5 DECEMBER 2012

TOWARDS A GENUINE ECONOMIC AND MONETARY UNION

Herman Van Rompuy, President of the European Council
In close collaboration with:
José Manuel Barroso, President of the European Commission
Jean-Claude Juncker, President of the Eurogroup
Mario Draghi, President of the European Central Bank

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At the June 2012 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*". Building on the Interim Report and the Conclusions of the October 2012 European Council, this Report provides the background to the roadmap presented at the December 2012 European Council. It suggests a timeframe and a stage-based process towards the completion of the Economic and Monetary Union (EMU) covering all the essential building blocks identified in the report "Towards a genuine Economic and Monetary Union" presented at the June European Council. It incorporates valuable input provided by the Commission in its communication "A Blueprint for a deep and genuine EMU – Launching a European Debate" of 28 November 2012. The European Parliament has also made a valuable contribution. As requested by the European Council, this report explores further mechanisms in the context of an integrated budgetary framework, including an appropriate fiscal capacity for the EMU, as well as the idea of euro area Member States entering into arrangements of a contractual nature with the EU institutions on the reforms they commit to undertake and their implementation.

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 EMU should be characterised by openness and transparency and be fully compatible with the Single Market in all aspects.

This report lays down the actions required to ensure the stability and integrity of the EMU and calls for a political commitment to implement the proposed roadmap. The urgency to act stems from the magnitude of the internal and external challenges currently faced by the euro area and its individual members.

The euro area needs stronger mechanisms to ensure sound national policies so that Member States can reap the full benefits of the EMU. This is essential to ensure trust in the effectiveness of European and national policies, to fulfil vital public functions, such as stabilisation of economies and banking systems, to protect citizens from the effects of unsound economic and fiscal policies, and to ensure high level of growth and social welfare.

The euro area is confronted with a rapidly evolving international environment characterised by the rise of large emerging economies. A more resilient and integrated EMU would buffer euro area countries against external economic shocks, preserve the European model of social cohesion and maintain Europe's influence at the global level.

Together, these challenges make indispensable a commitment to, and subsequent implementation of, a roadmap towards a genuine EMU. They underscore that 'More Europe' is not an end in itself, but rather a means for serving the citizens of Europe and increasing their prosperity.

The actions deemed necessary to ensure the resilience of the EMU are presented therein as a staged-process. Irrespective of their time horizon, all policy proposals have been conceived and designed as elements of a path towards a genuine Economic and Monetary Union. Given the strong linkages between the building blocks, they should be examined as part of a mutually reinforcing comprehensive package. The creation of an integrated financial framework has important fiscal and economic implications and therefore cannot be envisaged separately. Similarly, the proposals put forward in the fiscal and economic policy sphere are closely intertwined. And, as all the proposals imply deeper integration, democratic legitimacy and accountability are essential to a genuine Economic and Monetary Union.

Overview of sequencing

The process could rest on the following three stages (see also diagram in annex):

Stage 1 (End 2012-2013)
Ensuring fiscal sustainability and breaking the link between banks and sovereigns

The completion of the first stage should ensure sound management of public finances and break the link between banks and sovereigns, which has been one of the root causes of the sovereign debt crisis. This stage would include five essential elements:

- The completion and thorough implementation of a stronger framework for fiscal governance ('Six-Pack'; Treaty on Stability, Coordination and Governance; 'Two-Pack').
- Establishment of a framework for systematic *ex ante* coordination of major economic policy reforms, as envisaged in Article 11 of the Treaty on Stability, Coordination and Governance (TSCG).
- The establishment of an effective Single Supervisory Mechanism (SSM) for the banking sector and the entry into force of the Capital Requirements Regulation and Directive (CRR/CRDIV).
- Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry.
- Setting up of the operational framework for direct bank recapitalisation through the European Stability Mechanism (ESM).

