EUROPEAN CENTRAL BANK

EUROSYSTEM

10 June 2010

REINFORCING ECONOMIC GOVERNANCE IN THE EURO AREA

Executive Summary

This note sets out ECB proposals for (1) strengthening surveillance over budgetary policies and more effective prevention/correction of excessive deficits and debts; (2) an improved framework for competitiveness surveillance and the correction of economic imbalances and (3) the design of an appropriate euro area framework for crisis management. The proposals are meant to strengthen governance and enforcement structures in the economic policy framework of the euro area, and provide a permanent crisis management framework that safeguards financial stability in the euro area while minimising moral hazard. They require a quantum leap in terms of progress towards strengthening the institutional foundations of EMU, and thus towards a deeper economic union that is commensurate with the degree of economic integration and interdependency already achieved through monetary union. The proposals focus on the euro area, but could, selectively, also be applied to the EU-27.

I. Fiscal policy framework:

(1) Enhancing the euro area dimension *of fiscal policy surveillance by strengthening the ex ante discussions in the Eurogroup and making the Eurogroup the guardian of fiscal sustainability*

(2) Strengthening the implementation of rules and procedures *by (i) increasing the quasi-automaticity of the EDP procedures and steps and (ii) the quasi-automatic initiation of sanctions*

(3) Leaner and more effective fiscal surveillance *by (i) creating an independent EU fiscal agency; (ii) differentiating the surveillance processes applied to Member States according to their fiscal performance; (iii) assigning greater responsibilities to the Commission in making recommendations/proposals; (iv) measures to enhance the quality of statistics*

(4) Strengthening the implementation of sanctions in case of non-compliance *by (i) earlier application of sanctions or means to encourage compliance, already under the preventive arm, and in any case for excessive deficits; (ii) broadening the scope of application of sanctions, including for excessive debt ratios and in cases where progress towards the medium-term objective (MTO) is insufficient.*

(5) A wider spectrum of sanctions *by creating new types of (i) financial sanctions; (ii) non-financial sanctions (e.g. limitation or suspension of voting rights) or (iii) procedural sanctions (such as more stringent reporting requirements, monitoring missions, etc.)*

(6) Strengthening the independence of fiscal surveillance*, e.g. through the creation of an independent fiscal agency, preferably within the Commission, to monitor and assess the euro* *area countries' fiscal policies, without prejudice to the Commission's prerogatives in the formal policy-making process (related to warnings, recommendations and proposals).*

(7) ***Enhancing national fiscal frameworks****, by promoting a strengthening in national legislation of national fiscal rules and institutions consistent with the provisions of the EU fiscal framework, approved by national parliaments and monitored by independent national budget offices or fiscal institutions.*

II. Competitiveness framework

(1) ***Differentiated surveillance*** *with light surveillance for well-performing countries and tighter surveillance for those with "excessive vulnerabilities", implying for the latter increasing intrusiveness of (i) reporting/missions, (ii) policy recommendations, (iii) compliance requirements, and (iv) public peer pressure, (v) graduated financial steps to encourage compliance.*

(2) ***Introduction of a transparent and effective trigger mechanism*** *to determine the intensity of vulnerabilities and surveillance, based on nominal competitiveness measures and other supporting indicators relating to the private and public sectors.*

III. Crisis management framework

Strengthened fiscal and competitiveness surveillance along the lines proposed above is the appropriate instrument to minimise the risk of recurrent fiscal crises of the magnitude seen at present. If the new framework in place can effectively check deviating behaviours in fiscal and macroeconomic governance at the country level, and control their monetary union-wide consequences at an early stage, a crisis management framework becomes redundant.

However, if the risk of debt crises were to become relevant even under reinforced fiscal and competitiveness frameworks, a crisis management framework – providing last-resort financial support for euro area Member States experiencing impaired access to private credit – would need to remove the moral hazard, which is always implicit in any ex ante rescue mechanism. The following offers some suggestions for institutional safeguards which could minimise moral hazard.

