# EURO YEARBOOK 2017
# A future for the Monetary Union

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**IE Business School**

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# PRESENTATION

Fundación ICO and Fundación de Estudios Financieros jointly decided in 2012 to publish a periodic study entitled «*Euro Yearbook*», aimed at contributing to knowledge about the relevance 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 for informing readers of significant changes that have taken place over the past year in the monetary, fiscal, economic and political union, highlighting successes, limitations and any of their inadequacies.

The report we are presenting here, the fifth in this collection, is structured around 10 chapters that deal with the essential aspects of advances in constructing Europe. It is divided into three distinct parts. In the first of these, political and economic scenarios and post-Brexit Union priorities are discussed and the capital markets union is explained as a necessary step towards greater political and economic integration. In the second of these, the functioning of the Monetary Union, the Euro's evolution, the fragmentation and volatility of the financial markets in Europe, monetary policy and banking regulation and monitoring are analysed. The third and final part delves into what the supervisory priorities of the ECB will be in 2018, for the purpose of reducing the stock of non-performing assets in bank balances; lessons are provided from the first European bank resolution problem solving exercise; proposals are put forward for the new European fiscal governance framework, and it concludes with original contributions on the social dimension of the Euro.

The work includes an executive summary which systematises contributions by the different collaborators and introduces, for the first time, the 10 most important reforms needed for completing the European Monetary Union and providing it with stability and durability.

In this overly technical and complex context, it would appear necessary to explain and publicise, thoroughly and in detail throughout this volume, the changes taking place in the European Monetary Union, and to analyse their significance and how they influence us.

Research has been led by Mr Fernando Fernández Méndez de Andés, Professor at IE Business School. He, in turn, has been assisted by a team of expert collaborators with links with 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 Yearbook for 2017 will be an important contribution to the current debate regarding the euro and the construction of Europe and of relevance to all readers.

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# EXECUTIVE SUMMARY

**Fernando Fernández**[1]

## 1. AN EXCITING YEAR FOR EUROPE

For the seventh year in a row, thanks to the generosity of Fundación de Estudios Financieros and of Fundación ICO, I have had the opportunity of editing this Euro Yearbook. 2017 has been an exciting year for Europe. It started with anxiety and despair, as was reflected in the sceptical tone of last year's Yearbook. Europe felt under threat, politically and economically. Politically, populism and nationalism were questioning the process of increasing integration and the basic consensus that formed the building block of the European institutional architecture after World War II. Economically, activity was weak, deflation a real threat, job creation did not increase wages, and the European Central Bank seemed the only available player. But its policies created growing unease as it stepped into fiscal responsibilities, while governments remained idle, unable to define and coordinate common economic and fiscal policies. Disillusionment was widespread, and many citizens were heeding the clarion call of nationalism. Europe was no longer the solution and had in fact become the problem.

Nonetheless, 2017 has been an outstanding year in terms of European politics and economics. This is testimony to the strength of the integration project; strength not resilience, since the pro-Europe camp has not only resisted but gone on the offensive as we describe here. Political economy is particularly difficult today given the high volatility and extreme immediacy in public opinions. Political stories are made and destroyed in a matter of seconds, in 140 characters. It is, however, the duty of analysts to wade in and resist the temptations to follow the viral pack, to demand a time-out and to get to the roots of lasting trends. Particularly so in the European Union, a political construct built on consensus, and not on emotional attachment. A Union which is legitimised through its effectiveness and the ethics of responsibility, contrary to other charismatic or messianic Unions. A community of wills and interests that moves forward with considerable pain because the decision-making process is in itself the only guarantee of legitimacy, and thus of effectiveness. If democracy is always built on respecting rules and procedures, the European Union is hyper-democratic by definition and vocation, by sheer necessity. True, the economy moves at a faster pace, more so finance. There is a positive and necessary tension, some volatility and often times inevitable alarm. However, economic and social agents cannot and must not overlook the strength of

[1] Fernando Fernández Méndez de Andés is a lecturer at IE Business School and has been Director of the Euro Yearbook since its first edition.

European conviction and resolve, which was perfectly summed up by the president of the ECB's famous sentence, «we will do whatever is necessary».

A series of major political events have restored confidence and brought some enthusiasm to Europe. First, the systematic defeat of anti-European populists who have been unable to break through their glass ceiling in France, Germany, the Netherlands, Italy, Spain, as well as Poland and Austria, among others. Second, the Brexit utopia has turned into a nightmare that raises a wish to emulate or transmit it. The increasing complications of implementing a break up, the economic, social and human cost, and the political and strategic implications have all become a reality for a bewildered United Kingdom. Third, France, ever the sick man of Europe, has regained its self-esteem and is injecting new life into Europe under the leadership of a new, young and ambitious President. President Macron has brought back into the political agenda the basic idea of further integration, the founding spirit of the Union, despite pending disagreement on the details. Fourth, Germany has indisputably renewed its European commitment under the leadership of chancellor Merkel, albeit not without its difficulties. A wide-ranging commitment that goes from economics–banking and fiscal union–to politics–security and defence–, even to moral and ethics–immigration and refugees. Fifth, the Juncker commission has finally put on the table an ambitious project for institutional transformation towards a full banking, fiscal, economic, social, and defence and security union. A true roadmap towards a new constitutional Treaty[2]. And I am particularly pleased to say this because I have been a harsh critic. The Commission has rediscovered the EU method and defined the European agenda for many years to come. It is only natural that the Council has initially reacted negatively, feeling its leadership under threat, and its procedure called into question. The EU method is moving forward and replacing the complex web of international agreements open to different combinations of Member States favoured by some countries. The Union moves forward, while the Multi-speed Europe, the Strengthened Cooperations and the Variable Geometries are indeed in retreat.

The Eurozone economy strengthened in 2017 and ended with 2.5% annual growth, exceeding its growth potential according to estimates by the Commission itself. We are no longer in a recovery phase, but rather one of full expansion, following seven annual quarters in a row with positive data. An expansion that is wide based, since virtually all Member States have positive growth rates. Growth in Italy and France—a pleasant surprise—exhibited a strength that exceeded anyone's expectations. Corporate and consumer confidence are at a high; European political risk at a minimum; employment and wages are recovering across Europe, and industrial production is back in full swing. Investment and private consumption have overtaken exports as the catalysts of economic activity. Expansion is thus improving the wellbeing of the population at large. Indeed, at the end of 2017, unemployment in the Eurozone stood at 9%, which corresponds to levels recorded in 2009, prior to the European debt crisis. The very fact that the political

[2] Communication from the Commission to the European Parliament, the European Council and the European Central Bank, *Further Steps Towards completing Europe's economic and Monetary Union: A Roadmap*, Brussels, COM (2017) 821 and complementary documentation. December 6th, 2017.

debate has shifted from the unemployment rate to the quality of employment, to the purchasing power of wages and to inequality and income distribution is yet another sign that the cyclical crisis has been overcome. It also shows, however, that Europe must, without further ado, tackle the economic and social consequences of globalisation and the digital revolution. It is time for Europe to face its structural problem and set aside cyclical considerations. Europe is entering a new phase that should focus less on its internal problems and be more open to the world. A new phase that calls for a new economic policy. The fear of inflation being too low cannot continue to be the ultimate argument for monetary policy. Financial markets will have to contend with a new monetary cycle in 2018.

Economic and monetary authorities will strive to design and implement a plausible and effective exit strategy from the extraordinary monetary expansion which the Eurozone has enjoyed since 2010, without jeopardising stability. The real economy will have to grow once again on its own, without expansionary political stimuli. Real growth underpinned not by a cyclical rebound, which to a large extent has already occurred, but rather by productivity and competitiveness. Investors will have to deal with increased volatility and price corrections in monetary and financial assets, in their search for a renewed balance that is more in keeping with long-term sustainability. All of this will happen, not rhetorically, in the context of constitutional change in the European Monetary Union.

Last Yearbook called for a new Treaty, although it did not consider it possible in the short run. The year 2017 has brought the conviction that, sooner rather than later, there will be a new Treaty. A conviction shared, to varying degrees, by all European economic policy affairs experts. This is the true dimension of the political revolution that has happened in Europe, thanks to the revival of the Franco-German leadership. There are still a number of deep divides; there are still two opposing final steady states of EMU[3], in fact, of the Union itself. But the Union will survive as a closer political integrated area. Because that has been the undeniable outcome of Brexit, that the difference between EMU and the EU is only temporary, in order to allow for different speeds of adjustment. The final station will be a European Union with a single currency and greater political integration.

Both versions of the Union share a single objective: that of completing the Monetary Union with increased fiscal, social and political integration among the countries willing to belong to it; both for reasons of economic stability and political solidarity, because these two are inseparable in EMU. That is the lesson that we Europeans have learnt in 2017, and this is a cause for celebration. This Yearbook is therefore optimistic on the future of Europe, although unfortunately, Spain may once again miss out. Mired as it is in the old ghosts of nationalism and debates more in keeping with the Ancien Regime.

[3] Guntram Wolff (2017), *Beyond the Juncker and Schauble Visions of Euro Area Governance*, Bruegel Policy Brief, Issue 6, November 2017. A divide is all the deeper if we broaden the scope beyond the EMU. In the words of Donald Tusk, President of the Council, when leaving the December Summit, “Where monetary issues are concerned, the divide is between North and South; when it comes to defence and migration, it is between East and West”, Expansión, 15 December 2017.

This European optimism should not, however, be confused with euphoria or naivety. We still have a long way to go, and it will not be easy. There will be further surprises, moments of dismay, and heated political battles in shaping the Union. But there will be a new treaty, which will result in a politically and economically stronger and better integrated European Union. A more stable Monetary Union that better resembles an optimal currency area. There is no alternative, and current and future European leaders know this. Populism and demagoguery are in retreat.

Europe will be renewed in 2018, with or without Spain. This is why there is such a need for a yearbook that explains the European debate and offers policies to improve the Union. Europe needs to be explained and publicised in Spain without discouragement. Particularly in a year when in-fighting is so pervasive that it threatens to dry up all the political capital of our institutions. Knowing what is happening in Europe is not enough. We need to recover the political ambition and renew the consensus necessary to have any influence in Europe. Few years will be as vital; seldom will so many decisions be made that will have a bearing on the future of so many generations. Allow me to highlight this conclusion beyond usual rhetoric. If the future of Spain has been played out in Europe for centuries, today we need to be shaping that future as a leading player. It only requires setting our minds to it and remaining focused. Refounding the European Union is the first point on the political agenda in the continent's main chancelleries. It should also be the case in Spain. The stakes are very high; it may also be the one common exciting project to overcome our differences and the psychological exhaustion and deep-seated weariness with Catalan separatism.

## 2. EUROPEAN UNION: AN INSTITUTIONAL RE-FOUNDING

In December 2017, the Juncker Commission proposed a concrete project to reform the Monetary Union[4]. It was followed by the announcement of a counterproposal by France, published in some detail in the press, along with an alleged reaction by the German Chancellor, which is still not official, nor can be, since she is just in office. The match has started, and the rules of the game have been set.

In June 2015, the Commission had published the Five President's Report[5] which for the first time presented a systematic roadmap in response to design flaws in the Monetary Union that the crisis had highlighted. This document sparked a much-needed debate that, after many doubts and controversies (see the 2015 and 2016 Yearbooks), seemed to have vanished in the depth of European policy until the Commission published the White Paper on the Future of Europe[6]. This document reignited the agenda of institutional reform and was followed by five so-called

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[4] The aforementioned COM (2017) Communication 821 of 6 December 2017.

[5] *Completing Europe's Economic and Monetary Union*, Jean Claude Juncker in close partnership with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, Brussels, June 2015.

[6] *White Paper on the Future of Europe, Reflections and Scenarios for the EU27 in 2025*, COM (2017) 2025, 1 March 2017.

