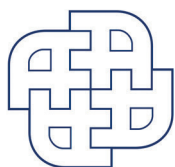


THE EURO IN 2020



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THE EURO IN 2020

A Yearbook on the European Monetary Union

Edited by
Fernando Fernández Méndez de Andés.
IE Business School

ISBN: 978-84-09-19649-4

Legal Deposit: in process, first quarter of 2020

Published by: Fundación de Estudios Financieros and Fundación ICO

Printed by: Reimpventa



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FOREWORD

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

This partnership translates into the regular production of an annual publication to inform readers of the changes that have taken place in the monetary, banking, fiscal, economic and political union; highlighting progress, limitations and possible shortcomings.

The report we are presenting here, now the seventh in the collection, is titled: *The euro in 2020. A Yearbook on the European Monetary Union*. It contains ten chapters, split into four different parts: (i) Political, economic and financial environment; (ii) Issues in monetary policy; (iii) Issues in fiscal policy and (iv) Issues in banking.

The first section of the Yearbook provides the context - political, economic and financial environment - for the euro, and provides an update on current developments, on what happened during the year, and most importantly what did not happen.

The second section is about monetary policy. It goes beyond analyzing specific ECB policy measures to cover two basic conceptual issues: the potential *Japanization* of Europe and the existence and implications of the Zero Lower Bound (ZLB). The question to be highlighted is whether the ECB has enough policy room and instruments to fight a new recession?

The third section is about fiscal policy and two questions stand out as crucial. First, is the issue of the fiscal stance of the Union, of whether the fiscal policy of the Union can define and implement its policy stance in a concerted and rapid manner? Second, debt sustainability remains a market concern, given historical highs in the debt-to-GDP ratios across the Eurozone, and the paper explores its definition and limitation in the new normal.

The final section is about banking. It starts with an analysis of digital currencies and continues with the description of the June banking package. The discussion then moves onto the European implementation of the Basel III reforms and the section ends with an article on monetary union as seen from a US perspective.

The report includes an executive summary that presents a critical analysis of the different contributions and postulates ten propositions, called the *Ten European lessons, for completing the Monetary Union*. They constitute the main messages of this *Euro Yearbook 2020*.



We continue to believe that it is necessary to explain the euro and to raise awareness about its implications. The euro is too often taken for granted, but it still needs to be better understood and improved. This is the task assumed in detail throughout this report, with the goal of ensuring its sustainability.

The review was led by Fernando Fernández Méndez de Andés, a Professor at IE Business School. He, in turn, has been assisted by a team of experts with close ties to academia, policy making and the financial community. We would like to express our gratitude to each of them and congratulate them on a job well-done.

Fundación de Estudios Financieros and Fundación ICO are confident that the *Euro Yearbook 2020* makes an important contribution to the current debate regarding Monetary Union and European integration and will prove useful and interesting to all readers.

Fundación de Estudios Financieros

Fundación ICO



EXECUTIVE SUMMARY

FERNANDO FERNÁNDEZ MÉNDEZ DE ANDÉS, IE BUSINESS SCHOOL¹

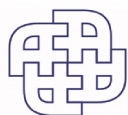
1. A YEAR LOST IN TRANSITION

The year 2019 was to be one of celebrations. The European Monetary Union reached 20 years of age. The long and difficult road to get to Maastricht fading away in our memories with the political passing away of its mentors. Practically only Jean Claude Juncker remains, and he too left his main job this year. In countries like Spain, the struggle to be a founding member of the EMU marked politics for decades and provoked a significant turn-around in economic policies. Fiscal stability, socioeconomic convergence, growth and inflation differentials, became the dominant themes. Everything in pursuit of international credibility and sustainable euro policies.

A new generation of European political leaders has taken over, and they still have to prove their willingness to compromise and their ability to forge fundamental consensus. Because the Euro at 20 needs to be repaired. It was an outstanding success at the beginning, in terms of both growth and inflation, until the global financial system suffered a crisis of confidence in the sustainability of the euro and the Eurozone. Like most, if not all, debt and currency crises, the real problems started in 2010 when locals lost confidence; when those Europeans who had saved and lent their monies to public or private investors in other Member States doubted their willingness and ability to repay them in the currency of everyone: the euro.

What followed is history and this Yearbook has described it. Our initial position, that the euro crisis resulted from institutional flaws in the design of the Eurozone, has now become common knowledge and official policy. But it was never meant to remove responsibility from wrong domestic economic policies. Precisely because of these unsustainable national policies, some countries experienced a serious recession while others came out barely scathed or even strengthened. But the core of the problem was at the euro

¹ Fernando Fernández Méndez de Andés is professor of Economics and Finance at IE Business School and editor of the Yearbook since the first issue.



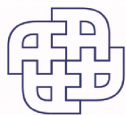
level, in a Monetary Union whose internal inconsistencies precipitated crisis, and which lacked a viable tool kit to address them. It took time, but rigorous analytical work like the one presented in this Yearbook has helped forge a technical and political consensus about the reforms that are needed in the institutional architecture of the Eurozone. Reforms which are necessary for its stability and survival.

Concepts like banking and fiscal union took too much time to travel from academic circles to opinion makers, and then to policy makers and regulators. It was a shame, because as a result, the crisis and its social and economic costs were longer and deeper. Lately, European politicians seem to have fallen into renewed complacency, in a voluntary denial of the full implications of a monetary union. Awash with conflicting social demands, in a Union that is significantly more diverse, complex and heterogeneous after the enlargement, where globalization and digitalization bring about very different challenges and opportunities for Member States, and for different socioeconomic groups therein, the Eurozone has basically opted out of its reform. Europe is banking on financial markets to remain understanding and comprehensive for an indefinite time. It may work, but it is not without risks.

The Eurozone momentum drained this last year. True, the Juncker Commission will go down in history as the one, that together with Mario Draghi's ECB, saved the euro. However, it will also be seen as having failed to consolidate this position while it could; when the economy, spurred by extraordinary monetary policy, had given it a window of opportunity with renewed growth and strong employment. Political capital was scarce and spent on more pressing issues: migration and refugees, security, and most of all Brexit. President Juncker and his Commission pushed for euro reform, and even came out with a meaningful road map, but did not succeed, despite its final effort to backtrack on some promises. The Council certainly did not help, with both major leaders, Merkel and Macron, focusing attention on unforeseen domestic problems. Renationalization of European politics has continued its course in 2019.

As this Yearbook goes to print, Boris Johnson has won an overwhelming majority with a simple message: get Brexit behind us. A sense of relief spread over all European capitals, and most certainly in Brussels. The idea of a country leaving the Union cannot be particularly exciting, but this nightmare has to stop. The Union needs to put an end to Brexit and build its new place in a world that has fundamentally changed. Europe's policy of soft power in a multipolar world is challenged by reality. USA and China find comfort in a bilateral relationship which gives them ample degrees of freedom to advance their mercantile interests in a world without rules. A "winner takes all" technology plays in their favor. The rise of populism and the constant downplaying of liberal capitalism erodes the foundations of the consensual approach to conflict resolution under the rule of law which has been the European trademark for almost a century.

Going back to "Fortress Europe" is a un understandable temptation. And clearly too much of it permeates some of the recent calls for "Europe First". It is worth remembering that the hard awakening from this mercantilist dream was at the heart of the creation of the European Union. Ursula von der Leyden has argued for a geopolitical Commission. There is merit in her determination to build a political union with a more active



international role for Europe and the euro, but it will only be possible if the Union is stronger internally, if monetary union is completed. And despite the many technical improvements and some minor political advances, nothing much has happened this year. The ECB has postponed *sine die* the discussion on the European safe asset, and the European Deposit Insurance System (EDIS) is still marred in an ideological discussion between risk reduction and risk sharing. The Council has been unable to provide any substance to the macro stabilization facility within the euro budget, and the approved Budgetary Instrument for Convergence and Competitiveness (BIIC), falls way short of being a meaningful instrument. Furthermore, the crisis prevention and resolution tool, the European Stability Mechanism (ESM), continues to be an external instrument dominated by national politics that will undermine its functionality and foster uncertainty, precisely at the time when clarity and timeliness are of the essence.

Completing monetary union is not a priority anymore. European politics have taken an emotional and nationalistic turn. Anti-European parties may have not been able to access the government in major countries but are clearly influencing the agenda. More worrying, internal domestic politics have become more confrontational, and European issues threaten to become part of the divisive agenda. New parties are gaining strong parliamentary representation and consensus is increasingly difficult to achieve. This was to be expected as the European debate moved on to areas with a substantial transfer of sovereignty. But political fragmentation does not help. A clear mandate and strong leadership were necessary to move forward. Neither of these came out of the European elections, as evidenced by the unprecedented difficulties of the incoming Commission to obtain the approval of the European Parliament.

Consequently, the von der Leyden Commission has opted for soft priorities that can receive ample support. The greening of the European economy is the best example. The idea of saving the planet, to preserve it for the next generations, has profound emotional appeal to an aging, prosperous and conservative European population. Coupled with the promise of the mobilization of huge financial resources it is unbeatable. It has been warmly endorsed by the industry, the scientific community and possibly even fiscal puritans. It seems capable of breaking inbred German resistance to a fiscal expansion and should therefore make monetary policy easier, and hopefully negative interest rates a thing of the past. The problem is, however, that public debt is never a free lunch, and the rest of the world is not so hot about global warming defining economic policies. The bottom line is that European politics have moved totally away from completing banking and fiscal union.

After seven consecutive years of growth, the European economy has left the crisis well behind in 2019. Labor markets remain strong and unemployment continues to fall while job creation has proven surprisingly resilient. Employment is at a record high and unemployment in the EU is at the lowest level since the start of the century. Although net job creation is likely to slow, the unemployment rate in the euro area is



expected to continue falling from 7.6% this year to 7.4% in 2020 and 7.3% in 2021.² The Eurozone is facing, however, a significant deterioration of the external environment. World trade is retrenching among substantial increases in tariffs, some already effective and some only announced. China's internal financial problems have been compounded by the trade war and the economy is decelerating faster than envisaged and desired; events in Hong Kong do not help the outlook. The perception of risk is particularly affecting the European manufacturing sector. A sector which is also experiencing self-inflicted structural wounds as a result of energy policies, as witnessed by the problems of the automobile industry and the politically induced recession in Germany.

