

6 December 2011

TOWARDS A STRONGER ECONOMIC UNION

INTERIM REPORT

The Euro Summit on 26 October 2011 tasked the President of the European Council, in close collaboration with the President of the Commission and the President of the Eurogroup, to identify possible steps to make the economic union commensurate with the monetary union with the following focus: further strengthening economic convergence, improving budgetary discipline and deepening economic union within the euro area. The present report takes stock of what has been achieved so far, which is often underestimated, and sets out the way forward. It takes into account the bilateral consultations that took place with all EU Member States in the preparatory process.

- 1) In reaction to the sovereign debt crisis, significant changes in governance have taken place in the last year and a half, with the creation of the EFSF, agreement on a future ESM, the decisions on budgetary surveillance and coordination of economic policies as well as on a more extended governance structure for the euro area taken by the October Euro Summit, and the package of six legislative acts on economic governance adopted on 16 November. Implementation of this package will start in December. Meanwhile, the Commission submitted on 23 November a new set of proposals to transform into legislation the orientations agreed upon in October concerning (i) the monitoring and assessment of draft budgetary plans and the correction of excessive deficit in euro area Member States and (ii) the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area.
- 2) The stability and integrity of the Economic and Monetary Union requires both the swift and vigorous implementation of the measures already agreed and further qualitative moves towards a genuine "fiscal union". This will entail significantly stronger coordination of economic policies and a higher degree of surveillance and discipline in the conduct of national policies. Longer term structural changes in the way policies are conducted in the euro area are important also to deal with short term uncertainties and to restore credibility and confidence.
- 3) This must be done while preserving the integrity of the EU and the coherence between the euro area and the EU as a whole; the EU institutions have an important role to play in guaranteeing the unity of the Union as a whole.

ECONOMIC COORDINATION AND CONVERGENCE IN THE EURO AREA

- 4) The crisis has shown that diverging macro-economic trends may adversely affect the whole euro area. While there can be no one-size-fits-all rule, a higher degree of coordination and integration is needed so as to avoid unsustainable trends. In a monetary union with an integrated financial sector, inter-dependence and spill-over effects are very high.

- 5) The measures already adopted include an excessive imbalances procedure set up in the legislative package on economic governance. It contains an early warning system based on a scoreboard of economic indicators (including labour costs, credit growth, current account, export market shares and housing prices) and a corrective arm with possible sanctions in case of repeated failure by a Member State to take action to address imbalances. In parallel, euro area Member States have taken on additional commitments within the framework of the Euro Plus Pact in four areas that are key for convergence: competitiveness; employment; sustainability of public finances; financial stability. These new instruments must now be implemented forcefully. At the same time, there is a need to further strengthen the system.
- 6) Against this background, the following **additional measures** should be considered:
 - a) The October Euro Summit agreed on ex ante examination at the euro area level of all major economic reform plans with potential spill-over effects. This agreement should be made fully operational, via a specific procedure to be set up, notably involving a discussion within the Eurogroup on the basis of an analysis by the Commission;
 - b) The lack of implementation of country specific recommendations for the euro area Member States adopted on the basis of Articles 121(2) and 148(4) TFEU and related to reforms that are indispensable for the smooth functioning of the monetary union, should be subject to financial sanctions. Clear criteria for ex-ante identification of the recommendations that could be subject to sanctions should be defined in the secondary legislation. Specific attention should be paid to euro area Member States with competitiveness problems and/or high unemployment.

These measures can be taken within the current Treaty framework, on the basis of Article 136 TFEU.

BUDGETARY DISCIPLINE

- 7) The legislative package on economic governance adopted on 16 November represents a major strengthening of budgetary discipline. The new mechanisms are based both on recommendations and sanctions. The scope for sanctions for euro area Member States has been enlarged (they can be triggered not only in the corrective arm of the Pact, but also in the preventive arm) and decision making has been accelerated and simplified so as to increase automaticity. The Commission's legislative proposals issued on 23 November will further strengthen discipline and compliance in the euro area.
- 8) The combined effect of all these measures will be very significant. However, moving the euro area towards a true economic union requires additional steps in terms of integration, towards a "new fiscal compact". To restore market confidence in the euro area and to ensure the political sustainability of solidarity mechanisms, it is crucial to enhance the credibility of our budgetary rules (deficit and debt levels) and to ensure full compliance. This is likely to require a change in primary law.
- 9) Two avenues are possible in this respect, while not being mutually exclusive:
 - a) A substantial revision of Protocol N°12 to the Treaty, combined with further reforms through secondary legislation.

b) Amendments to the Treaty through a revision procedure based on Article 48 TEU.

