European Commission

DEEPENING EUROPE'S ECONOMIC AND MONETARY UNION

Update ahead of the Euro Summit of December 2018

#FutureofEurope

BUDGETARY INSTRUMENTS FOR A STRONG AND STABLE EURO AREA WITHIN THE UNION FRAMEWORK

"I would like the euro area to benefit from a strong budget line within the future European budget, to support their reforms and benefit from the strength of European solidarity. Discussions on all our proposals continue. I think we know and understand what is at stake. What we now need is the political will to match."

European Commission President Jean-Claude Juncker, Tommaso Padoa-Schioppa Lecture, 5 June 2018

WHY THE ECONOMIC AND MONETARY UNION NEEDS SPECIFIC BUDGETARY INSTRUMENTS

The economic and financial crisis that started in the United States in 2008 exposed serious weaknesses in the architecture of the Economic and Monetary Union. Individual euro area Member States were unable to absorb large economic shocks on their own which then quickly spilled across borders leading to divergence in our economies.

This had profound and far-reaching consequences, for countries individually and for the euro area as a whole: lost growth, sinking investment, spiralling deficits and debt, bank failures, rising unemployment and poverty, increasing divergences, etc. For the Member States most hit, this meant a loss of access to financial markets, as a result of which the euro area had to put in place emergency firewalls to provide financial assistance.

Important lessons were learned from this experience: in a monetary union, it is essential to steer a high level of competitiveness and convergence, including appropriate fiscal buffers, to prevent crises and boost the resilience of each economy and of the union as a whole. However, when a large shock hits a Member State, as the crisis showed, it is equally key to have collective instruments capable of quickly and decisively dealing with such shocks to avoid the spread of contagion.

In recent years, Europe's Economic and Monetary Union has been considerably reinforced, but it is not yet complete. Building on the vision set out in the Five Presidents' Report of June 2015 and subsequent Reflection Paper of May 2017, as well as on the Future of EU Finances, the Commission developed a roadmap for the deepening of Economic and Monetary Union, which includes the **development of new budgetary instruments for a strong and stable euro area within the Union framework.**

WHAT IS ON THE TABLE

In the context of the preparation of the forthcoming EU Multiannual Financial Framework for 2021-2027, the Commission proposed in May 2018 to establish two new instruments within the future EU budget:

A Reform Support Programme will support priority reforms in all EU Member States, with an overall budget of €25 billion. It comprises three elements: a Reform Delivery Tool, to provide financial support for reforms; a Technical Support Instrument, to offer and share technical expertise; and a Convergence Facility, to help Member States on their way to joining the euro. The priority reforms will be identified through the European Semester of economic policy coordination, including through the Recommendation for the economic policy of the euro area.

A European Stabilisation Function will help stabilise public investment levels and facilitate rapid economic recovery in cases of economic shocks in euro area Member States and those participating in the European Exchange Rate Mechanism (ERM II). This Function will complement the role of existing automatic stabilisers. Subject to strict criteria of sound macroeconomic and fiscal policies, loans of up to €30 billion can be rapidly mobilised, together with an interest subsidy to cover their cost.

These new tools have been designed to serve the specific needs of countries which are in the euro area as well as those which are still out. They create incentives for Member States to boost reforms to strengthen their resilience and allow for support to those hit by large shocks which are not of their own doing. This is in everybody's interest.

Moreover, these new tools have been conceived to create maximum synergies between EU-level instruments, notably with the future European Structural and Investment Funds, and with the future InvestEU, which will be the successor to the Juncker Plan. Creating such synergies within the EU budget is the best way to make sure that every euro is invested/spent to best effect.

Important contributions and ideas were added to the debate on the possible architecture of a euro area budget as part of the EU budget. These options are fully compatible with the proposals on the table, both in terms of purpose and design. They can also be combined over time in a step-by-step approach. What is important is that instruments are conceived as a consistent package of robust and effective tools which can serve the diverse needs and priorities of the euro area and of the EU.

Budgetary instruments for a strong and stable euro area within the Union framework
Proposals for the EU Multiannual Financial Framework 2021-2027

Competitiveness and convergence			Stabilisation
European Structural and Investment Funds	InvestEU, successor to Juncker Plan	NEW Reform Support Programme	NEW Stabilisation Function
€391 billion	**€38 billion** guarantee	**€25 billion**	Possibility to borrow **€30 billion**
Grants and loans National and regional convergence EU-27	Loans and equity Investment support to specific projects EU-27	Grants and technical expertise Support to reforms Euro area and non-euro area (including Convergence Facility)	Loans and limited interest subsidy Support in case of shocks Euro area and ERMII countries

COMPETITIVENESS AND CONVERGENCE INSTRUMENTS

The proposals for the EU Multiannual Financial Framework for 2021-2027 include important novelties to enhance the efficiency and effectiveness of existing EU financial instruments in support of competitiveness, convergence and investment, as well to strengthen their link with the European Semester of policy coordination, including the policy guidance provided for the euro area as part of the Recommendation for the economic policy of the euro area.

