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Alessandro Leipold
Chief economist, the Lisbon Council

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Inching Forward in Testing Times: The 27-28 June 2013 European Council

Judgement on the success or otherwise of the European Council of 27-28 June 2013 depends, as in many ventures, on initial expectations.[1] The highest ambitions had been set out a year ago, when the June 2013 summit first began to be flagged, in the *Financial Times*' rendition, as "a gathering that would firmly put Europe on the path towards a 'banking union,' moving authority to supervise and bail out banks from national capitals to new European Union institutions in Frankfurt and Brussels."[2] Similarly high prospects were touted more recently in another area, with the meeting being billed as "the European Council on Youth Employment."[3] That such grand expectations would prove illusory should have been obvious. On banking union, the past year has been marked by delays and dilution of all its key elements. The single supervisor, direct bank recapitalisations, the bank recovery and resolution directive, the deposit guarantee scheme directive, and the single resolution authority are – albeit to different degrees – all behind schedule and less ambitious than originally entertained. As for youth employment, any optimism had to be tempered by the disappointing results of the Compact for Growth and Jobs in its first year of operation.[4]

At the other extreme, some observers feared an outright failure of the European Council, especially following the difficulties encountered at the pre-summit economic and financial affairs council (ecofin) in agreeing on rules determining who would bear the costs in the rescue of ailing banks (so-called "bail-in" rules). Such agreement was originally intended to

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[1] *Economic Intelligence 04/2013* is the fourth in a series devoted to pre- and post-European Council analysis. Previous briefings are available on the Lisbon Council website at http://www.lisboncouncil.net and http://www.lisboncouncil.net/chiefeconomist.

[2] Peter Spiegel, "Progress Report: European Union's Move to Banking Union," *Financial Times*, 25 June 2013. http://www.ft.com/intl/cms/s/0/a6e53a4a-dd96-11e2-892b-00144feab7de.html#axzz2XP4MkQfO

[3] Herman Van Rompuy, *Letter to the Members of the European Council on Youth Employment*, 24 May 2013. http://europa.eu/rapid/press-release_PRES-13-215_en.pdf

[4] European Commission, *The Compact for Growth and Jobs: One Year On* (Brussels: European Commission, 2013). http://ec.europa.eu/commission_2010-2014/president/news/archives/2013/06/pdf/2_en.pdf

be reached in March 2013, then slipped to the ecofin meeting of 20 June, and finally attained only in the early morning of 27 June, as heads of state and government were already on their way to Brussels. On youth employment, scepticism was nourished by the continued blockage of the funds (€6 billion) envisaged in the 2014-20 EU budget to support some of the agreed initiatives.

Depending on whether you bought more heavily into the first or second scenario, the European Council was either a failure or a success. In reality, it was neither. It was, as has been characteristic of responses to this crisis, an outcome that belied the doomsayers by pulling off further, gradual progress, but it also disappointed the more dedicated supporters of European integration insofar as progress fell short of requirements and aspirations. It perhaps can best be defined as a sort of "middling success," keeping a forward movement but, in the face of political obstacles, at an unsatisfactorily slow pace and with an insufficiently ambitious scope. However, given the evident political divisions in Europe, and the looming German federal elections, the maintenance of forward momentum is *per se* an accomplishment, for which much credit is due to effective Presidency of the Council of the European Union leadership from Ireland and Taoiseach Enda Kenny, who concluded an overall successful semester with this European Council.