Stage 2 (2013-2014)
Completing the integrated financial framework and promoting sound structural policies

This stage would consist of two essential elements:

- The completion of an integrated financial framework through the setting up of a common resolution authority and an appropriate backstop to ensure that bank resolution decisions are taken swiftly, impartially and in the best interest of all.
- The setting up of a mechanism for stronger coordination, convergence and enforcement of structural policies based on arrangements of a contractual nature between Member States and EU institutions on the policies countries commit to undertake and on their implementation. On a case-by-case basis, they could be supported with temporary, targeted and flexible financial support. As this financial support would be temporary in nature, it should be treated separately from the multiannual financial framework.

Stage 3 (post 2014)

Improving the resilience of EMU through the creation of a shock-absorption function at the central level

This stage would mark the culmination of the process. Stage 3 would consist in:

- Establishing a well-defined and limited fiscal capacity to improve the absorption of country-specific economic shocks, through an insurance system set up at the central level. This would improve the resilience of the euro area as a whole and would complement the contractual arrangements developed under Stage 2. A built-in incentives-based system would encourage euro area Member States eligible for participation in the shock absorption function to continue to pursue sound fiscal and structural policies in accordance with their contractual obligations. Thereby the two objectives of asymmetric shock absorption and the promotion of sound economic policies would remain intrinsically linked, complementary and mutually reinforcing.
- This stage could also build on an increasing degree of common decision-making on national budgets and an enhanced coordination of economic policies, in particular in the field of taxation and employment, building on the Member States' National Job Plans. More generally, as the EMU evolves towards deeper integration, a number of other important issues will need to be further examined. In this respect, this report and the Commission's "Blueprint" offer a basis for debate.

I. Integrated financial framework

The current European arrangements for safeguarding financial stability remain based on national responsibilities. This is inconsistent with the highly integrated nature of the EMU and has certainly exacerbated the harmful interplay between the fragilities of sovereigns and the vulnerabilities of the banking sector. The set-up of the Single Supervisory Mechanism (SSM) will be a guarantor of strict and impartial supervisory oversight, thus contributing to breaking the link between sovereigns and banks and diminishing the probability of future systemic banking crisis.

In its October 2012 Conclusions, the European Council invited the legislators to proceed with work on the legislative proposals on the SSM as a matter of priority, with the objective of agreeing on the legislative framework by 1 January 2013. It called for the rapid conclusion of the single rule book, including agreement on the proposals on bank capital requirements by the end of the year. It also called for the rapid adoption of the provisions relating to the harmonisation of national resolution and deposit guarantee frameworks.

The SSM will constitute a first step towards a financial market union. It is imperative that the preparatory work can start in earnest at the beginning of 2013, so that the SSM can be fully operational from 1 January 2014 at the latest. It will be crucial that the ECB is equipped with a strong supervisory toolkit, and that the ECB's ultimate responsibility for banking supervision is coupled with adequate control powers. In this regard, establishing an appropriate framework for macro-prudential policy that takes due account of both national and Europe-wide dimension will be important. The ECB has confirmed that it will establish organisational arrangements guaranteeing a clear separation of its supervisory functions from monetary policy.

Once an effective single supervisory mechanism is established, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly. The legal and operational framework for ESM direct bank recapitalisation should be finalised by end-March 2013. In order to move towards an integrated financial framework, the SSM will need to be complemented by a single resolution mechanism, as well as more harmonised deposit guarantee mechanisms.

Single resolution mechanism

Since the beginning of the crisis, support to financial institutions has been substantial. It has unduly weighed on public finances and reduced the ability to use fiscal policy to stave off the effects of the recession. A strong and integrated resolution framework would contribute to limiting the cost of bank failures to taxpayers. The current legislative proposal on recovery and resolution will ensure that harmonised tools necessary for orderly bank resolutions are available in all EU Member States, including early interventions, bailing-in and the creation of bridge banks.

In a context where supervision is effectively moved to a single supervisory mechanism, it is however essential that the responsibility of dealing with bank resolution is also moved to the European level. The Commission has already announced its intention to propose a single resolution mechanism once the proposals for a Recovery and Resolution Directive and for a Deposit Guarantee Scheme Directive have been adopted. This single resolution mechanism – built around a single resolution authority – should be established as the ECB assumes its supervisory responsibility in full. This mechanism covering all banks supervised by the SSM should be based on robust governance arrangements, including adequate provisions on independence and accountability, as well as an effective common backstop, which is indispensable to complete an integrated financial framework.