Inflationary pressures in the euro area are expected to remain muted over the next two years, basically driven by the loss of pricing power by companies brought about by digitalization. This outlook has led the ECB to maintain its monetary policy stance unchanged. Europe's public finances have and will continue to benefit from this interest rate outlook. Therefore, and despite lower GDP growth, the euro area's aggregate public debt-to-GDP ratio is forecast to continue declining for the fifth year in a row to 86.4% this year, 85.1% in 2020 and 84.1% in 2021. Government balances, by contrast, are set to deteriorate slightly, due to the impact of lower growth and looser discretionary fiscal policies. The euro area's aggregate deficit is forecast to rise from an historic low of 0.5% of GDP in 2018 to 0.8% this year, 0.9% in 2020 and 1.0%.³

Although the general outlook improved at the end of the year, the European economy is heading towards a protracted period of subdued growth and muted inflation. This assessment is broadly reflected in the December 2019, Eurosystem staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 1.2% in 2019, 1.1% in 2020 and 1.4% in both 2021 and 2022".⁴ In short, the Eurozone economy has recovered well from the crisis, both in terms of growth and employment, but potential GDP is still sub-optimal, which should be a matter of serious concern particularly in light of an aging population and high public debt. Unless of course, growth is no longer a priority, willingly sacrificed for the environment.

Against this macro background, nothing much has happened in completing monetary union. To prove it, this executive summary will briefly review developments in five different areas: monetary policy, supervision, regulation and resolution policies and practices and finally fiscal union. These are the topics covered extensively in the Yearbook, and my intention here is only to give my own rapid overview of developments.

Monetary policy has continued to support economic recovery and job creation through an extraordinary expansionary stance, both in terms of providing unlimited liquidity and negative interest rates. At its September meeting, the ECB responded to the deterioration in the growth and inflation outlook by providing a strong message to EMU governments to use fiscal policy where possible. To facilitate this shift, the monetary

² European Commission 2019, Autumn 2019 Economic Forecast, Brussels November 7.

³ See EC 2019, previously quoted

⁴ ECB press release after the first Governing Council chaired by Christine Lagarde as President. See <https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is191212~c9e1a6ab3e.en.html>



authority reinforced its forward guidance, restarted its open-ended QE program to the tune of €20bn monthly, sweetened conditions for TLTRO-III and further cut its deposit rate to -0.50%.⁵ Beyond these measures, three main developments stand out for the ECB in 2019: Christian Lagarde taking over the helm after Mario Draghi, the acknowledgement of the collateral damage of “lower for longer” negative interest rates and a renewed interest in central bank digital currencies.

Draghi’s mandate at the ECB will always be remembered for his “whatever it takes to preserve the euro” speech. But he was also the president that forcefully threw the ECB into the uncharted territory of negative rates⁶ and whose decisions raised heavy opposition from some of his colleagues and by the Bank’s main stakeholders, to the point of three resignations. In previous editions of the Yearbook we have discussed at length the rationale and consequences of his decisions. He has been universally praised, and only towards the end of his mandate, did Draghi start to receive some mild criticism for minimizing the implications of long-lasting negative rates. In all fairness, the jury is still out over the long-term consequences of the extent to which Draghi has pushed unconventional policies. Personally, I am deeply concerned about the ECB overstepping its boundaries, about it turning into a fiscal agency and putting its independence at risk. The peculiarities of the ECB, “a central bank without a country,”⁷ exacerbates “the only game in town syndrome” affecting major central banks after the financial crisis.

It is still too soon to have anything but intuitions or prejudices about what Christine Lagarde will bring to the ECB. Certainly, her record as a distinguished public servant and politician is impressive. It is also obvious that she lacks the standard academic background or professional experience that was deemed to be mandatory for a central banker. She is much too political for the job, but she was appointed precisely because of that, because she brings to the ECB much needed political savviness. She will need all of it to succeed.

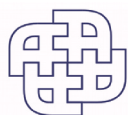
At the risk of rushing to conclusions, her very first days in office have already left her trademarks. She seems genuinely concerned about the impact that negative rates may end up having on the profitability and ultimately the solvency of commercial banks, and therefore on financial stability.⁸ She will enlarge the mandate of the ECB, considering the greening of the economy a macro-critical issue, and will not shy from using monetary

⁵ All these measures are described in detail in Part III of the Yearbook, Issues in Monetary Policy.

⁶ To an extent never reached in other major financial markets outside Europe, like the USA or Japan who have been very reluctant to go beyond the Zero Lower Bound.

⁷ Larry Summers in his speech at Sintra in August 2018, left us with one of his very provocative but completely accurate sentences: “throughout history we have seen countries without a central bank, but I have never before seen a central bank without a country”.

⁸ A concern clearly shared by the Central Bank of Sweden who in an unexpected late December move, abandoned negative policy rates and brought them up to zero, explicitly on its fears about the stability of the financial system, with no major macro justification, either in relation to inflation or growth.



and supervision policies to facilitate the transition to a carbon-free Europe.⁹ She will not change the monetary policy stance until its strategic review is completed; a task scheduled to take most of 2020. This review will be comprehensive and without exclusions, from the definition and measurement of the inflation target to its significance and relevance in light of technological and global developments.

The second and most obvious monetary development in 2019 has to do with the concept of a “zero lower bound”. It is now evident that if there is a lower bound, it is not at the frontier of zero interest rates, at least not in the short term. Households and non-financial corporations have proven to be willing to hold deposits at negative rates. This has been the case for many institutional investors and large-scale depositors already in 2019. But it is also true that the public at large has not yet felt the negative rates on their personal balances, since commercial banks have been very reluctant to pass them on to their retail clients.¹⁰ Traditionally, negative rates meant agents were anticipating a serious recession or a depression. This seems not to be the case nowadays. The question then becomes for how long and how negative rates may be, before perceptions and, therefore, behavior change.

Nevertheless, financial repression, a tax on savings as some call it, has proven to be a very divisive political issue in Europe and helped to excite national biases. It is also a fact that, as time goes by and interest rates remain negative, old habits will have to change. Deposits will not be free and even, conceivably, upfront payments at retail stores will be penalized. Interest rates will have to be understood very differently and explained in textbooks as the price for saving and postponing expenditures. A whole new world that will radically change the way the economy, not only finances, operates. Thus, reversal rates exist, a level at which negative rates are not only useless but counterproductive. We simply do not yet have any indication at what level they stand, but evidence mounts that we are fast approaching it.

Finally, Facebook’s launch of Libra, a stable digital coin, has changed the attitude and behavior of central banks, and of the ECB in particular, regarding digital currencies. At the risk of facing private competitors, with millions of clients worldwide, providing stable means of payments and store of value functions, most central banks have warmed to the idea of central bank digital currencies. Potential benefits may include reducing the cost of cash, financial inclusion, stability of the payment system, fostering innovation and facilitating monetary policy beyond the effective lower bound.

⁹ Thus, bringing the ECB into another political fight and moving it closer to a fiscal agent.

¹⁰ The banks that have actually done it have become well known in academic circles, but they are still very few and provide only anecdotal evidence of the reaction of consumers. Experts still doubt whether these banks are pioneers that will benefit from early adaptation or simply desperate and suicidal.

But there are also serious dangers and draw backs: banking-sector disintermediation, facilitating runs on banks, central bank monopoly on credit allocation and international implications for monetary overignty.¹¹

Supervision and regulation policies have not been in the news much in 2019. The ECB has pushed forward its strategy of risk reduction, demanding supervised institutions to present detailed plans to reduce balance sheet's exposures to non-performing assets (NPAs) with specific ambitious targets and close monitoring for those banks whose NPA ratios are still above desired levels. Consequently, asset quality in European banks has continued to improve, although at a slower pace compared to previous years. In June 2019, the latest data available, NPL (non-performing loans) ratio stood at 3%, the lowest since the NPL definition was harmonized across European Member States in 2014 (when it stood at 6.5%). The improvement in the ratio is mostly attributed to the reduction in gross NPLs, which in June 2019 stood at €635 bn; around €112 bn less than 1 year before. Since 2014, NPLs have almost halved (€1.2 trn). Increasing total loan volumes has also helped reduce the ratio.¹² The NPL ratio has improved by an average of 75 bps each year. However, the pace of adjustment has decreased in recent quarters, which might reflect both the gradual worsening of the economic outlook and the entrenchment of the problem in certain banks, and countries, which demands a new policy and a rethinking of stringent bailout and state-aid rules.¹³ Despite this broad reduction, NPLs remain unevenly distributed within the EU. All but three countries have reported an improvement in their NPL ratio during the last year. Some of the biggest declines were reported from those facing the highest NPL ratios, Cyprus, Greece etc. Italy, which had the highest volume of NPLs in absolute terms, reported a decrease of around 2 pp, and its NPL ratio stood at 7.9%.

The other, highly contentious, area of the risk reduction program has to do with reducing sovereign exposure in the balance sheet of commercial banks. Again, nothing has happened as Member States have failed to agree on even the rationale for it. Previous editions of this Yearbook reviewed the issue at length,¹⁴ providing the arguments for the different points of view. Let me briefly remind here my own position.

¹¹ Central Bank Digital Currencies: Four Questions and Answers, IMF Blog, December 12, 2019 by Tobias Adrian and Tommaso Mancini-Griffolli.

¹² See EBA, Risk Assessment of the European Banking System, November 2019. Paris, on which this paragraph is based.

¹³ As this book goes to print, the Greece government has announced a new plan to create a "bad bank", an asset management public institution, to facilitate the unloading of non-performing assets from commercial bank's balance sheets. Details are not yet available, but as always, two questions remain crucial: the price at which these assets will be transferred, and therefore the amount of recapitalization needed, and a firm decision on "who pays the bill", i.e. how much of these losses will be eventually covered by the taxpayer. Given stringent EMU rules this will prove to be not an easy task, but the scheme seems mirrored on Italy's Bad Loan Manager, SGA, which provides a politically creative precedent.

¹⁴ See 2018 Yearbook Executive Summary for a brief discussion and chapter 11, José Ramón Díez, Completing banking union: advances in risk reduction, for full coverage.



To penalize bank holdings of sovereigns is a mistake, regardless of how you do it (via capital add-ons beyond certain levels, concentration surcharges, or additional provisions through Pillar 2 supervisory discretionality). It would be equivalent to considering existing sovereign bonds as subnational and liable to default, which would be appropriate, if and when, the Eurozone has a euro area risk free asset, i.e. Eurobonds. Until that happens, and Eurobonds circulate freely and substantially, it is equivalent to extending an exorbitant privilege to the German bund, and therefore to German banking institutions, nonfinancial corporations and taxpayers.

