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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Reinforcing economic policy coordination

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"The euro area's governance and coordination of economic policies must be improved. This will involve both deepening and broadening economic surveillance arrangements to guide fiscal policy over the cycle and in the long term and, at the same time, address divergences in growth, inflation and competitiveness." (Commission Communication on "EMU@10: successes and challenges after 10 years of Economic and Monetary Union" – 7 May 2008 - IP/08/716)

I. INTRODUCTION

The global economic crisis has challenged the current mechanisms of economic policy coordination in the European Union and revealed weaknesses. The functioning of the Economic and Monetary Union has been under particular stress, due to earlier failures to comply with the underlying rules and principles. The existing surveillance procedures have not been comprehensive enough. This Communication proposes measures that should be taken in the short term on the basis of the Treaty of the Functioning of the European Union (TFEU) to remedy the situation.

The recent economic crisis has no precedent in our generation. The steady gains in economic growth and job creation witnessed over the last decade have been wiped out and the crisis has exposed some fundamental weaknesses in our economy. The fiscal and other macro-economic imbalances built up in the years before the crisis made the EU economy vulnerable when the global financial crisis and economic downturn struck. Our public finances have been severely affected, with deficits of 7% of GDP on average and debt levels over 80% of GDP clearly above the 3% and 60% of GDP reference values set in the Treaty.

High levels of public debt cannot be sustained indefinitely. The pursuit of the Europe 2020 strategy agreed by the European Council in March must be based on a credible exit strategy. The EU faces big challenges in the coming years – the need for fiscal consolidation and at the same time the need to boost sustainable growth levels. The Stability and Growth Pact provides the right framework for an orderly exit from the crisis. But to support the EU's economic growth potential and the sustainability of our social models, the consolidation of public finances requires setting priorities and making hard choices: coordination at EU level will be crucial in this task and help address spill-over effects.

The recent financial crisis and pressure on the financial stability in Europe have underlined more clearly than ever the interdependence of the EU's economies, in particular inside the euro area. Member States were supported by being part of the EU, with its 500-million-people strong internal market and common currency for sixteen Member States. Existing instruments and methods of co-ordination enabled the EU to pull together its recovery efforts and to weather a storm that no Member State could have done on its own. However, these recent experiences also showed gaps and weaknesses in the current system, underlining the need for stronger and earlier policy co-ordination, additional prevention and correction mechanisms and a crisis resolution facility for euro-area Member States.

Urgent action has been taken to deal with the immediate needs of the crisis culminating on 9 May when an extraordinary Ecofin Council decided, based on a proposal of the Commission, on the establishment of a European stabilisation mechanism and agreed on a strong commitment to accelerated fiscal consolidation where warranted. Lessons should be drawn and steps taken to strengthen the EU's system of economic governance for the future. In this Communication, the Commission sets out a three pillar approach to reinforcing economic policy co-ordination. Most of the proposals pertain to the EU as a whole, but a more demanding approach is proposed for the euro area, based on Article 136 of the Treaty on the Functioning of the European Union.

The Communication stresses the case for making full use of the surveillance instruments available under the Treaty. Where necessary, existing instruments should be modified and complemented. The Communication calls for reinforcing compliance with the Stability and Growth Pact and extending surveillance to macro-economic imbalances. To do this, it proposes the establishment of a European Semester for economic policy coordination, so that Member States would benefit from early coordination at European level as they prepare their national stability and convergence programmes including their national budgets and national reform programmes. Finally, it sets out the principles that should underpin a robust framework for crisis management for euro-area Member States.

These are ambitious and necessary ideas on which the Commission is seeking the views of Member States, the European Parliament and stakeholders. The Commission will come forward with legislative proposals to implement these ideas in the coming months.

