

Brussels, 31 May 2011

## EU Economic governance: a major step forward

*The EU and its Member States have taken a series of important decisions that will mean stronger economic and budgetary coordination for the EU as a whole and for the euro area in particular. In this way, an imbalance that has existed between the two parts of Europe's Economic and Monetary Union (EMU) is being rectified. The decisions will ensure that Member States more closely coordinate their economic policies – something the crisis has shown to be essential. As a result, the EU's interdependent economies will be better placed to chart a path to growth and job creation. It is a major step forward.*

The new economic governance is based on the three main responses to the crisis:

### 1. Reinforcing our common economic agenda with closer EU surveillance

- **We have agreed economic priorities for the EU:** The Europe 2020 strategy is the EU's common economic agenda. It sets out clear priorities and targets at EU and national level to boost Europe's growth over the next decade. The Annual Growth Survey (AGS) sets priority actions for the next 18 months, which are translated into national targets and measures tailored to the needs of each Member State. The Euro+ Pact sets additional commitments for the countries taking part.
- **There will be tighter EU surveillance of economic and fiscal policies:** The Commission has proposed giving the EU new tools to prevent unsustainable public finances and major competitiveness imbalances between Member States. The system includes sanctions: euro area countries not respecting the rules can face fines. The European Parliament and Council are expected to finalise the package in June 2011.
- **We will discuss our economic priorities and our budgetary policies at the same time every year:** Our new coordination device to monitor commitments at EU level is called the European Semester. Over the first half of each year, discussions will take place both on the EU's economic agenda, on the basis of the AGS presented by the Commission in January, and on Member States' priorities, presented in their national programmes in the spring. Country-specific recommendations will be issued in June, giving time for these to be incorporated into national budgets and economic policies for the following year.

### 2. Safeguarding the stability of the euro area.

In 2010, the EU responded to the sovereign debt crisis by setting up temporary support mechanisms, which will be replaced by the permanent European Stability Mechanism (ESM) in 2013. These support measures are helping to safeguard the financial stability of the euro area. They are conditional on rigorous fiscal consolidation and reform programmes, and are developed in close cooperation with the IMF.

### 3. Repairing the financial sector.

The EU has established new rules and agencies to address any problems earlier and make sure all financial players are properly regulated and supervised. Further work will be carried out, including the more systematic and rigorous bank stress tests currently taking place. A healthy financial sector is essential to allow businesses and households access to credit.

## 1. Reinforcing our common economic agenda with closer EU surveillance

A common framework is essential for the EU to tackle its economic challenges and return to a stronger growth path. In the past, the lack of a clear system of economic governance between Member States led to imbalances and lost opportunities, and made the EU more vulnerable when the crisis hit. To ensure that those days are behind us the Commission proposed the Europe 2020 strategy, which was endorsed by the European Council in June 2010. The strategy brings together (1) a common economic agenda and (2) a stronger EU surveillance framework, which should be decided upon and monitored in a synchronised way (3).

### 1.1 Europe 2020, the Annual Growth Survey and the Euro+ Pact

The **Europe 2020 strategy** \* <sup>1</sup> is the EU's common economic agenda – a plan to move beyond the crisis and boost smart, sustainable and inclusive growth over the next 10 years. It deals both with short-term challenges linked to the crisis and the need for structural reforms and growth-enhancing measures needed to help Europe recover from the crisis and make its economy more resilient to economic shocks in the future.

Europe 2020 is based on a simple and effective delivery mechanism, made up of targets, concrete priority actions and monitoring. It consists of:

- **Five targets for 2020.** Five targets have been set for 2020 to catalyse efforts in critical areas for the EU's future: employment, innovation, climate/energy, education and social inclusion. These targets have been agreed for the EU as a whole and have also now been translated into national targets by each Member State.

- 75% of the population aged 20-64 should be employed.
- 3% of the EU's GDP should be invested in Research & Development.
- The EU should reduce its CO2 emissions by 20%, increase its energy efficiency by 20% and raise the share of renewable energies in overall energy consumption to 20%.
- The share of early school leavers should be under 10% and at least 40% of the younger generation should have a degree or diploma.
- 20 million fewer people should be at risk of poverty.

