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Reforming Europe: which ideas make sense?

- **A rare opportunity:** Europe is popular again. The rise of Emmanuel Macron highlights the trend. Amid firm economic growth at low inflation, the backdrop for serious reforms in the EU27 and the Eurozone is unusually auspicious.
- **But which reforms make sense?** The major gap in the institutional architecture of the Eurozone – the lack of a lender of last resort – was filled long ago. Doomsayers who had detected further supposedly fatal flaws have been proven wrong by the firming economic recovery. Not all that is different in the Eurozone needs to be aligned to, say, US or UK standards to let the Eurozone or EU27 thrive.
- **What makes sense?** In this report, we examine various proposals to improve the economic performance and strengthen the cohesion of the EU27 and the Eurozone. We measure them against four criteria: do they i) improve efficiency, ii) provide incentives for member countries to pursue sensible policies, iii) safeguard against systemic risks and/or iv) provide a buffer against temporary asymmetric shocks? In addition, reforms need to be politically sustainable and economise on the use of scarce political capital to push them through.
- **European Defence Fund:** Reducing the duplication of weapons systems across the EU27 promises more value for money. A common fund can provide incentives to do so. Common spending on defence should not be counted as national spending under the EU's fiscal rules. A **European Security Fund** to fight terrorism and police the external borders of the Schengen area as well as fiscal incentives to participate in a resettlement of refugees also make sense.
- **Banking union:** Completing the banking union including a gradual build-up of a common deposit insurance for banks is desirable in the long run but not essential.
- **Fiscal transfers:** The EU27 already has extensive regional and structural funds to support less advanced regions. It needs no further fund for permanent transfers.
- **A joint Eurozone unemployment insurance** would set the wrong incentives in unreformed labour markets. But a scheme **to subsidise temporary cuts in working hours during an acute crisis**, akin to Germany's "Kurzarbeitergeld", would make sense.
- **Incentives for pro-growth reforms:** Strengthening a country's growth potential through structural reforms improves the economic outlook for its neighbours as well. While we see no strong case for pooling national investment spending, a **European Growth Fund** that subsidises public investment spending in countries that pursue genuine pro-growth reforms as certified by the OECD can be useful.
- **European Monetary Fund:** The troika and quadriga were ad hoc responses to immediate crises. The European Stability Mechanism (ESM) should evolve into a genuine European Monetary Fund (EMF), taking over the roles which the EU Commission, the IMF and the ECB currently play in fiscal support programmes.
- **The fiscal rules** are sufficiently flexible already. No change is needed. But the way in which they are enforced needs to be improved to minimise the inevitable strains.
- **Our proposal: an Independent Fiscal Council:** Instead of the EU Commission or the troika/quadriga, an Independent Fiscal Council (IFC) akin to the ECB board should regularly examine the fiscal positions of all euro members. It should not make detailed policy recommendations. But it should assess whether the current policies as well as potential policy changes and structural reforms would enable a country to comply with the fiscal rules either fully, largely or not at all.
- **A seal of approval:** Countries with a first-class IFC certificate should always have automatic access to an EMF credit line, countries that largely comply should be subject only to light conditionality if they had to apply for help. That would give Eurozone members a positive incentive to strive for the best possible status.

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Holger Schmieding
Chief Economist
+44 20 3207 7889
holger.schmieding@berenberg.com

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Disclaimer

Parts of this report draw on our Notes on the future of Europe (dated 20 June 2016).

For a discussion of the likely evolution of the EU into a club of clubs, see our report Europe at 60: the trends that shape the future (24 March 2017).

I. Europe: seize the moment

Bonjour Macron: a splendid opportunity to reform Europe

Seize the moment: The election of the staunchly pro-European Emmanuel Macron as French president with a solid majority in parliament provides a splendid opportunity to reform the EU27 and the Eurozone. Amid firming economic growth, low inflation and rising employment, the backdrop for a serious overhaul of rules and institutions in Europe could hardly be more auspicious. There has been no shortage of wake-up calls either. Just think of the Brexit vote and the new geopolitical vagaries embodied by Donald Trump, Vladimir Putin and Recep Erdogan. Support for the European Union (EU) has rebounded strongly across Europe (see Chart 1).

Proposals to reform Europe must make sense – and they must be feasible

Many observers have floated a panoply of ideas for deeper integration in recent months. All ideas to improve the cohesion of the EU27 and the Eurozone need to stand two major tests. First, they must make sense. They must help to make Europe work better. Deepening European integration for the sake of deeper integration does not suffice as a rationale. Second, all ideas must start from the premise that changing the rules and institutions for 27 EU members and/or 19 Eurozone members is not easy. Political capital to be expended on such tasks must be used wisely. European leaders thus need to look for those modest or most convincing changes to the current rules and institutions that can deliver the biggest possible gains in terms of better governance and greater resilience against systemic risks. Not all that may be desirable or beneficial on its own may be feasible.

New institutions, rules, instruments or common funds can make sense if they:

Four key criteria

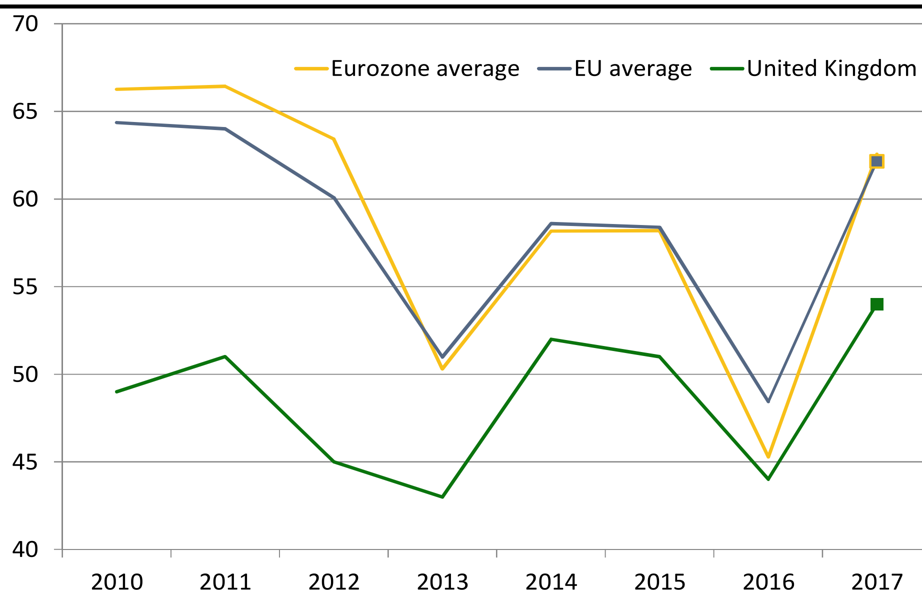
- increase economic efficiency;
- provide incentives for member countries to pursue sensible policies;
- safeguard against systemic risks such as those stemming from irrational market panics; and/or
- provide a buffer against temporary asymmetric shocks without distorting incentives to improve economic efficiency.

