Deepening of the Economic and Monetary Union

Marco Buti, DG Economic and Financial Affairs, European Commission

20th Banca d'Italia Fiscal Policy Workshop

Roma, 22-23 March 2018

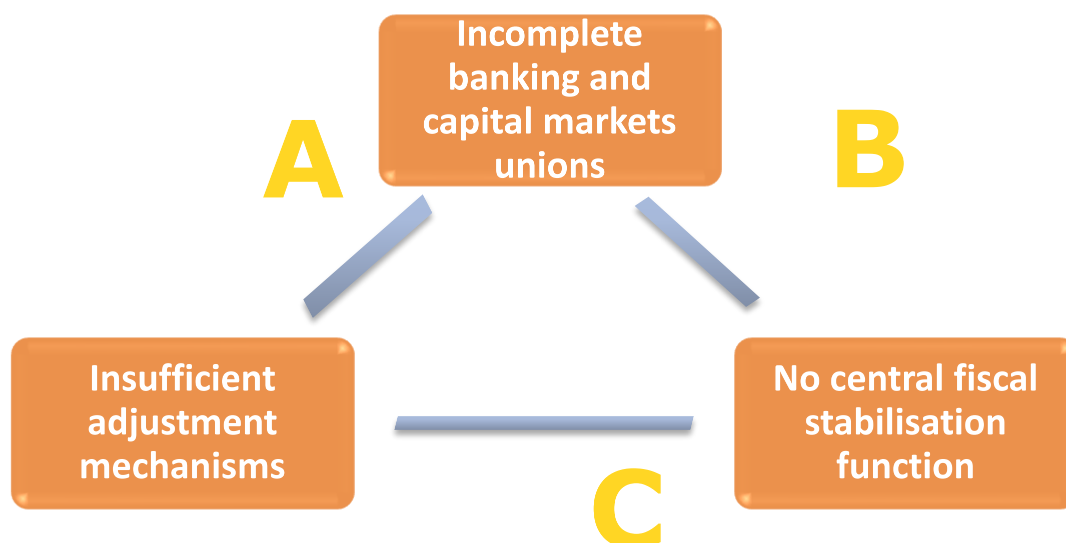
EMU: still characterised by an unstable equilibrium

Major steps have been taken to reinforce the integrity of the single currency since the financial and sovereign debt crisis. The crisis revealed various weaknesses in the Economic and Monetary Union's (EMU) construction and triggered some deep institutional reforms aimed at restoring and later safeguarding financial stability. First, the euro area was equipped with crisis resolution mechanisms: the European Stability Mechanism (ESM) provides financial assistance to euro area countries experiencing or threatened by severe financing problems. Second, several key elements of the Banking Union were also put in place: the Single Rulebook provides a single set of prudential rules applicable throughout the EU. It also acts as a foundation for the single banking market. The Single Supervisory Mechanism (SSM) ensures the single supervision of the most significant banks in the euro area, representing almost 82% of total euro area banking assets. The Single Resolution Mechanism provides a common and coordinated resolution regime for the Banking Union. Third, the Capital Markets Union (CMU), has been launched with the objective of creating a single market for capital across Member States by removing barriers to cross-border investment and lowering the cost of funding in the European Union. Several measures have been implemented since the start of the CMU to allow companies having easier access to diversified sources of capital and to increase investment opportunities. Fourth, the macroeconomic and fiscal surveillance of Member States has been strengthened with the introduction of the Macroeconomic Imbalance Procedure, enhanced national fiscal frameworks, and stronger preventive and corrective arms of the Stability and Growth Pact.

Although a lot of progress has been made, there is a broad consensus that the current setup of the EMU remains incomplete. A determined response to the crisis stabilised the situation, but key challenges still need to be addressed. The EMU today continues to rest on an unsustainable equilibrium. The incomplete nature of the financial union (Banking Union and CMU) and the absence of a fiscal stabilisation function at euro area level, imply insufficient mechanisms for the absorption of asymmetric shocks. At the same time, the current asymmetric nature of the surveillance processes – which put more emphasis on correcting fiscal or external deficits and have less influence on how to handle significant surpluses – coupled with the absence of a central stabilisation mechanism means that it is impossible to achieve simultaneously an appropriate fiscal stance for the euro area as a whole and an optimal distribution of the fiscal effort enabling to strike the right balance between stabilisation and sustainability at national level. This limits the capacity of the EMU governance framework to achieve satisfactory stabilisation for the euro area as a whole, leaving all the burden of stabilisation to Monetary Policy. Indeed, the ECB acted by taking both conventional and unconventional policy measures, the latter being activated when the Zero Lower Bond environment limits the effectiveness of the former. In addition, the absence

