EXECUTIVE SUMMARY

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1. An unsettling year for the Union

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

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

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will so evident, and the difference between words and events so stark.

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

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

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

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

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

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

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

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

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[3] What kind of times are we living in when a central bank has an explicit objective that there should be inflation? I confess that I still find it hard to believe, when I have spent much of my professional life fighting hyperinflation in emerging countries.

[4] European Commission (2016d).

[5] European Commission (2016c).

to clarify that the fiscal efforts of each member state depended on their individual circumstances, and must be compatible with compliance with Stability and Growth Pact obligations. An idea that is often unjustly overlooked in some public debates on austerity and fiscal cuts.

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

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

The UK referendum finished off one of the few political certainties that seemed unshakeable: the irreversibility of European integration. Until this seismic event, it seemed obvious that Europe's historic conflicts could be consigned to the past by ever closer economic integration, establishing a dense network of mutually beneficial relationships. But

[6] European Commission (2016a) and (2016b).

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

integration has given way to nationalism, an old European illness that we thought had been overcome. With Brexit, we have seen the return of political risk in Europe. With Trump, we are seeing a return of North American isolationism and mercantilism. With both, we are facing the risk of global recession.

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

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

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

Too many voices clamour for a return to a system of a la carte integration, to a Europe of variable geometries and different speeds. For some reason an idyllic image of the Austro-Hungarian empire is offered as an efficient model of sustainable flexibility.

However, this model would be completely incompatible with the sustainability of monetary union, because it would represent an on-going invitation to speculation against those countries perceived as most vulnerable at the time. And if we consider economic history over the last twenty years, these won't always be the countries now known as the PIIGS.

Europe has a democratic deficit and a functionality deficit. The Monetary Union requires a certain pooling of monetary, banking, financial and fiscal sovereignty, and this is incompatible with the lack of democratic legitimacy of its institutions. The Union needs a new Founding Treaty that simplifies decision making processes, creates authentically federal institutions and incorporates automatically-applied fiscal rules, in exchange for mutual protection. It requires a government and a Finance Ministry. The exceptional regimes of disguised intervention in countries in difficulties have to end. But the possibility of free riders - irresponsible national behaviour hidden behind grandiloquent appeals to European solidarity - must also end. The social pact that gave rise to the European project needs to be renewed. This is a daring step. But the alternative is not carrying on as though nothing has changed, it is disintegration and collapse.

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

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

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

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

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

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

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

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

The structure of the Yearbook 2016 is somewhat different to usual. It is becoming ever more difficult to distinguish those aspects that correspond to normal functioning of the whole monetary area from analysis of regulatory and legislative developments, and the highly controversial, but still only theoretical, issues on which the various actors are starting to take positions. There are two reasons for this. After being in operation for seventeen years, the Monetary Union is such a normal part of economic and political life, so much a part of every decision and every debate, that every economic proposal has to consider it. But it is also because the Monetary Union has changed so much since the outset, it has innovated so much and spread to so many territories that we believed were forbidden to it, that everything is now normal. Anything is possible in the new European normality. Monetary policy decisions are unorthodox and innovative; regulatory and prudential policy are built on and expanded year after year; and fiscal rules continue to evolve pointing - though many would still not dare to use the name - towards an embryonic European Treasury. Even arguments about the distribution of power between institutions, and decision-making and voting procedures in those institutions, usually end in agreement. It is just like any sovereign state.

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

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

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

We have been arguing that the original design of the Monetary Union is imperfect since our first study of the euro area[9]. However, the author underlines three no less important corollaries. Firstly, the leaders of the time were well aware of this, and intended to complete it when the time was right, giving the reforms adopted the legitimacy they needed. Secondly, there have been no cases in the history of monetary union, that have started out with the institutions needed for their sustainability, which makes arguments about the exceptional and provisional nature of the current Union meaningless. Thirdly, attempts have been made to resolve these deficiencies with aggressive and creative monetary policy. But the problem is not monetary. The problems that need to be addressed are institutional. Here, the authors strike a necessary note of optimism about the "possibilities of greater fiscal and political integration in the current environment".

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

Following this examination of the euro area from outside, Blanca Navarro, Almudena Gallego and Miguel Fernández, from ICO's Research Department, describe the panorama of the euro's role in the world, as a payment media in international trade and as an investment and reserve currency. They also examine its use as a parallel currency for deposits and loans outside the euro area and in financial markets (equities, fixed income, money market, FX and derivatives). They offer a comprehensive and exhaustive picture, backed by relevant information, and reflection on the reasons why the European currency has not fully established itself as a substitute for the dollar, and the

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

obstacles it will have to overcome to take on this role. Whilst the euro was the second most important international currency on practically all of the indicators analysed, it still remains a long way behind the US dollar. And this gap increased in 2015-16, with the global presence of the euro weakening to an extent not attributable to its depreciation against the dollar. As we said last year, it would seem that the addition of the Chinese renminbi to the list of global currencies is at the expense of the euro, more than any other currency. This is due more to political and institutional reasons than the strictly economic.

