

The 5 Presidents Report: a milestone for enhancing the Euro governance

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A second turn of screw to the Eurozone to get ready for 2025

The European Council today discussed a report on “[Completing Europe’s Economic and Monetary Union](#)” prepared by the Presidents of the European Commission, the Euro Summit, the Eurogroup, the Parliament and the ECB. This milestone towards more integrated Eurozone governance builds on the 2012 [Four Presidents Report](#) and outlines the roadmap towards a financial, fiscal, economic and political union. It presents a two-staged approach: until 2017, it focuses on completing the banking union, working under the existing legal framework. In a second stage (2017 to 2025), it brings forward a more far-reaching transformation of the EMU architecture. The Commission announced after the [European Council](#) meeting that further details on the stages to be followed will be provided in the following weeks. The White Paper that will be published in 2017 represents the next key step, as it will define the action in the second stage more clearly. The ultimate goal is to have in place a genuine EMU by 2025.

The outbreak of the financial crisis showed that the construction of the European Economic and Monetary Union (EMU) was flawed. After it was made clear that coordination was not sufficient to sustain the monetary union, the European Council announced in 2012 a plan to construct a stronger, more integrated Europe, encompassing a banking union, a fiscal union and an economic union, all of them underpinned by stronger democratic legitimacy, as the way to get out of the crisis.

The EU strategy to advance towards more integration was established in a report, "Towards a Genuine Economic and Monetary Union" first presented in June 2012 and finally endorsed by the European Council in December that year. The report (known as the “Four Presidents’ Report”) was produced by the President of the European Council, Herman Van Rompuy, in collaboration with the Presidents of the ECB, the Commission and the Eurogroup.

Three years later, the European institutions are reviving the integration thrive. After the October 2014 Euro Summit opened the floor, the mandate to the Four Presidents was endorsed by the European Council on 18th December. The outcome is the new report on “Completing Europe’s Economic and Monetary Union” or the “Five Presidents Report”, due to the additional participation of the European Parliament President this time. The report was released on 22nd June and subject to discussion at the European Council on 26th June.

The Five Presidents Report: New push for further integration in two stages

The report takes stock of the work undertaken since its antecessor and brings forward measures towards enhanced European integration. The proposal follows a two-staged approach: i) from 2015 to June 2017, progress will happen under the current framework and will focus on completing the banking union; and ii) from 2017 to 2025, the 5 Presidents envisage a deeper transformation of the EMU architecture. The EU institutions have postponed any reform of the EU Treaties after the UK holds its referendum, scheduled for end-2017. Ahead of the second stage, the Commission will elaborate a White Paper with a detailed roadmap and an overview of the legislative action to be pursued. The end of the road is to have in place a genuine and deep EMU by 2025 at the latest.

Figure 1

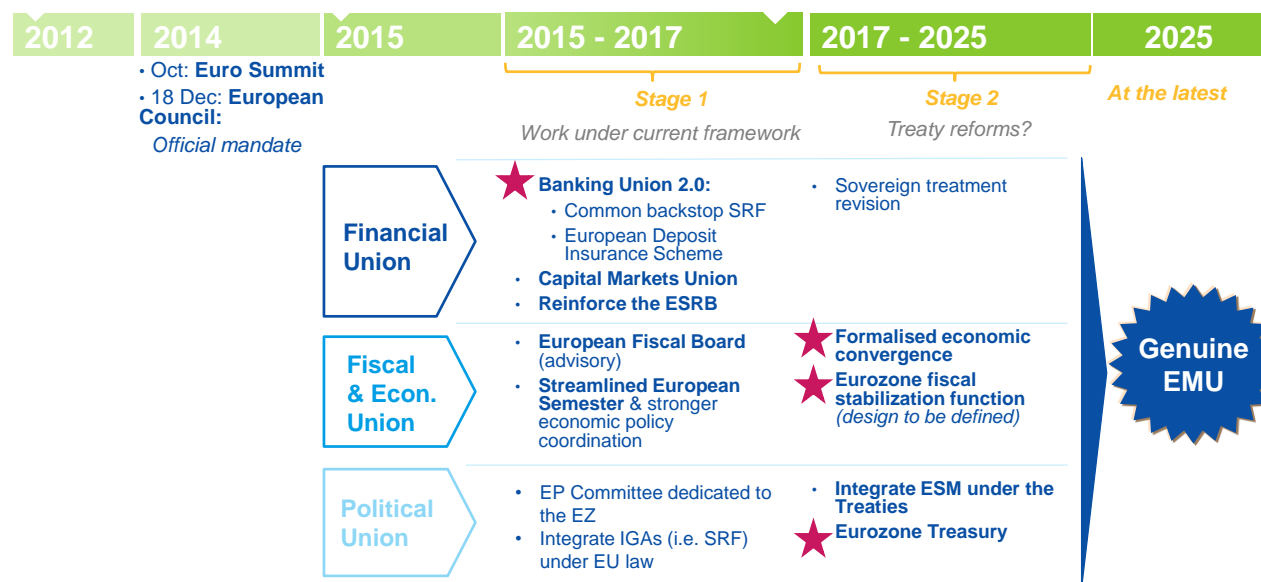
A 10 years journey towards a genuine EMU by 2025

