EMU reflection paper - mere "wish list" or plausible way forward?

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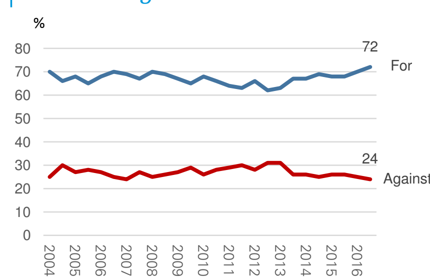
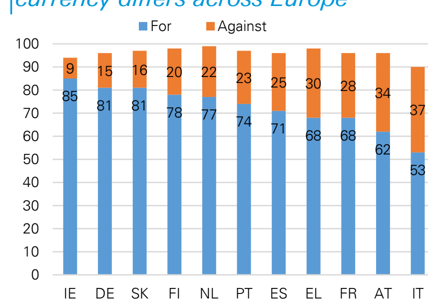
- Last week, the European Commission published a widely anticipated reflection paper outlining a "vision" for EMU. This is not a proposal. This is a paper designed to guide debate.
- The reflection paper contains two stages for the evolution of EMU. The first stage is about completing processes that remain open, for example, the Banking Union (BU) and the Capital Markets Union (CMU). Even here the decisions are not without political controversy, such as deposit insurance and a fiscal back stop for the Single Resolution Fund.
- The second stage would wait until after the European Parliament elections in 2019. Here the proposals are more far-reaching and fundamental, although there were no new ideas in the reflection paper. The ideas stretch from an EU Treasury and euro area finance minister to stabilization mechanisms and safe bonds. The reflection paper captures the complexity and contentiousness of these ideas. All the details are left for future discussion.
- A Merkel-Macron partnership at the heart of Europe is a unique opportunity to strengthen European institutions. The path won't be smooth. Not only do Germany and France need to find common ground on many issues, the other seventeen euro area members need to agree to changes as well, which will involve erosion of sovereignty. If Treaty change is required the EMU-outs have to agree also. Their resistance to an increasingly powerful EMU could rise as the UK exits their group.
- What next? If market confidence in the quality of stage two developments is conditional on the completion of stage one, progress needs to be made on BU/CMU rapidly to open the door to more fundamental EMU reforms after 2019. The discussion of the Commission's paper which should start at the December European Council promises to become very lively. However, Europe's immediate priority is dealing with Brexit and probably security/defense issues.

Figure 1: Popularity of single currency at record high



Source: Eurobarometer 2017, Deutsche Bank

Figure 2: Popular opinion on the single currency differs across Europe



Source: Eurobarometer 2017, Deutsche Bank

With Brexit looming and following the historical triggering of Article 50 by the United Kingdom in March, the discussion about the future of the European Union gained further pace. On March 25, when celebrating the 60th Birthday of the EU, European leaders signed the "Rome Declaration", confirming also their commitment to "working towards completing the Economic and Monetary Union."[1]

Last week, the European Commission published a widely anticipated reflection paper outlining a "vision" for EMU [2]. The paper envisages a two step approach for

1 European Council (2015): "Completing Europe's Economic and Monetary Union".
2 European Commission (2017):"Reflection paper on the deepening of the Economic and Monetary Union".

deeper integration of the euro area by 2025. The first stage focuses on completing already existing proposals and projects between 2017 and 2019, including a European Deposit Insurance Scheme and a fiscal backstop for the Single Resolution Fund. The second stage goes much further by presenting proposals for a number of far-reaching and significant changes to the euro area framework, such as a European Treasury under the chair of an EU Finance Minister, the introduction of a European "safe asset", a macroeconomic stabilization function as well as a European Monetary Fund.