The need for a single resolution mechanism

Establishing a single resolution mechanism is indispensable to complete an integrated financial framework:

- It would ensure a timely and impartial decision-making process, focused on the European dimension. This would mitigate many of the current obstacles to resolution, such as national bias and cross-border cooperation frictions. This would reduce resolution costs, as early and prompt actions contribute to maintaining the economic value of banks that need to be resolved.
- It would make resolution costs as low as possible and break the bank-sovereign nexus. A strong and independent resolution authority, backed by an efficient resolution regime, would have the financial, legal and administrative capability as well as the necessary independence to carry out effective and least-cost resolution. By ensuring that the private sector bears the primary burden of bank resolution costs, the authority would increase market discipline, and minimise the residual costs for the taxpayers of bank failures.
- The single resolution mechanism would complement the SSM by making certain that failing banks are restructured or closed down swiftly. The SSM would provide a timely and unbiased assessment of the need for resolution, while the single resolution authority would ensure actual timely and efficient resolution.

Under the single resolution mechanism, resolution actions should follow a least-cost strategy and could be financed according to a pecking order of bailing-in shareholders and some creditors, and relying on the banking industry. The latter would be organized through a European Resolution Fund, which would be a crucial element of the new resolution regime. It would be funded through *ex ante* risk-based levies on all the banks directly participating in the SSM. The single resolution mechanism should include an appropriate and effective common backstop. This could possibly be organized by means of an ESM credit line to the single resolution authority. 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.

Deposit guarantee mechanisms

The history of financial crises has illustrated the destabilising effect uncertainty surrounding bank deposits could have on individual financial institutions and on entire banking systems. The proposal on the harmonisation of national deposit guarantee schemes includes provisions to ensure that sufficiently robust national deposit insurance systems are set up in each Member State, thereby limiting the spill-over effects associated with deposit flight between institutions and across countries, and ensuring an appropriate degree of depositor protection in the European Union. A rapid adoption of this proposal is important.

II. Integrated budgetary framework

The crisis has revealed the high level of interdependence and spill-overs between euro area countries. It has demonstrated that national budgetary policies are a matter of vital common interest. This points to the need to move gradually towards an integrated budgetary framework ensuring both sound national budgetary policies and greater resilience to economic shocks of the euro area as a whole. This would contribute to sustainable growth and macroeconomic stability. The October Interim Report stressed the need for stronger economic governance and suggested, as an additional step, the possibility to develop gradually a fiscal capacity for the EMU, which could facilitate adjustment to economic shocks. Following the conclusions of the October European Council, this section explores the options for a euro area fiscal capacity and its guiding principles.

Sound national budgetary policies are the EMU's cornerstone

The near term priority is to complete and implement the new steps for stronger economic governance. In the past few years, 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), with greater focus on prevention of budgetary imbalances, on debt developments, on better enforcement mechanisms, and on 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 ample *ex ante* coordination of annual budgets of euro area Member States and enhance the surveillance of those experiencing financial difficulties.

Towards a fiscal capacity for the EMU

The history and experience of other currency unions shows that there are various ways of progressing towards a fiscal union and the EMU's unique features would justify a specific approach. Yet, while the degree of centralisation of budgetary instruments and the arrangements for fiscal solidarity against adverse shocks differ, all other currency unions are endowed with a central fiscal capacity. In this respect, the European Council in October 2012 asked to explore further mechanisms, including an appropriate fiscal capacity, for the euro area. It would support new functions which are not covered by the multiannual financial framework from which it is clearly separated.

In stage 2, structural reforms could, in specific cases, be supported through limited, temporary, flexible and targeted financial incentives as Member States enter into arrangements of a contractual nature with EU institutions. These arrangements would be mandatory for euro area Member States and voluntary for the others (see section III below). The Commission intends to make a proposal on specific ways to put in place such contractual arrangements and on the means to support their implementation, building on EU procedures.

