Economic and Monetary Union – developments and challenges

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1. Introduction

As ICE celebrates its 125th anniversary, the third phase of Economic and Monetary Union (EMU) —which introduced the irrevocable fixing of the exchange rates for the currencies of the 11 Member States initially participating in EMU— approaches its 25th anniversary.

While the euro's introduction has been the most significant form of European integration to date, we have learned that monetary unification of diverse economies can lead to significant challenges in the absence of adequate mechanisms to address economic and financial imbalances. Since the financial and sovereign debt crises, also referred to as the twin crises, EMU has been substantially strengthened, but gaps in its financial architecture remain.

The COVID-19 pandemic and the invasion of Ukraine have given renewed impetus to discussions on fostering further European integration. Importantly, concrete progress on the three main shortcomings of the institutional framework is necessary: completing the Banking Union (BU), deepening the Capital Markets Union (CMU), and strengthening the EU fiscal framework.

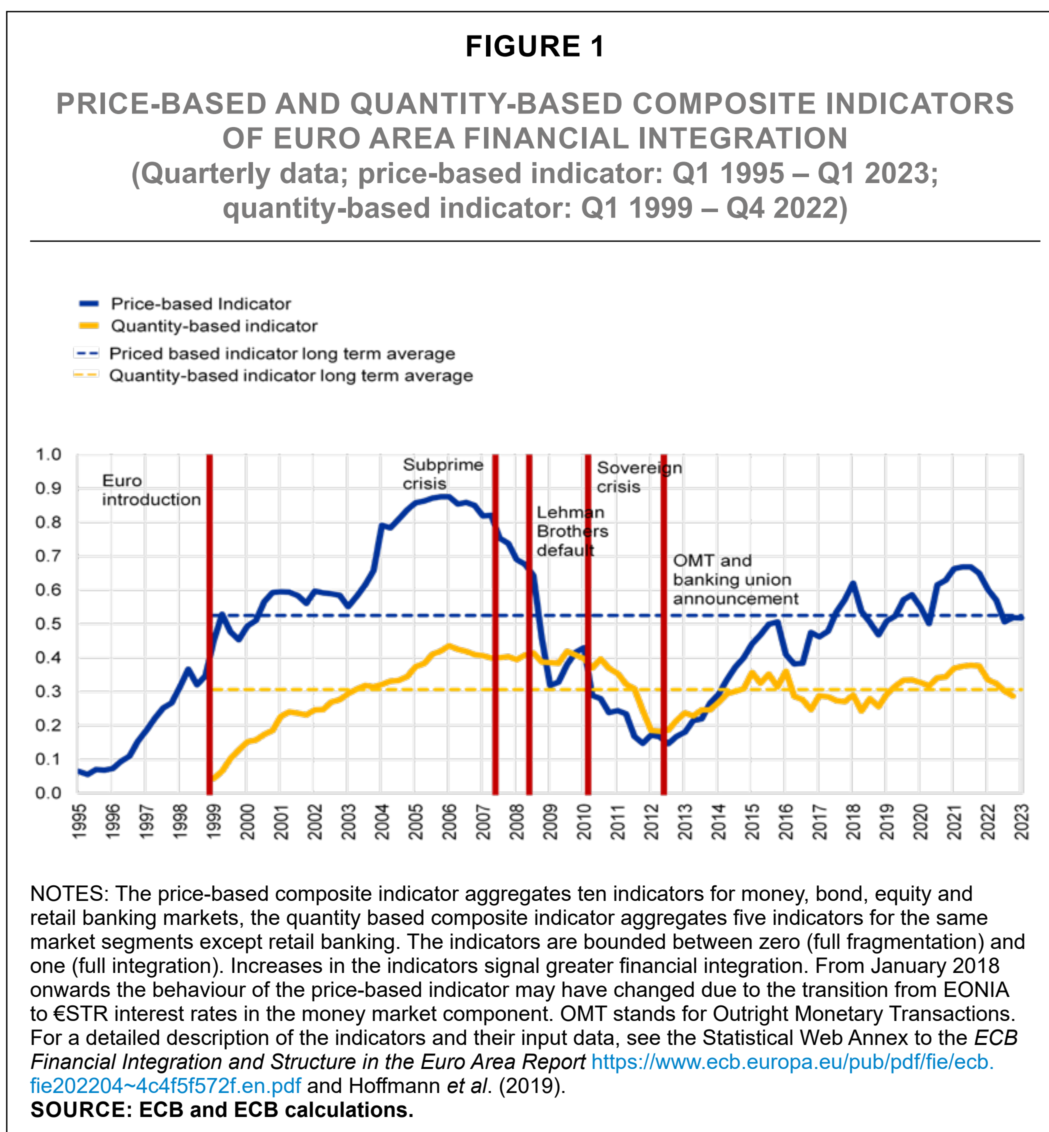
Against this backdrop, this article provides a historical perspective on financial integration since the start of EMU, examining how the twin crises exposed EMU incompleteness and the need for immediate decisive steps towards a stronger financial architecture for the EU. It then takes stock of where EMU stands today, highlighting the remaining gaps in its financial architecture, and reflects on Spain within EMU.

