Spanish position on the Future of Europe

February 2017

Introduction

Six decades after the signature of the Treaty of Rome, the European Union (EU) has proved to be the most effective solution ever devised to bring peace and prosperity to our continent. The European project has proved its ability to navigate different crises, and the latest one was no exception. However, Europe is still saddled with the legacy of the latest crisis: unemployment remains unacceptably high and growth remains subdued. On top of that, Brexit, the rise of populism, migration flows and the surge in protectionism pose major challenges. The European project will only endure over time if its citizens perceive that it is able to provide increasing levels of prosperity in a sustainable and inclusive basis. The Heads of State or Government in Bratislava focused on the right priorities, which should be the basis of action at the EU level to tackle citizens' most immediate concerns.

Within Europe, the creation of the Economic and Monetary Union (EMU) was an ambitious step forward in our supranational integration. Today, the euro is a successful currency regularly used by almost 340 million Europeans, which has provided price stability and promoted trade and investment. Accordingly, the EMU is not a project in contradiction to the EU but a complementary one, whose strength and dynamism benefits the Union as a whole. A strong EU needs a well-functioning euro area.

The economic crisis unveiled critical failures in the original design of the euro area architecture. In recent years, sweeping reforms have been successfully undertaken to overcome some of the most pressing problems. However, the EMU still needs to be completed with measures of a far-reaching nature to improve its institutional foundations.

Accordingly, the Spanish Ministry of Economy would like to contribute to the White Paper on the future of Europe by proposing a number of reforms for strengthening the euro area. Some of these reforms have to be undertaken by EMU countries since they pertain to the institutional set-up that is necessary to ensure a smooth functioning of the EMU. Other measures could include the EU as a whole, while taking into account that they bear a special relevance for the EMU, since within a monetary union convergence is especially necessary. The measures proposed will contribute to increasing the resilience of the European economies, unlocking potential growth and fostering job creation. The final objective is to bring the benefits of deeper European integration to all layers of the population.

EMU design failures and progress to date

The significant gaps in EMU architecture explain the differential impact of the latest crisis on the euro area. Indeed, the creation of the euro area inevitably implied that participating Member States had to give up nominal exchange rates as a national stabilization tool. As extensively discussed in the literature on Optimum Currency Areas, this feature of monetary unions makes them vulnerable to asymmetric shocks in the absence of other efficient shock-absorbing mechanisms.

In monetary unions the burden of the adjustment needs to rely on internal price and wage flexibility and on factor mobility, which are scarce in the EU as a whole. This scarcity is particularly relevant for the euro area, since it prevents the efficient absorption of shocks. As a result, unsustainable imbalances that had built up before the crisis, fueled by divergences in competitiveness, had to be corrected in an especially costly manner in the euro area, particularly in terms of high unemployment in the countries that were most affected by the crisis.

Over the last few years, an unprecedented number of reforms have been put in place through the implementation of both risk-reduction (the reinforcement of fiscal surveillance through the reform of the Stability and Growth Pact and the approval of the Fiscal Compact, the introduction of the Macroeconomic Imbalances Procedure, the Single Supervisory Mechanism) **and risk-sharing measures** (notably with the creation of the ESM as a backstop). Although these reforms have decisively contributed to address some of the shortcomings of the EMU´s original set-up, our work is far from complete. Indeed, until very recently, this reformist momentum mainly responded to short-term needs, rather than to a structured plan. However, the euro area needs not only firefighters but also builders.

In this regard, the Five Presidents' report, published in 2015, was a first step towards a more consistent strategy focused on the long-term. According to this report, 2017 should be the beginning of a new stage in which Member States agree on measures of a more far-reaching nature to complete the EMU's economic and institutional architecture.

Next steps

Any progress in completing the EMU requires an adequate balance between risk-sharing and risk-reduction measures **in financial, fiscal, and economic integration**, that also takes into account what has been agreed up to date.

