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EURO YEARBOOK 2018
**Completing Monetary Union to forge
a different world**

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Fernando Fernández Méndez de Andés.
IE Business School

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EDITOR

Fernando Fernández Méndez de Andés. Doctor of economics and professor at IE Business School. Member of the Bruegel advisory board and of Fundación de Estudios Financieros. Director at Bankia. He was formerly Chief Economist at Santander, Chief Economist at the IMF and Rector at Universidad Antonio de Nebrija and Universidad Europea de Madrid.

CONTRIBUTORS

José Ramón Díez Guijarro. Head of Research at Bankia, Lecturer on the Economic Environment at IE Business School and Lecturer on the Spanish Economy at CUNEF. He holds a Master's degree in Finance from ICADE. He took a degree in Economics at the Universidad Complutense de Madrid, specialising in Economic Analysis and Quantitative Economics.

Román Escolano. Trade Expert and State Economist. He formerly held the posts of Minister for the Economy, Industry and Competitiveness, Vice-President of the European Investment Bank, Chairman of the Instituto de Crédito Oficial (ICO) and Head of Institutional Relations at BBVA.

Miguel Fernández Acevedo. Research and Assessment Desk at ICO. He graduated in Business Administration and Management and Law at Universidad Carlos III de Madrid, and holds a Master's degree in International Business Management from CECO. He previously worked at COFIDES and the Spanish Economics and Trade Office in Oslo. He regularly conducts research for the OECD.

Santiago Fernández de Lis. Head of Financial Systems and Regulation at BBVA Research. He was formerly Chairman of the EBA's Banking Stakeholder Group, Managing Partner of the International Area at AFI, Head of the Monetary Affairs Division and Head of the International Department at Banco de España, Spain's central bank. He also worked at the BIS.

Eduardo García González. Partner at Clifford Chance, specialising in structured finance, project finance, acquisitions and fintech. Awarded a degree in Law and a postgraduate qualification in Legal Sciences by ICADE. He was formerly a lecturer at ICADE, the Universidad Autónoma de Madrid and Centro de Estudios Garrigues.



Alicia García Herrero. Chief Economist for Asia Pacific at Natixis, Senior Researcher at Bruegel and Real Instituto Elcano. She is an adjunct professor at HKUST Business School and holds a PhD in Economics from George Washington University, a Master's degree from the Kiel Institute for the World Economy and a "Laurea" degree in Economics from Bocconi University.

Carlos Gómez Fernández. Head of Research and Assessment at the Instituto de Crédito Oficial. Graduated in Economics, Law and Business Administration and Management at Universidad Carlos III de Madrid. Holder of a Master's degree in Public Law from Universidad Carlos III de Madrid. He has held positions at Banco Santander and the Consejo Económico y Social, a government advisory body.

Inês Gonçalves Raposo. Associate researcher at Bruegel, specialising in the field of macroeconomics, governance, finance and European regulation. She holds an Master's degree in Economics from the Nova School of Business and Economics (Nova SBE) and a bachelor's degree in Applied Mathematics from the Universidade de Lisboa. She previously worked in the Financial Stability department at the Banco de Portugal.

Olga Gouveia. Lead Economist for Financial Systems at BBVA Research. Graduated in Economics from Universidade do Porto and awarded an International MBA by IE Business School. She formerly worked as a banking analyst at Moody's and as an associate analyst at BPI Private Equity.

Pablo Hernández de Cos. Governor of the Banco de España and member of the Governing Council of the ECB, the European Systemic Risk Board (ESRB) and the Group of Governors and Heads of Supervision of the BIS. He holds a doctorate in Economics from Universidad Complutense de Madrid, a degree in Economics from CUNEF and a degree in Law from UNED.

Joaquín Maudos. Doctor of Economics. Full professor at Universidad de Valencia, assistant head of research at Instituto Valenciano de Investigaciones Económicas and lecturer at CUNEF. He has been a visiting researcher at various universities and a consultant for the European Commission, the UN and the EIB. Author of numerous academic papers and general interest articles.

Blanca Navarro Pérez. Head of Strategy and Assessment at ICO. Former Head of Research and Assessment at ICO. She holds a Master's degree in Finance from Centro de Estudios Financieros. Graduated in Economics from the Universidad de Zaragoza, specialising in economic analysis. She has also been an associate lecturer at Universidad Carlos III de Madrid and ICAI.

Miguel Otero Iglesias. Lead researcher at Real Instituto Elcano and Professor of International Political Economy at the IE School of Global and Public Affairs. PhD from Oxford Brookes University. He has been a visiting professor and researcher at the University of Oxford and the LSE.



Francesco Papadia. Lead researcher at Bruegel. Chairman of Prime Collateralised Security and of the selection committee of the Hellenic Financial Stability Fund. He graduated in Law from the University of Rome, and later undertook post-doctoral studies at the London Business School and the Istituto Adriano Olivetti. He was formerly the Director General of Market Operations at the ECB.

Fernando Restoy. Chairman of the BIS Financial Stability Institute. PhD in Economics from Harvard University and holder of a Master's degree from the London School of Economics. He was formerly a Deputy Governor of Banco de España, Chairman of the FROB, Spain's fund for orderly bank restructuring, a member of the ECB Supervisory Board and Vice Chairman of the CNMV, Spain's securities market regulator.

Federico Steinberg Wechsler. Lead researcher at Real Instituto Elcano and lecturer on Economic Research at the Universidad Autónoma de Madrid. He holds a doctorate in Economics from Universidad Autónoma de Madrid, an MSc in Political Economy from LSE and a Master of International Affairs degree from Columbia University. He specialises in international political economy and European integration.

Francisco Uría. Partner responsible for the financial sector at KPMG for the EMEA region and senior partner at KPMG Abogados. Doctor of Law and State Attorney on leave of absence. Former appointments include Technical Secretary General at the Ministry of Public Works and the Ministry of Finance, Under-Secretary at the Ministry of Finance, and Deputy Secretary and Head of Legal Affairs at the Spanish Banking Association (AEB).



FOREWORD

Fundación ICO and Fundación de Estudios Financieros jointly decided in 2012 to publish an annual review titled the *Euro Yearbook* with the aim of expanding knowledge and raising awareness of the importance and role of the single currency, and to suggest ideas and proposals for strengthening its acceptance and sustainability.

This partnership translates into producing an annual publication to inform readers of the changes that have taken place over the past year in the monetary, banking, fiscal, economic and political union, highlighting the successes, limitations and possible shortcomings.

The report we are presenting here, now the sixth in the collection, is titled *Completing the Monetary Union to forge a different world*. It contains twelve chapters, split into three different parts. The first of these, *Europe's existential debate*, discusses the risks and difficulties facing the Monetary Union, reflecting on the true meaning of the euro area and addressing the general lack of awareness, even among the people of Europe, of the consequences and costs of its eventual breakdown.

The second part, *European monetary policy and financial system*, includes an analysis of the end of the ECB's ultra expansionary monetary policy, the solvency, liquidity and profitability of the European banking sector, factoring in the impact of Brexit, and the challenges and opportunities facing the European financial system as a result of the technological revolution.

The third part, titled *Completing the Monetary Union: the state of the perennial question*, describes and analyses the advances made in European monetary and fiscal construction to ensure its sustainability and permanence. It also looks at the banking union, its many successes and the challenges remaining, with particular emphasis on the progress made in the area of risk reduction. Last but not least, it includes an article on the mutualisation of risk, which is ultimately the fiscal union.

The report includes an executive summary that lays out the contributions made by our various contributors and presents ten propositions, called the Ten European Lessons, which are essentially the main messages of this *Euro Yearbook 2018*.

In the current context, we continue to believe that it is necessary to explain and raise awareness, in detail throughout this report, of the changes taking place in the European Monetary Union, and to analyse their significance and how they influence us.

The review was led by Fernando Fernández Méndez de Andés, a Professor at IE Business School. He, in turn, has been assisted by a team of experts with close ties to



academia and the professional environment. We would like to express our gratitude to each of them and congratulate them on a job well done.

Fundación de Estudios Financieros and Fundación ICO hope that the *Euro Yearbook 2018* will make an important contribution to the current debate regarding the euro and European integration and will prove useful and interesting to all readers.

Fundación de Estudios Financieros

Fundación ICO



EXECUTIVE SUMMARY

FERNANDO FERNÁNDEZ¹

1. A DISAPPOINTING AND HAZARDOUS YEAR IN EUROPE

We started the year full of excitement. The European economy had recovered, it was growing, it was creating jobs, and the harm done by the crisis was healing. Adjustment plans were working. Greece and Portugal regained access to capital markets and returned to economic and social stability, avoiding a suspension of payments that could have endangered the very existence of the euro area and strain the European Central Bank beyond repair. Populist parties seemed isolated and defeated, and restricted to channelling the frustrations of a small percentage of the population with no real ability to influence decision-making at the highest level. There was even a major project in progress for the renewal of Europe (COM 2017), to complete the institutional design of the Economic and Monetary Union. An action plan leading to a new foundational treaty. And in the two powerhouses of Europe we had two unquestionable leaders, Macron and Merkel, whose strength, commitment and agreement on the essentials promised us a happy ending. A stronger and more politically and economically integrated European Union; a more stable Monetary Union. Europe's lost decade seemed to have come to an end.

A year later, European excitement has vanished completely. Nobody knows why, but the European ideal is no longer attractive. Perhaps because Europe's achievements are taken for granted: they have become part of our daily lives, and have lost all value. Perhaps because Europe has already wasted too much time rethinking itself, and remains unable to achieve a united response to Rodrik's trilemma² by continuing to dither be-

¹ Fernando Fernández Méndez de Andés is a professor at IE Business School and has been the editor of the Euro Yearbook from the outset.

² It was Dani Rodrik (2007) who for the first time expressly pointed out the impossibility of achieving at the same time full political democracy, economic globalisation and national sovereignty. Applied to the European Union, this argument translates into the need to transfer



tween two opposing visions of the Union.³ Perhaps because, lacking political leadership and strategic vision, Europe is ravaged by the downside of globalisation and digital transformation. Or perhaps simply because politics has become excessively national – parochial – in a low-quality emotional democracy, dominated by social media, which can be a perverse machine for political activism and lynch mobs.

Europe's 2018 has been a year of nationalisms and populisms, of the renationalisation of economic policy and of political rifts in the Union. The year in which extremes, to the Right and Left, have risen to executive power, legitimised by the main traditional parties, which have preferred confrontation and polarisation to the consensus that had so far been Europe's hallmark. In the absence of an idea, of a project for Europe, old fractures have resurfaced, and in some cases have broken out violently: in migration policy, in defence and security, in fundamental freedoms, in the common judicial space, in the reduction and mutualisation of financial risks, in investment, in the fiscal response to the digital revolution, in the stance towards Russia, in how to deal with the rise of China. A weak European Commission, frightened governments, and leaders in retreat due to severe domestic problems have failed to live up to expectations and promises.

The departure of the United Kingdom from the European Union on 29 March 2019 has shaped the calendar, the debate and the climate of European policy. Brexit is a defeat for European integration and a triumph for nationalism. At the time of writing, all possibilities are still open. A withdrawal agreement is pending ratification in the UK and European Parliaments.⁴ This deal is a lesser evil, and takes an approach that has been dubbed “Norway plus”⁵ whereby, broadly speaking, the United Kingdom would remain in the customs union for goods, but not for services. A common customs area for trade in goods, with regulatory, technical, and phytosanitary implications and an impact on competition policy and State aid rules. A novel legal and political construction with an uncertain outcome; a difficult balance that seeks to avoid the re-establishment of a hard border in Ireland while complying with the democratic will of the British people.⁶

sovereignty to the European authorities to ensure the survival of Monetary Union and the European Union itself. This thesis seems to have been discovered just yesterday by American academics, but it was already in the minds of the founding fathers of Europe, who always conceived of the Union as a political process of increasing integration and the creation of European citizenship.

³ See the executive summary of Euro Yearbook 2017 for a detailed explanation of the two visions of Europe that are still latent. We can call these visions “federalist” and “minimalist utilitarian”.

⁴ At its special meeting on 25 November 2018, the European Council approved the Withdrawal Agreement and the Draft Political Declaration on the future relationship between the EU and the United Kingdom. The debates in both parliaments will be bitter and fierce: in fact they already are, especially in Westminster, where the Prime Minister's parliamentary weakness is all too plain to see.

⁵ For a detailed description of the different possible relationship alternatives between the European Union and a third country, including what is meant by the so-called “Norway plus” arrangement, see Souta 2015.

⁶ This is the tragic greatness of what Theresa May and Michel Barnier are trying to do,



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So far, nothing is set in stone, and the agreement is in danger of being wrecked by hardline Brexiters, who believe that the United Kingdom is so important that the world needs it more than it needs the rest of the world, and will accommodate their whims, even in the teeth of those furious Europhiles who seek to punish the traitors. For these Brexiters, the only possible alternative is a hard break, a non-negotiated solution that would involve a painful exit and would precipitate the United Kingdom into chaos and the European Union into a period of harsh uncertainty. A way out that is also unwittingly pursued by all those fierce pro-Europeans who insist on putting the UK in its place and not making any more concessions. It is also possible that there will be a second referendum; and the request to trigger Article 50 of the Treaty could even be withdrawn.⁷ This is possible but unlikely, to the regret of many of us. There seems to be insufficient parliamentary support for that solution to succeed. It is more likely that the transitional period will be extended. The UK would remain within the Union during that time, at the UK's own request and with the unanimous consent of the remaining Member States. That extended transition period would give rise to a new general election and perhaps a new government, which might then change the UK's position on the issue and – finally – hold a second referendum. That is a possibility, but I still think that at the end of December 2018 the least harmful scenario is the Withdrawal Agreement that has already been negotiated. No one is particularly happy with the deal, but perhaps that is precisely why it is the only feasible way out.

In any event, Brexit is a European failure, and a harsh warning that the ideal of ever-closer integration is no longer paramount. While it is true that, to an unprecedented extent, the Union has closed ranks in trade negotiations, that strong stand does not extend to other areas of Community policy where there is no such basic unity. Europe could break up. European politicians would do well to heed this warning. No one is immune to a hypothetical political suicide: no country, no society.

But let's get back to the Union. Much was expected of the December Summit, especially since it seemed only a few months ago that there was sufficient political will and technical development work to give a powerful boost to the construction of a sustainable, efficient and solidarity-based monetary union. These hopes were misplaced. Appearances were kept up with a few advances of minor significance and questionable technical basis, but no real progress was achieved in the institutional design of the euro area. Yet again, and I have lost count of how many times this has happened before, the heavy lifting is entrusted to the ECB and its supposedly unlimited capacity for intervention.

regardless of what one might think about the alleged virtues of a referendum. In my opinion, a referendum is a populist oversimplification of the complexity of the real world that is difficult to reconcile with representative democracy.

⁷ This possibility will exist right up until the final day, since the European Court of Justice has ruled that it is a unilateral prerogative of the country requesting activation of Article 50: that country would retain its status prior to the request. Which in the case of the United Kingdom would mean keeping all its exceptions, the "UK rebate" among others, and its opt-outs from monetary union.



Unfortunately, it is hard to believe that the current system of decision-making, political structure and governance can ever meet the needs of a Union as complex and diverse as ours. Because, as we have insisted since the first edition of this yearbook, no monetary, banking, fiscal and economic union is possible without a political structure that gives it legitimacy. All the more so in a democratic system.

To complete the Union, the Commission had produced ambitious policy papers that (i) incorporated fiscal governance into the EU method and superseded inter-governmentalism, (ii) created a European macroeconomic stabilisation facility, (iii) gave borrowing powers to the bank resolution fund, (iv) established a small euro area budget to support structural reforms, (v) pointed to the future creation of a Euro finance ministry, and finally, (vi) moved forward with the implementation of the European Deposit Insurance Scheme, albeit in step with a reduction in banks' exposure to sovereign risk. All of these proposals could be debated, challenged and improved, but at least they were designed to address the current weaknesses of the Economic and Monetary Union.

Finally, the text presented for discussion to the Eurogroup substantially curtailed the original proposals and was circumscribed to the Meseberg Declaration (Germany 2018). Although it had little to say about economic integration, the Meseberg Declaration had great political significance and revived the momentum for the refounding of the euro area. It linked growth, convergence and stabilisation with the European budget and the multiannual financial framework, raising hopes for fiscal union. The Declaration set out a range of action plans to implement the commitment of Europe's two main driving forces to move forward with the institutionalisation and integration of the euro area. Although the price of this supposed entente between solidarity and austerity was, once again, and quite bafflingly, the European Deposit Insurance Scheme (EDIS), which was postponed and reduced to a mere statement of principle with no practical effect.

And finally, it wasn't even that. The finance ministers of the 19 EMU countries were barely able to reach agreement on the backstop for the Single Resolution Fund (SRF), which would enter into force in 2024, and the extension of the powers of the European Stability Mechanism, ESM, to act externally and independently from the Commission and the ECB as a European Monetary Fund and to design, negotiate, approve and monitor compliance with adjustment plans. These are adjustment plans whose range of instruments is clarified by facilitating the insertion of effective collective action clauses in European sovereign bond issues and implementing pre-emptive programmes that trigger automatically in the event of contagion, although this considerably toughens up *ex ante* conditionality (Claeys and Mathieu 2018) and turns on a concept as questionable and non-transparent as the "structural deficit". But the ESM will remain a multi-governmental institution outside the Treaty and the EU system.

Assuring liquidity in bank resolution is a necessity, as made clear in the case of Banco Popular. The difficulty is that the Single Resolution Fund has only EUR 60 billion to draw on to restore solvency and liquidity. While it is true that as far as solvency is concerned bail in procedures can be a help, the reality is that unless the bank to be resolved is bought by an existing bank and the latter uses its balance sheet and its access to ECB



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debt programmes to ensure liquidity,⁸ under any other of the mechanisms the SRF would have to underwrite it. Typical procedures include granting government bonds to the new bank or providing collateral. These are not trifling figures: HypoReal needed collateral worth EUR 145 billion and Dexia EUR 135 billion (Demertzis & Wolff 2018), both amounts going far beyond the original endowment of the SRF. Neither is now legally feasible. That is why the December Summit authorised the ESM to extend to the SRF a 3-5 year loan with a 35 bp spread. But there are difficulties: the ESM would have preferential creditor status, which makes additional financing difficult and expensive; the unanimity requirement for activation remains in place; and the existing facility for direct recapitalisation of banks is eliminated.

The Eurogroup has also made symbolic progress in fiscal matters, accepting in principle the idea of a budget for the euro area. But without specifying its size and subject to further technical work to be presented at the next summit. Exactly the same language as that used to postpone the EDIS yet again. The budget would include two funds: structural convergence and investment, but not a European fiscal stabilisation facility. Nor has there been any progress on fiscal compliance; no streamlining, no agreement on an expenditure rule, and no clarity on how to reduce apparent discretionality by reinforcing automatism and depoliticising compliance.

In short, a summit whose main success is that at least there have been no backward steps and there is still talk of completing EMU. This is perhaps no small feat in today's European political context. But the Eurogroup has proved unable to reach agreement on long-awaited and debated issues that were in the Commission's original papers. A meagre balance of achievement when we place it in relation to the expectations created and the real needs of a Union in a scenario of uncertainty, volatility and change of monetary cycle, where the central banks are, albeit to their regret, the only players (El-Erian 2017).

The Union has been unable to overcome the deep rifts (North-South, East-West) that have emerged in the European project. President Macron, distracted by internal strife in France, seems to have archived his great European project in the drawer of lost dreams. Chancellor Merkel is now a "lame duck", and since those who routinely hid behind her alleged intransigence are aware that German policy can only become less European, coalitions of countries have emerged that openly question further integration: the Hanseatic League in economic respects, and the Visegrad Group in the political, social and judicial domains. Now that the very foundations of EMU are in doubt, Italy has boldly and publicly shirked its European fiscal obligations. That stance has triggered an unprecedented response in the form of an excessive deficit procedure.⁹ This development opens up a disturbing horizon for the Union, although it appears that sanity has finally

⁸ Post-resolution, we have learned that Banco Popular lost 24% of its customer deposits, EUR 18,156 million, in the year prior to the intervention. Almost half of that amount bled away in the last two months.

⁹ The European Commission, after analysing the draft revised 2019 budget submitted on 13 November by the Italian government, found that Italy has incurred "*particularly serious non-compliance*" with the ECOFIN recommendations of 13 July as regards the debt criterion.



prevailed and a new budget is being negotiated. This is a necessary evil, but it continues to compromise the credibility of European rules, encourages Eurosceptics in creditor countries and is incompatible with the aim of supporting the role of the euro as a major currency in international trade and finance.

This is the worrying state of the Union at the end of 2018 and to deny it would be dishonest with the readers of this Yearbook, which is now in its eighth edition. Perhaps because, without losing our deeply pro-European spirit and conviction, we have never shied away from describing reality as we see it and understand it. Today, unfortunately, anything is possible in the Europe of disenchantment. Problems persist and vulnerability increases, but confidence in the proverbial authority and efficiency of the ECB remains strong. This is an institution that displays excessive presidentialism precisely now, when the mandate of its highest officer draws to a close. Certain individuals have been very important in the construction of Europe. But it is the institutions they built that will endure.

2. COMPLETING MONETARY UNION FOR A DIFFERENT WORLD

We had set ourselves the goal of producing a somewhat different Yearbook, more forward-looking and less focused on the Union's internal issues. A Yearbook open to the challenges posed by new technologies for monetary union, the financial sector and the central banks themselves. A Yearbook about virtual currencies, digital accounts and distributed ledgers that call into question monetary authorities' monopolistic powers and their ability to stabilise economies. A Yearbook on Europe's role in the growing antagonism between China and the United States. And all of that is indeed addressed in this Euro Yearbook 2018. But we must also address the failures of the Union, the risks of leaving work unfinished, the Italian failures and their possible fallout, a monetary policy that is running out of options to face a potential slowdown and a new downward cycle, the dangers of the banking union going off the rails, the difficulties in creating a genuine single European market in banking and financial services, and the sterile debate on fiscal union if the inevitability of Eurobonds is not accepted.

The book is structured into three distinct parts. The first, titled "Europe's existential debate", is intended to lay the foundations of where we are now. Twenty years of a functioning EMU have not dispelled doubts about its survival. The English-speaking academic world remains sceptical about the desirability of EMU and Europe's ability to build it. Confusion and misconceptions persist among the economic and political elites of emerging economies about the true meaning of the euro area. And the European public itself is largely unaware of the necessary consequences of monetary union or of the cost to be borne if it fails. Perhaps an in-depth debate, beyond wishful thinking and the pro-European vision, should have been engaged in at an early stage. It would be a cruel paradox, however, if it were precisely the single currency that were to wreck the European project through a refusal to understand or accept the inevitable implications.

The purpose of the Yearbook has always been to explain and publicise Monetary Union. This year, in which Europe has suffered renationalisation and an identity crisis,



that goal becomes all the more vital. But making EMU known and understood also means confronting it with its current weaknesses and the need for reform. Some might think that it is a matter of waiting out the rainstorm, of sitting down until the thundercloud of nationalist populism moves on. This is not, in my view, the attitude that people expect of their leaders, nor an approach that can be demanded of an academic. It is certainly not the stance that we have always taken. Therefore, the first part of the Yearbook points out the risks of leaving a job unfinished, describes what should be politically possible and confronts Europe with the need to define its strategy in the new post-globalisation economic order.

The second part focuses on the European financial system. It is well known that the financial sector is facing a technological revolution all over the world that has eroded traditional barriers to entry and prompted the emergence of new digital competitors. By reducing the traditional asymmetry of information, moreover, technology *empowers* consumers of financial services and enhances their ability to choose and make decisions. A real challenge to the banking business model, to which must be added the tsunami of post-crisis regulation and financial institutions' loss of credibility and legitimacy. And all these challenges have coincided with an ultra-expansive monetary policy that erodes financial margins and hurts the banks' bottom line. Monetary and supervisory authorities insist on searching for economies of scale and consolidation across the industry as the appropriate response.¹⁰

The second part of Euro Yearbook 2018 addresses these topics. More traditional issues include the implications of the end of unconventional monetary policy, a comparative description of the Spanish banking system, and the impact of Brexit on the European banking system. We also address forward-looking topics, such as central bank digital currencies (CBDC) and their implications for the financial industry, or the challenges of the blockchain. This year the debate has moved on from academics and techies to policy-makers, especially after Christine Lagarde has shown herself to be an avowed supporter (IMF 2018b).

In its third part, the Yearbook describes and analyses advances in European monetary and fiscal integration or, more accurately, the insufficient advances. We first review the banking union, its achievements and the challenges remaining. The success of this objective will depend on the banking union being able to spread European savings beyond traditional national borders. This in turn is likely to require European banks and success in the transnational diversification of the portfolios of European investors. Reducing risks has become a European mantra, which is why this year we look at the common strategy, and its demands, weaknesses and gaps. And we finish with an article on the mutualisation of risks, which ultimately leads to fiscal union. Such union is necessary, but it cannot be viewed solely as an obligation of solidarity, but also of the efficiency and sustainability of monetary union. It cannot be understood only as a right; it is also an

¹⁰ The words "*There is still a need for further consolidation in some markets, and for greater efficiency*" has become the standby quotation for European supervisors. See, for instance, Danièle Nouy, 2018.



obligation to comply faithfully with the rules that we Europeans have set ourselves. Fiscal union is not a contingent liability from one country to another, but a set of rules and procedures that allow European citizens' savings to flow freely within the Union without fear of redenomination, dilution or inconsistent policies. That we remain far from that goal is the inevitable conclusion drawn in this *Euro Yearbook 2018*.

In short, for yet another year we have tried to present to the interested reader the European debate in all its richness, all its nuances and all its rawness. We have tried to describe it and analyse it with the utmost intellectual rigour and honesty, but also filtered through all our prejudices. I am sure I am speaking for all the authors when I say that this is a Yearbook that is deeply committed to the idea of Europe, and which believes that Europe is the solution. We are convinced that only through rigour and passion can we try to understand and explain this collective project of living together, of building the new and unprecedented political entity that is Europe. With this idea in mind, it has been easy for me, once again this year, to bring together an unrivalled group of professionals from widely diverse fields of economics, finance, law and politics. I can only express my deeply felt gratitude to all of them for a job well done. And for their understanding of this highly personal executive summary, which they know is deliberately biased but in which I have also tried to be faithful to their ideas, while sometimes daring to disagree.

3. EUROPE'S EXISTENTIAL DEBATE

The book begins with an ambitious chapter by Pablo Hernández de Cos, Governor of the Bank of Spain, who, like all the authors of this collection, writes in an exclusively personal capacity. He reminds us that the crisis was also the outcome of flaws in the original design of Monetary Union. These shortcomings can be summarised as governance weaknesses, flawed fiscal rules, lack of economic coordination, lack of stabilisation capability and jurisdictional asymmetry between monetary union and banking union. All these shortcomings have been addressed to some extent since the Euro Council of 29 June 2012, but to widely varying degrees of success and uneven closeness of attention, I would add. But this is unfinished work. His contribution aims to prioritise those elements that “are essential” to surmount “long-term” instability.

The starting assumption is that any stable monetary union has three channels for sharing the impact of an asymmetric shock, with three mechanisms for mutualising risk, or for “cross border risk-sharing”. The most powerful channel (which absorbs 40% of shocks in the US) operates through private capital markets and relies on cross-border capital ownership, hence the importance of capital market union and measures to end domestic bias. The second, the credit channel, absorbs 20% of shocks. The banking system and its cross-border business, which has not yet recovered from its renationalisation following the crisis, play a key role. Finally, the budgetary channel only buffers 10% to 15% of shocks, but “its existence is crucial to support the development of the private channels.” This channel is entirely absent from EMU, because the EU budget is not designed on a basis of stabilisation but, at best, of convergence.



The chapter analyses the three existential risks of the euro and sets out proposals to mitigate them: the risk of redenomination,¹¹ the national fragmentation of financial markets and the absence of a common counter-cyclical fiscal framework. To explain them, he groups his proposals into the usual three main blocks: banking union, capital market union and fiscal union, focusing on the most critical issues.

The banking union will become a reality when there is a sufficient degree of wholesale and especially retail integration in Europe, a pan-European banking system, which would involve cross-border mergers. The author discusses why this has not happened yet, and looks at several causes that should be acted upon, cautiously yet persistently. First, and most importantly, the absence of Europe-wide deposit insurance, or at least a firm and detailed commitment to its implementation. But also more technical aspects, such as the lack of competitive pressures in some core countries,¹² lack of regulatory harmonisation, failure to take geographical diversification into account in the calculation of risk-weighted assets, or obstacles to the integrated treatment of pan-European banking groups. And he concludes that the lack of a definitive agreement on the final stage of the banking union “lays bare the political and social risk, ... only adds political risk to economic inefficiency.” This chapter does not merely point out the risks of the current paralysis, but proposes a way out: “the strategy of risk-sharing without legacy problems emerges as the most promising and swift solution.” This is one of the proposals advocated in this Yearbook.¹³

The author’s views on fiscal union are well known (Hernández de Cos 2017). We can summarise them here. EMU requires a stabilising supranational fiscal capability that, to avoid permanent transfers, would be implemented on the basis of a cyclical insurance system with automatic recourse, under *ex ante* macroeconomic and fiscal conditions. Such a system should be supplemented by a mechanism for coordinating and defining a suitable fiscal policy stance for the euro area; the mechanism should have an instrument to boost European integration and counter-cyclical investments. And with the strengthening and simplification of national budgetary and fiscal discipline, through an in-depth reform of the Stability and Growth Pact, based on a single objective, debt reduction, and an operational instrument, the nominal expenditure rule, which increases automatism and reduces political discretion.

¹¹ I would ask anyone with an interest in this subject to read the full article. I was especially interested in the defence of the need for a secure asset for the euro area, even if the request for Eurobonds is not explicitly formulated, and the author’s distrust of replacing that standby with synthetic assets through financial engineering.

¹² This is a pretty euphemism to refer to the persistence of covert national banking protectionism and the strong presence of banks with public or quasi-public ownership structures that make them immune to the pressures of margins, profitability or digital transformation faced by private entities, thus hindering the creation of a level playing field.

¹³ The sixth chapter of Euro Yearbook 2017 stated: “legacy issues” should not determine the “steady state” of Monetary Union; rather, they require imaginative transitional solutions, over the long term and with accurately designed incentives. Executive Summary, page 33.



Chapter 2 is the work of Román Escolano who, from his privileged vantage point as a former Minister of Economy and a Eurocrat in the best sense of the word, reflects on an unfinished task. He starts by rightly vindicating the policy measures taken to improve the institutional framework of EMU, which displayed the virtue of accompanying and supporting the ECB's unconventional policies. Such measures, despite the prevailing pessimism, have led to six years of recovery, six million jobs, activity rates close to 70% and public deficits that have fallen from 6% in 2010 to 1.4% in 2017. It would be wise to bear this in mind when listening to criticism and fear-mongering about those policies. Escolano is right; the measures were the correct course to take. Another question, however, is that the measures may have been insufficient and unorthodox monetary expansion may have lasted too long.

The author adopts a very suggestive, conceptual and pro-European approach when analysing the tasks remaining. He criticises Merkel's vision of November 2010, when she called for an overhaul of the European method and advocated a renationalisation of European policies. It was an unsatisfactory vision, which has made it harder to move forward and has led to a wrong-headed debate between two seemingly opposed concepts, "risk sharing and reduction", which under the euphemism of "sequencing" (timing of measures) masks fundamental differences and is an excuse for the rethinking of monetary union.

The idea that only after a long period of coordination and harmonisation of economic policies, and of convergence in inflation, growth and employment, can a process of mutualisation of financial risks be considered. The German "coronation theory", which harks back to the 1960s, is not only wrong, but a serious threat to the very objectives it purportedly seeks to defend. The reasons are threefold: (i) as long as the financial architecture is not complete, insofar as the vicious circle between banking and sovereign risk is prolonged, more cross-border bailouts and public transfers will be needed; (ii) transfers between countries will necessarily be larger in the absence of a European deposit insurance scheme (EDIS), because they will not only have to face solvency issues but also specific liquidity problems; and (iii) a situation of incomplete banking union may lead to political outcomes that are unacceptable in a democracy, such as national taxpayers being solely liable for the consequences of decisions by European authorities, i.e. the Single Supervisory Mechanism, SSM, or the Single Resolution Fund, SRF.

To complete the banking union, the author proposes two measures he himself has put forward earlier (Spanish Ministry of Economy, 2018): a common firewall for the SRF and a definitive agreement on EDIS, with an irrevocable date for its entry into force. That date would be irreversible, but can be deferred over time to allow for the cleanup of bank balances, the injection of sufficient resources into the system and the implementation of a firewall similar to the SRF. With the three pillars of the banking union complete and in place, EMU would gain time to resolve outstanding structural issues: a Stability Mechanism, a scheme for the origination of a risk-free European asset, and governance reforms to incorporate the Fiscal Compact and the ESM in the EU method. In short, it would be a catalogue of measures not all that different from the one formulated in the previous chapter, reflecting a broad consensus at the technical level on how to make



EMU sustainable and permanent. This technical consensus also exists in Europe, but it is politically resisted.

This first part of the Yearbook continued with Alicia García Herrero, a researcher at Bruegel and chief economist at Natixis for emerging markets. Chapter three essentially asks how Europe should respond to the challenge posed by the emergence of China and the new American nationalism. What should the Union do in the face of the new mercantilism in international relations? An important debate, because this Yearbook has always argued that Europe is too self-centred, obsessed with its internal problems and unaware of global changes. This chapter deals specifically with three issues: trade wars as a manifestation of the strategic rivalry between the United States and China that will mark the 21st century; a detailed sectoral study of European opportunities and the possible advantages of tariff rearmament; and a review of European strategic options in a polarised world.

The United States has decided to change the trade status quo and use its hegemonic power as a regulator, a *rule setter*. It has unilaterally imposed an additional 25% tariff on Chinese imports worth USD 50 bn, and has approved another list that would affect USD 250 bn. The macro impact has been felt above all in the Renminbi exchange rate (RMB), which slipped 20% over the year. The IMF estimates that China will grow 1.6 percentage points less in 2019 and United States 0.9 points. European markets have remained relatively immune, although recent data point to a marked slowdown in German and Spanish exports and more sluggish growth. And beware: the usual estimates only measure the direct impact on trade in goods, leaving out the effect on the flow of investments and other essential qualitative issues. The first round of tariffs aimed to contain Chinese technological progress. Of these tariffs, 62% were applied to products with a high technological content, some of which China does not yet even export to the United States. While the second round, planned but not yet implemented, is intended to encourage relocation of industrial production to the United States. However unacceptable his manners may seem, President Trump appears willing to negotiate on reindustrialisation, but not on how to curtail China's technological might. Is Europe aware of this, and does it have a strategy in place?

If the trade war goes further, Europe could conquer the ground that each contender leaves free to the other. To analyse this question, a granular study of trade flows at the sectoral level is provided. The author concludes that the structure of European exports suggests that it has a better chance of winning in the Chinese than in the American market, for the simple reason that European and American exports to China are good substitutes and because taking advantage of the relative advantages in the United States requires a size that Europe would take years to achieve. China will soon be a more important market to Europe than to United States. But, to achieve these benefits, "Europe would have to remain neutral and refrain from allying with the US and imposing sanctions on Chinese imports."

This central question prompts García Herrero to consider the strategy to be followed by Europe in the face of structural change in the paradigm of free trade. There are several decisions to be made. First, Trump has made it clear that the trade model based on



multilateral rules is dead, basically because he believes that rules are not applied fairly and its vast size has enabled China to evade compliance. He is not wrong about this. But it is a model that is particularly esteemed in Europe, among other reasons because of our own internal complexity. It therefore seems necessary to ensure the effectiveness of international rules and standards. Second, the WTO will have to deal with the role of state-owned enterprises (SOEs) in the production of goods and services, their dominant and perverse presence in many sectors and the immense subsidies they enjoy, such as privileged financing. This is a debate that internally the European Union has failed to resolve satisfactorily. Today, Europe is the only large market in which Chinese investment in acquiring companies, including tech firms, continues to grow. Third, the question of market access, which in an authoritarian and centralised political system is conflated with the previous issue, as the regime grants special anti-competitive advantages to SOEs. Overcoming this obstacle and gaining privileged access, without intermediate tolls, appears to be an obligation of reciprocity in the new economic order with China and a necessary component of any bilateral agreement. And, fourthly, the question of national security – a hot issue in the media – and access to sectors regarded as strategic, which coincide with the protagonists of the digital revolution. This is an issue that can only be resolved with far more transparency about the ownership, contracts and technology of Chinese companies, and with absolute respect for intellectual property rules.

This first part devoted to the Union's existential debate closes with an article by Francesco Papadia and Inês Gonçalves Raposo, both Bruegel researchers, about Italy, the elephant in the euro room and a chronic problem for European construction, as a founding member and, in the minds of many, a professional *free-rider*. At the time of writing, the Italian government had collided head-on with the Union in budgetary matters: a symptom of a deeper-seated rejection of the economic and human rights model prevailing in the Union, with an open outcome where everything is possible.

For the authors, the Italian draft budget posed a twofold challenge to the Union: institutional and economic. From an institutional point of view, this is a fresh attack on European fiscal governance, which is expressly disregarded. The Commission, as guardian of the Treaties, had no choice but to reject it and open an excessive deficit procedure in the hope that, like Tsipras in Greece, the Italian government will give way and, after much noise and posturing, apply EU rules. Everything suggests that this is in fact happening, although it is too early to tell, as until the European elections none of the parties has any interest in giving in or “kicking over the chessboard”.

The authors conclude that Italy has much more to lose than the Union, not least because the Italian economic plan makes no sense and is intrinsically unreasonable: it does not make Italy better able or more likely to achieve growth. The authors prove their points in their paper. But first they make some statements that I shall be so bold as to oppose, because they have spread too far in some European political sectors. To ask the question of whether a different fiscal framework would have avoided confrontation is a



necessary academic exercise,¹⁴ but using this potential imperfection as an argument to justify non-compliance opens the door to all kinds of populism. And to say that a less pro-cyclical fiscal framework would have prevented the Italian recession is an exercise in wishful thinking, since Italian stagnation predates monetary union. Furthermore, the Union cannot be stabilised or maintained on the basis of permanent mistrust and questioning of the common rules. And of course the rules apply to all countries, regardless of their size. That is precisely why we need clear, simple, comprehensible and automatic fiscal rules.

Papadia and Gonçalves devote much of their chapter to debunking the idea that the Italian budget generates growth. They begin by calling into question the calculation of the fiscal multiplier, which, we now know, reflects a non-linear relationship that depends on many factors. Applied to Italy, all these factors would give a very modest figure that is quite remote from that estimated or desired by the Italian government. It could even be negative if we assume a less-than-heroic reaction of interest rates to the quarrel with Brussels.

This chapter provides abundant empirical evidence on the types of contractionary effects of fiscal expansion that might be present in the Italian case. First, a permanent rise in interest rates would raise doubts about Italy's fiscal sustainability, given the magnitude of its public debt and its resistance to reducing it in a period of economic expansion and rates close to zero. Even more so at a time of change in the monetary cycle. Second, a shift from a "good" to a "bad" equilibrium with rising interest rates is by no means unthinkable. In fact, this is exactly what happened in the European debt crisis after 2010 (Papadia and Välimäki 2018). This phenomenon of seasonal regime change can be viewed as the modern and developed version of the Keynesian *animal spirits*. Third, we know today that in the euro area doubts about debt sustainability quickly translate into doubts about continued membership of the monetary area, provoking strong speculative movements on bank deposits and other Italian assets in the face of the risk of redenomination. And, fourthly, given the fragility of Italian bank balance sheets, fiscal conditions can substantially affect their capital bases and provoke a new spiral of mistrust and a perverse sovereign-banking cycle. The Union now has the ESM and the SRF in place to deal with this situation, but both need, as a precondition, the cooperation of the Italian government with the EU authorities, explicit acceptance of fiscal governance and the adoption of an adjustment programme.

4. EUROPEAN MONETARY POLICY AND FINANCIAL SYSTEM

Chapter 5 marks the beginning of the second part of the Yearbook, which is devoted to the description and analysis of monetary policy and the European financial system. Carlos Gómez Fernández, Miguel Fernández Acevedo and Blanca Navarro Pérez, from

¹⁴ There are countless academic comments on the subject. From the outset, this Yearbook has addressed the issue of how to complete the institutional framework of governance of the euro.



the research and strategy department of Spain's ICO, analyse the actions of the European Central Bank, and conclude that "monetary policy will never be what it used to be." This assertion is reinforced by insisting that we will never see high rates like the those of the past, and that the *Zero bound* – zero interest rates – has been crossed as a constraint on the effectiveness of monetary policy, thanks to the implementation of unorthodox and innovative measures. The authors reflect insightfully on how different the ECB is today, but I think they are perhaps too confident that "this time it really is different" and that the natural equilibrium interest rate has decreased forever.

Faced with the exceptional nature of the crisis, the monetary authorities improvised by expanding their tool-kit in two complementary directions: (i) by directly adjusting interest rates that affect the real economy, i.e., those applied to the private sector of the economy and by assuming direct credit risk; and (ii) by improving the functioning of the monetary policy transmission channel, even if they had to become market makers to achieve this. The first category includes "forward guidance" and programmes to buy government and private assets. Forward guidance is always determined by the credibility of the central bank, and will be tested now that the ECB starts a new rate cycle, under conditions of uncertainty about the true strength of the European economy. We shall see how effective it really is. Asset purchases have meant that the ECB ended the year with a portfolio of more than EUR 2.5 trillion in assets, equivalent to 23% of the nominal GDP of the euro area. They have succeeded in relaxing conditions for access to bank credit, in improving corporate credit markets and, in general, fixed income markets. But above all in making it cheaper to service government debt. However, one might ask whether this policy has not been kept up for too long, and whether it might lie at the root of the problem of excessive debt.

Among financial stability instruments, the following stand out: (i) full allotment in liquidity auctions; (ii) purchase of covered bonds, which began in 2009; (iii) long-term financing operations, first LTROs with a 36-month maturity in December 2011 and then in 2014, focused on additional credit, such as TLTRO; and finally (iv) the securities purchase programme known as SMP, "*Securities Market Programme*". Initiated in 2010, it was replaced in 2012 by the controversial *Outright Monetary Transactions*, subject to the macroeconomic conditionality of the ESM, which entailed the "sterilisation" of monetary injections until 2014, when an aggressive policy of enlarging the ECB's balance sheet was adopted.

This provided sufficient liquidity to avoid or replace the closure of some financial markets, but at the cost of the ECB becoming a market maker, and thus to generate a measure of dependence of the markets on the ECB's actions.¹⁵ This dependency will also be put to the test when it comes to deciding on the continuity of these programmes when they expire. The ECB has announced, and followed, a timetable to stop buying net assets, but has given no assurances about the renewal of TLTROs. In fact, this is one of

¹⁵ In a sense, we could talk about a *Draghi put* by analogy to the already famous *Greenspan put*, which followed the actions of the US Federal Reserve after the tech crisis in the 1990s.



the unknowns that weigh on European markets at the close of 2018 (Barclays Research 2018) and which the ECB did not clear up at its last meeting in December. Failure to continue this programme, albeit in a smaller and more demanding format, would increase the financing costs for some banks in a context of rising macro risk, while the entry into force of the regulatory liquidity ratios, LCR and NSFR, would lead other banks to reduce their balance sheets. For many analysts, from a point of view purely to do with financial stability, continuing the TLTROs is more important than asset purchases themselves.

The chapter highlights the positive effects of the ECB's extraordinary policies: (i) avoiding fragmentation of the euro area; (ii) contributing to 40% of real economic growth; and (iii) reducing inequality. Finally, there are some criticisms, "risks associated with such a long period of monetary accommodation", which by no means question the success of the strategy. They cite (i) the possible creation of bubbles through the search for positive returns, (ii) macroprudential risks, (iii) adverse effects on bank profits, and (iv) an increase in global debt.¹⁶

Chapter 6 describes the Spanish banking system from a European perspective. Joaquín Maudos, a tenured professor at the University of Valencia and the deputy director of the IVIE, offers us a wealth of statistics to conclude that these differences are a brake on stable progress. The banking union was born to overcome the well-known limitations of EMU, but the persistence of significant differences in borrower delinquency rates by country has slowed its implementation. These differences are also notable in other respects, such as profitability, efficiency, liquidity and solvency. They are partly the result of different macroeconomic developments, but also of divergent fiscal policies, different regulatory and supervisory treatments and the Union's own imperfections. Moving away from oversimplification in diagnosis is essential to avoid mistaken and populist conclusions.

The author begins by explaining the size and structure of European banking systems. From the weight of banking assets in GDP, to the density and capillarity of the network of bank branches with variations of 8 to 1; where Spain, in spite of the 40% reduction during these years of crisis, and some regrets about "unbanking", continues to be the country with the most branches per capita (1 for every 1,693). Such branch offices are also the smallest in Europe by number of employees. This chapter also provides figures on the fragmentation of the European banking market: 92% of bank credit is extended to residents of the country itself and only an additional 2% to other euro area countries. This is exacerbated by the fact that the European interbank market has practically disappeared, which, in my opinion, should be a matter of serious concern to the supervisory and regulatory authorities.

But where this chapter presents the greatest wealth of information is regarding the health of the financial system. I cannot summarise all of it here, but let me make a few

¹⁶ Readers interested in taking their own stock of the ECB's performance may find it useful to counter the highly positive view taken in this chapter with a slightly more critical review by José Ramón Díez (2017), and my own comments in that year's Executive Summary.



brief notes in order to encourage you to read it. Delinquency rates do not give the true picture of dispersion in the quality of bank balance sheets, with sharp differences that relate to the macro situation but also to significant differences in the use and rigour of internal models for estimating that macro environment. This should be supplemented by an analysis of foreclosed assets and losses that have already been recognised and provisioned. In terms of bank solvency, Spain is slightly below the euro area average, but it is the only one of the large European economies to have an efficient banking system. Efficiency is key in a market that is not growing, as befits a stage of deleveraging by companies and households, where margins will continue to be very narrow due to strong competition and monetary policy decisions. The profitability of European banking in general has improved, yet barely exceeds the cost of capital. The return on equity of US banking is practically double. These data are forgotten in the European political debate when regulatory, fiscal, prudential and conduct costs are charged to banks regardless of their real situation.¹⁷ Or when cross-border consolidation of the sector is encouraged, in disregard of the fact that there needs to be profitability to attract capital. There is no point in insisting on an increase in solvency if banking is unprofitable.

Finally, Professor Maudos analyses the exposure of European banks to sovereign debt, probably the most controversial issue in the current debate on the banking union, which is behind the lack of any real progress in European deposit insurance. The data are very clear, but the interpretations differ widely.¹⁸ There are two distinct groups of countries, which are defined almost exactly by the problems of access to the capital market during the crisis and with the mandatory role of sole provider of liquidity being played by the national treasuries, at the prompting of the ECB.

The author concludes by accepting the relationship between delinquency rates and deposit insurance that other authors and I have questioned in this Yearbook and even in this Summary. He states that, although now is not the best time, “as we move away from the end of QE, we should take steps to avoid excessive concentration of sovereign debt in bank balance sheets, with capital consumption being different according to the risk of each country and/or with limits on the weight of government debt as a proportion of bank assets.” This is a position that, as the author himself knows, I do not share. EMU is the only advanced and significant monetary jurisdiction without a secure asset for the area itself, making national sovereign bonds the secure assets of banks. All the more so in a banking system that is fragmented by national borders, like the one at issue. Only

¹⁷ It is striking that the banking solvency of the large European economies is below the EU average, with the exception of Germany, where, on the other hand, the problems of its leading bank are well known. To illustrate this apparent paradox, it is enough to see here how the solvency ranking changes if instead of measuring capital on risk-weighted assets, RWAs, we do so on total assets, thus cancelling out the impact of “*regulatory forbearance*” in some countries. This circumstance is well known to the ECB and led the SSM to consider a specific review of internal risk models as a strategic priority of its supervisory programme for 2018 and subsequent years.

¹⁸ This reinforces my idea that there are no data without a theory to explain them, but only chaos and unintelligible information.



with Eurobonds will the problem disappear. Or, by granting an exorbitant privilege to the German saver and making the *bund* the secure and dominant asset in the portfolios of euro area banks. We must not confuse the symptom with the problem, as some deliberately and dishonestly did with the imbalances in Target 2.

The seventh chapter takes us into the future, to analyse digital currencies issued by central banks (CBDC, Central Bank Digital Currencies) and even the possible end of the monopoly on currency issuance. Santiago Fernández de Lis and Olga Gouveia from BBVA Research dedicate their contributions to this exciting and speculative subject. They begin by noting that, despite their growing popularity, virtual currencies and their enabling technology, distributed ledger technologies (DLTs), are in their infancy, because they have yet to solve a central problem, namely scalability. This is why RTGS (Real Time Gross Settlement) systems, such as Target, are still more efficient today, and central banks have no interest in distributed ledgers beyond experimentation and monitoring of the future process.

Cash is a very special asset that combines four characteristics: it allows direct exchange without knowledge of the issuer (P2P in current terminology); it is universally accessible, anonymous, and bears no interest. But CBDCs are an alternative to cash that can be universal or restricted to a particular group of users, can allow anonymous transactions or transactions by prior identification only, and can bear interest or not. A highly illustrative summary table lists the possible varieties of CBDC depending on how these last three characteristics are combined.

Such combinations depend on the purposes pursued. First, (i) if it is a question of improving the functioning of payment systems such as Target, we would want restricted, identified and non-interest-bearing CBDCs, and the central bank would retain access control. Secondly, (ii) if we want to replace cash, CBDCs will have to be universal, anonymous and non-interest-bearing; their key advantage will be in the lower logistical costs. Third, (iii) if the objective is to overcome the restrictions of the “Zero bound”, CBDCs will be universal and anonymous, but will pay or earn interest. If, fourth (iv), it is a matter of reducing or eliminating banking crises in a fiduciary and fractional system, CBDCs would have to be universal, identified and non-interest-bearing. In the most radical, interventionist, and most illiberal version of a CBDC, every citizen would hold a current account earning no interest at the central bank, where he or she would deposit his or her idle wealth, and credit provision would be segregated from the payment system.

The authors devote much of the chapter to explaining clearly and simply the advantages and disadvantages of the various CBDC alternatives. For the first option (i), it would be a question of comparing efficiency, speed and competitiveness with the security and control of the payment system offered today by a central bank, which would undoubtedly lose its monopoly. This is a path that crucially depends on scalability and consumer protection. In the second case, option (ii), central banks would only replace cash with digital money if private currencies threaten their *seigniorage* income. But the problem is anonymity and the concomitant ease of tax evasion, money laundering and even terrorist financing. It is therefore ethically and politically more complex than it is technically and economically.



It was an economist as orthodox as Rogoff who in 2016 proposed introducing digital currencies as a monetary policy instrument to extend the dominance of negative interest rates (option iii). The solution seems simple, but it would lead us into a territory of increasing financial repression, perhaps as a permanent substitute for inflation. This move would force us to completely replace cash, to avoid the emergence of an arbitrage process, and to introduce capital controls to prevent the accumulation of monetary balances in foreign currencies (of a country whose monetary issue is not digitised). But, in addition, the financial instability associated with exchange rate volatility would multiply, if we are to judge by the experience of existing virtual private currencies. Especially if they compete with virtual currencies issued by central banks. To avoid “collateral damage” of that sort, central banks should be given such overbearing power that one would be forced to question their legitimacy and, above all, their independence (Tucker 2018).

But without a doubt it is option (iv) that poses a true structural revolution of the monetary and banking system. Current technology “offers us the possibility of segregating the generation of deposits from the provision of credit.” In its extreme version, it carries a certain risk of nationalisation of credit, because if the liabilities side of central banks’ balance sheets encompassed all the deposits of individuals, would their traditional assets, international reserves and public borrowing ever be enough? (IMF 2018a). The answer is obviously that either funding to governments grows exponentially, or new central banks must directly finance the private sector of the economy in unimaginable volume, modalities and timeframes. It would be a paradox if a technological development designed to free the individual from the slavery of physical money and its dependence on a centralised public ledger ended up making the financial system hostage to the central bank. Which would obviously become the most powerful institution on the planet. It would likewise be a travesty if, in the obsessive quest to put an end to banking crises, we were to replace them with more frequent and uncontrollable crises of the entire financial system, or with their complete nationalisation.

Chapter 8 is an extension of the previous paper. Eduardo García González, a partner at Clifford Chance, discusses the economic and, above all, legal challenges and opportunities of distributed ledger technologies for the European financial system. The article starts by framing the phenomenon of “fintech”, an irreversible process breaking into a sector that was not ready for such far-reaching innovation. There are two major legal difficulties involved: the supranational scope and the heterogeneity of the phenomenon. The absence of a harmonised international regulatory framework carries the risk of regulatory arbitrage. For this reason and after much dithering, on 11 October 2018 the International Monetary Fund and the World Bank published what is known as the “Bali Fintech Agenda”, a guide with 12 recommendations on legislative policy that we can summarise here as three key points: invest in infrastructure, adapt regulatory frameworks and supervisory practices and promote international cooperation.

In February 2017 the European Commission had already set up its Taskforce on Financial Technology to move forward in three key areas: financial regulation, data technology and competition law. In March 2018, the Taskforce published an Action Plan on Fintech proposing 23 specific initiatives. One such initiative is the recommendation



on “sandboxes”.¹⁹ In addition, the Commission has approved a proposal for a Regulation that creates a European passporting scheme for participatory financing platforms, known as crowdfunding, and protects investors in terms of advertising, governance and risk management. The Commission plans to exclude such platforms from the scope of MiFID2.

Regulatory scenarios are diverse, depending on the fintech product or service in question. It would therefore be desirable for common principles to apply to any legislative adaptation addressing fintech. Such principles should be based on flexibility and proportionality, detailed technological knowledge and pragmatism. In the same vein, in September 2018 the Association for Financial Markets in Europe, in partnership with PwC, published a report titled *Technology and Innovation in European Capital Markets*, setting out four conclusions: (i) technology is one of the most powerful levers banks have to face industry challenges; (ii) there are four technologies with huge transformative potential: data analysis, cloud computing, artificial intelligence and distributed ledgers; (iii) banks must give priority to operational agility, innovation and customer relations; and (iv) the risks of cyberattacks will be decisive in future and will require specific attention.

Lastly, the chapter provides an overview of the position of the European authorities with regard to DLTs. There are some basic questions that do not yet have binding legal answers: are they crypto coins, money, a token or a negotiable security?²⁰ What is their tax treatment? Are “smart contracts”²¹ binding? Europe also faces a specific challenge: reconciling EU Regulation 2016/679, on the protection and processing of personal data, with the free circulation of personal data, which is necessary for the development of DLTs. There are three points of friction: the “right to be forgotten”, difficulties in identifying the data controller, and the international transfer of data when the receiving country does not offer the same protection.

This second part ends with chapter 9, by Francisco Uría, the partner in charge of the financial sector at KPMG, which discusses the impact of Brexit on the European banking system. The consequences of the United Kingdom’s exit from the European Union have already been dealt with extensively in previous editions of this Yearbook. Here we focus exclusively on the effects on the banking and financial system. The final agreement on the terms of withdrawal and the future relationship – if it indeed comes together and chaos is averted – cannot be very different from the agreement now pending ratification in Westminster, especially in its financial respects. I agree with the author that the option

¹⁹ In this context, a “sandbox” is simply a self-contained regulatory space allowing for controlled experiments for the benefit of innovative development and consumer protection.

²⁰ It may seem like a minor issue, but the regulatory response is very different in the United States, where the SEC has considered cryptocurrencies to be negotiable securities for all intents and purposes. This has toughened the rules and considerably decreased the frequency and amount of ICOs (Initial Coin Offers), whereas in Japan or the United Kingdom the rules treat cryptocurrencies as tokens.

²¹ Contracts based on computer code stored in a *blockchain* that are carried out autonomously when triggered by certain events.



of the United Kingdom remaining in the Union after 29 March 2019 is out of the question. Likewise, since the United Kingdom has expressly rejected the application of one of the four fundamental freedoms, namely the freedom of movement of persons, the option of remaining in the European Economic Area, like Norway, is not feasible either.

The Union does not want to set a precedent and has made it clear that there will be no “cherry picking”. The United Kingdom would therefore have the formal status of a “third country”, and exclusively that status, without access to the Customs Union or the Internal Market. With regard to financial services, this would mean that the UK would be subject to the equivalence regime, which would basically oblige it to preserve the similarity of its regulatory regime, and financial institutions domiciled there would lose the benefit of the European passport. This right consists of the ability to offer financial services from any Member State with the authorisation of the country of origin only, without any formalities or authorisation in the receiving country. The passporting scheme largely explains the concentration of so many markets and financial activities in the City of London. Third country status would materialise, if there is an exit agreement, on 1 January 2021, after the end of the planned implementation regime.²² Until then, the current legal situation would remain in place. This does not, of course, prevent financial institutions from looking forward to its entry into force and advancing their strategic decisions.

The equivalence regime is “a fragmented regime with very limited effect”, which is applied individually for each applicant entity, and which does not release it from having to secure an administrative authorisation subject to the fulfilment of stringent requirements in the country of destination.²³ There should be no difficulties other than the administrative burden to achieve this scheme from the outset. But obviously its maintenance requires close coordination of the regulatory agenda for the financial sector in the United Kingdom and the European Union. Such coordination will be problematic insofar as the United Kingdom is not present in the debate, cannot influence that debate, and will naturally be exposed to separatist nationalist pressures. For their part, European Union entities that were part of British financial groups, as entities of the European Union, would enjoy the rights granted to them by European law, and specifically the right to a “passport”. European entities operating on British soil would not be able to benefit from the passport there, but the British FCA, the supervisory authority, has put in place a facilitating procedure to maintain business continuity.

This chapter specifically addresses securities clearing and settlement, given its significance. Today, almost 90% of euro-denominated derivative transactions are settled at UK-based clearing houses. This had been a concern for the European supervisory authorities, which had put forward legislative proposals to compel such transactions to be concluded in euro area jurisdictions. All indications are that an agreement ensuring continuity of business on British platforms after Brexit is possible, thanks to ESMA

²² In the last-minute negotiations surrounding the withdrawal agreement, the possibility has arisen of extending the transitional period by a further year. But there’s nothing set in stone.

²³ It is interesting to note that Britain’s claim to a more advantageous system than equivalence, known as “mutual recognition”, has been flatly rejected in the Brexit negotiations.



having been granted real access to this infrastructure²⁴ on British soil. But there is no “done deal”, and, in the face of uncertainty, Euroclear has already decided to move its operations to Union territory.

The first decision to be made by financial institutions in the UK must be either to retain their current domicile or move to Union territory. This requires authorisation at the venue of destination. Especially since the ECB has been strict about demanding a real move and not just a cosmetic one. There is also the option of setting up a new entity in a country of the Union and obtaining a passport from there. Or to carry on financial business from an existing branch in a Member State under the equivalence regime referred to above. This may be an effective strategy to buy time, but it does not seem sustainable in the long term without a reciprocity agreement or eventual adherence of the United Kingdom to the European Economic Area. Finally, all contracts containing clauses under English law will have to be modified, since English law will necessarily cease to be consistent with that of the Union. This is a source of legal uncertainty and, very possibly, litigiousness. In principle, nothing stops the contracting parties from agreeing to the application of the law of a third country, non-EU law, even if both signatories share European commercial law. But it would be most odd. Again, there may be a temporary solution, but that would not be sustainable without legal developments in parallel. Why would English commercial law be “superior” indefinitely?

5. COMPLETING MONETARY UNION: THE STATE OF THE ETERNAL QUESTION

Chapter 10 marks the beginning of the third and final part of the Yearbook. This is the most technical part, with a tight focus on outstanding issues for the completion of economic and monetary union. An unfinished and endless subject: partly by its very nature, integration will always be an ongoing process, and partly because there is no political will to move forward on issues that have been adequately diagnosed, but which have important redistributive consequences and involve a considerable surrender of sovereignty to a Europe without a personality of its own.

Fernando Restoy, the chairman of the Financial Stability Institute, analyses the achievements and outstanding challenges of the banking union. The banking union is a vital complement to monetary union that should result in a more stable and solvent financial system, more efficient and competitive institutions, and better and cheaper banking services for citizens. As we have already seen, an integrated banking market is the basis for an effective private risk mutualisation mechanism, and would help to unlink domestic economic and fiscal developments from financial stability (Draghi 2018). We can therefore judge the success of the banking union based on two criteria: facilitating an integrated banking system in the euro area; and decoupling an institution’s risk profile from the sovereign risk of the country in which it is registered. If we look at these

²⁴ Mainly LCH, ICE, Clear Europe and the London Metal Exchange.



points in isolation, despite the strong progress made elsewhere we are a long way from being able to describe the banking union as a success.

This chapter begins by recalling what has been achieved in the domain of supervision: (i) the launch in record time of the European supervisory authority, the SSM; (ii) this authority has managed to raise the volume and quality of capital and liquidity of European banking to comfortable levels; (iii) the crystallisation of a common supervisory culture with an emphasis on governance that touches on asset quality rating and validation of internal models. Special mention should be given to the supervisory strategy to reduce non-performing loans (NPLs), which has already reduced the volume of European banking NPLs by a third. Yet the delinquency rate is still around 10% in five jurisdictions and above 25% in two Member States. The ECB's strategy includes targeted enhanced supervision and the discretionary possibility of additional capital surcharges by application of Basel Pillar 2. This strategy is complemented by a controversial proposal from the Commission authorising the ECB to impose "prudential backstops" in case of insufficient provisions according to predefined parameters.

But the main structural weakness of European banking is its low profitability. After listing the possible causes, the author finally points to overcapacity in the European banking industry. He further argues that "in specific situations ... with a large number of very small, inefficient and unprofitable banks, [the structure of the industry] ends up adversely affecting financial stability ... which would be the basis for swift and decisive action by the supervisor." This constitutes a whole programme of regulatory activism bordering on interventionism for the ECB,²⁵ which I am not sure the competition authorities share. Moreover, I fear it would not alleviate the ECB's credibility issues.

The progress achieved in resolution is also quite clear, but, as we have seen, not without flaws: (i) the ECB's collateral and counterparty policies do not ensure funding in the course of resolution; (ii) the current SRF does not provide the necessary funding to preserve the critical functions of a bank in the midst of resolution; (iii) there are unresolved disputes over the scope, depth and detail of the resolution plans; and (iv) the concrete determination of the volume and composition of the MREL, the instruments capable of becoming capital in the event of a resolution, which will be binding from 2020 on non-global systemically important banks, is proving very complex, given the diversity of the balance sheets of these banks, and may end up radically transforming the structure of the industry.

The paper then provides a highly suggestive analysis of the integration of the European banking system. It begins by noting that, against all odds, the creation of the SSM and the SRM has had no impact on the number of cross-border mergers and acquisitions. This is because there are still major regulatory impediments: (i) the absence of a genuine *Single Rule Book*, because most European banking legislation is not in the form of

²⁵ I know of no precedent for such an action by any supervisor. In cases where this has been tried, let us remember Spain in the early 1990s: the resulting bank mergers did not coincide at all with those the minister and central bank governor had in mind at the time, nor with those advised by the experts – the famous "Revel report".



Regulations, but of Directives, which require national implementation and adaptation; (ii) the non-recognition of the euro area as a single jurisdiction for the purposes of G-SIBs and the failure to consider geographical diversification as a risk-mitigating factor; and (iii) the regulatory treatment of pan-European banks, which favours expansion via branches rather than through the creation or acquisition of local franchises, which have to meet both local and consolidated capital and liquidity requirements. This is due to the absence of Europe-wide deposit insurance, which compels the local supervisor to protect its depositors and taxpayers.

But the author adds that there are even more fundamental reasons: the excess of installed capacity; the presence of a large number of banks that are immune to competitive pressures;²⁶ and uncertainty about the effects of digital disruption on the profitability of the banking industry. A highly suggestive list to which, in my view, we could add the European policies of penalising banks, in purported compensation for the costs of the financial crisis, thus making them less attractive to investors. Under these conditions it is unrealistic to expect swift consolidation of European banking.

Finally, this chapter states that the nexus of sovereign and banking risk in the euro area crisis did not come from bank assets, i.e., their sovereign debt holdings, but from macroeconomic uncertainty and doubts about the ability of weak treasuries to support and protect bank liabilities. The author points to three outstanding issues in this respect. The first is to complete the banking union in the two known aspects, the European deposit insurance scheme and the “fiscal backstop” for the resolution fund. The second focuses on the practical application of the resolution rules, in the awareness that MREL requirements are particularly hard in EMU because it has been decided to establish bail-in requirements at 8% of the assets. This is not required in any other jurisdiction.²⁷ Finally, the need for a European bank insolvency regime to complement the resolution regime. An insolvency regime that, in line with international best practice, is a common administrative scheme whose central authority would be the European Resolution Fund and which could also use for banks in liquidation some of the tools provided only for resolution. Such a fund would require a change in the Treaties.

Chapter 11 deals specifically with the European risk reduction strategy. José Ramón Díez, the head of Bankia’s research desk, provides figures for the significant progress achieved in solvency, efficiency and, above all, in reducing delinquent assets. He starts by

²⁶ Tellingly, only 30% of European banks are listed, compared to 80% in the United States. And they only account for 50% of total bank assets. The reason being a proliferation of savings banks, local public banks or protected credit cooperatives, because their ownership and capital structure immunises them and exempts them from complying with requirements for bail-in-eligible capital and assets.

²⁷ These requirements do not create problems for large banks, which are already replacing senior unsecured debt with subordinated instruments. Neither are they a difficulty for small banks, which will be excluded. Because they are not systemic they will normally go into liquidation. It is medium-sized banks, however, that may find it hard to comply with this requirement and may end up in a forced merger. Another paradox of the European system, which may finally wipe out medium-sized private commercial banks that happen to be listed corporations.



quantifying the brutally far-reaching bank transformation. Specifically, in Spain, of the 53 entities operating in 2008, only 13 remain today. The market share of the five leading banks has exceeded 70%, when it was 42% in 2008. The number of employees has decreased by 30%, and the number of bank branches by 40%. The capacity of the Spanish banking system has dropped to the levels of the early 1980s. Non-performing loans fell by 65% to 4.2% on a consolidated basis, which is still in line with the European average. In addition, repossessions decreased by 20% and refinancing by 56%. In total, Spanish banks have cleaned up their balance sheet to an extent equalling 20% of Spanish GDP in 2018. As a result, impairment losses on assets as a percentage of average total assets fell to 0.44%, from a maximum of 3.5%. And they achieved this while the total volume of credit has fallen by 36% since the peak of 2008. This unprecedented recovery justifies the term “brutal” used at the beginning of this paragraph. Thanks to this restructuring, to Spain’s strong economic performance after the adjustment in 2012-14 and to advances in the banking union, the differential in the cost of financing for Spanish SMEs has been reversed. Whereas in 2013 a Spanish SME would pay interest at 5.39% on a loan of less than one million euros, i.e., 2.4 points more than in Germany, in September of this year 2018, the rate was 2%, below the rate typically paid by a German SME.

But there are still key weaknesses to be addressed: reducing the volume of bad debt (EUR 700 billion);²⁸ decoupling sovereign and banking risk, inter alia by reducing the weight of sovereign debt on balance sheets (135% of Tier 1 capital in the median of the European banking EBA sample); completing the banking union and creating some kind of risk-free secure asset for the euro area. This diagnosis coincides with all those reached elsewhere in this Yearbook.

To a certain extent, the immense effort to restructure Spanish banks and the spectacular reduction in the volume of delinquent assets on their balance sheets has served to guide and shape the European strategy to reduce NPLs. This strategy consists of four main elements: (i) enhanced supervision, which translates into action guides published by the ECB, the application of which will be taken into account in the SREP when setting the individual capital requirements for Pillar 2; (ii) a draft Directive presented by the Commission (COM 2018) to facilitate the recovery of bank debt, which would introduce a common European model for accelerated extrajudicial enforcement of security interests; (iii) measures to encourage the use of companies specialising in the management and recovery of impaired assets, removing obstacles to their disposal by banks, and common rules simplifying the licensing of such companies; and (iv) a guide to best practice in the use of so-called “bad banks” in the style of the Spanish Sareb, including issues such as eligible assets, scope of participation, asset valuation rules, capital structure, financing, governance, etc.

²⁸ Although the stock of delinquent assets has been reduced by 30% in European banking since 2014, it still accounted for 3.6% of total EMU lending in June. Half that total was in Italy. The cost of risk accounts for 67% of the aggregate capital losses of European banks in the 2018 EBA stress test.