(1) ***Any crisis management framework will need to minimise moral hazard and reinforce incentives*** *for pre-emptive fiscal and macroeconomic adjustment;*

(2) ***Establishment of a euro area crisis management institution*** *on the basis of the European Financial Stability Facility.*

(3) Support can only be provided as "ultima ratio" *in case market financing is no longer available, and on the basis of* ***strong policy conditionality – reproducing the EU/IMF financial support to Greece – with the possible participation of the IMF, and at penalty terms,*** *preferably under pledge of collateral and preferred creditor status. Mechanisms could also be established for the*

Eurogroup to be able to elicit the activation of the support mechanism by a country which – due to a loss of market confidence – could otherwise endanger the financial stability of the Union as a whole.

(4) ***Participation of euro area Member States*** *in financing the institution to sharpen the incentives for effective peer pressure and surveillance;*

(5) ***Graded sanctions regime in case of non-compliance with conditionality****, starting with auditing powers vested on the institution and escalating to a de facto loss of fiscal autonomy as the extreme form of sanction.*

In line with the approach to be taken by the Van Rompuy Task Force, these proposals aim to identify what is needed for a sustainable functioning of economic and monetary union.

Introduction

This note sets out the ECB preliminary proposals for the reform of the economic governance framework in the euro area. It focuses on the same three pillars as outlined in the mandate of the Task Force established by the President of the European Council, notably: *(1)* **the strengthening surveillance of budgetary policies and more effective corrective measures;** *(2)* and **improved surveillance of competitiveness developments and the correction of imbalances** and *(3)* the design of an **appropriate framework for crisis management**. In so doing, it first identifies the main shortcomings of the existing set-up and then puts forward a number of proposals. In line with the approach to be taken by the Van Rompuy Task Force, the proposals aim to identify what is needed for a sustainable functioning of economic and monetary union, without being constrained upfront by questions of legal feasibility under the current Treaty framework.

While the Commission's Communication on reinforcing economic governance contains many useful and innovative elements, **the ECB favours a more ambitious approach**, which should be based on a genuine sense of co-responsibility of all euro area countries for the smooth functioning of EMU and the soundness of fiscal and structural policies in the euro area. The proposals put forward in this note are a contribution to a framework that shores up the credibility and long-term solidity and sustainability of the euro and to make **a quantum leap towards strengthening the institutional framework of EMU**, that is, towards a deeper economic union, which is commensurate with the degree of economic integration and interdependency already achieved through monetary union. The proposals focus on the euro area, but could, selectively, also be applied to the EU-27.

I. Fiscal policy framework

The disappointing performance of fiscal policies under the EU framework was due to the weak governance of the Stability and Growth Pact (SGP), notably *(i)* a lack of enforcement of fiscal discipline at the EU level and *(ii)* insufficient national incentives to comply with the EU rules.

At the *EU level*, the European Commission, the Eurogroup and the EU Council have not been sufficiently stringent in applying the EU fiscal rules. EU decision-making involved complex, and not always fully transparent, procedures, a general bias towards not seeking to intervene in other countries' policy decisions prevailed, and country-specific fiscal analyses did not fully take into account the risk of spill-overs to other countries and the euro area as a whole. Insufficient peer pressure and peer support translated in a relative reluctance to give early warnings or candid and precise opinions and recommendations, excessive deficit procedures that extended over many months, and no recourse to the available sanctions regime. Moreover, reliable and comprehensive fiscal statistics have in some cases been lacking.

At the *national level*, incentives for sustainable fiscal positions were insufficient. Stability and convergence programmes have not been adequately specified and exhibited a bias towards being overly optimistic. Countries corrected excessive deficits too slowly, allowed fiscal policies to become procyclical in ‘good times’, displayed insufficient determination to adhere to medium-term budgetary objectives (MTOs), and postponed reforms needed to cope with the costs of ageing populations.

