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THE ECONOMIC AND MONETARY UNION

Stronger economies for a stronger Union

Council of the
European Union

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"It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its Member States."

Treaty of Rome, article 2

"Throughout the crisis, we have taken decisive action to preserve financial stability and promote the return to a sustainable growth. We will continue to do so and the EU and the euro area will emerge stronger from the crisis."

European Council conclusions, 17.12.2010

"The crisis was unprecedented, in intensity and magnitude. In the midst of a storm we had to repair our ship. Drastic decisions were required. We tried to get to the roots of the crisis. Each reducing debts and deficits in their country. Making our economies more competitive. Helping one another and standing united. [...] The European Union is now much better equipped to deal with the crisis at hand, and to prevent similar situations from arising in the future."

Herman Van Rompuy, President of the European Council, 1.3.2012
Acceptance speech following his re-election for a second term

"The euro crisis has put our community to the test. It raised doubts about member states' commitment to the rights and obligations within a monetary union. And subsequently that posed a threat to the heart of the community and the functioning of the euro area. But we reacted as a community should. We showed solidarity, strengthened our commitments and accepted our responsibilities."

Jeroen Dijsselbloem, President of the Eurogroup, 20.11.2013
Europe House Lecture

"The return of confidence in the euro area is evidence that the reform efforts will eventually pay off. This is visible from the return of *market* confidence. But, more importantly, it is visible from the return of *political* confidence. […] Ultimately, the common theme in all our efforts is to further the aims of the European Union. These are to promote peace, its values and the well-being of its peoples."

Mario Draghi, President of the European Central Bank, 27.2.2014
The path to recovery and the ECB's role

TABLE OF CONTENTS

What is the Economic and Monetary Union? 7

Who does what in the EMU? 8

The economic and financial crisis 11

How to solve the crisis? 11

Financial stability – Creating a banking union. 17

Stability mechanisms 19

Timeline – Consolidation of the Economic and Monetary Union 21

WHAT IS THE ECONOMIC AND MONETARY UNION?

"The Union shall establish an economic and monetary union whose currency is the euro."
(**Treaty on European Union**, article 3, paragraph 4)

The **Economic and Monetary Union**, or the EMU, refers to the process of integrating European economies. The ultimate goal is to see the euro introduced in all countries of the European Union. The EMU, together with the single market, contributes to economic stability, balanced and sustainable economic growth, high employment and the sustainable development of public finances.

The policy framework has two pillars: **monetary policy**: the single currency – the euro – and the European Central Bank (ECB); and **economic policy**: promoting the development and coordination of economic policies within the EU. The EMU involves the coordination of these two pillars.

The monetary policy is managed independently by the ECB. It includes the euro as a single currency, stability of its exchange rate and overall price stability in the EMU.

Member states remain in charge of their own economic and fiscal policies, such as taxation and national budgets (spending and borrowing).

Member states do, however, **coordinate** their overall policies at EU level in order to achieve an economic environment with balanced national budgets, regulated financial markets, stable prices, and increased growth and employment.

The **euro** has been adopted as the common currency by 18 member states so far, with Lithuania joining the euro area as its 19th member on 1 January 2015.

Comparing prices is easier in the euro area where 18 countries, and soon 19, share the same currency.
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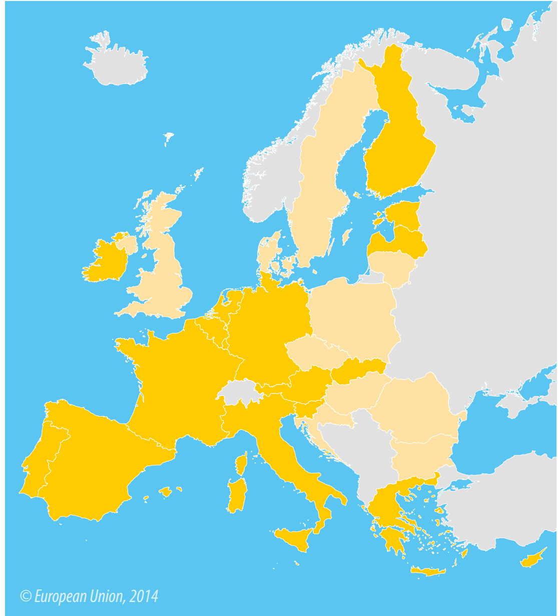
The euro makes it easier for consumers to compare prices, and no exchange fees or transaction costs have to be paid when buying goods and services in other member states in the euro area. In this way, the EMU supports the establishment of the single market with free flow of goods, services, people and capital.