- **Seven "flagship initiatives".** In order to drive progress towards the Europe 2020 goals, the Commission has come forward with a set of seven "flagship initiatives" covering: "A Digital Agenda for Europe"<sup>2</sup>, "Innovation Union"<sup>3</sup>, "Youth on the Move"<sup>4</sup>, "Resource Efficient Europe"<sup>5</sup>, "An Industrial Policy for a Globalisation era"<sup>6</sup>, "An Agenda for New Skills and Jobs"<sup>7</sup> and "The European Platform Against Poverty"<sup>8</sup>. The recent adoption of the Single Market Act<sup>9</sup> is a further example of the Commission's action to support Europe 2020.

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\* all items referred with \* are explained in the glossary attached to this MEMO

<sup>1</sup> See [IP/10/225](#)

<sup>2</sup> See [IP/10/581](#), [MEMO/10/199](#) and [MEMO/10/200](#)

<sup>3</sup> See [IP/10/1288](#) and [MEMO/10/473](#)

<sup>4</sup> See [IP/10/1124](#) and [MEMO/10/408](#)

<sup>5</sup> See [IP/11/63](#) and [MEMO/11/43](#)

<sup>6</sup> See [IP/10/1434](#), [MEMO/10/532](#) and [MEMO/10/533](#)

<sup>7</sup> See [IP/10/1541](#) and [MEMO/10/602](#)

<sup>8</sup> See [IP/10/1729](#) and [MEMO/10/687](#)

<sup>9</sup> See [IP/10/1390](#), [IP/11/469](#) and [MEMO/11/239](#)

- **Ten concrete priorities for 2011.** In January 2011, the Commission further detailed the way forward in its **Annual Growth Survey**<sup>\*10</sup> by setting out more immediate actions for the next eighteen months.
  - Three priorities to guarantee **macro-economic stability**: 1. putting our public finances in order; 2. taking action where we see large current account deficits or surpluses, and 3. ensuring the stability of the financial sector. An example: in 2011, all Member States are implementing fiscal consolidation plans, which set strict deficit targets to be met as of this year and which will bring their budget deficits below 3% of GDP within an agreed timeframe.
  - Four priorities to enhance structural reforms: 1. helping people get back to work or find new jobs by making work more financially attractive, 2. urgently reforming pension systems, 3. making sure that unemployment benefits provide an incentive to work and 4. better balancing flexibility and security in the labour market. This does not mean abandoning our common European social model. It means bringing in those who are currently excluded from the labour market.
  - Three priorities to frontload **measures that boost growth**: 1. abolishing barriers that still hamper the Single Market, 2. increasing investment in energy, transport and IT infrastructures, partially through innovative financing (including EU project bonds), and 3. creating cost-efficient access to energy. Speeding up growth will also help to accelerate fiscal consolidation and support structural reforms.
- A complementary agenda with **additional reforms** – called the **Euro+ Pact**\* – has been agreed among euro area Member States, as a reflection of their deeper interdependence, as well as six non euro area countries that have chosen to sign up: Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. The Pact focuses on **four areas: competitiveness, employment, sustainability of public finances and reinforcing financial stability**.
  - The Pact was endorsed at the [2011 Spring European Council on 24/25 March](#). All 23 signatories are committed to implementing the reforms it details. The remaining four Member States are free to sign up if they wish.
  - The Pact is fully embedded in the new economic governance framework and the commitments taken therein are included in the National Reform Programmes\* of the concerned Member States.
- **One integrated delivery mechanism** to ensure that EU commitments are effectively implemented through national reforms. Member States are committed to:
  - setting **national targets** to be met by 2020, committing themselves to contribute to the overall EU effort. This was done in 2010. The Commission is monitoring progress.
  - spelling out in their National Reform Programmes\* (**NRPs**) and Stability or Convergence Programmes\* (**SCPs**) the measures they intend to take domestically to contribute to what has been decided at EU level. This should cover both the AGS and the key areas included in the Euro+ Pact. These NRPs and SCPs should be sent to the Commission.
  - **translating these measures into concrete policy actions** through their national budgets and laws to be debated by their parliaments.

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<sup>10</sup> See [IP/11/22](#) and [MEMO/11/11](#)

## 1.2. Tighter EU surveillance of economic and fiscal policies

Over the past few years, the EU has not been able to respect the goals it set itself on economic and fiscal policies, partly because of a surveillance mechanism that was not stringent enough. To address this, on 29 September 2010 the Commission presented six legislative proposals (the so-called **Six-Pack**<sup>11</sup>). The European Parliament and the Council are expected to give their final agreement to the package in June 2011. The package has three main objectives:

### - 1<sup>st</sup> objective: Stronger *preventive action* through a reinforced **Stability and Growth Pact**

Member States must avoid excessive public deficits (beyond 3% of GDP) and excessive debt (beyond 60% of GDP), so as not to put fiscal sustainability at risk. These rules are enshrined in the Treaties and detailed in the **Stability and Growth Pact\* (SGP)**.

