Quit kicking the can down the road: a Spanish view of EMU reforms

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Diagnosis

The euro was expected to make Europe stronger and more integrated. So far, it has not succeeded in this endeavour. The EMU's original design underplayed the importance of banking, fiscal and political union and failed to provide the right incentives to promote the structural reforms needed to maintain Europe's high standard of living in an ever more globalised and competitive world.

The recent crisis was a wake-up call. It exposed serious shortcomings in the design of the euro and led to substantial reforms, including the creation of the European Stability Mechanism (ESM), the launch of a Banking Union with a single rulebook, a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), and the strengthening of the economic governance framework.

However, it was not until the ECB's President affirmed that he was ready to do 'whatever it takes to save the euro' that the financial crisis receded. Yet the single currency's present architecture cannot ensure its long-term survival. Much more needs to be done.

There needs to be further fiscal coordination and discipline and a joint facility for macro stabilisation within the currency area, an unconditional lender of last resort and an effective mechanism to break the link between banks and sovereigns, ensuring financial stability, more effective macroeconomic surveillance and coordination, and greater legitimacy in the overall governance structures.

Euro area countries learnt the hard way that joining EMU meant they were issuing debt in a currency they could not control. Without an independent monetary and exchange rate policy, or sufficient factor flexibility, the internal devaluation needed to adjust to falling competitiveness prompted a deep recession and persistently high unemployment in a number of countries. In hindsight, the euro area experience also shows that countries joining the currency union have insufficient incentives to implement the structural reforms

[1] This paper is a contribution to the ongoing debate about euro governance reform. All of the authors have contributed in a purely personal capacity, irrespective of the policy roles they may have or have had in the past.

needed to make their economies more flexible and convergent, and that external pressure only works in exceptional circumstances.

Despite significant progress in fiscal and macroeconomic governance, countries still have incentives to circumvent the tighter rules. There is still a widespread view in Europe that the main problems lie with the countries' unwillingness or inability to implement the rules properly. Nevertheless, experience shows that even strict adherence to fiscal rules (which is clearly necessary) is insufficient to guarantee a well-functioning and stable monetary union.

Although there have been substantial reforms, a number of obstacles remain. Political agreement is needed on a common fiscal backstop for the banking union, on a fiscal stabilisation function and on how to share the costs of dealing with failing banks and protecting depositors. Furthermore, the many bodies responsible for different aspects of financial policy need to coordinate better, and a proper lender of last resort for the euro area is still required.

While it is important to acknowledge the unprecedented rescue packages guaranteed by creditor states, the strategy of placing most of the burden of macroeconomic adjustment in EMU on deficit countries can, in the long-run, prove to be politically unsustainable and undermine the citizens' confidence in the single currency. Moreover, current fiscal rules are too complex and fail to provide the right incentives to ensure their compliance. Therefore, we need a revision of the macroeconomic governance framework.

Structural reforms and macroeconomic coordination have also been strengthened, but there is an underlying tension between national and European interests. Growth-oriented structural reforms are essential to make EMU function more effectively, but most of the responsibility for designing and implementing the reforms lies with individual countries. We need a new system that provides the right incentives to deepen reforms, along with better coordination.

Taken together, the economic governance reforms are moving in the right direction, but they do not go far enough to make EMU work effectively. Without deeper fiscal, financial and economic integration, and the institutions to deliver them, the euro will remain unstable and vulnerable to further shocks, especially in the financial sector, where the 'too big to fail' problem and the re-nationalisation of credit have only intensified.

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In order to deliver this deeper integration in a democratically legitimate and sustainable way, some degree of greater political integration will be required. There is no way around this.

We need to be realistic. Even in the case of sufficient economic convergence, some kind of fiscal transfer scheme would be indispensable to offset asymmetric shocks. However, there also needs to be a deeper fiscal union with strong and credible surveillance over countries' budgets in order to avoid moral hazard, and centralised debt instruments to fund a common budget capable of promoting pan-European projects to increase growth potential, ensure sufficient pan-European investment, reduce inequality and facilitate debt sustainability.

There is no trade-off between fiscal and market discipline on the one hand and solidarity mechanisms on the other. Rather, there is a virtuous circle: rules that ensure discipline would lead to a better acceptance of mutualisation of risks, and an increased solidarity would enhance the capacity to comply with the rules.

This can probably only be addressed by moving towards some form of greater political union involving enhanced powers for a more legitimate and reformed Commission and European Parliament. This poses yet greater obstacles, since it requires convincing Europe's citizens and reforming the European Union treaties accordingly.

It is essential that all EMU countries agree that these are indispensable long-term goals, and then build a strategy to achieve them gradually. A shared and clear vision on the euro's end-goals would make the long journey towards deeper economic and political integration easier and help re-establish trust between the member states.

In this respect, we support the core of the European Commission's white paper 'Doing Much More Together' scenario. Moreover, we are convinced that with these changes all EU countries will join the euro at some point in the future.

Recommendations

1. The experience of the crisis shows that, in order for EMU to function effectively, there needs to be **greater political, fiscal, financial and economic union** within the euro area to match the current degree of monetary integration. In addition, Eurozone economies need to accelerate their structural transformation to be prepared for the challenges posed by the digital economy.