Finally, this chapter attempts to shed some light on the complex and biased debate on exposure to sovereign debt. A debate that is closely linked to the need for a risk-free European asset that will become the benchmark for the valuation and pricing of assets in EMU. And the paper starts by recalling some obvious points: (i) banks' fixed income portfolios are intended as a structural hedge of commercial balance sheet risk and their ideal theoretical size is estimated at around 15% of total assets; (ii) they have been a balancing mechanism for bank profits during the crisis, both through generation of capital gains in a scenario of falling interest rates and through contribution to the margin; (iii) their greater volume at banks of countries undergoing crisis is due to the fact that banks were used to solving the financing difficulties of some treasuries (as the ECB is well aware, in that it used this mechanism for LTROs); and (iv) the domestic bias, which ranges from 60% to 90% in EMU, plays a stabilising role for government debt markets at times of idiosyncratic stress or mere financial contagion.

Reducing their size is a good idea, but the central question is how, and at what pace? Forcing this reduction as a quid pro quo to move forward with the mutualisation of risks only contributes to increasing instability, perpetuating the perverse risk-coupling and making future bailouts more likely. Forcing it through changes in regulatory treatment that penalise the holding of sovereign bonds by way of capital, provisions or "concentration charges" implies accepting the probability of sovereign default in the euro area, would single out the euro area and would previously require an active policy of bail-outs or an orderly sovereign debt restructuring scheme in the euro area. Forcing it without a safe substitute asset is nonsense.

The Yearbook closes with a chapter on fiscal union from a political perspective. As in all previous editions, the aim has been to provide the views of experts in political science, because European monetary union cannot be understood except as a constituent element of a political process of European integration. In chapter 12, Miguel Otero and Federico Steinberg, who are researchers at Real Instituto Elcano, make critical remarks on the fact that the fiscal union has been structured as a technical debate among economists, as a discussion on how to create a macro stabilisation facility while making fiscal rules more effective. For the authors this approach is a mistake, because "a monetary union has enormous political, social and even cultural implications ... and entails redistributive elements of a political nature."

They explain the current problems of the euro as the outcome of two opposing visions of money that were already present in the founding Treaty. While Germany saw monetary union as the culmination of a long process of economic but also political convergence based on the export of its model of price stability, for the French the key point was to constrict the expansion of German economic power. But European analysts, investors and politicians discovered that money was a power relationship when, in the midst of the crisis, they found that the ECB was only the lender of last resort for banks and not for the sovereign, while the Federal Reserve was the lender of last resort for both. And "QE is



nothing more than directly financing the government's public expenditure".²⁹ Given the fiscal nature of the monetary and banking union, a fiscal union with a federal budget is needed, which makes it necessary to enter into the debate on the transfer union and on how it is financed, and hence into the debate on European solidarity. The trouble is that the creation of a European fiscal sovereign requires a political union, and it does not seem likely today.

Having explained their conception of the nature of monetary union, Otero and Steinberg present their ambitious vision of the Final State of fiscal union, although they are fully aware that there is no consensus to achieve it. They propose the creation of a Central Legitimate Fiscal Authority headed by a strong political figure, who would be the Euro Commissioner and would have the power to set the Union's fiscal position, compel Member States to comply with the fiscal rules and decide which countries could access common funds. A genuine Euro Minister of Economy and Finance, proposed by the Eurogroup, but legitimised by ratification in the European Parliament. The funds for this European fiscal policy would come from the issuance of European debt, which would be common and joint and several as among the issuers, and newly created European taxes, such as environmental taxes or levies on financial transactions. Such funds would ensure a certain level of government investment in all countries, a common unemployment fund, and the financing of European integration projects. The tax authority would also assume the functions, powers and staff of the ESM, thus becoming the only agency executing bailout programmes. In short, this chapter presents a maximalist design of a fiscal Union that seems to be inspired more by the traditional ideas of a historically interventionist Keynesian than by the current and foreseeable European political reality. I ask the reader and the authors to allow me one final comment: I am not sure that these maximalist visions are useful, or that they drive forward the European agenda, that they serve to make monetary union more stable and sustainable. They might even serve only to bring too many ghosts from the past into the debate.

6. THE TEN EUROPEAN LESSONS OF THE YEAR

Last year, driven forward by an optimism (that has proved ill-judged) about what we thought to be the year of the refounding of Monetary Union, we ended the Yearbook with a list of the ten most important and urgent reforms. In this year of disenchantment, in an unfortunately more Eurosceptic mood, we return to the traditional format of the "decologue" of European lessons. Because we must learn from events as they happen.

First, only political will can move Europe forward. The Union has become more com-

²⁹ A verbatim expression that, I must admit, worries me seriously, because when read in Germany it will tend to seriously obstruct completion of monetary union. The claim is that the ECB was created to achieve something that the German Constitution has been designed to prevent since the time of the Weimar Republic. And, by the way, that approach has allowed Germany to perform extremely well both economically and socially.



plex and the political balancing acts more varied and unstable. Franco-German agreement is no longer sufficient, albeit essential. The European Parliament has gained institutional presence and cannot be ignored. The Commission has regained prominence and has put all the relevant reforms on the table. The European elections will usher in a new Commission and a new Parliament. As an independent development, the President of the European Central Bank will be replaced. Strong European leaders with personality and a future would be desirable, because the necessary changes require a new Treaty. It is no longer enough to choose great personalities from the glorious past, illustrious citizens from small countries. The construction of Europe requires far more. The threat of nationalism will not go away on its own.

Secondly, the European Union must look outward and simultaneously resolve the challenges of completing the banking union to ensure its stability and sustainability, and of tackling globalisation and digital transformation. The emergence of China and its confusion among private, public and State interests, the new American mercantilism, the digitisation of the economy with its “winner takes all” dynamic, are creating a new international economic order where existing rules are disregarded and multilateral institutions are in retreat. European size and ambition and the intelligent and active defence of its own interests call for a new, more active, persistent and systematic European strategy. Europe must firmly establish itself as a new global player and increase its international presence.

Thirdly, Europe has started a new monetary cycle without much room for manoeuvre, because the ECB has prolonged its ultra-expansionary policies beyond reason. The ECB should learn its lesson and rethink a decision-making system and excessive presidentialism that lead to inaction, and make it hard to conduct monetary policy with the agility to be effective as a counter-cyclical instrument. It would help if there were an adequate framework for defining and implementing a fiscal policy in the euro area, and if the banking union were complete, but their absence cannot be an excuse for inaction. In the short term, the ECB will continue to be the institutional apex of the euro area’s economic policy, and this will continue to create problems of credibility and acceptance. But it cannot lead to paralysis. The ECB will have to continue experimenting with digital innovation, but it will not get rid of the zero-bound restriction, or of the contradictions between monetary policy and financial stability. These will be tougher to manage in an environment of tightening liquidity, economic slowdown and potential interest rate hikes.

Fourth, it is necessary to continue the process of reducing banking risks in order to restore the profitability of financial institutions, and, with it, their contribution to the growth of credit, and economic activity and employment. This is the main *raison d’être* of the European NPL reduction strategy. Avoiding transfers between countries and easing the political acceptance of mutualisation of risks is only a secondary consideration, as any sustainable monetary union requires that money and credit flow from savings areas to those with profitable investment opportunities. To deny this principle is to deny monetary union. In order to be effective and credible, the European strategy for reducing banking risks must lend prominence to institutions specialising in the management and



liquidation of distressed assets, “bad banks” or national asset management agencies. It will also eventually force a rethink of the European Banking Recovery and Resolution Directive (BRRD) and, in particular, the idea and amount of the prior bail-in and the rule of not using taxpayers’ money. These are principles that no other major monetary jurisdiction expressly contemplates.

Fifth, there has been great progress in completing the banking union, but after the disappointing December Summit, there are still key issues to be resolved. The delay only casts doubt on the will for EMU to endure. It generates instability, increases the volume of necessary transfers and makes financial bailouts more frequent and costly. The most urgent reform is approval of a final and irreversible timetable for the implementation of a European deposit insurance scheme that will decouple banking risk from sovereign risk and enable comprehensive European liquidity management. As a matter of urgency, that point is closely followed by the need to address the problems highlighted by the first European banking resolution exercise. Mainly, what is known as “funding in resolution”, which involves giving the SRF the power to borrow the necessary amount, on its own behalf or by delegation. The planned solution of doing so through the ESM, a multinational institution outside the EU Treaties and requiring unanimity of its members, adds institutional complexity, complicates decision-making processes and unnecessarily politicises bank resolution.

Sixth, coordinating bank resolution and insolvency proceedings is a little-known but necessary task. In the euro area today, bank resolution is subject to European rules, while insolvency and liquidation follow national rules and therefore very different criteria and practices. This situation creates confusion and unequal treatment, which makes it very difficult to achieve horizontal fairness and the application of the principle that no creditor is worse off in a resolution with respect to the cost of liquidation. It is a source of litigiousness whose resolution requires the introduction of a European bank insolvency regime. This would be an administrative system whose central authority would be the European Resolution Fund, with all the standard tools at its disposal. A common bank insolvency regime would greatly facilitate the mobility of capital in the euro area and the denationalisation of savings.

Seventh, European experience shows there is a need for a risk mutualisation mechanism operating through private capital markets, to promote cross-border capital ownership and to remove domestic bias in the portfolios of institutional investors. A private and automatic stability channel to neutralise asymmetric shocks without the involvement of government authorities. The channel will be all the more effective the more pan-European banks are in existence. Rigorously analysing regulatory obstacles and proposing measures to overcome them is a necessary task, and it is not enough to argue that there are cyclical and more structural reasons why there have been no intra-European mergers. It would be a tragic paradox if monetary union were to fail because the European banking system is shielded from market transparency, competition and discipline.

Eighth, progress in the mutualisation of risks also requires strengthening the fiscal channel. Monetary union is not a transfer union, but it cannot function without a fiscal stability channel. In order to build it, it is first necessary to strengthen fiscal governance,



incorporate the “Fiscal Compact” to the *acquis communautaire* and modify the Stability and Growth Pact. It should be streamlined to make it more effective and automatic and to enhance efficiency and compliance safeguards. The fiscal rules of a monetary area must be simple, transparent and easily replicable by all stakeholders, including civil society in the various countries. A simple expenditure rule, similar to the current Spanish rule, could well be the scaffolding of the system. Only once clear rules are in place, and are implemented, will it be possible to foster the mutual trust that will enable a euro area budget to be assigned that is more than just a symbolic reallocation of existing funds. The Euro finance ministry would come later, to administer that budget and ensure compliance with the fiscal rules. That would be the logical and, I believe, politically viable sequence. The rest is rhetoric and posturing.

Ninth, in this Euro budget, we would have to accommodate an investment fund and, perhaps, European unemployment insurance. But first, a European macro-stability facility should be provided, in coordination with existing bailout mechanisms. It is not a good idea for the stabilisation capacity to be structured around the ESM because it is a non-EU institution and subject to intergovernmental agreements. A stabilisation capability is an inalienable power of the modern Public Treasury, a constituent part of the budget, and must be administered by the political authority, not by an ad hoc technical institution. If some think that the Commission does not have sufficient political legitimacy, then let us grant it legitimacy. But let us not try to hide under the garb of a technical body what is essentially a political decision in a democracy. Neither should we even think about new taxes before having the basic elements of a budget for stabilising the euro supported by current resources. If this is already going to demand a wealth of political capital, let us not make it impossible by taking advantage of it to increase the tax burden in Europe, which has nothing to do with the problem of the sustainability of the euro.

Tenth, reducing exposure to sovereign debt requires progress in creating a safe and risk-free asset for the euro area. It is not by accident, ignorance or political interference that bank portfolios are filled with sovereigns. In direct proportion, by country, to the financing difficulties experienced by their banks and sovereigns. Let’s not mistake the symptom for the disease. The problem is not the bank portfolios of sovereign debt, but the absence of a secure asset in the euro area that serves as an anchor for the system and that allows the valuation and repricing of assets, the implementation of monetary policy without quasi-fiscal consequences, or the valuation of a financial entity regardless of where it is registered. This year we have learned that financial engineering to create a safe synthetic asset is doomed to failure, as we had argued in the previous Yearbook. We have yet to learn that monetary union needs Eurobonds. Then, and only then, will we have to consider an orderly restructuring mechanism for sovereign debt, or a general bailout of sovereign debt according to the Hamiltonian model followed in the United States at the time.



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PART I
EUROPE'S EXISTENTIAL DEBATE



1. MONETARY UNION: THE RISKS OF A WORK IN PROGRESS

PABLO HERNÁNDEZ DE COS¹

1.1. THE CONSTRUCTION OF THE EURO FROM A COMPARATIVE PERSPECTIVE

The institutional architecture underpinning the single European currency has undergone a thorough overhaul since the “Great Recession” hit Europe and especially since the onset of the sovereign debt crisis within the euro area. This institutional review has been driven by the belief that the recent sovereign debt crisis in the euro area was the result of a set of factors, including shortcomings in the original design of Eurozone governance: in particular, weak implementation of the Stability and Growth Pact (SGP), the absence of economic policy coordination and crisis management mechanisms, and the asymmetry between a single Europe-wide monetary policy while banking supervision remained at the national scale. All these weaknesses were addressed during the crisis, to a greater or lesser extent, with the reform of the SGP (via the “Six Pack”) and its extensions – the Fiscal Pact and the “Two Pack” – the creation of the excessive imbalance procedure, the European Stability Mechanism (ESM) and the Banking Union (Single Supervisory Mechanism and Single Resolution Mechanism).

Although these changes should result in Monetary Union working more effectively in future, there is still a perception that the institutional design of the euro remains unfinished and, indeed, this issue has remained a recurrent element of debate and numerous

¹ The proposals put forward in this article reflect the general views of the author and not necessarily those of the Eurosystem.

The paper is based on information available at 1 December 2018.



proposals have been drawn up to complete it,² both in European institutions and in academic circles.

The truth is that this shortcoming has been known since the very conception of the euro, as Romano Prodi pointed out in 2001.³ Somehow, it was assumed that the missing pieces to ensure optimal functioning would be added at a later date. This gradualism has, in fact, gone hand in hand with the European integration process. Jean Monnet said: “I always believed Europe would be formed from one crisis to the next, and that it would arise from the sum of the solutions that we would give to these crises”.⁴ This is not even a central element in judging its foreseeable future, because, in a sense, the task of completing the design of the single currency will always be unfinished. This is a trait that the euro shares with virtually all the phenomena of monetary integration seen in recent centuries. The vital issue for the future of the single currency is that we become aware that the nature of some of the missing pieces may pose an existential risk. Together, we need to foster sufficient political consensus to effectively face the changes that will make it possible to find the missing parts, so that we can create a closer monetary union with greater capacity to deal with the storms that will certainly come upon us.

A comparison of the current institutional situation of the euro area with that of the United States and the dollar after the banking crisis of 1907 suggests a range of conclusions [see Kierkegaard and Posen (2018)]. The key point from a European perspective is to observe that an adequate but incomplete reaction to the challenges of the 1907 crisis in the United States left open the cracks through which the American economy fell years later in the Great Depression, with its profound economic, social and political consequences. This is the mistake that the European Union must not repeat now.

Following the classic account by Friedman and Schwartz (1963), the US authorities correctly identified the fundamental deficiencies of the institutional architecture after the 1907 panic, in particular the absence of an effective lender of last resort for the dollar. So the authorities decided to address this deficiency by creating the Federal Reserve system in 1913. However, owing to pressure from the financial industry and the political economy, the decision was not taken to its ultimate consequences and, in disregard of the risks of contagion, membership of and access to the Federal Reserve’s loan facilities were left as a voluntary decision in the discretion of each bank. This gave rise to a dual banking system, which was precisely the initial breaking point whereby, in 1929, what began as a crash in the stock market became a crisis of confidence and later outright panic in banks without access to Federal Reserve liquidity as the weakest link in the system. Once the process of retail contagion took hold in one part of the banking industry, the

² Among the most recent proposals, we find those of the European Commission (2017), the Franco-German consensus proposal in Bénassy-Quéré *et al.* (2018) and the proposal put forward by the ADEMU group, collected in Marimon and Cooley (2018).

³ Romano Prodi stated publicly in 2001: “I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created.”

⁴ See J. Monnet (1985), p. 410.



difficulties spread to the entire system, and finally led to a widespread banking crisis that plunged the economy into a situation of deflation and depression.

Beyond the differences in causal elements and their consequences, a lesson of political economy to be drawn is that a successful but incomplete economic policy reaction to a crisis operated as a breaking point to help trigger the next crisis. Hence the relevance of analysing the current shortcomings in Europe in terms of the design of the euro in order to prevent these from becoming the cracks through which this great economic and political construction of the Europeans, which is the common currency, might be placed at risk in the future.

It is also worth remembering that, on the eve of the first twenty years of the euro's existence, the European monetary union process is at a more advanced stage of institutional construction than the dollar and the US banking system were after 130 years of historical development. We face an incomplete monetary union, but one that has clearly demonstrated its ability to move forward and that must continue to move forward.

In the light of this diagnosis of the risks inherent in an unfinished institutional design, one temptation would be to take up a maximalist position for the immediate culmination of an optimal monetary union. While this is a useful point of reference that should be kept in mind, in practical terms it is not enough, since, in today's Europe, it must be assumed that the available political and institutional capital is limited (as it was also at the founding moments of the euro). Therefore, in order to be able to move as quickly as possible towards this ideal and, in any event, to have in place an institutional design for the euro that makes this a stable monetary union before it is tested by the next major disruption, it is appropriate to carry out an exercise of prioritisation and detection of the most critical elements that need to be tackled first.

Therefore, this paper aims to outline those elements that are indispensable for the euro to be considered a stable monetary union in the face of economic and financial shocks of an equivalent magnitude to those seen in the Great Recession. And this is not because of a lack of theoretical ambition; it is precisely because I have great practical ambition that I believe this can be a useful approach for successfully tackling the reforms of the euro that remain to be made.

1.2. THE SPECIFIC FEATURES OF FINANCIAL CRISES AND THE MECHANISMS FOR TRANSFERRING AND MITIGATING THEIR IMPACT ON ECONOMIC AND MONETARY UNION

When reflecting on the minimum elements necessary for a stable monetary union, I believe one should keep in mind the special features of financial turmoil as opposed to other matters that may affect the cyclical development of economies. As a rule, banking crises have a more long-lasting effect on economies and their growth potential.⁵ First,

⁵ See Furceri and Mourougane (2012).



since they affect confidence in the safety of deposits and the risk perception of many assets, they have a more persistent effect on agents' investment decisions than temporary disruptions of the flow of disposable income. Further, the dislocation of the financial system affects its ability to efficiently reallocate the capital factor among companies and sectors – evidence shows, for example, the difficulty of the most innovative companies to raise funds, the slowdown in the incorporation of new technologies that occurs after a financial crisis, and the difficulty of forming new companies –⁶ which impairs aggregate productivity and long-term growth potential.

In the case of Economic and Monetary Union (EMU), the latest financial crisis knocked-on very differently to each national economy, depending on the fragility of its banking system and the vulnerabilities and macroeconomic imbalances that had accumulated during the long period of expansion prior to the downturn.⁷

Moreover, the crisis in the euro area was amplified by the existence of wide contagion channels between the financial system and sovereign issuers (sovereign-bank linkage), and by the absence of common stabilisation and crisis management mechanisms. In contrast to the power of these contagion channels, in EMU risk mitigation and risk sharing mechanisms are still very limited compared to other monetary unions.

1.2.1. MECHANISMS FOR SHOCK ABSORPTION IN EUROPE: A COMPARATIVE VIEW

Empirical evidence shows that federal States and other more closely integrated monetary unions have powerful mechanisms that allow the impact of asymmetric shocks to be shared among different economies or regions (this in the literature is called *cross border risk-sharing* or “international mutualisation of risk”). The availability of channels for diversifying severe risks, mitigating the adjustment costs that an economy can sustain in the face of an idiosyncratic shock, is an essential element for the proper functioning of a monetary union where countries cannot use the exchange rate as an instrument for stabilising against this type of shock.

Evidence for the United States suggests that around 70 %–80 % of shocks hitting a specific State end up being diluted among the rest of the States through three fundamental channels.⁸ The most powerful buffer operates through private capital markets, and its intensity – which allows sharing of around 40% of asymmetric shocks in the United States – is determined by the size of financial assets issued by non-residents in the portfolios of residents in different States, i.e. cross-border ownership of capital. The greater the proportion of income of agents in a region or State that is generated by ownership

⁶ See European Commission (2013), and Redmond and Van Zandweghe (2016).

⁷ See chapter 2 of *World Economic Outlook*, October 2018, IMF.

⁸ The risk-sharing percentage refers to the proportion in which shocks affecting the gross domestic product (GDP) of a country or region are not transferred to the consumption of its agents. See Asdrubali *et al.* (1996) and Banco de España (2016) for a more detailed analysis of risk-sharing mechanisms in the United States and EMU.



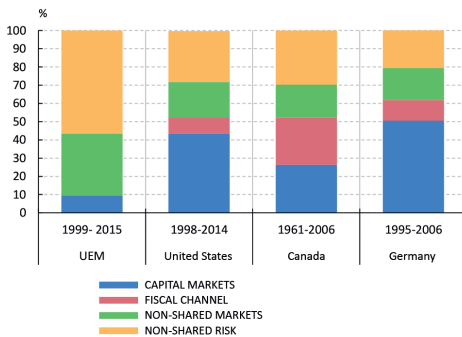
of shares or debt securities issued by non-residents, the greater their isolation from idiosyncratic shocks. The second is the credit channel, which acquires an international risk-sharing dimension when non-resident banks lend to resident agents (or vice versa). Available estimates situate its power at around 20% in the case of the United States.

Finally, a small percentage of shocks – around 10-15% – is buffered by transfers received from the Federal budget, a government channel (fiscal channel). This lesser potency should not tempt us to underestimate the importance of the government channel, since its existence is crucial to supporting the implementation of private channels. This is because private investors may be more willing to take on a stabilising role – by curbing, for example, capital outflows – if they know that the public sector will support them in this task.⁹ As a result, there are key synergies between public and private channels.

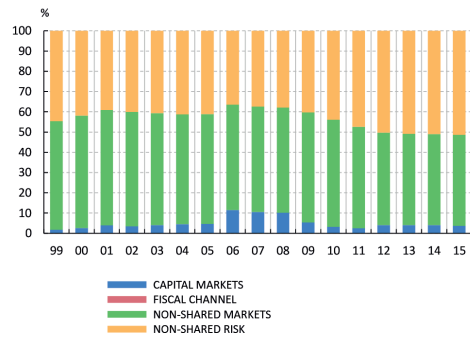
It is important to note that all these channels, including the public channel, are in force among the federal states of Germany and among regions within the same state (see figure 1.1). In contrast, in the euro area, evidence shows that private risk-sharing channels in EMU are less potent than those in the United States or Germany. In particular, capital markets barely buffer 10% of shocks, due to the sharp national bias that still persists in asset holdings. Mechanisms linked to the public sector are practically non-existent. This is because the European budget is not designed for stabilisation purposes, but as a driving force for real convergence of the more backward European regions, and as a financing mechanism for the Common Agricultural Policy (CAP). Moreover, the ESM, in force since 2012, is designed as an instrument of last resort for dealing with exceptional situations of severe crisis that may endanger the financial stability of EMU as a whole; hence the significance of proposals that seek to strengthen the preventive instruments available to EMU.

CHART 1. RISK MUTUALISATION MECHANISMS

1. Potency of risk mutualisation channels. International comparison



2. Change over time of the potency of risk mutualisation channels in EMU



⁹ E. Farhi and I. Werning (2017) show that, even if capital markets were fully integrated, a system that relies only on private mechanisms would not be optimal, because agents do not internalise the benefits of macroeconomic stability. A fiscal insurance mechanism would lead to a more efficient system.



Source: Banco de España.

a. Estimated according to the methodology of Asdrubali et al. (1996), which approximates the percentage of shocks to an economy's GDP that feed through to the income and the consumption decisions of residents in that economy. The potency of each channel is estimated from the following equations:

$$1 \Delta GDP_t - \Delta GNP_t = V1_t + \beta 1 \Delta GDP_t + \varepsilon 1_t$$

$$2 \Delta GNP_t - \Delta NNP_t = V2_t + \beta 2 \Delta GDP_t + \varepsilon 2_t$$

$$3 \Delta NNP_t - \Delta NNI_t = V3_t + \beta 3 \Delta GDP_t + \varepsilon 3_t$$

$$4 \Delta NNI_t - \Delta C_t = V4_t + \beta 4 \Delta GDP_t + \varepsilon 4_t$$

$$5 \Delta C_t = V5_t + \beta 5 \Delta GDP_t + \varepsilon 5_t,$$

where GDP is gross domestic product, GNP is gross national product, NNP is net national product, NNI is net national income and C is total consumption. All variables are expressed in logarithms and in deviations from the average for the euro area or, as the case may be, the United States. The coefficients $\beta 1$, $\beta 2$, $\beta 3$ and $\beta 4$ approximate risk-sharing across capital markets, depreciation (added to the chart with the percentage of non-shared risk), fiscal transfers and credit markets, respectively. The coefficient $\beta 5$ measures the percentage of unshared risk. The estimates for the United States and EMU are estimates made by Banco de España, Spain's central bank; those for Canada and Germany come from J. Melitz and F. Zumer (2002) and R. Hepp and J. von Hagen (2013).

The credit channel that runs through European banking institutions is the main risk-sharing channel in EMU, but during the crisis we saw it is exposed to strong instability, since the processes of uncertainty and generalised distrust that were unleashed ended up leading to a renationalisation of bank loans and other capital flows. For this reason, the importance of this channel declined markedly, precisely when it was most needed (see chart 1.2).

1.3. THE MAIN EXISTENTIAL RISKS FOR THE EURO

In the light of the experience of the crisis years, and evidence of the low potency of risk-sharing channels in EMU, three phenomena can be highlighted that pose especially severe danger to the stability of the euro in the event of a crisis: i) the risk of redenomination, tied to the possibility of market doubts about the sustainability of a sovereign issuer's debt, to such an extent that the exit of that country from the single currency becomes thinkable; ii) the perpetuation of fragmented wholesale and retail funding markets across national borders, which makes private risk-sharing channels less potent; and iii) the absence of a fiscal framework conducive to the design by countries of a countercyclical fiscal policy that encourages the creation of leeway in expansionary phases to cope with adverse circumstances, and the absence of supranational fiscal mechanisms that contribute to increasing the capacity of EMU economies to cope with idiosyncratic or common shocks.

With respect to the risk of redenomination, beyond noting that its very nature is the manifestation of a lack of confidence on the part of the international investment



community in the very survival of the single currency, it should be pointed out that it has a certain component of self-fulfilling prophecy, which is why it can be catalogued as the main risk that must be eliminated. This is so because of the conjunction of at least the following contagion channels: the most direct is the closeness of the sovereign issuer-banking linkages that prevail in EMU countries. In this context, contagion spreads rapidly from the sovereign issuer to the entire economic system of the affected country, causing a balance of payments crisis and a tightening of financial conditions that affects agents' spending decisions, thus opening up fresh channels of feedback and contagion.

The transfer of sovereign risk premia to the entire price structure of financial assets in the economy as a consequence of the anchoring role of sovereign debt in modern financial systems puts the private sector at a competitive disadvantage in terms of financing costs in certain parts of the euro area simply because of their location. If sustained over time, this would make the notions of a single market and freedom of movement incompatible with the political stability of the euro.

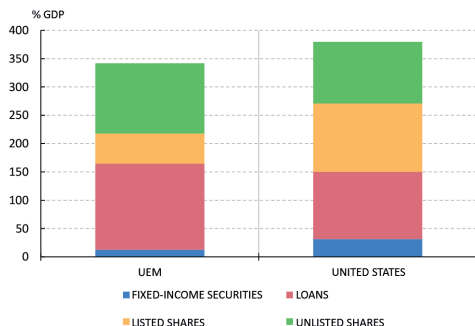
So it is necessary to point out the theoretical and practical limitations to the advantages that could be gained from the existing proposals to use financial engineering for the creation of synthetic assets backed by sovereign debt portfolios of EMU countries. This limited impact is due to the narrow diversification that can be achieved with portfolios of very small granular assets and which, precisely because of failings in the institutional architecture, can become highly correlated in stressed situations. However, as we have seen, the existence of secure assets as an anchor of the financial system is essential for its proper functioning and to reduce risks in bank balance sheets at times of financial and macroeconomic stress.

To make the situation still more complex, in the current institutional framework, which is incomplete and bereft of adequate shock absorbers, the only possible economic policy reaction at the national level to tackle the distrust that triggers the risk of redenomination is to carry out strong pro-cyclical fiscal adjustment processes during recessive periods in order to regain credibility. The final combination is a national policy mix that does not support recovery in the short term.

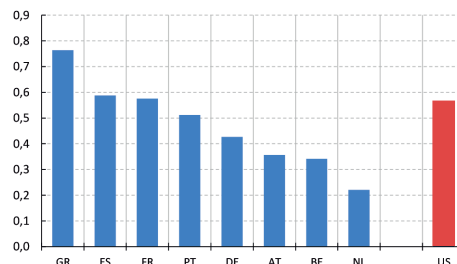
The financial markets in the euro area are, in one sense, generally underdeveloped, with a comparatively high share of bank financing and a low share of capital markets (see chart 2.1). Moreover, they are fragmented. The national bias in asset holdings and bank transactions remains high (chart 2.2), especially in the aftermath of the crisis, because, as shown by the indicators published by the European Central Bank (ECB) in its financial integration reports, the phenomenon of renationalisation of financial flows that took place at the height of the crisis has hardly been reversed, so while there is convergence in asset prices and interest rates, there is hardly any perceptible decline in the national bias in asset holdings and in bank loans and deposits.

CHART 2. DEVELOPMENT OF FINANCIAL MARKETS AND NATIONAL BIAS

1. Liabilities of households and non-financial companies (2017)



2. Domestic bias of investment in equity securities (a)



SOURCES: European Central Bank, Banco de España, World Bank, International Monetary Fund and Organization for Economic Cooperation and Development.

a. The indicator is calculated as 1 minus the ratio of foreign equity securities in each country's and the world's investment portfolio. An indicator value of 1 indicates that domestic investors invest 100% of their portfolio in domestic securities, a zero value indicates that there is no domestic bias and a negative value indicates that there is a bias towards holding foreign securities.

One of the most significant consequences of this phenomenon was pointed out by the ECB itself in the worst years of the crisis. The ECB found that market fragmentation even hindered the transfer of monetary policy to local credit conditions, rendering monetary policy as a whole less effective. As a result, the ECB has played a leading role, which is not declining significantly, as a default channel for cross-border funding flows through its various facilities in the absence of the integrated pan-European interbank market that existed before the crisis. Ultimately, decisive action is needed to return the euro area at least to the levels of wholesale financial integration in prices and quantities prevailing before the financial crisis.

At the retail level, deposit outflows, in particular those of a cross-border nature within the framework of a monetary union, are again a direct reflection of depositors' relative confidence in existing national safety nets supporting the main financial wealth component of households in many countries, namely deposits. The risks inherent in deposit leakage processes and their depressive impact are also profusely reflected in the classic account already cited by Friedman and Schwartz in the absence of credible government guarantee mechanisms (United States, 1929), or with mechanisms of questionable credibility.

Finally, the lack of supranational fiscal mechanisms aggravates the problem, because it requires the design of ad hoc fiscal coordination measures of dubious efficiency at a time when national fiscal policies have to address fiscal consolidation processes of a pro-cyclical nature in order to alleviate market mistrust of debt sustainability.



1.4. ESSENTIAL ELEMENTS TO MANAGE THE MAIN EXISTENTIAL RISKS

This section outlines those tasks which, in my view, may be most effective in averting the risks associated with the three elements mentioned above, since they would make it possible to improve public and private channels for buffering financial shocks. The proposed set of measures can be grouped into three broad blocks: i) completing the Banking Union project; ii) implementing the measures of the Capital Market Union; and iii) strengthening the policy and institutional framework for improving the effectiveness and coordination of fiscal policy.

1.5. BANKING UNION

The Banking Union project contains many elements, but I would like to focus now on those which, because of their critical nature, I consider essential. Although the list of elements includes a large number of initiatives of a legislative nature or with a potential fiscal impact, in reality these should be seen as the basic framework on which to build a new banking map in the euro area. This map should be characterised by closer integration, both wholesale (which, as we have seen, reached remarkable levels before the Great Recession) and, above all, retail, with the ultimate aim of fulfilling the initial claim at the birth of the single currency that one euro should be one euro regardless of the country in which it is deposited. Leaving aside the inevitable linkage between banking and sovereign risk determined by the common factor of non-diversifiable macroeconomic risk, the maximum feasible level of separation between banking and sovereign risk may occur when there is a sufficient level of provision of retail banking services, in particular deposit-taking, of a pan-European nature, and the bank resolution process is common. In short, to paraphrase Mervyn King, pan-European banking in life and death. This is the only way to achieve the objective of full fungibility of the euro even at times of the utmost financial stress.

Therefore, although certain risk-sharing elements with a potential impact on public accounts are necessary for their construction, the vital point is the increase in private capacity to absorb shocks that would be achieved through both the credit channel and capital markets, previously identified as fundamental in other monetary areas. It is therefore a question of laying the institutional and regulatory foundations for more effective private risk-sharing and risk mitigation in the euro area. In addition, as we shall see, the specific measures of the Banking Union themselves directly reinforce general financial stability, thus also reducing the risk of financial and banking instability.

The creation of a pan-European banking system could be achieved by merging and consolidating some of the banks operating in EMU countries. However, despite the existence of a large number of banks and relatively low levels of profitability, there have been few initiatives to consolidate banks in recent years. This is due to the weak competitive pressures that still prevail in some relevant segments of this sector in Europe (credit cooperatives, savings banks and some public or local entities), and to the lack



of regulatory harmonisation, which includes the absence of a single complete European regulation and the persistence of national specificities, the lack of consideration of geographical diversification in the calculation of credit-risk-weighted assets in the Basel standards, or the obstacles arising from the treatment in European banking regulation of pan-European banking groups [Restoy (2018)]. This underlines the need for further progress in this field.

It is also important in the long run to achieve a fully common deposit guarantee fund among euro area banks with sufficient mutualised fiscal support among all euro area Member States. Bank contributions to this fund should be based on the different risk profiles of the credit institutions covered in order to accommodate the adverse selection problems that arise in any insurance mechanism with a heterogeneous set of insured parties (in this case, banks), so that there are no systematic transfers between types of banks or between jurisdictions.¹⁰ Indeed, the accumulation of higher contributions to the common fund by those banks considered to have a higher risk – based on, among many other factors, their sovereign exposures – is perhaps an effective and viable strategy for separating banking and sovereign risk without the costs, in terms of overall financial stability, which may involve other strategies that would call into question the anchoring role of sovereign debt in international financial markets [see Bank for International Settlements (2017)].

In terms of an optimal strategy for deploying the agenda of the Banking Union, and given its potential impact on reducing the expectations of agents on the future risk of redenomination, a credible commitment to reach its final stage, even after a long transitional process with several stages and intermediate objectives, would have an immediate effect as soon as it was announced in reducing the vulnerability of the euro area. It is therefore imperative that European leaders agree on this before the next major crisis.

Finally, in terms of political economy, it must be pointed out that the delay in reaching a final agreement on the last stage of a fully common banking union serves only to expose the region to the political and social risk inherent in the current transitional situation. At this stage it is the common authorities (Single Supervisory Mechanism and Single Resolution Mechanism) that have the main supervisory and resolution powers for the most important banking institutions in Europe, and yet it is still the national banking consolidation mechanisms, and ultimately the national taxpayers in the event of a systemic crisis at national level, that must bear the consequences of decisions taken at Union level. This decoupling of decision-making and responsibility not only fails to provide adequate incentives, but also entails a risk of credibility and accountability vis-à-vis citizens. Once the step of creating institutions in the euro area for the surveillance and resolution of the main banking entities has been taken, the logical consequence should be to pool resources and capabilities to face the consequences of planned actions or omissions in

¹⁰ In Carmassi *et al.* (2018) it is shown that, based on past experience of banking crises, a common guarantee fund in Europe which is fuelled by contributions from institutions based on the relative risk profile of each institution in relation to the European banking community as a whole would not lead to significant permanent transfers between countries.



common by all euro countries. Delaying the implementation of this consequence resulting from decisions already taken only adds political risk to economic inefficiency and fuels mistrust among Member States, and between them and the institutions of Europe.

In this necessary process of alignment of powers and responsibilities, one must also bear in mind the idea that it is unreasonable to try to mutualise the consequences of situations arising from decisions or omissions when powers were vested in and exercised by national authorities. To say this means only that the common responsibility must not embrace risks originating prior to the entry into force of the Single Supervisory Mechanism in 2014, but in no event does it imply that common responsibility is triggered only when the level of risk assumed is small in a given set of metrics. Whether the final risk commonly assumed is high or low, its consequences should be assessed on a mutual basis if they go beyond the absorption capacity of the internal bailout or bail-in mechanisms.

As against the endless exchange of concessions, in terms of risk reduction and hopes for future risk-sharing the strategy of sharing risks without inherited problems seems a more promising and swifter avenue for the heralding of a credible commitment to the final stage of the Banking Union.

Another essential element to complete the Banking Union is that the single resolution fund has sufficient mutualised fiscal support, in order to make internal bailout strategies fully credible in the event of idiosyncratic banking crises, even of systemically important banks. We must in any event always bear in mind the limits of internal recapitalisation strategies in the case of systemic banking crises due to their potential adverse consequences for general financial stability, as recently pointed out by the International Monetary Fund.¹¹ Hence the need for last-resort mutualised fiscal support. Likewise, in order to make internal recapitalisation strategies credible, authorities must be equipped with mechanisms to ensure the provision of liquidity to banks once they have undertaken internal restructuring processes, until they manage to restore credibility and normalised access to markets.

1.6. UNION OF CAPITAL MARKETS

The low risk-sharing capacity through the existing capital channel in EMU reflects the weaker development of European capital markets relative to the United States, and their low pan-European dimension, due to the excessive national bias that still prevails in holdings of securities of countries in the area. There is ample evidence that financial systems that rely exclusively on bank financing are more prone to instability and tend to be more pro-cyclical, with consequences for long-term economic growth [Lagfield and Pagano (2016)]. Hence the importance of diversifying and broadening the sources

¹¹ The International Monetary Fund, in its *Euro Area Policies: Financial System Stability Assessment 2018*, highlights the desirability of recognising an exception to the bail-in requirements in the case of systemic crises, given the risk of contagion that their application would entail in these circumstances.



of finance for European companies and reducing their excessive dependence on bank finance by developing additional sources of finance. Therefore, although the initiative of the Union of Capital Markets generally draws less attention than the Banking Union, its importance is vital for achieving developed capital markets and strengthening their cross-border outlook, especially in equity markets,¹² which are the real drivers for increasing the potency of risk-sharing channels [see Demertzis, Merler and Wolf (2018)].

The development of efficient and integrated capital markets is a highly complex objective, requiring action on many fronts related to the implementation of market infrastructures, review and harmonisation of regulation, supervision of markets, etc. Therefore, this initiative has a high granularity and dispersion of objectives, which sometimes mask its overall significance.

There have been some steps forward to encourage capital to reach areas where bank financing does not usually arrive; for example, innovation projects, for which the support of venture capital funds is usually sought. Special mention is due to initiatives to facilitate bank lending to small businesses through greater recourse by institutions to securitisation as a risk transfer mechanism, for which implementation of simple, transparent and adequately supervised securitisations has been supported. These initiatives show the close complementarity between banking and capital markets, and prove that the initiatives of the Banking Union and the Union of Capital Markets are mutually reinforcing.

As for the development of the stock markets, which are the real powerhouses that provide the muscle to this risk sharing channel, steps have been taken towards the harmonisation and simplification of the information necessary for companies to launch on the exchange and raise capital there. Numerous studies have also been conducted to identify barriers to international investment. But, in general, the achievement of developed and integrated capital markets is a very ambitious objective that requires a greater emphasis on the harmonisation of regulation and supervision of capital markets [see Sapir, Veron and Wolf (2018)] and corporate insolvency proceedings,¹³ and a review of a bias towards debt financing that emerges from the tax structure of some countries.

¹² Available empirical evidence suggests that the potency of the risk-sharing channel that runs through capital markets depends fundamentally on the composition of assets, so it is much higher when residents of one country own equity of companies from other countries, rather than debt, which tends to be more volatile. Another important point is the term of the assets, which is usually longer in the case of shares (ECB, 2018).

¹³ It would also be important to build a common insolvency scheme for financial institutions that are not subject to resolution. This would probably require a single European administrative authority to enforce the scheme.



1.7. IMPROVING THE COORDINATION AND EFFECTIVENESS OF FISCAL POLICY

As pointed out above, all monetary unions have supranational fiscal instruments to buffer the effects when a shock hits a given economy. In addition, however, in the case of EMU, a substantial improvement in the coordination mechanisms of European fiscal policies is required in order to facilitate the discussion of the most appropriate fiscal policy tone for the area as a whole, and the implementation of common actions to confront especially adverse situations, such as those seen in the recent past, when national stabilisers are insufficient and monetary policy may be exhausting its room for manoeuvre [see Banco de España (2016)].

Recent literature has raised numerous options for implementing this “supranational fiscal capacity” [see Arnold *et al.* (2018)]. Among all the practicable alternatives, it is necessary at least that the euro area should have a cyclical insurance scheme in which countries accumulate resources at the top of the cycle, so as to use them automatically, simply and transparently in adverse situations. From an EMU perspective, this type of fund has the advantage of allowing not only spatial redistribution of resources among countries, but also inter-temporal redistribution that makes it possible for the funds to contribute to the design of aggregate fiscal policy and not only to deal with asymmetric shocks, especially if they have the capacity to borrow.

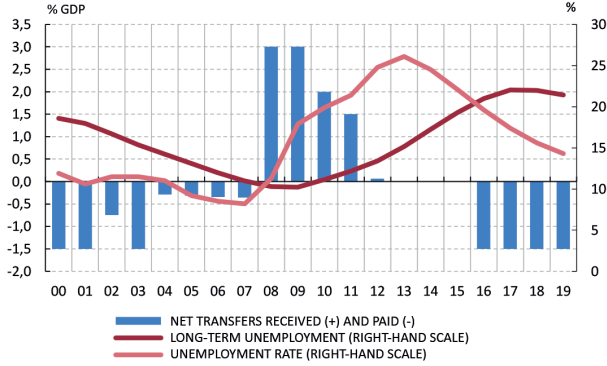
The fear that these mechanisms will lead to permanent income transfers among countries may be lessened by introducing standard mechanisms in all insurance systems that eliminate this possibility, so that in the end this capability is tantamount to a loan system. In addition, access to this capability could be subject to *ex ante* compliance with the rules of a new European fiscal framework, as described below.

As to size, most of the research suggests that, with an average annual contribution close to 0.3-0.5 percentage points of GDP, a risk-sharing capability similar to that which exists in other, more developed monetary unions (where these mechanisms contribute to buffering around 15% of the impact of a shock) could be achieved (see, for example, Banco de España (2016) and Eyraud *et al.* (2018)]. Chart 3 shows simulations using a rainy day fund¹⁴ scheme of this size since the beginning of EMU. As can be seen, both Spain and Germany would have benefited from such a scheme at the most adverse times (see charts 3.1 and 3.2). Moreover, it can be seen how net transfers under this scheme are countercyclical for EMU as a whole, so they could have helped to improve the design of aggregate fiscal policy (chart 3.3).

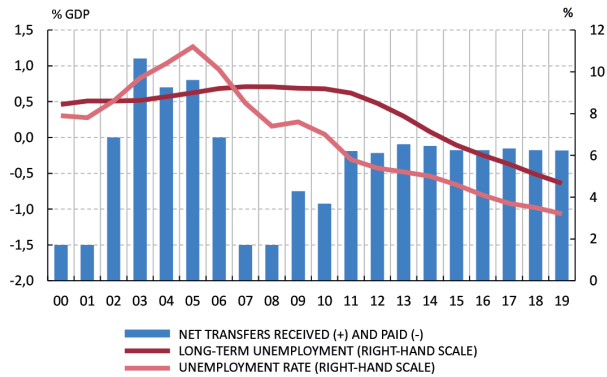
¹⁴ Under this type of scheme, countries in a strong economic situation accumulate funds that are distributed to those in a worse situation. The fund can accumulate net resources and even borrow at the aggregate level. In addition, mechanisms are introduced to ensure that there are no net transfers or net payments at the country level over a given period of time.

CHART 3. TRANSFERS OF FISCAL CAPACITY FOR EMU (1999-2019)

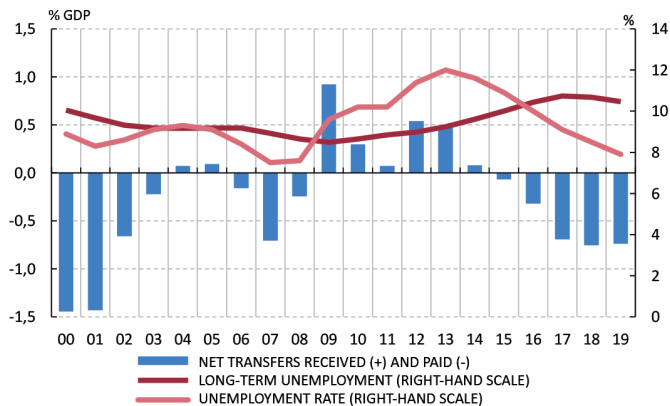
Spain



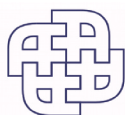
Germany



EMU



Source: Banco de España.



In any event, the contribution of these types of schemes to the aggregate tone of fiscal policy in the euro area is limited, and it would therefore be necessary to supplement these schemes with instruments and mechanisms that would open the door to discussion of the best fiscal tone for EMU as a whole and help implement a coordinated response in emergencies. This type of response should be particularly oriented towards schemes that allow new investments to be made at times of strong cyclical downturn by means of mutualised debt mechanisms. The priority focus on investment would make it possible to reduce the strong procyclicality of investment, both public and private, and thus mitigate one of the channels whereby crises become entrenched and hit growth potential all the harder. Natural candidates to take on this role would be the ESM (as a mutualised vehicle with access to the markets of the countries of the euro area, although without experience or institutional culture as an investment support bank) or the European Investment Bank, which, although it has the corporate culture and regular access to international capital markets, is an instrument for the whole of the European Union and not only for the euro area, and it would therefore be necessary to establish some kind of specific facility for the latter.

But the European fiscal framework also requires a thorough review to improve the design and coordination of national fiscal policies. Lest we forget: in a monetary union, fiscal policy is the main instrument available to a country to deal with asymmetric shocks. This is why it is important for each economy to maintain a countercyclical fiscal policy which, in expansionary phases, generates sufficient room for manoeuvre to deal with adverse situations.

The SGP was designed for this purpose. Moreover, compliance with this framework of budgetary rules and procedures is essential for the macroeconomic stability of EMU. Indeed, in EMU, the consequences of fiscal actions are the sole responsibility of countries, which led to the inclusion in the treaty of a no-bail-out clause, ruling out the possibility of a Member State's public debt being assumed by the area as a whole. The main purpose of this clause was for financial markets to play a disciplining role by requiring different risk premia for each country depending on the situation of their national economies. However, at the same time, limits were set on the deficit and public debt of States, complemented by the SGP, whose rationale stems from the assumption that financial markets do not always act as a deterrent to inappropriate policies and that the no-bail-out clause might not be completely credible, since situations of fiscal unsustainability in one country might have adverse repercussions on the rest and generate stresses throughout the Union which would make it more desirable for the Union as a whole to come to the aid of countries undergoing hardship.

As described in Hernández de Cos (2014 and 2017), this framework of fiscal rules is the result of a series of reforms aimed, in some cases, at ensuring the responsiveness of fiscal policy to adverse shocks – such as the 2005 reform or the introduction of flexibility criteria in 2015 – and, in others, at promoting fiscal discipline – introduction of the spending rule and the sanctions rule, operability of the debt criterion, etc. In addition to all this we find a set of agreements on how to interpret the existing rules, which generally seek to clarify those aspects that have caused the most tension between the Euro-



pean Commission and the Council, and which are embodied in a document, the SGP Vade Mecum, which illustrates the complexity of this whole framework in a text of over 200 pages.

Despite all these rules and procedures, the Pact has proved unable to contribute to the design of countercyclical fiscal policies. Its excessive complexity, with rules that sometimes overlap and procedures that lend themselves to discretion, makes it non-transparent and difficult to communicate to the general public, and this impairs its implementation. This complexity also makes it more likely that it will be applied across countries inconsistently, which will hurt its legitimacy and credibility. There is therefore an urgent need for a thorough review of the current fiscal framework, more quickly than perhaps envisaged in the roadmap established for the governance review.

There is a broad consensus that the reform should be aimed at reducing the number of rules around a single objective, debt reduction, and an operational rule, the expenditure rule that ensures that public expenditure does not exceed nominal long-term GDP growth and that it remains below that level for countries with high debt [see the recent proposal of the European Fiscal Board (2018) or Darvas, Martin and Ragot (2018)]. The advantage of the existence of an expenditure rule is that it exercises control over the variable where deviations in budget execution occur most frequently. Furthermore, it helps to ensure that the extra income frequently generated in expansionary periods is not used to finance permanent increases in expenditure, but rather to generate room for manoeuvre to deal with adverse situations. In contrast to those who argue that this rule may hinder fiscal policy response during severe crises requiring expansionary measures, this framework could incorporate clear and transparent escape clauses that introduce the necessary flexibility in the event of severe shocks.

However, we cannot expect that, on its own, a system of rules will be sufficient to ensure the radical change needed in the design of European fiscal policies in each country. Estimates based on the experience of countries that introduced expenditure rules in the years prior to EMU suggest that this introduction only had a differential impact on those economies that already had institutional governance that contributed to a more transparent discussion of budgetary plans and their implications. So, beyond simplifying the fiscal framework, it would also be necessary to move towards greater automaticity in its implementation so as to avoid excessive discretionality. Further, greater automatism in the operation of the rule can be linked to the functioning of the national independent tax authorities or the European Fiscal Board, so that these institutions could be given the power to monitor and evaluate the degree of compliance with the rules and, where appropriate, to activate the automatic adjustment mechanism.¹⁵

¹⁵ In any case, it is important to emphasise that, with this automatism, the sole intention is to limit the degree of discretion of governments in relation to compliance with the rule, though governments will still retain all their own functions in the areas of macroeconomic stabilisation, income redistribution and improving economic efficiency.



1.8. CONCLUSIONS

Throughout this article I have outlined the minimum elements of institutional architecture reform that I consider essential to ensure the stability of the single currency in the face of future severe shocks. This improvement in EMU's resilience to shocks could also have very positive effects on the growth and structural convergence of euro area economies. The December 2018 European Council meeting provides an excellent opportunity to make decisive progress on these elements and thus put EMU on a more secure footing.

In any case, we must recall that, in the final analysis, the euro is a fundamental anchor of a project that is built on the political will and consensus of European citizens. Without that will and consensus there can be no progress. And that will must be built on the basis of mutual trust between and among countries with regard to the institutions of the Union. Generating this trust is not only or mainly a technical concern, but also a political one, although adequate technical designs of economic policies that minimise undesirable effects may contribute to its achievement.

Beyond these advances, it is crucial to maintain as a long-term objective the achievement of a higher degree of credible and irrevocable sharing of sovereignty in fiscal aspects and control of government accounts, that is, the achievement of a political union. To this end, it would be useful to have a strategic framework for ongoing reflection among the Member States and the EU authorities. Assuming that this is a task in permanent progress, which requires constant buildup of political and institutional capital, will allow us to offer citizens a more stable and resilient common project.

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2. MONETARY UNION: THE POLITICAL SHORTCOMINGS

ROMÁN ESCOLANO

State Trade Expert, former Minister for the Economy

2.1. AN INCOMPLETE TASK, THE WRONG DEBATE

Ten years have gone by since the outbreak of the Lehman Brothers crisis, and nine years have passed since the government of George Papandreou publicly questioned his country's budget deficit figures after the Greek elections of October 2009. Thus began the chain of events that would finally mutate the global "Great Recession", which at first mainly affected the US economy, into a severe and far-reaching Eurozone crisis.

Much has been done since then to strengthen Europe's Economic and Monetary Union (EMU), especially if we compare this turbulent second decade of the euro with the apparent calm and stability of the first, after the adoption of the euro in 1998.

Especially after the Euro Council meeting of 29 June 2012, changes of the required depth and scope began to be considered from a political and institutional point of view. The later story is well known. Since then, and over the next six years, crucial measures have been adopted – at an unprecedented rate – to create the "Banking Union": it is worth recalling that this term was barely in use before that date.

This is not the occasion for an exhaustive review of all those measures. Thorough and rigorous analysis is available from other sources, including earlier editions of this "Euro Yearbook". But, to better understand what follows, we should bring to mind some of the milestones on this path.

First, after the stress tests targeting the leading credit institutions that took place in 2012, the first two "limbs" of the Banking Union were formally established: the Single Supervisory Mechanism in 2014, and in 2016 the Single Resolution Mechanism, which soon became fully operational.

In addition, Member States implemented – and began to apply – the statutory provisions of the *Single Rulebook*. This has gradually shaped a more cohesive regulatory framework and more effective supervision across the European Union, through:



- a) stricter prudential requirements for banks, introduced by the Regulation and the Capital Requirements Directive (CRD IV/CRR);
- b) a new resolution framework, set out in the Bank Recovery and Resolution Directive (BRRD);
- c) improved functioning of national deposit guarantee schemes (DGSs), reinforced by the Deposit Guarantee Scheme Directive (DGSD).

These reforms clearly had the effect of supporting the unusual (or “unconventional”) measures adopted by the European Central Bank since 2011-2012. ECB leaders have on several occasions reiterated that they would not have been able to tackle the measures alone, without political backing from the European Council, and, in particular, without the strong message arising from the June 2012 Summit.

Alongside structural reforms adopted at the national level, these changes brought highly positive results in terms of financial stability. Financial markets became less fragmented, thus lowering moral hazard, warding off the threat of bailouts funded by the public purse, and driving the risk of “redenomination” out of public debate once and for all.

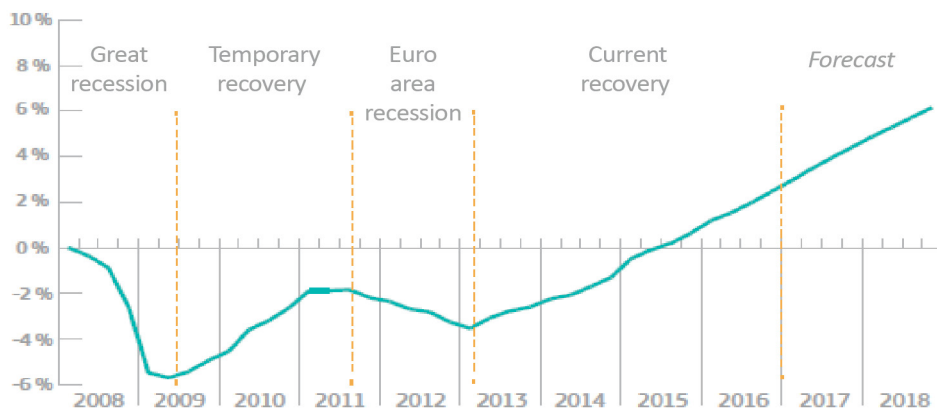
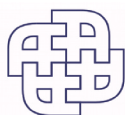
The effects also boosted economic figures in a broad sense. To quote recent figures from the European Commission,¹ the European economy has entered its sixth year of recovery, creating nearly six million jobs since 2013. The jobless rate has remained at its lowest level since 2013 and the activity rate, at 70%, is above historic highs. Investment has picked up. Public deficits have fallen from over 6% in 2010 to 1.4% in 2017, and public debt rates have begun to subside.

That economic performance has been strong is indisputable. EMU is now incomparably stronger and better prepared to deal with any economic shock than it was in the summer of 2009. According to recent editions of the Eurobarometer,² the single currency is still popular and appreciated by citizens, and its contribution to economic stability is seen as positive by a very large majority.

However, it is equally clear that we are faced with a historic task that remains unfinished. The Eurozone is yet to achieve the institutional maturity of a firmly established currency area.

¹ COM(2017) 291 final: “Reflection Paper: on the Deepening of the Economic and Monetary Union”, p.11.

² “Eurobarometer” Spring 2018, at europa.eu/rapid/press-release_IP-18-4118_es.pdf



Source: European Commission.

What remains to be done? The problem does not seem to be a matter of diagnosis. The outstanding issues have been fully identified. In the famous “Five Presidents’ Report” of 2015 and later papers,³ all the elements required to complete Economic and Monetary Union in definitive form are described in detail. If no further progress has been made, it cannot be said to be for lack of a thorough analysis of the situation.

Among the outstanding issues, we could mention two that are especially well-known. One of the fundamental pillars of EMU, in particular the “third limb”, remains to be developed: the establishment of a European Deposit Insurance Scheme (EDIS). If the key purpose of the reforms carried out since June 2012 was precisely to break the vicious circle of interaction between sovereign risk and banking risk, the absence of this decoupling means that the European Banking Union still suffers from fundamental problems of stability, even though progress has been made on other fronts.

Moreover, even in areas where tangible results have in fact been achieved, such as the first two limbs (the SSM and the resolution mechanism), the decision-making scheme is overly complex and takes the form of a dissatisfying blend of EU and intergovernmental procedures.

Indeed, one of the side-effects of the Greek crisis was a serious decline of political trust among the European institutions, which compounded the financial difficulties. In particular, mistrust took root between the Commission and the Member States, most notably Merkel’s Germany. This crisis of confidence and trust, the fallout of which is still felt today, left its mark on the new institutional framework of EMU developed after 2012.

³ “Five Presidents’ Report”, 2015, at www.consilium.europa.eu/es/policies/emu-report-2015; “ECOFIN Roadmap” www.consilium.europa.eu/es/meetings/ecofin/2016/06/17/.



In November 2010, a few weeks after the controversial Franco-German summit in Deauville, in a speech on the occasion of the opening of the European College in Bruges,⁴ the German Chancellor went as far as to “theorise” on the need to adopt a new institutional approach in future, stating that the European Union should be ready to go beyond the traditional EU method and operate on a different basis:

“As a representative of a member state I would like to say now that it sometimes seems to me that the representatives in the European Parliament and in the European Commission see themselves as the sole true champions of the community method ... I have to tell you I am rather sceptical about this argument and whenever I hear it, I want to refute it ... Given this new division of competences, I believe we must put old rivalries behind us, we must set common goals and adopt common strategies. Perhaps we can agree on the following description of this approach: coordinated action in a spirit of solidarity – each of us in the area for which we are responsible but all working towards the same goal. That for me is the new “Union method”.

This new “method” of intergovernmental agreements, carried out in parallel with, if not against, the EU institutions, was reflected in concrete initiatives such as the *Fiscal Compact* 2012 (formally, Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) or the creation of the ESM in 2011 by means of a Treaty signed by the Eurozone Member States.

Today, looking back, many think that this institutional scheme falls short. The reintegration of the new institutions into the EU framework has become another outstanding task.

The situation today, as we have seen, is different from that addressed at Deauville. An environment of economic recovery has driven up confidence in the euro, but has also brought new challenges. Following the several major agreements reached in 2012-2014, with markets in a stressed financial situation, severe financial fragmentation and fears of a breakup of the single currency, the pace of progress in EMU seems to have slowed.

Economic growth and, above all, the improvement in market tone have created a tougher political environment for further progress on the outstanding issues. It is not hard to understand why. In a more favourable macroeconomic situation – European growth even outstripped the United States for several years – the benefits of taking further steps towards integration seem more distant and less urgent; and what might be perceived as a sacrifice or a concession is harder to “sell” to public opinion. This would seem to prove Jean Monnet right, when he famously said, *“Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.”*

And although it is true that there is now a “canonical” view on the long-term design of EMU, revolving around the proposal made by in the “Five Presidents’ Report” – on which there is formally an agreement, at least in principle – this political environment means the discrepancies between Member States (the North versus the South, creditors versus debtors, the Franco-German pair itself) persist over time, and even fester and

⁴ “Speech by the Federal Chancellor at the Opening of the 61st year of the College of Europe in Bruges”, 2 November 2010.



worsen in some respects; so it is proving difficult to reach new agreements on the outstanding issues.

The problem springs from the fact that the opposing sides in each dispute have become embroiled in what I believe is a *mistaken debate* between two apparently antagonistic concepts: “risk reduction” and “risk sharing” in the Eurozone.

The June 2016 “ECOFIN Roadmap on EMU” further specified, in the form of highly detailed steps, the long-term vision set out by the “Five Presidents”. Today this remains the core working paper on the future of the Eurozone. The paper contains echoes of this debate:

“6. EL ECOFIN reconoce que para ello procede adoptar, con la oportuna secuencia, nuevas medidas relativas ECOFIN recognises that, to this end, further steps will be have to be taken in terms of reducing and sharing risks in the financial sector, in the appropriate sequence, in order to address a number of remaining challenges. (...)

d) On a European Deposit Insurance Scheme (EDIS), the Council will continue constructive work at technical level. Negotiations at political level will start as soon as sufficient further progress has been made on the measures on risk reduction, as mentioned above.”

This is the situation we are in now. We all claim to share the same long-term objective, and we say (sometimes more freely in private than in public) that, at an unspecified future date, the Eurozone will have a finished institutional design, as set out in the Roadmap.

Yet, barely cloaked in the euphemism of “sequencing”, serious differences remain. For the more sceptical countries, long-term goals will only be achievable after a long process of government debt reduction, while decreasing distressed assets and strengthening bank balance sheets. In the meantime, a definitive closure of the outstanding issues of Monetary Union will have to wait.

2.2. A PROBLEMATIC “CORONATION”

This debate brings us echoes of past disputes. Since the 1970s, at the very outset of the process of European monetary integration, certain circles in Germany, especially in or around the Bundesbank, advocated what was then known as “coronation theory”. I. Maes (2002)⁵ defines coronation theory as follows:

“The “economists”, under the leadership of Germany, emphasised the coordination of economic policies and the convergence of economic performances, especially inflation, as a precondition for EMU. According to their view, the so-called coronation theory, monetary union could only be the last and crowning phase in the process of economic integration.”

If we convert this theory to the terms of our current debate, and adapt its concepts: only if and when a long process of risk reduction in Member States’ banks and public

⁵ I. Maes (2002), “On the origins of the Franco–German EMU Controversies”, National Bank of Belgium.



accounts is completed, may a process of financial mutualisation be envisaged, in which the different pieces of EMU are finally put together, thus “crowning” the system agreed upon in 2015.

This is this idea that underpins, for example, the recent Charter⁶ of eight European finance ministers –of the countries of what has been ironically dubbed the new “Hanseatic League” – in which, again, we see how implementation of the Banking Union is made subject to a deliberately unspecified and indeterminate condition precedent: “sufficient progress” in risk reduction.

This disjunct between risk reduction and risk sharing – however popular and politically attractive it may be in some countries – is, in my view, fundamentally wrong, and, as contradictory as it may seem, harmful to the interests of those who advocate it.

And this is so for at least *three reasons*:

- 1) First, because as long as the architecture of the Banking Union is incomplete, elements of financial instability will continue. The need for cross-border transfers and bailouts, which lies at the heart of those States’ fears and criticisms, is maintained in practice.

Lest we forget, the central idea of all steps taken since 2012 was to break the vicious circle of reinforcement between sovereign and banking risk. The aim is to avoid, in crisis situations, a financial fragmentation of the Eurozone and the consequent re-appearance of the risk of redenomination that might finally lead to “sudden stops” in external financing.

The differences between a Monetary Union such as the European one and a system of fixed exchange rates sometimes do not seem to be properly understood. As explained repeatedly, Maastricht designed a system that is one of a kind. Its philosophy is perhaps encapsulated in a phrase by Goethe. Freely translated, he said: “Let everyone sweep in front of his own door, and the whole world will be clean.”⁷

This *sui generis* system, which at the time was viewed by some as a mere continuation of the EMS, was cast into doubt by two factors that were not entirely foreseeable by Maastricht: the EMU finally agreed in 1998 would be broader than expected (not limited to the five or six countries in the ERM-II core region,⁸ revolving around the Deutsche Mark); and finally, EMU membership would be irreversible, as demonstrated during the Greek crisis in 2012.

⁶ “Finance Ministers from Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden underline their shared views and values in the discussion on the architecture of the EMU”, open letter of 5 March 2018.

⁷ “*Ein jeder kehre vor seiner Tür, und rein ist jedes Stadtquartier*”.

⁸ Let us remember the idea of *Kerneuropa*, or central European core, advocated by Lamers and Schäuble in 1994.



However, an irreversible Banking Union with a wide membership, which lacks central elements such as EDIS for a transitional period – which could be quite a long time – does not successfully dispel the vicious circle and is far more vulnerable: it is ultimately prone regular and costly bailouts. This would not be the case of an institutionally perfected system.

In short, it is this *current* unfinished Monetary Union, due to its own design flaws, which paradoxically turns out to be a transfer Union. Or, put differently, and contrary to what is sometimes argued, to flesh out the Banking Union in full by implementing the institutional elements that are yet to be put in place turns out to be a key underpinning of risk reduction – perhaps even the main one.

- 2) Secondly, because an incomplete Monetary Union such as the current one may not only lead to more transfers, but also to such transfers being *larger* than they would have been in the presence of a robust and fully perfected institutional architecture. The Managing Director of the ESM, Klaus Regling, has consistently remarked that the lack of common safeguards such as EDIS during the last crisis exacerbated the need for and volume of the Programmes. His words are worth quoting:

“I know that common deposit insurance is a very controversial issue in Germany. So let me say a few more words about it and explain why I believe that Europe-wide deposit insurance is also in the interests of Germany. A common deposit insurance [EDIS] would help to reduce the fragmentation of financial markets in Europe, and help create common financial markets (...) The volume of the past ESM programmes would have been much lower had common deposit insurance already been in place, which shows why it is a useful tool. A large part of the ESM programme financing had to be used to recapitalise banks in programme countries, as nervous savers pulled their deposits out of banks during the crisis. A credible Europe-wide deposit insurance would remove savers’ fears that the euros they had put into the bank would be converted into a new national currency. And so, the risk of nation-wide bank runs would practically disappear. Depositors would know that the entire European banking system would back their savings, and not just their government. In other words: putting a credible deposit insurance in place is the best guarantee it would never be used.”⁹

- 3) Thirdly, because the implementation of only *some* key elements of the Banking Union, but not others (such as the single safety net for deposits), can give rise to budgetary consequences that are politically absurd and untenable. In certain banking crisis situations, there could arise a situation where national budgets have to cope with very large outlays to support bank restructuring decisions taken *at the European level*, outside the powers of national governments or the control of national parliaments.

It is easy to see how these situations could lead to political controversies that would be difficult to handle, thus providing fodder for populist agitation and fuelling anti-European discourse in general.

⁹ Regling, K. (2018): “Europa– Quo Vadis? The Role of the ESM”, Munich, 23 July 2018.



The European Central Bank itself, in its Opinion on the potential creation of a common deposit insurance system, echoed this same concern:¹⁰

“A European Deposit Insurance Scheme (EDIS) is the necessary third pillar to complete the Banking Union, following the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Since liability and control need to be aligned, establishing a common safety net for depositors at the European level is the logical complement to elevating responsibility for banking supervision and resolution to the European level. With the SSM and the SRM fully operational, national authorities, to a large extent, no longer have control over the key elements determining whether a national deposit guarantee scheme (DGS) has to make pay-outs to insured depositors or contribute to resolution financing. Thus, the liability for ensuring that there are sufficient financial means to underpin the confidence of all depositors and thereby safeguard financial stability should be assumed at the same level and be elevated to the EDIS.”

These three reasons, in my view, call into question the false and artificial distinction between “risk reduction” and “risk sharing” in which the debate on Monetary Union has become entangled since 2015.

And they also show that the idea that the completion of EMU can be put off indefinitely until it becomes a sort of “coronation” of a long risk-reduction process is not only wrong, but dangerous.

2.3. THE POLITICAL SHORTCOMINGS

The June 2016 ECOFIN Roadmap – referred to above – described in detail the EMU elements that are yet to be implemented. The European Commission later developed these ideas into a comprehensive package of legislative proposals¹¹ in December 2017.

To answer the question as to which of the unimplemented elements may be politically possible at this point in time, we would do well to consider a range of public statements, such as the Franco-German Meseberg declaration, the Euro Council conclusions of June 2018, various contributions by Member States, and even the “Letter of the Eight”. In particular, the Letter of the Eight provides us with vital clues as to where the debate is going to go next, precisely because it comes from the group of Member States that are most sceptical about the direction of the whole process.

In the light of all this, the sequence of next steps could, in my view, be as follows:

First, and beyond dispute, *the Banking Union must be completed*. Leaving aside the widely known nuances and qualifications, everyone seems to agree that this is the priority. In practical terms, this leads us to two specific points: developing a common “firewall” for the SRF and reaching a final agreement on EDIS.

¹⁰ “Opinion of the ECB on a proposal for a Regulation establishing an European Deposit Insurance Scheme”, 21 April 2016.

¹¹ COM (2017) 821 final.



Support for the Single Resolution Fund by the ESM was already included in the Euro Summit Declaration of 29 June,¹² at least from a political point of view, so it is now a matter of waiting for an effective implementation agreement: it may be reasonable to expect this to come about in 2019 or soon after.