This is achieved both through surveillance of national budgets and surveillance and coordination of economic policies (based on Article 121 of the Treaty). To this effect, each year Member States set out the structural reforms and efforts needed to achieve fiscal sustainability in their **Stability or Convergence Programmes\* (SCP)**.

The new governance system introduces three key changes:

- **Greater transparency:** Member States should ensure that their fiscal frameworks, at all administrative levels (national, regional and local) reflect the EU budgetary framework. This means bringing all elements – such as national public accounting systems, statistics and forecasting practices – into line with EU standards, allowing for more clarity and peer pressure.
- **Stricter rules:** Member States with unsustainable public finances will be required to make significant **progress towards medium-term budgetary objectives (MTO)** to respect the 3% deficit criterion. Expenditure growth should be linked to the mid-term GDP growth rate, so that any extra revenue leads to increased savings rather than higher expenditure. A faster adjustment path towards the MTO will be expected from countries with a debt ratio above 60%, countries with a strongly rising debt level or countries facing risks to long-term sustainability.
- **Better enforcement:** Failure to respect the agreed principles will make the concerned Member State liable to **a warning** from the Commission, even in the preventive phase. In case of a persistent and/or particularly serious failure to respect the rules, the Commission will draft **a recommendation** to the Member State to take corrective action. The recommendation will be adopted by the Council unless a qualified majority of Member States vote **against** it (the so-called reverse qualified majority voting procedure). For euro area Member States, the recommendation will be backed by an enforcement mechanism (based on Article 136 of the Treaty) in the form of **an interest-bearing deposit** amounting to 0.2% of GDP. This preventive arm of the SGP has been **further strengthened by the Euro+ Pact**, with euro area (and several other) Member States committed to translating EU fiscal rules as set out in the SGP **into national legislation through a specific national legal vehicle** of their choice. This should have a sufficiently strong binding and durable nature (e.g. a constitutional or framework law).

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<sup>11</sup> See [IP/10/1199](#), [MEMO/10/455](#), [MEMO/10/454](#) and [MEMO/10/456](#)

- 2<sup>nd</sup> objective: Stronger *corrective action* through a reinforced Stability and Growth Pact

When Member States do not respect the thresholds laid down in the Treaties, the **Excessive Deficit Procedure\* (EDP)** is triggered. However, the current fiscal situation in almost all Member States, and the sovereign debt problems in some, show that the existing EDP was not effective. The Commission has proposed giving teeth to the SGP through better enforcement and the ability to fine Member States (as outlined above). The two key changes are:

- **Stricter rules: debt reduction** will now be a criterion in the assessment of public finances. Member States with debt in excess of 60% of GDP must reduce the amount by which their debt exceeds the threshold by at least 1/20th per year over three years. If they do not, they will be placed in EDP. All relevant factors should be taken into account, as outlined in the Commission proposal, when assessing the satisfactory pace of debt reduction.
- **Better enforcement: a non-interest-bearing deposit of 0.2% of GDP** will be requested from a euro area country that is placed in EDP. The Commission will draft a **recommendation** to the Member State to take corrective action. The recommendation will be adopted by the Council unless a qualified majority of Member states vote **against** it (the so-called reverse qualified majority voting procedure). In case of non-compliance with the initial recommendation for corrective action, this non-interest-bearing deposit (see below) will be converted into a **fine**. The fine will be increased in case of repeated non-respect of the recommendations.

#### - 3rd objective: reducing macro-economic and competitiveness imbalances.

Over the past decade, Member States have made divergent economic choices, leading to competitiveness gaps and to major macroeconomic imbalances within the EU. A new surveillance mechanism will be set up to identify and correct such issues much earlier. It will rely on the following main elements:

- **Clear alert system: a scoreboard** of external and internal indicators (around 10) to detect imbalances emerging in different parts of the economy. The composition of indicators may evolve over time. Thresholds will be identified and announced. The assessment of such indicators will not be mechanical but will be done by the Commission based on in-depth reviews, Stability and Convergence Programmes and National Reform Programmes.
- **Stricter rules: a new Excessive Imbalance Procedure\* (EIP)** will now be created, based on Article 121 of the Treaty. This mirrors the Excessive Deficit Procedure for public finances. If the Commission considers that macroeconomic imbalances (or the risk thereof) exist, it will propose that the Council open an EIP and recommend that the Member State(s) concerned adopt a corrective action plan with a clear roadmap of implementing measures and a deadline. Progress made will be reviewed on a regular basis.
- **Better enforcement:** For euro area countries, the enforcement mechanisms will include both **finances** (0.1% of GDP) and non-financial measures in case the imbalances are not corrected.