Of course, life is full of grey areas

In addition, rules must be enforceable and all arrangements need to be politically sustainable. No rule, institution or common funds should prevent or delay necessary adjustments or incentivise countries to maintain dysfunctional economic policies. As always in life, there will be grey areas. We use these criteria to judge which steps the Eurozone or the EU27 should take to strengthen their cohesion and improve trend growth.

Chart 1: How many people like the EU?

The EU is popular again after a 2016 dip



Share of respondents to survey by the Pew Research Centre with a very favourable or somewhat favourable view of the U, in %. Source: Pew Research Centre, "Post-Brexit, Europeans more favorable toward EU", 15 June 2017; Berenberg calculations

II. Increasing efficiency

1. Defence and security union on the EU27 level

More value for money

In the age of Putin and Trump, Europe must do more to take care of its own defence. Although we cannot claim to be an expert on these issues, we trust reports that European countries could get significantly more value for money out of their defence budgets if they reduce the numbers of separate national weapons systems and pool defence capabilities. According to the European Commission, EU members have 178 different weapons systems compared to 30 in the US.[1] Avoiding duplication and developing more interoperable technologies can save money and strengthen EU's ability to defend itself at the same time. A European fund to subsidise the development and deployment of joint weapons systems and defence capabilities makes sense. The subsidy rate should increase with the number of member countries participating in the joint projects.

Common defence spending can ease strains on national budget

To give fiscally challenged countries a further incentive to participate in this scheme to spend public money more efficiently, the payments provided by the European Defence Fund should not be counted as national public spending of any country that benefits from such payments under the EU rules for fiscal deficits. Of course, this holds only for the subsidies and not the additional direct national outlays for such defence projects which would remain part of normal public spending.

A club for all those who want to join

While the facility should be open to all EU27 members, not all countries need to sign up to it. The fund could instead be set up for any subset of EU member countries willing to take part.

2. Common external border regime for Schengen members

A common fund to police a common external border

Similar arrangements to those described above for external defence could be found for aspects of a common security policy including a joint policing of a joint border regime for the external borders of the Schengen area. Parts of the direct public spending for refugees re-settled under a common distribution programme may also be subsidised by a similar fund and exempted from the relevant calculation under the EU's excessive deficit procedure.

III. Enhancing systemic stability in the Eurozone

1. A conditional lender of last resort

Searching for the lender of last resort

Every currency area with a fiat money needs a reliable safety net. The lack of a designated lender of last resort was the one and only crucial institutional shortcoming of the Eurozone and the root cause of the euro confidence crisis of 2011-2012. When panic spread like wildfire throughout the Eurozone after the July 2011 decision to restructure Greek public debt, the available fiscal facilities such as the EFSF did not suffice to restore order. Only the central bank with its potentially unlimited ability to intervene in markets in its own currency can reliably prevent or end a financial panic.

It took the ECB a while to assume its role

Once the European Central Bank (ECB) had stepped forward as the conditional lender of last resort on 26 July 2012, the systemic euro crisis faded. With the ECB's Outright Monetary Transactions (OMT) programme, the Eurozone now has a lender of last resort.

Conditional assistance

The ECB has tied its OMT programme to an ESM adjustment programme for the potential beneficiary country. Only countries for which enough national parliaments have endorsed an ESM programme that includes ESM bond purchases on the primary market can be eligible for potential ECB bond purchases on the secondary market in times of turmoil.

A veto for the Bundestag

All relevant ESM decisions have to be taken with a "qualified" majority of 80%. This gives the German parliament (Germany has a 27.07% share in ESM capital), France and Italy and/or groups of smaller countries a de facto veto over the ECB's OMT programme. The ECB itself does not take the key political decision, namely whether a country is worth supporting or not and which conditions should apply. As a result, "tough love" is the rule of the game in the Eurozone: one can only get help if one lets those granting it set the conditions for such

[1] European Commission: A European Defence Fund: €5.5bn per year to boost Europe's defence capabilities, press release, Brussels, 7 June 2017.

support.[2] In practice, this means that serious support within the Eurozone can only take the form of conditional credits, not of outright transfers.

“Tough love” is not just a political imperative. It also gets the incentives right. Countries in need of help are forced by the conditions to shape up. Transfer systems within nation states typically provide little incentive for the recipient regions to correct their policies. These transfers typically reward the laggards instead.

“Tough love” is the name of the game

2. A European Monetary Fund

Support programmes for struggling Eurozone members have so far been policed and supervised by a “troika” of the European Commission, the ECB and the International Monetary Fund (IMF) that evolved into a “quadriga” with an enhanced role for the ESM for the third Greek adjustment programme in mid-2015. Initially, the troika approach served as a useful ad hoc response to an immediate problem. To varying degrees, these three organisations had staff members with some of the relevant expertise to design and police an adjustment programme. But the troika has proven to be a problematic group, often posing as both judge and jury.

- The **European Commission** is a partly politicised organisation.
- The **ECB** does not have a mandate to police fiscal austerity and structural reforms in member countries.
- The **IMF** has shown time and again that it does not fully understand Europe. Unlike the ECB, the IMF had failed to grasp the contagion risks from the decision to let Greece default on its privately-held debt in 2011.

The Eurozone is also becoming reluctant to give the IMF a decisive say over intra-Eurozone affairs because the current US administration, the Brexiting UK as well as China and other distant emerging markets play a major role on the IMF’s executive board.

Dear IMF, thanks for the help...

By now, European institutions have built up significant expertise with adjustment and support programmes. It makes sense to develop the ESM into an EMF to take over the task of the current quadriga, relieving the IMF, the ECB and the European Commission of their current role in ESM support programmes.

...but we can now do it ourselves

3. Banking union: key ingredients are in place

Financial intermediation in the Eurozone works largely through the banking system, more so than in the US and the UK with their more capital-markets based systems of channelling money from savers to investors. That the Eurozone failed to address its banking issues fast and decisively right after the recent financial crises is a major reason why the economic recovery from the euro crisis remained shallow until 2015. Fortunately, most key requirements for a sounder banking system are being met.

