Contributions from the Sherpas of the Member States to the Five Presidents' Report

SPAIN

Second Contribution

Better Economic Governance in the Euro Area

Spanish Contribution

May 14th 2015

<u>The economic crisis confronted the Euro Area with its weaknesses</u>. The crisis might not have been exclusive to the Eurozone, but **specific factors** prolonged and aggravated its effects:

Monetary unions are vulnerable to asymmetric shocks. As Member States cannot make use of currency devaluations to absorb economic shocks, the burden of the adjustment falls on internal flexibility and on factor mobility. And the Euro Area lacks efficient shock-absorbing mechanisms.

First of all, **the Euro Area lacks adequate internal price and income flexibility**. Indeed, in the years preceding the crisis, nominal and real rigidities at national level delayed the necessary adjustments in prices and wages. While inflation remained low at the aggregate level, differences in product and labour markets led to differences in inflation among Member States.

In these circumstances, the single monetary policy stance proved to be inadequate for certain Member States and generated asymmetric effects. In some countries, monetary policy resulted excessively loose, leading to negative real exchange rates. Such financial conditions distorted rational behavior of economic agents and promoted excessive indebtedness and the accumulation of imbalances. These developments also fostered significant competitiveness losses in certain Member States.

At the same time, **the Euro Area lacks sufficient labour mobility** (while capital movements are unrestricted). This combination has amplified the volatility of asymmetric shocks, and hampered an efficient adjustment inside the EMU: imbalances could not be absorbed by the relocation of workers among countries, but by adjustments in the number of employed and unemployed within each country. This, ultimately, led, in some countries, to dramatic increases in unemployment.

Another central condition for an efficient monetary union is the existence of a truly functioning **internal market**. Market fragmentation increases the divergences among countries in their cyclical situation, which is a source of instability for the single currency and makes a single monetary policy difficult to implement.

Consequences were especially acute in the **financial sector**. The EMU had a fragmented banking sector and, in particular, a fragmented retail banking sector. This feature, which has still not been sufficiently addressed in the context of the banking union, aggravated the accumulation of imbalances. Debtors were concentrated in the banking sector of certain countries, while creditors were in others. As the financial crisis broke out, weak financial interconnections collapsed. This had two effects: (1) First, it triggered a severe banking crisis, as liquidity problems quickly turned into solvency problems; (2) Second, a financial crisis was rapidly transformed into a sovereign debt crisis. As confidence in banking sector solvency deteriorated, fears of a sovereign bail out, in a context of deteriorated fiscal accounts, shot up risk premia in countries under stress. At the same time, financial fragmentation along national borders restricted demand for sovereigns with high external imbalances.

One last feature of the 2008 financial crisis is that it also led to **unforeseen fiscal deficits**, caused, to a great extent, by a dramatic **revenue plunge**. Indeed, in low competiveness countries, fiscal revenues were excessively dependent on the artificial growth nurtured by negative real interest rates and on the accumulation of external deficits. The outbreak of the crisis provoked a sharp deterioration in their fiscal situation.

<u>In the last years, significant progress has been achieved in relevant areas</u>.

The Banking Union, the creation of financial sector support instruments in the framework of the ESM, and the liquidity measures adopted by the ECB have broken the feed-back loop between banks and national sovereigns.

Secondly, the creation of instruments (with adequate rules and conditionality) for debt market intervention, together with the setup of specific assistance programs helped, first, contain and, then, put an end to the sovereign debt crisis. Although the current situation cannot be qualified as of total normalization, countries that have exited Economic Adjustment Programs have returned to the market, and spreads differentials have moderated.

Thirdly, the macroeconomic adjustment and deep structural reforms put in place at national level have helped avert the external unbalances and reduce competitiveness differences among member states.

