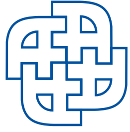

EURO YEARBOOK 2016
"Building Institutions for the Euro Area"

Editor
Fernando Fernández Méndez de Andés
IE Business School

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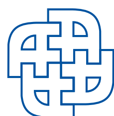

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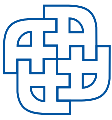

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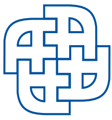

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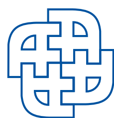

PRESENTATION

The Fundación ICO and the Fundación de Estudios Financieros reached a joint decision back in 2012 to publish a regular study - the "*Euro Yearbook*" - with the aim of raising awareness of the importance and role of the single currency, and to suggest ideas and proposals for fostering its acceptance and sustainability.

This partnership has resulted in an annual publication explaining the major changes in monetary, fiscal, economic and political union during the year, setting out successes, limitations and potential issues to be resolved.

This report - the fourth in the collection - has eleven chapters, addressing core aspects of progress in the construction of the European project. The first of these offers a global view of the Monetary Union in the world. The next two chapters quantify the use of the euro in international trade and financial markets, analysing progress and setbacks in European financial integration.

Chapters 4 and 5 are dedicated to monetary policy, which was in the economic spotlight in 2016. They describe the heterodox measures adopted by the ECB, and review the effectiveness and limits of its monetary policy, paying particular attention to possible undesired negative effects, and their potential impact on bank profitability.

The next three chapters deal with banking union and, more particularly, the financial stability and macroprudential policy pursued by the ECB through the twin focus of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). They review the regulatory changes introduced following the financial crisis, and remind us that a European Deposit Guarantee Scheme has yet to be created. They also review the ECB's recommendations on banking governance and business models.

Chapters 9 and 10 give a preliminary assessment of the type of fiscal union required in the euro area, and contrast this with the current European institutional fiscal situation. The final chapter reviews the current political situation in the EU following Brexit, and sets out a number of pending institutional reforms.

The book offers an executive summary that presents all of the contributions made by the collaborators, offering, as in previous years, ten conclusions summing up the main points we wish to get across.

In the current excessively complicated and technical context, there is a need to explain and highlight - rigorously and in depth - the changes that are taking place in the European Monetary Union, analysing what they entail and their likely impact on our daily lives. This is what we aim to achieve in this book.

The study was led by Fernando Fernández Méndez de Andés, Professor at the IE Business School. He was ably supported by a team of renowned collaborators from the academic and professional worlds, all of whom we would like to thank and congratulate for their excellent and invaluable contributions.

Fundación de Estudios Financieros and the ICO Foundation trust that the 2016 Yearbook will make a significant contribution to the current debate surrounding the euro and the construction of Europe. We also hope it will prove interesting to all of its readers.

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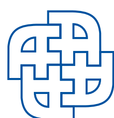

EXECUTIVE SUMMARY

Fernando Fernández[1]

1. AN UNSETTLING YEAR FOR THE UNION

I am grateful for the opportunity to edit this Euro Yearbook for the sixth consecutive year, on behalf of the Fundación de Estudios Financieros (Financial Studies Foundation) and the Fundación ICO (ICO Foundation). The future of the Monetary Union, and of the European Union itself, is once again in question - perhaps more than ever before. It would seem that Europe is enjoying swimming in dangerous waters. Or perhaps it is just that analysts and researchers, in fact all Europeans, need to get used to strong emotions. The year of consolidation of the Monetary Union that we announced in the 2015 Yearbook has resulted in the breakup in instalments of the European Union, following the unforeseen and unfortunate "No" vote in the UK referendum. It was a year in which all fiscal and monetary policy - and even euro area banking resolution and intervention - agreements blew up in Europe's face. In summary, it was a year when populism paralysed Europe, threatening the ideological and social pact that has defined the brilliant European adventure. Dissatisfaction with the European idea has exploded, and the siren songs of nationalism are being heard again, despite the European economy recovering and unemployment dropping sharply. All political leadership is being questioned. All European governments have weakened and suffered serious crises of confidence: some have even had to resign. For many citizens, Europe has ceased to be the solution and become the problem. Plunged into this unease, Europe's officialdom seems paralysed. The simile of the bicycle seems pertinent here: nobody wants to, nobody can or simply nobody dares to, keep on pedalling.

Perhaps we have become so used to Europe that it just seems part of the landscape. This means we don't dare discuss it, and even deny its existence. It is as real and inevitable as winter flu, football and taxes, there is no need to defend it. There is no need to complete it, repair its faults or overcome its limitations. The idea of Europe is so obvious that carrying on as normal is enough. Perhaps this inevitability was why some thought that *Brexit* was impossible; and that there would be no need to recapitalise Italian banks, clean up Spain's public finances or mutualise bank risk. Perhaps nobody dared question the existence of Europe, and this meant we could continue ignoring the reality. And the reality is that Europe has blown up in our faces. In the seven years I have been editing the Yearbook, the atmosphere has never been so pessimistic, the lack of political will so evident, and the difference between words and events so stark.

[1] Fernando Fernández Méndez de Andés is Professor of Economics at the IE Business School and has been the Editor of the Euro Yearbook since it was first published.

This inability to face up to reality was offset by the idea that economic growth would cure everything. It has been insistently repeated that Europe needs a good dose of Keynesian policy to get over its demand-side problems: more public investment and more private consumption. And the claim that Europe saves too much is repeated over and over. You will see this thesis explained in many of the articles in this Yearbook. It is no longer fashionable to talk of fiscal adjustments, structural reforms, open and competitive economies, productivity and unit labour costs, but some of our contributors stick their necks out and demand these. Domestic and international public institutions are implementing populist policies for fear of populism. European regulations - particularly some of those approved in the tough years between 2010 and 2012 - are being consciously ignored for reasons of public convenience. Nobody seems to be worried about losing credibility, because the alternative, it is claimed, is populism or breakup. And in the meantime, the party goes on.

After so many years of austerity, Europeans need a bit of joy: they need growth. It is as if there has been an evil plot to condemn Europe to stagnation. It is as if this wasn't a result of its own errors. And those who criticise this irrationality find support for their arguments in the calm in financial markets. True, these markets are peaceful and prospering at the moment, tamed by unprecedented quantitative easing (QE) policies, which have raised the balance sheet assets of the world's main central banks to over 30% of the size of their respective GDPs. But the apparent peace reigning in markets should not be mistaken for unanimous approval of the policies adopted. We are once again hearing that "this time it's different"[2]; that there are no signs of a bubble in the apparent irrationality of risk spreads; that there are powerful structural reasons why things are different this time. The theory of secular stagnation and the hypothesis of a natural interest rate close to zero are being brought back to life, public works programmes are being rediscovered, and politicians insist growth will cure everything. Memory is so short, and so selective! As we have been arguing since the first edition of this Yearbook, Europe's problems are structural. They have always been, and continue to be, structural. Monetary policy alone - no matter how creative and exceptional it might be - will never solve these problems.

The prevailing tone in last year's Yearbook was bitter-sweet: this time it is disenchantment. This is not to say that there were no significant achievements in 2016. The GDP of the euro area economy is now back to pre-crisis levels, although employment levels remain clearly insufficient and unevenly distributed. ECB action continues to reduce financial fragmentation and foster a recovery in lending. The ECB has unquestionably demonstrated its commitment to euro area stability, leading us into the unexpected territory of negative interest rates, penalising the accumulation of bank deposits. The President of the ECB has solemnly reiterated that he will not cease until the euro area returns to its target inflation rate of 2%[3]. The Single Supervisory Mechanism has

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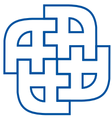
[2] A reminder, as set out in the now classic book by Reinhart and Rogoff (2009), that this phrase is used before every financial crisis.

[3] What extraordinary times we are living in when central banks have an explicit objective to create inflation. I still find it hard to believe, when I have spent much of my professional life fighting hyperinflation in emerging economies.



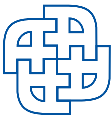
worked correctly, focusing on: improving governance and banking business models; the identification, provision and management of credit risk; and the standardisation of supervisory criteria to put an end to national options and discretions. The latest round of stress testing of European banks has helped to identify entities with problems and foster their recapitalisation. The European Single Resolution Mechanism for banks has been approved and is being implemented, at the customary gradual pace, with the Single Resolution Fund starting to be provisioned by contributions from financial institutions. There has even been some significant progress with fiscal union, although it must be said that we are still at the stage of making declarations setting out positions, and starting to discuss details. Even the Greek crisis seemed to be on course for a not particularly controversial solution, involving a mixture of compliance, adjustment and debt relief.

Though still fragile, at the end of 2016 the euro area economy was clearly free of the threat of recession, unless protectionist policy decisions push us back in that direction. Having grown at 2% in 2015, economic activity slowed slightly to 1.7% in the Commission's latest 2016 forecast[4]. Even so, the improvement is obvious in the gradual narrowing of the output gap and the recovery of employment to pre-crisis levels. Even so, some deeply-entrenched problems still persist, such as the scale of long-term unemployment, low investment and below-target inflation. This is despite spectacular monetary expansion, which has taken interest rates to levels that the monetary authorities themselves recognise as their technical limit.

At the time of writing this Yearbook, the figures for the last quarter of the year invite a certain degree of macroeconomic optimism, with reinvigorated consumption and an upbeat business climate in Germany and France, and the continuing strength of the Spanish economy. This is only partially offset by the weakness of Italy, resulting from the political uncertainty following the resignation of prime minister Renzi and the complications arising in its banking system.

The euro area public-sector deficit fell again in 2016, by 0.3 p.p. to 1.8% of GDP[5], though big disparities between countries and some flagrant defaults still exist. Savings on the servicing of public debt and cyclical recovery have permitted some small progress in fiscal consolidation. Four euro area members remain in excessive deficit procedures, including Greece, which is still subject to a bailout programme, and, notably, Spain. Public debt across the euro area as a whole fell slightly from its peak of 94.4% of GDP in 2014, but remains excessively high following years of extraordinary efforts. This is particularly acute in some countries where it remains above 100% of GDP. In November 2016, the Commission issued a Communication[6] arguing that the cyclical situation in the euro area presented a strong need for moderately expansionary fiscal policies to support recovery in 2017. This position is not shared by the Council, which obliged the Commission to clarify that the fiscal impulse of each member state depends on their individual circumstances, and must be in compliance with Stability and Growth Pact

[4] European Commission (2016d).
[5] European Commission (2016c).
[6] European Commission (2016a) and (2016b).



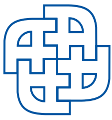
obligations. An idea that is often unjustly overlooked in some public debates on austerity and fiscal cuts.

Italy appeared to be the main cause for concern in the euro area at the end of the year, because of the potentially systemic impact of its financial and political problems. Whilst the other periphery countries remain vulnerable, Portugal is starting to show worrying signs of exhaustion with the adjustment and reform process and possible reversal; Greece is continuing its unstable balancing act between adjustment and non-compliance, in the hope of renegotiation of the debt, which was not helped by the adoption of unilateral fiscal stimulus measures. At the other extreme, there are increasing political and academic pressures on Germany to place a limit on its trade surplus, which is approaching 10% of GDP, and to adopt a fiscal stimulus to boost domestic demand. Paradoxically, recent undesirable events - such as the refugee crisis - may make this option more politically acceptable.

Whilst the economy might not be a cause for pessimism, European politics is in deep crisis. All of the usual equilibriums have been turned upside down by the refugee crisis and the UK referendum. Whilst neither of these events has anything to do with monetary union in principle, they have radically altered expectations, and the political and social climate. They have also been a blunt reminder that monetary union requires political will, and that Europeanism is flagging across Europe. And without this will, the stability and survival of the euro as a currency will be questioned, putting it at the mercy of speculators and opportunists: the composition of the euro area is becoming open territory. The reversibility of the European project was on the table in 2016, in a way that it never had been previously. The very survival of the single currency is once again under discussion, as it was in the worst moments of 2010[7]. Political parties that reject the euro have real chances of gaining power in several EU countries. This is the sad situation in 2016, that this Yearbook cannot avoid. It doesn't matter that the financial markets are maintaining enviable stability and acting as if a breakup were a metaphysical impossibility. The only way to achieve a successful diagnosis is to fully understand the problem. Populism will not be defeated by more populism; but by conviction, education and leadership. This is the challenge we have ahead of us as Europeans. To ensure our stability and prosperity in an era of globalisation, and to maintain our contribution to a world that is richer, freer and fairer.

The UK referendum finished off one of the few political certainties that seemed unshakeable: the irreversibility of European integration. Until this seismic event, it seemed obvious that Europe's historic conflicts could be consigned to the past by ever closer economic integration, establishing a dense network of mutually beneficial relationships. But integration has given way to nationalism, an old European illness that we thought had been overcome. With Brexit, we have seen the return of political risk in Europe. With Trump, we are seeing a return of North American isolationism and mercantilism. With both, we face the risk of global recession.

[7] For this reason, Brexit is particularly dangerous for the countries most vulnerable to investor sentiments. A liquidity problem for some sovereign Treasuries in Europe could once again develop into a solvency problem, if the markets start to suspect that these countries could be indebted in foreign currencies.

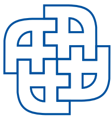


Economic authorities are asking us to remain calm, but the shock is fundamentally political. Economic policy will not be sufficient on its own, however active and unorthodox the ECB might be. The referendum result has refocused attention on the imperfect and incomplete design of Europe. The European Union will have to relaunch itself, just as the Monetary Union was partially relaunched following the debt crisis. The Union has been acting under a premise that is no longer sustainable: that whatever its faults in design, its democratic deficit and political errors, all the alternatives were worse. But the public has got fed up with a discourse based on inevitability, because national governments have used Europe as an excuse, blaming every unpopular decision on a distant and bureaucratic Brussels. Expenditure cuts, salary adjustments, labour market flexibility, pension reform: Brussels was always to blame. But these reforms were needed because the economy has become globalised, and the digital revolution has transformed the global value chain. Because Europe has lost its singularity, its competitive advantage and its technology. In addition, its demographics are stagnant, and the welfare state has mushroomed beyond what can be financed. This reality has nothing to do with European integration. In fact, integration is one of the most promising political strategies for responding to these challenges.