Reflection Papers on the Future of Europe. Three of these documents are particularly relevant to our purpose, since they deal with the Deepening of the Economic and Monetary Union[7], the Future of the Union's Finances and Budget[8], and the Social Dimension of Europe[9]. I have been highly critical of these documents[10], both in format and content. In terms of their format, because by wanting to reach wider and less specialised audiences, the Commission resorts to simplistic language, examples and illustrations as biased and populist as those it claims to be fighting against. As for content, because the Commission appeared to shy away from leading public opinion, limiting itself to designing simplistic scenarios, and to listing well-known pending issues. They simply describe ongoing debates and several old proposals, known for years, without expressing any preference or taking a side. The Commission appeared to have taken the role of an impartial arbiter over that of a truly European government. Moreover, in the typically and often times exasperatingly European participatory style, the Commission later began an intense process of consultation and consensus building, including endless national round table discussions in major European capitals. This process went on until October 2017.

When it appeared that the reform momentum had worn itself out, the Juncker Commission published in December the aforementioned communication. In it, it finally sets out specific proposals in several fields of monetary and fiscal governance, with a target timetable. Proposals that are set for a long debate until their eventual approval. In short, the Commission has proposed to (i) transform the European Stability Mechanism in a European Monetary Fund fully incorporated into EU legislation; a Fund that would act as a true fiscal backstop, also for the Single Resolution Fund; (ii) integrate into the Stability and Growth Pact the core of the Treaty on the Governance, Stability and Coordination, with the praiseworthy objective of simplifying fiscal rules in EMU and unifying them into a single legal text; (iii) create new European budgetary tools that would provide for a macroeconomic stabilisation facility on a European scale; (iv) allocate a European budget to support the necessary national structural reforms for enabling true convergence; and (v) create a European Ministry of Finance.

Reforms over the period 2018-2025, which are both very ambitious, and undeniably controversial. Reforms whose depth and scope have raised eyebrows and allowed the Commission to be back in the lead. There are of course many aspects subject to criticism. Many of them will need to be qualified, amended, completed or even eliminated[11]. But the political perspective is unambiguous, the set of proposals amount to the re-founding of the Monetary Union, of the European Union itself. The

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[7] COM (2017) 291, 31 May 2017.

[8] COM (2017) 358, 28 June 2017.

[9] COM (2017) 206, 26 April 2017.

[10] See, for example, *The European Commission wastes its soft power*, La Actualidad Económica, July 2017.

[11] Due to time constraints, so as not to further delay publication of this 2017 Yearbook, we have not been able to include details here.

relevance lies in its wholeness, in the global picture, rather than the myriad of specific battles on which there will always be objections. The backtracking on an essential matter such as the European Deposit Guarantee Scheme is however noteworthy; a firm red line for Spain. This roadmap for completing the EMU was published when the Yearbook had practically gone to press. Many of the papers here deal with aspects explicitly contemplated in the Communication. It could not be otherwise since they are long-standing controversial issues for economists and politicians alike. What is particularly relevant is that the Commission has made them its own. By doing so, it increases the likelihood that they be written into EU directives and regulations. They have been elevated to the status of draft legislation, from previously simple academic exercises, just as it happened in 2011 with the banking union, single supervision and resolution mechanisms. This is the most significant end-of-year European development, thanks to a much-criticised Juncker Commission. But give to Caesar what is Caesar's.

## 3. THE WORKINGS OF THE MONETARY UNION IN NORMAL AND EXCEPTIONAL CIRCUMSTANCES

The internal organisation of the Yearbook is a little different this time, although it has remained true to its dual objective of dissemination and contribution. It contains three distinct parts. The first one discusses political and economic scenarios and post-Brexit Union priorities. Once populism has been defeated, the capital markets union is explained as a necessary step towards greater political and economic integration. The second deals with a functioning Monetary Union: the international role of the euro; fragmentation and volatility in financial markets in Europe; monetary policy and banking regulation and supervision. This is the most informative part of the Yearbook, although the different authors do not hesitate to suggest reforms when describing Union policies and commenting on their limitations. The third and final part is an attempt to design the future. It therefore describes 2018 ECB supervisory priorities, mainly its previously-stated objective of reducing the stock of non-performing assets in bank balance sheets; it draws lessons from the first European banking resolution exercise, which unfortunately once again featured a Spanish bank; it puts forward proposals for a new European fiscal governance framework; and it concludes with original contributions on the social dimension of the euro.

As in previous years, the reader is introduced to the entire European institutional and political debate, in all its complexity and controversy, with no inconvenient exceptions or personal preferences. The reader will find here all topics currently being discussed in Europe which, one way or another, are or will be on the table at the Commission and the Council. Practically everything proposed by the Juncker Commission is there. We have only attempted to describe it, explain it in lay terms and put it in the context of the interests and objectives of the Spanish economic and social players. This is because an intelligent and functional consensus can only be forged by knowing the small print of the debate, and their consequences for the economy and for Spanish citizens. A national consensus that will enable Spain to once again become a major European player, as it is to be expected by history, size and ambition. To this purpose I have once again been able to assemble an unbeatable group of professionals from all fields of expertise; academics, economists, financiers, policy makers, consultants and legal experts. I wish to express to each of them my deepest gratitude for a job well done, and thank them for their understanding of this deliberately biased executive summary. I have tried to summarise their main points of view and then contrast them with mine, for the benefit of the reader who may then form their own opinion on issues that are often controversial, some even ideological, while others are entirely technical. Issues that will undoubtedly have profound social and redistributive consequences. As I previously wrote last year, "Europe is not built by pretending to be unanimous, but through an intense process of comparing views, reaching complex agreements and scrupulous compliance with the arrangements which we have together set ourselves".

The book begins with an introductory paper (chapter 1) by Joaquín Almunia, former Vice-President of the European Commission, on the future of Europe. An upbeat paper on economics and politics. Regarding the economy, he mentions a widespread recovery; the confirmation that the reforms in Greece are working and that the country is on its way out of its financial programme, the stability of the euro, the improvements in banking solvency and profitability. In the political arena, Macron election, Merkel confirmation, maintaining European unity faced with Brexit and its mounting difficulties, improvements in pro-European sentiment. Almunia calls to seize the moment and move decisively forward with European integration. A call that, as collaborators on this Yearbook, we all share one way or another, and which we have made the central conclusion of this edition.

From a more personal interpretation, this chapter presents what we could call the Brussels consensus[12]. A consensus that is at odds with frequent unfair and unfounded predictions of doom and gloom on the future of EMU by various North American economic gurus, such as Feldstein, Stiglitz and Krugman. A Brussels consensus defined in one sentence: "the problems of EMU have been more down to diagnostic errors in national imbalances… or to failings of domestic economic policy by national governments, than as a result of structural defects in the initial Maastricht design". This is a prevailing view in Brussels that I cannot share, as the readers of any previous edition should know. It is precisely this view in Brussels that has delayed the putting right of these institutional flaws–banking union, fiscal union, Eurobonds, etc.–and has needlessly drawn out and deepened the crisis. It is true that there have been serious errors of diagnosis, but these have been as much in Brussels and the EU authorities as in the national governments of Member States. Leadership and vision have been in particularly short supply in European institutions.

This is not the time for finger pointing though, but for correcting and completing the Monetary Union, as indicated by Almunia in dealing with the proposals included in

[12] I am using this expression here by extension of the so-called Washington consensus, that defined the economic orthodoxy of the 1980s and 1990s originating from international institutions such as the International Monetary Fund and the World Bank, in the words of the academic, John Williamson, who coined the term.

the Five President's Report. It is a process that needs to begin with a prior consensus between France and Germany. They need to arrive to a politically sustainable and economically functional commitment on EMU, that can then be exported to the remaining European countries, with some room for adjustments. A commitment to the paring of responsibility and solidarity. An existential debate between the two visions of Europe behind the main pending issue. Two visions that frame the debates in this Yearbook and in the Union. The debate between austerity and fiscal expansion, between reduction and mutualisation of risks, between balance of payment surpluses and fiscal transfers, between the European Monetary Fund or a European Minister of Finance as a means of facilitating macroeconomic stability in Europe, between orderly debt forgiveness and restructuring with conditions imposed by a European institution.

Almunia does not say so outright, but I would venture to say that his in-depth European experience will lead him to agree with me in that it is not possible to expect a comprehensive, systemic major solution, a goal-scoring victory by either of the two camps. The solution and compromise can only result, in the purest European style, from multiple detailed agreements and an infinite number of technical negotiations in all pending chapters. Negotiations that will score a much-needed, overall balance in the spirit of trade agreements. Hence the importance of Spain playing an active part in these technical debates, whose outcome will be the forging of the final political agreement. This is the second purpose of this Yearbook. If a political Union is developed pari passu with the Monetary Union, as it surely must, it will then be possible for the European government to apply a larger dose of solidarity or responsibility, depending on changing voting preferences by the European electorate, an electorate which, contrarily to what is often assumed, is not uniform within each country. All of this is to take place within margins predefined by the founding Treaty and EU legislation, as is the case in all Member States with regard to their fiscal, taxation, employment and educational policies or structural reforms. This is because the European Union remains the best platform for us Europeans to promote our values and defend our interests in the global world.

In the following chapter, Yolanda Azanza, Carlos Pérez Dávila and Francisco Pizarro, at Clifford Chance, interpret the capital markets union as a qualitative leap towards greater economic and financial integration, as a logical step in the direction of political union. They even quote Victor Hugo in this regard. The paper offers a detailed explanation and assessment of the current status of implementation of priorities defined by the Commission in its 2015 Action Plan which, following a public consultation process, was reformulated in June 2017 (the Mid-Term Review). It contains a range of suggestions and contributions of relevance to a debate that has been gathering momentum in the Union since the Commission made it its priority. Particularly, with Brexit looming, it has signalled the urgency and need to ensure the existence of broad, deep, liquid, and globally competitive financial markets within the Eurozone.

Ideally, the capital markets union would make it possible to: (i) mobilise more investment for European companies, (ii) increase their financing possibilities and options, (iii) improve financing of innovation and infrastructure, (iv) provide greater stability for the European financial system by enabling risk diversification, and (v) strengthen financial integration in Europe and thus improve its economy's competitiveness. Revision of the Action Plan has highlighted the need to advance in seven different areas. Perhaps of greatest importance is the financing of innovation, of start-ups and the different types of venture capital. This is because the greater part of Europe's positioning in the new economy is being played in this domain, in the development of this type of companies, regarded as vital to the future of employment and competitiveness. This is an area where the Union shows a considerable lag compared with other regions of the world. Although innovation is not only about financing, there is an exhaustive list of European initiatives in this regard. The majority focus on breaking down information barriers, enabling the development of fintech companies by means of allowing "regulatory sandboxes", and the defining of a common European system of tax incentives for initial investment, life cycle revenues of the company, and profits made when the investment comes to fruition.

Other interesting sections of the revised Action Plan for the capital markets union relate to (i) enabling access by small and medium-sized companies to organised capital and debt markets. The authors warn of the administrative burden and cost, which the indiscriminate application of IFRS may entail and of enlarging prudential requirements for small investment companies; (ii) protection of investment financing in sustainable infrastructures, an area that has been especially hit in regulatory terms by the CRR/CRD IV in accordance with Basel 3 guidelines, (iii) promotion of long-term saving via a European passport, cross-border competition and transparency in pension fund-type instruments. These are all aspects that the Commission intends to incentivise by creating the Pan-European Personal Pension Plan, (iv) recovery of the European securitisation market with close attention to securitisation of loans to SMEs which, according to the Commission's estimates, could entail an extra €150 billion's worth of financing. The authors note that it is a highly unequal market in the different European countries, and it is proving especially complex to harmonise. I venture to suggest, going a little beyond the authors, because in some countries there is an implicit element of State aid that would not be possible to generalise on a European scale, nor would it be desirable to do so.

Finally, this chapter underlines the three most significant obstacles to full integration of European capital markets: the convergence of national insolvency procedures, the different financial product consumer protection schemes and cross-border taxation barriers. In all three, it is proving difficult to make progress.

The following chapter (3) studies the role of the euro in the world and begins with the recurring part of the Yearbook which aims to describe the regular operations of the Union. Although it is a classic, Blanca Navarro, Almudena Gallego and Miguel Fernández, of the Research and Assessment department at ICO, are able to surprise us with their original analyses and thought-provoking insights. They also provide us with an impressive amount of disaggregated data. My aim here is not to summarise all that information, but rather to refer the reader to the corresponding chapter. I will limit myself to highlighting the major trends and emphasise a number of special aspects that I found to be particularly relevant. In doing so, I may not be doing justice to the overall wealth of information contained in the chapter.

