BRIEFING

The economic governance framework of EMU: Stocktaking of possible building blocks

The debate on the way to further enhance the economic governance in the Economic and Monetary Union (EMU) will be part of the policy agenda during 2015. This note gives a short description of the state-of-play and possible developments of various governance instruments of EMU.

The **Euro Summit**, in October 2014, concluded that closer coordination of economic policies is essential to ensure the smooth functioning of the EMU and asked the President of the Commission, to prepare in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the ECB, the next steps on improving economic governance.

The 5 Presidents of the EU institutions published on 22 June 2015 a report on "*Completing Europe's Economic and Monetary Union*", which covers the rationale and short and long term objectives, such as a stronger economic, financial and fiscal union with adequate democratic accountability and legitimacy.

The European Parliament is expected to be adopt on 24 June a Report on "*The review of the economic governance framework: stocktaking and challenges*" (Rapporteur *Berès*).

The European Commission, in November 2014, published a report on the application of the current economic governance framework. According to the report it is too early to drawn concrete lessons of the revised EU legal framework for economic policy surveillance and coordination.

Today the well-functioning of Economic and Monetary Union (EMU) is based on the following **main policy tools**:

- A single **monetary policy** for the euro conducted by the European Central Bank based on the Treaties;
- Common **fiscal rules** based on the Treaties, and its specification in secondary law;
- Multilateral **surveillance of national economic policies**, including macro-economic imbalances, based on the Treaties, and its specification in secondary law;
- Enhanced surveillance and the possibility to **grant financial assistance under strict conditions** in order to safeguard the stability of the euro based on International Agreements, Treaties and specifications in secondary law; and
- An introduction of a **banking union** based on the Treaties, International Agreements, and its specification in secondary law.

In addition a well-functioning **single market**, including progress to a capital markets union, in the European Union is an important component of the EMU. As regards banking supervision and banking resolution some competences have recently moved from national level to the EU level, in particular, for euro area Member States that take part in the Single Supervisory Mechanism and the Single Resolution Mechanism.

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As regards national economic policies, it should be noted that they remain, in principle, a competence of the respective Member States within **some framing elements at the European Union level**:

- *"The Member States shall* ***coordinate their economic policies within the Union****. To this end, the Council shall adopt measures, in particular broad guidelines for these policies. Specific provisions shall apply to those Member States whose currency is the euro. The Union shall take measures to ensure coordination of the employment policies of the Member States, in particular by defining guidelines for these policies. The Union may take initiatives to ensure coordination of Member States' social policies.* (Article 5 TFEU)

- "*Member States shall conduct their economic policies with a view to* ***contributing to the achievement of the objectives of the Union***" (Article 120 TFEU) and, hence, that they *shall regard their economic policies as a matter of common concern and shall coordinate them within the Council* [...]" (Article 121(1) TFEU); "*Member States shall avoid excessive government deficits*" (Article 126(1) TFEU).

- "*The Union shall* ***not be liable for or assume the commitments of central governments, regional, local or other public authorities****, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project"* (Article 125 TFEU)

- "*In order to ensure the proper functioning of economic and monetary union, and in accordance with the relevant provisions of the Treaties, the Council shall […] adopt* ***measures specific to those Member States whose currency is the euro****: (a) to strengthen the coordination and surveillance of their budgetary discipline; (b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance* (Article 136(1) TFEU).

The above mentioned framing elements on the EU level share a common set of objectives, which are mainly the prevention of unsustainable economic policies, the correction of unsustainable economic policies and in more general terms supporting sustainable growth and job creation in EU's Member States.

For the surveillance and coordination of economic policies the Union is following an established policy cycle in the form of the **European Semester for economic policy coordination** with the aim to guarantee coherence of the recommended policies. This is, in particular, the case when **country-specific policy recommendations** are addressed each year by the Council to the Member States and the Euro Area as a whole.

In addition, as a last resort, the possibility to grant financial assistance subject to macroeconomic adjustment programmes was created in order to **safeguard the stability of the euro**. The setting up of a **banking union** to supervise banks is part of the response of preventing financial stability risks stemming from the banking sector.