The key requirements for a sounder banking system are in place already

- **A common market needs common minimum rules** for competition to flourish. Such rules are in place.
- **The bank supervisor needs to be credible:** In the wake of the Lehman and euro crises, many national bank supervisors lost credibility with markets, being seen as overly lenient in their treatment of their domestic banks in order to avoid having to inject public money into banks. By turning the ECB into the supervisor for all major Eurozone banks as of November 2014, the region has tackled this issue.
- **The most problematic banks need to be wound down** in an orderly fashion. The processes for that are in place. The way the EU institutions dealt with Spain’s Banco Popular in May 2017 shows that the rules can work if they are allowed to do so.
- **Reliable backstop:** Markets need to know and believe that banks have a reliable sovereign backstop in cases of an extreme crisis. With the ESM and the ECB’s OMT programme, all national sovereigns in the Eurozone that abide by the rules of the club now have a reliable backstop. This ingredient is in place.

[2] See our report “*Tough Love – the true nature of the euro crisis*”, Berenberg, 20 August 2012.

How to break the doom loop

Many observers claim that Europe needs to go further: in order to break the "doom loop between banks and sovereigns for good, Eurozone taxpayers need to recapitalise the problem banks in problem countries directly. This argument is largely wrong. If a sovereign complies with an ESM programme, markets know that this sovereign will be supported whether or not its gross debt is inflated by the pass-through of ESM money into problem banks under its jurisdiction. Channelling €41bn of ESM money through the Spanish sovereign to Spanish banks certainly did not hold back Spain's ability to sell sovereign bonds.

4. Common deposit insurance: useful but not essential

Do not reward countries for past profligacy

Mutualising current national deposit insurance schemes would reward countries that have not tackled their banking issues forcefully enough yet. We see no need to fold the current national schemes into a Eurozone scheme, which would nurture fears in some core European countries that their previous contributions are to be used to bail out profligate banks elsewhere. A common deposit insurance can be desirable if it is built up over time through fresh contributions from Eurozone banks. But it is not essential. Savers need to know that there is a guarantee for deposits up to a given limit. As long as a compliant national sovereign can be backed up by the ESM and ECB, the national sovereign and the national deposits insurance schemes can remain the guarantors of such deposits until a common scheme can gradually take over that task.

IV. Fiscal rules and facilities

1. Fiscal rules

Fiscal spillovers

Countries that share a common currency have a legitimate interest in each other's fiscal affairs. They need to set and enforce rules to minimise the potential for negative spill-over effects including the risk of contagion within the currency area in case of a debt crisis in one member country. However, they do not need a common fiscal policy run by a common finance minister answerable to a common parliament. It suffices that all members live within their means. Whether they do that with a low tax/low government spending or a high tax/high government spending approach need not be a concern for other members as long as a country's overall fiscal deficit is under control and its policies do not depress its trend rate of growth to such an extent that its resulting structural economic weakness becomes a major burden for its neighbours.

Do not blame the rules, they were mostly fine

The Eurozone had a sensible set of fiscal rules from the very beginning, namely the requirements of the Stability and Growth Pact:

- to keep budgets in rough balance in normal times;
- to not let fiscal deficits exceed 3% of GDP except in extreme circumstances; and
- to bring debt ratios down to no more than 60% of GDP over time.

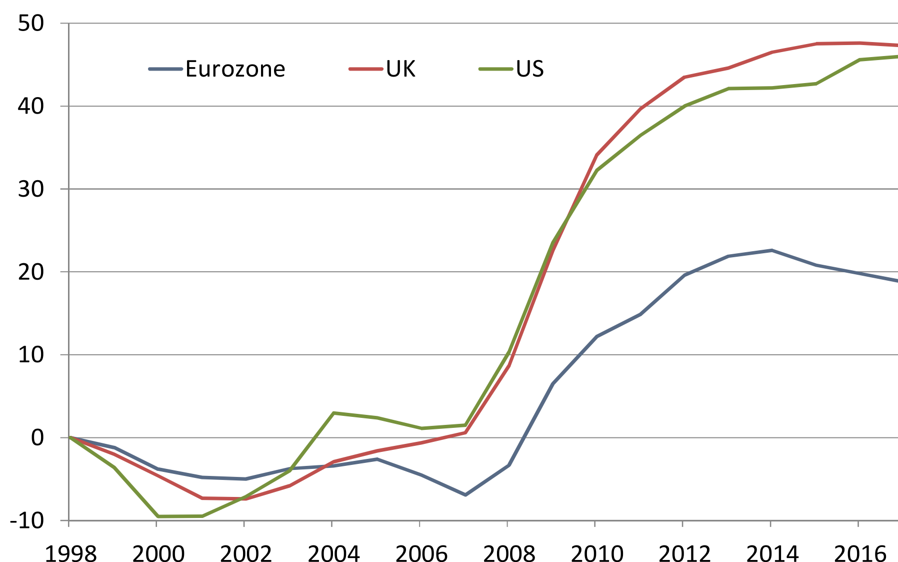
The rules are sufficiently flexible

After Germany and France broke and then watered down the original Stability Pact in 2002-2004, the rules were strengthened and adjusted again in various ways over the course of the euro crisis, most notably with the Fiscal Compact signed on 2 March 2012. The rules now leave sufficient flexibility to judge countries on their underlying fiscal trend rather than just the headline deficit number that can be heavily distorted by an adjustment crisis or one-off capital injections into banks. Countries now need to keep their structural fiscal deficits below 0.5% of GDP if their debt ratio exceeds 60% of GDP. The speed at which they need to correct excessive deficits is ultimately a political decision of Eurozone finance ministers.

No need to change the fortified rules

The fortified fiscal rules are fine. This ingredient for a stable currency union is in place. Relative to the US, the UK and Japan, the Eurozone has the least bad fiscal performance anyway (see Chart 1). We will discuss ways to improve the policing of the rules in the section on an Independent Fiscal Council (IFC) below.

Chart 2: Rise in the public debt burden since the start of the euro



Rise in the ratio of public debt to GDP, in ppt, since the end of 1998. Japan would breach any reasonable scale with a surge by 133ppt. End-2016 debt ratios: Eurozone 89.2%, US 108.1%, UK 89.3% Japan 250.7%. Source: European Commission, Eurostat

Who is the least profligate of them all? The Eurozone

2. Fiscal shock absorber: An overrated proposal

The EU budget amounted to a mere €144bn in 2016, equivalent to 1% of the region's GDP. In contrast, the federal budget in the US takes up 20% of GDP. Including Germany's federally mandated social security system, Berlin's federal budget consumes 32% of German GDP. No wonder that many observers argue that the Eurozone needs a bigger fiscal facility to cushion asymmetric shocks or even to provide more outright transfers from the rich to the poor.

The fiscal rules allow countries to let automatic stabilisers work

To deal with temporary asymmetric shock, member countries need the ability to let their automatic fiscal stabilisers work. The fiscal rules of the Eurozone already allow the borrowing of countries to breathe accordingly over time. The new focus on underlying structural deficits has strengthened this feature of the fiscal rules. If a country cannot borrow at reasonable terms to cover a temporary fiscal shortfall caused by an asymmetric shock because financial markets are panicking, it can apply for help from the ESM. For countries with sound policies, such assistance through a credit line should be available without onerous conditionality.

