

# A SMART MOVE: WHY THE FIVE PRESIDENTS' REPORT IS CAUTIOUS ON SUBSTANCE AND AMBITIOUS ON PROCESS

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## EXECUTIVE SUMMARY

### “IN VIEW OF THE POLITICAL CIRCUMSTANCES, IT IS A SMART REPORT”

The recently published “Five Presidents’ Report” proposes a reform of the Economic and Monetary Union (EMU) along four dimensions: economic, financial, fiscal and political. This policy paper summarises our assessment of the proposals. In view of the political circumstances, it is a smart report. Compared to the 2012 Four Presidents’ Report, the document contains few entirely new insights, but it offers a clear timeline and sufficiently ambitious proposals for the near term.

- The sections on financial and economic union are strong and constructive, whereas the ones on fiscal and political union are slightly weaker.
- A clear and specific three-stage roadmap may be the report’s most crucial element. It provides the EMU reform process with a structure. Putting short-term measures in the context of a long-term agenda is essential.
- Important substantial elements include 1) a drive to complete the Banking Union by mid-2017 and 2) a proposal to formulate binding “convergence indicators” that decide whether a country may accede to an EMU-wide shock-absorption mechanism.
- The report fails to discuss 1) improvements to the European Stability Mechanism’s governance and accountability and 2) measures to deal with a sovereign default in the euro area.
- Controversial elements of the report are to be specified by an expert group. We agree that a prominent and independent group could prepare the ground for a political agreement on the future of EMU.

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## INTRODUCTION

The report on “Completing Europe’s Economic and Monetary Union”, also known as the “Five Presidents’ Report”, was presented to the European Council on 25/26 June 2015<sup>1</sup>. On 24 pages, the presidents of the European Commission, the European Central Bank (ECB), the European Council, the Eurogroup and the European Parliament describe their vision of the future of the Economic and Monetary Union (EMU) along four dimensions: economic, financial, fiscal and political. The report draws up a three-stage roadmap consisting of immediate steps until 2017, more fundamental changes before 2025 and a final stage of consolidation afterwards.

### BOX 1 ► The roadmap of the Five Presidents’ Report:

- Stage 1 (before mid-2017): Groundwork. Immediate steps without Treaty change, preparation of proposals for stage two
- Stage 2 (from 2017 until max. 2025): Deep reform. New instruments to achieve convergence, stability, and legitimacy (e.g., binding convergence targets, shock-absorption mechanism, euro area treasury)
- Stage 3 (from 2025 or earlier): Consolidation.

The report received a lukewarm welcome from Europe’s heads of states and governments. The European Council of 25/26 June 2015 simply “took note of the report (...) and asked the Council to rapidly examine it”<sup>2</sup>. It is indeed not difficult to criticise the report. One is easily drawn into thinking that it relegates many of the real problems of the euro area to the time after 2017 and that it is vague about the question what elements are indispensable for EMU stability in the long run. It also seems to fall short of the “political ‘whatever it takes’ by all the EU institutions” that a pro-European open letter had demanded<sup>3</sup>.

### “THE AUTHORS DESCRIBE THEIR VISION OF THE FUTURE OF EMU ALONG FOUR DIMENSIONS: ECONOMIC, FINANCIAL, FISCAL AND POLITICAL”

Yet if one takes into account the current political circumstances, it is a smart report. In most member states, the government and public are gripped by reform fatigue. France and Germany recently indirectly voiced their hesitation to stronger common institutions in a joint position paper that is much less ambitious than the Five Presidents’ Report.<sup>4</sup> Also, the Greek drama currently casts doubt on the very existence of the common currency. The report’s cautious and pragmatic tone reflects that situation. At times, this may be disappointing, but generally, the report manages to walk the line between an agreement on the lowest common denominator and the over-ambitious 2012 “Four Presidents’ Report”<sup>5</sup>.

The authors choose their battles wisely. They propose pressing ahead where concrete proposals already exist but keep a low profile in areas where a basic consensus is lacking. Still: ambitious but controversial elements remain part of the reform plan. They are to be investigated in depth by an expert committee that will advise the Five Presidents on a White Paper to be published in 2017, which should name more specific reform options.

1. Juncker, Jean-Claude, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz, Completing Europe’s Economic and Monetary Union, 2015. [http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report\\_en.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf).

2. European Council conclusions, 25-26 June 2015. <http://www.consilium.europa.eu/en/meetings/european-council/2015/06/EUCO-conclusions-pdf/>.