The priorities of the Single Supervisory Mechanism (SSM) will shift substantially over the coming years. Climate risk (both physical and transition risks), conduct risk and anti-money laundering (AML), are top of the authorities' list. Clear regulatory definitions and metrics are nevertheless essential if the ECB wants to move beyond simple rhetoric and avoid legal uncertainty. European banks certainly do not need further supervisory ambiguity and discretionality. It is difficult to imagine how the Green Agenda can be implemented fairly and in a non-discriminatory way in the financial system, if the political authorities are still battling over the most basic definitions of sustainable finances, i.e. the taxonomy.

AML policies have received a great deal of attention, particularly after major money laundering was discovered at the heart of the banking system in countries that have traditionally prided themselves on their ethical behavior,¹⁵ and widely preached it to other Member States. It has led the authorities to challenge their prejudices and question the extent of the contagion. And most certainly to step up AML policies and its effective monitoring. Nevertheless, the possible creation of a European AML Authority, although an indication that things have definitely changed in this domain, is in my view unnecessary and would only create more bureaucracy, add to the number of information requests from European banks and increase compliance costs. Do we really need a new agency? Would information flow freely and timely among supervisory institutions? Will the European authorities create a new institution every time the existing ones fail to anticipate a problem? Furthermore, AML is just an example, a costly one indeed in terms of potential fines and reputational risks, of how serious conduct issues have become for European banks. Which may question the existing status quo of leaving this issue at the purview and under the surveillance of national central banks.

Nothing much has happened with regard to resolution in 2019, especially if we consider the failure of the last Council to agree on the specifics of the ESM funding for the Single Resolution Fund (SRF). We ended 2018 on a positive note with the Ecofin agreeing to the strengthening of the ESM, which would include the provision of funding for

¹⁵ It is worth noting the magnitude of the recent Danske Bank and Deutsche Bank scandals and what they reveal of their apparent complacency about laundering illegal Russian money. In a press release of 21 September 2017, Danske Bank, the largest Danish bank, acknowledged that it was "major deficiencies in controls and governance that made it possible to use Danske Bank's Estonian branch for criminal activities", with €200 bn of suspicious transactions from Estonian, Russian, Latvian and other sources flowing through it.



resolution since the SRF had only been endowed with €60 bn for both solvency and liquidity. The December 2019 Council was however unable to agree on the specifics of the well-known limitations, which meant there was no significant advance in the adoption of the proposed reform. The official communication limits itself to minimizing the obvious stalemate in nice political language.¹⁶

The negative reaction cannot surprise anyone: “The first issue with the reform is that the ESM would remain an intergovernmental organization, rather than one that has been transformed into a European institution...Its governance would remain dominated by national vetoes, its decisions would remain unaccountable to the European Parliament, and its powers would eat into those of the European Commission under a memorandum of cooperation that expands the monitoring and surveillance role of the ESM without increasing its accountability.”¹⁷ Markets however, have remained surprisingly mute, riding on the good trade news of the USA-China deal and comfortably supported by the continuation of QE.

The other disappointing news on banking resolution in 2019 had to do with a large German Bank, Nord LB.¹⁸ There was always skepticism about the fair application of the stringent SRM rules to a large country, most specifically to a large bank in a large creditor country. Particularly because these rules allowed no room for national authorities in the decision. The experience of Spain’s Banco Popular, and its sharp contrast with San Paolo and Veneto in Italy, showed that the European resolution framework would only be applicable if national governments were committed to play by the rules and there was no local support for taxpayers’ bank recapitalization. In those circumstances, and if a white knight appeared, a private bank willing to take over the ailing institution, the system would work just fine. In the case of the German public bank, EU Competition authorities approved the controversial €3.6bn, mostly taxpayer-funded, rescue package and concluded that it did not constitute state aid, “as private investors would have accepted similar terms”. However, academics and anti-

¹⁶ “We have reached a political agreement in the past based on this important project, on this important goal. It is a necessity for the Eurogroup to continue to work on the technical level in order to be able to implement this first important point.” Statement of the General Secretariat of the Council at the Euro Summit meeting (13 December 2019), Brussels, EURO 505/19

¹⁷ Shahin Vallée, Paul de Grauwe, Jérémie Cohen-Setton and Sebastian Dullien in a recent LSE blog that argues in favor of putting the planned overhaul of the Eurozone bailout fund treaty on hold.

¹⁸ Hanover-based NordLB is 65% owned by the two German state governments of Lower Saxony and Saxony-Anhalt with the remainder held by local municipality-owned savings banks. NordLB, the fourth largest Landesbank, equity shortfall that was caused by toxic shipping loans. It offers wholesale banking services to the local savings banks but also engages in corporate and real-estate lending. Impairments dragged down NordLB’s common equity tier one ratio to 6.5% at the end of September, well below the regulatory minimum requirement of 10.6%. This year, private equity groups Cerberus and Centerbridge offered around €600m for a 49% stake in NordLB. However, this bid was contingent on a similar cash injection from the taxpayer and a state guarantee for the remaining capital shortfall. It was rejected. Financial Times, December 12, 2019



trust lawyers all over Europe have questioned the decision, pointing to the high costs for the taxpayer. Unfortunately for the EMU project, the NordLB decision challenges the existence of a level playing field.

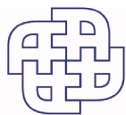
Completing banking union was always about three things: supervision, resolution and deposit insurance, and bringing these three banking areas to the same jurisdictional level as monetary policy. As it has always been the case in any durable monetary union, and as it is mandatory to avoid regulatory arbitrage and the building up of policy induced asymmetric risks. But EDIS is the missing link in the process. And a link that has provoked the strongest national resistances since it is, by definition, a quasi-fiscal transfer of sovereignty.

EDIS is obviously about risk sharing, an essential ingredient of any viable and lasting monetary union, which no advanced monetary jurisdiction can allow not to exist. Its mere existence ensures a level playing field and is a very powerful tool to stop financial fragmentation. EDIS would help banks to conduct liquidity planning with a pan-EMU perspective, a necessary condition for cross border M&A, and would make national supervisors more comfortable about relieving existing national liquidity and capital constraints. The original Commission proposal, dating back to November 2015, called for the phasing in of its introduction, taking into full consideration the different country legacies in terms of funding and size of the national funds. The sequencing of re-insurance, co-insurance and full risk mutualization seemed adequate, provided it was agreed as irreversible from its inception and envisaged “triggers for acceleration” if need be.

EDIS has nevertheless been a non-starter and the Commission was wrong to play politics and reduce the scope of its ambition in 2019 to removing the final full mutualization stage. A proposal considered unacceptable to most EMU countries. Towards the end of the year, the German Finance Minister, Olaf Scholz, surprised many, including his coalition partners, by publishing a call for a deeper and completed European banking union.¹⁹ It was a new German position which essentially eliminated the veto to a common EDIS and accepted that risk reduction and risk sharing could be achieved simultaneously. It also introduced old academic issues into the political debate, namely the need for common insolvency and bank resolution rules, as well as the harmonization of some elements of corporate taxation. But “there is also the negative side to the proposal, most importantly the demand for risk-weighting sovereign debt, and the specific structure of the deposit insurance”²⁰, via a three-layer set-up in which the national system would take the first hit, a quantitatively defined European pool takes the second and finally, if necessary, the national government in the country could step in.

¹⁹ Germany, Federal Ministry of Finance, Proposals for completing the banking union, 6 November 2019 https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial_markets/Articles/2019-11-06-Bankenunion.html;jsessionid=0F972ABD66D5439E52C-4C4642F3B53D4.

²⁰ Sunday Wrap, Erik F. Nielsen, Group Chief Economist (UniCredit Bank, London), November 10, 2019



The proposal could have been a way to open the negotiation. It was technically insufficient but could have been improved if its basic underlying assumption, risk reduction and sharing need to advance *pari passu*, were to be accepted by all Member States. Unfortunately, Mr. Scholz lost the internal SPD elections and therefore a considerable part of his political capital. The Italian government restated that sovereign risk weighting is a red line, without a Eurozone risk free asset. The new von der Leyden Commission has not endorsed the initiative to jumpstart negotiations and EDIS seems once again an impossible economists' dream, until the next crisis. The Eurozone has also lost another opportunity to move closer to an optimum currency area and banking union at the end of 2019, is still missing one basic component.

Banking union leads naturally and unavoidably to fiscal union, a concept that is now widely accepted includes governance and fiscal rules, a macro stabilization facility and a crisis resolution system. These are the current topics of fiscal discussion in the Union, notwithstanding the more fundamental debates on democratic accountability of fiscal policy and the respective role of the European Parliament, the Commission, the Eurogroup, and the Council. Of the three areas quoted, there has been no advance whatsoever in fiscal rules, only nominal progress in crisis resolution, and a minor but significant development in macro stabilization.

The debate on simplification versus perfection in fiscal rules is lingering to the point of exhaustion. In the meanwhile, the current rules leave no one satisfied. The rules are too complex, often contradictory, mostly redundant and always discretionary in their application. Their implementation requires long explanations and gives rise to all sorts of controversy, as witnessed by this year's debates around their application to the Italian budget. Moreover, the discussion continues about the proper European authority to (i) design, (ii) monitor compliance, and (iii) implement the fiscal rules.

Fiscal governance evokes two distinct debates in the EMU. First, there is the traditional discussion on the legitimacy of EU rules and institutions being applied to a subset of countries, i.e. the Eurozone. It can be summarized in the old question: do we need a Eurozone Parliament or at least a Eurozone-only plenary session of the EU Parliament? There is the growing illusion that Brexit may solve this constitutional issue, since it may reinforce the role of the euro as the one and only legal currency in the EU. But second, and more immediate, is the debate on who is the Fiscal Authority in the Eurozone. In the absence of a regular parliamentary process, of a Euro Treasury and of a Ministry of Economics and Finance for the Eurozone, the creativity of academics and policy makers multiplies, and the range of institutional proposals become unmanageable.