No reason to cut investment in a cyclical downturn

Countries that abide by the rules should have no reason to cut public investment spending in response to a downturn in the business cycle. Of course, if their fiscal policy is on an unsustainable path in the first place, adverse temporary shocks can reveal such problems. Shock absorbers should not prevent the necessary gradual adjustment of the underlying fiscal stance in such a situation.

The case for a common unemployment insurance looks weak

All-in-all, the case to build up a major common shock absorber looks weak. This holds especially for schemes to establish a joint unemployment insurance. Such schemes would likely get the right incentives wrong. They would reward countries with dysfunctional labour markets and hence high rates of structural unemployment at the expense of those with a flexible labour market. Any such scheme should only be considered if the structural characteristics of labour markets are virtually identical across the Eurozone. We do not expect that condition to be met for a long time. Arguably, a common unemployment insurance scheme may even require similar education systems so that employees have comparable qualifications and hence comparable risks of losing their job over time.

3. One sensible option: temporary subsidies to stay in a job

Temporary subsidies to keep underemployed people in a job during a sudden adverse shock can make sense

These incentive problems could be largely avoided if any assistance would be well-targeted and strictly limited in scope and duration. During the sharp and sudden collapse of GDP in late 2008 and early 2009, Germany successfully subsidised workers staying on their job at sharply reduced working hours (Kurzarbeitergeld) to prevent mass dismissals. Broadly speaking, companies were still paying for the reduced hours which their employees actually worked while Germany's unemployment insurance covered a major part of the gap between this reduced pay and the normal pay: partial unemployment benefits while still on the job. The scheme worked well. When the short-term shock was over, most works returned to normal hours. The fiscal cost were puny, especially as many of the subsidised workers would otherwise have lost their jobs and hence eligible for full unemployment benefits.

A Eurozone variant of such a Kurzarbeitergeld paid out of a common funds would need to be strictly limited, for instance providing the subsidy for each affected worker for no longer than twelve months. As a mere short-term shock absorber, it would not give countries an excuse to drag their feet on policy changes to make their labour market more flexible.

4. A facility for fiscal transfers?

A currency union can thrive without transfers

Internal transfers between member countries are sometimes seen as an essential ingredient of a currency union. This view is largely wrong. We need to consider the precise problem that transfers are supposed to address.

Structurally challenged countries need to get their own act together

Curing a permanent structural weakness: Countries that suffer from a very low rate of trend growth rather than a short-term adverse cyclical shock need to raise their growth potential. That requires domestic pro-growth reforms such as those which Germany undertook in 2003-2004, Spain in 2012-2014 and which France may now embark upon. If countries with a need for fundamental reforms fall victim to a sudden crisis of confidence, possibly in the wake of an adverse shock, they can get the support they may need during their adjustment crisis through conditional credits from the ESM facilities. They do not need huge additional transfers beyond that.

The EU already spends significant funds to help backward regions

Strengthening poorer regions: As part of its standard budget, the EU already has some limited redistribution mechanisms through its regional and structural funds. For the seven-year period from 2014 to 2020, Poland, Hungary and Romania are scheduled to receive net transfers of around 2% of their annual GDP on average per year, and Greece can expect transfers of around 1% of its GDP per year. Prioritising the use of such funds and making it easier for crisis countries to access them, for instance by largely waiving the co-financing requirements for European investment spending in Greece, can make sense. But that has happened already anyway. The EU may want to scale up these programmes (or to scale them down). But as such regional development and structural assistance funds already exist in the EU, the Eurozone has no clear need for a new fiscal facility to provide such transfers to support investment in member countries.

Major automatic transfers would distort incentives and trigger a political backlash

No need for a major fiscal shock absorber needed

Major automatic redistribution mechanisms would run into two big obstacles. First, they could blunt the incentives for the recipient countries to get their own policies right. Second, they could be political dynamite, weakening support in the creditor countries for a pro-European policy agenda. Political capital is a limited resource. In creditor countries, leaders ought to use their political capital to focus on what is essential, for instance support for ESM programmes and for the role of the ECB as lender of last resort, and not on highly contentious and non-essential tasks such as a bigger redistributive budget at the Eurozone (or EU) level.

A new fiscal facility is not required to transfer funds from richer to poorer regions. In addition, it is unclear whether pooling some national resources into a common fiscal facility for public investment would enhance the efficiency with which the money is being used.

5. Rewarding reforms

A new carrot? Yes. But no further stick, please

One variant of a fiscal facility deserves special consideration, though. Four years ago, German chancellor Angela Merkel proposed a Eurozone fiscal facility that would offer loans or guarantees on preferential terms to countries that enter into legally binding commitments to reform their labour markets and their public sector. The idea is to promote and reward reforms that raise the long-term growth potential of a country.

Structural reforms in one country benefit the region as a whole

The overall idea is sound. The entire Eurozone benefits if countries with deep-seated structural problems such as France, Italy and Greece raise their trend rate of economic growth. Hence, a common fiscal facility could offer funds to countries that implement serious structural reforms. The assistance could take the form of loans or guarantees at preferential terms or outright transfers to pay for some additional public investment. To judge which country should qualify for such funds, the EU could employ the expertise of the OECD, which conducts a detailed assessment of structural reform progress as part of its "Going for Growth" exercise each year[3]. For example, this fiscal facility could offer support to all Eurozone (or EU27) members with a ranking above 0.5 in the OECD's reform scorecard. A value of 0.5 indicates that a country has undertaken meaningful reforms in half of the priority areas identified by the OECD in the year before. Among the eligible countries, those with a higher reform score could be granted more access to the common fiscal facility than those with a less stellar score.

Success begins at home

The best way for a country to make its fiscal position more sustainable in the long run is to use its own resources better and to attract further resources from abroad. Suitable structural reforms can raise employment and make the country attractive for capital and skilled immigrants. That can raise future tax revenue more than a hike in tax rates which, through an additional tax burden, distorts incentives and represses economic activity.

Rewarding reforms? Desirable but not essential

Note that the recipients of such additional common funds for, say, investment and education may not be the poorer members of the Eurozone. Poor people and poor countries can live within their means, just as richer people and richer countries can still live beyond their means. If France continues to move up in the OECD ranking, as it has done in 2015-2016 while the current president Emmanuel Macron served as France's minister of economics, France could be a major beneficiary.