<u>However, much remains to be done to strengthen the European Monetary Union</u>, consolidate the economic recovery and prevent future crises and instabilities. In the medium and long term, **five elements** are needed to complete a sound and mature monetary union:

1. Eliminate real and nominal rigidities that hamper swift adjustment to economic shocks.
2. Reach sufficient levels of labour mobility
3. Achieve a sound Fiscal Union to complete and reinforce the Monetary Union. Such Fiscal Union should encompass three elements: (1) <u>transfer of sovereignty</u> to the Union on national revenue and expenditure policies; (2) a <u>common Eurozone budget</u>; (3) <u>common debt instruments</u>.
4. Complete the internal market. In particular, financial market fragmentation has to be tackled by ensuring adequate integration in the retail banking sector.
5. These advances will entail sovereignty transfers to the central level of the EMU, and thus need to be accompanied of enhanced democratic legitimacy and accountability.

The **key issue now is how to progress to this medium and long term scenario**. Bold measures need to be taken in the short term to anchor expectations and ensure the credibility of the process. At the same time, adequate incentives need to be put in place to promote balanced convergence and ensure sustainability.

The Government of Spain proposes a gradual approach, **based on a transparent new convergence process enshrined in a clear and predictable roadmap**. This gradual approach is similar in inspiration to the Maastricht convergence process that led to the adoption of the single currency. It would entail three stages, each of which will foster progress on each of the five elements identified as essential for the efficient functioning of the Monetary Union. Participation in the different stages will be conditional on Member States ensuring adequate fulfillment of newly defined **convergence criteria**. Such criteria have to be designed so as to promote fiscal and external balanced positions, as these are the two sources of instability for a monetary union.

I. First stage: 18 months (until 2017):

This is a preparatory stage. While engaging in deep analysis on the identified weaknesses, this stage will develop all the necessary work to design the convergence process, the convergence criteria and the policy coordination tools. Measures not requiring Treaty changes would be implemented at this stage to anchor the process.

The first and essential step is to **streamline and reinforce policy coordination processes**. Fiscal imbalances, as a source of instability in the EMU are already covered within the Stability and Growth Pact framework. However, more work needs to be done to prevent the negative spillovers of external unbalanced positions. And these imbalances need to be identified and tackled at an early stage. Therefore, at this stage, an appropriate set of indicators needs to be identified and regularly monitored based on periodic publication, in order to timely correct deviations. A process similar to the one foreseen for fiscal deviations within the Excessive Deficit Procedure should be set up. Member States would commit to take the necessary measures to swiftly correct identified imbalances. The design of specific correction policies, however, would remain a responsibility of Member States, in full respect of the subsidiarity principle.

Such indicators could be: inflation, real effective exchange rate, external deficit and differentials in unit labour costs. Inflation expectations measured by the evolution of interest rates could also be taken into account. An immediate option could be reintroducing, in the coordination process, nominal convergence rules of inflation established in the Maastricht Treaty. The paradox has been that fiscal criteria have been monitored after the creation of the single currency through the Stability and Growth Pact, while no similar treatment has been given to nominal convergence in inflation criteria.

The framework of imbalances identification and correction and policy coordination needs to be complemented by a **more adequate formulation of monetary policy**. In the years before and after the crisis, the ECB has maintained its definition of price stability essentially unchanged (a year-on-year increase in the Harmonized Index of Consumer Prices for the euro area of below, but close, to 2%). This definition must be adapted to take into account not only average inflation in the Euro area but also its variability across countries and the divergent conditions this variability creates.

Labour mobility: at this stage, the Commission would launch a green paper on a “Labour Market Union”. This paper would serve as a first analysis of all elements needed to achieve maximum labor mobility: deepening current initiatives such as the foreseen labour mobility package (in particular measures enhancing coordination in social security systems), initiatives in the field of education and recognition of professional qualifications; language and/or cultural barriers... The aim of this process would be to ensure coherence in the multiple fields related to labour mobility, identify the legislative changes needed and send a strong signal of political determination to advance.

