ESM conference on deepening EMU

Summary of proceedings

On 24 January 2022, the European Stability Mechanism (ESM) hosted a seminar, as part of the larger Conference on the Future of Europe, entitled "How to deepen Europe's Economic and Monetary Union further?". The ESM contributed in this way to the initiative launched in 2021 to give citizens the opportunity to discuss Europe's challenges and priorities going forward and help shape the future. ESM Managing Director Klaus Regling opened the conference with a keynote speech, followed by two panel discussions with representatives from European institutions and academia.

Keynote speech

ESM Managing Director Klaus Regling focused his intervention on two proposals from the Five Presidents' Report of 2015: the need for more risk-sharing in the euro area through the creation of a fiscal stabilisation function, and the possible integration of the ESM into the EU framework.

Mr Regling argued that risk-sharing was needed in a currency union to support convergence, avoid fragmentation, and smoothen business cycles. Mr Regling underlined that risk-sharing in EMU remained much more limited than in similar currency areas such as the US. To strengthen public sector risk-sharing, Mr Regling referred to the idea of a permanent fiscal stabilisation mechanism for the euro area, which could make additional financial resources available to countries hit by a shock, should national fiscal spaces prove insufficient. Among the several proposals that have been put forward to help strengthen public risk-sharing, an ESM facility could serve this purpose. It could take the form of a revolving fund drawing on the ESM's existing lending capacity with no need for additional taxpayer money.

Mr Regling also elaborated on the proposal to integrate the ESM into the EU legal framework through EU Treaty change. This could bring the ESM mandate closer to the European economic and fiscal policy coordination framework and make cooperation with other EU institutions easier and more consistent. For such an integration, the model of the EIB could be a useful framework to consider but it would require a change of the EU Treaty.

Session I: Panel discussion on EMU deepening agenda in the aftermath of the COVID-19 crisis

The first panel was chaired by ESM Secretary General and Management Board Member Nicola Giammarioli and featured the following participants:

- **Jean Pierre Vidal**, Chief Economic Advisor to the European Council President Charles Michel
- **Reinhard Felke,** Director of Policy Coordination, Economic Forecasts and Communication of DG ECFIN at the European Commission
- **Maria Demertzis**, Deputy Director at Bruegel

- **Marion Salines**, Deputy Head of Policy Strategy and Institutional Relations at the ESM

Panellists were invited to share their thoughts on the progress made in deepening EMU since the sovereign debt crisis, how euro area institutions have developed and possible improvements to the EMU architecture going forward.

First to intervene, Jean Pierre Vidal highlighted that monetary integration was a component of European integration and underlined the benefits the euro brought to the single market, in particular by removing monetary disorders. Referring to the sovereign debt crisis, Mr Vidal reminded the audience of the significant policy initiatives that followed, and most notably entrusting the ECB with banking supervision. He then pointed to the new emerging challenges for Europe (the digital and green transitions, geopolitical shifts) and the role the euro could play in addressing them. He concluded by underlining the most important initiatives in his view going forward: i) more financial integration with the advancement of the banking union (BU) and the capital markets union (CMU), ii) the digital euro, iii) the review of Europe's economic governance and (iv) a potential central fiscal capacity.

In his intervention, Reinhard Felke described the markedly different policy response to the current Covid shock, as compared to the policy response during the great financial crisis (GFC), which in turn has led to different outcomes. He underlined the exceptional and unprecedented nature of the Covid-19 shock and the common solidarity narrative that rapidly emerged. This common agreement allowed for the swift and coordinated response from European institutions and Member States to the crisis, taking the form of instruments deployed inter alia by the ESM and the European Commission, such as the Recovery and Resilience Facility and the temporary support to mitigate unemployment risks in emergency (SURE). He further underlined the fact that policy responses were designed at the EU level rather than the euro area level yet proved beneficial for EMU since no financial fragmentation occurred within this crisis. Mr Felke concurred with Mr Vidal on the formidable challenge that the climate transition brings and pointed to the potential benefits of an enhanced financial union in this regard.

Maria Demertzis focused on the political will that allowed Europe to better respond to the Covid-19 shock and remarked that dealing with previous crises allowed the European Union to learn from its experiences. She underlined the European policymakers' speed in deciding on a recovery plan and the fact that fiscal policy efficiently flanked monetary policy in responding to the economic shock. Looking ahead, she agreed with Mr Vidal on the importance of the discussions being held on reviewing the European economic governance framework. On this, she placed a particular emphasis on the review of the fiscal rules and the need to take into account investments for the green transition.