The second element (EDIS) is turning out to be more complicated. As we have seen, although all countries say that they are willing to accept the existence of an EDIS in the long term, the need for a long and uncertain period of risk reduction measures, discrepancies about the metrics to be used and lack of clarity about the concrete milestones along the way have rendered any agreement impossible so far.

The Spanish Government tried to provide a specific basis for agreement in its contribution¹³ to the debate last April. This paper advocated setting – as soon as possible – a final and irrevocable date for the entry into force of EDIS. This date would have to be specified as final, although the common safety net could take a few years to implement in full.

Reassured by the solemnity of a policy statement by the Euro Council, the markets would understand that any uncertainty about the final design of EMU now lay in the past. The difficulties of a protracted transition – as a result of keeping the system open-textured over time, as implied by “coronation theory” – would be bypassed.

At the same time, once a date were agreed upon, implementation of the deposit safety net could be delayed (but not indefinitely, as the deferral would be specified *ex ante*) to allow for the following three developments, at least:

- a) cleaning up of pre-existing bank balance sheets, so that upon adoption of EDIS there would no longer be “legacies” in the form of impaired and unprovisioned portfolios predating the establishment of the SSM in late 2014.
- b) gradual contribution of System resources (in line, for example, with the European Commission’s ideas in its legislative proposal)¹⁴ in such a way that the System could start operating with an adequate fund from day one.
- c) and, finally, implementation of a “firewall” similar to that of the SRF, in which the ESM could also play a central role.¹⁵

In addition, this relatively long period before the actual adoption of EDIS could facilitate a compromise on the gradual reduction of “home bias” in government debt port-

¹² Euro Summit Statement, para. 2. At consilium.europa.eu/media/35999/29-euro-summit-statement-en.pdf

¹³ “Spanish position on the strengthening of EMU”, available at www.mineco.gob.es/stfls/mineco/comun/pdf/Posicion_espanola_sobre_fortalecimiento_UEM.pdf

¹⁴ COM (2015) 586 final.

¹⁵ It is sometimes said that the SRF and EDIS should be designed as a single fund, following the US model. The available evidence does not seem decisive either way, so the Spanish paper did not take a position on this matter. See IMF Technical Notes and Manuals (2018): “*Resolution Financing: Who pays when Financial Institutions Fail?*”



folios currently existing in bank balance sheets, independently of any overall progress in discussions in the Basel Committee on the regulatory approach to sovereign risk.

This commitment would be a positive additional step towards decoupling the banking/debt “vicious circle”, and could point the way to a final agreement in the Eurogroup.

The European Commission’s legislative proposal mentioned the date of 2025. This date (or a similar date, such as 2028) may be acceptable, but in a sense the date itself would be secondary in relation to the matter of irreversibility of such date.

The completion of the Banking Union is, of all the outstanding issues, the one that seems most feasible from a political point of view. A final agreement in this area would be of immense significance.

It could be argued that the Banking Union alone is not enough for the euro area to have a complete architecture. I do not think there is any doubt on this point, but neither should its positive effect be underestimated: if the worst weakness of the system were removed, the Eurozone would become a more stable currency area and far more resilient to external or internal shocks. This would be particularly significant from 2019 onwards, given the prospect of normalisation of the ECB’s monetary policy starting from that date, and of a global economic environment that is expected to be much tougher.

Once the three pillars of the Banking Union are properly built and complete, the Eurozone would have fully operational instruments – funded by common resources – to deal far more effectively with any future banking crisis. The risk to individual banks, which emerges swiftly, would be insulated from domestic fiscal policies, which require a slower and more considered reaction. National banking systems would be better protected against a budgetary crisis in one Member State or another, and the financial stability of the Eurozone as a whole would be strengthened at a time when the economic environment poses tougher challenges.

In short, EMU would have *time* to address the remaining structural steps that remain to be implemented in its economic dimension, where negotiations will necessarily be gruelling and results will only be visible in the medium or long term.

Among them, the following would seem to be crucial:

First, the implementation of a “Stability Mechanism” revolving around the common budget for the Eurozone. This Mechanism could be fully implemented through countercyclical support to national unemployment protection systems, as stated in the Franco-German Meseberg Declaration, or through a public-private investment support scheme, in line with the Juncker Plan or “European Strategic Investment Fund” of 2014 (in which the EIB could play a role) or using some similar mechanism, as suggested in the new bilateral contribution of France and Germany presented to the Eurogroup in November 2018.¹⁶

¹⁶ <https://www.consilium.europa.eu/media/37011/proposal-on-the-architecture-of-a-eurozone-budget.pdf>



Secondly, a scheme to create “risk-free European assets”, in line with the proposals made, for example, by the ESRB,¹⁷ which allow for further progress in decoupling the debt/bank loop.

Last, but not least, reforms in the governance of the Eurozone, both with regard to the gradual integration at EU level of the current intergovernmental mechanisms (the Fiscal Compact or the ESM), as provided for in the recent legislative proposals of the European Commission,¹⁸ and by creating a political figure for matters relating to the euro equivalent to the High Representative of the Union for Foreign Affairs and Security Policy (whether styled “European Finance Minister”¹⁹ or referred to by some other job title that might be easier to swallow in some capitals).

All these are “must haves”, not just “nice to haves”, as insidiously stated in the “Letter of the Eight”.²⁰ Without progress on all of these fronts, we shall never have a real EMU.

But the priority objective, at this moment in the European political debate, must be to bring the Banking Union to completion.

This agreement is essential and should be possible, despite the well-known difficulties, before the next European elections in June 2019.

After the elections there will still be much to be done on all other fronts. Indeed, the Eurozone will always be under construction. In Europe, we shall never get to see anything close to what economists call an “optimum currency area”. Europe’s complexity makes it impossible.

Although there may be no optimum in the real world, in the Eurozone – even over the very long term – economic divergences will continue to be wider than in other currency areas of the world. Banks’ exposure to their home markets is greater, even if cross-border banks emerge in the future; and tax, legal and labour barriers, not to mention linguistic or cultural ones, will always be stronger.

But, as Jean Claude Juncker stated on the recent 25th anniversary of the signing of the Treaty (1 November 2018): “The euro and Maastricht are forever.” Monetary integration is here to stay.

An agreement on the Banking Union would be key at this stage. A deal would give us the time and stability to move forward with the remaining steps needed for Economic and Monetary Union, once the next European Commission and Parliament is formed as a result of the June 2019 elections, in a period in which political and parliamentary uncertainties and complications will be rife.

Of all the necessary measures, this is the one that is now both politically possible and necessary.

¹⁷ ESRB Working Paper (2018): “*Regulating the Doom Loop*”

¹⁸ COM (2017) 821 final. “Further steps towards completing Europe’s EMU: A Roadmap”

¹⁹ COM(2017) 823 final “A European Minister of Economy and Finance”.

²⁰ “The discussion on deepening EMU should seek a consensus on the “need to have” rather than focus on the “nice to have””, para. 3.



3. EUROPE IN THE MIDST OF CHINA-EU STRATEGIC ECONOMIC COMPETITION: WHAT ARE OUR OPTIONS?

ALICIA GARCÍA HERRERO¹

3.1. INTRODUCTION

As the European Union was recovering from the deepest economic crisis since the euro was created, a number of new challenges popped up. First and foremost, Brexit in June 2018 and a growing number of anti-European and/or populist governments with the most recent – and probably most relevant case – being Italy. Beyond those internal problems, another external shock has hit the EU in 2019, namely the trade war between the US and China. The US-led trade protectionism against China affects the European Union in several ways. First and foremost, it puts at risk multilateralism in trade relations and, in particular, the good functioning of the WTO (Jean, Martin, and Sapir, 2018). In addition, it opens the door to additional trade protectionism with could possibly target the EU as it sits on the largest trade surplus in the world. Third, trade measures taken by the US against China as well as China retaliation have indirect consequences on Europe. These can be positive for some sectors and European exporters have gained a comparative advantage against US exporters in China markets for the US goods on which import tariffs have been imposed and that Europe can produce (Wolff, 2018). Conversely, European exporters have an advantage in the US market compared to Chinese exports for those sectors targeted by the US with tariffs. However, this positive scenario gets blurred when one thinks of the complexities of the global value chain which can lead to increases in European costs of production due to third countries' import tariffs as long as they lie within Europe's production chain (Chiacchio, 2018). This is, no doubt, the case of China.

¹ Senior Research Fellow at Bruegel and Professor at Hong Kong University of Science and Technology.



Given the above complexities, it seems important to analyze in detail what has happened so far on the US-China trade war and beyond trade as this article will hold the view that trade is just one of the facets of much more structural economic confrontation between China and the US. Second, we move to analyse the EU's potential gains on the basis of the trade measures taken by the US and China on each other can help us focus on Europe's potential gains, at least at a sectoral level. Finally, a review of Europe's strategic options in a world that tends to be increasingly divided in two blocks (China and the US).

The paper is divided into 5 sections. The first section is to introduce the background of the US-China trade war. The second section is to provide a review of US-China trade protectionism and the impact of trade war on China and the US. The third section is to show a sectoral analysis of trade measures taken by China and the US. The fourth section illustrates EU's first-best strategy regarding the US-China trade war. The fifth section discusses how EU behaves in the US-China trade war.

3.2. AN ACCOUNT OF US-CHINA TRADE PROTECTIONISM

From seemingly untargeted measures announced in early February for solar panels and washing machines (**Table 1**), the US has moved to increasingly targeted action against China. The most obvious case in point was the announcement of 25% additional import duties to be applied to USD 50 billion equivalents of imported goods from China on the basis of China's infringement of intellectual property rights (Garcia Herrero, 2018a). More importantly, about two thirds of those import tariffs have been applied since July 6. The US' speedy introduction of the announced import tariffs, without allowing for much time to negotiate a deal between China and the US, shows that the US resolves to move away from the status quo in terms of the functioning of the global trading system, at least as China is concerned. On that basis, China had no choice but to retaliate with equivalent import tariffs on US goods.

Since then, the list of Chinese imports that the US is aiming at increasing tariffs has expanded again to an additional USD 200 billion. Thanks to a three-month truce reached recently at the side-lines of the G-20 summit, the additional USD 200 billion goods from China will not be confronted with a 25% import tariff yet but it looks increasingly clear that this is just a truce to buy time from both sides and that confrontation is escalating. The recent arrest of a Huawei's CFO because of a potential breach of sanctions against Iran is the proof of the pudding of how far the US is ready to go in weaponizing its current hegemonic position as rule setter.

Going back to the trade war, China's ability to retaliate on trade is obviously more limited as it does not import enough goods from the US to match the announced USD 200 in import tariffs from the US, which explains that China's second batch of second retaliatory measures have been more moderate, at least in size (USD 60 billion). Also the latter have been put on hold thanks to the recently agreed three-month truce.



TABLE 1. US TRADE MEASURES

Type of Product	Solar panels/ Washing machines	Steel / Aluminium	Intellectual Property (1102 products valued at USD 50bn)	Intellectual Property (6031 products valued at USD 200bn)
Rules	Section 201 Import Relief for Domestic Industries	Section 232 National security	Section 301 Intellectual property laws	Section 301 Intellectual property laws
Effective Date	7 th Feb	23 rd Mar	25% additional duty effective on July 6 for 818 products (worth 34bn) included in the proposed list on April 6, and 284 products (worth 16bn) will undergo further review.	10% or 25% (under public review until August 30, 2018)
Exemption	“GSP-Eligible” developing nations ¹	Australia, Argentina, Brazil and South Korea ²	Targeted at China	Targeted at China
Applied to China	√	√	√	√
Retaliation from China	N/A	Tariffs on \$3 billion of 128 products including pork, fruit, nuts and wine of up to 25%	25% duty effective on July 6 for 545 products valued at about \$34 billion and 114 products valued at about \$16 billion with no effective date announced	5207 products valued at USD 60bn (duties of 5, 10, 20 or 25 percent)

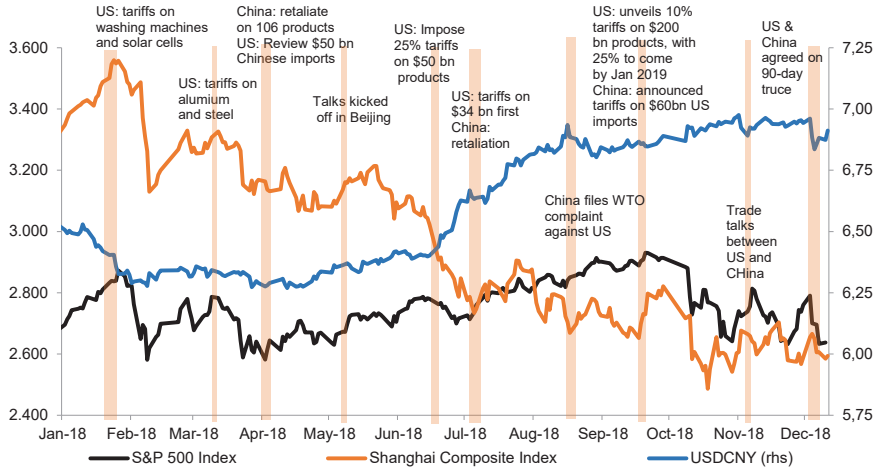
N.B. 1 Philippines and Thailand are not excluded, even though they are GSP-Eligible. 2 Exclusions from US steel and aluminium tariffs may take 90 days.

Source: Natixis, U.S. Government.

The market reaction so far seems to have been more negative for China than the US, at least as far as the stock market is concerned (**Chart 1 and Chart 2**), which has lost more than 20% year to date. Furthermore, the RMB has depreciated quite substantially since the beginning of the trade war until recently, helped by the recently announced truce between the US and China. One may wonder whether the market is overreacting to the potential consequences of such trade war on China or, perhaps, underestimating the impact on the US. So far European markets seem to have remained relatively more insulated from the US-China trade war except when the US pointed towards protectionist measures against Europe directly, as was the case when the temporary lifting of the tariffs

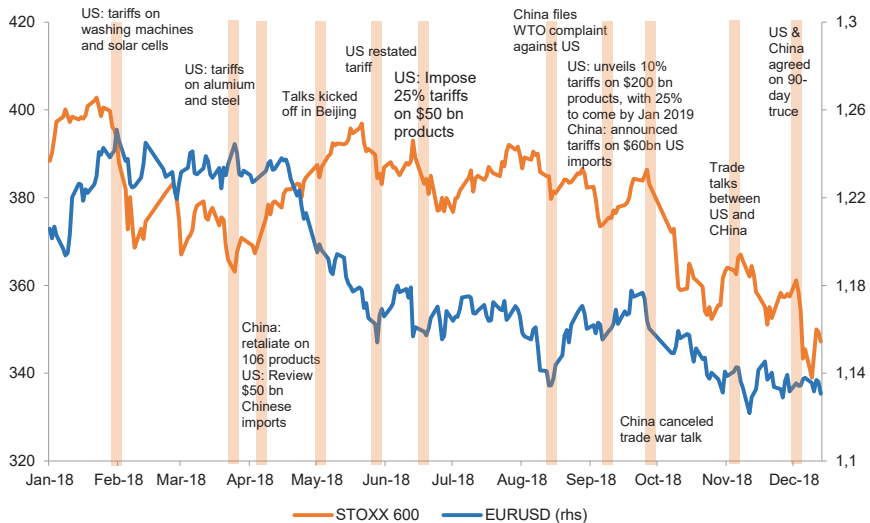
on steel and aluminum were lifted in spring and the threat of import tariffs of autos and auto parts was raised in early summer.

CHART 1. MARKET REACTION OF US AND CHINA



Source: Bloomberg, Natixis.

CHART 2. MARKET REACTION OF EUROPE



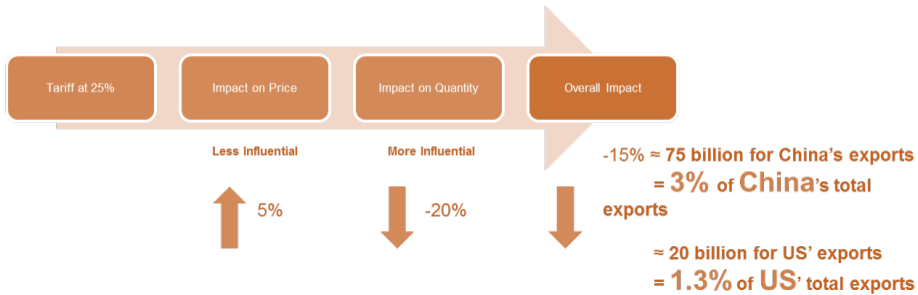
Source: Bloomberg, Natixis.

Moving on to the potential economic impact of the trade war, there have been attempts to estimate the direct impact of tariffs on trade and, thereby, on growth. For



example, the IMF in its latest World Economic Outlook has estimated that the Chinese economy would grow 1.6% point less in 2019 and the US economy will grow 0.9% point less in 2019 if the trade war were to be maintained in 2019. Also, the Euro area's growth rate would be shelved by 0.4% in that scenario. The World Bank, instead, has a much more benign scenario in its latest global economic prospects, as it has estimated that the Chinese economy will only grow 0.2% point less in 2019 and the US economy will grow 0.2% point less in 2019. In the same vein, estimates of price and income elasticities of Chinese exports into the US by Garcia Herrero (2018b) point to a relatively limited value of China's total exports affected by tariffs. Even if the USD 200 billion Chinese were to be confronted by full 25% tariffs, the overall impact on Chinese trade would be limited to only 3% of China's exports and only 1.3% of the US' exports (**Chart 3**).

**CHART 3. ESTIMATION OF THE A FULL-FLEDGED TARIFF WAR
ON CHINA-US BILATERAL TRADE**



Source: Natixis.

Overall, the reason for this relatively limited economic impact, especially when compared with the very negative market reaction, especially for China, is that such exercises only take into account the direct effects on tariffs on trade and not indirect effects on investment through a worsening of market sentiment, among many other channels. The impact on expectations and, thereby, future investment, is probably behind the market fear, especially in China but also in the US and, to a lesser extent, Europe.

The issue is that market may be realizing that the risk is not only protectionism but much more than that as the US' ultimate goal is to try to contain China. In fact, investors both in China and abroad are starting to worry that their investment is possible to be completed blocked by the US or indirectly affected by the worsened relationship between China and the US (Garcia Herrero and Xu, 2018). Moreover, the multilateral trade order maintained by the US is likely to be massively transformed. If that happens, the world will have to return to a much less free system for goods and service flow. It is due to the increasing uncertainties that the market investors' sentiment have become more and more negative.

One way to go about the potential impact of the ongoing trade war might be to look in more details at the measures taken so far and analyze its rationale so as to draw conclusions about their potential consequences down the road.



3.3. A DEEPER ANALYSIS OF THE TRADE MEASURES TAKEN BY THE US AND CHINA

The analysis of the sectoral composition of the goods targeted by the US administration would support the view of relevant structural changes to happen in the global economy due to the trade war. The first round of the US tariffs (USD 50 billion) aiming at China's high-end exports with a view to contain China's technological advance, with 7% of the products on the very high technology products and 55% on the high technology products (Garcia Herrero, 2018c). Some of the products included in the US tariff list has yet not been Chinese exports to the US, such as aircraft and aerospace or arms and ammunition, so the US' true intention of the tariff is not reducing trade deficit with China, but to contain China's moving up the technology ladder. By including products that do not contribute at all to the US bilateral deficit with China, one could argue that the US is revealing its preferences, at least indirectly, which are to contain China in what it wants to become, namely a technological power that competes with the US in high-end products.

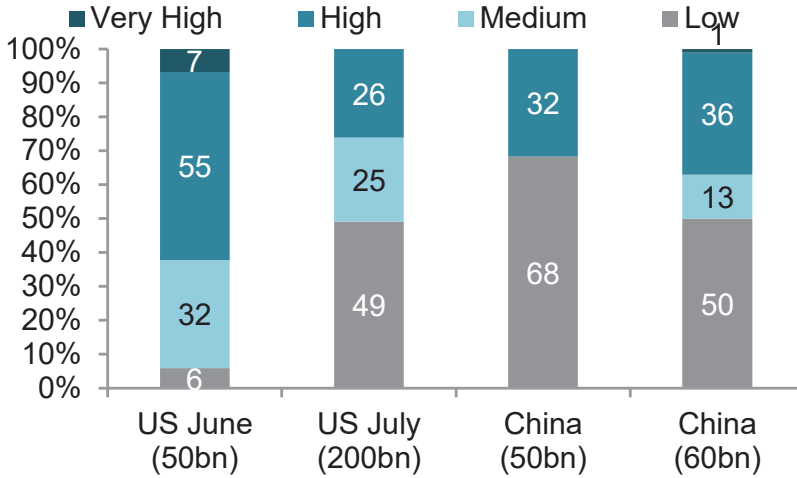
Very interestingly, China appears to have realized quite quickly of the US intention as it has rapidly modified its own retaliation list from a more balanced one which included high-end imports from the US (including aircraft and aerospace) to one more focused on low-end products, such as agriculture (especially soy) and energy. Such a strategy makes sense in as far as imposing tariffs on high-end products which China does not yet produce or cannot be sourced anywhere else would only hurt China. This is because it would only increase the price of products needed for China to achieve its ultimate objective, namely, to move up the ladder of the value chain.

Moving on to the second set of import duties announced by the US, namely that of USD 200 billion to be imposed by August 30, the product composition seems to be very different. In fact, low-end products dominate but, interestingly, very few of them are final – especially consumer – products (with only 22% of total) but rather intermediate products. One could interpret this second wave of import tariffs as a way to re-shore the production of intermediate goods back to the US (or at least to a third country which is not China) and reduce China's role in the global value chain. This interpretation of the second round of tariffs could have tangible implications for third countries which are now part of the value chain and have better economic relations with the US (even a free trade agreement which insulates them from increases in US import tariffs across the board). This is the case of Vietnam as well as Mexico (if NAFTA is finally renewed). But the US has silently removed some key products which would be expensive to substitute in terms of increase in prices for the final consumer (such as white goods for which China has become the largest supplier by far).

For this second round of tariffs, China's retaliation is much smaller with only 60 billion due to the limitation of the total volume China imports from the US. Yet, it is already a large bulk of the total retaliation list China can further extend. In this round of retaliation, all low, medium and high technology stuff are included which shows a determined stance that the Chinese authorities will not retreat from the US threat. Also, more high-technology products as China's imports from the US are limited (**Chart 4 and Chart 5**).

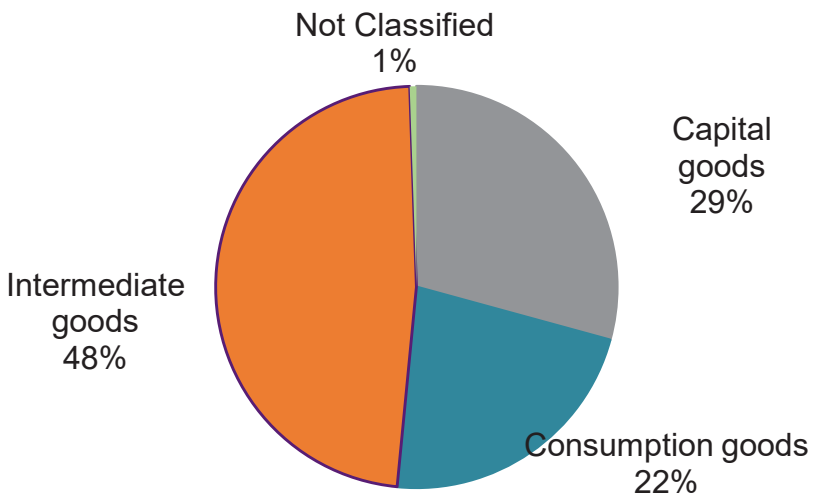


CHART 4. A COMPARISON OF THE US-CHINA TARGETED PRODUCTS RELEASED IN JUNE AND JULY (%)



Source: Natixis, USITC, UN Comtrade.

CHART 5. DECOMPOSITION OF US' IMPORTS FROM CHINA UNDER THE 200 BILLION TARIFF LIST



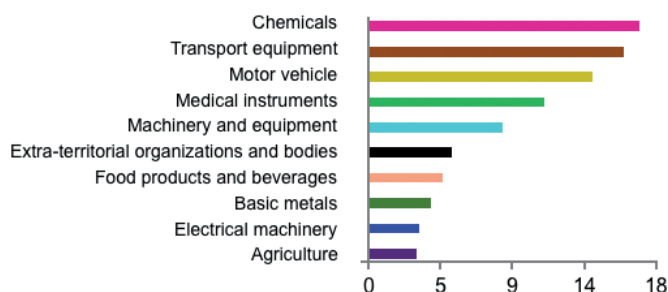
Source: Natixis, USITC.

3.4. WHAT IS THE IMPACT OF EUROPE?

Based on the above (namely the structural nature of the trade war between the US and China) the question to ask ourselves is how this may affect Europe.

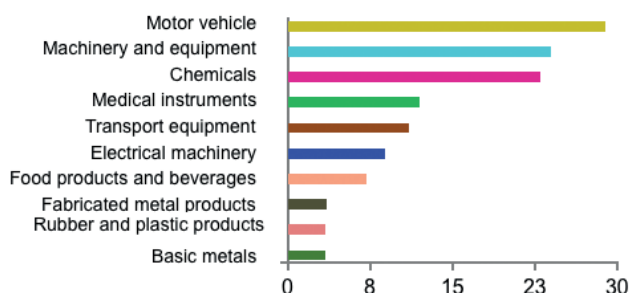
While a trade war can hardly have any winner in absolute terms, as trade is generally beneficial for global growth, there could be some relatively worse or better outcomes depending on the country and sector. If the current dispute between China and the US moves on with punitive tariffs upon each other, the market space left out in the two giants' territory should be, to a certain extent, filled by competitors from the rest of the world. As the biggest economic bloc in the world, the EU is, without doubt, a potential winner in this aspect. So far, the EU is the second largest exporter to both China and the US. This makes the EU exporters most likely to take up the market shares of both of China and the US' companies in midst of the trade war.

CHART 6. CHINA'S TOP 10 IMPORTS FROM THE US IN 2016 (USD BN)



Source: Natixis, UN Comtrade.

CHART 7. CHINA'S TOP 10 IMPORTS FROM THE EUROPE-5 IN 2016



Source: Natixis, UN Comtrade.

N.B. Europe-5 includes Germany, the U.K., France, Italy and Spain.

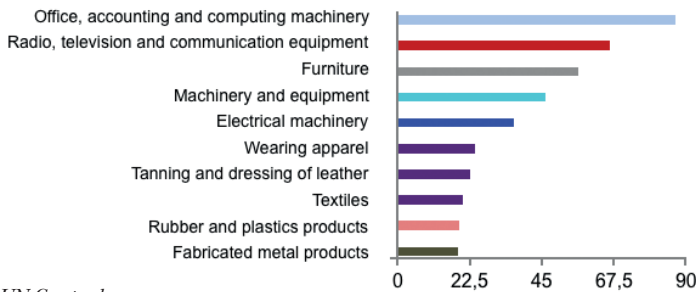
Note: The same color indicates the overlay of the US and the EU's exports to China among the top 10 imports in China.

At first sight, the size of the US market (€ 375.5 bn) is bigger than that of China (€ 198.2 bn), which seems to give the EU more opportunities in the US market than



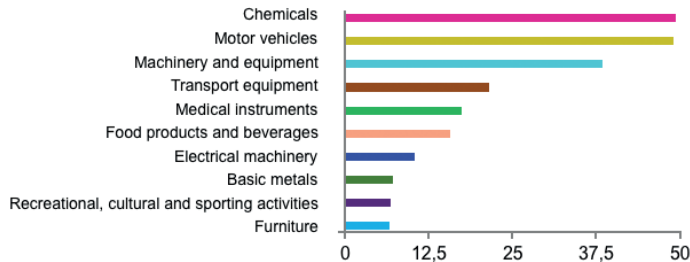
China's market. However, a more granular product-level analysis is needed to understand which sectors can potentially benefit from the trade war. When comparing the export structure of the three economic areas, we find that EU and US companies export more similar products than Chinese corporates, as it could not be otherwise, given the three regions 'different level of development. For example, the top 10 Chinese imports (at the ISIC 2-digit level) from the US and the EU are exactly the same including Transport equipment, Motor vehicles, Medical instruments, Machinery & equipment and Chemicals (**Chart 6 and Chart 7**). While in the US' market, the top two exporting products from China include Office, accounting & computing machinery and the white goods, which are not even top 10 exports from the EU yet (**Chart 8 and Chart 9**). This means, if the US and China are crowding out each other's exports, the EU's exporting structure would suggest more chances in China's market. Also, European products are potential substitutions of American products in the Chinese market but also the other way around, namely substituting Chinese exports into the US by European ones. It goes without saying that, for Europe to reap such benefits, it would need to remain neutral in its trade policies and refrain from aligning from the US to impose tariffs on Chinese goods.

CHART 8. THE US' TOP 10 IMPORTS FROM CHINA IN 2016 (USD BN)



Source: Natixis, UN Comtrade.

CHART 9. US TOP 10 IMPORTS FROM THE EUROPEAN-5 IN 2016 (USD BN)



Source: Natixis, UN Comtrade.

N.B. Europe-5 includes Germany, the U.K., France, Italy and Spain.

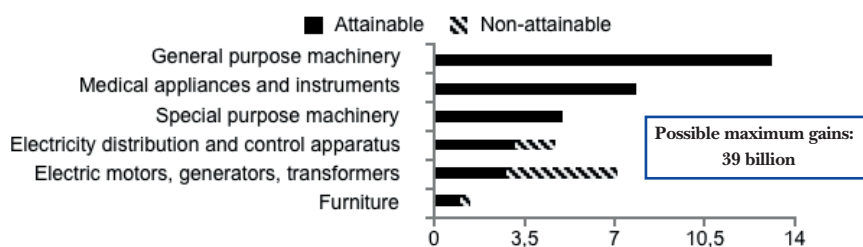
Note: The same color indicates the overlay of the US and the EU's exports to China among the top 10 imports in China.

In such a case, one could estimate the potential maximum gains of substituting Chinese exports into the US and the other way around in the sectors on which tariffs have been imposed upon. The end result is that some specific sectors can really benefit to the extent of nearly doubling their production for exports. This is especially the case of the general purpose machinery sector for the first USD 50 billion package of import tariffs imposed by the US. EU exporters clearly gain more from substituting Chinese exports into the US than the other way around. In other words, the EU dependence on the US goes well beyond the Atlantic Alliance and lands right on economic issues such as trade dependence.

To quantify the benefits for European companies, we first calculate the product overlap (at the HS-6 level) between EU and Chinese exports to the US market, and the EU and US exports to China's market, respectively, and then confine the overlapping product list to the targeted products during the trade war. This gives us a list of the maximum gains that Europe can make for every product both in China's market as well as that of the US. Finally, we match the HS-6 products to the 3-digit level ISIC Rev.3 sectors² to get the maximum potential gains for EU. The relevant sectors are defined as those that have been targeted by the US or China (or both) with additional import tariffs and, at the same time, what the EU has already exported with certain product value (>\$1 billion) into the US or China (or both).

In the first round of the crossfire, both the US and China targeted \$50 billion products on each other. The biggest winners (with potential gains bigger than \$10 billion) from China's market are the EU's aircraft & spacecraft and basic chemicals sectors and the general purpose machinery sector from the US' market (**Chart 10 and Chart 11**). While both countries' target the exact amount of imports, the potential sector gains are higher in the US' market (\$ 39 billion) than China's market (\$ 30 billion).

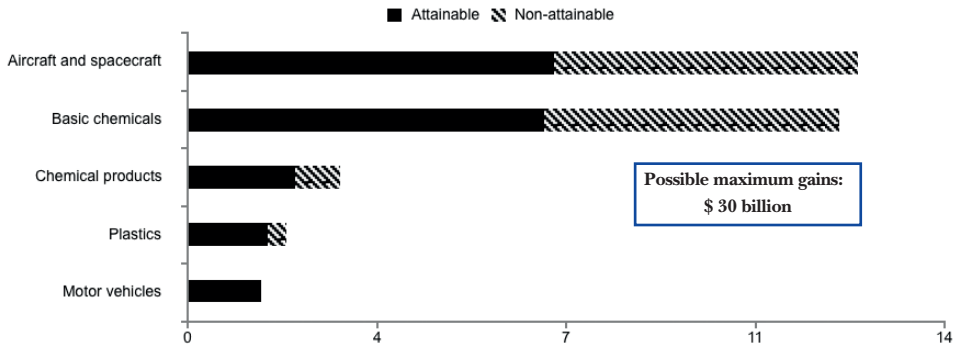
CHART 10. EUROPE'S GAIN IN US' MARKET FOR THE FIRST 50 BN TARIFFS ON CHINA (FOR SECTORS > \$1 BN)



Source: UN Comtrade and the concordance table from WITS. The calculation of the sector's maximum market gain is based on all the related goods in the first round of the tariff lists. The solid part of the bar indicates the EU's current exports to the destination market.

² We use the concordance table provided by the WITS to converse the HS classification into the ISIC Rev.3 classification.

CHART 11. EUROPE'S GAIN IN CHINA'S MARKET FOR THE FIRST 50 BN TARIFFS ON THE US (FOR SECTORS > \$1 BN)



Source: UN Comtrade and the concordance table from WITS. The calculation of the sector's maximum market gain is based on all the related goods in the second round of the tariff lists. The solid part of the bar indicates the EU's current exports to the destination market.

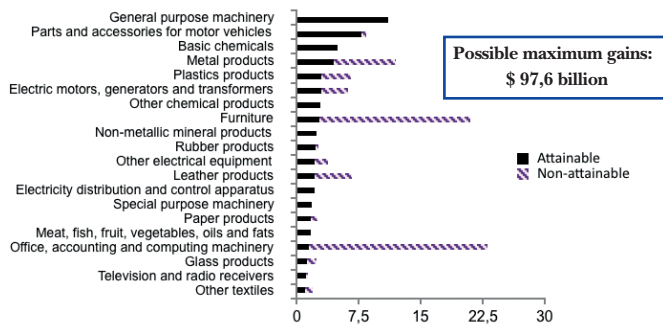
In the second round of the crossfire, the US has escalated the tariff list to \$200 billion imported products from China (although the current three-month truce has limited the tariff increase to 10% instead of the 25% planned). This again gives the European firms more room to access to the US' market, with the possible maximum gains reaching \$97.6 billion (or 50% of total). The benefits will now be extended to some of China's key exporting field such as office, accounting & computing machinery as well as furniture, both of which are already the EU's top 10 exports to the US and have potential to substitute China's exports (**Chart 12 and Chart 13**). That said, the two sectors are restricted in their current capacity to replace the related products in second round of the US' tariff list, as China's exports to the US on these products are more than seven times as large as the EU's current exports so it takes longer time for the EU to accumulate enough capacity to take place of Chinese producers.³ On the other side, the EU's relative benefits in China's market is much smaller as the tariff list only covers \$ 60 billion products in total (only \$38.5 billion but a larger percentage of the total amount goods on which tariffs have been imposed upon, namely 66%). In China's market, European gains will be extended to medical & precision products and basic chemicals, and to lesser extent, to general purpose machinery.

That said, European potential gains will very much depend on Europe remaining neutral on the US-China trade war instead of following the US by imposing import tariffs on China. If the EU is forced to pick the US side and impose its own import tariffs on China, China will probably also retaliate against EU companies. It should also be noted, though, that the potential gains to be made are bigger in the US (beyond the already

³ In the calculation of the maximum gains, we take into consideration the capacity restrictions by imposing the maximum gains as three times as large as the current EU companies' exports.

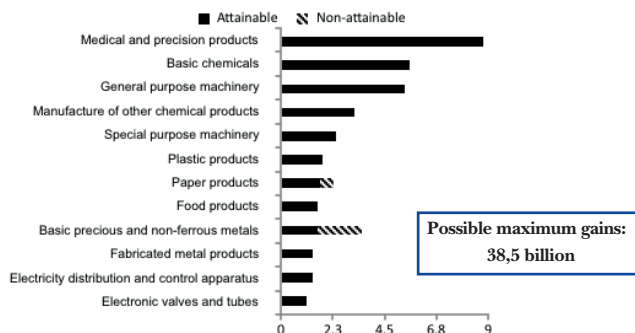
larger export revenues) largely due to more tariffs imposed from the US' side. In other words, beyond Europe's historical alliance with the US which will keep EU policies closer to the US than they would ever be with China, the EU also fears losing the US market even more than that of China as its export share to the US is larger than China (Chart 14) while China remains more relevant for EU imports (Chart 15). The fact that Europe, an overall net exporter, continues to maintain a bilateral trade deficit with China does not help (Chart 16). Obviously, a neutral stance as regards China is the best of all situations with some clear winners among European export sectors but the US clearly comes first in the EU's interests even if you only focus on trade gains.

CHART 12. EUROPE'S GAIN IN US' MARKET FOR THE SECOND 200 BN TARIFFS ON CHINA (FOR SECTORS > \$1 BN)



Source: UN Comtrade and the concordance table from WITS. The calculation of the sector's maximum market gain is based on all the related goods in the second round of the tariff lists. The solid part of the bar indicates the EU's current exports to the destination market.

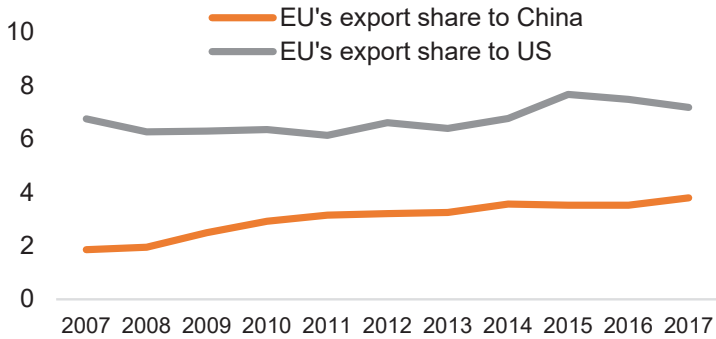
CHART 13. EUROPE'S GAIN IN CHINA'S MARKET FOR THE SECOND 60 BN TARIFFS ON THE US (FOR SECTORS > \$1 BN)



Source: UN Comtrade and the concordance table from WITS. The calculation of the sector's maximum market gain is based on all the related goods in the second round of the tariff lists. The solid part of the bar indicates the EU's current exports to the destination market.

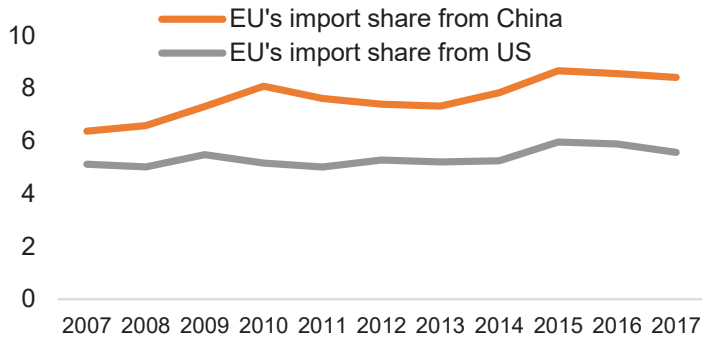


CHART 14 EU'S EXPORT SHARE TO CHINA AND US, 2007-2017, %



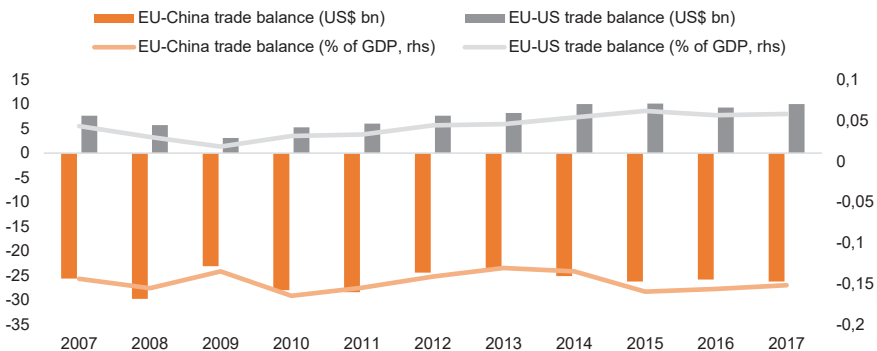
Source: UNCTAD.

CHART 15 EU'S IMPORT SHARE FROM CHINA AND US, 2007-2017, %



Source: UNCTAD.

CHART 16 TRADE BALANCE OF EUROPE WITH CHINA AND US, 2007-2017



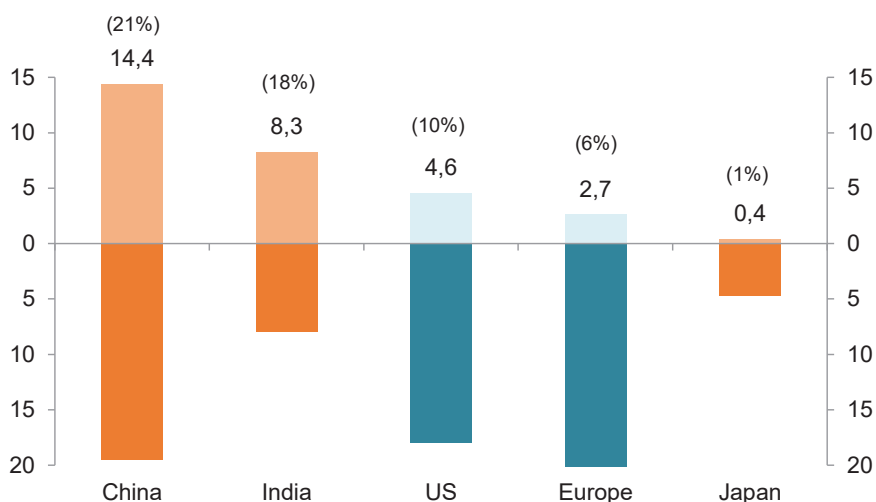
Source: UNCTAD.

All in all, our analysis shows US-China trade frictions are here to stay in as far as they respond to a fight for hegemony in the global economy. The US wants to contain China’s future – which basically implies direct competition with Chinese products in third markets. In that regard, Europe, being export oriented and with a similar economic structure can benefit by substituting some of their exports to China. This, however, requires no retaliation from the US towards Europe. Otherwise, it will be extremely difficult for the EU to keep a neutral stance on the trade war.

3.5. OPTIONS FOR EUROPE IN THE LIGHT OF INCREASING ECONOMIC COMPETITION BETWEEN CHINA AND THE US

What the US-China trade war has brought about is not only short-term trade tensions, but more importantly, a systematic shift of the trade order which has supported the world’s development for the past century. Undoubtedly, the US and China will be the most influential bloc in the 21st century, and their conflict is doomed to be long lasting. While the two countries may find some temporary solution to the current tariff disputes, their conflicts are intrinsically embedded in the competitive stance which could only exacerbate in the future. This is all the more natural when realizing that China’s economy is already as large as that of the US (at least in purchasing power terms and soon in USD terms) but, most importantly, will contribute more than three times the US to the global economy in the next 10 years (**Chart 17**). In other words, although the US is a more important market for Europe today, this will soon no longer be the case, based on the positive growth differential between the US and China, which continues to be very large.

CHART 17 CONTRIBUTION TO WORLD GROWTH (USD TRILLION, %)



Source: Nataxis.



The global influence of the US-China cold war will be persistent. At this turning point, as the world's only one figure that can balance the power between the US and China, the EU has to decide how to respond to the trade war. There are several options under current discussion.

3.5.1. SAFEGUARD MULTILATERALISM?

The EU has been long called for economic multilateralism and is pushing for the reform of the WTO to adapt to China's sheer size without having become a market economy. In fact, one could argue that one of the key areas of contention from the US side is indeed China's different economic model while still being part of a free trade world. The European response to this reality is to keep, if not enhance, multilateralism, by reforming existing institutions, especially the WTO so as to impose market practises on all members in order to protect fair trade (Demertzis, 2018).⁴ This really means that the WTO will need to address the issue of the large role of state-owned enterprises in the production of goods and services and the pervasive role of subsidies to the production. This would bring the WTO close to the US concerns over China's unfair practices in international trade.

While the EU may easily find common ground on the key issues with the US (only if the current US administration were to engage in such reform which is not the case now), but the reform requests could be hard with China. In fact, the role of SOEs is considered key in China's model of socialism with Chinese characteristics and, thus, impossible to dismantle in the foreseeable future. Chinese will argue that the role of SOEs remains moderate⁵ and, thus, should be a no issue for WTO reform. The Chinese have also borrowed the concept of competitive neutrality from the OECD and argue that they are increasingly close to applying competitive neutrality among companies operating in China. Garcia and Xu (2017) hold a very different view on the role of SOEs in the Chinese economy both because of its more pervasive influence but, more importantly, because of their very different nature to other SOEs in the world. In fact, the key reason for their unequal footing with the rest of companies operating in China, including private Chinese companies, is their preferential access to market in many sectors as well as their special connection with China's long-standing party, namely the Communist Party.

That said, the EU will also find the US difficult to cooperate in the reform of the WTO. Since its arrival to power, Trump has pushed the "American first" policies and certainly not the support of multilateralism. In fact, the tariff measures taken by the US based on the "security" reasons while bypassing the WTO's multilateral settlement mechanisms is a clear sign that the US may overthrow the multilateral value at its own interest.

⁴ For more details as to how Europe can defend multilateralism in the world and what are the options for Europe, please Jean, S., Martin, P., and Sapir, A. (2018) and Wolff G. (2018).

⁵ According to China's National Bureau of Statistics, in 2015 SOEs accounted for 38.8 percent of total assets for industrial enterprises above scale.



As such, while the US seems to share more of the market and democratic values with the EU, it does not seem ready to fully conform with the EU's proposal for a WTO reform so as to preserve multilateralism.

Under such circumstances, it does not seem very credible for the EU to continue to push the agenda of multilateralism without the US and China. On the other hand, though, it looks extremely dangerous for the EU not to do as it is no longer a superpower, nor does it intend to be one. All in all, while continuing to make efforts to preserve multilateralism, Europe may need to explore other responses to the current standoff between China and the US, aware of the increasingly slim chance that multilateralism becomes the driving force again.

3.5.2. ENHANCING EUROPE'S RELIANCE ON THE TRANSATLANTIC ALLIANCE?

Another potential option for Europe is to keep the status quo while reinforcing it on the basis of an increasing economic confrontation between the US and China. In other words, the EU may also choose to lean completely on the US. The question is how wise it is to do so in the current environment with clear changes in the US attitude towards multilateralism. This is all the more disappointing in as far as it was the US, who pushed for such a system, as a way to create a safe environment for its allies and eventually to engage the rest of the world after the collapse of the Soviet Union.

The current US administration has made it very clear that multilateralism and open trade is something of the past. The gunfire that the US has triggered is not only against China but against many other countries including the EU. Only in 2018, the US has already threatened tariffs on steel, aluminium, and cars on the EU. It also criticized the EU for its large trade surplus against the US. Also, the US has criticized the EU for not fulfilling its economic responsibility on military spending as members of NATO. As such, the EU alliance with the US will be more costly for the EU than it has ever been as the US is not happy with the current distribution of costs and benefits of such Transatlantic Alliance.

More importantly, because the US has chosen a non-market bilateral way to deal with China as well as other issues, the EU's complete support for the US will mean that it has to give up on its rule-based approach to problem solving and, thereby, its principles. This is obviously very costly for the EU as its own internal market is based on a strong rule-based system as well as for the world since the EU is the bastion of multilateralism. The case of the reform of the World Trade Organization is a clear case in point since the EU is really holding to it and would probably not manage to do so if pushed towards a relation of clear dependence from the US.

There is another practical reason which restricts the EU from leaning on the US completely. The EU is not a single country, but a group of 28 (soon probably) countries which have different views about the US and also about China. In fact, while Western Europe may be easier to unite against China, Eastern Europe, but also Greece and Portugal, and recently perhaps even Italy, may express opposing views as to a strategic alliance with the US which requires leaving China aside. In fact, the recent effort for the EU to



establish an EU-level investment screening system resembling the US' famous CFIUS has been vetted by some EU members so that its final version is really very limited in scope and hardly a threat for China. China has also created a platform with Eastern European and Balkan countries, the so-called 16+1, since all of these countries are part of China's led Belt and Road Initiative (BRI). Many of these countries expect to ease their financial concerns through investment from China as well as to reduce their dependence on Brussels. This, in itself, poses problems for the EU and might actually push it even closer to the US notwithstanding the costs.

3.5.3. STRENGTHENING COOPERATION WITH CHINA

Strengthening cooperation with China is also a practical – albeit unlikely – choice for the EU in as far as its current strategic ally, the US, is moving away from multilateralism, thereby harming EU interests. In fact, not only is China's economy of similar size to the US already today but its contribution to the global growth will be much bigger as previously shown. This means that the opportunities in the medium term should be bigger in China but under a very important hypothesis: market access.

This is why most of the discussion as to whether Europe should rebalance its economic partnership towards China, at least partially, boils down to improving European companies' market access in China. Within that context, the EU started negotiating a bilateral investment agreement (BIT) with China at a time when the economic relations still have a positive perception from the European side but things have changed quite dramatically since then. In fact, the 12th round of BIT negotiations has been without an agreement. The key stumbling block is indeed market access for European companies in China and reciprocity, which is of course related to the perceived lack of market access.

Beyond market access, EU authorities are concerned about potential discrimination against EU investors operating in China, including explicit or implicit preferential subsidies for certain enterprises. Such discrimination may also be a factor for Chinese companies operating in Europe. While market access is a more general issue, potential discrimination by means of implicit or explicit subsidies has linkages to the role played by Chinese SOEs. This is not only true for the Chinese economy, but also for Chinese investment in Europe because a good part of it (most of it until very recently) originates from SOEs.

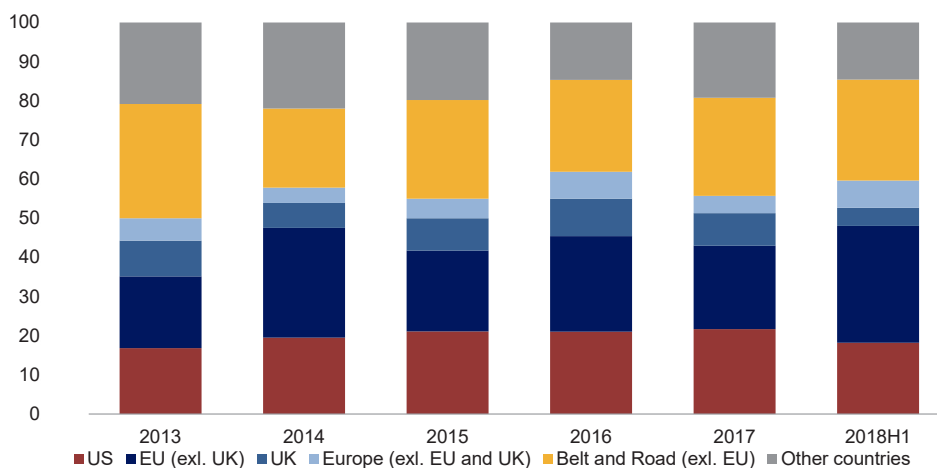
In China, SOEs have a much wider scope as they originate from the planned economy era when they dominated all sectors (either SOEs or collectively-owned companies). Most Chinese SOEs, even now, are not established on the basis of correcting market failure, but more to carry out government objectives. Chinese SOEs are bigger, more pervasive, more dominant than their EU counterparts, and more importantly, exist in nearly every key sector in Chinese society (**Table 2**). Against the backdrop, the Chinese government has created a special favorable environment for the SOEs. This actually triggered the concerns over their unfair competition in the international market and is one of the key barriers confronting China's building economic alliance with the EU.

TABLE 2. SECTORIAL SALES DISTRIBUTION OF SOES, POES AND FOES IN CHINA IN 2008, IN PERCENTAGE

Sector	SOE	POE	FOE
Health	58.92	41.06	0.02
Wholesale & Retail	2.20	97.73	0.08
Construction	24.43	75.26	0.30
Culture	54.71	44.36	0.94
Education	34.06	64.85	1.09
Finance	21.74	76.78	1.48
Accommodation	25.96	71.60	2.44
Real Estate	7.32	90.11	2.57
Environment	43.65	53.51	2.83
Research	33.94	62.28	3.78
Lease business	26.94	64.65	8.41
Restaurant	4.00	86.96	9.04
Manufacturing	15.11	75.26	9.63

Source: Bruegel based on China's Economic Census Data. Note: FOE = foreign-owned enterprise.

CHART 18. DESTINATION OF THE OVERSEAS COMPLETED M&A (THE PERCENTAGE BY NUMBER OF DEALS)



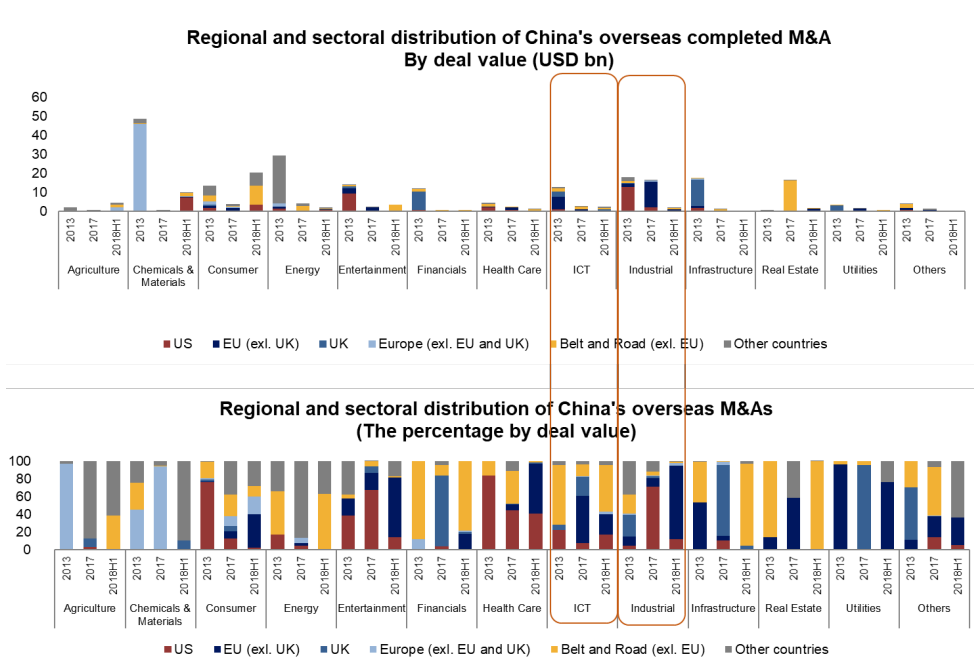
Source: Mergermarket, AEI, NATIXIS.



EUROPE IN THE MIDST OF CHINA-EU STRATEGIC ECONOMIC COMPETITION: WHAT ARE OUR OPTIONS?

The hope of a EU-China BIT is that it should foster investment on both sides, but the reality is that, at this current juncture, Chinese investment into the EU is ballooning while EU investment into China is slowing down and is already smaller than that of China into the EU. More specifically, in 2011, China’s outward FDI (including that from Hong Kong) accounted for only 1 percent of EU total inward FDI, whereas China took 3.5 percent of the EU’s outward FDI. Given the size of the Chinese economy in the world already in 2011, this can be considered relatively modest. The situation today is very different. **Chart 18** shows that EU has been seen the largest growth in attracting Chinese investment since 2016, particularly in the industrial and ICT sectors where China has been eager to cooperate to climb up on the technology ladder (**Chart 19**). Because the US has closed its door to China on the basis of “national security concerns”, the EU is now the only place that is easier for China to access in buying foreign companies.

CHART 19



All in all, given the increasingly difficult relation with the US, a certain degree of rebalancing towards China should be explored by the EU. However, the key stumbling block will continue to be China’s state capitalism and the lack of market access to foreign companies. For the specific case of state-owned ownership, preferential market access in China, rather than ownership of SOEs, should be the key consideration for European policy makers when evaluating the undue advantage enjoyed by Chinese corporates. This is because private companies with ties to the Chinese government might also



benefit from preferential market access. The recent case of Huawei shows how much the Chinese leadership may fall behind key private companies, especially if they belong to strategic sectors.

More generally, the first priority issue that an EU-China BIT should pursue is market liberalization, so that any market access granted through the BIT puts European companies on an equal footing to their Chinese competitors (even with SOEs). This obviously requires, at least, reciprocity (García Herrero and Xu, 2017). In fact, market liberalization is important not only for foreign companies but also for Chinese private companies so that gains are also shared with China (European Parliament, 2016).

While engaging with China in the liberalization and opening up, the EU cannot remain fully open to China's acquisitions of technology and the competition of Chinese state-supported companies in the single market. Europe has just announced a stricter framework for the screening of foreign investment (mainly directed at Chinese companies). Still, three key instruments might be used, with some reinterpretation of the EU Treaty, namely competition, dispute resolution and state aid policy. The first one does not require explanation nor state aid policy, with the caveat that it cannot yet be applied to non Member States. As for the dispute resolution, identifying unfair behavior by a firm can be easier after a firm reveals its status by operating in the EU market. An appropriate dispute settlement mechanism can protect both European and Chinese corporates. Among the different options, an investor-state dispute settlement system (ISDS) seems to be favoured internationally, but would need to be revised so that governments (either China or EU governments) do not fall prey to corporates suing them without clear justification. Furthermore, in the Chinese case, the very close links between corporates and the Chinese government (especially when operating abroad) could make ISDS a double-edged sword for the EU, because in certain cases China could, for its own purposes, support its enterprises in suing EU companies. In addition, the implementation of the ISDS might be difficult in China where experience with investor-state arbitration is rather limited and there is very low probability that the Chinese government will enforce foreign court decisions (US-China Economic and Security Review Commission, 2016). A revision of the ISDS is thus warranted to balance the interests of the parties in the BIT negotiation.

As such, we could see that Chinese internal reform is the key for the EU to pursue a better alliance relationship with China. The priority issue that EU and China need to pursue is market liberalization, so that any market access granted through the BIT puts European companies on an equal footing to their Chinese competitors (even with SOEs). This obviously requires, at least, reciprocity. Yet, there is still a long way towards the direction.

3.6. CONCLUSIONS

This paper reviews the impact of the US-led trade war against China and its immediate consequences, not only for China and the US, but specially for the European Union.



The first thing to note is that, although protectionism can never be growth enhancing, and certainly not for a net exporter like the EU, there are still gains to be made by European companies from the ongoing US-China trade confrontation in as far as they may be able to substitute US exporters into China or, less so based on our findings in this article, Chinese exporters into the US. Unfortunately, the current truce agreed between the US and Chinese governments at the sidelines of the G20 meeting might reduce such opportunities for EU exporters and might even create trade diversion again from European products and in favour of American products.

The fact that the EU feels increasingly squeezed between the US and China in their strategic competition should push us to ponder on our options in the current global set-up. So far the EU's option seems to have been to support multilateralism at any cost. Unfortunately, the latter is increasingly less likely as the US has no intention to revert to the model which it once helped create. On that basis, and given Europe's reluctance to play a leading role without the US, the push for a return in multilateralism seems more an option of the past than an option of the future, let alone the present. The second most obvious option for the EU would be to increase its dependence on the US or, in other words, to fush its strategic alliance further. However, but we should realize that this comes at a cost, more specifically two which were not as present before. The first is the increasing unreliability of the US as ally and a seemingly different distribution of costs and benefits for its allies (more costs for the EU, such as military expense, but less benefits on the trade side). The second caveat of a further reliance on the US is the need to align against China in issues of interest to the US. Although such issues are not too different from the complaints raised by the EU on China (market access, reciprocity, excessive role of the State in the economy and a stronger defense of intellectual property rights), the reality is that the US interest will come first in this battle. On the words, the EU could lose its potential preferential access to China because of a stronger alliance with the US. Finally, the third option, namely rebalancing toward China, at least partially, cannot be an option for Europe in the current circumstances because of a very limited access to the Chinese market. However, if China were really to further open up its economy to foreign competition (i.e., offer full market access), this option could become much more favourable. Based on the past experience since China entered WTO, this option seems highly unlikely but worth pursuing. In that context, China's willingness to open up its markets to foreign competition clearly requires market access and reciprocity. While China makes up its mind on whether the above is a real option, the EU has not choice but protect its strategic sectors from China's acquisitions and to safeguard the single market for unfair competition from Chinese SOEs.

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4. ITALY'S 2019 FISCAL BUDGET: A DOUBLE CHALLENGE

FRANCESCO PAPADIA AND INÊS GONÇALVES RAPOSO

4.1. INTRODUCTION

Italy's 2019 fiscal budget raises a double challenge, one for the European Union and one for Italy.

The former is of an institutional nature, the latter of an economic nature. In this chapter, we analyse these two challenges. When looking at the latter, in order to assess the potential macroeconomic impact of the Italian budget, we focus on the effects of a fiscal expansion on the cost and availability of funding for the private sector, in particular non-financial corporations.

4.2. AN INSTITUTIONAL CHALLENGE FOR THE EUROPEAN COMMISSION

The institutional challenge for the Commission concerns the future of the framework for the steering of the fiscal policies of the Member States. This framework started with the Stability and Growth Pact (SGP) and has developed over the years into a multi-component machinery.

The EU fiscal framework has been criticised on three different grounds. One first line of criticism is that it is much too complex and is a vain attempt to cover all possible configurations of events with rules, instead of establishing the criteria and principles of a structured discretion (as prevails in national settings).¹ A second line of criticism is that

¹ For instance, Darvas et al. (2018) argue that reforming the complex European fiscal rules should be a priority in the reform of the euro area and propose a simple new rule based on



the EU's fiscal framework is intrinsically unable to calibrate an appropriate fiscal policy for the entire euro area consistent with the economic cycle. This led, for example, to the strongly pro-cyclical fiscal tightening during the recession years 2011–2013. A third line of criticism is that the framework lacks effectiveness, in the sense that it does not provide real constraints to the pursuit of overly lax national fiscal policies. This last point is only partly valid: an admittedly bland test of effectiveness, namely whether the framework made any difference at all, should conclude that fiscal policies would have been less prudent without the framework: the EU fiscal machinery is neither perfectly effective nor completely ineffective against overly lax policies.

This partial effectiveness of the EU fiscal machinery is now being challenged by the Italian budget. After Italy has exhausted, with previous governments, all possible margins of flexibility built into the framework,² the new government has bluntly said that it is not willing to respect the EU rules, which Italy has freely accepted and translated into national constitutional norms. In line with this attitude, the government presented to the Commission in mid-October a fiscal budget that does not even pretend to be consistent with the European fiscal framework. The Commission then asked to change the fiscal plan so as to make it consistent with the EU rules, but the Italian government has resent practically the same plan, with very minor modifications, again challenging the Commission and indeed the entire common fiscal set-up.

The European Commission and the Council are confronted with a hard choice: either to let Italy do as it pleases, and undermine the credibility of the framework in constraining overly lax fiscal policies, or to use all available tools to maintain whatever effectiveness the framework has established so far. The latter option would imply entering into a struggle with the government of a large EU country with a strong electoral backing, at a time when the important European Parliament election is looming. However, the former course of action is not really possible: the Commission, as guardian of the Treaty, cannot condone such a blatant break of the rules. The Commission is trying to keep the lines of communication open with the Italian government and to convince it that the Italian budget is not only not compliant with the EU rules but also bad for the Italian economy. Indeed, the Commission's caution is justified by its desire not to fuel market panic with excessive reactions. Still, the Commission, in the end, has to hold its ground and have recourse to all available options to bring Italian fiscal policy back within the common fiscal rules. This course of action is reinforced by two important factors: first, the Commission enjoys the support of all other EU governments in its firm stand; second, the Commission regards the fiscal deficit and

nominal expenditure growth, long-term nominal income and the country's debt levels. See also the Franco-German proposal arguing for the reform of fiscal rules "to make them less pro-cyclical, increase national 'ownership', and make them easier to enforce" (Benassy-Quéré et al. 2018).

² A registry of former procedures in the context of SGP is available in https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/closed-excessive-deficit-procedures/italy_en



growth assumptions of the Italian government as too optimistic, so much so that the deviation of Italian fiscal policy in terms of deficit looks even graver than in the Italian government plan, getting close to 3.0% in 2019 and surpassing this level in 2020. Broadly, the Commission forecasts are similar to those of the International Monetary Fund, which also sees growth slower and the deficit higher than in the plans of the Italian government.³

The options open to the Commission to deal with the Italian budget have been detailed by e.g. Claeys and Mathieu–Collin.⁴ Basically the choice is between using the tools within the preventive arm of the Growth and Stability Pact or instead moving to the corrective arm and launch an Excessive Deficit Procedure. The main difference between the two options is in terms of calendar: a Significant Deviation Procedure, within the preventive arm, can be launched only after the budget is implemented, while an Excessive Deficit Procedure can be started three months after the submission of the budget. .

According to the preventive arm of the Growth and Stability Pact, Member States' should have their so-called structural fiscal balance, i.e. the fiscal balance adjusted for the economic cycle, converging towards a country-specific medium-term budgetary objective (MTO). This MTO is 0% in the case of Italy and, like other member-states, Italy should improve its structural balance in order to meet this objective. Both the MTO and the rate at which countries should converge to it are recommended by the Commission, based on the country's debt level and macroeconomic adjustment. In 2019, Italy should adjust its structural balance by 0.6% of GDP. Given that the Italian budget does not respect the MTO, the Commission could issue first a warning and then a recommendation that, if not heeded, would lead to an interest bearing deposit equal to 0.2% of Italian GDP, i.e. around 3.5 billion euro, unless a qualified majority in the Council would decide otherwise. Given the isolation of the Italian government in the Council, this looks extremely unlikely.

The Commission could also have recourse to the corrective part of the Growth and Stability Pact, and launch an Excessive Deficit Procedure, based on the fact that the Italian Debt to GDP ratio does not come down as required by the Growth and Stability Pact, according to which the ratio should decrease, on average over 3 years, by 1/20 of the difference between the actual and the 60% level. At the end of the process, Italy would be again subject to a non-interest bearing deposit and a fine up to 0.5% of GDP.

In both cases Italy would be the first country to be financially penalized because of the deviation of its fiscal policy from the common rules.

The game between the Italian Government and the Commission looks like the proverbial chicken game in which two drivers, wanting to show their bravery, drive their cars one against the other, the one blinking first being the "chicken". The other wins the game. The critical question about Italy and the Commission is who will blink first.

No definitive answer can be given to this question, but there can be partial enlight-

³ The IMF predicts a GDP growth for 2018 of 1.2%, 1% for 2019 and 0.9% for 2020.

⁴ Claeys and Mathieu–Collin (2018).



enment from two factors: first, the experience of Greece; second, the relative strength of the two players.

How the Greek saga ended is well known, the Greek government went to the brink of exiting from the euro and, at the last moment, also taking into account that opinion polls indicated that there was a majority of the population in favour of maintaining the euro, changed policy and accepted the cure imposed by the troika. Whether the cure was the best one is debatable, but this is another story.

The considerations about the relative strength of the Italian government and the Commission are more complex. A first parameter here is the size of the Italian economy relative to the size of the remaining 18 members of the euro area. At around 1/5 this gives a first rough indication of the damage that Italian developments can cause to the two players: Italy would suffer 5 times the damage to the rest of the euro–area. The very limited contagion so far from Italy to other peripheral countries is consistent with this indication. A second consideration is about the economic sense of the Italian plan as opposed to the logic underlying the Commission position: if, contrary to the Commission expectation, the Italian budget would have a significantly positive growth effect, the Italian position would be strengthened. The opposite, of course, would occur if the Italian plan would prove ineffective or even damaging. The evidence collected in the second part of this article goes in this latter direction. The third consideration is about the political support enjoyed by the two players. Here the evidence is mixed. On the one hand, the Commission has, as mentioned, the support of all other euro–area countries and the benefit of complying, unlike Italy, with the European rules. On the other hand, the two parties supporting the Italian government clearly won the last elections and have currently a very strong support in the country. Two facts qualify, but do not offset, this last point: first, the two coalition parties are very different and their agreement could prove fragile in the medium run; second if the government action would end up threatening the participation of Italy to the EU and to the euro, public opinion could turn up against the government and the parties supporting it.⁵

Overall the considerations developed above lead to conclude that the two players in the chicken game have different strengths and that the Commission has a better hand than the Italian government. Still, concluding from this asymmetry that necessarily it will be the Italian government that will blink first is not warranted.

What is developing into an Italian saga, reminiscent of the Greek saga, is the most serious test to which the euro–area fiscal framework has been put so far, even more serious than the one through which it went in 2003 when France and Germany objected being constrained by it. As mentioned above, the Commission has no real alternative to implement the framework as it is, but the question arises whether a different framework would have avoided the clash between Italy and the Commission.

⁵ On the latest Flash Eurobarometer (October 2018, 473), twice as many Italian respondents (57%) think that “having the euro is a good thing”, compared to those who think it is a “bad thing” (30%).