V. The case for an Independent Fiscal Council

1. The problem: how to police the rules?

Policing the rules is an awkward process

Policing fiscal rules in the Eurozone is an awkward process. For "programme countries" that receive financial support from the ESM (currently only Greece), the "quadriga" of EU Commission, ECB, ESM and IMF negotiates and polices the conditionality. Eurozone finance ministers then sign off on these findings and recommendations before the relevant national institutions of ESM members have the final say over any significant use of ESM funds. For all other Eurozone (and EU) members, the EU Commission checks the draft budget during the "European semester" and issues detailed recommendations on fiscal repair, structural reforms and other areas of economic policy. These recommendations, which usually make a lot of sense, are then discussed and endorsed by the Council of finance ministers – after which usually not much happens. Few countries comply with these recommendations. That the proposals originate from the European Commission, a body that is not always perceived to be a disinterested outside observer, does not help.

Minimising the political strains

The challenge is to augment, implement and enforce the rules in a way that minimises the inevitable political strains of the mutual surveillance that common rules entail. A better surveillance and enforcement process of the fiscal rules should:

- de-politicise the process as much as possible while preserving the prerogative of national parliaments and executives to make the ultimate decisions;
- restrict or eliminate the role of the current quadriga;
- apply to all euro member countries, not just to those in a support programme.

Too big to pay: financial sanctions are unlikely to work against major countries

For countries which do not depend on outside support, the Eurozone currently has no credible mechanism to promote compliance. Setting up a common investment fund to reward countries for pro-growth reforms as discussed above would serve as a carrot in the future. But there is no real stick. Financial sanctions, while possible in principle, are unlikely to be ever imposed on any member country with political clout, as the German/French refusal to accept the rules of the old Stability Pact had shown in 2002-2004.

The ultimate sanction: the threat to withhold support for those who flout the rules

The ultimate sanction which the Eurozone could wield against individual members that break the fiscal rules but do not need ESM assistance would be to tell markets that, on

[3] For the most recent edition, see OECD, Going for Growth 2017, Paris, 17 March 2017.

current policies, a specific country would not be eligible for support if the need were to arise. For markets, that would be an invitation to sell the country's debt and hence to put pressure on the country to mend its ways. But the Eurozone has no well-structured and politically acceptable way in which to wield such power.

Outsiders should not issue overly detailed recommendations...

Nudging a country back onto the path of fiscal virtue causes serious political strains. In order to minimise these strains, the outsiders policing and enforcing the rules should be seen as much as possible as disinterested outside observers who give the political process in the country as much room as possible. For that reason, the outsiders should not issue a set of detailed recommendations or demand adherence to one set of detailed conditions. Instead they should help to spell out the choices: which policy changes would contribute roughly how much to making the fiscal position of a country sustainable in the long run? Debtor countries ought to be told that, in order to fix their fiscal position, they have a de facto choice between more austerity and less dismissal protection for workers, between more deregulation and more public sector wage cuts.

...but assess the longer-term consequences of policy options

Put differently: outsiders should retreat as much as possible from making politically sensitive detailed recommendations. Instead, they should assess the longer-term fiscal consequences of various policy and reform options, passing judgement as to whether any combination of policies under consideration by a member country would or would not be in line with the fiscal rules of the euro.

2. The solution: an IFC

Room for judgement calls

But which institution should evaluate fiscal sustainability and assess the policies and reform options? Economics is a not a precise science. It leaves significant room for judgement calls. Because of its consequences, the evaluation of policies and reform choices is likely to be a highly political affair.

Entrust the more technical tasks to an independent body of technical experts

The best way to de-politicise the process as much as possible is to leave all technical aspects outside the realm of direct political interference. The world has fared well with entrusting the technical task of setting monetary policy to pursue a politically given mandate such as some definition of price stability to an independent body of technocrats, that is to an independent central bank such as the ECB. Some countries such as the UK also have IFCs that make the economic growth and revenue forecasts for the national budget and assess the fiscal consequences of certain policy choices.

Final decisions will need to be made by a political body

Of course, all final decisions to grant or withhold support in a specific instance will need to be made by the relevant political bodies in the end. However, the technical aspects of evaluating the choices should be moved from the European Commission (for non-programme countries) and the quadriga (for programme countries) to an IFC. The task of the council of experts should be to

The three tasks of a fiscal council

- regularly monitor the fiscal sustainability of all euro member countries,;
- certify every year for each euro member country whether the country is currently meeting and likely to meet in the next two years the fiscal rules either fully (a first-class seal of approval), or largely or not at all; and
- assess the fiscal consequences of policies and reform options.

On track – or not?

Once a year, the IFC should certify whether or not a country with its budget and its set of relevant policies is on track to reduce its structural fiscal deficit to no more than 0.5% of its annual GDP in line with Eurozone's fiscal rules and at the pace agreed by Eurozone finance ministers. For these assessments, the IFC needs to take into account the likely impact of structural reforms that have been passed into law already or are being passed with a proposed budget.

A rating agency in disguise – but with clout

In a way, the IFC would be similar to a rating agency. It would neither set policies nor issue detailed recommendations. But it would rate the overall set of policies a country is pursuing, leaving the choice among various options to ensure fiscal sustainability to the political process of a country.

Teeth that can bite

But would such a fiscal council have teeth? Or would it just be an expert panel that gets ignored, possibly even more so than the recommendations for non-programme countries currently issued by the European Commission and endorsed by the Ecofin Council of European Finance Ministers? A simple change to the way in which the ESM safety net can be used can give such an independent fiscal council teeth. Upon establishing the IFC, euro

members could either enshrine in a treaty or simply pledge that, forthwith, the potential access of countries to support funds from the ESM/EMF (and, by extension, from the ECB's OMT programme) would depend on their IFC rating. More precisely, countries that are fully compliant with EU fiscal rules could be granted automatic access to an ESM credit line, countries that are largely compliant could be automatically eligible for potential support loans with no more than light conditionality while countries that are not compliant could only get access to any support funds from the ESM under a full-fledged programme with tough conditionality. Markets could take their cue from that.

In practice, it would suffice for a national parliament of one member countries with a de facto veto such as the Germany, France or Italy to clearly state that only countries with IFC approval of their current policies (or of a reform programme) need apply for ESM support in the future.

Issuing an annual seal of approval

The seal of approval should be granted or withheld once a year for every euro member country, except for countries which have to apply for support and thus need to be monitored more frequently. Even for such "programme countries", the IFC should not issue a single set of conditions. Instead, it should ask countries to submit their own programmes and support the national debate in that country by spelling out whether and to which extent various policy options would contribute to the task of making the fiscal position fully sustainable again. With IFC approval of a reform programme, the door would be open for potential ESM support.

A clear verdict from the IFC could shape the national debate

For non-programme countries not currently under market suspicion, the lack of a first class or second class seal of approval from the IFC may not suffice to force them back onto the path of fiscal virtue. But a clear verdict from the IFC could still have a major impact on the national debate. It would have been quite interesting to see how the German political process would have reacted if such an IFC, with a legal position similar to that of the ECB, would have passed a verdict on the long-term fiscal consequences of the recent German move to let some workers retire with a full pension at 63 rather than 65. Again, the purpose of the IFC is not to prevent such policy choices. Instead, it is to force countries to face up to the consequences of such choices.