II. THE GLOBAL FINANCIAL CRISIS HAS EXPOSED AND AMPLIFIED THE CHALLENGES FACING THE EUROPEAN ECONOMY

Public debt was not sufficiently reduced over the past decade. There was not enough commitment to fiscal consolidation, in particular during good economic times. In some Member States, revenues were temporarily boosted by tax-rich activity, driven by unsustainable booms in housing, construction and financial services. As these macro-financial imbalances have unwound sharply due to the crisis, tax revenues in concerned Member States have collapsed, revealing a much weaker-than-anticipated underlying fiscal position. Government budgets in the European Union have gone from close to balance (-0.8% of GDP in EU and -0.6% in the Euro area) in 2007 to an expected deficit of close to 7% of GDP in 2010. Public debt continues to rise. According to the latest Commission services' forecasts, public debt will reach 84% of GDP in 2011 (88% in the Euro area), wiping out the results of twenty years of consolidation. Sizeable contingent liabilities related to financial rescues, representing another 25 percentage points of GDP in the EU, present an additional source of concern, adding to the long-standing fiscal challenges related to ageing.

Other macroeconomic and financial imbalances aggravated the vulnerability of the euro-area economy in particular. Persistent competitiveness divergences and macroeconomic imbalances within the euro area cause a risk to the functioning of Economic and Monetary Union. In the years preceding the crisis, low financing costs fuelled the misallocation of resources to often low productive uses, feeding unsustainable levels of consumption, housing bubbles and the accumulation of external and internal debt in some Member States. The competitiveness gap reached an all-time high just before the crisis. From a balanced position in 1999, current account surpluses in the euro area steadily accumulated

and reached 7.7% of GDP in 2007, while aggregated deficits rose from 3.5% of GDP in 1999 to 9.7% in 2007[1]. The economic and financial crisis has triggered a partial rebalancing of current accounts. But this rebalancing is only partly structural. Major policy reorientation is needed to bring about the necessary adjustment in terms of costs and wages, structural reform and reallocation employment and capital.

The exceptional combination in Greece of lax fiscal policy, inadequate reaction to mounting imbalances, structural weaknesses and statistical misreporting led to an unprecedented sovereign debt crisis. The underlying public finance situation was brutally revealed to be partly due to data misreporting in the past, but in fact was mainly the result of inappropriate fiscal policy. While this situation was in part made possible by the shortcomings of the existing economic surveillance framework, it clearly highlights the vital importance of ensuring effective compliance with rules. Confronted with an exceptional sovereign debt crisis, for which the euro area was left with no remedial instrument, the Member States agreed on a package of measures to preserve financial stability in Europe[2]. This Communication is intended to resolutely strengthen our surveillance mechanism in order to prevent a Member State from slipping into such a situation again. But the crisis also underscores the need for appropriate tools to manage a situation that threatens euro-area financial stability.

III. ENHANCING ECONOMIC POLICY COORDINATION

III.1. Reinforcing compliance with the Stability and Growth Pact and deeper fiscal policy coordination

The rules and principles of the Stability and Growth Pact are relevant and valid. But, despite the Pact, Member States failed to build up adequate buffers in good times. Reinforcing the preventive dimension of budgetary surveillance must be an integral part of closer coordination of fiscal policy. Also, compliance with the rules needs to be improved and more focus needs to be given to sustainability of public finances.

The preparation and assessment of Stability and Convergence Programmes forms the core of the preventive work under the Pact. Its impact and effectiveness should be decisively strengthened by increasing the ex-ante dimension of the process, and by giving it teeth. The former is addressed below (in Section III.3) through the introduction of a "European Semester". The latter could be done, for example, by including the possibility of imposing interest-bearing deposits in case of inadequate fiscal policies when Member States make insufficient progress towards their budgetary Medium-Term-Objectives in good economic times. This would require a change in secondary legislation.

National fiscal frameworks to better reflect the priorities of EU budgetary surveillance. Member States should be encouraged to integrate the Treaty objective of sound public finances in their national law. A national fiscal framework is the set of elements that form the basis of national fiscal governance, i.e. the country-specific institutional policy setting that shapes fiscal policy-making at national level. To give concrete meaning to the complementarity between the EU and national fiscal frameworks, the obligation in Protocol Nr 12 TFEU for Member States to have in place budgetary procedures that ensure compliance

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[1] The current account surplus ratios reported here reflect the combined surpluses of Germany, Luxembourg, the Netherlands, Austria and Finland. The current account deficit ratios reflect the combined deficits of Ireland, Greece, Spain, Cyprus, and Portugal.

