Spanish position on strengthening the EMU

April 2018

Background

The Euro-Summit on 15 December 2017 has created a renewed momentum for discussions on deepening the Economic and Monetary Union (EMU) during the first semester of 2018, with a view to agreeing by June the next steps to be taken. Substantial political expectations have been created. Delivering on them would send a positive signal on the EMU, which is especially important in the current international juncture.

Now that the EMU benefits from broad-based growth is the time to build more resilient structures to be in a better shape to face future crises, in particular those of a systemic nature. The architecture of the EMU should contribute to prevent crises but also to manage them when they strike. In a monetary union, countries give up nominal exchange rates and monetary policy, which are powerful national stabilization tools. This should be offset with appropriate shock-absorbing mechanisms at the EMU level. In particular, economies in a monetary union have **three main channels to absorb economic shocks**:

- Financial channel: which redistributes risks through financial markets and the private sector. The crisis exposed the vulnerabilities of financial integration in the EMU, with sudden reversals of financial flows, financial fragmentation and non-adequate transmission of monetary policy. In order to restore pre-crisis levels of integration in wholesale financial markets, to expand financial integration also to the retail market and, above all, to prevent similar episodes in the future, the completion of the Banking Union, together with the Capital Markets Union, should be a key priority in the EMU reform. Making this channel fully workable is a necessary pre-condition for addressing contagion stemming from banks to sovereigns.

- Economic union: based on structural reforms that make individual economies more resilient and prevent the build-up of unsustainable imbalances. A swift reallocation of resources following price signals, both capital and labour, would help to better absorb negative shocks. In particular, a sound financial sector is essential to ensure a swift and efficient capital reallocation among economic sectors and firms, thus preventing capital from remaining tied up in unproductive uses and thereby increasing resilience to shocks and protecting potential growth.

- Fiscal channel: in the EMU, there is currently no fiscal mechanism to protect countries against asymmetric shocks. Fiscal policies are instead coordinated through the Stability and Growth Pact (SGP) and, for Member States with impaired market access, the European Stability Mechanism (ESM) provides funding subject to strict conditionality. On top of this, it is necessary to introduce a commensurate stabilization fiscal capacity that would limit the impact of asymmetric shocks and help address the contagion channel from sovereigns to the private sector.

These channels, as presented, are not to be seen in isolation. Many of the measures proposed in this proposal can have a simultaneous impact on several of these channels, which are mutually reinforcing. Although a number of aspects in these channels pertain to the EU, ensuring adequate risk absorption mechanisms is of particular importance to the euro area if it is to ensure increasing levels of growth and employment to its citizens.

Priorities

1- Financial integration

The main priority in the short term should be strengthening financial integration to prevent new episodes of fragmentation. In this respect, the Banking Union and the Capital Markets Union are essential to manage and absorb shocks within the private sector.

- The **completion of the Capital Markets Union** will help provide stable and diversified funding sources and distribute risks efficiently in the EU, while contributing to a smoother monetary policy transmission

- In the **Banking Union** where already two pillars are operational, both **a European Deposit Insurance Scheme (EDIS)** and a **common backstop to the Banking Union (for EDIS and Single Resolution Fund, SRF)** need to be implemented as a matter of priority if the full benefits of a Banking Union, notably in terms of integration, are to be reaped. Now that supervision and resolution rules have been centralized for a number of years, ensuring that depositors benefit from the same guarantee independently of their location will help to **align decision-making, responsibility and liability in the Banking Union**. The current set-up of the Banking Union may expose individual Member States to losses for decision taken at the central level by supervision and resolution authorities. This imbalance between decision-making and liability may in the long run undermine political support for the EMU, and eventually for the EU itself. In order to resolve this contradiction, the Banking Union needs to be completed with appropriate risk pooling mechanisms, to be introduced in line with the reduction of legacy exposures in the Banking Union.

Financial institutions in the Banking Union are currently subject to **a centralized supervision with common resolution rules** while **a single rulebook** ensures a level-playing field. This framework may soon be further strengthened with an agreement on the November 2016 Banking Package. This guarantees a **homogenous prudential risk management treatment of net exposures across financial institutions** in the Banking Union as of the entry into force of this framework.