'It is Imperative to Break the Vicious Circle Between Banks and Sovereigns'

That's what euro area leaders declared in their 29 June 2012 communiqué, and that's what the EU27 repeated at this European Council one year later.[5] It is thus fair to judge the European Council's outcome against its own stated objective – which is, by the way, essential to the resolution of this crisis. The eurogroup meeting of 20 June and the ecofin councils of 20-21 June and 26-27 June reached eleventh hour agreements on 1) the operational framework for direct bank recapitalisations by the European Stability Mechanism (ESM), and 2) the "bail-in" rules for distressed banks. European heads of state and government took note of these agreements, and called for further work to allow adoption of the directives on bank recovery and resolution and on a deposit guarantee scheme "before the end of the year." They also recognised – significantly – that "a fully effective Single Supervisory Mechanism (SSM) requires a Single Resolution Mechanism (SRM)" and said they look forward "to the Commission's proposal establishing an SRM with a view to reaching agreement in the Council by the end of the year so that it can be adopted before the end of the current parliamentary term." Although the resolutions are important and potentially far-reaching, the timetable seems overly sanguine, particularly as regards the European parliamentary process.[6] And the December European Council is again being set up as yet-another "make-or-break" meeting for the future of European banking union.

The key banking issues before ministers and summit leaders at the flurry of end-June meetings regarded direct ESM bank recapitalisations and rules for burden-sharing ("bailing-

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[5] Council of the European Union, *Conclusions of the European Council*, 28 June 2013, DOC 13/5. http://europa.eu/rapid/press-release_DOC-13-5_en.pdf

[6] European Parliament elections will take place on 22-25 May 2014, and the Autumn legislative season is already seen as something of a lame-duck session.

in") in the rescue of troubled banks. As mentioned, the eurogroup reached agreement on ESM bank recapitalisations prior to the European Council, and even added some scope for useful flexibility, regarding in particular their "retroactive" use.[7] But, regrettably, the European Council stuck to the eurogroup's not entirely helpful timetable, whereby direct ESM bank recapitalisations will be possible only "when an effective single supervisory mechanism is established" – rendering this vital programme operational only toward late 2014, well beyond the schedule recommended by the European Central Bank.

The second central item – that of recovery and resolution rules – proved to be more difficult. This was predictable, since the ecofin that met on the eve of the European Council was asked to resolve in a single last-ditch meeting an issue that has bedevilled and divided economists since Walter Bagehot first developed the lender of last resort theory in the mid-1800s.[8] The question was, what is the appropriate degree of flexibility in the setting of bank recovery and resolution procedures? Is it best to have clear rules or preferable to allow scope for discretion? Should bank managers be left guessing how a resolution will be handled in the event of emergency or is the resulting uncertainty ultimately harmful to business decisions and the shaping of expectations?

The response to these queries goes to the heart of the so-called "moral hazard" debate, implicit in all forms of insurance. In the case at hand, capital injections into an ailing bank – a particular form of insurance – may affect behaviour in two ways. First, they may induce bank managers to assume additional risks so as to maximise the subsidy implicit in the public rescue – the recent leaks of Anglo-Irish tapes bear sorry testament to such misconduct.[9] Second, the possibility of official sector bail-outs of failed financial institutions likely reduces the incentives for uninsured depositors to monitor the behaviour of the institutions to which they have lent.[10]

By way of simplification, there are essentially two schools of thought on the matter, one favouring the flexibility of what has come to be known as "constructive ambiguity," and the other supporting clear and fixed rules.[11] The most cogent exposition of "constructive ambiguity" was that provided in 1990 by Gerald Corrigan, then president of the Federal Reserve Bank of New York, in his testimony to the U.S. Congress, in which he argued that, by introducing an element of uncertainty into the provision of support, pressure can, in principle, be maintained on banks to act prudently, since the latter will not know individually

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7 See Alessandro Leipold, "'*Les yeux plus gros que le ventre?*:' The 27-28 June 2013 European Council," *Economic Intelligence 03/2013* (Brussels: Lisbon Council, 2013). http://www.lisboncouncil.net//index.php?option=com_downloads&id=870

8 Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: H S King, 1873).

9 Paul Williams, "Abuse The Bank Guarantee, Don't Get Caught," *Irish Independent*, 25 June 2013. http://bit.ly/10Qhqmc

10 As Walter Bagehot put it well over a century ago, "any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank." Bagehot, *op. cit.*.

