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Note for discussion by Sherpas

Preparing for Next Steps on Better Economic Governance in the Euro Area: Overview of contributions by Member States and the European Parliament

This note offers an overview of the replies to the questions raised in the Analytical Note presented to the informal European Council of 12 February 2015. It is prepared on the basis of the discussion at the dinner of Sherpas of the 28 EU Member States, of the Four Presidents and of the President of the European Parliament on 11 March and the subsequent written contributions. It frames the debate by highlighting primarily the general trends and main topics raised in the various opinions that were submitted. It does not bind the Four Presidents nor does it prejudge the final content of the Report, but it offers a basis for discussion by the Sherpas on 27 April 2015.

1. Overview

Overall, there is a sense that the forthcoming Report on Next Steps on Better Economic Governance in the Euro Area should be sufficiently concrete on its proposals, while finding the right balance between ambition and pragmatism. The process towards its finalisation should be as inclusive as possible among the 28 Member States. It should also build on the 2012 Four Presidents Report ("Towards a Genuine Economic and Monetary Union") and the Commission's "Blueprint for a Deep and Genuine Economic and Monetary Union". The forthcoming Berès report of the European Parliament, the Helsinki speech of ECB President Draghi of 27 November 2014, and the Dublin speech of Mark Carney, Governor of the Bank of England, of 28 January 2015 were also mentioned by some as important inspirational documents.

There is a general recognition of the significant progress made over the last few years to strengthen economic governance and the EMU architecture. Some contributions would consider this progress broadly sufficient and not see the need for significant further steps. On the other hand, other contributions consider that, given the experience so far, the minimum requirements for a stable EMU are still not in place. Further steps would be necessary to strengthen the EMU architecture along the lines of more mature currency unions in order to increase its resilience to future shocks and avoid the risks of economic and political fragmentation, even if some of those steps would only be implemented in the medium to longer term. Some have mentioned the approach and literature on optimal currency areas as a potentially useful benchmark. A possible way to reconcile these views in the Report could be the proposal of an incremental approach in the format of a stage-based roadmap where the most pressing measures for a stable EMU would be implemented first, while a second phase of more far-reaching reforms could follow, possibly within the context of a new convergence process.

Finally, there is consensus that, even though the Report would focus on the Euro Area, the process towards deeper EMU should be inclusive and transparent and fully compatible with the Single Market in all its aspects. The continuous work on the Single Market as an important building block for a successful EMU was referred to by many.

2. Main issues

There is a general consensus that accelerating growth, raising employment and strengthening social cohesion must be the main drivers behind further steps to reinforce the EMU. This should imply greater convergence in performances between and within Member States. The advantages of belonging to a currency union need to be visible to all. "More Europe" and a stronger EMU is not an end in itself but rather a means for serving the citizens of Europe and raising their prosperity, now and in the future.

In the short and/or near term, most contributions consider that the emphasis should be on the full implementation of the current governance framework as strengthened in recent years through the adoption of the six- and two-packs, the Treaty on Stability, Coordination and Governance (TSCG) and the setting up of the European Stability Mechanism (ESM). The European Semester, including the improvements introduced this year, is seen as a step in the right direction towards strengthened coordination at the EU level. The launch of the Banking Union (Single Supervisory Mechanism and Single Resolution Mechanism) is seen as a major step in addressing a crucial gap in the EMU architecture. The strengthening of financial sector regulation is welcome as a way to reduce the risk of future systemic financial crisis. The current overall economic strategy, promoting the "virtuous triangle" of stimulating investment (including through the European Fund for Strategic Investments (EFSI), fostering structural reforms and ensuring fiscal responsibility, with the overall objective of stimulating jobs and growth, is considered appropriate. The role played by the ECB, notably the recent launch of the Public Sector Asset Purchase Programme **(**PSPP**),** is highlighted and welcomed in a number of contributions. Completing the Single Market (digital, services, energy, capital markets) is widely seen as a key element of a strategy that not only boosts growth but also raises the resilience to shocks; a deeper Economic Union should be firmly built on this.

