European Commission

Completing Europe's Economic and Monetary Union

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Introduction

The Euro Summit of October 2014 underlined the fact that 'closer coordination of economic policies is essential to ensure the smooth functioning of the Economic and Monetary Union' (EMU). It called for work to continue to 'develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity' and 'to prepare next steps on better economic governance in the euro area'.

This report has been prepared by the President of the European Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank, and the President of the European Parliament.

It has benefitted from intense discussion with Member States and civil society. It builds on the report 'Towards a Genuine Economic and Monetary Union' (the so-called 'Four Presidents' Report'), on the Commission's 'Blueprint for a Deep and Genuine EMU' of 2012, which remain essential references for completing EMU as well as on the Analytical Note 'Preparing for Next Steps on Better Economic Governance in the Euro Area' of 12 February 2015.

This report reflects the personal deliberations and discussions of the five Presidents. It focuses on the euro area, as countries that share a currency face specific common challenges, interests and responsibilities. The process towards a deeper EMU is nonetheless open to all EU Members. It should be transparent and preserve the integrity of the Single Market in all its aspects. In fact, completing and fully exploiting the Single Market in goods and services, digital, energy and capital markets should be part of a stronger boost towards economic union, as well as more jobs and higher growth.

A complete EMU is not an end in itself. It is a means to create a better and fairer life for all citizens, to prepare the Union for future global challenges and to enable each of its members to prosper.

1 The Nature of a Deep, Genuine and Fair Economic and Monetary Union

The euro is a successful and stable currency. It is shared by 19 EU Member States and more than 330 million citizens. It has provided its members with price stability and shielded them against external instability. Despite the recent crisis, it remains the second most important currency in the world, with a share of almost a quarter of global foreign exchange reserves, and with almost sixty countries and territories around the world either directly or indirectly pegging their currency to it.

Europe is emerging from the worst financial and economic crisis in seven decades. The challenges of recent years forced national governments and EU institutions to take quick and extraordinary steps. They needed to stabilise their economies and to protect all that has been achieved through the gradual and at times painstaking process of European integration. As a result, the integrity of the euro area as a whole has been preserved and the internal market remains strong.

However, as economic growth and confidence return to much of Europe, it is clear that the quick fixes of recent years need to be turned into a lasting, fair and democratically legitimate basis for the future. It is also clear that, with 18 million unemployed in the euro area, a lot more needs to be done to improve economic policies.

Europe's Economic and Monetary Union (EMU) today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly. It is now high time to reinforce its foundations and turn it into what EMU was meant to be: a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress. To achieve this, we will need to take further steps to complete EMU.

The euro is more than just a currency. It is a political and economic project. All members of our Monetary Union have given up their previous national currencies once and for all and permanently share monetary sovereignty with the other euro area countries. In return, countries gain the benefits of using a credible and stable currency within a large, competitive and powerful single market. This common destiny requires solidarity in times of crisis and respect for commonly agreed rules from all members.

However, this bargain only works as long as all members gain from it. For this condition to hold, countries have to take steps, both individually and collectively, to compensate for the national adjustment tools they give up on entry. They must be able, first, to better prevent crises through high quality governance at European and national level, sustainable fiscal and economic policies, and fair and efficient public administrations. Second, when economic shocks occur, as they inevitably will, each country has to be able to respond effectively.

They must be able to absorb shocks internally through having suitably resilient economies and sufficient fiscal buffers over the economic cycle. This is because, with monetary policy set uniformly for the whole euro area, national fiscal policies are vital to stabilise the economy whenever a local shock occurs. And with all countries sharing a single exchange rate, they need flexible economies that can react quickly to downturns. Otherwise they risk that recessions leave deep and permanent scars.

Yet relative price adjustment will never occur as quickly as exchange rate adjustment. And we have seen that market pressures can deprive countries of their fiscal stabilisers in a slump. For all economies to be permanently better off inside the euro area, they also need to be able to share the impact of shocks through risk-sharing within the EMU. In the short term, this risk-sharing can be achieved through integrated financial and capital markets (private risk-sharing) combined with the necessary common backstops, i.e. a last-resort financial safety net, to the Banking Union. In the medium term, as economic structures converge towards the best standards in Europe, public risk-sharing should be enhanced through a mechanism of fiscal stabilisation for the euro area as a whole.

Preventing unsustainable policies and absorbing shocks individually and collectively did not work well before or during the crisis. Though several important institutional improvements have since been made, the legacy of the initial shortcomings persists. There is now significant divergence across the euro area. In some countries, unemployment is at record lows, while in others it is at record highs; in some, fiscal policy can be used counter-cyclically, in others fiscal space will take years of consolidation to recover.

Today's divergence creates fragility for the whole Union. We must correct this divergence and embark on a new convergence process. The success of Monetary Union anywhere depends on its success everywhere. Moreover, in an increasingly globalised world, Member States have a responsibility and self-interest to maintain sound policies and to embark on reforms that make their economies more flexible and competitive.

Progress must happen on four fronts: first, towards a **genuine Economic Union** that ensures each economy has the structural features to prosper within the Monetary Union. Second, towards a **Financial Union** that guarantees the integrity of our currency across the Monetary Union and increases risk-sharing with the private sector. This means completing the Banking Union and accelerating the Capital Markets

Union. Third, towards a **Fiscal Union** that delivers both fiscal sustainability and fiscal stabilisation. And finally, towards a **Political Union** that provides the foundation for all of the above through genuine democratic accountability, legitimacy and institutional strengthening.

All four Unions depend on each other. Therefore, they must develop in parallel and all euro area Member States must participate in all Unions. In each case, progress will have to follow a sequence of short- and longer-term steps, but it is vital to establish and agree the full sequence today. The measures in the short term will only increase confidence now if they are the start of a larger process, a bridge towards a complete and genuine EMU. After many years of crisis, governments and institutions must demonstrate to citizens and markets that the euro area will do more than just *survive*. They need to see that it will *thrive*.

This longer-term vision needs the measures in the short term to be ambitious. They need to stabilise the European house now and prepare the ground for a complete architecture in the medium term. This will inevitably involve sharing more sovereignty over time. In spite of the undeniable importance of economic and fiscal rules and respect for them, the world's second largest economy cannot be managed through rule-based cooperation alone. For the euro area to gradually evolve towards a genuine Economic and Monetary Union, it will need to shift from a system of rules and guidelines for national economic policy-making to a system of further sovereignty sharing within common institutions, most of which already exist and can progressively fulfil this task. In practice, this would require Member States to accept increasingly joint decision-making on elements of their respective national budgets and economic policies. Upon completion of a successful process of economic convergence and financial integration, this would pave the way for some degree of public risk sharing, which would at the same time have to be accompanied by stronger democratic participation and accountability both at national and European levels. Such a stage-based approach is necessary as some of the more ambitious measures require changes to our current EU legal framework – some more profound than others – as well as significant progress in terms of economic convergence and regulatory harmonisation across euro area Member States.

