Contributions from the Sherpas of the Member States to the Five Presidents' Report

LUXEMBOURG

Deepening the EMU- LU contribution

General remarks

Even if the pressure on the Council to make progress on further integration of the EMU has decreased since the crisis receded, we should not be complacent but keep up efforts to take forward the EMU project. The EMU stands for growth, jobs and social cohesion. This message needs to be communicated to the EU citizen. An action plan should be set up defining the next milestones.

LU broadly shares the assessment of the four Presidents in the analytical note presented to the informal European Council in February.

LU supports the general approach as outlined by the President of the European Commission in its presentation at the European Council:

- we should come to a common understanding of the imperfections and weaknesses of the EMU as experienced during the last 15 years;
- we should openly discuss and agree upon a common vision for a "more balanced and solid Union";
- the common vision should be implemented in an incremental manner rather than by a big-bang approach;
- we suggest identifying as a first step the "low hanging fruits" which consist in improvements that can be realized in the short to medium term without treaty change;
- the accountability and legitimacy of the EMU process should be further improved through an appropriate involvement, at both the European and the national level, of parliaments and social partners.

How could a better implementation and enforcement of the economic and fiscal governance framework be ensured?

The governance framework as revised by the six-pack, two-pack and the fiscal compact has been implemented recently so that it is too early to draw final conclusions on its efficiency

and appropriateness. As of today, there is room for improvement in a number of areas with a view to promote national ownership and better implementation in Member States. These improvements do not require a Treaty change. Possible actions are as follows:

- streamlining the EU semester

The revised governance framework is highly complex. Layers of complexity have been added over the years to accommodate for the specific circumstances of Member states. This development may give a disincentive to Member states to properly implement the framework at national level. Furthermore, it may raise the sentiment of unfair treatment in smaller Member States. A streamlining of the process with clear rules applicable to all Member states is the appropriate way forward;

- clarifying the macro-economic imbalance procedure

Despite the recurrent existence of excessive imbalances in some Member States, the corrective arm of the macro-economic imbalance procedure has not been applied so far. This may put the credibility and national ownership of the macro-imbalance procedure into jeopardy. We advocate that the Commission clarifies how it intends to use the procedure, as it has done lately for the use of the flexibility clauses under the Stability and Growth Pact. The clarification could be enshrined in a code of conduct instrument to be negotiated with the Council;

- giving incentives to Member states to take structural reforms

Generally speaking, Member states have a poor track record in implementing structural reforms in line with country specific recommendations (CSR). Progress may be achieved in a number of ways:

i. a review of the design of CSR

The first option consists in the Commission and Council providing short and focused guidance to Member States as to the structural reforms to be undertaken. The second option consists in the Commission and Council providing general guidance to Member States on the main structural challenges the latter need to tackle. It would then be up to the Member States to decide on the national reform agenda and to report back to the European institutions on the progress achieved. The second option has the merit to promote national ownership of the process;

ii. a systematic involvement of national stakeholders in the reform agenda

In conformity with the subsidiarity principle and national practices, national stakeholders (parliaments and social partners) should be involved in the European semester process with a view towards promoting ownership of the reform agenda. A light codification of the European semester might foster proper consultation of relevant national stakeholders;

iii. a periodic review of the progress achieved by Member states

Periodic reports by the Commission to the Eurogroup and the Euro Summit on the progress made by Member States in implementing structural reforms in line with CSR might be a way forward. This could be a tool to build up peer pressure on Member States lagging behind the reform agenda. This procedure should go hand-in-hand with a “comply-or-explain” procedure where Member States which decide not to implement a CSR have to explain why they choose not to do so and what alternative measures producing a similar outcome they intend to take.

Is the current governance framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run?

Although the current governance framework gives the right incentives and sets out appropriate mechanisms, it has not delivered its full potential.

Currently, the growth potential in many Members states is below pre-crisis levels. The situation can partly be explained by a lack of national ownership and lack of implementation of structural reforms by Member states. Although structural reforms are not an aim *per se*, they are necessary to improve the adjustment capacity of euro area economies, thereby rendering the euro area more shock resilient. Efforts need to be made on this front within the existing framework.

