EUROPEAN COMMISSION'S

Reflection paper on the future of the Eurozone

Global Macroeconomic Scenarios / Regulation

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The European Commission has published a reflection paper on the future of the euro area, the proposals in two steps (up to 2019 and to 2025) on key issues such as banking and capital markets union, centralization of supervision in markets and insurances, safe bonds, regulation of sovereign debt on bank balances, fiscal stabilization and a European Treasury. The document goes mostly in line with our views on what is need to deepen integration in EMU (clearly on banking union and fiscal policy) although it remains more ambiguous on issues related to sovereign debt, and does not commit to mutualization of sovereign debt (eurobonds). The successful implementation of the measures included in this proposal will rely on the political negotiations among Eurozone Member States, where divergent views on the priorities and timing of reforms still exist.

Context and timing of the proposals

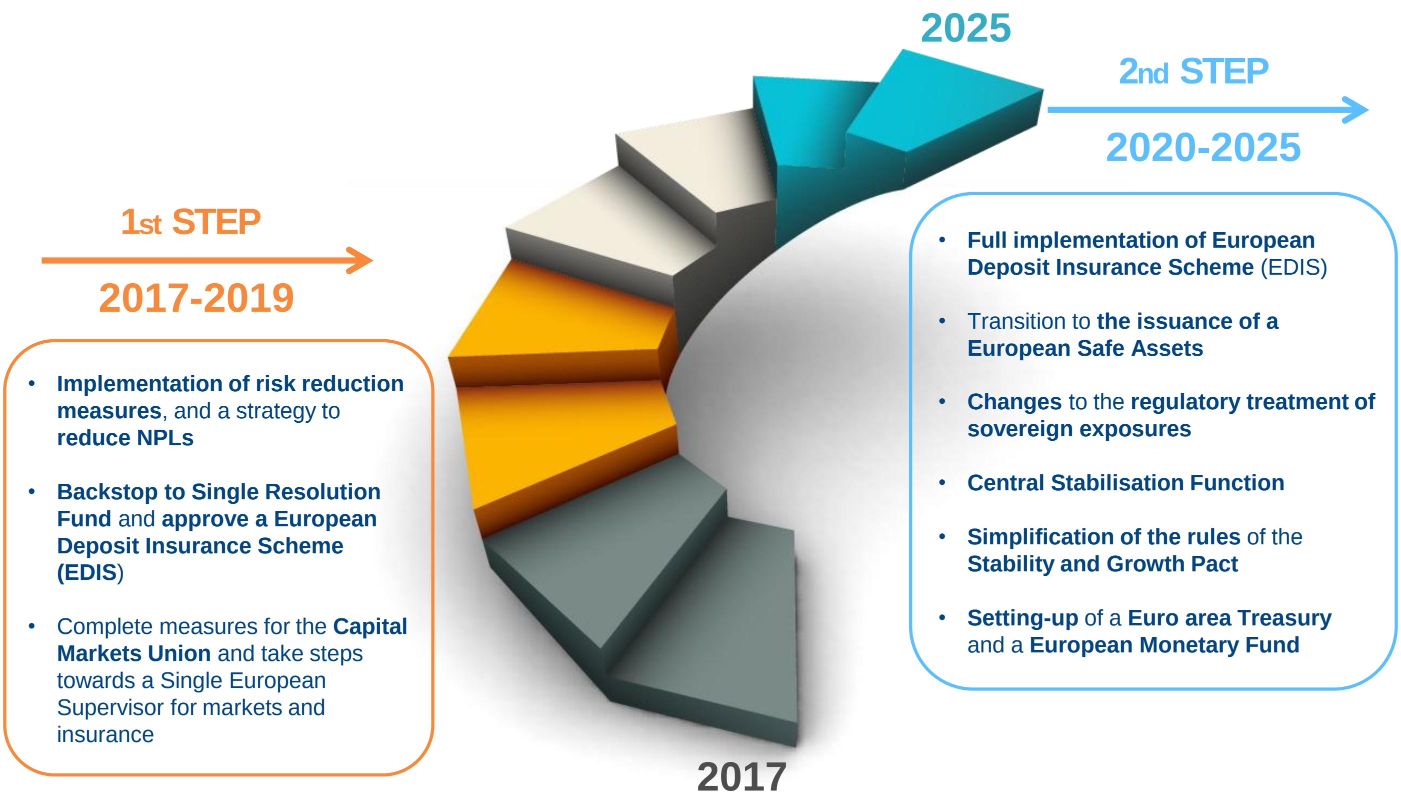
On May 31 the European Commision issued a **Reflection Paper on the future of the Economic and Monetary Union (EMU) with proposals to strengthen the well-functioning euro area**. This document is the latest in a series on the future of Europe. The most recent one, the White Paper on the future of Europe, was devoted to the European Union (EU) as a whole and more focused on security and other EU-related issues. This widely expected document revisits the views of the **Five Presidents' Report** (June 2015), which included bold proposals to deepen EMU integration (such as completing the banking union and moving towards the fiscal union) but did not result in concrete steps, due the very different views on the priorities and timing of reform between Germany and some small countries, on the one hand, and France and periphery countries, on the other.