Concerning the **debate on the future governance structure of EMU**, one can in general terms rely on the following (non-exclusive) approaches:

- Improve the current "**EU rule based surveillance system without legal modifications**" (e.g. improve the underlying analytical framework and the policy recommendations; improve enforcement and commitment to current procedure at EU and national level and among stakeholders);
- Improve the current **"EU rule based surveillance system with legal modifications"** (making the framework more/less strict or more/less comprehensive);
- Changes to the current "**competences between national and EU level"** in the area of economic governance i.e. by changes to primary law (EU Treaties and/or Intergovernmental agreements) in order to establish new EU and/or national tools;
- Complement the EU rule based surveillance with "**stronger institutions" at the EU and/or national level** in order to establish new EU and/or national tools;
- Complement or partly replace the EU rule based surveillance with a system relying more on sovereign responsibility based on **"market discipline"** (e.g. bail-ins in bank restructuring, broader use of risk-weighting and collective action clause of sovereign debt).

The views among politicians and academics[1] vary widely about the optimal way to improve the governance framework of the EMU under the current economic and institutional environment.

Below, summary overviews of the state-of-play of various governance instruments of EMU are presented. These overviews focuses on the current governance tools within the current framework related to the surveillance of national economic policies and the establishment of a "Banking Union". In addition, they outlines some possible future developments, mainly based on elements included in the Commission Blueprint for genuine EMU[2], 2012 four President report towards a genuine EMU[3],the 5 EU Presidents report on Completing Europe's Economic and Monetary Union, and the draft EP report as mentioned above.

Optimally the various building blocks for stronger governance in EMU should seek to establish a framework that would give the correct incentives for Member States to pursue sustainable economic and social policies over the economic and political cycles.

Finally in the annex, a chart can be found, presenting the current and possible future building blocks related to the economic governance tools and structures.

[1] See, for instance, the summary of proceedings, of a workshop organised in December 2015 for Members of the Economic and Monetary Committee of the EP.
[2] Communication from the Commission (COM (2012) 777 final/2): A blueprint for a deep and genuine economic and monetary union: Launching a European Debate.
[3] Towards a genuine Economic and Monetary Union, 5 November 2012.

Banking Union

Legal basis
- Articles 127(6) ("specific tasks to ECB") and 114 ("functioning of internal market"") of TFEU
- Intergovernmental Agreement on the transfer and mutualisation of contributions to the SRF

Background:
One of the key lessons learned from the financial crisis was that the institutional framework for the supervision and resolution of banks is needed to be strengthened and harmonized. Since then, the banking union has seen **considerable progress** within a very short time frame.

Single Supervisory Mechanism (SSM):
The Single Supervisory Board (SSB) together with national supervisory authorities forms the SSM. The SSB is organisationally separated from the ECB. By setting standards at central European level and taking direct responsibility for the most significant banks, the Board plays a key role in making sure that the supervision of banks becomes more independent, better harmonized, and more efficient.
In the past year, the ECB has recruited the Single Supervisory Board's management and staff. In addition, it carried out an extensive financial health check of the banks it is responsible for.

Single Resolution Mechanism (SRM):
SRM includes the Single Resolution Board (SRB) and the national resolution authorities. In case a bank fails or is at risk of failing, the SRM shall come into play and ensure its orderly resolution, with minimal costs for taxpayers and the real economy. One of its main tasks is to take a forward-looking perspective and ensure that banks have drawn up credible resolution plans that can actually be implemented in times of need. The SRM is not yet fully operational. Thus far, the top level management has been appointed and there is an ongoing recruiting process of staff.