The implementation of contractual arrangements and the associated incentives would support a convergence process, leading in stage 3 to the establishment of a fiscal capacity to facilitate adjustment to economic shocks. This could take the form of an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks. Such a function would ensure a form of fiscal solidarity exercised over economic cycles, improving the resilience of the euro area as a whole and reducing the financial and output costs associated with macroeconomic adjustments. By contributing to macroeconomic stability, it would usefully complement the crisis management framework based on the European Stability Mechanism.
Since a well-functioning shock absorption function would require a further degree of convergence between economic structures and policies of the Member States, the two objectives of supporting growth-enhancing structural reforms and cushioning country-specific economic shocks are complementary and mutually reinforcing.

Economic rationale for such a fiscal capacity

In a common currency area, the burden of adjusting to country-specific economic shocks falls on labour and capital mobility, price and cost flexibility, and fiscal policy. In order to protect against negative fiscal externalities, it is important that fiscal risks are shared where economic adjustment mechanisms to country-specific shocks are less than perfect. This is clearly the case in the euro area, where labour mobility is comparatively low, capital flows are susceptible to sudden swings that can undermine financial stability, and structural rigidities can delay or impede price adjustments and the reallocation of resources. In such cases, countries can easily find themselves pushed into bad equilibria with negative implications for the euro area as a whole.

In this context, setting up risk-sharing tools, such as a common but limited shock absorption function, can contribute to cushioning the impact of country-specific shocks and help prevent contagion across the euro area and beyond. However, this needs to be complemented with a mechanism to induce stronger economic convergence, based on structural policies aiming at improving the adjustment capacity of national economies and avoiding the risk of moral hazard inherent to any insurance system. Hence, in addition to fulfilling their intrinsic purpose, successfully implementing reforms specified in a contractual arrangement could also serve as a criterion for participating in the asymmetric shock absorption function established in stage 3. This would provide countries with an additional strong incentive to implement sound economic policies both before and once they join the shock absorption mechanism. In the transition towards establishing this automatic stabilisation function, and depending on their specific circumstances, limited, temporary and flexible financial incentives could be provided to Member States to promote structural reforms. In order to avoid the relapse or emergence of macroeconomic imbalances once countries have gained access to the shock absorption function, the contractual approach to reforms would continue. In addition, net transfers under the shock absorption function could be modulated to reflect ongoing compliance with the commitments undertaken under the contractual arrangements.

Options for the shock absorption function of the euro area fiscal capacity

An EMU fiscal capacity with a limited asymmetric shock absorption function could take the form of an insurance-type system between euro area countries. Contributions from, and disbursements to, national budgets would fluctuate according to each country's position over the economic cycle.

The specific design of such a function could follow two broad approaches. The first would be a macroeconomic approach, where contributions and disbursements would be based on fluctuations in cyclical revenue and expenditure items, or on measures of economic activity. The second could be based on a microeconomic approach, and be more directly linked to a specific public function sensitive to the economic cycle, such as unemployment insurance. In this case, the level of contributions/benefits from/to the fiscal capacity would depend directly on labour market developments. In this scenario, the fiscal capacity would then work as a complement or partial substitute to national unemployment insurance systems. Transfers could, for example, be limited to cyclical unemployment by covering only short term unemployment.

Assessing the individual merits of each approach would require a more in-depth analysis. Importantly, the magnitude of the shock absorption function assigned to the fiscal capacity would depend largely on its size, and the financial implications for national budgets would depend on its precise design and parameters. However, it will be important to ensure that, irrespective of the approach that is followed, establishing this function does not affect the overall level of public expenditure and tax pressure in the euro area. Equally, the exact conditions and thresholds for the activation of transfers would need to be studied carefully, as only country-specific shocks of a sufficient magnitude should be absorbed centrally. For example, in the case of the microeconomic approach, unemployment-related transfers could be activated only once the increase in short-term unemployment exceeds a certain threshold.