2. A vision for Europe - a historical perspective on financial integration since the start of EMU

Creating a single capital market has been a European objective for decades. In the 1980s, the Single Market Programme set objectives for the financial services sector and led to several Community directives. The removal of capital controls followed at the end of the decade. Interest rates converged across countries; new investment and diversification opportunities became available for households and firms.

FIGURE 1

PRICE-BASED AND QUANTITY-BASED COMPOSITE INDICATORS OF EURO AREA FINANCIAL INTEGRATION
(Quarterly data; price-based indicator: Q1 1995 – Q1 2023; quantity-based indicator: Q1 1999 – Q4 2022)



NOTES: The price-based composite indicator aggregates ten indicators for money, bond, equity and retail banking markets, the quantity based composite indicator aggregates five indicators for the same market segments except retail banking. The indicators are bounded between zero (full fragmentation) and one (full integration). Increases in the indicators signal greater financial integration. From January 2018 onwards the behaviour of the price-based indicator may have changed due to the transition from EONIA to €STR interest rates in the money market component. OMT stands for Outright Monetary Transactions. For a detailed description of the indicators and their input data, see the Statistical Web Annex to the *ECB Financial Integration and Structure in the Euro Area Report* https://www.ecb.europa.eu/pub/pdf/fie/ecb.fie202204~4c4f5f572f.en.pdf and Hoffmann *et al*. (2019).
SOURCE: ECB and ECB calculations.

The introduction of the euro was the natural next step of single market integration. By eliminating exchange-rate risk between Member Stats and reducing transactions costs, it facilitated cross-border trade. Its launch in 1999 and, shortly afterwards, the Financial Services Action Plan (FSAP), which were milestones in the integration process, aimed at tackling remaining obstacles to integration stemming from currency and regulatory segmentation.

Importantly, the euro brought price stability and fostered European citizens' trust in the value of their currency, thereby also supporting economic growth and investment.

In anticipation of the introduction of the euro, a period of increasing integration started already well before. Steadily further increasing throughout the early 2000s, the level of financial integration reached its peak around the beginning of the sub-prime mortgage

crisis in 2007, which marked a clear turning point, as shown by the ECB's two composite indicators of financial integration[1] (see Figure 1).

3. The twin crises, institutional shortcomings and the need for a stronger financial architecture

Global Financial Crisis and Sovereign Debt Crisis

When the global financial crisis hit in 2007, financial integration quickly reversed, at a point when it was most needed. In response to global and local shocks almost all financial markets became highly fragmented and retrenched inside domestic borders. This posed an existential threat to EMU.

The sovereign debt crisis in the euro area led to even further fragmentation and it took until mid-2012 before this process started to reverse. The reversal was related to two main political events in 2012, namely the agreement between the Heads of State and Government to create the BU and the announcement of the ECB's Outright Monetary Transactions (OMT) programme.