This question does not lend itself to an easy answer. If the euro–area fiscal framework was loose enough, the Italian government would have no reason to deviate from it. But for the fiscal framework not to be constraining for the current Italian government it should be based on a macroeconomic model in which fiscal deficits and growth have a bi–univocal relationship: fiscal deficits bring growth in all possible circumstances and growth always requires fiscal deficits. This is of course not the macroeconomic model underlying the euro–area fiscal rules and the last section of this chapter just argues against the plausibility of such a model, which surely does not, in particular, apply to current Italian circumstances.

An indirect, and less certain, link can, however, be found between the euro–area fiscal framework and the Italian insurrection against it. If, over the years, the euro area fiscal deficit had been more capable of promoting appropriate countercyclical policies, maybe we would not see today's Italian refusal to comply with it. The fact, recalled above, that in the triennium 2011–2013, when the euro area was in a grave recession, the aggregate fiscal policy was seriously pro–cyclical⁶ may have impacted the credibility of the framework, aggravated the recession and fed the hostility towards Europe of a large minority of the Italian electorate. Whether this is indeed the case is very difficult to prove, but has a certain degree of plausibility.

4.3. AN ECONOMIC CHALLENGE FOR ITALY

The challenge for Italy mentioned at the beginning of this chapter centres on the effects the budget will have on the economy. The critical variable here is growth: will the budget sustainably improve growth or not? The government has presented growth prospects for 2019, 2020 and 2021⁷ that have been considered optimistic by the Italian Parliamentary budget office, by Moody's rating agency, and by the Banca d'Italia, in addition to the European Commission and the International Monetary Fund, as mentioned above.

If the government's optimistic projections were fulfilled, two significant positive developments would take place. First, the sustainability of Italian public debt would be put on safer ground. Second, the limited employment improvements achieved so far would consolidate and further progress. Both improvements are badly needed.

Debt sustainability assessments mostly conclude that Italian debt is sustainable,⁸ but this conclusion is tempered by a margin of uncertainty: it is sufficient for limited, unfavourable changes in the critical variables (real growth, inflation, the primary surplus and interest rates) to bring the debt–to–GDP ratio onto an unsustainable path. Doubts about

⁶ See for example F. Papadia, Mistakes, Presentation at the Turku European Forum, in <http://moneymatters-monetarypolicy.eu/portfolio/conferences/>

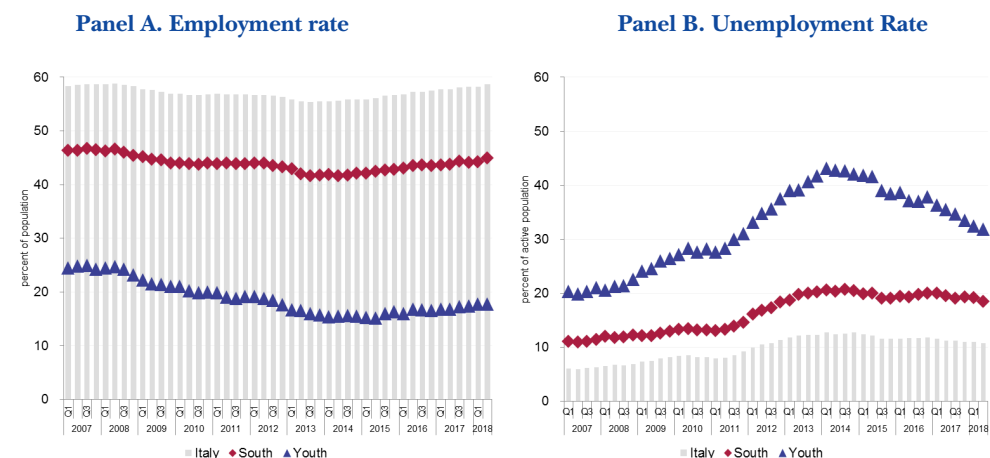
⁷ Namely, the government's draft budget foresees a real GDP growth of 1.5 % in 2019, 1.6% in 2020 and 1.4% in 2021.

⁸ Papadia (2017).

the sustainability of Italian debt will be avoided only if the positive growth effects of the fiscal expansion would offset the negative mechanical impact on the primary surplus.

As regards employment, the situation in Italy has improved over the last four years but remains totally unsatisfactory – not only because of the excessively high level of average national unemployment but also because of the pronounced dualist situation, with the South of the country and the young population suffering disproportionately from low employment (Figure 1). Of course, the bad employment situation is consistent with the persistently bad growth experience, which is the fundamental weakness of the Italian economy.

FIGURE 1. EMPLOYMENT AND UNEMPLOYMENT IN ITALY



Source: IStat.

In conclusion, growth is both something Italy desperately needs and something that is promised by the Italian budget. The fundamental question is whether this promise is credible.

One simple, indeed simplistic, way to frame the question is: what would be the fiscal multiplier? In other words, by how much would GDP grow for a 1% increase of the fiscal deficit? The “multiplier approach” is simplistic as far as it conveys the idea that there is a constant relationship between fiscal expansion and growth that can be estimated once and for all. Instead the list of factors affecting the fiscal multiplier at any given point in time is long, depending on the degree of openness of the economy, as well as whether the economy is in a fixed or variable foreign–exchange regime, whether the country is at the lower bound for interest rates, and whether the fiscal change is enacted through changes in taxes or expenses.

Another light under which one can analyse the effects of the proposed budget is the effect of a fiscal expansion on interest rates and therefore on the cost of funding for the private sector. Our remaining analysis concentrates on this effect. The experience of Italy



and Spain during the Great Recession is particularly interesting in this respect. While the effect of fiscal expansion on interest rates is only one part of the story and no attempt is made here to estimate a plausible value for the fiscal multiplier in current Italian conditions, the expert knowledge of the authors of this note leads them to think that the multiplier will be very low.⁹ An econometric estimate of this assessment would indeed be useful to check its validity.

A first approach to the question of the effect of a fiscal expansion on interest rates, and consequently on the funding of the private sector and finally on economic activity, is given by the so-called ‘crowding-out’ hypothesis. This was developed as a monetarist line of attack against the Keynesian view of using the public budget in a countercyclical mode, to deal with deficits in aggregate demand. The idea behind crowding-out is that fiscal easing increases the interest rate and this can make funding for the private sector more expensive, thus compensating the direct, mechanical effect of more public demand.

There is, however, a less ideological, and subtler, version of the same idea that fiscal expansion can, under certain conditions, see its mechanical effects on aggregate demand more or less compensated by an increase of interest rates and thus higher cost of funding for the private sector.

This more convincing crowding-out effect recognises that the effect on interest rates – and thus on private aggregate demand, for investment more than for consumption – depends on the conditions in which fiscal easing takes place. The effect will be small, or even zero, when a country is in recession; it would be much more important when growth is at potential, or beyond, and fiscal expansion is accompanied by negative confidence effects on the sustainability of debt, which may lead to a disproportionate impact on interest rates.

While confidence effects can be caused by a fiscal expansion that could lead debt onto an unsustainable trajectory, they can also come about without a fiscal expansion. Anything affecting the confidence of the investor about the safety of her/his investment can lead to higher interest rates.

Three particular cases are relevant in this respect. All of them are especially important when a country has a high debt-to-GDP ratio.

Firstly, a deterioration of growth prospects or a permanent increase in the real rate of interest can generate doubts about the sustainability of debt. This could lead to sharply higher yields, as lenders would need to be compensated for the higher risk of their lending.

Second, the shift from a “good” to a “bad” equilibrium can raise interest rates as the debt situation that was sustainable with lower interest rates could become unsustainable, because of the increase of the cost of debt brought about by the shift from one equilibrium to the other. This is far from being just a theoretical case. Indeed, what happened in

⁹ Blanchard and Zettelmeyer (2018) reach the same conclusion, indeed they even conclude that the multiplier could be negative.



the euro–area with the Great Recession conforms quite well to a shift from a “good” to a “bad” equilibrium.¹⁰ The revelation that Greek fiscal deficits were not correctly reported led market participants to review their expectations about the debt sustainability of the peripheral countries that had put themselves in a vulnerable situation, either because of unbalanced fiscal conditions, i.e. too high a debt–to–GDP ratio like Italy and Portugal, or because of excessive private debt (most of which was accounted for by unsound real estate investment, funded by imprudent banks not sufficiently reined in by their supervisors) like Ireland and Spain.

Third, in the specific euro–area framework, any doubt that lenders might have about the borrowing country’s continued participation in the euro–area would engender fears about being repaid in a devalued, reinstated national currency instead of the euro, and in turn generate negative confidence effects that would raise interest rates. Higher interest rates would, then, be transmitted to the cost of funding of the private sector, with the inevitable restrictive effect on aggregate demand, especially investment.

The phenomena described so far find quite precise correspondence in actual economic developments in Italy, as is shown in what follows. This is also the case because the ambiguous attitude of the Italian government about the continued participation of Italy in the euro area has largely contributed to the increased yield on Italian government securities.¹¹

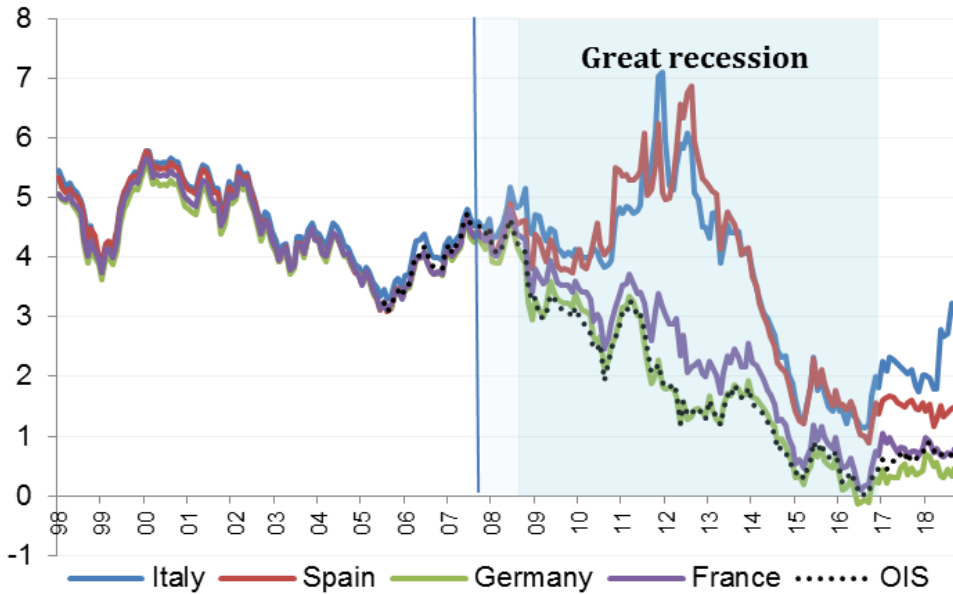
Figure 2 illustrates the first link in the chain of events that leads to recessionary effects from an increase of the interest rate on government securities. The figure shows that, since the launch of the euro at the end of the 1990s and until the beginning of the Great Recession (dated either to August 2007 or September 2008), there was practically no difference between the yield on German, Italian, French and Spanish government securities on one hand, and the so–called rate on OIS (Overnight Index Swap) contract on the other hand. The latter is the best indication of market assessment and expectations about central bank policy: basically, an increase of the OIS rate denotes monetary tightening and a decrease has the inverse meaning. This rate can usefully be denominated as monetary policy rate.

With the onset of the Great Recession in 2008, rates on Italian and Spanish securities increased just at the time when the ECB was easing monetary policy (as indicated by the OIS rate). Confidence effects were at work, making interest rates in the two largest peripheral countries deviate from the monetary policy rate. German and, to a lesser extent, French rates instead continued following the monetary policy rate. The phenomenon gradually lessened over the years and Spanish and Italian yields reached their lowest level in the summer of 2016, getting close to the monetary policy rate. Subsequently there was an increase for the two peripheral countries, much sharper for Italy, especially since the March 2018 elections.

¹⁰ Papadia and Välimäki 2018, *Central Banking in Turbulent Times*, Oxford University Press.

¹¹ Gros, D (2018), *Italian risk spreads: fiscal versus redenomination risk*, Vox EU, 29 August 2018, available at <https://voxeu.org/article/italian-risk-spreads-fiscal-versus-redenomination-risk>

FIGURE 2. YIELDS ON SELECTED EURO-AREA COUNTRIES TEN-YEAR GOVERNMENT BONDS AND TEN-YEAR OIS RATE (1998–2018)



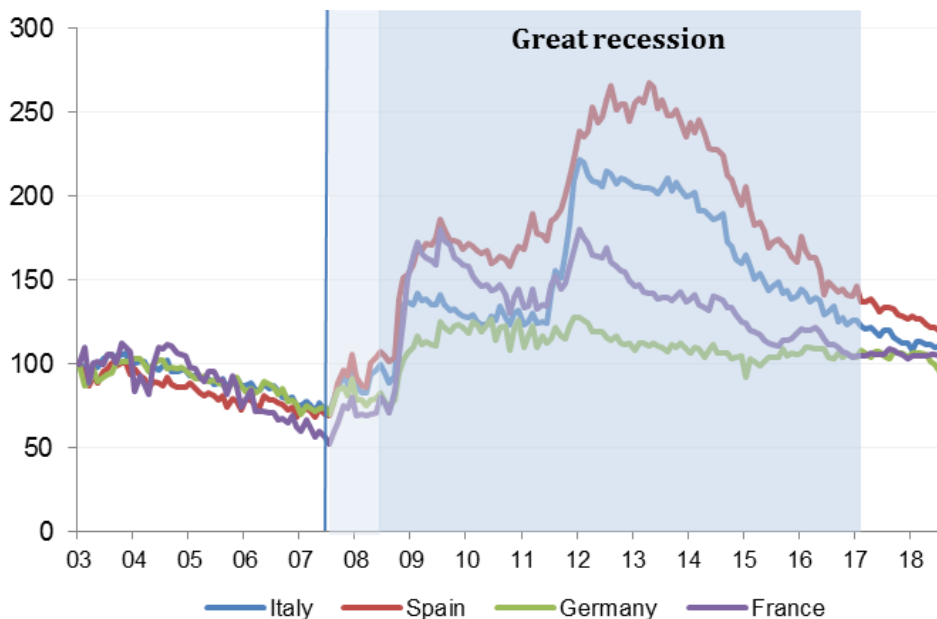
Source: Bloomberg.

The interest rate on government securities has a special role in an economic system: because of its ability to raise taxes, normally the government is the most credible borrower in each jurisdiction.

This means that the interest rate on government securities is the floor for the entire structure of interest rates in a country: if the government has to pay X on its borrowing, any other borrower will have to pay X plus something.

This effect is very visible in the cost of bank loans reported in Figure 3, which increased dramatically in the peripheral countries during the Great Recession, being pulled up by the increased yield on government securities. So, while in Germany and France the Great Recession brought about only a limited deviation of the cost of bank lending with respect to the decreasing rate controlled by the central bank (so-called EONIA), the deviation was very large for the two largest peripheral countries, Spain and Italy – particularly in the European phase of the Great Recession, since the beginning of 2011. Again, as the ECB eased monetary conditions, these got tighter in Spain and Italy because of the increased spread.

FIGURE 3. SPREAD BETWEEN INTEREST RATES ON NEW LOANS UP TO EURO 1 MILLION AND EONIA IN SELECTED EURO-AREA COUNTRIES (2003–2018), JAN 2003=100



Source: Authors based on ECB.

The negative effect on the cost of bank loans, caused by higher yields on peripheral countries' debt, was mitigated in the summer of 2012 by the famous statement of “whatever it takes” from ECB president Mario Draghi, and by the introduction of the Outright Monetary Transactions (OMT) programme. Indeed, the spread between bank loan rates and EONIA was gradually reabsorbed and the cost of bank loans relative to EONIA returned closer to levels similar to those prevailing before the crisis, in both core and peripheral countries.

There is another channel through which fiscal conditions can affect the funding of the private sector: the possible influence on the equity base of banks.

Banks have to keep a balance between their capital base and lending: this is required not only by supervisory standards but also by prudent management. Fiscal developments can, under unfavourable circumstances, reduce the capital value of banks, which may be thus induced to reduce the quantity of lending to the private sector and increase its cost.

This is what happened during the Great Recession, particularly in peripheral countries, as can be seen in Figure 4, which reports the yields on Spanish and Italian government securities and the Italian and Spanish bank stock indices.

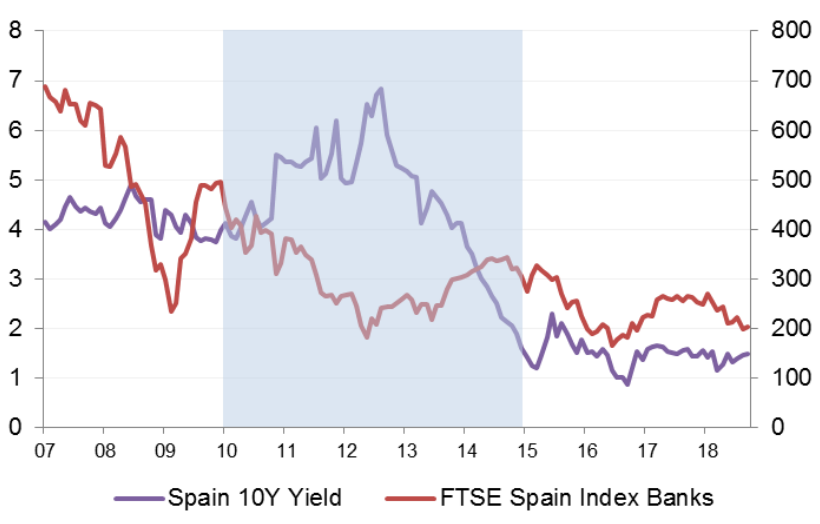
Stock exchange levels depend on many factors, but there is one recent period in which a strong negative correlation appeared between each respective yield's level and



the corresponding banks' stock index: the period roughly between the beginning of 2010 and the beginning of 2015, in which first increasing bond yields coincided with decreasing stock evaluations, and then decreasing yields prevailed with higher stock evaluations.

**FIGURE 4. GOVERNMENT SECURITIES YIELD (LHS)
AND BANK STOCK INDICES (RHS)**

Panel 1. Spain



Panel 2. Italy



Source: Bloomberg.

Figure 5 reports the lending to non-financial corporations (NFCs) in the two selected peripheral countries, together with yield developments. The negative correlation between the two variables is clearer in Spain than in Italy, but also in the latter country the very high yield on government securities coincides, after the beginning of 2011, with a very sharp decrease in the amount of loans.

Overall, the evidence is that, as government bond yields in Italy and Spain increased, bank lending became costlier and scarcer, clear symptoms of a negative shift in the supply of bank loans.

FIGURE 5. BANK LOANS TO DOMESTIC NFCS AND 10-YEAR GOVERNMENT YIELDS

Panel 1. Spain



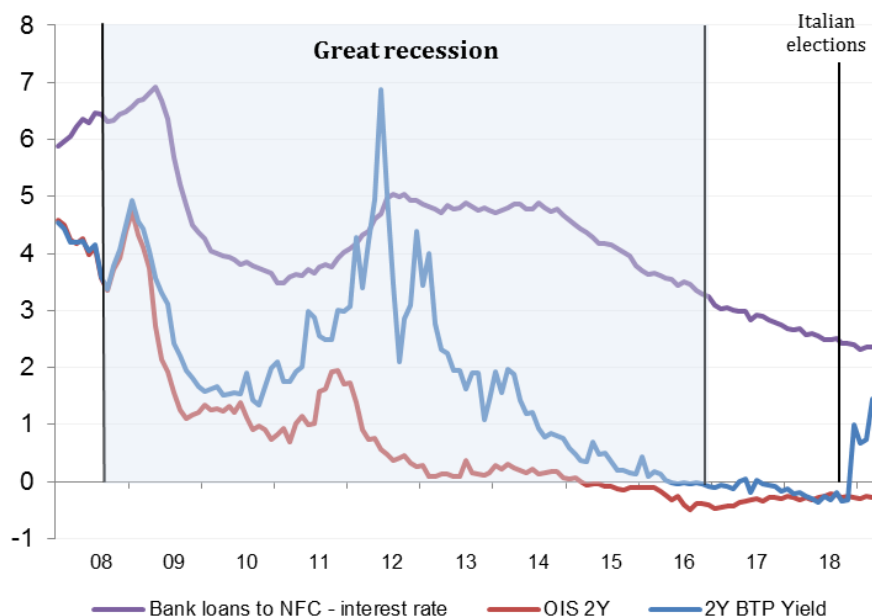
Panel 2. Italy



Source: Authors based on ECB, Bloomberg.

The phenomenon of fiscal developments having a negative impact on the funding of the private sector is, unfortunately, now starting to reappear in Italy (Figure 6), where yields on government securities have sharply increased after the March elections. This contrasts with developments in early spring 2018, when the rate on two-year BTP (i.e. Italian government bonds) had moved close to the monetary policy rate, while the cost of bank loans was at its lowest level since the beginning of the Great Recession and still gradually coming down. No effect is visible as yet on the cost of bank loans, due to the lag with which the BTP yield affects it. But it is an easy forecast that the effect will be visible before too long.

FIGURE 6. OIS RATE, BTP YIELD AND THE COST OF BANK LOANS TO DOMESTIC NFCs IN ITALY



Source: Bloomberg, ECB.

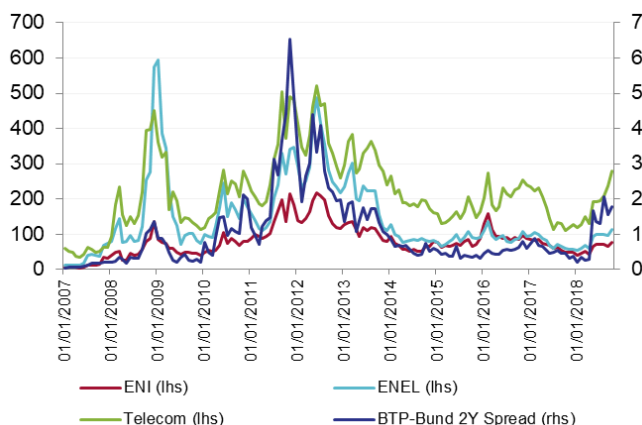
While there is no increase in the cost of bank lending as yet, there already seems to be an effect on the banks' overall terms and conditions agreed in loan contracts. In fact, according to the October 2018 ECB Bank Lending Survey, credit terms and conditions for new loans or credit lines in Italy have tightened in the third quarter of 2018.¹²

In the same vein, as the financial market reacts more quickly than the banking market, we already find the negative consequences of the higher yield on government securities

¹² https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2018q3.en.html#toc5

in corporate Credit Default Swaps (CDS). These report the cost of insuring against the failure of a corporation. This cost has been pulled up by the higher spread on Italian government securities, as can be seen from Figure 7.

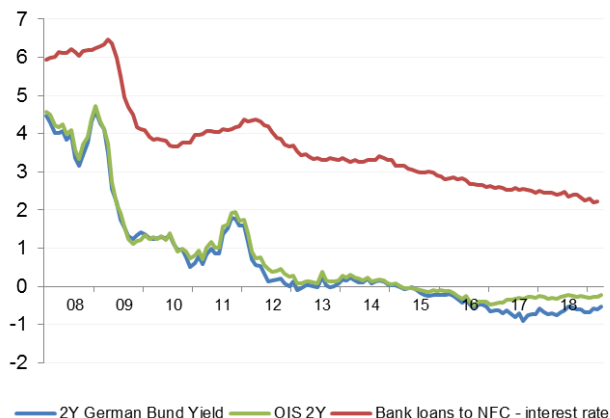
FIGURE 7. CORPORATE CDS OF ENEL, ENI AND TELECOM ITALIA (LHS) AND THE SPREAD ON BTP



Source: Bloomberg.

Of course, no similar effects are appearing in Germany, where Schatz yields are duly following the monetary policy rate and the cost of bank loans continues its gently downward trend, as can be seen in Figure 8.

FIGURE 8. OIS RATE, BUND YIELD AND THE COST OF BANK LOANS IN GERMANY

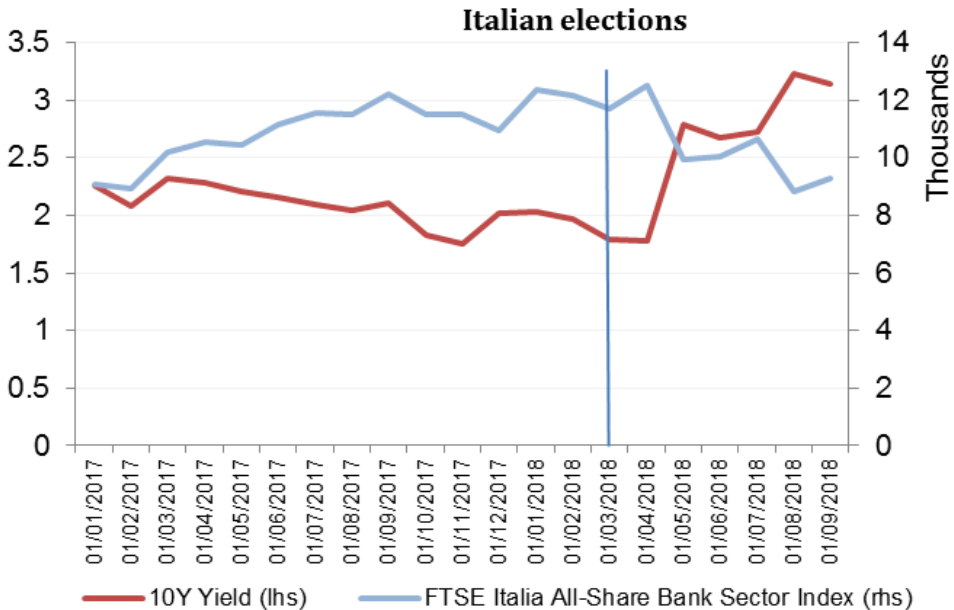


Source: Bloomberg, ECB.



Analogously, the stock index of Italian banks has been hit by the tensions on the market for Italian government bonds. This can be seen in Figure 9, reporting the yield on Italian government securities and the bank stock index in that country, which shows a negative correlation between the two variables over the most recent months.

FIGURE 9. GOVERNMENT YIELDS (LHS) AND BANK STOCK INDEX (RHS)



Source: Bloomberg.

4.4. CONCLUSIONS

The fiscal policy intentions of the new Italian government are creating an institutional challenge for the EU Commission and an economic challenge for Italy.

The EU Commission is forced to choose between a complete loss of effectiveness of the EU fiscal framework to avoid too loose fiscal policies and entering into conflict with a large euro area economy. While the Commission has to use all the tools available to bring Italian policy within the fiscal rules, the Italian government has shown no inclination to move away from its fiscal plans. Looking at the objective situation, the latter seems to be in a weaker position than the former, but this does not necessarily mean that it will change policy any time soon.



While no direct link appears between the Italian refusal to comply with the EU rules, that Italy has voluntarily agreed to, and the specific form of these rules, one can suspect that if, over the years, the EU fiscal framework had been capable of carrying out anti-cyclical policies, or at least had avoided strongly cyclical ones during recessions, one could have avoided the current insurrection of the Italian government against the common fiscal framework.

The economic challenge for Italy is to revive growth through an expansionary fiscal policy. The experience during the Great Recession raises substantial doubts that this is going to happen. In that period there was a clearly visible negative association between the yield on Spanish and Italian government securities and the cost and availability of bank loans in these countries. Thus, while the ECB was easing its monetary policy to fight the recession, monetary conditions got perversely tighter in the two peripheral countries, with clear recessionary consequences.

No such phenomenon was observable in the core of the euro-area, namely in France and, especially, in Germany, where firms could benefit fully from the expansionary monetary policy of the ECB.

Conditions gradually normalised in the euro area and, by the end of 2017, they had surpassed most of the tensions generated during the Great Recession.

Tensions reappeared, however, in Italy in the spring of 2018, with the increased yield on government bonds generated by renewed doubts about debt sustainability and uncertainties over the continued participation of Italy in the euro area. It is to be feared that crowding-out effects will be clearly visible before too long, with bank credit becoming scarcer and more expensive. This will offset, at least partially, any expansionary effect on demand from the fiscal easing planned by the Italian government.

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PART II
EUROPEAN MONETARY POLICY AND FINANCIAL SYSTEM



5. THE END OF THE ECB'S ULTRA EXPANSIONARY MONETARY POLICY: REVIEW AND PROSPECTS

**CARLOS GÓMEZ FERNÁNDEZ, MIGUEL FERNÁNDEZ ACEVEDO
AND BLANCA NAVARRO PÉREZ,**

Research Department. Strategy Division

Instituto de Crédito Oficial

5.1. INTRODUCTION

Forceful and determined action by the central banks was key to weathering the worst storms of the recent financial and economic crisis. The central role played by central bankers is undeniable: in Europe, all the more so. Though a young institution, the European Central Bank (ECB) earned respect for its unwavering stance; and the severity of events certainly tested its ability to deploy every weapon in its armoury so as to secure the common project that is the euro. And all of this within a constrained framework of action and a mandate focused solely on the control of inflation. The ECB was forced to push the boundaries of its legal framework, creating new instruments to safeguard the financial stability of the euro area as a prerequisite for restoring the transmission channel of monetary policy so that monetary accommodation would reach the real economy.

This paper reviews the ECB's policy, eschewing the more usual chronological approach to anatomise the instruments used, discuss their purposes and evaluate the overall outcome. In my view, the ECB's actions of recent years have, in fact, prompted a major shift in the parameters within which monetary policy used to be analysed. Thus, as will be seen, the scope of monetary policy has widened significantly to embrace additional tools while continuing to use more conventional instruments.



The exit strategy is already in place, so this is an appropriate time to reflect on how different the ECB is today from what it was only a few years ago. The withdrawal of stimuli poses challenges that are analysed in this study. Yet the truth is that, after the response to the last crisis, monetary policy will never be the same again. The ECB has equipped itself with a number of instruments which, even after the withdrawal, will continue to be at its disposal to fulfil its express and implied mandates to shore up the single currency.

5.2. THE DYNAMICS OF OFFICIAL INTEREST RATES

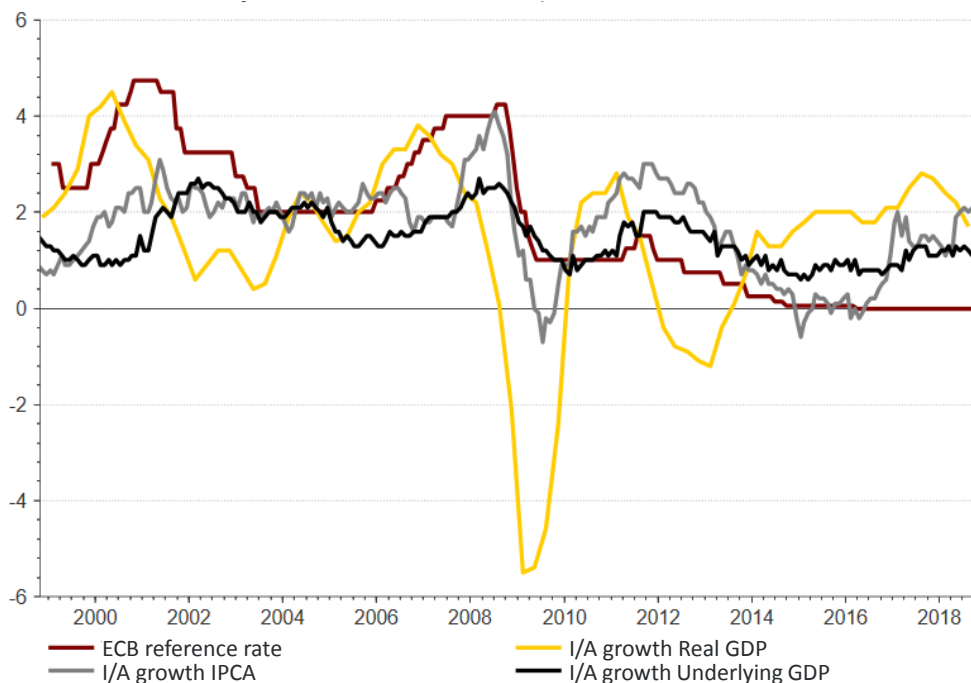
Until the advent of the last global financial and economic crisis, the ECB's handled its monetary policy through the typical instrument: by varying official interest rates to contain or encourage price growth so that inflation expectations remain anchored below, but close to, 2%, as mandated.

So the main lending rate, the earliest value of which was 3% in 1999 at the inception of the euro, went as high as 4.75% in 2000 and as low as 0% in March 2016. At the same time, the ECB sets the rates for its deposit facility and its marginal lending facility. The difference between these rates is known as the “rate corridor”, which has been fashioned as a key monetary policy tool.

At its monetary policy meetings, the Governing Council of the ECB reviews the economic and financial situation in the euro area and decides on the most appropriate level of reference rates to bring medium-term inflation expectations close to 2%. Although the ECB's history is still a relatively short one, changes in rates have generally tracked the economic cycle: raising them during slumps and lowering them during boom periods. This is not because monetary policy aims to shape the economic cycle itself, but because inflationary dynamics move in step with growth figures. However, in the event of disagreement, the inflation target prevails, because, as we know, it is the ECB's sole formal mandate.

Although the adoption of Governing Council decisions entails a far more complex process and analysis of many other variables, Figure 1 shows how the reference rate has tracked the needs of each inflation situation, as constrained by the information available at the given time. If we look at the last two years, special attention was paid to core inflation, and, as we shall see later, to prospective inflation indicators. Looking only at the change in the overall consumer price index we find it is already very close to the target set in the ECB's mandate.

FIGURE 1. ECB REFERENCE RATES, INFLATION AND EXPECTATIONS

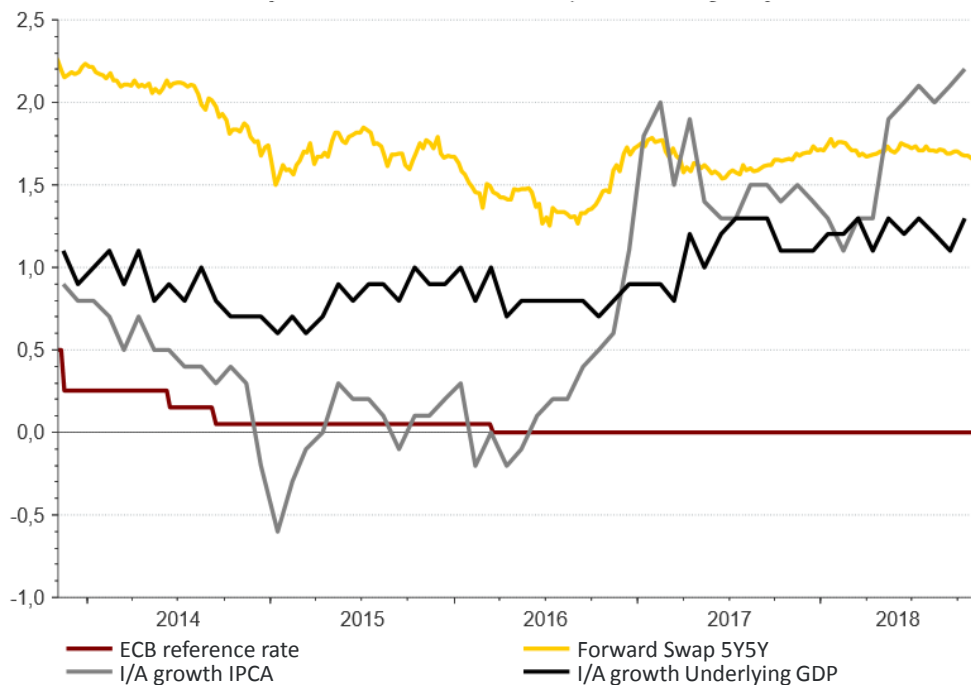


Source: Thomson Reuters Datastream.

Leaving aside the history of reference rates and any mistakes or successes of the past, it may be of interest to focus on 2015. Although economic growth was already at levels that could be viewed as satisfactory, inflation was still very modest. This was despite the fact that the ECB's reference rates were already at extremely low levels, approaching zero. Observed inflation was very low and, moreover, future inflation was expected to be even lower (see figure 2). One of the bugbears of central banks seemed about to make its appearance, although for the moment it was only in the minds of analysts: deflation. So the ECB needed to relax its monetary policy even more, but there was simply no room for nominal rates to move further down.

At the time, estimates guided by Taylor's rule suggested an optimal interest rate level below the actual lower bound: leaving to one side any discussion of the liquidity trap and its precise level, the fact is that the ECB decided not to apply a negative main lending rate. However, it did apply a negative rate to its deposit facility, which stood at minus 40 basis points as from March 2016. The monetary authority was faced with the challenge of emerging from a situation of sluggish prices and, above all, of inflation expectations with no more room for rate cuts. To do so, the ECB had to create new monetary policy instruments, the so-called "non-standard" measures.

FIGURE 2. ECB REFERENCE RATES, INFLATION AND EXPECTATIONS



Source: Thomson Reuters Datastream

In this way, the catalogue of monetary policy instruments was expanded: and not as a merely temporary measure, but forever. As Draghi himself has often stated, these non-standard measures are already part of the “toolbox” available to the ECB and will continue to be so after withdrawal, for use whenever necessary in the future.

5.3. EXPANDING THE CATALOGUE OF MONETARY POLICY INSTRUMENTS

The “classical” monetary policy instruments are fixing official interest rates, setting minimum reserve ratios, operating the standing facilities and managing open-market transactions at certain maturities. All of these tools have been put to work since the creation of the ECB so as to implement the monetary policy of the given time.

However, due to the exceptional situation of the European economy over the past decade, the ECB has expanded its catalogue of tools. For this purpose, the ECB made use of the experience of other central banks, such as the US Federal Reserve (the Fed) or the Bank of Japan, which had used these instruments previously. These instruments used by the ECB in recent years to address emerging challenges are often referred to as “non-standard measures”. It was the Governing Council itself that designed the measures



– with an eye on the experiences of other central banks – because in Europe there were no existing rules in this field.

In this paper, I draw a distinction between two types of instrument: instruments designed to have a direct impact on interest rates in the real economy, and instruments intended to reinforce the transmission channel of monetary policy, in particular by safeguarding financial stability. These are not two watertight compartments but an academic distinction for the purposes of analysis. The fact is that both functions are present in all the instruments discussed below: the distinction is drawn according to which of the two functions is dominant. With this distinction, we move away from a chronological narrative and adopt a functional point of view, which is more useful for understanding each measure, the reasons for its adoption and the effects its withdrawal might have.

5.4. INSTRUMENTS DIRECTLY AFFECTING INTEREST RATES IN THE REAL ECONOMY

Given that the lower effective bound of official rates had almost been reached, the ECB adopted a range of measures that sought to influence the yield curves of the markets to exert downward pressure, with the ultimate aim of transferring the reductions to households and businesses in the form of easier terms for borrowing.

First, we need to consider the **guidance of expectations**, mainly via the ECB's schedule of messages about its intentions with regard to official interest rates. Typically, the Governing Council states a commitment not to raise interest rates before a specified (or an approximate) date. This approach was first used expressly in July 2013, when the ECB announced that rates would remain at the same or lower levels for an extended period. Since then, the ECB has always provided medium-term guidance on its interest rate intentions.

This sends a signal to economic actors, who adapt their expectations in line with the message. In general, rates move downward in the face of higher certainty as to the period of low rates. The usefulness of this guidance has sometimes been disputed, as in the end monetary policy is based on a reaction function in which many factors come into play. The key here is credibility and mitigation of uncertainty. It has to be said that the policy of guiding expectations has been effective, precisely because the ECB's credibility is strong and so far it has handled its message outflow very consistently. The ECB has dispelled the possibility of abrupt changes in monetary policy, because guidance has been consistent, and this is where the mitigation of uncertainty comes into play. Yet we should bear in mind that so far circumstances themselves have not veered off-track in a way that might face the ECB with the dilemma of abiding by its expectation guidance or, instead, reacting to the unexpected shift. In any event, the ECB's messages are not unconditional: they are a sketch of what will happen if matters proceed as foreseen. Indeed, ECB officials have always said they are ready to react differently to unforeseen events. If an unforeseen event compelled a change of course, the ECB would face a serious risk: if it were unable to explain its change of position satisfactorily or if such a change were not



understood by economic actors, there could be a loss of credibility that would render the expectations guidance mechanism far less effective. So far, however, no such situation has arisen, and the ECB has supplemented its policies with messages that have been fulfilled over time, thereby reinforcing this platform for guiding expectations.

Although the original intention was for guidance of expectations to be limited to decisions on official rates, the fact is that it was later also used to send out signals as to the duration and volume of the asset purchase programme. This is a logical consequence of the fact that, as we shall see, the “non-standard” instruments have now become a further component of the monetary policy arsenal and, as such, can form the subject matter of relevant expectations guidance.

TEXT BOX 1 – DRAGHI QUOTATION

The ECB’s communication policy has traditionally been very transparent, with the intention to announce possible future movements some time in advance, and there are few cases in which its decisions have surprised the market.

However, this communication policy has gone a step further by starting to provide specific expectations guidance on future movements in rates, size of the balance sheet, pace of purchases, future actions, etc.... The Governing Council has at its disposal a new and extremely effective tool that sends messages to the markets, which are quickly interpreted. Credibility is the foundation of this system. Let us go over some of the statements that have had the most impact.

One difficulty with this new tool is the possibility of its being withdrawn. The ECB, in a general context conducive to normalisation of its policies – all the more so as it will have a new President in 2019 – may be tempted to become predictable in the interests of gaining room for manoeuvre. Given that the ECB has so far adopted a very clear communication policy with regard to its future intentions, it could become a prisoner of this same predictability, because as soon as it stops sending out messages that silence in itself would be construed as a message in its own right. For example, the effects of attenuated guidance of expectations could lead to higher volatility in debt markets, albeit moderate in any case, given the major role that the ECB will continue to play for a long time as a debt holder within the Eurozone.

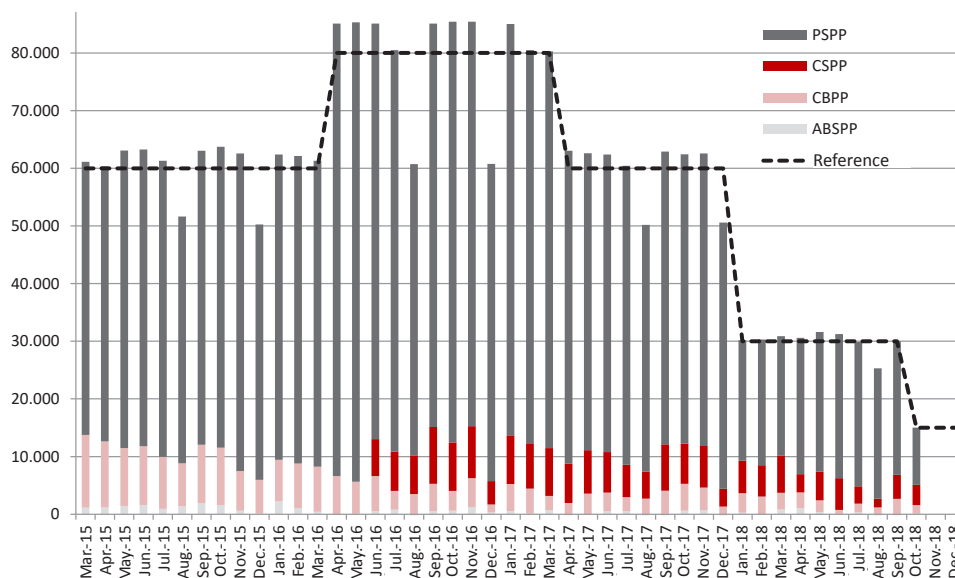
The second category of measures that seek to directly influence yield curves in the markets are **asset purchases** under the Asset Purchase Programme. This umbrella programme encompasses purchases of four types of asset: public sector assets (Public Sector Purchase Programme, PSPP), covered bonds (Covered Bond Purchase Programme, CBPP3), asset-backed securities (Asset-Backed Securities Purchase Programme, ABSPP) and corporate sector debt (Corporate Sector Purchase Programme, CSPP).

Under these programmes, the ECB injected directly into the Eurozone economy an average monthly volume that began at €60 billion from March 2015 onwards, rose to €80 billion from April 2016 to March 2017, and returned to €60 billion until December 2017, after which time it came down to €30 billion, which became €15 billion in the last



quarter of 2018, so that in December 2018 the purchase of new securities ended, but not reinvestment of amounts falling due during this period, in addition to the amounts referred to above. Reinvestment will continue after the end of new purchases for a period that is yet to be determined.

**FIGURE 3. ASSET PURCHASE PROGRAMME:
MONTHLY VOLUME (MILLIONS) €**



Source: ECB.

Monthly purchases, together with reinvestment of amounts falling due, led the ECB to end 2018 with a portfolio of more than €2.5 trillion across several asset classes. This represents around 23% of the nominal GDP of the Eurozone, which, together with the rest of the balance sheet, means that the ECB holds total assets amounting to 40% of the GDP of the Eurozone (the Fed reached a peak balance sheet size of 25% of US GDP, and in late 2018 is approaching a level of 20% of US GDP, while the Bank of Japan is approaching a total balance sheet close to 100% of Japan’s GDP).

Most purchases involve public sector assets. As is well known, purchases are made according to the “capital key”¹ of each country in the Eurozone at the ECB, to ensure

¹ The capital key reflects the percentage of the ECB’s total capital subscribed for by each of the national central banks of the EU Member States (note that all EU central banks – not just Eurozone central banks – participate in the ECB; in fact the shares of all Eurozone central banks account for 70.3915% of the total, the rest being held by central banks of EU Member States outside the Eurozone). Each national central bank’s specific share in this capital is calculated



neutrality. The ECB takes up different maturities depending on the availability of outstanding debt in the various jurisdictions.

As mentioned above, the strategy of guiding expectations has also been used to provide clues on volume and time horizons of purchases. The exit strategy was clearly foreshadowed, almost millimetrically specifying the rate of reduction of purchases and their ceasing altogether in December 2018. Although reinvestments will continue after that date, we are already at the beginning of the end of the most expansionary period of monetary policy. Managing this new stage is probably the main challenge facing the monetary authority, as will be discussed below.

Without going into the technical details of the purchasing programme, the fact is that it has met the objective of amplifying the degree of monetary accommodation in a zero-rate environment. Both the markets targeted by the programme and their adjacent markets have seen their yield reduced, and the benefits have been transferred to households and businesses.

As an example, the answers to the specific questions included in the latest waves of the Bank Lending Survey produced by the ECB in cooperation with the national central banks: in the April 2018 and October 2018 surveys banks showed a slight relaxation of lending terms to both households and businesses as a result of the purchasing programme. The impact on spreads – especially on credit to businesses – was even more noticeable. A clearly salutary effect was also seen on credit volume in all lending categories. Therefore, through the banks, the real economy has received an improvement in financial conditions, which was the goal of the Central Bank, as the programme continued to encourage, in all segments, a relaxation of lending terms and an increase in lending volume. These effects were more pronounced in Spain than in the Eurozone as a whole.

And not just through the banks. There is also evidence that companies have seen their financial position change for the better due to the impact of the corporate debt purchase programme. Although this programme is not quantitatively the largest, research papers by De Santis, Geis, Juskaite and Vaz Cruz (2018) for Europe and Arce, Ó., Gimeno, R., and Mayordomo, S. (2018) for Spain show how there has been a relaxation of financing conditions for non-financial companies, lower spreads on corporate bonds and an improvement in primary fixed income markets, and in bank lending to entities that do not have access to capital markets.

Therefore, the purchasing programme can be regarded as having fulfilled its purpose of further monetary accommodation. Along the way, the programme has also supported

using a key that reflects the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting. The ECB adjusts the shares when there is a change in the EU Member States and every five years even if there are no changes in the Member States. According to data on the ECB's website, the total paid-up capital amounts to €10,825,007,069.61 of which, by way of example, the Deutsche Bundesbank (Germany) is the central bank with the largest share (17.9973%) while the Central Bank of Malta has the smallest (0.0648%). The Bank of Spain has a share of 8.8409%. Each jurisdiction's share has been used and continues to be used as a yardstick for the distribution of asset purchases by the ECB.



the public finances of governments, which have seen their financial costs reduced, and this in turn has aided many countries in their fiscal consolidation processes. For the banking sector, although such a protracted spell of very low rates may cause difficulties, as will be discussed later, the fact is that the impact of the purchase programme has enabled them to lighten their public debt portfolio, making a profit on rising prices and obtaining better and cheaper financing directly through covered bonds and securitisations and indirectly through the rest of the instruments. So the effect of the purchasing programme itself has, at the very least, left banks unharmed.

5.5. INSTRUMENTS THAT SEEK TO SAFEGUARD FINANCIAL STABILITY, TO IMPROVE THE TRANSMISSION CHANNEL

Although chronologically the ECB adopted these measures from the outset in its response to the crisis, we turn to them only now, because their role is subordinated to the measures discussed earlier. The measures discussed below do not directly affect the interest rates faced by households and businesses, but are a step behind, in a bid to restore the transmission channel of monetary policy, which at the start of these non-standard policies was in a severely impaired state. The ECB was aware from the outset that rate cuts were not being transferred to the real economy uniformly in the euro area. The sharp financial fragmentation, which peaked in 2012, called into question the very existence of the single currency.

The vicious circle of mutual feedback between sovereign risk and banking risk that arose in the peripheral countries called for swift action to ensure monetary policy was effective and its benefits spread throughout the entire euro area. This required restoring confidence and safeguarding financial stability.

As is well known, many important decisions were taken at both national and European level, which finally deactivated the vicious circle: bailouts, national structural reforms, improvement of European Union institutional architecture (especially, the banking union). All these measures were important to for normality to be restored to some extent. However, the most important role, and this is hardly debatable, was taken up by the ECB, which established itself as a key player and even went beyond its functions, as it was the only institution with the ability to respond immediately and forcefully, and this was what was needed.

The first of the measures, which often goes under the radar when compared to more eye-catching decisions, was the **introduction of fixed-rate full allotment in the ECB's liquidity tenders**. This policy came into play in October 2008. Although the financial crisis was in full swing, contagion to European sovereigns was still only a distant prospect. The idea was to ensure banks' access to liquidity in an environment that might otherwise prove tough.

The second measure was the **purchase of covered bonds through the CBPP1 programme**, which began in July 2009 (and had a successor, CBPP2, in October 2011). I include this tool under this heading because when it was launched it was not intended



to drive down yield curves, like the 2015 purchasing programme. Rather, the aim was to improve access to finance for banks, which were the conveyor belts of monetary policy and were beginning to show signs of inadequacy for this role.

Thirdly, there was a flood of liquidity after the launch of **long-term refinancing operations** (LTROs). These operations, which had been carried out in 2008 and 2009 with shorter maturities (6 and 12 months), came to a crossroads in the period between December 2011 and February 2012, when the first rounds of the 36-month LTRO were implemented (maturing January and February 2015 respectively, although an early repayment option was available after the first 12 months). In general, LTROs were aimed at improving the financing of banks in the face of the shutdown of many markets that had hitherto been customary, as they provided financing to banks by accepting their on-balance-sheet transactions as collateral. The idea was to free up capital and encourage new credit at the (low) official interest rates prevailing at the time. In short, the intention was, again, to enhance the transmission of monetary policy. These policies, at least in terms of the amounts requested, given the environment of almost entirely defunct inter-bank markets in many EEA countries, were very successful. The operations in December 2011 and February 2012 alone accounted for nearly €1 trillion across all Eurozone banks (more than 800 banks used this instrument), although the net impact was somewhat lower (about €700 billion), since some amounts allotted earlier at shorter terms were rolled over into this new instrument.

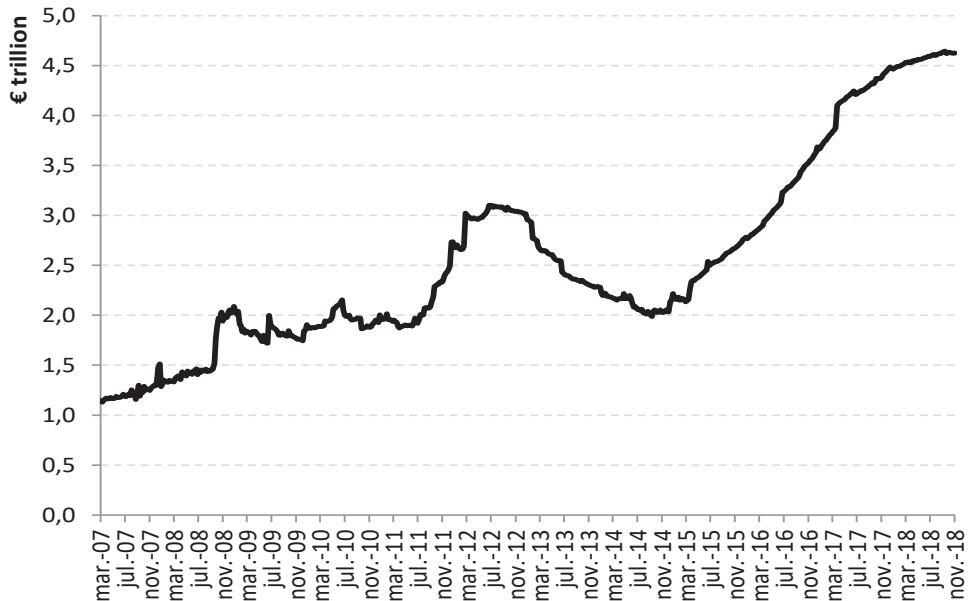
As indicated above, these instruments fell due in early 2015, but this did not mean the programme was over. As early as June 2014, with a few months to go before maturity, the ECB announced a new programme of TLTROs, **targeted longer-term refinancing operations**. The term was extended to 4 years, subject to a requirement that banks increase lending to households and non-financial corporations (or at least not to reduce such lending or to do so to a lesser extent). The June 2014 TLTRO-I operations were followed in June 2016 with a second series (TLTRO-II). Leaving aside the technical specifications introduced over time (in practice almost the entire amount of TLTRO-I was rolled over into TLTRO-II), these measures are effectively a continuation of the original LTROs, to an amount in excess of €750 billion.

So LTROs at first and, later on, TLTROs, with a sufficiently long maturity, provided banks with more than enough liquidity to replace the shutdown of a wide range of funding sources. And, albeit indirectly, sovereign borrowers were financed insofar as banks used the excess proceeds of these operations to buy government debt.

With these measures, progress was made in repairing the bank-mediated transmission circuit of monetary policy. These operations were a great success in terms of volume, bringing the ECB's assets to more than three trillion euros.



FIGURE 4. TOTAL ASSETS OF THE ECB



Source: ECB.

These measures were designed to help banks to channel monetary policy effectively, which was the ECB's concern since the onset of the crisis. For such transmission to be adequate, there must be financial stability, and banks must be healthy: the healthier the banks, the more effective the monetary policy they transmit. This is shown by Imbierowicz (2018), a paper arguing that the ECB's non-standard measures provided a lifeline for many banks that enhanced the effectiveness of monetary policy. In fact, these measures involved a "concealed recapitalisation" that shored up bank balance sheets so that they could effectively play their financial intermediation role, which in the end is what monetary policy can bring to the real economy. Clearly, the ECB's mandate makes no express mention of bank recapitalisation. Instead, we are faced with an indirect, though not unexpected, consequence of the policy of improving the effectiveness of the ECB's actions.

Protecting financial stability must therefore be a precondition of the effectiveness of monetary policy: this was understood by the ECB very early on. And, at the time, this protection was as much about shoring up banks' balance sheets as it was about warding off attacks on sovereign bonds issued by non-core countries. Hence the **Securities Market Programme (SMP)** was announced in May 2010. The stated aim of the SMP was to provide depth and liquidity in certain sovereign debt markets, but in reality it was intended as a firewall against speculative attacks on sovereign debt, which were causing severe instability in the financial markets. The programme, which grew to €210 billion, was replaced in September 2012 by **Outright Monetary Transactions (OMT)**, a programme that involved a measure of conditionality and the support of bailout funds (the Europe-



an Financial Stability Facility, EFSE, and later the European Stability Mechanism, ESM). In any event, with the SMP the main objective was to restore financial stability, rather than provide greater monetary accommodation, as shown by the fact that the amounts purchased under the SMP were “sterilised” (liquidity was drained from the market), because at that time there was no desire to cause quantitative expansion. Sterilisation of SMP amounts was discontinued in mid-2014, when the ECB was laying the groundwork for its balance sheet expansion programme.

5.6. A MINOR ASSESSMENT IN PERSPECTIVE: NECESSARY AND EFFECTIVE

Now that many voices are calling for the withdrawal of monetary stimuli, the main argument being that the highpoint of the economic cycle has run its course for quite a few quarters and will not last forever, we must not lose sight of how necessary these measures were, or of their contribution to improving the situation of the Eurozone. However, the largely positive analysis that follows should not overlook the adverse effects of such a protracted period of low rates, especially for savers. It should also be borne in mind that, despite the undeniable progress made, a full restoration of pre-crisis normality has not been achieved (if the situation prior to the crisis can indeed be described as “normal”).

Financial fragmentation was so intense in the period 2010-2013 that it even threatened to break up the European Economic and Monetary Union. Faced with this real risk, which is much less talked about today, largely because of the ECB’s action, measures to support the financial sector and the debt markets were necessary and effective in achieving their purpose: safeguarding financial stability, an essential requirement for the effective transmission of monetary policy. These measures have been withdrawn in terms of volume, i.e., LTROs and TLTROs have expired (not yet in their entirety) without major problems for banks, which were given enough time to improve their financial and liquidity position, while the markets generally calmed down. Neither was it necessary to continue with the purchases of the SMP, whose assets are to be held to maturity on the ECB’s balance sheet.

However, although they have been withdrawn to some extent, it should be noted that these tools are now always a part of the toolbox available to the ECB, so they could be triggered if necessary in the future. This undoubtedly contributes to a climate of confidence that discourages speculative attacks such as those seen in the past. Economic actors have factored this development into their decision-making and act accordingly.

In mid-2014, despite the decrease in financial fragmentation with respect to the most critical moments suffered a couple of years earlier, and a better position of banks, the Eurozone faced an environment of low inflation with the risk of expectations being de-anchored. All this in an environment of economic recovery that was still brittle and unsustainable by itself after a twofold recession. For this reason, greater monetary accommodation was necessary. With an improved transmission channel, that accommodation was suitably transferred to households and companies, with the result that they now enjoy far more favourable financial conditions than at the start of the zero-rate period.



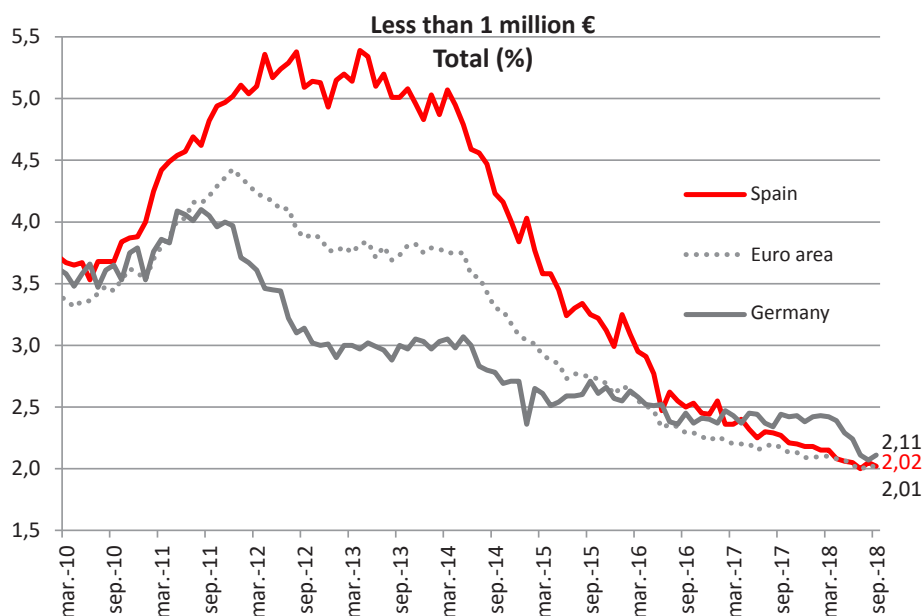
Banks and capital markets have thus supported the intended reduction in interest rates to be transferred to the real economy, with the ultimate aim of encouraging investment and activity, while creating jobs and raising disposable income.

More specifically, papers such as that of the Bank of Spain (2016) estimate that monetary policy could explain around 40% of nominal growth in the euro area between 2015 and 2016, which shows that without this monetary support the recovery would have been much weaker. From 2017 onwards, although the economic cycle has continued to move in its favour, monetary policy has remained very accommodative, due to the fact that inflation expectations remained contained.

As noted above, monetary policy always has a redistributive effect: in this case the protracted period of accommodation has meant a transfer from savers to debtors, which has prompted criticism from certain sectors. More specifically, however, there are also research papers that conclude that the ultra-loose monetary policy pursued by the ECB in recent years has led to some decline in inequality at the aggregate level. This is due to the fact that low rates affect economic actors differently according to their financial position. In the paper by Ampudia *et al* (2018), it is stated that this situation reduces inequality because lower-income households see their position improved due to the indirect effect generated by improving activity and employment, because in these households the increase in wage income is the key driver, since they have few productive assets. In any event, the overall impact on inequality is modest.

Looking at the change over time in interest rates (see figure 5) applied by lenders to households and businesses, the success of recent monetary policy is also visible. Positive results are seen in two ways: first, in the reduction in financial fragmentation, which was crucial for the transmission of monetary policy and, secondly, in the reduction of the rates actually borne by economic actors when obtaining financing, in this case from banks. As an example, we can observe the statistics on interest rates applied to bank loans to companies of less than one million euros, in the Eurozone, in Germany and in Spain: the two phenomena mentioned above are in evidence: first, a reduction in financial fragmentation from 2014 onwards when rates begin to converge and, secondly, a general reduction in the rates applied as a result of the transmission of ultra-loose monetary policy.

FIGURE 5. INTEREST RATES FOR NEW TRANSACTIONS



Source: ECB.

There has also been a process of normalisation of credit flows, which remained depressed in the period of greatest uncertainty and which began to rebound when the transmission of monetary policy was repaired as a result of the non-standard measures. In the case of Spain, this has been compatible with a process of deleveraging of the private sector, so that the volume of indebtedness over GDP of the private sector has declined while new credit flows recovered, enabling new credit to flow into the activities that needed it without increasing the level of indebtedness of the economy as a whole.

Although the influence of monetary policy on the economic cycle is obvious – and this sometimes leads us to think that on the upside it is always necessary to raise rates – it is no less true that the ECB’s mandate is clear and explicit and refers only to inflation. GDP growth is approaching potential, jobs have been created and investment is on the rise, economic actor confidence has also improved, and the banking sector is now more resilient: this combination of factors should point to a rebound in inflation expectations that, for the time being, has not materialised. This would be one of the areas where it is not yet possible to speak of success, so more work is necessary.

Therefore, throughout 2017 and 2018, loose monetary policy has been kept in place to continue supporting price growth that is “self-sustainable”, in Draghi’s own words. And this, for the time being, is not coming through clearly, so the ECB prefers to act cautiously. This is because, although there has been progress in the general consumer price index, in the underlying index and in market expectations (the behaviour of the



indices over the past few years is shown in figure 2), no robust growth in line with the ECB's mandate is yet in evidence.

Structural changes in the goods and labour markets of developed countries and factors such as technological progress and globalisation have removed the basis of the relationship formerly traced by the Phillips curve between unemployment and inflation. So we have witnessed a period of strong employment growth in Europe but without inflationary stress. This is pointed out by Aspachs-Bracons (2018), who argues the Phillips curve has flattened due to both circumstantial and structural factors. This topic was also discussed at last summer's central bankers' conference at Jackson Hole. This poses a challenge for the ECB, which is witnessing a period of enduring economic expansion that does not translate into rising inflation. Therefore, as will be discussed in the next section, perhaps we have entered a new stage where what we might view as a restrictive monetary policy will no longer imply rates as high as in the past.

5.7. NEW PARADIGM: HIGH RATES MAY NEVER BE WHAT THEY USED TO BE

Looking at the historical data series of the ECB's official rates, one might think that the last few years are an anomaly, as the period of very low rates seems to drag on for so long, because in the other low interest rate episode of the short history of the European Monetary Authority (2004-2006), the start of the upward path occurred much earlier. Similar conclusions apply if we look at the history of the Bank of England or the Fed.

However, it could be that looking at official rate charts alone is not enough. It has already been pointed out that guidance of expectations and quantitative easing have made it possible to drill below what used to be the effective lower bound of monetary policy. From that point of view, I suggest that **the “centre of gravity” of European monetary policy has shifted downwards**. Therefore, the scaling-down of purchases already taking place and the announcement of the completion of the programme by the end of 2018, although not yet shrinking the ECB's balance sheet, can already be interpreted as the beginning of a “hike” in rates. No hike is visible from a classical perspective. But there is a very striking difference between injecting an additional €80 billion in monthly asset purchases and no injection at all (as will occur in January 2019), even if the proceeds of repayments continue to be reinvested.

This downward shift of the centre of gravity of monetary policy means there is still some time left “underground”. The tightening of monetary policy will take place at the official rate of zero. This is already being done, as we have seen, so the next step, once new asset purchases cease in January, will be, after a few months, to start on a path of interest rate hikes similar to that already initiated by the Fed and, a little later, by the Bank of England. At this point, we should note that the upward trend in interest rates will be determined by the specific economic juncture, so it is not easy to anticipate the level interest rates could finally reach. After the beginning of the rate increases, as from an unspecified time which, all else being equal, would come after a cautious wait following the first rate increase, and always in parallel with rate increases, which would be staggered over time, the ECB would begin to shrink its balance sheet. This balance sheet reduction



would in any case proceed cautiously. At first, the ECB would stop reinvesting the total of repayment proceeds (tapering off over time the percentage of total repaid volume that is reinvested). At the end of a long period of tapering-off, nothing at all would be reinvested. So this is a long process that could be knocked off course by any number of contingencies that might call for speeding up or slowing down this “heading for the exit”. And even if there are no major shocks, the process will be a long one. To determine when such milestones might occur, we would do well to review the example of the Fed (this chronology will be reviewed later), which has already completed each of these steps. Although one might think that the ECB could be somewhat quicker to complete these phases, a similar path is to be presumed. In any event, given the strong commitment to forward guidance, whatever the strategy finally adopted it will be properly announced beforehand so as not to cause undesirable imbalances in the markets.

5.8. THE CONSEQUENCES OF SUCH A PROTRACTED PERIOD OF LOW RATES

The ultra-loose monetary policy we have had in Europe in recent years has undoubtedly contributed to improving the situation in the Eurozone, as mentioned earlier. This does not mean there are no risks posed by such a long period of monetary accommodation. On the face of it, none of those risks appear as significant right now, but it is appropriate to comment on them and remain alert to possible issues in any of these fields, also during the exit stage.

In general, low rates and strong intervention in debt markets could generate **bubbles**, as prices do not reflect a cross of real demand and supply. The negative yields on much of the debt curve of many of the countries in the Eurozone contradict the fundamentals of financial economics, but, nevertheless, we have taken them on board without fuss and they are already part of the financial reality. Leaving aside the question of whether these assets are overvalued, it is essential that the exit strategy be predictable and create as few distortions as possible. When the end of stimulus was announced in the United States, developing economies in the dollar sphere were hit hard by expectations of higher rates, although the actual withdrawal of the measures has not played out as harshly as the initial reaction. I therefore hope that the end of the growth of the ECB’s balance sheet and its subsequent reduction will not cause significant distortions in the markets, especially since the roadmap announcements will be clear and transparency about deadlines and jurisdictions is both widespread and known to all. The ECB has always insisted that the capital key will remain in force for the remaining reinvestments, and – we should assume – for divestments, too: always subject to the flexibility with which the ECB has operated.

This overvaluation of assets could create bubbles in other markets in search of returns, such as housing. In this case, there would be significant differences by country: the IMF (2018) takes the view that in Luxembourg, in some German cities and in some areas of Portugal and the Netherlands there could be gaps between supply and demand that might lead to sharp price increases. In any case, with the exit strategy for non-standard measures already underway (although still at a very early stage), it does not seem that these processes will take their course in an environment of expectations of rate hikes.



This market intervention that drives up prices can create trouble in the financial sector, generating what are known as **macroprudential risks**: imbalances that can affect the financial system as a whole, putting financial stability at risk. The past crisis taught us that the bank-by-bank approach is not enough. It is also necessary to have an overall view that allows us to evaluate whether too much risk is being taken on in the aggregate. Macroprudential regulation has therefore grown rapidly in recent years and the supervisory authorities in this area constantly monitor risks and stand ready to implement preventive measures. The European Systemic Risk Board plays this role in Europe. Monitoring by the Board and national authorities should also continue to track potential risks throughout gradual tightening of monetary policy.

