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Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

**on enforcement measures to correct excessive macroeconomic imbalances in the euro
area**

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

The emergence of large macroeconomic imbalances, including wide and persistent divergences in competitiveness trends, proved highly damaging to the European Union, and in particular to the euro, when the crisis struck. In the years preceding the crisis, low financing costs fuelled misallocation of resources, often to less productive uses, feeding unsustainable levels of consumption, housing bubbles and accumulation of external and internal debt in some Member States. It is therefore important to develop a new structured procedure for prevention and correction of adverse macroeconomic imbalances in every Member State.

In its Communication and report on 'EMU@10: successes and challenges after 10 years of Economic and Monetary Union'¹ the Commission proposed a broad policy agenda with the aim of improving the functioning of the EMU. It stressed, in particular, the need to broaden economic surveillance in order to detect and address macroeconomic imbalances at an early stage. Enhanced surveillance was seen as particularly warranted in the areas of external competitiveness and current account balances, where noticeable divergences between Member States had emerged since the launch of the euro. In order to address these challenges, in July 2008 the Euro Group agreed to initiate a regular review of developments in competitiveness within the euro area that has been fruitful.

Europe 2020 sets out an ambitious and comprehensive strategy towards smart sustainable and inclusive growth for the EU economy. Against the background of the crisis it sets a new focus on addressing Europe's weaknesses in the surveillance of macro-financial and structural challenges. Taking account of the deep economic and financial inter-linkages within the euro area and their impact on the single currency, Europe 2020 calls for the development of a specific policy framework for the euro area to tackle broader macroeconomic imbalances². A mechanism embedded in legislation monitoring sources of macroeconomic imbalances and ensuring appropriate corrective action when necessary is required from that perspective. The necessary linkage between preventive and corrective action is crucial to avoid painful economic adjustment when imbalances grow out of control.

2. RESULTS OF CONSULTATIONS WITH INTERESTED PARTIES

Against the background of a crisis on an unprecedented scale and beyond the urgent action that was taken to deal with the immediate needs, the Commission reacted quickly with an ambitious yet realistic agenda of reforms. This took the form of two communications to the European Parliament and the Council, issued on 12 May and 30 June 2010 respectively. By choosing public legal documents as a channel of communication, the Commission was eager to demonstrate its commitment to dialogue with Member States, the European Parliament and all other stakeholders, while at the same time delivering practical proposals for action.

¹ European Economy No 2/2008, European Commission, DG Economic and Financial Affairs.

² The Commission made the case for deeper and broader economic coordination in the euro area repeatedly in the past, including in the 2009 Annual Statement on the Euro Area and the 2008 Communication on "EMU@10: successes and challenges after 10 years of Economic and Monetary Union".

In its Communication of 12 May 2010, the Commission set out a multi-pillar approach to reinforcing economic policy coordination. The communication stressed the case for making full use of the surveillance instruments available under the Treaty. Where necessary, existing instruments should be amended and supplemented. The communication called for reinforcing compliance with the Stability and Growth Pact and extending economic surveillance. To achieve this, establishment of a 'European semester' for economic policy coordination would allow Member States to benefit from early coordination at European level. Finally, the communication set out the principles that should underpin a robust framework for crisis management for euro-area Member States. Overall, most of the proposals applied to the EU as a whole, but euro-area issues would be approached by means of more demanding rules.

In the meantime, tensions on financial markets heightened and on 9 May 2010, based on a proposal from the Commission, an extraordinary Ecofin Council decided on establishment of a European stabilisation mechanism and agreed on a strong commitment to faster fiscal consolidation where warranted.

On 30 June 2010, the European Commission adopted an updated communication specifying in greater detail the principles for economic surveillance set out in the communication of 12 May. It focused on implementation and enforcement issues. It stressed that the EU needed stronger macro-economic country surveillance, integrating all relevant economic policy areas. Macroeconomic imbalances should be looked at jointly with fiscal policy and growth-enhancing reforms in the framework of Europe 2020. Enhanced surveillance was to be anchored in the concept of a 'European semester' and to be accompanied by an array of sanctions to prevent or correct excesses that could jeopardise the financial stability of the EU and the euro area. On the fiscal side, both the preventive and the corrective parts of the Stability and Growth Pact should be reinforced. A broad outline to address the macroeconomic imbalances between Member States was also presented.