We hereby propose a two-pronged strategy to increase the resilience of the EMU focused on:

1- **Shock reduction**: this would call for a strategy to foster greater real convergence and increase the flexibility of the European economies, mainly through the completion of the economic union, but also through risk reduction measures in the financial and fiscal unions.
2- **Shock absorption**: this calls for mechanisms that manage risks efficiently, including by appropriate risk sharing.

This overhaul of the EMU architecture will necessarily entail sharing more sovereignty between Member States and therefore should be accompanied by measures to increase democratic legitimacy and to **progress towards a genuine political union**, as discussed in the last section.

Financial Union

The Banking Union and Capital Markets Union are effective mechanisms to increase the resilience of the EMU and to reduce the frequency and magnitude of financial shocks. Given their strategic importance to absorb shocks efficiently and increase private risk sharing, their completion should be prioritized.

The **Banking Union** is already significantly advanced with the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). These first two pillars ensure a consistent application of the single rulebook and of resolution strategies. However, the Banking Union project is still unfinished and should be completed as a matter of priority in a timely manner in line with the roadmap already agreed by Member States, focusing especially on the following areas:

- **Introducing a credible common backstop for the Single Resolution Fund that will contribute to the preservation of financial stability in the Banking Union as a whole.**
- Setting up a **European Deposit Insurance Scheme, with its corresponding backstop**, as a means of building the third pillar of the Banking Union and reinforcing its credibility. Common instruments to protect depositors are consistent with a framework of European-wide supervision and resolution authorities.

Common rules should be applied consistently to all banks in the Banking Union to ensure a common approach to tackling risks in the banking sector. In addition, we should ensure that the regulatory framework provides a level-playing field for European banks to compete at the global level.

Non-performing loans (NPLs) are one of the main legacies of the crisis and remain at unacceptably high levels in many euro area Member States, reducing credit supply for productive businesses and projects, thus hampering growth. **Some harmonization of insolvency laws** is essential to reduce future levels of NPLs and financial fragmentation.

Accelerating the completion of a **Capital Markets Union** is also essential for the EU as a whole, but even more important for the euro area. This project will be key for the reduction of European businesses' structural dependency on bank financing, which increases their vulnerability given the procyclicality of bank credit supply, and for encouraging investment in Small and Medium innovative firms. Moreover, it will provide an efficient risk sharing mechanism involving the private sector. For this purpose, progress in areas such as **covered bonds, private placements, SME-mini-bonds and crowdfunding** will help spur growth, productive investment and create jobs in the medium term.

<u>Fiscal Union</u>

Whereas euro area Member States have pooled sovereignty in monetary policy, fiscal policies are designed and implemented at the national level under the rules-based approach of the Stability and Growth Pact (SGP). In this regard, the sound and credible application of the SGP is essential for the sustainability of public finances. However, in the face of large shocks the system in place can lead to the implementation of pro-cyclical policies in order to avoid breaching the common fiscal rules.

Besides, the combination of a centralized monetary policy with insufficient coordination of national fiscal policies makes it very difficult to achieve an appropriate policy-mix at the euro area level. When the monetary policy reaches the zero-lower bound, the coordination of fiscal policies becomes particularly relevant in order to improve the transmission of monetary policy.

Accordingly, it is necessary to enhance the coordination of fiscal policies. **Setting a target for an appropriate fiscal stance for the euro area requires a common tool** to fulfil this objective and at the same time ensure compliance of national fiscal policies with the SGP. A **common fiscal capacity** for the EMU would provide a stabilisation tool to effectively counter:

- Asymmetric shocks. It would support the stabilisation of economies facing asymmetric shocks without endangering the sustainability of national finances. It would therefore be compatible with a strict enforcement of the rules of the SGP.
- Symmetric shocks, if provided with a counter-cyclical borrowing capacity to borrow during euro area-wide downturns and reduce the debt during economic booms.

In line with the **principles set out in the Five Presidents Report**: (i) the common fiscal capacity should not lead to permanent transfers, (ii) it should neither undermine the incentives for sound fiscal policy-making at the national level, nor the incentives to address national structural weaknesses, (iii) it should not be an instrument for crisis management.