The crisis struck Europe with unexpected force, forcing the financial fragmentation of the euro area. It tore the Monetary Union apart at the seams, because the original design was faulty. No long-term monetary union is possible without banking and financial union. But fiscal union is also required, because no fiat banking system can survive without a credible fiscal backstop. We should all have learnt from recent episodes. Starting with the most vulnerable countries, which need to redouble their efforts to reduce their domestic imbalances and guarantee structurally sustainable fiscal positions. But many of these countries harbour a temptation to trust in the presumed expansionary effects of deficits. There are frequent calls for a relaxation of fiscal policy in the Union, confusing what might be necessary in some countries that are in surplus with political incapacity to face up to the costs of the necessary adjustments to government accounts.

But countries with fiscal and trade surpluses also have something to learn. They cannot continue putting off the mutualisation of bank debt through a European deposit insurance system (EDIS) and a credible Single Resolution Fund. Neither can they refuse to offer solutions to the issue of sovereign debt. A common risk-free asset is an inescapable feature of any monetary union with a pretence to permanence. This means credible and effective limits must be imposed on public deficits. It would be even better to move forwards with a fiscal union that includes a system of simple, automatic and mandatory fiscal rules, and the euro area's macroeconomic stabilisation facility.

Too many voices clamour for a return to a system of a la carte integration, to a Europe of variable geometries and different speeds. For some reason an idyllic image of the Austro-Hungarian empire is offered as an efficient model of sustainable flexibility. However, this model would be completely incompatible with the sustainability of monetary union, because it would represent an on-going invitation to speculation against those countries perceived as most vulnerable at the time. And if economic history over the last twenty years is the rating guide, these won't always be the countries now known as the PIIGS.



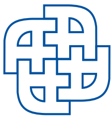
Europe has a democratic deficit and a functionality deficit. The Monetary Union requires a certain pooling of monetary, banking, financial and fiscal sovereignty, and this is incompatible with the lack of democratic legitimacy of its institutions. The Union needs a new Founding Treaty that simplifies decision making processes, creates authentically federal institutions and incorporates automatically-applied fiscal rules, in exchange for mutual protection. It requires a government and a Finance Ministry. The exceptional regimes of disguised intervention in countries in difficulties have to end. But the possibility of free riders - irresponsible national behaviour hidden behind grandiloquent appeals to European solidarity - must also end. The social pact that gave rise to the European project needs to be renewed. This is a daring step. But the alternative is no longer carrying on as though nothing has changed, it is most likely disintegration and collapse.

Against this backdrop of disenchantment, the 2016 Yearbook seeks to remain faithful to itself and cover the European debate, without limit, in all dimensions and from all perspectives, even if some of these are contradictory, and even if the authors do not always agree with each other, or with the editor. Because this was my goal from the outset: to offer every possible point of view faithful to the European spirit. Last year we did this with sovereign-debt restructuring, with Greece very much in mind. This year we are looking at the continuity and effects of the ECB's unconventional monetary policy, and euro area fiscal policy. Because, if there is one lesson that I have learnt personally from this prolonged crisis, it is that consensus leads to complacency and, as Karl Popper warned us many years ago, complacency is the main danger for developed societies. The European economy and European politics need contrarian opinions that challenge politically correct certainties. The euro area still needs to be completed, to provide common policies and carry them out; not only short-term growth priming the fiscal and monetary pump.

Once again, the Yearbook has two objectives: to explain and to influence. Firstly, it helps to inform readers who are interested in the European Monetary Union but not necessarily specialists. I imagine this reader as also being a stranger to the intricacies of European politics, its distant and unnecessarily technical and bureaucratic language, its intricate and changing legislative process, and the continuous modifications to its institutions and competencies. The euro area is a political creature that is under construction. It is a living and unfinished political project. As such, it is difficult to follow. Anyone who does not understand this will be incapable of understanding Europe, and their political and economic conclusions will be wrong[8].

But the Yearbook also seeks to influence the construction of Europe. We have argued that the economic and political future of Spain will be played out in Europe. Following a lengthy period on the sidelines, Spain once more has a stable government. It is to be hoped that it will now recover its leading role in Europe, and contribute to building European monetary, economic, budgetary and political union. Combining defence of

[8] As we have so often seen in the simplistic arguments of certain North American gurus who have made a fortune predicting the imminent collapse of the euro from their distant ignorance.



Spanish interests with strengthening the euro area and its political space is a complex tax requiring technical knowledge, negotiating skills and political will. Above all, it will require wide-ranging national consensus, because only strong and united countries, with consistent and lasting policies that do not stoke volatility, sectarianism or try to reinvent the wheel can aspire to influence the future of Europe.

In this dual role of explaining and influencing, I believe I have managed to bring together yet again a group of leading collaborators, who are ideologically and professionally diverse, and truly international. Not everyone who contributed in the past has been able to appear this year due to other commitments, however, all of the authors here are of recognised intellectual repute with a true commitment to Europe. They all contribute their rich and varied professional and life experiences to share their understanding of what has happened to the euro, and their opinions on what remains to be done. It bears repeating that this is a collective work, in which I am only responsible for choosing the authors and the issues, and that the authors present their opinions with absolute freedom. This book does not shirk the debate and seeks to contrast opinions. It opens with this partial but - I believe - faithful summary of the opinions of the authors. This is an unusual summary, in that it seeks to compare the authors' opinions with my own, benefiting the reader by giving them the tools to make up their own mind about topics that are necessarily controversial and subject to politics and ideology. This is because Europe will not be built by fake unanimity, but through an intensive exchange of opinions, reaching complex agreements and complying rigorously with the rules we have agreed.

This is perhaps my first personal conclusion for the 2016 Yearbook: European regulations are there to be applied, and to be changed if we don't like them, if they are insufficient or if their application results in unexpected and undesirable outcomes. This has happened several times over recent years, with the excessive deficit procedure and banking union, for example. But the rules must be respected. If not, the credibility of European construction will be tested to the limit. This is the rule of law and Europe can only be built as a political space subject to the rule of law: it cannot and must not appeal to any legitimacy of religious, racial or cultural origin. Europe is not and never will be a nation state, if these have even existed outside of 19th century romanticism, and if such a concept is compatible with the idea of democracy.

2. A MONETARY UNION BETWEEN NORMALITY AND THE SEARCH FOR A NEW INSTITUTIONAL FRAMEWORK

The structure of the Yearbook 2016 is somewhat different this year. It is becoming ever more difficult to distinguish those aspects that correspond to normal functioning of any monetary area from analysis of regulatory and legislative developments, and the highly controversial, but still only theoretical, issues on which the various actors are starting to take positions. There are two reasons for this. After being in operation for seventeen years, the Monetary Union is such a normal part of economic and political life, so much a part of every decision and every debate, that every economic proposal has to consider it. But it is also because the Monetary Union has changed so much since the

outset, it has innovated so much and spread to so many territories that we believed were forbidden to it, that everything is now normal. Anything is possible in the new European normality. Monetary policy decisions are unorthodox and innovative; regulatory and prudential policies are built on and expanded year after year; and fiscal rules continue to evolve pointing - though many would still not dare to use the name - towards an embryonic European Treasury. Even arguments about the distribution of power between institutions, and decision-making and voting procedures in those institutions, usually end in agreement. It is just like any sovereign state.

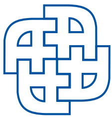
To reflect this, the Yearbook is set out as a continuum, from the general to the specific, from a global vision of monetary union in the world (chapter 1) to a final discussion of reform of the Treaty (chapter 11). Sandwiched between these we have exhaustive details of: the role of the euro in the world (chapter 2); financial fragmentation in Europe (chapter 3); the effectiveness and limits of the ECB's monetary policy (chapter 4) and the potential impact of this on banking profitability (chapter 5); an initial assessment of the ECB's supervisory activity from both a global perspective (chapter 6) and from the point of view of those supervised (chapter 8); this is preceded by a sketch of the European deposit insurance system (chapter 7); and followed by an outline of the type of fiscal union that might be possible, and necessary, in the euro area (chapter 9); and a comparison of this with the actual institutional fiscal reality in Europe (chapter 10). This is rounded off with a purely political discussion (chapter 11) about the final destination set out in the Five Presidents' Report.

Attentive readers will no doubt have spotted that the list of contents does not include a specific chapter on the European story of the year, the UK referendum. We had one last year, when it was little more than a possibility that almost nobody considered likely. This year we have to assume that it is inevitable. It is a sovereign decision. It might be profoundly wrong and dangerous - in my opinion - but it is legitimate and definitive. The relevant question is, therefore, now what? This is addressed by nearly all of the authors in their chapters - some explicitly and some more subtly or in passing - because no European observer can ignore the "elephant in the room".

The book opens with an introductory article by Jaime Caruana, the general manager of the Bank for International Settlements and Goetz von Peter, from the same institution. This is an excellent exercise for placing the euro area in the context of international economic concerns. Their central thesis is attractive and powerful: the European institutional framework is imperfect and insufficient, but it is too often blamed by European leaders for exclusively domestic problems and the deficiencies of the international monetary and financial system.

We have been arguing that the original design of the Monetary Union is imperfect since our early study of the euro area[9]. However, the authors underline three no less important corollaries. Firstly, the leaders of the time were well aware of this, and intended to complete it when the time was right, giving the reforms adopted the legitimacy they

[9] A 2013 study edited by the FEF entitled La Arquitectura Institucional de la Refundación del Euro (The Institutional Architecture of the Re-founding of the Euro).



needed. Secondly, there have been no cases of monetary union in history that have started out with all the institutions needed for their sustainability, which makes arguments about the exceptional and provisional nature of the current Union meaningless. Thirdly, attempts have been made to resolve these deficiencies with aggressive and creative monetary policy. But the problem is not monetary. The problems that need to be addressed are institutional. Here, the authors strike a necessary note of optimism about the possibilities of greater fiscal and political integration in the current environment".

Progress in the euro area would be much easier if accompanied by domestic structural reforms and international policies that focus more attention on global imbalances, the accumulation of global financial risks and contagion effects. Based on BIS studies, the authors underline that among the global weaknesses that need to be: (i) monetary and regulatory authorities interpret their mandates in exclusively domestic terms, and are guided solely by domestic indicators; (ii) analysis is mainly in terms of net flows, paying insufficient attention to gross flows and even less to stocks, i.e. debt levels; (iii) there is insufficient global coordination of national policies, and attempts at cooperation run into insurmountable practical difficulties; (iv) global - and indeed European - debt levels remain excessive; (v) insufficient attention is paid to the consequences of weak productivity, particularly in Europe; and (vi) fiscal policy - which is so in-demand by some international institutions - might help mitigate some of the adverse effects of implementing structural reforms - when they are applied-; but there is a danger of overdoing this, overestimating the capacity of fiscal policy and exhausting any fiscal leeway for the future. These are clear words and a direct message that the BIS has been repeating for years, faithfully reflecting its diagnosis of the crisis as one of repairing balance sheets, not increasing effective demand.

Following this external look at the euro area, Blanca Navarro, Almudena Gallego and Miguel Fernández, from ICO's Research Department, describe the panorama of the euro's role in the world, as a means of payment in international trade and as an investment and reserve currency. They also examine its use as a parallel currency for deposits and loans outside the euro area and in financial markets (equities, fixed income, money market, FX and derivatives). They offer a comprehensive and exhaustive picture, backed by abundant data, and reflection on the reasons why the European currency has not fully established itself as a substitute for the dollar, and the obstacles it will have to overcome to take on this role. Whilst the euro was the second most important international currency on practically all of the indicators analysed, it still remains a long way behind the US dollar. And this gap increased in 2015-16, with the global presence of the euro weakening to an extent not attributable to its depreciation against the dollar. As we hinted last year, it would seem that the addition of the Chinese renminbi to the list of global currencies is at the expense of the euro, more than any other currency. This is due more to political and institutional reasons than strictly to economics.

Currency movements have had the expected effects on international trade, with the corresponding lags. Thus, euro area exports have increased by a higher proportion than in previous years, despite the weak performance of international trade. However, the use of the euro as a means of payment for imports and exports by euro area countries has decreased, and remains below pre-crisis levels. This leads to consideration of the possi-

ble accounting, regulatory, intra-industrial and financial infrastructure factors that might be limiting its use and favouring the dollar, and what might be done to address these.

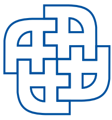
This chapter features a fascinating consideration of the relationship between exchange rates and trade, which some economists argue may have weakened over recent years, with the rise of global value chains and intra-company trade. This proposition has significant implications for so-called competitive devaluations. Taken to the limit, this would undermine the monetary approach to the balance of payments, which underpins much of the theory of open economies and the IMF's policy recommendations. However, the results appear to confirm that the estimated relationships hold, between exchange rates, commercial prices and gross volumes of imports and exports, and that the exchange rate remains an important instrument in the transmission mechanism of monetary policy through to inflation, as the ECB also appears to wish.

The reorientation of capital flows towards assets denominated in currencies with better returns, and lower demand for debt issued in the euro area, is explained by QE policy over the last few months of the year and the different cyclical positions of the ECB and the Federal Reserve. A process of diversification in holdings of global reserves that began in parallel with the financial crisis. This has been fostered by the monetary policies of the world's main central banks, resulting in increasing weight for currencies such as the yen and the Canadian and Australian dollars. It will be interesting to see whether this trend survives the change in the monetary-policy cycle.

There were no changes in the number of countries that peg their currency to the euro in 2016, and virtually no changes to the exchange regimes of countries that do peg their currency to the euro, following the changes in 2014 and 2015. However, confidence in the euro among those outside the euro area, and desire to join it, decreased with the Brexit vote, as was to be expected. There were no new euro members in 2016, and there are no plans for any new members to join. There are still 19 countries in the euro area, and it is legal currency in the same four countries (Andorra, Monaco, Vatican City and San Marino) and two others, Kosovo and Montenegro, which adopted it unilaterally. Bulgaria's exchange system is pegged firmly to the euro, as is that of Bosnia and Herzegovina, which is outside the EU. Meanwhile, Denmark, the Czech Republic and Croatia have a weak peg system, as does Macedonia which is not in the EU. Despite being EU members, Hungary, Poland, Sweden and the UK have free-floating systems compatible with their inflation targets. This is also the case in Albania, Iceland, Serbia and Turkey, which are not EU members.