### 1.3. The European Semester

In the past, the EU Institutions looked at economic policy in the spring and fiscal frameworks in the autumn, with the implementation by Member States of commitments made at EU level only reviewed retrospectively. Basically, we decided on economic objectives without necessarily knowing how much money we could mobilise.

From now on, Member States and the Commission will discuss structural reforms, growth-enhancing measures and fiscal surveillance at the same time. These discussions will occur at EU level every year from January to June (the **European Semester**\*<sup>12</sup> actually refers to the first semester of each year). In this way, Europe will ensure consistency between economic decisions and budgetary constraints so as to reinforce their effectiveness and improve delivery at national level. The extra commitments taken under the Euro+ Pact will also be fully integrated into this new process.

How will it work?

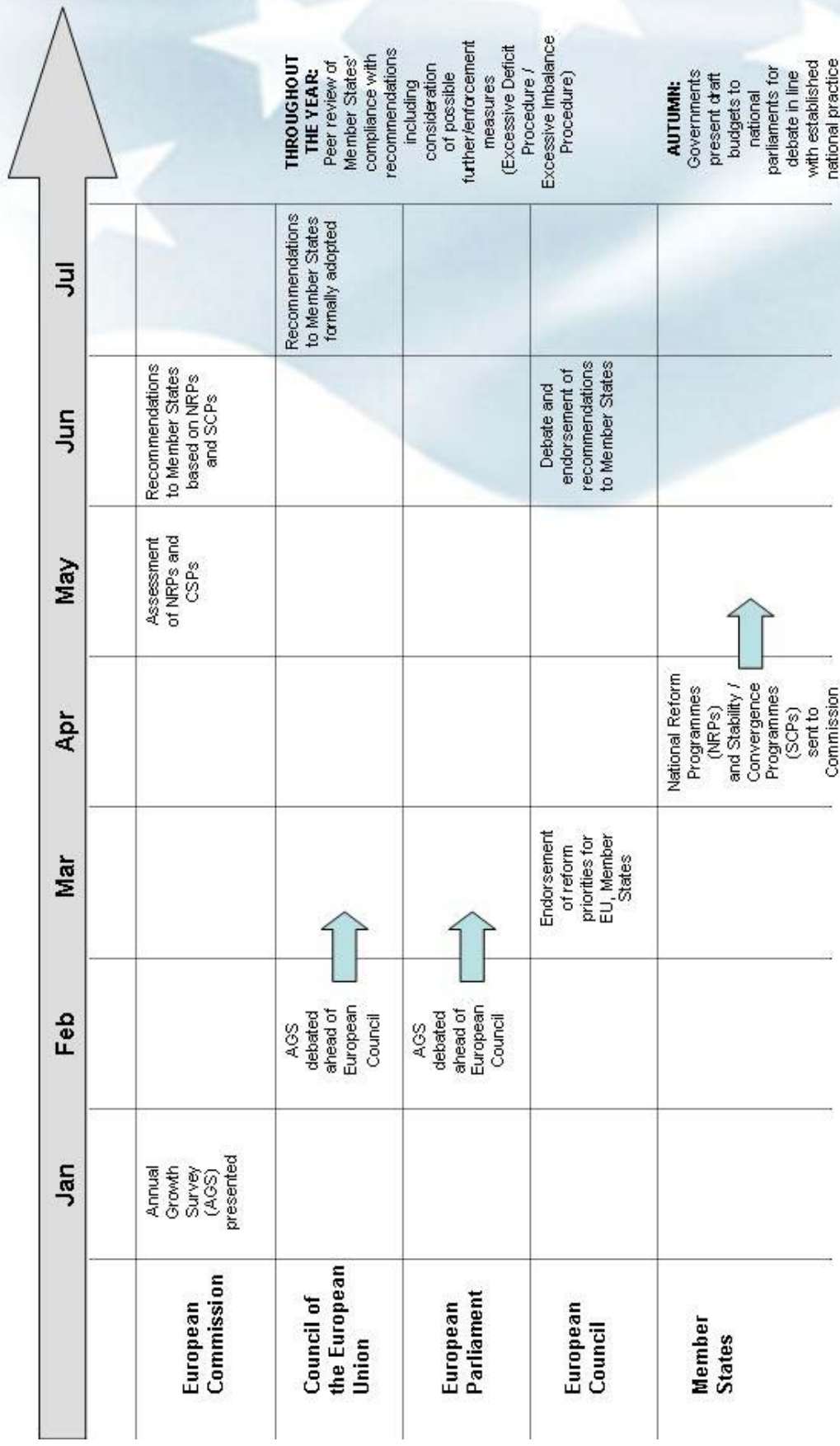
- **January: steer by the Commission.** The Commission will launch each cycle by presenting its Annual Growth Survey\*<sup>13</sup> in January, with a clear assessment of the EU economic situation and guidance for further priority actions to be delivered at both EU and national levels. The Survey will encompass three economic policy components: macro-economic and fiscal policy, structural reforms and growth-enhancing measures.
- **March: political endorsement by the European Council.** The Spring European Council will discuss and endorse this menu for economic reform and fiscal policy in one single set of conclusions. Heads of State and Government will thus take ownership of this common economic agenda and budgetary surveillance framework, and will be committed to proper implementation in their respective countries.
- **April/May: presentation of national programmes.** Member States will then submit to the Commission and their peers their National Reform Programmes\* (NRPs) and Stability (for euro area countries) or Convergence (for non-euro area countries) Programmes\* (SCPs). The NRPs set out Member States' agendas for structural reform and measures to boost growth and jobs and move towards the achievement of the Europe 2020 targets. They also include the short-term commitments made under the Euro+ Pact by the countries that have signed up to it. The SCPs on the other hand set out national plans for sound and sustainable public finances. The synchronisation of the preparation of these two programmes will ensure will ensure the streamlining of processes and reflect the virtuous circle of sound public finances and structural reform.
- **June: recommendations by the Commission.** After due assessment of these national reports, the Commission will present in June draft country-specific recommendations to the Council, flagging the progress and shortcomings of each Member State in delivering the agreed actions. The June European Council will discuss these recommendations, and the Council will subsequently adopt them. Member States will take into account the guidance received from the Council when drawing up their budgets for the following year. Draft budgets will continue to be sent from governments to national parliaments for debate in the second half of the year, since they continue to exercise fully their right to decide on the budget. In other words, the new framework in no way represents a limit to the sovereignty of national parliaments.