Currency movements have had the expected effects on international trade, with the corresponding lags. Thus, euro area exports have increased by a higher proportion than in previous years, despite the weak performance of international trade. However, the use of the euro as a payment media for imports and exports by euro area countries has decreased, and remains below pre-crisis levels. This leads to consideration of the possible accounting, regulatory, intra-industrial and financial infrastructure factors that might be limiting its use and favouring the dollar, and what might be done to address these.

This chapter features a fascinating consideration of the relationship between exchange rates and trade, which some economists argue may have weakened over recent years, with the rise of global value chains and intra-company trade. This proposition has significant implications for so-called competitive devaluations. Taken to the limit, this would undermine the monetary approach to the balance of payments, which underpins much of the theory of open economies and the IMF's policy recommendations. However, the results appear to confirm that the estimated relationships between exchange rates, commercial prices and gross volumes of imports and exports have not weakened, and that the exchange rate remains an important instrument in the transmission mechanism for monetary policy through to inflation, as the ECB also appears to wish.

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

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

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

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

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

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

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

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

This chapter includes an initial assessment of the ECB's unconventional policies, to which we devote a lot of attention in this Yearbook, in the light of the objective of halting financial disintegration in the euro area. An indicator of the transmission of monetary policy to achieve this has been built and is presented. The conclusion is clear, "the measures adopted have managed to avoid disruptive events in the euro area", enabling a degree of normality to return to financial markets. The transmission mechanism in credit markets has been repaired, with interest rates in peripheral economies converging strongly on the levels of core economies, with only a small spread for the smallest and most local SMEs. But we must be on guard. We could just be witnessing an illusion conjured up by the ECB's strong interventionism. The test of fire for euro area financial integration will come when the ending of QE is signalled and rates start to rise, decoupling the financial system from the guarantee of free liquidity for an indefinite period

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

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

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

In Chapter 4, José Ramón Diez, of Bankia's Research Department, describes and analyses monetary policy in 2016. He argues that the major development was the ECB explicitly adopting the objective of creating inflation. Having got past the theoretical debate about whether the target should be "around or under 2%", the ECB has got to work to create inflation. It is pursuing this by extending its asset-purchasing programmes and provision of guaranteed long-term liquidity. Boxes 1 and 2 of the chapter summarise the nature and size of the ECB's intervention programmes. Perhaps the ECB can be content, as preliminary indicators point to euro area inflation of 1.1% in December 2016, the highest since 2013. However, it is also true that this is partly due to rebounds in oil prices and increased inflationary expectations following the election of President Trump.

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

In parallel, excess liquidity in the system - understood as deposits by banks with the ECB in excess of their legal obligations - has continued to grow, and now exceeds EUR one trillion. This underlines the importance of the deposit facility rate, which sets the floor price at which the central bank can buy or sell assets in the market. Although the

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

author of this chapter does not go so far, some argue that the ECB's strategy is reviving the notorious *Greenspan put*: i.e. it is setting a floor for the prices of financial assets and contributing to a certain extent to a potential market bubble, particularly in the public debt market[13].

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

In any case, it is true that the QE strategy has had tremendous impact all along the interest rate curve[14]. This is shown, for example, by the 12-month euribor - a key benchmark interest rate for the financial system used as the basis for most mortgage rates in Spain - having been negative since February 2016; by 80% of German public debt having negative returns over the year; and by returns on investment-grade private issuers standing at less than 1%. Extraordinary funding conditions, that sought to drive demand for credit for both consumption and investment, and which are consistent with a diagnosis of the crisis as a problem of insufficient demand.

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

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

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

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

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

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

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

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

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

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

17 Jaime Caruana (2014).

productivity, and these end up bursting violently. The problem is that financial repression unnecessarily extends the adjustment process, by reducing the cost of holding excess debt and poor assignment of funds.