of a Euro wide safe asset implies that the Euro Area is not sheltered completely from liquidity and self-fulfilling crises, especially when triggered by redenomination risk concerns, while incentives for sound domestic policies remain insufficient. Finally, EMU governance has become too complex. The design of the EMU's architecture reflects a process of incremental integration over the past thirty years. As a result, the institutional architecture of the EMU is now a complex mix of the EU and inter-governmental institutions. The common interest of the euro area is currently insufficiently represented within the governance of the EMU and the system is perceived in some quarters as lacking legitimacy and accountability at the appropriate level.

Figure 1 ***EMU today: an unsustainable equilibrium***



Insufficient public and private adjustment mechanisms: Links A and C

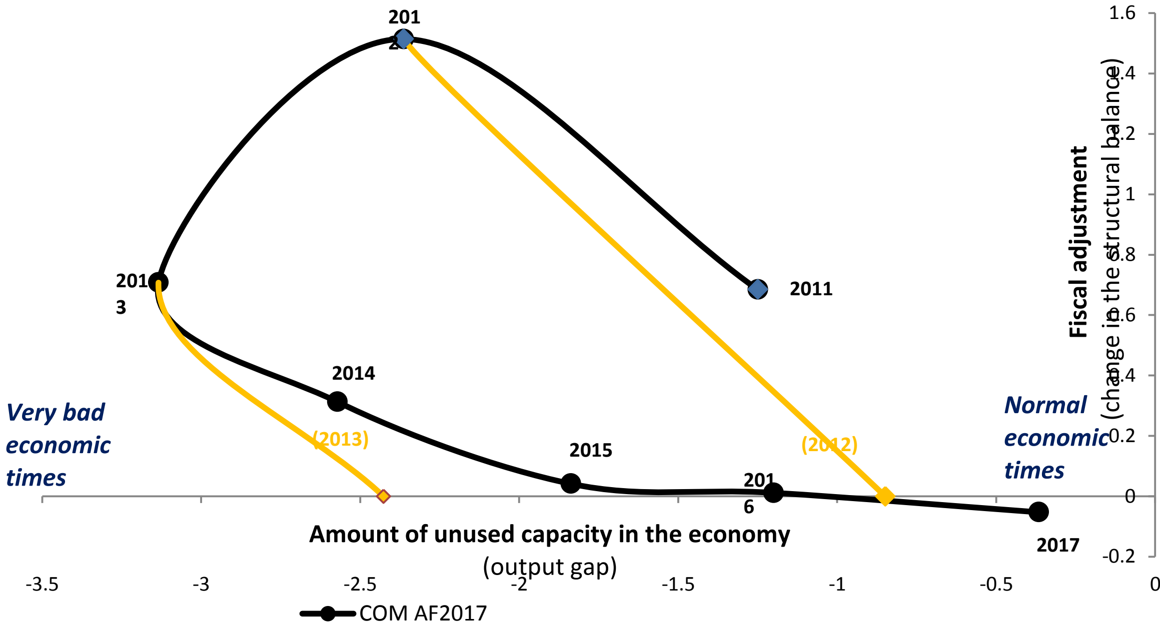
Private and public absorption channels of economic shocks in the EMU are not sufficiently developed. Both channels are less developed in the euro area than in mature monetary unions (e.g. the USA, see Box). Moreover, the fragmented financial sector acted in a pro-cylical manner amplifying shocks rather than mitigates them. The Banking and Capital Markets unions will enhance the role of private channels to absorb shocks, but only over time. Unlike in other functioning monetary unions, there are only limited collective tools available in the euro area to stabilise the business cycle. If national fiscal automatic stabilisers are insufficient and governments face difficulties in borrowing to absorb a shock, there are no common instruments at the euro area level available to help stabilise the cycle.