How to enlist the bond markets to enforce the verdict

For countries with a standing in markets that is not quite as stellar as that of the Netherlands or Germany, the IFC's first-class seal of approval – or the lack of it – would likely have a noticeable impact on bond yields and hence on financing cost for the sovereign as well as households and companies. Because only countries with that first-class seal of approval could rely on automatic and non-conditional help from a lender of last resort in case of turmoil, the impact on bond yields could be much bigger than that of standard rating agencies. This effect could easily be amplified if regulators and the ECB discriminate between sovereign bonds of euro member countries that do and do not come with that seal. If the ECB would accept bonds from countries deemed as only partly compliant with EU fiscal rules only at a hefty discount in its refinancing operations and if banks would have to set aside extra capital for holding sovereign bonds of euro members without a first-class seal of approval, the impact could be significant.

A governance structure similar to that of the ECB

The members of the IFC's decision-making board should be selected and appointed to non-renewable eight-year terms in a process akin to that of choosing the six executive board members of the European Central Bank. For their staff, the IFC could draw partly on the relevant departments within the EU Commission's Directorate for Economic and Financial Affairs and those ECB staff members that have contributed to troika missions or analyses. Of course, the IFC could also enlist the technical help of the independent fiscal commissions or similar bodies on the national level that individual euro members already have while leaving the ultimate judgement calls to the IFC executive board.

Open to non-members – if they dare to hear the verdict

Membership in the IFC, and hence the chance to get the annual IFC seal of approval, should also be open on a voluntary basis to all non-euro members of the EU and other European countries with a high degree of institutional integration with the EU such as Switzerland, Norway and Iceland or – in a post-Brexit world – the UK. Without having assessed the national data in detail, we presume that at least Switzerland and Norway could confidently expect to get the IFC top seal of approval without any problem whereas the UK would not.

3. The IFC versus the EMF

In one respect, the roles of the proposed IFC and the EMF would overlap. They would both take very close looks at fiscally challenged Eurozone members. The key differences are that the IFC would:

- pass a verdict on all Eurozone members each year;
- have a board of independent experts akin to the ECB's executive board rather than country representatives as its decision-making body;
- merely pass judgment on the sustainability of a country's fiscal stance without taking any decision on actual assistance for fiscally challenged countries.

The policing and supervision of support programmes would be the mainstay of the EMF. While the IFC and EMF would perform separate tasks and should be separate institutions, the EMF may well be allowed to enlist some IFC staff members with the relevant expertise whenever the EMF has to design and supervise an adjustment programme in a member country.

Of course, the tasks of the proposed IFC could be folded into the EMF. However, a body directly answerable to representatives of national governments, as the EMF probably would be like the IMF and the current ESM, may not be independent enough to pass the kind of judgements than an IFC could.

Two institutions that can complement each other

VI. Insiders versus outsiders

1. Turning into a club of clubs

A flexible arrangement

The EU is a flexible arrangement. It can accommodate various degrees of integration. It has various clubs within the overall club, including the Schengen area of passport-free travel. The key point is that these clubs within the EU are open to all EU members who want to join.

A well entrenched trend towards coalitions of the willing

The trend towards "coalitions of the willing" seems well entrenched. The increasing difficulty to get all EU members to agree on and ratify substantial – and sometimes even minor – changes makes it virtually inevitable that significant new European initiatives will extend only to subsets rather than to all 27 post-Brexit members. Ideally, the mandatory requirements for all members and all sub-groups of members should be:

Minimum requirements for a club of clubs

- the common market for goods and services, capital and labour;
- common standards for human rights and the rule of law, including the acceptance of the European Court of Justice as the ultimate arbiter in disputes about the interpretation of EU rules;
- common financing of common policies through the EU budget; and
- a requirement to keep all sub-groups of countries who work more closely together on some policy areas open to all other EU members to join if they want to and meet the entry criteria.

Subject to these criteria, the proposals discussed above need not be realised by all EU27 or Eurozone members. To facilitate their introduction, they could be agreed within "coalitions of the willing" instead.

2. Exit option? Key requirements are already in place

If countries do not like the rules, they may leave...

EU and Eurozone members are sovereign countries. They can decide on their own whether or not they want to be part of any club. That also holds for the decision to accept the euro and its "tough love" rules, or not. Of course, the countries have to bear the consequences of their choices, including the potential loss of access to the Common Market if a member leaves the EU or the grave financial turmoil that an exit from the common currency may entail.

...but they would have to bear the consequences

In the hypothetical case that a member country wanted to leave the euro, the other members would need a mechanism to insulate themselves from the potential exit turmoil. Fortunately, this requirement is in place. Since the ECB promised to do all it takes to keep all compliant

members in the euro, the contagion risk has subsided. Problems can be contained. For example, the initial botched plan to confiscate a share of all Cypriot bank deposits barely caused a ripple in other countries in March 2013. Contagion control is working.

Contagion control is working

Because the Eurozone now has the instruments to contain contagion risks, it is in a much better position to enforce rules than before. In the theoretical case that a member no longer wanted to live by the rules and rather leave the club, the Eurozone could handle the consequences

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Contacts

BERENBERG
PARTNERSHIP SINCE 1590

JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com

E-mail: firstname.lastname@berenberg.com

EQUITY RESEARCH

AEROSPACE & DEFENCE

Name	Phone
Ryan Booker	+44 20 3753 3074
Andrew Gollan	+44 20 3207 7891
Charlotte Keyworth	+44 20 3753 3013
Ross Law	+44 20 3465 2692

AUTOMOTIVES

Name	Phone
Cristian Dirpes	+44 20 3465 2721
Alexander Haissl	+44 20 3465 2749
Paul Kratz	+44 20 3465 2678
Fei Teng	+44 20 3753 3049

BANKS

Name	Phone
Adam Barrass	+44 20 3207 7923
Stephanie Carter	+44 20 3207 3106
James Chappell	+44 20 3207 7844
Andrew Lowe	+44 20 3465 2743
Andreas Markou (EM)	+44 20 3753 3022
Alex Medhurst	+44 20 3753 3047
Eoin Mullany	+44 20 3207 7854
Peter Richardson	+44 20 3465 2681

BEVERAGES

Name	Phone
Javier Gonzalez Lastra	+44 20 3465 2719
Batuhan Karabekir (EM)	+44 20 3465 2631
Matt Reid	+44 20 3753 3075