Another of the key debates on the consequences of extended monetary expansion is the effect on **bank profits**. The effects of the earliest non-standard measures on the banking sector have already been discussed: they improved banks' financial position. Fernández de Lis and Rubio (2018) point out the conflicting effects on banks' profitability, where adverse effects predominate: the spread between the cost of deposits and the return on loans is narrowed, and, what is more, it is not possible to transfer to depositors the negative rates that banks sustain in some of their financing channels. Also there was a flight of depositors to non-bank products due to the very low return offered by banks. However, Arce and Del Río (2018) are more optimistic, and point to a neutral or even positive impact through offset of the adverse effects with gains from the reduction in the cost of liabilities, lower provisioning needs (as the credit quality of the loan portfolio improves due to economic recovery), and gains through securities portfolios. This view is also supported by the responses to the Bank Lending Survey, where the effects of asset purchases and LTROs are regarded positively in net terms. In any event, we must take into account the heterogeneity of the European banking sector. Banks have widely different financial positions and business models, and the specific impact on them has likewise been completely different.

In a recent paper, the BIS (2018) warns of a range of risks to financial stability. First, although banks have generally been able to protect themselves from declining profits, some banks or countries could suffer more heavily due to their weaker position, because they are in very competitive markets. Secondly, although so far there has been no increase in risk-taking in search of returns, we must be vigilant so that, if the period of low rates persists, such additional risk-taking does not occur. The paper also warns of possible solvency issues at the banks that could suffer most from those effects. Finally, a return to normal rates could lead to a loss of value in certain portfolios, which requires heightened vigilance.

This monetary policy, not only the ECB's but also of the rest of the world's leading central banks, has led to very loose financial conditions in all currencies, which in turn has encouraged an **increase in global debt**. This debt growth may pose a risk in the monetary normalisation phase. Although normalisation is far more advanced in other jurisdictions, vigilance must be kept up. So BIS data corroborate this growth in indebtedness since the beginning of the crisis (figure 6) in almost all the countries considered (but there is no such increase in either the United States or Germany). However, if the data

are broken down, it can be seen that, to a large extent, where it exists, this growth is driven by the increase in government indebtedness, as private indebtedness (figure 7) has generally remained far more stable (except in France). Of course, as one might expect, the situation in the emerging economies is different, as illustrated by the performance seen in data from China. The observation that the behaviour of government debt has driven the increase in debt overall vindicates the relevance of the reminders that Mario Draghi continues to provide in his statements to keep up the efforts of fiscal consolidation in the European economies, since the new phase of monetary tightening will impact the interest rates that governments have to face in order to refinance their liabilities.

FIGURE 6. TOTAL LIABILITIES OF THE NON-FINANCIAL PRIVATE AND PUBLIC SECTOR (% OF GDP)

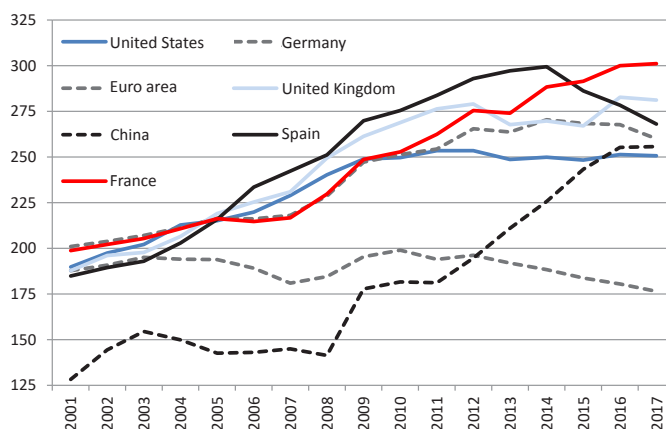
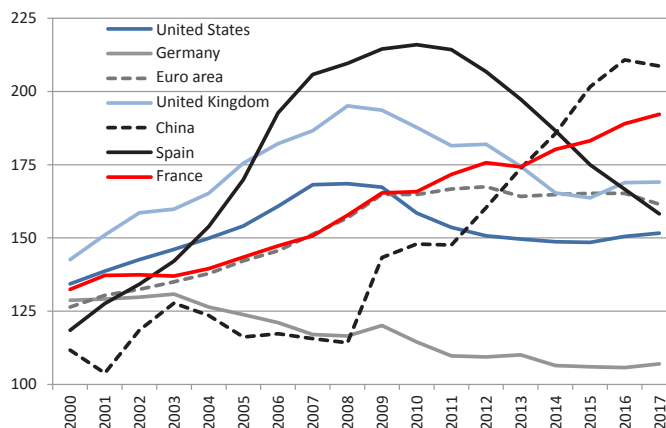


FIGURE 7. TOTAL INDEBTEDNESS OF THE NON-FINANCIAL PRIVATE SECTOR (% OF GDP)





5.9. THE EXIT STRATEGY HAS BEGUN

Although the ECB's balance sheet is still expanding and the guidance of expectations is still delaying the timing of rate hikes until at least the summer of 2019, in 2018 there has been a turning point: the pace of purchases slowed significantly and a cessation of purchases was announced for the end of the year.

Economic recovery is a fact, and so are improved job figures and enhanced confidence. However, as noted, inflationary pressures still fail to make an appearance, so the ECB is still cautious.

The patience, prudence and persistence that continue to inform monetary policy – despite the fact that they are no longer expressly mentioned in recent meetings – follow in the footsteps of other institutions, such as the IMF (2018), which considers it “vital” to maintain the unusually low levels of interest rates at least until the summer of 2019, as has been announced. The OECD (2018) also argues that policy should remain accommodative, although gradual normalisation should be prepared for as inflation expectations recover. The OECD is in fact as bold as to suggest not reducing the balance sheet at all before the first rate hike in order to minimise the risk of adverse market movements.

With regard to the foreseeable exit strategy, it should be noted that the catalogue of non-standard measures whose main purpose was to repair the transmission mechanism of monetary policy has already been largely withdrawn without causing any distortion. Banks have become more resilient and less exceptional support is needed for them to do their job properly. Yet the disappearance of these measures does not imply their elimination altogether: they remain available to the ECB should their use become necessary at any time.

Economic theory argues for the existence of a **natural interest rate**, which should be the rate upon which actual interest rates will converge in the following period. The natural interest rate is not immutable; on the contrary, it is modified by changes in the economy. It has been argued that the past crisis and the subsequent response has lowered the natural interest rate in most economies, including Europe. There are several models for estimating the natural interest rate, but what is important now is not to determine a specific figure but to analyse its determinants.

Galesi, Nuño and Thomas (2017) identify the factors explaining the decline in the natural interest rate, distinguishing between long-term elements and those relating to the recent financial crisis. With regard to long-term factors, they point out that there is an excess of savings supply in relation to investment demand, explained by demographic factors (aging leads to greater savings) and the decline in the propensity to invest (which could be explained by prospects of slow growth in productivity). As for the changes wrought by the past financial crisis, the increase in uncertainty associated with it may have led households to increase their savings and businesses to amass liquidity.

These authors also address the question of whether this fall in the natural interest rate is a permanent or temporary phenomenon. Perhaps it is too soon to give an answer, as there are arguments in both directions. In any case, for our purposes of trying to esti-



mate the interest rate at which the ECB will arrive in its normalisation process, the fact is that it will be lower than rates we have seen in previous cycles, due to the fall in the natural interest rate and the downward shift in the centre of gravity.

It is not easy to predict how far rates will go in this new phase of normalisation, since it will depend on how the economic cycle advances and how it is capable of generating higher inflation expectations than currently. This will also depend on when the cycle is exhausted, at which point those expectations may be frustrated and the ECB forced to relax monetary policy again. Although still a doubtful argument, this pleads in favour of a little more speed when it comes to monetary normalisation, as some voices are calling for. As discussed in this paper, it is not necessary to have high rates in order to lower them and thus generate more monetary accommodation; this can be achieved by other means, particularly the purchase of assets. Thus, if in the midst of monetary normalisation inflation expectations were to deteriorate again, the Governing Council would be willing to act, with messages and facts, to redirect those expectations.

In any event, to resume the debate on the path the ECB might take from now on, we could use the Fed's precedent as a guideline. The Fed ended its asset purchase programme in October 2014 after tapering off its purchase volume, as the ECB has also done. A little over a year after ending purchases, in December 2015, the Fed raised its interest rates, after seven years of no change. Since then there have been further rate hikes. In fact in 2018 there have continued to be rate increases: on three occasions until the beginning of November. Almost two years after the first increases in official interest rates in October 2017, the Fed began to reduce its balance sheet by not reinvesting all proceeds of repayments.

Given the above, and assuming that the ECB will stop purchasing new assets as early as January 2019, a rate hike can be expected during 2019, probably in the summer or immediately after. From this point onwards there will be regular rate increases, always depending on the situation. Although it took the Fed three years from the end of the asset purchasing to the beginning of the offloading of its balance sheet, it is likely that the ECB will take less time to complete this journey. Naturally, as mentioned above, this whole process must be in line with the economic situation and, in particular, with the extent to which the inflation target is followed. It would not be logical to maintain a path of monetary policy normalisation that did not take account of these developments in order to create room for manoeuvre in the future if this were to hinder recovery. In addition, the ECB would still have some scope to even expand its balance sheet if necessary: as we have seen, the ECB hovers around a total balance sheet size of 40% of GDP, which is above the 25% of GDP reached by the Fed at its peak, but well below the almost 100% reached by the Bank of Japan. Although Japan is certainly not an example of successful policy, the fact that its central bank has grown such a large balance sheet without creating a worse situation than it intended to avoid indicates that, if at all, the ECB could still have some room for manoeuvre even to expand its balance sheet, through the purchase of assets or through other instruments (TLTROs or similar arrangements). However, the capacity for expansion is not infinite and, with regard to the purchasing programme, debate has flared within the ECB on what to do in the event of bond shortages in certain



jurisdictions and maturities. The ECB has managed this situation without much trouble and could do so again if further accommodation is needed in this way, using the flexibility of the programme.

As to the end of reinvestment of debt already on the balance sheet, given that such debt has very different average terms per country, it would be advisable for this balance-sheet reduction to take place in the awareness of this heterogeneity, in such a way as to maintain neutrality in the process and ensure that the ECB's balance sheet position does not deviate excessively from the capital key followed when making purchases initially.

Finally, although it should really come first, it is essential for the ECB to continue with its expectations guidance and to draw up its monetary normalisation roadmap. The credibility earned over the past few years is a vital asset that must be preserved, and the ECB will surely strive to do so. In any case, this normalisation is going to be absolutely “data dependent”. Monitoring of the indicators and models used by the ECB will determine its next steps, so we should not wait for a pre-established route. Instead, at each meeting messages will be modulated according to the needs of the moment. Draghi has made this type of communication quite an art, and his term of office expires in October 2019. His successor will have to continue in this same line of guiding expectations masterfully.

In view of the forthcoming reduction in the balance sheet and an increase in interest rates, a positive effect is to be expected, although it is also heterogeneous for banks. Again following Fernández de Lis and Rubio (2018), the banks and countries with the greatest share of variable remuneration on credit, such as Spain, are set to improve margins more quickly. In systems with a greater weight of retail deposits, the improvement will be more noticeable, since certain funding sources will no longer be penalised with negative rates that cannot be passed on to the customer. The general rise in yields will also lead to increases in the cost of funding in the capital markets for banks, resulting in an effect carrying a negative sign. Banks' debt portfolios will also suffer, as their prices fall in the new scenario.

The effects of normalisation on the banking sector will be varied and will affect institutions in different ways. For this reason, it is especially necessary that the communication policy is clear, and that there are no unexpected shocks that could hurt the stability of the markets.

There will also be a restructuring of portfolios as a result of the end of purchase programmes and subsequent reduction of the ECB's balance sheet, although following the same pattern, given the predictability of these actions, there should be no adverse effects as economic actors already have sufficient information.

5.10. CONCLUSIONS

The classic central bank dynamics of official interest rate movements proved insufficient to respond to the challenges of the past crisis. The sharp reduction in reference rates failed to reach the real economy and financial fragmentation threatened the single



currency. The ECB was soon aware that the transmission mechanism of monetary policy was obstructed by a serious crisis of confidence due to the particular architecture of the euro monetary area: under full European monetary sovereignty but without sufficient financial, economic and fiscal integration. Hence instruments were put in place to try to repair the transmission channel. The proximity of official rates to the effective lower bound called for further monetary accommodation, which could not be achieved by conventional means, but which was achieved by other means, as described above.

Although certain sectors criticised the proactivity of the monetary authority pushing its regulatory framework to the limits, the fact is that when viewed in perspective such measures were both necessary and effective. The creation of new monetary policy instruments outside convention has been one of the legacies of the crisis. These instruments that will continue to be available to the ECB in the future, thereby improving its capacity to react. The protracted period of very low rates carries some risks, although most of them have not so far materialised.

The challenge now is to withdraw them in an orderly fashion. The process has already begun and friction may arise, but if all arrangements are made in a predictable way, economic actors will be prepared for it. We will then see a “new normal”, in which high rates will never be what they once were, as the centre of gravity of monetary policy has shifted downwards, and we have seen that there is scope for even greater monetary accommodation even when rates are close to zero.

The ECB will continue to watch over price stability in the Eurozone. The ECB has emerged from the crisis with enhanced credibility and a wider range of tools at its disposal than in the past, which will allow it to react, predictably, to future challenges, which is a great asset for a central bank.

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6. DIFFERENCES BETWEEN THE EUROPEAN BANKING SECTORS: AN OBSTACLE TO BANKING UNION

JOAQUÍN MAUDOS¹

6.1. INTRODUCTION

One of the European Commission's priorities is to achieve "deeper and fairer economic and monetary union", and financial union is one of the areas of action. Financial union "means ensuring that Europe has strong and stable banks and capital markets capable of financing the real economy. Banking union is at the core of this priority. The objective is to maintain a healthy banking sector that guarantees protection for depositors' bank accounts".

Achieving true and full economic and monetary union requires not only a common currency and a single monetary policy, but also an integrated financial market where aspects such as regulation, supervision and resolution rules to deal with banking crises are unified and where there are no differences between member countries. The 2007 crisis, which was exacerbated by the sovereign debt crisis in 2010, made it very clear that progress towards European banking union was a necessary complement to the raft of exceptional measures adopted by the ECB in 2012. The two initiatives (ECB + banking union) helped us find a way out of the crisis by weakening (although not eliminating) the vicious circle of banking-sovereign debt that gave rise to it. However, a single financial market in Europe remains a long way off (there are still differences between countries with regard to the conditions under which they can access funding), partly because banking union is as yet incomplete, as a third pillar is still required to give it stability, such as a common

¹ Lecturer in Economic Analysis at the University of Valencia, assistant head of research at Ivie and collaborator at CUNEF. This article is part of research project ECO2017-84828-R of the Ministry of Science and Innovation.



deposit guarantee insurance mechanism, and because there are still doubts concerning whether the amount of the resolution fund is sufficient in the event of a systemic crisis.

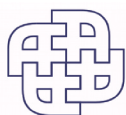
The concept of banking union was created to address the EMU's limitations, evidenced in aspects such as the inability of banks to deal with the financial crisis without public aid provided by taxpayers, the national differences in how the banking crisis was managed and the lack of standardised supervisory practices. To resolve these deficiencies, a banking union was conceived to build an integrated European market backed by a single regulation (governing capital, liquidity, bail-in rules, protection for customers holding financial products, etc), single supervision (single supervisory mechanism), a single resolution mechanism and a Europe-wide deposit guarantee fund. While the first three parts of the project are being developed, the proposals put forward to date in relation to the last pillar remain just that; proposals.

One of the obstacles that has halted the advance toward European banking union is the significant differences in default rates between euro area countries. Some countries view the higher rates seen in those countries which were hardest hit by the crisis (distressed countries) with distrust, and are therefore not prepared to mutualise risks through a single European deposit guarantee fund. The argument is simple: if countries with higher rates of problematic assets are more likely to use this fund, the countries with lower default rates will be those that end up footing the bill in any hypothetical banking crisis, as they are unlikely to need access to the fund. This is the reason for the pressure being brought to bear by the ECB and the European Commission through their recommendations to step up provisioning requirements for problematic assets.

The requirement put forward by some countries (non-distressed countries) that the other countries must reduce their default rates for banking union to be completed is a throwback to the Maastricht criteria for membership of the EMU, a club reserved for countries meeting certain conditions that show they are in good macroeconomic health (low inflation, debt and public deficit, long-term interest rates, etc.). The difference is that at that time these were criteria that had to be met to join the club, whereas now the club has already been formed and any countries that do not meet a determined criterion (e.g. default rate) are not going to be expelled. Therefore, the key now is deciding when and at what pace risk should be shared, as this is main issue that needs to be resolved for banking union to be completed with the implementation of a European deposit guarantee system.

The differences between the various euro area banking sectors (that came to light in the EBA stress tests conducted in 2018) relate not only to default, but also to the other variables that define that state of health, such as profitability, efficiency, liquidity and solvency. As we will explain in this article, the variation ranges for these variables compared to 2017 data are significant.

Hence, our purpose is to present the most recent picture of the structure and health of the different European banking sectors in dimensions such as the size of the sector, market structure, degree of integration with other euro area sectors, profitability, solvency, efficiency, asset quality and liquidity. To achieve this, we will refer to information con-



tributed by both the ECB and the EBA, and 2017 is the last full year available for these references at the time of writing.

The analysis is closely related to the banking union progress reports drawn up by the European Commission (in conjunction with the ECB, the Single Supervisory Mechanism and the Single Resolution Mechanism) and has two objectives: a) to provide detailed information on the achievements made in relation to risk reduction measures; and b) to present the impact of these measures using quantitative evidence. These risk indicators assess aspects such as capitalisation, leverage, liquidity, net stable funding and default in relation to European banking. Our article analyses these and other aspects to provide a fuller picture of the current differences between the European banking sectors.

Aside from this introduction, the article has the following structure. Section 2 looks at the dimension and market structure of the European banking sectors. Section 3 addresses the progress toward the integration of the European banking market, which is currently a long way from being a single market, particularly in the area of retail products. In section 4, we use a variety of economic-financial indicators to assess the health of European banking and look at the significant differences that exist between countries, which are key to understanding the reluctance of some nations to mutualise risks and implement a single European deposit guarantee mechanism. Section 5 analyses one of the current most concerning issues in the advance toward banking union, and which was the cause of the sovereign debt crisis (the government-banking debt loop): banks' exposure to government debt. Section 6 presents the article's conclusions and offers some further reflections by the author.

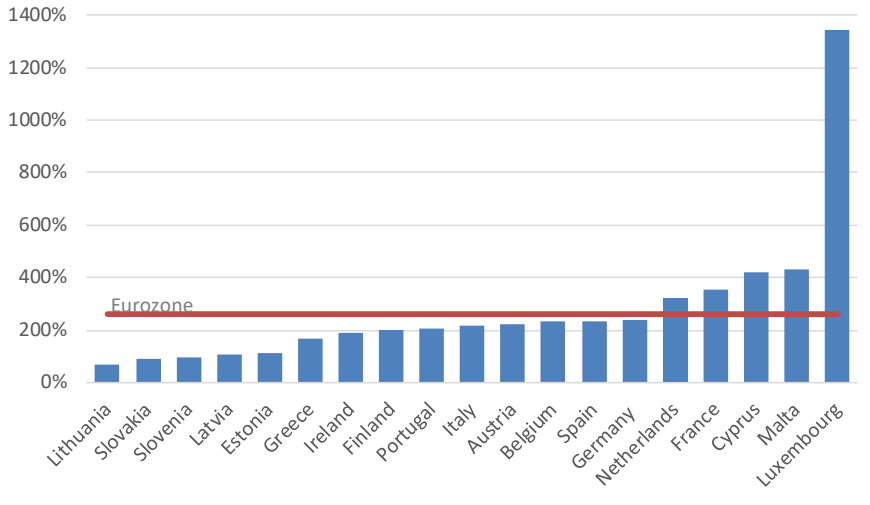
6.2. DIMENSION AND MARKET STRUCTURE OF THE EUROPEAN BANKING SECTORS

The degree of banking penetration in European countries varies widely, as reflected by the weight of banking assets in GDP (see chart 1). Excluding the case of Luxembourg (which has a banking assets/GDP ratio of 1.346%, where banking contributes 16.8% and 7.6% of added value and employment, respectively, compared to the euro area average of 3.1% and 1.5%), the variation range is from 1 to 7, with a ratio of 431% in Malta compared to just 68% in Lithuania. Among the largest EMU economies, France has the highest weighting of banking assets in its economy (354%), while Germany (236%), Spain (233%) and Italy (216%) all come in below the European average.

Since 2008, coinciding with the start of the financial crisis, the banking sector underwent significant deleveraging in many countries, with the volume of banking assets decreasing in 10 of the 19 euro area countries, at a rate of over 20% in Ireland (61%), Greece (36%), Cyprus (35%), Austria (22%), Luxembourg (20.4%) and Spain (20.3%).



CHART 1. ASSETS OF CREDIT INSTITUTIONS/GDP IN EURO AREA COUNTRIES. 2017. DOMESTIC BUSINESS. PERCENTAGE



Source: ECB and Eurostat.

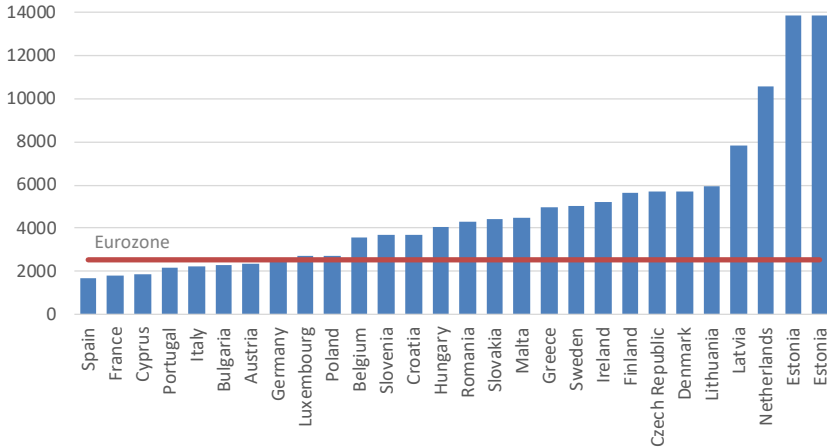
Another indicator that provides information on the degree of banking penetration is the density of the branch network, calculated according to the average number of inhabitants serviced by one branch. As we can see in chart 2, in 2017 there were also major differences between European countries, where Estonia headed up the ranking (with almost 14,000 inhabitants per branch) with a figure that is eight times that of Spain, the country with the greatest network density (1,693 inhabitants per branch).

Installed capacity has changed a great deal over the past few years due to the adjustments made after the crisis. In the countries most affected, the adjustment has been greater, with branch networks falling by 43% in Greece, 40% in Spain, 50% in Cyprus, 21% in Ireland and 22% in Portugal compared to 2007. Meanwhile, employment in the sector has also fallen (by 16% between 2007 and 2017 in the EU-28), with reductions of 35% in Greece, 34% in Spain, 17% in Italy, 24% in Portugal and 6% in Cyprus. The UK has also seen major changes, with 30% fewer jobs.



DIFFERENCES BETWEEN THE EUROPEAN BANKING SECTORS: AN OBSTACLE TO BANKING UNION

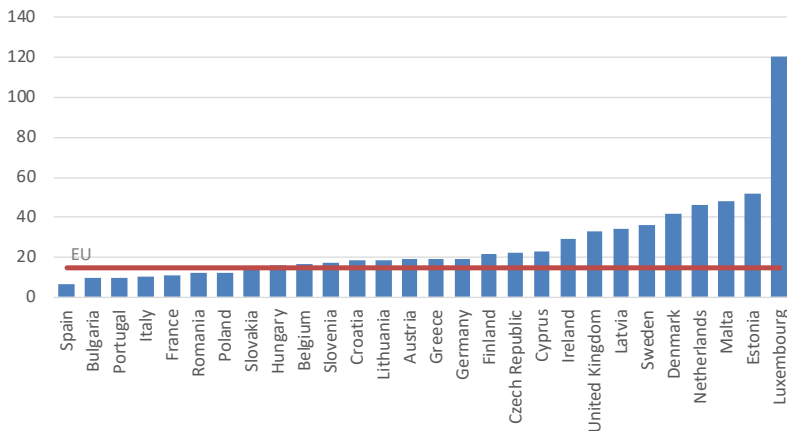
CHART 2. NUMBER OF INHABITANTS PER BRANCH IN EU COUNTRIES. 2017



Source: ECB and Eurostat.

Following the changes in installed capacity, average branch size increased in most European banking sectors, although there are countries with very different levels, ranging from a maximum (with the exception of Luxembourg, which has 120 employees per branch) of 48 in Malta to a minimum of 6.6 in Spain. Among the large EU countries, France (10.9) and Italy (10.3) are smaller than the European average (14.7), while Germany (19.3) and the UK (32.8) are bigger.

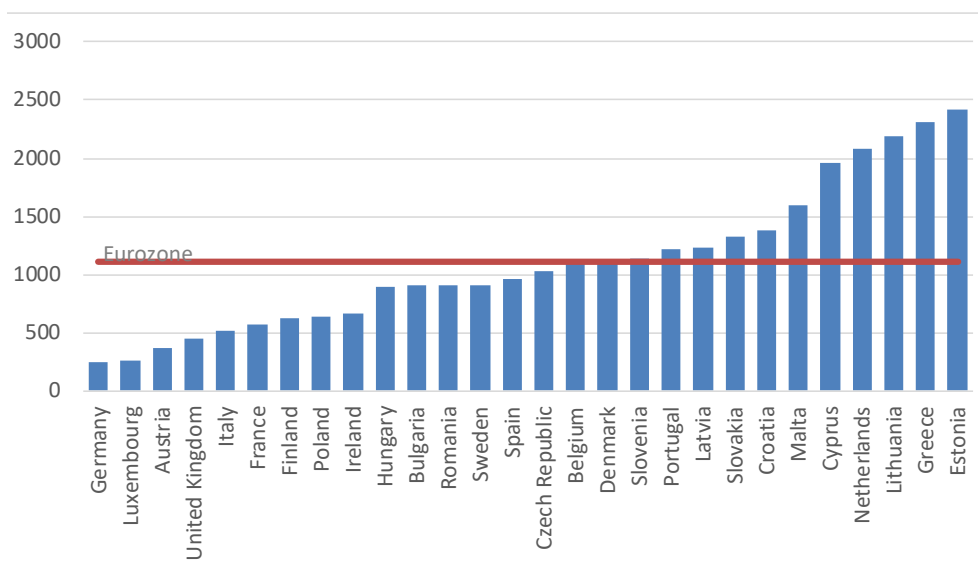
CHART 3. NUMBER OF EMPLOYEES PER BRANCH. 2017



Source: ECB.

The crisis has led to a restructuring of the banking sector in some European countries, where mergers and absorptions are used as a strategy to seek out synergies and reduce costs. This has resulted in a significant fall in the number of competitors (between 2008 and May 2018 the number of credit institutions dropped by 28% in the euro area, from 6,570 to 4,715, with decreases of over 40% in Cyprus, Spain, France, Greece and Holland) and market concentration has increased. For the latter, the average (unweighted) concentration (measured using the Herfindahl index) increased by 7.2% in the euro area from 2008 to 2017, most notably in Greece (97%), Spain (94%) and Cyprus (93%), countries where the banking sector has been most heavily impacted by the crisis. However, the increase in concentration is not common to all European banking sectors, as in countries such as Austria, Belgium, Luxembourg and Holland it has fallen. As we can see from chart 4, in 2017, concentration in Estonia (2,419 points) was 10 times higher than in Germany (250), and five countries (Cyprus, Holland, Lithuania, Greece and Estonia) have broken the threshold of 1,800 points, beyond which a market is considered to be excessively concentrated. In this scenario, the question is whether the vast differences in the levels of market concentration between countries imply different levels of competitive intensity, and hence in profitability levels.

**CHART 4. CONCENTRATION IN THE EU BANKING MARKETS.
HERFINDAHL INDEX. 2017**



Note: The euro area figure is an unweighted average.

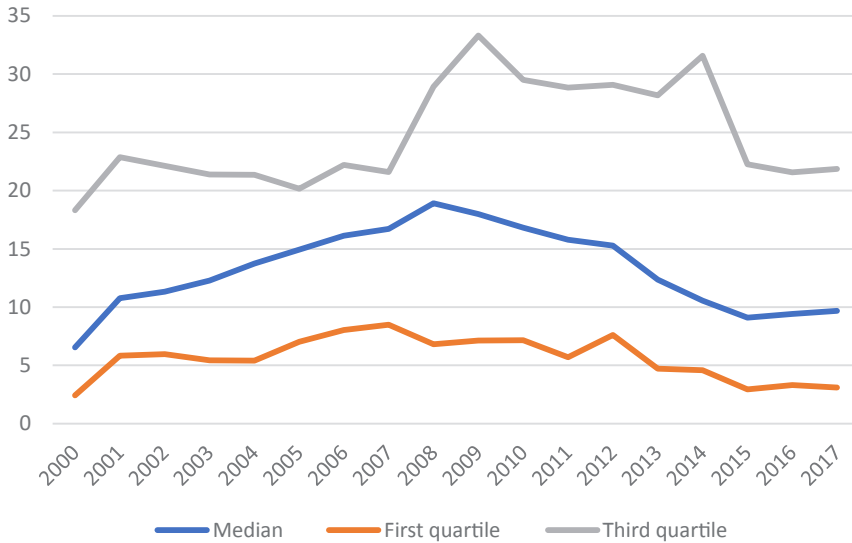
Source: ECB.



6.3. INTEGRATION OF THE EUROPEAN BANKING MARKETS

As described in the ECB annual reports on European financial market integration, wholesale markets are much more integrated than retail markets, and this also applies to the banking sector. A leading indicator of the low levels of banking integration in Europe is the small market share held by European banks in some euro area countries. As shown in chart 5, the average market share increased when the euro was created in 1999 through to 2008, when it peaked at 19%. However, when the crisis broke in that year, this market share slipped to 10%, losing almost half of the maximum share reached pre-crisis. In some countries (those in the first quartile) the market share was 3% in 2017, reflecting a low integration rate with other European countries.

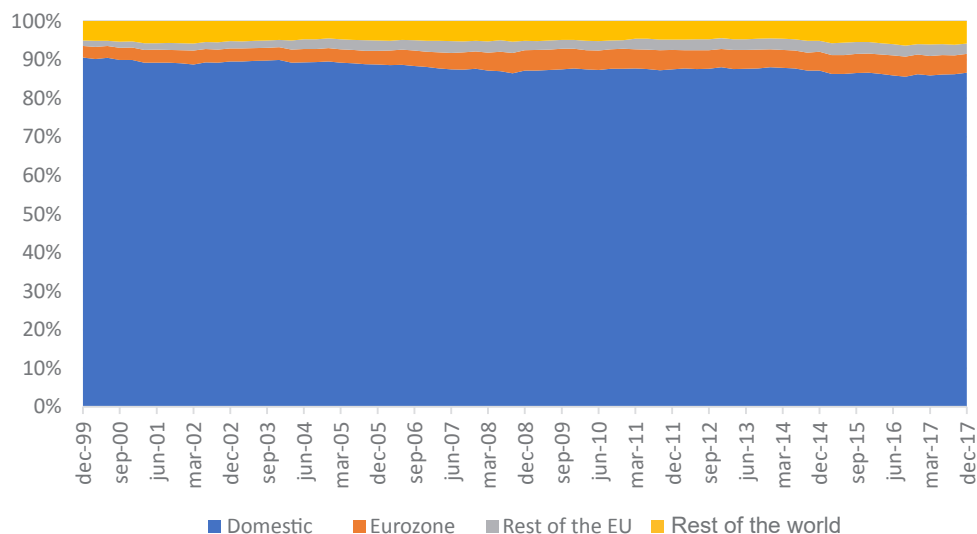
CHART 5. WEIGHT OF ASSETS OF BRANCHES AND SUBSIDIARIES OF EURO AREA BANKS IN OTHER EURO AREA COUNTRIES. PERCENTAGE



Source: ECB.

The low integration of European banks can be clearly observed if we look at the geographical distribution of loans to the non-financial sector. In 2017, for every 100 euros lent by monetary financial institutions in the euro area to the non-financial sector, 92% were lent to residents of the same country, and only 2% to residents of other euro area countries (chart 6). As a result, there is a clear domestic bias in the lending market that reflects a low level of integration at European level.

CHART 6: PERCENTAGE DISTRIBUTION OF LOANS BY MFIS TO NON-MFIS BY GEOGRAPHICAL DESTINATION



Source: ECB.

The impact of the 2007-08 financial crisis and, more intensely, the sovereign debt crisis of 2010, gave rise to a two-speed Europe in the financial realm, opening a rift between the funding costs of those countries that had been hardest hit and the rest of the euro area. As we can observe from chart 7, the interest rate on loans to companies increased at a much sharper rate in the first group of countries (distressed countries) than in the rest, opening a gap from mid 2010 to hit levels of close to 300 basis points by mid 2013. Subsequently, thanks to the extraordinary measures implemented by the ECB and the announcement of the banking union project, the reduction in the risk premium on sovereign debt extended to all other interest rates, triggering a sharp fall in funding costs and causing the gap between the two groups of countries to close to only 50 basis points in 2018 (May). In the specific case of mortgage loans, the gap between the two groups of countries has always been smaller and it also increased when the sovereign debt crisis started. The measures implemented by the ECB also caused it to narrow to only 29 basis points in May 2018.

6.4. THE SITUATION OF EUROPEAN BANKING

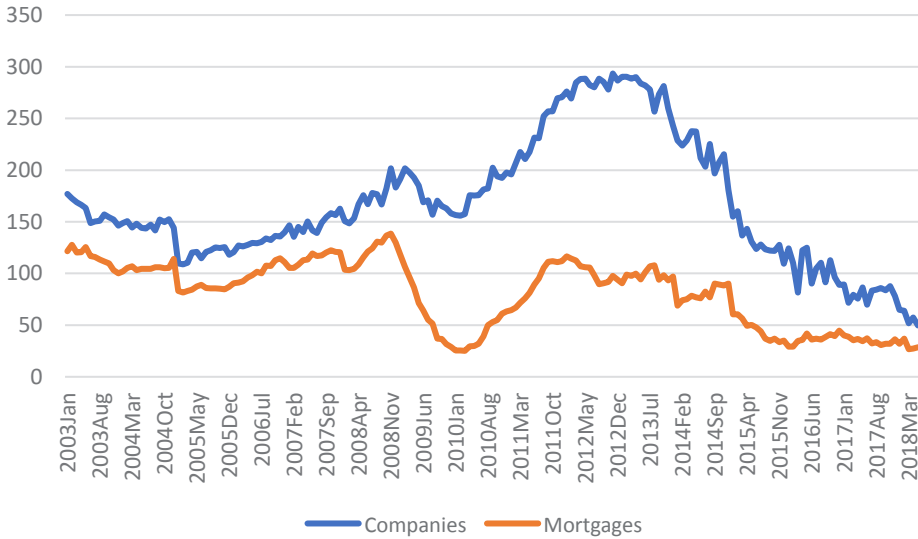
a) Asset quality

As mentioned in the introduction, the greatest obstacle to completing banking union by establishing the third pillar, which is a European deposit guarantee fund system, is the large volume of non-productive assets on the balance sheets of certain euro area



countries, this being the main and most regrettable legacy of the crisis by causing default rates to rocket.

CHART 7. INTEREST RATE SPREAD BETWEEN THE COUNTRIES MOST AFFECTED BY THE CRISIS (CYPRUS, GREECE, IRELAND, ITALY, SPAIN AND SLOVENIA) AND THE REST OF THE EURO AREA. BASIS POINTS



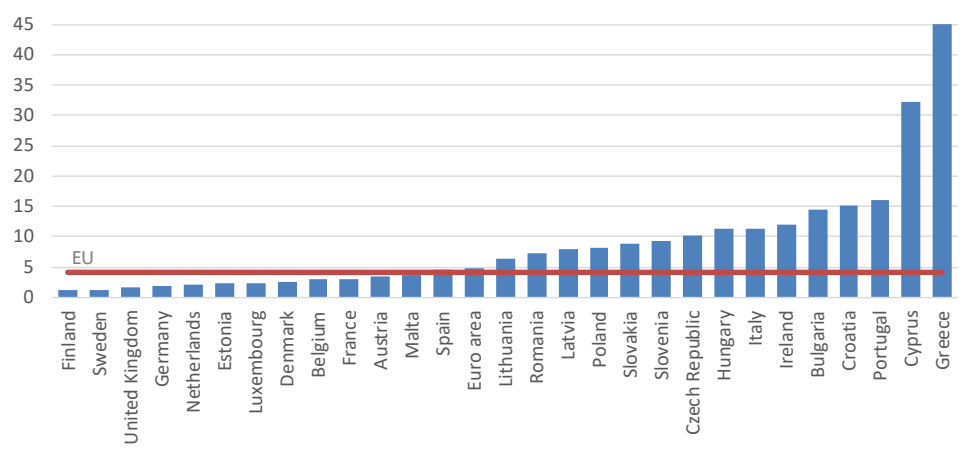
Source: ECB.

As illustrated in chart 8, although the asset default rate² has fallen recently on the back of the economic recovery, it still remains high. Specifically, at year-end 2017 this rate was 4.8% for euro area banks and 4.1% for the EU-28, exceeding 10% in nine countries, notably Italy (11.4%), Ireland (12.1%), Portugal (16%) and Greece (45%).

The stock of problematic assets stood at 731,000 million euros at the end of the year. As shown in chart 9, four countries (Italy, France, Spain and Greece) account for two thirds of this figure (169,000 million euros in Italy, 127,000 million euros in France, 95,000 million euros in Spain and 76,000 million in Greece). The countries hardest hit by the crisis account for just over half the amount (54% = 396,000 million euros) of toxic assets in the European banking system.

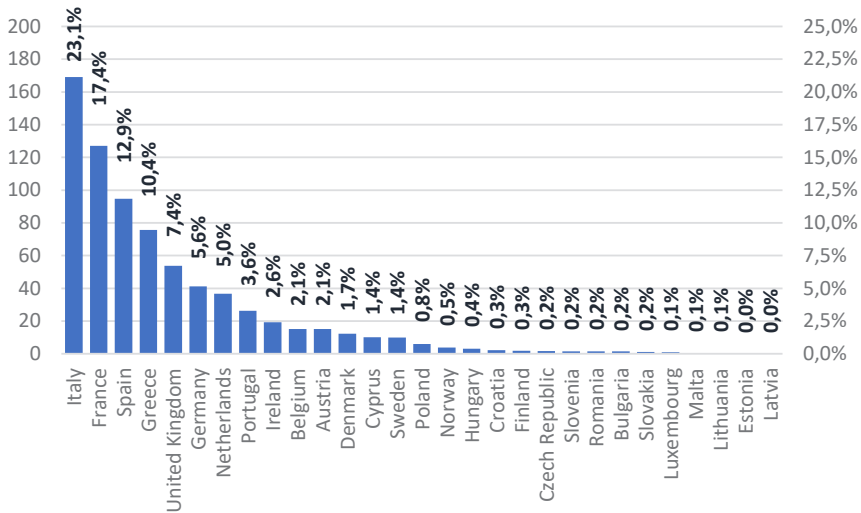
² The NPL rate is the percentage of loans and other assets whose recovery is doubtful.

CHART 8. NPL RATE IN EU BANKING SECTORS. 2017. PERCENTAGE



Source: ECB.

CHART 9. BREAKDOWN OF THE VOLUME OF NON-PERFORMING LOANS IN EU BANKING SECTORS. BILLION (LHS) AND PERCENTAGE OF EU TOTAL (RHS)



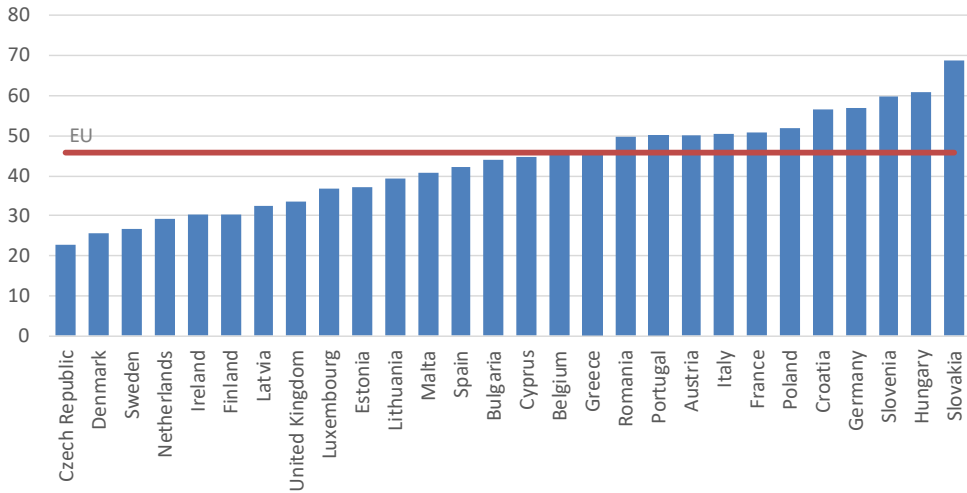
Source: ECB.

The true scale of the problem posed by a high volume of toxic assets not only relates to the default rate, but also to the losses that are recognised and provisioned. While international comparisons of the coverage ratio should be undertaken with caution for a



variety of reasons,³ it is useful to conduct such a comparison for European banks. In this context, as shown in chart 10, the coverage rate for problematic assets in the EU banking sector in 2017 stands at 45.7%, and is slightly higher (47.4%) for euro area banks. The percentage is lower in those countries that were hardest hit by the crisis than in the rest, falling below the average in Ireland, Spain and Cyprus, but above the average in Italy.

CHART 10. NPL COVERAGE RATIO. PERCENTAGE



Source: ECB.

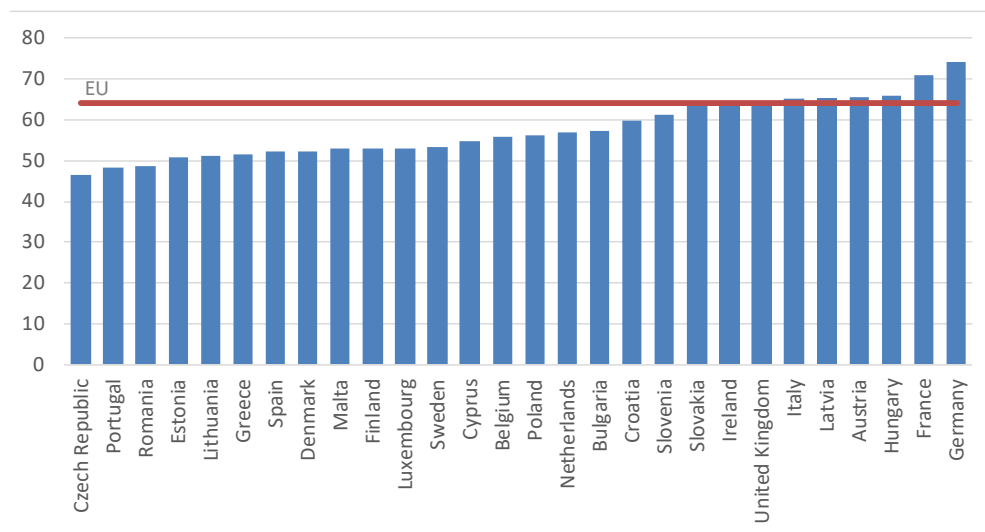
b) Efficiency

In a context where the profitability of the European banking industry is lower than the cost of raising capital (querying the viability of a banking business that is not able to offer what its shareholders' are asking for), a key variable to monitor and improve is management efficiency, which requires costs to be cut and financial margins improved. The second channel is complicated in the current context where interest rates are at unprecedented levels (even heading into negative territory), putting downward pressure on the net interest margin. Therefore, efforts must be aimed at cutting operating costs, which largely depend on the number of branch offices, explaining the radical adjustments to installed capacity seen in some European banking sectors.

³ There are differences in provisioning criteria and parameters across different EU nations, and therefore high volumes of provisions do not necessarily mean higher asset quality. Sometimes the level of coverage is lower either because the balance sheet is stronger or because the provisions required are laxer. The composition of the portfolio and different weightings of the sectors are also factors to be taken into account. For instance, for the same level of defaults, legal provisions will be higher the greater the weight of real estate loans, and lower if there are more loans to companies.

As we can observe in chart 11, there are also substantial differences in efficiency between European banking sectors, with a variation range of almost 28 percentage points between the maximum operating efficiency ratio of 74.1% in Germany and 46.6% in the Czech Republic. It is important to note that levels of management efficiency are lower (high efficiency ratio) in the main euro area countries, with the German banking industry ranking as the most inefficient, followed by France. The Italian banking system also has an efficiency ratio that is higher than the EU average, while the UK ranks close to the average. The only big European economy with an efficient banking industry is Spain. It is troubling to see that countries such as Italy and Ireland, which have high default rates, also have low levels of efficiency.

**CHART 11. OPERATING EFFICIENCY RATIO
 IN EU BANKING SECTORS. 2017. PERCENTAGE**

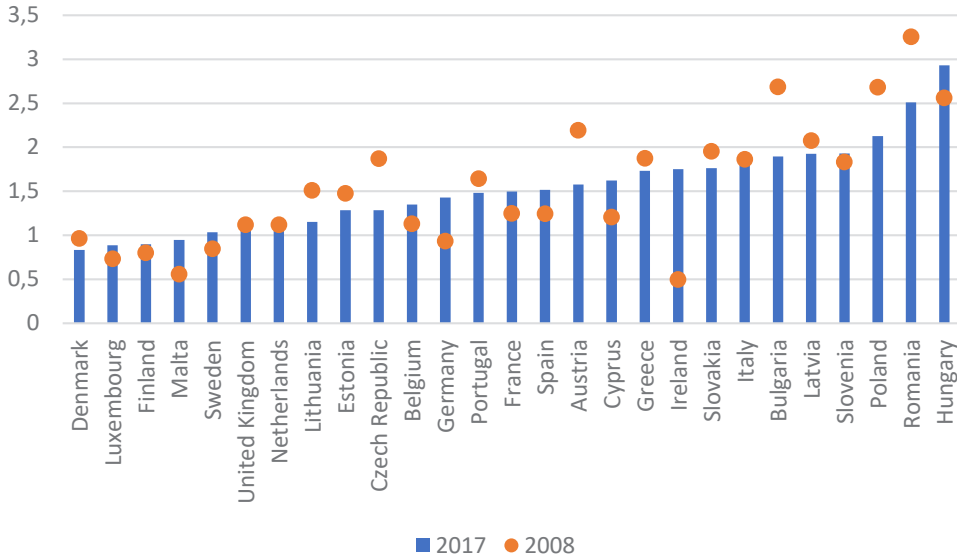


Source: ECB.

It should be noted that despite the capacity adjustments made in many European banking sectors, efficiency has deteriorated in a context of slumping margins and deleveraging, which explains why unit costs (per asset unit) have not fallen, but moved in the other direction. Specifically, in the main European banking sectors, the operating costs/asset ratio increased by 0.5 pp in Germany, 0.3 pp in Spain and 0.25 pp in France between 2008 and 2017. In Italy it is unchanged and in the UK it dropped only 0.03 pp. As a result, and as warned by the ECB, further efforts are required over the coming years to reduce costs, particularly in countries with higher unit cost ratios (see chart 12).



CHART 12. OPERATING COSTS PER ASSET UNIT. PERCENTAGE

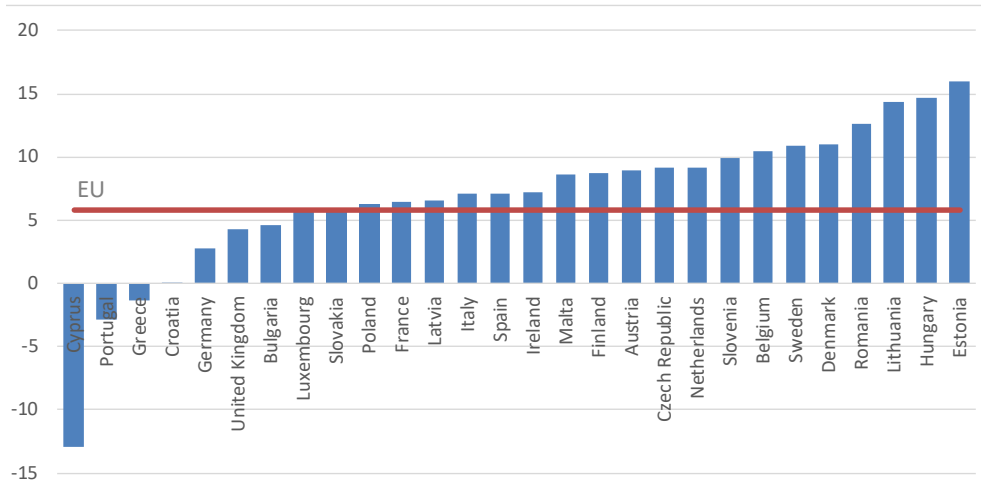


Source: ECB.

c) Profitability

After the crisis, profitability has gradually recovered in the European banking industry, although it is still the main problem for a large number of countries with levels that are lower than the cost of raising capital. Therefore, in 2017, RoE increased (from 3.2% in 2016 to 5.7% in 2017 in the euro area as a whole, mainly due to the reduced need for write-downs, which were concentrated in the countries most affected by the crisis), though in 17 of the 28 EU member states it stands at below 8% (the minimum estimated cost of capital). This low profitability is due to a combination of factors: the large quantity of non-productive assets, regulatory pressures (and costs) and the prevailing climate of low interest rates, which is putting downward pressure on banks' net interest margins. Based on the average of 5.7% in the euro area, the variation range moves between a low of -12.9% in Cyprus and a high of 16% in Estonia. The main EU countries (Germany, UK, France, Italy and Spain) are posting returns lower than their cost of capital (8%), and the low profitability of German banks (2.7%) and UK banks (4.3%) is particularly noteworthy.

**CHART 13. RETURN ON EQUITY (ROE)
IN EU BANKING SECTORS. 2017. PERCENTAGE**



Source: ECB.

d) Solvency

One of the main lessons learned from the recent financial crisis was the insufficiency of the equity held by banks to deal with the multimillion losses stemming from the impairment of bank assets, which largely became toxic. This lack of equity is the reason for the capital regulations set down in the Basel III accords, which require more capital in terms of both quantity and quality. These additional capital needs were also reinforced with new requirements (anti-crisis debt) such as MREL (liabilities able to absorb losses) and TLAC (liabilities required of global systemically-important banks to absorb losses in the event of resolution).

As a result of these demanding new regulations, the European banking system has significantly shored up its capital adequacy, with an 8.7 pp increase in the total capital ratio between 2007 and 2017 (from 12.2% to 18.9%). The ratio for the highest quality capital (CET1) stood at 15% for EU banks and 14.7% for euro area banks in 2017.

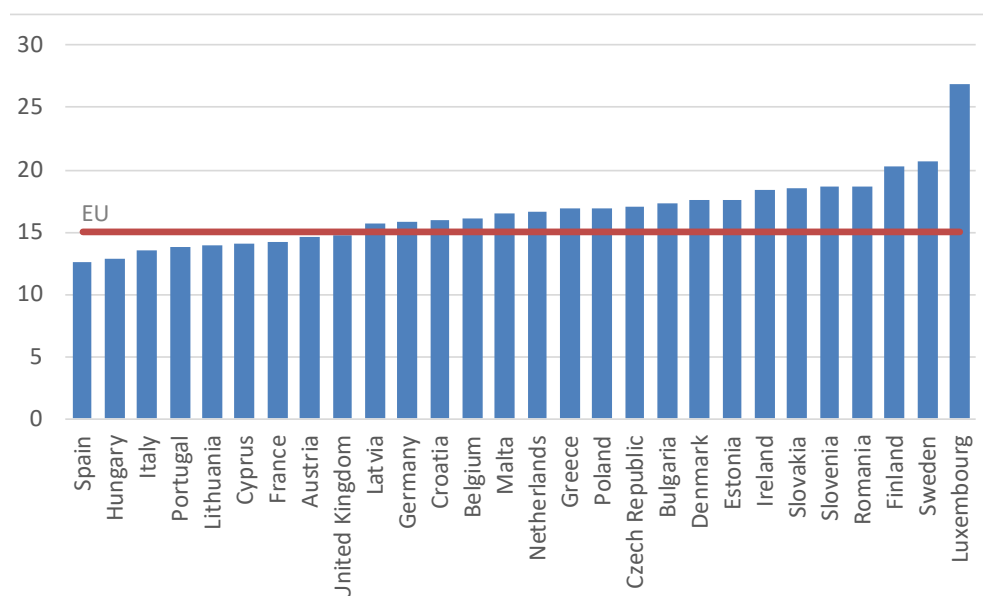
Although all countries comfortably meet the requirements set down in the new Basel III accord, which calls for a CET1 ratio of 7% by 2019, including the conservation buffer (2.5%), and a total capital ratio of 10.5%, once again there are significant differences between countries (see chart 14), with a maximum of 26.9% in Luxembourg, which is more than double the minimum ratio posted by Spain (12.6%).⁴ With the exception of Germany, the solvency of the other large European economies is below the EU average.

⁴ The figure for Spain in 2017 is influenced by the losses corresponding to Banco Popular.



Clearly, the sectors in the lower part of the ranking must make more effort to increase their capital, and the supervisor's recommendation is to allocate part of their profits to building up reserves. As indicated by the ECB (2017), the CET1 ratio of the countries hardest hit by the crisis is on average lower than the other countries, due partly to their reduced capacity to allocate part of their profits to reserves.

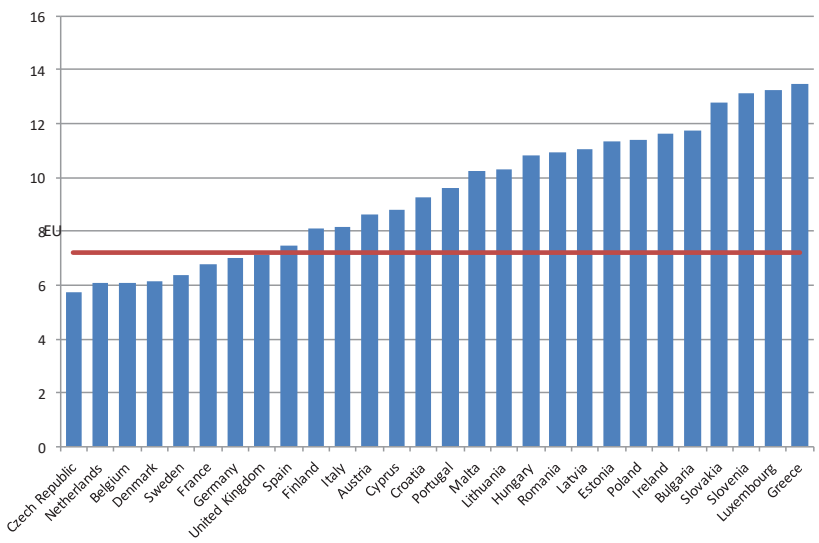
**CHART 14. SOLVENCY OF THE EUROPEAN BANKING INDUSTRY (CET1)
2017. PERCENTAGE**



Source: ECB.

As the denominator of the capital ratio (RWA) is not harmonised at an international level and there are methodological differences between countries, the international comparisons shown in chart 14 should be read with caution. Effectively, the relative position of some countries in the ranking varies considerably in terms of the equity to assets ratio (without weighting for risk), as illustrated in chart 15. This is the case of the Spanish banking system, which ranks last in terms of the solvency ratio, but occupies a higher position when it comes to capitalisation.

CHART 15. RISK WEIGHTED ASSETS AS A PERCENTAGE OF TOTAL ASSETS. 2017. PERCENTAGE

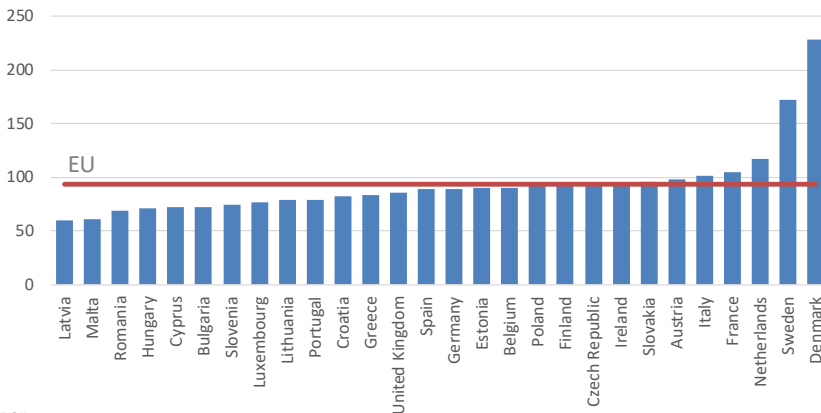


Source: ECB.

e) Liquidity

With regard to liquidity, after the widespread deleveraging that took place in the post-crisis years in countries where lending had previously increased the most, the liquidity gap has improved, with a sharp fall in the loan-to-deposit ratio. Therefore, at the end of 2017 there are no values that cause concern, except in Sweden and Denmark, with ratios of 172% and 229%, respectively.

CHART 16. LOAN-TO-DEPOSIT RATIO. PERCENTAGE

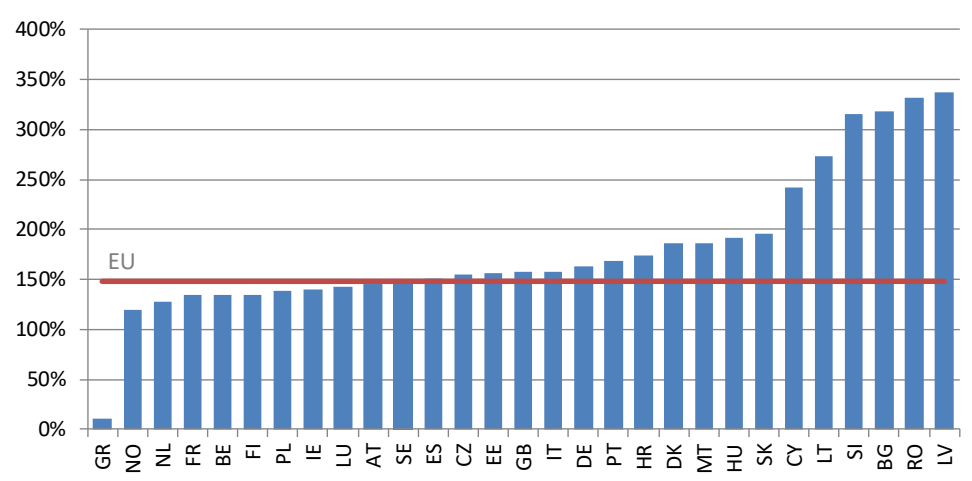


Source: ECB.



In terms of the liquidity coverage ratio introduced in the Basel III accords (the aim of which is to address short-term liquidity problems in a period of 30 days), with the exception of Greece, all the EU banking sectors comfortably meet the requirement of over 100% in 2018; in some cases the ratio stands at over 300% (see chart 17) and in nine countries it is below the average of 148%.

CHART 17. LIQUIDITY COVERAGE RATIO. 2017. PERCENTAGE



Source: EBA.

6.5. EUROPEAN BANKS' EXPOSURE TO SOVEREIGN DEBT

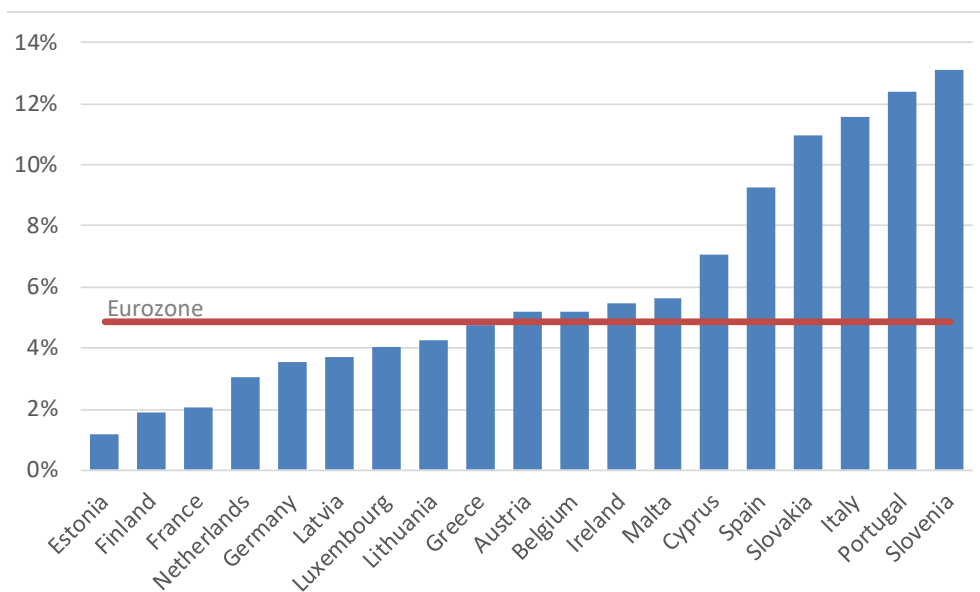
One area of concern with regard to breaking the banking-sovereign debt circle which caused the debt crisis in Europe, and which has forced many countries to run up debt in bailing out banks and is a key objective of banking union, is the observation that there are clearly two different Europes in terms of the weighting of sovereign debt on the balance sheets of European banks. As we can see in chart 18, the banking sectors of the countries that suffered most in the crisis are most exposed to sovereign risk, with percentages of over 10% in Italy, Portugal and Slovenia. The Italian banking system has the highest government debt in terms of absolute value (434,000 million euros), while the debt held by Spain is also noteworthy (249,000 million euros).

In this context, the proposals to reform the regulation governing RWAs are understandable,⁵ factoring in the different risk relating to government debt in euro area

⁵ Currently no agreement has been reached by the BIS to reform the treatment of this type of asset for risk purposes. Given that the ECB asset purchasing programme is due end in late 2018, it

countries. The European Union is also proposing⁶ to create a new type of financial asset backed by government debt for euro area countries (sovereign bond-backed securities, or SBBS) to encourage banks to diversify their public debt positions and weaken the banking-sovereign debt circle.⁷

CHART 18. WEIGHT OF GOVERNMENT DEBT ON THE BALANCE SHEETS OF MFIS IN THE EURO AREA. JUNE 2018. PERCENTAGE



Note: The euro area figure is an unweighted average.

Source: ECB.

does not appear to be a good time to penalise the holding of government debt on banks' balance sheets with capital consumption (see BIS, 2017). Furthermore, some countries have high debt levels and public deficits, which makes funding difficult if the purchase of government debt by banks is penalised.

⁶ See European Commission (2018).

⁷ A summary of the different proposals for the treatment of government debt on banks' balance sheets can be found in Bergés *et al* (2018).



6.6. CONCLUSIONS

The integration of the European banking system is currently low, especially within retail markets. There are still substantial differences between countries in terms of access to funding, while the flow of cross border transactions between euro area nations remains low, and has even diminished since the start of the recent crisis. Integration indicators show that we are a long way from achieving a single European banking market, which prevents greater convergence in terms of well-being (per capital GDP), the ultimate goal of EMU. In this context the banking union project as a way achieving true Economic and Monetary Union is of the utmost importance.

Banking union is still incomplete even though two of its three pillars have been in operation since 2014 (single supervisory mechanism) and 2015 (single resolution mechanism). The last euro summit held in December 2018 managed to dispel the uncertainty over the back-stop for the single resolution fund (it will be the ESM), but no progress has been made towards the single guarantee deposit mechanism, the third pillar required to complete European banking union. Neither has the key issue of banks' elevated exposure to national government debt been addressed, which was a source of the recent crisis.

As explained in this article through indicators that analyse the organisation and health of the banking system, the huge differences between the different European banking sectors are an obstacle to the much-needed mutualisation of risks inherent to banking union. These differences emerged in the last stress tests published by the EBA in November 2018. As discussed in the appendix, the tests revealed significant differences in the strength of the EU banking sectors to deal with a stress scenario, due to their different starting positions in terms of solvency and their resilience.

In the same way that significant differences in the macroeconomic imbalances in EMU countries have fuelled the risk of a two-speed Europe and prevented progress being made towards fiscal union and the creation of eurobonds, the differences in variables such as the default rate, efficiency, solvency and profitability, also draw a picture of a dual European banking sector, particularly in the area of defaults, where the sectors at the head of the ranking belong to the countries that were hardest hit by the sovereign debt crisis (distressed countries). So long as the differences in default rates between the banking sectors do not narrow (the country with the highest rate has a rate of almost 40 times greater than the one with the lowest), it will be difficult to persuade the countries with lower rates to share risks with countries with higher rates, as evidenced at the last euro summit. Therefore, the priority assigned by the ECB and the European Commission to reducing the volume of non-productive assets in the European banking system (through proposals such as the creation of a secondary market, new provisioning methods for NPLs, etc.), a necessary condition (but not sufficient, as discussed in the next paragraph) for the mutualisation of risks through a Europe-wide single deposit guarantee fund, should be understood in this context.

While the priority should be the start-up of the third pillar of banking union, it should be remembered that the cause of the sovereign debt crisis was the often mentioned vicious circle between banking debt and sovereign debt, a circle which, while weakened



by the three pillars of banking union, will not break completely if the balance sheets of European banks continue to hold an excessive amount of national government debt. Clearly now is not the best time to impose limits or require capital to be consumed for holding government debt on balance sheets, as after the end of the ECB's asset purchase programme and given the high levels of government debt (and the subsequent refinancing needs for the next few years), banks will play a key role in absorbing the debt that is currently being held by the ECB. However, as we gradually move away from the end of the ECB's QE programme, steps should be taken to avoid excessive concentration of banking risk in sovereign debt, with capital consumption being different according to the risk of each country and/or with limits on the weight of government debt as a proportion of a bank's assets.

One final reflection. The dilemma that exists today for completing banking union lies in the choice between sharing (which is consistent with banking union) and reducing risks (especially defaults). If priority is given to reducing risks, the problem is that the time needed to reduce defaults to reasonable levels could excessively delay the achievement of banking union. If priority is given to sharing risks (stepping up banking union through the prompt implementation of a European deposit guarantee system), this could jeopardise financial stability and the recovery of credit. Finding a middle path is clearly the best option, and the strategy most likely to be accepted by all concerned is the implementation of the deposit guarantee fund as soon as possible but with an implementation period for the full mutualisation of risks (as occurred with the single resolution fund). However, restrictions (limits and/or capital consumption) should be imposed progressively (with a phase-in calendar) on the banks' exposure to public debt if we truly want to break the sovereign-banking risk loop, which was the source of the crisis.

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APPENDIX: STRESS TEST CONDUCTED ON EU BANKS

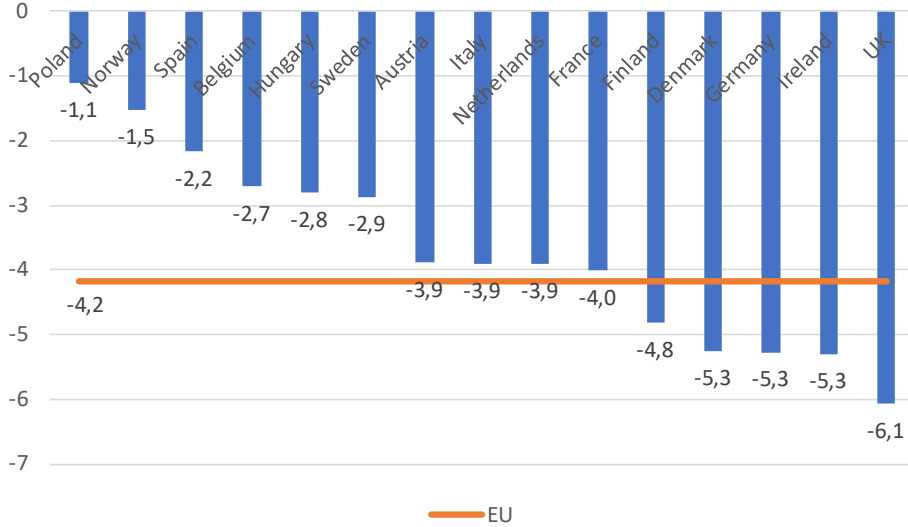
The stress test carried out in 2018 using EBA methodology (2018) includes 48 EU institutions, accounting for around 70% of its banking assets. For the EU average, the adverse scenario contemplates the following economic and financial conditions: cumulative fall in GDP of 8.3% between 2018 and 2020 compared to the baseline scenario; a jobless rate 3.3 pp higher than expected in 2020; a cumulative drop (deflation) of 3.5% in the CPI; a 27.7% slump in the price of real estate assets in the three years; an annual average loss of 26% for the stock markets; and a long-term interest rate that is 80 bp higher than the baseline scenario in 2020. The macroeconomic scenario for each country is different.