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<sup>12</sup> See [IP/11/22](#) and [MEMO/11/14](#)

<sup>13</sup> See [MEMO/11/11](#)

# The European Semester: Who does what and when?



## 2. Safeguarding the stability of the euro area

The economic crisis has put great pressure on public finances, increasing levels of deficits and public debt in all Member States. Three non-euro area Member States have been granted financial assistance by the EU (through the balance of payments mechanism), IMF and World Bank, in exchange for agreeing to implement programmes of fiscal consolidation and structural reforms. The first was agreed with **Hungary**, which received disbursements of €5.5bn between October 2008 and November 2010. A second programme was approved for **Latvia** in January 2009, in exchange for assistance of up to €7.5bn. And a third programme was agreed with **Romania** for €5bn in May 2009. The Romanian and Latvian programmes are currently ongoing.

The evolution of sovereign debt has become a matter of serious concern since 2010 and has closed access for some euro area Member States to sustainable sovereign debt refinancing on the market.

To guarantee the stability of the euro area as a whole and assist individual Member States in financial difficulties and/or under serious market pressure, temporary mechanisms have been set up as a backstop of last resort. An agreement has also been reached on a permanent mechanism to be put in place as of 1 July, 2013.

Financial assistance can be provided to a euro area Member State which requests it, subject to strong conditionality reflected in an economic adjustment programme to be negotiated by the Commission and the International Monetary Fund (IMF), in liaison with the European Central Bank (ECB). With such mechanisms, the EU has the capacity to act to defend the euro, even in the most stressed scenarios. They are a clear reflection of the common interest and solidarity within the euro area, as well as the individual responsibility of each Member State before its peers.

- **Mechanism of bilateral loans (for Greece)**. An ad hoc mechanism was set up on 2 May 2010 to face the imminent threat of Greek insolvency. The euro area Member States agreed to provide, together with the IMF, €110bn of financial assistance to Greece in the form of bilateral loans, with specific interest rates, for a period of three years. These loans were made conditional on a strict fiscal consolidation programme, and were discussed with the Commission, the ECB and the IMF. The Commission monitors progress through quarterly missions and reports to Finance Ministers.