[2] Conclusions of the Ecofin Council of 9 May 2010.

with their Treaty obligations on budgetary discipline could be specified through legally binding instruments. Such instruments would for instance require national frameworks to reflect multi-annual budgeting procedures, so as to ensure the achievement of the budgetary Medium-Term-Objectives.

The Excessive Deficit Procedure (EDP) forms the cornerstone of the corrective part of the Stability and Growth Pact. But, the corrective dimension embedded in the EDP comes into play too late to provide the right incentives for Member States to tackle emerging fiscal imbalances. The functioning of the EDP could be improved by speeding up the procedures, in particular with regard to Member States in repeated breach of the Pact. This will require changes in secondary legislation.

More prominence should be given to public debt and sustainability. Recent events have highlighted not only the vulnerability of Member States servicing a very large public debt burden, but also the potentially negative cross-border repercussions. High indebtedness weighs on medium- and long-term growth prospects and deprives governments of the ability to run credible counter-cyclical policies when they are needed most. This applies particularly in view of mounting threats to the sustainability of public finances, including those deriving from recent bank rescue packages as well as from ageing populations.

The debt criterion of the excessive deficit procedure should effectively be implemented. The EDP should better take into account the interplay between debt and deficit to improve incentives to run prudent policies. Member States with debt ratios in excess of 60% of GDP should become subject to the EDP if the decline of debt in a given preceding period falls short of an appropriate benchmark. Specifically, the Commission and the Council would need to assess whether the budget deficit is consistent with a continuous and substantial decline in public debt. Fiscal risks stemming from explicit and implicit liabilities should be taken into account as a relevant factor. Symmetrically, the abrogation of the EDP for Member States with debt in excess of the 60% of GDP threshold should be conditional on an assessment of projected debt developments and risks.. This approach is fully consistent with Article 126 of the TFEU and would require some changes in secondary legislation.

To ensure better compliance with the rules of the Stability and Growth Pact, , more attention should be paid to the use of the EU budget. Currently, the suspension of the Cohesion fund, from which only a limited number of Member States is eligible, is only considered at a late stage of the EDP (Article 126(8) of the TFEU).

Broader and more timely use of EU budget expenditure as an incentive for compliance should be considered when decisions on the next Financial Framework are prepared. The aim should be to establish fair, timely and effective incentives for compliance with the Stability and Growth Pact rules. Conditionality could be enhanced and Member States could be asked to redirect funds to improve the quality of public finances, once the existence of an excessive deficit is established (according to Article 126(6) of the TFEU).

Cohesion policy should have a clearer role to play in supporting Member States actions to address structural weaknesses and competitiveness challenges. The forthcoming 5th Cohesion Report will present proposals in this respect, particularly with a view to strengthening institutional capacity and efficiency of public administrations.

During the current Financial Framework a more rigorous and rules-based application of the existing suspension clause for Cohesion fund commitments should be pursued in case of recurrent breaches of the Pact.

Improving the functioning of existing mechanisms under the Stability and Growth Pact

- Increase effectiveness of Stability and Convergence Programmes assessments through better ex-ante coordination
- National fiscal frameworks to better reflect the priorities of EU budgetary surveillance

Addressing high public debt and safeguarding long-term fiscal sustainability

- Give new prominence to the debt criterion of the Treaty
- Take better account of the interplay between debt and deficit

Better incentives and sanctions to comply with the rules of the Stability and Growth Pact

- Interest-bearing deposits in case of inadequate fiscal policies
- More rigorous and conditional use of EU expenditure to ensure better compliance with the rules of the Stability and Growth Pact
- Recurrent breaches of the Pact to be subjected to more speedy treatment and more rigorous use of the Cohesion Fund Regulation

III.2. Towards broader surveillance of intra-euro area macroeconomic and competitiveness developments

The EU's comprehensive Europe 2020 strategy for growth and jobs puts the focus on macro-financial and structural imbalances. Europe 2020 sets out an ambitious and comprehensive strategy towards smart sustainable and inclusive growth for the EU economy. Against the background of the crisis it sets a new focus on addressing Europe's weaknesses in the surveillance of macro-financial and structural challenges. Taking account of the deep economic and financial inter-linkages within the euro area and their impact on the single currency, Europe 2020 calls for the development of a specific policy framework for the euro area to tackle broader macroeconomic imbalances[3]. Accordingly, in March 2010, the European Council called the Commission to present by June 2010 proposals to strengthen coordination within the euro area, making use of the new instruments for economic coordination offered by Article 136 of the Treaty (TFEU).