11 See Xavier Freixas, Curzio Giannini, Glenn Hoggarth and Farouk Soussa, "Lender of Last Resort: A Review of the Literature," *Bank of England Financial Stability Review*, November 1999 (Bank of England: London, 1999); http://www.bankofengland.co.uk/publications/Documents/fsr/1999/fsr07art6.pdf and Charles Enoch, Peter Stella and May Khamis, "Transparency and Ambiguity in Central Bank Safety Net Operations," *IMF Working Paper*, WP/97/138 (IMF: Washington DC, 1997). http://www.imf.org/external/pubs/ft/wp/wp97138.pdf

whether they will be rescued or not.[12] This approach was supported in a 1997 G10 report, which argued that "any pre-commitment to a particular course of action in support of a financial institution should be avoided by the authorities, who should retain discretion as to whether, when and under what conditions support would be provided."[13]

A second school of thought has pressed instead for clear and unambiguous rules regarding public intervention into ailing banks, partly prompted by increasing moves toward transparency. Rules advocates argue that in order to influence expectations – crucial for policy success – the parameters must be clear and understood. They also note that rules serve to tie policymakers' hands and curtail their bias toward so-called "forbearance" – i.e., regulators' inclination to allow a bank to continue operations despite an impaired capital position in the hope of an eventual recovery in its conditions. Examples of such regulatory forbearance abound in the course of the current European crisis – notably in Spain (with regard, for example, to the classification of mortgage loans), Ireland and Cyprus. In light of such experience, it has been argued that – whatever the academic case in favour of discretion – the political reality in Europe is that flexibility is bad on two counts. First, it implies the prevalence of *ad hoc* decision-making, heightening the role of national political considerations. Second, flexibility would favour countries with the means to bail out troubled banks.[14]

How does the ecofin agreement of 27 June measure up in relation to these considerations?[15] Ultimately, the compromise between the supporters of clear rules (the Commission and Germany) and those favouring discretion (France and non-eurozone countries) contains – as all compromises – elements to please both. The result is a murky mix, lacking certainty, as reflected in a new bureaucratic oxymoron it coined: so-called "framed flexibility" (meaning that the exercise of discretion will be reviewed by the European Commission for consistency with state aid rules). Ultimately, a high degree of national discretion seems to remain nonetheless possible, thanks to a number of loopholes. Countries will for example be allowed to protect certain liabilities at their discretion for rather vague reasons (e.g., "to avoid value destruction to other creditors" or "to avoid contagion"). As observed in a recent Deutsche Bank research note, "this will allow strong countries to bail out (and not bail in) their banks more fully than weak countries" – which is not precisely in the spirit of a self-proclaimed "banking union."[16] Tellingly, following the agreement, shares in banks in weak countries have fallen more than those in strong ones – reinforcing the fragmentation problem that banking union is intended to fix.

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12 E. Gerald Corrigan, *Statement Before U.S. Senate Committee on Banking, Housing and Urban Affairs,* Washington D.C., 1990.

13 G10 Working Party on Financial Stability in Emerging Market Economies, *Financial Stability in Emerging Market Economies* (Basel: Bank for International Settlements, 1997). http://www.bis.org/publ/gten02.pdf

14 See Martin Sandbu, "Flexibility Decided By States is a Wrong Move for Europe's Banks," *Financial Times*, 26 June 2013. http://on.ft.com/157HiJw

15 For details of the agreement, see Council of the European Union, *Council Agrees Position on Bank Resolution*, 1128/13, 27 June 2013. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf

16 Deutsche Bank Market Research, "European Banks – Banking Union Falters," *Deutsche Bank Breaking News*, 27 June 2013. http://pull.db-gmresearch.com/p/1552-E0E7/44127005/0900b8c086f6884f.pdf

More fundamentally, do the combined decisions regarding ESM recapitalisations and the bail-in rules succeed in breaking the bank-sovereign link, as so often invoked? The short answer is no: the link is not broken, not as long as resolution authority and related funds (along with deposit insurance) remain at a largely national level. Indeed, the European Council's agreement on recovery and resolution makes no mention of the ESM as a shared backstop – nor does it envisage any common fiscal backstop if the upcoming asset quality review and the ECB's stress tests of Spring 2014 reveal some important capital shortfalls.[17] The question arises: what is the point of tough stress tests if the shortfalls they uncover cannot be filled? The result could well be a further loss of confidence. These considerations notwithstanding, the agreement focuses rather on the setup of national resolution funds (financed via bank contributions). These would be allowed to lend to each other, but only on a "voluntary basis" – likely, in practice, to mean not-at-all.