The agreement of 11 March 2011 aligned the maturities of both the future and already disbursed tranches of the loans to Greece with those of the loan to Ireland (seven-and-a-half years on average). Furthermore, it was decided to reduce the pricing of both the future and already disbursed tranches of the loans of the Greek facility by 100 basis points.

- **Temporary mechanisms worth up to €500bn (2010–2013)**. In the face of persistent pressure on the sovereign debt markets, the euro area Member States and the Commission decided on 10 May 2010 to set up two temporary financial backstop mechanisms worth up to €500bn to support any other euro area countries which could need financial support. These are the **European Financial Stabilisation Mechanism\* (EFSM)**, based on guarantees from the Community budget up to €60bn; and the **European Financial Stability Facility\* (EFSF)**, an inter-governmental body providing up to €440bn in guarantees from the euro area Member States. The IMF decided to complement these mechanisms with a potential financial support to euro area countries of up to €250bn.

In November 2010, **Ireland** requested €85bn in assistance from these newly set up mechanisms, following a sharp deterioration in its fiscal position due to extraordinary banking problems which came on top of the impact of the recession. A programme was negotiated by the Commission, the IMF and the ECB. The United Kingdom, Denmark and Sweden decided to complement this assistance mechanism with bilateral loans<sup>14</sup>.

In light of the Irish experience and in order to face any other request before 2013, the 24-25 March **European Council further improved key elements** of these temporary mechanisms. The pricing of the EFSF's loans (and subsequently those of the EFSM) has been lowered to better take into account the debt sustainability of the assisted countries, while remaining above the funding costs of the facility, in line with the IMF's pricing principles. The EFSF's scope of activities has also been made more flexible: it may, as an exception, intervene in the primary debt market (i.e. buying newly issued sovereign bonds) in the context of a programme with strict conditionality. Finally, the agreed lending capacity of the EFSF of €440bn will be made fully effective, as recommended by the Commission. The amendments to the EFSF legal agreement will be prepared so as to allow national parliamentary procedures to be completed by the end of June 2011, in full respect of national constitutional requirements.

In May 2011, financial assistance of €78bn was also granted to **Portugal** to enable the country to deal with its financing difficulties. Two thirds of the assistance will come from EU sources: €26bn from the EFSF and €26bn from the EFSM, with the remaining €26bn provided by the IMF. The assistance will be disbursed over three years, conditional on the outcome of quarterly assessments of Portugal's implementation of the agreed programme, comprising an ambitious fiscal adjustment, a wide range of reforms to enhance growth and competitiveness and measures to reinforce the stability of the financial sector.

- **European Stability Mechanism\* (as of 1 July, 2013)**. Last autumn, euro area Member States decided to set up a permanent mechanism, enshrined in the Treaty, as a structural response to any future request for financial assistance beyond 2013.

The European Stability Mechanism<sup>15</sup> (ESM) will provide a permanent crisis resolution framework and will assume the role of both the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in providing external financial assistance to euro area Member States from 1 July, 2013. Access to ESM financial assistance will be provided on the basis of strict policy conditionality under a macro-economic adjustment programme and a rigorous analysis of public-debt sustainability, which will be conducted by the Commission together with the IMF and in liaison with the ECB. The beneficiary Member State will be required to put in place an appropriate form of private-sector involvement, according to the specific circumstances and in a manner fully consistent with IMF practices. Non-euro area Member States may decide to participate in operations conducted by the ESM on an ad hoc basis (as it is the case now with Ireland).

The terms of the ESM, including its governance, capital structure and repartition, location, instruments and IMF involvement, were agreed by the euro area summit on 11 March and confirmed by the European Council on 24-25 March. The ESM will have an **effective lending capacity of €500bn** (a total subscribed capital of €700bn, from which €80bn will be in the form of paid-in capital and €620bn in a combination of committed callable capital and of guarantees from euro area Member States).

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<sup>14</sup> See [IP/10/1768](#)

<sup>15</sup> See [MEMO/10/636](#)

**The Treaty on the Functioning of the EU** (Article 136) will be amended to set up the ESM. After the Commission and the European Parliament gave their positive opinions, the European Council agreed on this change in February and March 2011, paving the way for national ratifications.

### 3. Repairing the financial sector

Since the outbreak of the financial crisis in 2008, EU action has focused on filling in the gaps in financial sector regulation and strengthening the supervision of this sector, with a view to improving stability, transparency and confidence.