The role of Independent Fiscal Authorities has come into the debate, both at a national and Eurozone level, as if institutional engineering and well-respected technocrats could solve a basic political problem: no taxation without representation, democratic legitimacy and accountability. Fiscal rules are essentially an EMU imposed limitation on Member States fiscal sovereignty; a restriction on the capacity of national governments and parliaments to decide unilaterally on taxes, public expenditure and the resulting overall public sector balance. They can legitimately be only adopted by the corresponding European legislative process, and implemented and monitored by a branch of the



executive, i.e. a Ministry of Finance of the Eurozone. Be it a Euro-only Commissioner (if the EU wants to transform the Commission into the European government) or the Eurogroup, which then has to be fully developed, budgeted and staffed, with the idea of it becoming permanent and full-time as the evolving Eurozone Ministry of Finance. Either of them, a Eurozone Commissioner or the Euro Group President, can be technically advised on its monitoring function by a group of experts, called Independent Fiscal Authorities, both at the local level - to have first-hand information and assessment -, and at the euro level - to ensure horizontal fairness and a level playing field -. But under no circumstances can these administrative institutions have anything but an advisory role, otherwise we will undermine the democratic foundation of EMU and contribute irresponsibly to alienating it further from the people of Europe.²¹

After years procrastinating on the two natures of the European Monetary Union,²² all arguments are on the table, and the Eurozone needs to make up its mind on the kind of fiscal union it wants. Basic economics tells us there are only two working possibilities: loose fiscal central rules and frequent national defaults under a no-bail-out regimen, or sufficiently strong fiscal discipline imposed centrally with automatic risk sharing mechanisms. It is clear to me, and to most economist after events in 2010-2012, that the European Monetary Union can only survive with the latter. The Eurozone can simply not afford any sovereign defaults without contagion reappearing, and financial fragmentation giving way to internal capital controls and to the issuing of national money-like instruments to facilitate payments and the conduct of business; a process made all too easy by digitalization. But the Union is reluctant to move consequently forward with fiscal transfers of sovereignty and the corresponding institutional reform.

Progress in crisis resolution in the Eurozone has to do with the strengthening of the ESM as a central institution to design and monitor rescue packages, and with moving its statutes and toolkit closer to a European Monetary Fund. The shortcomings of the ESM reform have already been highlighted in this Summary. Mainly the fundamental paradox of assigning a central role in European sovereign crisis to an *outside* institution, multinational not supranational, subject to national political control. A paradox that threatens to make ESM useless in a real-world crisis and will certainly increase market doubts and volatility surrounding the outcome of any rescue program. Precisely what a financial crisis does not need.

²¹ The argument exposed here mirrors the one made by Paul Tucker in his most controversial and influential book, *Unelected Power*, which warns over the dangers to central banks' independence and legitimacy emerging from the post-crisis extension of their core powers. What he calls the Administrative State is, in my view, a real threat in the Eurozone as weak governments, and a flawed decision-making process, substitute reaching political agreements with a growing recourse to technocratic solutions. This has two damaging consequences: increased opacity and, therefore, discretionality, and declining support for the euro.

²² See 2018 Euro Yearbook for a full discussion on, and the two opposing views still fighting over, how to move forward. In particular, Part I: The existential debate over Europe and the short version on the Executive Summary.



On the bright side, it is true that during this year, the main ESM policy instruments have been refined and improved. On December 5 2019, the Eurogroup agreed to the “amended Guideline on Precautionary Financial Assistance...and also welcomed the finalization of the working document on a common methodology on debt sustainability and repayment capacity analysis prepared by the Commission and the ESM”.²³ The reform of the ESM Precautionary Conditioned Credit Line (PCCL) clarifies the *ex-ante* conditionality and substitutes the controversial Memorandum of Understanding for a Letter of Intent pledging “continuous adherence” to EMU policy guidelines, but at the cost of introducing too stringent *ex ante* conditionality.²⁴ Finally, the December Eurogroup also agreed to introduce *single limb* Collective Action Clauses as of January first 2022, which essentially remove blocking power from entrenched bond holders. A positive but not fundamental change that does not increase the possibility of debt restructuring, but certainly facilitates it. Single limb CACs will have little impact on the market, because they practically already exist, albeit informally, and because current monetary policy makes them redundant.²⁵ A final testimony of the complexities and slowness of EMU processes is that after a three-year discussion on a minor and transitory reform, the 2019 Eurogroup *expects* amendments to the ESM Treaty to be signed by mid-2020.

Finally, on fiscal union, in 2019 the Eurozone moved significantly to create the potential foundations of a macro financial stability facility, although it has shied away from calling it that, and has instead adopted the title of the Budgetary Instrument for Convergence and Competitiveness (BICC). Together with the 2021-2027 budgetary framework, which will amount to 1.11% of Gross National Income, the EU has approved this new instrument for its EMU Members. The exact amount remains to be determined, although it is currently estimated at about €17bn (0.14% of Eurozone GDP). Most of this allocation (80%) will go towards financing investment projects in any EMU country; “having in mind”, but not necessarily being in proportion to, its population and GDP per capita, which opens up the possibility that the majority of BICC may be spent for non-stabilization purposes. Only 20% of BICC will be of a direct counter-cyclical nature and this will be distributed in countries in difficulties, to finance investments and reforms without a formal rescue program and the associated policy requirements. Projects will have to be co-financed at 25% by receiving Member States, with a possible reduction to 12.5% in adverse circumstances. The logical need to avoid moral hazard explains the co-financing, but it damages the utility of the instrument in a capital drought situation, such as the one suffered in 2010-14.

²³ Letter from Mario Centeno, Chairman Euro Group to Charles Michel, president of Euro Summit, December 5, 2019. https://www.esm.europa.eu/sites/default/files/20191205_letter_president_of_the_eurogroup_to_cm.pdf

²⁴ These stringent criteria will be: (i) a debt benchmark (60% GDP or a 1/20 annual reduction); (ii) a safety margin over structural balance and 3% overall deficit; (iii) the country not experiencing Excessive Imbalances or Deficit Procedure; (iv) and debt deemed sustainable.

²⁵ IMF Staff Paper, PPEA2019008, Fourth progress report on inclusion of enhanced contractual provisions in international sovereign bond contracts, March 6, 2019.



Moreover, the name of the policy tool, BICC, is anything but trivial. It reflects the lack of political consensus in the Union about a macro stabilization facility, the continuous illusion that monetary union will bring about convergence and the remaining confusion that the Euro crisis was about competitiveness. In short, convergence and competitiveness are essential for Europe to succeed, both politically and economically. They have merit on their own, but they have nothing to do with the problem at hand, namely, to make the EMU sustainable so that it can survive the next financial crisis. This is why the Eurozone needs a macro stabilization facility, just like any long-lasting monetary union. In its absence, Member States will always be tempted to break the rules, help their ailing economies, expand their public expenditure and eventually print their own money. The markets know this, which creates bouts of anxiety and skepticism and leaves the Union at the mercy of expectations and animal spirits. The fact that the Union has only been able to move ahead in creating a macro stabilization facility by disguising its nature, watering down its fire power and playing around with words, is testimony to the fact that political capital is in short supply. It will not be used to educate Europeans at large on the irreversible consequences of a monetary union, i.e. to build a political union for the European Central Bank, in Larry Summers lucid expression. And without a political union, there can simply not be a sustainable monetary union, as we have argued extensively since our first report back in 2011.

2. THE EURO AT 20

The 2020 Yearbook is organized around the central theme of building a sustainable union for at least another 20 years. We begin by taking stock of the State of the Union and then delve into important issues in monetary, fiscal and banking policy. The first section of the Yearbook provides the political, economic and financial environment. That way, the readers benefit from an update on current developments, on what happened during the year, and most importantly on what did not happen.

The second section is about monetary policy. It goes beyond analyzing concrete ECB policy measures to cover two basic conceptual issues: the potential Japanization of Europe and the existence and implications of the Zero Lower Bound (ZLB). Japan has been in deflation for over 20 years now and the Bank of Japan has carried out aggressive quantitative easing for almost that long, to such an extent that its balance sheet amounts to 103% of GDP (versus “only” 40.5% for the ECB). Nevertheless, the BoJ has avoided negative rates beyond -0.1%, and even then, only with careful tiering. ZLB has been the other dominant topic in monetary policy, particularly as Europe is heading towards a period of decelerating economic growth, from an already very low potential output growth. The basic question we address is simply if the ECB has enough room and instruments in its tool kit to fight a new recession.

The third section is about fiscal policy and two questions stand out as crucial. First, since fiscal policy is receiving increased attention in the new monetary and growth environment, the Union needs to be able to define and implement its policy stance in a concerted and rapid manner. In other words, are the fiscal rules and institutions designed to



enforce deficit reduction able to implement a fiscal expansion? Second, debt sustainability remains a market concern, given the historical highs in the debt to GDP ratios across the Eurozone. Nevertheless, certain new theories question its relevance in the context of prolonged very low rates. Not only very old theories like the so called Modern Monetary Theory that essentially call for the monetization of public debt, but also new post-Keynesian theories that have similar policy prescriptions.

The final section is about banking in a general sense. It starts with the analysis of the changing nature of money in a digital world, and with a discussion about the challenges and opportunities of digital currencies, both for their users and for monetary and financial stability policies. It continues with the description of the June Banking Package, which can be described as the European implementation of the Basel III Reforms. A process that translates into legislation the lessons learnt from the crisis, and a compendium of the reforms the Eurozone has been able to agree in completing banking union. This part, and the Yearbook, ends with an article on monetary union as seen from a US perspective. While constructing a special type of union, and delivering on its reform, it is mandatory not to lose track of international monetary developments, nor of the expectations and requirements imposed by international financial markets and players. This is what we emphasize in the concluding chapter, a good reflection of our idea that the European Monetary Union is only as good as the extent to which it strengthens Europe's openness and attractiveness to the outside world. It is worth remembering that EMU is not an end in itself, but only a tool to advance European stability and progress, and to foster European interests and priorities in the world - including the European social model and an open rules-based multilateral order.

2.1. THE CONTEXT

Chapter 1, The new political cycle in Brussels, what to expect? is written by José Ignacio Torreblanca and Pawel Zerka, from the European Council of Foreign Relations. They describe in a positive light the priorities announced by the new von der Leyden Commission. In their own words, a geopolitical Commission focused on “using economic power for political gain” that is keen to reinvigorate the “Community method” and leave behind the era of intergovernmental policy making. A Commission that wants to “deliver Europe” and one that has chosen to address climate change and ensure the decarbonization of the economy as the measure of its success. A very ambitious target that has positioned Europe as a clear leader in this field, but that moves the Union away from the preoccupations, policies and priorities of the other world contenders.