In order to remedy the identified governance weaknesses, in the wake of an apparent greater willingness to enhance surveillance and peer pressure, the ECB proposes to *(i)* enhance EU and in particular euro area fiscal surveillance and *(ii)* limit the degree of discretion in applying rules and procedures at the EU level; *(iii)* strengthen the role of sanctions and direct policy interventions; *(iv)* expand the spectrum of sanctions; and *(v)* introduce an independent EU fiscal agency; and *(vi)* enhance the national ownership and acceptance of the framework through the adoption of national fiscal rules.

I.1.: Enhance euro area dimensions of fiscal policy surveillance

For the *euro area*, the Eurogroup should assume a shared responsibility for sound national fiscal policies. The Eurogroup, as the guardian of fiscal sustainability, should review in detail national budgetary plans, consider the risk of adverse spill-over effects and agree on a number of precise *ex ante* fiscal policy guidelines to ensure compliance with the EU fiscal framework which euro area countries would be invited to follow when drafting their budgets for the forthcoming year. At the national level, the Minister of Finance, when submitting the draft budget to the national parliament, would also submit the Eurogroup guidelines accompanied by an explanation of how these have been incorporated. Deviations from these Eurogroup guidelines should then form the basis for Commission warnings and Council/Eurogroup recommendations addressed to the euro area country, triggering a comply-or-explain approach, and possibly leading to sanctions in case of non-compliance for reasons that are deemed unjustified. Improving coordination on budgetary policy, Member States can avoid negative cross-border effects and maximise policy synergies within the EU and the euro area.

I.2.: Strengthening the implementation of rules and procedures

A more rigorous, quasi-automatic implementation of the fiscal rules at the EU level (Council voting in euro area composition), in which the scope for (political) discretion about the application of further procedural steps is limited, should reduce uncertainty about how procedures and sanctions are used and thus strengthen compliance. While fully recognising the intrinsically political nature of national budgetary policy, the following proposals merit further reflection:

(a) Initiating the EDP procedure and steps quasi-automatically would reverse the burden of proof for decisions on the existence of an excessive deficit and the subsequent procedural steps. Once a euro area country notifies an actual or planned deficit in excess of the 3% of GDP deficit limit, or a debt ratio in excess of 60% of GDP (see proposal 1.4 below), the Council would only be able to stop the escalating provisions under the EDP on the basis of an explicit decision.

(b) A quasi-automatic application of sanctions, whereby the term “sanctions” is understood as means to encourage compliance with existing rules and/or disincentives against “bad” policy behaviour, with some form of “sanctions” being introduced already under the preventive arm and earlier in the EDP

process (see proposal 1.4. below for options for early and differentiated sanctions), or if a country fails to correct its excessive deficit by the given deadline.

It could be useful to broaden the existing rules by well-designed expenditure rules, such as medium-term expenditure frameworks.

I.3.: Leaner and more effective fiscal surveillance

The EU institutions are overwhelmed by procedures, allowing less time for surveillance and follow-up.

(a) Surveillance should be differentiated among Member States according to their fiscal performance, allowing policy-makers to focus on the most critical cases, while countries with sound fiscal positions could be subjected to a lighter surveillance procedure.

(b) Strengthening the role of the Commission, in particular, by *(i)* reversing the voting majorities necessary to adopt, for example, recommendations on sanctions (i.e. sanctions are deemed adopted if not rejected by a qualified majority); and *(ii)* relying on Commission proposals rather than recommendations, both for the steps of the EDP and in case euro area countries do not follow the Eurogroup's *ex ante* fiscal policy guidelines (as discussed under proposal 1.1 above); (*iii*) in order to enhance the credibility of the Commission as an unbiased and neutral party in the decision-making process, the position of the Economic and Financial Affairs Commissioner within the *collège* should be strengthened[1]; *(iv)* giving the Commission the power to assess individual fiscal policy measures in the countries under surveillance, in liaison with the ECB if deemed appropriate, and to make this assessment public.