The crisis exposed the limits of individual Member States in absorbing the impact of large shocks. Fiscal policy's role is to stabilise the economic cycle in the short-term without compromising the goal of long-term sustainability. During the crisis, national budgets, and welfare systems in particular, played the role of "automatic stabilisers", helping to cushion the shock. However, in several countries, the availability of fiscal buffers was limited and the

market access to finance public debt was uncertain, reflecting fears of putting at risk public finance sustainability. As a result, national fiscal policies in these countries were not able to counter the recession (see Figure 2). The lack of adequate central stabilisation tools contributed to heighten the amplitude and the length of the recession leading to large increases in public debt levels. Concerns over public debt sustainability, coupled with uncertain lender of last resort responsibilities, worsened market sentiments causing debt financing costs to rise, escalating in higher public debt levels and opening the way to the materialisation of "self-fulfilling crises". This experience shows that the lack of proper stabilisation tools intensify the likelihood that a Member State hit by a large shock loses access to capital markets and needs to ask for support from the European Stability Mechanism.

Figure 2 shows the potential benefits that a central fiscal stabilisation function could bring to the euro area. The horizontal axis presents the amount of unused capacity in the economy. The further left, the worse the economic situation that a economy faces. The vertical axis reflects fiscal adjustment. The higher the value, the more contractionary fiscal policy is. If it was in place in 2012 or 2013, the stabilisation function could have eased the fiscal adjustment and moved the euro area economy closer to its potential, thus reducing the severity of the recession.

Figure 2 ***Benefits of a central stabilisation capacity***

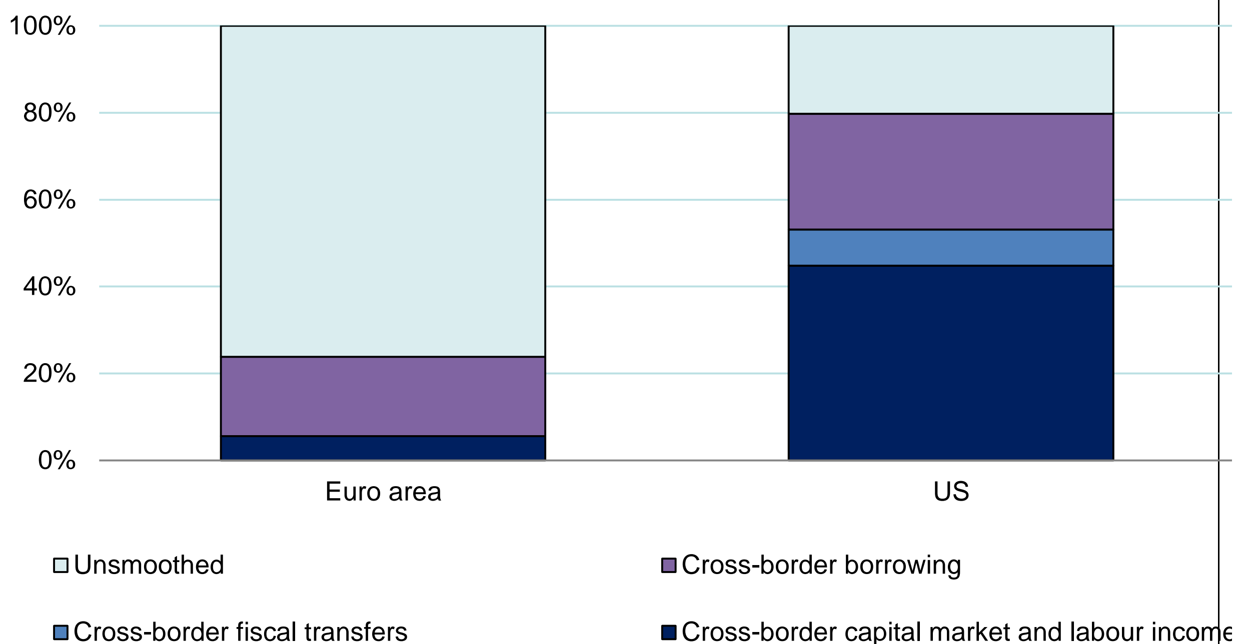


Source: European Commission, Autumn 2017 Economic Forecast

Box: Smoothing income shocks in the euro area compared to the US

A study by the European Commission compared the relative roles of private and public risk sharing in the euro area and the US.[1] The results of the study clearly show that the euro area lags significantly behind in insuring against asymmetric shocks, and highlights the untapped potential of private channels of risk sharing. A comparison with the US is relevant because the US can be seen as an economic and monetary union that has developed the necessary institutional framework for insuring against large localised shocks by 'cross-border' means. It is a functioning banking and capital markets union and it also has provisions for smoothing of shocks by fiscal means.