The euro has undisputedly been the second most used currency internationally, including during 2016 and 2017. However, its use continued to decline slightly, a trend that started in 2015, and which goes beyond a mere cyclical phenomenon linked to interest rates and exchange rate movements. A soft declining trend that is more closely associated with what ultimately constitutes a reserve currency, particularly in a context where geopolitical conflicts have taken on special relevance and the Chinese authorities have ratified their intention to protect and nurture the international status of the yuan. This point was made in the 2017 Government's Annual Report, even at the cost of the stability and "fair value" of the Renminbi exchange rate. Should this statement translate into a sustained policy, the international role of the yuan will increase, as it staves off fears of protectionist intervention.

The steady decline in the use of the euro as a means of payment in international trade also continued. Albeit more in the exchange of goods than in services, as befits the Union's international trade pattern. This fact reminds us of the familiar difficulties experienced by the European currency in establishing itself as a means of payment utside Europe, in transactions not originating in and not bound for Europe. As a result of the lack of synchronisation of monetary cycles in the United States and Europe, interest rate differentials between the two regions have widened considerably during the period. This has led to foreign investors realigning their portfolios to assets outside EMU.

The euro's share in worldwide deposits and loans remained stagnant, while the weight of the dollar increased. This is probably the most significant development for the purpose of this Yearbook, as it basically depends on institutional credibility and confidence, and less on monetary cycles. The dollar is still the currency of choice in the main financial markets (equities, fixed income, money market, currency market, or derivatives market), setting itself further apart even from the euro. Only in the interest rate derivatives markets, the euro remained the most used currency for another year. In terms of the holdings of official international reserves, the euro has increased its share both in terms of volume and percentage. This is perhaps the most positive aspect in the euro's performance in this period. Because it shows a certain degree of abatement of the political risks associated with the European currency. Let us not forget though that we are still light years away from the dollar (64% v. 20%). Analysing disaggregated data, the absence of inroads by the euro into Latin American central banks' portfolios is especially noticeable since it plummeted following the beginning of the European debt crisis and has not yet recovered.

Lastly, the chapter comprehensively covers developments in foreign exchange, from the analysis of the euro's exchange rate performance against the major currencies, to describing the exchange rate systems of the various countries which, one way or another, peg their currency to the euro (formal or informal euroisation, hard or soft pegs, explicit or implicit fluctuation bands, etc.). Regarding exchange rate movements, it should be underlined that the euro's appreciation "may be a cause for concern for the ECB's Governing Body", particularly in a context where the inflation outlook remains excessively low. The EU has formulated a new and decisive official policy to promote the use of local currencies in countries applying to join the Union, and in those thinking of applying, as a way of contributing to their domestic financial stability and avoiding limitations to the implementation of monetary policy in the Eurozone. This policy is a thought-provoking fact in terms of exchange rate systems, a new policy that signals a fundamental political turn, although the authors do not go as far as saying so. Entry into the Monetary Union will no longer be as straightforward as it has been until now, because events have convinced Member States that a smooth exit is virtually impossible. This new informal policy will need to be reconciled with the assumption, implicit in the Commission's Communication of December 2017, that the euro will eventually be the currency of the entire European Union.

José Ramón Díez, from Bankia's Research Department, describes and analyses the Union's monetary policy. This subject will feature heavily in the ECB's actions in 2018, and will be the subject of much criticism, since there is no doubt that the European monetary authority has started the process to normalise rates and the size of its balance sheet[13]. The real question for the ECB is then: when will the first increase in official rates need to take place and how much will they go up. Monetary normalisation is the natural consequence of the fundamental change in the economic health of the Eurozone, now in a full generalised recovery as we have already mentioned. But, as the author states, it is also a response to the need to: (i) gradually recover degrees of freedom for monetary policy to face the new cycle, (ii) put an end to the anomaly that is distorting the decisions of economic agents and their risk perceptions, and (iii) "avoid vulnerabilities in the demanding valuations" prevailing in securities markets or in the extremely low levels of volatility[14].

This chapter first describes the current economic and monetary momentum of the Eurozone and contains a number of interesting contributions, such as the confirmation that the interest rate of the deposit facility has by default become the ECB's reference rate, supplanting the repo rate; or the need by the ECB to gradually increase the list of eligible financial assets for its purchases, in light of the huge monetary expansion that has taken place. Some figures illustrate this: the size of the ECB balance sheet has quadrupled since the crisis began, and by the end of 2017 represented virtually 40% of the Eurozone's GDP, surplus liquidity was estimated at around €2 billion, 83% of acquired assets have been sovereign bonds from the different EMU countries. Most significant, however, is the fact that since 2015, the purchases of bonds have noticeably surpassed net issues, which has never occurred in the USA. This explains the problem of scarcity of eligible assets faced by the ECB, and never by the FED, and the increased exiting difficulties that this extraordinary policy will entail for EMU.

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[13] A good demonstration of the importance that the communication policy of central banks has taken is that analysts now almost unanimously accept that standardisation starts with the simple announcement that monthly injections are to be reduced and not so much with the first effective rise in rates or effective reduction in the balance sheet. It seems excessive to me, although it is true that Mario Draghi has showed mastery in stimulating the market through words rather than with actions. That said, I cannot forget the famous line by Lincoln: "you cannot fool all the people all the time".

[14] What a superb euphemism these last two points are for referring to the mounting evidence of a bubble in the bond markets.

The author's central thesis is that the time has come to gradually reduce current extraordinary monetary stimuli. And that only the lack of inflation has prevented the ECB from doing so earlier. Therefore, the article goes to considerable length in explaining the ultimate causes of the lack of inflationary pressure. Thus, it discusses the structural stagnation hypothesis, the possibility of a near-zero new normal for equilibrium interest rates, and the resulting loss of monetary policy effectiveness. I would invite the reader to delve deeper into this discussion, which will shape the neutral level of interest rates in the new normal and the appropriate size of the balance sheet of CBs in the steady state. These are and will be two key variables for economic authorities, for investors and for all economic and social players. These are obviously fundamental questions, but please allow me to warn that they assume a degree of "this time different".[15] An assumption that cost so much in the last financial crisis, from which we are only just recovering. Perhaps we should all be more cautious and mindful that this is not the first nor will it be the last round of technological revolution and globalisation. We should also learn useful political lessons, not only of economic policy, of precisely how the previous infatuations with new eras turned out.

This chapter ends describing the scenario that can be expected for monetary normalisation. It moves away slightly from the market consensus, not so much in terms of the sequencing of measures, but rather in the timing. First, the continuation of the gradual reduction in net purchases by maintaining reinvestment. Second, the adjustment during 2018-19 of the interest rates corridor, by decreasing the cost of the deposit facility. A move that might have a considerable impact down the line, notably on the Euribor, 12 months later, taking it into positive territory[16]. Lastly, the effective increase in intervention rates, which will not take place until spring 2019. I am concerned by this benign consensus because all risks are on the rise, particularly in view of the strength of the European economy, and as we discussed in this Yearbook, of possible significant progress in completing the Monetary Union. I am also concerned about the understandable emphasis central banks are placing on the search of a steady transition without surprises in markets. This rational insistence in avoiding unwelcome peaks in yields, may become a huge moral risk. It would seem that it is the responsibility of central banks to ensure positive and stable returns for investors, or at least to ward off unpleasant surprises for them (the so-called Greenspan put), when there is no doubt that this cycle has gone on for long enough for investors to understand the mounting risks. And warnings have been issued ad nauseam by authorities.

In chapter 5, Gerard Arqué, Enric Fernández, Pau Labró and Estel Martín from Strategic Planning and Research at CaixaBank analyse the advantages, difficulties and possibilities of pan-European bank mergers. The idea has been doing the rounds for a while that investors will believe in the European Monetary Union when they see real

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[15] It is the name of a classic written about the crisis by Reinhart and Rogoff, which made reference to the belief during the wonderful years of Greenspan's *Goldilocks economy* that economics had managed to master the cycles and overcome inflation for good.

[16] Let us remember that the Euribor is the key rate in Spain, in how it affects both disposable income of borrowers, and profitability of the financial system.

European banks, retail banks with a major presence in several EMU countries. What is certain is that, thus far, there are none[17], that the latest European mergers have been on a national level, and the few that are not have been primarily outside the Eurozone. It is also certain that ECB directors waste no time in encouraging and preaching about the virtues of transnational mergers, to the point where some statements could raise concerns by competition authorities. Certainly, the CNMC (Spanish National Commission on Markets and Competition) would have initiated proceeding against the AEB (Spanish Banking Association) for much less.

This chapter begins by describing the European banking structure and analysing the advantages that can be expected from pan-European mergers, and then discusses in detail the different ways of promoting them. The European banking market continues to display a significant domestic bias. European banks grant 90% of their financing to companies domiciled in their own country, and only earmark 5% of the total to companies in other EMU countries. These figures are all the more extreme for household borrowings and deposits. Moreover, the five most important European banks make up barely 15% of EMU deposits, compared with 40% in the USA.

The theoretical advantages of pan-European mergers seem clear: diversification of macro and economic cycle risks, reduction in asymmetrical exposure to the respective Treasuries, dilution of the sovereign and banking risk nexus, more stable and diversified financing through access to a larger and more diverse pool of investors, economies of scale and cost reduction which would enable margins to be improved. At any rate, clear enough advantages for one to wonder why they have not come about. Language, cultural, even psychological, managerial and market knowledge reasons partly explain the high pan-European merger costs and the reluctance of executives to carry them out, and that of investors to demand them. In other words, many of the intended advantages have turned out, in practice, to be more theoretical than real. This is largely due to the continuing existence of strong national barriers inside the Eurozone that prevent transnational institutions from operating as a single bank. The success of any international expansion depends on being able to analyse and really profit from those expected competitive advantages, on being well versed in the national idiosyncrasies, and being able to identify who and what to buy. Few banks appear to succeed when simply replicating their business models in other countries.

The last part of this chapter focuses on identifying remaining internal obstacles and exploring means of reducing existing regulatory fragmentation. A very obvious regulatory stumbling block is the absence of a European deposits scheme. Not only because it maintains the sovereign bank risk nexus but because it prevents joint management of a pan-European institution's liquidity and thus complicates management of potential banking crises. It is therefore surprising that the latest proposal by the Commission[18] on a European deposit insurance mechanism is an outright step back and eliminates the third phase of full mutualisation from the project.

[17] Only three European institutions, BNP, ING and Unicredit have made the top ten in more than one of the six largest EMU countries.

[18] EC Communication for completing the banking union, COM (2017) 592.

A feature found to be wanting when creating a true, level playing field. According to the authors, "it does not appear consistent for a European bank to be supervised and resolved on a European level, whereas if a bank with offices in several euro countries goes bankrupt, separate national deposit funds are to pay compensation to its nationals, depending on its availability of resources". This is wholly inadequate and represents a red line for the common project.

This chapter lists additional obstacles of significance: different national insolvency regulations for individuals and corporations; domestic regulatory discretion regarding capital requirements; diversity in the use of internal models for calculating them; different consumer protection regulations; and, uncertainties with regard to the value of doubtful assets in bank balances in some countries. The chapter ends describing the different initiatives under way from the SSM, Commission and Council for reducing NPA —non-performing assets —in bank's balance sheets. A policy that has become a genuine European obsession. It also mentions at the end, the need to improve the current framework of recovery and resolution of credit institutions, in particular the coherence between the BRRD and State aid regulations.

Francisco Uría, principal partner at KPMG Abogados, suggests in the following chapter, number six, a difficult trinity of improvement, convergence and regulatory stability in EMU. As we know all too well, the financial crisis has unleashed a global, European and Spanish regulatory deluge. Adding to it judicial activism, we can conclude that it has substantially affected the business model and profitability of financial institutions. For this reason, he writes, a two-fold exercise is urgent. On the one hand, revision of the new regulations to detect duplications, redundancies and contradictions, while on the other, encouraging the use of new technologies for enabling both compliance and actual implementation. Some of this has already been done at EBA, the Academia[19] and the FSB, although more systematic research is still needed.

