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**Strengthening the euro area architecture: recent progress in fiscal
governance and banking crisis management**

Opening speech/Master's Degree in European Economic Governance

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Good afternoon.

I am very happy to be here today and mark the start of what will surely be a very interesting academic year for you. During this year, you will study the European institutional architecture from many different angles. And I hope that after completing your studies, many of you will go on to work on the European project and bring it closer to completion.

Over the past decade and a half, the Economic and Monetary Union (EMU) in Europe has been tested by a number of severe shocks: the global financial crisis, the sovereign debt crisis, the COVID-19 pandemic and the ongoing war between Russia and Ukraine. As you will soon learn, each of these shocks has exposed shortcomings in the construction of the EMU. In response to these shortcomings, the European economic and financial architecture has undergone profound changes, resulting in a more integrated area. Nevertheless, the EMU still remains incomplete.

Looking ahead, the environment might be fundamentally different from the pre-pandemic one. The European economies may be subject to more frequent supply-side shocks, due to geopolitical tensions, climate change-related events or future pandemics. Making the EMU more resilient to shocks, investing in green and digital transitions and improving the growth potential of the European economies require large public (and private) investments. These investment needs arise at a time when public debt and structural deficit levels in many EMU countries are high. Financial fragilities may also have been building up during the prolonged period of low interest rates before the COVID-19 pandemic, and digitalisation has made bank runs faster.

It is clear that these challenges cannot solely be addressed at national level and require increased coordination at the European level, complemented by more elements at supranational level. In my address today, I will focus on two of these elements, which are currently under discussion at the European level - a new fiscal governance framework and an extended bank crisis management framework. But these two elements should be part of a larger reform of the EMU's economic and financial architecture, which should involve completing the banking union and capital markets union and creating mechanisms for the provision of public goods at the European level.

First, the reform of the fiscal governance framework

The COVID-19 crisis has prompted unprecedented policy actions on the fiscal front. The enforcement of the rules used to monitor and coordinate fiscal policies under the Stability and Growth Pact was temporarily suspended, allowing governments to provide ample fiscal support. This was complemented by the introduction of several pan-European fiscal instruments, such as the Support to mitigate Unemployment Risks in an Emergency (SURE) and the [European Stability Mechanism's \(ESM\) Pandemic Credit Line](#). Additionally, the Next Generation EU (NGEU) package was put in place, funding investments that increase the growth potential and resilience of the EU economies, with a focus on green and digital transitions.

These are temporary and ad-hoc instruments, but they have successfully compensated for the EMU's incomplete institutional design. This positive experience should guide our thinking about which features to incorporate into the permanent construction of the EMU.

At the same time, the large fiscal support has resulted in a significant increase in public debt levels and a reduction in the fiscal space available to Member States, right at the time when public investment needs are large. There is now broad consensus among Member States that these challenges would be best addressed with a new fiscal governance framework in place. There are a number of reasons for a reform of the current fiscal rules.

The EMU originally envisaged by the Maastricht Treaty had two core elements: a single, independent central bank (the ECB) tasked with conducting monetary policy for the euro area as a whole, and a framework for the coordination of national fiscal policies. This institutional design placed the responsibility for conducting fiscal policies on national governments. At the same time, it recognised that, in a monetary union, fiscal policy conduct in one Member State affected other members and the functioning of the union itself. In particular, unsustainable fiscal policies in one country could generate negative economic and financial spillovers across the union, with consequences for the single monetary policy.

Thus, the Treaty introduced a number of mechanisms meant to prevent such situations. First, the prohibition of monetary financing and the "no-bail-out" clause. In addition, it stipulated that Member States should avoid excessive deficits and debt levels, which it implemented through two quantitative reference values: 60% for the public debt-to-GDP ratio and 3% for the budget deficit-to-GDP ratio. Note that these quantitative limits were set taking into account the average economic situation prevalent in the late 1990s. The European Commission was tasked with monitoring public finances to identify significant deviations that could endanger the macroeconomic and financial stability of the Union. Non-compliant countries would enter the corrective arm of the Stability and Growth Pact, with the aim of correcting excessive deficits in a given period of time.

It was hoped that these supranational mechanisms would ensure national fiscal policies consistent with the smooth operation of the monetary union. However, over the years and as the euro area experienced several severe shocks, in particular the global financial crisis and euro area's own sovereign debt crisis, a number of shortcomings have become apparent.

First, the original fiscal rules did not take into account how cyclical positions affected national headline deficits. This resulted in pro-cyclical fiscal policy conduct, as the framework would not encourage the build-up of buffers during good times and, conversely, would induce unnecessary tightening during recessions. Subsequent reforms that have attempted to correct for the cycle by employing medium-term structural variables introduced complexity, without ultimately solving the problem.

