermined confidence in the financial markets and amongst investors and consumers. The resulting sluggish economic growth and outright recession in a number of EU countries has its impact well beyond the EU.

The financial and economic crisis in the EU is now in its fourth year. The first wave of the crisis originated in the financial sector and partly blew over from the US. Few people foresaw that the banking crisis would escalate so quickly in a sovereign debt crisis.

The inadequate capitalization of many European banks has resulted in the bank and debt crises becoming intertwined and the euro-crisis was born.
The EU Treaties, which are based on a no-bailout clause, do not provide for massive financial assistance to manage such a crisis. In the euro-zone there is no lender of last resort as is the case in the US. No account was taken that members of a monetary union are more vulnerable to liquidity problems. Countries in a monetary union incur debts in a currency over which they themselves cannot exercise any control. And, as we have seen, in integrated financial markets liquidity problems can degenerate fairly quickly in solvency problems. Moreover fiscal imbalances were accompanied by macro-economic imbalances in various euro-zone countries undermining their competitiveness.

Much has been written about the root causes of the present financial and economic crisis. They are partly due to lacunae in the existing Treaties (notably as far as economic policy coordination is concerned), but mainly the result of failing implementation of Treaty provisions. The Stability and Growth Pact was virtually set aside, national banking supervision (micro and macro) was a failure, systemic threats of financial innovations were hugely underestimated, and light touch financial regulation and ineffective economic policy coordination prevailed. The management of the sovereign debt crisis has been fragmented and wavering. The response to it since the potential bankruptcy of Greece came to light can best be summed up as “too little, too late”. After the first Greek support operation in 2010 also Ireland and Portugal required emergency assistance. Eventually a loan facility (EFSF) was set up which led to the creation of a permanent stability mechanism (ESM) which entered into force in the beginning of this month. The entire process that led to the subsequent bail out decisions was unable to restore confidence in the financial markets and to prevent contagion to such countries as Spain and Italy. Without the innovative intervention of the ECB in providing liquidities to the

banking sector (LTRO's) and buying up governments bonds on the secondary markets the euro-crisis would have become unmanageable. This summer new tensions in the government bond markets led ECB President Mario Draghi to pledge that the ECB would do "whatever it takes" to retain the euro. The ECB Governing Council subsequently decided to provide, under appropriate conditions, a fully effective backstop in the government bond markets "to counter the impairment of monetary policy transmission and to preserve the singleness of the ECB's monetary policy". Through so-called outright monetary transactions (OMT's) the ECB will intervene ex ante and unlimited, and under strict conditions, in government bond secondary markets. The ECB will conduct OMT's if and as long countries comply with the conditions attached to an appropriate programme via the European Stability Mechanism. Moreover the European Council, with a view to the Spanish situation, already decided in June that the ESM under certain conditions could intervene directly to recapitalize banks. These decisions have eased the tensions in the government bond markets but need to be implemented by governments concerned and followed up by effective action of the EU institutions both for the short and longer term.

The EU is facing no doubt its most serious crisis since its foundation. But the rule of "never waste a crisis" has been from the outset inherent to European integration. The banking crisis has given a significant push to supervisory and regulatory repair of the EU financial system. An EU wide system of macro-and micro prudential supervision was set up comprising a network of national and European regulators. This was an important first step towards more effective EU supervision. The banking crisis has also led to higher capital requirements (Basel III) and an extended regulation of financial services.
The sovereign debt crisis has triggered far reaching decisions for a much stronger framework for coordinating national economic and

fiscal policies and for enhanced budget discipline. The Stability and Growth Pact had been given teeth with the introduction of semi-automatic sanctions in both the preventive and corrective phases. The European Semester was established which sets a framework to improve economic policy coordination in the EU. The excessive deficit procedure has been reinforced and a procedure has been set up for monitoring and correcting macro economic imbalances. The European Commission was invested with a stronger role in ensuring tighter supervision and stronger enforcement. The Treaty on Stability, Coordination and Governance in the EMU, the so-called "fiscal compact", of January of this year introduced moreover the "golden rule": the budget must not exceed 0.5 % of GDP. The adoption of the "fiscal compact" by the European Council sends a strong political signal that the euro countries are serious about introducing and enforcing strict budget discipline.