Total deposits in euros at current exchange rates fell to their lowest level since the start of the crisis, as a result of the depreciation of the euro and its penalisation by the ECB with negative interest rates. Lending in euros continued to contract, as a result of deleveraging in the euro area. At constant prices, the relative weight of deposits and lending in euros outside the euro area - a better indicator of confidence - fell, to the benefit of the dollar and the group of "other currencies", which is in second place.

Most financial markets (except interest-rate derivatives) show the euro consolidating its second place internationally, but with the gap between it and the dollar increasing. The unknown for the coming year is whether the uncertainty associated with use of the euro, and the possible withdrawal of financial activity from the City of London, might



boost or undermine use of the euro as a denomination for asset trading. The capitalisation of equities in dollars is more than double that in euros, and is growing. The situation is similar for fixed income instruments, although the euro is continuing its recovery from the historic lows of 2013. The fact is that issuance conditions are favourable for the dollar, despite added complexity, needs for hedging, arduous legal requirements and the additional marketing effort required. In the money markets, there has been growth in the volume managed by US systems, mainly FEDWIRE, whilst European markets, TARGET 2, have stabilised[10]. There were no major developments in the FX market, with the dollar maintaining and increasing its considerable lead. Finally, and striking a discordant note, euro contracts continue to dominate the interest-rate derivatives market, accounting for nearly 50%.

The introduction of the euro brought with it rapid financial integration among member states of the European Economic and Monetary Union (EMU), which was almost complete in inter-bank markets, but somewhat weaker in securities markets[11]. Retail markets however remain prisoners of national barriers. The crisis put integration radically into reverse, provoking financial "renationalisation", which was only contained by the launch of banking union and the ECB's firm resolve "to do everything necessary". The fragmentation process has since reversed, but has still not returned to the levels previously seen. In Chapter 3, Sonsoles Castillo, Santiago Fernández de Lis and María Martínez, of BBVA Research, analyse this financial fragmentation, through a synthetic indicator that combines the performance of euro area debt, lending and bank-funding markets in one simple instrument. This tool has enabled them to distinguish three clear periods during these years.

It is perhaps surprising that the last of these periods - from mid-2014 to the present - has seen a halt in financial integration, with a slightly increasing trend towards fragmentation. However, the factors behind this increase are completely different to those during the years of re-nationalisation, 2010-12. This time not due to market-access problems, widening spreads or capital outflows from some markets, but to the effects of QE and the accumulation of bank balances in the ECB, despite the negative rates. But it is still a symptom of the poor functioning of inter-bank markets in the euro area, and a lack of risk appetite among banks from other banks and lending beyond national boundaries, even if within the euro area.

This chapter includes an initial assessment of the ECB's unconventional policies, to which we devote a lot of attention in this Yearbook, in the light of the objective of reversing financial disintegration in the euro area. The conclusion is clear, "the measures adopted have managed to avoid disruptive events in the euro area", enabling a degree of normality to return to financial markets. The transmission mechanism in credit markets has been repaired, with interest rates in peripheral economies converging strongly on the levels of core economies, with only a small spread for the smallest and most local SMEs.

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[10] Stabilisation that does not stop the scale of these flows still being interpreted by those with an agenda as a disguised bail-out mechanism, when it is simply a mechanism for the reassignment of liquidity that any monetary union would need.

[11] In some cases - such as public debt markets - convergence of returns could even be excessive.

But we must be on guard. We could just be witnessing an illusion conjured up by the ECB's strong interventionism. The test of fire for euro area financial integration will come when the QE exit is signalled and rates start to rise, decoupling the financial system from the guarantee of free liquidity for an indefinite period.

Being aware of the difficulty of estimating isolated impacts, this chapter also seeks to specifically analyse the effectiveness of negative interest rates from the sole perspective of fostering financial integration in the euro area, ignoring the wider debate about its general effects. It concludes that they have not had the desired effect, because they have not eliminated excess liquidity in the banking system or boosted the volume of trades in inter-bank markets. In fact, these surpluses have increased over recent months. The authors are particularly concerned that negative rates could feed through to retail depositors. I believe that this is inevitable if the ECB's policies persist over time, as banks will have to defend their net interest income. This could lead to significant withdrawals of bank deposits, putting banking intermediation at risk and pushing more conservative savers towards riskier assets, with resulting social and financial instability.

In conclusion, the ECB's initial announcement and subsequent action have been key to stopping financial fragmentation in the euro area. But the recovery in the level of financial integration has been fostered by institutional progress in banking union, avoiding the feared re-nationalisation that would have been incompatible with the sustainability of the Monetary Union. Whilst impressive progress has been made in banking, some significant weaknesses remain. Firstly, implementation deficiencies, in harmonised supervision, which has not dispelled doubts about the quality of the balance sheets of some banks in some countries. Secondly, some important elements are still awaiting approval, such as the European deposit insurance scheme (EDIS), the continuing absence of which preserves an important and justified degree of national fragmentation. Finally, whilst institutional reforms are important, it is even more important to increase cross-border competition, so that bank customers can fully benefit from monetary union, against the backdrop of the digitalisation of finance. Cross-border mergers and simple, transparent, common, European regulation of financial technology (*fintech*) are key elements in this.

Monetary policy took centre stage in 2016[12]. The ECB - too late for some, and with excessive zeal for others - has been adopting ever more unorthodox policies, even exploring the uncharted waters of negative interest rates. Something the Fed has never risked doing, and which had previously only been explored by small central banks, such as those of Sweden and Switzerland. We have therefore devoted a couple of chapters of this Yearbook to this topic, and I have made some additional comments in this summary.

In Chapter 4, José Ramón Diez, of Bankia's Research Department, describes and analyses monetary policy in 2016. He argues that the major development was the ECB explicitly adopting the objective of creating inflation. Having got past the theoretical debate about whether the target should be "around or under 2%", the ECB has got to work to create inflation. It is pursuing this by extending its asset-purchasing programmes and provision of guaranteed long-term liquidity. Boxes 1 and 2 of the chapter summarise the

[12] Bech, M. and Malkhozov, A. (2016).

nature and size of the ECB's ntervention programmes. Perhaps the ECB can be content, as preliminary indicators point to euro area inflation of 1.1% in December 2016, the highest since 2013. However, it is also true that this is partly due to rebounds in oil prices and increased inflationary expectations following the election of President Trump.

The result has been a rapid increase in the ECB's balance sheet to EUR 3.4 trillion, 32% of euro area GDP at the end of 2016. This makes the ECB an outstanding student, as the Fed has only dared go as far as 25% of the USA's GDP. The composition of that balance sheet is also completely different, and has turned towards the long term. Operations related to QE - known as LTROs - are now 15 times the size of the ECB's traditional liquidity auctions (MROs). The average duration of the ECB's bank funding has increased from less than one year in 2007 - the norm in monetary theory and practice prior to the crisis - to more than three years. It would be naive to expect such a radical change not to affect the inter-bank market and to have no effect on the practices and strategies of financial institutions.

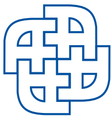
In parallel, excess liquidity in the system - understood as deposits by banks with the ECB in excess of their legal obligations - has continued to grow, and now exceeds EUR one trillion. This underlines the importance of the deposit facility rate, which sets the floor price at which the central bank can buy or sell assets in the market. Although the author of this chapter does not go so far, some argue that the ECB's strategy is reviving the notorious *Greenspan put*: i.e. it is setting a floor for the prices of financial assets and contributing to a certain extent to a potential market bubble, particularly in the public debt market[13].

This potential bubble curiously coincides with an appreciable lack of liquidity in public-debt markets, which are becoming ever more dominated by central banks that are obviously not involved in trading, and affected by lower activity by traditional market makers, who are limited by increasing regulatory restrictions. The volume traded has fallen by 50% in just two years, and the ratio to the outstanding balance stands at 0.7 times, the lowest since 1989. The problem of lack of liquidity is most pronounced for private debt, as this is the most diverse market, and the most dispersed, and has been aggravated with the possibility that the ECB will acquire up to 70% of a specific issue. If we add the risk of over-valuation to liquidity risk and reduced issuer solvency, particularly for sovereign issuers, it should be no surprise that questions are being asked about the credit risk being increasingly acquired by the ECB - in other words, the European tax payer. And whether public debt can continue to be considered a risk-free asset, with the problem this poses for asset management.

In any case, it is true that the QE strategy has had tremendous impact all along the interest rate curve[14]. This is shown, for example, by the 12-month euribor - a key benchmark interest rate for the financial system used as the basis for most mortgage rates in

[13] See Torre (2016). For an opposite point of view, refer to Claeys (2016), which minimises the financial risks of QE and insists on the need to generate inflation. We would also point out that the Bank of Spain, in application of the ECB's monetary decisions, bought nearly half of all public debt issued by the Spanish Treasury in 2016.

[14] Cruz, Fernández de Guevara and Maudos (2016).



Spain - having been negative since February 2016; by 80% of German public debt having negative returns over the year; and by returns on investment-grade private issuers standing at less than 1%. Extraordinary funding conditions, that sought to drive demand for credit for both consumption and investment, and which are consistent with a diagnosis of the crisis as a problem of insufficient demand.

This chapter also offers an initial analysis of the effects of QE as a transfer of income from savers to debtors, which explains its unpopularity in countries such as Germany. The author cautiously states that "it seems that, in addition to being asymmetrical", the impact being different by countries depending on conditions in the banking system and the institutional characteristics of credit markets, "the marginal efficiency of these measures is starting to decline considerably". The author therefore shares the view that it is becoming dominant in the economic literature[15] that unconventional policies will have more prejudicial than beneficial effects, if they are prolonged unnecessarily: "we are approaching rates at which negative effects will predominate" (*reversal rates*). This is because, inter alia, they affect the profitability and solvency of the financial system.

The author therefore concludes that it would be appropriate for the world's leading central banks to start moving their monetary policies back to normal, before it is too late. This will be no easy task. The Federal Reserve has already started, and more intensively than expected, without any significant impact on financial markets, which had factored it in. However, it does not seem that the ECB is willing to do this yet, judging from the declarations of its President and what we know from the minutes of its meetings: perhaps nobody is too worried about a likely depreciation of the euro, which would help to stabilise the fledgling recovery, which still seems excessively fragile.

The so-called undesired effects of unconventional policies have developed into an important issue for questioning the presumed beneficial effects of QE. They are a euphemism for the collateral damage of QE, and have received a certain degree of attention during the year[16]. Allow me to share my main conclusions, to the extent that they are more critical than those of the previous chapter.

The first problem - the most fundamental problem with QE - is that it may be based on a diagnostic error. Perhaps we are not dealing with a crisis of demand but rather a balance sheet crisis[17], as the BIS systematically argues. Because the case is that global demand has not suffered structurally: rather, it has moved to other parts of the world. This would be a crisis of globalisation, against which conventional demand-management policies, including monetary policies - no matter how unorthodox - are not, and cannot be, effective.

The second is that the policy of exceptionally low interest rates is a form of financial repression, and leads to inefficient resource allocation and damage to the risk-return trade-off as an investment criterion. This stokes irrationality in the markets.

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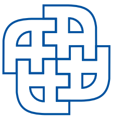
[15] Altavilla, Carboni and Motto (2015), Burriel and Galesi (2016) and Claudio Borio and Anna Zabai (2016).

[16] See F. Fernández (2016), for analysis and justification of the arguments summarised here.

[17] Jaime Caruana (2014).



The third is that it transfers the costs of the crisis to savers, a sophisticated form of silent and disguised debt restructuring. Whilst this would be controversial in any country, in the euro area it has additional and inescapable geographic and political connotations. However, the facts are not that obvious, because they depend greatly on the structure of household wealth and the savings culture and practices. Thus, to the surprise of many, Italy is one of the countries most negatively affected by this financial repression, as its households hold a large amount of bank assets (deposits and senior debt)[18]. Spain, on the other hand, is a clear beneficiary, because households' interest payments on their mortgage borrowings exceed income from savings in bank deposits. If this punishment of savers continues over time, it will put at risk not just the long-term stability of the EMU, but its very survival. The rise of certain ultra-nationalist movements and the outright opposition of Germany to QE are based on this point. Ignoring it would be tantamount to ignoring the pact that gave rise to the birth of the euro.

The fourth reason is that credit booms tend to undermine the productivity of the economy, by channelling lending to less productive or competitive sectors. This generates bubbles of growth with low productivity, which end up bursting violently. The problem is that financial repression unnecessarily extends the adjustment process, by reducing the cost of holding excess debt and poor allocation of funds.

The fifth reason is that unconventional policies generate perverse effects in terms of the willingness to reform. As the OECD has pointed out, reform momentum has fallen sharply in Europe, particularly in those countries that have benefitted most from this monetary policy by participating in the Troika's bailout programmes[19] This result shouldn't surprise us. If debt is sustainable and there are no costs in maintaining it, why reduce it? This leads - as could be expected - to populist movements that propose additional growth in public debt or that defaulting on payments would be harmless.

The sixth, and perhaps most important, is that the negative effects of unconventional policies on the profitability and solvency of the financial system can no longer be ignored. It is true that monetary policy, to the extent that it has contributed to the recovery of economic growth and employment, has improved the health of bank debtors, and therefore the banks' income statements. But, perhaps the effects of this are now exhausted, or could have been achieved with less aggressive and pro-cyclical regulatory policies, its continuation could lead to lasting damage of the financial sector. Specifically, against a backdrop of interest rates close to zero: (i) it damages the profitability of entities by making maturity transformation - a core business of any bank - less profitable; (ii) it enables weaker banks to distribute profits to their shareholders, rather than retaining them to bolster their capital· creating undesired opportunities for regulatory arbitrage; and (iii) it accelerates banking disintermediation, with the resulting risk for customers and taxpayers, to the extent that this only responds to regulatory or political incentives. In summary, as the IMF has said, there comes a time when the negative effects of interest rates on bank profitability "outweigh the benefits from higher asset values and stronger aggregate demand"[20].

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[18] ECB (2016).
[19] OECD (2015).
[20] Jobst & Lin (2016).