Fiscal Union: At this stage steps towards a fiscal union are meant to set strong foundations for deeper integration. These steps are to be taken in three areas:

✓ First: **measures in the taxation area**. Harmonization of budgetary frameworks and fiscal alignment is critical and constitutes a frequently forgotten feature of a prospective fiscal union. A first and urgent step is to ensure swift progress against aggressive tax planning, base erosion and profit shifting (BEPS). Action should be taken along the following lines:

- Approve new initiatives against aggressive tax planning, base erosion and profit shifting (BEPS). In particular, the EU should ensure swift implementation of proposals to favor the exchange of information and the widest possible scope of application for the automatic exchange principle.
- Protect internal markets from tax avoidance and engage in transversal and coordinated actions with other countries in the fight against tax heavens.
- Take a close look in the fiscal treatment of hybrid instruments, the international fiscal rules, the rules against exit tax and so on.
- Introduce a European fiscal identification number that will facilitate the identification of tax payers that embark in cross-border operations.
- Enhance fiscal transparency including through enhanced cooperation and the application of counter-measures against non-complying jurisdictions. A Code of Good Practices will be a useful tool in this endeavor.

✓ Second: progress on the expenditure side, in particular on **public investment** within the framework of the European Investment Plan (Juncker Plan). The following measures could be considered:

- Include, in the framework of the SGP, a “golden rule” for investment, to be applicable in the case of investments made in the interest of the EMU. Under this “golden rule”, Member States could temporarily and in a limited and small manner deviate from their adjustment path.
- Create a specific ESM facility to finance or “guarantee” infrastructure projects in the interest of the Union. These projects should have a participation of the private sector and render market yields, in line with the projects considered under the Junker Plan.
- Allow for the EFSI to find additional leverage in the financial markets in order to increase the effects of the Junker investment Plan.

✓ Third: **agree on a precise roadmap to achieve a full fiscal union**. This roadmap needs to be simple and predictable, while incorporating adequate incentives and strict conditions to ensure the stability of the Union. **The process should be based on the strengthened policy coordination process and its set of indicators, which will function as a continuous and dynamic monitoring and correction mechanism**.

That is, not only accessing further phases of fiscal integration will be conditional on the fulfillment of established thresholds for fiscal and external sector indicators, but these thresholds will also be considered permanent requirements. By enshrining the convergence process in a stable policy coordination framework, the EMU guarantees that adequate monitoring will continue once the Fiscal Union is in place, triggering correction mechanisms if necessary.

Internal market: the process of completion of the internal market should be accelerated. The Commission has announced its intention to present an Internal Market Strategy. The Government of Spain considers that this could be a good opportunity to adopt a comprehensive and ambitious approach. The strategy should identify remaining shortcomings and propose the necessary legislative changes and specific measures. On the basis of this analysis, measures immediately applicable should be adopted already in phase one and a time-bounded roadmap developed to ensure completion of the process.

In this stage, the EMU should proceed to **full implementation of the Banking Union**. The Single Resolution Mechanism and the Single Resolution Fund will become operative as of January 2016. The banking union framework should be completed by further integration in the deposit guarantee area, with the creation of a Single Deposit Guarantee Scheme. Furthermore, work should proceed on the development of an adequate backstop for the Single Resolution Mechanism as committed by the ECOFIN Ministers in their statement of December 18th 2013.

Additionally a complete Banking Union requires an **integrated retail banking sector**. In this stage, a Green Paper on the integration of retail banking markets should be launched. Fifteen years after the introduction of the Euro, retail banking remains dominated by domestic banks in most EMU countries. It is very common to find Eurozone banks that have larger retail operations outside the EMU than in other EMU countries. The objective of this green paper would be to analyze the barriers to the establishment of pan-European retail banks. While the Banking Union should clearly help remove some of these barriers, there are particular areas where further liberalization of cross-border investments may be needed, looking at areas such as national supervisors' powers to block mergers, consumer protection regulations and cross-selling restrictions.

Political Union: **Increased democratic accountability and greater cooperation among national parliaments** is increasingly needed. It could take the form of biannual hearings of the Presidents of the Eurosummit, the Eurogroup and the ECB as well as of the Vice President of the Commission in charge of Euro matters and of the relevant Commissioners who will report on the economic situation and action taken to representatives of the economic Commissions of the European Parliament and national parliaments (applying the distribution key of countries representation in the European Parliament).

II. Second stage: 2017- end of current legislative period (2019):

In this stage, the focus should be set on implementation and legislative development, including changes in the EU Treaties, as needed.