(c) All necessary measures should be undertaken to enhance the powers of Eurostat to check in detail and in real time the quality of the statistics that are relevant for surveillance purposes and to continuously guarantee their full reliability. This could include audit powers to be given to Eurostat as well as strengthening its independence and accountability.

At the same time, fiscal surveillance should include debt management policies for countries with high debt, using indicators such as refinancing needs and stress tests.

I.4.: Strengthened implementation of quasi-automatic sanctions

A credible application of sanctions has been a problem of the existing policy framework so far, and remedying this situation represents a considerable challenge. However, an effective sanctions regime would clearly strengthen national incentives to comply with the SGP, through an early activation of sanctions and a semi-automatic increase in the scale of sanctions over time.

(a) Appropriate means to encourage compliance should be introduced, including the initiation of sanctions earlier in the process, already when a country fails to achieve the minimum structural

[1] The Commission could be invited to consider adjusting internal procedures to minimise the scope for interference by other members of the *collège* of Commissioners with the proposals of the Economic and Financial Affairs Commissioner under the various surveillance procedures.

adjustment effort towards its Medium-Term Objective (MTO). Such sanctions should be initiated in any case when a country exceeds the 3% of GDP deficit limit. With increasing severity or duration of the fiscal imbalance, the scale of the sanction should be increased.

(b) The debt criterion should be put on an equal footing with the 3% deficit limit, meaning that countries with government debt ratios above 60% of GDP would be made subject to an excessive deficit procedure (also when the deficit is below 3% of GDP) if the debt ratio is not sufficiently diminishing and approaching the reference value at a satisfactory pace and thus liable to sanctions. Moreover, MTOs and minimum structural adjustment efforts must be raised for countries where high deficits coincide with high debt ratios. Finally, as in the case of the 3% deficit limit, the 60% debt/GDP criterion should be seen as a ceiling so that, once achieved, a further reduction may be pursued so as not to exceed this limit under potentially adverse future economic circumstances.

I.5.: A wider spectrum of sanctions

The spectrum of sanctions could be diversified, including token sanctions, more diverse financial sanctions and also non-financial and procedural sanctions.

(a) Financial sanctions could include reduced access to EU cohesion funds and other types of EU transfers including EU structural funds and EU subsidies in general.

(b) Non-financial sanctions could include a limitation or suspension of the voting rights in the Eurogroup/Council for countries with an excessive deficit or excessive debt, either only for decisions under Article 126 (SGP), or also for all other decisions.

(c) Procedural sanctions could be envisaged, whereby the degree of EU intervention in national fiscal policies could be increased as fiscal imbalances and the risk of spill-overs to other euro area countries rise. In particular, such intervention could start with enhanced requirements to submit detailed and specified adjustment programmes and report on their implementation. This could be supported by on-site monitoring via special missions by the Commission, in liaison with the ECB if deemed appropriate, which could be converted into resident missions if necessary. As a further escalation, the respective government could be mandated to seek prior consent for budgetary measures or government borrowing from the Council. The effectiveness could be increased if such intervention would extend to data auditing.

I.6.: Strengthening the independence of fiscal surveillance

In order to strengthen the independence of budgetary surveillance, an independent European fiscal agency could be set up under a mandate from the Eurogroup/Council, acting as its ‘watchdog’. It would preferably be located within the Commission (e.g. comparable to OLAF), would bring together eminent fiscal experts and draw on independent national budget offices or fiscal institutions. Its task would be to monitor and assess national budgetary developments and advise the Eurogroup and the Council, without prejudice to the Commission’s prerogatives in the formal policy-making process (related to warnings, recommendations and proposals). A possible alternative could be a group of wise persons which would regularly screen the fiscal policy of every euro area country and publish its reports. Other institutional mechanisms to enhance the independence of fiscal surveillance could also be considered, such as the requirement for national fiscal agencies to deliver their assessment to the Commission; a separate ECB assessment at the request of the Council or as a second opinion (like in the case of the Convergence Report), whereby the Council decision would continue to be formally based on the Commission recommendation/proposal.