All EU member states should eventually accede to the **euro area**, except the United Kingdom and Denmark, who have chosen to opt out. To accede to the euro, a member state must comply with a certain number of criteria in terms of economic and financial stability, known as **convergence criteria**. The key criteria are:

- price stability: the inflation rate and long-term interest rate must lie within certain limits
- sound public finances: a public deficit of no more than 3 % of GDP (gross domestic product, the total value of a country's production of goods, services etc.)
- sustainable public finances: a public debt of no more than 60 % of GDP.



The euro area member states are: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain. As of 1 January 2015, Lithuania joins the euro area.

WHO DOES WHAT IN THE EMU?

The main actors involved in the EMU are the following:

The **European Council** sets the main policy orientations which feed into the work of the Council, the European Parliament, the European Commission, the member states and sometimes the European Central Bank (ECB).

The European Council is composed of the President of the European Council, the President of the European Commission and the EU leaders (heads of

state or government, be it as president, prime minister, chancellor, Taoiseach, etc.). The European Council meets at least four times a year.

The **Euro Summit** sets the orientations for economic policies in order to improve competitiveness and convergence in the euro area. Together with European Council meetings, the Euro Summit was the highest political forum in which concerted action was agreed in response to the public debt crisis.

The Euro Summit brings together the euro area leaders, the President of the Euro Summit and the President of the European Commission. The President of the ECB is also invited. The Euro Summit meets twice a year.

The **Council** in its configuration of Economic and Financial Affairs Council, the Ecofin, adopts EU legislation, coordinates economic policies at EU level and decides whether a member state may adopt the euro. It is composed of the ministers for the economy and/or finance from the EU member states. The European Commission also takes part in Ecofin meetings. In general, it meets once a month.

The **Eurogroup** coordinates economic policies within the euro area in order to promote financial stability and economic growth. As part of its duties, the Eurogroup prepares and follows up on Euro Summit meetings. It is an informal grouping of ministers for the economy and/or finance from euro area member states. The European Central Bank and the European Commission also take part in Eurogroup meetings.

Meeting of the Eurogroup, 10 March 2014.
© European Union, 2014

The **EU member states** are all members of the EMU. They adopt legislation in the Council, draw up their national budgets in line with the limits for deficit and debt, and develop their own structural policies involving labour markets, pensions and capital markets.

The **European Commission** proposes new EU legislation, and monitors whether member states are meeting targets and complying with existing rules, including the rules on economic govern-

ance. It also assesses the economic situation and makes recommendations to the Council on decisions to be taken.

The **Eurosystem**, which comprises the European Central Bank and the national central banks of euro area member states, is the monetary authority of the euro area. The **European Central Bank (ECB)** is the central bank for the euro area. It develops and implements monetary policy, with price stability as the primary objective, but also sets interest rates for its lending.

The **European System of Central Banks** (ESCB), brings together the European Central Bank and the national central banks (NCBs) of all EU countries, whether they have adopted the euro or not. The 28 EU member states' central banks are the owners and shareholders of the ECB. Member states outside the euro area coordinate their monetary policy with the ECB.

The **European Parliament** is involved in the EU legislative process, in some areas of economic policy coordination, as co-legislator together with the Council. The members of the European Parliament are elected by citizens in the member states. The Parliament meets in plenary for one week every month.

The European Central Bank is based in Frankfurt am Main. © Ralph Orlowski, Reuters

THE ECONOMIC AND FINANCIAL CRISIS

When the economic and financial crisis hit Europe in 2009, it became clear how interdependent European economies were, in particular in the eurozone. The crisis exposed the weaknesses of the European economy: financial difficulties in certain countries spilled over to other countries and threatened public finances, the banking sector, and growth, jobs and competitiveness in Europe.

Public debt in certain countries had risen to unmanageable levels, pushing borrowing interest rates up to intolerable levels and bringing some countries to the brink of bankruptcy. Banks all over Europe had financed loans that were in risk of not being paid back, thereby putting the lending banks at risk too.