Eliminating structural rigidities: As previously said, **the new policy coordination and imbalances correction process will be permanent**. It will foster real economic convergence and prevent the accumulation of imbalances. Sustained fulfillment of established thresholds will be required in this phase for Member States to access to the first stages of the Fiscal Union.

As countries aim for economic convergence in this stage, **the ECB's mandate will be adapted** to regulate the contribution of monetary policy to this objective. While price stability (under the revised definition envisaged previously) will remain the primary objective of the ECB, its contribution in the prevention of macroeconomic divergences and imbalances across countries will be made explicit.

Labour mobility: In this phase, legislative work identified in the Green Paper on labour mobility will be developed and approved, and other identified measures will be implemented.

Internal market: The EMU should complete all the legislative work required for the completion of a sound internal market, as established in stage one. This would include the approval of specific legislation to ensure sufficient integration in the retail banking sector.

Fiscal Union: The second phase of the fiscal union process involves the **creation of a limited common fiscal capacity within the EMU**. This fiscal capacity will be of a cyclical nature and linked to the financing of public investments. It will be financed by the EMU´s own resources (to be defined) and will have limited borrowing capacity. To ensure its cyclical nature, debt emission will be subject to strict conditions and will be contingent on cyclical needs: Debt issued in "bad times" will have to be absorbed in "good times" thus preventing unsustainable debt accumulation dynamics.

Another important feature of any fiscal union is common debt management. Currently the EMU is confronted to high stocks of public debt, both at the national level and in the EFSF/ESM framework. A reflection process, enshrined in a specific Green Paper, should be launched on the future of this debt within a fully-fledged fiscal union (third stage) with a view to preserve fiscal sustainability.

Political Union: Progress in economic integration has to be accompanied by deeper political integration. At this stage, an **Authority responsible for economic policy in the Eurozone**, sort of a Eurozone Minister of Finance, will be needed. This Authority would be responsible for the limited fiscal capacity already in place; would be in charge of the coordination and supervision of the convergence process; and will promote the analysis of public debt management. Furthermore, he or she would make recommendations to foster the deepening of the Internal Market and labour mobility. The Authority will be appointed by representatives of the European Parliament and national parliaments (applying the distribution key of countries representation in the European Parliament), acting on a proposal of the European Council.

III. Third stage: beyond 2020:

This phase requires not only changes in the Treaties, but also institutional changes without a limited timeline (this timeline is to be decided during the second stage). Access will be conditional on sustained fulfillment of convergence fiscal and external sector criteria in the framework of the monitoring and correction procedure.

Eliminating structural rigidities: The EMU should have reached sufficient flexibility levels to ensure its smooth functioning. In any case, the monitoring and correction procedure for policy coordination will continue to function during the third stage, preventing divergences and accumulation of imbalances. The European level should be granted clear competences in fields most related with the reduction and elimination of structural rigidities.

Labour mobility: All competences related to labour mobility should be transferred to the European level, including, for example, matters related to social security, unemployment insurance, or professional qualifications.

Internal market: To ensure an efficient functioning of the internal market, responsibilities should be clearly assigned between the European level and Member States. The **Government of Spain proposes an approach based on lists**. The aim will be to order regulatory elements (either by topic or by their nature of primary law or implementing legislation). The highest level will correspond to legislation to be approved at the European level. Other norms will require a qualified majority of the Council, while a simple majority will suffice to approve lower categories.

Fiscal Union: Based on the analysis on public debt undertaken in stage II and once the budgetary responsibilities are clearly assigned between member States and the European level, the limited fiscal capacity could be enhanced to create **a true Fiscal Union** encompassing the three central elements (1) transfer of sovereignty on revenue and expenditure policies to the European level; 2) a common Eurozone budget; 3) common debt instruments.

Participation in the Fiscal Union will be conditional to Member States achieving a significant degree of convergence, as demonstrated by sustained fulfillment of established criteria. Common debt instruments will be subject to controls and limits to ensure fiscal stability.

Political Union: The Authority responsible for economic policy in the Eurozone will assume full responsibility for the EMU fiscal policy and will be granted direct sanction powers towards national administrations.