To reap the benefits of a fully-fledged Banking Union, risk sharing through a common deposit insurance scheme is warranted. This however requires **full assurances that risk sharing will not be used for material legacy exposures pre dating the Banking Union** in order to avoid adverse selection problems. Risk mitigation tools, where appropriate, might be envisaged as a way to accelerate the fulfillment of the criteria to enter fully mutualized schemes. In any event, we should now recognize that these legacies are bound to disappear with the roll out of portfolios originated before the entry into force of the first two pillars of the Banking Union. In addition, the provisioning requirements by the supervisor will ensure that those legacies that become non-performing are netted out in the balance sheet of banks. This opens the way for enabling the whole EMU banking sector to be covered by fully mutualized instruments at a future date that should be specified now, together with the criteria to advance it if effective risk reduction measures are taken.

Therefore, by June, the Euro Summit should provide **a clear mandate for establishing a concrete and final date** for the entry into force of **a fully-fledged European Deposit Insurance Scheme, fully mutualized and with a common backstop**. The practical entry into force of this instrument would be conditional on a final assessment by the EU institutions that **no material non-provisioned exposures pre-dating the Banking Union remain at that date**.

The period until that agreed date should be divided in two stages:

- **<u>Stage 1: Transition period</u>.** During the transition period, **the first stage of re-insurance that does not entail sharing risks should be implemented swiftly**. **Milestones for tackling legacies** could be set that would enable national financial systems to **gradually increase risk sharing,** until a fully-fledged EDIS is implemented no later than the date agreed by the Euro Summit.

- **<u>Stage 2: Set-up of EDIS</u>**. After a positive assessment by all the relevant EU institutions, EDIS would enter into force. In order for EDIS to act as an efficient insurance mechanism and avoid cross-subsidization**, individual banks' contributions should be risk-based**, taking into account individual banks' specificities. This would provide an efficient solution for some debates on risk reduction measures, while at the same time providing incentives for policy-makers to improve their national frameworks.

In addition, the Banking Union **requires a common fiscal backstop to strengthen its credibility by ensuring a sufficient availability of resources:**

- Its size should be commensurate to the estimated needs of a **potential systemic banking crisis in the Banking Union.**
- **Its trigger should not be subject to discretionary decisions**. Conditions for accessing the backstop should be equivalent to those of the instrument that is being backstopped.

Risk sharing mechanisms will also contribute to reducing risks in the Banking Union. A European Deposit Insurance Scheme is a necessary condition for considering the Banking Union as **a single jurisdiction from a prudential perspective**. In this sense, some actions like ring-fencing of liquidity can be optimal from a national perspective, but self-defeating at the aggregate level. The removal of such barriers requires that national authorities can rely on credible mechanisms in the Banking Union for failing banks. Only with the elimination of barriers to cross-border banking will truly pan-European banks emerge that will help citizens benefit from a more integrated and well-diversified financial system with an increased resilience thanks to the Banking Union. Therefore, we propose that the **identification and removal** of such barriers becomes a political priority for the Eurogroup.

2. Economic integration

The crisis showed that price stability and sustainable finances alone are not sufficient to ensure financial stability. It also exposed the risks that the build-up of unsustainable imbalances can entail.

An appropriate **coordination of structural reforms, which reduces divergences in competitiveness**, will help tackle imbalances in the EMU and better absorb shocks through swift relocations of productive factors.

At the same time, the EU should reap the full benefits of an **integrated single market** for goods and services, digital, energy, labor and capital. In particular, the reduction of barriers to cross-border transactions in the Banking Union should enable the EMU to benefit from a diversified banking sector, able to swiftly reallocate capital, thus increasing the resilience across the EMU.

A combination of structural reforms and the completion of the single market will promote a swifter adjustment to adverse shocks. However, economic shocks cannot be totally avoided, and the EMU will still need appropriate macroeconomic tools for absorbing shocks in an efficient manner even after the implementation of the reforms described up to now. A stabilization capacity in the euro area is also needed to mitigate severe shocks.

3. A stabilization capacity for the EMU

In the EMU, fiscal policies are currently coordinated through the SGP, which relies on national fiscal stabilizers to absorb adverse shocks. While this approach is sufficient for regular economic fluctuations, its limits have been exposed in the recent crisis:

- National fiscal policies can be overburdened when shocks are especially severe, thus forcing Member States to implement pro-cyclical policies.
- The euro area lacks the capacity to implement an adequate policy mix and there has been an overreliance on monetary policy for stabilization.

The main **objective** should be the **stabilization of large economic shocks** that overburden national fiscal policies. **National automatic stabilizers should remain the first line of defense**, but in severe downturns they would be complemented by an EMU-wide stabilization capacity.