As stated above, this common fiscal capacity would need to be **complemented with a strict enforcement of the rules of the Stability and Growth Pact** to ensure the sustainability of national finances and avoid negative spill-over effects. In order to increase national ownership, the methodologies underpinning the application of rules which rely on a great extent on potential output estimates should be improved and greater focus should be given to observable variables under the control of the government, such as expenditure indicators. A rules-based approach, based on a consistent enforcement of the SGP, is best placed to ensure fiscal discipline in a countercyclical manner. The recent crisis has shown that markets tend to behave pro-cyclically, by underestimating sovereign risk during economic booms and overestimating it in times of market stress.

A common fiscal capacity can take a variety of forms. As convergence in the EMU advances, more ambitious forms of fiscal capacity can gradually be implemented.

- In the shorter term, a “rainy day fund”, where member States’ withdrawals would be calculated on the basis of observable cyclical indicators, could be envisaged. It could for example help support investment, thus contributing to improvements in productivity.
- At a later stage, once progress in the harmonization of labour markets has been achieved, a common unemployment insurance scheme, which partly replaces national schemes, might be envisaged.

To the extent that a common fiscal capacity would partly replace national budgets (for investment or spending in unemployment insurance), it does not necessarily imply an overall increase in the euro area spending, or an increase in the tax burden at the aggregate level.

In the long term, another important feature of any fiscal union is **common debt management**. In order to enhance confidence in the euro and credibly tackle the problem of redenomination risks, participating Member States should allow for a certain degree of debt mutualisation.

It should be noted, however, that participation in the Fiscal Union should be conditional to Member States achieving a significant degree of real convergence and progress in the Economic Union. This will increase the resiliency of the economies and reduce the need to use the risk sharing mechanisms described in this paper.

Economic Union

Given that the root causes of the crisis can be found in divergences in competiveness that led to unsustainable external imbalances, progress in the Economic Union, although important at the EU level, is essential to reduce risks in the EMU. At the EU level, the European Fund for Strategic Investments can continue to play a major role in supporting investments that promote the convergence of the economies. **In the EMU, a more ambitious approach is required to reinforce the coordination and monitoring that ensure the effective implementation of structural reforms. This will (i) increase the resilience of the European economies, therefore reducing the impact of asymmetric shocks, and (ii) eliminate real and nominal rigidities that hamper a swift adjustment to economic shocks when they strike.**

In addition, the Economic Union is important to ensure that European economies remain competitive at the global level and improve their positioning as an **attractive place for investments. This will unlock potential growth and ensure a sustained increase of prosperity in Europe**.

Structural reforms can become the main risk reduction instrument in the EMU, and will complement risk sharing initiatives:

- They address moral hazard issues
- They help build trust among Member States and therefore a political momentum to support risk-sharing initiatives.

Therefore, deepening the single market should remain a priority, and in particular:

- Fostering labour mobility and increasing the flexibility of national labour markets
- Deepening single markets, particularly in services, capital (through the Capital Markets Union initiative), energy and digital.
- Promoting reforms in national product and services markets to tackle bottlenecks to investment and ensure an efficient allocation of resources. In particular, deepening the single market will contribute to remove obstacles for SMES, especially the new and innovative ones, to scale up quickly where needed.

This calls for an improvement in the implementation of reform commitments under the European semester, particularly during good economic times. In order to achieve this, increasing the ownership of these commitments will be essential, thus the importance of continued dialogue between national authorities and European institutions, as well as the role that exchanges between Member States and peer pressure can play. Given the particular importance of **advancing in the Economic Union for the EMU**, **euro area Member States could benefit from even stronger coordination, enforcement and monitoring mechanisms than those in place for the whole EU**.

Risk-reduction should start with an **early detection and correction of imbalances in the EMU in order to prevent them from accumulating to unsustainable levels and thus contain risks in the EMU**. Accordingly, the already existing **Macroeconomic Imbalances Procedure could be improved by strengthening its focus on forward-looking indicators** that enable action at an early stage.