Role of EP:
- Co-legislator
- Access to information on the SSM; and
- Organizing public hearings, ad-hoc and confidential meetings with the Single Supervisory Board and the Single Resolution Board based on an inter-institutional or other agreements

Possible future developments
Short term:
- Making the SRM fully operational
- Implementing agreed legislation on national level

Medium term:
- Completing the funding of the Single Resolution Fund
- Participation of non-euro zone countries in the SSM and SRM

Long term:
- Steps to a complete banking union (e.g. common deposit guarantees, euro area safe assets, and financial backstops)

Budgetary surveillance

Legal basis

- Articles 121 ("multilateral surveillance"), Art. 126 ("excessive deficit procedure"), Art. 136 ("euro area specific measures") and
- Protocol No 12 and 13 of TFEU
- Intergovernmental Treaty on Stability, Coordination and Governance in the EMU (TSCG)

Background

The sovereign debt crisis in the euro area highlighted the weaknesses in many EU countries' budget positions and also some gaps in the Stability and Growth Pact (SGP), which had not been addressed sufficiently during the 2005 reforms. The secondary law implementing the SGP was therefore revised in 2011 (as part of the so-called "6-pack"). In March 2013, the SGP was complemented (as part of the so-called "2-pack") by additional reporting and surveillance of draft budgetary plans for euro area Member States.

Preventive arm of the SGP

The goal of the preventive arm is to ensure sound public finances by multilateral surveillance. Its key concept is a medium-term sound fiscal position, called medium-term budgetary objective (MTO). Euro area Member States outline in Stability Programmes the way they intend to reach their MTOs and the country specific adjustment paths are adopted by the Council (as part of the Country Specific Recommendations) based on Commission proposals. The current SGP rules also include an expenditure benchmark, according to which growth of public expenditure (net of discretionary revenue measures) has to be lower than medium-term potential GDP growth. The aim is to complement the assessment based on the structural balance in judging progress towards or remaining at the MTO. Major deviations from the adjustment path to MTO can lead to warning or sanction, if no appropriate measures are taken for correction.

Corrective arm of the SGP

The corrective arm refers to the implementation of the excessive deficit procedure (EDP). The EDP is triggered by the deficit breaching the 3% of GDP threshold or the public debt being above 60% of GDP and not diminishing at a sufficiently rapid pace as defined by the debt reduction benchmark stipulating that the distance to the 60% threshold should be reduced by 5% on average per year (over the past 3 years or in the next 2 years). In case of non-compliance, the EDP foresees sanctions.

On 13 January 2015, the Commission published a communication, which outlines how "flexibility" may be used within the existing rules of SGP. The Council is in the process of revising the Code of Conduct relating to the SGP.

Fiscal compact

The main element of the intergovernmental "fiscal compact", which was signed in March 2012 by all Member States (except the UK and CZ) is a balanced budget rule that needs to be incorporated into national law. Member States may be brought by other Member States before the European Court of Justice if the rule is not properly implemented.

National fiscal institutions

All Member States (except the UK) are required to have in place independent bodies which produce or endorse national medium-term fiscal plans and draft budgets as well as their underpinning macroeconomic forecasts; these bodies shall be endowed with functional autonomy vis-à-vis the budgetary authorities of a Member State and they shall monitor compliance with country-specific numerical fiscal rules.

Draft budgetary plans

To ensure the coordination of fiscal policies, the EU Regulation (No 473/2013) introduced common budgetary timelines for all euro area Member States and rules to assess Member States' draft budget plans by the Commission. In case of serious non-compliance with the SGP, the Commission can request that the plans be revised.

Role of the European Parliament (EP)

- Co-legislator
- Possibility to invite other EU institutions to Economic Dialogue
- Possibility to invite Member States to Economic Dialogue under the EDP

Possible future development

Short term:

- Effective enforcement of the rules (imposition of sanctions in case of non-compliance and/or application of flexibility of the rules in an objective and credible manner over the economic cycle).
- Possible methodological improvements of the complex concepts (notably of the potential output underpinning the concepts of output gap and structural balance).
- The review clause of "6- and 2-Packs" could potentially lead to amendments (though Commission did not propose changes in its review published at the end of 2014).
- Enhance the discussions on euro area wide aggregate fiscal stance
- Establish an EU level fiscal advisory board.