Revision of Protocol N°12 and secondary legislation

- 10) The obligation for euro area Member States to reach and maintain a balanced budget over the economic cycle could be introduced in Protocol (N°12) on the excessive deficit procedure, as a means to ensuring that excessive deficits are avoided and that debt is brought down below 60%. A resolute convergence towards balanced budgets from current positions should be envisaged for euro area Member States in line with a calendar established with the Commission. In addition, the Protocol would also include the obligation for euro area Member States to include such a rule in their national legal systems, preferably at constitutional or equivalent level. The Court of Justice would have jurisdiction to control the transposition of this rule at national level. This rule should be complemented with an automatic correction mechanism (for example automatic reductions in expenditures, increases in taxes or a combination of both), to be specified by each Member State, in case of deviation. Euro area Member States should report ex-ante on their national debt issuance and a centralized recording and monitoring of all general government debt issuance at euro area level should be undertaken.
- 11) This could be complemented with further reinforcement of the excessive deficit procedure for euro area Member States to be introduced through secondary legislation on the basis of Article 136 TFUE. This would allow for a higher degree of precision of the measures to be adopted by the Member States, in close partnership with the Commission, which could review and endorse the programme put forward by the Member State. The overall objectives set out in a Commission or Council act could be binding as to the results to be achieved.
- 12) Changes to Protocol N°12 can be introduced by a unanimous decision of the Council on a proposal from the Commission after consultation of the European Parliament and the European Central Bank. This decision does not require ratification at national level. This procedure could therefore lead to rapid and significant changes.

Treaty amendments through Article 48 TEU

- 13) Another avenue to be pursued either in parallel or subsequently would be to undertake a revision of the TFUE articles related to Economic and Monetary Union, through the revision procedure set out in Article 48 of the Treaty on European Union. Such a revision could consist in a modification or replacement of Article 136 and/or a revision of Protocol N°14 on the Eurogroup.
- 14) This procedure would be more time-consuming and subject to ratification in all Member States, but it would allow more fundamental changes in the budgetary framework, such as:
 - a modification of the excessive deficit procedure (Article 126) for euro area Member States, notably by reinforcing its automaticity, both in the triggering and in the decision-making process by extending the recourse to reverse qualified majority voting;
 - an enhanced role for the EU institutions, with a higher intrusiveness in the case of lack of implementation. For euro area Member States in an excessive deficit procedure, there could be a the possibility for the Commission and the Council (Eurogroup) to request changes in a draft budget before it is submitted to the national parliament if the budgetary

stance is not in line with the agreed plans. In the case of euro area Member States that are under an assistance programme and persistently fail to meet the conditionality, the Commission could receive exceptional powers, such as ex-ante approval of all major economic reforms;

- the integration into a revised Protocol N°14 of the changes agreed upon in the euro area governance.

ECONOMIC UNION

- 15) Two additional steps, closely related to progress to be made in economic convergence and budgetary discipline, could also be considered :

- **Recourse to enhanced cooperation**, with the participation of all euro area Member States, focusing on areas which are essential for the smooth functioning of the euro area such as the functioning of labour markets, sustainability of pensions and social security systems, as well as pragmatic tax coordination measures. Steps toward further financial integration in the euro area should also be considered. In the context of a possible Treaty change, a similar mechanism to that which already exists in the area of Freedom, Security and Justice could be introduced to accelerate the recourse to enhanced cooperation. Such developments must not undermine the internal market.

- **Opening up the possibility, in a longer term perspective, of moving towards common debt issuance in a staged and criteria-based process**, for example starting with the pooling of some funding instruments. Any steps towards that end would have to be commensurate with a robust framework for budgetary discipline and economic competitiveness to avoid moral hazard and foster responsibility and compliance. This would also require more intrusive control of the national budgetary stance by the EU. Such a process would underline the irreversibility of the euro, give a long term prospect for the funding issue, and reinforce the role of the euro as a global reserve currency. At the same time, it would in fact also be a very powerful mechanism for budgetary discipline.

STRENGTHENING THE EXISTING CRISIS MECHANISMS

- 16) Longer term reforms such as the ones set out above must be combined with **immediate action** to forcefully address current market tensions.

- 17) First, there is a need to complete the implementation of the substantial measures that have already been decided. This entails :

- rapid agreement, ideally by March 2012, between the European Parliament and the Council on the two Commission proposals tabled on 23 November; possibly reinforced in line with the changes to Protocol N°12 outlined above;
- rapid deployment of the EFSF leveraging, through the two concrete options agreed upon by the Eurogroup on 29 November.

- 18) Second, the ESM treaty should be finalised and ratified rapidly, while adjusting it to make it more effective through:

- stating unambiguously, with regard to PSI, the commitment strictly to adhere to well established IMF principles and practices, and clearly reaffirming that the decision taken on 21 July concerning Greek debt is unique and exceptional. This is key to restore market confidence in sovereign debt markets;
 - bringing the ESM decision making procedures more in line with mechanisms in place in the IMF (unanimity being restricted to a limited number of decisions);
 - introducing the possibility for the ESM to directly recapitalise banking institutions and to have itself the necessary features of a credit institution;
 - the possibility to review the clause limiting the consolidating ESM and EFSF lending capacity to EUR 500 billions to give ESM its full lending capacity according to the phasing in of its capital.
- 19) Finally, there is a need to ensure that the IMF has sufficient resources to deal with the crisis through the provision of additional means, as was done in 2009, in particular through bilateral loans.

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