Under the *preventive arm of the SGP*, the agency could be mandated to make an independent assessment of fiscal policies and sustainability in individual countries. If necessary, it should have investigative powers to ensure a sound information base (or else be able to draw on Eurostat resources for this purpose). This analysis and the agency's policy advice would be published and then form the basis for Commission's recommendations/proposals and would be taken into account in discussions and decisions in the European fora.

Under the *corrective arm of the Pact*, the agency should undertake special missions to ascertain the existence of excessive deficits as well as the time necessary for their correction. The agency would present public assessments as a basis for the Commission's recommendations/proposals. This would take political considerations out of the economic analysis, while allowing the Council to either accept or reject the assessments of the agency and the Commission's recommendations/proposals.

I.7.: Enhancing national fiscal frameworks

Sound national fiscal policies are a crucial element of the policy framework of monetary union. The rules of the SGP should therefore specify that countries anchor the objectives of the EU fiscal framework in national law, possibly in the constitution, and give concrete meaning to the Treaty obligation that adequate national budgetary procedures are in place for meeting these objectives. All Member States should establish independent budget offices or fiscal monitoring institutions. Assuming that compliance would be monitored by independent national budget offices or fiscal institutions, as well as by national parliaments, their enforcement does not raise issues of sovereignty.

II. Competitiveness framework

While the current crisis has focused market and policy attention on fiscal sustainability, the problem of significant divergences in competitiveness and intra-euro area macroeconomic imbalances also needs to be urgently addressed. The current set of policy instruments and procedures to monitor competitiveness developments in euro area countries has only recently been installed, show different degrees of formalisation and are not clearly interlinked[2]. In view of the crucial importance of an effective surveillance of competitiveness developments in the euro area, and the urgent need to put in place a correction mechanism in case of emerging imbalances, mechanisms should be found which go significantly beyond the existing processes.

The surveillance framework needs to allow for targeted surveillance and follow up which focuses on countries which experience present and potentially future significant competitiveness losses. Broad based surveillance across the board spreads policy-makers' attention too widely, overburdens institutions and therefore becomes too thin – leading to a lack of engagement with and commitment to the surveillance process. Surveillance should therefore be staggered in terms of its intrusiveness and scope. More freedom would be given to well-performing Member States with regard to the conduct of their economic policies, while problem cases should be subjected to fuller scrutiny under a new corrective arm with an excessive vulnerability procedure. Surveillance of surplus countries remains part of the Europe 2020 framework.

II.1. Transparent and effective triggers of surveillance:

A single criterion or at best a limited number of criteria, encompassing key aspects of competitiveness should serve as trigger values to classify countries and determine the surveillance needs. Preferably this criterion should directly be linked to the smooth functioning of EMU, and could therefore be based on the convergence criteria, and should be simple and robust. The following criteria could be considered as primary indicators:

- HICP and/or GDP deflator-based competitiveness index as published by the ECB
- ULC (total economy)-based competitiveness index as published by the ECB, or deviations from stability-oriented sectoral/national wage developments.

Additional indicators which link cost and price competitiveness to imbalances – including external imbalances and indebtedness of the public and private sectors, asset prices and credit booms, degree of convergence – need to be used for qualitative assessment as robustness checks while avoiding excessive complexity.

According to the degree of competitiveness loss and macro imbalances which these indicators reveal, countries should be categorised into: unproblematic ("green") as vulnerabilities are limited, problematic and potentially risky for the functioning of the euro area given significant vulnerabilities ("yellow"), extremely problematic that pose a very significant risk for the well-functioning of the euro area ("red").