3. Roberto Castaldi, “We, Europeans”, 21 June 2015. <http://www.eutopiamagazine.eu/en/roberto-castaldi/speakers-corner/we-europeans>.

4. Deutsch-französischer Beitrag zur Wirtschafts- und Währungsunion, May 2015. [http://ec.europa.eu/priorities/economic-monetary-union/docs/french-german\\_contribution\\_1\\_de.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/french-german_contribution_1_de.pdf)

5. Van Rompuy, Herman, José Manuel Barroso, Jean-Claude Juncker, and Mario Draghi, Towards a Genuine Economic and Monetary Union, 2012. [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134069.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf).

In very difficult times, the report thus keeps the door open for more far-reaching discussions after the British referendum in 2016 or 2017 and the French and German elections in 2017.

The report's most crucial element may thus be its clear and specific roadmap. It provides the EMU reform process with a structure and deadline for negotiations. As we have argued in a previous study, it is essential to put short-term measures in the context of a long-term agenda, showing how the building blocks fit together and depend on each other<sup>6</sup>.

This policy paper summarises our assessment of the proposals. It does not discuss every particular item, but rather singles out the ones we find most noteworthy. We find that the sections on financial and economic union are strong and constructive, whereas the ones on fiscal and political union are slightly weaker. But overall, we come to a favourable conclusion. Two especially important elements stand out: a drive to complete the Banking Union by mid-2017 and a proposal to formulate binding "convergence indicators" in stage two that decide whether a country may accede to an EMU-wide shock-absorption mechanism.

## 1. Economic Union

### BOX 2 ► Key proposals of the report:

- Stage 1: Euro area system of Competitiveness Authorities that coordinates with the Commission in order to prevent imbalances
- Stage 1: Stronger and more encompassing Macroeconomic Imbalance Procedure (MIP) that emphasises developments on the euro area level and fosters reform through its corrective arm
- Stage 2: Binding targets for structural convergence of euro area economies. Surveillance via the MIP.

### “THE RECOMMENDATION TO PUT INTO PLACE A BINDING CONVERGENCE PROCESS (...) PLAYS A CENTRAL ROLE”

The most significant element in the proposals on “economic union” is the recommendation to put into place a binding convergence process after 2017. That plan is easy to miss among a flurry of less significant proposals in this section. Yet it plays a central role in the proposed process of building a stronger EMU architecture. The idea is that a certain degree of resilience and structural similarity among euro area economies is needed in order for EMU to function smoothly. From an economic point of view, convergence is necessary to avoid the emergence of dangerous imbalances. From a political perspective, it is needed to justify future stabilization payments.

The report proposes common standards in a number of areas such as labour markets, competitiveness, business environment and tax policy, although it concedes that more in-depth work is needed on the details. Only countries that comply with the proposed requirements would be entitled to join a yet unspecified shock absorption mechanism. In simpler words, there would be more solidarity, but only for reformed countries. We clearly agree with that procedure. It is very close to our own proposals made a few months ago.<sup>7</sup> The reasoning is straightforward: Some kind of temporary stabilization mechanism is an economic necessity in a monetary union. But access to this mechanism should be subject to certain conditions in order to facilitate the political discussion about structural reforms and convergence. Such a quid-pro-quo would create new incentives for reform. It would also make stabilization mechanisms more acceptable, since the overall resilience of the euro area would increase and the fear that some countries would have to pay for the policy mistakes of others would diminish. However, a stabilisation mechanism would need to be specified at an early stage of the reform

6. Enderlein, Henrik, Joachim Fritz-Vannahme, and Jörg Haas, Repair and Prepare: Strengthening Europe's Economies after the Crisis, 2014. <http://www.delorsinstitut.de/wp/wp-content/uploads/2014/12/Pilot-Study-Repair-and-Prepare.pdf>.

7. Enderlein et al. 2014, op. cit.

process in order to serve as a useful incentive. The report recognizes this and suggests asking an expert group to discuss details such as mechanics, or scope.