2. The euro area needs a **central fiscal authority** with its own sources of revenue and the ability to issue joint debt. This authority (headed by a person proposed by the Eurogroup to become the Commissioner for the Euro and specifically ratified by a newly created Committee for EMU affairs in the European Parliament) should be responsible for enforcing fiscal rules, which should be both simpler and more credible. It would, in addition set the overall fiscal stance for the euro area as a whole, with a view to ensuring an adequate stimulus in recessions and consolidation in expansionary periods.

3. **The current ESM and its staff should fall into EU law and become the staff of the existing Fiscal European Stability Board** (FSB) that monitors national fiscal and macroeconomic policies. The FSB would therefore be in charge of the technical analysis of fiscal stability while the fiscal authority would take the ultimate political decisions on these matters under the following incentive structure: countries that abide by the rules receive counter-cyclical fiscal support in downturns; countries that break the rules do not.

4. The banking union is still incomplete, and so is the capital markets union. There needs to be further progress on **a common deposit guarantee mechanism and further convergence in bankruptcy laws**, while the entire structure of the

banking union needs to have a sufficiently credible fiscal backstop, ultimately provided by the central fiscal authority mentioned above. Moreover, as long as there is no large Eurozone treasury and no Eurobonds, **all euro zone sovereign bonds should continue to be considered risk-free assets**, implicitly backed by the ECB. Proposals that question their risk-free nature carry the risk of instability in the bond markets, worsening the current financial fragmentation and threatening to create another episode of market turmoil.

5. **Positive incentives need to be put in place for countries to undertake unpopular structural reforms** on an ongoing basis so that their economies are flexible, innovative and socially-inclusive enough to live within a single monetary area. The central fiscal authority could provide finance for pan-European public goods, such as security, border protection, digital transformation and country-specific reforms that are essential for the area as a whole. The work of the European Semester and its country-specific recommendations could be useful, but they need to be enforceable. In order to provide the adequate incentives and avoid the problem of moral hazard, only countries that commit to reforms should be able to receive financial support from the centre. This mechanism would facilitate politically difficult structural reforms and reduce the risk of deflation.

6. **The ECB needs to be able to act as the lender of last resort for member states in exceptional circumstances**, as it does for the banking sector. Building on its current Public Sector Purchase Programme (PSPP), the ECB needs to be the ultimate provider of unconditional liquidity, through the sovereign debt markets, for circumstantially illiquid countries that might suffer market panics or speculative attacks. In the event of the official insolvency of a member state, the central fiscal authority would take control of the public finances and negotiate a memorandum of understanding with the country under stress. The fiscal authority would then, drawing on the independent technical work of the FSB, be in charge of monitoring and implementing the adjustment programme under the supervision of the Committee on Euro Affairs of the EP.

7. Undoubtedly, some of these reforms will require new institutions, in addition to changes to the mandates of existing ones. Reaching an agreement on the creation of a central fiscal authority and its financing and **a greater involvement of the Euro committee of the European Parliament** in electing the head of such an authority, controlling the eurozone budget and monitoring fiscal policy and structural reforms at the national level, will be particularly challenging. We are aware that it would require treaty changes.

8. This unavoidable level of deeper integration will require a **greater degree of political union** to provide democratic legitimacy and accountability. Our proposals imply a significant transfer of sovereignty from member states to European institutions. However, we believe they are necessary for the euro's long-term sustainability. Ultimately, the eurozone needs to create its own sovereignty, for only a European sovereign can make EMU last for centuries.

9. **Treaty change** is in the final analysis the best path to greater integration. We are aware that the last ratification process left many countries reluctant to follow that path. Nonetheless, the changes are needed to make EMU work effectively, to

realise its potential and to avoid future crises that could threaten its existence. Hence, as an intermediate step the enhanced cooperation procedure might need to be activated. States that want to integrate further should not be pulled back by those that do not. However, the door should always remain open for those who want to join later on.

10. To sum up, in the short term some further integration can proceed without treaty change, such as broadening the powers of the Eurogroup President, developing a common insurance deposit scheme and making the ESM the fiscal backstop for the banking union and enabling it to perform a macroeconomic stabilisation function. However, this would not be enough to make EMU sustainable in the long term. To achieve the more radical –but necessary– integration reforms, **possible enhanced cooperation as an intermediate step and, ultimately, a new treaty will be required**. A major priority for a new treaty would be to pool more sovereignty at the European level by creating a single fiscal authority for the euro area democratically controlled by a more legitimate and reformed European Parliament.

Epilogue

EMU reform cannot wait until all countries have carried out all their domestic reforms. Both risk sharing and risk reduction need to proceed simultaneously. In fact, Eurozone countries share the risk already, as the risk is systemic, but they do not yet share the costs. Some of the structural problems mentioned above are systemic issues that affect the entire euro area. Therefore, they can only be tackled with common public instruments at the European level, whose mere existence will reduce the risk.

Such reforms require the support of the people. Euro area citizens need to be given a real choice between continued fragmentation (which leaves the euro exposed to structural weaknesses and recurrent crises) and greater integration (which pools more sovereignty at the same time as it strengthens EMU governance). In a world subject to ceaseless technological transformation and revived geopolitical tensions, with increased great-power rivalry, kicking the proverbial can further down the road is no longer an option.