The Commission contributed, in the form of the above-mentioned communications, to the work of the Task Force on economic governance chaired by the President of the European Council and established by the March European Council. The Task Force acknowledged that imbalances were a particular problem, especially for members of the euro area. The need for more thorough monitoring of macroeconomic developments by a small set of key indicators was recognised, in particular via a warning mechanism. Overall, it was agreed that macroeconomic surveillance should function alongside the budget surveillance under the Stability and Growth Pact.

The European Council followed closely the work of the Task Force. First orientations were contained in the conclusions of the 17 June European Council, which agreed on the development of a scoreboard for early detection of unsustainable or dangerous trends. The conclusions of the European Council of 16 September 2010 welcomed the development of a new macro-surveillance framework to monitor and correct unsustainable competitiveness divergences and imbalances in timely manner.

3. LEGAL ELEMENTS OF THE PROPOSAL

The fully fledged mechanism for the prevention and correction of macroeconomic imbalances is made up of two draft proposals for regulations. This first proposal sketches out the excessive imbalance procedure (EIP), while the second focuses on the associated enforcement measures. Both are described in succession in this explanatory memorandum.

This first proposal sets out to provide a framework for identifying and addressing macroeconomic imbalances, including deteriorating competitiveness trends. As such, it complements the macrostructural country surveillance process provided for under Europe 2020.

The EIP is a completely new element of the economic surveillance process. It comprises a regular assessment of risks of imbalances, including an alert mechanism, coupled with rules designed to allow corrective action in case of adverse macroeconomic imbalances extending beyond fiscal policy. The EIP applies to every Member State.

Surveillance starts with an alert mechanism that aims to identify Member States with potentially problematic levels of macroeconomic imbalances. The alert mechanism consists of a scoreboard (Article 3) backed up by judgmental analysis. The scoreboard is designed to be transparent, reasonably simple and underpinned by economic rationale. For that purpose, a set of indicators aims to ensure timely identification of imbalances emerging in different parts of the economy. The set of indicators should be broad enough to cover any possible case of major imbalance and to make sure that it is sufficiently sensitive to detect imbalances early on. The scoreboard will be made up of several indicators for each Member State.

Alert thresholds will be set and announced for each indicator to increase transparency and accountability. For some indicators, thresholds will be symmetric; they will detect both excessively high levels and excessively low levels of the variable. It is, however, important to bear in mind that indicators should not be regarded as either policy targets or policy instruments. For instance, a current account deficit of 3 % may be considered acceptable in a converging country with strong investment needs but not in a more advanced country with a rapidly ageing population. The thresholds should therefore be seen as indicative values to guide the assessment, but should not be interpreted in a mechanical way; they should be supplemented by economic judgment and country-specific expertise.

The Commission will release the indicators composing the scoreboard, their respective values and their associated underlying methodologies in a separate document in order to provide full transparency on the functioning of the alert mechanism. The composition of the scoreboard could evolve over time, in line with changing threats to macroeconomic stability or advances in data availability. Possible indicators would most likely include both external and internal ones. Measures of the external position (e.g. current accounts and external debt) and price or cost competitiveness (e.g. real effective exchange rates) would facilitate the detection of external imbalances. The use of internal indicators (e.g. private and public sector debt) is justified on the ground that external imbalances necessarily have internal counterparts. The monitoring of internal indicators can also be justified on its own sake on the ground that internal imbalances can have repercussions on other Member States, particularly via financial contagion. Combined, these indicators would cover much of the analytical needs for a preliminary assessment of possible imbalances.

The Commission will release the results of the scoreboard regularly and attach a Commission report putting into perspective any potentially conflicting signals from the various indicators on it (Article 4). On the basis of all available information, the Commission will compile a list of Member States deemed at risk of imbalances. Early discussion of this within the Council and the Euro Group will enable the Commission to obtain appropriate feedback from Member States and ensure the transparency of the Commission's deliberations. Following such discussions, for Member States where the alert mechanism indicates possible imbalances or a risk thereof, the Commission will provide country-specific in-depth reviews (Article 5). The

in-depth review will consist of a detailed investigation of the underlying problems in the Member State identified. The review may be undertaken, where needed, in conjunction with surveillance missions to the country concerned. Any early warnings or recommendations from the European Systemic Risk Board will be taken into account, along with the policy intentions of the Member State under review, as reflected in its Stability and Convergence Programme and National Reform Programme. As a result of this in-depth Commission analysis, three different outcomes are possible, as provided for in Articles 6 and 7:

- If the macroeconomic imbalances are considered unproblematic, the Commission will propose that no further steps are taken.
- If the Commission considers that macroeconomic imbalances (or a risk thereof) exist following the in-depth review, it will recommend to the Council to adopt the necessary preventive recommendations to the Member State concerned in accordance with Article 121(2) of the Treaty. Consistent with the Broad Economic Policy Guidelines and depending on the nature of the imbalance, the preventive recommendations may address challenges across a range of policy areas.
- If the in-depth review points to severe imbalances or imbalances that jeopardise the proper functioning of the Economic and Monetary Union in a specific Member State, the Council may, on a recommendation from the Commission, adopt recommendations in accordance with Article 121(4) of the Treaty declaring the existence of an excessive imbalance and recommending the Member State concerned to take corrective action within a specified deadline and to present its policy intentions in a corrective action plan. Member States with excessive imbalances within the meaning of the EIP would be subjected to stepped-up peer pressure. These ‘EIP recommendations’ should be made public; they should be more detailed and prescriptive than the ‘preventive’ recommendations provided for in Article 6. Depending on the nature of the imbalance, the policy prescriptions could potentially address fiscal, wage, macrostructural and macroprudential policy aspects under the control of government authorities.

Following the opening of an EIP, the Member State concerned will be under an obligation to adopt a corrective action plan within a specific timeframe, as provided for in Article 8, to set out a roadmap of implementing policy measures. The corrective action plan would confirm the determination of the Member State concerned to work towards resolving its imbalances. Within two months after submission of a corrective action plan and on the basis of a Commission report, the Council shall assess the corrective action plan. If considered sufficient, on the basis of a Commission proposal, the Council shall adopt an opinion, endorsing it. If the actions taken or envisaged in the corrective action plan or their timetable for implementation are considered insufficient to implement the recommendations, the Council shall, on the basis of a Commission proposal, invite the Member State to amend its corrective action plan within a new deadline. The flexibility embedded in the procedure should enable the Council to set the appropriate deadline when issuing EIP recommendations, taking into account the scale and urgency of imbalances and the capability of policies to address the situation. Unlike fiscal policy, not all policy levers are under the direct control of national governments when it comes to resolving imbalances. Furthermore, corrective policies may have a delayed impact on imbalances, depending on their nature. For instance, during the ten years preceding the crisis in 2008, the euro area experienced a steady divergence in the competitive position and the current account balances of its Member States. Correction of competitiveness and external imbalances requires significant changes in relative prices and costs and reallocation of demand and supply between the non-tradable sector and the export

sector. The economy of many euro-area Member States is shaped by a relatively high level of labour and product market rigidities which – in the absence of appropriate reforms – is likely to lengthen the period of adjustment. In all cases, the Commission will monitor implementation of corrective action by the Member States concerned, who have to submit regular progress reports, as provided for in Article 9. If economic circumstances change, the EIP recommendations may be amended on the basis of a Commission recommendation.

On the basis of a Commission recommendation, the Council will conclude whether or not the Member State concerned has taken the recommended corrective action. Article 10 sets out the conditions for this assessment. If the Council decides that the Member State concerned has taken appropriate action, the procedure will be placed in abeyance. Abeyance means that the Member State is making satisfactory progress with corrective action. However, due to the possibly long lags between adoption of corrective action and its effect on the ground, effective resolution of macroeconomic imbalances might take some time. The Member State concerned will be subject to periodic reporting and surveillance until the EIP is effectively closed.

Eventually, sustained and successful corrective action will help to resolve imbalances. As provided for in Article 11, the excessive imbalance procedure will be closed once the Council concludes, on the basis of a recommendation by the Commission, that the Member State is no longer experiencing excessive imbalances.

If the Member State concerned has not taken appropriate action, it will remain subject to the excessive imbalance procedure. The Council would have to adopt revised recommendations with a new deadline – likely to be shorter – for taking corrective action. For euro-area Member States the enforcement mechanism could ultimately lead to the sanctions described in the regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area. Furthermore, insufficient compliance with the recommendations based on the surveillance of imbalances could also be considered an aggravating factor in the assessment of the fiscal situation under the Stability and Growth Pact, creating self-reinforcing synergies between various policy strands at enforcement level.