Figure 3 ***Cross-border risk sharing through different channels, in % of total asymmetric shock to output***



Source: Buti et al. (2016). Smoothing economic shocks in the Eurozone: The untapped potential of the financial union, VOX August.

- First, **the direct impact of output shocks on consumption is almost four times bigger in the euro area** – close to 80%. In other words, a 1% decline in GDP leads to a decline of about 0.8% in consumption in the euro area, against only 0.2% in the US. This shows the huge potential for improving cross-border shock absorption in general, including by completing the architecture of the EMU.
- Second, **cross-border risk sharing through fiscal means is virtually non-existent in the EMU**, though neither is it particularly strong in the US. This does not mean that

[1] Buti M., Leandro J., Nikolov P. (2016), *Smoothing economic shocks in the Eurozone: the untapped potential of the financial union*, 25 August 2016, https://voxeu.org/article/smoothing-economic-shocks-eurozone-untapped-potential-financial-union

fiscal policy does not have a stabilisation role within each euro area Member State, but that fiscal shock absorption takes place almost exclusively through national fiscal stabilisers. When large idiosyncratic shocks occur, as they did during the recent crisis, this can lead to a sub-optimal level of stabilisation not just for each Member State individually but also for the euro area as a whole.

- Finally, the difference with the US is particularly striking in terms of the **cross-border capital and labour income channels**. Shock absorption through these channels **in the euro area amount to around 6% of the shock, while in the US it represents over 40%**. So far as the labour income channel is concerned, there is a relatively high share of commuter workers in the US who cross state borders to work, whilst in the euro area this phenomenon is common only in Luxembourg. In addition, the US has very well developed capital markets that operate across state borders, whilst firm financing in much of the euro area is still predominately through banks, often based on established relationships with local branches.

Incomplete financial union/no central fiscal stabilisation tool: Link B

Several studies show that in US the bulk of asymmetric shocks effects are smoothed through private risk sharing. Specifically this is done by the combined effect of capital markets (private risk-sharing via cross-border ownership of assets or income smoothing) and international credit markets (saving and borrowing by households, firms, government via the banking sector). This finding is one of the main arguments used to support the view that a resilient and robust Monetary Union does not necessarily needs a fiscal union, rather it should aim at attaining full integration in the financial markets (banking and capital market unions). However, in order to draw this fundamental consideration, it is crucial to question whether, from an economic point of view, fiscal and financial unions act as complements or substitutes.

In the US, the large role of private risk channels in absorbing shocks is supported by the full financial integration of banking and capital market across US federal states. Hence, a first question to be explored is what conditions need to be put in place to achieve full financial integration in the EMU. In this regard, it is important to recognise that the peculiarities of the US financial integration in terms of cross-border ownership of assets are not easy to be replicated in the EMU because: i) State and municipal debt ownership is widespread across United States; ii) banks holdings of regional sovereign is limited; iii) the US banking system is characterised by a large number of small regional banks and only by a small number of big banks; iv) cross-border holdings of state-municipal bonds and private holdings of assets and corporate debt securities is a long standing practice in US. In the EMU the very central role played by the national banking system in financing public and private agents and the very high number of SMEs and family-run companies which makes participation of foreigners very difficult, limits the possibility to achieve deep financial integration in the short-term.

Full financial integration in European financial markets is unlikely to be observed in the short medium-term nevertheless, a set of policy measures including a fiscal stabilisation

mechanism at the level of the Euro Area can foster its development. The structural features described above suggest that a certain degree of home-bias in cross-border holdings will stay. This is also due to an inevitable degree of asymmetric information between different national countries. For this reason, it is likely that in the short-medium term the capital market channel will not be able to absorb asymmetric shocks in the EMU to the size observed in the US. This structural difference highlights the importance to rely of a variety of tools to reduce the likelihood and the size of asymmetric shocks and to make member states economies more resilient to their impact. Achieving these goals requires a set of measures to be taken at national and euro area level including, among the others, building up domestic fiscal buffers and tackling macroeconomic imbalances. These policies are crucial to reduce country specific risks and to foster cross-border risk sharing of private agents. By helping member states to absorb shocks, a central stabilisation tool can also play a significant role to reduce risk-aversion and increase the propensity to invest outside national borders.