Financial resources of the fiscal capacity and ability to borrow

Specific resources would have to be raised to finance both functions – promoting structural reforms and absorbing asymmetric shocks. These resources could take the form of national contributions, own resources, or a combination of both. In a longer term perspective, a key aspect of a future fiscal capacity, which would need to be examined carefully, would be its possible ability to borrow. A euro area fiscal capacity could indeed offer an appropriate basis for common debt issuance without resorting to the mutualisation of sovereign debt. The question of applying a fiscal golden rule, such as the balanced budget rule enshrined in both the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance, to this fiscal capacity should then be explored. Finally, an integrated budgetary framework would require the establishment of a Treasury function with clearly defined responsibilities.

Guiding principles for the shock absorption function of an EMU fiscal capacity

Irrespective of the approach – macro or micro-economic – the design of such a shock absorption function should rest on a number of guiding principles reflecting also the EMU's specific features:

- Elements of fiscal risk-sharing related to the absorption of country-specific shocks should be structured in such a way that they do not lead to unidirectional and permanent transfers between countries, nor should they be conceived as income equalisation tools. Over time, each euro area country, as it moves along its economic cycle, would in turn be a net recipient and a net contributor of the scheme.
- Such a function should neither undermine the incentives for sound fiscal policy making at the national level, nor the incentives to address national structural weaknesses. Appropriate mechanisms to limit moral hazard and foster structural reforms should be built in the shock absorption function. Linking it tightly to compliance with the broad EU governance framework, including possible arrangements of a contractual nature (see section III below), should be envisaged.
- The fiscal capacity should be developed within the framework of the European Union and its institutions. This would guarantee its consistency with the existing rules-based EU fiscal framework and procedures for the coordination of economic policies.
- The fiscal capacity should not be an instrument for crisis management, as the European Stability Mechanism (ESM) has already been established for that purpose. By contrast, the fiscal capacity's role should be to improve the overall economic resilience of the EMU and euro area countries. It would contribute to crisis prevention and make future ESM interventions less likely.
- The design of the fiscal capacity should be consistent with the principle of subsidiarity, and its operations transparent and subject to appropriate democratic control and accountability. Equally, it should be cost-effective and not lead to the undue development of costly administrative procedures or unnecessary centralisation. It should not lead to an increase in expenditure or taxation levels.

III. Integrated economic policy framework

The sovereign debt crisis painfully exposed that the unsustainable economic policies pursued by some euro area countries in the past and the rigidities existing in their economies have negative repercussions for all members of the EMU. An integrated economic policy framework is necessary to guide at all times the policies of Member States towards strong and sustainable economic growth to produce higher levels of growth and employment.

In the near term, it is essential to complete the Single Market as it provides a powerful tool to promote growth. In addition, there is a need for a thorough assessment of the performance of labour and product markets in the euro area. In the absence of exchange rate adjustments, a well functioning EMU requires efficient labour and product markets. This is essential to fight large scale unemployment, and to facilitate price and cost adjustments that are key for competitiveness and growth. Urgent attention should be paid to promoting labour mobility across borders and addressing skills mismatch in the labour market. The Commission could undertake this assessment as a matter of priority. Finally, a framework for systematic ex-ante coordination of major economic policy reforms, as envisaged in Article 11 of the Treaty on Stability, Coordination and Governance (TSCG), should be put in place.

In order to remain a highly attractive social market economy and to preserve the European social models, it is important for the Union to be globally competitive and to avoid excessive divergences in competitiveness among EMU members. The reforms introduced to the EU surveillance framework through the creation of the European Semester with country-specific recommendations and of a new Macroeconomic Imbalances Procedure with possible sanctions are a step in the right direction. But there is a need to go further and to put in place a stronger framework for coordination, convergence and enforcement of structural policies. In this context, the October European Council Conclusions called for further exploration of the idea of arrangements of a contractual nature between Member States and the EU institutions on reforms promoting competitiveness, growth and jobs that countries commit to implement. A staged approach would be used to put in place these arrangements.

