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

SPAIN

First Contribution

THE FUTURE OF THE EMU: BETTER ECONOMIC GOVERNANCE

In the ongoing process of discussion to help advance a forward-looking report by the Four Presidents on a better economic governance of the European Monetary Union, Member States have been asked to address the following questions:

- ✓ *How can we ensure sound fiscal and economic positions in all euro area Member States?*
- ✓ *How could a better implementation and enforcement of the economic and fiscal governance framework be ensured?*
- ✓ *Is the current governance framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run?*
- ✓ *To what extent can the framework of EMU mainly rely on strong rules and to what extent are strong common institutions also required?*
- ✓ *What instruments are needed in situations in which national policies continue – despite surveillance under the governance framework – to go harmfully astray?*
- ✓ *Has the fiscal-financial nexus been sufficiently dealt with in order to prevent the repetition of negative feedback loops between banks and sovereign debt?*
- ✓ *How could private risk-sharing through financial markets in the euro area be enhanced to ensure a better absorption of asymmetric shocks?*
- ✓ *To what extent is the present sharing of sovereignty adequate to meet the economic, financial and fiscal framework requirements of the common currency?*
- ✓ *Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?*
- ✓ *Under which conditions and in which form could a stronger common governance over structural reforms be envisaged? How could it foster real convergence?*
- ✓ *How can accountability and legitimacy be best achieved in a multilevel setup such as EMU?*

The Spanish views on the main issues related to improving the Economic Governance in the Euro Area **can be summarized as follows**. These views serve as a response to the aforementioned questions.

The economic crisis unveiled significant weaknesses in the design of the Economic and Monetary Union. The Euro Area lacks efficient mechanisms to absorb asymmetric shocks. Labor mobility is reduced, yet capital movements are unrestricted. Structural rigidities delay price and wage adjustments. As a consequence, countries can find themselves in different cyclical situations, hence rendering inefficient the implementation of a single monetary policy stance.

Differences in competitiveness are at the heart of the problem. In the absence of the exchange rate as a tool to regain competitiveness or to face an asymmetric shock, the burden of adjustment must lie on the mobility of factors and on internal flexibility. <u>Structural reforms implemented at the national level are critical to facilitate this adjustment</u>. However, these should be complemented by <u>mechanisms to share financial and fiscal risks at the central level,</u> since the Eurozone as a whole is more diversified and more resilient against a negative shock than its members taken separately. In parallel, we should advance towards the completion of a genuine Single Market, key for the convergence of economic cycles.

The report of the Four Presidents "*Towards a genuine economic and monetary Union*" of December 2012 paves the way for the reform. Integrated financial framework and budgetary framework could provide the necessary adjustment mechanisms while an integrated economic framework should facilitate the completion of the internal market. **We can congratulate ourselves for the progress achieved in the construction of the Banking Union, but the other areas of integration lag behind.** The Government of Spain would like to recall its contribution to the debate on the construction of a fiscal union[1]. In our view, a fully-fledged fiscal union should encompass a budgetary risk-sharing arrangement, joint decision making for a European orientation of fiscal policy and a certain level of risk pooling in debt issuance. These proposals are still valid and need to be approached in the medium to long term.

Indeed, **the construction of a complete an efficient EMU is a gradual process**, as it has always been the case for the whole process of European integration. This step by step approach entails, however, that bold decisions are taken in the short term to map out the path of reform, anchor expectations and prove the commitment of Member States.

Priority should be given to the **development of mechanisms to promote greater convergence of economic cycles**, as this is a prerequisite for a soft transition to fully fledged EMU. These should include **sound mechanisms to prevent the accumulation of both fiscal and external imbalances inside the EMU**, as well as greater coordination for the correction of asymmetrical shocks and the development of a truly European oriented policy formulation framework.

In this spirit, **Spain would like to put forward concrete short term proposals**, to be implemented in the next 18 months, in two areas identified by the Four Presidents Report: coordination of economic policy and fiscal union.

POLICY COORDINATION:

Important progress has been made in the surveillance and prevention of fiscal imbalances. The Growth and Stability Pact (GSP), as reinforced by the six-pack and the two-pack regulations and the Treaty on Stability, Coordination and Governance, provides a sound framework for their detection and correction.