Four Presidents report

Towards a Genuine Economic and Monetary Union

EC White Paper

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Source: BBVA Research

Financial Union

The new label “Financial Union” broadens this first building block to encompass the new capital markets union flagship, yet the immediate priority is to complete the banking union by 2017. The existing banking union 1.0 embodies the greatest transfer of sovereignty since the creation of the euro and Member States can reap important benefits from it. However, it must be completed with a single deposit guarantee scheme and a common public backstop to the new Single Resolution Fund (SRF). The current absence of these elements could end up undermining the credibility of both the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), and therefore they are essential to ensure a fully stable banking union of second generation, in line with what we already highlighted in a recent [BBVA Research Watch](#) on completing banking union. It is worth noting that these two elements are not in place due to a lack of political willingness driven by their link with fiscal union. It was possible to launch a banking union 1.0 without these elements, although it must be borne in mind that it remains incomplete.

Notwithstanding, completing the banking union requires first and foremost that Member States fully transpose the BRRD into their national frameworks and that the ratification process of the intergovernmental agreement on the SRF is completed before it becomes operational on 1st January 2016. In addition, the report also asks for a bridge financing mechanism for the Fund before that date.

Apart from this immediate action, the report proposes taking the following steps before 2017:

- **Setting up a credible common backstop for the SRF**, to be financed by banks’ ex post contributions to ensure that it is fiscally neutral in the long term. It could be designed as a credit line from the European Stability Mechanism (ESM) to the SRF, just as the FDIC has a line from the US Treasury.
- **Launching a common European Deposit Insurance Scheme (EDIS)**. The report acknowledges that a fully-fledged EDIS cannot be achieved overnight, but it is vital to take concrete steps in the right direction already in the first stage. Working under the existing Treaties, EDIS would be designed as a re-insurance system for national schemes at European level, to be funded by ex-ante contributions of

banks under the SSM scope. Having said that, it remains unclear whether this implies a truly new European scheme or just a formalization of the voluntary loans among national schemes (See [BBVA Research Flash](#) on the DGS Directive). The existing framework with national schemes remains vulnerable to large crisis, and therefore, a truly European Deposit Insurance Scheme is preferred, as it increases the resilience of the Eurozone. In addition, an EDIS is more likely to be fiscally neutral in the long run, as it provides for greater risk-sharing among a larger number of financial institutions and countries.

- **Reviewing the ESM's direct recapitalisation instrument** by relaxing the eligibility criteria, thus contributing to break the sovereign-bank doom loop (More information on the ESM direct recapitalisation tool in the December 2014 [Financial Regulation Outlook](#))
- **Ensuring a level playing field for all Eurozone banks.** With that aim, the 5 Presidents suggest ensuring a consistent implementation of the single rulebook, reducing the margin for national discretion and working towards more harmonised legislative and institutional frameworks.

In line with ongoing work at international level, the report also urges to monitor the shadow banking sector and pay attention to evolving risks. To this end, it envisages strengthening Europe's macroprudential authorities, including by reinforcing the powers of the European Systemic Risk Board (ESRB) and enhancing the macroprudential toolkit.

Complementing these efforts, the report acknowledges the potential of the capital markets union initiative as a driver of European integration, as it can contribute positively to deepen the Single Market. Both projects, banking union and the capital markets union are different in nature and scope, but mutually reinforcing in that they take the Economic and Monetary Union further. The report includes few details on this initiative, although a comprehensive roadmap is expected in the Commission's action plan to be released in September 2015. However, it must be borne in mind that it is essentially a long-term project, and therefore it will take time until tangible results materialize.

In the medium term, the report also considers a potential revision of the sovereign exposures treatment that would set a large exposure limit. Before conducting this exercise, Europe should wait until the Basel Committee finalises its revision at a global level.

Fiscal Union

In the first stage, the report emphasises the importance of national budgetary policies (based on Two-Pack, Six-Pack and the Fiscal Compact) that are able to guarantee the debt sustainability and the effectiveness of the fiscal automatic stabilisers in case of shocks. It also aims at maintaining an appropriate fiscal stance at the level of the euro area as a whole, avoiding pro-cyclical policies. In this regard, the positive news is the creation of an advisory European Fiscal Board to coordinate and complement the national fiscal councils and provide a public and independent assessment, at European level, of how budgets perform. It will be important to know to what extent this body has real powers and influence on the stance of fiscal policies, or remains an advisory body with small impact on the debate.