Still, despite these shortcomings, the establishment of a bail-in hierarchy by order of seniority will serve to protect taxpayers, and help if not quite to break then at least to weaken or dilute the "pernicious link." With the first 8% of total liabilities due to be borne by bank shareholders and the lower rungs of other designated debt owners before resolution funds are allowed to intervene (with a cap set at 5% of liabilities), bank crises should be less costly for the public purse. The direct burden on governments is eased, with taxpayers set to foot the bill only as a last resort. It is in this light that Fitch Ratings evaluates the overall agreement as being (in credit agency parlance) "credit positive for eurozone sovereigns."[18] Also, with shareholders and bondholders on the hook for losses, the market should exert greater discipline on banks not to run excess risks.

But all of this will take time: banks have 10 years to make their annual contributions until resolution funds reach a minimum level of 0.8% of covered deposits (only a handful of countries currently have standalone resolution funds), and the bank recovery and resolution directive itself is slated to enter into full effect only in 2018.[19] In the meantime, not only does the European regime for troubled banks remain unclear (possibly putting further pressure on banks' funding costs), but available funds risk being woefully insufficient (even if the ESM were tapped, given its €60 billion cap for capital injections) – and sovereigns would again be on the hook. In brief, the agreement is positive in having set a "bailing-in" hierarchy, but ultimately provides too much national discretion, and is too spread over time to truly "break" the doom loop in the foreseeable future.

Youth Employment: A Small Fillip

Besides banking union, the June 2013 summit placed youth employment and financing for small- and medium-sized enterprises (SMEs) at the centre of its agenda. Urgent actions on

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[17] Language calling for ESM bank recapitalisations to be ready in time for the stress tests' fallout was reportedly removed from drafts of the summit communiqué; see Alex Barker, "Improvisation the Rule in Bank Bail-In Deal," *Financial Times*, 27 June 2013.
http://www.ft.com/intl/cms/s/0/dd534582-df3e-11e2-a9f4-00144feab7de.html#axzz2XWvLaS6I

[18] Fitch Ratings, "ESM, Bank Resolution Positive But Sovereign Link Unbroken," *Fitch Ratings*, 28 June 2013.
http://bit.ly/17Lz3XE

[19] The arbitrariness – and ultimate likely untenability – of this deadline is reminiscent of the "no-sovereign-rescheduling-before-mid-2013" mantra that prevailed in 2010-11.

both fronts were said to be needed to confront the current crisis. While the effectiveness of singling out the youth unemployment rate (23.5% in the EU27 in April 2013) for special treatment is questioned in some quarters – given the larger problem of overall unemployment and the very different youth participation rates in many countries – there is one undeniable and seriously disheartening figure: more than 7.5 million young people under 25 are currently "neither in employment, education or training." The problem is so acute it has generated a numbing new acronym for this group: the NEETs, as they are now known in official parlance, a living expression of a potentially lost generation.[20]

Given the magnitude of the problem and the hard political realities surrounding the community budget, EU-wide initiatives that would make a significant dent in youth unemployment could not realistically be expected from the European Council. The fear, rather, was that the Council would engage in rhetorical grand-standing with little substantive content. Such a fear turned out to be unfounded. As we wrote in our pre-summit analysis, "the European Council would be a success on the employment front if it simply managed to carry forward and fully fund the initiatives already decided – ideally via some front-loading – rather than diffusing the effort with yet another grandiose (but unfunded) announcement whose implementation prospects would remain typically bleak."[21] This is precisely what the European Council delivered. First, it focused on furthering existing initiatives, eschewing new ones. Second, it increased funding and usefully front-loaded that for the Youth Employment Initiative and Youth Guarantees. The European Council's decisions furthermore came on the heels of an agreement between all EU institutions (the Council of the European Union, the European Commission, and the European Parliament) on the multi-annual EU budget, the so-called multi-annual financial framework for 2014-2020 – another achievement of the Irish Presidency.