Nevertheless, two clear conclusions come to light: there are unwanted effects on economic performance and these effects stem more from national regulations than international ones. Probably, I believe, because national legislation and regulation are more tied to political populism and to the apparent need to generate rapid responses to complex problems.

This chapter provides a thorough description of the new global standards regarding capital, liquidity and leverage, and the long and complex process of transposing international legislation on the European equivalent which culminated in 2013. By November 2016, however, the European Commission had introduced a legislative package known as "European Banking Union Reform" which already amended it. The European Banking Authority or EBA has had the central role in this harmonisation, particularly in developing the European Single Rule Book. The ECB in turn, as the supervisor within the SSM, has had a leading role in harmonising criteria and in

[19] The text explicitly mentions a recent Harvard University White Paper highlighting the existence of a number of regulations whereby profits made are clearly less than the costs generated: regulations relating to institutions' separation of activities (Volcker Vickers regulations, etc.), the new leverage ratio or restrictions on salaries in the finance sector.

implementing the regulation. It has detected more than 150 “national options and discretions”, more than a hundred of which it regards as already corrected.

The author then goes on to make substantial comments on eight different lines of supervision and regulatory action. The first is the measures for tackling the problem of systemic institutions, and specifically for guaranteeing them access to a volume of assets readily convertible into capital in times of crisis, (TLAC). The second is the development of the new European Bank Resolution Mechanism, SRM, which unlike SSM does not operate with full autonomy, since the Regulation provides for successive intervention, where appropriate, by the Commission and even the Council, as we have seen in 2017, and “which imposes upon institutions new and intense regulatory requirements which are superimposed on prudential constraints”. The third is the new regulations concerning corporate governance, which have become subject to monitoring at the annual SREP and have created instrumental, organisational and procedural obligations. The fourth is the compensation policies which create competitive disadvantages for regulated banks as compared with their non-banking competitors. The fifth is the new information requirements that strengthen protection for investors and banking clients, of which MiFiD2 is of course of particular note. New requirements that are forcing institutions to rethink their business and commercial models. The sixth is the new Payment System Directive, PSD2, and data protection regulations that will grant new technology competitors, fintech, access to bank clients’ accounts, under certain conditions, and represent a real threat to their existing information advantages. The seventh is the new international accounting rule, iFRS9, and the Spanish national one, Appendix IX. And finally, the urgent measures approved in Spain regarding “floors” (minimum interest rates) and other clauses on mortgage contracts, which will have relevant implementation costs that may be offset by decreased litigation.

A veritable tidal wave of regulations, a tsunami, which calls for stabilisation and simplification. If anyone–regulator, politician, analyst or journalist–had any doubts regarding the substantial costs imposed upon institutions, I trust that reading this chapter or its abridged form in the preceding paragraph, will have dispelled them for good.

Part II of the Yearbook begins with chapter 7, in which Maria Demertzis and Alexander Lehmann, at Bruegel, analyse the European strategy for reducing NPA, non-performing assets on bank balance sheets. Given the importance and current relevance of the subject, we considered it appropriate to incorporate a European perspective, since the Spanish one has already influenced the previous chapters. The authors, recognised European experts, start with a political economy premise which is both interesting and questionable. That any effort made to reduce default risk in banks must also reduce the financial burden on bank debtors. That is, it must consider measures for restructuring and writing-off their bank debt. Interesting but politically difficult to sell, since what does it mean in practice? That bank shareholders should cope with greater losses? That banks will have to raise new and additional capital? Or that there will be additional State aid to facilitate those write-offs, in direct contradiction of the European principle of no more money from taxpayers?

Let us take a closer look at this proposal. As stated in this chapter, Italian and Greek banks have the greatest exposure to non-performing assets (NPA). Bruegel's proposal of forcing restructuring means that they would have to attract more private or public capital, and some probably may have to be liquidated or resolved. It seems clear to me that, without having completed banking union beforehand, such a policy can only reinforce the bank sovereign nexus, further weaken public finances in both countries, hurt their chances of economic and social recovery and threaten another round of crisis countries. Unless the European strategy to reduce NPA, the so-called risk reduction strategy, incorporates a proactive and quantitatively highly significant European Stabilisation Fund, a new European bail-out. This time to pay for banking debt write-offs in countries with still weak banking systems, which incidentally is not the case in Spain. I fail to see any desire for an additional bail out in today's European political landscape. I tend to think that the premises on which this paper rests are politically overly naïve, technically inadequate and potentially explosive. Naive because it fails to address the politics of the distribution of losses, which are part and parcel of any debt restructuring. Technically inadequate because it is well known that balance sheet crises, as appropriately defined by the BIS and now widely accepted[20], take a long time to be digested. Trying to take short-cuts only risks making them more frequent and costly. And politically explosive, because it may spur another European debt crisis.

The rest of the European strategy for NPA reduction proposed by the authors in this timely and thought-provoking paper is part of the technical and political European consensus. As such, it has in one way or another been set out by the ECB in its prudential policy, by the Commission and by the Eurogroup. Let us remember that NPA reduction is the focus of a special inspection by the SSM in 2017-18. It encompasses three fundamental actions. (i) Changes in restructuring and insolvency schemes, bankruptcy laws, to encourage early restructuring and enable highly indebted companies to survive, albeit at the cost of the expropriating some of the traditional rights of original owners. (ii) Direct participation of specialist investors in the restructuring of assets. These companies, known as "distressed funds," have for example been very active in bank restructuring in Spain, in spite of the fact that public opinion, and part of the political establishment across all parties, have vilified them as "vulture funds". Investment pools which the European consensus nevertheless require as a necessary part of the process since they provide specialist knowledge and the necessary liquidity to contribute to price formation of these assets. And (iii) the establishment of asset management companies (AMC), better known as bad banks, such as Spain's SAREB, which help to overcome market and coordination failures and facilitate the quick cleaning of bank balance sheet. Asset Management Companies "in which public participation is inevitable", although the authors show only lukewarm support for the proposal of a European wide AMC. The chapter finally observes that there is not a great deal of difference between the strategy now recommended in Europe and the one followed in the 2012-2014 bank restructuring in Spain. Which perhaps explains its considerable success and why the Spanish experience has contributed so much to creating the European consensus.

[20] I invite interested readers to take a look at chapter 1 of the 2016 Yearbook, in which Jaime Caruana introduces the BIS' analysis of the European debt crisis.

In chapter 8, Manuel Conthe introduces us to the finer details of European bank resolution with his characteristic enthusiasm for dilemmas. As soon as doubts arise over a bank's liquidity or solvency, investors and depositors face a typical prisoner's dilemma. And the authorities, the typical collective action problem. The traditional rules and procedures for resolving these problems do not work in the financial system, as it is known since the Great Depression. Because banks have too many short-term creditors, its depositors, and because the dismay impact of banks failures on the real economy. Therefore, the liquidation and intervention of financial institutions, which we now call resolution, have never been guided by general bankruptcy procedures. Up until this crisis, they were based on taxpayer's unlimited resources as the ultimate guarantee of banking confidence.

However, the huge costs of this crisis have taken its social and political toll and delivered bail-in as an alternative to the bail-out. The idea is that the financial system pays for its own mistakes: shareholders, creditors and depositors, rather than the taxpayer. Consequently, many legal changes have been implemented: (i) mandatory expropriation of the traditional rights of shareholders and creditors in resolution situations, (ii) new administrative mechanisms for managing bank resolution; mechanisms that combine powers traditionally vested in central banks and in ministries of Finance; an administrative mechanism because experience has shown that in the world of banking, "effective legal protection can only be enforced retrospectively"; and (iii) forcing banks to issue a new type of "bailinable" asset, a debt security capable of withstanding losses in the event of resolution. A significant new legislation, compounded with the additional difficulty that it needs to be compatible with the limitations imposed in the Maastricht treaty and the completion of banking union. All of this resulted in a brand new Single Resolution Mechanism (SRM) for the Euro Area, whose procedure is described in technical detail in this chapter.

Surprisingly, this mechanism was put to the test in June 2017 with the urgent resolution of Banco Popular in Spain. We are all aware of how it turned out, with the sale of Banco Popular to Santander for 1 euro, after assuming all debts, including contingent legal liabilities. Previously, Popular shareholders and holders of contingent convertible bonds or COCOs and subordinated debt saw the entire value wiped off their investment. This chapter provides an interesting analysis of the case. More relevant for the purposes of this Yearbook, however, are the lessons learnt from that resolution exercise. It has been widely considered a European success, but it leaves a lot of questions yet to be answered.

First, the slightest suspicion that a bank is under the radar of the Resolution Authority causes a "downward death spiral" that is particularly harmful to small listed banks that cannot rely on the presumption of being systemic. It would be paradoxical for SRM to result in a "delisting" process of a medium-sized bank and therefore resolved instead of liquidated. Such an outcome would only jeopardise the transparency of the financial system and increase vulnerability of customers and depositors. Second, the supervisory process and stress tests are by definition always limited and subjective and may overlook fundamental weaknesses that only come to light in times of crisis. True, but please allow me to qualify this conclusion. There is not, and there will never be, a perfect supervision and regulation system that will prevent any and all banking crises.

The current system, and the proposed changes, must be evaluated in terms of cost-effectiveness, because supervision, as resolution, is always nothing more than an informed, intelligent, value judgement; an opinion as to whether an institution "is failing or likely to fail". Third, the current Resolution scheme must be completed with official mechanisms to provide liquidity, avoid downward spirals of solvent but illiquid banks and offer bridge financing when resolution processes take a long time. Liquidity providing mechanisms which, in my opinion, may only be European in scope. Thus, bringing back the essential role of the ECB as lender of last resort. I am nevertheless, very sceptical, regarding the feasibility of bridge financing, once news of the resolution is public and the bank's management has been relieved of its duties. And if it has not been relieved, I have serious difficulties injecting public money. A point which brings to emphasise that bad management should not be confused with criminal behaviour but should anyway be removed at resolution.

Chapter 9 returns to the topic of Fiscal Union, which was analysed in detail the previous year[21]. This time, however, it is not about providing information on the possible different versions of an issue that is already part of the European agenda. But rather about stating an option, a European model of fiscal rules and institutions, as does Pablo Hernández de Cos, Director General at Banco de España. He starts by highlighting the improvements in the framework of European fiscal governance since the beginning of the crisis: (i) the expenditure ceiling in the preventive arm of the Stability and Growth Pact, SGP, (ii) the strengthening of the debt criteria in the monitoring process of the SGP, (iii) the tightening of the sanctions regime and (iv) the creation of Independent Fiscal Authorities. Significant but insufficient improvements that have not resolved the excess complexity and lack of transparency, or the discretion and lack of automation of the process; have not created macroeconomic stabilisation tools, nor have they progressed with the mutualisation of the sovereign debt or the creation of a risk-free European asset as a benchmark. This chapter therefore provides systematic and thorough arguments to overcome theseoutstanding weaknesses. Arguments that are rooted in mechanisms already provided in the 2015 Five Presidents Report and have been reinforced by the Commission's December 2017 Communication. Arguments that start with the premise that the inevitable advances in fiscal integration can only come about as a result of increased fiscal discipline. A motto of this Yearbook since its first editions. There is no contradiction between solidarity and fiscal responsibility; rather, one cannot exist without the other.

To begin with, Europe needs a framework of simpler fiscal rules, both for effectiveness and for legitimacy. This complexity is reflected in the number of rules[22], in the amount and nature of exceptions–whereby one needs to be a veritable expert in subtleties and euphemisms–and in the monitoring and assessment of these rules, in

[21] Look specifically at chapters 9 and 10 in the 2016 Yearbook, written by Martine Guerguil and José Luis Escrivá.