Efforts to limit future imbalances also play a central role in other proposals on “economic union.” Plans to introduce a “euro area system of competitiveness authorities” address the divergence of labour costs in the run-up to the crisis, as well as the need for symmetrical adjustment. Newly created competitiveness authorities would meet regularly with the Commission in order to exchange views on the evolution of wages and advise the domestic level accordingly. What we still fail to understand, however, is how meaningful coordination could occur without infringing upon wage-setting autonomy, which often lies not even at the national level, but in the hands of employers and employees. Since the Commission could thus be unable to make sure its preferences can be taken up, the new competitiveness system would operate under the risk of becoming a tiger without teeth. The workaround proposed by the Five Presidents’ Report is to sanction deviant behaviour through the MIP if there is dissatisfaction with the outcome of the consultations. While we think it is a good idea to link the MIP to structural reforms and the broader conduct of economic policies, there certainly is still work to be done to make clear what kind of policy targets should be met by governments, and how and under which conditions sanctions would be applied.

In this context, the report’s ideas for improving the effectiveness of the MIP are not revolutionary, but generally point in the right direction. Using the MIP to monitor reform implementation would make it the structural convergence counterpart to the Stability and Growth Pact. Ultimately, however, the procedure can only hope to have an impact on Member States’ policies if the corrective arm is smartly applied and in the necessary cases actually used. The authors acknowledge this, but cannot offer any solutions since the Commission already has all the necessary powers – it just does not exercise them.

## 2. Financial Union

### BOX 3 ► Key proposals of the report:

- Stage 1: Stronger Single Resolution Fund (SRF), supported by bridge financing and a credible backstop
- Stage 1: European Deposit Insurance Scheme to reduce fragmentation and break the vicious circle between banks and sovereigns
- Stage 1: Capital Markets Union to improve private risk-sharing.

**“ THE REPORT ENCOMPASSES TWO MAJOR CHANGES TO THE BANKING UNION’S CURRENT SETUP THAT ARE HIGHLY SIGNIFICANT AND HIGHLY CONTROVERSIAL ”**

The section on “financial union” is the report’s greatest strength. The authors could have chosen to take the easy way by relying on the Commission’s “Capital Markets Union” initiative in this field and leaving the difficult parts for later. Instead, the report envisages a completion of the Banking Union as part of the first stage, to be implemented in less than two years. This is a very ambitious target. It encompasses two major changes to the Banking Union’s current setup that are highly significant – and highly controversial.

The first element is a fiscal backstop to the Single Resolution Fund (SRF), which is supposed to provide money in case a bank needs to be restructured. This has long been demanded by many scholars<sup>8</sup>. At a size of about 55 billion EUR (1% of covered deposits), the SRF as it is currently planned will be small compared to European banks’ balance sheets (and will be even smaller during the build-up phase, i.e., until 2024). It relies heavily on

8. E.g., Schoemaker, Dirk. 2014. “On the Need for a Fiscal Backstop to the Banking System”. DSF Policy Paper Series, No. 44. <http://www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-44-On-the-need-for-a-fiscal-backstop-to-the-banking-system.pdf>.

rules that foresee the “bail-in” of shareholders and creditors, thus minimising the need for external financing. In a full-blown crisis, the fund may seem too small to prevent markets from panicking. The Five Presidents propose a credit line from the European Stability Mechanism (ESM) to the SRF. This fiscal backstop would express the euro area’s commitment to preventing a systemic crisis while not falling back into a “diabolical loop” in which individual member states put their public finances at risk by spending large sums to rescue their banks. The fiscal backstop would acknowledge a common responsibility for the European banking system, an important signal to markets and to the public. Euro area member states would have an incentive to focus less on the well-being of national banks but on that of all European banks.

The second element in a completed Banking Union is a European Deposit Insurance Scheme (EDIS), which would go beyond harmonising national schemes, as the Banking Union currently does, by merging – or re-insuring – them at the European level. An EDIS would provide an enormous boost to the stability of EMU in times of crisis since the safety of deposits would no longer depend on the health of the national banking system. Capital flight and the fragmentation of the financial system would be limited and the effectiveness of monetary policy strengthened. The idea was part of the original negotiations on Banking Union in 2012 but was ultimately dropped due to strong resistance from countries such as Germany. The fear was that solid, “Northern” systems would be made to pay for irresponsible lending in the “South”. Indeed, several German banks condemned the proposal immediately after the publication of the Five Presidents’ Report. One has to acknowledge that this part of the Report is controversial – in particular from a German perspective. However, the risk to continue with a banking union that does not have some kind of deposit insurance or re-insurance is simply too big. The creation of the Federal Deposit Insurance Corporation in the US was a breakthrough moment in the creation of a fiscal federation. So the Five Presidents’ Report is right in putting that issue on the agenda. There needs to be a solution beyond emergency liquidity provision from the ECB or bank recapitalization programs from the ESM to deal with bank deposits in a monetary union.