In other countries, banks had been too willing to lend money for the construction of houses, as prices continued to rise. When the housing bubble burst, it undermined the banking sector, leading to huge losses. Governments had to step in and recapitalise banks with public money. Banks became reluctant to lend money to businesses that needed capital for the development of their activities or start-ups – the so-called credit crunch.

Economic development came to a halt, the economy entered recession, businesses closed and workers were laid off. Tax revenues fell, the funding for unemployment benefits went up and states had to borrow more money to cover rising deficits. It was a vicious circle.

HOW TO SOLVE THE CRISIS?

In response to the crisis, the member states, the euro area and the European Union as a whole have made a huge effort to ensure financial stability, support growth and employment, and improve economic governance.

The crisis revealed systematic shortcomings in the architecture of the EMU. In response, national governments and the European institutions took a wide range of initiatives to safeguard the euro area's financial stability and strengthen the regulatory structure of the euro area and of the EU as a whole. They agreed on a broad reform of economic governance in order to avoid similar shocks in the future.

At EU level, policy coordination between member states has been improved. This applies to all EU countries, but goes a step further for those that share the euro as their currency.

The new economic architecture ensures that decisions taken at EU level are followed up at national level. Monitoring is continuous in order to detect alarm signals as soon as possible. All of this aims to

reinforce the EMU and make it more stable, so that it can deliver more solid and sustainable budgeting in member states, robust economic growth and more jobs for EU citizens.

Stable budgets

The keystone of coordination of budgetary policies is the **stability and growth pact** (SGP). It was established to ensure that public finances are sound across the EMU, and that budget policies are coherent in the countries that share the euro. It sets reference values that member states must comply with: they must keep their public deficit below 3 % of GDP (gross domestic product: the value of goods and services produced within a country) and their public debt below 60 % of GDP. The pact was reinforced in 2011 when the **'six pack'** – a package of six pieces of legislation – entered into force and strengthened EU economic governance.

The SGP consists of two parts: a preventive and a corrective arm.

Preventive arm

The preventive arm focusses on the assessment of national budget plans for the following year and budget policies for the following three years. The aim is to prevent the build-up of excessive deficits.

A member state which has a deficit above the 3 % limit and/or a debt level above 60 % of GDP must demonstrate how it intends to reduce its deficit and/or level of debt on the basis of an agreed timetable.

Corrective arm

The corrective arm is activated if a country is running excessive debt and deficit levels. If a euro area member state does not take the necessary steps to correct them, progressive financial sanctions can be imposed, initially in the form of deposits made to the Commission, and subsequently in the form of fines.

Budgetary stability has been further strengthened by the **'two-pack'**, which will improve economic and financial surveillance in the euro area. Euro area member states must submit budgetary plans to the European Commission by a set deadline, allowing the Commission to **assess national budgetary plans** before their adoption by national parliaments. If a member state experiences serious financial difficulties or instability, the European Commission can place it under **enhanced surveillance**.

Sound public finances: the fiscal compact

The **Treaty on Stability, Coordination and Governance** (TSCG, fiscal compact) builds on and supplements the budgetary rules of the stability and growth pact. It requires euro area member states to implement uniform and permanently bind-

ing budgetary rules in their national legislation, preferably in their constitution.

To comply with the balanced budget rule, the annual structural government deficit – the deficit caused by a persistent imbalance in a country's revenue and expenses – must not exceed 0.5 % of GDP. Actions to reduce this budget deficit will be triggered automatically. Failure to comply can result in a case being brought before the European Court of Justice.

Countries participating in the TSCG must inform each other, the Council and the European Commission in advance when they plan to issue new debt. They also discuss all plans for major economic policy reforms.

The 18 euro area member states (Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain) and seven non-euro area member states (Bulgaria, Denmark, Hungary, Lithuania, Poland, Romania and Sweden) have already signed the treaty; the Czech Republic has also started procedures to sign.

Coordination of economic policies: the European semester

The **European semester** is a cycle of economic and fiscal policy coordination within the EU. The member states are given guidelines and recommendations which they take into account when preparing their national budget plans.

The process covers the six-month period from the beginning of each year, hence its name – the "semester". During the European semester, member states align their budgetary and economic policies with the objectives and rules agreed at the EU level. In this way, the semester aims to:

- ensure sound public finances
- foster economic growth, and
- prevent excessive macroeconomic imbalances in the EU.