Arrangements of a contractual nature need to address vulnerabilities at an early stage

Macroeconomic imbalances tend to build up slowly and are often masked by favourable economic growth and liquidity conditions. But given structural rigidities in labour, product and services markets, and institutional settings, once identified they are often difficult to correct quickly. It is therefore important to address the root causes of imbalances at an early stage, including by ensuring that these essential markets can adjust quickly to shocks and that national frameworks facilitate growth and employment. Contractual arrangements would thus need to focus on microeconomic, sectoral and institutional bottlenecks, and aim at enhancing the competitiveness and growth potential of the economy. The future contractual arrangements should therefore be mandatory for all euro area countries, but voluntary for other Member States.

Contractual arrangements need to focus on key weaknesses

Not all economic inefficiencies represent a burden for the functioning of the EMU. Also, the degree of competitiveness and growth challenge varies across countries. Content and breadth of the reform agreements would reflect this diversity and would adapt to country-specific needs (e.g. efficient labour market to fight youth unemployment; improve judicial systems). However, for these arrangements to take this heterogeneity into account, an intense dialogue between each Member State and the EU institutions, both at technical and political levels, would be essential. This would take the form of an in-depth analysis by both parties, providing the basis for a tailor-made and detailed agreement on some specific reforms. Depending on the type of measures necessary, the length of these agreements would vary for each country, but would likely be of a multiannual nature. In order to maintain the focus on key weaknesses, such arrangements would need to allow for some flexibility to deal with major shocks and changing economic circumstances and priorities. Depending on the specific situation of each country, in stage 2, this could be supported by targeted, limited and flexible financial support under the fiscal capacity.

Contractual arrangements need to be integrated into existing EU processes

The crisis has led to a strengthening of the EU economic governance framework. Every year, integrated country-specific recommendations by the Council, based on a proposal by the Commission, are addressed to all Member States. In addition, a Macroeconomic Imbalances Procedure (MIP) has been put in place to detect and correct imbalances at an early stage. To avoid inconsistencies and duplication, contractual arrangements should be included in the European Semester. They should be consistent with and support the overall policy mix resulting from the Annual Growth Survey and should be based on the country-specific recommendations. In accordance with the objective of early detection, the in-depth reviews would be generalised to all EMU countries. In-depth reviews would need to be based on a very thorough and on-the-ground dialogue and on analysis of Member States' economies. Based on the conclusions of the in-depth review, the Commission's country-specific recommendations would be the basis for a dialogue with each country on the specific and detailed measures contained in the reform arrangements, including a timeframe for implementation. For Member States under the corrective arm of the MIP, the agreement would be the corrective action plan, and as foreseen in the current regulation non-compliance would lead to sanctions.

Contractual arrangements need to benefit from full domestic and European ownership and accountability

National ownership is pivotal to implementation of structural reforms. A national debate on the priority measures and approval of reform agreements by national parliaments are essential to ensure national ownership. The Commission should be able to inform the European and national parliaments of the necessity of these measures from an EMU perspective. Both contractual parties would be responsible for content and implementation of their part of the convergence and competitiveness agreement, and for reporting to their respective parliaments (national and European) on progress achieved. Full accountability of both parties can only be ensured if the agreed reform agenda is specific, detailed and measurable. This requires *ex ante* agreement on concrete timelines, on the specific modalities for monitoring and on access to information. The agreements and compliance reports would be published on a regular and timely basis. Significant economic changes or altering political circumstances, such as the election of a new government, could lead to a renegotiation of the precise measures and steps to reach the reform objectives.

Key elements of arrangements of a contractual nature on structural reforms

In summary, such arrangements embedded in the EU governance framework could rest on the following principles:

- They would be embedded in the European Semester, be consistent with and support the overall euro area policy mix; they would be mandatory for euro area Member States but voluntary for the others, on the basis of thorough, on-the-ground reviews of the main bottlenecks to growth and employment. These reviews would be conducted by the Commission.
- They would cover a multiannual, specific and monitorable reform agenda jointly agreed with the EU institutions and focussed on competitiveness and growth that are crucial for the smooth functioning of the EMU.
- Member States and the Commission would be accountable, respectively, to national parliaments and the European Parliament on the content and implementation of their duties under the agreements.
- Structural reforms would be supported through financial incentives and would result in temporary transfers to Member States with excessive structural weaknesses. This targeted support should be financed through specific resources.
- Compliance with the agreements can be ensured by an incentive-based framework. Compliance could be one of the criteria for participating in the shock absorption function of the fiscal capacity. In addition, national contributions to the fiscal capacity could be increased in case of non-compliance.