Marion Salines then focused on EMU governance and, in particular, the possible institutional evolution of the ESM. She reminded the audience that the ESM was first created as an intergovernmental institution and drew a parallel with similar policy initiatives in domains closely tied to national sovereignty, such as home affairs. She then explored how the EMU governance could evolve, first recalling that all institutions, irrespective of their governance model, had cooperated well to cope with the euro crisis, and that the blueprints created during this crisis had proven useful in deploying instruments to boost the recovery. Against this background, Ms Salines argued that integrating the ESM into the EU legal framework could enhance the consistency and visibility of the EMU architecture, further improving cooperation among institutions and formalising the role of the European Parliament in the ESM's governance. Ms. Salines suggested that the EIB could be a blueprint for such an integration, as it had many similarities with the ESM in terms of market activity and with regards to its governance model, underpinned by a strong involvement of Member States.

In the ensuing Q&A session, Jean Pierre Vidal underlined the role of the European Council in building political consensus on the EU policy response to the COVID-19 crisis. Responding to a question on the social dimension of the recovery, he outlined that social objectives were embedded in each of the Union's policy choices to help smoothen the covid shock.

Mr Felke warned that discussions ahead, notably on economic governance, could prove more challenging. On integrating the ESM in the EU legal framework, Mr Felke referred to the Commission proposal from 2017 as a potential pathway.

Ms Demertzis agreed with both Mr Vidal and Mr Felke on the positive political narrative for greater integration. She also explained that the central management of the RRF could be useful when thinking about novel ways to ensure Members States delivered on the green ambition, especially those with higher debt burdens and less fiscal space. Finally, Ms Demertzis suggested that in light of the slow progress made on CMU, it could make sense to focus first on developing national capital markets. Concluding the session,

Ms Salines answered a question on the benefits of using the EIB model for an ESM integration into the EU legal framework and highlighted the needs of current investors for legal certainty. On the ESM's Pandemic Crisis Support credit line, Ms Salines explained that the ESM's instrument had a confidence-enhancing effect on markets, even in the absence of any take-up. On the economic governance review, she drew the audience's attention to the recent ESM staff proposals[1] concerning the reform of EU fiscal rules. Finally, she argued that as a currency union, the euro area has specific policy needs and called to consider the EMU dimension of policy making without prejudice to initiatives involving all 27 EU Member States.

Session II: Panel discussion on risk-sharing in the euro area

The second panel was chaired by ESM Chief Economist and Management Board Member Rolf Strauch and featured the following participants:

- **Nicolas Carnot**, Director from the French Statistical Office (INSEE)
- **Lucrezia Reichlin,** Full Professor of Economics from the London Business School
- **Isabel Vansteenkiste,** Director General of the Directorate General European and International Relations at the ECB
- **Matjaž Sušec,** Head of Policy Strategy and Institutional Relations of the ESM.

Focusing on risk-sharing in the EMU, participants were invited to share their views on the resilience of the euro area to future shocks and the potential scopes for improvement from a legal, economic, and policy-based approach.

First to intervene, Nicolas Carnot highlighted the progress the euro area has made since the great financial crisis. Whilst household incomes and cross-border flows were protected during the early stages of the pandemic, it would be too optimistic to consider the problem of risk-sharing solved. Building on his own analytical work[2], Mr Carnot identified two guiding principles for an efficiently designed central fiscal capacity: economic relevance and political acceptability. In the former, the key characteristics to consider are the size and timing of disbursements. In this sense, a semi-automatic trigger condition focused on large shocks would be most adequate, together with a level of support related to the magnitude of the shock. For the latter, political acceptability must credibly address the question of permanent transfers and the moral hazard risks of a possible central fiscal capacity, which requires an ex-ante veil of ignorance as to likely beneficiaries. Strict ex post inter-country neutrality would be counterproductive, but one could consider several proposals such as soft clawback features or experience ratings to differentiate premia contributions.

Following this, Lucrezia Reichlin argued that the multiple crises of the last 15 years have shown the limits of the economic governance, as designed by the Maastricht Treaty. We have learned that fiscal and monetary policy have meaningful interactions when the balance sheet of the central bank is large and when government debt is at a high level. Because of this, the risks involved, and the geographical distributional consequences need to be managed. Having understood that monetary and fiscal policy need to be coordinated in some circumstances, and that there is a need to have tools to make sure that national fiscal policies generate the appropriate euro area fiscal stance in coherence with the stance of monetary policy; an additional problem is the lack of a euro area safe asset. Such an asset is needed to avoid fragmentation of financial markets in time of stress, and also because it is a condition to develop an EU capital market. Some institutional innovations have taken place in an attempt to confront these problems, but have not fully addressed them.