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

The sixth, and perhaps most important, is that the negative effects of unconventional policies on the profitability and solvency of the financial system cannot be ignored. It is true that monetary policy, to the extent that it has contributed to the recovery of economic growth and employment, has improved the health of bank debtors, and therefore the banks' income statements. But, perhaps the effects of this are now exhausted, or could have been achieved with less aggressive and pro-cyclical regulatory policies, and continuing excessive use could lead to lasting damage of the financial sector. Specifically, against a backdrop of interest rates close to zero: (i) it damages the profitability of entities by making maturity transformation - a core business of any bank - less profitable; (ii) it enables weaker banks to distribute profits to their shareholders, rather than retaining them to bolster their capital, creating undesired opportunities for regulatory arbitrage; and (iii) it accelerates banking disintermediation, with the resulting risk for customers and taxpayers, to the extent that this only responds to regulatory or political incentives. In summary, as the IMF has said, there comes a time when the negative effects of interest rates on bank profitability "outweigh the benefits from higher asset values and stronger aggregate demand"[20].

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

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

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

They base this on the profitability of banks being impacted through three separate channels. Firstly, as bond prices rise, QE bolsters bank balance sheets, generating huge potential gains[25]. Secondly, there is the well-known negative effect on bank profits from shrinking net interest income. And thirdly, by facilitating economic recovery, QE increases the volume of, and opportunities for, banking business, and decreases non-performing loans. In their opinion, the net effect of these three channels should, a priori, be positive. However, they do recognise that the banks themselves take a much more negative view, as shown in the ECB's Bank Lending Survey. This chapter

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

[22] Many authors agree with the monetary authorities and argue that the negative impact on net interest income could have been offset by higher fees and, above all, capital gains. But, putting things in perspective, a massive increase in bank fees would have been required to offset the negative impact on net interest income. And there is no need to imagine the effect this would have had on bank customers who are not used to paying anything for some of the services they receive.

[23] Nouy *(2016)*.

[24] Demertzis & Wolff, 2016.

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

offers an interesting empirical attempt to estimate the relative impacts of these three channels. The first - the fall in interest rates - is well known and even better documented, and there is no need for additional empirical confirmation. The third - the macro impact of QE - appears clear in their opinion, as they argue that “since the launch of QE, growth has accelerated in the euro area, through an increase in gross capital formation and consumer spending”. However, they also recognise that it is difficult to prove a causal relationship and that some studies are much more sceptical. This not withstanding, the authors focus on the second channel in their chapter.

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

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

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

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

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

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

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

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

The article includes a long list of recommendations for improvements to the SSM. Allow me to underline the three I consider most important: stability of regulatory requirements, as a necessity for capital and liquidity planning; the standardisation of risk weightings among national banks to ensure a fair and balanced framework; and the elevation of the level of supervisor dialogue, as banks send a huge quantity of information to the supervisor, but receive very little feedback, and very seldom any definitive criteria.

Whilst the authors do not call for it, this suggested to me that it would be appropriate to have a binding SSM consultation system, similar to the one with the tax authorities in Spain.

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

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

The European Deposit Guarantee Scheme (EDGS) was one of the three key components that defined banking union as originally formulated in 2012. However, political difficulties have made it impossible to approve this so far, apart from a 2014 directive that harmonised some minor aspects, and the horizon appears somewhat hazy. The Commission’s November 2015 proposal has not achieved the minimum agreement needed. However, it continues to be an essential component if we want to end the banking-risk/sovereign-risk loop. This was the starting point for Gerard Arqué, Enric Fernández and Cristina Plata, from Caixabank’s Research and Strategic Planning

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

Department, in chapter 7. Their chapter concludes with an optimistic message: that it is only a matter of time before the logic of implementing the EDGS wins the day. The European electoral calendar does not help in such a sensitive issue, and the deadlines will inevitably be pushed back, but it will eventually be achieved.

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

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

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

Another obstacle to the implementation of an EDGS relates to the banking legacy, and the significant differences in the quality of the balance sheets that banks would take with them into an EDGS. Whilst this is true, these differences are becoming ever less linear and predictable by national origin: this is why a transition period has been defined and why the SSM is working on unified supervision. The authors also mention some of the other proposals for dealing with this legacy problem, namely: (i) the accelerated reduction in national options and discretions (NODs) in the European capital requirements directive, CRD IV; (ii) implementation of the MREL, which would give legal certainty to the bail-in, to the extent that financial entities have securities in circulation that are issued for this purpose; (iii) harmonisation of national solvency laws; and (iv) a review of the regulatory treatment of sovereign risk.