[22] A note about this complexity. While Federal States usually have two tax regulations in place, in the EMU, in the Stability and Growth Pact, there are six side by side, in addition to those approved nationally.

which Independent National Authorities and the European Fiscal Stability Board now also need to be added along with the EU Commission and Council. Complexity only adds to the likelihood of non-compliance and to the inconsistency of potential imposing of sanctions. The author therefore suggests replacing all this confusion for two straightforward numerical rules: an expenditure ceiling, similar to the current one in Spain, and a debt ceiling, which would simply be a correction factor of the expenditure ceiling if public debt exceeds a certain threshold (see details of these rules in the corresponding chapter). A straightforward expenditure ceiling imposes discipline in the budgetary process, facilitates the identification of deviations, and above all, saves the ex post cyclical increase in revenue. In addition to defining a new rule, it would also be necessary to progress in its simple implementation. To that effect, the possible use of the Independent National Authorities and the European Fiscal Stability Board is suggested, if certain conditions are met. In my view, however, in a fiscal union this political and executive function belongs by definition, and without excuses, to the planned European Ministry of Finance. Otherwise its establishment makes no sense.

As far as the Stabilisation facility is concerned, the author starts by revisiting existing channels to deal with asymmetric economic shocks in EMU, both public and private. He highlights that financial channels normally absorb 80% of those shocks in any monetary Union, while in EMU, for a host of known reasons, they have much less offsetting power. This fact merely underlines the urgency of the fiscal channel, as well as ultimately progressing into banking and financial union to increase the stabilising factor of the financial channel. The chapter therefore proposes the creation of an automatic stabilisation fund, not unlike the oil stabilisation fund in Norway or the copper stabilisation fund in Chile. A Fund which would be financed by direct contributions by Member States, depending on their cyclical position and their actual versus potential growth and employment. A Fund which may have direct access to capital markets, with joint and common guarantee from EMU countries. The Fund would restrict itself to cover a country's cyclical position, one-off problems like exogenous recessions or cyclical unemployment. This elaborated proposal competes with the potential direct use of the European budget for stabilisation purposes. It is interesting but complicated, and it would require greater technical detail to avoid moral hazard, to preserve adequate incentives to the implementation of appropriate national policies, particularly if linked to the unemployment rate. This proposal is however, not essentially all that different to the one contained in the Juncker Commission 2017 December Communication.

Technical justification of a risk-free asset in EMU is straightforward and well known. Its absence leads to financial fragmentation; exacerbates asymmetric crises and converts them into systemic ones through contagion; worsens the bank sovereign loop; impedes carrying out of monetary policy; and prevents consolidation of the euro as an international reserve currency. As we know, there are many options for a potential free asset on the table, three of which are described in the text of this chapter. The author appears to take the institutional stance, opting for the so-called Sovereign Bond Backed Securities, consisting in the securitisation of national sovereign bonds currently in circulation, with different tranches of seniority. Only senior tranches would be nvestment grade and would receive a regulatory treatment equivalent to current sovereign debt. This proposal entails the creation of a European Debt Agency, which I understand would be part of the future European Ministry of Finance.

The whole proposal is based on the idea of avoiding mutualisation of sovereign risk in Europe. This is why it cannot work and is in fact very dangerous. It would involve, as I already discussed at length in chapter 7 of the 2013 Yearbook[23], junior tranches not being rated as investment grade, but equivalent to junk bonds. Bank holdings of "excessive" sovereign bonds would be penalised regulatorily. In other words, all domestic public debt, issued or in circulation, above a specific level of indebtedness over GDP would be a junk asset. This would seriously limit the ability to carry out economic policy in countries fiscally regarded as weak or too deep in debt. It would maintain financial fragmentation of the Eurozone, the bank sovereign loop and the inequality of private sector funding conditions in the different Member States. I did not agree with this proposal when it was made in 2011[24], and I agree even less with it today. Notwithstanding how much political headway it has made, being practically demanded by the Franco-German consensus. But think twice, if for instance the Spanish government regards the Catalan government's debt as being as senior as that of the Kingdom of Spain, how could it be any different in EMU? There can be no monetary union without mutualisation of sovereign risk. We can discuss legacy assets as much as we like, but financial engineering with public debt, like the one we saw in the private sector during the recent crisis, will merely serve to postpone the inevitable reckoning. Only the proposal that this chapter calls "de maximums" guarantees the sustainability and permanence of EMU.

Finally, the Yearbook includes a chapter on the social dimension of the European Union, written by Rafael Doménech, at BBVA Research, and Javier Andrés, at the University of Valencia. They start with a declaration of principles that the crisis has widened inequalities between countries and reduced the legitimacy of the European project. Boosting more inclusive growth[25], is then a political necessity if we intend to advance with economic integration. This is a thesis that has gained momentum, and is hardly being disputed by European authorities or politicians at large. I tend to think, however, that a little more comparative empirical research would not go amiss. There is no data that allows to conclude that economic and monetary unions that have most reduced internal regional inequalities are more sustainable. This is certainly not the case with any large monetary area such as the United States, Brazil or China. Nor is it clear whether Brexit, a prime example of disaffection with the European project, is necessarily a result of crisis induced differences, since the UK has fared, on average, somewhat better and has not endured the single monetary policy.

Indeed, this chapter devotes a whole section to measuring inequality in the European Union and shows results that strike me as being somewhat at odds with this central

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[23] See Fernando Fernández, 2013 Yearbook, chapter 7, Fiscal Union, and particularly heading 7.3. *Hacia un activo europeo para la gestión de la política monetaria común (Towards a European asset for managing common monetary policy)*, pp. 229-235.

[24] See Fernando Fernández, *La crisis en Europa: ¿Un problema de deuda soberana o una crisis del euro? (The crisis in Europe: A sovereign debt problem or a Euro crisis?)* FEF 2011.

[25] An increasingly used concept for which it would be helpful to have an operational definition rather than just a regulation.

thesis. First, inequality of income distribution in the European Union is the lowest of the world's major blocs. Second, the level of development explains equality to a large extent. So, do the fiscal system and the Welfare State. Third, within that comparatively low inequality, there is still a great deal of diversity among the different European countries. Fourth, however, inequality of household disposable income after taxes or transfers, has remained relatively stable or has even decreased in the EU, unlike in the United States for example. Fifth, the functioning of the labour market is the one factor that best explains inequality, the unemployment rates and quality of employment. It therefore follows that in countries in which unemployment has increased the most, so too have inequality and social discontent, including political disaffection internally and with the European Union[26]. Hence the importance of employment and education policies for internal social cohesion and that of the European Union.

Social and economic convergence among EMU countries is desirable, but not at any cost. It cannot be the ultimate objective of the Union, in the same way as it is not in Spain. According to the authors themselves, "converging Welfare State among countries must take into account differences in social preferences, while prioritising the increasing of employment rates" and without undermining the international competitiveness and growth perspectives of the Eurozone, I may add. We must not lose sight either of the inter-temporal dimension in redistribution. The specific proposal of the authors is to progress at the European level, to use the terminology of the White Paper on the Future of Europe and in the Reflection Paper on Social Europe. To progress by means of a mix of known techniques: peer pressure, European monitoring, best practices and benchmarking[27], and particularly through the implementation of policies financed and enforced entirely on a European scale, while observing the EU subsidiarity principle at all times. The chapter ends with an extensive catalogue of objectives and specific social policies that could be driven on a European scale. I invite interested readers to reflect on their consequences for the distribution of political and administrative authority within the EMU.

[26] There is a wealth of empirical evidence that in societies with greater inequality, parents' income and level of education ends up being the main determining factor in their children's educational achievement, and therefore in their human capital and salary expectations. See Miguel Marín (ed.) 2015, *Desigualdad, oportunidades y sociedad del bienestar en España (Inequality, opportunities and welfare society in Spain)*, Informe FAES, Madrid.

[27] Techniques that have been extensively used in the Union in the domain of economic and structural convergence, albeit with limited success. So limited, in fact, that it eventually led to more centralised procedures, with common policies and even sanctions such as the Macroeconomic Imbalances Procedure.

## 4. TEN NECESSARY REFORMS

Typically, the Yearbook ends with Ten European lessons. This year, however, as I expect to see the Monetary Union re-founded, it feels more appropriate to end it with the ten most significant reforms, the ten reforms which I find necessary to complete the institutional building of EMU and to bring stability and a sense of permanence to the European Monetary Union, with the 10 Hamiltonian[28] reforms. Most of them will sound quite familiar to the long-standing readers of the Yearbook. Different versions of them have been repeated since the early days of research on this issue, albeit in much less technical detail.

**First,** to restore a more normal monetary policy stance and to move away from using it exceptionally as the Eurozone's sole instrument of economic policy. The ECB cannot ignore the cyclical momentum of the Union, nor can it continue to take quasi- fiscal decisions in the absence of a European fiscal policy. Unless, the ECB seriously thinks that (i) inflation is gone for good and it is reasonable to use monetary policy with the sole purpose to bring it back, (ii) there is no risk whatsoever of a price bubble in sovereign bonds, (iii) the loss of information on risk premiums is good news for financial stability, (iv) it is reasonable to weaken the Eurozone's banks to force them to merge and create truly transnational European financial institutions, and (v) there are no limits on the policy of negative rates (no zero bound) and it is reasonable to face a new economic cycle from rates at that level, that the natural interest rate is zero in the new normal[29]. I am not convinced the ECB council has completely come around to the theory of structural stagnation, but rather that it has been held in check by strong institutional inertia in decision-making. It is also puzzled by lingering doubts regarding the inadequacies of the European fiscal framework and the instability this may mean for the markets in the upturn. The fears that any early abandonment of a policy of very low rates and an overwhelming communication policy to that effect may endanger its credibility, could also be delaying a necessary policy shift.

**Second,** full normalisation of the Eurozone requires the ECB to stop being the only central bank of systemic significance that does not use its own area-wide bonds for monetary policy decisions. Thus, they become quasi-fiscal decisions with redistribution consequences within the Union. This fiscal consideration will become much more important and polemic in the new cycle of deleveraging of the ECB when it begins to reduce the size of its balance sheet, which today already represents more than 40% of the Eurozone GDP, and therefore forces fiscal consolidation of European governments. The need for balance sheets of European banks to stop showing a strong domestic bias in their holdings of sovereign bonds cannot delay nor condition the bringing into circulation of a risk-free, safe European asset. If anything, causality would go the other way; only when this European asset is in circulation will fragmentation of European financial markets cease, and bank balance sheets will stop displaying strong national idiosyncratic risk.

[28] The term should be interpreted in the usual sense, to refer to the final consolidation of Member States following the war of secession.

[29] Questions that I venture to use in a personal and somewhat bold interpretation of a Natixis report.

**Third,** full normalisation of ECB thus requires the existence of a European Treasury that issues this European safe asset with sufficient depth, liquidity and width of maturities to be used as the final reference for interest rates in Europe. In its absence, the German bund will continue to play this role, which brings a dangerous asymmetry to EMU and an exorbitant privilege[30] to Germany. A privilege which some analysts prefer to forget, but not precisely the German government, and which forces it to take on supranational responsibilities more often than internal political circumstances would recommend. The bringing into circulation of Eurobonds, in any of the numerous proposals for their circulation which have been analysed in previous Yearbooks, is not a question of solidarity, but more one of institutional normality and Monetary Union stabilisation. The problems of the very different national starting points, the legacy issues, may be resolved through a negotiated mix of adjustment, solidarity, creativity and financial engineering, but these are minor issues. The real problem is not wiping the slate clean, the stock of liabilities, but rather starting over, the new flow.

**Fourth,** it is not possible to progress with ECB normalisation without an agreement on fiscal governance in the Eurozone, as can easily be deduced from the previous two points. For this reason, the Juncker Commission's December proposal of integrating the Treaty on Governance, Stability and Coordination into the Stability and Growth Pact, into the EU "acquis communautaire" and into the Maastricht treaty, is so important. Because it helps to unify and clarify fiscal governance in the Eurozone, it brings fiscal rules closer to full automation and it reduces discretion and political considerations in its implementation. It seeks to calm public opinion in fiscally orthodox countries and increase their confidence in not having to write a blank check for non-compliant countries. It is an official important step towards the tacit agreement that we have been calling for, to bring stability to the euro: fiscal discipline in exchange for mutualisation of joint debt, fiscal responsibility and solidarity hand in hand. Consequently, the Commission's December Communication includes the implementation of two fiscal backstops, of two regulated bailout procedures with borrowing capacity: the European Monetary Fund for sovereign debt and the Single Resolution Fund for the bank debt, both part of EU processes and no longer as ad hoc international agreements.