Figure 3: EC roadmap for completion of Economic and Monetary Union by 2025 (key measures)

Period 2017-2019	Period 2020-2025
Setting up a fiscal backstop for the Single Resolution Fund, agreement on European Deposit Insurance Scheme (EDIS)	Issuance of a European safe asset and changes to the regulatory treatment of sovereign exposures
Finalisation of Capital Markets Union initiatives	Agreement on central stabilization function (investment protection fund, unemployment reinsurance), euro area budget
Stronger focus on support of reforms and convergence standards	Eurogroup with a permanent chair and as official Council configuration
Integrating Fiscal Compact into EU legal framework	Euro area Treasury and/or a European Monetary Fund

Source: European Commission (2017): Reflection paper on the deepening of the Economic and Monetary Union

No groundbreaking new ideas, but a comprehensive framework for debate

The paper is part of a series of proposals to reform the EMU, following the 2015 "Five Presidents Report" and the Commission's March White Paper on the future of the EU [3]. None of the ideas presented in the 40 page paper break new ground and most proposals have been on the table in one form or the other over the years already. But rather than being a shortcoming, this is what the paper aims at – to provide a framework for discussion between member states in order to build political consensus on which direction the EMU should move; not as a "blueprint" but as a collection of potential actions, broadly focusing on three key areas for reform:

- Complete Financial Union
- Further integration of Economic and Fiscal Union
- Strengthen democratic accountability and governance

2017-2019: starting small – ongoing work and existing proposal

Aware of the risk that current reform momentum could be lost by a heated debate on the more audacious proposals in the paper, the Commission goes for a pragmatic approach: starting with the agenda points that are already work in

3 For a detailed discussion of the Commission's White Paper see Deutsche Bank Focus Europe (24 March 2017): "The future of the EU: Which Road to take?"

progress or where consensus between member states could be build relatively easily. This includes, for example, the translation of the **Fiscal Compact** into European law, as already envisaged in 2012 when it was signed as part of an intergovernmental treaty to enforce stricter discipline and address shortcomings in the Stability and Growth Pact. The Commission also calls for a rapid agreement on the third pillar of the Banking Union, the **European Deposit Insurance Scheme (EDIS)** by 2019[4]. However, the sequencing and timing of EDIS implementation remains critically discussed, such as by the Association of German Banks which highlights the necessity of harmonization of national insurance schemes as a prerequisite and emphasizes the risk of setting wrong incentives through joint liability [5]. Setting up a **fiscal backstop to the Single Resolution Fund** is a second step towards full Banking Union demanded by the Commission.

2020-2025: aiming high – far reaching and significant changes to the euro area framework

The Commission saves its more radical proposals, some of which would require changes to the European treaties, for after the 2019 European parliamentary elections. At the heart of the Commission's vision lies the creation of a **euro area Treasury**, an idea that has been discussed for some time already and emphasized in the 2015 Five Presidents Report as a way to allow taking collective decisions on fiscal policy. The creation of a euro area Treasury is closely linked to the Commission's proposal to strengthen the Eurogroup by turning it into a **Council with a permanent Eurogroup Chair**. This function could also be merged with the Member of the Commission responsible for the EMU, effectively creating an EU Finance Minister who would both head the Eurogroup and be in charge of the Treasury. As more national competences are transferred to the European level, oversight powers should be given to the European Parliament (possibly only a euro area chamber, even though not explicitly outlined in the paper) in order to warrant democratic accountability.

The Treasury could serve as an "umbrella" to coordinate a range of fiscal functions. Proposals include the management of a "**macroeconomic stabilization function**" to mitigate the impact of asymmetrical external shocks on euro area members. Relatedly, a **euro area budget** that goes beyond crisis mitigation is discussed to support "broader objectives" including convergence among member countries.

Macroeconomic stabilization function or a euro area budget

With the fiscal rules and the macroeconomic scoreboard the EU has implemented a sort of preventive mechanism that should help to synchronise growth cycles in the EU, support the effectiveness of monetary policy and foster stability for the currency union. But reactive mechanism for fiscal stabilisation of countries in recession can be found only on national level. The call for a "common stabilization function" reflects the perception that EU members might be asymmetrically hit by external shocks and that fiscal policies should be adjusted accordingly. Two main proposals under discussion are the creation of a **European Investment**

4 The three pillars of the European Banking Union are the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the European Deposit Insurance Scheme (EDIS).
5 Deutscher Bankenverband (2017): "Dossier Europäische Bankenunion".