The aim of this report is two-fold: to lay out the first steps that will launch this process today, and to provide a clear orientation for the longer-term measures. The process would be organised in two consecutive stages (see Roadmap in Annex 1):

Stage 1 (1 July 2015 - 30 June 2017): In this first stage **('deepening by doing')**, the EU institutions and euro area Member States would build on existing instruments and make the best possible use of the existing Treaties. In a nutshell, this entails boosting competitiveness and structural convergence, completing the Financial Union, achieving and maintaining responsible fiscal policies at national and euro area level, and enhancing democratic accountability.

Stage 2: In this second stage **('completing EMU')**, concrete measures of a more far-reaching nature would be agreed to complete EMU's economic and institutional architecture. Specifically, during this second stage, the convergence process would be made more binding through a set of commonly agreed benchmarks for convergence that could be given a legal nature. Significant progress towards these standards – and continued adherence to them once they are reached – would be among the conditions for each euro area Member State to participate in a shock absorption mechanism for the euro area during this second stage.

Final Stage (at the latest by 2025): At the end of Stage 2, and once all the steps are fully in place, a deep and genuine EMU would provide a stable and prosperous place for all citizens of the EU Member States that share the single currency, attractive for other EU Member States to join if they are ready to do so.

The Presidents of the EU institutions will follow up on the implementation of the recommendations in this report. To prepare the transition from Stage 1 to Stage 2, the Commission will present a White Paper in spring 2017 assessing progress made in Stage 1 and outlining the next steps needed, including measures of a legal nature to complete EMU in Stage 2. The White Paper will draw on analytical input from an expert consultation group, which will further explore the legal, economic and political preconditions of the more long term proposals contained in this report. It will be prepared in consultation with the Presidents of the other EU institutions.

This report puts forward ideas which, following further discussion, can be translated into laws and institutions. This requires a broad, transparent and inclusive process – a process which should begin without delay.

2 Towards Economic Union – Convergence, Prosperity and Social Cohesion

The notion of convergence is at the heart of our Economic Union: convergence *between* Member States towards the highest levels of prosperity; and convergence *within* European societies, to nurture our unique European model.

In EMU, monetary policy is centralised, but important parts of economic policy remain national. However, as the crisis made particularly visible, euro area members depend on each other for their growth. It is in each member's common and self-interest to be able to cushion economic shocks well, to modernise economic structures and welfare systems, and make sure that citizens and businesses can adapt to, and benefit from, new demands, trends and challenges. It is equally in each member's interest that all others do so at a similar speed. This is crucial in a Monetary Union like EMU where large scale fiscal transfers between members are not foreseen and where labour mobility is relatively limited.

This does not mean that all Member States that share the single currency are or should be alike, or that they should follow the same policies. What ultimately matters is the outcome: that all euro area Member States pursue sound policies so that they can rebound quickly from short-term shocks, are able to exploit their comparative advantages within the Single Market and attract investment, thereby sustaining high levels of growth and employment.

Much can be achieved already through a deepening of the Single Market, which is important for all 28 EU Member States but in particular for the Member States which share the euro as their currency. In significant policy areas, such as goods and services, as well as in areas with untapped potential, such as energy, digital and capital markets, the Single Market is still incomplete. This shows that there are significant political obstacles despite the enormous economic potential associated with a truly Single Market. In order to make progress, relevant decisions in each of the areas should be seen as part of a political package which benefits all Member States, instead of being conceived as independent from each other. But that alone is not enough. Sustainable convergence also requires a broader set of policies that come under the heading of 'structural reforms', i.e. reforms geared at modernising economies to achieve more growth and jobs. That means both more efficient labour and product markets and stronger public institutions.

For convergence to happen between euro area members, further progress is required. First, in the short term (Stage 1), we need to set in motion a renewed effort for all to converge towards the best performance and practices in Europe, building upon and further strengthening the current governance framework. The ultimate aim is to achieve similarly resilient economic structures throughout the euro area. This should lead to a new boost for jobs and growth with competitiveness and social cohesion at its core.

In Stage 2, this convergence process would be formalised and would be based on a set of commonly agreed standards with a legal character. Significant progress towards the latter would be regularly monitored and would be a condition for members to benefit from further instruments, such as a shock absorption mechanism to be set up for the euro area as a whole.

2.1. A new boost to convergence, jobs and growth

A renewed impetus for reform is in the spirit of the 2011 Euro Plus Pact on Stronger Economic Policy Coordination for Competitiveness and Convergence, which, however, largely failed to deliver the expected results in view of its intergovernmental, non-binding nature[1]. Instead of further 'pacts', concrete progress on the basis of EU law is needed to move towards an Economic Union of convergence, growth and jobs. It should rest on the following four pillars: the creation of a euro area system of Competitiveness Authorities; a strengthened implementation of the Macroeconomic Imbalance Procedure; a greater focus on employment and social performance; and on stronger coordination of economic policies within a revamped European Semester. This should be implemented in the short run (Stage 1), on the basis of practical steps and in line with the Community method.

A euro area system of Competitiveness Authorities

Euro area governance is well established for the coordination and surveillance of fiscal policies. It needs to be improved in the broader and increasingly central field of 'competitiveness'. The European Semester – and the creation of the Macroeconomic Imbalance Procedure – are a first step to correct this shortcoming, but much more needs to be done to make sure all Member States improve their competitiveness as part of the same momentum.

The creation by each euro area Member State of a national body in charge of tracking performance and policies in the field of competitiveness is recommended. This would help to prevent economic divergence and it would increase ownership of the necessary reforms at the national level. These Competitiveness

[1] The 'Euro Plus Pact on Stronger Economic Policy Coordination for Competitiveness and Convergence' was agreed in 2011 by the Heads of State and Government of the euro area and Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. It is open to other EU Member States on a voluntary basis. It was conceived as an intergovernmental solution to foster reforms and coordination. However, its implementation has suffered from a number of shortcomings, including the absence of a monitoring institution, but its underlying rationale is still relevant and should be revived. Hence, its relevant parts should be integrated into the framework of EU law.

Authorities should be independent entities with a mandate to 'assess whether wages are evolving in line with productivity and compare with developments in other euro area countries and in the main comparable trading partners', as already agreed by a large majority of Member States under the Euro Plus Pact. In addition, these bodies could be mandated to assess progress made with economic reforms to enhance competitiveness more generally. In the end, a competitive economy is one in which institutions and policies allow productive firms to thrive. In turn, the development of these firms supports the expansion of employment, investment and trade.

A euro area system of Competitiveness Authorities should bring together these national bodies and the Commission, which would coordinate the actions of national Competitiveness Authorities on an annual basis. The Commission should then take into account the outcome of this coordination when it decides on steps under the European Semester, in particular for its Annual Growth Survey and for decisions to be taken under the Macroeconomic Imbalance Procedure (MIP), including whether to recommend the activation of the Excessive Imbalance Procedure.