Drawn from her recently published study[3], Lucrezia Reichlin made the point that we need to clarify the "rules we play with" and highlighted that many meaningful reforms can be introduced without treaty change but with a clarification of its interpretation and changes in secondary laws. Beside a revision of the fiscal rules with a refocus on country-specific debt sustainability analysis, she advocated for the creation of a standing contingent facility for emergency response. Over the long term, there is room for concern, given the high cost of the green transition combined with high levels of legacy debt. A key question today is therefore to find ways to ensure the provision of common EU goods, like net zero, while managing sovereign risk.

In her intervention, Isabel Vansteenkiste offered a comprehensive breakdown of "where we stand" and "where we can go". Echoing previous remarks made during the panel, debates on risk-sharing have existed for as long as the euro, and the pandemic offered a potential new hope for further changes. While noting that the traditional measures of risk-sharing, through observing consumption changes, were distorted in the early stages of the pandemic, risk-sharing did occur and was stable and resilient but remained at a low level according to Ms Vansteenkiste.

She also reminded participants of potential gains to be made in the private risk-sharing channel through further progress in completing the banking Union and deepening the capital markets union. With regards to the latter, a specific priority could be given to policies that foster cross-border equity markets. She highlighted the importance of the European Single Access Point and measures to address the debt-equity tax bias. Nonetheless, previous studies have shown that individuals do not internalise risk-sharing sufficiently and thus the private channel must be complemented by the public channel. In this sense, a central fiscal capacity would be most welcome.

To conclude this panel, Matjaž Sušec presented ESM findings on public risk-sharing and argued that now is the appropriate time to consider setting up a fiscal stabilisation mechanism for the euro area, which the ESM could host. Mr Sušec recalled that setting up a fiscal mechanism is a priority for the euro area, considering high debt levels in some Member States, low fiscal buffers, and the possible adverse impact of climate change on financial stability. After briefly summarising the three main frameworks that have already been proposed – re-insurance funds, rainy day funds and revolving funds – Mr Sušec argued that the ESM is well placed to provide a fiscal stabilisation facility in the form of a revolving credit line without requiring additional contributions. Such a facility would not exclude other fiscal stabilisation mechanisms for the euro area in the future. At present, a revolving fund would be a key first step to bolster public cross-country risk-sharing and could be set up swiftly.

In the Q&A section, members of the virtual audience first evoked the current review of the European fiscal framework and most notably, the interaction between the Stability and Growth Pact and a potential fiscal stabilisation mechanism. To this end, panellists noted the complementarity between the two, particularly given the reinforcing effect a fiscal stabilisation mechanism could have on national fiscal stabilisers and on compliance with fiscal rules by Member States.

Following this, a second question was raised on the market effect of a fiscal stabilisation mechanism and the current low interest rate environment. In response, panellists agreed that whilst euro area Member States have benefitted from favourable financing conditions, more efforts may be needed to maintain the "safe" characteristic of sovereign debt, given the large spending needs and possible turbulence generated by the green transition. In the long run, a fiscal stabilisation mechanism could provide a greater source of safe assets. But work on completing banking union and CMU, focusing on creating a highly liquid euro area safe asset, would still be needed.

On the question of prior convergence needs, it was acknowledged that a greater convergence between euro area Member States would facilitate the political consensus on a central fiscal capacity, although the minimum level of convergence required is difficult to ascertain. Still, one should also be mindful of the progress that has been made so far, most notably with setting up the Single Supervisory Mechanism. However, progress has been slow on other aspects, such as the creation of a European Deposit Insurance Scheme.

Still on the question of convergence and stabilisation, the increased need for such facilities given climate change was addressed by Mr Sušec. In the future, it is reasonable to expect that climate-related shocks will become more frequent and thus a central fiscal capacity is even more necessary. A country severely affected by the inevitable climate transition or hit by a natural disaster with financial stability implications could access an ESM credit line. It could thereby receive sufficient liquidity with favourable lending terms to help address the shock and be in a better position to maintain its fiscal efforts in addressing the long-term climate transition.

Following the end of this panel, the conference was concluded by the ESM Secretary General and Management Board Member Nicola Giammarioli. Throughout both panels, different participants were able to testify to the progress of the euro area's crisis resilience. Moving forward, there is today a common drive to further improve the functioning of EMU, and these panels were able to provide some important reflections to that end.

Keynote speech by Klaus Regling

Transcript of intervention by Marion Salines

Transcript of intervention by Matjaž Sušec