Desirable principles for the design of the stabilization capacity would be the following: (i) increased **counter-cyclical** character of fiscal policies (with a build-up of fiscal buffers in good economic times and payouts in bad economic times); (ii) **no permanent transfers**; (iii) **automatic and temporary support;** (iv) **ex-ante eligibility and usage rules** should take into account indicators on **competitiveness and fiscal performance** in order to avoid moral hazard; (v) clear **separation of this capacity from crisis management instruments.**

The stabilization capacity should facilitate the **enforcement of fiscal rules** by reducing the trade-off between stabilization and sustainability needs in national fiscal policies. At the same time, fiscal rules need to be simplified to make them rely on observable indicators under the control of governments, such as an expenditure rule. This would improve external communication and strengthen ownership by governments.

We suggest a two-pronged approach for the design of a stabilization capacity, based on (i) **an insurance mechanism** and (ii) **a lending/investment facility, with the participation of the European Investment Bank (EIB)**.

i) The insurance mechanism would be based on a fund built-up by Member States in good economic times in order to transfer pay-outs in case of a severe shock:

- By accumulating resources in good times, the fund would have the potential to deliver substantial stabilization with a relatively small average size, and would reinforce the countercyclical character of national fiscal policies.
- Its transfers would provide budgetary support to Member States to finance increased expenditure associated with the impact of a severe shock.
- Safeguards to avoid permanent transfers can be easily embedded in an insurance mechanism, for instance through experience ratings or caps to contributions and payouts.

While potentially appropriate for dealing with asymmetric shocks, the size of this fund will probably be limited in relation to the needs associated to a broad-based shock in the euro area.

ii) Therefore, to fill the gap in the euro area of productive investments, **a new lending facility by the EIB**, supported by a guarantee fund provided by Member States (following the model of EFSI, European Fund for Strategic Investments), would provide sufficient resources to protect investment, particularly in the private sector, in case of severe downturns, thus mitigating the cyclical effects while protecting long term potential growth.

- It would provide **loans** at preferential financing conditions. This would prevent permanent transfers.

- It would support investment projects that Member States have in the pipeline. Its **focus on investment** would help promote real convergence and potential growth.
- The EIB would leverage its resources to mobilize **private** investment. Therefore, its final impact would be a high multiple of the public resources invested.
- The capital and guarantees required for this new facility would be provided by euro area Member States.
    - Guarantees would be used for investment projects in countries hit by a **severe shock**.
    - Conversely, in better economic times, guarantees would be **freed up** and firepower would be accumulated in the facility for the next crisis.
    - Individual Member States' participations in the guarantees could be **reviewed periodically** depending on past uses of the facility by each Member State.

A stabilization capacity would fill a gap in the EMU architecture by providing countries hit by a severe shock with an instrument to stabilize their economies, thus reducing the likelihood they need to approach the ESM for financial assistance, which they usually do once a severe crisis has already taken place. This stabilization capacity would provide only temporary support since structural problems are best addressed with structural reforms. For countries facing deeper-rooted structural challenges and whose market access is impaired, the ESM would provide funding subject to conditionality to address the country's challenges.

4. Crisis management: the European Stability Mechanism (ESM)

The ESM has proved to be an essential element of the EMU architecture to safeguard its financial stability. There is a growing consensus that this institution needs to be reinforced. In the long run, the ESM should belong to the EU institutional framework. **The ESM should be a key instrument in the euro area to preserve financial stability. This would entail a strong crisis management mandate based on two main roles:**

- **Providing financial assistance to Member States with impaired market access subject to conditionality**. A stronger role can be envisaged for the ESM in financial assistance programs, notably in negotiating and monitoring conditionality alongside the Commission, while avoiding duplications. The regular monitoring of countries outside a program should continue to be performed by the Commission, as foreseen in the EU Treaties.

- **Supporting the stability of the banking sector by providing the common backstop to the Banking Union and by increasing the flexibility of the Direct Bank Recapitalization Instrument.**

Conclusion: a resilient EMU that promotes sustained growth and job creation

We have just sketched out a series of reforms that will complete the EMU architecture by strengthening its resilience to shocks. These measures are mutually reinforcing and should be combined in a comprehensive package. The sequencing is important: financial union (banking union and capital markets union) should be prioritized in the short term, and then greater economic union will pave the way for new fiscal instruments.

At the June summit, Leaders should have a broad-ranging view of the “landing zone” for the EMU. Decisions can only be made on the basis of a comprehensive package that includes the different elements envisaged here, given the strong interlinks between them.

These reforms must be accompanied by appropriate mechanisms to ensure adequate democratic accountability. A more resilient union that promotes sustained growth and job creation will best serve the interests of all European citizens.