Competitiveness Authorities

The aim of the Competitiveness Authorities should not be to harmonise practices and institutions in charge of wage formation across borders. Those processes vary widely within the EU and rightly reflect national preferences and legal traditions.

Based on a common template, each Member State should decide the exact set-up of its national Competitiveness Authority, but they should be democratically accountable and operationally independent. National actors, such as social partners, should continue to play their role according to the established practices in each Member State, but they should use the opinions of the Authorities as guidance during wage setting negotiations. Some Member States, like the Netherlands and Belgium, already have such authorities.

A stronger Macroeconomic Imbalance Procedure

The Macroeconomic Imbalance Procedure (MIP) was created at the height of the crisis. It is part of the European Semester, the annual cycle of reporting and surveillance of EU and national economic policies. It serves as a tool to prevent and correct imbalances before they get out of hand. It has become a vital device for European surveillance, for instance to prevent real estate bubbles, or to detect a loss of competitiveness, rising levels of private and public debt, and a lack of investment. It needs to be used to its full potential. This requires action on two fronts in particular:

- It should be used not just to detect imbalances but also to encourage structural reforms through the European Semester. Its corrective arm should be used forcefully. It should be triggered as soon as excessive imbalances are identified and be used to monitor reform implementation.
- The procedure should also better capture imbalances for the euro area as a whole, not just for each individual country. For this, it needs to continue to focus on correcting harmful external deficits, given the risk they pose to the smooth functioning of the euro area (for example, in the form of 'sudden stops' of capital flows). At the same time, the Macroeconomic Imbalance Procedure (MIP) should also foster adequate reforms in countries accumulating large and sustained current account surpluses if these are driven by, for example, insufficient domestic demand and/or low growth potential, as this is also relevant for ensuring effective rebalancing within the Monetary Union.

A stronger focus on employment and social performance

The employment and social situations vary widely across the euro area, partly as a result of the crisis but also because of underlying trends and poor performance predating the crisis. Europe's ambition should be to earn a 'social triple A'.

This is also an economic necessity. For EMU to succeed, labour markets and welfare systems need to function well and in a fair manner in all euro area Member States. Hence, employment and social concerns must feature highly in the European Semester. Unemployment, especially long term unemployment, is one of the main reasons for inequality and social exclusion. Therefore, efficient labour markets that promote a high level of employment and are able to absorb shocks without generating excessive unemployment are essential: they contribute to the smooth functioning of EMU as well as to more inclusive societies.

There is no 'one-size-fits-all' template to follow, but the challenges are often similar across Member States: getting more people of all ages into work; striking the right balance between flexible and secure labour contracts; avoiding the divide between 'insiders' with high protection and wages and 'outsiders'; shifting taxes away from labour; delivering tailored support for the unemployed to re-enter the labour market, improving education and lifelong learning - to name but a few. Beyond labour markets, it is important to ensure that every citizen has access to adequate education and that an effective social protection system is in place to protect the most vulnerable in society, including a 'social protection floor'. Our populations are ageing rapidly and we still need major reforms to ensure that pension and health systems can cope. This will include aligning the retirement age with life expectancy.

To secure EMU's long-term success, we should go a step further and push for a deeper integration of national labour markets by facilitating geographic and professional mobility, including through better recognition of qualifications, easier access to public sector jobs for non-nationals and better coordination of social security systems.

A stronger coordination of economic policies

The European Semester has significantly strengthened the coordination of economic policies. However, the addition of numerous 'packs', 'pacts', 'procedures' and manifold reporting requirements has blurred its rationale and effectiveness. The European Semester must be about setting our priorities together and about acting on them, in a European perspective, with a clear sense of our common interest. Steps have been taken to simplify and strengthen the European Semester: a greater focus on priorities, fewer documents and more time to discuss them, greater outreach at political level and engagement with national authorities. These steps must be pursued further in order to:

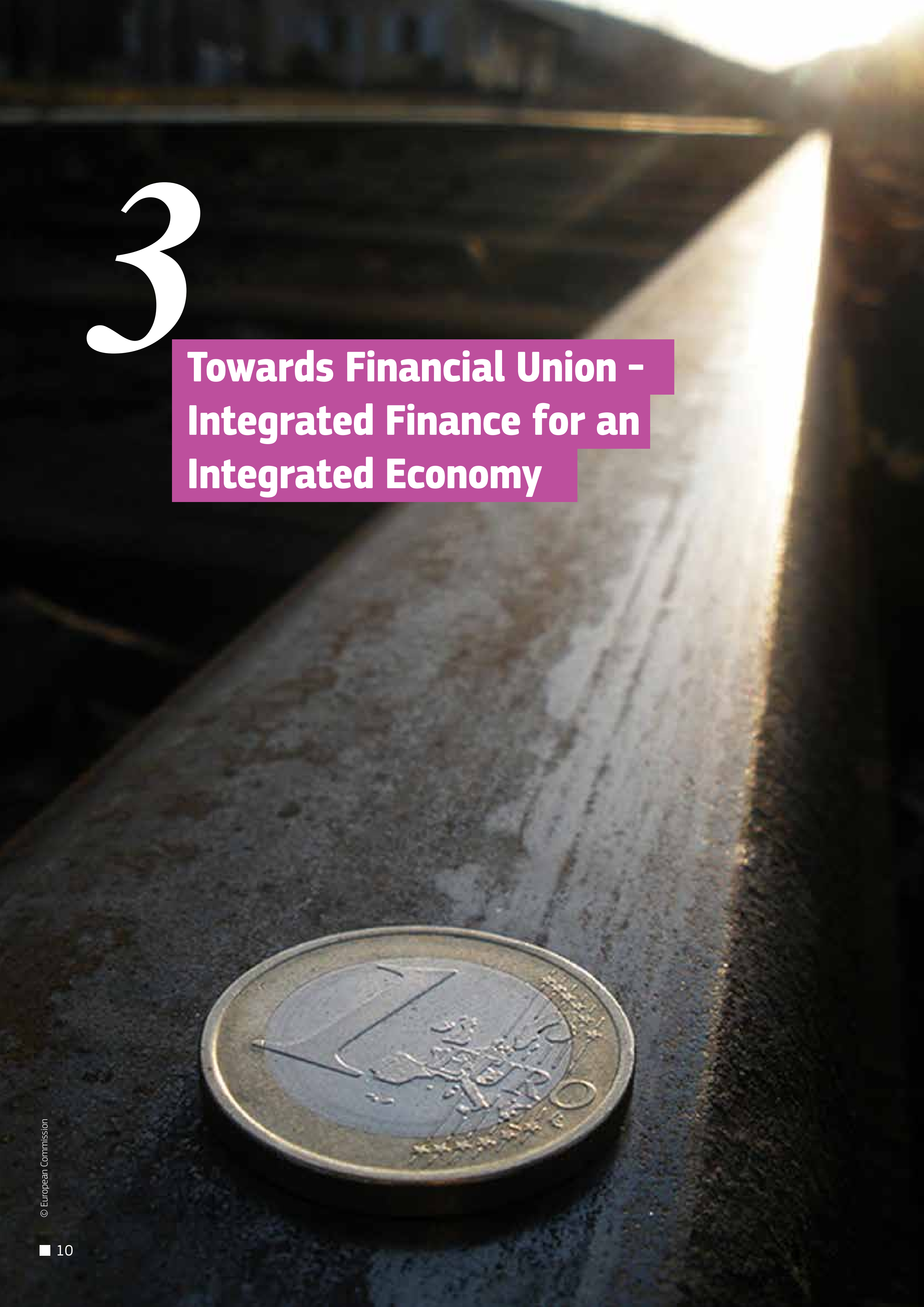
- Give Member States clear recommendations that continue to focus on priority reforms that are essential to raise potential growth, support job creation and exploit the opportunities offered by the Single Market. Country-Specific Recommendations need to be concrete and ambitious, especially as regards their expected outcome and the time-frame for delivery. At the same time, they should remain 'political', i.e. Member States should have a degree of freedom concerning the exact measures to be implemented. The national reform programmes that Member States prepare every year should serve as a basis for them to discuss their reform intentions.
- Hold Member States accountable for the delivery of their commitments. Periodic reporting on implementation, regular peer reviews or a 'comply-or-explain' approach should be used more systematically. The Eurogroup could already in Stage 1 play a coordinating role in cross-examining performance, with increased focus on benchmarking and pursuing best practices. This must go hand in hand with the use of the Macroeconomic Imbalance Procedure (MIP) to its full potential.
- Better integrate the euro area and the national dimensions. To this end, the European Semester should be structured into two successive stages - a European and a national stage. This means that discussions and recommendations concerning the euro area as a whole should take place first, ahead of country-specific discussions, so that common challenges are fully reflected in country-specific action. Annex 2 illustrates this proposal.
- Establish a clear long-term vision: not everything can or should happen in one year. The annual cycle of the European Semester should go together with a stronger multi-annual approach in line with the renewed convergence process.

