**EUROPEAN COUNCIL
THE PRESIDENT**

Brussels, 12 October 2012

TOWARDS A GENUINE ECONOMIC AND MONETARY UNION
Interim Report

12 October 2012

At the June European Council "*the President of the European Council was invited to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union*". This interim report for the European Council builds largely on ideas and proposals that were expressed during a series of bilateral meetings in September with all EU Member States and with the European Parliament and its President. The aim of this report is to highlight points of convergence and to outline areas that would require further work for the final report due in December.

Under the Treaty, the Union has established an economic and monetary union whose currency is the euro. The views set out in this report focus on the euro area Member States as they face specific challenges by virtue of sharing a currency. The process towards a deeper economic and monetary union should be characterised by openness and transparency and be fully compatible with the Single Market in all aspects.

The report is structured around the essential building blocks identified in the report "*Towards a genuine economic and monetary union*" presented to the June European Council.

I. Integrated financial framework

Financial sector integration in the European Union has deepened significantly following the introduction of the single currency. However, supervision, crisis management and resolution of banks are still organized along national lines. As a result, the absence of common bank resolution tools has hampered effective crisis management, increasing the costs of financial sector support for the taxpayers as well as financial and fiscal stability risks. The crisis has brought about a fragmentation of the euro area financial market, with adverse implications for credit conditions. As mentioned in the bilateral consultations, the establishment of an integrated financial framework is necessary for the achievement of a genuine economic and monetary union. An integrated financial framework must comprise a single supervisory authority, a common resolution framework implemented by a common resolution authority, and national deposit guarantee schemes built on common standards.

Single Supervisory Mechanism

The major regulatory overhaul carried out in 2010 created the European System of Financial Supervision. The European Supervisory Authorities, including the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB), have been endowed mainly with coordinating functions, but essential decision-making powers have remained in national hands. New draft legislation put forward by the European Commission now proposes to establish a single supervisory mechanism (SSM) hosted by the European Central Bank, covering the euro area and open to all Member States. The adoption of the SSM is a matter of priority. In this respect, there are three important elements: first, a clear separation between ECB monetary policy and supervisory functions; second, a balance between rights and obligations for all Member States participating in the new supervisory arrangements; third, appropriate accountability of the new single supervisor, including to the European Parliament.

The SSM should operate in a manner that is fully consistent with the Single Market. To this end, the existing European Banking Authority will maintain its role and its focus on establishing and ensuring the implementation of a single rulebook in order to preserve the level playing field across the EU. It will also preserve its mediating role between the various supervisors. In this respect, the voting modalities of the EBA must be adapted to allow for fair representation and effective decision-making within the single market for financial services.

Finally, it is important that this centralised supervision allows a seamless continuity between micro-prudential and macro-prudential policy and contributes to reinforce the working of the ESRB.

Resolution

The European Commission has already proposed a Recovery and Resolution Directive that will ensure (i) the use of best practice and superior bank resolution tools to protect taxpayers (e.g. bail-in, creation of bridge banks, etc.) and (ii) consistency of national schemes to facilitate home/host resolutions and cross-border crisis management. The national resolution funds that the directive proposes will also ensure that the cost of resolution is borne first and foremost by the private sector.

In a context where supervision is effectively moved to a single supervisory mechanism, a common resolution authority with an appropriate backstop would come to be required so as to ensure that resolution decisions are taken swiftly, impartially and in the best interest of all. During the transition phase and after the establishment of an effective SSM, the ESM will have the possibility to recapitalise banks directly, relying on appropriate conditionality.

Deposit guarantee mechanisms

Credible deposit guarantee schemes can play an important pre-emptive role in the stability of the financial system. The legislative proposal harmonising national deposit guarantee schemes is an important step towards achieving this objective. It establishes a strong general principle for such schemes to be sufficiently financed by contributions from the financial sector, while ensuring a level playing field across different schemes.

Overall, the creation of an integrated financial framework has important fiscal, economic and political implications and therefore cannot be envisaged separately from steps towards more integrated fiscal and economic frameworks and more political accountability. Sharing banking sector risks without more effective fiscal discipline could otherwise lead to adverse incentives for sovereigns.