However, **no equally specific procedure has been put in place for current account imbalances, and these were at the very heart of the crisis**. The Macroeconomic Imbalances Procedure takes these factors into account, but the analysis is diluted by the consideration of other variables and depends on extensive and complex judgment. Furthermore, the current design of the MIP is excessively biased towards backward looking analysis. The inclusion of stock variables and the consideration of three year averages hamper the early identification of trends, which is crucial for an effective evaluation of economic policy.

Proposal:

Streamline the European Semester. To efficiently fulfill its role as early warning mechanism and as a transparent tool to prevent the accumulation of external imbalances, which constitute the main danger for the stability of the EMU, the **MIP should be**

[1] Spanish Non paper *Towards a European Fiscal Union*, August 1st 2012.

simplified and should focus exclusively on current account imbalances and competitiveness. In particular, a simplified, forward looking MIP considering only current account balance and REER (Real effective exchange rate) could more accurately identify the building up of external imbalances and better qualify the application of structural reforms and their effects. Fiscal indicators (public debt) are more accurately assessed in the framework of the Stability and Growth Pact. As for unemployment and social indicators, their inclusion in the MIP is not accurate, since they do not constitute early warning indicators.

A simplified and more focused MIP, together with the SGP, **will permit early and transparent identification of imbalances incompatible with the good functioning of the EMU.** The correction of such imbalances (fiscal and external) constitutes the **rationale for the coordination of national structural reforms.** Therefore, in full respect of national sovereignty and the application of the subsidiarity principle, the coordination of national structural policies needs to take into account the <u>spillover effects of these policies towards the EMU and be circumscribed to, at least, one of these two areas</u>:

a) They have an <u>impact on the external balance</u> and thus the competitiveness of the economy (<u>new MIP</u>);
b) They have an <u>impact on the fiscal accounts</u>, thus are needed to reestablish fiscal balance (<u>SGP</u>);

This should not be understood as detrimental to policy coordination, but, on the contrary, should reinforce and clarify its application. Duly justified policy coordination can be much more intense than it is now: In particular, the EMU should foster specific results of the reforms implemented in terms of competitiveness and external sector.

<u>Proposal:</u>

The **coordination of national structural reforms should be duly justified.** Since the rationale for coordination is the prevention and correction of imbalances, and in full coherence with the framework of the European Semester, coordination should take place when national structural reforms have spillover effects on the EMU and:

a) have an impact on the external balance and thus the competitiveness of the economy (new MIP); or
b) have an impact on the fiscal accounts, thus are needed to reestablish fiscal balance (SGP);

In these cases, **the stability of the EMU justifies policy coordination, which could be reinforced**. In particular, the EMU should foster specific results in terms of competitiveness and external sector and even consider the need for corrective action.

This framework of imbalances identification and correction and policy coordination needs to be complemented by a **more adequate formulation of monetary policy**. Currently, price stability is exclusively defined in terms of average price stability, resulting in the formulation of a monetary policy stance which does not take sufficiently into account the different cyclical positions of Member States.

<u>Proposal:</u>

In the **formulation of monetary policy**, **price stability should be looked into by the ECB not only in terms of average price stability, but also taking into account**

inflation rate dispersion among EMU countries. The ECB should regularly analyze both of these elements.

<u>FISCAL UNION:</u>

The framework for fiscal discipline enshrined in the SGP needs to be complemented by **mechanisms allowing for a European orientation of fiscal policy**. While maintaining sound budgetary positions in the medium and long term, the EMU needs to be capable of providing a coordinated fiscal policy stimulus in times of economic crisis or output growth below its potential.

<u>Public investment</u> should be at the center of this response. The Government of Spain proposes the adoption of a limited and targeted "Golden rule" for investment -allowing exclusion of certain investment expenditures from the calculation of deficit and debt in the framework of the SGP- to be applied in the case of investments qualifying as investments of interest for the EMU.

<u>Proposals:</u>

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 both in the preventive and corrective arm.

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.

Harmonization of budgetary frameworks and fiscal alignment is also critical to advance towards a fiscal union. Insufficient levels of harmonization, coordination and transparency hamper the efficient functioning of the internal market. In this area, a first and urgent step is to <u>ensure swift progress on measures against aggressive tax planning, base erosion and profit shifting (BEPS)</u>.

<u>Proposals:</u>

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. The Government of Spain considers that a Code of Good Practices will be a useful tool in this endeavor.