Medium and long term:

- Granting the right to the Commission to require a revision of individual decisions of budget execution
- Competence for the EU to harmonise national budgetary laws
- Stronger risk-weighting of sovereign debt in banking and central banking
- Fiscal capacity (counter-cyclical buffer for euro area)

Surveillance of Macroeconomic Imbalances

Legal basis

- Article 3 of the TEU
- Articles 121(3) ("multilateral surveillance") and 136 ("euro are specific measures") of the TFEU

Background

Over the past decade, several EU Member States have experienced major macroeconomic imbalances. In order to identify and correct such imbalances, including those with potential spill over effects, a new surveillance and enforcement procedure, the Macroeconomic Imbalance Procedure (MIP) was created at the end of 2011. This surveillance mechanism is integrated in the European Semester.

Preventive arm

Under the preventive arm of the MIP, the Commission and the Council adopt recommendations in line with article 121(4) of the Treaty. These recommendations are inserted in the package of country-specific recommendations (CSRs), which the Commission puts forward in May/June within the framework of the European Semester. Among the 158 CSRs that were proposed by the Commission in June 2014 and adopted by the Council in July, 66 were linked to MIP.

Corrective arm

In severe cases, the corrective arm of the MIP is used. An Excessive Imbalance Procedure (EIP) may be opened for a Member State that, according to MIP regulation, has excessive imbalances. Surveillance will be stepped up by the Commission on the basis of a corrective action plan submitted by the Member State concerned. The lack of implementation of the plan can lead to sanctions for Euro Area Member States. Although, in the past years the Commission has identified excessive imbalances in several Member States (three in 2014), so far, no EIP has been proposed by the Commission.

Role of the EP

- Co-legislator
- Informal consultation on any modification of the scoreboard used to identify imbalances
- Possibility to invite other EU institutions, and representative of Member States to under the EIP to an Economic Dialogue

Possible future developments

Short term:

- Effective enforcement/implementation/ownership of MIP
- Strengthening the link between SGP and the MIP regarding structural reforms
- Improvement of MIP scoreboard and a stronger link to social and employment indicators
- Introduce national competiveness authorities

Medium and long term:

- Facilitation of the implementation of structural reforms, based on a system of contractual arrangements and financial instruments
- Increased common decision-making on national budgets including taxation and employment

The European Semester for Economic Policy Coordination

Legal basis

- Articles 121 ("broad economic policy guidelines"), 146 ("employment guidelines"), 136 ("euro area specific measures") of the TFEU

Background

Before the crisis, budgetary, labour and other economic policy planning occurred along separate and different processes. In the framework of the European Semester, introduced in 2010, budgetary, macro-economic and structural policies are coordinated, analysed and assessed so that Member States can take EU considerations into account at an early stage of their national budgetary processes and in other aspects of economic policymaking.

Semester cycle

The Union is following a single annual policy cycle in this context integrated into the European Semester for economic policy coordination with the aim to guarantee coherence of the recommended policies. This is, in particular, the case when country-specific policy recommendations are adopted each year, addressed to the Member States and the Euro Area as a whole. Drawing on the experience of the past cycles, the implementation of CSRs varies among Member States.

Role of the EP

- Co-legislator for the main underlying procedures
- Possibility to invite other EU institutions to Economic Dialogue
- Co-operation with national parliaments (e.g. European Parliamentary Week)
- Adoption of resolutions on the AGS and on the implementation of the Semester
- Opinions on the annual Employment Guidelines and resolutions on the Broad Economic Policy Guidelines, when appropriate

Possible future developments

Short term:

- Proper implementation and increased ownership of the CSRs
- More focused CSRs on key reforms based on underlying assessment and procedures (SGP, MIP, BEPS, EG)
- Streamlining/revamping the Semester (e.g. simplifying reporting, more time for feedback, and the strengthening of the multilateral nature, stronger euro area dimension)
- Establishing and inter-institutional agreement on the operation of the Semester at the EU-level
- Enhancing the social dimension of EMU, including activating a social and employment scoreboard
- More specific link between the EU2020 and the European Semester

Medium and long term:

- Transforming the BEPGs and EGs into EU's multiannual programme agreed with the EP and the Council
- Introducing more binding convergence guidelines for economic policies
- Increased common decision-making on national budgets including taxation and employment

Financial Stability of the Euro

Legal basis

- Articles 121(3) ("multilateral surveillance"), 123(1) ("no monetary financing"), 125(1) ("no bail-out"), 136 ("specific measures of the euro area" + "stability mechanism") of the TFEU
- ESM Treaty

Background

The sovereign debt crisis in the euro area generated the need for the ability to grant financial assistance to a Member State under severe market distress. Financial assistance instruments based on strict conditionality were created to ensure the financial stability of the euro area.