Evidence suggests that financial fragmentation has increased in recent years. Efforts should continue to further deepen the internal market and make it more efficient. Efforts should focus in particular on building an energy union, a digital union, and a Capital markets union, and on reducing regulatory obstacles and administrative burden. Further, labor mobility remains modest and is likely to remain low given cultural, linguistic, and behavorial

considerations. Initiatives aimed at promoting the mobility of factors of production should be considered in order to strengthen the shock-resilience of the EMU.

In addition to following up on structural reforms under the current framework and deepening the internal market, increased emphasis should be put on the general fiscal stance of the euro area so as to strengthen the coordination of national fiscal policies. This change in approach does not require a prior Treaty change.

In the short run, a clarification of the concepts of structural deficit and potential growth should be envisaged.

To what extent can the framework of EMU mainly rely on strong rules and to what extent are strong common institutions also required?

Weak accountability and legitimacy under the current framework explain in part the weak track record when it comes to national implementation of CSR. The way forward to ensure an effective functioning of the EMU consists in underpinning the framework by strong rules. To fully deploy their potential, robust rules need to be accompanied by strong common institutions. The latter are a prerequisite for ensuring an effective enforcement of the rules and an equal treatment of Member States.

What instruments are needed in situations in which national policies continue – despite surveillance under the governance framework – to go harmfully astray?

National policies remain to a large extent the exclusive competence of Member states so that the EU institutions have-as of today- limited power to influence the decisions by Member states. To remedy this situation, new avenues would need to be explored.

The least intrusive instrument to prevent disastrous national policy-making scenarios consists in engaging in a regular dialogue with national stakeholders (government, parliament, social partners) to raise awareness of the economic and fiscal challenges to be faced by a Member state and to discuss the policies to be used to address these challenges. Representatives of the EU institutions could e.g. present the country report, including their

assessment of a Member states' PSC and PNR, in the national parliaments. This instrument would be part of the preventive toolbox and is aimed at improving national ownership of the governance framework.

Building up peer pressure through regular reporting to the Eurogroup and Euro area bodies on the progress made by countries at risk might give an additional incentive to Member states to take appropriate action to address the economic and fiscal challenges.

The most intrusive instrument to prevent disastrous national policy-making scenarios consists in granting common institutions powers to force Member states to make corrections to national policies that "go harmfully astray". These powers would need to be clearly framed in EU law in light of the sovereignty and subsidiarity principles and should only be available in exceptional circumstances, e.g. to avoid contagion risk to other Member states.

Has the fiscal-financial nexus been sufficiently dealt with in order to prevent the repetition of negative feedback loops between banks and sovereign debt?

Major progress has been achieved regarding the implementation of the Banking union. The single rule book based upon CRR and CRD IV provides for an enhanced and harmonized prudential framework throughout the Union and the SSM will cater for a uniform application of these rules within the euro area.

The new framework for recovery and resolution of banks (BRRD) sets the stage for future crisis management in case of potential bank failures and provides the necessary tools (bail-in, resolution fund) which allow for an industry funded resolution of troubled banks, avoiding the injection of taxpayer's money. The creation of a single resolution fund leverages the possibilities for industry-funded bank rescues, even in case of troubled large banks, thus reducing the risk of negative feedback loops between banks and sovereign debt. Furthermore, the SRM regulation does not foresee the use of the government stabilization tools contained in the BRRD within the banking union, which further reduces the risk of negative feedback loops.

There remain, however, a series of weaknesses that need to be addressed:

- the decision to build up the single resolution fund and to mutualise risks over a transitional period of 8 years is a missed opportunity to strengthen the SRM framework even further. A shortening of the transitional period could be considered;
- the missing common backstop for the single resolution fund is weakening the intervention potential of the single resolution fund and hence should be implemented as soon as possible;
- the third pillar of the Banking union- a common European deposit guarantee scheme-should be implemented without delay in light of the fiscal impact of the implicit government guarantee for the national DGS;
- a revision of the European Stability Mechanism (ESM) mandate to allow for a bank recapitalization should also be considered to strengthen the euro area safety net for banks;
- measures should be considered to minimize the risks that the de-leveraging and fragmentation of the financial markets along national borders, which have been observed during the crisis and which are not conducive to breaking the link between the sovereign and the banks nor to an efficient Internal Market for financial services, will happen again in future;
- the BSR proposal can help facilitating the resolution of very large and complex banking groups. The benefits of the future regulation will be largely dependent on the clarification in the BSR of the respective responsibilities of the competent authorities and of the resolution authorities.