Once full financial integration is attained, financial union and fiscal union can in principle being regarded as substitute in normal times while they are complements in bad times, when large asymmetric shocks are at play. In this regard another difference with the US emerges. In fact the business cycle of US regional states is much synchronised than across EA Members and asymmetric shocks are often of a residual nature and lower size compared to those experienced at EA level. US symmetric shocks are absorbed to a larger extent by central borrowing from the federal state.

In the event of large crises, private risk sharing does not optimally work as shocks absorber as private markets tend to behave pro-cyclically. The EMU case during the crisis showed that cross-border holdings of debt securities (mostly governments bonds) and cross-border credit flows increased prior to the crisis and collapsed afterwards. Therefore, even if the banking system experienced a good extent of integration prior to the crisis, the absence of key supranational financial institutions (which have now been partially put in place) led to abrupt and sizeable pro-cyclical reactions causing a sudden-stop crisis. This crisis triggered a set of negative spillovers originated in the inter-banking market and then spreading out to the real economy primarily via credit restraint. This inherent pro-cyclicality implies that even an integrated financial system can result disrupted in its ability to smoothing shocks during large crisis. While macro-financial prudential regulation can help avoiding unsustainable bubbles in the credit market, a cyclical decline of credit and investment inflows in an economy affected by a shock is likely to occur in any case and risks lasting longer in an incomplete currency union where adjustment channels are lower. Some studies also point out that financial markets are not Pareto-efficient since private agents often fail to hold the type and the right amount of assets to ensure proper risk sharing, in particular in case of very large shocks which are often not internalised in portfolio risk-management. (Fahri-Werning 2012).

Furthermore, even after the completion of the banking union and eventually the introduction of risk-reduction measures, national banking systems will continue suffering from real economy shocks occurring in the domestic economy. The role of fiscal insurance in this scenario assumes vital importance as it is meant to respond directly to shocks affecting the real economy and reducing the impact of further feedback effect (Alcidi, Thirion

2016). As mentioned before, the introduction of a stabilisation capacity able to reduce the country-specific consequences of idiosyncratic shocks can favour the development of an integrated financial union by fostering private risk-sharing through its insurance function.

Next steps: Completing the banking union and introducing a stabilisation function

The two key short-term priorities to deepen the EMU are the completion of the banking union and the introduction of a European stabilisation function, while keep advancing with the Capital Market Union. The Banking Union needs to be completed with the backstop for the Single Resolution Fund and the European Deposit Insurance Scheme. The introduction of these forms of public risk sharing is crucial in order to make the system robust by strengthening financial stability, reducing pro-cyclicality and maximising its capacity to smooth asymmetric shocks. The US example is again very telling in this regard: The Federal Deposit Insurance Corporation (FDIC), which has large borrowing capacity from the US Treasury deals with both banks resolution and deposit insurance and its main function is to resolve regional banks. In most cases the FDIC has dealt with the resolution of relatively small banks and only in few cases has shut down very large banks. In the few cases where very large banks have been resolved in the US, this has occurred with the combined support of the Federal Reserve, the FDIC and the federal state, while also involving losses for shareholders, without triggering neither a systemic or a large-scale regional crisis.