The second proposal for a regulation addresses enforcement of measures to correct excessive macroeconomic imbalances. It accompanies this EIP regulation, focusing on enforcement for euro-area Member States. It specifies that if a Member State repeatedly fails to act on Council recommendations to address excessive macroeconomic imbalances, it will have to pay a yearly fine, until the Council establishes that corrective action has been taken. Repeated failure is defined as failure to address Council recommendations by the new deadline set in accordance with Article 10(4) of Regulation (...). Moreover, the Member State will also have to pay a yearly fine if it repeatedly fails to provide the Council and the Commission with a corrective action plan that is sufficient to address the recommendations of the Council. In this case, repeated failure is defined as failure to provide a sufficient corrective action plan by the new deadline set in accordance with Article 8(2) of Regulation (...). The yearly fine will give euro-area Member States the necessary incentive to address the recommendations or to draw up a sufficient corrective action plan even after the first fine has been paid.

To ensure equal treatment between Member States, the fine should, be identical for all euro-area Member States and equal to 0.1% of the GDP of the Member State concerned in the preceding year. As a rule, the Commission will propose the maximum amount of the fine provided for and this proposal will be considered adopted, unless the Council decides to the contrary by qualified majority within ten days of the Commission adopting its proposal. The

Council may amend the Commission proposal by acting unanimously, in accordance with Article 293(1) of the Treaty.

The Council may decide, on the basis of a Commission proposal, to cancel or to reduce the fine. The Commission could make a proposal to this end following assessment of a reasoned request by the Member State and this would reverse the burden of proof for application of the sanction. Furthermore, the Commission could also make a proposal to the same end on the basis of exceptional economic circumstances, as defined in the Stability and Growth Pact (SGP) (Regulation (EC) No 1467/97).

Council decisions concerning such fines will be made only by the members representing Member States whose currency is the euro. The vote of the member of the Council representing the Member State concerned by the decisions will not be taken into account.

The fines provided for in this proposal for a regulation constitute other revenue, as referred to in Article 311 of the Treaty. In line with the practice established in the corrective part of the SGP (Regulation (EC) No 1467/97), this revenue will be distributed between Member States whose currency is the euro and which are not involved in an excessive imbalance procedure within the meaning of Regulation (...), and not involved in an excessive deficit procedure within the meaning of Regulation (EC) No 1467/1997, in proportion to their share of the total GNI of the eligible Member States.

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THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 136, in combination with Article 121(6) thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national Parliaments,

Having regard to the opinion of the European Economic and Social Committee³,

Acting in accordance with the ordinary legislative procedure,

Whereas:

- (1) The coordination of the economic policies of the Member States within the Union, as provided for by the Treaty, should entail compliance with the guiding principles of stable prices, sound public finances and monetary conditions and a sustainable balance of payments.
- (2) There is a need to build upon the experience gained during the first decade of functioning of economic and monetary union.
- (3) In particular, surveillance of the economic policies of the Member States should be broadened beyond budgetary surveillance to prevent excessive macroeconomic imbalances and help the Member States affected devise corrective plans before divergences become entrenched. This broadening should go in step with deepening of fiscal surveillance.
- (4) To help address such imbalances, a procedure laid down in legislation is necessary.
- (5) It is appropriate to supplement the multilateral surveillance referred to in Article 121(3) and (4) of the Treaty with specific rules for detection, prevention and correction of macroeconomic imbalances. The procedure should be embedded in the annual multilateral surveillance cycle.
- (6) Enforcement of Regulation (EU) No [.../...] ⁴ should be strengthened by establishing fines for Member States whose currency is the euro in case of repetitive non-compliance with the recommendations to address excessive macroeconomic imbalances.

³ OJ C , , p .