The political impact of the financial and economic crisis has been huge. We have seen governments tumble all over Europe. Many of EU member states, both within and outside the euro-zone, face great challenges in stabilizing their public finances and strengthening their competitiveness. Unemployment is at unacceptable levels in most Member States. The pressure of markets and loan programmes of the EFSF have forced governments to fundamental fiscal and structural reforms demanding great sacrifices from populations and provoking important social tensions. The good news is that change is happening. We see positive signs of fiscal consolidation and a wave of structural reforms is being implemented both in programme countries (Ireland, Portugal and Greece) and weak peripheral economies like Spain and Italy. And I think that it is justified, as we are in Rome, to pay tribute to the exceptional performance of Mario Monti and his government.

All these decisions-both at EU and national level- were by all accounts unprecedented by any standards from before the financial crisis. While good progress has been made one can still argue whether the glass is half empty or half full. Still more needs to be done to convince financial markets that decisive progress is being made to achieving stable and sound foundations for the euro-zone as a whole. Are national and European politicians able to learn from the current crisis to make crisis management more effective and convincing? How effective is the firewall of the ESM and the back up of the ECB? How to manage the case of Greece? Will Member States stay on course for sound fiscal policies and structural reforms? And last but not least are Member States fully committed to take the necessary steps towards "a genuine economic and monetary union"? The euro-zone and the EU as a whole are at crossroads and much depends on the capacity of the EU institutions and Member States to tackle these fundamental questions. This is a tall order. European governance is in disarray and the support amongst the populations is eroding. The qualitative jump needed to achieve a robust and sustainable economic and monetary union will have to go hand in hand with a major effort to strengthen political and public support.

It may be true that the tensions in the government bond markets have eased since the ECB commitment to intervene in government bond secondary markets. It is equally true that the conditions subject to this commitment have not been met so far. Spain has not applied yet to programme aid of the ESM and Italy seems reluctant to do so. Direct recapitalization of banks by the ESM can only be contemplated when effective European banking supervision is in place. It took 10 hours for the October European Council to confirm its earlier decision to establish a European banking supervision as from 2013. Not without some backtracking as to the actual date and modalities. The operational criteria for direct bank recapitalization by the ESM need still to be agreed upon and they will be most likely subject to stiff conditions.

The road to a European banking union-integrated financial framework in EU speak- will be a rather long and bumpy one.

The European Commission has tabled detailed legislative proposals to establish a Single Supervisory Mechanism for banks in the euro area. According to this proposal the ECB should ultimately be responsible for the financial supervision and stability in the euro zone. Presently banking supervision, crisis management and resolution are still managed along national lines. The European Banking Authority (EBA) and the European Systemic Risk Board (ESRB) exercise mainly coordinating functions. Under the Commission proposals, broadly endorsed by the European Council, as from 2013 the ECB will progressively assume micro prudential supervision of the whole European banking sector. This entails the setting up a distinct organizational structure within the ECB completely separated from the monetary policy function. The issues at stake are rather complex and as usual the devil is in the detail. This became pretty much apparent in the October European Council. Which banks should be covered by European supervision? Which supervisory tools and powers are necessary? How to ensure coherence between banking supervision in the euro area and the European Union as a whole? Each of these questions has already led to a good deal of controversy between EU member states. In a full fledged banking union one has also to deal with bank recovery and resolution and deposit guarantee schemes. According to the Commission proposals ultimately the ECB should also be responsible for bank resolution and crisis management involving a European Resolution Fund and a European Deposit Guarantee Scheme. The question of burden sharing and deposit insurance is still completely open and raises important financial and national sovereignty issues.
Notwithstanding the difficulties and controversies lying ahead I would argue that as far as the banking union is concerned the glass is half full. Member states do realize that the perspective of a banking union is a prerequisite for a sustainable economic and

monetary Union. But the roadmap to achieve it, and to be decided in December of this year, should be as clear and as detailed as possible. This time the financial markets expect firm commitments.

A genuine economic and monetary union requires more than a banking union. In his interim report of last month European Council President Herman van Rompuy (together with the Presidents of the Commission, ECB and Euro-group) made also the case for an integrated budgetary and economic policy framework. As mentioned before in the last couple of years significant improvements have been made to the rules based framework of fiscal policies in the EMU. The so-called “six-pack” has been enacted and the “fiscal compact” has been ratified. Further strengthening of fiscal governance is in the legislative process. This so- called “two-pack” will provide for ex ante coordination of national budgets of the euro area and enhance the surveillance of those member states experiencing financial difficulties.