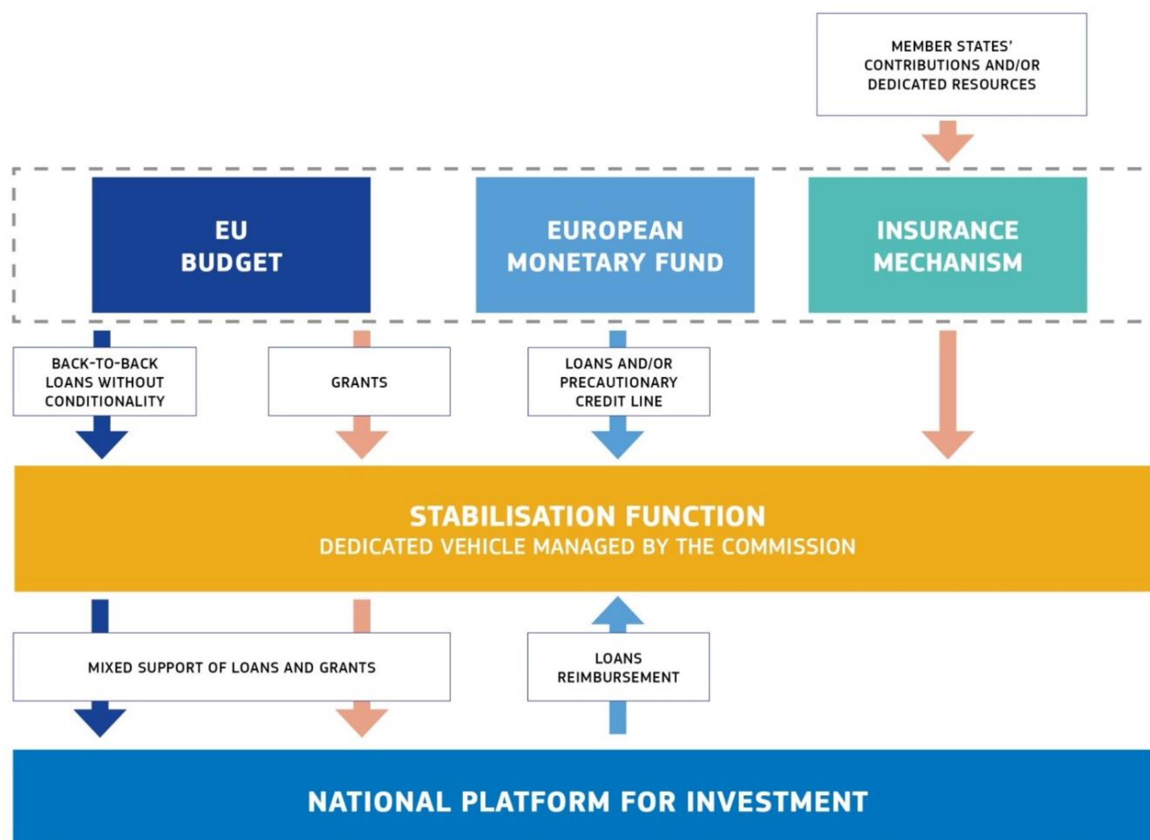
The financial system still suffers from a number of vulnerabilities in particular high NPLs and a sizeable share of national sovereign bonds he0ld by the domestic banking system. Although it stabilised significantly over the past few years thanks to bold reforms and ECB policies, reducing the existing remaining vulnerabilities in the banking system is, for a number of Member States governments, the pre-condition to advance with the completion of the Banking Union. One first source of vulnerability characterising certain banking system more than others is the high level of "non-performing loans" (i.e. loans that may never be fully repaid) accumulated in banks' portfolios. Several policy actions taken at European and national levels in the past months have already contributed to a significant decrease in the share of NPLs. A further source of vulnerability is represented by the high levels of national sovereign debt held by domestic banks, resulting in one residual but significant tie which prevents severing further the "bank-sovereign" loop. In fact, banks' exposure to domestic sovereign implies a strong correlation between the refinancing costs of banks and the value of their collateral on the one hand, and the yields on their respective sovereigns on the other hand. This creates a "home bias" or "feedback loop" that work in both directions so that a problem arising in either of the two sectors unavoidably leads to a destabilisation of both.

Although achieving progress on risk-reduction has been proposed as the way out to find a compromise to deepen the EMU and move towards common risk-sharing there is no real dichotomy between risk-sharing and risk-reduction. Risk-reduction and risk-sharing are not mutually exclusive approaches towards strengthening the EMU**.** The only viable solution – from both an economic and a political perspective – is to reduce risks and increase risk sharing in parallel. Overly focusing on risk-sharing or solidarity would create moral hazard, lack of policy discipline, and ultimately, higher risk. Similarly, an excessive focus on

risk-reduction measures would, ironically, lead to increasing risks. For instance, limiting the exposure of banks to their sovereigns, also require collective risk-sharing to minimise the risk of financial distress in more indebted Member States with a potential of a domino effect between Member States. After all the effort to regain financial stability, there are good reasons in favour of proceeding very carefully and ensuring that all available means to increase and preserve financial stability in the euro area are deployed, before any changes to the regulatory treatment of sovereign exposures are considered. The preconditions would include the completion of the Capital Markets Union and the Banking Union with a functioning backstop to the Single Resolution Fund and European deposit insurance – as well as the introduction of a suitable common European safe asset to secure stability in the euro area banking system and a continuous access of sovereigns to affordable financing. This is why the Commission emphasised in its reflection paper on deepening the EMU that any decision regarding a euro area safe asset and the regulatory treatment of sovereign exposures should be taken at the same time. A safe asset would be even more important if one were to contemplate introducing additional market discipline in the system through sovereign debt restructuring mechanisms to apply in extreme circumstances.