Second, the framework did not avoid a general increase in public debt levels across union members, although the increase in public debt levels has been a general trend in most advanced economies around the world.

Third, the focus on fiscal imbalances made it difficult to detect the build-up of other imbalances, such financial and current account ones, which turned out to have a similar potential to destabilise the euro area. In response, the European Semester¹ and the Macroeconomic Imbalances Procedure² (MIP) were introduced to provide a framework to coordinate national economic policies and detect the build-up of potentially harmful imbalances. So far, this framework has been employed with limited success.

Equally important, the Treaty did not envisage the creation of a union-wide crisis management framework for the sovereigns to compensate for the absence of a lender of last resort at the euro area level. It was only in the wake of the sovereign debt crisis that the ESM was created to provide loans to Member States in financial distress.

Finally, no supranational fiscal elements were originally considered that would deliver an aggregate fiscal stance at the Union level as a counterpart to the single monetary policy, which makes it hard to achieve a balanced fiscal and monetary policy mix.

Therefore, the European Commission is currently reviewing the EU's fiscal framework,³ with the aim of simplifying it, promoting a more countercyclical conduct of fiscal policy and improving compliance, as well as accommodating new investment needs.

The main objective of the proposal is to ensure that public debt ratios are put on a downward path or stay at prudent levels, keeping the debt-to-GDP ratio of 60% as the reference value and the 3% rule for budget deficits. Member States will be asked to present medium-term fiscal-structural plans ensuring that debt ratios remain or, in the case of high debt levels, are gradually put on a sustainable path. Crucially, these medium-term plans will incorporate public investment and reform commitments in line with the EU's strategic priorities, which could warrant a more gradual fiscal adjustment.

The proposed fiscal adjustment path is based on a long-term debt sustainability anchor and implemented through a simple expenditure rule. The role of independent fiscal institutions is reinforced, although it remains informal. Enforcement mechanisms are also improved, with increased automaticity, a strengthening of reputational sanctions and the introduction of macroeconomic conditionality applied to structural funds and EU financing.

The European Commission has also put forward proposals to reform the framework for the prevention and correction of macroeconomic imbalances, strengthening the MIP with more risk analysis and risk management features and putting the focus on actual policy implementation to address imbalances.

While many technical details are yet to be specified, I think that this proposal is a good starting point. It clearly tries to address some of the shortcomings affecting the current framework. Lessons from past experience and crises have been learned, and conclusions from the literature on how to design fiscal rules have been taken into account. In line with

¹ <https://www.consilium.europa.eu/en/policies/european-semester/>

² <https://ec.europa.eu/eurostat/web/macroeconomic-imbances-procedure>

³ European Commission. (2022). "[Building an economic governance framework fit for the challenges ahead](#)", press release, 9 November.

the ECB's opinion,⁴ I particularly appreciate the proposal acknowledging that structural reforms, investment and fiscal sustainability are mutually reinforcing and should be promoted with an integrated approach.

The proposed framework would be anchored in debt sustainability, which is the relevant concept for public finances. This anchoring would also provide incentives for structural reforms by linking fiscal variables with other macroeconomic variables such as potential growth and the interest rate. Also, the simple expenditure rule proposed as an intermediate target is under the direct control of the governments. This could also make it easier for the extraordinary revenues accrued during good times to be saved. Another key improvement is the allowance for cross-country heterogeneity in the design of fiscal consolidation and national medium-term plans. The proposal also allows for redirecting additional public funds towards the climate and digital targets through the use of an extended adjustment period. These elements, coupled with a revised approach to sanctions, have the potential to improve national ownership of, and compliance with, the rules. Nevertheless, the effective application of this new framework remains to be seen and some previous shortcomings will be more difficult to address than others. In particular, the new framework would need to better define the incentives to mitigate the procyclicality of public finances and encourage a faster pace of consolidation during economic expansions.

Let me also mention the trade-off between complexity and simplicity that the new framework would need to navigate. Experience has shown that an overly complex and opaque framework hinders effectiveness, credibility and compliance. Conversely, some complexity is needed to embed countercyclicality and debt sustainability in the framework. For instance, the concept of debt sustainability is not easy to operationalise and it needs to employ unobservable variables. The key issue is for the complexity not to affect the target itself, as it currently does.

Finally, let me also add a few elements that have not found their way into the Commission's proposal, but which are important in my opinion. One such element is an enhanced and more formal role for independent fiscal institutions. Evidence shows that well-designed independent fiscal councils can enhance the accuracy of fiscal forecasts and improve compliance with fiscal rules.