The (annual) review of trigger indicator(s) should be in line with the Europe 2020 calendar.

[2] These three processes are a) an informal exchange of views taking a workshop format in the Eurogroup; b) a competitiveness review based on a Commission surveillance report agreed by the Eurogroup in July 2008; c) country surveillance under the planned Europe 2020 strategy establishing Broad Economic Policy Guidelines (BEPGs). There is so far no or only limited experience with the actual operation of these procedures and still some lack of clarity how these procedures would be linked and implemented.

II.2 Effective and graduated procedures and incentives:

A graduated increase in intrusiveness of surveillance should be generated through a system of stepped up surveillance, peer and public pressure, procedural and financial steps to encourage compliance by euro area countries (see annex 1 for a graphic overview).

- **A) Countries with indicators at unproblematic levels ("green")** should be subject to a light regular surveillance under the Europe 2020 framework based on NRPs. Their good performance should be explicitly acknowledged – and a further incentive for "good" policy behaviour – and there would be, a priori, no need to address specific policy recommendations.
- **B) Countries with problematic indicators** ("yellow") should be subject to stricter surveillance under the initial stage of an "excessive vulnerability procedure" with the following elements:
  1) Report by the Commission based on surveillance mission, peer review; preferably additional independent assessment following the review of trigger indicator(s);
  2) policy recommendations on the basis of proposals by the Commission (that can only be changed with unanimity)
  3) formal follow up with comply-or-explain approach;
  4) if no appropriate follow-up, the country moves to "red".

  This second stage remains relatively light, while still leading to concrete policy recommendations. Incentives for early action arise in particular from the threat of moving to the next procedural stage. This would support a correction of policies already at an early stage/in good times.

  In case of compliance the country would remain in the procedure or move back to normal surveillance (abrogation) depending on the remaining vulnerability.
- **C) Countries with very problematic indicators ("red")** should immediately be subject to an intensified procedure. This corrective arm would include the following elements and steps:
  1) Report by Commission and ECB/Eurosystem based on surveillance mission; report is to be published.
  2) Agreement on policy action on the basis of mission of the Commission, in liaison with ECB, to be published after adoption, assessment of compliance and re-assessment of vulnerability every 6 months.
  3) Increasing degree of sanctions, in case of serious infringements modelled along proposal for fiscal framework (under Article 136 or using alternative legal arrangements).

  In case of compliance the country would remain in the intensified procedure or move back to normal surveillance (abrogation) depending on the remaining vulnerability.

  These steps remain procedurally straightforward while providing strong incentives for corrective action through public commitments and financial measures. The procedure would require a strict fiscal framework as a complement to lower the risk of emerging vulnerabilities and the activation of this procedural stage.

A country that requests financial assistance under the crisis management framework would automatically move into "red" and an intensified procedure that should be consistent with a related country assistance programme.

III. Crisis management framework

Strengthened fiscal and competitiveness surveillance along the lines proposed in sections I. and II, above is the appropriate instrument to minimise the risk of recurrent fiscal crises of the magnitude seen at present. If the new framework in place can effectively check deviating behaviours in fiscal and macroeconomic governance at the country level, and control their monetary union-wide consequences at an early stage, a crisis management framework becomes redundant.

However, if the risk of debt crises were to become relevant even under reinforced fiscal and competitiveness frameworks, a permanent crisis management framework – providing last-resort financial support for euro area Member States experiencing impaired access to private credit – would need to remove the moral hazard, which is always implicit in any ex ante rescue mechanism. The following offers some suggestions for institutional safeguards which could minimise moral hazard.

With the European Financial Stability Facility, the euro area has put in place a temporary crisis management framework aimed at safeguarding financial stability in the euro area. A new framework for last-resort financial support to euro area Member States experiencing impaired access to private credit could be established, incorporating many of the features of the European Financial Stability Facility.