The European semester is launched in November with the publication of the Commission's **annual growth survey** (AGS). The survey analyses the economic situation in the EU and identifies broad priorities for economic policy in the following year, including the fiscal policies and reforms necessary for stability and growth.

In January and February, member states discuss these priorities with their EU partners in the Council.

The European Parliament also discusses the survey during the same period and issues an opinion on the employment guidelines in the growth survey.

Based on these discussions, EU leaders set the policy orientations for that year at the Spring European Council in March.

Based on those guidelines, member states outline how they would implement the orientations through their

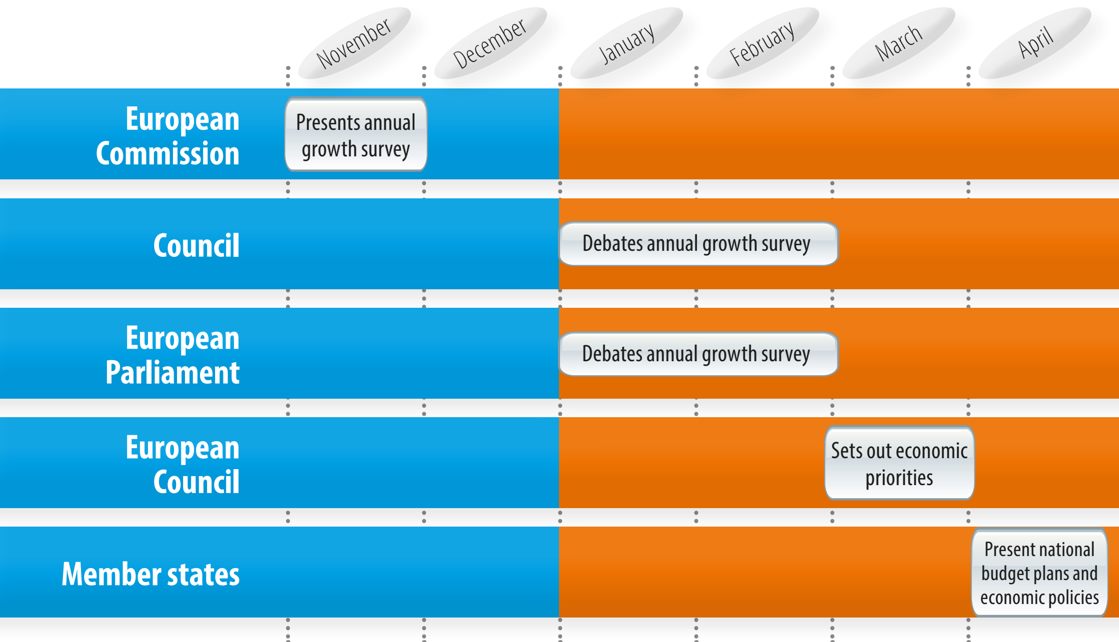
budgets and economic policies. In April they present their medium-term budget plans (stability programmes for euro area members and convergence plans for non-euro area members) and national economic plans (national reform programmes).

In May, the Commission proposes specific recommendations for each EU country, the so-called **country-specific recommendations**. These recommendations are tailored policy advice to member states.

In June, the Council discusses and agrees on the country-specific recommendations. The June European Council approves them, and they are ultimately adopted by the Ecofin Council in July.

The following six-month period is sometimes called "the national semester". Member states finalise the following year's national budgets taking account of the country-specific recommendations. Euro area member states must submit their draft budget plans to the Commission by mid-October.

At the end of the year member states adopt their national budgets, and the Commission launches the next cycle of the European semester with the publication of the annual growth survey for



the following year, taking account of the extent to which member states have followed the recommendations.