The **new impetus for the debate on the future of Europe** comes in the aftermath of the Brexit referendum and as a reaction to the political wave of populist and anti-European sentiment after the crisis. It also builds on the momentum created by the victory of pro-European parties in recent elections (Netherlands, France). Overall, there is a wide-ranging debate within Europe on **what to do and at what pace**: should we deepen integration only on EU-wide priorities such as security, immigration and defence, or should we also focus on strengthening the Eurozone in order to avoid future crises? Should we proceed quickly and change the treaties if necessary or should we take a pause, focus on risk reduction and consolidate what has been achieved so far?

The reflection paper highlights that full integration requires an **adequate balance between risk sharing and risk reduction** measures **in three key areas: financial union, economic and fiscal union and political integration,** with the aim to anchoring democratic accountability and strengthening euro area institutions. To achieve this objective the document proposes a reform agenda that includes a **two-phase road-map (2017-2019 and 2020-2025).** It is a sequence of gradual proposals with internal logic, although some key issues are open to debate.

The paper provides details of the actions to be taken in the first two years, and sets the strategic lines on which the EU must work in a second phase, so that **by 2025 the Eurozone should have a Eurozone Treasury, a European Monetary Fund, a new treatment of sovereign exposure of the banking sector and start the transition to issue "European Safe Assets" (ESA) (see Figure 1)**. As these are complex reforms to implement, discussions are expected at a legal, institutional and mostly political level.

Figure 1 Road map on main measures to complete EMU proposed by the commission



Source: BBVA Research

Financial Union

In a first phase (2017-2019) the target would be to **break the sovereign bank doom loop by** means of:

1. Mitigating risks by implementing strategies for **reducing default credits (NPLs)** and applying an ongoing review of risks in the banking sector.

2. Completion of the Banking Union (BU) with two key actions:

a. **A credible backstop for the Single Resolution Fund (SRF)** that favors financial stability within the Banking Union, for which two options are under consideration: i) a credit line from the European Stability Mechanism (ESM) to the SRF, or ii) Member States providing simultaneously either loans or guarantees for the SRF, the first being the preferable option due to its neutral fiscal impact; and

b. **Incorporate a European Deposit Insurance System (EDIS),** with its correspondent Backstop, to complete the third pillar of the BU and reinforce credibility of the institutional framework.

3. Completion of the Capital Markets Union, which is key for reinforcing the Euro and providing more innovative, sustainable and diversified sources of funding for household and business. For this goal, **more integrated supervisory framework** ensuring common implementation of the rules for the financial sector and more centralised supervisory enforcement in markets and insurance is crucial.

4. It also introduces the possibility to develop a new type of financial instruments (so-called Sovereign Bond-Backed Securities, SBBS), to enhance diversification of the sovereign debt portfolio of financial institutions. This instrument, also named by the academic community as European Safe Bonds or Esbies, is currently under discussion in the European Systemic Risk Board (ESRB) and would be a securitised asset based on a diversified portfolio of euro area sovereign debt, with no mutualisation needed neither a change of regulatory treatment of underlying sovereign bonds. Given the innovative character of this instrument a smooth introduction in the market would be necessary. In any case, it is envisaged as a transitional measure before starting the European Safe Assets in the second phase.

In a second phase, after 2019 the document sets out the possibility to develop a **European Safe Asset (ESA)** that could serve as a benchmark in the financial European market and as an instrument to enhance the development of monetary policy. **The Commission will study different types of European safe assets for the possible future development** of **these instruments.**

Economic and Fiscal Union

The document recognizes that there are available instruments in the euro area to foster convergence (all the economic policy coordination framework and the use of structural and investment funds), but they should be strengthened in **a more integrated Eurozone and fiscal union**. In particular, the document makes the following key suggestions and proposals:

1. In order to **favour economic convergence**, the document mentions **several instruments that can be reinforced**, and makes several **"soft" proposals to improve coordination among them:** the Single Market along with the Digital Single Market, the Energy Union, the Banking and Capital Markets Unions. To maximize the effectiveness of national policies, the EC proposes improving their coordination under **a strengthened European semester**, with more focus on the **aggregate euro area dimension** and through a **multi-annual approach**.

2. To **encourage structural reforms**, which are mostly a national competence but have been absent in many countries over the past 20 years, the paper proposes to develop a **strong link between reforms, the use of EU structural and investment funds and access to a potential macroeconomic stabilisation function**.

3. On the **macroeconomic stabilisation function** the document mentions aggregate fiscal policies (and an appropriate euro area fiscal stance) although in practice its concrete proposals aim at countering the asymmetric shocks across countries. The options proposed (for the second stage) are an **unemployment reinsurance** mechanism (after making labor policies more homogeneous across countries), an **investment protection scheme** (to protect investment in country specific recessions) and/or **a rainy day fund** (cumulated in time and used for contingencies). There is **not much detail on the funding of these options**, but it is mentioned that it could come from the ESM, the EU budget, or designing a new instrument for these specific goals.