2.2. Formalising the convergence process

In the medium term (Stage 2), the convergence process towards more resilient economic structures, as described above, should become more binding. This would be achieved by agreeing on a set of common high-level standards that would be defined in EU legislation, as sovereignty over policies of common concern would be shared and strong decision-making at euro area level would be established. In some areas, this will need to involve further harmonisation. In other areas, where different policies can lead to similarly good performance, it will mean finding country-specific solutions. The common standards should focus primarily on labour markets, competitiveness, business environment and public administrations, as well as certain aspects of tax policy (e.g. corporate tax base). Progress towards these standards would be monitored regularly. Country-Specific Recommendations would continue to be used in this context. Furthermore, the Macroeconomic Imbalance Procedure (MIP) could be utilised as a tool not only to prevent and correct imbalances but also to foster reforms and monitor progress in each euro area Member State towards these common standards. Significant and sustained convergence towards similarly resilient economies should be a condition for access to a shock absorption mechanism to be set up for the euro area, as briefly outlined in sub-section 4.2.

Defining the specific standards and indicators requires deeper analysis. However, as an example, the standards for labour markets should combine security and flexibility and could be developed along the various pillars of the 'flexicurity' concept (e.g. flexible and reliable labour contracts that avoid a two-tier labour market, comprehensive lifelong learning strategies, effective policies to help the unemployed re-enter the labour market, modern social security systems and enabling labour taxation).

3 Towards Financial Union – Integrated Finance for an Integrated Economy



Progress towards a stronger Economic Union will go a long way to improving the functioning of EMU. At the same time, this must be accompanied by the completion of a Financial Union. Indeed, Economic and Financial Unions are complementary and mutually reinforcing. Progress on these two fronts must be a top priority in Stage 1 of the Roadmap towards a genuine EMU.

In a Monetary Union, the financial system must be truly single or else the impulses from monetary policy decisions (e.g. changes in policy interest rates) will not be transmitted uniformly across its Member States. This is what happened during the crisis, which in turn aggravated economic divergence. Also, a single banking system is the mirror image of a single money. As the vast majority of money is bank deposits, money can only be truly single if confidence in the safety of bank deposits is the same irrespective of the Member State in which a bank operates. This requires single bank supervision, single bank resolution and single deposit insurance. This is also crucial to address the bank-sovereign negative feedback loops which were at the heart of the crisis.

At the same time, the financial system must be able to diversify risk across countries, so it can moderate the impact of country-specific shocks and lower the amount of risk that needs to be shared through fiscal means.

All these reasons justify the urgent need for a Financial Union. We have largely achieved the goal on bank supervision with the setting up of the Single Supervisory Mechanism. The Single Resolution Mechanism has also been agreed, but not yet fully implemented. To complete the Financial Union, we need to launch a common deposit insurance scheme and the Capital Markets Union. Given their urgency, these measures should all be implemented in Stage 1.

3.1. Completing the Banking Union

Completing the Banking Union requires first and foremost the full transposition into national law of the Bank Resolution and Recovery Directive by all Member States. This is crucial for sharing risk with the private sector. Indeed, the Banking Union is a way to better protect taxpayers from the cost of bank rescues.

Second, we also need a swift agreement on an adequate bridge financing mechanism – a way of ensuring there is enough money if a bank needs to be unwound even if the financing in the Single Resolution Fund is not enough at that time – for the Fund by the time it becomes operational on 1 January 2016.[2]

Third, setting up a credible common backstop to the Single Resolution Fund and making progress towards a full level playing field for banks in all Member States should be a priority during the transition period to the creation of the Single Resolution Fund. A backstop should therefore be implemented swiftly. This could be done through a credit line from the European Stability Mechanism (ESM) to the Single Resolution Fund. This backstop should be fiscally neutral over the medium term by ensuring that public assistance is recouped by means of *ex post* levies on the financial industry.

Next, we propose the launching of a European Deposit Insurance Scheme (EDIS) - the third pillar of a fully-fledged Banking Union alongside bank supervision and resolution. As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks (in particular when the sovereign and the national banking sector are perceived to be in a fragile situation), common deposit insurance would increase the resilience against future crises. A common scheme is also more likely to be fiscally neutral over time than national deposit guarantee schemes because risks are spread more widely and because private contributions are raised over a much larger pool of financial institutions. Setting up a fully-fledged EDIS will take time, but taking concrete steps in that direction should be a priority already in Stage 1 using the possibilities under the current legal framework. A possible option would be to devise the EDIS as a re-insurance system at the European level for the national deposit guarantee schemes. Just like the Single Resolution Fund, the common EDIS would be privately funded through *ex ante* risk-based fees paid by all the participating banks in the Member States and devised in a way that would prevent moral hazard. Its scope should coincide with that of the Single Supervisory Mechanism.