The accumulation of large and persistent macroeconomic imbalances among euro-area Member States has the potential to undermine the cohesiveness of the euro area and hamper the smooth functioning of EMU. To prevent the occurrence of severe imbalances within the euro area, it is therefore important to deepen the analysis and expand economic surveillance beyond the budgetary dimension to address other macroeconomic imbalances, including competitiveness developments and underlying structural challenges. It is proposed to upgrade the peer review of macroeconomic imbalances now carried out by the Eurogroup into a structured surveillance framework for euro-area Member States by making use of Article 136 TFEU. This framework will imply deeper surveillance, more demanding policy

[3] The Commission made the case for deeper and broader economic coordination in the euro area repeatedly in the past, including in the 2009 Annual Statement on the Euro Area and the 2008 Communication on "EMU@10: successes and challenges after 10 years of Economic and Monetary Union".

co-ordination and stronger follow-up than envisaged under Europe 2020 for all EU member States. As with the EU's fiscal framework, which also applies to all EU Member States, more stringent rules would apply to euro area Member States.

The surveillance will include a scoreboard that will indicate the need for action. A scoreboard, reflecting both external as well as internal developments, would be defined and regularly monitored. It would encompass a relevant set of indicators and reflect, inter alia, developments in current accounts, net foreign asset positions, productivity, unit labour costs, employment, and real effective exchange rates, as well as public debt and private sector credit and asset prices. It would appear particularly important to detect asset price booms and excessive credit growth at an early stage to avert costly corrections of fiscal and external imbalances at a later stage. This analysis would form the basis for the formulation of the recommendations for preventive or corrective measures in the Member State(s) concerned.

As regards the euro area, the Commission will also assess macroeconomic imbalances developments and prospects as a whole. Looking at the euro area as a whole and on a country-by-country basis, the Commission would assess the risk of all possible forms of macroeconomic imbalances that jeopardise the proper functioning of the euro area. In such a case, the Commission would conduct a more in-depth analysis of the underlying risk of emerging imbalances. This analysis will be the basis for policy orientations. The Council, with only euro-area Members voting, would invite the Member State(s) concerned to take the necessary action to remedy the situation. Should the Member State(s), within a stipulated time frame fail to take the appropriate measures to correct the excessive imbalance, the Council, with a view to ensure the proper functioning of EMU, could step up the surveillance for the Member State concerned and decide, on a proposal by the Commission, to issue precise economic policy recommendations. Where necessary, the Commission would use its possibility to issue early warnings directly to a euro-area Member State. Recommendations, if and when appropriate, could also be directed to the euro-area as a whole.

Preventive and corrective actions are potentially needed in a wide range of policy areas to effectively influence the macroeconomic imbalances and their underlying structural causes. Unlike in the correction of excessive deficits, economic policies tend to have only an indirect and lagged impact on the development of external imbalances. Therefore, depending on the specific challenges of the economy concerned, policy recommendations could address both the revenue and expenditure side of fiscal policy (in the context of the Stability and Growth Pact) as the crisis has shown that the evolution of the composition of government revenues is also an important lead-indicator of potential imbalances. In this context, recommendations could address the functioning of labour, product and services markets in line with the broad economic policy and employment guidelines. They should also cover macro-prudential aspects to prevent or curb excessive credit growth or exuberant asset price developments, in line with the future European Systemic Risk Board analysis.