Building on the success of the European Fund for Strategic Investments – the core of the Juncker Plan – in catalysing private investments throughout Europe, the Commission proposes to set up a new, fully integrated investment fund, **InvestEU.** This fund will anchor all centrally managed financial instruments inside the EU in a single, streamlined structure. With a contribution from the EU budget of €15.2 billion, InvestEU is expected to mobilise more than €650 billion of additional investment across Europe.

The Commission is also proposing to modernise and strengthen the **European Structural and Investment Funds**. Working together with other programmes, the funds will continue to offer essential support for investment across EU Member States and regions with a total amount of €391 billion. The Commission proposes to strengthen the link between the EU budget and the European Semester so that investment priorities at national and regional level closely support the priority reforms needed to modernise Member States' economies. Regional specificities will also be better taken into account.

The new Reform Support Programme will offer additional technical and financial support for reforms at national level with an overall budget of €25 billion. This new programme will include a **Reform Delivery Tool** providing financial incentives across all Member States for key reforms identified as part of the European Semester. It will include a **Convergence Facility** for Member States outside the euro area to support their reform efforts on their way to adopting the euro. It will also include a **Technical Support Instrument** to help Member States design and implement their reforms. Over the last three years, at the request of the Member States, about 500 technical support projects have already been initiated by the Commission's Structural Reform Support Service.

STABILISATION FUNCTION

The logic of a stabilisation function for the euro area is to be able to deal with severe shocks affecting individual Member States that cannot be tackled at national level alone and to do this before the shocks become crises and spread to other countries, which can prove more costly to everyone. This is a typical feature of any mature monetary union.

Such stabilisation function is not a "silver bullet" to prevent or absorb all shocks by itself: it is meant as a new, necessary complement to the Economic and Monetary Union toolbox, alongside the fulfilment of the rules under the Stability and Growth Pact to create the necessary fiscal buffers, as well as the strengthening of further private risk-sharing channels and mechanisms across EU economies, such as the deepening of the single market, the completion of the Banking Union and the development of the Capital Markets Union.

With this in mind, the Five Presidents' Report set out four criteria that any stabilisation mechanism should meet:

- it should not lead to permanent transfers between countries or to transfers in one direction only;
- it should neither undermine the incentives for sound fiscal policy-making at the national level, nor the incentives to address national structural weaknesses;
- it should be developed within the framework of the European Union;
- it should not duplicate the role of the European Stability Mechanism as a crisis management tool.

Building on the Five Presidents' Report of June 2015, the Commission highlighted three practical options in its Reflection Paper on the Deepening of the Economic and Monetary Union:

- A ***European Investment Protection Scheme*** could protect investment in the event of a downturn, by kicking-in to support pre-defined projects, such as infrastructure or skills development.
- A ***European Unemployment Reinsurance Scheme*** could act as a "reinsurance fund" for national unemployment insurance schemes.
- A ***rainy day fund*** could regularly accumulate funds from Member States and disbursements would be triggered on a pre-defined basis.

A European Unemployment Insurance?

This type of stabilisation mechanism has been discussed over the years.

In July 2016, the Slovak Presidency of the Council organised a high-level conference gathering prominent academics and policymakers to discuss the key elements of such a system.

In January 2017, with the support of the European Parliament, the European Commission completed an extensive research project on the topic, conducted by a consortium of external experts led by the Centre for European Policy Studies (CEPS). This consortium discussed various ways of dealing with problems such as the risk of permanent transfers across Member States and of moral hazard.

A fully-fledged European Unemployment Insurance System would complement and partly replace national unemployment benefit systems. This would provide for a very strong macroeconomic stabilisation effect: in times of crisis and stretched public finances, the financing of unemployment benefits would come from a European scheme and thus ease the burden on national budgets.

However, setting up such a scheme would also require a high level of intrusiveness in national systems and/or a high level of convergence, including harmonisation of certain core aspects of national models, such as the design of unemployment benefits, the functioning of certain labour market institutions and the content of active labour market policies. Agreeing to such a scheme and preparing for it would also require a very lengthy and difficult process of technical, financial and political transition.

By comparison, a European Unemployment Reinsurance Scheme would allow for national unemployment benefit schemes to draw on additional resources when unemployment increases. Such a scheme could combine loans and grants. It would reinforce the functioning of automatic stabilisers and thereby reduce the likelihood of aggravating budgetary cuts in downturns. However, even if lighter than a fully-fledged insurance system, the creation of the scheme would still require difficult-to-agree eligibility conditions and governance systems, including minimum or possibly harmonised standards in the social domain.