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

Chapter 8 returns to analysis of the ECB's supervisory model. Alberto Calles and Álvaro Benzo, of PwC Spain, argue that the banks' governance and business models are the two wheels driving the direction of supervision. Banking supervision has always evolved hand-in-hand with the industry. Until the crisis, it focused on requiring minimum levels of capital, trusting entities to assess risks adequately. Everything changed with the crisis. The authorities understood that this was caused by weaknesses in banks' business strategy, excessive risk taking and serious management and control weaknesses. As a result, in addition to the expected increase in capital and liquidity requirements, and enhanced emphasis on asset quality, "a new vision of governance was introduced, accompanied by an extensive and in-depth list of requirements". This vision of the supervisory function has been extended to the banking business model, as the authorities understand their function to be to "assess, give opinions and issue opinions" on areas that had previously been reserved for the judgement of the entities. The best example of this

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

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

change of approach is the SSM's supervisory methodology - SREP - to which we have already referred, as this gives an equal 25% weighting to governance, the business model, capital and liquidity in the supervisor's final rating of each entity.

Some might think that this is overzealous, that market failure does not necessarily justify public intervention, particularly if the party intervening does not have better management experience or knowledge, and that "supervisor risk" is high and increasing, and even that the regulatory and supervision failures in the crisis were as, or more, important than those of the entities. But these are pointless considerations. They are intellectually legitimate, but have little relevance in practice. This is because the course undertaken by global supervisory authorities - not just the ECB - is clear, and irreversible in the short term. We will have to pay attention, question some excesses, call for rationality, efficiency and horizontal equity in intervention, as the authors do in this chapter, but the supervisory paradigm shift is unquestionable. This change will also impose new transparency and accountability[29] obligations on the authorities, which they are surprisingly continuing to resist.

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

And if the new regulation and supervision of banking governance is proving controversial, the SREP's emphasis on the business model is even more so. It is clear that the banking business, as we understand it today, is being threatened by many and varied factors. This chapter addresses some of them: the economic and low interest rate environment, shadow banking, digitalisation and fintech, the impact of new regulation (including EMIR, MREL and European regulations on investment in software, which not only fail to incentivise this investment, but actually penalise it in comparative international terms). The monetary, political and legal authorities are not unaware of such aspects, as

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

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

in the case of legal uncertainty challenging basic principles of banking business. Supervisors are obliged to show their concern for, and interest in, having profitable, solvent and solid entities, and to seek to assess their future viability through stress testing. But whether the SREP business analysis model described in this chapter adds any value or simply creates excessive compliance requirements, in terms of the entity's time and resources, is still an open question and only time will tell. And neither will it be relevant to investors, to the extent that the SSM insists on keeping its assessments of the quality and perceived robustness of the banks' business model confidential.

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

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

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

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

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

[33] European Commission (2016a).

Significant progress has been made: The European Stability Mechanism (ESM), the strengthening of the preventive arms and the correction mechanism under the fiscal deficit procedure, banking union, the European Fund for Strategic Investments, commonly known as the Juncker plan. However, the sad conclusion is that the most decisive action to stabilise the euro area has come from the ECB. Therefore, further progress is proposed. Firstly, banking union is incomplete, deposit guarantees are lacking and the scale of the Single Resolution Fund is insufficient, lacking credibility as a backstop. Secondly, the euro area needs automatic stabilisers, whilst the fiscal discipline framework continues being essentially preventive, and hardly credible, I would add, because its discretional nature makes it politically difficult to apply, as we see year after year. Thirdly, the ESM is clearly insufficient, and stability policy continues to fall to the ECB: yet this is not one of its competencies, and this undermines legitimacy.

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

The chapter finishes by analysing and describing the institutional developments required for the four theoretically-possible types of fiscal union, which are, from the most to the least ambitious: (i) a euro area Finance Ministry with its own stability budget. The characteristics required are discussed in detail in the text, to which the reader is referred; (ii) the issue of "eurobonds". These have the advantage of not requiring a new Treaty, and only require limited institutional development of the existing basis of the ESM. However, these have the disadvantage that they would be logically perceived as a transi-

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

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

tory stage on the path to full fiscal union; (iii) the establishment of a macro Stabilisation Fund, similar to other existing funds, which, it is estimated, would need to be equal to around 2% of the Union's GDP; and (iv) a common unemployment insurance system, or a complementary common European scheme. Apart from the obvious problems of moral hazard, and even the perverse effects that could arise for the labour institutions of member countries, this is a proposal that is gaining traction in some more interventionist academic and political circles, that are seeking symbolic action to counter increasing Euroscepticism. However, I believe that this is bad idea, both technically and, even more so, politically. Technically, it does not avoid the complex problems of country risk and adverse selection. Politically, it would open the door to all types of populist movements. It is not a substitute for fiscal union, and would end freedom of movement in the Union.