**Fifth,** the creation of a Ministry of Finance for the Eurozone is more cosmetic although it lends credibility and political visibility, and thus democratic legitimacy, to the two aforementioned commitments, to create a European Treasury and a European Monetary Fund. Giving it substance would entail the Ministry taking on the implementation and enforcement of fiscal discipline, of applying the fiscal rules, and the management of European safe assets and of the European Treasury. It also involves the most concerted attempt to-date to overcome another European institutional deficiency which has proven most costly in this crisis; the absence of a macroeconomic stabilisation authority which all large monetary unions have. A budgetary responsibility which is a substantial part of any modern Government and which helps avoid domestic crises

[30] By using the same terminology as Professor Eichengreen to describe profit the issuing of an indisputable world reserve currency would mean for the United States.

turning into systemic ones and national fiscal problems becoming European banking crises.

**Sixth,** the banking union needs to be completed with a European deposit guarantee scheme. In spite of the theoretical attraction of the concept of moral risk, there is no advanced monetary jurisdiction, with a sophisticated financial system, that does not have in place this kind of insurance. National insurance schemes being in place in Member States in the Eurozone do not reduce its urgency nor make a EU-wide scheme less needed. More conservative savings will not move freely around the Union, one of the basic objectives of EMU, if the risk of losing bank deposits is determined by the strength and solvency of the National Treasury. European banks will not be able to compete on equal terms, there will be no European banks, the sovereign bank risk nexus will continue to threaten the future of Member States and of the Eurozone itself. Not even the existence of a fully mutualised European Resolution Fund is an ideal replacement, since it is an extraordinary procedure that demands a political decision at the European level, and one that allows differential treatment of institutions (intervention, restructuring or liquidation) depending on national political and economic considerations. Once again, the different starting positions, the legacy issues, cannot determine the steady state of the Monetary Union, but instead, they require imaginative transitional solutions over a period of time and with well-designed incentives.

Seventh, no advanced monetary jurisdiction has ever considered or is considering penalising holdings of sovereign bonds in their banks' portfolios, because this would be tantamount to officially regarding those bonds in default, as likely to suspend payments. The unusual current debate within the Monetary Union is however considering regulating to limit the size of these portfolios by insisting on (i) specific provisions, which would equate to regarding them as a special risk category worth monitoring and controlling, or (ii) additional capital requirements via the discretional use of Basel Pillar 2, the opinion of the supervisor regarding the quality of the assets, the strength and efficiency of control systems and the quality of the management of the institutions. This is a nonsensical debate, despite attempts to disguise it with the grandiose title of "risk reduction". It simply hides the determination to avoid mutualisation of Eurozone bank debt. No monetary union has been able to survive without such mutualisation, and EMU will be no exception, because it is equivalent to regarding financial assets in euros as different assets, depending on the country of residence of the issuer or the holder. I am particularly surprised by the apparent understanding with which these proposals have been met by some Spanish banking institutions and Banco of Spain itself. To me, it is a head-on attack against the principles of the Monetary Union, and therefore against its very survival, as was the case back then with another outlandish idea that was also defended emphatically by a number of German academics and politicians, that of regarding Target 2 balances as a symptom of unsustainable disequilibrium (see previous Yearbooks). Moreover, if the different National Treasuries are truly worried by asymmetric risks of different bank exposure, there is a quick and effective route to reducing that asymmetry, which is the prompt bringing into circulation of Eurobonds, a secure European asset that banks would happily have in their portfolios.

**Eighth,** the European Resolution Mechanism has been tested for the first time this year. Any Spanish analyst holds strong views on its application in the case of Banco Popular, for obvious reasons. What is important, however, is that application of the SRM has been met with a mixed reception across Europe, with some calling for its immedia te reform. First, while discretion is inevitable, it is excessive, which translates into a long and heated process of legal disputes. It is therefore worthwhile specifying the procedure for determining when an institution is "failing or likely to fail" and particularly for legally acknowledging that any decision on resolution is at the end a value judgement, a strong and documented opinion by the authorities entitled to exercise their power in accordance with the law. These authorities should therefore be free of all civil or criminal—albeit not professional—responsibility, in exercising their duty. Obviously except in the event of deceit, fraud or abuse of authority. Second, the SRM must have enough capital available to intervene in any institution it decides to resolve. This amounts to have a borrowing capacity of its own without authorisation or intervention by any other political or monetary authority. The December 2017 Communication aims at this. The decision regarding how to handle an institution being resolved cannot be dependent on finding a private party to take care of the corporate or contingent liabilities. Third, unequal and unfair treatment needs to be corrected, meaning that, if an institution is regarded as non-systemic, it may currently be bailed out in accordance with applicable national legislation and therefore benefit from State aid. Fourth, although we are witnessing considerable political pressure for the SRM to be able to call a standstill of creditors, a sort of bank holiday for a specific institution, it would be a mistake. The signal effects are very powerful, and it seems difficult to avert bank runs once the moratorium has been called, at least in listed institutions. It is therefore better to accept some inevitable discretion and underline the fact that decisions to resolve will be made through urgency and uncertainty. Any alternative would be worse. This has been the banking doctrine since Bagehot's day, and nothing seems to have fundamentally changed. If anything, new technology has increased immediacy and made confidence all the more fragile.

Ninth, in order to have any chance of success, the European Union has to rebuild and strengthen its political legitimacy. To complete the Monetary Union requires new European governance, a new fully legitimate and representative decision-making system on a European scale. Transferring sovereignty to Europe demands political visibility and accountability at European level. It demands scrapping of bureaucratic technicalities, ambiguity and secrecy, and setting forth with administrative and political simplification of the EU in order to bring it closer to citizens so that it makes more sense to them. To begin with, it requires having institutions that citizens can recognise, albeit vaguely, as a Government, a Parliament and a European constitution. It needs more than a Trade club if European citizens, and those from outside the Union, are to take it seriously as a political entity. This is why, for all its difficulties, a new Treaty is inevitable. Technocratic solutions cannot work when the Monetary Union demands increasing surrender of sovereignty to European institutions. Let us take advantage of there being a strong pro-European Franco-German leadership in order to progress to a new Constitution, in order to overcome the permanent sense of crisis typical of a youthful Europe.

And **tenth,** the increasing surrender of sovereignty to EU institutions is a necessary condition of sustainability and permanence of the Monetary Union and of the European Union. We should however not raise false expectations in the European population. Completing the banking, financial, economic, fiscal and even social union, being such an extraordinarily ambitious project, does not imply solving all of Europe's problems, nor does it exhaust the European political agenda of the next few years. Responding to globalisation and the digital revolution demands much more than completing EMU, even though this process is a necessary condition. The political debates about real convergence or inequality of income or expenditure do not arise, and are not substantially transformed, because the European Union has decided to be a monetary union. These considerations were not decisive when launching EMU, and neither are former and consolidated monetary areas such as the United States, Brazil or China free from these debates. European politicians, starting with the Commission and the Council, and no small number of academics and analysts, make the well-meaning mistake of selling the monetary union as something it is not, and which it cannot offer by itself: growth, full employment, high salaries, a reduction in inequality and convergence among the Member States. This only creates disappointment and defeatism. Europe has to bring to a close the debate on how to complete the Monetary Union as soon as possible. It was broadly resolved years ago by academics. Political Europe needs to close it soon, so as to be able to open another pressing one; how to tackle, as a Union, the new globalised and digital world, how to retain its technical leadership, its economic competitiveness and its social model.

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# PART I
# EUROPEAN SCENARIOS IN A NEW POLITICAL CONTEXT

# 1. SCENARIOS FOR THE EUROPEAN UNION AFTER THE WHITE PAPER BY THE COMMISSION AND DOCUMENTS FOR REFLECTION

**Joaquín Almunia**[1]


## EXECUTIVE SUMMARY*

The triumph of Brexit in the June 2016 referendum has been a hard blow for the EU supporters, both in the UK and in continental Europe. For the first time, a member of the club has decided to leave. The negative consequences of such decision are going to hit everybody, although the British will be the main victims of it, regardless the outcome of the ongoing negotiations. But at the same time, there is a silver lining when it comes to the analysis of the European outlook. There are different reasons for that.

First and foremost, because growth has resumed, fuelled by the monetary policy stance of the ECB, that presses downward interest rates without increasing inflationary expectations. The evolution of the euro exchange rate and oil prices also contribute to create favourable conditions for the prolongation of the dynamism of the economic cycle. Together with the fiscal adjustments adopted in the previous years, public and external deficits are constrained and unemployment rates have decreased to reach the lower levels since the beginning of the crisis. Even Greece, after the adoption of very painful decisions in exchange of the financial support received from its partners, seems to be in the right track.

On the political front, Brexit and the arrival of Donald Trump to the White House have helped the EU leaders to react. Last but not least, the populists have not been able to achieve their electoral objectives, and the electoral victory of Macron has given new arguments for optimism, as reflected in the opinion polls. Only the results of the recent German elections, and the difficulties of Angela Merkel to get a stable majority for her next government, cast a shadow on the positive expectations created throughout 2017 in the EU. Depending on the way the Franco-German tandem will function once the new German government will be in place, the EU will succeed when tackling the main issues of the agenda for 2018: the cooperation to reinforce our internal and external security, including defence; the expansion and deepening of the single market in the services sector and in the energy, digital and capital markets; and of course, the completion of the Economic and Monetary Union.


[1] former Vice-President of the European Commisision.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

Those responsible of the euro area, and France and Germany in particular, must strike the adequate balance between the «risk-sharing» and «risk reduction» proposals. Without this agreement, the Banking Union will miss some of its necessary instruments, and the fiscal policies carried out but the member states will not produce the best results. On top of this, the debate opened by the recent summit that took place in Gotemburg around the need of a social dimension of the EU must help to reconcile the idea of an integrated Europe with the sectors of the public opinion seriously affected by the consequences of the crisis. Indeed, a happy end of the negotiations between the UK and the EU-27 will contribute to further dispel uncertainties, in the markets as well as among citizens.

Given the increasing heterogeneity of the EU, the use of the instruments provided by the Treaty to adopt decisions by a group of countries, whenever some of the member states prefer not to be part of the agreement, could be an option. Because, given the number and the importance of the challenges ahead of us, the future of the EU will require the adoption of relevant decisions in the near future.

# 2. THE CAPITAL MARKETS UNION: A PATH TOWARDS A GREATER UNION

**Yolanda Azanza, Carlos Pérez Dávila y Francisco Pizarro**[1]

*A day will come when all nations on our continent will form a European brotherhood ... A day will come when we shall see ... the United States of America and the United States of Europe face to face, reaching out for each other across the seas.*

Victor Hugo, International Peace Congress, 1849

## EXECUTIVE SUMMARY*

Since the creation of the European Coal and Steel Community in the 1950s, the first major step towards creating today's European Union (EU), efforts to bring together European states have made it possible to for the continent to recover from the devastation in the wake of the Second World War, and have allowed the region to enjoy over half a century of prosperity and development.

EU Member States today share a single market based on European policies geared towards enabling free movement of people, goods, services and capital. The Schengen area has scrapped national passport controls, and most Member states have shared a single currency since the end of last century.

Major progress has been made so far by the EU, albeit with an enormous task still ahead in terms of constructing Europe. In this regard, one of the priorities of the current European Commission is to strengthen the region's economy, which has been badly hit by the recent crisis, as well as to boost investment in order to stimulate growth and the crea-tion of employment. In order to boost long-term investment, Europe needs more developed capital markets that open up new means of financing to companies, and enable savers to diversify their investment options, and in so doing strengthen the economy as a whole. To this end, one of the Commission's priorities is to create a single capital market for Member States.

In this regard, it should be highlighted that, in spite of the progress made over the past 50 years, capital markets in the EU continue to be underdeveloped, particularly when compared with their North American counterparts, where financing the busines

[1] Clifford Chance.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

community depends to a lesser extent on bank financing, which makes their companies less vulnerable when banks tighten their lending. The recent financial crisis has brought lower levels of capital market integration on a European level.