From our limited perspective of completing EMU, this new Commission will adopt “a geopolitical dimension to elements such as trade, investment, the euro and markets”. While the authors, and many political commentators in Europe, are excited about this, I am concerned that (i) it will diffuse attention from delivering on completing banking and fiscal union, and more fundamentally, (ii) it will add to the Trump-era real threat of weaponizing economic policies. In a certain undefined way, mercantilism permeates this idea of a geopolitical Commission and it could easily fall into a retaliatory world order,



particularly since we can count on formidable players of brinkmanship at the other end, Trump, Putin and Jinping.

The authors are nevertheless confident that Europe's strengthened political influence in the world will help advance its regulatory superpowers as the international standards setter for the new problems of data privacy, competition policies, technology transfers and industrial property, tax shopping and energy transition. Europe will surely be reinforced by promoting this multilateral order, though the question remains about its capacity to do so while being marred in a scenario of low productivity, low growth, poor demographics, and while the remaining institutional flaws in the design of EMU still make it vulnerable to the vagaries of capital movements.

Moreover, as Torreblanca and Zerka underline, "Europe has to learn to speak the language of power" and to exploit the concept of European sovereignty. Wishful thinking in light of the existing deep internal divisions on every relevant political issue - migration, defense, trade, enlargement, energy, climate. Issues where progress has stopped, once past the stage of empty declarations of principles. Trade policy is a good example. It is perceived by many as a tool for regaining European economic sovereignty and as an instrument to pursue a European agenda on environment and labor rights. The introduction of a Border Carbon Adjustment Tax is predicated to this effect. Just as few years ago the Financial Transactions Tax was announced as the cure for all remedies. It is worrisome how progressive Europeans are increasingly adopting Trump language, from Macron to Borrell, and talk extensively of fair trade to really mean new-age protectionism. What it would mean for the multilateral order is a serious concern. It will not sell well in emerging and developing economies, always wary of "Fortress Europe".

In the second chapter, Oscar Arce, Esther Gordo and Javier J. Pérez from Bank of Spain, write on The Economic State of the Union: how extensive and lasting will the slowdown be? They provide the reader with a very helpful and complete diagnosis of the current maladies of European economies and a comprehensive menu of policies to address them. Throughout last year the EMU, faced global trade tensions and geopolitical uncertainties. Compounded with secular trends related to an aging population and declining productivity, lasting disinflationary pressures and persistent very low (and even negative) interest rates, and exacerbated by the incomplete architecture of the EMU, its growth outlook has deteriorated, and potential output has declined further. Moreover, traditional demand policies are increasingly ineffective and political resistance to structural change is pervasive, witness the "guillet jaune" in France. It is thus very important to improve our understanding of this "new normal."

Specifically, trade tariffs and the associated uncertainty over additional hikes has taken global GDP 0.35% below the baseline scenario in cumulative terms, over the 2019-21 period (a GDP contraction of 0.26% for the Euro Area). Moreover, the impact of Brexit on the Eurozone "may prove significant." Consequently, real GDP growth in the Eurozone slowed from rates close to 0.8% quarter on quarter on 2017 to 0.2% in the second and third quarters of 2019. Fortunately, domestic fundamentals remained resilient as the current expansion has been employment-rich and very accommodative financial conditions have underpinned private consumption.



The ECB addressed the deteriorating outlook at its September meeting, and this chapter offers a detailed account of the measures taken. These actions “have been effective in easing financial conditions”. A different issue is whether with negative interest rates at 0.5%, despite tiering, the ECB has surpassed the level of reversal rates. It is interesting to note that the authors attribute the persistently lower potential Eurozone growth vis à vis the USA to “lower productivity growth and weak investment”. Both of them can be traced back, in my view, to heightened resistance to structural change, to a social preference for lower growth and reduced inequality embedded in European policy making. And both insensitive to monetary policy.

Persistent low inflation has prompted an intense debate over its determinants, and specifically over the Phillips curve in the context of structural changes brought about by an aging population, globalization and digitalization. Therefore, a reappraisal of macroeconomic thinking is in order; a strategic review of ECB’s monetary policy and a more active role for other policies, fiscal policy in particular. The arguments are well known: (i) fiscal policy becomes more powerful when monetary policy is at or near the ZLB; (ii) fiscal multipliers are higher in a monetary union, also for Members not implementing the fiscal expansion; (iii) the Eurozone needs to better align national fiscal policies with European monetary policy, and (iv) the Stability and Growth Pact is ill equipped to foster expansionary fiscal policies. Therefore, the authors argue for a central fiscal capacity at the Eurozone level and defend an investment-led stimulus, as probably most effective.

All this became standard ECB doctrine under Draghi but, in my view, fails to answer the basic question. Why is there low investment in the Eurozone? Why is potential output so low? It is certainly not because of the cost of money. Neither is it because fiscal rules have been too stringent, since they have seldom been implemented, even less enforced. It may simply be because financial fragmentation is impeding private capital to move freely across the Eurozone, because the obsession with risk reduction has halted any progress with EDIS, and because the absence of a risk-free euro asset creates a structural asymmetry in the cost of public capital. Not to mention that labor and environmental regulations make investment costly and very time-consuming in Europe. In short, my point is simply that yes, the EMU needs a fiscal stabilization capacity, but that before increasing public debt to even higher limits and before pushing universally for additional fiscal deficits, the Eurozone would be wise to revamp its structural policies and to complete banking and fiscal union. The fiscal expansion short cut may prove very dangerous if market sentiment were to change, because this time is no different. A point I will get back to in Part III of this Yearbook, when commenting on fiscal policy.

José Manuel Campa, at the European Banking Authority (EBA), writes Chapter 3, the last article on the external context of the EMU, The status of the European banking industry. A decade after the financial crisis, the industry has undergone a substantial transformation, cleaning up balance sheets and strengthening capital levels while redefining their business models and competitive positions to respond to enhanced regulatory framework, technological transformations, consumer awareness, new competitors and a challenging macro and interest rate environment. Despite significant progress in



most areas, a number of challenges remain. Campa emphasizes two in particular, low profitability and credit quality.

European banks have significantly increased their capital positions over the last five years, and as of June 2019, their Common Equity Tier 1 (CET1) ratio stood at 14.6% on a transitional basis, and the total capital ratio at 18.9%. Asset quality has also improved: weighted average NPLs ratio declined to 3%, the lowest ever since EBA introduced a homogenous definition in 2014, while coverage and forbearance ratios accompanied the improvement. Profitability, however, “remains below what would be considered an adequate level.”, with return on equity (ROE) at 6.5% (versus 11.9% for US peers). Moreover, 80% of US banks were trading at a price to book multiple (PtB) above 1 in July 2019, compared to less than 30% in the EU. European banks are not only less profitable, they are also expected to remain so for a good while. Although there is no single reason, “the prolonged low interest rate environment has been a key factor.” Surprisingly, or perhaps not so much given internal EMU barriers that were extensively analyzed last year,²⁶ consolidation of the banking industry has moved much faster in the US, both in terms of M&A activity and in the number of exiting institutions.

In this banking context, regulatory reform continues and creates additional demands. This year in the area of resolution and resolvability, but also in operational risks. There is no end in sight, however, and banks will have to adapt to (i) the final agreement in capital standards, (ii) higher emphasis on consumer protection, (iii) conduct and AML practices and policies, and (iv) strengthened supervision of climate risk and environmental, social and corporate governance (ESG) factors. As an addendum, the new president of the Single Supervisory Mechanism (SSM), and former EBA Chairman, Andrea Enria, publicly demanded robust instruments to extend the authorities say on corporate governance. It is a bad omen for the future of the industry that while supervisors and regulators insist on increasing its powers and enlarging its toolkit, the industry as a whole complains about the overwhelming intrusiveness and the costs of compliance. This endless regulatory reform creates prolonged uncertainty and confusion, complicates strategic planning and harms international competitiveness for European banks.

It is my contention that we have reached a tipping point where regulation has to stop for an in-depth cost benefit analysis. Regulation is a public good, but it is not only about ensuring that every imaginable risk is taken care of, including the regulators’ legal risks. It is mostly about fostering financial stability. To do so, financial institutions, banks, have to be part of the solution, they have to be profitable and thriving on a level playing field. Level in terms of other financial competitors, to avoid regulatory arbitrage, which is increasingly pervasive as evidenced, inter alia, by the rise of private equity. Level in terms of new technologies, and certain EU regulations, on innovation and data sharing for instance, which are clearly biased against banks. And level geographically, both internal-

²⁶ See in particular, Fernando Restoy, Chapter 10 of the 2018 Euro Yearbook, The European Banking Union: achievements and challenges.



ly, at EMU level, to avoid national regulatory forbearance, and internationally to ensure there will be European banks, especially after Brexit.

2.2. ISSUES IN MONETARY POLICY

Part II of the Yearbook is about Monetary Policy. It analyses policy measures and gives context to the announced ECB strategic review. Therefore, the first article of this section, Chapter 4, is called, Europe confronts the challenge of Japanization, written by José Ramón Díez at Bankia. The purpose of the article is to assess the risk that Europe falls into the Japanese trap. It starts by describing the characteristics, causes and consequences of the Japanese situation. After more than a decade of GDP growth above 4% annually in the eighties and strong increases in asset prices, contractionary monetary policy resulted in economic stagnation, price deflation, private sector deleveraging and exponential public debt growth that has continued practically to these days. Very poor demographics and a negative productivity shock exacerbated the crisis and resulted in a sharp drop in the natural rate of interest. Analysts believe that the problems remained unanswered for too long and that indeed wrong economic policies transformed the necessary consolidation of an overheated economy into something very similar to a secular stagnation. Prolonged fiscal adjustment, lack of decisive action on bank liquidation and recapitalization and insufficient monetary expansion are usually blamed for Japan falling into a liquidity trap where quantitative easing has become structural. Finally, after much hesitation, the Bank of Japan initiated the expansion of its balance sheet, purchasing all sorts of assets, private and public, debt and equity, to the point where it has reached 103% of GDP.