In due course, the effectiveness of the ESM's direct bank recapitalisation instrument should be reviewed, especially given the restrictive eligibility criteria currently attached to it, while respecting the agreed bail-in rules. A more easily accessible mechanism for direct bank recapitalisation would boost depositor confidence by keeping distressed sovereigns at arm's length in the governance of restructured banks, and it would break the sovereign-bank nexus at national level.

All banks participating in the Banking Union need to enjoy a level playing field. This will require further measures, in addition to and beyond the single rule book, to address the still significant margin for discretion at national level which has important implications, notably for the quality and composition of banks' capital. A large part of the discrepancies could be addressed within the context of the Single Supervisory Mechanism. But for other issues legislative changes are necessary, in particular for those related to differing

[2] This follows up on the ECOFIN Council statement of 18 December 2013.

legal and institutional frameworks. Similarly, the recent revision of the Deposit Guarantee Schemes Directive has led to more harmonisation, especially on pre-funding of national schemes, but it still contains some national discretion, which should be reviewed.

At the same time, the EU needs to continue to pay attention to potential new risks developing in the banking sector, including risks related to the shadow banking sector. Existing structures need to be able to detect risks to the financial sector as a whole. To this end, we should consider strengthening our macroprudential institutions, building on the role and powers of the European Systemic Risk Board (ESRB), while maximising its synergies with the ECB. Finally, in the medium term, it may make sense to review the treatment of bank exposures to sovereign debt, for example by setting large exposure limits. This could further de-link financial stability from national public finances. However, such far-reaching changes to the current framework should only be considered as part of a coordinated effort at the global level.

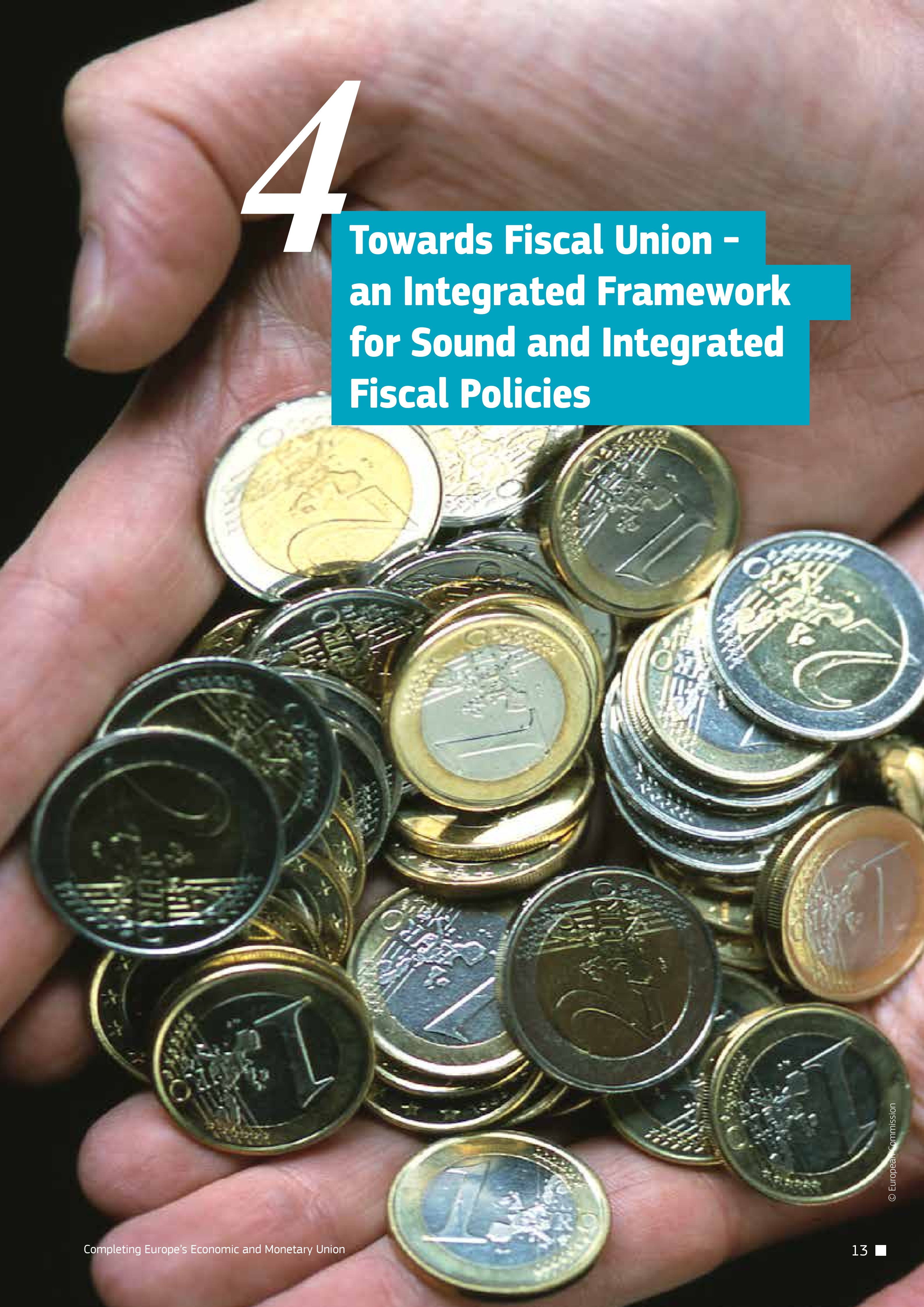
3.2. Launching the Capital Markets Union

Alongside Banking Union, launching the Capital Markets Union must be seen as a priority[3]. This applies to all 28 EU Member States, but it is particularly relevant to the euro area. It will ensure more diversified sources of finance so that companies, including SMEs, can tap capital markets and access other sources of non-bank finance in addition to bank credit. At the same time, a well-functioning Capital Markets Union will strengthen cross-border risk-sharing through deepening integration of bond and equity markets, the latter of which is a key shock absorber. Truly integrated capital markets would also provide a buffer against systemic shocks in the financial sector and strengthen private sector risk-sharing across countries[4]. This in turn reduces the amount of risk-sharing that needs to be achieved through financial means (public risk-sharing). However, as the closer integration of capital markets and gradual removal of remaining national barriers could create new risks to financial stability, there will be a need to expand and strengthen the available tools to manage financial players' systemic risks prudently (macro-prudential toolkit) and to strengthen the supervisory framework to ensure the solidity of all financial actors. This should lead ultimately to a single European capital markets supervisor.

In this context, it is important that regulation creates incentives to risk-pooling and risk-sharing and ensures that all financial institutions have sufficient risk management structures in place and remain prudentially sound. Taxation can also play an important role in terms of providing a neutral treatment for different but comparable activities and investments across jurisdictions. A true Capital Markets Union also requires other improvements, some of which can only be achieved through legislation, such as: simplification of prospectus requirements; a revived EU market for high quality securitisation; greater harmonisation of accounting and auditing practices; as well as addressing the most important bottlenecks preventing the integration of capital markets in areas like insolvency law, company law, property rights and as regards the legal enforceability of cross-border claims.