V. Democratic Legitimacy and Accountability

In its October Conclusions the European Council stressed the need for strong mechanisms for democratic legitimacy and accountability. One of the guiding principles is that democratic control and accountability should occur at the level at which the decisions are taken. The implementation of this guiding principle is key to ensuring the effectiveness of the integrated financial, budgetary and economic policy frameworks. This implies the involvement of the European Parliament as regards accountability for decisions taken at the European level, while maintaining the pivotal role of national parliaments, as appropriate.

Decisions on national budgets are at the heart of Member States' parliamentary democracies. At the same time, the provisions for democratic legitimacy and accountability should ensure that the common interest of the union is duly taken into account; yet national parliaments are not in the best position to take it into account fully. This implies that further integration of policy making and a greater pooling of competences at the European level should first and foremost be accompanied with a commensurate involvement of the European Parliament in the integrated frameworks for a genuine EMU.

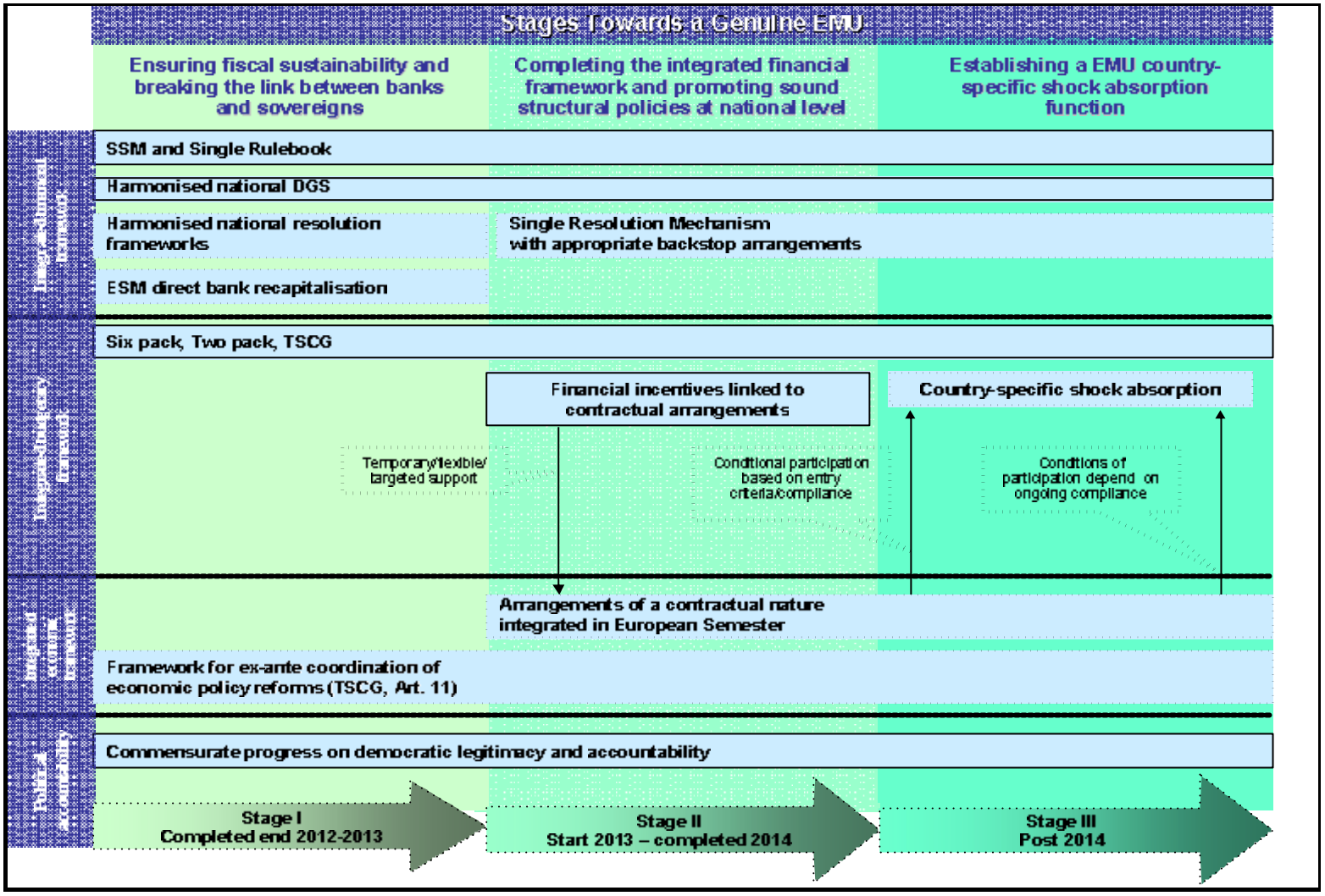
First, in an integrated financial framework: while accountability of both the European Central Bank as single supervisor and of a future single resolution authority should take place at the European level, this should be complemented by strong mechanisms for information, reporting and transparency to national parliaments of the participating Member States.