BUSINESS SERVICES, LEISURE & TRANSPORT

Name	Phone
Roberta Ciaccia	+44 20 3207 7805
Najet El Kassir	+44 20 3207 7836
Stuart Gordon	+44 20 3207 7858
Josh Puddle	+44 20 3207 7881
Kate Somerville	+44 20 3753 3081

CAPITAL GOODS

Name	Phone
Nicholas Housden	+44 20 3753 3050
Sebastian Kuenne	+44 20 3207 7856
Philippe Lorrain	+44 20 3207 7823
Rizk Maidi	+44 20 3207 7806
Simon Toennessen	+44 20 3207 7819

CHEMICALS

Name	Phone
Sebastian Bray	+44 20 3753 3011
Rikin Patel	+44 20 3753 3080
Andrew Heap	+44 20 3207 7918

CONSTRUCTION

Name	Phone
Saravana Bala	+44 20 3753 3043
Lush Mahendrarajah	+44 20 3207 7896
Robert Muir	+44 20 3207 7860
Olivia Peters	+44 20 3465 2646

ENERGY

Name	Phone
Tibor Bokor	+44 20 3207 7804
Yuriy Kukhtanych (EM)	+44 20 3465 2675

FOOD MANUFACTURING AND H&PC

Name	Phone
Rosie Edwards	+44 20 3207 7880
Yordana Mavrodieva	+44 20 3207 7817
Philip Patricha	+44 20 3753 3039
Fintan Ryan	+44 20 3465 2748
James Targett	+44 20 3207 7873

FOOD RETAIL

Name	Phone
Batuhan Karabekir (EM)	+44 20 3465 2631
Dusan Milosavljevic	+44 20 3753 3123

GENERAL MID CAP - DACH

Name	Phone
Gunnar Cohrs (DACH + US)	+44 20 3207 7894
Martin Comtesse	+44 20 3207 7878
Thomas Eble	+44 20 3753 3014
Charlotte Friedrichs	+44 20 3753 3077
Gerhard Orgonas	+44 20 3465 2635
Benjamin Pfannes-Varrow	+44 20 3465 2620
Julia Scheufler	+44 20 3753 3016

GENERAL MID CAP - EU core

Name	Phone
Aymeric Lang	+44 20 3753 3037
Anna Patrice	+44 20 3207 7863

GENERAL MID CAP - UK

Name	Phone
Calum Battersby	+44 20 3753 3118
Robert Chantry	+44 20 3207 7861
Sam England	+44 20 3465 2687
Ned Hammond	+44 20 3753 3017

GENERAL MID CAP - UK (cont'd)

Name	Phone
Omar Ismail	+44 20 3753 3102
Ian Osburn	+44 20 3207 7814
Antony Plom	+44 20 3207 7908
Edward James	+44 20 3207 7811
Benjamin May	+44 20 3465 2667
Owen Shirley	+44 20 3465 2731
Donald Tait	+44 20 3753 3031

GENERAL RETAIL

Name	Phone
Conrad Bartos	+44 20 3753 3053
Camilla Mazzolini	+44 20 3753 3042
Michelle Wilson	+44 20 3465 2663

HEALTHCARE

Name	Phone
Scott Bardo	+44 20 3207 7869
Jakob Berry	+44 20 3465 2724
Alistair Campbell	+44 20 3207 7876
Klara Fernandes	+44 20 3465 2718
Tom Jones	+44 20 3207 7877
Joseph Lockey	+44 20 3465 2730
Laura Sutcliffe	+44 20 3465 2669
Charles Weston	+44 20 3465 2746

INSURANCE

Name	Phone
Charles Bendit	+44 20 3465 2729
Trevor Moss	+44 20 3207 7893
Emanuele Musio	+44 20 3207 7916
Iain Pearce	+44 20 3465 2665
Sami Taipalus	+44 20 3207 7866

LUXURY GOODS

Name	Phone
Mariana Horn	+44 20 3753 3044
Zuzanna Pusz	+44 20 3207 7812

MEDIA

Name	Phone
Robert Berg	+44 20 3465 2680
Laura Janssens	+44 20 3465 2639
Alastair Reid	+44 20 3207 7841
Sarah Simon	+44 20 3207 7830

METALS & MINING

Name	Phone
Alessandro Abate	+44 20 3753 3029
Fawzi Hanano	+44 20 3207 7910
Yuriy Vlasov	+44 20 3465 2674

REAL ESTATE

Name	Phone
Kai Klose	+44 20 3207 7888
Tina Munda	+44 20 3465 2716

TECHNOLOGY

Name	Phone
Jean Beaubois	+44 20 3207 7835
Josep Bori	+44 20 3753 3058
Georgios Kertsos	+44 20 3465 2715
Richard Odumosu	+44 20 3207 7851
Tammy Qiu	+44 20 3465 2673

TELECOMMUNICATIONS

Name	Phone
Ondrej Cabejsek (EM)	+44 20 3753 3071
Nicolas Didio	+44 20 3753 3091
Usman Ghazi	+44 20 3207 7824
Siyi He	+44 20 3465 2697
Laura Janssens	+44 20 3465 2639
Paul Marsch	+44 20 3207 7857

THEMATIC RESEARCH

Name	Phone
Nick Anderson	+44 20 3207 7838
Oyvind Bjerke	+44 20 3753 3082
Asad Farid	+44 20 3207 7932
Robert Lamb	+44 20 3465 2623
James Sherborne	+44 20 3753 3073

TOBACCO

Name	Phone
Jonathan Leinster	+44 20 3465 2645

UTILITIES

Name	Phone
Oliver Brown	+44 20 3207 7922
Andrew Fisher	+44 20 3207 7937
Neha Saxena	+44 20 3753 3048
Lawson Steele	+44 20 3207 7887

ECONOMICS

Name	Phone
Florian Hense	+44 20 3207 7859
Carsten Hesse (EM)	+44 20 3753 3001
Kallum Pickering	+44 20 3465 2672
Holger Schmieding	+44 20 3207 7889

EQUITY SALES

SPECIALIST SALES

AUTOMOTIVE & THEMATICS

Name	Phone
Chris Armstrong	+44 20 3207 7809

BANKS, DIVERSIFIED FINANCIALS & INSURANCE

Name	Phone
Iro Papadopoulou	+44 20 3207 7924
Calum Marris	+44 20 3753 3040

BUSINESS SERVICES, LEISURE & TRANSPORT

Name	Phone
Rebecca Langley	+44 20 3207 7930

CONSTRUCTION,CHEMICALS, METALS & MINING

Name	Phone
James Williamson	+44 20 3207 7842

CONSUMER DISCRETIONARY

Name	Phone
Victoria Maigrot	+44 20 3753 3010

HEALTHCARE

Name	Phone
Abigail James	+44 20 3753 3078

MEDIA & TELECOMMUNICATIONS

Name	Phone
Julia Thannheiser	+44 20 3465 2676

SALES

BENELUX

Name	Phone
Miel Bakker	+44 20 3207 7808

GERMANY

Name	Phone
Michael Brauburger	+49 69 91 30 90 741
Nina Buechs	+49 69 91 30 90 735
André Grosskurth	+49 69 91 30 90 734
Florian Peter	+49 69 91 30 90 740
Joerg Wenzel	+49 69 91 30 90 743