According to JR Díez there are three defining characteristics of Japanization: (i) the secular collapse of total factor productivity (TFP), (ii) a negative natural rate of interest as a result of an aging population and excess savings, and (iii) entrenched deflationary expectations. In those circumstances, conventional monetary policy becomes inefficient. Once the phenomenon is identified, the chapter goes on to ask if the Eurozone is in risk of Japanization? Some variables would indicate so. Mainly, low potential growth, real interest rates near zero, even an aging population. But there are some crucial differences. The most important, according to the author, is that the size and heterogeneity of the Eurozone hides in its aggregates very important and significant differences in the degree of Japanization²⁷ of the different Member States, which in itself helps to avoid falling into the trap. Second, although inflation has remained stubbornly low in the Eurozone, it has not been negative, and certainly not for a substantial period. Third, population growth is low but not negative, and migration is a recurring and significant fact, contrary to Japan where racial homogeneity is a secular social value. And fourth, Europe has addressed

²⁷ Jose Ramon Díez borrows from Takatoshi Ito (2016) the index of Japanization as the arithmetic sum of the output gap, inflation rate and nominal interest rate. The closer to Zero, the higher the degree of Japanization.

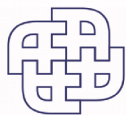


quite decisively its banking problem and, as already indicated, solvency ratios and asset quality have much improved since the crisis.

Avoiding the Japanization of the Eurozone is of the utmost importance, because all evidence shows that it is much easier than abandoning it once entrapped. So, the rest of the chapter is dedicated to explaining the economic policies necessary to that effect in the EMU. First and foremost is monetary policy, where, despite initial postponement, the ECB has adopted QE with extraordinary conviction and has brought negative nominal rates to never-seen levels (-0.5%), certainly much lower than in Japan, where the lower bound has been -0.1% . The crucial question is whether Europe has already reached the reversal rate, whether the transmissions channels of monetary policy are still operative at -0.5% . New empirical evidence show that this is only the case when the banking system is still strong, sufficiently profitable and capitalized. Consequently, pursuing financial stability should figure prominently in the ECB strategic review. Second, fiscal policy in the Eurozone requires better coordination and a common Eurozone fiscal instrument - a recurrent theme throughout this Yearbook - that would both help discipline countries like Spain, with excessive structural deficits, and ensure expansion in others, like Germany, with unjustified structural surpluses. And again, the newly created budgetary instrument does not address this.

Chapter 5, Facing the lower bound: what will the ECB do in the next recession? by Aliénor Cameron, Grégory Claeys and Maria Demertzis at Bruegel, looks at the central banks' evolving post-crisis toolkit and explores the possible responses to an eventual new financial crisis. The authors, who acknowledge that the ECB - like all major central banks - appears increasingly constrained by the environment of very low interest rates, provide a detail account of the changes to the operational framework and toolkit of the ECB since the start of the crisis in 2007, and finally make very concrete recommendations.

Cameron, Claeys and Demertzis set the stage from the beginning. Although it would be tempting to blame the ECB, as the monetary authority responsible, for the downward trend in long-term interest rates, the real argument lies in the behavior of the "neutral rate." So, it is essential to fully understand the concept, "mostly determined by the saving behavior of households and the potential growth rate of the economy...in itself largely determined by productivity and population growth." This is indeed the standard macro definition but let me take issue with it, as it has two major drawbacks. First, it relies on unobserved variables and it is, therefore, nothing more than a theoretical construct, the measurement of which requires a large number of assumptions. And the problem is that from those subjective measurements of structural trends, central banks derive drastic short-term policy implications. Second, it is puzzling that a crucial financial variable has in its definition no reference to the way the financial sector works or should work. To be more explicit, it is unimaginable that the neutral rate would not be affected by the solvency and profitability of the financial sector, by its ability to intermediate savings and investment, by the functioning of the monetary transmission mechanisms: in short, by financial stability considerations. In light of these considerations, the usefulness of the neutral rate is much overplayed, in my view. An obsession with this concept explains much of the collateral damage of the "lower for longer negative rates" mantra that has permeated ECB policy until now. And the unnecessary damage caused to economic



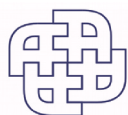
recovery and growth in Europe by ignoring that the so-called neutral rate is in fact endogenous, it is at least influenced if not determined by central bank interest rate policies.

But let me go back to the authors' recommendations. The first has to do with the need to mitigate the collateral effects of negative interest rates, since "the ECB cannot wait for research to conclusively determine whether the reversal rate has already been reached." And the paper describes various ways to compensate banks for the damage done to their interest rates margin and therefore to their operating income.²⁸ The second focuses on the revisions to issuer limits for the ECB's asset purchase program to maintain its credibility and operability in the not-too-distant future. To avoid the danger of monetary financing of deficits, and to assuage some national concerns, the authors argue in favor of extending the program to other asset classes, like bank loans and equities, which will lead to the ECB assuming credit risk.

Third, as regards the review of the monetary policy framework, the paper argues for a two-sided definition of the "around 2%" inflation target, to set a tolerance band around the target, to lengthen the period over which price stability is measured from 18 to 36 months, and most significantly, to change the target from headline to core inflation. This is interesting, but in my view does not address the nucleus of the problem. Central banks have to acknowledge that disinflationary pressures are a necessary but temporary by-product of globalization, digitalization and an aging population. While these long but temporary positive trends operate, central banks simply cannot create inflation but only asset bubbles and risk-premium confusion. So, the strategic review should upgrade the importance of financial stability in the reaction function, to the detriment of inflation. The fourth recommendation calls for the ECB to be fully prepared to use Outright Monetary Transactions (OMT). Sensible advice as long as the OMT is not wrongly conceived as a growth tool and its link to an exceptional adjustment program is not weakened.

Finally, the authors would like to see the ECB "thinking out of the box", being innovative and unconventional and ready to implement helicopter money if necessary. But remember that helicopter money is essentially a fiscal expansion, a way to create a fiscal impulse without Ricardian equivalence, without taxpayers ever thinking of having to pay it back. The ECB can be instrumental, if asked to be so by the proper authorities, but never a decision maker. This is a perfect example of the need to rethink the Statute of Autonomy and Limitations of Central Banks in the new normal and cannot be taken lightly.

²⁸ Let me note how much the prevailing view on this issue has changed in a short period of time, as highlighted by the recent decision by the Central Bank of Sweden. It was not that long ago that the insistence on the 2016 Yearbook Executive Summary on the collateral damage of QE to the profitability of banks and therefore to financial stability and economic growth was received with disdain as a self-interest opinion.



2.3. ISSUES IN FISCAL POLICY

Part III of the Yearbook is about fiscal policy, which has become quite popular lately, particularly in the Eurozone. It includes two different articles. The first is a detailed account of fiscal governance in the EMU, reviewing the evolution of the fiscal framework, offering a reform of fiscal rules and concluding with an analysis of the challenges ahead. The second offers a more theoretical and provocative discussion on the proper role of fiscal policy in a zero-interest rate environment and the sustainability of public debt in that context. Not quite a discussion on the so-called Modern Monetary Theory, but close.

Carlos Martínez Mongay and Mirzha de Manuel, at the European Commission, Directorate-General for Economic and Financial Affairs, write Chapter 6, The EU Fiscal Rules during the Juncker Commission. Implementation, reform and challenges ahead. The article may be read like an inside justification of the Juncker Commission, but it is much more than that. When Juncker took office in 2014, the post-crisis reform of the SGP was fully in force, including an expenditure rule, a debt reduction benchmark and a more gradual system of sanctions. Additionally, the European Semester had been established and Independent Fiscal Institutions set up.

The Eurozone achieved significant fiscal consolidation during Juncker's mandate. Its aggregate fiscal deficit was 0.5% in 2018, down from 2.4% in 2014, and public debt recorded a substantial fall, from 92% of GDP in 2014 to 85% in 2018, yet still 20 bp over the pre-crisis level in 2007. Nevertheless, the adjustment was "driven primarily by economic expansion rather than by the recommended fiscal adjustment paths", and the structural balance remained practically constant, hovering at a deficit of around 1% of GDP and forecast to increase in 2019-20, with the worsening being in countries like Spain and Italy. Government expenditure in the Eurozone came down from 49.1% of GDP in 2014 to 46.8% in 2018, with approximately 20% of this being accounted for by lower interest rates. Public investment represented 2.7% of GDP in 2018 only marginally lower (1/4 pp) than the average 2010-2014.

But perhaps what defined the Juncker Commission in fiscal terms was its decision to favor a flexible interpretation of the Stability and Growth Pact (SGP) to reduce its pro-cyclicality, without changing the rules.²⁹ It amounted to a temporary suspension of the fiscal adjustment path to carry out structural reforms or investment projects and to the introduction of a "margin of discretion" in assessing the degree of compliance with the rules. Controversial measures indeed, endorsed by the authors as illustrated in their chapter with a discussion of "five prominent cases of some of the challenges faced by a judgmental non-mechanical implementation of the Pact" and which make very interesting reading for the "orthodox Brussels view". Let me just bring to the attention three considerations: (i) discretionality in the implementation of the rules opens the discussion of "fair and equal treatment" for all Member States, and introduces the

²⁹ COM/2015/012. "Communication on making the best use of the flexibility within the existing rules of the Stability and Growth Pact", European Commission, Brussels 13 January 2015,



EXECUTIVE SUMMARY

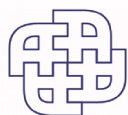
risk of “politicization”, certain governments being treated more favorably than others depending on the political color of the national government and/or the Commissioner in charge; (ii) political judgment requires democratic legitimacy and accountability, and this is precisely an asset the Commission is not full of; an additional good reason to move forward with a formal Finance Ministry of the Eurozone. If the rules require discretion, political and institutional reform is a must. And (iii) a more fundamental economic point, investment and structural reforms need also to be financed. Money is fungible and public debt is not earmarked, nor subject to different sovereign risk depending on its purpose. Debt does not trade differently whatever its purpose.

The Juncker Commission rightly shifted the emphasis to deficit prevention, introduced an expenditure benchmark and operationalized the debt reduction objectives. These reforms enhanced the “economic intelligence” of the fiscal rules, but at the cost of increasing complexity, discretionality and pro-cyclicality. It was not therefore so much a question of “stupid vs smart” fiscal rules, but more of a reversal on the old question of rules versus discretion, predictability versus flexibility, and adjustment versus endless needs. The triumph of the neo-Keynesian approach versus the old German school. Nowhere is this more visible than in the new political emphasis on the so-called “quality of public finances”, a euphemism, I would imagine, for the idea of preserving public investment and social expenditure from the vagaries of the economic cycle. Which results in the hysteresis of public debt. But this is no longer a problem to this school of thought, as we will see from the next chapter.