Far more controversial are the suggestions for some sort of fiscal capacity for the euro zone to provide asymmetric shock absorption at the central level or the pooling of treasury bills on a limited and conditional basis (euro-bonds). The interim report also calls for further strengthening of the EU surveillance framework of national economic policies including promoting structural reforms through contractual arrangements between member states and EU institutions.

Establishing an integrated budgetary and economic policy framework requires a more far-reaching division of powers between individual countries and the EU institutions. Fiscal policies and socio-economic policies are at the heart of national governance. Further integration implies reduction of policy autonomy and adjustment capacity of member states. The euro crisis and the ineffective action of EU institutions and European heads of state and government has not only undermined confidence in the financial markets but also among large sections op the

European populations. It has become paramount to strengthen public support in order to secure the future of the EMU and the EU itself. The van Rompuy report rightly underlines the need of democratic legitimacy and accountability.

The euro crisis has forced European leaders to strengthen the foundations of economic and financial governance in the EU- substantially, procedurally and institutionally. However, European governance remains fragmentary and the tensions between the Community method and the intergovernmental approach make it difficult to arrive at coherent and effective policies. Moreover this has to be done against the background of sluggish economic growth, high unemployment, sizeable competitiveness differences between member states, fiscal unbalances, towering national debt and faltering public support for the European project. The economic outlook for the next few years is not encouraging. A mere 0.4 % growth in the EU27 in 2013 (1.6 % in 2014) with shrinking economies in Spain, Italy, Portugal and Greece. An unemployment rate in the euro zone of 11.8 % and more than double of that in Spain and Greece. The good news is that fiscal unbalances are being reduced and that structural reforms are under way with signs of improving competitiveness in several countries, including Italy.

Another piece of good news was this week's agreement between the Eurogroup and the IMF on measures to reduce Greek debt to 124 % of GDP by 2020. This opens the way to releasing an additional tranche of much needed financial aid to Greece. Next to Greece the main focus is on Spain where it is anticipated that the government will apply shortly for ESM support to recapitalize the banking sector.

The improved sentiment on the financial markets may not last. What is needed is a strong commitment to the irreversibility of the euro by agreeing a long term vision for the EMU. The EU is

indeed at cross-roads and the December European Council should give an important signal both to European citizens and financial markets. A detailed roadmap to a banking union is a first requisite. There should however also be a clear perspective of further reducing both fiscal and macro-economic unbalances and strengthening the competitiveness of south-European countries. Establishing an integrated budgetary and economic policy framework as advocated by van Rompuy calls also for a certain degree of solidarity to mitigate the most painful elements of structural reforms and to create new prospects of restoring growth and jobs in the peripheral economies.

The spirit of solidarity was not very present at last week's European Council which had to deal with the multiannual financial framework (2014-2020). It has become standard EU practice on these budget negotiations that each member state is fighting its own corner offering too little and asking too much. This display of national egoism reinforces however the public image of deeply divided and ineffective European governance at the highest level. At the moment that the EU is at crossroads and major decisions are needed to secure the future of the EMU and the EU as a whole governments should show the necessary commitment and unity.

Enhanced and more effective economic and financial governance in the EU may eventually require Treaty changes. The community method offers by and large the best safeguards for efficient and sound policies. Further strengthening the role of the institutions, and particularly the European Commission, in implementing and enforcing policies will very much depend on strengthening democratic legitimacy and accountability. The European Commission may be accountable to the European Parliament but public distrust in both institutions is significant. Here there is an important role for governments and national parliaments with regard to communicating to the public.

As European governance has become an integral part of national governance national parliaments should moreover be actively involved in the preparation of European decisions.

As I said in the beginning of my speech Europe and the single market, as well as the financial stability of the euro zone, are of crucial importance to the industry. Notwithstanding the shifting balance of power worldwide the EU will remain one of the major global actors. If it gets its acts together it can make a major contribution to a brighter economic outlook worldwide. European integration has been a step by step process during the last 60 years. And it will continue to be a step to step process. But the euro crisis has been a wake up call. There is no alternative to further and deeper European integration. Governments are well aware of this but are at pains to convey the message to their constituencies. National governments will need to clarify the necessary reforms for European citizens and highlight what is at stake in terms of prosperity. In strengthening public support for the European project there is a clear role for industry as well. Maintaining the single market and the euro is of crucial importance to the industry both inside and outside the EU.

It is my firm belief that the EU will eventually emerge stronger from the present crisis. It will not happen overnight but progressively foundations are being laid for a more robust and sustainable economic and monetary union. It is up to the December European Council to elaborate the long term vision and the roadmap towards it.

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