UK

Name	Phone
Alexandra Clément	+44 20 3753 3018
Fabian De Smet	+44 20 3207 7810
Jules Emmet	+44 20 3753 -3260
Karl Hancock	+44 20 3207 7803
Sean Heath	+44 20 3465 2742
David Hogg	+44 20 3465 2628

UK ctd

Name	Phone
Gursumeet Jhaj	+44 20 3753 3041
Peter Kaineder	+44 20 3753 3062
James Matthews	+44 20 3207 7807
James McRae	+44 20 3753 3036
David Mortlock	+44 20 3207 7850
Eleni Papoula	+44 20 3465 2741
Bhavin Patel	+44 20 3207 7926
Kushal Patel	+44 20 3753 3038
Richard Payman	+44 20 3207 7825
Clémence Peyraud	+44 20 3465 2651
Christopher Pyle	+44 20 3753 3076
Joanna Sanders	+44 20 3207 7925
Mark Sheridan	+44 20 3207 7802
George Smibert	+44 20 3207 7911
Alexander Wace	+44 20 3465 2670
Paul Walker	+44 20 3465 2632

FRANCE

Name	Phone
Thibault Bourgeat	+33 1 5844 9505
Alexandre Chevassus	+33 1 5844 9512
Dalila Farigoule	+33 1 5844 9510
Benjamin Voisin	+33 1 5844 9507

SCANDINAVIA

Name	Phone
Marco Weiss	+49 40 350 60 719

SWITZERLAND, AUSTRIA & ITALY

Name	Phone
Andrea Ferrari	+41 44 283 2020
Carsten Kinder	+41 44 283 2024
Gianni Lavigna	+41 44 283 2038
Jamie Nettleton	+41 44 283 2026
Yeannie Rath	+41 44 283 2029
Benjamin Stillfried	+41 44 283 2033

CRM

Name	Phone
Laura Cooper	+44 20 3753 3065
Jessica Jarmyn	+44 20 3465 2696
Rita Pilar	+44 20 3753 3066
Greg Swallow	+44 20 3207 7833

CORPORATE ACCESS

Name	Phone
Lindsay Arnold	+44 20 3207 7821
Jennie Jiricny	+44 20 3207 7886
Stella Siggins	+44 20 3465 2630

EVENTS

Name	Phone
Laura Hawes	+44 20 3753 3008
Suzy Khan	+44 20 3207 7915
Charlotte Kilby	+44 20 3207 7832
Natalie Meech	+44 20 3207 7831
Rebecca Mikowski	+44 20 3207 7822
Ellen Parker	+44 20 3465 2684
Sarah Weyman	+44 20 3207 7801

SALES TRADING

HAMBURG

Name	Phone
Tim Storm	+49 40 350 60 415

PARIS

Name	Phone
Vincent Klein	+33 1 58 44 95 09
Antonio Scuotto	+33 1 58 44 95 03

LONDON

Name	Phone
Assia Adanouj	+44 20 3753 3087
Charles Beddow	+44 20 3465 2691
Mike Berry	+44 20 3465 2755
Stewart Cook	+44 20 3465 2752
Mark Edwards	+44 20 3753 3004
Tom Floyd	+44 20 3753 3136

LONDON (cont'd)

Name	Phone
Tristan Hedley	+44 20 3753 3006
Peter King	+44 20 3753 3139
Christoph Kleinsasser	+44 20 3753 3063
Simon Messman	+44 20 3465 2754
AJ Pulleyn	+44 20 3465 2756
Matthew Regan	+44 20 3465 2750
Michael Schumacher	+44 20 3753 3006
Paul Somers	+44 20 3465 2753

EQUITY TRADING

HAMBURG

Name	Phone
David Hohn	+49 40 350 60 761
Gregor Labahn	+49 40 350 60 571
Lennart Pleus	+49 40 350 60 596
Asbjoern Rogge	+49 40 350 60 798
Marvin Schweden	+49 40 350 60 576
Omar Sharif	+49 40 350 60 563
Philipp Wiechmann	+49 40 350 60 346
Christoffer Winter	+49 40 350 60 559

LONDON

Name	Phone
Edward Burlision-Rush	+44 20 3753 3005
Richard Kenny	+44 20 3753 3083
Chris McKeand	+44 20 3207 7938

ELECTRONIC TRADING

Name	Phone
Jonas Doehler	+44 40 350 60 391
Matthias Führer	+49 40 350 60 597
Matthias Schuster	+44 40 350 60 463

BERENBERG CAPITAL MARKETS LLC

Member FINRA & SIPC

E-mail: firstname.lastname@berenberg-us.com

EQUITY RESEARCH

Name	Phone
Corinna Freedman	+1 646 445 4877
Adam Mizrahi	+1 646 445 4878

CRM

Name	Phone
LaJada Gonzales	+1 646 445 7206
Monika Kwok	+1 646 445 4863

CORPORATE ACCESS

Name	Phone
Olivia Lee	+1 646 445 7212
Tiffany Smith	+1 646 445 4874

EQUITY SALES

SALES

Name	Phone
Enrico DeMatt	+1 646 445 4845
Kelleigh Faldi	+1 617 292 8288
Isabella Fantini	+1 646 445 4861
Ted Franchetti	+1 646 445 4864
Alexander Frankiewicz	+1 646 445 4870
Shawna Giust	+1 646 445 7216
Rich Harb	+1 617 292 8228
Zubin Hubner	+1 646 445 5572

SALES (cont'd)

Name	Phone
Michael Lesser	+1 646 445 5575
Jessica London	+1 646 445 7218
Ryan McDonnell	+1 646 445 7214
Emily Mouret	+1 415 802 2525
Peter Nichols	+1 646 445 7204
Kieran O'Sullivan	+1 617 292 8292
Rodrigo Ortigao	+1 646 445 7202
Ramnique Sroa	+1 415 802 2523
Matt Waddell	+1 646 445 5562

SALES TRADING

Name	Phone
Michael Haughey	+1 646 445 4821
Christopher Kanian	+1 646 445 5576
Lars Schwartau	+1 646 445 5571
Brett Smith	+1 646 445 4873
Bob Spillane	+1 646 445 5574

ECONOMICS

Name	Phone
Mickey Levy	+1 646 445 4842
Roiana Reid	+1 646 445 4865