The ECB has defended itself in public against these charges, by saying that its competencies do not stretch to defending the margins or profitability of banks, and that this vulnerability is not general, but depends on domestic banking practices and structures. It is true that the vulnerability of domestic banking systems to zero interest rates is not linear or homogeneous, and depends on[21]: (i) the sensitivity of assets and liabilities to interest rates, which would benefit the most rigid and opaque systems, by not transferring the conditions prevailing in wholesale markets to bank customers; (ii) the capacity to generate alternative sources of revenue to net interest income, which implies charging for services and increasing fees, despite this becoming increasingly unpopular with bank customers[22]; (iii) the initial intermediation margins, which would penalise systems such as Spain's, where loans are overwhelmingly indexed over the short term, and where funding is very dependent on retail deposits, despite this having been one of the strengths of traditional commercial banks in the crisis; and (iv) the business model of each bank, which has become a central plank of the Single Supervisory Mechanism's programme.[23]

The impact of QE on the financial system is a crucial issue, as if it damages the transmission mechanism of monetary policy - through a negative impact on the money multiplier -, the increase in liquidity will have been in vain. This is also a controversial subject. To provide a contrast to my point of view, I have asked Guntram Wolff, author of a recent European paper in this area[24] to contribute his opinion to this Yearbook. Working with Maria Demertzis of Bruegel, in chapter 5 he sets outs his argument that QE has been basically positive for bank income statements.

They base their proposition on the profitability of banks being impacted through three separate channels. Firstly, as bond prices rise, QE bolsters bank balance sheets, generating huge potential capital gains[25]. Secondly, there is the well-known negative effect on bank profits from shrinking net interest income. And thirdly, by facilitating economic recovery, QE increases the volume of, and opportunities for, banking business, and decreases non-performing loans. In their opinion, the net effect of these three channels should, a priori, be positive. However, they do recognise that the banks themselves take a much more negative view, as shown in the ECB's Bank Lending Survey. This chapter offers an interesting empirical attempt to estimate the relative impacts of these three channels. The first - the fall in interest rates - is well known and even better documented, and there is no need for additional empirical confirmation.

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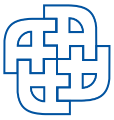
[21] IMF, *Global Financial Stability Report*, April 2016.

[22] Many authors agree with the monetary authorities and argue that the negative impact on net interest income could have been offset by higher fees and, above all, capital gains. But, putting things in perspective, a massive increase in bank fees would have been required to offset the negative impact on net interest income. It is easy to imagine the effect this would have had on bank customers who are not used to paying anything for some of the services they receive.

[23] Nouy *(2016)*.

[24] Demertzis & Wolff, 2016.

[25] Capital gains and net interest income are not perfect substitutes in bank income statements, and investors treat them differently. Whilst net interest income is considered recurring revenue and contributes positively to market capitalisation, capital gains are considered one-offs, and have much smaller effects on capitalisation. The ECB understands this, as demonstrated by the Single Supervisory Mechanism, which takes a particularly favourable view of recurrent revenues and sustainable business models.



The third - the macro impact of QE - appears clear in their opinion, as they argue that "since the launch of QE, growth has accelerated in the euro area, through an increase in gross capital formation and consumer spending". However, they also recognise that it is difficult to prove a causal relationship and that some studies are much more sceptical. This not withstanding, the authors focus on the second channel in their chapter.

They demonstrate that the credit spread has indeed fallen significantly , and now stands at just 1.55 p.p. and 1.77 p.p. for new lending to companies and individuals, respectively. However, they emphasise that net interest income (NII) has remained extraordinarily stable, with national differences being explicable by differing levels of provisions. Furthermore, bank profitability has increased, particularly due to efforts to clean up balance sheets, i.e. by reducing non-performing loans (NPL). However, the fact that NPL rates fell at the same time as the ECB implemented QE does not imply any causal relationship between the two. It could be argued that reducing NPL rates was the only option available to financial institutions to survive the crisis. And they might even have been more effective in reducing the NPL ratio if they could have increased their net interest income at the same time as lending recovered, thus improving their capacity to make provisions with no need to incur losses.

The authors also highlight that low banking profitability is a problem that predates the unconventional policies - QE - and relates to the low quality of loans, legal and regulatory costs, and other problems not related to net interest income. This is exactly what one would expect to see in a banking crisis, and has more to do with the "legacy" of the pre-crisis party, or the new competitive environment resulting from changing models at a time of technological revolution, than monetary policy. This is perhaps why their conclusion that they have found no clear evidence that the ECB's QE policy has had any significant impact on the poor results of Europe's banks is a little surprising. However, they end by sounding a note of caution, encouraging the ECB to consider measures to increase the slope of the interest rate curve - as recently attempted by the Bank of Japan, although the results of this are as yet uncertain - to enable banks to mitigate potential negative effects on their margins and profitability.

This recommendation is more sensible than that repeated by authorities and analysts to exploit the opportunities created by QE for banking mergers as a strategy for restoring profit margins. It is one thing for the European Monetary Union to need European retail banks - and there are none today with a significant retail presence across multiple euro area countries - and something quite different to encourage entities to increase their monopoly positions so that they can squeeze additional returns from consumers as a recommendable strategy for offsetting collateral damage from monetary policy.

The next three chapters deal with banking union and, more particularly, the prudential policy and financial stability pursued by the ECB through the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The first provides a global perspective, setting the ECB's policy in the context of the regulatory changes introduced following the global financial crisis; the second sheds light on pending issues of the design of banking union and the European deposit insurance scheme; and the third focuses on the ECB's banking-governance and business-model recommendations.

José Manuel Campa and Alberto Buffa, from Banco Santander's Regulation unit, set themselves three objectives. Firstly, to describe regulatory progress in the euro area, highlighting its successes and limitations. Secondly, to analyse the new European supervisory framework, discussing its methodology and priorities. This section is very important, as is provides the necessary clarity, that is not always provided by the competent authorities. Finally, they discuss what remains to be done from the perspective of a bank that is both global and Spanish, i.e. with the legacy of Spanish regulatory practices and customs.

The financial crisis triggered a worldwide recession that resulted in an accumulated loss of around 25% of one year's global GDP. The international community responded with a veritable regulatory revolution, focusing on four main areas: more resilient institutions, through more demanding capital and liquidity requirements; Basel III; mitigating the problem of systemic banks (*too big to fail*); and moving a large part of derivatives trading onto organised markets and transforming shadow banking. In general, this agenda has been successfully completed. Banks are adjusting their business models to these changes, whilst their market valuations continue to be under pressure against a backdrop of ultra loose monetary policy, mediocre macroeconomic performance and the digital revolution, in addition to regulatory pressures.

In Europe, the application of this new regulatory framework has coincided with the launch of banking union and a new institutional map with the ECB at its centre. Thus, a new supervisory structure has been established, comprising (i) a standard methodology - SREP -for all European banks, combining quantitative and qualitative elements with a clearly preventive, forward-looking approach; (ii) the creation of joint supervisory teams (JST); and (iii) the application of Thematic Reviews, horizontal supervisory initiatives, approaches and policies establishing the supervisory priorities for these years, namely: corporate governance, risk appetite, cyber-security, the sustainability of business models and the use of internal risk models.

Whilst this process has been a success, "we are still a long way from single and standardised supervision". Firstly, the institutional framework has to be completed with the European Deposit Insurance Scheme. Secondly, a number of important regulatory changes are still pending national transposition or full implementation, such as the revaluation of CRR/CRD IV, and the European transposition of TLAC, as approved by the G-20, and its coordination with the European MREL framework. Thirdly, the operation of these new mechanisms is still at a stage of trial and error, as we saw with the new Pillar 2 Guidance (P2G), qualifying regulatory P2R, in 2016[26].

The article includes a long list of recommendations for improvements to the SSM. Allow me to underline the three I consider most important: stability of regulatory requirements, as a necessity for capital and liquidity planning; the standardisation of risk

[26] The SSM has divided Pillar 2 into two separate elements: P2R and P2G. P2G is the recommended capital buffer for banks to absorb the most negative shocks revealed by stress tests, and is calibrated for each entity individually. Following the events in some major German banks and doubts about Pillar 2 regulatory requirements, the introduction of P2G has reduced levels of P2R regulatory capital, increasing the capacity and flexibility of banks to distribute dividends, pay bonuses and pay coupons on debt and hybrid instruments.

weightings among national banks to ensure a fair and level playing field; and the elevation of supervisor dialogue, as banks send a huge quantity of information to the supervisor, but receive very little feedback, and very seldom any definitive criteria. Whilst the authors do not call for it, their idea suggested to me that it would be appropriate to have a binding SSM consultation system, similar to the one with the tax authorities in Spain.

As a conclusion to this section, we can use this nuanced quotation: "the number of European institutions involved in safeguarding the stability of the financial system has increased substantially, but they appear to suffer from a lack of coordination in their strategy". But whilst there is scope for improvement of the coordination between the SSM, the SRM and the EBA, this is practically non-existent in terms of joint supervisory efforts with authorities outside the euro area, although it is essential for global banks.

This chapter also underlines some priorities for the efficient completion of banking union. Firstly, and most urgently, put an end to regulatory uncertainty, by clarifying and setting down banking resolution requirements. Initial estimates suggest that the need for issuances of "*bail-inable*" assets will be substantial. However, greater legal certainty and full transparency with regard to their seniority and treatment in the event of resolution is required for the markets to be able to price these. The ECB, European Commission and FSB have issued calming messages over recent months, but concrete decisions are required. Secondly, accelerate the transition to full implementation of existing regulations, particularly with regard to new standards for credit, operational and market risk, and the treatment of internal risk models. Many of the calming declarations include the launch of a thematic review mechanism for such models - the TRIM - but again, there are no decisions. Thirdly, establish the SSM as the core of European supervisory activity. This would involve adopting a strong, single, corporate culture not inherited from the source central banks, a proprietary, horizontally consistent methodology and a strong, single international presence in representation of the euro area. And fourthly, confront the challenges of digitalisation. The objective is simple to set out, but very difficult to achieve: to ensure the same regulation of financial activity, irrespective of the character, legal nature or nationality of the institution involved. This is even more pressing in an international context in which regulatory arbitrage can provide a significant competitive advantage, or disadvantage, but can also give rise to systemic risk.

The European Deposit Insurance Scheme (EDIS) was one of the three key components that defined banking union as originally formulated in 2012. However, political difficulties have made it impossible to approve it so far, apart from a 2014 directive that harmonised some minor aspects, and the horizon appears somewhat hazy. The Commission's November 2015 proposal has not achieved the minimum agreement needed. However, it continues to be an essential component if we want to end the banking-risk/sovereign-risk loop. This was the starting point for Gerard Arqué, Enric Fernández and Cristina Plata, from Caixabank's Research and Strategic Planning Department, in chapter 7. Their chapter concludes with an optimistic message: that it is only a matter of time before the logic of implementing the EDIS wins the day. The European electoral calendar does not help in such a sensitive issue, and the deadlines will inevitably be pushed back, but it will eventually be achieved.

After reminding us of the theoretical arguments in favour of a deposit guarantee scheme, –the risks inherent to maturity transformation, the need for trust in a fiat system and moral risk in central bank liquidity facilities–, the chapter analyses the characteristics needed by a DIS to be effective: general and sufficient, but limited, coverage, mandatory funding by the entities themselves, and the credibility of the backstop guarantor, which can only be the state's power to collect taxes and create money. The authors also provide an interesting description of institutional diversity worldwide. The German case is particularly interesting, combining both mandatory and voluntary insurance for commercial banks. It is also noteworthy that the weight of deposits guaranteed exceeds 50% of GDP in all developed countries, as befits societies with mature banking sectors. In response to the banking crisis, the 2014 European directive, consistently with other jurisdictions: increased the amount insured and harmonised it at EUR 100,000; established contributions based on the banks' risk levels, not just their size; stipulated that the Fund had to reach a minimum of 0.8% of the deposits guaranteed; and cut the period for payment to depositors to 7 days. Good, but not enough.

It is argued that the bail-in rules and the existence of the Single Resolution Fund (SRF) make a deposit guarantee fund less necessary, because they make it less likely that additional funds will be needed. But they do not eliminate this possibility entirely, as we have seen in recent cases. The bail-in mechanisms are a long way from being accepted and applied without dispute: in fact, there is a great deal of legal uncertainty, and evidence so far invites scepticism, Moreover, the SRF is undergoing a transition to full mutualisation, which even in the best-case scenario will not be completed until 2024, and has also aroused significant political and legal resistance. But even if both were fully credible and operational, it would still be a mistake to confuse functions and institutions: to mix liquidity crises with solvency crises. There is also - and above all - a basic principle of democratic legitimacy: if banking regulation and supervision are European, any budgetary consequences of banking problems that might arise as a result must also be European.

Even so, despite the near total absence of theoretical debate in this regard, the reality is that there are many political obstacles to implementation. There are some who argue moral risk to underline the limited interest governments would have in maintaining discipline in their finances if non-payment did not directly impact on their tax payers and voters. This is true, but marginal. However, it does point to a very real fiscal problem, the weakness of the public finances of some euro area governments, and, in particular, a need for parallel progress on fiscal union. This is because an EDIS would be a step towards the mutualisation of public debt. Therefore concerns - mainly German - about the need to first establish clear and automatic fiscal rules are understandable, and need to be addressed appropriately.

Another obstacle to the implementation of an EDIS relates to the banking legacy, and the significant differences in the quality of the balance sheets that banks would take with them into the system. Whilst this is true, these differences are becoming ever less linear and predictable by national origin: this is why a transition period has been defined and why the SSM is working on unified supervision. The authors also mention some of the other proposals for dealing with this legacy problem, namely: (i) the accelerated reduction in national options and discretions (NODs) in the European capital require-

ments directive, CRD IV; (ii) implementation of the MREL, which would give legal certainty to the bail-in, to the extent that financial entities have securities in circulation that are issued for this purpose; (iii) harmonisation of national solvency laws; and (iv) a review of the regulatory treatment of sovereign risk.

For economic and historical reasons, banks' exposure to public debt tends to be heavily concentrated in domestic issues. This is even more so in countries that have recently experienced funding difficulties, and which are therefore not immune to an imperfect functioning of the Monetary Union[27]. The proposals on the table would involve the introduction of risk weighting for domestic public debt - which in my opinion would set a historical precedent and is difficult to justify[28] - or the application of some form of prudential limit on risk concentration. If the latter, being unique and injurious, is well set up and calibrated, it would be less harmful and discriminatory for the periphery banking system. Germany is seeking parallel progress on both issues: the EDIS and limits on exposure to national public debt. Irrespective of the fact that it does not make much sense to make progress on the latter while the Basel Committee is preparing a global regulatory proposal, the authors suspect that this position masks a head-on resistance to the mutualisation of banking debt ahead of a true fiscal union. This is a position that I share and which we flagged up in last year's Yearbook, calling for a political decision.