In addition, in order to foster convergence and rebalancing within the EMU, Spain proposes a **binding process of real convergence, based on the fulfilment of a set of convergence criteria, as a precondition for accessing the Fiscal Union**. The criteria would have to be defined so as to promote fiscal and external balanced positions, as these are the two sources of instability for a monetary union. Once Fiscal Union is achieved, the fulfillment of the convergence criteria will remain compulsory.

These reforms would promote greater synchronization of economic cycles and would improve Member States' resilience to shocks and act as ex-ante shock absorbers. In addition, a real convergence process would help build the necessary trust among Member States, which is necessary for further progress in economic integration.

Political Union

Completing economic integration involves further sharing of sovereignty and requires political legitimacy.

This calls for progress towards a real economic government of the euro zone, with sufficient legitimacy and democratic supervision. We cannot transfer responsibility for decisions that are enormously important for citizens to institutions without democratic legitimacy and without ensuring adequate accountability.

This would imply:

- Guaranteeing national ownership in domestic parliaments and a proper dialogue with the European Parliament and all relevant stakeholders.
- On the institutional front, advancing towards a euro area Treasury responsible for a Eurozone budget (the common fiscal capacity), overseeing the implementation of conditionality in Member States having received a financial assistance programme and, in the longer term, common debt management.

Finally, in order to facilitate the well-functioning of the EMU's architecture, the different intergovernmental agreements concluded during the crisis (e.g. the Fiscal Compact or the Intergovernmental Agreement on the Single Resolution Fund) should be integrated into the legal framework of the EU. This also applies to the Treaty of the European Stability Mechanism, which should also be integrated into EU law, making its governance and decision-making processes more efficient.

Conclusion

The EMU has made substantial progress in the last few years with the adoption of different risk sharing and risk reduction measures. Nevertheless, this is no time for complacency. The euro area remains an unfinished project. In this regard, we propose the adoption of a number of reforms in the financial, fiscal, economic and political fronts that will complete the architecture of the EMU and set the stage for its smooth functioning. These reforms will provide the shock absorption mechanisms that the EMU needs in order to increase its resilience.

On the financial front, we see the urgency of completing the Banking Union, with the adoption of a credible common backstop to the Single Resolution Fund and the introduction of the

European Deposit Insurance Scheme. The reduction of NPLs, a legacy of the crisis which hampers credit and growth, should be undertaken as a matter of priority. Given the high dependency of European businesses on bank financing, completing the Capital Markets Union will reinforce the resilience of the monetary union.

Regarding the fiscal union, pursuing an aggregate fiscal stance target for the euro area will ensure an adequate policy mix in the EMU. This requires the introduction of a common fiscal capacity that stabilises the economy, whereas national fiscal policies could ensure their sustainability by adhering to the rules of the SGP. This common fiscal capacity would support Member States facing asymmetric shocks and, if provided with a counter-cyclical borrowing capacity, would be an effective instrument to counter euro area-wide shocks. In the longer term, common debt management could be envisaged to counter redenomination risks. Member States' participation in the fiscal union would be conditional on achieving a significant degree of real convergence.

We envisage the introduction of a binding process of real convergence based on the fulfilment of a set of convergence criteria as a precondition for accessing the Fiscal Union. The criteria would have to be defined so as to promote fiscal and external balanced positions, as these are the two sources of instability for a monetary union. Once Fiscal Union is achieved, the fulfilment of the convergence criteria will remain compulsory.

Finally, developments also need to take place on the political front, with the reinforcement of democratic legitimacy. From an institutional point of view, the introduction of a euro area Treasury, responsible for the common fiscal capacity, overseeing the implementation of financial assistance programs and the possibility for common debt issuance could also be envisaged.

Given the uncertain environment at the international level, the euro has an important role to play as an anchor for economic and political stability, underpinning the European project based on open economies. It is now up to the European Union to take on a bigger international role and advocate open markets as a path to sustainable growth and prosperity for its citizens.