[3] See the Green Paper **'Building a Capital Markets Union'**; European Commission, 18 February 2015.

[4] 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).



4 Towards Fiscal Union – an Integrated Framework for Sound and Integrated Fiscal Policies

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One of the main lessons of the crisis has been that fiscal policies are a matter of vital common interest in a Monetary Union. Even a strong Economic and Financial Union and a price stability-oriented common monetary policy are no guarantee for EMU to always function properly. Unsustainable fiscal policies not only endanger price stability in the Union but they also harm financial stability insofar as they create contagion between Member States and financial fragmentation.

Responsible national fiscal policies are therefore essential. They must perform a double function: guaranteeing that public debt is sustainable and ensuring that fiscal automatic stabilisers can operate to cushion country-specific economic shocks. If this is not the case, downturns are likely to last longer in individual countries, which in turn affects the whole euro area. But this is not enough. It is important to ensure also that the sum of national budget balances leads to an appropriate fiscal stance[5] at the level of the euro area as a whole. This is key to avoiding pro-cyclical fiscal policies at all times.

Finally, in case of a very severe crisis, national budgets can become overwhelmed, as was the case in some countries in recent years. In such situations, national fiscal stabilisers might not be enough to absorb the shock and provide the optimal level of economic stabilisation, which in turn can harm the whole euro area. For this reason, it would be important to create in the longer term a euro area-wide fiscal stabilisation function. Such a step should be the culmination of a process that requires, as a precondition, a significant degree of economic convergence, financial integration and further coordination and pooling of decision making on national budgets, with commensurate strengthening of democratic accountability. This is important to avoid moral hazard and ensure joint fiscal discipline.

In the meantime, we need to reinforce trust in the common EU fiscal governance framework. A continued thorough, consistent and transparent implementation of our current fiscal framework is therefore essential to prepare the ground for further steps ahead.

4.1. Responsible budgetary policies as EMU's cornerstone

In recent years, the so-called 'Six-Pack', the 'Two-Pack' and the Treaty on Stability, Coordination and Governance have brought significant improvements to the framework for fiscal policies in the EMU. Together, they drive our efforts to prevent budgetary imbalances, to focus on debt developments and on better enforcement mechanisms, as well as on national ownership of EU rules. This new governance framework already provides for ample *ex ante* coordination of annual budgets of euro area Member States and enhances the surveillance of those experiencing financial difficulties. Every Member State must stick to the rules, or the credibility of this framework is at risk. The rules are admittedly complex, but the forthcoming review of the 'Six-Pack' and 'Two-Pack' should be an opportunity to improve clarity, transparency, compliance and legitimacy, while preserving their stability-oriented nature.

In the short run (Stage 1), the current governance framework should be strengthened through the creation of an advisory European Fiscal Board. This new advisory entity would coordinate and complement the national fiscal councils that have been set up in the context of the EU Directive on budgetary frameworks. It would provide a public and independent assessment, at European level, of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal governance framework. The composition of the Board should be pluralistic and draw from a wide range of expertise. The mandate of this new European Fiscal Board should rest on a number of guiding principles as set out in Annex 3.

Such a European Fiscal Board should lead to better compliance with the common fiscal rules, a more informed public debate, and stronger coordination of national fiscal policies.

4.2. A fiscal stabilisation function for the euro area

There are many ways for a currency union to progress towards a Fiscal Union. Yet, while the degree to which currency unions have common budgetary instruments differs, all mature Monetary Unions have put in place a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone.

This would be a natural development for the euro area in the longer term (Stage 2) and under the conditions explained above, i.e. as the culmination of a process of convergence and further pooling of decision-making on national budgets. The objective of automatic stabilisation at the euro area level would not be to actively fine-tune the economic cycle at euro area level. Instead, it should improve the cushioning of large macroeconomic shocks and thereby make EMU overall more resilient. The exact design of such euro area stabilisers requires more in-depth work. This should be one of the tasks of the proposed expert group.

[5] The concept of fiscal stance reflects changes to the fiscal balance in order to influence aggregate economic demand and output. Under the Stability and Growth Pact, the fiscal stance is measured on the basis of the structural fiscal balance, i.e. the fiscal balance corrected for the effects of the economic cycle and net of one-off and other temporary measures. Generally speaking, a fiscal deficit (surplus) would suggest an expansionary (contractionary) fiscal stance.

Options and guiding principles for a euro area stabilisation function

A prospective stabilisation function could, for example, build on the European Fund for Strategic Investments as a first step, by identifying a pool of financing sources and investment projects specific to the euro area, to be tapped into according to the business cycle. Various additional sources of financing should be considered. It will be important to ensure that the design of such stabilisation function rests on the following guiding principles:

- It should not lead to permanent transfers between countries or to transfers in one direction only, which is why converging towards Economic Union is a precondition for participation. It should also not be conceived as a way to equalise incomes between Member States.
- It should neither undermine the incentives for sound fiscal policy-making at the national level, nor the incentives to address national structural weaknesses. Accordingly, and to prevent moral hazard, it should be tightly linked to compliance with the broad EU governance framework and to progress in converging towards the common standards described in Section 2.
- It should be developed within the framework of the European Union. This would guarantee that it is consistent with the existing EU fiscal framework and with procedures for the coordination of economic policies. It should be open and transparent vis-à-vis all EU Member States.
- It should not be an instrument for crisis management. The European Stability Mechanism (ESM) already performs that function. Instead, its role should be to improve the overall economic resilience of EMU and individual euro area countries. It would thus help to prevent crises and actually make future interventions by the ESM less likely.

5 Democratic Accountability, Legitimacy and Institutional Strengthening

Greater responsibility and integration at EU and euro area level should go hand in hand with greater democratic accountability, legitimacy and institutional strengthening. This is both a condition for success and a natural consequence of the increasing interdependence within EMU. It also means better sharing of new powers and greater transparency about who decides what and when. Ultimately, this means and requires more dialogue, greater mutual trust and a stronger capacity to act collectively.

At the height of the crisis, far-reaching decisions had often to be taken in a rush, sometimes overnight. In several cases, intergovernmental solutions were chosen to speed up decisions or overcome opposition. Now is the time to review and consolidate our political construct – and to build the next stage of our Economic and Monetary Union.