The proposal for such a mechanism is predicated on the assumptions that: *(1)* any financial support extended by the crisis management institution would not be used to bail out private creditors; *(2)* expulsion from the euro area/EU should not be considered a viable option, because the very existence of this option would put the viability of the common currency into question and would thus not be seen as credible; and *(3)* conditions for financial support should be at penalty rates and stringent, so as to control and minimise the moral hazard associated with the existence of the crisis management institution.

Any new framework needs to respect the independence of the ECB, and the prohibitions of monetary financing and privileged access.

III.1 A crisis management framework needs to minimise moral hazard

The absolute precondition to the establishment of a crisis management institution is the need to remove the moral hazard – which is implicit in any *ex ante* rescue mechanism. With a view to limiting moral hazard, the mechanism must be very unattractive for the country concerned and should be used only as a "last resort," accompanied by very restrictive conditionality. The mechanism should only be activated in very exceptional cases, when market access for the country concerned is no longer possible. Mechanisms could also be established for the Eurogroup to be able to elicit the activation of the support mechanism by a country which – due to a loss of market confidence – could otherwise endanger the financial stability of the Union as a whole

III.2 Establishment of a crisis management institution

A euro area crisis management institution could be established. Financing of this mechanism through contributions from euro area countries would maintain a transparent link for each country involved between providing financial resources and the exercise of effective mutual surveillance.

The institution would need to be sufficiently capitalised in order to send a strong signal that the euro area has an effective last-resort crisis management mechanism in place that can be activated at short notice. To this end, a special purpose reserve could be created within the crisis management institution collecting the proceeds of the financial sanctions levied on countries in violation of the criteria mentioned in sections I and II. The accrual of such resources would be used to scale down the guarantees provided by euro area Member States to back the liabilities of the crisis management institution.

III.3. Strong conditionality

Any assistance must be based on strong conditionality. This must be defined in such a way that the economy can leave the crisis management framework as soon as realistically possible. To this end, the involvement of the IMF in the loans extended by the crisis management institution (see below) could be envisaged.

III.4 Safeguards underlying financial assistance

Financial assistance could come in two forms: (i) loans and/or (ii) purchases of government debt securities issued by a Member State in distress. Under (ii), the crisis management institution, vested with the power to purchase government debt securities, would be able to quickly address disruptions in sovereign bond markets with likely contagion effects and the potential of putting financial stability in the euro area at risk. Authority to purchase debt securities in the open market would be a guarantee that euro area resources made available to Member States in severe financial difficulties would not be used to bail out private creditors, but resources would be used to repurchase bonds at their market prices. This financial assistance should contribute to ensuring full consistency with the no-bail-out rule, meaning that neither the Union, nor the Member States, should be liable for or assume the commitments of governments or public authorities of another Member State.

For adequate credit protection, it could be considered to request the beneficiary Member State(s) to collateralise the loans received via the crisis management mechanism. For example, the possibility of pledging specific state-owned property – after securitisation to standardise it and make it tradable – and receivables such as future EU transfers as collateral should be further explored. In addition, the beneficiary Member State could grant preferred creditor status for the loans extended under the financing mechanism. Activation of the crisis management framework would then increase the probability that pre-existing creditors are paid in full. Therefore, preferred creditor status could be seen as a fair distribution of the burden between euro area taxpayers and pre-existing creditors.

III.5.: Graded sanctions regime in case of non compliance with conditionality

Non-compliance with conditionality should be met with sanctions. A gliding scale of sanctions can be envisaged whereby deviations from programme commitments would trigger: *(i)* initially, enforced regular auditing by the Commission on behalf of the Eurogroup in concert with the ECB and the insurance institution; *(ii)* suspension of transfers from EU Cohesion and Structural Funds; *(iii)* suspension of voting rights in the Council; *(iv)* establishment of an Enforcement Officer appointed by the Eurogroup with loss of fiscal sovereignty.

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Annex 1: A possible framework for the competitiveness surveillance