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

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

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

On balance, the author underlines three types of pending problems, relating to: design, application of and compliance with regulations; enforcement; and legitimacy and national appropriation of the ownership process With regard to the first aspect, the regulations are manifestly excessive, opaque and allow excessive discretion. On the second, the Commission lacked the political will, or courage, to exploit the autonomy conferred on it by recent reforms, resulting in the GSP being seriously questioned. Likewise, the process of national appropriation of European fiscal commitments is also failing to live up to expectations. Some progress has been made on budget information, macroeconomic forecasts and even IFIs, but there have been serious problems relating to access to detailed information, insufficient resources and problems of functional autonomy and material independence.

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

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

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

The authors perceive two conflicting trends in the current situation: the desire of the Commission to continue advancing political integration and German reticence, supported by the absence of social legitimacy to justify this increasing integration, being more inclined to take small steps to consolidate a system of varying speeds in the euro area. This is a very real dilemma, and it is very dangerous. The crisis has certainly created unknown tension, with the result that many people perceive the Union as an "unrepresentative, technocratic government lacking transparency and accountability". It is also true that the single currency has made the transfer of new powers and resources to the Union both more necessary and, at the same time, more difficult. They conclude that the challenge now is to set the legitimate and limited power of the Union and make it compatible with national democracies: this is certain to require reform of the Treaties.

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

For Spanish readers, the parallel with the process of defining and distributing competencies between the state and the Autonomous Communities is obvious. And we cannot forget that the attempt to sort this out in the Harmonisation of Autonomous Community Processes Act (LOAPA) was not exactly a success. For that reason, this seems to me an intriguing proposal, but I do not think that the need for a new Treaty can be avoided. In fact, the authors of this chapter dedicate the next section to this, based on the Five Presidents' Report. However, they do not limit themselves to this, but also set out an ambitious agenda for European institutional reform, which I merely summarise here: (i) step up supervision by the European Parliament and national Parliaments, particularly of economic aspects, including suggesting regular appearances by Commissioners before national parliaments. This proposal would effectively set in stone the confederate role of the Union, but would also make the already excessively complicated and lengthy decision making process for policies and governance in Europe even more complex. For this reason, following an initial stage of co-existence, they opt for a mixed European Parliament, with half of the delegates elected in direct European elections and the other half appointed by their national parliaments; (ii) provide resources and stability to the presidency of the Eurogroup so that it becomes an embryonic euro area Finance Ministry, acting as the vice-president of the new

Commission. This proposal can be inferred from the current direction of things in the European framework. But the crucial factor is the details of its competencies and relations with other European institutions that would fall within its remit, such as the ESM and the Fiscal Stability Board; (iii) progressively transform the Commission into a real European "cabinet", led by a head of European government, as a result of merger of the two current presidencies, the Commission and the Council. This president would be able to appoint the members of their team without national quotas, and would answer to the European Parliament, and could dissolve Assembly and call elections.

These are obviously very ambitious reforms, and would require new Treaties. This in itself is not just politically difficult, but also very complicated legally. This chapter offers some interesting reflections in this regard. These reforms however tiptoe around a fundamental problem: are we talking about creating new institutions for the euro area or for the European Union? Unless, of course, we make the heroic assumption that - following Brexit, and having overcome a certain transition period when the countries from the Great Expansion adjust their socio-economic structures, and Sweden and Denmark clarify their emotional preferences - all of the countries currently in the European Union will adopt the single currency without exception.

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

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

3. TEN LESSONS FOR EUROPE

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

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

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

Three. The idea that Europe needs growth at any price is spreading, demanding a strong dose of Keynesian policy to overcome demand problems, with more public investment and private consumption. This deliberately ignores that we are facing a balance sheet crisis that requires major adjustments. Europe's economic problems are structural. They have always been, and continue to be, structural. Monetary policy alone - no matter how creative and unorthodox it might be - will never solve these problems. There can be no doubt that the European institutional framework is imperfect and insufficient. But it is not responsible for exclusively national problems, or the deficiencies of the international monetary and financial system. Debt remains excessive, and insufficient attention is being paid to productivity issues and an ageing population. It seems necessary that Europe should - in the near future - become a standard bearer for globalisation and will have to develop an activist model of an open and competitive economy, both internally and externally.

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

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

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

Seven. Banking union, with a European deposit guarantee scheme, is required to break the loop between banking risk and sovereign risk. This is because: bail-in mechanisms are far from being accepted and applied unreservedly; the Single Resolution Fund is in transition; mutualisation remains controversial; it is not appropriate to confuse functions, competencies and institutions; and, above all, because of a basic principle of democratic legitimacy. If banking supervision and regulation are European, then the budgetary consequences of banking problems should also be European. Hiding behind legacy problems or the need to make progress with fiscal union - despite these being valid issues that must be resolved - only further increases instability and the risk of new and deeper crises.

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

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

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

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