A number of concrete steps towards more accountability and participation should be taken already in the short run (Stage 1):

A key role for the European Parliament and national Parliaments

First practical steps have been initiated by the European Parliament to strengthen parliamentary oversight as part of the European Semester. 'Economic dialogues' between the European Parliament and the Council, the Commission and the Eurogroup have taken place in line with the provisions of the 'Six-Pack' and 'Two-Pack' legislation. This has already been part of the last European Semester rounds. These dialogues may be enhanced by agreeing on dedicated time-slots during the main steps of the Semester cycle. A new form of inter-parliamentary cooperation was established to bring together European and national actors. This takes place within the European Parliamentary Week organised by the European Parliament in co-operation with national Parliaments, which includes representatives from national Parliaments for in-depth discussions on policy priorities. The 'Two-Pack' also enshrined the right for a national Parliament to convene a Commissioner for a presentation of the Commission's opinion on a draft budgetary plan or of its recommendation to a Member State in Excessive Deficit Procedure – a right that should be exercised more systematically than at present.

We could further strengthen the timing and added value of these parliamentary moments in line with the renewed European Semester outlined in Annex 2. In particular, the European Commission could engage with the European Parliament at a plenary debate before the Annual Growth Survey is presented, and continue the debate following its adoption. Moreover, a second dedicated plenary debate could be held upon presentation by the Commission of the Country-Specific Recommendations, in accordance with the relevant provisions of the 'Six-Pack' on economic dialogue. At the same time, Commission and Council representatives could participate in inter-parliamentary meetings in particular in the context of the European Parliamentary Week. This new practice could be progressively agreed upon in more detail between the EU institutions (Commission, Ecofin Council, Eurogroup and the European Parliament) in full respect of their respective institutional role, in the form of a non-binding interinstitutional agreement.

The European Commission should also work out model arrangements to make the interaction with national Parliaments more efficient. Such interaction should apply to national parliamentary debates both on the Country-Specific Recommendations addressed to the Member State and within the annual budgetary procedure. That would give more life to the right recognised in the 'Two-Pack' to convene a Commissioner. As a rule, national Parliaments should be closely involved in the adoption of National Reform and Stability Programmes.

The European Parliament should organise itself to assume its role in matters pertaining especially to the euro area.

Consolidating the external representation of the euro

As EMU evolves towards Economic, Financial and Fiscal Union, its external representation should be increasingly unified. This process may take place gradually, but it should be put in motion starting in Stage 1.

The EU is the world's largest trading block and the world's largest trader of manufactured goods and services. It has achieved this by acting with one voice on the global stage, rather than with 28 separate trade strategies. The large economic and financial size and the existence of a single monetary and exchange rate policy for most of its members make the EU policy decisions and economic developments increasingly relevant for the world economy.

However, in the international financial institutions, the EU and the euro area are still not represented as one. This fragmented voice means the EU is punching below its political and economic weight as each euro area Member State speaks individually. This is particularly true in the case of the IMF despite the efforts made to coordinate European positions.

Integrating intergovernmental solutions within the EU legal framework

Several intergovernmental arrangements were created during the crisis. This was explained by the shortcomings of the EMU's architecture but ultimately they need to be integrated into the legal framework of the European Union. This is already foreseen for the Treaty on Stability, Coordination and Governance, and should be done also for other cases, such as the Euro Plus Pact and the intergovernmental agreement on the Single Resolution Fund.

Finally, the European Stability Mechanism has established itself as a central instrument to manage potential crises. However, largely as a result of its intergovernmental structure, its governance and decision-making processes are complex and lengthy. In the medium term (Stage 2), its governance should therefore be fully integrated within the EU Treaties.

A central steer by the Eurogroup

The Eurogroup has a central role to play in discussing, promoting and representing the interest of the euro area. It will step up its involvement in the revamped European Semester. In the short run, this may require a reinforcement of its presidency and the means at its disposal. In the longer run (Stage 2), a full-time presidency of the Eurogroup could be considered with a clear mandate within the framework of this report. With the support of all EU institutions, it could play an even greater role in representing the interest of the single currency, within the euro area and beyond.

A euro area treasury

The Stability and Growth Pact remains the anchor for fiscal stability and confidence in the respect of our fiscal rules. In addition, a genuine Fiscal Union will require more joint decision-making on fiscal policy. This would not mean centralisation of all aspects of revenue and expenditure policy. Euro area Member States would continue to decide on taxation and the allocation of budgetary expenditures according to national preferences and political choices. However, as the euro area evolves towards a genuine EMU, some decisions will increasingly need to be made collectively while ensuring democratic accountability and legitimacy. A future euro area treasury could be the place for such collective decision-making.

CONCLUSION

This report has put forward the principal steps necessary to complete EMU at the latest by 2025. It offers a roadmap that is ambitious yet pragmatic. Some of these steps can and should be implemented without delay. First initiatives to this end should be launched by the EU institutions as of 1 July 2015. Others will require more time. But above all, the report offers a clear sense of direction for Europe's EMU. This is essential for citizens and economic actors alike, and for their confidence in the single currency. Translating these proposals into action will require a shared sense of purpose among all Member States and EU institutions. The European Council is invited to endorse these proposals at the earliest occasion.

Annex 1

Roadmap Towards a Complete Economic and Monetary Union

STAGE 1 — 1 JULY 2015 - 30 JUNE 2017

IMMEDIATE STEPS

Economic Union

- **A new boost to convergence, jobs and growth**

- Creation of a euro area system of Competitiveness Authorities;
- Strengthened implementation of the Macroeconomic Imbalance Procedure;
- Greater focus on employment and social performance;
- Stronger coordination of economic policies within a revamped European Semester.

Financial Union

- **Complete the Banking Union**

- Setting up a bridge financing mechanism for the Single Resolution Fund (SRF);
- Implementing concrete steps towards the common backstop to the SRF;
- Agreeing on a common Deposit Insurance Scheme;
- Improving the effectiveness of the instrument for direct bank recapitalisation in the European Stability Mechanism (ESM).

- **Launch the Capital Markets Union**
- **Reinforce the European Systemic Risk Board**

Fiscal Union

- **A new advisory European Fiscal Board**

- The board would provide a public and independent assessment, at European level, of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal framework. Its advice should feed into the decisions taken by the Commission in the context of the European Semester.

Democratic accountability, legitimacy and institutional strengthening

- **Revamp the European Semester**

- Reorganise the Semester in two consecutive stages, with the first stage devoted to the euro area as a whole, before the discussion of country specific issues in the second stage.

- **Strengthen parliamentary control as part of the European Semester**

- Plenary debate at the European Parliament on the Annual Growth Survey both before and after it is issued by the Commission; followed by a plenary debate on the Country-Specific Recommendations;
- More systematic interactions between Commissioners and national Parliaments both on the Country-Specific Recommendations and on national budgets;
- More systematic consultation and involvement by governments of national Parliaments and social partners before the annual submission of National Reform and Stability Programmes.

- **Increase the level of cooperation between the European Parliament and national Parliaments**
- **Reinforce the steer of the Eurogroup**
- **Take steps towards a consolidated external representation of the euro area**
- **Integrate into the framework of EU law the Treaty on Stability, Coordination and Governance; the relevant parts of the Euro Plus Pact; and the Inter-governmental Agreement on the Single Resolution Fund**

STAGE 2

COMPLETING THE EMU ARCHITECTURE

Economic Union

- Formalise and make more binding the convergence process

Fiscal Union

- Set up a macroeconomic stabilisation function for the euro area
- Convergence towards similarly resilient national economic structures would be a condition to access this mechanism.