Protection Scheme and/ or a European Unemployment Reinsurance Scheme. The Investment Protection Scheme is meant to mitigate the shortfall of public investment in an economic downturn and prevent an amplification of the crisis. A European Unemployment Reinsurance Scheme can be seen as a complementary instrument to protect national social safety nets during downturns and warrant their function as automatic stabilizers. Access to both funds would be conditional on compliance with EU fiscal rules and other criteria and permanent transfers should be avoided. Commission proposals for financing such instruments reach from using existing tools such as the ESM (requiring some legal changes), the EU budget or the creation of a new rule-based instrument for national contributions (e.g. GDP-weighed). In that context, the Commission paper also mentions the idea of a **euro area budget** that goes beyond mitigating the impact of asymmetric shocks as a potential long-term goal but falls short on any more detailed discussion [6].

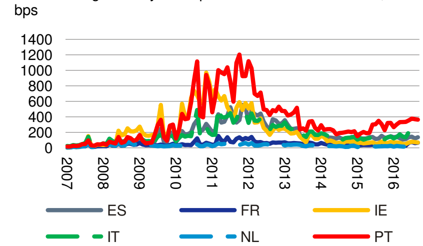
According to the Commission, the Treasury could also integrate the European Stability Mechanism (ESM), once it is translated into EU law and building on it, a European Monetary Fund that could provide liquidity assistance to euro area members as well as serve as a "last resort backstop" to the Banking Union. Finally, the paper sees the Treasury coordinate the issuance of a European "safe asset", a particularly controversial idea among many member countries.

The idea of European "safe assets" has caught the attention of financial markets

The recent years have seen a number of proposals for euro area debt instruments often labeled as Eurobonds but in fact with different design. The latest idea is that of a "safe asset", thought as a euro area equivalent to US Treasuries and serving as a European benchmark instrument. According to the Commission, it could help banks to diversify their assets and cut their exposure to their national sovereign's debt, thus reduce the correlation risks between national banking systems and sovereigns. Many euro area members, including Germany, have expressed strong opposition to the prospect of "debt mutualisation" (i.e. the common issuance of euro area sovereign bonds and therefore joint liability). The EC paper therefore emphasizes an assumedly less controversial variant, called **sovereign bond-backed securities (SBBS)**. These instruments are currently discussed by the European System Risk Board (ESRB) [7] as a candidate for a euro area wide safe asset that should avoid the issue of joint liability.

Figure 4: Euro area sovereign borrowing costs

10Y sovereign bond yields spreads over German Bunds, bps



Source: ECB, Deutsche Bank

In a nutshell, the SBBS envisioned by the ESRB would work as follows: a commercial or public entity purchases a portfolio of euro area sovereign bonds, which is diversified according to some clear rules (e.g. GDP-weighed). To finance this purchase it would issue two financial instruments: a senior tranche - European Safe Bonds (ESBies) and a junior tranche - European Junior Bonds (EJBies). The tranching protects the ESB as it would only defaults if the junior tranche has been "wiped out" already.

The most obvious advantage of the SBBS is to avoid the hot issue of joint liability. However, from a practical point of view, many open questions remain. First of all, it can be asked whether the proposed vehicle would really fulfill

6 For a deeper discussion of these elements see Deutsche Bank Research EU Monitor „Do all roads lead to fiscal union?"(2013).
7 European Systemic Risk Board (2016): "ESBies: Safety in the tranches".

the requirements of a safe asset. According to Standard & Poor's, the tentative answer is "no" [8]. Earlier this year, the rating agency issued a statement regarding the ESRB proposals. Rather than assigning an equivalent security the desired AAA-rating it would actually put it far below in the "lower half of the investment-grade" range, based on lacking diversification and strong correlation of default risk of underlying sovereign bonds. But if a respective instrument would not benefit from preferable creditworthiness, the next question would be if there is really sufficient demand – given that market participants already now can diversify their portfolios accordingly. This applies particularly for the higher risk junior tranche of the vehicle, for which a functioning market is crucial to fulfill the role of a safety vehicle for the senior tranche. On top of that, an issuing entity would be needed – either private or public. At least for the variant of a public entity, it can be assumed that resistance amongst member countries concerned about the issue of "debt mutualisation" remains unchanged. However, given that European institutions like the ESRB or the ECB have looked deeper into this indicates that this proposal will remain on the agenda for the future.

A fresh reform momentum – but will it last?