Most proposals for reform advocate the simplification of the rules, the reduction of the number of indicators, with a clear preference for the expenditure benchmark. Some also include a relative tightening of the rules. Other proposals focus on reviewing the corrective and preventive arm of the SPG, which should only differ in its intrusiveness and capacity to impose sanctions, and not on the range of indicators used. Some others propose to substitute economic conditionality for economic sanctions. Even the institutional architecture of fiscal governance is discussed, with some favoring decentralizing surveillance to external Independent Fiscal Authorities limiting the role of central European institutions.³⁰ The Commission was expected to release its review of the Two Pact and Six Pact at the end of 2019, but it was postponed. Worryingly, there are still significant fundamental differences of opinion in Member States.

In their last section, Martínez-Mongay and de Manuel look at fiscal governance reform from the point of view of the challenges being confronted by the EMU. Namely, a protracted slow down with deep structural roots, an increasingly bilateral trade and economic world order, a reinforced environmental awareness. Such shocks are affecting Eurozone countries in different ways according to their economic and social structures, and there are important uncertainties regarding Eurozone and national policy responses. The global nature of these challenges demands a coordinated fiscal

³⁰ Seeing fiscal coordination at work in Spain and what it has done for the explosion of regional debt, it is hard to be in favor of such a decentralized approach, unless the real goal is to abandon fiscal discipline.

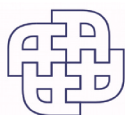


response in the Eurozone, thus calling for mechanisms and institutions to articulate an EMU response. A response that in the current institutional world of asymmetric fiscal rules can only come out of the political will of Eurozone countries to coordinate within the Eurogroup. Not a very reassuring setting to avoid “the risk of the 1% economy”, as the authors call what we have described earlier as Japanization. In a nutshell, they claim that the risks “...are likely to require higher public spending, and in particular higher investment in order to decarbonize the economy, upgrade infrastructure and improve education to increase productivity”. A not very modern recipe in my opinion, but one that closely resembles the old Mitterrand, “Keynesianism in a single country” at the grand Macron-like European level.

In Chapter 7, Fiscal policy when interest rates are zero, Angel Ubide, at Citadel, elaborates further on the idea that there is ample room for fiscal expansion in the Eurozone. His starting point leaves no doubt, “the fiscal framework in use today was created for a world that no longer exists, a world of positive interest rates, and only inertia and behavioral biases impede a radically more active fiscal policy.” He demands an end to the term “unconventional monetary policies”, because they are the new normal in central bank theory and policies. The natural rate of interest is estimated at close to zero or negative and attitudes toward inflation have changed. Very low real rates may look like a great outcome, but they are not, because they increase the expected future output gap. Which leads Ubide to his conclusion, “policy makers - in their quest to be conservative and prudent - are, mistakenly, not aggressive enough and make the outlook riskier.” The inertia of decades of considering monetary policy the “only game in town” has delayed for no good reason the adoption of a much looser fiscal stance.

Let me, for the sake of the discussion and the benefit of the reader, reverse his own arguments. Policy inertia may lead us to expect too much from fiscal policy expansion; the endowment effect, of sitting on negative rates as if collateral damage were not mounting and may actually be impeding recovery once the reversal rate has been reached in Europe; and behavioral biases in policy makers inducing them to ignore structural policies. This is the problem with arguing repeatedly that “this time is different”, that temporary becomes structural, and a prolonged anomaly is taken as the new normal; like the Great Moderation once was.

On the basis that the world has definitely changed, this chapter calls for a drastic review of the fiscal framework. First, monetary and fiscal policy should be coordinated and not envisaged as offsetting tools. Second, when inflation expectations are below target and interest rates are already zero or negative, “fiscal policy must lead with an expansionary stance and monetary policy must cooperate.” Third, interest rates should be kept this low for as long as it takes, since expansionary fiscal policy would be costless and have large multiplier effects. Fourth, fiscal space is a function of the willingness of governments to adjust during bad times, “of the political choice about the allocation of the costs of adjustment between creditors and taxpayers”. Fifth, modern estimates of the debt limit range between 150% and 200% of GDP, with a median of 180%, so European preoccupations about debt sustainability, even in periphery countries, are grossly overestimated. Sixth, fiscal space, like debt sustainability, is a flow concept, not a stock one.



The crucial variable is debt service, and it is sustainable if it remains below 15% of GDP in developed countries. Seventh, with ECB forward guidance committed to maintain the current interest rates, public investment financed with debt improves the debt path. And eight, government bonds are priced as bonds, and therefore as a function of the expected path of short-term rates and the term premium, and only in exceptional circumstances as credit. Typically, when the debt is issued in foreign currency, which arguably is not the case of the Euro Area Member Countries, or when the country is forced to default by external forces.

Allow me to express some skepticisms of this promised land of a new, and yet so mid-sixties, economic thinking. As long as central banks accommodate and provide for zero interest rates, a well-designed investment program pays for itself, and smart governments led by intelligent economist should embark in an ambitious expansionary investment program financed by debt. The decarbonization of the European economy provides the necessary moral justification. Problem is though that (i) there is no guarantee that interest rates will remain at this level long enough, and what will happen if and when they increase, and what if they do so abruptly? (ii) Structural forces pushing for disinflation will not last forever, just as the forces fueling the real estate bubble in Spain were long but temporary. (iii) Increased deficits do not result in higher debt-to-GDP ratios nor in higher debt services, critically because markets are overly understanding, complacent and rational. They do not compare countries; do not have policy uncertainty or lingering doubts and they unanimously accept the ECB as the one and only market maker. Question is for how long. (iv) Significant redenomination risks persist in the Eurozone and therefore the two cases for bonds being priced as credit are or may become very present. In sum, Ubide and some very prominent economist like Blanchard³¹ stipulate that European policy makers should have faith that markets are confident of continued ECB support, the eternal Greenspan put, and that national governments within the Eurozone, if and when they are forced to default to preserve the euro, would rather default on their national taxpayers than on their foreign creditors. A big gamble indeed.

Notwithstanding my comments, this chapter presents a very powerful view of the increasingly popular idea among some academics and policy makers that the Eurozone needs a debt-financed fiscal expansion and sets a new dimension for fiscal rules in the EMU. Bygones are bygones with respect to debt-to-GDP ratios. Net public investment should be financed with debt because at the ZLB, a well-designed multi-year investment program pays for itself. Increases in current expenditure or tax cuts boost demand and should be paid for (offset with lower expenditures or higher taxes) on a 5-year forward basis or longer, depending of the size of the recession, and Eurozone Member States should embark on a mandatory expenditure review to improve the quality of public finances. It all amounts to very simple rule, for as long as monetary policy continues at the ZLB, the budget should ensure that the primary balance does not lead ex-ante to a reduction of the debt-to-GDP ratio. Quite different to the actual rule, and even to the

³¹ Blanchard and Ubide 2019, Why critics of a more relaxed attitude on public debt are wrong, PIIE Real Time Economic Issues, July 15, 2019



reforms on the agenda, which ensures that fiscal policy discussions will be intense and exciting in the immediate future and will create additional tensions within Member States.

2.4. ISSUES IN BANKING

Part III is about banking. It contains three articles from very different perspectives. We start by looking at the concept of money and its future in the digital world. We basically wanted to study whether new technologies like distributed ledger technology (DLT), and artificial intelligence (IA), would radically change what we understand as money and the way we do banking. Second, and getting into the industry itself, we analyze the June banking package, the legislation approved by the European Union that incorporates in European law the final Basel III agreement. The third and final article brings a necessary international perspective and tells the EU banking story from a US angle, highlighting differences and potential points of conflict, and concluding with a discussion on the merits and obstacles for consolidation.

Manuel Conthe writes about The future of money in Chapter 8. He starts with an interesting discussion on the origins and nature of money, tracing the concept to classical philosophers and moralists. Money is an extremely powerful product of civilization,³² a construct that combines two separate functions, standard of value and means of payment. Both functions are subject to “network externalities” (the more people using them, the more useful they become) and together form what we call money. There are two gravitational forces that pull both functions together: the emergence of means of payment denominated in the standard of value, and the natural tendency for the unit of the frequently used means of payment to become the unit in which prices and debts are set, i.e. to become the standard of value.³³ But money is also defined by the role of government in creating it, or at least in facilitating its general use, particularly since it became “fiat money” and objects used as money lost any intrinsic value and ceased to be backed in real assets, i.e. gold.

This article includes an interesting account of the two complementary schools of thought on money, the “Metallist theory” and the “credit theory”. For the former, the prevailing view until recently, was that money emerged as a market-driven spontaneous innovation to avoid the practical inconveniences of barter. But some economists and historians are challenging this story, underlining that from time immemorial debts and credit played an essential role in the creation of money, and that the role of government in creating those debts, taxes, was instrumental.

Modern money is only worth something as long as people have confidence in its

³² See Niall Ferguson, *The ascent of money*, Penguin, October 2009

³³ A force so powerful today that probably the modern US dollar is the best example. A feature that has given rise to an interesting economic debate on Trade Invoicing. See Gita Gopinath and Jeremy Stein, 2018, *Trade Invoicing, Bank Funding and Central Bank Reserve Holding*, AER Papers and Proceedings, 108, mayo.



general acceptance, a role traditionally, but not necessarily, guaranteed by the government. But not any government, thus the phenomenon of dollarization. Governments have protected this privilege through the legal monopoly of “printing money” and entrusted it to an ad-hoc institution, the central bank. But new technologies are challenging this monopoly, as digital currencies promise to bring better “usability, reliability and trustworthiness” than legal tenders. In a certain sense, digitalization is making possible the “denationalization of money” which Hayek had long argued for. And central banks around the world, after much initial hesitation and the logical tendency to protect themselves, are facing this reality and adopting the new technologies. 2019 can be defined as the year of Libra, a failed experiment, but also as the rise of Central Bank Digital Currencies (CBDC), with most central banks experimenting with them.

Currently, money consists primarily of cash, a claim against the issuing central bank, but also of bank money, the credit balance of demand deposits made by the public with commercial banks. This chapter describes existing and potential means of payment according to the several features they can incorporate, because this is precisely what new technologies do. They allow the bundling or unbundling in various different forms of the separate functions and characteristics of money, thus giving way to different types of monies. They also make it possible to think of a world without cash and even without legal tender. In 2016, even an orthodox economist like Kenneth Rogoff, former Head of Research at IMF, argued in favor of advanced economies phasing-out paper currency, to discourage tax evasion and money laundering and particularly to allow central banks to overcome the Zero Lower Bound. Another prominent economist, former ECB Head of Research, Otmar Issing, heavily criticized this idea and described paper currency as “coined liberty,” because many new monies, and most of their proponents, underestimate the powers of Leviathan allocated to the issuer.