“ A BACKSTOP FOR THE SRF AND A EUROPEAN DEPOSIT INSURANCE SCHEME WOULD BE AN ENORMOUS STEP TOWARDS BETTER PRIVATE RISK-SHARING ”

Jointly, a backstop for the SRF and a European deposit insurance scheme would be an enormous step towards better private risk-sharing in the euro area. This is even more the case if the two measures are combined with a push for the capital markets union (also scheduled to be implemented before 2017) that is already on the Commission’s agenda. The ideas as such are not new, but the proposals are significant, specific and fitted with a negotiation deadline. We do not think that a financial union alone is sufficient for a strong EMU. Yet it could make a difference if Europe faces a new crisis before it has managed to build a resilient economic and political framework for EMU.

### 3. Fiscal Union

#### BOX 4 ► Key proposals of the report:

- Stage 1: Advisory European Fiscal Board to assess how budgets perform in view of the European fiscal governance framework
- Stage 2: "Fiscal stabilisation function" for the euro area to cushion large macroeconomic shocks. Details to be developed by expert group.

The section on fiscal union is less ambitious. Ensuring an "appropriate fiscal stance at the level of the euro area as a whole" is identified as a target<sup>9</sup>, but the report does not mention any specific measures to achieve it. One of the two key proposals, a European Fiscal Board that assesses countries' budget execution is probably based on the consideration that a more institutionally and politically independent economic assessment should be conducted to assess member states' fiscal policies. While we see the need for discretion, we think that Board might actually be somewhat redundant. It is supposed to fulfil tasks very similar to those of the European Commission itself, but would play a mere advisory role, lacking the Commission's tools of enforcement. That proposal creates the impression that the Commission would like to make voices heard that within the Commission do not get sufficient attention. Quite remarkably, the Fiscal Board is supposed to "form an economic, rather than a legal, judgement", but would be required to do so "on the basis of the Stability and Growth Pact (SGP),"<sup>10</sup> which is a legal document. We understand all this as a political proposal to pave the way for more open-minded discussions on the conduct of fiscal policies, in particular after the recent interpretation by the Commission of the Stability and Growth Pact<sup>11</sup>, but we think further work is needed to get there.

The second proposal in this section is the above-mentioned call for a fiscal stabilisation mechanism as part of stage two. The proposal here follows very closely the assessment of the 2012 Four Presidents' Report.<sup>12</sup> But it adds the above-mentioned link between accession and compliance with the convergence targets. We think this is the right approach - it actually corresponds to our own proposals<sup>13</sup>. However, the overall outline on fiscal stabilization and conditions to have access to it still very vague, even considering how controversial the topic is.

**“THERE IS AN  
OMNIPRESENT ABSENCE OF  
THE NECESSARY REFORMS  
OF THE EUROPEAN STABILITY  
MECHANISM”**

Finally, there is an omnipresent absence in that section of the necessary reforms of the European Stability Mechanism (ESM). We believe the ESM should continue to be changed into a vehicle much closer to a genuine European Monetary Fund under appropriate democratic control - as will also be argued in the next section. We understand why changes to the ESM are not discussed: it is politically and legally difficult to do so. But at the same time, and perhaps more importantly, a fresh look at the ESM would have given rise to a discussion on a European insolvency regime and measures to contain the damage in the case of a sovereign default in the euro area. This discussion is almost completely absent from the report. Large exposure limits for sovereign debt are mentioned briefly, but the matter is then sidelined as a problem that requires a "coordinated effort at the global level"<sup>14</sup>. For obvious reasons, a short-term discussion on dealing with sovereign debt restructurings in the euro-area could be counter-productive, but thinking about how the excessive debt in the euro-area can be brought under control and how the ESM could play a role in this respect could have been helpful in the report."

9. Juncker et al 2015, op. cit., p. 14.

10. Juncker et al 2015, op. cit., p. 9.

11. European Commission, Making the Best Use of the Flexibility within the Existing Rules of the Stability and Growth Pact. Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank, 13 January 2015. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015DC0012>.