At the same time, the vast majority of contributions emphasise the remaining shortcomings which continue to hinder the economic governance framework and/or the EMU architecture. Some stress that these weaknesses do not only raise questions about the viability of the EMU in the longer term, but also make it more difficult to achieve a more rapid, even, and sustainable recovery in the short run.

The following topics emerge as the **main issues** in this respect:

2.1 European Semester

There is a widespread view that the European Semester process needs to be refocused and streamlined to promote national ownership and transparency of the enforcement of the rules. Overall, the governance framework is seen as excessively complex and unwieldy, both in terms of rules and processes, having a negative impact on transparency, compliance and legitimacy. Some perceive the amended rules as not yet being applied to the full (e.g. the corrective arm of the Macroeconomic Imbalance Procedure has not been used so far), and there are doubts about the feasibility of applying sanctions on a sovereign. Ensuring equal treatment among Member States is seen as crucial. However, there is a broad consensus not to reopen the rules governing the Stability and Growth Pact (SGP) and the Macroeconomic Imbalances Procedure as this could undermine their credibility. Instead, the emphasis should be on fine-tuning, streamlining, focus and better implementation.

More specifically, the following suggestions have been put forward:

- **Emphasise priority reforms in each Member State** that are essential to raise potential growth, exploit the opportunities offered by the Single Market and that have potentially high spillover effects. Country Specific Recommendations should be as concrete and ambitious as possible, especially as regards their expected outcome and the time-frame for delivery, while remaining "political", i.e. Member States should have a degree of freedom concerning the exact measures to be implemented. Efficient labour and product markets, an enabling business environment and efficient public administrations are seen to be among the key focal areas for the smooth functioning of EMU and hence for the country recommendations. Periodic reporting on implementation of the reforms, regular peer reviews or a "comply-or-explain" approach have also been proposed as ways to raise compliance.

- **Greater ownership at national level** is widely mentioned as one of the keys to improving the implementation record. To achieve this, it is suggested to ensure a more systematic involvement of national stakeholders (national Parliaments, social partners, civil society) in the European Semester process. This is primarily the responsibility of each Member State but such consultations could be made a requirement. In addition, greater engagement of Commission representatives at the political level with national stakeholders would also be important. This would further contribute to achieving greater legitimacy of EU advice. The importance of the social dimension and the social impact of reforms are mentioned by several in this context.

2.2 Correction of imbalances, structural reforms and stronger coordination of structural policies

Some contributions note that the Macroeconomic Imbalances Procedure remains underutilised as a means to correcting harmful imbalances. Others see scope to use the Macroeconomic Imbalances Procedure not just to correct imbalances but also as a tool for better implementation of structural reforms within the European Semester. Proposals to streamline the procedure and refocus it on a smaller number of indicators (e.g. only on current account imbalances and competitiveness) have also been put forward. Finally, a number of contributions stress the need for a more symmetric framework, capable to correct not only harmful external deficits but also excessive surpluses as this would facilitate intra-Euro Area adjustment.The current framework is seen as relying excessively on regaining price competitiveness.

Looking ahead, there is a widespread view that a stronger drive and mechanism for the coordination of structural policies will be required for the smooth functioning of EMU. The experience of the Euro Plus Pact is referred to. Real convergence should be the overarching objective of such mechanism, while keeping the social dimension and social cohesion of the Euro Area in mind. It should focus on those areas that are seen as essential for the smooth functioning of EMU because of their impact on (internal and external) imbalances and competitiveness, such as labour and product markets, and business environment. Measures against aggressive tax planning, base erosion and profit shifting (BEPS) were also mentioned.

2.3 Fiscal surveillance and a prospective fiscal capacity for the Euro Area

The need to adhere to the criteria set in the Stability and Growth Pact is widely seen as essential to protect the credibility of the system. In addition to this, a number of contributions stress that the fiscal framework should not only ensure responsible fiscal policies in each Euro Area Member State but it should also guarantee that the sum of budget balances achieves an appropriate Euro Area-wide fiscal stance. In their view, this would contribute to a smoother functioning of EMU by ensuring better coordination between fiscal and monetary policies, especially during times when conventional monetary policy is constrained by the zero lower bound in interest rates.