How could private risk-sharing through financial markets in the euro area be enhanced to ensure a better absorption of asymmetric shocks?

A well-functioning, market-oriented financial system provides the robustness and stability that is necessary to effectively absorb shocks.

Evidence shows that the cross-border lending activity is far below what could be expected in a monetary union. This shows that geographical considerations (e.g. location of borrowers and creditors) continue to play an important role in capital allocation decisions by financial actors. Divergences in national liquidation rules and in national enforcement, as well as legal uncertainty pertaining to these divergences explain partly the home bias.

Furthermore, a recent study suggests that there exists also a home bias in cross-border equity holdings in the euro area. Cross-border risk sharing and loss absorption is less widespread than it could be expected in a monetary union. Banks with a network of branches across the EU can offset losses in one jurisdiction with gains in other jurisdiction and tend to perform better in terms of shock absorption than purely national players, which are exposed to a concentration risk. Moreover, cross-border banks have more diversified funding sources in geographical terms and hence are less likely to be cut off from markets as intragroup funding acts as a shock-absorber. Companies tend to rely more on debt than equity financing, which lowers the potential for risk-sharing and loss absorption. The recent introduction of bail-in rules in the banking sector contributes to greater risk-sharing in future.

To improve the shock absorption capacity in the euro area and beyond, the creation of the Capital markets union must be a priority. Better access to cross-border funding for companies in general and SMEs in particular, more diversified sources of funding, convergence in liquidation rules and rights in securities are among the initiatives that are conducive to fostering growth, jobs and financial stability in the European Union.

Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?

Ambitious steps such as the development of a euro area fiscal capacity or the design of a framework for the issuance of common bonds should be part of the issues to be considered in the long run. The development of own resources for fiscal capacity (see Monti report) is a topic that merits further examination.

Pre-conditions for such considerations are the willingness of Member States and national parliaments to further yield sovereignty to the European level, and the reinforcement of the fiscal surveillance framework.

Further risk-sharing must go hand in hand with i) the definition of a clear legal framework minimizing the risk of free-riding and guaranteeing a level playing across Member states, and ii) the establishment of common institutions with a clear mandate and appropriate enforcement powers.

Under which conditions and in which form could a stronger common governance over structural reforms be envisaged? How could it foster real convergence?

With its recent communication on flexibility within the SGP, the Commission intends to provide more importance to the structural reform agenda in the policy mix of the EU. LU shares the view that fiscal consolidation needs to be accompanied by growth-friendly structural reforms and by focused investments to create a business-friendly environment and to promote growth, jobs and social cohesion in the European Union.

However, many questions remain open as to the operational use of the structural reform clause. A clarification on how the review clause and the corrective arm of the macro-economic imbalance procedure will be used is highly desirable.

To further incentivize structural reforms, the use of contractual arrangements as discussed in the recent past could be an option.

More generally, real convergence goes beyond structural reform. A review of European programs with the objective to determine their contribution to real convergence is a venue that could be usefully explored at the occasion of the mid-term review of the current multiannual financial framework.

How can accountability and legitimacy be best achieved in a multilevel setup such as EMU?

Better involvement of national parliaments and social partners in the European semester, as emphasized by the COM, could lead to an improved ownership at the national level, contributing to reaching the overall objectives of the EMU. Reinforcing the dialogue between the national and the European level could also be envisaged. Such initiatives could be undertaken under the existing framework.

More ambitious steps could be envisaged in the long run, such as the development an euro area fiscal capacity or the issuance of common bonds, and the creation of an euro area format of the European parliament to accompany these steps of further fiscal integration.

Accountability and democratic legitimacy of the EMU could be further strengthened by including a social dimension in the governance framework. The assessment of the social consequences of structural reforms in the CSR is one venue that could be explored. Member states could eventually be asked to make adjustments to their national policies to mitigate to the extent possible negative social consequences without jeopardizing fiscal consolidation and growth-friendly structural reforms.