The catalyst for this fragmentation was a series of events that had undermined trust in the stability of global financial markets and subsequently the euro area (Draghi, 2018). Following problems in the United States (US) subprime mortgage market and the collapse of Lehman Brothers, in September 2008, money markets around the world stopped functioning and banks' liquidity situation became extremely dire. Public authorities provided support to prevent further harm and some banks exposed to toxic US assets were bailed out by their governments. From late 2009, sequential upward revisions of Greek government deficit and debt figures and the prospect of substantial public funds being needed for banking sector bailouts triggered a rapid and wider repricing of sovereign risk and shattered trust in public debt. Financial market turbulence spread to other euro area countries perceived as vulnerable. Higher sovereign risk was transmitted to the domestic banking sectors through two channels: via banks' holdings of their national governments' bonds —the sovereign-bank nexus— and via negative confidence effects triggered by investors' perception of a more limited ability of the sovereign to support banks, which in turn impacted banks' performance. In this way, the crisis spread to otherwise healthy banks that did not have significant exposure either to US sub-prime assets or to domestic real estate.

Given the lack of fiscal space of affected governments, the latter found themselves unable to provide adequate public support to their banking sectors or pursue sufficiently countercyclical fiscal policies. In financial markets, cross-border funding dried up, exacerbated by defensive risk management by banks and ring-fencing of liquidity by supervisors in core euro area countries. This lack of market liquidity, coupled with capital

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[1] These indicators assess financial integration in two ways: the extent to which euro area financial assets are held outside of their country of origin, so-called quantity-based integration and the degree of convergence of asset prices across euro area jurisdictions, so-called price-based integration.

depletion from domestic losses, precipitated a renewed credit crunch aggravating the ongoing recession. Faced with a downward growth spiral and fearing redenomination into lower-value currencies, investors sold off domestic debt, further widening spreads and exacerbating bad equilibria within vulnerable economies.[2] In addition, interest rates faced by firms and households in vulnerable countries became increasingly divorced from short-term rates set by the European Central Bank (ECB), posing a profound threat to price stability. The ECB responded, for example, with its announcement of OMTs which restored confidence on government bond markets, helped repair the monetary policy transmission mechanism, and broke the downward spiral.

Steps in EU institutional architecture and EMU deepening

The crises highlighted institutional shortcomings of EMU. It became clear that a financial system that is highly integrated, comprising banks with significant cross-border activities, cannot only be built on policies that are conducive to the free and resilient flow of financial services. Instead, a highly integrated financial systems also needs regulatory, supervisory and institutional frameworks that ensure that integration is not reversed in a crisis. Without such underpinnings, (banking) crises can be propagated more strongly when there is greater market integration.

Consequently, a wide range of reforms were set in motion to, on the one hand, strengthen EMU's institutional architecture, and on the other hand, ensure that Member States pursued sound economic policies that would improve the resilience of euro area countries to future adverse shocks. Reforms that attenuate adverse consequences of country-specific downturns could prove particularly valuable for macroeconomic stabilisation and even more important in a currency union where the single monetary policy has limited flexibility in responding to asymmetric shocks and national fiscal policies are subject to common rules under the Stability and Growth Pact.

More specifically, first, it became clear that banking required substantially stronger supervision and regulation, including with a macroprudential focus, which led to a first wave of regulatory and institutional reform in the European Union (EU), following agreement on a fundamental reform of banking regulation at the international level. A wider vision was set out in the 2012 Four Presidents' report, which led to the establishment of the BU at the end of 2013 followed by a series of legislative texts that were adopted throughout 2014, a milestone in the process of strengthening the EU institutional architecture and EMU deepening.

The elevation to the European level of banking supervision, under the so-called first pillar of the BU, the Single Supervisory Mechanism (SSM), better aligned banking oversight with the cross-border nature of banking groups. Common European level supervision has been key to strengthen supervisory standards across the BU, ensuring a level playing

[2] In 2012, spreads *vis-à-vis* German ten-year government bonds reached 500 basis points in Italy and 600 basis points in Spain, with even wider spreads in Greece, Portugal and Ireland.

field, fostering a harmonised application of rules, and avoiding risks of forbearance by national supervisors. The establishment of the SSM was a significant improvement over the mere regulatory cooperation between the three European Supervisory Authorities (EBA, ESMA and EIOPA) set up in 2011 which was considered insufficient to tackle the weaknesses in the EMU architecture exposed by the sovereign debt crisis.