Strengthening and broadening surveillance of macroeconomic developments in the euro area

- Building on Europe 2020, develop a framework for enhanced and broader macroeconomic surveillance for euro area Member States in form of a regulation based on Article 136 TFEU
- Develop a scoreboard of indicators to identify alert thresholds for severe imbalances
- Formulate country-specific recommendations
- Recourse to formal Council acts, by the Council voting in euro-area configuration

III.3. An integrated economic policy coordination for the EU: a "European Semester"

With a view to achieving a more integrated surveillance of economic policies, it has been suggested under the Europe 2020 initiative to synchronise the assessment of fiscal and structural policies of EU Member States. The outcome of broader macroeconomic surveillance should be reflected also when fiscal policy recommendations under the SGP are being formulated. In particular, the emergence of sizeable macroeconomic imbalances may call for more ambitious budgetary targets. Likewise, when assessing the risk of severe imbalances and deciding on the appropriate policy response, the Commission would take into account relevant input from the European Systemic Risk Board. Warnings and recommendations from the European Systemic Risk Board addressed to one or several Member States would be considered as a matter of common concern, while applying appropriate peer pressure for remedial action. Synergies and consistency between the different strands of economic surveillance should be facilitated by an integrated surveillance cycle under a European Semester.

Prevention is more effective than correction. The current cycle of economic surveillance consists mainly of an ex-post assessment of the appropriateness of economic policies with the rules of the Stability and Growth Pact (SGP) and the broad economic policy guidelines. The currently missing *ex-ante* dimension of budgetary and economic surveillance would allow the formulation of genuine guidance, taking into account the European dimension, and their subsequent translation into domestic policymaking. The formulation of more timely country-specific recommendations would benefit all aspects of surveillance - fiscal, macro-financial and structural.

A system of early peer-review of national budgets would detect inconsistencies and emerging imbalances. To ensure true and accurate data, a prerequisite would be to strengthen Eurostat's mandate to audit national statistics in line with recent Commission proposals. It is important to bring this proposal swiftly into force as this will improve the quality of reporting on public finances. An earlier tackling of the building-up of fiscal imbalances would ease their reversal and avoid becoming a serious risk to macroeconomic stability and fiscal sustainability. The submission of the Stability and Convergence Programmes should take place in the first half of the year rather than towards the end of the year as is the current practice. In full respect of the prerogatives of national parliaments, the early peer-review would provide guidance for the preparation of the national budgets in the following year.

For the euro area a horizontal assessment of fiscal stance should be carried out on the basis of the national Stability Programmes and the Commission forecasts. Special consideration to the aggregate stance should be given in the cases of serious economic stress in the euro area, when sizeable fiscal policy measures taken by individual Member States are likely to produce important spill-overs. In case of obvious inadequacies in the budget plans

for the following year, a revision of the plans could be recommended. The Eurogroup should have a crucial role to play in this new system of enhanced coordination and, where appropriate, have recourse to formal decision making as provided by the Lisbon Treaty.

A European Semester should encapsulate the surveillance cycle of budgetary and structural policies. It would start early in the year with a horizontal review under which the European Council, based on analytical input from the Commission, would identify the main economic challenges facing the EU and the euro area and give strategic guidance on policies. Member States would take conclusions of this horizontal discussion into account when preparing their Stability and Convergence Programmes (SCPs) and National Reform Programmes (NRPs). SCPs and NRPs would be issued simultaneously, allowing the growth and fiscal impact of reforms to be reflected in the budgetary strategy and targets. Member States would also be encouraged, in full respect of national rules and procedures, to involve their national parliaments in this process before submission of the SCPs and NRPs for multilateral surveillance at the EU-level. The Council, based on the Commission's assessment, would subsequently provide its assessment and guidance at a time when important budgetary decisions were still in a preparatory phase at the national level. In this context, the European Parliament should be appropriately engaged.

A "European Semester" for better ex-ante integrated fiscal policy coordination

- Align submission and discussions of SCPs and NRPs to assess the overall economic situation and improve timing with national budgetary cycles
- Ensure effective and timely policy advice from the European Council and the Council based on the Commission assessment

→More effective integrated surveillance, reaping the full benefits of peer review

III.4. Towards a robust framework for crisis management for euro area Member States

The unravelling of the Greek crisis showed that a robust framework for crisis management for euro area Member States is needed.