Democratic accountability, legitimacy and institutional strengthening

- Integrate the European Stability Mechanism (ESM) into the EU law framework
- Set up a euro area treasury accountable at the European level

FINAL STAGE AT THE LATEST BY 2025

Annex 2

A More Integrated European Semester

To better integrate the euro area and the national levels, the European Semester should be structured into two successive stages distinguishing more clearly between a European moment and a national moment (the figure below illustrates the new structure).

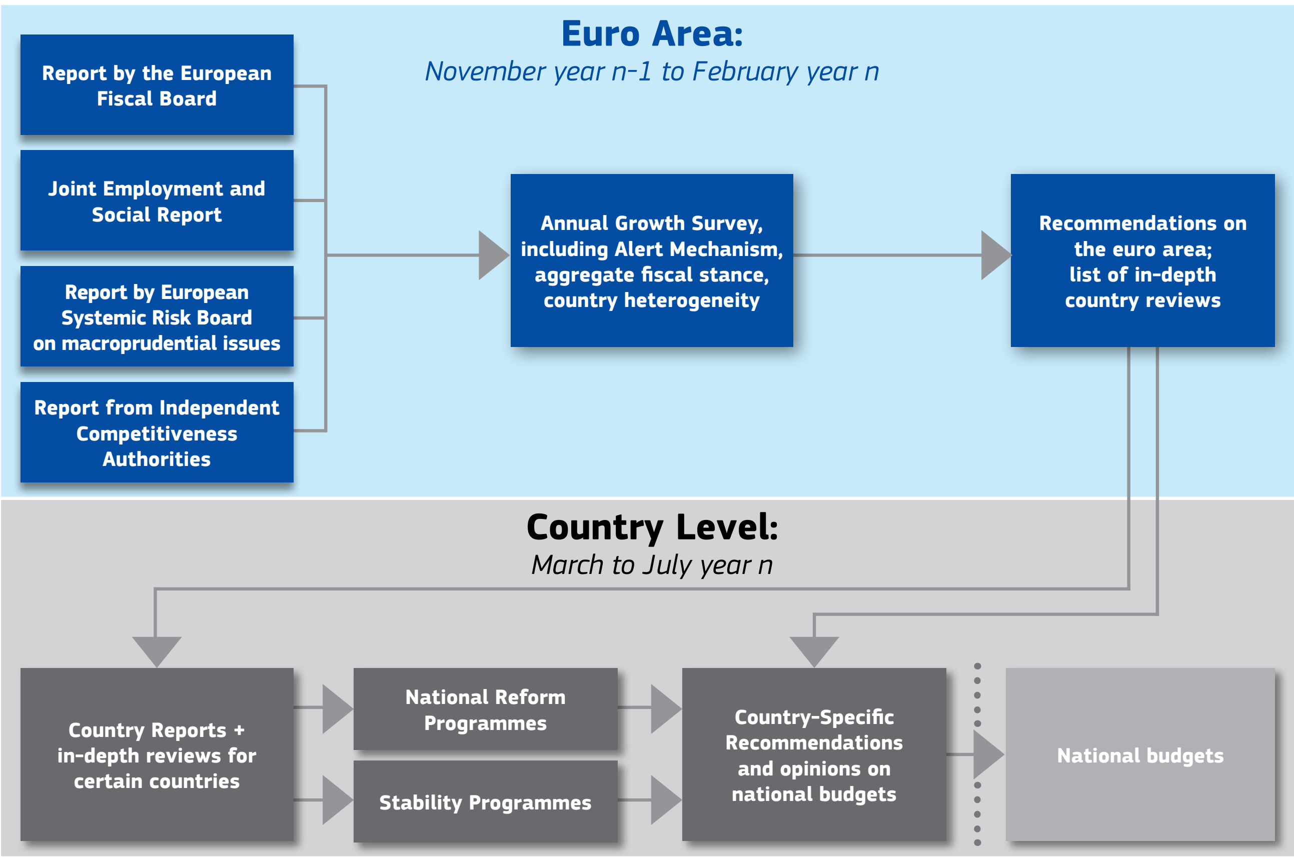
The first stage (November of year 'n-1' to February of year 'n') would be devoted to assessing the situation in the euro area as a whole. The Commission's Annual Growth Survey (AGS) would be the basis for this discussion and would draw on a number of thematic reports, such as the Alert Mechanism Report, the annual report of the European Systemic Risk Board, the Joint Employment and Social Report, as well as the views of a new European Fiscal Board and the new euro area system of Competitiveness Authorities. Together, these reports would give a complete picture of euro area challenges. The AGS would be presented to and discussed by the European Parliament. At the same time as the AGS, the Commission would present a dedicated recommendation for action within the euro area, as well as a list of Member States it considers for 'in-depth reviews', according to the Macroeconomic Imbalance Procedure (MIP). These documents would be discussed with the European Parliament within the framework of the economic dialogue, as foreseen in the 'Six-Pack' legislation, and with the different formations of the Council and the Eurogroup. This means that by end-February every year a genuine discussion will have taken place on the priorities set for the EU, and the euro area in particular, for the coming year.

The following stage (March to July of year 'n') would be devoted to reviewing and assessing the performance and policies of the Member States in the light of these priorities. This is the phase where Member States should systematically involve national Parliaments, together with social partners and civil society, in the discussion of national priorities. This stage will start with the publication of the Commission's Country Reports, which summarise Member States' challenges and performance. This stage would end with the adoption of Country-Specific Recommendations which should clearly take into account the euro area dimension agreed in the first stage.

EU-level social partners could be involved in discussions earlier, for instance through a renewed Tripartite Social Summit and Macroeconomic Dialogue, to maximise their contributions to this new process.

Annex 2

A MORE INTEGRATED EUROPEAN SEMESTER



Annex 3

Advisory European Fiscal Board – Guiding Principles

The mandate of the advisory European Fiscal Board should rest on the following principles:

- It should coordinate the network of national fiscal councils and conform to the same standard of independence.
- It should advise, not implement policy. Enforcing the rules should remain the task of the European Commission, which should be able to deviate from the views of the European Fiscal Board provided that it has justifiable reasons and explains them.
- It should form an economic, rather than a legal, judgement on the appropriate fiscal stance, both at national and euro area levels, against the background of EU fiscal rules. This should be done on the basis of the rules set in the Stability and Growth Pact (SGP).
- It should be able to issue opinions when it considers it necessary, including in particular in connection with the assessment of Stability Programmes and presentation of the annual Draft Budgetary Plans and the execution of national budgets.
- It should provide an *ex post* evaluation of how the governance framework was implemented.