Chapter 8 returns to analysis of the ECB's supervisory model. Alberto Calles and Álvaro Benzo, of PwC Spain, argue that banks' governance and business models are the two current drivers of supervision. Banking supervision has always evolved hand-in-hand with the industry. Until the crisis, it focused on requiring minimum levels of capital, trusting entities to assess risks adequately. Everything changed with the crisis. The authorities understood that this was caused by weaknesses in banks' business strategy, excessive risk taking and serious management and control weaknesses. As a result, in addition to the expected increase in capital and liquidity requirements, and enhanced emphasis on asset quality, "a new vision of governance was introduced, accompanied by an extensive and in-depth list of requirements". This vision of the supervisory function has been extended to the banking business model, as the authorities understand their function to be to "comment, assess and issue opinions" on areas that had previously been reserved to the management of financial institutions. The best example of this change of approach is the SSM's supervisory methodology - SREP - to which we have already referred, as this gives an equal 25% weighting to governance, the business model, capital and liquidity in the supervisor's final rating of each entity.

Some might think that this is overzealous, that market failure does not necessarily justify public intervention, particularly if the party intervening does not have better management experience or knowledge, and that "supervisor risk" is high and increasing, and even that the regulatory and supervision failures in the crisis were as, or more, important than those of the entities. But these are pointless considerations. They are intellectually legitimate, but

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[27] Chart 3 in this chapter shows the weight of public debt on bank balance sheets in various countries. This reveals the importance of this issue for Spanish banks.

[28] It would involve regulatory acceptance of the possibility of default of a sovereign issuer in that jurisdiction.

have little relevance in practice. This is because the course undertaken by global supervisory authorities - not just the ECB - is clear, and irreversible in the short term. We will have to pay attention, question some excesses, call for rationality, efficiency and horizontal equity in intervention, as the authors do in this chapter, but the supervisory paradigm shift is unquestionable. This change will also impose new transparency and accountability[29] obligations on the authorities, which they are surprisingly continuing to resist.

In terms of governance, supervisors are pursuing a three-lines-of-defence model for risk control[30]. These lines of defence are independent of each other, and strengthen the role of the CRO (Chief Risk Officer), who is given a status analogous to the Internal Auditor. Complimenting this, the supervisors are also seeking to: (i) align incentives with long-term objectives, which requires rethinking remuneration policy to make it compatible with the risk appetite framework (RAF); (ii) avoid concentration of power, leading it to suggest models as significant and debatable as separating the roles of Chairman and CEO or, alternatively, strengthening the role of the Independent Lead Director, as a counterweight; (iii) protect control functions through special internal statutes, toughening up conditions for removal from posts, requiring this to be publicised and explicitly justified; and (iv) enhance the supervisory role of the Board of Directors, to such an extent that the authors consider that "Boards are now in the eye of the regulatory hurricane", being increasingly, and more intrusively, regulated in terms of their composition, functioning and remuneration, to limits that need to be reconsidered as they may end up being counterproductive[31].

If the new regulation and supervision of banking governance is proving controversial, the SREP's emphasis on the business model is even more so. It is obvious that the banking business, as we understand it today, is being threatened by many and varied factors. This chapter addresses some of them: the economic and low interest rate environment, shadow banking, digitalisation and fintech, the impact of new regulation (including EMIR, MREL and European regulations on investment in software, which not only fail to incentivise this investment, but actually penalise it in comparative international terms). The monetary, political and legal authorities are not unaware or irresponsible of such aspects, as in the case of legal uncertainty challenging basic principles of banking business. Supervisors are obliged to show their concern for, and interest in, having profitable, solvent and solid entities, and to seek to assess their future viability through stress testing. But whether the SREP business analysis model described in this chapter adds any management value or simply creates excessive compliance requirements, in terms of time and resources, is still an open question and only time will tell. And it won't be relevant to investors, to the extent that the SSM insists on keeping confidential its assessments of the quality and perceived robustness of the banks' business model.

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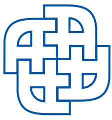
[29] The proposal by the US Senate to submit the Federal Reserve to an annual management audit is a good example of this. The European Parliament has not yet dared go so far with the ECB, but it will come in the end. Refer to European Court of Auditors (2016).

[30] What these three lines are exactly is still a thorny topic in the SSM, the Basel Committee and the banks themselves. However, the idea is simple and powerful: the business line, the risks division, internal audit and the Board of Directors are all responsible for monitoring and controlling the entity's risk.

[31] As happened with regulation of the obligations and responsibilities of CFOs following the Enron scandal and the Sarbanes-Oxley Act.



The next two chapters deal with fiscal policy. The big story this year is, perhaps, that the Commission has adopted a clearly favourable position on fiscal expansion, arguing the existence of both a need and opportunity to act, even if only to rebalance a policy mix that is excessively biased towards monetary activism[32], and the macroeconomic impact of fiscal policy today probably being greater than under normal circumstances. For our purposes, in terms of completing the institutional design of the Monetary Union, the biggest revelation is without doubt the approach it adopts for the first time in its assessment of the fiscal stance of the euro area: "To assess the current situation, it is important to consider the euro area as a single entity, as if there were a Finance Minister for the euro area as a whole"[33]. The next two chapters discuss how we reach this point.

Martine Guerguil, drawing on her experience as Deputy Director of the IMF's Fiscal Affairs department, asks herself explicitly what type of fiscal union the euro area needs. Her starting point is a premise on which I believe there is ample academic agreement on both sides of the Atlantic, even if political arguments continue: namely, that the fiscal framework of the Euro is insufficient to withstand a sharp future shock. There are many proposals for alternative institutional frameworks[34], but none of these have sufficient political consensus, and none have been able to overcome resistance to an increased distribution of risks. However, the chapter concludes that greater fiscal integration remains necessary.

The chapter rigorously describes the institutional changes that have taken place in the European fiscal framework in response to the euro area crisis - with which assiduous readers of the Yearbook will already be familiar. It then analyses the potential theoretical alternatives and submits them to a type of policy credibility test, and finally concludes that integration is not only possible, but indeed cannot be put off any longer. The original sins of the euro - lack of banking union, lack of a fiscal stability facility for the euro area and member states at the mercy of the crisis - are all bluntly diagnosed as self-fulfilling prophecies. As a result, whilst federal states, such as the USA, Germany and Canada, sterilise and isolate 80% of local shocks, in the euro area this is hardly 40%.

Significant progress has been made: The European Stability Mechanism (ESM), the strengthening of the preventive arm and the correction mechanism under the excessive fiscal deficit procedure, banking union, the European Fund for Strategic Investments, commonly known as the Juncker plan. However, the sad conclusion is that the most decisive action to stabilise the euro area has come from the ECB. Therefore, further progress is proposed. Firstly, banking union is incomplete, deposit guarantees are missing and the scale of the Single Resolution Fund is insufficient, lacking credibility as a backstop. Secondly, the euro area needs automatic stabilisers, whilst the fiscal discipline framework continues being essentially preventive, and hardly credible I would add, because its

[32] This latter argument is rather weak, as all that is needed to bring the policy mix back into balance is a return to normality in monetary policy, not complementing extraordinarily expansionary monetary policy with expansionary fiscal policy.

[33] European Commission (2016a).

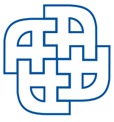
[34] Refer, perhaps most significantly, to IMF 2013, which takes a position from this international institution, and Bénassy-Quéré, A. Ragot, X. and Wolff, Guntram B. (2016) because of its closeness to the Commission position.

discretional nature makes it politically difficult to apply, as we see year after year. Thirdly, the ESM is clearly insufficient, and stability policy continues to fall to the ECB: yet this is not one of its competencies, and undermines its legitimacy.

The author believes there are five main challenges in designing a fiscal union for the euro area. Firstly, the sui generis character of the Union, which obliges it to minimise pooling of sovereignty and limit it to the exact minimum required for its stability and permanence. Secondly, the illusory but explicit decision that fiscal integration cannot lead to permanent transfers of income among States to another, requiring ex-ante agreement of explicit rules on functioning and distribution, with hardly any margin for discretion in its application[35]. Thirdly, the resulting structure has to minimise moral hazard and opportunities for free riding. But, at the same time, we must avoid the danger of insisting on access conditions for the fiscal union that are so restrictive that we end up defining a union with no members. To summarise, we need a politically feasible and fair balance between solidarity and adjustment. Fourthly, whilst the decision on whether fiscal union should be voluntary or a requirement for permanent membership of the Monetary Union is not trivial, it is more emotional and political than anything else. Despite what some may argue, it is difficult to imagine a country belonging to the euro in the medium term if it is not subject to the discipline and under the umbrella of fiscal union. Either market forces would throw it out of EMU, or it would be constantly turning to the ECB as its sole provider of liquidity. Fifthly, the current Treaty does not support a fiscal union of the type required, because the euro area does not have its own legal personality. This is a point that, rather curiously, could be solved by Brexit.

The chapter finishes by analysing the institutional developments required for the four theoretically-possible types of fiscal union. Ordered from the most to the least ambitious: (i) a euro area Finance Ministry with its own stability budget. The characteristics required are discussed in detail in the text, to which the reader is referred; (ii) the issue of "eurobonds". These have the advantage of not requiring a new Treaty, and only require limited institutional development of the existing basis of the ESM. However, these have the disadvantage that they would be logically perceived as a transitory stage on the path to full fiscal union; (iii) the establishment of a macro Stabilisation Fund, similar to other existing funds, which, it is estimated, would need to be equal to around 2% of the Union's GDP; and (iv) a common unemployment insurance system, or a complementary common European scheme. It creates obvious problems of moral hazard, and even perverse effects for the labour institutions of member countries, but this proposal is gaining traction in some more interventionist academic and political circles, that are seeking symbolic action to counter increasing Euroscepticism. However, I believe that this is bad idea, both technically and, even more so, politically. Technically, it does not avoid the complex problems of country risk and adverse selection. Politically, it would open the door to all types of populist movements. It is not a substitute for fiscal union, and would end freedom of movement in the Union.

[35] I cannot avoid the temptation of establishing the obligatory parallel with the current Spanish debate on the new system of regional funding, to which, just in case it was too easy, an additional and equally illusory restriction has been added: all the Communities must be winners.

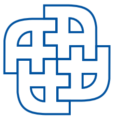


In summary, this chapter illustrates the debate about the future of the Union. This is set out very well in its attempt to describe three post-Brexit scenarios: caution or consolidation, social or fiscal expansion, and the accelerator of a qualitative leap in integration. The interested reader will already know my position well. They will be pleased to hear it is not an isolated case. Although I agree almost entirely with this chapter, I believe there is one issue where political differences are apparent. We must not confuse the fiscal position of the euro area with the need for a fiscal union with clear and well defined rules. This is not a question of fiscal multipliers, but of political structure and clear definition of competencies. Irrespective of whether euro area fiscal policy is expansionary or contractionary - which is a political decision to be taken by the appropriate European authorities - we need a European fiscal policy, we need fiscal union, because we cannot continue with European monetary policy in tandem with national fiscal policy.

Taking a short-term view, which is more pragmatic and more immediate, in chapter 10 José Luis Escrivá, president of the Independent Fiscal Responsibility Authority in Spain (Autoridad Independiente de Responsabilidad Fiscal, AIREF) makes 10 recommendations for the institutional development of European fiscal union. He shares the view that all the mechanisms contained in the Treaty to foster fiscal discipline have failed. Neither the markets nor the Stability Pact have avoided free-riding. However, he is sceptical about the fiscal union, as set out in the Five Presidents' Report, which "could only be possible in the very long term". Neither does a model such as the North American one, based on the credibility of the bail-out clause appear feasible in Europe. For these reasons, he favours strengthening national commitments and national ownership of adjustment programmes, through adequate fostering of the fiscal frameworks agreed in the Fiscal Compact, in which the Independent Fiscal Institutions (IFIs) play a central role. This is a fiscal coordination mechanism based on the principle of collective self-discipline, or peer pressure, to comply and explain. A tool widely used - and controversial - in other areas such as corporate governance and structural reforms.

The chapter analyses the characteristics, properties and functions of IFIs, a hybrid model combining Anglo-Saxon elements of positive analysis with a more Germanic touch of regulatory compliance. This establishes the IFIs as guarantors of fiscal commitments and regulations at the national (stability laws and principles) and European (excess deficit, spending and debt rules) levels. It also highlights the evolution of the centralising elements of European fiscal discipline, in the reforms approved prior to the Five Presidents' Report, which sets out the roadmap for fiscal union. In compliance with this roadmap, in October 2015 the Commission agreed to set up a Fiscal Stability Board, which came into operation in the autumn 2016. This has been something of a let down, in terms of both its composition and the competencies assigned to it, which were watered down considerably in a protracted struggle between the Council and the Commission.

On balance, the author underlines three types of pending problems, relating to: design, implementation and compliance with regulations; enforcement; and legitimacy and national ownership of the fiscal process. With regard to the first aspect, the regulations are manifestly excessive, opaque and allow undue discretion. On the second, the Commission lacked the political will, or courage, to exploit the autonomy conferred on



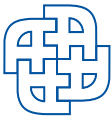
it by recent reforms, resulting in the Stability Pact being seriously questioned. Likewise, the process of national appropriation of European fiscal commitments is also failing to live up to expectations. Some progress has been made on budget information, macroeconomic forecasts and even IFIs, but there have been serious problems relating to access to detailed information, insufficient resources and problems of functional autonomy and material independence.

Almost ten years after the crisis, what is more worrying is that we can still talk of a lack of clarity about the fiscal governance model for the EMU. There is still an ongoing debate between a centralised model with a euro area Finance Ministry, as argued for in the previous article and the Five Presidents' Report, and a hybrid model of national ownership, as argued for in this chapter. This is a model - the original one from the Maastricht Treaty - that the author believes can be rescued, if three principles are strictly complied with: (i) no bail-outs for countries in difficulties, which leads to the need to approve orderly restructuring frameworks for sovereign debt; (ii) a ban on monetary funding of public deficits, which I understand, although it is not stated, would require the suspension of ECB intervention programmes such as OMT and PSPP; and (iii) a ban on privileged funding of public-sector accounts. This latter aspect leads to a proposal to penalise excessive holdings of public-sector instruments in bank portfolios.