- A **new financial supervision architecture** with real teeth was set up in January 2011 with a European Systemic Risk Board (ESRB) to ensure that macro-economic risks are detected sufficiently early. This is complemented by three sectoral European supervisory authorities: the European Banking Authority (EBA – London), the European Insurance and Occupational Pensions Authority (EIOPA – Frankfurt), and the European Securities and Markets Authority (ESMA – Paris)<sup>16</sup>.
- **Strengthened rules on capital requirements for banks, investment firms and insurance companies** are being defined: a fourth revision of the Capital Requirements Directive (CRD) for banks and investment firms, and a “Solvency II” Directive for insurance companies (this enters into force in 2013). Better risk management in financial institutions will be facilitated by existing and new rules on governing remuneration and bonuses in financial institutions and reducing incentives for short-term risk-taking. A global approach is being implemented to **ensure that no financial actor, market or product escapes appropriate regulation and effective supervision**<sup>17</sup>. Action has already been taken to create a framework for hedge funds and private equity and some rules governing credit rating agencies, although more work is still needed. More initiatives are under negotiation or coming up in the near future<sup>18</sup>, including on derivatives, short-selling, financial markets and market abuse. The Commission is committed to making all the necessary legislative proposals to implement the G20 commitments made in London, Pittsburgh and Washington before the end of summer 2011.
- It is also essential to **move away from the current state of moral hazard where banks de facto rely on governments to step in** if they face serious difficulties. That is why the Commission will propose in the next few months a comprehensive framework for the resolution of failing banks – to ensure that banks can fail, in an orderly manner, and that taxpayers don't have to pay when there are difficulties.

In parallel, work is ongoing to **ensure the viability of the banking sector and overcome the crisis**.

- **Bank stress tests** are one of the supervisory tools used at EU level to detect potential weaknesses and prevent bankruptcy or system failure. In concrete terms, the tests assess the overall resilience of the EU banking sector and individual banks' solvency in the face of hypothetical adverse events. This work is led by the EBA. The other stakeholders are the ECB, the Commission, and national supervisors, who are responsible for conducting the tests at national levels

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<sup>16</sup> See [MEMO/10/434](#)

<sup>17</sup> See [IP/10/1353](#), [MEMO/10/506](#) and [MEMO/10/660](#)

<sup>18</sup> See [MEMO/11/6](#)

- Two rounds of stress tests have been conducted since 2008. The EBA started a new round of stress tests on a broad sample of EU banks in March. A rigorous peer review and quality control will be carried out and the results will be published in mid-June 2011. Full transparency regarding banks' exposures must be ensured. Any banks identified as vulnerable and possibly undercapitalised under the stress test will be expected to take the necessary action. Member States will release, ahead of the publication of the new stress test results, specific remedial plans for the restructuring of vulnerable institutions, including potential market-based solutions such as direct financing on the markets or asset sales, but also solid frameworks for the recapitalisation of individual institutions and the acceleration of bank restructuring where needed, within the framework of EU state aid rules. The stress scenarios, developed by the EBA in close collaboration with the ECB, the ESRB and the Commission, are rigorous and address market concerns regarding the degree of severity and the scope of the test. As to sovereign risk, shocks will be applied to exposures in banks' trading books.
- Separately, the EBA is carrying out a review of banks' funding structures and the **liquidity** of their asset portfolios.

## **GLOSSARY: GUIDE TO KEY ECONOMIC GOVERNANCE TERMS**

**Annual Growth Survey (AGS)** – Presented by the Commission at the start of each year, the AGS sets out the economic priorities for the EU to boost growth and jobs for the next twelve months. The AGS is the basis for the Spring European Council to issue its guidance, which is then translated into national plans by April/May. The presentation of the AGS also marks the start of the European Semester.

**Euro+ Pact – The Euro+ Pact** is a complementary agenda to the AGS, setting out additional reforms to which the euro area Member States have committed, and to which other Member States can sign up if they wish (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania have done so). The Pact, agreed in March 2011, focuses on competitiveness, employment, sustainability of public finances and reinforcing financial stability.

**Europe 2020** – This is the EU's common economic agenda: a ten-year reform strategy to boost growth and job creation while promoting social inclusion and combating climate change. Agreed in March 2010, the strategy sets out five levers for growth and five targets to be achieved by 2020 in relation to employment, research & innovation, energy, education and poverty reduction.

**European Financial Stability Facility (EFSF)** – Established in May 2010, the EFSF is an inter-governmental body able to lend up to €440bn to euro area countries in need of financial support. The euro area Member States themselves provide the loan guarantees. The EFSF will be replaced as from 1 July, 2013 by the ESM.