II. Integrated budgetary framework

The crisis has underlined the high level of interdependence between euro area countries and even beyond. It has shown that national budgetary policies are a matter of vital common interest. This points to the need to complement the current framework for the surveillance and coordination of budgetary policies with a more ex ante coordination framework, as proposed in the 'Two-Pack', and to move gradually towards a fully-fledged integrated budgetary framework. This will ensure sound budgetary policies at the national and European levels and thereby contribute to sustainable growth and macroeconomic stability.

The history of other currency unions shows that there are various ways of progressing towards fiscal union. The degree of centralisation of budgetary instruments and the arrangements for fiscal solidarity against adverse macroeconomic and financial shocks differ across currency unions. The EMU's unique features would justify a specific approach.

Stronger economic governance

In the near term, the priority is to complete and implement the new steps for stronger economic governance. Significant improvements to the rules-based framework for fiscal policies in the EMU have been enacted ('Six-Pack') or agreed (Treaty on Stability, Coordination and Governance) in the last couple of years, with greater focus on prevention of budgetary imbalances, more importance given to debt developments, better enforcement mechanisms and national ownership of EU rules. The other elements related to strengthening fiscal governance in the euro area ('Two-Pack'), which are still in the legislative process, should be finalised urgently and be implemented thoroughly. This new governance framework will provide for ex ante coordination of annual budgets of euro area Member States and enhance the surveillance of those experiencing financial difficulties.

Fiscal capacity

Strengthening discipline alone is however not sufficient. In the longer term, there is a need to explore the option to go beyond the current steps to strengthen economic governance by developing gradually a fiscal capacity for the EMU. Such a fiscal capacity could take several forms and various options would need to be explored more in detail in the run-up to the December European Council. It would support new fiscal functions which are not covered by the multiannual financial framework. Ways to develop this capacity within the framework of the EU and its institutions will have to be examined.

One of the functions of such a new fiscal capacity could be to facilitate adjustments to country-specific shocks by providing for some degree of absorption at the central level. In the EMU, the response to a symmetric shock affecting all countries simultaneously should primarily be provided by monetary policy, whereas in the context of country-specific economic shocks, the response falls primarily on national budgets. The European Stability Mechanism is a crisis management instrument and was not designed to perform such a shock absorption function. Moreover, low levels of cross-country labour mobility and structural impediments to price flexibility make economic adjustment mechanisms less effective than in other monetary unions. Asymmetric shock absorption at the central level would represent a form of limited fiscal solidarity exercised over economic cycles, improving the economic resilience of the EMU. Elements of fiscal risk sharing can and should be structured in such a way that they do not lead to permanent transfers across countries or undermine the incentive to address structural weaknesses.

Another important function of such a fiscal capacity would be to facilitate structural reforms that improve competitiveness and potential growth in relation to an integrated economic policy framework (see section III below). A well-functioning shock absorption function would require a further degree of convergence between economic structures and policies of the Member States. Therefore, the two objectives of shock absorption and support to structural reforms are complementary and mutually reinforcing.

The establishment of such a new fiscal capacity should not water down the compliance with fiscal rules and fiscal discipline in individual Member States. A key aspect of a future fiscal capacity, which would need to be examined carefully, would be its possible ability to borrow. In this respect, the balanced budget rule enshrined in both the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance would need to apply to this fiscal capacity. A fully-fledged integrated budgetary framework would require the establishment of a Treasury function with clearly defined fiscal responsibilities.

A safe and liquid financial asset for the euro area

It has been suggested that establishing a genuine euro area safe and liquid asset could contribute to limiting the negative feedback loops between banks and public finances, which has been one of the sources of contagion in the current crisis. In this context, the pooling of some short term sovereign funding instruments (e.g. treasury bills) on a limited and conditional basis could be examined further. This would require a greater degree of common decision-making on budgets, building on the provisions in the 'Two-Pack' regarding the examination of draft budgetary plans and the ex ante coordination of debt issuance. Proposals have also been made to deal with the existing stock of sovereign debt on a conditional and temporary basis through the gradual roll-over into a redemption fund of the legacy debt that has been accumulated by most Member States in the run-up to and during the financial and debt crisis.