Taking the static position at year-end 2017 as a reference, the stress test includes three years to the end of 2020. As shown in chart A.1, in the adverse scenario the fully-loaded CET1 ratio would fall by 4.2 pp in the EU banking system. By country, the variation range of the fall is a minimum of 1.1 pp in Poland and a maximum of 6.1 pp in the UK (influenced in this case by the fallout from Brexit). The decline in the CET1 ratio in Ireland, Germany and Denmark (5.3 pp in all cases) is also noteworthy.

Given the different starting positions among the European banking sectors in terms of solvency and their resilience in an adverse scenario (which is uneven in intensity), there are significant differences in the final CET1 ratio in 2020. As we can see in chart A.2, the ratio ranges from a minimum of 8.3% in the UK to a maximum of 17.9% in Sweden, with five countries falling below the EU average (10.1%): UK (8.3%), Spain (9%), Austria (9%), Italy (9.1%) and France (9.7%).

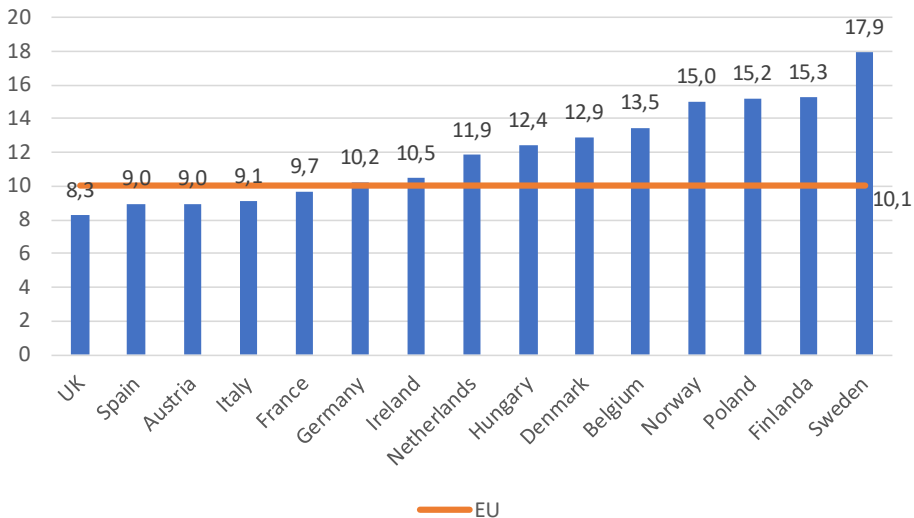
Therefore, the differences in the original solvency levels of the European banking sectors and in the strength and resilience they have to cope with an adverse scenario, help to explain the different positions adopted by the countries with regards to the mutualisation/reduction of risks that is required to complete banking union with a Europe-wide single deposit guarantee fund.

CHART A.1. REDUCTION IN THE FULLY-LOADED CET1 RATIO THROUGH TO 2020 IN AN ADVERSE SCENARIO (PP)



Source: EBA.

CHART A2. FULLY-LOADED CET1 RATIO IN 2020 AFTER THE ADVERSE SCENARIO. PERCENTAGE



Source: EBA.



7. CENTRAL BANK DIGITAL CURRENCIES: FEATURES, OPTIONS, PROS AND CONS

SANTIAGO FERNÁNDEZ DE LIS
OLGA GOUVEIA¹

7.1. INTRODUCTION

The development of cryptocurrencies in recent years has triggered a debate on whether Central Banks may attempt to issue cash in digital format. An emerging literature on Central Bank Digital Currencies (CBDCs) tries to analyze the viability of digital issuance, the forms it may adopt and the pros and cons of different modalities. This article, largely based on Gouveia et. al (2017), compares four stylized variants of CBDCs and assesses their relative merits. It also incorporates an analysis of the evolution of Central Banks' balance sheets and the risks embedded when their size expands considerably.

The motivation behind this analysis is based on the observation that the first papers on the topic² directly focused on what looked like the most disruptive variants, combined with the intuition that there were other modalities that may provide a better combination of pros and cons.

It is important to introduce a caveat upfront: cryptocurrencies have been accompanied by Distributed Ledger Technologies (DLTs), the best known of which is blockchain, which provides a decentralized mechanism for proving the legitimate possession of the currencies and transferring this property. By analogy, the literature on CBDCs generally assumes that they will rely on a modality of DLT. But scalability remains a challenge for DLTs, and the comparison with traditional Central Bank-based payment systems (Real Time Gross Settlement Systems – RTGS) concludes that the latter are generally more

¹ BBVA Research.

² See for instance Barrdear and Kumhof (2016).



efficient than blockchain-based payment systems, introducing certain doubts on the premises of CBDCs: why would Central Banks move away from a more to a less efficient system? The implicit assumption in this paper is that DLTs are in their infancy and in the near future we will see dramatic improvements in their efficiency, solving the scalability problem, including in energy consumption.

7.2. CBDCS FEATURES AND VARIANTS

Cash is a very special type of asset that combines four features: (i) it is exchanged peer to peer (without knowledge of the issuer), (ii) it is universal (anybody can hold it); (iii) it is anonymous and (iv) it does not yield any interest. CBDC is an alternative to cash that is also peer to peer (P2P), but it opens the possibility of introducing changes in the other three features:

- They can be universal or restricted to a particular set of users. Likewise, DLTs can be open or closed (for instance, limited to banks or financial institutions).
- They can be anonymous (like cash) or identified (like current accounts). The first corresponds to the idea of token-based CBDCs, and the second to account-based CBDCs.
- They can pay interest or not. The delinking of cash from paper money opens the possibility of including interest-bearing as a feature, either in the account based or in the token based variant.

These options can be combined in several ways to generate different modalities of CBDCs. The variants are summarized in the table below.

A	CBDC for interbank settlement	Restricted	Identified	No yield bearing
B	CBDC similar to cash	Universal	Anonymous	No yield bearing
C	CBDC as new policy tool	Universal	Anonymous	Yield bearing
D	CBDC as public deposit in CB	Universal	Identified	No yield bearing

The choice depends crucially on the objectives pursued with the introduction of CBDCs. There are basically four possible objectives: (i) to improve the working of wholesale payment systems; (ii) to replace cash with a more efficient alternative; (iii) to enhance the instruments available for monetary policy, especially when confronted with the zero lower bound and (iv) to reduce the frequency and cost of banking crises. How do these objectives match with the different options that CBDCs open as compared to cash?



- 1) If the objective is **to improve the functioning of wholesale payment systems**, and assuming that DLT technology would in the future be more efficient than RTGS,³ you may introduce CBDCs that are only accessible to banks and other financial institutions that participate in the wholesale payment system. The resulting CBDC would be **restricted, identified and non-interest bearing**: restricted because the general public will not have access to it; identified because participants will be known by the rest; and non-interest bearing because payment systems rely on fixed nominal amount accounts, although they are normally accompanied by yield-bearing (positive or negative) accounts in the Central Bank to and from which these institutions move funds in the context of their liquidity policy. The Central Bank, which in traditional RTGS is at the center of the system, would be just another player in this scheme, although it may retain control over certain features of the system, like for instance admission and membership.
- 2) If the aim is **to replace cash** with a more efficient means of payment you would introduce a CBDC that is **universal, anonymous and non-interest bearing**: universal like cash, which can be used by anyone who holds it; anonymous because this is an essential feature of cash;⁴ and non-interest-bearing to emulate cash. Why would the authorities wish to replace cash with a digital variant? Among other reasons, cash logistics are costly (to issue, circulate and retire cash requires an expensive infrastructure), it deteriorates over time, it is dirty and transmits diseases, and it generates crime (theft) and falsifications. A digital variant would be more efficient, cleaner and safer.
- 3) If the authorities want to **enhance the instruments of monetary policy**, in particular in the proximity of the zero-lower bound, they would introduce a CBDC that is **universal, anonymous and yield-bearing**. It should be universal because you want to reach the public (and ultimately replace the banknotes in the hands of the population); yield-bearing because you want to exploit the opportunity digital money provides of carrying interest rates, either positive or negative; and anonymous also for similarity with cash, although it could be identified too (but for reasons of clarity of the different models this option is reserved to the next variant). As mentioned above, interest rates may be positive or negative. Historically the former is much more frequent than the latter, but the objective of this proposal being overcoming the problems of the zero-lower bound, the proponents are rather thinking on negative interest rates situations.

³ As mentioned before, this is a very strong assumption. At the same time, however, closed DLTs (like the ones needed in option (i)) do not face the scalability problem of open DLTs (like those under options (ii) to (iv)). Although DLTs are less efficient now than RTGS, the distance between both is not huge. This implies that a little improvement in DLTs can offer a suitable alternative to RTGS.

⁴ According to some studies, the demand for cash in a significant part driven by anonymity and related to fraud, criminal activities or tax evasion. Rogoff (2016) mentions that in some countries this type of demand reaches as much as 40%.



- 4) If the aim of introducing CBDCs is **to reduce (or even eliminate) the likelihood and destabilizing impact of banking crisis**, then the modality would be **universal, identified and non-interest bearing**. Universal because the idea is to open accounts for the population in the Central Bank; identified like in the case of bank deposits; non-interest bearing because, like in the previous variant, we want to differentiate option (iv) from option (iii), although the possibility of combining both features (identified and interest bearing) is always an option. According to the logic behind this proposal, banking crises are the result of fractional reserves, which implies that sight deposits with fixed nominal value are behind longer-term credit with an uncertain value and limited liquidity. This mismatch makes banks vulnerable to bank runs. If the Central Bank provided deposits to the population in the form of CBDCs, the provision of payments would be delinked from the provision of credit and, following this logic, most banking crises would be avoided.

7.3. PROS AND CONS OF THE DIFFERENT VARIANTS

These variants have very different implications, and their viability would also be quite different. Option (i) is less ambitious and would “only” imply a change in the functioning of wholesale payment systems, whereas options (ii), (iii) and (iv) are potentially very disruptive, and probably increasingly so. Replacing cash with a digital variant would change many of our habits, but in option (ii) only cash changes, not the economy or the financial system. In option (iii) the possibilities of monetary policy would be significantly enhanced, and the Central Bank would have at its disposal a very powerful instrument. In option (iv) the financial system would be completely transformed from what we know.

Assessing the pros and cons of these variants is not easy. In general, the most radical modalities are potentially more rewarding, but also riskier. And the uncertainty of this assessment also increases with the ambition of the proposals.

In **option (i)** one may expect an increase in the efficiency of the wholesale payment systems. Current RTGS infrastructure provided by Central Banks is secure and reliable, but expensive from the point of view of collateral consumption. An alternative based on DLT has the potential to reduce the collateral needs. Also the role of the Central Bank as guarantor of the transactions would be decentralized, with potential efficiency gains. And it would probably be opened to more participants beyond banks, which would increase competition and reduce costs. Admittedly, the latter is a trend that is in any case ongoing in existing payment systems, and that will take place anyway as the implications of new regulations like the PSD2 in Europe extend their impact.⁵

One area where there is a huge potential for efficiency gains is in cross-border payment systems.⁶ Cryptocurrencies offer an opportunity for dramatic cost reductions,

⁵ Mersch (2018) defends the idea that conventional technology, not virtual currencies, is the one that is making real progress in the payments field.

⁶ See IMF (2017).



which may translate into faster and less expensive transactions, for instance in remittances. But it is unclear whether CBDCs may compete with cryptocurrencies in this, being based on national payment systems. Central Banks may, however, have incentives to develop interconnected payments systems for cross-border transactions if threatened by the competition of cryptocurrencies.

Option (ii) opens the possibility of replacing cash with a far more efficient alternative. As mentioned before, cash is costly to produce and replace, requires a heavy infrastructure, and is also easily lost or stolen. CBDCs open the possibility of Central Banks offering a far more efficient alternative to facilitate P2P payments. The incentives for Central Banks to develop this new type of cash can be enhanced if the competition of cryptocurrencies is seen as a threat for seigniorage. This is not the case now, due to the huge volatility of cryptocurrencies, but this may change, especially with the development of new, more stable cryptocurrencies (the so called “stablecoins” – see below).

The main drawback of this option lies in the anonymity. One thing is to issue banknotes that by their very nature are anonymous and a very different one is that Central Banks issue a digital means of payment that is deliberately chosen to be anonymous and therefore a channel of illegal payments and criminal activities. It is very difficult that the same Central Banks that require commercial banks to implement costly mechanisms to prevent money laundering and the financing of terrorism (the AML/CFT regulation) are issuing at the same time the means to carry such activities. One may argue that this is already the case with cash. But anonymity is intrinsic to cash, whereas in the case of CBDCs it would be a deliberate decision. This is the reason why most Central Banks consider that, in case they issue CBDCs, they would do it under the account modality (option (iv) in our taxonomy) rather than under the token modality (option (ii)). This implies that the demand for cash driven by anonymity would move to other currencies, including cryptocurrencies. The loss of income (seigniorage) for Central Banks (and ultimately treasuries) would be significant. If Central Banks decide to opt for the account based modality it would have far reaching implications, analyzed under option (iv) below.

Option (iii) would open new possibilities for monetary policy. The recent crisis, to which Central Banks reacted with aggressive monetary easing, opened new questions related to the zero-lower bound of interest rates. As rates approached this limit, but the economy continued to require stimulus, Central Banks embarked on new Quantitative Easing (QE) strategies, including entering into negative interest rates territory in some of their operations with banks. But the existence of cash, with fixed nominal value, sets a limit to the scope of negative interest rates. If they go too far into negative territory, arbitrage will lead to cash hoarding. In practice this means that Central Banks cannot go beyond a few basis points, perhaps as far as minus one percentage point, but no farther. This constraint is a limitation to the expansionary monetary policies that can be implemented in a recession.

Hence the proposal to introduce CBDCs to extend the negative interest rate territory (Rogoff (2016)). The firing power of monetary policy would be greatly reinforced. But this proposal has profound implications. To start with, physical cash would need to be eliminated (or limited to very small denominations), to avoid arbitrage. Furthermore,



this option would probably require the introduction of capital controls, because with negative interest rates on domestic cash, the population would probably tend to resort to foreign currency (dollarization). Capital controls may limit deposits denominated in other currencies, but cash in dollars or other foreign currency would be much more difficult to control. We would enter into a world of “financial repression”, in the terminology of Carmen Reinhart (2012).

The key question is whether an independent Central Bank in charge of maintaining price stability would have the legitimacy to impose such policies. Central Banks are vulnerable to democratic legitimacy criticisms; more so the more functions they accumulate. Accountability is easier when you have just one objective (price stability), but much more difficult with several objectives whose weighting is arbitrary. Having at their disposal a tool that may imply the impoverishment of the whole population (at least in nominal terms) and that is in the frontier between monetary and fiscal policy is probably incompatible with Central Bank independence.

Finally, **option (iv)** opens the possibility for the general public to open an account at the Central Bank. This is the most disruptive and ambitious option. Proponents of this modality in general want to address the question of recurrent banking crises and banks vulnerability. In their view, crises are a consequence of the fractional reserves of banks as well as their role as providers of deposits with a fixed nominal value in their liability side and as providers of credit with a variable and uncertain value on the asset side. According to this view, technology offers now the possibility to delink the generation of deposits from the provision of credit, radically transforming the role of banks and Central Banks. There are several variants of this family of proposals: in some of them banks are transformed into credit institutions that raise their resources in the market. In others, banks issue deposits but only invest in a safe asset like public debt (narrow banking). In yet others, banks compete with Central Banks in the generation of deposits.⁷ In most of them existing safety nets like Deposit Insurance and the role of the Central Bank as Lender of Last Resort (and even important aspects of present prudential regulation of banks) would probably be redundant and can therefore be eliminated or significantly reduced.

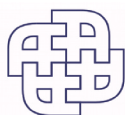
The goal of this family of proposals is a very relevant and ambitious one: to reduce and eventually eliminate banking crises. This would require profound changes in financial intermediation. In the most elaborated proposal (Barrdear and Kumhof (2016)) Central Banks issue deposits that do not necessarily crowd out banks' deposits. The latter would always have the possibility of paying interest⁸ and providing transactional services (like transfers and direct debits)⁹ which would make them more attractive to compensate the higher security of Central Bank deposits.

One drawback of this proposal is that it could facilitate bank runs in the case of ru-

⁷ See Kotlikoff (2010) and King (2016).

⁸ In option (iv) the account in the Central Bank may or may not pay interest. I opt for the latter to differentiate from variant (iii). But a combination of options (iii) and (iv) is possible, in which the pros and cons of both options would be exacerbated.

⁹ It is unlikely that Central Bank accounts would offer these transactional services.



mors – founded or not – on the financial health of a bank or banking system. In such a situation depositors will move to the Central Bank with the speed of a click. This is the reason why this proposal is sometimes accompanied with the idea of limiting the convertibility between both types of deposits (see Kumhoff and Noon (2018)). But this implies another weakness, related to the establishment of capital controls and the related enforceability problems.

Furthermore, the drop in the money multiplier would probably imply, at least initially, a credit squeeze. Gradually new institutions will likely arise, providing credit to households and companies, but probably at a higher cost. And in any case a transition problem seems difficult to avoid. Although the rewards of this option (taken at face value) in terms of eventual elimination of banking crisis are huge, the risks are very significant too.

It is important to acknowledge that currently banks are the safest place for individuals to place their savings. There are no other best options for the public and under this proposal it would become clear that individuals would have a safer option: the Central Bank. Therefore, to a greater or lesser extent, banks would stop collecting the savings of the economy in the form of deposits. The degree in which individuals would be more prone to do so would be in line with their risk profile as nowadays some individuals also opt for not placing all their savings in banks. Therefore, deposits in banks would be safer than savings placed in an investment fund but riskier than in a Central Bank. All in all, if the main objective of this option is to reduce banking crisis it is unclear whether it will achieve it (or if the concentration of risks would move to other parts of the financial system, namely investment funds and/or the Central Bank itself) and, in any case, it is very difficult to envisage a situation in which the Central Bank concentrates knowledge, capacity, ability, resources to make better informed investment decisions than what banks do currently. In this scenario banks would not be at the epicenter of problems because banks basically would reduce their importance in intermediation and therefore banking crises would evolve to broader financial crises.

In this sense, it is important to analyse what the Central Bank would do with the proceedings of the deposits in this family of proposals. It can basically do four things:

- Lend to the government or buy public debt. This would open the way for monetary financing to the public sector, which is normally prohibited in the statute of modern independent Central Banks. It would also lead to so called “fiscal dominance”, in which monetary policy is subordinated to fiscal policy objectives.
- Lend to the private sector. It would require developing in the Central Banks an expertise that is far beyond their present capabilities, and more importantly, would imply a degree of interventionism difficult to reconcile with a market economy. This would be seen as a nationalization of credit as the Central Bank would act as a Public Bank.
- Acquire foreign exchange reserves (gold or positions in other currencies): it would hugely aggravate the inherent currency mismatch of any Central Bank balance sheet (a result of their liabilities being denominated in domestic currencies but



part of their assets being in foreign currency) and expose it to the risk of losses as a result of foreign exchange volatility.

- Lend to banks or financial institutions. This would put the Central Bank in between the generation of deposits and the provision of credit. Depending on how this is done, the current implicit guarantee of banks deposits (which was one of the roots of the crisis and one of the problems that the recent regulatory reform is trying to fix) may become explicit, thus exacerbating moral hazard.

The main drawback of variant (iv), like in the case of variant (iii) – and even more in the combination of both, where the Central Bank offers interest bearing deposits to the general public – is that the resulting Central Bank is too powerful. As a result of the crisis, Central Banks are currently doing too many things already: monetary policy, financial stability, payments systems, banking supervision, consumer protection... and with the QE after the crisis they already intermediate an important part of interbank transactions. If they were also in charge of providing deposits — and perhaps credit, or financing the public deficit, or holding a significant part of the nation’s foreign assets — it would be incompatible with their independence. The political economy aspects of the most disruptive variants of CBDCs should be analyzed in an extremely careful way before moving in that direction.

7.4. THE EVOLUTION OF CENTRAL BANKS’ BALANCE SHEETS UNDER THE DIFFERENT OPTIONS

In order to understand the design and potential evolution of Central Banks’ balance sheets once a CBDC is set up there are two dimensions that need to be taken into consideration:

- The liabilities’ side of the Central Bank balance sheet. And within this, two aspects: (a) who has access to the CBDC and (b) the convertibility of the CBDC with other types of “legal money”
 - a) Access to the CBDC:** For this we need to establish if the CBDC is universal (option (ii) and (iii) and (iv) or restricted (option (i)). Under option (i) the issuance of CBDC has no impact on monetary aggregates or on the Central Bank balance sheet. However, if it is universal and only banks and similar institutions have access to the Central Bank (options (ii) and (iii)) – what the ECB refers to as value based CBDC – the implications are different from option (iv), in which the CBDC is also universal but everyone has an account at the Central Bank (account based CBDC). In the latter, as discussed below, the issuance of CBDC has a large effect on deposits, therefore on reserves at the Central Bank and ultimately has a more meaningful impact on the size of Central Banks’ balance sheet.
 - b) The convertibility of the CBDC to cash and reserves.** Once again this only applies to options (ii), (iii) and (iv). The base scenario is that the CBDC is as



similar as possible to cash and therefore it is convertible to cash and or reserves on demand. Although the objective of creating a CBDC could be the introduction of another monetary policy tool (particularly under option (iii)) the non-convertibility of the CBDC into cash and reserves would raise several issues from which the most meaningful is that from an operational point of view it would be equivalent to the implementation of some sort of capital controls across CBDC, cash and reserves. Giving consideration to a scenario in which someone has CBDCs and can't convert it to cash and vice-versa limits the credibility of the Central Bank, limits the confidence on the different types of money, limits the stability of the monetary framework, raise several difficulties in terms of monetary policy implementation and control of monetary aggregates. The Bank of England in a paper by Kumhof and Noone (2018) contemplates a scenario in which the CBDC is universal, pays an adjustable interest rate and CBDC and reserves are distinct and not convertible into each other. The CBDC would be like a second policy tool. Although we acknowledge the potential benefits for the banking sector and for financial stability, as it would limit the possibility of bank runs (as the substitutability of CBDC and deposits would lose weight), it would be a very unrealistic scenario, in light of the above mentioned problems. Therefore in this analysis, the CBDC is convertible to cash and vice-versa and the Central Bank controls the joint amount of both of them but not the breakdown among them.

Having this in mind it is important to distinguish the differences on CB balance sheet liabilities' side under the two main options. For simplicity we do not analyse the implications of option (iii) but they would be more similar to option (ii).

- Option (ii) (only banks have access to the CB, and the general public holds anonymous CBDCs in the form of tokens). The issuance of CBDC will increase the monetary base. Although it is likely that the amount of bank notes slightly decreases when the CBDC is set up, there is a slight fall in reserves held by commercial banks in the CB as some people will switch from bank deposits and hold directly CBDC, see table 1. At the same time, and assuming a constant supply of money, i.e. the amount of deposits, CBDC and cash remains constant (and therefore the fall in deposits is compensated by the increase in CBDC and part of the increase in CBDC reduces the amount of cash), the multiplier falls from 4 to 2,5. Along the same lines, the level of loans falls (assuming a banking sector that is just financed by deposits and that all its assets are loans). Given that the monetary base increases considerably and the multiplier falls, the capacity of CBs to influence money supply and the transmission of monetary policy diminishes.
- Option (iv) (everyone has access to an account at the CB). Assuming that the Central Bank maintains the monetary supply constant and that more people are willing to switch from deposits to CBDC (because they can access directly the CB and this is safer than holding their savings at commercial banks), the amount of CBDC has

to increase further while the amount of deposits drops even more and accordingly the reserves of banks at the CB: the multiplier falls further in this scenario, emphasizing the effect commented in the prior scenario. In addition the size of the Central Bank's balance sheet increases further.

TABLE 1. THE EVOLUTION OF THE MONETARY BASE AND MONETARY SUPPLY AND THE MULTIPLIER WITH CBDC ISSUANCE

	Current situation and option (i)		Option (ii) and (iii)		Option (iv)
Deposits in banks (1)	100	-25	75	-50	50
Reserves at the Central Bank (2)	10		2.25		1.5
Loans	90		72.75		48.5
CBDC (3)	0	+35	35	+60	60
Currency in circulation (4)	20	-10	10	-10	10
Monetary Base (2+3+4)	30		47.25		71.5
Monetary Supply (1+3+4)	120		120		120
Multiplier	4.0		2.5		1.7
Size of the CB Balance Sheet	30		47.25		71.5

In summary, it is important to have in mind that although the issuance of CBDC per se would not change the mechanics of monetary policy implementation, the need to accommodate a higher or lower demand for CBDC versus bank deposits would have an impact on the size of the Central Bank balance sheet. As seen, despite the issuance of CBDC, in principle, always increasing the monetary base (even if the increase in CBDC is partially compensated by a decline in banknotes in circulation), it might decrease the monetary supply if deposits fall and banks are forced to reduce lending. Naturally, this could be compensated with a larger increase in the monetary base, i.e. the issuance of more CBDC, which would automatically translate into a larger balance sheet.

- The assets' side: When Central Banks issue CBDC they have to do it against some sort of assets (as highlighted in section 3 above). We will explore the evolution in terms of size and risks embedded in this issuance. Typically Central Banks hold government securities, other securities (with the QE CBs expanded significantly the amount and diversity of securities that they hold) and foreign exchange reserves (table 2).



TABLE 2. BALANCE SHEET OF A CENTRAL BANK

Assets	Liabilities
• Foreign assets (net)	• Reserves held by commercial banks
• Public sector securities	• Cash in circulation
• Private sector securities	• Deposits from banks
• Lending to banks	• Equity

In principle, and assuming that the issuance of a CBDC is not totally offset by a decline in banknotes in circulation, there will be an expansion of the balance sheet. The CB can purchase government securities. In this scenario (mostly associated with option (ii) where the decline in bank deposits would be more moderate, the Central Bank would not engage in liquidity or credit risks substantially different from the current situation (table 3). In any case, as mentioned before, the need to expand the Balance Sheet and not engage in credit risks, could open the way for monetary financing to the public sector (lending to the government).

**TABLE 3. EXPANSION OF THE CB BALANCE SHEET IN OPTION (II)
(ASSUMING AN EXPANSION OF SECURITIES)**

Assets	Liabilities
• Foreign assets (net)	• Reserves held by commercial banks
• Public sector securities increase	• Cash in circulation + CBDC
• Private sector securities	• Deposits from banks
• Lending to banks	• Equity

However, if we are in option (iv), although the initial movement can be fairly similar, the need to accommodate the decline in money supply will lead to the need to expand significantly the monetary base, i.e. the issuance of CBDC and, therefore, the size of assets on balance sheet (table 4, expressed as stage 2).

In this alternative, and to compensate for the decline in bank deposits and the subsequent decline in loans, the Central Bank needs to finance the private sector. This can be done through the acquisition of private sector securities and/or lending to banks which in turn will lend to the private sector. Thus, under this option, the Central Bank balance sheet is likely to expand considerably.

TABLE 4. EXPANSION OF THE CB BALANCE SHEET IN SCENARIO D: (1) INDICATES INITIAL PHASE AND (2) SECOND PHASE

Assets	Liabilities
• Foreign assets (net)	• Reserves held by commercial banks fall (2)
• Public sector securities increase (1)	• Cash in circulation + CBDC (1) CBDC (2)
• Private sector securities increase (2)	• Deposits from banks
• Lending to banks increase (2)	• Equity

The risks embedded in this activity for the Central Bank can be significant because it starts to engage in activities in which it has no experience or expertise. Currently, when Central Banks lend to banks these transactions are always secured. Under this option, in which commercial banks are less reliant on deposits and more reliant on Central Bank funding it is difficult to foresee banks' ability to generate sufficient collateral to get this secured funding from the CB and therefore the exposure of CB to banks will be most likely unsecured. The analysis of credit, maturity and liquidity risks would need to be developed at Central Banks completely changing the monetary and financial system landscape that we know today.

In summary, although at first sight it could seem that the Central Bank would have the option to choose the size of its balance sheet and the assets it wants to acquire to issue CBDC, this might get out of control under option (iv) when everyone is given an account at the Central Bank. In this scenario the Central Bank will have no other option than lending to banks and buying private sector securities to maintain the level of lending to the economy that will no longer be provided by commercial banks.

7.5. FIAT MONEY, DISCRETIONARY POLICIES, CRYPTOCURRENCIES AND STABLECOINS.

Fiat currency relies on the confidence on the Central Bank. Since the collapse of the gold standard in the 1930s and the move to floating rates in the 1970s Central Bank issued currency lacks any external anchor. Independent Central Banks in charge of price stability have been established in most countries to ensure that the money issuance does not take advantage of the lack of an anchor to inflate the economy according to the convenience of the government or the electoral cycle.

The debate on rules vs discretion of monetary policy has long ago been settled in favor of discretion. The instability of money demand led to the abandonment of monetary aggregates as objectives of monetary policy. Anchors defined in terms of nominal exchange rates were abandoned too in most countries as a result of the difficulties to



deal with speculative attacks in a world of free capital movements. In a majority of countries monetary policy objectives are defined in terms of inflation targets. In practice this implies a high degree of discretion for Central Banks, since the link between interest rates and inflation is not a direct one. And the more objectives the Central Bank has the higher the room for policies that may depart – at least temporarily – from price stability, to reach other objectives like financial stability.

All this implies a challenge for independent Central Banks, whose role has been questioned in the political debate on grounds of their limited accountability. One may even argue that the recurrent financial crises have been to a certain extent a result of the asymmetric discretionary reaction of monetary policy to asset prices bubbles. For instance, the Fed reacted with aggressive easing when asset prices drop (in 1987, 1990, 1998 and most notably 2008), but did not increase rates so aggressively when asset prices escalated in the booming phase immediately before each of these episodes. This asymmetry arguably led to moral hazard and fueled the development of bubbles in the markets, whose players were confident that the authorities will “mop up after” (the so-called “Greenspan’s put”).

What has all this to do with cryptocurrencies? In a world of pure fiat money, the attractiveness of cryptocurrencies lies partly on their delinking from discretionary decisions of the authorities. The issuance of Bitcoin is based on an algorithm that is certainly not transparent, but in accordance with a preset rule. The external anchor provided by cryptocurrencies has some similarities with gold, and for this reason the emergence of cryptocurrencies reignited the longing for the gold standard. The main drawback of Bitcoin and the like for being an anchor lies in their extreme volatility.

To address this problem, recent initiatives have been developed to create “stablecoins”, a type of cryptoasset whose value is linked to an external anchor, be it a fiat currency or a commodity, collateralized or not, or an algorithm that manages the price controlling the quantity of the cryptocurrency in circulation. Most of them are still in an experimental phase, but if they succeed they may turn out to be more serious competitors to Central Bank money than present cryptocurrencies.

It is interesting to observe that, on the one hand, markets are developing currencies that may challenge the role of Central Banks and lead to some type of external anchor to the international monetary system and, on the other, the authorities are analyzing (so far from a purely academic viewpoint) the issuance of account-based CBDCs that would strengthen the role of Central Banks and confer them much more power than the considerable one they currently have. It seems that the debate is open to extreme forms of means of payment: one private and rules-based and the other public and discretionary. We may witness in the future an interesting competition between both, first in the academic field and perhaps later in practice.

7.6. SOME CONCLUDING REMARKS.

- The emergence of cryptocurrencies is opening the way to Central Bank Digital Currencies. The competition of the former may be an incentive for Central Banks



to issue a similar digital currency, but so far the size of the cryptocurrencies stock is far from being a threat for cash.

- Cryptocurrencies are not a threat for cash so far mainly because of their volatility, which prevents them from being used as money to the extent that they do not fulfill its role as means of payment and store of value. They also face a scalability problem. But the development of stablecoins may imply a bigger challenge for cash in the future.
- The different options of CBDCs analyzed here present a correlation in terms of risks and potential benefits: from the more modest proposals (limited to the wholesale payments systems), where risk and reward are both relatively small, to the most ambitious ones (accounts in the Central Bank for the whole population), where the ambitious aspiration of ending banking crises is confronted with a serious disruption of financial intermediation as we know it and the political economy problems of an excessive concentration of power in the Central Bank.
- The main dilemma for Central Banks lies in anonymity: to issue tokens (like present cryptocurrencies) or account-based CBDCs. For most Central Banks it is unacceptable to issue an opaque instrument that may be used for crime-related transactions. The only option is therefore account-based CBDCs, which implies a radical transformation of financial intermediation, with serious risks attached.
- The main drawback of account-based CBDCs is that they would imply extending the role of the Central Bank far beyond its present functions. It would need to either lend massively to banks (making explicit the implicit guarantee of banks) or become a mechanism for financing the public sector (breaking the present prohibition of monetary financing), or lend directly to the private sector (or a combination of the three). This is incompatible with the present paradigm of independent Central Banks with a specific mission of maintaining price stability. This is why most Central Banks that studied this topic apparently have decided not to go ahead.
- The Central Banks that are more seriously considering issuing CBDCs are those that face a reduction in the use of cash and its potential elimination due to the use of alternative means of payment like credit cards.
- The topic is in any case still under analysis and discussion. If one Central Bank decides to go ahead there may be pressure on others to follow.

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8. THE FINTECH PHENOMENON. CHALLENGES AND OPPORTUNITIES OF BLOCKCHAIN TECHNOLOGY FOR THE EUROPEAN FINANCIAL SYSTEM

EDUARDO GARCÍA

Partner at Clifford Chance

8.1 FINTECH

8.1.1. A LOOK AT THE FINTECH PHENOMENON

Over the past few years the financial sector has undergone an irreversible change as a result of the use of technology to improve or transform the way in which financial services are provided. This phenomenon, known as “fintech”, is a term that combines the financial services provided (“*fin*”) with the use of new technologies as a necessary tool to provide them (“*tech*”). However, the financial sector is not the only area to be affected by the disruptive use of new technologies, as the revolution has extended to the insurance sector (“*insurtech*”) and the regulatory compliance sector (“*regtech*”).

Fintech is a phenomenon that has the potential to revolutionise in several different areas: increasing efficiency, reducing costs, optimising access to and the provision of financial services, improving the customer experience, creating new markets, generating new, innovative financial products, etc. However, it also brings many challenges in aspects ranging from money laundering to legal and reputational risk, cybersecurity, consumer protection, personal data protection, etc. Nonetheless, all financial market participants, be they financial institutions, supervisors or new players, all recognise that it is an irreversible development and that the opportunities outweigh the risks.



The range of financial products and services that interrelate with this technology in the fintech universe is very broad. Blockchain is without doubt a key element due to its transversal disruptive capacity, but the catalogue of fintech activities also encompasses peer-to-peer (P2P) loans, online currency payments and services, digital wallets and electronic money, automated advice (*robo advice*), artificial intelligence, data analysis (*big data*), cryptocurrencies, etc. While these are all different, they all share the use of new technologies for the purpose of (i) providing traditional services in a manner that is more cost effective, accessible and easy to use for the customer, and (ii) facilitating the creation and expansion of innovative financial products and services.

The important technological component of all these products and services means that the number of players in the financial world has increased, to include not only credit institutions (duly supervised) but also tech companies, both newly minted and the technology giants that are competing for a place in this universe. Similarly, supervisory bodies are being forced to expand their focus to include entities that are not part of the financial world but which develop financial products. One of the main consequences of this increase in players is that each party (financial institutions, tech companies and supervisors) requires the others to have a holistic view of the phenomenon and therefore active collaboration between them is commonplace, although eventually some could be tempted to withhold information for fear of giving an advantage to a potential competitor.

Lastly, it should be noted that this is a phenomenon that has taken hold in a strictly-regulated sector and is subject to rules that are not prepared to deal with the introduction or rapid development of technology. Therefore, while European public administrations struggle to present themselves as the drivers of innovation, in reality their approach to this phenomenon is not aligned with its rapid development. Nonetheless, all the European supervisory bodies, including the FCA in the UK, the AMF in France, BaFin in Germany, the CSSF in Luxembourg, the Central Bank of Ireland, the AFM and DNB in Holland, the CNMV and Banco de España in Spain, the European Parliament and Commission, the European Central Bank and ESMA have publicly stated their support for the fintech sector and have carried out a variety of initiatives to raise awareness of innovation in financial services, while at the same time warning investors and other market participants of the risks involved (particularly in the area of cryptocurrencies).

An example of this is the innovation portal created by the CNMV in December 2016.¹ This portal has two objectives: to help promoters and financial institutions with the regulatory aspects of the securities market that could affect their projects, and to create an informal space where initiatives in this area can be discussed. As a result of this work, the CNMV has published a series of interpretative criteria² in response to some of the questions submitted through the portal, which is a positive reflection of its determination to protect investors.

¹ <https://www.cnmv.es/portal/Fintech/Innovacion.aspx>

² <http://cnmv.es/docportal/legislacion/faq/qasfintech.pdf>



8.1.2. FINTECH AND THE REGULATORY FRAMEWORK

Two of the major difficulties brought about by the fintech universe are its supranational nature and the heterogeneity the phenomenon. Both these features mean that it is difficult to set up a regulatory framework, or rules of the game, that are common to all countries and cover all types of financial services provided using new technologies.

8.1.2.1 *Required international coordination*

In terms of territory, the world of new technologies recognises no borders, and therefore the provider of the service and its recipient may be located in countries where different regulations apply (in some cases radically different regulations). Further, as noted by IOSCO, among others,³ the lack of a harmonised international regulatory framework gives rise to the risk of “regulatory arbitrage”; the practice of seeking out jurisdictions with less stringent regulatory standards under which to provide services, by-passing the stricter controls imposed by other countries.

At different levels, advances are being made towards the creation of a set of rules that harmonise, as far as possible, the approach adopted by public institutions to the fintech phenomenon.

At global level

The Ministers of Economy and Governors of the Central Banks known as the “G20” issued a joint notice in March 2018 recognising the potential benefits of technological innovation and stating their commitment to developing international standards to prevent money laundering and terrorist financing in the area of cryptocurrencies. However, despite the petitions submitted by some of the countries involved, they rejected the implementation of a basic, all-inclusive regulation for cryptocurrencies, on the understanding that they do not yet pose a risk to the stability of the financial system.

On 11 October 2018, the International Monetary Fund (IMF) and the World Bank published the Bali Fintech Agenda⁴ (the name derives from the annual meeting of both these institutions held in Indonesia), a set of 12 policy elements helping member countries to harness the benefits and opportunities of rapid advances in financial technology that are transforming the provision of banking services, while at the same time managing the inherent risks. The document seeks to address a reality: there are 1.7 billion adults in the world without access to financial services and fintech can have a major social and economic impact for them and across the members of the financial sector in general. Greater international cooperation is fundamental, not only to reap the benefits of this and mitigate the risks, but to make sure that the advances benefit the many and not just the few.

³ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf>, section 7.1 “Implications for the regulatory perimeter”, page 70.

⁴ <https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/10/11/pp101118-bali-fintech-agenda>



The 12 pillars of the Bali Fintech Agenda submitted for consideration to all member states and financial market participants are as follows:

- 1) Embrace the promise of Fintech: innovation in financial services is nothing new, but the speed, intensity and consequences of the fintech phenomenon exceeds all precedents. This rapid development should be welcomed due to its potential wide-ranging benefits. However, it requires governments to be prepared by strengthening their institutional capacity, ensuring they have experienced staff, improving communications with stakeholders and creating intra-ministerial bodies to offer a cross-agency approach.
- 2) Enable new technologies to enhance financial service provision: investment must be made in the infrastructures that support new technologies (broadband, data services – including rural areas, etc.), promoting the digitalisation of public administrations, improving cross-border payment services, etc.
- 3) Reinforce competition and commitment to open markets: Fintech also helps bring down entry barriers, thereby strengthening competition.
- 4) Foster *Fintech* to promote financial inclusion and develop financial markets: areas of the population that for different reasons (lack of resources, geographical location, etc) are not able to access certain financial services may benefit from the easy entry offered by new technologies, thereby preventing this type of social exclusion.
- 5) Monitor developments closely to deepen understanding of evolving financial systems: in a world that is changing due to the rapid advance of technology, innovation must be closely monitored to ensure that there is equivalent progression in the financial world.
- 6) Adapt regulatory framework and supervisory practices for orderly development and stability of the financial system, facilitate the safe entry of new products, activities, and intermediaries, sustain trust in the system and respond adequately to risks.
- 7) Safeguard the integrity of financial systems by identifying, understanding, assessing, and mitigating the risks of criminal misuse of fintech, and by using technologies that strengthen compliance with anti-money laundering and combating the financing of terrorism (AML/CFT) measures.
- 8) Modernise legal frameworks to provide greater legal clarity regarding key aspects of fintech activities. Sound legal frameworks support trust in financial products and services.
- 9) Ensure the stability of domestic monetary and financial systems through improved understanding of the implications of fintech innovations to central banking services and market structure.
- 10) Develop robust financial and data infrastructure to sustain fintech benefits, that are resilient to disruptions –including from cyber-attacks– and that protect the integrity of data management and financial structures.



- 11) Encourage international cooperation and information-sharing across the regulatory community to share knowledge, experience, and best practices to support an effective regulatory framework. As new technologies increasingly operate across borders, international cooperation is essential to ensure effective policy responses.
- 12) Enhance collective surveillance of the international monetary and financial system and the adaptation and development of policies to support inclusive global growth, poverty alleviation, and international financial stability in an environment of rapid change.

At European level

In February 2017, the Vice-President of the European Commission, Valdis Dombrovskis, stated that the organisation's objective is to ensure that regulatory union in the European Union enables the financial sector to benefit in full from new technologies, while at the same time ensuring that consumers and investors are protected. For this purpose, the Commission set up a work group for technology in the financial sector (*Taskforce on Financial Technology*) formed by experts in areas as diverse as financial regulation, data technology and competition law. The mandate of the taskforce includes an analysis of the different ways in which technology is changing the way financial services are provided, the way in which each member state is responding to this challenge, and an assessment of the potential long-term implications.

In March 2017, the Commission submitted for public consultation a document on the creation of a more competitive and innovative financial sector in Europe⁵ and, on the basis of the 226 responses received,⁶ published a *Fintech* Action Plan on 8 March 2018, with the aim of benefitting from the opportunities offered by technology-based innovation in the area of financial services, and factoring in the advantages of the European single market.

The plan is part of the goal of achieving capital markets union (CMU), an authentic single market for financial services for consumers and a single digital market. The plan sets out 23 steps to enable innovative business models to scale up, support the uptake of new technologies, and to enhance cybersecurity and the integrity of the financial system. These steps include:

- Creation of European “fintech lab”, where European and national authorities can engage with tech providers in a neutral, non-commercial space.
- Analysis of the challenges and opportunities of crypto-assets.
- Work on a common strategy for all sectors of the economy in the area of *Distributed Ledger Technology* (DLT), and *blockchain*.

⁵ https://ec.europa.eu/info/sites/info/files/2017-fintech-consultation-document_en_0.pdf

⁶ https://ec.europa.eu/info/sites/info/files/2017-fintech-summary-of-responses_en.pdf



- Conduct consultations on the digitisation of information published by listed companies, including the use of new technologies to connect national databases.
- Promote seminars to improve the dissemination of information on cyber security.
- Present a project to develop good practices for *regulatory sandboxes*, based on the recommendations of the *European Supervisory Authorities* (ESAs).

In addition, the European Commission has approved a proposal for a Regulation that will allow participatory financing platforms, crowdfunding to offer their services and make it easier for companies to access new types of financing. The proposal will allow crowdfunding platforms to apply for a “passport” that will let them offer their services throughout the European Union. It also includes measures aimed at protecting investors by establishing clear rules for advertising, governance and risk management, in addition to a harmonised supervisory approach. Further, the Commission has implemented a draft directive to amend MiFID2 to exclude crowdfunding platforms from its scope. The introduction of an “EU passport” for crowdfunding platforms is without doubt a promising step toward the harmonisation of EU regulations and the creation of a real single market for financial services provided using new technologies.

The impact of Brexit

In line with the result of the referendum held on 23 June 2016, on 29 March 2017 the United Kingdom triggered article 50 of the Treaty on European Union to leave the European Union. Unless the UK and the other members of the European Union (EU27) agree unanimously to extend this period, it will conclude on 29 March 2019. At the date of this article (October 2018), it is not clear whether we shall see a “hard Brexit” (i.e. with no specific agreement between the UK and the EU27), a transition period during which the UK will retain its status quo until an agreement is made, or a “soft Brexit” (i.e. an agreement that recognises a new framework for the relationship between the UK and the EU27).

For our purposes, it will particularly important to know whether the financial institutions domiciled in the UK that currently provide services to the rest of Europe through the “EU passport” system will continue to benefit from a special right to access the European market, and whether European clients will be able to benefit from the services originating in the UK. If a “hard Brexit” prevails, in the post-Brexit era the UK will become a third country for the purposes of the European single market and the existence of equivalent recognition systems will have to be assessed on a case by case basis to be able to continue providing services in the European Union. This would be particularly problematic for companies that provide services which are regulated by EU regulations that do not extend to services provided by third countries (e.g. CRD4, 2EMD, PSD2). Further, the UK government’s proposal reflected in the *EU (Withdrawal) Bill* is to “import” EC legislation, maintaining its substance but amending any elements where it considers there are “deficiencies”. Therefore, if no agreement is reached, British financial companies will be treated as third countries in the EU27 regulatory environment for the purposes of MiFID2/MiFIR, CRD4/CRR and similar. As the potential impacts of Brexit



on the fintech sector will depend on the outcome of the political negotiations, any speculation on this would require an analysis of myriad variables, which is well beyond the scope of this article.

8.1.2.2 *The heterogenous nature of the fintech phenomenon*

In terms of specific adaptations to the rules, it should be remembered that the term fintech encompasses a multitude of products and services (crowdfunding, payment methods, blockchain, robo advice, etc.) which are generally unrelated, and which also affect financial sectors that have their own regulations (banks, stock markets, etc). Therefore, the way in which each financial rule should be adjusted to the reality of new technologies will be different and solutions that work in one area may not work in others.

Hence, according to the fintech product or service in question, different regulatory scenarios arise: from a regime that is relatively harmonised at European level (such as the regulation governing international FX payments) to simply applying existing rules without adapting to them to the provision of services using new technologies (e.g. lending between individuals (P2P lending)), or partly reforming the existing rules but without achieving the desired harmonisation between member states.

Bearing mind these differences, it would be desirable for common principles to apply to any legislative amendments addressing the existing framework for fintech products and services. Specifically, the following principles should serve as a guide:

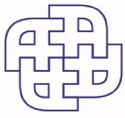
- (i) Flexibility and proportionality. Although the main concern of all supervisors and regulators is to mitigate risks, ensure financial stability and protect market participants, these fears should not be a barrier that unduly restricts access to new services or innovations. ESMA refers to this principle as the “turning point” for regulators, or in other words the point of equilibrium between “too small to intervene” and “too big to ignore”. Any legislative change must address proven risks, and at the same time be consulted on with the industry to avoid undesirable consequences.

In May 2017, the European Parliament Committee on Economic and Monetary Affairs⁷ stated that “*the main challenge for financial regulators is achieving the right balance: the regulatory framework may need adjusting to allow innovations in fintech that benefit the economy and the financial system but it must also manage the corresponding risks*”.⁸

- (ii) Knowledge about technology: it is very important that any changes in the regulatory framework take into consideration the characteristics and potential limits of new technologies; a technology neutral approach, despite being continuously called on by different sectors, may not be appropriate.

⁷ [http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602042/IPOLIDA\(2017\)602042_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602042/IPOLIDA(2017)602042_EN.pdf)

⁸ Free translation from the original English text.



- (iii) Pragmatism: If the development of a new technology, product or service represents a challenge in terms of its compliance with existing regulations, a practical approach must be adopted so that the regulatory framework precedes said development.

8.1.3 IMPACT OF TECHNOLOGY AND INNOVATION IN THE EUROPEAN CAPITAL MARKETS

In September 2018, the Association for Financial Markets in Europe (AFME) in partnership with PwC, published a report titled “*Technology and Innovation in the European Capital Markets*”.⁹ Based on interviews with its members¹⁰ about their vision of the challenges posed by new technologies in the banking sector, and particularly for investment banks, the report established four conclusions:

- 1) Technology is one of the most powerful levers banks have to address current industry challenges and deliver future opportunities. The reduction of costs and inefficiencies is the primary driver for the adoption of new technologies, but not the only one, as they will also enable banks to improve customer services, productivity and open new ways of collaboration. Only those banks which place technology at the centre of their long-term strategy and embed it across their areas will be in a position to realise maximum benefits.
- 2) Four (4) technologies have the potential to transform banks and the industry: Data & Analytics (i.e. the ability to extract conclusions through the control and management of data), cloud computing, artificial intelligence (AI) and distributed ledger technology (DLT). Specifically, data & analytics and IA are expected to have a high impact on sales and trading, and DLT on all post-trade activities. The level of implementation of each of these technologies varies between institutions but data & analytics is considered to be a long-term priority, while DLT/blockchain is a medium-term priority given that it requires the adoption and large-scale implementation of common standards.
- 3) New technologies and a focus on innovation will require banks of the future to be increasingly automated, data-led, open and agile. Business models are expected to be relationship-based, with banks connected into a wider pool of technology and other service providers.
- 4) The adoption of new technologies will require facing up to new risks and cyber attacks. Therefore, banks should adopt eight basic principles to keep pace with these concerns: maintain a long-term focus; embed data as an enabler; embrace

⁹ <https://www.afme.eu/globalassets/downloads/publications/afme-pwc-tech-and-innovation-in-europes-capital-markets.pdf>

¹⁰ AFME members include 48 banks, 37 law firms, 4 ratings agencies, 3 audit firms and 16 investors.



open technology; adopt a collaborative approach; identify industry priorities; use agile work practices; develop a relationship-based strategy; and enable secure and resilient operations.

8.2. THE *BLOCKCHAIN* PHENOMENON IN EUROPE

8.2.1 A BASIC APPROACH TO THE *BLOCKCHAIN* CONCEPT

In this section we offer a basic approach to the blockchain concept without going into technical detail. Blockchain is a method of registering or verifying data (transactions or assets – such as virtual currencies like bitcoin –) using electronic means, that is decentralised in nature. It is precisely this lack of a central register or reference point that makes blockchain such a revolutionary method.

If we are asked what we understand a “register” to be, the image that springs mind would certainly be that of a file in the custody of a sole party (registrar), where the custodian is also responsible for making any corresponding entries or amendments to the information recorded (and, if pressed to provide an example, we would probably come up with the Property Register, or in the financial sphere, Iberclear, as the entity in charge of keeping accounting records and securities settlement transactions).

The blockchain revolution resides precisely in the absence of a centralised register or a sole party responsible for the custody and administration this record. Through blockchain technology an electronic record of transactions and data is created that is accessible to all participants of the system. This way, each of these participants is responsible for registering and verifying the transactions that are reported. In the event of discrepancy in the data supplied, any participant can “veto” the transaction and it will not be registered. For instance, if party A wishes to pay 100 bitcoins to party B but party A’s virtual wallet does not have enough bitcoins, when a request is made to record the transaction all the participants in the system (not only the two parties involved) will be able to verify that A does not have sufficient funds, and that the transaction cannot therefore go ahead.

For a fuller understanding of the blockchain phenomenon, it should be explained that this is effectively a combination of several technologies:

- *data registration system*: data are stored through the creation of datablocks and these are combined using a logarithm; if anyone tries to alter the recorded information by modifying a specific block, the logarithm will make sure that successive blocks do not coincide, thereby preventing any malicious alteration of the register;
- *data encryption*: to guarantee privacy and security, all data are encrypted, and to obtain access participants must know both the “public key” (i.e. the decryption method common to the whole system) and the “private key” (the unique key for each participant);
- *distribution ledger*: this is not a centralised register (as we saw earlier) or is a register that is simply decentralised (in the sense that non interconnected replicas of the record in question exist so that in theory there may be diverse data in each



register). Every PC that connects to the system (known as a “nodule”) contains a full version of the register and any changes made must be validated by a sufficient number of nodules before all nodules can be updated; and

- *consensus mechanisms*: the nodules participating in the system agree the rules for recognising the transactions recorded by each one. If a sufficient number of nodules agrees to include a new data block in the system and the transaction is approved, the register is automatically updated in all nodules on the network.

8.2.2 POSITION OF THE EUROPEAN AUTHORITIES

The European authorities recognise the fundamental role that *blockchain* technology can play in the integration of all EU member states and the European Commission plans to develop a common approach to *blockchain* technology.

In May 2017, during the progress review of the Single Digital Market, the Commission recognised that *blockchain* inspired technologies have enormous potential for public administrations, companies and society as a whole. Further, the conclusions of the European Council meeting of 19 October 2017¹¹ identify the need to urgently address all questions relating to innovation that are likely to play a major role, such as *blockchain* and artificial intelligence. Therefore, the European Commission services are continuously interacting with private entities that are interested in promoting the use of *blockchain* technology.

We highlight the following initiatives being put forward by European institutions in the area of *blockchain*:

- “*Blockchain for social good*”: As part of the “Horizon 2020” programme (the purpose of which is to provide financial support for innovative projects) the European Innovation Council was created to support entrepreneurs and small companies that develop new technologies and wish to expand internationally. One of the initiatives of the European Innovation Council is “*Blockchain for social good*”, a prize of 5,000,000 euros offered to the best project that uses *blockchain* technology to bring about a positive impact for society as a whole (e.g. transparency in public spending and government processes, decentralised platforms for the collaborative economy, support for fair trade, etc). The deadline for registration is 2 April 2019.
- Funding for *blockchain-based* projects: The European Union has allocated a budget of up to 340,000,000 euros to fund *blockchain* projects in 2018-2020. Projects financed to date include D-Cent,¹² DECODE¹³ and MyHealthMyData.¹⁴

¹¹ <http://data.consilium.europa.eu/doc/document/ST-14-2017-INIT/en/pdf>

¹² <https://dcentproject.eu/>

¹³ <http://www.decode-project.eu/>

¹⁴ <http://www.myhealthmydata.eu/>



- *EuroChain*: The European Commission plans to create an infrastructure based on *blockchain* (EuroChain) on which to build an open, innovative and transparent space that fully complies with European regulations (especially in the area of data protection).
- *European Blockchain Partnership (EBP)*: On 10 April 2018, 21 member states and Norway signed a declaration to create the *European Blockchain Partnership (EBP)* and agreed to work together to set up a *European blockchain services infrastructure (EBSI)* to support the provision of cross-border digital public services with the highest standards of security and privacy. Spain was one of the original signatories and today the partnership has been signed 26 countries in total.
- *EU Blockchain Observatory and Forum*: Following the recommendations of the European Council, on 1 February 2018 the European Commission set up the *EU Blockchain Observatory and Forum* for the purpose of visualising the current possibilities and future potential of *blockchain*, understanding the challenges it brings and making recommendations for European institutions concerning their role in the *blockchain* environment.

Lastly, it is worth reflecting briefly on the European legal framework and its impact on the development of *blockchain* technology. The European environment does not differ from other regions in terms of the basic questions that arise relating to *blockchain* such as: are crypto currencies or *tokens* marketable securities? what is their tax treatment? are *smart contracts* (contracts based on a computer code stored in a *blockchain* that are carried out autonomously when triggered by certain events) truly binding for the parties involved? if the parties to *smart contract* do not understand the computer code, is their consent invalidated? As we mention at the beginning of this article, we need to provide a harmonised regulatory framework at European level that provides the legal security needed for the development of new technologies.

Additionally, Europe faces a specific challenge in the conciliation of Regulation (EU) 2016/679 of the European Parliament and of the Council, of 27 April 2016, on the protection of individuals with regard to the processing of personal data and the free circulation of that data (GDPR) and the development of *blockchain* technology. The regulation was created and drawn up prior to the definitive expansion of *blockchain* technology, and therefore it assumes that a “database” can only be “centralised”, which is in complete contrast to the decentralised scenario described for *blockchain*.

Other areas where clashes occur are as follows:

- exercise of the “right to be forgotten”, i.e. the right to erase personal data when they are no longer necessary. The fact that *blockchain* technology is based on the addition of new blocks and these blocks cannot be deleted creates a clear point of tension for the use of *blockchain* for the management of data protected by GDPR;



- the difficulty in identifying the party “responsible for handling” the data. *Blockchain* is based precisely on the fact that there is no single party in charge and all participants in the network are responsible for verifying the data.
- international transfer of data. In accordance with GDPR, data may only be transferred outside the European Union if the recipient country offers similar levels of protection. Since the nodes of a *blockchain* platform may be located in multiple countries, it could be impossible to verify that they are all in suitable jurisdictions.

As a result, one of the main challenges facing *blockchain* technology in Europe is this conciliation with the GDPR. The large-scale development and application of *blockchain* technology depends on the success of this task.



9. THE IMPACT OF BREXIT ON THE EUROPEAN BANKING SYSTEM

FRANCISCO URÍA

Partner responsible for the financial sector at KPMG-EMA and main partner at KPMG Abogados

9.1. SUMMARY

On 29 March 2019, two years will have passed since the United Kingdom gave formal notification of its intent to leave the European Union. At the time of completing this article, the two parties have reached a preliminary political agreement on the terms of the UK's exit, its future relationship with the European Union and the implementation and duration of a transition period. All this has been set down in a first draft agreement approved by the European Council on 25 November 2018, accompanied by a political declaration.¹ However, the agreement must be ratified by the British Parliament (which today is not guaranteed), the European Parliament (which looks more probable) and the European Council (which also seems probable), thereby greatly reducing the uncertainty over whether a deal will actually be in place before 29 March 2019.

If a formal agreement is reached between the two parties, the relevant authorities and entities affected on both sides of the Channel will have a period of time (at least until 31 December 2020) to adapt and prepare for the new situation. At the end of the transition period, the United Kingdom will, for all purposes, become a third country for the European Union and its financial sector, important for the UK and EU alike, will certainly be

¹ The agreement was made at an extraordinary meeting of the European Council held on 25 November 2018. The text of the agreement was published on 14 November 2018 with reference TF50 (2018) 55- Commission to EU27.



affected by this major change in its legal status. The objective of this article is to describe the different scenarios that could emerge and the respective consequences of each one.

9.1.2. ABSTRACT

On 29 March 2019 two years will have elapsed since the United Kingdom gave formal notice of its intent to leave the European Union. The two parties have reached a preliminary political withdrawal agreement governing the exit of the United Kingdom, its future relationship with the European Union and the implementation and duration of a transition period set out in a first draft agreement passed by the European Council on 25 November 2018, accompanied by a political declaration. Nevertheless, the agreement must be ratified by the UK Parliament, the EU Parliament and the European Council, and there is still a significant amount of uncertainty surrounding the possibility of reaching a final, formal agreement before 29 March. If this is the case (as I hope), the competent authorities and affected entities on both sides of the Channel would have a certain period of time (at least, until 31 December 2020) to adapt and prepare for the new situation. From the end of this transition period, the United Kingdom will, for all purposes, be considered a third country for the European Union and its financial sector, as important for the UK as it is for the European Union as a whole, would be doubtlessly be affected as a consequence of this major change in its legal status. The purpose of this paper is to describe the alternative scenarios that may take place and their respective consequences.

9.2. CAVEAT

This article was completed (and submitted) on 10 December 2018, after a political agreement was reached on the terms of the UK's withdrawal from the European Union. However, a decisive vote must still be held in the UK Parliament (the generator of the greatest uncertainty), the European Parliament and the European Council (both slightly less uncertain).² It should also be noted that aside from the vote on the agreement, the British Parliament must also vote on an equally relevant issue (even for the purposes of this article), which is the approval of an internal law that, among other measures, will convert the European *acquis* into British national law.

The agreement has been set forth in a complex document (585 pages) which covers a raft of important issues, including some of the most controversial topics arising during the negotiations such as the regime to be applied for the border between Northern Ireland and the Republic of Ireland, and that between Northern Ireland and the United

² The key points of the agreement can be consulted in the “Political Declaration Setting Out the Framework for the Future Relationship Between the European Union and the United Kingdom”.



Kingdom, or the last-minute questions relating to the agreement over Gibraltar, a very sensitive issue for Spain.

Therefore, this article is shaped by the information available at the time of writing, and there is a risk that subsequent events may in some way influence the reflections made herein.

The main objective of this work is to look at the consequences of Brexit for financial institutions in the United Kingdom, the European Union and third countries, both within the framework of an agreement that regulates the UK's withdrawal and in the hypothetical case that no agreement is reached.

Despite the importance of some of the other issues included in the negotiations between the United Kingdom and the European Union, and being aware of their importance and of the existing connections between one issue and another (e.g. all questions relating to the rights of EU citizens and workers residing in the UK), the scope of this article will be limited to analysing the questions and consequences relating to or deriving from Brexit which will have a major, direct impact on financial institutions in Europe, the United Kingdom and third countries.

9.3. BACKGROUND

The United Kingdom joined the (then) European Economic Community in 1973, having signed the Treaty of Accession to the Community on 22 January 1972. In the United Kingdom, the legal instrument for accession was the 1972 "European Communities Act".

The accession process was anything but a smooth ride. In a turn of events that is not always remembered, but of which the United Kingdom is usually well aware, the country had attempted to join the Community on two previous occasions, in 1963 and 1967, but its application was rejected both times, mainly due to the French position.

At first, joining the European Economic Community was a popular move, as reflected by the fact that in the 1975 referendum, 67 per cent of UK citizens voted in favour of joining the Community.

Relations between the two parties changed when the conservative government led by Margaret Thatcher came to power. After lengthy negotiations, she achieved the so called "UK correction", an annual rebate received by the UK in exchange for its reduced of European agricultural subsidies.

The United Kingdom remained in what was now the European Union but under a unique legal regime.

The next step in its gradual distancing from Europe was the UK's decision not to participate in the EU's most ambitious integration project: the creation of the euro, previously announced with the inclusion of a clause in the Treaty of Maastricht in 1992, in virtue of which the United Kingdom's right not to participate in the so-called "Third phase of the European Union" was expressly recognised.



From that time on, there was a period in which the relationship was relatively conciliatory, mainly under the successive labour governments, and in 2008 the United Kingdom ratified the Lisbon Treaty without too much ado. However, it should be noted that in April 2004, Prime Minister Blair announced his intention of offering a referendum on the European Constitution, although this did not materialise.

From 2010, with the change of government and the conservative party regaining power, another difficult period ensued in the relationship between the two parties, which coincided with the serious repercussions of the global financial crisis that broke in the summer of 2007 and worsened in the autumn of 2008.

On 23 January 2013, the incumbent Prime Minister, David Cameron, promised to call for a referendum on the United Kingdom's continued membership of the European Union if the Conservative Party won the elections in 2015, as effectively occurred.

On 20 February 2016, it was officially announced that the referendum would take place on 23 June 2016, once an agreement had been made with the European Union on the reforms that would be introduced in the Union to allow the UK to remain.

Despite this agreement, on 23 June 2016, a majority of UK citizens voted to leave the European Union, triggering the almost immediate resignation of the Prime Minister who was replaced by the current leader, Theresa May. The decision adopted in the referendum was subsequently ratified by a vote in the two chambers in the form of the "European Union (Withdrawal) Act" of 2018. The decision received royal assent and became a Law of the British Parliament on 16 March 2018.

In March 2017, the British government formally "triggered article 50 of the Treaty" through a letter of intent dated 29 March 2017 signed by the Prime Minister and addressed to the President of the European Council, Mr. Tusk, stating textually that "I hereby notify the European Council in accordance with Article 50(2) of the Treaty on European Union of the United Kingdom's intention to withdraw from the European Union". The same notification was submitted to the Economic Coal and Steel Community and the European Atomic Energy Community (EURATOM).

Article 50 sets forth that:

- 1) Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
- 2) A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
- 3) The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notifica-



- tion referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
- 4) For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it. A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.
 - 5) If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.

The European Council published a set of guidelines (recommendations, in the official Spanish translation) for the Brexit negotiations under article 50 on 29 April 2017. This document established some of the principles for the negotiations such as the autonomy of the European Union in its decisions and the role of the Court of Justice, the principle of indivisibility of the four fundamental freedoms, that the talks will be conducted in transparency and as a single package (nothing is agreed until everything is agreed) and that there would be no bilateral negotiations between member states and the UK but a single negotiation process that would be carried out by the team headed by the former European commissioner, Michel Barnier.

Later, on 19 June 2017, both parties published a Terms of Reference document for the negotiations for the application of article 50 of the Treaty.

During this time, the European Council has held several follow-up meetings, and published various conclusions and guidelines (dated 20 October 2017, 15 December 2017, 23 March 2018 and 29 June 2018).

As we mention above, on 25 November a first agreement (Withdrawal Agreement) between the European Union and the United Kingdom was reached on the terms that would govern the UK's withdrawal, the regime applicable during the transition period which would extend until 31 December 2020 and the definitive situation that would arise once the declaration of article 50 occurred in full effect.

9.4. OPTIONS FOR THE FUTURE RELATIONSHIP BETWEEN THE UNITED KINGDOM AND THE EUROPEAN UNION

In principle, the most extreme options for the future relationship between the European Union and the United Kingdom would be either for the United Kingdom to remain a fully-fledged member of the European Union, or to withdrawal from the European Union without any type of deal in place that would make it different from any other third country outside the EU, and therefore no Association Agreement with the European Union would be ratified.

As things stand today, the first option should be ruled out. The United Kingdom has adopted a binding democratic decision that has to be respected, and therefore, what-



ever happens, it seems unlikely that there will be any other outcome than the country's withdrawal from the European Union on 29 March 2019. The United Kingdom's wish to cease to be a member state of the European Union would appear to be unequivocal and irrevocable, for the time being at least, and the possibility raised by certain media sources or in some circles (although legally possible, as recently established by the European Court of Justice) that the decision could be reversed or a new referendum called in the short term are currently without foundation, although this situation could probably change in the future if there is another general election.

Although the second option, a no-deal withdrawal, is not the preferred option of either of the parties, especially after the aforementioned agreements reached on 25 November, it cannot be ruled out so long as the Agreement remains unratified. Therefore, the authorities (particularly the financial supervisors on both side of the Channel) continue to advise entities to make preparations by drawing up contingency plans for both the Agreement going ahead and a no-deal Brexit.

This is not a theoretical exercise. In the opinion of all political analysts there is a real risk that the Agreement will not be ratified by the British Parliament, given the current status of the parliamentary groupings in the UK, particularly the party propping up the government.

The provisional Agreement reached clearly satisfies no one, but in reality, once article 50 had been triggered, the negotiating capacity of both parties was truly limited. However, the seriousness of the consequences of leaving with no deal would be such that I am willing to believe that the Agreement will eventually be ratified, although today (10 December) this would be more of a wish than a conviction.

Nonetheless, as we will discuss in this article, both parties have repeatedly shown their willingness to seek an agreement that covers not only the terms and conditions (and implications) of the UK's withdrawal from the European Union, but also the future links between the two, within a framework of friendship and cooperation. This was set forth in the political declaration that accompanied the Agreement signed on 25 November.

However, it is also clear that the decision taken by the United Kingdom was not only to leave the European Union, but also, and to no lesser extent, to cease to apply some of its four freedoms. On the understanding, as set down at the time article 50 was triggered by the United Kingdom, that it would not be possible to keep some of these freedoms and at the same time restrict others (a strategy known as *cherry picking*), this means that the UK will not be able to be part of the European Union or have the same access to the internal market as other member states or states, such as those belonging to the EFTA and hence the European Economic Area, that have opted to effectively apply the four fundamental freedoms in exchange for access to the European internal market for products and services.

Therefore, negotiations between the two parties should lead to a situation in which the United Kingdom will have the formal and exclusive condition of a "third country", with no access to the Customs Union or the internal market, and which, for the purposes of financial services, would be subject to the EU's equivalence regime in order to access the benefits of the European financial regulation for entities in this situation. This ba-



sically implies that the financial regulations of the European Union and the state from which the financial institution in question derives are substantially similar (although not identical).

This has been reflected in the Agreements reached, and in relation to financial services, it has been expressly stated that “Noting that both Parties have equivalence frameworks in place that allow them to declare a third country’s regulatory and supervisory regimes equivalent for relevant purposes, the Parties should start assessing equivalence with respect to each other under these frameworks as soon as possible after the United Kingdom’s withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020. The parties will keep their respective equivalence frameworks under review”.³

The final agreement could not substantially alter this pre-defined scenario due to the decisions already taken by the two parties. Relations between the European Union and third countries are divided between cases where these third countries accept the four fundamental freedoms and align their legal systems with EU regulations to ensure their effectiveness (e.g. EEA states), and those that do not accept or implement these freedoms and therefore have no access to the internal market. This has a direct impact on the fundamental issue of passporting for financial institutions.

In the last few weeks a new political possibility has emerged, according to which the effects of invoking article 50 could be delayed so that United Kingdom could remain a member of the European Union for a longer period of time, and if this were to occur, it would affect the content of this article given that the legal effects of the declaration would be postponed.

9.5. IMPLEMENTATION CALENDAR. THE TRANSITION PERIOD

If there is an Agreement on the terms of the UK’s withdrawal (and only in that case), the legal effects of Brexit would be postponed until 1 January 2021, giving companies and businesses an additional period to adapt to their new circumstances.