Indeed, financial distress in one Member State can jeopardize the macro-financial stability of the euro area as a whole. The crisis has demonstrated that a robust framework for crisis management is a necessary complement to the instruments for surveillance, prevention and adjustment discussed above. The EU's balance-of-payments assistance provided crucial support to non-euro-area Member States in financial distress. The uncertainty related to the availability and modalities of financial assistance to Greece aggravated contagion to other Member States and put at risk the overall financial stability within the euro area.

A clear and credible set of procedures for the provision of financial support to euro-area Member States in serious financial distress is necessary to preserve the financial stability of the euro area in the medium and long term.

A framework for well-designed conditional financial assistance should strengthen euro-area financial stability while avoiding moral hazard. At the heart of this euro-area crisis resolution mechanism are strict conditionality and interest rates that create incentives to return to market-based financing while ensuring the effectiveness of the financial support. When crisis prevention fails, and this is evidenced by an objective financing need, assistance would

be activated as a last resort, to safeguard financial stability in the euro area as a whole. It would be accompanied by a detailed and demanding programme of policy conditionality which would ensure that the assistance period is used to implement the necessary adjustments (fiscal and structural) to ensure solvency in the long run and so facilitate the swiftest possible return to market-based financing.

Financial assistance should be provided in the form of lending. Lending to a euro-area Member State – as opposed to assuming its debt - is not in contradiction with Article 125 TFEU. The policy programme and conditionality should be set within Article 136 TFEU. The experience with the EU's balance-of-payments assistance for non-euro area Member States has demonstrated that a single framework, with the EU issuing debt to finance emergency loans, provides a good combination of relative efficiency of management with political oversight by the Council.

Policy conditionality must aim first at tackling the underlying imbalances in the affected Member State to ensure a smooth functioning of EMU. Conditionality would typically involve an appropriate mix of fiscal consolidation and the strengthening of fiscal governance including tax policies; financial sector stabilisation to the extent that financial sector distress is at the root of the public finances problems; and broader policy interventions to restore macroeconomic stability and external viability. Beyond the budgetary dimension priority should be given to addressing macroeconomic imbalances, including competitiveness developments and underlying structural challenges. This will imply closer surveillance, more demanding policy co-ordination and stronger follow-up to ensure that necessary structural reforms are implemented swiftly.

On 9 May, based on a proposal of the Commission, the ECOFIN decided on the establishment of a temporary European stabilisation mechanism to deal with the immediate needs of the crisis. This was part of a wider package, including strong commitments to fiscal consolidation where warranted and involvement of the IMF through its usual facilities in line with the recent European programmes.

This mechanism was created to respond to the current exceptional circumstances and entails an overall financial support of up to EUR 500 billion. Financial assistance will be subject to strong conditionality, in the context of a joint EU/IMF support, and will be on terms and conditions similar to the IMF. This mechanism will be financed through two complementary sources. The first, building-on a Council Regulation based on Article 122(2), can mobilize up to EUR 60 billion. In addition, the euro-area Member States stand ready through an intergovernmental agreement to complement such resources through a Special Purpose Vehicle. This SPV would borrow using financial guarantees of the participating Member Sates up to EUR 440bn.

This mechanism largely respects the basic principles for a permanent robust crisis resolution mechanism. Therefore, the Commission considers that the first priority must now be to make this mechanism fully operational. Based on this experience, the Commission intends in the medium-to-long term to make a proposal for a permanent crisis resolution mechanism..

IV. NEXT STEPS

The Commission will develop the reform proposals presented in this Communication, in line with its responsibilities under the Treaty. It considers it important to make swift progress on the reform agenda laid out in this Communication: the present economic situation requires urgent action to implement the measures proposed to improve the economic governance of the EU and the euro area. The first European Semester should start with the beginning of 2011.

The Commission stands ready to follow-up swiftly with legislative proposals, including amending the regulations underpinning the Stability and Growth Pact, to enhance the prevention and correction of macroeconomic imbalances within the euro area, and to establish a more permanent framework for crisis management.