

## BRIEFING

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

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*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 spring 2015. This note gives a short description of the state-of-play and possible developments of various governance instruments of EMU.*

The European Council concluded in [December 2014](#) that *closer coordination of economic policies is essential to ensure the smooth functioning of the EMU. Following a discussion on this issue, on the basis of an analytical note, at the informal meeting of the Heads of State or Government in February, the President of the Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the ECB, will report at the latest to the June 2015 European Council. The Member States will be closely involved in the preparatory work.*

The Commission published 28 November 2014 a [report on the application of the current economic governance framework](#). EU secondary legislation on economic governance was extended and revised in 2011 and 2013 (i.e. “6-pack” and “2-pack”). According to the Commission it is too early to draw concrete lessons of the revised EU legal framework for economic policy surveillance and coordination.

The European Parliament is in the process of preparing a report on the review of the EU economic governance framework (Bérès report), which is expected to be adopted in April 2015.

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, and its specification in secondary law.

In addition a well-functioning single market 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 taking part in the banking union in the sense of the Single Supervisory Mechanism and the Single Resolution Mechanism.

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 Union level:

One main element is that "*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). In this context, to ensure closer coordination and sustained convergence of the economic performances of Member States, the competence to recommend broad guidelines, multilateral surveillance powers and a possibility to issue country-specific recommendations are vested in the Union. These powers are further specified in secondary legislation, including the macro-economic imbalance procedure.

A second framing element in relation to national economic policies is the stability and growth pact's provision whereby "*Member States shall avoid excessive government deficits*" (Article 126(1) TFEU). This is coupled with an elaborate system of monitoring national budgetary situations, and possible sanctions, foreseen directly in the Treaty. The Union legislature has specified these powers in a "preventive arm" and a "corrective arm".

A third element is that "*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).

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

For the **prevention of unsustainable economic** policies the EU has established surveillance procedures (including possible sanctions) for national budgetary policies, based on the preventive arm of the Stability and Growth Pact and the preventive arm of the Macro-economic Imbalance Procedure. For the **correction of unsustainable policies** the EU has established surveillance procedures (including possible sanctions) for the correction of excessive fiscal imbalances and the correction of excessive macro-economic imbalances.

The Union is following a single annual policy cycle in this context integrated into the **European Semester for economic policy coordination** (defined in EU secondary law) framework 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.

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 or 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) in the prevention and correction of unsustainable national economic policies.

The views among academics<sup>1</sup> vary widely about the optimal way to improve the governance framework of the EMU under the current economic and institutional environment.

Below, a short overview of the state-of-play of various governance instruments of EMU is presented. This overview 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, it outlines some possible future developments, mainly based on elements included in the [Commission Blueprint for genuine EMU](#)<sup>2</sup> or/and the [2012 four President report towards a genuine EMU](#)<sup>3</sup>.

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

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<sup>1</sup> 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.

<sup>2</sup> Communication from the Commission (COM (2012) 777 final/2): A blueprint for a deep and genuine economic and monetary union: Launching a European Debate.

<sup>3</sup> 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 form 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 based on an interinstitutional agreement

## Possible future developments

### *Short term:*

- Completing the recruiting process of the SRM
- Preparing an interinstitutional agreement on the accountability of the Single Resolution Board

### *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.

### **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).

*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 area specific measures”) of the TFEU

## Background

Over the past decade, the EU has experienced major macroeconomic imbalances, which worsened the consequences of the financial crisis. 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

### *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 (defined in EU law) 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. We are currently under the 5th Semester cycle. 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 the Semester (e.g. simplifying reporting, more time for feedback, and the strengthening of the multilateral nature )
- 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
- 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.

The ECB has had the status of observer in the surveillance of the implementation of the macroeconomic adjustment programmes. It should be noted that a case is currently pending before the Court of Justice of the EU which could clarify the relations between monetary and economic policies. In this context, the Advocate General delivered an opinion to the Court whereby in the event of activating the Outright Monetary Transactions (“OMT”) programme, the ECB cannot be directly involved in the adjustment programme applying to the state concerned upon which the OMT programme would be conditioned. The Court is not bound by this opinion, and the Judgment has yet to be delivered.

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.

## 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 (*Long term*):

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

## Future of EMU: Building blocks

	Today	<i>Short term...</i>	Future	<i>Long term...</i>
<b>Banking Union</b>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Single Supervisory Mechanism (Eurozone)</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Single Resolution Mechanism (Eurozone)</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Harmonised national Deposit Guarantee Schemes</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Single Rulebook (all EU Member States)</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">ESM direct bank recapitalisation (Eurozone)</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">National Resolution Funds (according to the Bank Recovery and Resolution Directive )</div>		<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Further harmonisation of technical standards/definitions</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Phasing-out of elements that allow for national discretion</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Single Resolution Fund (as of 1.1.2016) + phasing-out of national compartments</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Potential opt-in of "non-euro Member States"?</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Common deposit guarantee scheme?</div>	
<b>Budgetary surveillance</b>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Surveillance of national draft budgetary plans (Eurozone)</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Surveillance based on the revised SGP</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">National fiscal rules and institutions</div>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Enhanced enforcement, implementation and ownership of the policy recommendations/commitments</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Streamlining of the European Semester</div>		<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Stronger fiscal capacity?</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Right to require revision of national budgets?</div>
<b>Economic surveillance</b>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">European Semester for policy coordination</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Surveillance of macroeconomic imbalances</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Framework for ex-ante coordination of economic policy reforms (TSCG, Art.11)</div>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Analytical improvements</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Enhanced co-operation in the area of taxation</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Deepening of the EU's social dimension</div>		<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Better risk weighting of sovereign debt ?</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Financial incentives linked to contractual arrangements?</div>
<b>Financial stability of Euro</b>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Rules for enhanced surveillance, financial assistance and post-programme surveillance</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">European Stability Mechanism</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">ECB unconventional monetary policy measures</div>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Streamlining of the Troika?</div>		<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px; text-align: right;">Transforming ESM to an EU institution?</div>
<b>Political accountability</b>	<div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Progressively increased involvement of national parliaments in national level decision-making relating to EU governance</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Progressively increased involvement of EP at the EU level decision-making relating to EU governance</div> <div style="border: 1px solid black; padding: 2px; margin-bottom: 2px;">Progressively increased co-operation among national parliaments and the EP under the European Semester and Art 13 TSCG</div>			