For what concern stabilisation, a fiscal stabilisation mechanism will be introduced in the next Multiannual Financial Framework proposal. The Commission has issued a communication within its package of 6 December 2017 proposing a fiscal stabilisation mechanism which would provide the possibility to activate resources rapidly for Member States in case of large asymmetric shocks, to complement the role played by national budgets. Strengthening the stabilisation capacity of the system is important to cope with protracted recessions that spur divergences, however the basic condition to set up such an instrument in the EMU is that its design it is able to minimise risk of moral hazard and not lead to permanent transfers and create the right incentives in the system to enable that Member States continue building adequate fiscal buffers especially in good times. The specific proposal of a budgetary instrument would rely on different sources of funding at the EU level in order to help maintaining sound national investment levels. All these features will be developed as part of the Commission proposal for the post-2020 Multiannual Financial Framework. It will be a key opportunity to modernise the Union public finances and to find new synergies to support national reforms and investment.

Figure 4: ***A European stabilisation function to protect investment***



Conclusion: proposed way forward

The steps required to complete the EMU need to be properly sequenced. There is now a growing awareness that further steps are needed. The Commission proposes to move forward in two steps. Certain elements, including the backstop to the Single Resolution Mechanism or EDIS, are indispensable and need to be put in place quickly to increase the EMU's resilience. Once these are done, a number of other elements should be addressed by 2025.

In 2017, the Commission laid on the table its proposals to deepen the EMU. The Commission provided its vision on the future of EMU, including the Financial, Fiscal and Economic Unions, in its May 2017 Reflection Paper. Then in September 2017, President Juncker indicated in his State of the Union address what the Commission intends to do to move forward in the coming years. The Commission's communication on Banking Union in October 2017 indicated a possible way forward for the European Deposit Insurance Scheme. Notably, the proposal suggested disentangling liquidity assistance and loss sharing. Under the revised first phase, the European Deposit Insurance Scheme would only provide liquidity, which would need to be repaid. Any form of loss sharing would only occur in a second phase and be made subject to adequate conditions.

The December 2017 EMU deepening package consisted of several concrete proposals, including four legislative acts. The draft legislative acts included:

- a proposal to transform the European Stability Mechanism into a European Monetary Fund anchored in EU law that would also provide the backstop for the Single Resolution Fund;
- a proposal to integrate into the Union legal framework the Treaty on Stability, Coordination and Governance (the so-called 'Fiscal Compact');
- proposals for new budgetary instruments for a stable euro area within the Union framework (a new reform delivery tool to give incentives to implement national reforms; expanded technical support to reform implementation at the request of Member States; a dedicated convergence facility for Member States on their way to joining the euro; a stabilisation function to maintain investment levels in the event of large asymmetric shocks). To pilot test the reform related elements, the Commission presented legislative proposals to extend the Structural Reform Support Programme and amend the Common Provision Regulation within the current Multiannual Financial Framework.

Finally, to enhance democratic accountability and oversight of the EMU, the Commission proposed to create a European Minister of Economy and Finance. The full proposals for the reform delivery tool, convergence instrument and for a stabilisation function will be specified in the context of the post-2020 Multiannual Financial Framework proposal of May 2018.

In March 2018, the Commission came forward with a package of measures on non-performing loans (NPLs). The package capitalised on the significant progress already made to reduce risks in the banking sector. The progress report on NPLs that the Commission adopted shows that NPLs are falling. The new measures are meant to sustain this trend and prevent their resurgence in the future. The package proposed a mix of actions in four areas: (i) ensuring that banks set aside sufficient funds to cover the risks associated with NPLs from future loans; (ii) encouraging development of secondary markets where banks can sell their NPLs; (iii) facilitating debt recovery; and (iv) assisting Member States in the restructuring of banks, by providing non-binding guidance for establishing 'bad bank' Asset Management Companies. These proposals are now in the hands of the Council and the European Parliament. It is important that all the proposals on the table are discussed in a constructive manner by the co-legislators.