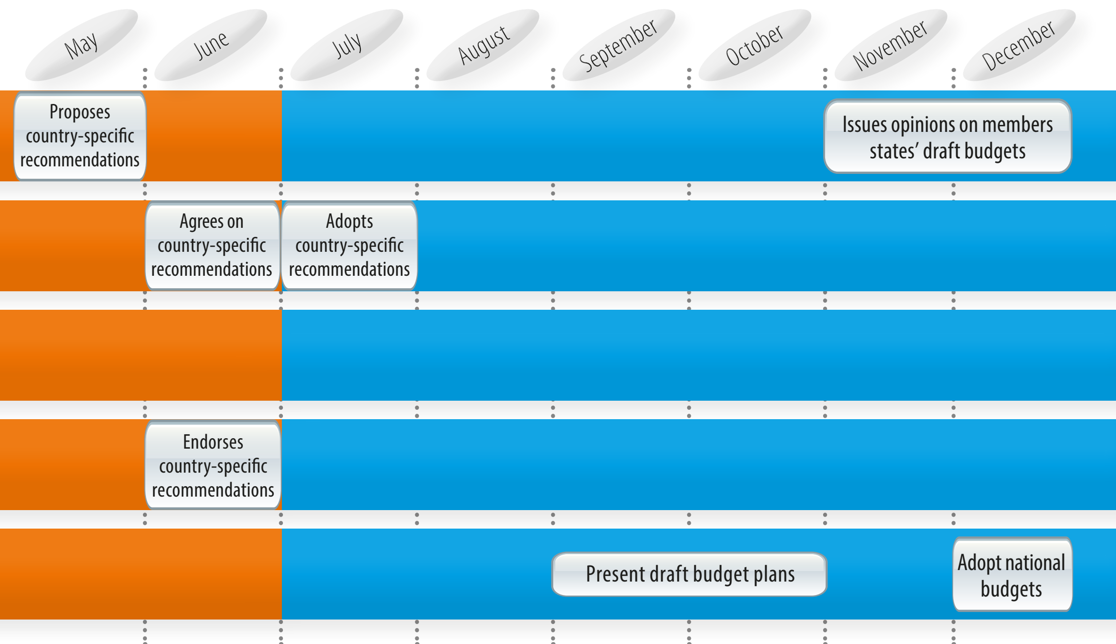
Prevention and correction of macroeconomic imbalances

In order to prevent imbalances in the economy within individual countries and across the EU, an **early warning system for macroeconomic imbalances** has been introduced. Member states are screened for potential imbalances against a scoreboard of indicators, including unemployment rates, labour costs, differences between imports and exports, and housing price trends, to understand how economies evolve over time.

The mechanism is triggered if the values of individual indicators go beyond agreed limits. The Commission makes an annual assessment and identifies potential problems in advance. Based on this assessment, it proposes recommendations to individual member states that are usually integrated into the European semester procedure.

If a euro area country fails to comply with the recommendations on an ongoing basis, sanctions may be imposed.

budget and economic policies, from January to June



Stable economies

The economic crisis led to a recession in many EU countries. Growth fell sharply, unemployment rose and competitiveness declined. The crisis could not be resolved only by more monitoring, by tightening national budgets, and by strengthening the regulation of financial markets. The EU also needed a dynamic growth strategy.

The EU's growth and jobs strategy, **Europe 2020**, sets a range of priorities to boost a smart, sustainable and inclusive economy. The strategy sets common targets in the areas of employment, education, research and innovation, social inclusion and poverty reduction, and climate and energy. Monitoring of member states' progress in reaching these targets is included in the European semester process.

The **compact for growth and jobs** is another initiative aimed at relaunching growth, investment and employment and making the EU more competitive. There are targeted actions at member state, EU and euro area level. Furthermore, the compact mobilised €120 billion for immediate investment in the EU economy.

One of the main concerns is the high number of unemployed young people in Europe. Up to €8 billion will be spent under the **youth employment initiative** to create jobs for young people.

An **investment action plan** will help restore credit flows to the economy. Funds from the EU budget and the European Investment Bank will be mobilised to support small and medium-sized enterprises.

Under the youth guarantee scheme, all young people under the age of 25 must receive a quality offer of employment, continued education, or an apprenticeship or traineeship within four months of becoming unemployed or leaving formal education.
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FINANCIAL STABILITY – CREATING A BANKING UNION

Financial supervision

The crisis revealed severe flaws in the financial sector. Governments had to step in to prevent a number of banks from collapsing.

To avoid a similar situation arising in the future, the EU has set up new supervisory authorities for financial institutions:

- the **European Banking Authority** (EBA) focuses on the banking sector and is based in the City of London
- the **European Insurance and Occupational Pensions Authority** (EIOPA) on insurance and pension schemes, based in Frankfurt am Main, Germany
- the **European Securities and Markets Authority** (ESMA) on the functioning of financial markets, based in Paris, and
- the **European Systemic Risk Board** (ESRB), which carries out the overall macroeconomic supervision of the financial system as a whole; it is hosted and supported by the European Central Bank.