The election of pro-European Emmanuel Macron in highly contested French presidential elections and upcoming German parliamentary elections in September are embraced as a "unique window of opportunity" to strengthen the framework of the EMU[9] . The public demonstration of unity between new French President Emmanuel Macron and German Chancellor Angela Merkel in their willingness to reform the EMU - if necessary even through changes of EU treaties - underlines the current sentiment among European leaders that this opportunity should not be squandered. The increased public support for the euro (apart from Italy) could also help to foster more initiatives, with the Eurobarometer reaching a record high of 72% for the single currency in 2017 (see first figure of the article). The Commission's reflection paper now provides a structured guideline on how this fresh reform momentum can be used for constructive discussion between member countries on how to proceed.

In its most radical reform proposals, the European Commission's paper tries to address the underlying shortcomings of EMU that Jens Weidmann, President of the Bundesbank and François Villeroy de Galhau, Governor of Banque de France, called the "asymmetry between national sovereignty and common solidarity"[10]. To remove this imbalance and source of instability, member countries are presented with two options: to move further towards "fully-fledged" EMU, requiring further transfer of national sovereignty to and strengthened democratic accountability on the European level; and a "decentralized approach" relying on strengthened fiscal rules. Many of the discussions among EU leaders about the future of EMU go along these lines. The Commission clearly favors the first option – in fact the second one is not even mentioned - as already implied in the title of its working paper. However, the political feasibility of most of the required reforms towards Fiscal Union remains a big question mark.

Even among France and Germany, the EU's two largest economies and frequently depicted as engine of EU integration, opinions tend to differ when it comes to

8 Standard & Poor's (2017): „How S&P Global Ratings Would Assess European "Safe" Bonds (ESBies)"
9 François Villeroy de Galhau, Governor of Banque de France (2017), quoted in European Commission (2017): "About the Brussels Economic Forum 2017".
10 Deutsche Bundesbank (2017): "Europe at the crossroads".

details on what and how it should be done. French President Macron promotes the idea of a European Finance Minister, Treasury and euro area budget, calls for the creation of a euro area parliament (an idea not explicitly mentioned in the Commission paper), and favors macroeconomic stabilization funds. German Minister of Finance Wolfgang Schäuble (CDU), however, has voiced skepticism regarding the feasibility of such proposals as they would require changes to the European treaties – to be signed by all 28 European member states – which he considers unrealistic at the current moment (FAZ, 09.05.2017). He instead favors further integration through agreements between member countries rather than treaty changes, such as the creation of a European Monetary Fund based on the ESM. But controversies regarding an EMU reform agenda are not only found between member states. Ahead of September parliamentary elections, the German government coalition hardly speaks with one voice. Minister of Foreign Affairs Sigmar Gabriel (SPD) endorsed the Commission's paper and together with Martin Schulz, SPD chancellor candidate supports the call of French president Macron for a European budget (Die Zeit, 10.05.2017, Der Spiegel, 15.05.2017 and 03.06.2017).

But even the idea of further euro area integration as such is not seen by all EU members in the same light. With the United Kingdom leaving, the balance between euro and non-euro countries within the EU will shift substantially. It leaves 19 countries that adopted the single currency compared to eight countries outside the euro area. Post-Brexit, the euro area's share of total EU GDP will increase from currently 72% to 86% (based on 2016 Eurostat numbers). The percentage of European citizens living in the currency union will increase from 67% to 76%. Critics of stronger euro area integration warn that non-euro members (the Nordic EU countries Denmark and Sweden as well as six out of eleven Central and Eastern European countries that joined the EU in 2004 and later) might increasingly feel being marginalized and could block any attempts to change EU treaties (Deutschlandfunk, 25.05.2017). While this could in principle be circumvented by the creation of new institutions (along the lines of the ESM as a body of international law), this would not only reduce further transparency and democratic control in the euro area but would also come at the price of further fragmentation within the EU. Bridging the differences regarding positions and approaches to EMU deepening will be challenging. The discussion of the Commission's paper which should start at the EU December summit, i.e. after the German (and possibly Italian) elections thus promises to become very lively even though many member states agree that 2018/ 2019 should be used to push on with policy changes in the EU.

Appendix 1

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