In the second stage, the document focuses on designing a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone, though the plan is currently rather hazy. The core principles of the function suggest that it should: i) not be a way to equalise incomes between Member States; ii) prevent moral hazard; iii) be consistent with the existing EU fiscal framework and iv) not be an instrument for crisis management. These principles make sense, although the last one raises the point of what fiscal instruments are projected for situations of deep crisis such as the one of recent years.

Economic Union

The main goal pictured in the short term is to gain a renewed impetus to convergence, jobs and economic growth, basing the efforts on four main pillars:

1. The creation of a euro area system of Competitiveness Authorities that would coordinate the actions of national Competitiveness Authorities which would be in charge of tracking performance and policies in the field of competitiveness. The Commission should then take into account the outcome of this coordination when it decides on steps under the European Semester.
2. A stronger Macroeconomic Imbalance Procedure should encourage structural reforms and better capture imbalances for the euro area as a whole.
3. A firmer focus on employment and social performance.
4. A stronger coordination of economic policies in order to give Member States concrete and ambitious recommendations, hold Member States accountable for the delivery of their commitments with periodic reporting on implementation, and establish a clear long-term vision.

As for the long term, the report emphasises the need of formalising the convergence process, agreeing on a set of common high-level standards that would focus primarily on labour markets, competitiveness, business environment, tax policy and public administrations; significant and sustained convergence towards similarly resilient economies should be a condition for access to a shock absorption mechanism.

Political Union

The process towards more integration in the Eurozone should be underpinned by enhanced democratic legitimacy and accountability, and requires further transfers of sovereignty from national to European level. These principles should be a constant along the process and once the genuine EMU is achieved. In the short run, the report identifies a number of priorities, starting by guaranteeing that the views of the European and National Parliaments are sufficiently taken into account, and improving coordination among them. A Eurozone-dedicated Committee in the European Parliament is considered as well. In addition, the report also takes stock of the fact that Europe has often acted with urgency during the crisis, building Europe out of the treaties. Now the time has come to integrate under the *acquis communautaire* all the new instruments, including the Treaty on Stability, Coordination and Governance, the Euro Plus Pact and the intergovernmental agreement on the SRF.

In the medium term, the ESM should be fully integrated within the EU Treaties, so as to reconcile the no bail-out clause to governments with the existence of an institution like the ESM, which is essentially aimed at offering financial assistance to governments. In addition, the presidency of the Eurogroup should be made permanent. The European Parliament, in its report adopted last 24 June, goes beyond this proposal and even suggests that this role should be assumed by the Commissioner for Economic Affairs. Finally, a Eurozone Treasury would be set up to coordinate the elaboration of collective fiscal policies, although full centralisation is not envisaged.

The divergence of approaches casts doubts on the final outcome

The report discussed today at the European Council intends to follow the roadmap already initiated in 2012. Yet, once again, the final outcome will depend on a number of factors and will require high doses of political willingness, which are yet to be seen given the different approaches and levels of ambitions shown by European institutions and Member States during the preparatory discussions. The final version of the report that has been made public lays half-way between Member States' contrasting stands.

France and Germany's joint contribution to the governance debate proposes working under the current Treaties and leaves the fiscal union project aside. On the financial union, these countries have called for further efforts to complete the banking union, especially concerning the rules on banking resolution and a

common safety net, yet with no reference to establishing a credible common backstop for the Single Resolution Fund. On the contrary, the Italian and Spanish contributions are far more ambitious and represent a closer follow-up to the 2012 Four Presidents Report. Their proposals would require reforming the Treaties, further transfers of sovereignty and possible reforms on the institutional framework (in the case of the Spanish proposal). In the short term, both countries aim to complete the Banking Union framework with a common public backstop for the Single Resolution Fund, a single deposit insurance scheme and the integration of the retail banking sector. In the medium to long term, they propose a fiscal union for Europe, which under the Spanish proposal would be built on three pillars: transfer of sovereignty of tax and budget competences to the EU level, a Eurozone budget and common debt instruments.