Single rule book

New rules are being introduced in order to reduce the risk posed by banks to the general public. Some of its most important elements are:

- a set of **rules on capital requirements** which ensure that banks hold sufficient funds to meet potential losses at any time
- harmonised **deposit guarantee schemes** which safeguard citizens' deposits up to €100 000. Financial institutions (deposit banks, pension funds, investment banks) will fund the schemes
- clear rules for dealing with troubled financial institutions. In the future, the **recovery and resolution process** will start early, i.e. as soon as the supervisor detects that there is a risk of a bank becoming non-viable.

These rules apply to all EU member states as they are part of the internal market legislation. The euro area, however, is taking another step forward: towards a banking union with a single supervisor and a single resolution mechanism. Non-euro area member states may also join the banking union if they so wish.

Common bank supervision

Under the **single supervisory mechanism** (SSM), responsibility for bank supervision in the euro area will be shifted from the national authorities to the European Central Bank (ECB).

The deposit guarantee scheme will prevent future bank runs, when people rush to withdraw their savings fearing a collapse of the bank.
© Lee Jordan, Creative Commons 2.0

The European Central Bank and national supervisors will closely coordinate the oversight of banks in the euro area as well as in participating non-euro area countries. This will lead to better surveillance of the financial services sector and rapid action when weaknesses are detected.

The biggest banks, considered to be a risk to the whole of the financial system owing to their size, will be placed under the direct supervision of the European Central Bank. National supervisors will continue to carry out a number of supervisory tasks for the smaller banks.

Bank resolution mechanism

The **single resolution mechanism** (SRM) regulates the resolution of non-viable banks. The winding down of such banks will shift from national to EU level. Should a bank supervised directly by the European Central Bank be at risk of becoming unviable, a single resolution authority will be in charge of its resolution.

Instead of each country having a national resolution fund, a single resolution fund will be established. The fund will be financed by the entire banking sector in the banking union and can be used for the resolution of any bank in this union.

STABILITY MECHANISMS

Since 2010, some euro area countries have been experiencing difficulties financing their debts. When borrowing on the financial markets, their interest rates became too high for them to keep their overall public debt at a sustainable and affordable level.

Therefore, **temporary mechanisms** were created in order to restore stability quickly to the euro area, followed later by the permanent European stability mechanism (ESM).

The Eurogroup agreed first to provide bilateral loans to Greece through the **Greek loan facility** (GLF). Later, it established the **European financial stability facility** (EFSF), which eventually took over support for Greece. Ireland and Portugal have also received assistance from the EFSF, which was funded by euro area members, as well as from another EU instrument, the **European financial stabilisation mechanism** (EFSM), which was funded from the EU budget.

The cornerstone of the European firewall, the permanent **European stability mechanism** (ESM), replaced these temporary schemes in October 2012. The ESM is an international financial institution set up by the euro area countries and is the main instrument for assisting euro area countries that encounter **financing difficulties**.

The ESM has a **maximum lending capacity** of €500 billion. Loans are financed by the ESM's borrowings on the financial markets. Up to €60 billion of the lending capacity can be used to recapitalise banks directly. It currently covers support to Cyprus. In the future, any new financial assistance programme will be financed by the ESM.

Each tranche of the loan is paid to the country being assisted only if it fulfils the conditions for restoring sustainable public finances and reforming its economy previously agreed upon. The European Commission and the European Central Bank monitor implementation. The International Monetary Fund is always involved at a technical level, and in most cases financially as well.

All euro area member states are members of the ESM. The ESM headquarters are in Luxembourg.

Conditions for support

Financial support is always based on **strict conditions** agreed between the lenders and the borrowing country. The countries must commit to achieving certain goals, which may relate to fiscal adjustment (improving tax collection, cutting government spending, reforming public administrations, privatising public services or companies, selling-off government property), restructuring of the banking sector (recapitalisation, strengthening of regulation and supervision, rescuing solvent banks and closing down non-viable banks), or labour mar-

Overview of financial assistance committed by the EU/euro area (€ billion)

Instrument	Overall lending ceiling	Greece	Ireland	Portugal	Spain	Cyprus
GLF	52.9	52.9				
EFSM	60		22.5	26		
EFSF	440	144.7	17.7	26		
Bilateral loans			4.8			
ESM	500				41.3	9
Totals		**197.6**	**45**	**52**	**41.3**	**9**

ket reform. These conditions will help the assisted country reform its economy and return to steady sustainable growth and viable public finances.