The Commission believes that a Capital Markets Union will enable (i) channelling more investment into the European business community, (ii) more efficient connecting of available financing with investment projects in the EU, (iii) strengthening of the financial system as a whole through better risk redistribution, and (iv) strengthening of EU financial integration and competitiveness.

In light of these objectives, the Commission published a Green Paper in February 2015 on the Capital Markets Union as well as two "straightforward, standardised and transparent" consultations on securitisations and on a new Prospectus Directive, two of the main cornerstones of the Capital Markets Union.

In September 2015, the Commission published an Action Plan, on the basis of the contributions received, consisting of over 30 specific measures aimed at creating a true Capital Markets Union in 2019. This Action Plan identified the following priorities: (i) to provide more financing options for European small and medium-sized companies, (ii) to coordinate a regulatory framework favouring long-term investment in European infrastructures, (iii) to increase investment options for individuals and institutional investors, (iv) to strengthen the financing capacity of credit institutions, and (v) to remove barriers to cross-border investment. In view of the insights gained, the Commission recently updated and improved on the 2015 Action Plan.

This paper analyses the priorities identified in the Action Plan, providing an overview of progress made thus far on each, with particular emphasis on those where major progress has been made (such as issues regarding the new regulations on prospectuses, or the new European regulation on securitisation).

# PART II
# A MONETARY UNION THAT WORKS AND RUNS ITS NATURAL COURSE

# 3. AN OVERVIEW OF THE ROLE OF THE EURO IN THE WORLD

**Blanca Navarro, Almudena Gallego and Miguel Fernández**[1]

## EXECUTIVE SUMMARY*

In 2016 and the beginning of 2017, the euro has held its position as the second international currency, clearly behind the dollar which has remained the reference currency, but comfortably above the yen and pound sterling which lag way behind the common European currency in its use at an aggregate level.

With the aim of offering an overview of the euro's role in the world, different perspectives around any currency in the economy are analysed: as a means of payment, as an investment and reserve currency, as a parallel currency, and in financial markets. In general, it can be said that, between 2016 and 2017, international use of the euro fell on aggregate terms, continuing the downward trend in its use seen in 2015. Nevertheless, some positive developments have been found in some indicators. For instance, the share of the euro in international payments increased in 2016 after three years of decreases, although it is still behind the dollar. Likewise, the proportion of international currency reserves represented in euros increased in 2016 despite the context of uncertainty and after having declined for six consecutive years.

Last year, a series of events influenced the evolution of currencies, among them the most remarkable are: the referendum in favour of the United Kingdom leaving the European Union (EU), the new Government in the United States (US), the persistence of geopolitical conflicts, the increase in uncertainty due to the holding of various elections in some Euro Area (EA) countries and the strengthening by the European Central Bank (ECB) of its accommodative monetary policy stance.

However, most of the analysed indicators have shown a weakening of the euro's role from an international perspective in 2016. Firstly, the euro has showed lower use as payment currency in international trade both in absolute terms, due to the weakness in foreign trade, and also in relation to other currencies, and more sharply in transactions of goods than in services. Equally, foreign investors have moved their investment portfolios towards securities outside the EA throughout 2016, mainly in terms of bonds due to the low yields resulting from the ECB's accommodative monetary policy. Furthermore, the share of the euro in global deposits and loans has remained stagnant while the weight of

[1] Research and Assessment, ICO.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

the US currency has continued advancing and consolidating its number one position, demonstrating the need to continue making progress with the completion of the European Banking Union and the deepening of the Capital Markets Union to help promote loans and deposits in euros to households and businesses inside and outside the EA. Regarding the main financial markets (equities, fixed income, monetary market, currency market and derivatives market) the distance between the dollar and the euro has increased year-on-year as in the case of international debt issues or forex operations and it is only in the interest-rate derivatives market where the euro remains the most used currency.

Another phenomenon to be borne in mind referring to last year is that the use of local currencies of candidate countries and potential EU candidates was promoted significantly by its local authorities, with the intention of avoiding financial stability risks and a limited monetary policy in these countries, which could occur due to the high degree of linkage with the euro or *euroisation* that they have. This could lead to a lower use of the euro by the above mentioned countries even though available data suggest that the use of local currencies in said region only shows a slight growth, especially in deposits, which mainly continue in euros.

Besides the latter, it should be stressed that new waves in favour of the euro have recently emerged. The common European currency has regained the support of European citizens in this period as demonstrated in recent surveys on this issue after having deteriorated during the crisis. At the same time, in the last State of the Union Address[2], the President of the European Commission, Jean-Claude Juncker, supported the enlargement of the Economic and Monetary Union to the remaining EU member countries: «*The euro is meant to be the single currency of the European Union as a whole*», in such a way that the euro should be something more than the currency of a group of countries, giving strength and unity to the EU bloc too. This greater confidence in the common currency is based on the momentum of the European economic recovery in the last period and the revaluation of the euro during 2016 and, particularly, in 2017 compared to the rest of main currencies.

However, the recent appreciation in the exchange rate may be a concern for the Governing Council of the ECB as it would cause undesirable consequences on inflation. Nevertheless, studies from the ECB[3] suggest that the downward pressure that the euro's appreciation may have on producer and consumer prices is much weaker in the current context. This is due, firstly, to changes in structural factors related to globalisation (composition of imports, trade integration and the boom of global value chains) and, secondly, to the current point of the economic cycle. That is to say, the negative effects that the appreciation of the euro could have on inflation may be partially offset by the current economic momentum phase of the EA as well as the ECB's accommodative monetary stance. In any event, the evolution of the euro in the coming period will be another challenge for the European monetary policy and will continue to be monitored closely by the monetary authorities.

[2] Juncker, J.C. (2017), «State of the Union Address 2017», Brussels, 13th September 2017.

[3] Cœuré, B. (2017), «The transmission of the ECB's monetary policy in standard and non-standard times», speech at the workshop «Monetary policy in non-standard times», Frankfurt am Main, 11th September 2017.

In this paper, a study has been carried out on the evolution of the role of the euro between 2016 and 2017 in the global environment with the following structure: firstly, the use of the euro as a means of payment in international trade and its relationship with other currencies is detailed; secondly, the role of the euro as a means of investment and international reserves is analysed; thirdly, the presence of the euro in other countries outside of the EA is considered and confidence in the currency is assessed; subsequently, its share in global deposits and loans is examined; and finally, the role of the EA single currency in financial markets (equity, fixed income, money market, currency market and derivatives markets).

# 4. THE ROAD TO STANDARDISATION, OR HOW TO MOVE AWAY FROM AN UNORTHODOX EXPANSIONARY POLICY

**José Ramón Díez Guijarro**[1]

## EXECUTIVE SUMMARY*

After several years bearing much of the weight of anti-cyclical economic policy, the European Central Bank finds itself at a turning point. Monetary policy is set to gradually normalise as the effects of the last financial crisis continue to wane and the European economy grows at some pace. The marked improvement in the euro area's economic situation over the last 12 months – which has been one of the greatest surprises in international affairs of the last year – drove GDP growth to over 2% and saw prices gradually rising, taking inflation to 1.5% and alleviating the risk of deflation. In other words, the region's nominal growth rate has doubled to around 4% in just a year. As a result, while it is clear that inflation has not hit the monetary authority's target (2%), economic conditions are far removed from those that required the use of unconventional measures in recent years. They therefore warrant continuing to tailor financial conditions to this new economic reality. Moreover, although it is unclear whether the supply-side shocks dragging down inflation will be short-lived, even if they are here to stay because they are related to structural changes in the economy, they will probably prompt central bank targets to be revised in the near future. In fact, the first monetary authority to set an inflation target (the Reserve Bank of New Zealand) is probably already analysing a possible revision. This will probably also involve including an employment target under the central bank's remit.

At the same time, central banks need to push ahead with their exit strategies over the coming 18 months, even if it is only with a view to managing risks prudently and therefore gaining some elbow room with regard to monetary policy looking forward. Given the current fiscal situation, it would not be the best option to dip into another recessionary period given balance sheet sizes and interest rates at present. It would also not help if anomalies that may be distorting agents' decision-making persist. These include the penalisation of banks' surplus liquidity in a climate in which businesses are not facing any difficulties in sourcing credit, or the extremely low (even negative) savings rates.

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[1] BankiarResearch Service.

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Lastly, as the IMF recently highlighted, following in the tracks of the BIS, although the financial stability risk map has improved in the short term, the medium-term outlook shows heightened vulnerability. This is demonstrated by higher prices in securities market, compression of corporate bond spreads, and extremely low volatility. All this suggests a return to normal monetary policy is advisable, even though everyone understands that the definition of normality will be very different to before the crisis.

The extraordinary economic policies (in one direction or the other) are a response to special challenges and it is never easy to unwind them. In the case of monetary policy, the return journey is always rockier, especially when it is from uncharted territory as is the case now. The need for patience is also understandable if past errors are to be avoided, as long as interest rates are not highly decoupled from economic fundamentals This is because the challenge is for the markets to remain calm should they detect such a discrepancy. At this point in the expansionary phase of the cycle, financial stability should therefore gain increasingly more weight in the ECB's response function.

The difficulty lies in how to reverse the steps taken by central banks in recent years without triggering unwanted effects on the financial markets. The only precedent is the now prolonged – commencing in December 2013 – and uncertain phase of normalisation by the Fed, following Bernanke's major response to the financial crisis (which was three times greater than that following the Grand Depression) covered in one of the points in this article. Furthermore, there is the additional problem of what would happen if several of the main central banks tightened monetary policy at the same time. In this regard, one prerequisite to avoiding a messy return to normality will be for the main central banks act in concert and the right messages to be sent out, even if it is just to avoid any major imbalances in exchange rates that hinder managing the process.

Given the importance of communication, having a clear idea of where the natural rates of interest lie (the new norm) is crucial to then decide on how quickly to move towards them. However, if the maturity of the expansionary phase of the global economic cycle means it is unlikely this theoretical level will be reached – especially in the ECB's case – efforts would at least focus on regaining the maximum degrees of freedom possible. The second variable central banks must consider is what size of balance sheet would be ideal at the end of the process. We are undoubtedly facing a complex process, with practically no prior cases we can learn from. However, retracing out steps towards normalisation would only exacerbate the risk of central banks falling behind the curve.

# 5. WHEN WILL WE SEE PAN-EUROPEAN BANKING?

GERARD ARQUÉ, ENRIC FERNÁNDEZ, PAU LABRÓ AND ESTEL MARTÍN[1, 2]

## EXECUTIVE SUMMARY*

One of the goals of the banking union is to lay the foundation for the emergence of pan-European banks. Pan-European banks would have more diversified balance sheets; customers could benefit from a more stable supply of funding; banks could take advantage of economies of scale to improve their efficiency and profitability; and the link between banking and sovereign risks would be mitigated. However, this vision has not yet materialized. The great majority of banking acquisitions in Europe in recent years have taken place domestically and the presence of banks across euro area countries is still very limited in comparison with the experience in the United States.

To encourage the formation of pan-European banks, this article emphasizes the need to remove some barriers that are hampering this process. In particular, regulatory fragmentation should be reduced in order to promote economies of scale. This requires further progress in the single-rule book, which forms the essence of the banking union. In addition, measures that would help mitigate the link between bank and sovereign risks are also necessary. In this area, the most important change would involve the introduction of a European deposit insurance scheme, a significant shortcoming of the banking union in its current form, but a lender of last resort (a backstop) for both the Single Resolution Fund and deposit insurance scheme as well as a reduction of home sovereign exposures in the portfolios of banks would also be needed. Finally, two uncertainties are also hindering the creation of pan-European banks: the doubts about asset quality, concentrated on some banks in a few countries that have important amounts of non-performing assets; and the uncertainty related to some regulations or requirements currently under discussion that will affect the value of banks (such as the review of internal models for the calculation of risk-weighted assets or the calibration of the minimum requirements for own funds and eligible liabilities).

In addition to the removal of existing barriers, we expect that the increased digitalisation of banking and its impact on business models will also play a key role in fostering economies of scale and promoting the emergence of pan-European banks.