European Stability Mechanism (ESM)

The ESM is a permanent inter-governmental mechanism, the main objective of which is to provide, through a number of financial assistance instruments, stability support to Member States whose access to market financing is impaired or is at risk of being impaired. Granting of financial assistance to a Member State under the ESM is conditional on the ratification of the TSCG Treaty (*Fiscal Compact*).

EU surveillance framework

EU Regulation (No 472/2013) introduced the possibility of the Commission to decide to subject a Member State to enhanced surveillance, if is experiencing or threatened with serious difficulties with respect to its financial stability with adverse spill-over effects on other Member States in the euro area. Furthermore, a Member State requesting financial assistance, shall prepare, in agreement with the Commission, acting in liaison with the ECB and, where appropriate, with the IMF, a draft macroeconomic adjustment programme.

On 22 January 2015, the ECB announced an expanded asset purchase programme (not the OMT programme) in order to start buying bonds issued by a multitude of Euro Area central governments, agencies and European institutions in the secondary market for a total of €60 billion per month until at least September 2016. For countries under financial assistance programmes, eligibility will be suspended for the duration of programme reviews and would resume only in the event of a positive outcome.

On 6 September the ECB approved the main parameters of so-called "Outright Monetary Transactions (OMT)" in the secondary sovereign bond market that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. The ECJ ruled on 16 June that the OMT programme as not being against EU law.

Role of the EP

- EP may invite the other concerned EU institutions, in particular the Commission and the Council, as well as a Member State under certain conditions to an Economic Dialogue
- Reporting obligations by the Commission as regards the implementation of adjustment programmes

Possible future developments

Short term:

- Strengthen macro-prudential tools and institutions, such as the work of the ESRB.

Long term:

- Transforming the ESM into an EU institution and making the surveillance based Union tools

Future of EMU: Possible Building blocks

	Today	*Short term...* Future *Long term...*
Banking Union	Single Supervisory Mechanism Single Resolution Mechanism Harmonised national Deposit Guarantee Schemes Single Rulebook (all EU Member States) ESM direct bank recapitalisation (Eurozone) National Resolution Funds (according to the Bank Recovery and Resolution Directive)	Further harmonisation of technical standards Phasing-out of elements that allow for national discretion Single Resolution Fund (as of 1.1.2016) + phasing-out of national compartments Effective EU backstop for bank resolution and, if necessary, recapitalisation Better risk weighting of sovereign debt? Common deposit guarantee scheme
Budgetary surveillance	Surveillance of national draft budgetary plans Surveillance based on the revised SGP National fiscal rules and institutions	Enhanced enforcement and implementation Stronger fiscal capacity for stabilisation Increasing the effectiveness of the European Semester Right to require revision of national budgets EU fiscal advisory body Analytical improvements Convergence guidelines
Economic surveillance	European Semester for policy coordination Surveillance of macroeconomic imbalances Framework for ex-ante coordination of economic policy reforms (TSCG, Art.11)	National Competitiveness Authorities Financial incentives linked to contractual arrangements Enhanced co-operation in the area of taxation Deepening of the EU's social dimension
Financial stability of Euro	Rules for enhanced surveillance, financial assistance and post-programme surveillance European Stability Mechanism ECB unconventional monetary policy measures	Streamlining of the Troika Transforming ESM to an EU institution
Political accountability	Progressively increased involvement of national parliaments in national level decision-making relating to EU governance Progressively increased involvement of EP at the EU level decision-making relating to EU governance Progressively increased co-operation among national parliaments and the EP under the European Semester and Art 13 TSCG	