I am surprised that this option for fiscal union has been proposed here today. It is a theoretical possibility for a federal fiscal system. This is how the United States works. And this was the original idea in the Maastricht Treaty. But it is an idea that was overtaken by the events of 2010-12, when Germany, and with it the euro area, seriously considered the expulsion of Greece and refusal of any bail-out, but discarded it for fear of contagion, and the likelihood that it would indefinitely reopen the euro area map. I believe that there are no realistic medium-term alternatives other than full fiscal union. Any other approach - however well intentioned - would only fuel possibilities for speculation and breakup of the Monetary Union. This would be incredibly damaging for countries considered weak because of their volumes of public debt, because of the weakness of their banks and the recent trajectory of macroeconomic imbalances, and because of pure geographic discrimination. If the European debate heads in that direction, it would be a good idea to have an exit strategy in place ready for the Monetary Union.

José María de Areilza and Marie-José Garot open chapter 11, Political Institutions for the euro area, with a declaration of principles: the European Union is besieged by the crisis, and all eyes are on the government in Berlin, which, without ever proposing it, has been leading the Union on its own for eight years. Their article defines the current political paralysis, aggravated by Brexit. It then reviews attempts to legitimise the increasing political power exercised from Brussels, before concluding with an ambitious agenda of institutional reforms.

The authors perceive two conflicting trends in the current situation: the desire of the Commission to continue advancing political integration and German reticence, supported by the absence of social legitimacy to justify this increasing integration, being more inclined to take small steps to consolidate a system of varying speeds in the euro area. This is a very real dilemma, and it is very dangerous. The crisis has certainly created unknown tension, with the result that many people perceive the Union as an "unrepresentative, technocratic government lacking transparency and accountability". It is also



true that the single currency has made the transfer of new powers and resources to the Union both more necessary and, at the same time, more difficult. The challenge now is to set the legitimate and limited power of the Union and make it compatible with national democracies: this is certain to require reform of the Treaties.

This chapter describes the attempts to establish a degree of material limitation on the Union's powers as a way of protecting national democracies and, above all, to disincentivise use of the German Constitutional Court. In their opinion, the Union is not, and should not aspire to be, a federal state. It lacks sufficient social legitimacy[36] and the direct loyalty of the public. The Union has emerged as a legal federation based on a political confederation. And - the authors argue - that is exactly where it should remain. This is no easy task. But it could be achieved with an explicit mandate for the EU Court of Justice on the legal limits on the extension of the Union's competencies.

For Spanish readers, the parallel with the process of defining and distributing competencies between the Central Government and the Autonomous Communities is obvious. And we cannot forget that the attempt to sort this out in the LOAPA Act was not exactly a success. For that reason, this seems to me an intriguing proposal, but I do not think that the need for a new Treaty can be avoided. In fact, the authors of this chapter dedicate the next section to it, based on the Five Presidents' Report. However, they do not limit themselves to it, but also set out an ambitious agenda for European institutional reform, which I merely summarise here: (i) step up supervision by the European Parliament and national Parliaments, particularly of economic aspects, including regular appearances by Commissioners before national parliaments. This proposal would effectively set in stone the confederate role of the Union, but would also make the already excessively complicated and lengthy decision making process in Europe even more complex. For this reason, following an initial stage of co-existence, they opt for a mixed European Parliament, with half of the delegates elected in direct European elections and the other half appointed by their national parliaments; (ii) provide resources and stability to the presidency of the Eurogroup so that it becomes an embryonic euro area Finance Ministry, acting as the vice-president of the new Commission. This proposal can be perceived in the current direction of things in the European framework. But the crucial factor is the details of its competencies and relations with other European institutions that would fall within its remit, such as the ESM and the Fiscal Stability Board; (iii) progressively transform the Commission into a real European "cabinet", led by a head of European government, as a result of merger of the two current presidencies, the Commission and the Council. This president would be able to appoint the members of their team without national quotas, and would answer to the European Parliament, and could dissolve it and call elections.

These are obviously very ambitious reforms, and would require new Treaties. This in itself is not just politically difficult, but also very complicated legally. This chapter offers some interesting reflections in this regard. These reforms however tiptoe around a fundamental problem: are we talking about creating new institutions for the euro area or for

[36] It occurs to me that social legitimacy is perhaps endogenous to the political process and is built upon this, as the recent experience of some Spanish territories seems to show.

the European Union? Unless, of course, we make the heroic assumption that - following Brexit, and having overcome a certain transition period for the countries from the Great Enlargement to adjust their socio-economic structures, and Sweden and Denmark to clarify their emotional preferences - all of the countries currently in the European Union will adopt the single currency without exception.

This seems like a dream - or a political nightmare. However, I become more convinced everyday that the sustainability and permanence of the Monetary Union requires a degree of political integration that today appears impossible. And I believe that the authors of this Yearbook share this opinion, with differing degrees of conviction. But just as monetary union has led to banking union, this will lead to fiscal union. And together these will lead to political union. We must never forget the quote that has featured in this Yearbook since its first edition, and which summarises democracy: *no taxation without representation*. The form and timetable for this will be subjects of intense debate. In this Yearbook we have only sought to set out some of the basic questions that Europeans will have to address in the not too distant future. The historic and institutional anomalies of the EMU cannot last forever. We do not need to resolve everything tomorrow. But we will need a clear roadmap very soon. The financial markets will not put up with such fundamental uncertainties forever.

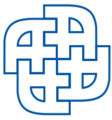
3. TEN LESSONS FOR EUROPE

As in every edition since the first analysis of the euro for Fundación de Estudios Financieros, I will finish with ten lessons for Europe.

One. The future of the Monetary Union, and of the European Union itself, is in question. The UK referendum has ended the irreversibility of the integration process. Too many voices call for a return to a system of a la carte integration, to a Europe of variable geometries and different speeds. This idea is particularly dangerous for the countries most vulnerable to investor sentiments. We should all have learnt from recent episodes. Starting with the most vulnerable countries, which need to redouble their efforts to reduce their domestic imbalances and ensure structurally sustainable fiscal positions. But countries with fiscal and trade surpluses also have something to learn. They cannot keep putting off the reforms we have discussed. Business as usual is not a realistic option. We cannot mistake the current calm in financial markets for general acceptance of European economic and institutional policies.

Two. Europe has a democratic deficit and a functionality deficit. The Monetary Union requires a certain pooling of monetary, banking, financial and fiscal sovereignty, and this is incompatible with the lack of democratic legitimacy of its institutions. The Union needs a new Founding Treaty. This would have to start by solemnly ratifying an unequivocal commitment to deepening political integration of the Monetary Union and for some form of its political institutionalisation at the heart of the existing governing bodies (the Commission, Council and Parliament).

Three. The idea that Europe needs growth at any price is spreading, calling for a strong dose of Keynesian policy to overcome demand problems, with more public investment and private consumption. This deliberately ignores that we are facing a balance sheet crisis



that requires major adjustments. Europe's economic problems are structural. They have always been, and continue to be, structural. Monetary policy alone - no matter how creative and unorthodox it might be - will never solve these problems. There can be no doubt that the European institutional framework is imperfect and insufficient. But it is not responsible for exclusively national problems, or the deficiencies of the international monetary and financial system. Debt remains excessive, and insufficient attention is being paid to productivity issues and an ageing population. It seems necessary that Europe should - in the near future - become a standard bearer for globalisation and will have to develop an activist model of an open and competitive economy, both internally and externally.

Four. The recovery in financial integration has stalled, and the index of euro area fragmentation is on a slight upward trend. This is an additional effect of unconventional monetary policies, and the accumulation of bank deposits at the ECB, despite negative interest rates. But it is also a symptom of the malfunctioning of inter-bank markets in the euro area. The real test for euro area financial integration will come when the ending of QE begins, decoupling the financial system from the guarantee of free liquidity for an indefinite period.

Five. Unconventional monetary policy has had its day. It helped avoid disruptive events in the euro, but the European macroeconomic situation is no longer in recession but recovery. We have left behind deflation, and now face rampant inflation. And the collateral effects of QE are starting to be excessive. Negative interest rates create perverse effects on the allocation of funds. They have not solved the excess liquidity in the financial system, but they have caused profitability problems for the banking system and made the normal functioning of the money multiplier more difficult. They also threaten to create asset bubbles. And this is without considering political effects. These policies represent a silent transfer from savers to debtors, weakening the will for reform and fostering strong opposition in the core countries, undermining the legitimacy of the Union. Strategies to end QE must be studied and made public. This will probably involve reducing asset-purchase commitments and announcing an end date for indefinite liquidity.

Six. The application of the new international regulatory framework has coincided in Europe with the launch of banking union and a new institutional map with the ECB at its core. This regulatory and supervisory revolution has so far been a notable success, but we are still a long way from single and consistent supervision. The financial system now needs stability and regulatory simplification, a fair and balanced framework of competencies, a new supervisory dialogue, and a great deal of international coordination, particularly with regard to competitive markets. The potential needs for issuances to meet new banking resolution criteria appear substantial, and will require much greater legal certainty and a clear outlook for the profitability of the sector.

Seven. Banking union, with a European deposit insurance scheme, is required to break the loop between banking risk and sovereign risk. This is because: bail-in mechanisms are far from being accepted and applied unreservedly; the Single Resolution Fund is in transition; mutualisation remains controversial; it is not appropriate to confuse functions and institutions; and, above all, because of a basic principle of democratic legitimacy. If banking supervision and regulation are European, then the budgetary conse-

quences of banking problems should also be European. Hiding behind legacy problems or the need to make progress with fiscal union - despite these being valid issues that must be resolved - only further increases instability and the risk of new and deeper crises.

Eight. The supervisory paradigm shift to a more intrusive model is an unquestionable reality. The supervisors understand that the crisis justifies enhancing their functions to “assess, comment and issue opinions” on areas that had previously been reserved for bank management, such as their governance and business models. However, regulatory risk is a burgeoning reality and must lead the authorities to new transparency and accountability obligations, which they continue to resist.

Nine. No long-term monetary union is possible without banking and financial union. But fiscal union is also required, because no fiat banking system can survive without a credible fiscal backstop. There has been significant progress in European fiscal discipline and governance, but the decisive stabilisation actions have come from the ECB. There is open debate in academic circles - and more discretely in political circles - about the type of fiscal union the euro area needs. There is one basic agreement. A risk-free European asset is required: a European public-debt instrument. And this asset will lead to a European Treasury, a European macroeconomic stabilisation fund and, ultimately, a euro area Finance Ministry. But it is a political mistake - and a threat to the integration required - to confuse the debate about the fiscal position of the euro area with the need for fiscal union with clear and well defined rules. There is hardly any disagreement about this. How we get there is another matter: one on which this Yearbook offers a range of interesting contributions and diverse viewpoints. However, get there we must.

Ten. Monetary union requires banking union. It has been fifteen years and we still aren’t there yet. Banking union leads inexorably to fiscal union. We cannot wait another fifteen years. We don’t have that long. And in a democratic Europe, we cannot have fiscal union without political legitimacy. This is the great challenge for the European Union. And it is one to which Spain - now that it has a stable government again - has to contribute actively. This will require wide-ranging national consensus, because only strong and united countries, with consistent and lasting policies, can hope to influence the future of Europe.

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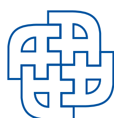

1. THE EURO AREA IN AN ERA OF GLOBAL IMBALANCES

Jaime Caruana[1]
Goetz von Peter[2]

EXECUTIVE SUMMARY[*]

In the past year, Europe has faced serious political challenges in addition to the economic challenges of sluggish growth, persistently low inflation and high levels of indebtedness. The referendum on the UK's exit from the European Union put into sharp relief the growing feeling of discontent across the continent and the increase in geopolitical risks. Even before this momentous decision, the European institutional framework had shown significant shortcomings.

However, European institutions are often blamed for problems that are to a large extent domestic, and for shortcomings in the international monetary and financial system (IMFS). For this reason, analysis of what ails Europe should be conducted on three different levels: domestic policies, European policies and institutional framework, and, on a higher level, global imbalances that the IMFS cannot mitigate. We focus on domestic and global influences, leaving the discussion of policies and institutions at the European level to other contributors to this volume.

How can we build European institutions that are effective and reinforce social cohesion at the same time? Rather than answering this question directly, we analyse the global environment and the national constraints to the European framework. We believe they help explain what has happened and should be part of the answer.

To be sure, the European architecture is imperfect and in need of critical analysis and improvement. That said, progress at the European level becomes more feasible and effective when accompanied by domestic structural reforms and policies that place more emphasis on the build-up of financial risks and internalise spillovers between countries, in their own interest. Indeed, progress at the domestic and the global level may ease the pressure on European institutions.

At the global level, the IMFS not only fails to constrain the build-up of financial imbalances but, within the dominant analytical framework, also makes it hard to see them coming and to correct them. This can be considered as a «blind spot» in our current international monetary system which escapes conventional analysis.

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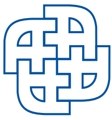
[*] Full report in the Spanish version «Euro Yearbook 2016» available in www.fef.es and www.fundacionico.es

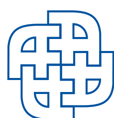


Even if the rules that central banks play by are mostly local, removing the blind spot in the system will require them to take a global view. They need to follow their «enlightened self-interest», on that takes into account the extent to which their decisions affect other countries and feed back on their own economies.

At the domestic level, prudential, fiscal and structural policies play an important role, and each EU member country should apply them domestically, within the cooperative framework agreed as part of Economic and Monetary Union (EMU). Domestic adjustment policies are more necessary –and possibly more difficult– for countries without independent monetary policy and exchange rate flexibility. This puts a premium on structural, fiscal and prudential policies that face no such external constraint. Solid domestic policies are important in their own right, and have positive effects at the European and global levels.

Almost 10 years after the global financial crisis, there is still too much reliance on debt-driven growth, and too little attention paid to the negative trend in productivity in Europe and beyond. Productivity growth has slowed in most OECD economies, in most sectors and in both small and large firms.

This article suggests that a push towards ever closer union must be accompanied by a rebalancing of policy , putting more emphasis on structural reforms and a view of economic policy that internalises the benefits and implications of a globalised world. It is necessary to better anchor domestic policies by taking financial factors into account, and to understand and internalise the international spillovers.