Monitoring the implementation of the conditions

At regular intervals the European Commission, the European Central Bank and the International Monetary Fund (IMF) (commonly referred to as "the Troika"), review whether the conditions agreed are being respected. A positive review is a condition for payment of each instalment of financial assistance.

The first positive results have already been identified. Ireland successfully concluded its programme in December 2013 and regained access to financial markets. Spain exited its financial sector programme in January 2014 having thoroughly restructured its banks.

TIMELINE – CONSOLIDATION OF THE ECONOMIC AND MONETARY UNION

2009

Autumn: Greece announces a public deficit at 12.7 % of GDP and debt amounting to 113 % of GDP.

2010

11 February: EU leaders ready to act over Greek debt, confirmed by the Spring European Council in March. Rising concerns over debt levels in Portugal, Ireland and Spain. The value of the euro declines.

23 April: Greece requests financial support.

2 May: Eurozone leaders and IMF agree a rescue package for Greece. Interest rates on loans to Portugal, Ireland and Spain rise to dramatic levels. The value of the euro continues to fall.

9 May: Ecofin ministers approve a European rescue package worth €500 billion, comprising the European financial stability facility (EFSF) and the European financial stability mechanism (EFSM).

18 May: Greece receives first loan tranche.

17 June: EU leaders adopt the strategy for growth and jobs, Europe 2020, and the European semester.

12 September: Banking supervisors agree on stricter capital rules for the banking industry.

19 October: Ecofin Council adopts stricter rules for hedge funds.

21 November: Ireland requests financial support.

2011

1 January: Estonia joins the euro area.

January: Three supervisory bodies, covering banks, stock exchanges and insurance companies, start work. The European Systemic Risk Board provides macroeconomic supervision of the financial system as a whole.

The first European semester is launched covering national budget planning for 2012.

12 January: Ireland receives first loan tranche.

24-25 March: EU leaders agree to establish a European stability mechanism, and to conclude a fiscal compact treaty.

7 April: Portugal requests financial support.

June: Portugal receives first loan tranche.

26 October: Euro Summit decides that banks must increase their core capital.

13 December: The 'six-pack' on economic and fiscal coordination and governance in the EU enters into force.

2012

2 February: Eurozone leaders sign the European stability mechanism treaty introducing rescue mechanisms to countries under financial stress.

1-2 March: Twenty-five EU leaders sign the fiscal compact treaty (Treaty on Stability, Coordination and Governance in the EMU).

25 June: Spain requests financial support.

28-29 June: EU leaders adopt the compact for growth and jobs. It will relaunch economic growth, investment and employment, and make the European economy more competitive.

6 September: The European Central Bank announces a new programme for buying bonds issued by euro area members receiving financial assistance from euro area stability mechanisms.

8 October:	The European stability mechanism is launched. It will provide financial assistance to its members to safeguard financial stability.
23 November:	Cyprus requests financial support.
11 December:	Spain receives first loan tranche.

2013

1 January:	The fiscal compact enters into force. It commits the 25 signatories to implementing the budget/debt rules in their national legislation.
8 February:	EU leaders agree on the EU's 2014-2020 budget programme, the multiannual financial framework (MFF).
13 May:	Cyprus receives first loan tranche.
30 May:	The 'two-pack' enters into force, tightening budgetary discipline and economic surveillance in the euro area.
3 November:	The regulation on the single supervisory mechanism (SSM) comes into force. It confers new supervision powers on the ECB for euro area banks.

2014

1 January:	Latvia joins the euro area.
	The package on capital requirements for banks enters into force.
15 April:	Political agreement is finalised on the single resolution mechanism. The mechanism manages the resolution of failing banks in an orderly manner without recourse to taxpayers' money. Part of the SRM enters into force on 1 January 2015, another part on 1 January 2016.
4 November:	The SSM becomes fully operational.

2015

1 January:	Lithuania joins the euro area.

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