Another aspect to consider as mentioned at the beginning of my address, the public investment efforts needed to address forthcoming challenges are large and cannot be met with the fiscal space available at national level. A common, permanent, European financing instrument should be introduced, applying the lessons learned from the NGEU initiative. Such instrument would allow for the funding of large-scale projects providing public goods at the European level, while avoiding any excessive or unequal impact on national public finances and any disruptions to the single market. Additionally, some of the initiatives that have been adopted during the pandemic could be expanded, such as the SURE, which allowed substantial interest savings for most Member States.⁵

⁴ [Opinion of the European Central Bank of 5 July 2023 on a proposal for economic governance reform in the Union \(CON/2023/20\) 2023/C 290/03.](#)

⁵ See P. Burriel, I. Kataryniuk and J. J. Pérez. (2022). ["Computing the EU's SURE interest savings using an extended debt sustainability assessment tool"](#). *Documentos Ocasionales - Banco de España*. 2210.

Last but not least, the establishment of a central fiscal capacity, capable of ensuring that the aggregate stance of the national fiscal policies is appropriate for the euro area as a whole. Such capacity should be adequate in size and have sufficient and reliable funding, which is crucial to create an efficient macroeconomic stabilisation instrument.

Any new fiscal governance framework should be complemented by efficient crisis management frameworks, for sovereigns and for banks. While the ESM Treaty is in the process of being ratified, recent proposals have been put forward for improving the banking crisis management framework.

Let me discuss these proposals in more detail

The European Union has made significant progress in the last decade to improve its bank crisis management framework, developing two out of the three pillars that constitute the banking union: the Single Supervisory Mechanism and the Single Resolution Mechanism. Thanks to these efforts, banks have taken essential steps to increase their crisis readiness and to be able to operationalise the recovery and resolution measures in a potential stress scenario. This includes the gradual build-up of individual and collective loss-absorbing capacity by banks to comply with their minimum requirement for own funds and eligible liabilities (MREL) and with the Single Resolution Fund (SRF) target, whose respective transition periods end in January 2024.

Despite this remarkable progress, our crisis management framework exhibits some drawbacks, and further work is needed to complete it.

I would like to start by discussing the difficulties of handling the failure of small and medium-sized banks, as highlighted by the fact that, according to the European Commission, so far most failing small and medium-sized banks managed under national regimes have entailed the use of taxpayer money – a bail-out.⁶ A remarkable exception was the resolution of Banco Popular which did not require the use of public or resolution funds.

Precisely, to address this issue and following the mandate by the Eurogroup, in April 2023 the European Commission presented the Crisis Management and Deposit Insurance (CMDI) reform proposal, which takes into account the experience acquired so far by the different stakeholders. I very much welcome the proposal, currently under discussion, as a means for further increasing efficiency at handling banking crises in Europe in a more efficient and harmonised manner.

In a nutshell, the CMDI reform proposal aims to strengthen the crisis management framework for small and medium-sized banks (that is, banks financed mainly with deposits and own funds and for which building up individual loss-absorbing capacity would be very costly), extending the scope of the resolution process to institutions which are currently deemed to be suitable to be liquidated under national insolvency proceedings. In doing so, it broadens the toolbox that authorities have to finance a bank resolution process. In this regard, note that the cost of resolving a bank is first covered through the bank's own resources (MREL), then, if needs be, complemented by funds from deposit guarantee schemes (DGSs) and, finally, by resolution financing arrangements (national resolution funds

⁶ [“Impact Assessment Report Accompanying the CMDI proposal reform”](#)

or the SRF in the banking union). The CMDI reform aims to boost the capacity of national DGSs to finance a bank resolution process.

I do think that the CMDI reform proposal is a step in the right direction. That said, we should bear in mind three issues when assessing the CMDI reform proposal.

First, bringing even the smallest banks into the scope of resolution may be inefficient. Indeed, applying insolvency proceedings to the smallest banks might be appropriate, as the impact of their failure on the real economy and financial stability would be limited, especially if national insolvency proceedings are adapted to enhance the efficiency of liquidation processes for credit institutions. In addition, the smallest institutions could face material problems to build up their loss-absorbing capacity, since they often have limited access to bond markets.

Second, we need to ensure that DGSs can provide funding in resolution as a second line of defence, when needed, and that those funds do not exceed the cost that liquidating the bank would entail for the DGS. The CMDI achieves that by proposing a “pari passu” ranking of the DGS claims and non-covered deposits in insolvency, eliminating the current “super-preference” of DGSs. This is, in my view, an efficient way of ensuring that DGSs can provide funding in resolution. If a bank is in resolution, the DGS would absorb losses in parallel to non-covered deposits as per the “pari passu” ranking. If the use of the DGS is not eased this way, the available funding in resolution may remain limited and the ability of authorities to manage a crisis may be hampered.