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2. A PANORAMIC VIEW OF THE ROLE OF THE EURO IN THE WORLD

Blanca Navarro[1]
Almudena Gallego and Miguel Fernández[2]

EXECUTIVE SUMMARY*

The euro has remained the second most important international currency over the past year, although there is still a large gap with the dollar. The euro's performance during this latest period has been influenced by the slowdown in the global recovery, the divergent monetary policies of the world's leading countries and the turbulences in global financial markets. Furthermore, the currencies of emerging countries, especially the Chinese renminbi, are playing a more important role, affecting the share of traditional currencies in the international market. Overall, the global influence of the euro weakened to some extent between 2015 and 2016, although the EU's currency has maintained its strong international presence and still remains in a solid second position.

The depreciation of the euro against the dollar in 2015 has slowed in 2016, although the continuation of divergent monetary policies between the European Central Bank (ECB) and the US Federal Reserve (Fed) seems to suggest that the weakness of the common currency will persist into the next period. Against the Japanese yen, the euro has continued to depreciate since 2015, with Japan's currency acting as a safe-haven against a backdrop of some market volatility. On the other hand, the appreciation of the euro against the pound has intensified, after the result of the Brexit referendum, and the euro has also gained some weight against the renminbi as a result of continued uncertainty concerning the slowdown of the Chinese economy.

These currency movements have impacted on international trade. The intense depreciation of the euro against the dollar in 2015 contributed to an increase in Eurozone exports in 2015 bigger than in previous years. However, in relative terms, the use of the euro as the payment currency by Eurozone member countries decreased in 2015 for imports of goods and services and, to a larger extent, for exports, compared with other currencies. Furthermore, it remains at levels beneath those witnessed before the financial crisis. Therefore, some measures are required to strengthen the euro in

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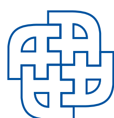


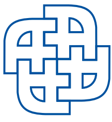
world trade and to reduce some accounting, regulatory or financial constraints, that, according to the empirical evidence, may have an influence on the choice of a foreign currency as an invoicing currency.

As a reserve currency, the use of the euro in total reserves has fallen for the sixth consecutive year, although its use among the advanced economies has improved slightly. However, the proportion of euro deposits to total deposits increased in 2015, like in the proportion of euro loans to total loans, although these are still below pre-financial crisis levels.

In relation to the position of the single currency in the main financial markets (equities, fixed income, money market, FX markets and the derivatives market), the euro has consolidated itself as the second most important currency behind the dollar, with the exception of the interest-rate derivatives market, in which euro contracts represent the largest portion of this market, twice the volume of dollar contracts. However, the euro remains far behind the dollar's leading role in the finance world and the Eurozone crisis has deteriorated expectations of a possible approach to the dollar.

Looking ahead, one of the most significant challenges faced by the single currency is the ongoing exit process of the United Kingdom from the European Union. This may lead to greater uncertainty and lower confidence in the common European project, especially in the Economic and Monetary Union (EMU). Further developments in the banking union and the capital markets union in Europe are important steps in consolidating the euro in a global environment and may help to strengthen confidence in our currency.

This chapter analyses the use of the euro in 2015 and 2016 taking into consideration the different roles assumed by a currency in the economy. In other words, firstly, as a form of payment in international trade and its relationship with other currencies; secondly, as a way of international reserves and investment, with particular reference to countries whose currency is pegged to the euro; thirdly, its use in deposits and loans; and, finally, its role in financial markets (equities, fixed income, money market, FX markets and derivatives market).



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3. FINANCIAL FRAGMENTATION: HALT, REVERSAL OR PAUSE?

SONSOLES CASTILLO, SANTIAGO FERNÁNDEZ DE LIS AND MARÍA MARTÍNEZ[1]

EXECUTIVE SUMMARY*

This article analyses the evolution of fragmentation in the Eurozone over the last few years. In order to better evaluate such evolution, we present a synthetic indicator that allows us to set different stages on the process of fragmentation since the outbreak of the global financial crisis. In particular, this indicator combines developments in three different market segments: sovereign debt, credit rates to the real economy and liquidity provision of the banking system from the ECB (alongside the net position of national central banks in the TARGET2 system vis-à-vis the ECB).

According to this indicator, fragmentation in the Eurozone showed three distinct stages. First, from 2010 to mid- 2012 financial markets in the Eurozone registered an unprecedented increase in segmentation amid the European debt crisis; second, from mid-2012 to mid-2014 fragmentation almost reverted to pre-crisis levels, as result of the ECB´s announcement of the OMT programme to curtail the risk of a euro break-up and backed by the launch of the process of banking union in the Eurozone; and thirdly, in the most recent period which starts by mid-2014, the improvement in the process of integration seems to halt, and the indicator of fragmentation showed a moderate increase. Fortunately, the factors behind the recent dynamic are completely different to those observed in 2010. This time both sovereign debt and credit rates dispersion among countries remain contained and, more importantly, the upturn in TARGET2 balances is not related to capital outflows from peripheral countries (as happened during the debt crisis), but rather to the beginning of QE. In any case, this accumulation of balances vis-à-vis the ECB is a symptom of an abnormal functioning of interbank markets, as banks with excess of liquidity as a result of the ECB´s asset purchases prefer to maintain such liquidity (paying 40 basis points to the ECB) instead of lending to other banks. All in all, the financial system in the eurozone is far from a full integration.

Additionally, we examine the disintegration and ulterior integration of financial markets in the eurozone under the lens of ECB´s monetary policy measures, mainly non-standard measures, as well as the parallel banking union process. In our view both have played a key role, not only to avoid very disruptive scenarios, but also favoring

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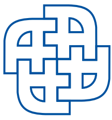

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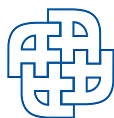
an improvement in the functioning of financial markets in the Eurozone. In fact, the measures already taken by the ECB have allowed the repair of the transmission of monetary policy in the region. In particular, the combination of TLTROs and asset purchases programmes launched since mid 2014, including QE, have helped to repair such mechanism. These measures can be seen as a necessary condition to favor the re-integration of financial markets in the Eurozone but certainly not a sufficient condition. Regarding negative interest rates, beyond the open debate about its unintended consequences (i.e. its impact on economic agents' behavior, financial intermediation, banks profitability and financial stability), its effectiveness in terms of favoring financial integration is questionable, as the excess of liquidity of the banking sector has increased over the recent years.

On the institutional front, the progress on the banking union process has been impressive, with the launch the SSM and the SRM, designed for a single supervision and resolution in the Eurozone. However, we are still far from the optimal level, not only from an institutional point of view but more importantly from a true integration of financial markets. There are at least to areas of improvement. First, some doubts remain about the implementation process, particularly regarding the bail-in tool, which is a cornerstone to avoid the sovereign-banking feed- back loop. Second, there are some pending elements to achieve a true banking union such as the establishment of a European Deposit Insurance Scheme (EDIS). Progress in this area seems more difficult to achieve considering its connection with the debate on fiscal union.

All in all, despite the improvements, it is important to keep in mind that a significant part of the progress has been artificially supported by the continued intervention of the ECB. It remains to be seen what would happen without such assistance. Significant steps have been taken in the right direction, but we are still far from a complete and optimal financial integration.



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4. MONETARY POLICY IN THE EURO AREA IN 2016

José Ramón Diez Guijarro[1]

EXECUTIVE SUMMARY*

It's been eight years since, at the end of 2008, the European Central Bank (ECB) began a long road seeking to offset the negative effects of the crisis on inflation, activity and financial stability in Europe. The ECB has applied a wide battery of measures, both conventional and innovative, and has assumedresponsibility for banking supervision. The decisions of the last twelve months have meant to delve into the strategy of previous years, expanding financial asset purchase programmes and intensifying long term liquidity programmes with the aim of countering the collapse of inflation expectations in the last two years.

The result, so far, is an increase in the balance sheet of the ECB, which is close to3.4 trillion euros (32% of euro area GDP, compared with a maximum of 25% in the U.S.), with a securities portfolio amounting to 1.8 trillion euros. In addition, composition of ECB funding to the banking sector has changed and is nowpredominatedby long term loans (LTRO already exceed 500 billion euros) while traditional auctions of short-term funding have been losing share (33 billion euros in October 2016). The average duration of ECB funding granted to financial institutions stands about three years, compared to less than one month in 2007. However, excess liquidity has increased steadily, reaching 1trillion euros currently. This shows the lack of normalization of the funding channel and increases the importance of the deposit facility rate within the operational framework of monetary policy, since it currently sets the minimum rate at which the ECB can purchase assets in primary or secondary markets.

This extensive package of measures has sought to complement the bank transmission mechanism, relaxing credit conditions to the private sector and reactivating credit growth. But, above all, its main goal has been to counter the collapse in inflation expectations from the spring of 2015 due to the intense fall in oil prices. It is early to tellwhether the objectives have been met as price expectations have not undergone noticeable changes until Trump's victory in the U.S. presidential elections. However, although inflation is still far from its objective (0.5% in October), forecasts for the next 24 months have increased

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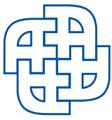


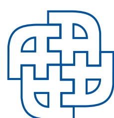
significantly, thanks to the stabilization of oil pricesaround $45/50. Moreover, according to ECB's own internal calculations, in the absence of extraordinary measures, prices in Europe would be more than one full percentage point below current levels.

The result of all these measures has been a deep impact on all tranches of the yield curve. The Eonia entered into negative territory in September 2014, followed by the Euribor 12 months in February 2016. Consequently, public debt yields have steadily dropped down, until Trump'svictory. In some cases such as in Germany, almost 80% of public debt references have shown negative returns. And, similarly, in the third quarter of 2016 yields of private investment-grade issuers dropped below 1%.

In the banking sector, the unconventional measures the ECB have had a relevant impact on lending conditions, contributing to the improvement of supply conditions and a significant reduction in loan rates. However, the recovery of activity is modest andheterogeneous, both by sector (stronger for households than for non-financial corporations) and by countries (with stockgrowing in core countries, but falling in the periphery, still on deleveraging mode). Therefore, it seems that the marginal efficiency of these measures, besides being asymmetrical, is starting to decrease significantly. In addition, unintended consequences for the profitability of the financial sector are becoming important. In fact, the risk is that we are approaching the benchmark rate (reversal rate) at which the negative effects on bank profitability end up affecting credit performance.

Ultimately, such an aggressive strategy has its risks and its costs, including the transfers of income from savers to debtors, the risk of corrections in the bond markets or the negative impact on business models of key sectors such as finance and insurance. Moreover,its implementationmay also have opposing effects. The extension of quantitative easing to private bonds has ended negatively affecting bank financing to large corporates, hindering the target that banks must comply with to fully benefit from the TLTRO.

In this context, the anticipated increase in inflation during the following months,together withthe probability of a more expansive fiscal policy in Anglo-Saxon countries in the coming years, point to a change in the combination of economic policies at the global level, which would require central banks to begin to normalize monetary policy from 2017. In the case of the ECB, the first step of the normalization process will be the management of the withdrawal of QE over the next 18 months to avoid overreaction in debt markets. Certainly, the task will not be easy and communication strategy will play a key role in order to minimize the potential negative effects. However, the sooner the ECB gets started the better.



5. WHAT IMPACT DOES THE ECB'S QUANTITATIVE EASING POLICY HAVE ON BANK PROFITABILITY?[1]

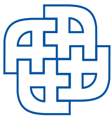
Maria Demertzis and Guntram B. Wolff, Bruegel

EXECUTIVE SUMMARY*

- Quantitative easing (QE) affects banks' profitability in three main ways:
  1. First, as QE drives up bond prices, banks holding such bonds see their balance sheets strengthened.
  2. Second, QE reduces long-term yields and thereby reduces term spreads. With this, the lending-deposit interest rate spread falls, making it harder for banks to generate net interest income on new loans.
  3. Last, QE improves the economic outlook, which should help banks exposed to the economy find new lending opportunities and should reduce problems with non-performing loans. The effects of QE on bank profitability are therefore not one directional. If anything, the immediate effect should be positive.
- Banks themselves have been quite negative about the impact of QE on their net interest income, but they have also acknowledged its positive impact on capital gains (ECB Bank Lending Survey).
- We show that lending-deposit spreads for new lending have fallen significantly. Looking at actual bank profits, net interest income has been stable. Moreover, bank profitability has increased mostly as a result of efforts to clean balance sheets of impaired assets (at least until the end of 2015). This is consistent with a reduction in non-performing loans (NPLs), particularly in countries where NPL levels were abnormally high.
- Moreover, we show that bank profitability in some countries has been a concern for many years now, starting well before the QE programme. The main drivers of low profitability have been non-performing loans, legal risks and other problems unrelated to net interest income, which has remained fairly stable.
- Overall, we cannot yet see any major bank profitability issue arising out of the ECB's QE programme.

[1] We would like to thank Gregory Claeys for comments and suggestions and Justine Feliu and Konstantinos Efstathiou for excellent research assistance. All errors remain ours.

* Full report in the Spanish version «Euro Yearbook 2016» available in www.fef.es and www.fundacionico.es



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6. EUROPEAN BANKING SUPERVISION AND PRUDENTIAL REGULATION IN THE GLOBAL CONTEXT

By José Manuel Campa and Alberto Buffa di Perrero[1]

EXECUTIVE SUMMARY*

The journey towards achieving a fully operational Banking Union in Europe is a trip with a one-way ticket. So far it is on the right track, but much ground still has to be covered, and the risk of stumbling blocks along the way is high. Therefore, momentum should not be lost.

The acceleration of the Banking Union project is one of the positive outcomes of an otherwise terrible financial crisis, which has left the European economy with record-high levels of unemployment and public debt, and with a still fragile banking system. These outcomes from the crisis are partially shared by other countries around the world. The global regulatory community reacted with a large overhaul of regulation in the financial industry, led by the initiative of the Financial Stability Board (FSB). However, Europe had its own additional challenges. As a reaction to the near collapse of the European banking system at the peak of the crisis in 2012, authorities have since then worked hard towards reaching a common set of regulatory, supervisory, and resolution rules.

The achievements so far deserve much praise. The FSB's agenda on increasing the resilience of the financial sector has led to better capitalized banks and more transparency in the market. In Europe, the newly created Single Supervisory Mechanism (SSM) is implementing a «supervisory revolution», whereby all banks in the Eurozone are now subject to the same set of supervisory scrutiny. Additionally, the Single Resolution Board (SRB) fosters prompt resolvability of troubled banks, minimizing the use of taxpayer's money. We therefore have better regulation, institutions and tools to prevent and manage financial crises.