The second pillar of the BU, which is its crisis management leg, was instrumental both to introduce a common, uniform and harmonised set of rules and tools across the EU (via the Bank Recovery and Resolution Directive, BRRD) and to establish a Single Resolution Mechanism (SRM), endowed with a Single Resolution Fund (SRF) whose resources can be used to support resolution actions. The new bank crisis management framework has the goal of making bank failures possible without systemic spillovers or costs for taxpayers.

These two pillars of the BU have helped the banking system to become more resilient. With higher required capital and liquidity resources, and fewer non-performing assets;[3] banks are now also better prepared for crises, for example via the requirement to have sufficient loss-absorbing capacity in resolution, and via *ex-ante* resolution planning.

Second, the establishment of the European Stability Mechanism (ESM) in 2012 represented another important milestone in strengthening the euro area crisis management framework. Together with its predecessor —the European Financial Stability Facility (EFSF)— it provided financial support to five Member States in financial distress against policy conditionality to address the domestic weaknesses and imbalances that led to economic and financial problems, thereby playing an important role in preserving the integrity of the euro area during the Sovereign Debt Crisis.[4]

Third, complementary to the BU, capital market reforms were triggered with the adoption of the first *action plan on building a capital markets union* in 2015. The aim was to achieve a truly single market for capital in Europe with the idea to broaden and diversify financing opportunities for European Union companies and a more integrated capital market by strengthening the cross-border dimension of investments. A second action plan followed in 2020 —also as a reaction to Brexit— to further promote investments and savings and make sure that these flow across the EU for the benefit of consumers, investors, and companies.

Finally, in the aftermath of the global financial crisis, also the EU economic governance framework underwent significant reform, with the adoption of the Two-pack and the Six-pack.[5] These legislative packages included measures geared towards bolstering fiscal discipline, enhancing economic policy coordination, and addressing macroeconomic imbalances within the euro area.

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[3] For an overview on how key risk metrics for significant institutions in the banking union have improved since 2014, see: European Commission Services, European Central Bank, Single Resolution Board (2021), *Monitoring Report on Risk Reduction Indicators* - November 2021. Available at: https://www.consilium.europa.eu/media/52788/joint-risk-reduction-monitoring-report-november-2021-for-publication.pdf

[4] Please refer to section 5 for an overview of the financial assistance to Spain.

[5] Further information on the Two-pack is available at: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_13_457; Further information on the Six-pack is available at: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_11_898

4. Lessons learned, challenges ahead and missing elements in the institutional architecture

Pandemic, Russian invasion of Ukraine, inflation developments

A strong post-crisis reintegration trend in the euro area followed until 2015. Since then, developments in financial integration were mixed, characterised by substantial volatility in price convergence and the stalling of growth in cross-border investment. Contrary to previous crises, a material decrease in euro area financial integration induced by the COVID-19 pandemic reversed relatively quickly. The levels of integration now compare to those of the mid-2000s but indicators are not back to levels observed before the global financial crisis.

Overall, integration has been resilient to large shocks since the sovereign debt crisis. Monetary and fiscal policies have also successfully worked in tandem to fight the fall-out from the most recent crises. During the pandemic, this avoided a deeper economic and financial crisis and lifting the economy towards recovery. A common European response —the Next Generation EU— reinforced these efforts by strengthening the recovery and catalysing the structural transformation of European economies. Also thanks to preparatory work by EU and national authorities, Brexit at the turn of 2020/2021 —and thus the loss of the UK as the EU's financial centre— did not materially affect financial integration.

The Russian invasion of Ukraine brought about new retrenchment in European integration. In the first weeks after the invasion, we saw visible implications for financial integration in the euro area, driven primarily by disturbances in bond markets. Announcements of sanctions against Russia led —initially, at least— to some increase in divergence of sovereign and corporate bond yields across euro area countries. This caused euro area indicators of financial integration to temporarily recede —as measured by the convergence of asset prices across the euro area.