Assessment

- **The report includes much, although not all, of the necessary work towards enhanced Eurozone governance.** It is a good follow-up of the 2012 Four Presidents Report and the work undertaken since, and constitutes a crucial step in the right direction as it lays out the roadmap towards more integration on the financial, fiscal economic and political grounds.
- **Despite an overall positive assessment, the report sometimes remains elusive on the details and the calendar.** This is particularly noticeable in three aspects: i) the willingness to reform the EU Treaties, ii) the exact design of the EDIS in the first stage and whether further work will follow after 2017 and iii) the precise construction of the fiscal stabilisation function and the Eurozone Treasury.
- **Reforming the EU Treaties will be difficult, but it is an unavoidable step to achieve a genuine EMU** with full financial, fiscal and political unions. Since designing such a reform will prove to be challenging and time-consuming, it is essential to start working on it as soon as possible.
- **Financial union is the block where faster and deeper progress can be expected.** The renewed commitment to complete the banking union is timely and welcome, and it represents a great leap forward to ensure the credibility of the Euro and break the doom loop between banks and sovereigns. Although the common deposit insurance - the third pillar of a fully-fledged banking union alongside bank supervision and resolution - appears as a short term objective, a fully-fledged EDIS will take time.
- **A major shortcoming of the report is the lack of initiative or even debate on what has been understood in the recent past as the main next steps of a fiscal union: debt mutualisation,** probably linked to a higher degree of cession of fiscal powers to the European level. Though the momentum for major reforms in this area probably is not there, given the reform and crisis fatigue from recent months and years, this should be a good point to at least discussing the issue. Ideas such as eurobills, and the debt redemption fund, deserve at the very least to be debated. The [Comission's 2011 document](#) had useful ideas and proposals in this respect, as well as the [Tumpel-Gugerell](#) task force.
- **More coordination on economic union is welcome.** This is an area were the disparity of policies at European level is very large. Probably a more specific calendar aiming at improving coordination would be appreciated.
- **Member States have shown different views and levels of ambition and this could end up being an obstacle in the journey towards a genuine EMU.** The approach presented by the 5 Presidents implies shifting from a system of rules to a system of common institutions and policy-making. This requires Member States to accept further transfers of sovereignty on key issues like fiscal and economic policies, which they might be reluctant to. In fact, during the preparatory discussions southern countries like Spain and Italy have tabled considerably more ambitious proposals than France and Germany. In addition, the UK referendum to be held in 2017 will be a key stop along the way, as the result could open the door for a change in the EU Treaties.

Box 1. The 2012 “Four Presidents’ Report” towards a Genuine Economic and Monetary Union

The 2012 Four Presidents Report envisaged the creation of a banking union, a fiscal union and an economic union, all of them underpinned by stronger democratic legitimacy, as the way to get out of the crisis by building a stronger, more integrated Europe.

Building block 1. Banking union: The European Council foresaw agreement on the main legislations of the single rulebook (CRDIV-CRR package, Bank Recovery and Resolution Directive and the Directive on Deposit Guarantee Schemes) and the operational rules for the direct recapitalisation of banks by the European Stability Mechanism (ESM) by 2013, as well as the establishment of the Single Supervisory Mechanism (SSM). According to the text, a single resolution authority and a Single Resolution Fund – SRF – should be set up in 2014, with the same scope than the SSM. The ESM would be able to provide a credit line to the single resolution authority as a public, but fiscally neutral, backstop. The first version of the Report presented in June 2012 also envisaged a Single Deposit Guarantee Scheme. However, the December version dropped this proposal and only called for a quick adoption of the new (harmonising) Deposit Guarantee Scheme (DGS) Directive.

Building blocks 2 and 3. Economic and fiscal unions: The report foresaw that the “Two Pack” and the “Six Pack”, as well as a framework for ex-ante coordination of economic policies, should be implemented before 2014. In a second stage, the economic coordination of structural reforms should be reinforced by giving the arrangements a mandatory contractual nature for all euro area countries. These contractual arrangements would be supported with temporary financial assistance, using funds independent from the multiannual financial framework. At a final third stage, after 2014, the text foresees giving the EMU a formal fiscal capacity through a centralised shock-absorbing fund (“euro area budget”) and common decision-making powers on economic policy issues.

Building block 4. Political union: The Report of the Four Presidents concluded that all these three building blocks would have to be accompanied by stronger legitimacy and accountability at the level at which the decisions are to be taken. With regard to financial integration, as policy-making will gather mostly at the European level, the parallel involvement of the European Parliament would have to be increased. With regard to the fiscal and economic integration blocks, appropriate mechanisms will be established for close cooperation between the national Parliaments and the European Parliament.

Figure 1
The 2012 Four Presidents Report and progress since

	Proposals	Status
Banking Union	Single rulebook	✓
	Single Supervision	✓
	Single Resolution	✓
	Single DGS	Pending
Fiscal & Econ. Union	Two-pack, six-pack	✓
	Structural reforms	✓
	Common shock-absorbing fund	Pending
	Centralized econ. & fiscal competences	Pending
Political Union	Full integration	Pending

Source: BBVA Research

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