However, much remains to be done. As far as the regulatory arena is concerned, the agenda is far from complete, with still considerable chunks of regulation such as the Basle framework and the TLAC/MREL loss-absorbing rules to be defined. Here, individual jurisdictions still have to overcome significant legal divides and local interests have

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[1] Respectively, Global Head of Regulatory Affairs, and Head of European Supervisory Relations, at Banco Santander.

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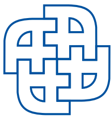
to be narrowed down, not only within Europe, but also between Europe, the US and other countries. Supervision worldwide is still lacking a proper track record in implementing the new regulatory framework.

Within the euro area banking union still has a long way to go. There is clear space for improvement in the way day-to-day supervision is conducted by the SSM. The new resolution authorities (the SRB jointly with the national resolution authorities) are still in their infancy and are expected to apply resolution rules which have not yet been finalized. The absence of a single deposit guarantee scheme means that depositors may still be treated differently across member states, depending on local regulations. Last but not least, the number of European institutions involved in safeguarding the stability of the financial system (EBA, SSM, SRB, etc) has increased substantially and they appear to lack a coordinated strategy.

This paper tries to elaborate on these issues, and is organized around three sections. The first one describes the progress made on the regulatory front, and the challenges ahead. The second one focuses on the new supervisory framework, and describes its functioning, methodology, and priorities, drawing a first balance of its activity. The third one highlights the steps ahead in the global regulatory agenda.



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7. A EUROPEAN DEPOSIT GUARANTEE SCHEME?

Gerard Arqué, Enric Fernández and Cristina T. Plata García[1]

EXECUTIVE SUMMARY*

The sovereign debt crisis of 2012 highlighted the weaknesses of the Eurozone's financial system and made clear the perverse link between bank risk and sovereign risk. The banking systems of countries with a weak sovereign, the ultimate guarantor of the deposits of the system, were especially penalized, and this generated an excessive financial fragmentation among the different countries of the monetary union. In order to redress this unsustainable situation, member states committed themselves to build a banking union, supported by three pillars: the single supervisory mechanism (SSM), the single resolution mechanism (SRM) and the European Deposit Insurance Scheme (EDIS). The first two pillars are already operational and only the EDIS remains to be developed.

This article argues why an insurance scheme at the European level (EDIS) is needed to complete a banking union and analyzes the EDIS proposal made by the European Commission (EC) in 2015.

In general, deposit guarantee schemes (DGS) increase depositors' confidence in the banking sector, thereby reducing the risk of bank failures and fostering financial stability. All over the world, DGS have experienced a strong growth in recent decades (at present there are more than 120 countries with a DGS in place, while in 1980 there were only 16). Unlike national DGS, the EDIS would have the guarantee of all the countries of the monetary union (and not only the guarantee of a single sovereign). For this reason, the EDIS would contribute to reduce the link between the sovereign and the banks of the same country and would underpin the confidence of all depositors of the banking union, regardless of the country's location of their bank. The EDIS would also offer other advantages, such as scale (it is more efficient to offer insurance on a larger scale because risks are more diversified), or consistence with the functioning of the banking union (since supervision and resolution tasks are already developed at the European level).

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Enric Fernández, CaixaBank's Chief Economist and Corporate Director of Strategic Planning and Research.

Cristina T. Plata García, Research Assistant in Research and Strategic Planning at CaixaBank.

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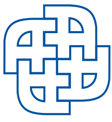

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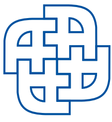
The debate over the structure of the EDIS has led to different proposals which vary according to the degree of mutualization of risks between countries: reinsurance, coinsurance and full insurance. The EC's proposal to establish the EDIS, which would be mandatory for all the members of the monetary union, combines these three elements in different successive phases until 2024. Although most countries in the Eurozone support the EC proposal, others such as Germany and the Netherlands argue that there are significant differences in terms of quality among the balance sheets of the different European banking systems and would like to see a reduction in such differences before committing to any agreement on EDIS. On this matter, they demand, for instance, changes in the treatment of sovereign debt held by banks so as to reduce their weight in banks' balance sheets and the concentration of risks.

Despite these constraints, the implementation of a fully mutualized EDIS should be a matter of time. The deadlines proposed by the EC may need to be modified, but the point of arrival is clear.



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8. THE ECB: GOVERNANCE AND BUSINESS MODEL

Alberto Calles and Álvaro Benzo[1]

EXECUTIVE SUMMARY*

In the recent history of the banking industry, regulation and deregulation stages have occurred one after another. Nowadays the trend is marked by an unprecedented increase in regulatory requirements, derived from authorities' reaction to the crisis.

The crisis brought to light the need to reconsider the supervisory model. Financial institutions which were, a priori, fundamentally sound, held adequate capital levels according to the supervisors and complied with regulatory requirements, required financial assistance or even failed. The analysis of the causes revealed weaknesses in business strategy, excessive risk taking, grave deficiencies in terms of governance and underestimation of risk.

Regulator's response to this problem materialized in a full overhaul of the existing prudential framework (so called Basel III agreements) and subsequently, in the creation of a Banking Union in the Euro Area with a single supervisor (the Single Supervisory Mechanism), a single resolution authority (the Single Resolution Board) and common regulatory framework with a significant reduction in national discretions. In addition to the perhaps expected increase in capital requirements, the authorities embraced a deep change in supervisory standards, adding to the more traditional oversight of solvency and asset quality, a particular focus and a much more intrusive approach on strategy and business model, governance, internal management and risk taking.

The depth of the new requirements and supervisory expectations indicates that authorities seek fundamental changes to existing governance frameworks. The main focal points of such changes are the role of banks' Boards in the oversight of risk, including by challenging the business strategy on the grounds if its impact from a risk appetite perspective as well as a comprehensive rethinking of banks' risk control function. For this purpose, on the one hand, banks are being asked to redefine their control functions following the model of three Lines of Defense (3 LOD), along with the redesign of the incentive and remuneration mechanisms which must incorporate much more prominently, factors which affect banks' risk profile. On the other, banks are being required to perform a comprehensive review of the Board's role, strengthening its supervisory func-

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[1] Financial Regulation Unit, PwC.

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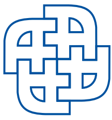
tions, adding to its organization specialized consultative committees, reviewing the suitability of its members, increasing their time commitment to risk control, entrusting new and more specific tasks and ensuring all Boards approve and regularly monitor a Risk Appetite Framework in order to set the risk strategy of the bank and embed it in the decision making processes of banks.

As if this were not enough, as a result of the challenges posed by the current economic environment for banks' business models –characterized by a cocktail of low interest rates, balance sheets scarred by high non-performing loan levels inherited from the crisis, and growing competition fueled both by high liquidity levels and new competitors from the shadow banking and fintech space–, the supervisor has flagged the risks to banks' profitability as one of the key priorities for 2016 and has set in its agenda, a thematic review on profitability and business models.

This regulatory avalanche is not exempt of criticism. First, institutions find new requirements as overwhelming in volume, excessively intrusive for banks' management of their business strategies as well as very costly and time consuming since it requires distracting resources from their core responsibilities to address regulatory requests. Also, the aggressive harmonization of standards in Europe is being criticized for ignoring the diversity of business and governance models up to the point where some identify a «supervisory risk» derived from a blind application of standardized criteria to institutions with very different realities, generating potentially strong collateral damage. Lastly, in the current moment of considerable difficulties arising from the economic environment, there is great concern that both the direct and indirect costs stemming from the increase in regulatory requirements will not help but rather aggravate what some supervisors believe is an incipient profitability crisis for the banking industry.



9. WHICH FISCAL UNION IN THE EURO AREA?

Martine Guerguil[1]

EXECUTIVE SUMMARY*

Fiscal union in Europe is a bit like the Arlesian of Alphonse Daudet's theater play: everybody talks about it, everybody has an idea of how it should look like, but it is nowhere to be seen. This chapter argues that stepped up fiscal integration is a necessity for the economic stability of the Eurozone. The Maastricht+ arrangements now in place, with enhanced surveillance, a partial banking union and a conditional emergency liquidity facility, will be insufficient to mitigate the impact of future large shocks. Worse: the current arrangements are unlikely to shepherd the much-needed recovery in investment and employment, and continued lackluster social and economic outcomes will erode support for the common currency.

Many options have been articulated, some in great detail, to enhance area-wide fiscal stabilization. They range from the most extensive and ambitious, establishing a Finance Minister and common budget, to more modest options like joint debt instruments or common insurance funds against growth or unemployment shocks. However, none of these options has so far been able to overcome pervasive reluctance to increased risk and sovereignty sharing.

In the aftermath of the Brexit vote, new paths have been put forward for stepped up integration: the «consolidate» option seeks to secure existing arrangements and bolster protection against a financial crisis; the «stimulate» option seeks to boost growth and social protection to prevent further anti-integration backlash; and the «quantum leap» option seeks to take advantage of the Brexit vote to introduce more ambitious political and institutional reforms. There is a however a significant risk that a wait-and-see path prevail, at high costs for the euro project. To avoid this outcome, decisions should be taken urgently to contain the most important risks revealed by the Brexit vote. In the fiscal area, these should include providing a fiscal backstop for the banking union to mitigate economic risks, and reforming the fiscal rule framework to boost public investment and reduce social tensions. But these will only postpone the day of reckoning: greater fiscal integration remains necessary, hopefully sooner than later, to provide stability to the monetary union.

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[1] Economist, former Deputy Director of the Fiscal Affairs Department of the International Monetary Fund.

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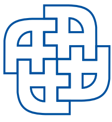


10. INSTITUTIONS FOR EUROPEAN FISCAL UNION

José Luis Escrivá[1]

EXECUTIVE SUMMARY[*]

The economic and financial crisis has revealed the flaws that the governance of the Eurozone had in three main areas. In the financial sphere, it has been proved that, in the absence of a banking union, there were great difficulties to overcome liquidity and solvency problems within financial institutions. In the economic sphere, low potential growth and the lack of mechanisms to absorb shocks have been made evident. And, in the fiscal sphere all the mechanisms foreseen by the Treaty to promote sound public finances have failed. Neither the market, nor the rules of the Stability and Growth Pact (SGP) have prevented *free-riding*.

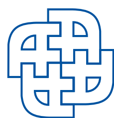
There is a growing consensus that there is a need for a new model of economic governance that would face all these problems and challenges in a joint and simultaneous manner. When reviewing what has been done so far, my perception is that some decisions were the correct ones, such as the promotion of the *national ownership* of fiscal discipline. However, the future of this reformist path has become dubious and unclear. From my point of view, the Fiscal Union envisaged in the «Five Presidents' Report» where risk sharing is accepted in exchange of more control to the «*center*» would only be viable in the very long run. There are doubts about whether an actual will to keep going forward exists. We will have to wait until next year to see the reaction to the Commission's proposals, announced to be included within the White Paper on the Economic and Monetary Union (EMU). A model like the USA one with a strong federal budget and market driven fiscal disciple, based on the credibility of the *no bail-out clause*, does not seem easy to establish in the short run either. Therefore, in my view for quite some years we will continue with a hybrid model characterized by centralized fiscal discipline and backstops facilities together with the lack of a relevant central budget.

With these perspectives, the most promising and urgent reforms are: the reinforcement of the national commitments with sound and sustainable fiscal policy which would make the center's control more dispensable; and the reinforcement of the market discipline. For the first objective, national ownership of fiscal discipline should be fully reinforced with national Independent Fiscal Institutions (IFIs) playing an essential role. As

[1] President of the AIREF.

[*] Full report in the Spanish version «Euro Yearbook 2016» available in www.fef.es and www.fundacionico.es

for the second, efforts should be made to restore the credibility of the *no bail-out* clause and consideration should be given to include mechanisms to make the resolution of sovereign insolvencies more predictable.



11. POLITICAL INSTITUTIONS FOR THE EURO AREA

José M. de Areilza and Marie-José Garot[1]

EXECUTIVE SUMMARY*

After Brexit, the refugee crisis and new threats to its security, the list of priorities of the European Union has changed. The Union seems to agree to achieve some concrete and specific targets, according to its classical way of legitimatizing its action, but in no way seems to be ready for a strong push towards further centralization. Yet in the short and middle term, some institutional and legal reforms are needed to strengthen the Eurozone, beyond the various «roadmaps» proposed by the different Presidents of the European Institutions since 2012. The redesign of the euro since 2010 has set up a new economic governance in the Eurozone that has further complicated social acceptance of the European governance. The current Union needs political and institutional reforms to accompany and sustain the economic ones and to improve substantially representation, transparency and accountability in the Eurozone. The survival of the Eurozone and hence of the European Union is at stake.

In order to do so, the authors propose to reinforce the executive power of the Eurozone mainly through the creation of a European cabinet in the hands of a smaller European Commission, chaired by a President in charge also of the presidency of the European Council. The new cabinet would count with a European Minister for Economic and Monetary Matters conceived as the visible face of the Economic policy. This Minister would also chair permanently and exclusively the Euro group. This set of reforms would lead to a more efficient economic policy reinforcing the mechanisms of coordination between the Member States. It would also identify more clearly the tenants of the design of such policy. This would inevitably rebound in the transparency of the Eurozone. In addition, in order to increase the democratic legitimacy of the institutions of the Eurozone, the European Parliament and the national parliaments would be called to play a major role in the definition of the economic policies, through a major control of the new executive power, Euro group included.

Parallel to this and in order to gain a major support of the European citizens to the common currency (and hence the European project), the authors propose to introduce new mechanisms in order to justify all the powers transferred to Brussels and to limit eventually

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[1] José M. de Areilza Carvajal, Aspen Institute and Esade.
Marie-José Garot, IE Business School.

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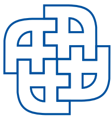

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the material extension of competences of the European Union. Without being transformed into a Federation, the European Union has to find solutions to combine flexibility to act when needed with a clear limitation of transfer of powers to the supranational level.

The authors also respond to the temptation of a rigid two-speed Europe in order to foster the European integration process, in the current context of the post-Brexit.

Finally, the institutional and competencies reforms are analyzed from their legal and political feasibility. The authors advocate for a deep reform of the Treaties in order to respond to the current challenges faced by the Eurozone. However, in order to be able to do so, a very first reform of article 48 of the Treaty of the European Union to get rid of the unanimity requirement in the ratification process proves to be absolutely necessary.

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