That said, Martin Schulz, president of the European Parliament, is right to point out that even after the increase to €8 billion, up from €6 billion, in the funds for the Youth Employment Initiative, the amount remains a "drop in the ocean."[22] As President Schultz noted, according to International Labour Organisation estimates, €21 billion would be needed to implement the Youth Job Guarantee properly. And the "drop in the ocean" is unlikely to be increased much by the European Council's accompanying decision to reassign, as the budget unrolls, any unspent funds in other areas as a priority to employment. Still, for some beneficiary countries, the sums are not insignificant. It will consequently be important that they make every effort to be eligible, meeting the Youth Guarantee requirement that within four months after finishing school or becoming unemployed, all young people under 25 be offered a job, additional education or training. In several countries with weak employment support agencies – Italy being among them, as Prime Minister Enrico Letta acknowledged – this will be a challenge. Without this national effort, the EU employment

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20 See European Council, *European Council – 27-28 June 2013: Factsheet on Youth Unemployment.* http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/137631.pdf
For a questioning of youth unemployment targets, see Daniel Gros, "Europe's Youth Unemployment Non-Problem," *Project Syndicate*, 06 June 2013. http://bit.ly/1a3KNEx

21 Leipold, *"Les yeux plus gros que le ventre," op. cit.*.

22 Martin Schultz, *Speech by President of the European Parliament Martin Schulz to the European Council of 27 June 2013.* http://bit.ly/17Lz9hQ

funds risk remaining lamentably unused – as is the case with a far-too-large proportion of structural funds in general.

The issue of the dearth of credit to SMEs, particularly in crisis countries, and related fragmentation of financial markets, was also taken up by the European Council. Here, there are grounds for scepticism over the decisions taken: the launch of what was billed as a "new" investment plan to support SMEs and boost the financing of the economy lacks detail, and appears largely as a repackaging of a plan already decided in June 2012, when the European Investment Bank was granted a capital increase as part of the Compact for Growth and Jobs. In addition, the initial intention to call on the EIB to raise its lending activity by 50% over 2013-2015 was scaled back to "at least 40%" in the face of concerns regarding maintenance of its AAA rating. Ultimately, the issue of the fragmentation of Europe's financial markets will be dependent on true progress toward banking union, with only a marginal contribution being possible via EIB lending initiatives and the expansion of joint risk-sharing financial instruments between the European Commission and the EIB (to leverage private sector and capital markets investments in SMEs). There also is a role – in countering financial fragmentation – for the ECB's outright monetary transactions.

In sum, there are grounds for reasonable satisfaction with the outcome of this European Council. The issues on the table were either very complex and divisive (bank resolution rules) or largely intractable within the limited Community budget envelope (youth unemployment and SME financing). While a decisive exit from the crisis would have required bolder and swifter action across all fronts, the results were fundamentally positive when set against the political constraints and the less-than-auspicious run-up to the summit. Much remains to be done and many key decisions have been postponed to the end of the year, with the December 2013 European Council again set to have an overcharged agenda. It remains to be seen whether the passing of the German elections will facilitate the needed progress on this agenda. This has to be Europe's hope.

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Alessandro Leipold is chief economist of the Lisbon Council. Previously, he served as acting director of the European Department of the International Monetary Fund.

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The Lisbon Council asbl
IPC-Résidence Palace
155 rue de la Loi
1040 Brussels, Belgium
t. +32 2 647 9575
f. +32 2 640 9828
info@lisboncouncil.net
twitter @lisboncouncil
www.lisboncouncil.net

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