High inflationary pressures resulting from commodity price shocks due to recovering global demand following the pandemic and from energy price increases following the war, led the ECB to start raising rates at an unprecedented pace as of mid-2022. In June 2022, the ECB announced the Transmission Protection Instrument (TPI) to counter unwarranted, disorderly market dynamics and safeguard the singleness of monetary policy. Consequently, euro area indicators of financial integration have partly recovered in a relatively short time span and, importantly, their movements were nowhere near those observed during the global financial crisis or at the beginning of the pandemic. This shows that, as long as EMU remains incomplete, a proper coordination of national fiscal and economic policies is crucial and can still be effective.

Economic and Monetary Union – missing elements

As discussed above, the creation of the BU has made a crucial contribution to strengthening the resilience of the banking system, however, the BU construction is still unfinished.

First, a common European deposit insurance system is still missing: the 2015 proposal by the European Commission to establish a European Deposit Insurance Scheme (EDIS) faced political obstacles which have to date prevented its actual adoption. EDIS would ensure uniform deposit protection across the BU, regardless of banks' location, and thanks to its size and risk diversification benefits it would be better able than national deposit insurance schemes to bear the cost of pay-outs and losses from its interventions. This would in turn reinforce depositors' confidence and contribute to break the bank-sovereign nexus.

A second area where the BU is still incomplete is the common backstop to the Single Resolution Fund (SRF). The latter is expected to be provided by the ESM, with the goal of making additional resources available to the Single Resolution Board to deal with bank resolution in case SRF resources would be exhausted, without having to resort to taxpayers' money. The establishment of the backstop will further underpin the credibility and effectiveness of the BU crisis management regime. However, its establishment is currently still pending, as the introduction of the backstop is legally embedded in the revised ESM Treaty, which has not been ratified by Italy yet.

Third, the review of the crisis management and deposit insurance (CMDI) framework launched by the European Commission in 2023 is key to reinforce the EU's ability to smoothly handle the failure of banks of all sizes. This entails facilitating the resolution of more mid-size banks, including by ensuring that sufficient financial resources are available for such resolutions. In this context, it should become possible to make use of national deposit insurance funds to contribute to resolution or liquidation if this helps to safeguard financial stability, and minimise costs to taxpayers (Eule *et al*., 2022).

Fourth, greater efforts are needed for European capital markets to play a meaningful role in financing the twin transitions and in shock absorption. Despite progress since the launch of the project in 2015, Europe's capital market remains fragmented across national borders and are less developed than in other major jurisdictions. Especially equity markets play a crucial role in mobilising funding for innovation given that equity funding acts as a catalyst for other financing by enhancing transparency and is well suited to financing risky projects. Further deepening EU capital markets would require removing structural obstacles to cross-border investments, notably by harmonising insolvency rules and taxation frameworks and strengthening EU level supervision to enable more consistent and harmonised supervision of capital markets.

Finally, in the fiscal realm, on 26 April 2023 the European Commission put forward a legislative proposal to reform the EU economic governance framework. A central objective of the proposed reform is to ensure government debt sustainability while promoting growth via adequate reforms and investment. The ECB expressed its support for the Commission proposal in a formal opinion released in July and offered suggestions clustered along four main priorities —lower sovereign debt and lower heterogeneity of debt levels across countries as well as higher growth and higher countercyclicality of fiscal policy—[6], with a

[6] See also speech by Christine Lagarde, President of the ECB, at the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament. https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230925~036083efca.en.html

view to further enhance the new framework and ensure it will be more transparent and predictable.[7] Completing the legislative process by the end of the legislative term is of utmost importance to anchor expectations for debt sustainability, accelerate reforms and support investment. At the same time, the ECB would welcome further progress on euro area-related aspects of the Union's economic governance framework such as a more effective coordination of the euro area fiscal stance. Moreover, the Commission proposal is silent on the establishment of a central fiscal capacity, a still missing element in EMU. Such a tool, if appropriately designed and funded, would play a pivotal role in enhancing macroeconomic stabilisation and convergence in the euro area, thereby also supporting the single monetary policy.

5. Spain as part of EMU: Benefits of Spain being part of this institutional framework over time

Overall, the Spanish economy went through a long and challenging process until it was able to reap the benefits of being part of EMU. Concerning the early years of Spain being part of EMU all may have seemed well on the surface. The economy was growing strongly, by almost 4 % a year between 1999 and 2007 and well above the euro area average of 2.5 %. Unemployment declined to a historic low of just 8 %, down from 25 % in the mid-1990s. And the government ran persistent fiscal surpluses, thus easily complying with the Stability and Growth Pact.