This period is referred to by both parties to the negotiations as the “implementation period” and it would run from 29 March 2019 until 31 December 2020. During this time, authorities and companies would have time to fully prepare for the impact of the UK leaving the European Union.

During the implementation or transition period, the United Kingdom would continue to apply European law, although it would no longer be a law maker.

In exchange for keeping European regulations (and the four fundamental freedoms) the current legal situation would be maintained so that British companies would continue to have access to the European internal market under the same terms, investment

³ Paragraph 38 of the political declaration establishing the framework of the future relationship between the European Union and the United Kingdom.



services companies would continue to access the European market through passporting and other regulated procedures, while EU financial services companies would maintain their current presence in and/or access to the UK market with no further requirements.

However, the implementation or transition period is not an automatic consequence of complying with the two-year period from the date the UK officially stated its intention to leave the European Union. While the withdrawal (exit from the European Union and becoming a third country) is an automatic consequence, the existence of a transition period depends on a final agreement being ratified and effective between the United Kingdom and the European Union.

At various moments during the negotiations the possibility arose (although it did not finally materialise) of the transition period being extended in some form (an extra year) to help companies and individuals adapt to the new situation, but this possibility was not included in the Agreement reached and therefore the end of the transition period is still 31 December 2020.

It should be noted, however, that although many things will remain unchanged, there are other aspects that *will* change as a direct result of the UK's withdrawal.

For instance, although the United Kingdom will have to apply European regulations, and will be subject to the decisions of the European Court of Justice, among others, it will no longer be a member state and therefore will not be a part of EU institutions or influence their decisions (in accordance with the aforementioned principle of autonomy).

The fact that the transition period will give governments and companies some time to adapt to the new situation is one of the main advantages (and incentives) of both sides reaching an Agreement and would temper the initial consequences of Brexit, although it will not change the longer-term effects of the UK's decision to leave the European Union, which, as we explore below, will be particularly important for the British financial sector.

9.6. CURRENT STATUS OF THE BRITISH FINANCIAL SECTOR. ITS IMPORTANCE

Up until now, the British financial sector has been part of the European financial sector with full rights to operate in the European internal market and benefit from the freedom of establishment, and particularly from the so-called “passporting” rights, a right that is recognised on a fragmented basis (for different financial activities) in European regulations, and which means that a financial institutions can operate in the territory of another member state without special authorisation from the local supervisor (*host*) on the basis that it would have already obtained authorisation from its own supervisor (*home*).

The financial sector is a major part of the UK economy, contributing a significant portion of the country's GDP. In contrast to popular belief, and according to data published



by the British government,⁴ neither is it confined to the city of London. In fact, two thirds of financial sector employees in the UK are located outside the London area. According to 2015 data,⁵ the sector reported profits of 63 billion pounds in that year, more than the United States, Switzerland and Luxembourg combined.

Other key data for 2015 also show that the United Kingdom was leader in financial services exports (97 billion pounds), once again more than double the figure reported by the US financial sector.

The United Kingdom is home to the third largest financial centre in the world, with more than two hundred and fifty foreign banks domiciled in London, and 17 per cent of all loans extended by international banks were made in the United Kingdom.

These figures, along with many others, illustrate the importance that any Brexit impact affecting the British financial sector would have for the UK economy as a whole. Further, as we have already seen, these effects would be greatly exacerbated if the Agreements reached on 25 November are not ratified.

9.7. POST-BREXIT SCENARIOS. AN ANALYSIS OF THE ALTERNATIVES

Once the Brexit deadline is reached, the potential situations that could arise are very different:

- a) As we have seen, if no deal is reached before the deadline (29 March 2019), there would be no transition period and the Treaties of the Union would no longer apply to the United Kingdom, which would become a third country. British financial institutions would become institutions of a state that is not a member of the European Union, or the European Economic Area. They would therefore lose their passporting rights and to operate in the European Union they would need to obtain authorisation through the equivalence system.⁶

It should be noted that the initial proposals put forward by the United Kingdom included a suggestion for an alternative equivalence regime, the so-called “mutual recognition” procedure, which would essentially be equivalent to the passporting system.

This suggestion was rejected immediately by the EU negotiators, and therefore the United Kingdom will have to adhere to the same regime as other third coun-

⁴ *Brexit White Paper*. February 2017.

⁵ *Key Facts about the UK as an international financial centre 2016*. 1 November 2016. Published by the City of London.

⁶ This has been expressly stated by the European Commission in a document entitled “Withdrawal of the United Kingdom and EU rules in the field of banking and finance, Directorate-General for Financial Stability, Financial Services and Capital Markets Union (European Commission), February 2018. https://ec.europa.eu/info/publications/180208-notice-stakeholders-withdrawal-uk-banking-and-finance_en



tries, the equivalence regime, which is basically a procedure that is applied for each institution individually, whereby the competent supervisory authorities verify the similarity/equivalence of the regulations applicable to the entity (in this case, British) in comparison with those in force in the European Union, and if they are acceptable, certain exemptions and facilities will be recognised allowing it to operate in the EU at a lower cost.

It is important to understand the large differences between the current passporting regime and the new equivalence regime to which the British financial sector would be subject at the end of the transition period.

The passporting system allows credit institutions, insurance companies and investment services firms to carry out their activities in other EU member states without having to obtain new administrative authorisation and subject to the same source regulation, so that compliance with the relevant capital and liquidity requirements may be achieved at consolidated group level in accordance with the funds available at the main entity.

In contrast, the equivalence regime is a fragmented regime with very limited effect, which does not release an entity from having to secure administrative authorisation subject to the fulfilment of relevant requirements in the country of destination.

Obviously, UK institutions should not have any difficulty being accepted for the equivalence regime at first as British regulations will be aligned with European regulations (it will largely be a case of transposing European rules), as set forth in the political declaration shown above. However, once the United Kingdom leaves the EU, maintaining this equivalence will require the UK to coordinate its regulatory agenda with that of the EU, which will certainly not be the best fit with the ideologies on which the vote in favour of *Brexit* were founded (fundamentally the desire to regain full sovereignty and decision-making capacity).

It is understandable that the United Kingdom would try to keep a similar system to passporting in place at the end of the transition period, but the European Union has been inflexible on this point, certainly with good reason, as it considers that one thing is belonging to the European Union or the European Economic Area (which implies accepting the four fundamental freedoms), while not belonging is quite another.

European Union entities that were part of British financial groups, as entities of the European Union, would enjoy the rights (and be subject to the obligations) granted to them by European law, including the possibility of operating in other European states through the passporting system.

European entities operating on British soil would not be able to benefit from passporting as such, given that the United Kingdom will be a third country, although the UK authorities have put in place a facilitating procedure to maintain business continuity that is similar to the current situation. Specifically, the Finan-



cial Conduct Authority (FCA) has established temporary amendments to the regime for third countries.⁷

From now on, institutions from third countries that are established and operate in the United Kingdom will deal exclusively with the supervisory authorities of that country. Any authorisation obtained to carry out their activities would be limited to the United Kingdom.

Although both sides have expressly stated that they consider a “no deal” to be both unlikely and undesired, the UK supervisory authorities have attempted to mitigate the legal uncertainty that could potentially affect the financial sector by issuing statements aimed at anticipating and clarifying the situation that would exist if this were to happen.⁸

Therefore, the necessary legal procedures have been adopted to ensure that the current laws applying to the financial sector in Europe remain in force (as internal legislation), and national regulators and supervisors have been delegated powers to make the required adjustments to the binding delegated regulations and technical standards, to ensure the continuity of the regulations in place at the end of the period during which the first legal effects of the Brexit notification are felt.⁹

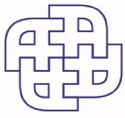
- b) If there is a deal before the end of the period, all the terms and conditions of such a deal would be logically be applied. However, given that the United Kingdom has, a priori, rejected access to the internal market as it is not prepared to accept the four freedoms, the situation arising from the provisional agreement adopted will not differ greatly from the situation described above once the transition period ends on 31 December 2020.

During the transition period (in principle until 31 December 2020) the current situation would remain unchanged, and UK institutions would maintain their passporting rights, operating under a common financial regulation, although they would need to obtain temporary authorisation to do so.

⁷ “Temporary transitional arrangements in relation to certain prudential requirements for solo regulated firms in respect of EU originated exposures” as the transition period is referred to by the FCA in its “baseline approach”.

⁸ A example of this can be found in the document published by the British treasury on its website (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/720298/HM_Treasury_s_approach_to_financial_services_legislation_under_the_European_Union_Withdrawal_Act.pdf).

⁹ One of the practical problems to be resolved is the substitution of references for European Union bodies and authorities, such as the supervisory authorities (EBA, ESMA and EIOPA), with their British equivalents, unnecessary arrangements such as those referring to relations between the authorities of member states or those that have ceased to become applicable such as all arrangements referring to the direct and automatic effects of certain acts or decisions made by the European authorities on the financial sector in the United Kingdom.



The same would occur for European Union entities operating in the United Kingdom.

The status of third country entities would not change during the transition period.

- c) In any case, European Union institutions domiciled in the UK will have to leave the country before 30 March 2019 and, as a result of this, the European Banking Authority, currently domiciled in London, will move to Paris.

Therefore, there is no doubt that the existence or lack of a deal for the UK's withdrawal from the European Union is key to determining the impact that *Brexit* will have for British financial institutions and European entities that are present or carry out their activities in the United Kingdom, and at the current moment in time it is not possible to say if there will be an Agreement or not.

Shortly before this article was completed, an event occurred that was difficult to read at the time, in the form of a public statement issued by the vice-chairman's office of the German supervisor (BaFin) saying that bilateral talks were ongoing with the UK supervisor to ensure the "softest possible transition"¹⁰ in regard to Brexit in the case that no agreement was reached at European level. This would mark the first bilateral interaction between two states in the area of financial services since the Brexit negotiations began. It is still early to determine whether this move opens up the possibility of bilateral agreements but it would not appear to be easily compatible with the legal framework regulating financial services in the European Union or with the principles adopted by the EU in the Brexit negotiations.

Subsequent to these declarations, the German government passed a draft law which has been submitted to Parliament, establishing the groundwork for its future relationship with the United Kingdom in the area of financial services if there is no deal. This draft law establishes a "national" transition regime (in contrast to the European agreement) for British firms conducting financial activities in Germany.

Other states, including Spain, could make similar moves in the next few weeks in order to reduce the uncertainty that Brexit is causing for financial institutions (mainly banks and insurance companies) if there is no deal between the United Kingdom and the European Union.

It is important to note that these initiatives should be read as part of the what the European Commission has referred to as preparatory actions that should be carried out by citizens, companies and the member states. The Commission sent out two key messages

¹⁰ The declaration was reported by Reuters on 22 October 2018 (<https://www.reuters.com/article/britian-eu-bafin/German.watchdog-eyes-backstop-bilateral-ties-with-uk-ahead-of-brexit-idUSL8N1X22UK>), pages 1 and 2. The news item affirmed, although the statement was not in quotation marks unlike the quote in the text, that on Monday of that week BaFin had stated that "it would negotiate its own regulatory ties to prevent market disruption if the United Kingdom and the European Union were not able to reach any wider agreements before Brexit".



in a communiqué addressed to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank with regard to “preparations for the United Kingdom’s withdrawal from the European Union on 30 March 2019: contingency plan”.¹¹

The first is that “member states, including national authorities, will play a fundamental role in the application of and compliance with EU legislation in relation to the United Kingdom’s status as a third country...”

The second message, which is no less important than the first, is that “the Commission is working with member states to coordinate the measures to be adopted to ensure that contingency preparations are consistent across the European Union and comply with the general principles shown below (in the same document)....” But that, “member states should abstain from tabling debates or arranging bilateral agreements with the United Kingdom, as this would be detrimental to the unity of the EU”. Referring specifically to financial services, the document stated, “the European Supervisory Authorities are encouraged to start preparing cooperation agreements with the UK supervisors to ensure that information relating to financial institutions and agents can be shared immediately after the withdrawal date in the event of a no deal Brexit”.

9.8. THE SINGULAR CASE OF CLEARING HOUSES. THEIR IMPORTANCE.

In addition to the figures shown above reflecting the importance of financial activity in the United Kingdom, we would also highlight the relevance of another specific activity: the clearing and settlement of securities that takes place daily in the UK clearing houses.

For the transactions carried out by these clearing houses on assets denominated in sterling and other international currencies there will be no special changes, other than those mentioned in the previous section of this article.

The future of transactions on assets denominated in euros is another story.

Today, almost 90% of euro-denominated derivatives transactions are settled at UK-based clearing houses, according to British government calculations.¹² The daily transaction volumes occurring in these infrastructures total thousands of billions of dollars.

The European authorities, including the European Central Bank, have expressed their concern that such a significant activity would be carried out in a non-EU territory, and have drawn up legislative proposals that are clearly aimed at re-establishing these infrastructures within the European Union.¹³

¹¹ Strasbourg, 13.11.2018. COM (2018) 880 final, page 4.

¹² The BIS considers that three quarters of all derivatives transactions denominated in euros in 2016 were made through UK infrastructures. One of these alone, the London Stock Exchange, announced that it had made transactions of over 900,000 million USD in that year.

¹³ In a letter to stakeholders dated 8 February 2018 (<https://ec.europa.eu/info/sites/info/>



The proposals suggest that the European supervisory authorities should be able to request that clearing houses which are considered systemic due to the volume of their activity denominated in euros should not be accepted as suitable infrastructures to be used by European banks, or impose significant capital penalties if they are used, unless compliance with European regulations can be ensured and European supervisors can access these infrastructures.

However, it should also be noted that if euro-denominated clearing transactions are separated into different infrastructures than those used for clearing transactions in other currencies, this could have a significant impact not only (inevitably) for the infrastructures and markets themselves but also, to a lesser extent, for the institutions that hold relevant positions in these markets, which benefit from the treatment of risk through netting.

For this reason, both the UK authorities and representatives other international entities and infrastructures (in the US and Japan, to quote two key examples), are in favour of reaching a solution that would allow all or part of the status quo to be maintained.

While in the past few days it would appear that some advances have been made that would suggest a possible softening of the EU stance, so that in exchange for an agreement that gives the European supervisor (ESMA) the possibility to gain real access to the infrastructures and a suitable framework of cooperation with the British supervisor, a similar status quo could be maintained. However, no definitive Agreement has been released on this issue. Clearly, such an agreement would be easier to arrange during the transition period than after it.

ESMA has informed the British clearing houses (basically LCH, ICE Clear Europe and the London Metal Exchange) that it may not be able to accept authorisation requests for them to be recognised under the equivalence regime until the United Kingdom actually leaves the European Union, and therefore the uncertainty could persist for some time. As a result of this, British infrastructures could potentially be unable to continue performing their activities with European Union institutions.

[files/file_import/post_trade_services_en_0.pdf](#)) the European Commission stated the following: “As of the withdrawal date, derivatives traded on a UK regulated market will not fulfil the definition of Exchange traded derivatives (ETDs) under EU law. According to Article 2 (32) of MIFIR, ETDs are derivatives traded on an EU regulated market, or on a Third-country market considered to be equivalent. Thus, under EU law, as for the withdrawal date, ETDs traded on a UK regulated market will be over-the-counter (OTC) derivative contracts”. It also states that “OTC derivatives that are subject to the clearing obligation must be cleared by a central counterparty (CCP) which is authorised and established in a Member State of the EU or a CCP established in a third-country which is recognized by the... (ESMA) under Article 25 of EMIR to clear that class of OTC derivative. As of the withdrawal date, CCPs established in the United Kingdom will be third-country CCPs which would need to be recognized under EMIR before they could be used to fulfil the clearing obligation”. The main consequence of all this, as the document goes on to explain, will be that counterparties in the European Union will see their capital requirements increased for the derivatives positions held in *clearing houses* in the United Kingdom, which would be a clear disincentive to use them.



Given this situation, some of the most significant market entities¹⁴ have decided not to endure such uncertainty any longer when there is so little time before Brexit takes place (and no agreement has been made) and have moved their activities from the United Kingdom to a European Union country (e.g. Paris).

This will logically affect the UK infrastructures, which would lose part of their business (although they will keep their international activities), but it will also affect the large European entities that trade through them on a daily basis, as separating euro transactions from transactions in other currencies (making any netting of transactions to minimise risk impossible) would exponentially increase their capital requirements.

The legislative proposals for the transactions mentioned above, and specifically, the proposal published in Germany, offer some additional legal security as they would bring continuity, even if no deal is reached between the European Union and the United Kingdom, for financial services previously provided by UK operators to their EU counterparts, even if they have not been unable to obtain a European licence (German, in the case in reference) by 29 March 2019.

The document on European contingency plans referred to previously¹⁵ also includes tries to calm the waters, stating that “OTC derivatives contracts that are not settled between EU and UK counterparties, will in principle remain valid and exercisable until their maturity”.

For cleared derivatives, the document states that “if an agreement is not reached, the Commission will adopt temporary or conditional equivalence decisions to ensure that there are no interruptions in the central clearing or depository services. These decisions will be supplemented by the recognition of infrastructures established in the UK, which have been encouraged to request recognition from the European Securities and Markets Authority (ESMA) as early as possible”. This is where the aforementioned document calling on the European supervisory authorities to reach cooperation agreements with the UK supervisors¹⁶ becoming meaningful.

9.9. OTHER SIGNIFICANT EFFECTS

Even if a definitive Agreement is reached as described above, which both defines the situation during the transition period, and above all, the future medium-term relationship between the United Kingdom and the European Union, the mere fact of the UK's withdrawal will have significant legal effects that require financial entities to adapt to the new situation as soon as possible.

The supervisory authorities are also affected (above all the European Banking Authority, which will have to move its headquarters to continental Europe) and entities on

¹⁴ Euroclear.

¹⁵ See note 11, page 8.

¹⁶ See note 15.



both sides of the English Channel have asked all companies affected by the new situation to prepare detailed contingency plans describing all the impacts that *Brexit* will have for them, and the specific measures that they will adopt in response to these.

One of the first decisions for financial entities domiciled in the United Kingdom will be whether to keep their current residency or to move, as a certain number have already done, to another member state to maintain their current status as members of the European Union, with continued access to passporting rights. A practical problem that the entities that have started down this path have encountered lies the need to obtain authorisation from the state they are moving to, which is taking longer than would normally be expected mainly due to the accumulation of requests.

Further, the European Central Bank has insisted that entities making such a move must not make a “cosmetic”, “limited” or “front office” transfer that would legitimise maintaining their current status as entities resident in the European Union when they are really still operating in the United Kingdom. Entities that do make such a transfer must have all the organisational requirements in place to allow them to operate in compliance with stringent European regulations, and therefore any such “apparent” transfers would not have the desired effect.

Another option would be to open a financial entity in another European Union country, obtaining the corresponding authorisation to do so. The investee would for all purposes be a European Union financial entity with all the rights and obligations recognised in European financial regulations, including passporting rights.

A third possibility would be to carry out their activity through a branch opened in an EU member state. This would require them to request and obtain authorisation from the destination state, which would be subject to the aforementioned “equivalence” procedure. Obtaining this type of authorisation would not be problematic at first, given the similarity between UK and EU legislation. Later on, especially after the end of the transition period, the situation could change substantially, and if significant divergence were to arise between the regulations in place in the UK and the EU, the benefits of the declaration of equivalence would be lost, and the entities involved would simply become entities of a third country outside the European Union.

Entities of third countries currently operating on British soil would be able to continue operating there without any problems, provided that authorisation for the activities they carry out has been extended by the British supervisor. If it has been extended by another EU supervisory body, fresh authorisation would have to be requested from the UK supervisor.

The final case is that of European Union entities with a presence or operating in the United Kingdom.

During the transition period, if the projected Agreement is signed between the United Kingdom and the European Union, the status of these entities would be similar to their current status, with some small changes, as described below. Obviously, as we have already seen, in the event of no deal the situation would be very different.



One of the issues to be resolved, aside from the questions relating to maintaining their current administrative authorisation, the requirement of temporary authorisations and the use of the European passport, refers to their access to British *clearing houses*. In this case, unless a specific agreement is made maintaining the status quo, they should expect to have to move the part of their activity in euro-denominated financial instruments (especially derivatives) to European trading centres.

Another key question is the inclusion in financial contracts governing the relations of these entities with third parties of clauses that specify a right, such as English, which will not necessarily be consistent with those of the European Union, or that establish submission to British legal bodies in the event of discrepancy, when, as a result of Brexit, the resolutions of these bodies will lose the benefits of enforceability which they currently enjoy in Europe. All contracts that contain clauses of this type, and there may be thousands, will have to be modified. In some cases, the changes will be easy to make, but on other occasions discrepancies may arise between the parties, or there may be additional novation requirements for one of them. This could be a source of legal uncertainty and, very possibly, litigiousness. This has been one of the most complex aspects for financial entities when supervisors have asked for their contingency plans to deal with the effects of a no-deal Brexit.

9.10. CONCLUSIONS

On 29 March 2017, one of the saddest and potentially most serious events in the history of the European Union occurred when the United Kingdom formally gave notice of its intention to leave the Union by triggering article 50 of the Treaty of the Union, as a consequence of the referendum held in the UK on 23 June 2016.

The repercussions of this decision remain to be seen, and will depend on whether the preliminary agreement reached between the two parties at the extraordinary council meeting held on 25 November will be ratified or not, which will determine the terms of the UK's withdrawal, the future framework of its relations with the European Union and the existence of a transition period (or implementation period) and its duration.

I am positive that such an Agreement will be reached. It may be difficult, especially in terms of getting it through the House of Commons, but I believe the seriousness of the all the effects that would arise in the event the Agreement is not ratified will finally persuade even the most unwilling politicians to adopt a responsible stance. The prospect of no transition period to allay the consequences of *Brexit* for all parties concerned, giving them time to prepare properly for their new circumstances, should be a sufficient incentive.

If no agreement is made, one of the most significant impacts of *Brexit* for the financial sector on both sides of the Channel will be the reciprocal consideration of EU member states and the United Kingdom as third countries, and the need to process declarations of equivalence as the only way of continuing the activity between the two areas, which would not be an easy task given the limited time available, and an impossible one if the



UK starts to implement different legislation to the EU with regard to financial regulations.

If, on the other hand, an Agreement is reached, and there is a transition period, at first (in principle until 31 December 2020) there will be no major changes to the status quo other than the need to obtain the pertinent authorisations, the pending question of the regime for trading financial instruments, particularly derivatives, denominated in euros through UK trading centres and the need to amend regulations and contracts to reflect the new legal situation.

At the end of the transition period, the situation will be similar to that described for the no-deal scenario. The European Union members states and the United Kingdom will become third countries for the other party, the passporting regime will cease to exist and cross-border activity between the two areas will be shaped by a declaration of equivalence, which implies that the two corresponding regulations will continue to develop in parallel.

The consequences of this will not be good on either side of the Channel. The United Kingdom will suffer, and is in fact already suffering, the impact of the withdrawal of key financial institutions that were domiciled in the country wishing to benefit from the combined effect of being able to operate in an efficient, global financial arena and enjoy privileged access to the European Union. This second advantage will disappear once the implementation period has ended and UK financial institutions will be in a situation very similar to that of the United States or Japan, to quote two relevant examples, when it comes to operating in the EU.

The European Union will lose its largest and most efficient financial centre, which will doubtlessly affect the EU's proposed "Capital Markets Union". The United Kingdom is clearly the most developed capital market in the European Union and its withdrawal will have a very significant impact.

The Agreement that was finally reached on 25 November was negotiated over the months that followed the triggering of article 50. It was important to get to this point, although there are still major procedural obstacles to work around.

If the Agreement is implemented, it will temper some of the damage caused by the separation, but the impact will still be huge.

During the negotiations, the United Kingdom attempted to gain an advantageous regime for its future relations with the European Union while at the same time refusing to accept the four fundamental freedoms. This was unacceptable to the European Union due to the essential principles and rules of the Union and because it would have set a very dangerous precedent. As we have seen, the regime that will be applied will be that applied in all other relations with third countries, the equivalence regime.

If this is the case, it should also be noted that for credit institutions from the United Kingdom and other third countries (Switzerland, United States or Japan, among others), the equivalence regime and procedures are insecure, barely efficient and can be revoked



at any time, which subjects the entities that benefit from them to a serious lack of predictability. One of the desirable consequences of *Brexit* must surely be the improvement of this regime, as set down in several paragraphs of the agreement.

In any case, the British Parliament, the European Parliament and the European Council will have the final say. We can only hope that each of these bodies lives up to its responsibilities.

PART III
COMPLETING MONETARY UNION:
THE STATE OF THE PERENNIAL QUESTION



10. THE EUROPEAN BANKING UNION: ACHIEVEMENTS AND CHALLENGES¹

FERNANDO RESTOY

Chairman, Financial Stability Institute

10.1. INTRODUCTION

The banking union is a signal achievement of the European process. As originally envisaged, it should comprise a single supervisor and resolution framework, as well as a common deposit guarantee scheme. At present, the euro area does have a fully operational single supervisory mechanism (SSM), hosted by the European Central Bank (ECB), and also a common resolution authority – the Single Resolution Board (SRB), which is responsible for applying a common set of rules and for managing the industry-funded European Single Resolution Fund (SRF). However, the SRF has only limited firepower, since a public backstop has yet to be implemented. Moreover, no European deposit insurance scheme (EDIS) has yet taken shape, despite intensive negotiations.

The banking union originated in the euro area crisis that started in 2010. The malign link between banks' viability and the capacity of domestic treasuries to support them in

¹ This paper is a revised and extended version of a recent public lecture (Restoy (2018b)). I wish to thank without implicating Ignazio Angeloni, Patrizia Baudino, Jazbec Boštjan, José Manuel Campa, Elisa Ferreira, Pentti Hakkarainen, Mariano Herrera, Korbinian Ibel, Andreas Ittner, Elke König, José Luis Malo de Molina, Yves Mersch, Pedro Neves, Peter Praet, Nicolas Véron, Ruth Walters and Charles Wyplosz for comments and suggestions. I am also grateful for the support provided by Christina Paavola.



troubled times was a destabilising force that rocked the single currency. What we call the banking union is, in fact, a series of actions taken to decouple sovereign risk from the financial variety, with the aim of restoring the monetary union's stability and credibility.

From a conceptual viewpoint, the banking union logically complements monetary union (European Commission (2018)). In particular, by facilitating the integration of European banking markets, the banking union should result in safer, more efficient institutions (Hildebrand (2018)) as well as better and cheaper banking services.

An integrated banking market with truly pan-European institutions would underpin an effective private risk-sharing mechanism, helping to break the link between domestic economic and fiscal developments and financial stability (Draghi (2018)). This would appear essential given the ample scope for economic upsets in individual euro area countries, the limited power of national policies to smooth economic and financial cycles, and the potential impact of domestic banking crises on the euro zone's stability. Arguably, the Capital Markets Union project launched in 2015 by the European Commission is a move towards such integration. However, given that banks are the main intermediators of credit in Europe, it is banking integration that must be a key component of any effective private risk-sharing mechanism within the euro area.

Thus, the banking union is a prerequisite if the European project is to be preserved and deepened. Its success depends on its ability, first, to ensure a more closely integrated banking system in the euro area and, second, to weaken the link between the perceived safety and soundness of financial institutions (and hence the value of their liabilities), and the fiscal soundness of their home jurisdictions.

The first of these two objectives requires the conditions necessary to facilitate the provision of cross-border banking services within the euro zone to be put in place and, in particular, many more banks need to operate in multiple jurisdictions. The second objective requires that the mechanisms for dealing with failing banks are effective, ensuring a comparable treatment of creditors and shareholders of all banks in the euro zone, regardless of domicile. How far these objectives have been achieved is a good indicator of the banking union's success. And, by extension, to ask why there has been insufficient progress in those two areas will help to spotlight any possible missing pieces in the project. To help put matters in perspective, Section 2 of this paper outlines the current functioning of the banking union since its inception in 2014, while Sections 3 and 4 address the lack of integration of European banking markets and the remaining shortcomings in the framework for managing a banking crisis.

10.2. THE ACHIEVEMENTS SO FAR

At present, the banking union is charged with prudential supervision and bank resolution. Those functions are performed, respectively, by the ECB, through its Single Supervisory Mechanism (SSM), launched in November 2014, and the Single Resolution Board, which took shape as an independent EU agency in January 2015.

10.2.1. THE SUPERVISORY FUNCTION

In record time, the ECB has been able to put in place a fully functioning supervisory authority. This entailed the development of a supervisory capacity (with more than 1,000 experts and support staff), the creation of joint supervisory teams (comprising members of the ECB and national competent authorities (NCAs)) for all significant institutions (now 118) and the establishment of a central decision-making body, the Supervisory Board, which comprises the Chair and the Vice-Chair and up to 23 additional voting members appointed by the ECB Governing Council and NCAs.

The SSM's main achievement has been to help restore confidence in the stability of the euro area's banking system. This is largely thanks to the efforts made to ensure adequate capital and liquidity through regular supervisory action and stress tests.

TABLE 1. SELECTED INDICATORS OF SIGNIFICANT EURO AREA BANKS

		2018	2017	2016	2015
Solvency	CET1 ratio (%)	14.1	13.1	13.3	12.7
	Total capital ratio (%)	17.8	17.6	16.9	15.8
	Leverage ratio	5.1	5.1	4.9	–
Liquidity and funding	Loan-to-deposits (%)	118.0	118.3	123.3	126.7
	Liquidity Coverage Ratio (%)	140.9	142.8	137.6	–
Asset quality	Non-performing loans (€ bn)	657.1	795.4	936.6	988.9
	NPL ratio (%)	4.4	5.4	6.6	7.5
	NPL coverage ratio (%)	46.4	44.7	43.9	–
Profitability	Return on equity (%)	6.9	7.1	5.1	5.4
	Cost-to-income (%)	65.9	62.7	64.2	60.5

Source: ECB. All data as at second quarter of each year, except loan-to-deposits in 2016, which refers to third quarter.

Table 1 shows the progress made in ensuring the resilience of significant institutions. Average capital ratios have reached comfortable levels after a steady increase since the creation of the SSM. Liquidity coverage has increased less, but remains on average substantially above the Basel minimum.

Another success is the SSM's progress in developing a common supervisory culture. The approaches of the NCAs have traditionally diverged in areas such as the emphasis attached to revising the governance of supervised institutions, the degree of intrusiveness in monitoring reported asset values and provisions, and the criteria used to validate internal models used to calculate risk weights. In all those areas, the SSM has conducted horizontal reviews and developed common specific supervisory criteria that will contribute to more consistent practice throughout the euro area.



A major challenge is the accumulation of large volumes of non-performing loans (NPLs) in several jurisdictions. The aggregate volume of NPLs was roughly EUR 1 trillion in 2015, or 7.5% of total loans. Since then, NPLs have been reduced by a third. Moreover, the provisioning of those NPLs has also improved, again helping to enhance the quality of reported asset values. Yet, the issue is still far from being resolved, as NPLs ratios remain close to or above 10% in five jurisdictions and above 25% in two of them.

The SSM has put in place an ambitious strategy for NPLs. In particular, its recent guidance (ECB (2017, 2018a)) calls for their disposal and adequate provisioning. On this latter issue, the approach has been to establish supervisory expectations on provisions depending on the availability of collateral for NPLs, and to take action under Pillar 2 in case of unjustified deviations from those expectations.

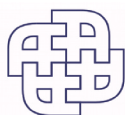
The ECB guidance is supplemented by a European Commission proposal to establish prudential backstops for insufficient provisions against NPLs. This would let supervisors deduct from regulatory capital any deviation of actual provisioning from a pre-established reference level. While this measure does not imply any direct accounting powers for supervisors, it does allow them to adjust solvency ratios if provisions are deemed to be inadequate. The prudential backstop approach, now considered in Europe, has already been used for some time in other jurisdictions (Restoy and Zamil (2017)).

Undoubtedly those measures would help to prevent the future build-up of insufficiently provisioned NPLs in banks' balance sheets. Yet, if prudential backstops are to provide the right incentives for adequate valuation and management of NPLs, supervisory examinations must result in a sufficiently granular analysis of assets classification and measurement practices, including collateral valuation, in line with the practice followed in the past by some but not all NCAs. Moreover, since the EC proposal provides that the prudential backstops will be binding only for newly originated loans, the ECB must still find an effective and pragmatic way to deal with the large stock of NPLs that continue to be held by financial institutions in several jurisdictions.

But the main structural weakness of European banks is their persistently low profitability. As seen in Table 1, return-on-equity (RoE) remains quite subdued, despite a recent mild improvement, lying significantly below most estimates of the cost of capital. As a result, most significant banks have only limited capacity to accumulate reserves to strengthen their solvency positions. In addition, they are likely to have difficulties in raising capital in the market as they cannot offer attractive returns to potential equity investors.

The sector's weak profitability can be partly explained by persistently low interest rates, stricter regulation and competition from technology companies in the provision of some services. But overcapacity is another factor that will need to be corrected before sustainable profitability can be restored.

Many indicators point to this excess capacity (see Table 2). For instance, the euro zone's banking sector is large, amounting to roughly 280% of GDP, compared with 91% in the United States. RoE has remained subdued since the global financial crisis (4.5% on average between 2013 and 2017), significantly below that in the United States (9.0%). In addition, efficiency indicators – such as cost-to-income ratios (around 69% in the euro area, and 60% in the United States) or branches per population (44 per



100,000 inhabitants in the euro area, and 26 in the United States) – are also consistent with the overcapacity hypothesis.²

TABLE 2. SOME COMPARATIVE INDICATORS OF THE US AND EURO ZONE BANKING SECTORS

	Euro area	United States
Size of banking system (% of GDP)	280%	91%
RoE (avg 2013–17)	4.5%	9.0%
Cost-to-income	69%	60%
Branches (per 100,000 inhabitants)	44	26
Publicly traded banks (% of total assets)	52%	78%

Sources: CGFS (2018), EBF (2018), *Banks around the World* (2018), *Badenhausen* (2018) and own calculations.

Traditionally, supervisors have promoted the safety and soundness of individual institutions while remaining neutral on the industry's structure. Yet, the argument could be made that, in some circumstances at least, financial stability could suffer negative effects from an excessively fragmented sector with a large number of small, inefficient and unprofitable institutions. In that situation, some action by the supervisor to facilitate an orderly consolidation may be warranted.

The SSM is paying increasing attention to the sustainability of business models in the new macroeconomic, technological, regulatory and competitive environment (ECB (2018c)). This analysis could be the basis of swift action by the supervisor to gradually promote a more efficient structure for the industry.

10.2.2. THE RESOLUTION FUNCTION

As with the SSM, the SRM is already fully functional. The Single Resolution Board has handled the resolution of only one institution (Banco Popular Español) although it has also been involved in the procedures leading to the winding up of three additional significant banks: Banca Popolare Vicenza, Banca Veneto and the Latvian banking group ABLV. In the latter three cases, the SSM declared those banks as *failing or likely to fail* but

² The data in this paragraph are from CGFS (2018), relating to 2016 and updated to 2017 wherever possible using official statistics.



the SRB considered that they did not meet the public interest criteria required for resolution. As a consequence, the three banks were liquidated according to domestic rules.

These episodes pointed to several possible flaws in the crisis management framework. In particular, the resolution of Popular showed that the current arrangements do not facilitate the funding of banks in resolution. Yet funding is essential if the critical functions of such institutions are to be preserved, and the aims of the resolution met. Current ECB counterparty and collateral policies cannot guarantee the provision of central bank liquidity for banks in resolution. Moreover, without a large backstop (see Section 3), the single resolution fund cannot provide meaningful liquidity support for any significant bank. Work is currently under way to consider the development of a possible Eurosystem resolution liquidity framework that could well mirror the approach adopted by the Bank of England, following the commitment by the Euro summit in June 2018 on this matter.

The SRB has also made progress in developing resolution planning. The target is to develop resolution plans for nearly all significant institutions by end-2018. The SRB is well on the way to meeting that objective. It seems, however, that some discrepancies exist among European authorities on whether the resolution plans already approved are sufficiently mature and, in particular, whether they have sufficient information on the nature and relevance of possible impediments to resolvability (European Parliament (2018)).

Within the resolution planning domain, a major task for the SRB is determining the minimum requirement for eligible liabilities (MREL), ie the volume of eligible instruments that can be converted into equity in the event of resolution. The SRB has already issued binding MREL targets for large banks and has specified, where required, transition periods to satisfy those obligations. The determination of binding targets for smaller institutions must be completed by 2020 (SRB (2018)). This may constitute an especially delicate exercise, given that many smaller institutions fund themselves mainly from deposits and have little experience in tapping the capital markets (see Section 4). The SRB will also need to specify bank-by-bank which proportion of MREL requirements should be covered with subordinated instruments. Finally, the MREL policy will need to be adjusted in view of the forthcoming modification of relevant legislation (BBRD II).

The banking union has already proven itself capable of performing the basic oversight and resolution functions, despite the remaining challenges. But this performance, satisfactory as it is, will not necessarily guarantee that the main aims of the banking union will be achieved; namely, the development of an integrated banking system and the elimination of the malign linkage between bank risk and the home jurisdiction's financial condition. The next two sections focus on these two topics.

10.3. THE INTEGRATION OF THE BANKING SECTOR

As explained in the introduction, an integrated market for banking services with truly pan-European institutions would not only promote more efficient banks while better serving consumers, but it would also act as a stabilising device for the euro area.



The predominantly domestic focus of European banks amplifies the link between national economic developments and financial stability in individual countries. Most banks in euro zone countries are overly exposed to adverse national economic developments that automatically trigger the deterioration of asset quality, put pressure on solvency and are ultimately liable to provoke a crisis of confidence that affects banks' ability to obtain funds in wholesale markets. In an extreme case, this may also result in deposit runs.

The potential stress in domestic and European markets is amplified by the constraints that national authorities face in managing critical situations with their own resources in the context of a currency union. Indeed, as we have seen in several recent episodes, this type of crisis is a major destabilising risk factor, to the point of materially threatening the monetary union's integrity. Increased cross-border diversification of banks' exposures would not eliminate the risk of a crisis, but it would reduce the exposure of domestic financial systems, and of the euro zone as a whole, to such country-specific shocks.

10.3.1. THE FACTS

In principle, by establishing a single supervisory jurisdiction in all euro area countries, common resolution rules, a mutualised contingency fund and a single administrative authority to deal with the failure of significant banks, the banking union could help eliminate institutional barriers to the cross-border integration of the banking industry.

Yet, the evidence shows that, at least so far, the existence of the SSM and the SRM have not had any marked impact on the banking industry's structure. For example, the share of cross-border loans to and deposits from non-banks in the euro zone remains low – around 8% and 6%, respectively – and has fallen slightly over the last few years (ECB (2018b)). In the same vein, the share of domestically owned banks in the national banking systems remains high, at 83%, roughly the same as in 2014, before the SSM's establishment (CGFS (2018)). Moreover, cross-border merger and acquisition activity among banks within Europe is very low and has not increased since the launch of the banking union project (Gonçalves Raposo and Wolf (2017)).

It seems, therefore, that more is needed to foster the sector's integration. Indeed, some observers and policymakers have pointed to several remaining obstacles that may obstruct further integration. Most have a regulatory character.

10.3.2. THE REGULATORY IMPEDIMENTS

The first set of obstacles is related to Europe's lack of a comprehensive single rule-book. As much EU banking legislation is still in the form of Directives, rather than Regulations, it needs to be transposed into domestic legal systems through parliamentary processes that often entail the addition of national specificities. More importantly, European banking law includes options and discretions for national authorities, again leading to different rules across countries (Nouy (2018) and Lautenschläger (2018)). This suggests that further legislative action at the European level, in the form of Regulations

that would remove remaining national particularities, may be needed to achieve full convergence of prudential rules.

The second group of impediments relates to the general regulatory treatment of internationally active banks. Typically, those institutions are subject to stringent capital requirements associated with the complexity and greater systemicity arising from their interconnectedness. Moreover, the international standards for the identification and prudential treatment of global systemically important banks (G-SIBs) do not recognise the euro zone as a single jurisdiction and thus treat cross-border operations within the zone as they do any other international exposure.

At the same time, regulation fails to fully acknowledge the potential prudential benefits associated with the geographical diversification of exposures.

The academic literature suggests that cross-border diversification significantly reduces the credit risk of financial institutions (Duijm and Schoemaker (2017)). Experience in European countries suffering a severe banking crisis, such as Italy and Spain, also illustrates how internationally active banks incorporated in those jurisdictions were better able to overcome the crisis than purely domestic institutions could, thereby contributing effectively to the containment of systemic stress.

However, the geographical diversification of exposures is not directly factored into the computation of risk-weighted assets for credit risk in accordance with Pillar 1 of the Basel standards. Nor is it usually considered a risk mitigation factor in evaluating the risk profile of institutions for which capital add-ons under Pillar 2 are determined. Moreover, stress-testing exercises tend to contemplate in their adverse scenarios parallel shocks to most relevant jurisdictions, and therefore to implicitly understate any additional resilience associated with geographically diversified credit or market exposures.

The third and last category of regulatory obstacles relates to the treatment in European banking legislation of cross-border groups. In particular, pan-European banks that control subsidiaries in different member states must, in principle, satisfy liquidity and capital requirements at the level of both the subsidiary and the consolidated balance sheet.³ Additionally, although the MREL that could absorb losses in resolution is calculated by the SRB on a consolidated basis, there is scope for national authorities to impose additional requirements for national subsidiaries.⁴

The imposition of requirements at the subsidiary level – which constitute different

³ Although waivers for liquidity at the subsidiary level are envisaged, the conditions required in terms of collateral and guarantees are overly restrictive. In principle, waivers for capital requirements are not foreseen in the European Commission's proposal for a review of the Capital Requirements Regulation.

⁴ It is envisaged, however, that BRRD II will introduce coordination arrangements and mediation procedures between the SRB and national resolution authorities in the jurisdictions where the bank has subsidiaries. It could also include quantitative restrictions for the MREL imposed to the subsidiaries. The latter could take the form of an obligation for the (internal) MREL imposed on the subsidiary not to exceed the contribution of that subsidiary to the external MREL requirements for the group.



forms of ring-fencing – in addition to those at the group level dampens the flexibility for institutions to allocate resources within the group, which in turn reduces the attractiveness of a possible cross-border expansion of European banks (Praet (2018)).

Yet those national requirements seem, at least to some extent, associated with the lack of formal obligations for the parent company to support subsidiaries in case of need. If there is a risk that the failure of a subsidiary could be systemic in the jurisdiction where it is located, some prudential safeguards at that local level may be warranted.

The case for those safeguards is naturally strengthened by the fact that, in the absence of a European deposit guarantee scheme, it would be up to the domestic banks, and ultimately domestic taxpayers, to cover the costs of the failure of a local subsidiary of a foreign bank.

One option could be to promote the conversion of subsidiaries into branches or to impose solidarity schemes across entities within the group (Andrès et al (2018)), thereby ensuring group support in case of need and minimising the burden for the deposit guarantee scheme in the host jurisdiction.

However, the way internationally active banking groups are organised is geared not only to the regulatory framework but also to their business model and risk management strategy. For instance, some groups have a legitimate reason for adopting legal forms that would give the parent company flexibility to decide whether or not to support a foreign subsidiary when the latter is under stress. That flexibility could be particularly valuable when the subsidiary is located in a country subject to potential macroeconomic or political shocks that lie outside the bank's control but might significantly affect the profitability of the operations in that country. Under those conditions, the introduction of explicit or implicit support obligations – even if accompanied by regulatory waivers at the subsidiary level – may in fact act as a disincentive for banks to operate in foreign jurisdictions.

As a consequence, in a context where economic integration remains insufficient and countries may be subject to severe idiosyncratic shocks, any material increase in the participation of banks in foreign markets may be more likely to take place through subsidiaries than through branches. Moreover, since financial stability remains largely a national policy objective and the risk mutualisation instruments of the banking union – in particular, EDIS and the backstop for the SRF – are not yet developed, that form of integration of the European banking industry will have to coexist with prudential safeguards in host jurisdictions. Arguably, this implies that the lack of economic integration promotes banking structures that are not optimal to facilitate financial integration.

10.3.3. THE LACK OF A GENERAL BUSINESS CASE FOR INTEGRATION

At any event, even if regulation may not provide sufficient support for the integration of the banking market – and some adjustments could be helpful in that regard – it may be the case that the main obstacle preventing faster and deeper integration is the genuine absence of significant profit opportunities for banks in other European jurisdictions.



If Europe is overbanked, as suggested in Section 2, the time should, in principle, be ripe for some consolidation of the industry. However, this is more likely to take place at the domestic rather than a cross-border level, as economies of scale may be more easily realised by the merger of banks already operating in the same area. In fact, the excess capacity in domestic banking sectors in the euro zone acts as a natural barrier to the entry of new (foreign) competitors.

Another obstacle to cross-border merger activity is the banking sector's structure. In the euro zone, there are many banks that operate under only limited market pressure. For example, only 30% of the significant banks in the euro zone (the ones directly supervised by the SSM) are publicly traded companies (Restoy (2016)). Those banks hold roughly half of the banking sector assets in the euro area, while in the United States stock market-listed banks represent almost 80% of the industry.

Most of the non-listed banks in the euro zone are savings banks, regional banks or mutual (cooperative) banks. A large portion of those banks do not typically follow standard profit-maximising objectives and cannot be taken over by ordinary commercial banks through ordinary M&A activity.⁵ In Germany for example, banks that are not organised as regular joint stock companies, such as savings banks (including Landesbanken) and cooperative banks, have an aggregate market quota for loans and deposits that lies between 50 and 60%.⁶ These two types of bank are the leaders in the retail banking businesses in all regions of the country.

Under those conditions, European banks typically see little scope for entering foreign retail markets where well established incumbents can sustain competitive pricing policies, thanks partly to the lack of pressure they face to deliver profits aligned with market return-on-capital expectations. Moreover, the legal character of such institutions often obstructs any potential acquisition by foreign institutions.

It is possible that, over time, technological innovations could facilitate the provision of cross-border banking services and enhance competition in the deposit and credit market as well as in the provision of payment and other ancillary services. Yet, at least in the short term, the incentives for traditional banks to expand their operations abroad are likely to be further eroded by uncertainty as to the scope and the nature of the disruption that new *fintech* and *bigtech* companies will bring.

As a consequence, while some transnational tie-ups could well take place, it seems quite unrealistic to expect rapid cross-border consolidation of Europe's banking industry. Any moves in this direction would probably need to be preceded by domestic consolidation to reduce overcapacity and help restore sustainable profitability. But even if that were achieved, any significant expansion of cross-border operations might still depend on a substantial reorganisation of the European industry with the aim of trimming the

⁵ A related issue is the relevance of political interference in the European banking industry as this may also imply constraints on profit maximisation. According to Véron (2017a), there is some political interference in at least 64% of all significant institutions in the euro zone.

⁶ See Behr and Schmidt (2015) and Deutsche Bundesbank (2018).



market presence of mutual and savings banks to levels more comparable with those seen in other jurisdictions.

10.4. THE DENATIONALISATION OF BANKS' RISK

Another yardstick against which the success of the banking union project could be assessed is the progress made in delinking the attractiveness of banks to depositors and investors from the economic conditions and, specifically, the budgetary situation of their home euro zone countries.

The accumulation of domestic public debt in banks' balance sheets could help to strengthen the link between public finances and banks' solvency. This obviously provides a rationale for considering restrictions or disincentives for the concentration of banks' exposures to their sovereign debt (Véron, 2017b), Mersch (2018)). This complex matter is outside the scope of this article. Yet, in the European financial crisis, the asset side of bank balance sheets was not the prime factor behind the linkage between the fiscal situation and bank risks. Indeed, except partially in Greece, bank stress in euro area countries since 2010 has not been caused by their sovereign exposures. The major source of distress that generated adverse feedback loops between sovereign and bank risk was rather the uncertainty whether already vulnerable treasuries could step in to protect the liabilities of banks facing difficulties.

Therefore, the denationalisation of banks' risk essentially requires that the value of banks' liabilities should depend predominantly on the intrinsic safety and soundness of the institutions themselves and not on the perceived likelihood of eventual support from the domestic treasury in case of need.

European leaders have made remarkable progress in establishing a robust framework to achieve that objective. The core element of the strategy followed has been to put in place a stringent resolution framework that severely restricts any form of public support for weak institutions, adopts ordinary liquidation as the default option for dealing with bank failures, and relies heavily on the contribution of creditors to absorb losses and restore solvency for banks performing critical functions. Moreover, although a common resolution fund contributed to by the industry is available for bank resolution, use of that fund is subject to restrictive minimum bail-in conditions.

This framework – contained in the Bank Recovery and Resolution Directive (BRRD) and the SRM Regulation – is fully consistent with the international standards for banks resolution – the Financial Stability Board's Key Attributes – and goes even beyond that standard by including additional elements that strengthen the bail-in requirements. Consequently, by minimising public sector involvement, this approach is conceptually aligned with the objective of reducing the link between the viability of domestic banks and the national fiscal position.

Yet, in order for the new European framework for banks' failures to be fully effective in achieving the desired goals, several further actions are needed. First, the framework would need to be complemented by the pending institutional components



of the banking union; second, a few relevant implementation challenges still need to be addressed; and finally, the perimeter of institutions subject to the common framework should be expanded to reduce the scope for potentially inconsistent national interventions.

10.4.1. THE COMPLETION OF THE BANKING UNION

The main pending issues of the banking union are the development of a common deposit guarantee scheme and a public backstop for the SRF.

It could be argued that the availability of a common European deposit guarantee fund has, in principle, limited practical relevance for systemic institutions, which are subject to the new single resolution framework. Indeed, given the “super” preference for insured deposits, the extensive bail-in requirements, supported by MREL, and the existence of the single resolution fund, it is unlikely that the crisis of a systemic bank would affect insured deposits. Yet one should not underestimate the strong symbolic nature of the deposit guarantee scheme as a major factor in deterring customers from running at the first signs of stress, and hence the need to keep those schemes as trustworthy as possible. Moreover, for less systemic institutions that are likely to be subject to regular insolvency procedures rather than to resolution, the burden for the deposit guarantee scheme may at times be significant, particularly if the crisis affects a number of banks simultaneously. Clearly, imposing that entire burden on the domestic banking industry alone, and ultimately on domestic treasuries, seems incompatible with the objectives of the banking union.

Similar arguments could be put forward to underline the importance of ensuring that the SRF has sufficient firepower to support resolution processes without compromising either financial stability or the credibility of the no-bailout principle. In particular, it is necessary to create the conditions for the SRF to borrow from a European body, in case of need. Although, as previously mentioned, access to the SRF is constrained by minimum bail-in requirements, it constitutes an essential backstop that helps to ensure the preservation of critical functions of failing systemic institutions while minimising the impact on domestic resources, eventually by using fully mutualised funds contributed by the European industry. The recent agreement by the Eurogroup (on 4 December 2018) on the terms of reference for a future common backstop for the SRF to be provided by the ESM is, therefore, a welcome development.

10.4.2. THE IMPLEMENTATION CHALLENGES OF THE NEW RESOLUTION FRAMEWORK

As important as completing the banking union by incorporating the missing elements is the need to ensure that the arrangements already in place function properly. In particular, the perception that the new resolution framework can and will be effectively



applied in all relevant crisis situations is key to ensuring that banks' clients and investors consistently value the liabilities of otherwise similar banks located in different jurisdictions.

In that regard, recent experience of the actual functioning of the SRM points to some challenges – in particular, with regard to the application of the bail-in rules for banks in resolution. This tool has not been used effectively in any bank failure since the creation of the SRM. It therefore remains somewhat uncertain whether and how the strict bail-in requirements would operate in practice. Since the EU framework has essentially precluded public support in resolution, resolving this uncertainty is key, as difficulties in applying bail-in may seriously jeopardise the ability of authorities to manage the bank crises that should be resolved under the new framework.

There is broad agreement that a necessary condition for effective use of bail-in is to require banks to issue a sufficient amount of securities that – through appropriate contractual or statutory mechanisms – can be smoothly converted into equity in the event of resolution. That is the rationale behind the total loss-absorbing capacity (TLAC) standard at the global level and of the MREL requirements in the European Union.

In the EU's case, MREL requirements need to be particularly stringent as, unlike in other jurisdictions, the law establishes minimum bail-in requirements (8% of total liabilities) as a condition for the use of external resources (from the SRF) in resolution. As a consequence, the SRB has established preliminary requirements for significant banks that normally lie between 24 and 26% of risk-weighted assets (Laboureix (2017)).

Large institutions have already shown they have sufficient capacity to issue eligible securities. Given their typical balance sheet structure, which includes significant amounts of capital market funding, those institutions would typically meet applicable requirements by replacing senior unsecured debt with subordinated instruments⁷ and accepting a normally moderate increase in their funding costs.

Similarly, bail-in, and the MREL to support it, are not relevant for small banks, which would typically be subject to liquidation under regular insolvency procedures rather than to resolution in the event of failure.

By contrast, meeting MREL requirements can be challenging for medium-sized institutions, as they are typically financed by capital and deposits and have little experience of tapping capital markets. As noted in Section 3 those institutions represent a sizeable proportion of the European banking sector. Given that a number of them are considered significant, they are subject to direct supervision by the ECB and fall within the jurisdiction of the SRB.

Restoy (2018) argues that MREL requirements may constitute a binding constraint on the sustainability of the business model of a large set of European institutions. Moreover, there is no scope to significantly reduce those requirements for banks subject to

⁷ How far this will be needed will depend on the subordination requirements to be established by the SRB on a case-by-case basis.



resolution if the minimum bail-in conditions – a cornerstone of the European framework – are not first relaxed. Considering that this is unlikely to be politically feasible, authorities may need to accommodate, one way or another, a reorganisation of the market segment of mid-sized institutions whose failure could be considered systemic but which are unable to meet stringent MREL obligations.

Meanwhile, European resolution authorities will continue to face periodically serious difficulties in managing bank crises where, due to insufficient MREL, the bail-in tool cannot be smoothly applied. In a recent case involving two significant banks, authorities chose to handle those failures through regular insolvency procedures – governed by domestic law – and to allow for public support in that context to avoid a major systemic impact. In the circumstances, this could be seen as a pragmatic solution that was likely to be superior to any feasible alternative. Yet this approach highlights some internal inconsistencies, as it entails making public funds more easily available under insolvency procedures, which should only be applied to non-systemic institutions, than under resolution, which is the route to be followed for institutions meeting a public interest threshold. As a minimum, the required use of domestic public resources to manage bank failures shows the limitations of the existing framework in meeting the declared objectives and the need to ensure consistency between resolution and insolvency procedures.

10.4.3. THE NEED FOR A COMMON INSOLVENCY REGIME

In Europe, a clear distinction is made between resolution and insolvency. The former, governed by European law and conducted in the banking union first and foremost by the SRB, refers to the arrangements aimed at avoiding systemic disruption by preserving the critical functions of failing institutions. The latter, governed by domestic law, is meant to deal with the liquidation of non-systemic institutions, and may be directed by the aim of preserving creditor value.

A recent study at the FSI (Baudino et al (2018)) shows that the distinction between a resolution and an insolvency regime is less clear-cut in other jurisdictions. For example, in Brazil, Mexico, Switzerland and the United States, the resolution authority is also the authority in charge of insolvency procedures.

The experience so far is that European banks, unless very small, have rarely been put into insolvency procedures. However, in future, the new regulatory framework that considers insolvency as a default option for failing banks, and restricts resolution to systemic institutions, may make the application of insolvency regimes more common. In that context, there is a logical interest in ensuring that insolvency regimes are an effective option for managing the failure of banks in an expeditious and orderly manner.

**TABLE 3. INSOLVENCY REGIMES AND PROCEEDINGS
COURT-BASED VS ADMINISTRATIVE PROCEEDINGS AND TYPE OF REGIME**

Jurisdiction	Type of regime	Administrative vs court-based proceedings
Europe		
France	Corporate insolvency law	Court-based
Germany	Corporate insolvency law	Court-based
Greece	Free-standing bank insolvency regime	Administrative
Ireland	Modified corporate insolvency law	Court-based
Italy	Free-standing bank insolvency regime	Administrative
Luxembourg	Free-standing bank insolvency regime	Court-based
Slovenia	Free-standing bank insolvency regime	Administrative
Spain	Corporate insolvency law	Court-based
United Kingdom	Modified corporate insolvency law	Court-based
Switzerland	Free-standing bank insolvency regime	Administrative
Rest of the world		
Brazil	Free-standing bank insolvency regime	Administrative
Canada	Free-standing bank insolvency regime	Court-based
Mexico	Free-standing bank insolvency regime	Administrative
Philippines	Free-standing bank insolvency regime	Administrative
United States	Free-standing bank insolvency regime	Administrative

Source: Baudino et al (2018).

Insolvency regimes vary markedly in Europe (see Table 3). In some jurisdictions (such as France, Germany and Spain), banks' insolvency is governed by ordinary bankruptcy law, while others have a specialised regime for financial institutions (for example, Greece, Ireland, Italy, Luxembourg and the United Kingdom). In the latter cases, the



liquidator can be an administrative authority (Greece, Italy) or appointed and supervised by a judicial court (Ireland, Luxembourg and the United Kingdom).

The divergences between insolvency regimes have already proven an obstacle for the swift crisis management of significant institutions in the euro zone. For example, while resolution can be applied to banks that are declared failing or likely to fail, provided a public interest condition is met, in some jurisdictions insolvency proceedings can be applied only to insolvent banks. That implies that there is no obvious framework for dealing in an orderly manner with banks that are non-viable but not yet insolvent for the purposes of an insolvency framework, and which do not meet the public interest criterion required for resolution.

Another example is the application of the “no creditor worse off” principle. Bail-in actions taken by the resolution authority should not involve higher losses for creditors than would have been realised if the banks had been liquidated under the applicable insolvency codes. Divergent insolvency rules could then, in practice, imply different bail-in approaches for failing significant banks depending on the jurisdictions in which they are located (König (2018)). The ultimate availability of public support in liquidation in some jurisdictions could also make it more difficult to apply a robust bail-in policy while satisfying the “no creditor worse off” principle.

The evidence suggests that specialised insolvency regimes are preferable to the application of general bankruptcy rules, insofar as they adapt the procedures to the singularities of banks and the role those institutions play in the economic system. Moreover, the allocation of responsibilities to an administrative rather than a judicial authority tends to facilitate the faster management of insolvency procedures with more specialised technical competence.

Yet a distinctive feature which makes some banks’ administrative regimes particularly effective is the availability of a sufficiently broad toolbox. A case in point is the US Federal Deposit Insurance Corporation (FDIC), which when liquidating banks can exercise powers that in other jurisdictions are available only in the event of resolution. In particular, the FDIC, which managed the failure of around 500 banks in the course of the global financial crisis (FDIC (2018)), has at its disposal tools such as the sale of businesses through different types of purchase and assumption transaction, with the option of using a bridge bank where necessary. Moreover, the FDIC has provided cash and loan loss guarantees to the acquirer of failing banks when this was deemed compatible with the least-cost principle for the deposit insurance fund.

Against that background, there is a strong case to consider the creation in Europe of a common administrative regime to deal with the crisis of financial institutions that are not subject to resolution. That regime should include common rules, perfectly compatible with the spirit of the resolution framework that would be applied by a single administrative authority. Following the example of other jurisdictions, the administrative authority could well be the SRB in order to ensure consistency of action in managing the crisis of different types of financial institution. Importantly, the administrative authority should be able to employ also for non-significant institutions some of the instruments currently envisaged in the BRRD for banks in resolution, if this is most likely to preserve value for



creditors – especially depositors – and minimise the impact on the (ultimately common) deposit guarantee scheme. The adoption of a fully fledged European insolvency regime may need Treaty changes. Yet, a reform of the BRRD and the SRM regulation to enlarge the powers and responsibilities of the SRB for non-significant institutions together with the harmonisation of some aspects of the national insolvency legislation may already represent a significant improvement.

10.5. CONCLUDING REMARKS

When analysing the state of the European project, most observers tend to focus on all remaining actions needed to strengthen and complete the most complex process of integration of sovereign countries ever known.

When it comes to the banking union, the current arrangements do indeed show a number of shortcomings. As argued above, much remains to be done to deliver a more integrated market for banking services and to dismantle the remaining linkage between domestic fiscal conditions and the perceived soundness of banks and their liabilities. Having introduced a single currency, Europe also needs to adopt new reforms to make currency-like instruments – including bank deposits – as location-independent as possible.

Those additional reforms range from further harmonisation of regulation to the creation of a common regime for dealing with crises affecting all types of bank. They include the development of the remaining institutional elements of the banking union project, an effective response to the implementation challenges of the new resolution framework, and the removal of structural obstacles to market integration.

Yet, it would be a mistake not to give sufficient credit to what has already been achieved. In particular, the euro zone now has fully functioning supervisory and resolution authorities that have already proven their worth – despite a still imperfect legal framework – in preventing or managing banking crises. Although the euro zone’s banking sector still has significant vulnerabilities, the new arrangements have helped to restore trust after the crisis. The challenge now is whether the timely adoption of the required improvements can be pursued with the same resolve that was seen, some years ago, when the banking union was launched to save the euro.

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11. COMPLETING BANKING UNION: ADVANCES IN RISK REDUCTION

JOSÉ RAMÓN DIEZ GUIJARRO

Head of Research at Bankia

Associate professor in Economics - IE Business School and CUNEF

11.1. SUMMARY

The European banking market has recovered its health and is increasing in strength ten years after the start of the crisis. Further, in the past two years, significant progress has been made to reduce the volume of distressed assets that still exist on banks' balance sheets, and interesting plans have been drawn up to create some type of risk-free asset for the EMU. These advances in risk reduction should smooth the path to completing banking union with the required mutualisation mechanisms.

11.2. INTRODUCTION

The health of the European banking market has recovered substantially ten years after the start of the Global Financial Crisis. The euro area has healthier institutions, more streamlined and efficient structures, more integrated markets and the capacity to fund growth. Its strength was measured in the traditional stress tests conducted by the European Banking Authority in 2018, revealing adequate base levels of solvency and reasonable adjustments in the adverse scenario. This achievement is the result of the far-reaching restructuring of the systems most affected by the crisis and the creation of a new regulatory and supervisory framework, the Banking Union.



However, the recovery process is not yet complete. There are still areas of weakness that could reverse the advances made. The first of these is the 700,000 million euros of non-performing loans that remain on the balance sheets of European banks. The second is the link that still persists between sovereign risk and banking risk due to the weight of government debt on banks' balance sheets, a phenomenon that once again reared its head during the episode of turbulence seen in Italy in 2018. Furthermore, Banking Union is incomplete and the advances made toward achieving this goal would appear to have stalled as a result of the difficulties reconciling the demand of some members that banks should first be free of the effects of the crisis, and that of other members that want the risk sharing process to start as soon as possible. However, this divergence should be gradually start to disappear given the progress made in the past two years to reduce distressed assets and the new and increasingly compelling plans to create some type of risk-free asset for the Economic and Monetary Union (EMU). The Gordian knot of how to reduce risks while at the same time mutualising them is now becoming an issue of political willingness to continue the European construction process.

In this article, we first look at the current status of the European banking market, followed by an in-depth analysis of the progress made in reducing non-performing loans and management of sovereign exposures, and finish off with a brief conclusion.

11.3. CURRENT STATUS OF THE EUROPEAN BANKING MARKET

The key indicators of the strength of banking institutions have not only recovered after the crisis, but now surpass pre-crisis levels in terms of both quality and quantity. This is the result of the restructuring processes brought about in the systems most affected by the turmoil, global regulatory reform (particularly Banking Union) and, in the last few years, the growth dynamic.

The total capital ratios of EU banks have increased significantly over the last ten years, marking an average of 18.75% in the second quarter of 2018, compared to just under 13% in 2009, according to data released by the European Banking Authority¹ (EBA). This increase of nearly seven percentage point is partly a reflection of the efforts made by the sector to generate and attract more equity, mainly in the form of high quality capital, in addition to reducing risk exposures on the balance sheet by disposing of distressed assets, simplifying business lines and withdrawing from non-core activities in a context of global deleveraging. In terms of ordinary tier 1 capital or CET1, the average EU ratio stood at 14.50% in mid 2018, its highest level since 2014, the first year of application of Basel III under the CRR/CRD IV directive (see chart 1). Capital will continue to increase over the next few years to comply with the remaining development objectives under the Basel III global capital framework, estimated by the EBA for a representative sample of banks at an additional 24,500 million euros² based on data at year-end 2017. This amount

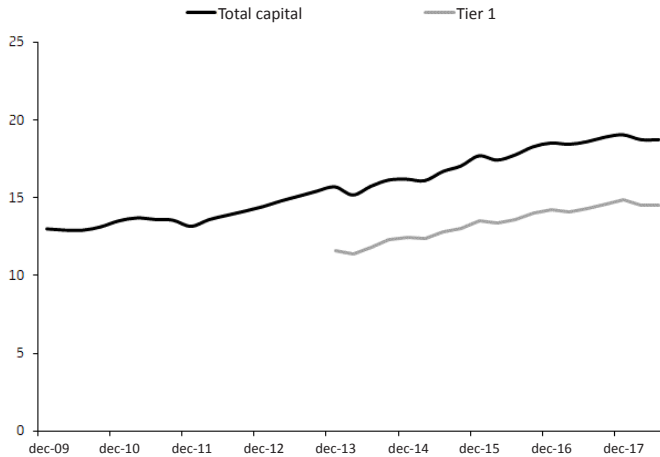
¹ European Banking Authority. (2018). *Risk Dashboard*.

² European Banking Authority. (2018). *Basel III Monitoring Exercise*, September.



will be concentrated mainly in large systemic banks and in the form of additional Tier 1 and 2 capital.

CHART 1. CAPITAL RATIOS OF EU BANKS (PERCENTAGE)



Source: Bankia Research based on the EBA risk dashboard.

Liquidity has also ceased to be a concern for institutions, for the time being at least. The non-conventional monetary policy measures adopted by the European Central Bank (ECB) have clearly contributed enormously to this, generating close to 1.9 billion of excess liquidity in October 2018, but there have also been significant changes in institutions' liquidity management arising mostly from the new regulatory requirements in that area. In the short term, European institutions have more liquid assets to handle stress situations, while complying comfortably with the liquidity coverage ratio, which stood at an average of 148% in June 2018 (much higher than the required 100%). Further, the funding models of European banks have evolved toward more stable and sustainable structures, where retail financing based on household and company deposits has gained ground and now accounts for over half of all funding.³ The greater alignment between asset and liability maturities means that the percentage of loan vs deposits for households and companies, which stood at over 145% before the crisis, normalised at around 105% in mid 2018. This is much more balanced and in line with the new regulatory requirements for long-term liquidity (the net stable funding ratio, NSFR), which will be applied from 2018.

The improvements in the funding mix will be even more relevant in the next few years, when liquidity will probably be more stressed than it is now, due to a combination of the gradual withdrawal of monetary stimuli (long-term funding transactions or

³ European Banking Authority. (2018). *Report of funding plans*, September.



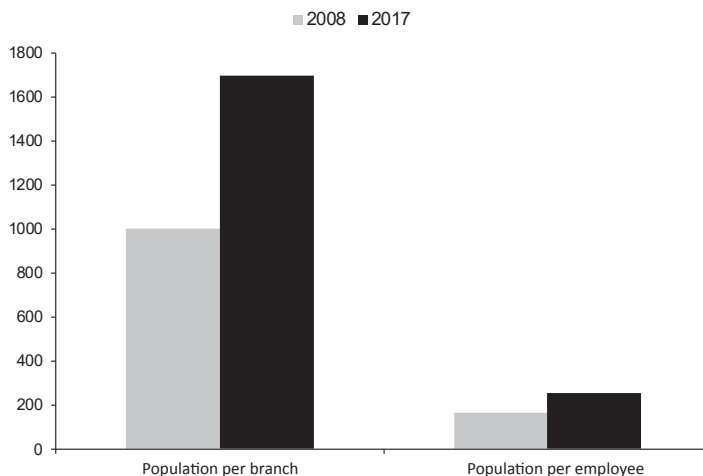
TLTRO in the EMU and TFS in the UK), increased activity and a growing need for issuances to meet loss-absorption criteria (international TLAC and MREL in Europe). Nonetheless, an extension of the TLTRO programme cannot be ruled out, with different conditions and adapted to reflect the new monetary policy situation.

From a structural standpoint, the transformation of the banking markets after the crisis has been far-reaching, and has altered the dynamics of competition. The number of competitors in Europe has reduced significantly as a result of bankruptcies, disposals of non-core business and mergers and acquisitions, with one quarter of the entities existing in 2008 disappearing. This process has been accompanied by an overall capacity adjustment to correct the oversizing built up in the years prior to crisis in all affected areas, while at the same time the sector has embarked on a broader transformation that is propelling it toward the new paradigm of digital technology.