Finally, access to the SRF should be the third line of defence in order to effectively manage banking crises. According to the current framework, access to the SRF is only possible once the balance sheet of the bank has absorbed losses derived from the crisis by an amount equivalent to 8% of its total liabilities and own funds. In this context, funds provided by the DGS should count towards the achievement of the 8% amount that grants access to the financing arrangements.

In any case, the discussion on the CMDI should not make us forget that the third pillar to complete the banking union is still pending. The European deposit insurance scheme (EDIS), or common safety net for depositors at the European level, is needed for at least three reasons.

First, a common deposit insurance scheme would equalise the level of depositor confidence across the single market. This would be consistent with the common supervision and resolution powers, and would help to dampen any incentive that depositors may have to switch funds from one jurisdiction to another, therefore reinforcing the level playing field for banks in the banking union.

Second, the EDIS would further weaken the sovereign-bank nexus, as it would detach the depositor protection from the depositor location. Potential concerns from financial markets on the eventual impact of a banking crisis on national public finances would be mitigated as any costs to support depositors would be covered by the European banking system as a whole.

Third, a common deposit insurance scheme strengthens depositor protection against local shocks. The EDIS would have larger resources to tackle banking crises than a national DGS. Therefore, it would increase the credibility of depositor protection schemes and buttress depositor confidence. Additionally, the EDIS would increase our diversification against regional and national shocks and help to reap the benefits of risk-sharing across Member States.

As the CMDI proposal increases the possibility of using DGS funds for managing crises at individual banks, it does not reduce the need of having a fully fledged EDIS in our European institutional framework; it even intensifies that need.

To end my discussion on the future of the EU crisis management framework, I would like to share some thoughts about the recent banking crises in the US and Switzerland, and draw some tentative lessons.

First, some aspects that have worked well. Communication and coordination across authorities were swift and smooth, thanks to the channels established to share information and take decisions in a prompt and timely manner. In addition, in the specific case of Credit Suisse, the work done during the resolution planning phase helped to better handle bank failures, as it provided an understanding of bank business models, internal structure and interconnections with other financial institutions. Thanks to these planning efforts, it had sufficient own resources to eventually absorb losses, even though Credit Suisse did not enter into resolution.

However, the recent banking crises have also shown that there is still room for improvement in the current resolution framework.

In this regard, it is worth noting that the internal recapitalisation of the failing bank (bail-in tool) was not chosen as the main resolution tool to tackle recent crisis events. In that respect, transfer strategies (the sale of the failing bank) have become more prominent as an efficient resolution tool that resolution authorities can use to deal with different crisis situations. In this context, preparedness for transfer strategies, and not only for bail-in tools, shall be considered a priority for resolution authorities.

In addition, recent events remind us how critical it is to have powerful liquidity backstop mechanisms in place. Liquidity may vanish as market confidence in a failing bank disappears. Moreover, an idiosyncratic banking crisis may spillover and turn into a systemic event. US authorities were able to take bold measures to stabilise markets, launching the Bank Term Funding Program and resorting to the systemic risk exemption. All in all, they managed to restore market confidence and prevent further spillovers. The lessons for EU policymakers are clear: authorities need strong public liquidity backstops and to retain flexibility to handle crises.

A final lesson from the recent crises is that technology and social media have a big impact on deposit behaviour. Bank runs take place quickly and quietly. We should analyse how to be better prepared to face this new reality.

In addition to this and to complete this picture, a common framework for banking insolvency proceedings would be also desirable.

To conclude, the ongoing discussions on the proposals for a new fiscal governance framework and an expanded banking crisis management framework are significant. The former would be geared towards strengthening the sustainability of public finances, which is essential to ensure macroeconomic stability and the smooth functioning of the euro area. The later would expand the set of instruments available to authorities to finance bank resolution processes and make handling banking crises in Europe more efficient and homogeneous.

These positive developments should be complemented by further steps to strengthen the European economic and financial architecture. As mentioned at the beginning of my address, large challenges lie ahead for the European economies, starting with the green and digital transitions which require significant amounts of public and private investment. An environment conducive to private investment and the financing of large-scale public projects cannot be achieved without first reducing the financial fragmentation and limited risk-sharing that still characterise the euro area. Therefore, it is essential to push ahead with pending reforms in the European architecture - most importantly, with the completion of the banking union and capital markets union, as well as with setting up a permanent macroeconomic stabilisation capacity.