The experience of the European Deposit Insurance Scheme (EDIS), another important element for the completion of the Economic and Monetary Union, shows that it is difficult to establish this kind of reinsurance system, even in domains which do not require the full harmonisation of national policies or institutions.

On this basis, as part of its proposals for the EU Multiannual Financial Framework for 2021-2027, the Commission proposed in May 2018 a concrete set-up for a euro area stabilisation mechanism in the form of a European Stabilisation Function. This mechanism combines the various elements mentioned above and is now for discussion by the European Parliament and the Council.

Stabilisation function: how they can work

	European Stabilisation Function (proposed by the Commission)	**European Unemployment Reinsurance Scheme** (intermediate)	**European Unemployment Insurance System** (fully-fledged)
What is the rationale?	Stabilise economic activity during economic shocks by supporting/maintaining levels of public investment	Stabilise economic activity during severe crisis by lending money to national social security systems	Stabilise economic activity during severe crisis by easing the burden of financing unemployment benefits
What is the geographic scope?	Euro area and Exchange Rate Mechanism II (fixed exchange rate)	To be determined	To be determined
What type of support?	Loans (guaranteed by the EU budget) and limited grants (to subsidise the interest rate cost of the loan). Member States will need to pay back the loans in better times	Loans and possibly grants	Grants
How would it work?	Money will be borrowed under the ceiling of the EU budget in case of need. A new Stabilisation Support Fund is created to cover the interest subsidy	A new Stabilisation Fund at euro area level would be needed	An EU structure managing the scheme in cooperation with national schemes would need to be set up
Who would finance the support?	EU would borrow money to finance the loans National contributions to finance the grant component (interest rate subsidy) would go to the dedicated Fund	The fund could be partially or fully financed ex-ante through national contributions	National contributions would need to feed into the European scheme, which would partly replace national ones. A system of "insurance premium" could be envisaged
How much money?	Maximum €30 billion for the loan component. Interest rate cost subsidised at 100%	To be determined	To be determined
What kind of conditions ?	Member States have to comply with the commonly agreed EU fiscal and macroeconomic rules	Several preconditions have been suggested, including compliance with relevant EU rules but also new minimum standards for social protection schemes	In addition to compliance with fiscal rules, this most likely requires a degree of harmonisation of essential labour market institutions and social benefit schemes across countries
Who would receive the support?	Transfer to the national budget subject to the condition to maintain past levels of public investment	The fund could lend directly to national systems	Support through transferring money back to the national unemployment insurance funds
What could be trigger to activate the scheme?	Absolute increase in the unemployment rate (above 1 percentage point), and deviation from historic averages	To be determined	To be determined

The various ideas on the table, including those recently presented – such as by France and Germany – are very compatible with the Commission's proposal. In particular:

- The focus of the Commission's proposal is for the euro area Member States (and those that have their currency pegged to the euro in the Exchange Rate Mechanism (ERM II)).
- The scheme builds on loans within the EU Multiannual Financial Framework, which will need to be repaid when economic times get better. This provides for a sound and cost-effective financial anchoring.
- The eligibility criteria are such that they create extra incentives to comply with the Stability and Growth Pact and thus prevent risks of moral hazard.
- The activation trigger is based on a sudden rise in unemployment levels and fits other existing ideas on the table. This trigger is easier to measure and fits better the notion of shocks than other ideas based on investment, for which data often lags behind the economic reality.
- The scope of the scheme includes protecting investment levels in the broad sense, including training/retraining activities for the unemployed and other social investment, which prove particularly necessary and urgent in the event of a major shock.
- The financing of the interest subsidy of the scheme would build on national contributions through a Stabilisation Fund. This component has the potential to grow over time if participating Member States so wish, which means that the architecture remains flexible and can be adjusted to circumstances.

All in all, the Commission's proposal thus already provides a sound legal and technical underpinning for the design of such a stabilisation function: tested legal basis under the Treaty on the Functioning of the European Union, clear eligibility rules, sound trigger mechanism, financial construction which avoids permanent transfers, proven governance and accountability system, etc. While the proposal can always be improved in the discussion with the co-legislators, these features provide a useful basis on which to build any stabilisation instrument.

THE WAY FORWARD

The Eurogroup of 3/4 December 2018 discussed the question of possible new budgetary instruments and referred to the Euro Summit of 14 December 2018 for further guidance.

One important take-away from recent discussions is that such budgetary instruments should be designed in the context of the EU Multiannual Financial Framework for 2021-2027.

The proposals and initiatives on the table are largely convergent and compatible. The legal proposals of the European Commission provide a pragmatic and flexible basis for the European Parliament and the Council, including the Eurogroup, to take the discussion forward: they allow the incorporation of various ideas and sensitivities as part of an overall consistent framework at European level, by adding value to and maximising synergies with the existing instruments, and they provide the best chance of a rapid and cost-effective implementation afterwards.