In Spain, there have been largescale changes in market structure. Today there are only 11 relevant institutions, compared to 53 operating on the market in 2008; 80% less. This reduction in competitors has led to an unprecedented increase in concentration, which has given the five largest entities a domestic market share of more than 70%, compared to 42% in 2008, bringing the sector into line with other European banking systems such as Finland, Belgium or the Netherlands, which have traditionally had more concentrated markets. At the same time, installed capacity and staffing levels have been severely scaled back, reducing the number of branches by 40% between 2008 and 2017 and the number of employees by one third, one of the largest adjustments in the euro area in absolute terms, and putting the capacity of the banking system at similar levels to the early 1980s. As a result, in a sector that comprises fewer entities, which are of a larger scale and less intensive in physical resources, significant gains in productivity and efficiency have been achieved (see chart 2). This means that each branch and each employee today provides service to 70% and 50% more of the population than in 2008, although there is still considerable scope for improvement, as these levels are still low in comparison with the rest of the EMU.



**CHART 2. POPULATION PER BRANCH AND EMPLOYEE IN SPAIN
(NUMBER OF PEOPLE)**

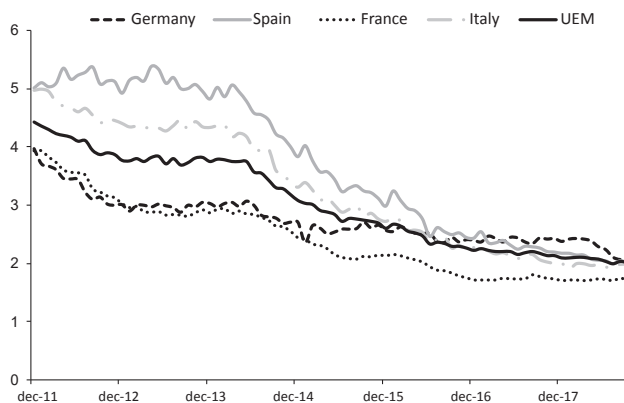


Source: Bankia Research based on ECB EU structural financial indicators and INE data.

Further, the fragmentation of the EMU banking markets, which at the height of the crisis even threatened the integrity of the single currency, has also apparently been resolved, at least in terms of prices.

The implementation of Banking Union in the area of supervisory and resolution mechanisms, together with the very favourable financial conditions provided under the ECB monetary policy, have led to a re-convergence of bank interest rates in the euro area. In Spain, specifically in April 2013, the interest rate payable by a Spanish SME in a new transaction for an amount less than one million euros was 5.39% compared to 2.97% payable in Germany; 2.4 points more expensive. However, in 2018, this difference was slightly favourable to the Spanish SME, with a low rate of around 2% in September (see chart 3). In habitual lending transactions with large companies (for amounts over one million euros), the dispersion range for rates in the main countries (Austria, Belgium, Germany, Spain, France, Ireland, Italy, the Netherlands and Portugal) has moved from four percentage points in early 2012 to less than one point in September 2018, with a rate of 1.51% in Spain. Bank deposit rates have also converged to close to zero, in a context of negative benchmark rates which entities have been reluctant to pass on to household savings, although in some countries, such as the Netherlands, Belgium or Germany, they have been applied in the corporate segment.

CHART 3. INTEREST RATES ON NEW LOANS TO COMPANIES (LESS THAN ONE MILLION EUROS) (PERCENTAGE)



Source: Bankia Research based on ECB data.

However, the convergence in prices has not been accompanied by greater integration in terms of quantity. Indicators of cross-border retail activity in the EMU continue to reflect a significant home bias, with local business accounting for more than 90% of total loans to companies and 98% of household financing.⁴ The geographical breakdown of deposits paints a similar picture, corroborating the view that the integration of the European banking market is far from complete.

Activity has performed well over the past few years, reflecting the stronger position of the banking markets and a more robust financial and economic context. Loans to households and companies have increased in the euro area from mid 2015, with balances climbing an average of 2.4% in 2018 year-on-year, returning to levels seen in 2011. However, for those economies most exposed to the crisis the recovery has not been reflected in total volumes, which have continued to fall, dragged down by the lengthy but necessary deleveraging process, but by the surge in new transactions. In Spain, for example, the flow of new household loans has been increasing almost continuously since 2014, with a total cumulative variation of 21% in consumer loans and 14% in mortgage loans at September 2018. For loans to companies of less than one million euros, typically extended as funding for SMEs, the cumulative increase in new loans to September was 6% year-on-year.

In short, the current status of the Euro banking market is favourable. The euro area has healthier institutions, more streamlined and efficient structures, more integration and the capacity to fund growth. Its strength was measured in the EBA's traditional stress carried out in 2018. The results published in November showed that the 48 EU institutions taking part in the exercise, representing 70% of banking assets, had starting

⁴ European Central Bank. (2018). *Financial Integration in Europe*, May.



solvency levels that were higher than in the previous tests carried out in 2016; CET1 of 14.2% excluding temporary measures (CET1 fully loaded), which boils down to a very satisfactory 10.1% stripping out the 4.2 percentage points impact under the severely adverse scenario. The test also reveals that the losses deriving from credit risk (67% of aggregate losses) are still the leading indicator of capital vulnerability.

Furthermore, despite the improved status of the sector, there are still areas of weakness that could reverse the advances achieved if they are not addressed in time and in full.

The first of these is the 700,000 million euros of non-performing loans that remain on the balance sheets of European banks (3.6% of loans to June), of which almost one quarter are located in Italy. This legacy of the crisis is a heavy burden for institutions to bear. The most immediate consequence is the drop in profitability, evidenced by the decrease in interest income, and particularly, the increase in impairment losses on assets on the lower half of the balance sheet. It also consumes economic and human resources that could be put to more productive use, and above all, sustains a climate of ongoing mistrust in the robustness of the banking system.

Another salient point is the enduring link between sovereign risk and banking risk caused by the weight of government debt on banks' balance sheets (Veron, 2017). The impact of this link is a high correlation between banking and sovereign tensions in the event of internal shocks, as observed during the crisis in some peripheral economies. The phenomenon once again reared its head during the episode that took place in Italy in 2018, when the surge in the risk premium, which reached over 300 basis points, was accompanied by a sharp correction in the European stock markets, particularly the Italian markets (Avalos and Xia, 2018), anticipating the direct *mark-to-market* impact of bond portfolios on earnings and capital. Inevitably, the link between bank and sovereign risk remains intact after the crisis, and this could have a negative impact on the financial system when investors lose confidence in the sustainability of a country's debt. The situation is made worse by the lack of pan-European mechanisms that sufficiently ensure the financial stability of member states, given that the third pillar of banking union has yet to be implemented; namely the European deposit insurance scheme (EDIS), which is still at the political discussion phase and little progress has been made. Against this backdrop, domestic shocks could trigger negative banking and sovereign risk spirals, as occurred in the past, in a context, however, in which monetary policy has a more limited scope after three years of negative interest rates.

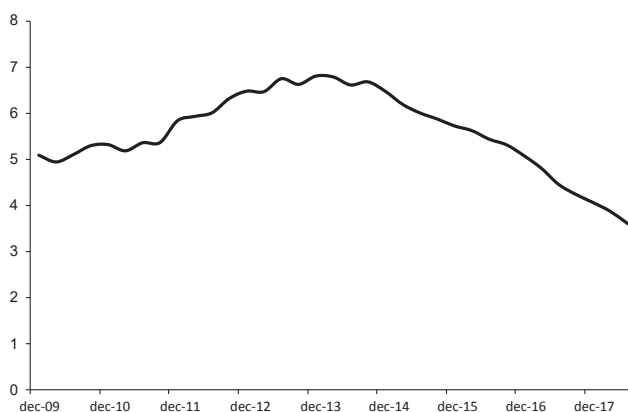
Rectifying these weaknesses and reducing underlying balance sheet risks has become a priority for European institutions and authorities alike. The volume of distressed assets has been reduced significantly thanks to the active management of entities and specific regulatory and supervisory developments. Discussions with regard to the sovereign link are still at a preliminary stage, but interesting proposals have been opened to debate.

11.4. REDUCING NON-PERFORMING LOANS

The management of non-performing loans has kept European financial institutions and authorities both occupied and preoccupied and two main action lines have been pursued: to reduce the inherited stock and improve risk management for the future.

In the EU, the problem of non-performing assets became unsustainable when in September 2014 volumes reached 1.13 billion euros, accounting for 6.7% of total EU lending at that date. Since then, the stock has decreased by more than one third, to 700,000 million euros at June 2018, accounting for 3.6% of the current lending portfolio (see chart 4), with this figure falling to 2% if coverage with special provisions is included, accounting for 46%. Despite the progress made, the ratio is still high in historic terms, underscoring the general opinion that in terms of financial restructuring EU banks are falling behind other systems that were affected by the crisis, such as the United States, where NPLs have now normalised, standing at around 1% at September 2018.⁵

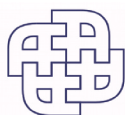
**CHART 4. EU NON-PERFORMING LOAN RATIO
(PERCENTAGE)**



Source: Bankia Research based on EBA data.

If this opinion is extrapolated to a comparison between EU countries, very different credit quality profiles can be observed, indicating the unevenness of the positions of economies in the process of restructuring. Some countries are still a cause for concern, with NPLs accounting for more than 30% of loans, such as Greece and Cyprus (45% and 34% respectively, in June 2018), while for others (Portugal and Italy) the ratio remains at around the two digit mark. Spain, with a ratio of 4.2% at consolidated level, is close to the European average, although based on domestic data alone this position changes. At the other end of the scale, Luxembourg, Finland and Germany all have a ratio of around

⁵ United States Federal Deposit Insurance Corporation (3Q18).



1%–2%. The breakdown by entity is similar, in terms of assets, with 40% of banks reporting NPL ratios of over 3% in 2018 (6% had ratios higher 8%). This is a long way off the 66% seen in 2014, but it is still considered to be high.

These figures suggest that there is still a fair way to go to reduce risks in some EU markets, although this is no impediment to assessing the efforts made to date, which have been enormous and have intensified over the past two years in the countries hardest hit by this problem. In these countries, institutions have taken advantage of the favourable moment in the cycle to make a decisive effort to clean up their balance sheets. The results have been reflected in the year-on-year variations seen since June, with very significant decreases in the NPL ratio achieved in Cyprus (–8.6 percentage points), Portugal and Ireland (–5 pp), Italy (–2.5 pp) and Spain (–2 pp with individual data). This means that the management of these portfolios has been intensive since the summer of 2017, aided by a benign economic scenario, which in the past few months has been losing some degree of strength.

To gain an overview of the financial restructuring process carried out in addition to the NPL management, we should also consider the measures implemented to address other deficient portfolios such as refinancings and asset foreclosures, which in some countries took on enormous importance during the crisis. The weighting of refinancing transactions (NPLs or other) on the lending portfolio of European banks at consolidated level has diminished from an average of 4% in December 2014 (close to 700,000 million euros) to the current figure of 2.3% (some 470,000 million euros at June 2018). This implies more than 200,000 million less in loans refinanced on the lending portfolio, and where the largest falls were recorded in the countries which saw the largest NPL adjustments (in Ireland the refinancing ratio dropped by 9 percentage points in the same period to 7%, in Spain, it fell by 5.4 pp to 4.6% and in Portugal by 2 pp to 9%).

Within the EU, Spain compares favourably in the restructuring process. At the height of the turmoil, the Spanish domestic banking sector held almost 200,000 million euros of non-performing loans on its balance sheet, 80,000 million in foreclosed assets (gross carrying amount) and refinancings totalling more than 180,000 million euros. Four and a half years down the line, the volume of NPLs has been cut by more than half, to just over 70,000 million euros (–65%), with foreclosures of just 62,000 million (–20%) and refinanced loans totalling less than 80,000 million euros (–56%). Overall, Spanish banks have cleansed their balance sheets of close to 250,000 million euros of non-productive assets from the end of 2013, an amount equivalent to 20% of GDP for that year. To achieve this, measures such as the management of refinancing transactions, the proactive sale of portfolios, which picked up throughout 2018 and, fundamentally, the existence of a favourable environment for economic growth and employment, to which the ECB's monetary policy contributed greatly, were all decisive.

In absolute terms, the correction is significant and the trend over time, for non-performing loans, tracks the performance of previous cycles. However, it was based on a maximum volume that was ten times higher than the volume seen in the crisis in the 1990s and a lending volume that was seven times larger. Specifically, the reduction in the stock of non-performing loans fifty eight months after the NPL ratio peaked (in the



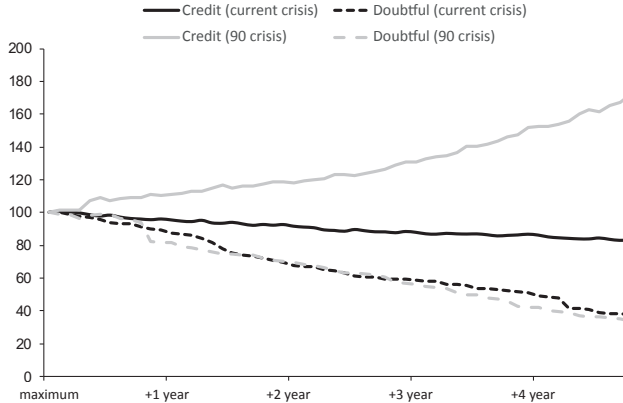
resident private sector), was 63%, similar to the correction seen in the 1990s, when it fell by around 66% in the same period, after peaking in early 1994.

However, in regard to the NPL ratio, this effort is less visible as the ratio decreases at a relatively moderate pace. The differential factor is the “denominator effect”, i.e. the performance of the credit activity affected still by the general deleveraging of the economy. The volume of loans to the resident private sector in Spain by deposit entities has been falling year-on-year since 2009, with a 36% reduction from the high seen at year-end 2008 (some 650,000 million euros less). This decline could still be observed at September 2018, with a fall of 3%, and positive figures are not expected until well into 2019. The denominator effect partly offsets the sharp adjustment of non-performing loans in the numerator (see chart 5) and puts the NPL ratio for the resident private sector at 6.2% in September that year, 7.4 pp less than the figure of 13.6% seen in 2013. In other words, one of the distinguishing features of economic recovery in Spain is that at no time did the credit stock recover, which is unprecedented and has negatively impacted the restructuring process conducted by financial entities. According to Banco de España estimates,⁶ if there is no active management of portfolio sales, the NPL ratio will remain high at year-end 2020 (close to 4%).

The improved asset quality in Spain is more visible in terms of P&L. At domestic level, impairment losses as a percentage of total average assets fell to 0.44% at the close of 2017 (excluding the resolution of one entity) from a high of 3.5% in 2012, but still above the pre-crisis average of 0.28%. The lower provisions are a sign of the improved quality of new loans and consistent with the adjustment in lending standards that took place during the crisis, as reflected in the surveys on bank loans which show a hardening of criteria in virtually all segments between the beginning of the crisis and 2013, and which started to ease off somewhat as recovery progressed. Similar conclusions can be reached with regard to operating income. Impairment losses, which absorbed 356% of the operating margin in 2012 at domestic level, accounted for 35% at year-end 2017 (excluding the resolution of one entity), falling to around 20% by June 2018.

⁶ Banco de España. (2017). *Annual report*

**CHART 5. COMPONENTS OF THE NPL RATIO FOR LOANS TO THE PRIVATE SECTOR IN SPAIN
(BASE 100 DEC-13 CURRENT CRISIS AND FEB-94 CRISIS 90S)**



Loans to the resident private sector extended by deposit institutions.

Source: Bankia Research based on Banco de España data.

The pressure exerted by distressed assets has decreased in terms of capital. The ratio of the volume of non-performing loans to the resident private sector, net of specific provisions, to equity stands at 19.7% compared to over 40% between 2012 and 2014, which suggests a more manageable pressure, even without factoring in the collateral used to secure part of the portfolios.

Indicators reveal that Spanish entities have made a huge effort to redirect the legacy of distressed assets deriving from the crisis. Volumes have fallen significantly, in line with previous cycles, write-downs have been extended to portfolios showing signs of weakness, the cost of risk is normalising, leading to tangible improvements on the P&L and relieving pressure on capital. This improvement is being reflected in the NPL ratio, although it is still impacted by the decline in lending and will probably not enter positive ground until later next year.

The outlook for the coming years is favourable. The Spanish economic cycle will contribute to further advances in GDP and a lower in the jobless rate; variables that are correlated with the NPL ratio. Further, sectors such as construction or real estate development, which are still reporting NPL rates of over 10%, are recovering fast with year-on-year NPL rates correcting by around 50% last June, partly due to the portfolio sales (which will continue in the coming months if entities are true to their word and market conditions remain favourable). The dispersion between banks is also decreasing, indicating not only a fall in the average ratio, but also that the entities with the highest exposure to distressed assets are those making a relatively greater effort.

It is also important to note that from an institutional standpoint, a global action framework has been implemented in Europe with the priority of reducing existing levels of non-performing loans and improving the way these loans are managed in the future.

The milestone of this programme was the global Action Plan defined by the ECOFIN Council in July 2017.⁷ This plan addresses the problem of non-performing assets from origination and across a very broad area (see chart 6), combining domestic and Europe-wide measures, marking the priority lines of work, indicating the institutions responsible and setting timelines.

CHART 6. PACKAGE OF MEASURES DRAWN UP BY THE COMMISSION TO REDUCE NON-PERFORMING LOANS

Deal with possible shortfalls in provisions through automatic, time-linked provisions	Increase protection for secured creditors	Develop secondary markets for non-performing loans	Develop an SGA project
Interpretation of article 16 of the SSM regulation and article 104 of the DRCIV	Comparative assessment of the national insolvency and loan enforcement frameworks	Greater attention to insolvency issues in the European semester	Strengthen data infrastructures for non-performing loans
Increase guidance on non-performing loans extended by the SSM to small banks	Adopt guidance on the management of non-performing exposures at EU level	New directives on the concession, supervision and internal governance of bank loans	Stricter disclosure requirements on the quality of assets and non-performing loans for all banks
	Improve the detailed information on loans required from banks	Draw up macroprudential plans to prevent the build up of non-performing loans in the future	

Source: European Commission. (2018). *Second progress report on the reduction of non-performing loans in Europe*, March.

As indicated in the second progress report on the reduction of non-performing loans in Europe, dated March 2018,⁸ first of all, banks should have sufficient provisions in place to cover any new NPLs, thereby creating appropriate incentives to work out NPLs at an early stage to prevent any excessive future build up. This process would be supported by more efficient enforcement mechanisms for secured loans. If despite these measures, NPL stocks become too high, banks will be able to sell NPLs to other operators on efficient, competitive and transparent secondary markets. Lastly, where NPLs have become a significant and broad-based problem, Member States that so wish may set up national AMC's or other measures under current state aid and bank resolution rules.

In line with this plan, actions have been designed in four areas: supervision, reforms of national restructuring, insolvency and debt recovery frameworks, developing second-

⁷ ECOFIN Council. (2017). *Action plan to tackle non-performing loans in Europe*, July.

⁸ European Commission. (2018). *Second progress report on the reduction of non-performing loans in Europe*, COM, March.



ary markets for distressed assets, along with guidelines for creating asset management companies, and fostering, as appropriate and necessary, restructuring of banks.

In the area of supervision, in 2017 the ECB published guidance⁹ for significant entities in the Single Supervisory Mechanism on how to manage non-performing loans and refinancing. In this document, the supervisory authorities require banks with high levels of non-performing loans to define strategies to reduce their NPLs over realistic but sufficiently ambitious time-bound horizons, focusing on the governance structure and operating framework to manage the process. In March 2018, an addendum to¹⁰ this guidance was published, establishing the quantitative supervisory expectations for the provisioning of new non-performing exposures. Entities' results in this area are factored into the supervisory review and evaluation process (SREP), under Pillar 2, and may give rise to specific requirements if their performance is not satisfactory. According to ECB expectations, the unsecured parts of new non-performing exposures must be 100% allocated after two years and the secured parts after seven. These expectations will be specific for each entity and in accordance with its NPL ratio and main financial characteristics, on a equal footing among comparable banks. In July 2018, the ECB announced new expectations on bank-specific provisioning for the stock of NPLs not only the flow of new NPLs, to achieve the same level of coverage of NPL stock and flow over the medium term.

Along these lines, in October 2018, the EBA published guidance similar to that of the ECB, applicable to over six thousand entities operating in the EU, and in March 2018 the Commission put forward a supplementary legislative proposal aimed at introducing a provisioning calendar for future NPLs through amendments to the Capital Requirements Regulation (in Pillar 1).¹¹ These initiatives are very important because they affect entities that are not directly supervised by the ECB (less significant institutions, or LSIs), which in some countries account for a substantial portion of the financial system.

With regard to recovery of debt, the draft Directive on credit servicers, credit purchasers and the recovery of collateral,¹² presented by the Commission in March 2018, considers the introduction of a clause for the accelerated extrajudicial enforcement of security interests. This would be a common model for the rapid and efficient accelerated extrajudicial enforcement of security interests, which would allow the parties extending secured loans to recover the value of the collateral contributed by companies or entrepreneurs only. This procedure could be used if previously agreed by the lender and borrower in the loan agreement and would not be applicable to consumer loans. It would also be subordinate to restructuring and insolvency procedures and would not modify the ranking of creditors. Due to the technical complexities involved, work on harmonising NPL regulations at European level is at a preliminary stage.

⁹ European Central Bank. (2017). *Guidance on non-performing loans for credit institutions*, March.

¹⁰ European Central Bank. (2018). *Addendum to the ECB guidance to banks on NPL*, July.

¹¹ European Commission. (2018). *Proposal for a regulation on amending the CRR as regards minimum loss coverage for NPEs*.

¹² European Commission. (2018). *Draft Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral*, March.



There are also many impediments to the development of a Europe-wide secondary market for distressed assets. Firstly, the problems of asymmetric information, as described by Akerloff's "lemons" concept (Akerloff, 1970), are particularly relevant for this type of transaction, leading purchasers to significantly reduce prices to protect themselves from worst information on the quality of the portfolios with discounts at which entities are not prepared to sell. Additionally, the aforementioned inefficiencies in regard to the repayment of debt and the enforceability of collateral mean that the legal procedures for the recovery of debt are still inconsistent within the European Union, being long and costly in some countries, which makes the final amount of the recovery uncertain. Further, there have traditionally been entry barriers for non-banking entities (*servicers*).

To boost these markets, the Commission has included in the above-mentioned draft proposal measures to remove obstacles that prevent the administration of loans by third parties and the transfer of such loans, eliminating impediments to the transfer of loans by banks to non-banking entities so that the latter may take ownership of the loans and manage them, thereby safeguarding consumer rights. Common rules have also been defined to simplify and harmonise the authorisation requirements for this type of company, so that the transparency of the process is ensured and they may operate as cross-border companies throughout the European Union, which would increase the market investment base, their competitiveness and improve the price setting mechanism.

In a supplementary move, the Commission, along with the European Banking Authority and the ECB, is exploring the possibility of creating trading platforms or clearing houses for non-performing assets. This type of support could increase the transparency of transactions with non-performing loans, reduce transaction costs, broaden the investor base and diminish the problems of coordinating between creditors when assets belonging to the same debtor are being traded (Fell *et al.* 2017). These platforms could play a key role in boosting securitisation activity in this type of market, which would make disinvestment easier. This would be especially important for domestic asset management firms or "bad banks".

The Commission has released guidance on how to create bad banks.¹³ Properly designed domestic asset management companies can be very efficient in reducing the burden of distressed assets, segregating them from banks' balance sheets and allowing them to be managed separately to maximise the recovery of their value. The guidance includes the best practices based on recent experiences (such as Sareb in Spain, or Nama in Ireland) in areas such as types of eligible assets, scope of participation, asset valuation, capital structure, financing, governance, etc., which serve as a reference for countries and entities that wish to build their own bad banks, now that the creation of a Europe-wide company has been ruled out.

In short, the resolve of the entities involved, coupled with ongoing regulatory actions and incentives for the sale of distressed assets, is allowing the non-performing loan problem to be addressed more rigorously than before. Work is also ongoing in countries

¹³ European Commission. (2018) *AMC Blueprint. Commission staff working document*, March.



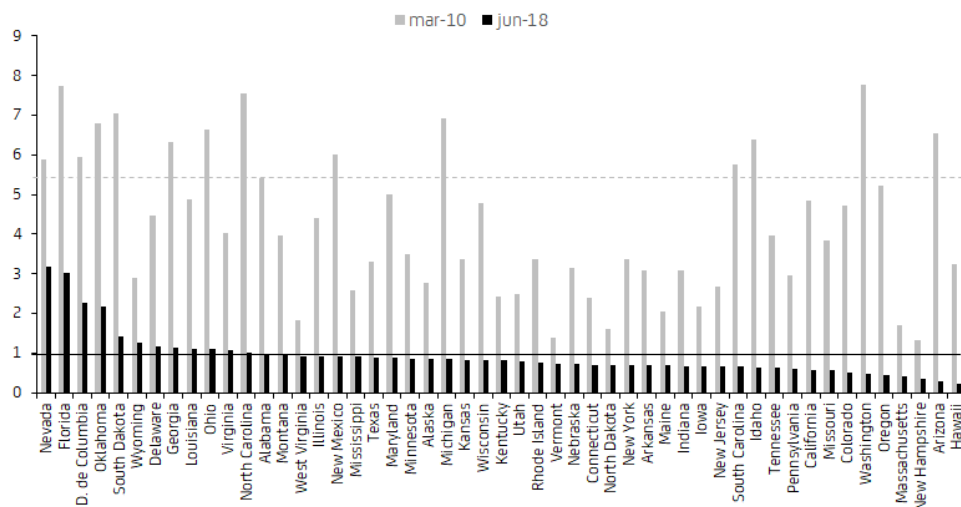
such as Greece, where the Bank of Greece (Pantelias, 2018) has announced a proposal to set up a bad bank, similar to the Sareb in Spain, to which Greek banks would be able to transfer half of the non-performing assets in the sector, which still account for more than 40% of the lending portfolio. The Greek central bank estimates that this would allow the country's NPL ratio to reach single digits in two to three years under certain conditions, although it would have an average cost of around 300 basis points in terms of capital (CET 1 fully loaded at 9.8% from 12.8% in the second quarter of 2018). The restructuring process is therefore not exempt from risk and it would be reasonable to expect it to be carefully modulated according to the circumstances of each country, the specific characteristics of each entity and on a medium-term time horizon. The objective is to maximise the correction of risk assets during this cycle but above all to create a legislative and action framework to address the problem much more efficiently in the future.

The effort to reduce risks is expected to come close to meeting this target, but it will not be complete if a broader integration of the markets (and hence economies) is not achieved, which will necessarily involve some degree of risk sharing. The aim is to improve intra-European integration, increase the possibility of diversification, and raise confidence in the entities' capacity to resolve problems whenever they arise, leading to increased financial stability and lower risks. The two targets are not substitutes for one another, but mutually strengthening.

The United States is an example of how integration can help to absorb asymmetric shocks. The US states were affected by the crisis to a different extent, depending on their exposure to the housing sector and other vulnerable sectors, so that in March 2010, when the national NPL ratio was at a high of 5.47%, the NPL ratio of each state varied, ranging from a high of 7% in Washington, Florida, North Carolina and South Dakota to a low of 2% in five states. Since then, there has been a significant decrease in the ratios and their dispersion, with an overall trend toward convergence, with a few exceptions.

To restore the quality of banks' balance sheets a variety of very different factors came into play, which contributed to the absorption of local shocks (Mikolov, 2016). These included labour mobility, fiscal redistribution, high asset diversification through well-integrated capital markets, and also the existence of traditional risk sharing mechanisms, such as the FDIC (Federal deposit guarantee fund) in the banking sector, which enabled the resolution of more than 500 entities with minimal consequences for the sector and the economy. Major synergies can clearly be found between risk reduction strategies and the existence of public and private risk sharing mechanisms.

**CHART 7. US NON-PERFORMING LOAN RATIO
(PERCENTAGE)**



Credit default. The horizontal lines correspond to the national average for the periods considered.

Source: Bankia Research based on FDIC data.

11.5. SOVEREIGN EXPOSURE

The debate on sovereign exposure in the financial system is closely linked to the need to have a European asset that can be used as a reference for issuances throughout the EMU, allowing the euro to compete on equal terms with other currencies such as the dollar,¹⁴ and enforcing monetary policy. Without such an asset, the ECB's functions are limited, not only in operational terms, as may occur now once quantitative easing (QE) has been enforced, but also frequently bringing it close to a thin line which, if crossed, would lead to state funding. Further, without such an asset, it will be very difficult to break the banks' practice of buying bonds issued by their own countries, a trend that goes a long way to explaining the link between banking and sovereign risk, one of the main causes of the last European crisis.

However, it should be remembered that the function of the fixed income portfolios of financial entities that include sovereign exposures is to act as a structural hedge against commercial balance sheet risk. This risk is caused by the combination of a significant volume of variable rate loans and a significant percentage of sight deposits, which are not sensitive to interest rate movements. Therefore, during the trough of the mon-

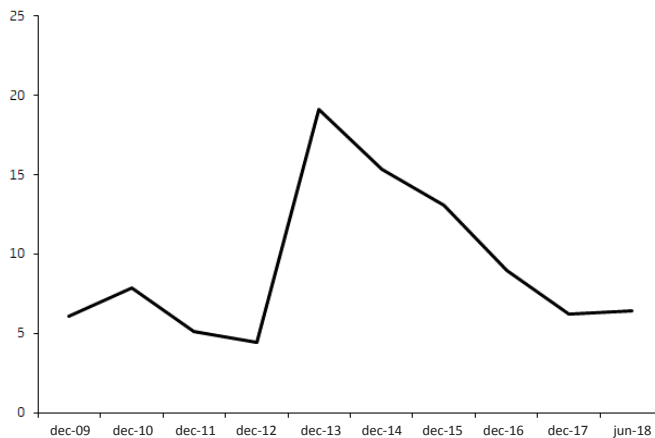
¹⁴ Proposals such as the redenomination in euros of all oil purchase contracts made by European countries are steps in the right directions, and are necessary but not sufficient conditions to raise the importance of the euro in international transactions.



etary cycle, the entity's interest margin is protected. In this sense, the purchase of fixed income bonds by European banks helped to offset the fall in the loan stock (volume effect) and the drop in interest collected on variable-rate loans (price effect), especially in peripheral countries, in many of which credit investment continues to decline (aggregate of -1.9% in peripheral countries in September).¹⁵ Both the coupons collected on these bonds¹⁶ and the capital gains (results of financial operations, or ROF) recognised when the sale is made acted as a balancing mechanism on financial entities' income statements throughout the crisis (see chart 8).

However, the bond purchases made at specific times during the crisis resolved the financing difficulties of some Treasuries when the uncertainty was at its height, specifically from the summer of 2011 to the summer of 2012, when the ECB's capacity to intervene in the market was limited due to the reluctance of northern European countries to allow the central bank to continue using the emergency debt purchasing programme approved in early 2010. The first two LTRO (*Long Term Refinancing Operation*) auctions in December 2011 and February 2012 resulted in a liquidity injection of almost one billion euros for 600 EMU financial institutions, a large portion of which was used to acquire sovereign debt due to the weakness of demand for household and company loans at that time. In this way, the ECB killed two birds with one stone, as it smoothed the transition of financial institutions' income statements toward a climate of very low interest rates and helped to finance the Treasuries, given the ECB council's strong opposition to direct intervention in the debt market.

CHART 8. WEIGHT OF ROF AS A PERCENTAGE OF THE GROSS MARGIN IN SPAIN (PERCENTAGE)



ROF and exchange differences. Individual sector data.

Source: Bankia Research based on Banco de España data.

¹⁵ Italy, Spain, Portugal, Ireland, Greece, Cyprus, Slovenia and Malta.

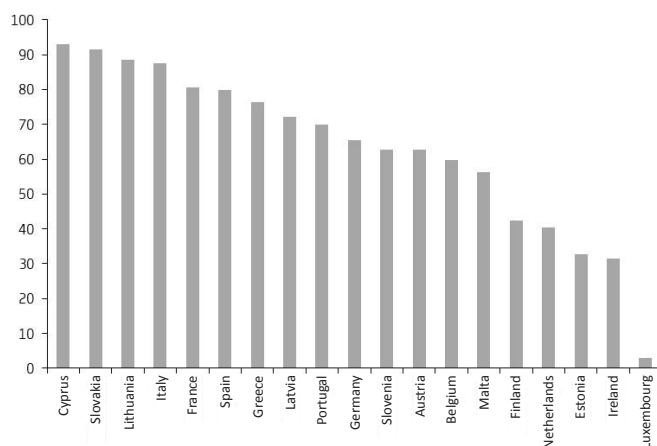
¹⁶ In the post-crisis years, these coupons accounted for 20% to 25% of financial income.

Additionally, government debt portfolios are assets that facilitate compliance with liquidity requirements and enable financial institutions to perform other functions that complement their traditional business model: origination and distribution of issuances, market-making for treasury desks, etc. Therefore, the banks’ bond portfolios (ALCO portfolios) play a major role, not only for covering structural risks but as a balancing mechanism for the income statement, or a liquidity source, among others.

The size and composition of these debt portfolios is another story. The “target” (ideal) size of the portfolio relates directly to the volume and stability percentage of the sight accounts, although other factors such as the duration of the portfolio and the hedged vs. the unhedged portion should also be taken into account. For the Spanish financial sector, at year-end 2017, ALCO portfolios accounted for around 15% of total assets and were mostly sovereign risk (between 70% and 90% of the total portfolio), which would be logical bearing in mind that other fixed income has lower liquidity, higher credit risk and consumes more capital; this was partly offset by the higher returns and lower sensitivity to movements in interest rates (in expansive cycles improved company fundamentals can lead to spread reductions). Therefore, a theoretical ALCO portfolio should have a weighting of 75%/80% of sovereign bonds and the remainder should be corporates, agencies and other.

In terms of the composition of the sovereign bond portfolios, the bias toward units issued by the source country is very common in most financial systems. According to the latest available information, in the EMU, this percentage ranges from 60% to 90% of sovereign exposure to the euro area, with the exception of Finland, the Netherlands, Estonia, Ireland and Luxemburg (see chart 9). On average, home bias would account for 75% of exposure and around 130% of Tier 1 capital.

CHART 9. HOME BIAS OF SOVEREIGN DEBT IN BANKS’ BALANCE SHEETS (SEP-18, PERCENTAGE)



Home bias is defined as the ratio of domestic sovereign debt over aggregate sovereign debt in euro countries. Aggregate data of other financial and monetary institutions.

Source: Bankia Research based on ECB data.



In Spain, it accounts for 80%, although the volume of Spanish bonds on the portfolio has fallen from 224,000 million euros in 2014 to 158,000 million euros in July 2018 (380,000 million euros for Italian banks to September). From the highs reached in 2009, the percentage of total government debt on the portfolios of public Spanish banks has reduced from 30% to 15%. It should be noted that, when analysing the data for Spain,¹⁷ both the sensitivity of banking risk to sovereign risk and the sensitivity of sovereign risk to banking risk has notably diminished, if we compare figures from the start of this year with the situation between May 2010 and June 2012. In other words, the link between banking and sovereign risk is weaker, in contrast to what is happening in Italy, where the sensitivity of banking risk to sovereign risk has increased in comparison to the situation during the harshest part of the European financial crisis. According to the ECB, the negative impact of the higher sovereign risk premium applied to Italy in the second quarter of 2018 is the equivalent of 25–84 basis points of CET1¹⁸ for Italian banks. Further, risk sensitivity in Spain to changes in risk in Italy has fallen dramatically.

It should also be borne in mind that the home bias seen in sovereign debt portfolios has a stabilising effect on the government debt markets, due to the liquidity it contributes to listed issuances (market makers) and to the creation of a stable investment base (wholesale and retail). Based on this data, it is clear that the level of concentration remains high, especially if problems of financial instability were to reappear; but it is also true that financial institutions hold a preference for financial assets for which they have more information in order to assess the credit risk involved. Therefore, different suggestions have been made over the past few years on how to increase portfolio diversification without mutualising risks. In other words, how to reduce the home bias to put an end to the reluctance to use bank deposits secured by the deposit guarantee fund (EDIS) to buy debt from the financial institution's country of origin.

One way would be through changes in the regulatory treatment of sovereign exposures. It seems unlikely to be achieved through Sovereign Concentration Charges (SCC), as independently of whether these appear to be correct (the valuation of a country's solvency is not an exact science), they are difficult to implement. Whether in the form of additional capital requirements, provisions, the prudential application of "Pillar 2" or the application of a weighting factor.¹⁹ All of this implies the use of external ratings, market valuations or country risk classifications that always have a large subjective component, and in some cases, a high volatility component. This could exacerbate the negative effects of banking/sovereign risk spirals. In addition to creating distortions in competition if the treatment of sovereign debt holdings in terms of capital requirements is not harmonised between the different jurisdictions.

In practice, this would mean penalising the holding of sovereign bonds and hence assigning a default probability to debt issued by treasuries, which is the same as recognis-

¹⁷ Banco de España. (2018). *Financial stability report*, November.

¹⁸ European Central Bank. (2018). *Financial Stability Review*, November.

¹⁹ Introducing a fixed weighting factor (e.g. 1%) for all sovereign exposures, would increase capital requirements but would not reduce the bias toward home country bonds.



ing that there is no risk-free financial asset in the financial system. Further, during the implementation period, portfolio adjustments would probably trigger a new fragmentation process. Grandfathering solutions, starting from scratch, or phasing-in solutions would not appear to be the most suitable in this case either, especially when we consider the average duration of the bond portfolios held by European institutions.²⁰ In the case of *grandfathering*, i.e. when capital charges are applied to excess concentration in government issuances from the date the regulation comes into force, this could cause fragmentation in the debt markets (*juniorisation* of new issuances).

In the same way, in order to analyse the proposals linked to financial engineering, and therefore all types of synthetic bond structures (sovereign bond-backed securities or SBBS) formed by different national references, the intrinsic weakness of this type of infrastructures during periods of financial instability should be taken into account. When things become complicated, volatility surges and there is a flight to quality, as occurred in 2008, contaminating the whole structure down to the equity tranche. The possibility of the ECB extending preferential regulatory treatment to this structure (or guaranteeing it) is just another way of describing the components of the eurobond.

The recent proposal put forward by the European systemic risk board or ESRB (European High-Level Task Force)²¹ is the latest attempt to create a perfect substitute (after the *blue and red bonds*, ESBies and others) for something that does not have one. In this case, the synthetic asset would be a basket of sovereign bonds issued by euro area countries and the weighting would be that of the ECB capital key. Risk would not be mutualised as each government would be responsible for its own obligations. This synthetic asset would not be assigned a rating higher than BBB or, AA– at most, as already stated by the rating agencies. Only the equity tranche²² could obtain a rating anywhere near AAA, so that there would be a junior first-loss tranche (10% of the total size of the bond) and another mezzanine tranche (20% of the total). Who would buy these tranches? Especially because in theory the banks would not be permitted to buy them (Bénassy-Quéré et al, 2018) and investors would always seek out much more tried and tested alternatives with more market liquidity, especially in the BBB scale.²³ In the end, this is the problem. The market is struggling to find value in the parts of these structures that are potentially more fragile at times of financial tension. Therefore, it is not easy to find a broad and stable investor base, especially if the objective is to minimise the impact on the liquidity of national sovereign bond markets, not to mention the difficulties thrown up by other technical issues relating to structuring the issuances such as requiring all treasury depart-

²⁰ The Basel Committee on Banking Supervision, responsible for analysing the issue, recently recommended not to start a process to reform the regulatory treatment of sovereign debt exposures.

²¹ European Systemic Risk Board. (2018). *Sovereign bond-backed securities: a feasibility study*, January.

²² The ESRB recommends that the equity tranche should account for 70% of the structure.

²³ BBB-rated bonds represent 49% of all issuances with an investment rating (25% in 2000) for a total listed volume that could exceed 2.5 billion dollars.



ments to coordinate their issuance strategies or the funding requirements for the vehicle structuring the sovereign bond pool. Lastly, it should be noted that the regulatory treatment for this type of structure would be penalising in terms of both capital and liquidity requirements, and would require changes to offset this cost.

These are all attempts to solve the true problem. Namely, that without a risk-free European financial asset (safe haven asset), the EMU will remain incomplete. It is not an issue of solidarity or of mutualisation of risk, but a key element in the institutional design of the euro area. Risk-free assets play a fundamental role in any market economy, and since the 17th century sovereign debt has mainly played this part (Gorton, 2016), as using private debt requires a great deal of collateral. There is always demand for safe haven assets and the recurrent financial crises, particularly the last one, reflect the difficulty in responding to this demand and the financial instability this causes. But substitutes, particularly private ones, are imperfect.

Without a eurobond, the EMU would continue to be an anomaly as a monetary union. However, attempts to find a second-best solution make little sense in terms of economic efficiency as they do not come close to the best choice, and lead straight back to fragmentation. Further, if there are no safe haven assets, the private sector will try to cover this market need, which will make the economy more fragile due to its potential impact on financial stability, as we observed in the last crisis.

In short, the risk-free asset for the euro area can only be a eurobond. Although we may prefer to give it another name and use indirect channels such as public guarantees or sureties to reach the same final solution. No having one in the EMU is a major competitive disadvantage, as a large part of the story of humanity could be written as the search for and production of different types of secure assets (Tooze, 2018). The question then is: why is a large group of countries opposed to issuing eurobonds? The answer can only lie in one of the three following reasons:

- 1) The existence of a large number of non-productive assets in the banking systems of European countries, i.e. the same reason that would prevent progress being made toward the Deposit Guarantee Fund and the Resolution Mechanism. Fears that mutualisation will have a cost for the citizens of the countries with better public finance structures and/or lower levels of impaired assets. Here, the key would be to continue to reduce defaults and foreclosed assets in the most problematic countries, to levels that are considered acceptable for the new Hanseatic League.²⁴ Once this target has been met and a new institutional framework designed to prevent the same errors being repeated, it would much easier to turn the counter back to zero. Something that, as we mention above, appears to be a step in the right direction.
- 2) The lack of a suitable framework of fiscal discipline, as evidenced by the recent

²⁴ Czech Republic, Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands, Sweden and Slovakia.



problems in Italy. There are no *ex-ante* control mechanisms or a suitable disciplinary framework to address challenges such as those that have arisen recently in that country. The *too big to fail* status of the financial system applied to the region's large economies. Only an improvement (or complete redesign) of the Stability Agreement, which could involve the addition of a new control framework, would make a significant number of countries overcome their reluctance to take a step in this direction. Northern European countries have submitted a proposal for the reform of the European Stability Mechanism (ESM) which would, in practice, require a dual control mechanism to be established. The ESM, in exchange for acting as support for the Banking Union Resolution Mechanism²⁵ and the Deposit Guarantee Fund, will have access to all economic and financial information of all countries to assess the health of their public finances at any given time, a role that has been played by the European Commission until now. In other words, budgetary control would be exercised in two spheres, increasing the *ex-ante* pressure on the most wayward countries. In exchange, the ESM would become a lender of last resort in the euro area, to preserve the financial stability of the region if necessary.

In exchange of course for strict terms that allow aid for compliance with the European Treaties that prohibit fiscal transfers between countries to be aligned (*no bail out clause*). Therefore, the ESM must decide on the terms of the aid package, including its volume, bearing in mind the sustainability of the debt of the country in question, for which financial assistance will be received from the Commission and the International Monetary Fund. The proposal that when these strict conditions are not sufficient to re-establish the solvency (payment capacity) of the country in question, measures should be developed to improve sustainability, in agreement with the remaining creditors (collective action clauses)²⁶ is less likely to be passed. This is a red line that countries such as Italy will be unlikely to cross (at least in the short term), but which could contain the key for a definitive move forwards in the European project. This new framework of fiscal discipline and the reinforced role of the ESM would lay the groundwork for the issuance of a European risk-free asset.

- 3) Political opposition to further advances in the European construction project for ideological reasons, which is now not just confined to a handful of Eastern European countries, or because some countries have given up on the capacity of peripheral nations to meet the requirements in terms of competition or fiscal discipline. Because without a eurobond, and hence, without mutualising risk, the sustainability of the EMU will always be in doubt, at the whim of market pressures and hence the response of the ECB.

²⁵ In June 2012, the European Council was already talking about the need to break the loop between sovereign and banking risk, and the ESM's role to recapitalise banks if necessary.

²⁶ At the Eurogroup meeting of 5 December, the Italian Minister of Economy and Finance once again expressed the country's opposition to the ESM/MEDE reform including CACs.



11.6. CONCLUSIONS

The existence of a risk-free financial asset is a necessary condition to achieve a definitive advance in the European construction process, to increase the importance of the euro in international transactions and solve problems such as the negative spiral between banking and sovereign risk.

To do this, it will be necessary to move forward in the process to reduce non-productive assets in the financial system and to improve fiscal discipline mechanisms in the region. In both cases there should not be any unsurmountable obstacles that will prevent the necessary advances from being achieved over the next few years and minimum solutions being reached that will satisfy all players involved. From then on, it will be depend on the political will to see it through.

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12. THE INESCAPABLE NEED TO SHARE RISKS: THE LONG AND WINDING ROAD TO FISCAL UNION

MIGUEL OTERO IGLESIAS AND FEDERICO STEINBERG WECHSLER

Real Instituto Elcano

12.1. INTRODUCTION

For decades, the debate on fiscal union in the euro area has tended to involve a technical discussion among economists. Based on the theory of optimum currency areas, which brings up the need for some kind of transfer system to deal with asymmetric shocks when countries lose their monetary sovereignty and have restricted labour mobility, the focus has been on the need for instruments such as an independent budget that would have a stabilising function, how to fund this budget and what to spend it on. Further, northern European countries, that are more reluctant to share risks, have stressed the need for increased monitoring of the public accounts of euro area countries (particularly those in the south of the region) to avoid the problem of moral hazard. In short, a combination of “sticks” and “carrots” has been used (today there are more of the former than the latter), treating the fiscal side of economic and monetary union (EMU) as just another area in European Union studies that is reserved for specialists (in this case macroeconomists), as occurs with areas such foreign policy, trade or agriculture.

However, treating EMU in general, and its fiscal component in particular, as just another part of European integration, and exclusively from a technical standpoint, is an error. The euro crisis that took hold in 2009 has revealed that being part of a monetary union has enormous political, social and even cultural implications for its members, that



go beyond strictly economic involvement. In a general sense, fiscal union is really a kind of political union entered into through the back door. It should be remembered that both fiscal support for the resolution fund or deposit guarantee fund for banking union and the European Stability Mechanism (MEDE), and the distributive effects of certain monetary policies, contain political redistributive components. Therefore, understanding the nature of fiscal union, and the need to complete it in the current context of the construction of EMU, requires an analysis that goes beyond a technical discussion between economists. This does not mean that proposals for how it should be designed should not be technical, but for its ratification we should take a step back and consider the meaning of money as a social and political phenomenon before drawing up a viable action plan.

This is because money is so much more than just economics. If, as we explain below, we consider it to be debt, then it is a social relationship between a creditor and a debtor that also contains an inherent balance of power. Therefore, money cannot be understood without politics (Kirshner 2003), which implies that EMU cannot survive without legitimate political support.

Against this backdrop, the first part of this article explains why to properly define fiscal union, a broader conceptualisation of money that includes political and sovereign components, is needed. In the second part, we discuss how solidarity between euro area countries should develop to enable them to share and mitigate risks more efficiently while at the same time establishing the required control mechanisms to prevent opportunistic behaviour. We will also discuss why the euro area needs a central fiscal authority with its own sources of income and capacity to take on debt, which is responsible for ensuring that fiscal regulations are complied with, defines the aggregate fiscal position of the euro area, maintains a dialogue with the monetary authority and is well-integrated within the Union's institutional fabric so that it has the necessary legitimacy.

12.2. MONEY, POWER AND POLITICS: UNDERSTANDING EMU BEYOND THE THEORY OF OPTIMUM CURRENCY AREAS

That EMU needs political union to endure as a project has become something of a cliché. To understand why, it is useful to go back to the different theories of the origins of money. The so-called orthodox theory that originated with Adam Smith has many shortcomings (as we will see below), while the heterodox theories accepted by Schumpeter will be more useful. Money, like language, is an essential component in the creation of a political community. This is why EMU should be considered from a holistic and multi-disciplinary standpoint. Firstly, it cannot be understood without a historic context. From the beginning, it was hoped that the euro would consolidate the European integration project, which gave it a clear political incentive. In particular, like the whole European integration project, it was expected to help eliminate tensions between Germany and France, which led to the inclusion of a *quid pro quo* in the founding agreement whereby France would contain the monetary strength of the Bundesbank with the creation of the



euro, while Germany would cede its monetary sovereignty in exchange for reunification. The euro was also devised to be a symbol of union. Internally, because it would create monetary links, and hence common social links, but also externally, in response to the (at times predatory) dollar hegemony and the role of the United States in the international currency system, which had been the cause of so many headaches for Europe. Lastly, it was thought that the euro would also stimulate economic activity, improving internal market functions and strengthening trade flows and financial integration.

However, the underlying vision of money in the design of EMU is that of optimum currency areas, which does not include political considerations. This vision, based on the work of Mundell (1961), the future developments of which are expediently synthesised by Krugman (2012), establishes that the greater the synchronisation of the economic cycle, convergence and movements of capital and labour between different regions, the more sense it makes for these to share the same currency. In the 1970s and 80s this gave rise to different views of how and when EMU should be constructed. The Bundesbank and much of the German economic and political elite were of the opinion that, just like the union of the German states in the 20th century, the single currency would be the culmination of a long process of economic, but also political and cultural convergence. The viewpoint of the so-called German ‘economists’ was that the countries that shared the euro should also share a culture of price and budgetary stability for the experiment to work. In other words, the future union would have to be more than just economic union, and include social and cultural aspects.

However, the French monetary, economic and political leaders had another vision entirely. The most important goal was to reduce the economic power of Germany and the monetary power of the Bundesbank, and therefore the priority in European construction should be the creation of a single currency as step toward achieving greater economic, political and cultural convergence. This view held by the so-called French ‘monetarists’ was expertly summarised in the words of Jacques Rueff in 1950, *LEurope se fera par la monnaie ou ne se fera pas* (Europe shall be made through the currency, or it shall not be made). For the French, the political capital of this union should always be Paris. This was where all geo-economic and geo-strategic decisions should be made.

Therefore, toward the end of the 1980s, when the Delors report that would lead to the creation of the euro was being drawn up, the French monetary elite agreed with German leaders that the countries that would make up EMU were not an optimum currency area but argued that the creation the single currency would be a catalyst for convergence. As it could not be devalued, and given that they adhered to the Stability and Growth Pact that would be added to the Treaty of Maastricht, the weaker countries would undertake the structural reforms needed to increase their productivity and competitiveness. This would lead to integration resulting in an endogenous move toward an optimum currency area.

This is exactly what appeared to happen in the euro’s first ten years. The peripheral economies reported higher growth and saw their per capita income fall into line with that of the core countries. The good ship euro proved to be a sturdy vessel and its strength was reflected in its appreciation against the dollar. The single currency gained almost 100% from 2002 to 2008. However, when the crisis broke in the United States,



Lehman Brothers collapsed and with it the US and North Atlantic financial system, the weaknesses of the euro came to light. At this point, those economists who had criticised the optimum currency areas theory for being too economicist won credibility. It became clear that money was not just a neutral medium of exchange. As demonstrated by Goodhart (1998) in an excellent article published a year before the creation of the euro, there are two interpretations of money, and if one accepts the heterodox version, then the optimum currency areas theory has many limitations and the problems affecting the euro are easier to understand.

This is because the optimum currency areas theory arises from the traditional or orthodox interpretation of the origins of money. According to this version, which dates back to Adam Smith, money arose spontaneously from mercantile activity (Ingham 2004). The explanation of the origin of money can be summarised as follows: at an undefined moment in history, in an imaginary settlement, the producers of goods and services, and the traders, grew tired of bartering and chose to use a commodity with an intrinsic value, that was divisible and non-perishable, as a method of exchange to facilitate their economic activity. Historically, gold and silver have been used for this function, and therefore this is known as the “metallist school”. Money has three traditional uses, as a method of payment, a unit of account and a store of value. The most important of these is as a method of payment. In this interpretation money works just like any other commodity, it is neutral and its value is determined by the law of supply and demand. This interpretation of money does not factor in either politics or power.

12.2.1. ANOTHER VISION OF MONEY

There is, however, a second school of thought. The chartalist or heterodox theory. According to this theory, money does not arise spontaneously from trade because its most important function is not as a method of payment but as a unit of account. It is a scale for measuring value, and historically has always been established or imposed by a political power to collect taxes (Goodhart 1998; Ingham 2004). The scant prehistoric evidence available suggests that Adam Smith’s story about the settlement never happened. Rather, it is thought that money arose in the Mesopotamian and Egyptian empires around 3,000 B.C. when the emperors started to collect taxes using a specific value scale. This does not mean that private money systems were not used throughout history. Cryptocurrencies can be considered an example of just that. But in the event of default, war or epidemics, legitimate sovereign political power and the monopoly of power are the factors that have brought stability to currency areas (Martin 2011). Money, state and military might have always been linked. And this makes the euro, currently an orphan currency, without state or army, a special case.

According to this interpretation, money is always debt, and therefore also affords social relationship between a debtor and a creditor. As with all social relationships, it implies a relationship of power. In modern times, this relationship of power is mediated by the state, as it is the most indebted agent (it issues debt to build infrastructures and provide public services) and the largest creditor (it collects taxes and will continue to do



so in the future, if necessary, through its monopoly on the legitimate use of force). The fact that today we live in a fiduciary, not metallic, monetary system demonstrates that the operability of money is not based on a tangible commodity with intrinsic value but on a totally abstract element: trust. The trust that a certain political community, i.e. the sovereign issuing the money, will return in goods and services the value stipulated on a paper note (the *charta*, a Latin term for ticket or token) used to pay taxes (hence the term *chartalism*).

The real problem lies in that the euro is not backed by a European sovereign state (Otero-Iglesias 2015). In its first decade of life, this was seen as an advantage. History is replete with sovereigns that have manipulated the production of money to create inflation and reduce the real value of their debts. The depoliticisation of the euro and the orthodoxy of the ECB, inherited from the Bundesbank, were seen as factors of credibility and made the euro an attractive store of value. However, when the global financial crisis broke and panic ensued, with a flight to safe haven assets, many international investors started to raise the question: Where is the player that will stabilise the situation in the euro area? Where does the legitimate political authority to deal with the crisis lie? The theory of optimum currency areas did not have an answer for this type of question. For various reasons. But mainly because of its orthodox interpretation of the origins of money. This theory establishes that a currency area must have a federal budget to be able to deal with asymmetric shocks because the mobility of factors of production is never perfect, but does not explain why this is so or how it should be achieved. As we mention above, the orthodox interpretation of money does not factor in either politics or power.

Additionally, the orthodox theory of money tends to leave the concept of credit to one side. As they consider money to be a neutral commodity, macroeconomic models do not sufficiently factor in financial variables. Macroeconomics and finance were studied in separate, independent silos. However, the euro crisis that kicked off in Greece in late 2009 cannot be understood without analysing the credit flows that arose in the first ten years of the euro. When the crisis broke, many economists correctly identified the growing divergence between the current account balances of northern and southern countries as one of the contributing factors. This was caused partly by divergences between inflation and productivity, but the other side of current account imbalances are the imbalances in capital accounts (Jones 2016). If countries import much more than they export, someone has to finance these purchases. And that someone was the northern European creditor countries.

As we explain above, money is a social relationship between a creditor and a debtor that always brings with it a relationship of power. At the same time, depending on the scale of the relationship, it will cause greater friction but also greater interdependence. After all, when there is an irresponsible debtor there must always be an irresponsible creditor. The euro has given rise to this type of relationship. By simply not analysing credit channels, the theory of optimum currency areas has not been able to identify it. Firstly, it failed to understand that the credit itself was feeding the macroeconomic imbalances that led to the crisis, and secondly, it failed to recognise that this interdependence in terms of credit would result in core countries bailing out the peripheral economies, even



though this went against the spirit (and for many, the text) of the Treaty of Maastricht (Steinberg and Vermeiren 2016).

Therefore, Germany and France did not agree to bail out Greece, Ireland and Portugal, and later and more importantly Spain, for reasons of solidarity but because if they failed to do so their banks would fail. For this reason, the literature that has studied the social aspects of money considers that a shared currency is like a common language (Helleiner 1998). Its users, be they debtors or creditors, share a series of monetary phenomena that create tensions and adverse events but also forge links and strengthen the community. Even more so if the same currency is attacked from outside, as has occurred in the past few years, particularly from the anglo-saxon sphere, which has been announcing the sinking of the good ship euro from almost the first day (Otero-Iglesias 2017).

Specifically, by considering money as a neutral element that has no long-term impact on the performance of the real economy, the theory of optimum currency areas did not pay sufficient attention to the lending system and therefore did not raise the need for banking union. This recognition only arose when numerous analysts, investors and politicians discovered that the ECB was the lender of last resort for retail banks, but not for sovereigns, and when it became clear that a diabolic loop was emerging between the increasingly weak national banks and peripheral EMU states (De Grauwe, 2011). This is a problem, because as we mentioned previously, historically sovereign debt, through control of or collaboration with the central bank, has been responsible for stabilising the monetary and credit system in the event of a systemic crisis. Europe quickly discovered that the Federal Reserve and the Bank of England were rolling out quantitative easing (QE) programmes, which is simply a way of directly funding government public expenditure, while the ECB was prohibited from doing so by Maastricht. To overcome this legal barrier, the ECB had no choice but to intervene in the secondary sovereign debt markets, but this only strengthened the loop. National banks acquired more and more sovereign debt and sold it to the ECB.

Finally, the logic of money prevailed. If there is cross-border credit activity, particularly banking activity, there must also be supranational banking regulation and supervision. This means that monetary union requires banking union. So the question then is: Can there be banking union without fiscal union? According to the chartalist interpretation of money, the answer is no. Just as at a national level US, British and German banks had to be rescued in 2008 and 2009 using tax-payers' money because the crisis was systemic, the same occurred at a Europe-wide level in the next systemic crisis. This means that fiscal union should also have a federal budget. The explanation comes on top of the interpretation most widely accepted by economists, according to which, given the limitations on fiscal policy due to European regulations, a federal fiscal instrument is required to offset any drops in demand that may arise due to external events, especially those related to investment or unemployment, that penalise long-term growth. This fuels the debate over the need for a transfer union, and above all how this would be financed. The best possible scenario would be to keep intra-regional transfers to a minimum, but to achieve this, it is also necessary to build an economic union that ensures a certain degree of real convergence between the economic structures of the different countries, through



specific structural reforms, which would not necessarily be restricted to a more flexible and liberalised job market and extending the retirement age, but also to better education and ongoing professional training, a policy of innovation, increased transparency and a culture of meritocracy in public administrations.

In any case, the most important question is whether all three pillars of monetary union (banking, fiscal and economic) can be built without political union. Once again, the chartalist interpretation of money would suggest that the answer is no. What legitimacy do senior officials of the ECB, as sole supervisor of the banking union, have to close down a bank such as Société Générale? What legitimacy does the chairman of the Eurogroup have to decide on active employment policies in Spain? What legitimacy does the German finance minister have to decide whether the next bail-out for Greece should be financed by tax-payers from all EMU members states? What legitimacy does Chancellor Angela Merkel have to rule whether Greece stays in the EMU or leaves it? Very little. The history of money dating back 5,000 years is very clear on this. Monetary unions do not survive without a legitimate political authority, i.e. a sovereign, to sustain, stabilise and protect them. Therefore, political union is also necessary.

In short, those who, from a narrow, economist position, continue to postulate that fiscal union is not necessary, and that a credible system of fiscal rules is sufficient to ensure the stability of the euro and its long-term viability, are mistaken. Fiscal union that is supported by a European sovereign body and articulated through specific macroeconomic stability mechanisms in a shared budget, with the capacity to raise its own funds (through the issuance or collection of debt) and act in the event of systemic crises, is essential. Without it, the euro will remain a weak construction and the ECB will have to continue to step outside its mandate in times of crisis, thereby eroding its legitimacy in the eyes of some euro area countries. The problem is that the creation of a sovereign Europe requires some degree of political union, and this is still difficult to achieve due to both the reluctance of some countries to share risks and the rise of new nationalist movements.

12.3. COMPLETING FISCAL UNION

Now that the case for fiscal union has been established, we look at the specific form it should take. Some of the suggestions we put forward below require institutional reforms and treaty amendments that today could be politically difficult to achieve. However, we have drawn up an ambitious proposal that outlines what the final outcome should be like. Further, we believe that the Meseberg declaration of June 2018, in which France and Germany consider moving forward in some of the areas we discuss below (specifically, regarding a euro budget and common unemployment insurance, in addition to the transformation of the MEDE into the fiscal support of banking union), lead us to be moderately optimistic. Further, in July 2018, the declaration of Madrid was approved, whereby France and Spain put forward an even more ambitious road map, demonstrating that Spain is beginning to play a more active role in Europe in this important debate,



and that France remains optimistic with regard to the reform of the euro.¹

Both proposals are in favour of mutualising and reducing risks at the same time, in the banking and fiscal arena alike. However, the order of the reforms must be agreed and there is still no consensus. Overall, northern European creditor countries want risks to be reduced before they are shared, while debtor countries in the south of Europe contend that risks cannot be reduced unless there is some kind of parallel mutualisation programme.² Further, Germany's traditional reluctance to move forward in the development of risk-sharing mechanisms has been shored up by the appearance of a new group known as the Hanseatic League, headed by the Netherlands (but also including Austria, Belgium, Estonia, Finland, Ireland, Latvia, Lithuania, Luxembourg and Malta), which is vehemently opposed to advancing in this direction, and specifically to the creation of a euro area budget.

Reconciling these creditor and debtor positions will be difficult, but not impossible. Since the Greek debacle of 2009, significant steps have been taken to consolidate monetary union, and many of the red lines that were considered to be unbreachable only ten years ago have been crossed. It is understood, and reflected in detail in the reports of the fourth (Van Rompuy 2012) and fifth (Juncker 2015) presidents of the Union, that it is essential to achieve greater fiscal, banking, economic and political union to make the euro more stable. The direction, therefore, would seem to be the right one. Monetary union has been improved to some degree by the fact that the ECB is not afraid to buy sovereign debt on the secondary markets if its inflation targets so require, or if the irreversibility of the euro is in jeopardy. It can be said that the central bank has indirectly become a lender of last resort for sovereigns. Further, banking union has been created and the single supervisory mechanism and resolution fund are now operational, although the third pillar, the common deposit guarantee fund, is still missing. Lastly, in regard to fiscal union, the MEDE has been set up, with lending capacity of 500,000 million, and budgetary supervision and discipline have been shored up with the *two-pack*, the *six-pack*, the fiscal compact and the European Semester (Hernandez de Cos 2017).

However, there is a consensus that believes that all this is not enough (Bénassy-Quéré 2018, Almunia *et al.* 2018, Constâncio 2018), and in its last report reflecting on how to move forward with EMU, the European Commission (2017) listed the issues still pending

¹ The Meseberg declaration is available at <https://www.bundeskanzlerin.de/Content/EN/Pressemitteilungen/BPA/2018/2018-06-19-meseberg-declaration.html> and commented on by Silvia Merler at <http://bruegel.org/2018/06/the-meseberg-declaration-and-euro-zone-reform/>. The Madrid declaration is available at <http://www.lamoncloa.gob.es/presidente/actividades/Documents/2018/Declaración%20de%20Madrid%20sobre%20la%20reforma%20del%20área%20euro.pdf> and commented on by Miguel Otero-Iglesias at <http://agendapublica.elperiodico.com/el-futuro-del-euro-sanchez-y-macron-frente-a-la-liga-hanseatica/>

² In the United States, for example, states can go bankrupt, but there is also a federal budget that covers the costs of unemployment subsidies and social security, which means there are powerful counter-cyclical measures in place that will alleviate the crisis in the bankrupt state.



in different areas. Looking at the fiscal aspect, it becomes apparent that fiscal rules are too complex and inconveniently pro-cyclical, while the MEDE shows deficiencies in its operations, and therefore both should be revised. However, the main argument revolves around the need to create a macroeconomic stabilisation mechanism for the entire euro area (which may or may not take the form of a new budget), how funds for this mechanism would be raised, what they would be spent on and how it would fit into the complex European institutional fabric in order to command sufficient democratic legitimacy.

12.4. A CENTRAL LEGITIMATE FISCAL AUTHORITY

Beyond the political difficulties raised by the lack of trust among member states, the ideal solution would be the creation of a Central Legitimate Fiscal Authority headed by a strong political figure, who would be the Euro Commissioner (Almunia *et al.* 2018). The role of this authority would be to monitor and ensure compliance with fiscal rules, in addition to establishing the euro area's common fiscal position, working to ensure a suitable counter-cyclical policy is in place for the EMU as a whole, in the form of fiscal stimulus measures at times of recession and fiscal consolidation during periods of growth.

Central fiscal capacity is essential given that domestic fiscal policies have very little wriggle room due to the need to comply with fiscal rules, which would have to be simplified and made more automatic, i.e. less likely to be politicised. We, therefore, recommend that the current European Fiscal Stability Board (FSB) take on the role of monitoring macroeconomic policy in euro countries from a technical standpoint. However, in addition to analysis, the Central Fiscal Authority would take the decisions as to which countries would be able to access these common funds, under a clear incentives structure: countries that comply with the rules could receive aid during recessions, while those that fail to comply with the rules would not. The legitimacy of the head of the Fiscal Authority would be guaranteed because the figure would be put forward by the Eurogroup, which would continue to have an intra-governmental role, but it would be ratified by a new European Parliament committee dedicated to EMU.

Funding for this counter-cyclical fiscal policy would come mainly from two sources. From debt issued jointly and based on solidarity, i.e. Eurobonds. This would also provide the EMU with a risk-free asset which would facilitate the monetary policy transmission mechanism. Secondly, from European taxes in areas where there are clear externalities, e.g. environmental taxes, taxes on financial transactions or technology taxes. Both sources of funds would be fed by a euro area budget administered by the Central Fiscal Authority, which could also make the use of the funds conditional on the approval certain structural reforms. This would increase trust between euro area countries and improve the convergence of the economic models of the different countries, which is key to preventing intra-euro area current account imbalances, that were a root cause of the crisis.

Lastly, the question of how these funds should be deployed is being hotly debated. We believe that, first of all, an effort should be made to prevent levels of investment from falling during periods of recession, and therefore the European budget should guarantee



a certain degree of public investment in all euro area countries, not only in infrastructures but in other items that increase growth potential such as human capital and R&D investment. Secondly, we are in favour of an unemployment benefit scheme such as that proposed by Dullien *et al.* (2018), which would be available to countries experiencing sudden rises in unemployment as a result of external shocks, provided that they have approved the labour reforms authorised by the European Commission. Thirdly, the euro budget could be used for projects that help to strengthen European integration and unity, such as security and defence, or migration policy or the policy for critical energy and digital infrastructures. The experience of fiscal integration in the United States reveals that it is more useful to define the common policies that are needed and then look for the funds to finance them, than to create a large budget that it is not clear how to use, trusting in the solidarity of the member states (Kirkegaard and Posen, 2018). Therefore, against a backdrop in which the European Union needs to integrate further and have a common voice in an increasingly complex international stage dominated by large powers, any new policies that are designed could be funded by the new euro budget.

Lastly, the MEDE, which is currently still an inter-governmental body, and therefore slow acting and complex, would have to be transferred to the community method. Its current role as a bailout fund would be taken on by the Central Fiscal Authority, and its staff would form part of the FSB and the Commission.

All of these changes once again reflect how EMU is not just another area of European Union policy, but the fundamental pillar of the integration project that cuts through the thick layers of sovereignty of the countries forming monetary union. If the European Semester is to be strengthened by linking structural reforms to convergence and cohesion funds, a Central Fiscal Authority and a euro area sovereign debt asset are to be created, and the international representation of the euro area is to be integrated, i.e. through a single chair at the IMF, a level of sovereign integration is needed that requires a parallel process of endorsement and democratic control of common funds on a European scale. The Commission recognises this as part of its role, but the political union pillar is the least developed in terms of documentation, reflecting that achieving progress in political union, while essential, is the hardest part.

12.5 EPILOGUE: THE UTOPIA OF POLITICAL UNION

In a recent article, the economist Kenneth Rogoff (2018) said that “Monetary union without fiscal union is an accident waiting to happen”. We would add that, in reality, seeking monetary (and fiscal) union without some degree of political union is an accident waiting to happen. The chartalist theory of money we mentioned earlier demonstrates this to be true, and the hard lessons learned from the euro crisis, where the European Union’s performance was clearly lacking because it did not have the fiscal and monetary instruments to deal with the situation, bear testament to this.

The challenge is large but not impossible. By setting debtor against creditor, money can play a divisive role, but it can also create an interdependency which raises the likeli-



hood of cooperation. You can never tell. Despite all the negatives, the European Union could be reviving the spirit of the Holy Roman Empire, becoming a cross-border political union that is fragmented on the inside (and therefore a long way from becoming the United States of Europe) but united on the outside, with the capacity to raise taxes to weather external storms. Achieving this would meet the chartalist theories of money and the holes in the good ship euro would be sealed.

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