Strengthening the EMU architecture

The document considers that member states should accept to **share more competences and decisions on euro area matters in an incremental way**, within a common legal framework, to achieve a stronger EMU. It makes several relevant proposals on governance of EMU:

1. The **Fiscal Compact and** the **ESM Treaty** have to be integrated **into EU law**.

2. A **new balance** could be established **between the Commission and the Eurogroup** to facilitate further steps in the integration of the euro area, while increasing **a unified external representation of the Eurogroup (for instance at the IMF)**. In addition, the decision-making process needs to become more transparent and democratic to ensure the support for the euro.

3. In the **second stage**, the EC proposes setting up **a common Treasury**, supported by the European Fiscal Board, which would be tasked with: (i) **issuance of the new common debt instrument**, (ii) **budget execution**, (iii) **macro stabilising instruments** and (iv) incorporating the **ESM competencies**. The Treasury would be led by **an EU**

Finance Minister, who could also be Chair of the Eurogroup/ECOFIN. The **decision-making capacity would be attributed to the Eurogroup**, while the Treasury would prepare the decisions and execute them.

4. In addition, the EC proposes to turn the ESM into a **European Monetary Fund**, with the **current liquidity assistance mechanisms in addition to the future common backstop of the Banking Union**. This underlies tensions with the German finance minister W. Schäuble, who wants to empower the ESM to counteract the Commission and the eventual European Treasury.

BBVA Research assessment

- **The proposal presents a bold roadmap to strengthen the institutional architecture of the Eurozone.** It rightly makes reference to the elements included in the 5 Presidents Report to finalize the financial union and to initiate a path towards a fiscal union.

- **After the paralysis on institutional reforms over the past two years, there is added value in resuming the discussion on priorities, alternatives and the pace of change**. Most of the issues proposed are already known. There are some new elements in this roadmap such as the SBBS or more concrete details on fiscal stabilisation instruments and a euro area Treasury, but above all it is very positive that the discussion seems to re-emerge after Brexit and anti-euro trends.

- **The steps ahead crucially depend on a political negotiation**, which will be focused on further mutualization of debts versus further control of policies, which reflects in turn the tension between risk control and risk sharing. The key issues to complete the Banking Union (EDIS and backstop for the SRF) are first in the line, together with the implementation of ESBies and the regulation of the treatment of sovereign debt. Somewhat further away are issues for directly linked to a fiscal union, such as some sort of eurobonds and the powers of new authorities in the area.

On the specific proposals:

On the Financial Union

- The paper offers a practical way forward for the years to come. We agree that to finalize the financial union, real steps need to be taken in the next two years. In this vein, it is key to complete the Banking Union including a common fiscal backstop for the SRF, create an EDIS and move forward in the Capital Markets Union.
- On the possible introduction of SBBS as a way to ensure private risk sharing, it is positive that different options are being analised, although the current ESRB proposal is at a very early stage of development and key aspects of the instruments are no specified yet, which is challenging given that this is a complex and novel product. Overall, the proposals for the second stage (by 2025) are presented in a more open way and could be decided later, once initial steps (completing the financial union) have been taken.

On Economic and Fiscal Union

- The idea of introducing incentives for structural reforms has circulated around recently and seems sound. Linking structural and investment funds to structural reforms is the logical way to do, although it would be desirable that they are positive incentives, rather than seen as sanctions for countries that do not implement them, given the difficulties in promoting them especially those ones that imply short-term costs for given sectors of the population. Designing these incentives, in practice, will not be easy.
- Instruments to face asymmetric shocks are also positive, although one must bear in mind that they would have only marginally mitigated a crisis as large as the one faced over the past decade (which was large, systemic and not the usual cyclical recession, which could be faced by the standard leeway provided by the Stability and Growth Pact). Among the instruments proposed, the unemployment insurance mechanism would be difficult to be accepted by those countries with low unemployment rates and relatively stable labor markets, while the investment protection scheme seems easier to agree upon.
- The lack of concrete proposals to implement a truly Eurozone fiscal policy, with steps to define an area-wide fiscal stance, is one important missing point in the document.

On strengthening the EMU architecture

- One of the main proposals of the document is the idea to set up a Eurozone Treasury, with proper competences on managing a common budget, issuing debt and incorporating the European Monetary Fund. The decision powers remain in the hands of the Eurogroup, which implies that the proposal falls short of a complete fiscal union where countries lose further powers over their budget decisions, beyond the rules of the SGP. The idea of a Treasury absorbing an eventual EMF subsidiary to the Treasury has to be seen in the context of informal German proposals to convert the current EMS into an EMF and empower it with surveillance of fiscal and economic policies, which are currently in the hands of the European Commission.

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