Beyond this matter, **the need for a prospective fiscal capacity for the Euro Area is raised in several contributions**. The history and experience of other currency unions show that there are various ways to progress towards a fiscal union. There is no set template. Yet, while the degree of commonality of budgetary instruments and arrangements differ, all mature currency unions are endowed with some sort of common fiscal capacity. This may take several forms and would need to be a gradual process. Such a capacity could be endowed with its own resources (e.g. building on work by the Monti High Level Group). According to this view, such capacity could take the form of an investment tool at the European level (e.g. building on the European Fund for Strategic Investment). Some consider also that it should be shaped in a way to address significant asymmetric shocks (e.g. through a complementary unemployment insurance scheme). However, some contributions also acknowledge that such a fiscal capacity should be based on strong preconditions and conditionality, including a closer coordination of the national budgets at the Euro Area level.

Finally, as an alternative to the fiscal capacity, some contributions also mention a need for sovereign debt mutualisation. According to this view, this should be done in a way that minimises moral hazard and is commensurate with additional pooling of sovereignty as regards budgetary policy.

2.4 Completing the Banking Union

There is a strong consensus that the launching of the Banking Union represents one of the major achievements in recent years. The focus should now be on its full implementation.

There remain, however, a series of weaknesses that are seen by many as fundamental. The missing common backstop for the Single Resolution Fund is seen as weakening its credibility as an effective tool and, therefore, should be implemented starting during the transition phase, as agreed already. The same applies to the possibility of bridge financing for the Single Resolution Fund. The backstop should be fiscally neutral over the medium-term by ensuring that public funds are recouped by means of ex post levies on the financial industry. Finally, the need to set up a common European deposit insurance scheme – the third pillar of a Banking Union—is mentioned in several contributions, in light of the potentially destabilising effects associated with the implicit sovereign guarantee for the national deposit guarantee schemes.

2.5 Capital Markets Union

Rapid progress on the launching of the Capital Markets Union is mentioned by most as an essential step. In the short run, it would break down the barriers that are blocking cross-border investments in the EU and preventing businesses from getting access to finance. In the longer run, a well-designed Capital Markets Union would also enhance private risk sharing and therefore raise the resilience against future shocks, such as financial crises and severe economic downturns[1].

2.6 Democratic accountability, legitimacy and institutional strengthening

There is a strong consensus that further steps towards a stronger EMU require increased democratic accountability and legitimacy. The need for stronger involvement of national Parliaments and the European Parliament (e.g. through an interinstitutional agreement), as well as social partners, is considered essential. In the longer run, some would envisage the creation of a Euro Area format within the European Parliament. Mechanisms to increase cooperation between the national and European Parliaments (e.g. building on Art 13 of the Treaty on Stability, Coordination and Governance and Protocol No 1 of the EU Treaties) could also contribute to enhancing democratic legitimacy and accountability.

A few proposals have also been made to put in place a full-time permanent President of the Eurogroup. The need for a more consolidated representation of the EMU within the International Financial Institutions and other international fora is also mentioned as a natural step in the process towards a stronger EMU. This would better reflect the significant international role of the euro and ensure a less fragmented external representation of the Euro Area commensurate with its weight in the global economy.

Finally, some contributions propose to transform the European Stability Mechanism into a European Monetary Fund fully under EU law.

Next steps

Following the discussion of Sherpas on 27 April, a further meeting in the same format will be held on 26 May 2015.

[1] Increased cross-border investment flows should in principle lead to greater private-sector risk sharing. This is for two reasons: 1) holding a more geographically diversified portfolio of financial assets, including corporate bonds and equities, provides for returns that are less volatile and less correlated with domestic income (capital market channel for risk sharing); 2) when a country is hit by an economic shock, cross-border flows should enable its residents to lend or borrow to offset the shock (credit market channel of risk sharing).