In these early years of EMU, however, the Spanish economy was not converging. There was a persistent inflation differential: HICP inflation[8] averaged 3 % in Spain between 1999 and 2007, a full percentage point above the euro area average. Wage growth —and hence unit labour costs— were far in excess of most other euro area countries. Consequently, Spain lost competitiveness, ran a large and growing current account deficit (which reached 9 % of GDP in 2007), and the private sector accumulated a very large stock of external debt. These accumulated macro-financial imbalances also included excessive bank credit growth especially directed to the real estate sector.

With the 2008 financial crisis hitting Spain and morphing into the 2011–2012 sovereign debt crisis hit, the Spanish economy and banking sector were drawn to the centre of the turmoil given a strong reliance on bank financing. Different measures such as the financial assistance programme, used for the recapitalisation of financial institutions and requested by Spain in June 2012, aimed at increasing the long-term resilience of the Spanish banking sector and restoring stable market access. The swift implementation of the programme —completed in January 2014— was key to avoid a disorderly deleveraging

[7] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023AB0020

[8] Harmonised Index of Consumer Prices (HICP) is used to measure consumer price inflation, measured as the change over time in the prices of consumer goods and services purchased by euro area households.

with harmful consequences for the financial and macroeconomic stability, not only in Spain, but in the euro area as a whole.

The sovereign debt crisis, and the mechanisms put in place to deal with it, heralded a structural change in Spanish economic policy and the functioning of the Spanish economy. The EUR 40 billion financial assistance programme was used not only to recapitalise and solidify the banking system, but also to embark on the fiscal, labour and product market reforms necessary for Spain to prosper in EMU.

Since recovering from the 2012-2013 recession, the Spanish economy has grown not only at a healthy rate but in a healthy way. Growth has been balanced, driven not only by domestic demand, but also by exports. Spain's inflation rate and wage growth have remained below the euro area average, allowing Spain to gain competitiveness, run current account surpluses and steadily reduce external debt. This has made the Spanish economy and its financial sector more resilient. And while the COVID-19 pandemic affected the Spanish economy materially given Spain's large tourism sector, the policy response was effective at limiting the damage (*e.g*. with the highly effective temporary lay-off —ERTE— scheme) and GDP is now estimated to have recovered its pre-pandemic level in mid-2022. Spain managed to run trade surpluses even during the pandemic because goods and services exports have become more diversified. Spain is now also a major recipient of EU funds under Next Generation EU, whereby EU funding for investment goes hand in hand with reform efforts designed and implemented at national level.

This said, Spain's unemployment rate remains one of the highest in the EU. And on the fiscal front, the government debt-to-GDP ratio remains very high; and risks to its sustainability are not negligible as the Government continues to run large and persistent structural deficits, while spending obligations, including those related to an ageing population, continue to build. Against this background, Spain needs to continue moving forward with the implementation of growth-enhancing structural reforms and to embark upon a renewed phase of fiscal consolidation in order to fully reap the benefits of a stability-oriented economic policy built on strengthened, European institutional foundations.

6. Conclusion

Since the launch of the euro at the end of the 1990s, the EMU has witnessed major progress but also faced strong headwinds in its integration process. In response to the twin crises, financial markets became highly fragmented and retreated behind domestic borders. Significant institutional reforms were taken to reverse fragmentation, including the creation of the BU, restoring the proper functioning of the monetary union.

Since these major reforms, financial integration has proved more resilient to large shocks, but it remains short of its potential so that the burden of adjusting to shocks continues to rest with national governments. In a highly uncertain world, it is key to close remaining gaps in the EMU's institutional architecture —notably through the creation of EDIS, a common backstop to the SRF, revamped crisis management rules

and a reform of the EU economic governance framework— to further strengthen the resilience of euro area countries to future adverse shocks. The significant adjustment efforts undertaken by Spain after the great financial crisis and sovereign debt crisis show what is at stake.

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