III. Integrated economic policy framework

In order to remain a highly attractive social market economy and to preserve the European social model, it is important for the Union to be globally competitive and for the monetary union to avoid excessive divergences in competitiveness between Member States so that each and every country is able to adjust smoothly and rapidly to shocks. This includes flexibility in prices across the economy as well as the ability to handle asset and credit bubbles. A careful balance must be struck between, on the one hand, the need to maintain policy autonomy and adjustment capacity of Member States and, on the other hand, the enforceability of measures aiming to prevent the build-up of imbalances and to facilitate price and cost adjustments. This is essential to ensure that national policies are orientated towards strong and sustainable economic growth, competitiveness and employment and do not undermine the financial stability of the euro area as a whole.

The reforms of the EU surveillance framework

The crisis revealed the shortcomings of the previous economic policy framework and led to several reforms of the EU surveillance framework, culminating in the creation of an integrated European Semester with country specific recommendations and a new Macroeconomic Imbalances Procedure with sanctions, to detect and correct possibly harmful imbalances. Impetus was also given by the Euro Plus Pact, which has since been integrated into the European Semester. A complete assessment of the newly implemented surveillance mechanisms is premature. However, early evidence highlights a number of areas where these procedures could benefit from greater visibility, authority and impact.

Institutional quality, labour market and business climate indicators show weaknesses across the EU and sizeable differences between Member States. Completing the Single Market is a powerful way to address some of these flaws. The rapid implementation of the measures included in the June 2012 Growth and Employment Compact is a top priority.

Promoting structural reforms through arrangements of a contractual nature

Beyond the completion of the Single Market, the smooth functioning of the EMU requires stronger coordination, convergence and enforcement in the field of economic policy. In this context, as mentioned in the bilateral consultations, an idea to be explored is for the euro area Member States to enter into individual arrangements of a contractual nature with the EU institutions on the reforms promoting growth and jobs these countries commit to undertake and their implementation. This could include supporting reform efforts through limited, temporary, flexible and targeted financial incentives. Such arrangements could be linked to the reforms identified in the country-specific recommendations of the Council, and build on EU procedures, such as the corrective action plans under the excessive imbalances procedure or the economic partnership programmes. An integrated economic policy framework, including ex ante coordination of major economic policy reform plans with significant spillover effects on the euro area, would also help guide policies in areas such as labour mobility or tax coordination. Such coordination mechanisms could be open to the Member States that have not yet adopted the euro.

Strengthening macro-prudential policy

Finally, an integrated economic policy framework contributes to avoiding the large and rapid build-up of imbalances that can be fuelled by inadequate financial conditions at the national level. A possible step, consistent with the development of an integrated financial framework, could be the enhanced use of macro-prudential policy tools. Providing such tools to a future single supervisor – as currently foreseen in the draft legislation on the single supervisory mechanism already presented by the Commission – would significantly improve the impact of macro-prudential policy. It could help in better managing the development of especially country-specific credit and asset price risks. In this context, the ESRB should play an increased role.

IV. Democratic legitimacy and accountability

As a general principle, democratic control and accountability should occur at the level at which the decisions are taken. This implies relying on the European Parliament as regards accountability for decisions at European level but also maintaining and securing the pivotal role of national parliaments, as appropriate.

The Lisbon Treaty has already introduced improvements to the EU's democratic accountability, both for the European Parliament and for national parliaments. A further strengthened role of EU institutions must be accompanied with a commensurate involvement of the European Parliament in the EU procedures. A number of concrete steps to increase the level of cooperation between national parliaments and the European Parliament can also be taken, building on Article 13 of the Treaty on Stability, Coordination and Governance and on Protocol 1 of the Treaty on the Functioning of the European Union, in the respect of the Community method. In this spirit, ways to ensure a debate in the European Parliament and in national parliaments on the recommendations adopted in the context of the European Semester should be explored.

Governance within the euro area should be further improved building on the euro area summit statement of 26 October 2011 and the Treaty on Stability, Coordination and Governance.

The governance framework would also benefit from an active and open social dialogue.

V. Next steps

Building on this interim report and taking into account the exchange of views at the 18-19 October European Council and its conclusions, a specific and time-bound roadmap for the achievement of a genuine Economic and Monetary Union will be presented at the 13-14 December European Council.

During the preparatory process informal consultations with Member States and the European Parliament will continue. Exchanges of views with other major stakeholders may also take place.