**European Financial Stabilisation Mechanism (EFSM)** – Also set up in May 2010, the EFSM is available to provide loans of up to €60bn to euro area Member States in need of financial support. The EFSM is guaranteed by the Community budget, without being effectively paid from the budget itself. The EFSM will also be replaced by the ESM as of 1 July, 2013.

**European Stability Mechanism (ESM)** – The EU's permanent crisis resolution mechanism will be operational from 1 July, 2013. It will replace the EFSM and the EFSF as the vehicle through which financial assistance will be provided to euro area Member States in need. Assistance will be on the basis of strict policy conditionality and tied to a macro-economic adjustment programme. The terms of the ESM were agreed at the March 2011 European Council. It will have an effective lending capacity of €500bn. To allow for the establishment of the ESM, a change has been agreed to Article 136 of the Treaty on the Functioning of the EU.

**European Semester** – Starting in 2011, the first half of each year will see a cycle of intensive policy coordination between the EU Institutions and the 27 Member States on both the economic agenda and budgetary surveillance. This is a key element of the enhanced economic governance. The Semester kicks off in January with the presentation by the Commission of the Annual Growth Survey, which sets out the priorities for the EU in terms of economic reform and fiscal consolidation. These priorities are then discussed and endorsed by the March European Council. In April, Member States submit their National Reform Programmes and their Stability or Convergence Programmes to the Commission and to their peers. The Commission then issues recommendations on these programmes, which are endorsed by the June European Council and formally adopted by the Council in July. Member States take this guidance into account when they draw up their budgets, which are debated in national parliaments in the usual way in the second half of the year – ensuring that this process includes a European dimension for the very first time.

**Excessive Deficit Procedure (EDP)** – Member States must avoid excessive public deficits (beyond 3% of GDP) and excessive debt (beyond 60% of GDP). The Commission has proposed to strengthen the existing Excessive Deficit Procedure, which is aimed at preventing governments from breaching these thresholds. When a Member State does not respect the thresholds, the Council decides on the basis of a recommendation by the Commission to launch an Excessive Deficit Procedure. Euro area countries placed in EDP will be requested to make a non-interest-bearing deposit worth 0.2% of their GDP and to take a course of corrective action as recommended by the Council. If a country fails to comply with the recommendation, the deposit will be converted into a fine.

**Excessive Imbalance Procedure (EIP)** – A key element of the EU's new economic governance is the emphasis on tracking and correcting macro-economic and competitiveness imbalances, particularly within the euro area. Using a scoreboard of around ten indicators, the Commission will detect imbalances emerging in different parts of the economy. On a recommendation from the Commission, the Council can open an Excessive Imbalance Procedure against a Member State in which imbalances exist or are at risk of emerging. For euro area countries, a failure to correct imbalances in accordance with an agreed roadmap and within a specified deadline can lead to the imposition of fines of 0.1% of GDP.

**National Reform Programme (NRP)** – All Member States submit in April/May an NRP to the Commission following the March European Council. This sets out the economic reforms and growth-enhancing measures to be passed over the coming year and beyond to move the Member State in question towards the targets it has signed up to in the context of Europe 2020. Member States present their NRPs together with their Stability and Convergence Programmes (which focus on fiscal consolidation). The Commission bases its country recommendations on both plans.

**Stability or Convergence Programmes (SCP)** – In the weeks following the March European Council, Member States submit to the Commission their plans for sound public finances and fiscal sustainability. For euro area countries, these are called Stability Programmes; for other Member States, Convergence Programmes. The Commission assesses these programmes together with Member States' National Reform Programmes over the course of April/May. Its recommendations are endorsed by the June European Council and formally approved by the Council shortly afterwards.

**Stability and Growth Pact (SGP)** – The Stability and Growth Pact is the framework through which the EU ensures the fiscal sustainability of all 27 Member States and of the euro area in particular. The reforms to the EU's economic governance that will be formally agreed in June 2011 will make the SGP clearer, stronger and more effective, at both the prevention and enforcement stages. Public debt and public deficit criteria will be placed on an equal footing for the first time. Member States will be required to make significant progress towards medium-term budgetary objectives and expenditure growth will have to be kept in line with GDP growth. The Commission will recommend fines of 0.2% of GDP for euro area countries which fail to take corrective action to achieve these objectives within an agreed timeframe. These fines will apply unless a qualified majority of Member States votes against them.