12. Van Rompuy et al., 2012, op. cit.

13. Enderlein et al. 2014, op. cit.

14. Juncker et al. 2015, op. cit., p. 12.

## 4. Political Union

### BOX 5 ► Key proposals of the report:

- Stage 1: Better parliamentary oversight through more dialogue between the parliaments and Commission and Council; a euro area sub-committee in the European Parliament
- Stage 1: Unified euro area representation in international financial institutions (e.g., IMF)
- Stage 1 and 2: Integration of intergovernmental arrangements (Fiscal Compact/TSCG, Euro Plus Pact, Single Resolution Fund, European Stability Mechanism) into the EU legal framework
- Stage 2: Strengthened euro area agency: Full-time presidency of the Eurogroup, euro area treasury.

In the section on “democratic accountability, legitimacy and institutional strengthening”, or political union, the report assembles a long list of diverse proposals of widely varying significance. The proposals on parliamentary oversight are very specific, probably reflecting the involvement of Martin Schulz, the president of the European Parliament, as one of the report’s authors. The report quite specifically proposes measures to balance further increases in surveillance with adequate checks and balances. However, these suggestions are limited to rather technical aspects of economic governance. The “elephant in the room” is the lack of suggestions on governance and accountability of the European Stability Mechanism and the institutions formerly known as the Troika, even though this is a much more salient topic for most European citizens than the European Semester. The report does include a proposal to integrate the ESM within the EU Treaties in stage two, but only mentions legal efficiency, not accountability, as the rationale and possible objective of such a move.

Generally, the report is right to propose integrating any intergovernmental treaties that concern euro area governance into EU law. Aiming at doing so before 2017 seems quite ambitious, however, even if the current Treaties foresee integration in the near future (e.g., Art. 16 TSCG).

“SOME OF THE INSTITUTIONAL PROPOSALS LOOK APPEALING, BUT COULD BENEFIT FROM FURTHER SUBSTANTIATION”

Some of the institutional proposals look appealing, but could benefit from further substantiation. The plans for a full-time president of the Eurogroup and a euro area treasury remain vague, but would need to be spelled out to be fully convincing. At what point would these new actors and institutions be needed? Why? What is the relationship between a fiscal stabilisation function and a euro area treasury?



## CONCLUSION

**I**f you can't agree on substance, get the process right. This is the logic of the Five Presidents' Report. And it is the right logic.

Compared to the 2012 Four Presidents' Report, the document contains few entirely new insights, but it offers a clear timeline and several priorities for the discussion.

Putting the emphasis on a completion of banking and financial union, then proceeding with less haste but with a clear roadmap in the area of economic convergence seems very sensible. Financial stability is crucial. And convergence is an economic and political cornerstone of a deepened EMU. Since there is no consensus yet on specific convergence indicators, the report is right to at least name a formalised convergence process as a priority while detailed options are being worked out.

Mandating an expert group is a very good proposal, given the political timetable. It is unlikely that the political deadlock can be solved in the two years before the British referendum and the 2017 elections in France and Germany. Such a group could provide detailed assessment of some of the proposals, clarify technical aspects and make specific recommendations. It could thus prepare the ground for a political agreement on the future of EMU. The stronger and the more prominent such a group, the greater its potential impact on the process. We disagree with the argument that expert committees are an instrument to kill a project. Europe has seen extremely influential expert groups that did well because they used their independence to successfully trigger urgently needed political debate within and among the member states.

**“THE FIVE PRESIDENTS' REPORT CAN PROVE A USEFUL GUIDE FOR THE REFORM PROCESS”**

Overall, the Five Presidents' Report can prove a useful guide for the reform process: Its roadmap is sound. Its reform proposals for the immediate future are sufficiently ambitious considering the political environment. Perhaps, the configuration of a Three Presidents' Report would have facilitated the exercise, authored only by those three Presidents that represent the narrowly defined EU-level perspective (Draghi, Juncker, and Schulz, by contrast to the more inter-governmental perspective of Dijsselbloem and Tusk). Member States should not be blamed for defending their interests. But why not start with a definition of how to maximize the interest of the EU as a whole, and then discuss with Member States as a second step?

We recently argued: “EMU in its current institutional set-up is not viable in the long run”<sup>15</sup>. If we are right, then the Five Presidents' Report is the ideal starting point for an overhaul of EMU.

15. Enderlein et al. 2014, op. cit., p. 11.

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Yves Bertoncini, Henrik Enderlein, Sofia Fernandes, Jörg Haas and Eulalia Rubio, Policy paper No 122, Jacques Delors Institute, June 2015

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