**European Economic Governance**
**- A Franco-German paper -**

Over the past few **months**, Europe has demonstrated unwavering commitment to the stability, unity and integrity of the eurozone.

We have not only designed arrangements that ensure eurozone financial stability; we have also been working to provide effective EU economic governance, based on learning from the deep crisis we faced, as agreed by the French President and the German Chancellor on June 14th 2010 in Berlin.

It is our resolve and our duty to take action and to make specific, detailed proposals that translate our commitment into credible, effective changes as to how we manage our economic policies together. We must move swiftly yet operationnally, leveraging all options offered under the existing treaties to cement the financial stability of our Union with a view to delivering better value and more jobs. For this reason, France and Germany are jointly committed to propose for Europe the means to achieve its ambitions.

A single currency simply cannot work properly without enhanced economic policy coordination. The coordination and surveillance instruments available to us – the stability and convergence programmes and the Broad Economic Policy Guidelines, along with competitiveness reviews and financial stability analyses – need to be interlinked more effectively while remaining formally separate. Together with Europe 2020, they must provide **the foundations for a genuine European economic strategy that generates growth and jobs.**

The European Commission’s proposals represent on the whole a step in the right direction. On June 17th, the European Council validated the guidelines developed by the working group as presented by President van Rompuy. Based on those guidelines, France and Germany hereby intend to put forward specific, operational proposals. The key issue is to make major progress in developing both the preventive (1) and (2) the corrective arms of the Stability and Growth Pact. Building on our experience, we should also establish a credible crisis resolution framework.

1. **Strengthen multilateral budgetary surveillance to ensure that national budget plans are better coordinated with the Stability and Growth Pact**

    - **Economic policies should be coordinated to a greater extent in advance, yet without encroaching on the budgetary prerogatives of national parliaments.**
        - **A "European Semester" should be organised** to enhance EU coordination, yet without encroaching on the budgetary prerogatives of national parliaments, which will continue to play the leading role in designing and controlling national budgets. The timetable should be flexible enough to take account of national budgetary procedures.

    - Member States would be expected to enact national laws that **formalise the public finance recovery path and set budget targets** that are consistent with the medium-term objectives in the Stability and Growth Pact.

    - **Far greater importance should be given to debt levels and trends as well as to the overall sustainability** of budgetary surveillance. For instance, desirable trends of debt reduction could be presented as an increasing function of the distance from the 60% threshold, applying therefore a supplementary debt reduction effort for high-debt countries as implemented in the determination of the MTOs.

    - **Surveillance should be extended to include competitiveness gaps, structural reforms <u>and private debt</u> in addition to financial stability.**
        - Establish **an effective EU competitiveness surveillance mechanism** underpinned by a set of objective indicators so that trends in competitiveness **<u>and private debt</u>** can be monitored accurately. The goal is to be able to detect as early as possible any unsustainable developments that could lead to systemic risk and take the steps required to overcome them. To be more specific, we need ways to identify and deal with Member States that are engaged in unsustainable macro-economic strategies in particular those that show poor competitiveness and finally endanger the smooth functioning of the monetary union. We must also be in a position to issue clear, binding recommendations ;

- Draw on the analyses of the future **European Systemic Risk Board** tasked with financial stability surveillance ;
- Draw on the analysis of a specially appointed group of independent experts ;
- Take more explicitly into account implicit liabilities (including structural reforms such as pension or health care reforms) when assessing the overall fiscal sustainability of a member State.

- **More extensive use of power to issue policy warnings and recommendations** to Member States whose policies are not consistent with the Broad Economic Policy Guidelines or risk jeopardising the proper functioning of the EMU as set forth in Article 121.4 of the Treaty should be made, preceded by a discussion within the Council.

- **We could make accounts and statistics more transparent and subject them to more effective controls** by approving the Commission's proposal to extend the audit powers of Eurostat, ensuring that all offices for statistics abide by professional standards of independence.

- The euro area Members' stability programmes could undergo more rigorous examination.

**2. Effective enforcement of economic surveillance through appropriate sanctions**

- We need to strengthen the credibility of the EU's fiscal surveillance through a rules-based application of sanctions. The sanctions shall rapidly be imposed on Member States that breach the Stability and Growth Pact (SGP, preventive and corrective arm).

- For the euro area Member States, an interest bearing deposit should be temporarily imposed to countries making insufficient progress with budgetary consolidation towards the MTO.

- The EU budget could work as complementary leverage to ensure compliance with the key macro economic conditions of the SGP. Sanctions should clearly distinguish between funds which are attributed to national budgets and those which are the consequences of an individual right under EU law. The sanctions should be proportionate to the extent of non compliance with the provisions of the SGP. They should relate to cohesion policy (structural and regional funds).

- Excessive Deficit Procedure, or even the introduction of sanctions for countries being repeatedly subject to an Excessive Deficit Procedure should be accelerated.

- **Political sanctions such as suspension of voting rights for Member States that materially and/or repeatedly fail to comply with joint commitments should be established.** The legal basis for imposing such penalties must be studied in depth. This mechanism would have to be included in any revision of the Treaty that may in future be agreed to.

- In the short term, a non-binding political alternative could take the form of a **political** accord that would enable Euro area Member States either to bar an offending Member State as described above from taking part in specific votes or even specific deliberations, or to make a political commitment to neutralise the effect of that Member's vote.

3. **In the medium term, establish a credible crisis resolution framework that respects the budgetary prerogatives of each Member State.**

Any resolution framework has to avoid moral hazard. Therefore, we have to improve incentives for countries to pursue solid fiscal policies, and for financial market participants to lend responsibly.

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Strengthening economic governance has become a crucial necessity. It requires **a cohesive, ambitious European economic strategy that fosters vigorous, sustainable, job-creating growth.**