Second, in the context of integrated budgetary and economic policy frameworks: Members States should ensure the appropriate involvement of their national parliaments in the proposed reform arrangements of a contractual nature and more broadly in the context of the European Semester. In this spirit, the European Council asked in October to explore ways to ensure debates in the European Parliament and national parliaments on the recommendations adopted in the context of the European Semester. New mechanisms to increase the level of cooperation between national and European parliaments, for example building on Article 13 of the TSCG and Protocol 1 of the Treaty, could contribute to enhancing democratic legitimacy and accountability. Their precise organisation and modalities are a responsibility of the European Parliament and national parliaments to determine jointly.

Third, the creation of a new fiscal capacity for the EMU should also lead to adequate arrangements ensuring its full democratic legitimacy and accountability. The details of such arrangements would largely depend on its specific features, including its funding sources, its decision-making processes and the scope of its activities.

Finally, the crisis has shown the need to strengthen not only the EMU's surveillance framework but also its ability to take rapid executive decisions to improve crisis management in bad times and economic policymaking in good times. Some intergovernmental arrangements have been created as a result of the shortcomings of the previous architecture but these would ultimately need to be integrated into the legal framework of the European Union. This is already foreseen under the Treaty on Stability, Coordination and Governance, and could be envisaged also for other cases. Reinforcing the capacity of the European level to take executive economic policy decisions for the EMU is essential. Finally, as the EMU evolves towards banking, fiscal and economic union, its external representation should also be unified.

Ultimately, these far-reaching changes undertaken by the European Union in general and the Economic and Monetary Union in particular require a shared sense of purpose amongst Member States, a high degree of social cohesion, a strong participation of the European and national parliaments and a renewed dialogue with social partners. The openness and transparency of the process as well as the outcome are crucial to move towards a genuine Economic and Monetary Union.


Stages Towards a Genuine EMU
Ensuring fiscal sustainability and breaking the link between banks and sovereigns
Completing the integrated financial framework and promoting sound structural policies at national level
Establishing a EMU country-specific shock absorption function
Integrated financial framework
SSM and Single Rulebook
Harmonised national DGS
Harmonised national resolution frameworks
Single Resolution Mechanism with appropriate backstop arrangements
ESM direct bank recapitalisation
Integrated budgetary framework
Six pack, Two pack, TSCG
Financial incentives linked to contractual arrangements
Country-specific shock absorption
Temporary/flexible/ targeted support
Conditional participation based on entry criteria/compliance
Conditions of participation depend on ongoing compliance
Integrated economic framework
Arrangements of a contractual nature integrated in European Semester
Framework for ex-ante coordination of economic policy reforms (TSCG, Art. 11)
Political accountability
Commensurate progress on democratic legitimacy and accountability
Stage I
Completed end 2012-2013
Stage II
Start 2013 – completed 2014
Stage III
Post 2014