- (7) Macroeconomic imbalances are likely to generate undue fluctuations in public revenues and spending throughout the economic cycle, affecting headline figures and distorting the picture for fiscal planning and decision-making. Inappropriate fiscal policy choices based on distorted trends could weaken, and possibly compromise, the sustainability of public finances. If unchecked, fiscal and other macroeconomic imbalances have the potential to reinforce each other and possibly to jeopardise the proper functioning of economic and monetary union. For these reasons a system of correction of macroeconomic imbalances should contribute to the budgetary discipline of the Member States whose currency is the euro.
- (8) Repeated failure to comply with Council recommendations to address excessive macroeconomic imbalances should, as a rule, be subject to a yearly fine, until the Council establishes that the Member State has taken corrective action to comply with its recommendations.
- (9) Moreover, repeated failure of the Member State to draw up a corrective action plan to address the Council recommendations should be equally subject to a yearly fine as a rule, until the Council establishes that the Member State has provided a corrective action plan that sufficiently addresses its recommendations.
- (10) To ensure equal treatment between Member States, the fine should be identical for all Member States whose currency is the euro and equal to 0.1% of the gross domestic product (GDP) of the Member State concerned in the preceding year.
- (11) The procedure for the application of the fines on the Member States which fail to take effective measures to correct macroeconomic imbalances should be construed in such a way that the application of the fine on those Member States would be the rule and not the exception.
- (12) The collected fines should be distributed between Member States whose currency is the euro which are neither the subject of an excessive imbalance procedure nor have an excessive deficit.
- (13) The power to adopt individual decisions for the application of the fine provided for in this Regulation should be conferred on the Council. As part of the coordination of the economic policies of the Member States conducted within the Council as specified in Article 121(1) of the Treaty, these individual decisions are an integral follow-up to the measures adopted by the Council in accordance with Article 121 of the Treaty and Regulation (EU) No [.../...].
- (14) Since this Regulation contains general rules for effective enforcement of Regulation (EU) No [.../...], it should be adopted in accordance with the ordinary legislative procedure referred to in Article 121(6) of the Treaty.
- (15) Since an effective framework for detection and prevention of macroeconomic imbalances cannot be sufficiently achieved by the Member States because of the deep trade and financial inter-linkages between Member States and the spillover effects of national economic policies on the Union and the euro area as a whole and can be better achieved at Union level, the Union may adopt measures in accordance with the principle of subsidiarity, as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in

⁴ OJ L [...], [...], [...]

the same Article, this Regulation does not go beyond what is necessary to achieve those objectives.

HAVE ADOPTED THIS REGULATION:

Article 1

Subject matter and scope

1. This Regulation sets out a system of fines for effective correction of macroeconomic imbalances in the euro area.
2. This Regulation shall apply to Member States whose currency is the euro.

Article 2

Definitions

For the purposes of this Regulation, the definitions set out in Article 2 of Regulation (EU) No [...] shall apply.

In addition, the following definition shall apply:

- ‘exceptional economic circumstances’ means circumstances where an excess of a government deficit over the reference value is considered exceptional within the meaning of the second indent of Article 126(2)(a) of the Treaty and as specified in Council Regulation (EC) No 1467/97⁵.

Article 3

Fines

1. A yearly fine shall be imposed by the Council, acting on a proposal by the Commission, if:
 - (1) two successive deadlines have been set in accordance with Articles 7(2) and 10(4) of Regulation (EU) No [.../...], and the Council thereafter concludes in accordance with Article 10(4) of that Regulation that the Member State concerned has still not taken the recommended corrective action, or if
 - (2) two successive deadlines have been set in accordance with Articles 8(1) and 8(2) of Regulation (EU) No [.../...], and the Council thereafter concludes in accordance with Article 8(2) of that Regulation that the Member State concerned has again submitted an insufficient corrective action plan.

The decision shall be deemed adopted by the Council unless it decides, by qualified majority, to reject the proposal within ten days the Commission adopting it. The Council may amend the proposal in accordance with Article 293(1) of the Treaty.

2. The yearly fine to be proposed by the Commission shall be 0.1% of the GDP of the Member State concerned in the preceding year.

⁵ OJ L 209, 2.8.1997, p. 6.

3. By derogation from paragraph 2, the Commission may, on grounds of exceptional economic circumstances or following a reasoned request by the Member State concerned addressed to the Commission within ten days of adoption of the Council conclusions referred to in paragraph 1, propose to reduce the amount of the fine or to cancel it.

4. If a Member State has paid a yearly fine for a given calendar year and the Council thereafter concludes, in accordance with Article 10(1) of Regulation (EU) No [.../...] that the Member State has taken the recommended corrective action in the course of the given year, the fine paid for the given year shall be returned to the Member State *pro rata temporis*.

Article 4

Distribution of the fines

Fines collected in accordance with Article 3 of this Regulation shall constitute other revenue, as referred to in Article 311 of the Treaty, and shall be distributed, in proportion to their share in the total gross national income (GNI) of the eligible Member States, between Member States whose currency is the euro and which are not the subject of an excessive imbalance procedure within the meaning of Regulation (EU) No [.../...] and do not have an excessive deficit as determined in accordance with Article 126(6) of the Treaty.

Article 5

Voting within the Council

For the measures referred to in Article 3, only members of the Council representing Member States whose currency is the euro shall vote and the Council shall act without taking into account the vote of the member of the Council representing the Member State concerned.

A qualified majority of the members of the Council mentioned in the previous paragraph shall be defined in accordance with Article 238(3)(a) of the Treaty.

Article 6

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in the Member States in accordance with the Treaties.

Done at Brussels,

For the European Parliament
The President

For the Council
The President