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[1] CaixaBank Strategic Planning and Research.
[2] The authors thank Ignacio Martínez for the comments and the help provided for the preparation of this article.
* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

# 6. TOWARDS REGULATORY STABILITY IN THE WAKE OF POST-CRISIS ACTIVISM

**Francisco Uría Fernández**[1]

## EXECUTIVE SUMMARY*

There has been, at least, three levels on the regulatory response to the financial crisis: global, regional (European, in our case) and national.

Global response to the crisis was mainly focused on the review of the Basel II agreements with the approval, in a process that has been recently ended, of the new Basel III agreements. New requirements on capital, liquidity and leverage were imposed on the financial entities that are now stronger that they were before the crisis.

In addition to the reform of the banking regulation, new rules and requirements on banking resolution were imposed also at global (TLAC), regional (MREL) and local level. If the new prudential and resolution requirements are considered jointly the effect on the financial institutions and its profitability has been really important.

Also in the field of investor protection, corporate governance, remuneration policy, payment services, personal data protection, accounting (and provisions) more regulation has been passed and more requirements has been imposed.

None of those new requirements has opened, until now, a reflection on the previously approved or on the cumulative effect they could have on the financial entities and their ability to lend. The impact analysis has been limited to the singular effects of each of the new regulations that were about to be proposed.

Now, we are looking to what seems to be the end of this «regulatory tsunami». After more than ten years of frenetic legislative activity all the main regulations are already passed or about to be passed.

As the recent statements from the EBA and the FSB seem to indicate, the time has come to conduct a global and systematic analysis of the cumulative effect of the new regulation, not only on the financial institutions (which it is important in itself) but also on the economies they served. To a certain degree I am personally convinced that if the new prudential, banking resolution and accounting (IFRS 9) are considered together probably some part of the new regulation could be reconsider. This is the urgent task we have ahead.

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[1] KPMG.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

# PART III
# COMPLETING THE MONETARY UNION IN ORDER TO GUARANTEE ITS SUSTAINABILITY

# 7. TACKLING EUROPE'S CRISIS LEGACY: A COMPREHENSIVE STRATEGY FOR BAD LOANS AND DEBT RESTRUCTURING

**Maria Demertzis and Alex Lehmann**[1, 2]

## EXECUTIVE SUMMARY*

Eight years after the start of Europe's financial crisis, the legacy of non-performing loans and excessive private debt remains a key obstacle to the recovery of bank credit and investment.

We argue that efforts to reduce and remove NPLs from the balance sheets of creditors must simultaneously remove excess debt from the balance sheets of debtors. This is the only way to ensure that bank balance sheets are restored to health sustainably, and that both supply and demand for new credit revive.

A comprehensive strategy to tackle legacy assets should include national debt reduction strategies that guide bank NPL reduction targets, strengthen frameworks for restructuring and insolvency, simplify the engagement of specialist investors within the capital markets union and, crucially, create a blueprint for national asset management companies.

There is a need to strengthen policies in four key areas:

1. First and foremost, recapitalise banks to enable them to provision distressed loans adequately, and then actively participate in restructuring or writing off unviable loans.
2. Second, encourage further legal reform that is also supported by adequate restructuring capacity within the banks and elsewhere in the private sector, including by attracting specialist investors.
3. Third, create a tax regime and flexibility in revenue management that encourages the public sector to participate in debt restructuring.
4. Finally, establish asset management companies that can overcome the various market failures in terms of removing distressed assets from banks' balance sheets.

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[1] Bruegel Policy Contribution.

[2] We are grateful for comments from Dirk Schoenmaker, Nicolas Véron and Guntram Wolff. This paper benefitted immensely from discussions at the Bruegel conference on NPLs and debt restructuring on 3 February 2017, and was previously published as Bruegel Policy Contribution 11/2017. All errors are those of the authors alone. Justine Feliu and Inês Gonçalves Raposo provided valuable research assistance.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

NPLs are concentrated in particular countries but are a problem for the entire euro-area banking system given the many financial and real spillovers across the currency area. There is a clear need for national reforms that create a more supportive environment for debt restructuring and deleveraging. But many policies will also need to be coordinated within the euro area, and possibly within the single EU capital market.

# 8. STATE TRADE SPECIALIST AND ECONOMIST

**Manuel Conthe**[1]

## EXECUTIVE SUMMARY*

As soon as questions arise regarding a bank's solvency or liquidity position, its creditors will face a typical «prisoner's dilemma»: they all have an incentive to act fast and withdraw their deposits or refuse to roll-over short term loans, in order to ensure they get their money back if their fears were to materialize; but such rationally selfish behavior compounds the deposit run and may cripple even solvent banks.

Traditional methods to deal with financial crises of industrial companies (e.g. gentlemen's agreements among creditors or court-managed bankruptcy procedures) are not effective in banking crises, since banks have too many short terms creditors (depositors, senior bondholders, junior bondholders…) to be able to coordinate them effectively and they have a unique effect on financial stability and the real economy; a stay on payments may lead to a cascade of contractual breaches by the bank's clients; and fears about the solvency of one bank may easily spread across the entire banking system.

In the wake of the Great Depression, deposit-guarantee schemes were set up to assuage the fears of small depositors and prevent bank runs. Subsequently, a system of prudential supervision of banks was established and banks were further required to maintain sufficient levels of capital to make them more resilient to setbacks.

One of the lessons from the 2008 international financial crisis, however, was that, when these prevention measures fail, if failing banks are not to be bailed-out with public funds, at taxpayers' expense, they need to be subject to a special «resolution» procedure, managed not by the courts but by a special authority, and involving, as required, the "bail-in" of shareholders and creditors, i.e. debt write-downs. To facilitate this possible contingency, authorities must prepare resolution plans (or «living wills») for every bank in «peace time» and require them to issue enough «bailinable securities».

This new approach, enshrined in the 2009 Financial Stability Board's Principles of Effective Bank Resolution, led in the European Union to the new Banking Recovery and Resolution Directive 2014/59 (BRRD) and to Regulation 806/2014 creating the Single Resolution Board (SRB).

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[1] State Trade Specialist and Economist.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

Somewhat unexpectedly, the new resolution regime had to be applied, as early as June 2017, to Spain's Banco Popular. The procedure was triggered by the ECB, when it declared the bank as failing or likely to fail on June 6 after Popular communicated that it had run out of money, as the emergency liquidity assistance provided by the Bank of Spain had not been enough to stem the hemorrhage of deposits. Later that evening the SRB invited bids for Popular and in the early hours of June 7 the SRB wiped-out all the equity and convertible contingent bonds of the bank, converted into equity its subordinated debt and sold it to Santander -the only final bidder for the bank- for the offered price of 1 euro.

While the resolution went surprisingly smoothly and took place literally overnight, it laid bare three key problems:

- As soon as there are suspicions that a bank is a potential candidate for resolution, the bank may become trapped into a "death spiral", as attempts to cut losses by shareholders and bank creditors (including corporate depositors) who could potentially be subject to bail-in will lead to a slump in the price of its shares and liabilities and to a run on deposits, two processes which will feed on each other. Small and medium-sized listed banks may be particularly vulnerable to this risk, as their "non-systemic" size may make Governments particularly reluctant to offer solvent banks under attack the preventative liquidity assistance potentially authorized under the BRRD.
- Official stress tests and banks' public balance sheets may fail to reflect underlying weaknesses, which will only come to light when the crisis arrives.
- The new resolution regime should be supplemented with adequate official liquidity mechanisms, both ahead of resolution, to prevent solvent banks from failing as a result of self-fulfilling bank runs driven by the mere fear of resolution, but also once the resolution procedure is triggered, to provide adequate bridge financing when the process takes longer than in the case of Popular.

[2] Thomas H. Jackson, «Bankruptcy, Non-Bankruptcy Entitlements, and The Creditors' Bargain» (1982) 91, *Yale Law Journal*, página 862.

# 9. RULES AND INSTITUTIONS FOR FISCAL GOVERNANCE IN EUROPE

**Pablo Hernández de Cos**[1]

## EXECUTIVE SUMMARY*

The reform of fiscal governance in the European Union during the crisis included unquestionable progress relative to the previous situation. Inter alia, it reinforced the preventive arm of the Stability and Growth Pact (SGP) by establishing a spending rule; it gave greater relevance to the public debt criterion throughout the fiscal oversight process; it strengthened sanctioning arrangements; it made it obligatory to transpose to national legislation the obligations acquired at the European level; and it included the creation of independent fiscal authorities. However, certain weaknesses of the new governance framework cannot be overlooked, in particular from the standpoint of Economic and Monetary Union (EMU). Firstly, the framework is now more complex, which might reduce its transparency and applicability and hamper accountability, and the room for discretionality in its application remains high. Secondly, the new fiscal governance arrangements are some way off a true fiscal union, given that there is not a sufficiently large common European budget allowing for the softening of the economic impact of shocks that affect only one or few countries or of serious, common shocks that affect the Union as a whole; and nor can they count on pooled debt issues that help mitigate the vulnerability of individual issues in the face of processes involving a loss of confidence, such as those experienced during the crisis.

Against this background, this article argues that headway should be made in the simplification, automaticity and effectiveness of the framework of fiscal rules and in the creation of a common cyclical insurance mechanism that contributes to alleviating the absence of a centralised fiscal capacity in EMU. Pooled debt issues suitably designed so as not to discourage fiscal discipline might also prove key, through the creation of a common and safe asset, to reducing financial fragmentation, weakening the link between sovereign and banking risk, facilitating the implementation of monetary policy and promoting financial integration within EMU.

The latest European institutional initiatives support this course of action. Specifically, the implementation of a macroeconomic stabilisation function and the need for a safe European asset were already suggested in the Five Presidents' Report, published in June 2015, and this objective has been confirmed more recently in March 2017 by the EC in its reflection paper

[1] Banco de España.
* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

on the future of EMU. In both cases, nonetheless, it is also made clear that compliance with the EU's budgetary rules is crucial for its sound functioning, underscoring the idea that greater fiscal integration must necessarily go hand in hand with greater budgetary discipline.

# 10. REFLECTIONS ON THE SOCIAL DIMENSION OF THE EU[1]

**JAVIER ANDRÉS[2], RAFAEL DOMÉNECH[3]**

## EXECUTIVE SUMMARY*

In this chapter we analyse the social dimension of the EU and its implications for the future of the European project. The EU will have to deal with common challenges in the coming decades, going beyond the fiscal, banking and economic union, and ensure that Europe moves towards a more inclusive growth, perceived as fair by a broad social majority. To increase the political and social legitimacy of the European project, it is essential that its citizens perceive tangible benefits in terms of welfare and social inclusion, which go beyond those provided by financial and fiscal stability itself.

The evidence analysed in this chapter shows that the EU has favoured the convergence of different indicators that measure the well-being and prosperity of its population. Despite these achievements, differences between countries in equal opportunities and other social development indicators remain significant. In addition, social progress in some areas has slowed down or even reversed, due to rising unemployment in many EU countries. The crisis has generated a pessimism that is still latent in large sectors of the population. All this has been reflected in a loss of confidence in the European project, which the recovery of recent years has not managed to return to the levels prior to 2007.

Convergence at the level of the welfare state between countries must be achieved while respecting different social preferences and without jeopardizing economic growth. As unemployment and low quality of employment are the main cause of inequality and social exclusion in many countries, a necessary and absolute priority of any national or EU social policy should be not have any harmful effect on the creation of stable jobs, particularly among the most disadvantaged segments of the labour market. On the contrary, these policies must seek to simultaneously reduce income inequality and increase efficiency, growth and social mobility.

The best strategy is to advance the EU's social dimension by doing much more together, by setting common objectives on social indicators, closely monitoring their follow-up, advising and recommending best international practices, and implementing

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[1] The authors are grateful for the comments and suggestions of J. Cubero and the help of the CICYT ECO2014-53150 and GVPROMETEO2016-097 projects.

[2] University of Valencia.

[3] BBVA Research and University of Valencia.

* Full report in the Spanish version «Euro Yearbook 2017» available in www.fef.es and www.fundacionico.es

common policies in specific areas that are designed, financed and fully implemented at European level. In the latter case (e. g., the European unemployment insurance), these policies must be preceded by a convergence of regulations and factors that determine the risks to be covered by these benefits, with the objective that the reduction and mutualisation of social risks between countries progress in parallel.