Another economist, James Tobin, had already gone much further in 1985 and argued to allow individuals to hold demand deposits with central banks, thus eliminating the role of commercial bank as intermediaries and guaranteeing the safety of deposits and the absence of a banking crisis. But at the cost of giving central banks a major role in the provisions of credit, particularly in times of stress. The idea of providing greater access to central bank liabilities has resurfaced with digitalization and has led to an ebullient market for CBDC. A market that the adventure of Facebook with Libra has only made more real. Stablecoins are here to stay, whether as money or just another asset is a different regulatory story. BIS has underlined that the benefits of CBDC would be limited if fast efficient private retail payment products were already in place or soon developed, thus emphasizing the need to improve in the payments function of current monies. But a general purpose CBDC, competing with guaranteed bank deposits, would have serious implications for the pricing and composition of bank funding, adding to the fragility of the banking system and helping the flight to safety, even more so internationally. In conclusion, any step towards the possible launch of a CBDC should be subject to careful considerations. The debate over money is very much alive, and goes beyond new technologies and pure economics to more fundamental political issues. It goes back to the basic concept of liberty.



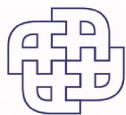
Chapter 9, The June Banking package, describes the regulatory reform in the European Monetary Union. Sofia Rodríguez Rico, Enrique Corcóstegui and Josep M^a Vendrell at Banco Sabadell, assess the banking legislation enacted in 2019, which seeks to reduce risks in the financial sector by strengthening capital, leverage and liquidity requirements, and improving bank's resolvability. Although the EU has made good progress, the authors conclude that the regulatory and supervisory framework is still not sufficiently conducive to cross-border interaction and incentives for ring-fencing and home bias remain.

European authorities discovered with the crisis, that the proper functioning of the EMU would require a Banking Union (BU), as within a currency union the financial sector creates far-reaching externalities and taxpayers' risk across borders. The three pillars of BU are well known, as is the absence of the third, EDIS. From an international regulatory perspective, the crisis resulted in Basel III, which was adopted in the EU through two legislative packages: the 2013 Capital Requirements directive (CRD IV) and regulation (CRR) and the 2014 Bank Recovery and Resolution directive (BRRD). Additionally, consumer protection has become a central piece of legislation (MiFID), wholesale funding markets and infrastructure have been made more transparent (EMIR), and macroprudential considerations have become prominent.

Already, in 2015, the Five Presidents' Report had suggested that European banks needed to reduce risks further, in order for those remaining risks to be mutualized. But the Risk Reduction Package, RRP, was not finally enacted until June 2019. The RRP comprises three distinct elements: amendments and clarifications to the Basel standards, EU specific issues and a revised resolution framework. Basel standards include a leverage ratio, the Net Stable Funding Ratio, a large-exposures framework, a fundamental review of the Trading Book and an overhaul of the internal model's approach, and a standard approach to counterparty credit risk.

EU specific issues include splitting the Pillar 2 capital requirement into a binding requirement, P2R, which can be partially met with capital instruments other than CET1, and a recommendation component, P2G, a guidance. Additionally, the RRP (i) extended the reduction of capital requirements to some SME's exposures; (ii) adapted the prudential framework to the introduction of IFRS9, an expected losses standard with impact on capital; (iii) envisaged the regulatory treatment of software as an intangible asset; (iv) included anti-money laundering (AML) considerations in the regular supervisory review and evaluation process (SREP); (v) required third-country groups operating in the EU to set up an Intermediate Parent Undertaking (IPU), in the EU to allow a holistic supervision; (vi) mandated EBA to include environment, social and governance (ESG) considerations in the SREP; and (vi) simplified disclosure and reporting for small and less complex banks.

Finally, the RRP incorporated the TLAC standard for G-SIBs and developed a European-specific Resolution Framework through the revision of the BRRD and the Single Resolution Mechanism Regulation (SRMR). Consequently, European banks will have to meet an intermediate target level of MREL in 2022 and a binding, full requirement for 2024. To facilitate meeting these targets, the Directive 2017/2399 created a new subordinated TLAC/MREL-eligible debt called "senior non-preferred" that ranks in solvency



above own funds instruments but below other senior liabilities. Breaching MREL/TLAC requirements implies restrictions on the distribution of dividends and the payment of Additional Tier 1 instruments. BRRD 2 also includes mechanisms to prevent mis-selling of MREL instruments to retail investors.

The RRP represents an important milestone in preventing bank failures and avoiding bailouts. But in some respects, the approach taken is not ideal and may penalize European banks, generating a competitive disadvantage with regards to banks in other jurisdictions. For instance, “regulation seems to have gone too far when establishing a minimum subordinated MREL requirement.” Beyond the logical discussions between the industry and regulators, the need to avoid regulatory disadvantages for European banks is of the utmost importance in an industry already punished by negative interest rates, lack of progress in completing banking and capital markets union and the threat of predatory regulation in the UK after Brexit.

The implementation of the RRP does not put an end to regulatory reform in the EU. On December 2017, the BCBS, Basel Committee on Banking Supervision, published its final document on what is known as Basel IV. It should be phased-in as of 2022. It will have an impact on the standardized approach to credit risk, the Internal Ratings-Based approach (IRB), the final calibration and design of the output floor, operational risk approaches and the quantification of Credit Valuation Adjustment (CVA) risk. Finally, and despite all efforts, financial fragmentation has become entrenched in the Eurozone. (i) There is still ample room for national discretions, particularly in the area of sovereign and large exposures, liquidity regimes and waivers of prudential requirements. (ii) Countries have maintained ring-fencing measures put in place during the crisis, hindering the free flow of capital and liquidity within cross-border banking groups, particularly those affected by solo and consolidated supervision, as is the case for Spanish banking groups. (iii) A fully-fledged EDIS is still absent. (iv) The EU still lacks a common insolvency regime. European banks and regulators need to reduce uncertainties and compliance costs to be able to focus attention, strategies and capital to confront the more global pressing risks of digitalization, cybersecurity, decarbonization and customer empowerment. And EU regulation has to move soon and decisively from risk reduction to risk mutualization so as to be better prepared if and when the next crisis hits.

In the final chapter, Chapter 10, Consolidation of the European Banking Industry: obstacles and policies, Martin Boer and Andrés Portilla from the Institute of International Finance (IIF) provide a much-needed international perspective on regulatory efforts in Europe. It starts by assessing the health of the European banking industry, its challenges and opportunities, and then focuses on one basic question, is Europe overbanked? While the business case for consolidation is clear to the authors, there are a number of significant obstacles preventing M&A activity in Europe.

European banks have substantially strengthened their capital and liquidity positions. However, a number of factors have negatively impacted their profitability, with many banks currently unable to meet their cost of capital. European authorities have consistently taken the view that profitability problems stem from a poor capital base, loan quality deterioration and - mostly due to overbanking - because of excess capacity in



the industry, as weak banks do not exit the market³⁴ and as banking union remains unfinished and banks continue to operate on a national basis, mostly in retail. Boer and Portilla provide some very powerful numbers to sustain this claim: (i) intra-area cross border claims and the market share of foreign branches and subsidiaries have declined since the year 2008; (ii) consolidation has been significant in Europe, the number of institutions has fallen by 29% since 2009, roughly equivalent to the 31% in the USA, but it has mainly occurred domestically; (iii) the ratio of bank assets to GDP in Europe stands at 250% compared to only 80% in the US, but the 5 largest banks in the USA hold 50% of bank assets while they only account for less than one quarter in Europe, and (iv) only 1% of European households and 9% of non-financial corporations took out cross-border loans and almost no private household and only 8% of corporations made cross-border deposits.

The benefits of cross-border consolidation are well known. Savers would have more investment options, more sources of financing would be available to companies, and risk sharing would be improved, thereby diminishing idiosyncratic risks for banks and sovereigns. Moreover, national consumption and income would be decoupled. A consolidated European banking market could also foster new business opportunities and models. There are even trade-related benefits to cross-border mergers. Although there seems to be the presumption that consolidations are mainly defensive, evidence shows that M&A are basically pro-cyclical, as mergers imply risks and are much more likely during periods of strong economic confidence and performance, when there is also a higher probability of delivering higher returns.³⁵

Against this theoretical economic and financial background for consolidation, this chapter draws an extensive list of political obstacles. Most notably, the different policy and legal treatment of privately-owned and state-owned banks, their different return on equity (ROE) targets and governance structures, “which make it difficult to acquire public and cooperative banks”. This is particularly pervasive in some core countries that, despite the crisis, have managed to avoid a major restructuring of their banking system. Also, the issue of holdings of domestic sovereign debt explained in part “by the scarcity and asymmetric provision of safe assets.” But perhaps the biggest political hurdle has been, and as argued extensively in this report still is, the lack of agreement to complete European Banking Union.

Significant regulatory hurdles maintain a policy-induced fragmentation of European financial markets. Member States apply strict capital and liquidity measures to branches and subsidiaries, rather than at the group level.³⁶ The European Commission’s proposal to grant capital waivers within banking groups on an EU cross-border basis would have addressed this point, but it was finally dropped from the EU Capital Requirement Regu-

³⁴ See Danièle Nouy 2017, Too much of a good thing? The need for consolidation in the European banking sector. September 27. Or Andrea Enria, The banking union -a personal view on its past, present and future, October 30, 2019.

³⁵ ECB 2018, Financial Integration in Europe, May 2018

³⁶ Luis de Guindos 2018, “Euro area banking sector: current challenges”, November 15, 2018



lation. The authors also rightly argue that international banking regulation should treat the Union as a single jurisdiction, a single geographical area when it comes to calculating capital surcharges for global systemically important banks. Finally, uncertainty prevails with regards to when and how new regulation will be deployed. The implementation of the Fundamental Review of the Trading Book (FRTB), of the final Basel III package³⁷, the adoption of TLAC provisions,³⁸ the national ring-fencing measures and the national powers on macroprudential measures, are all good cases in point.

The final chapter in the Yearbook concludes that political decisions will have a significant role in inducing change and reducing financial fragmentation in Europe. If the authorities consider bank consolidation convenient, and even necessary, to ensure the solvency, profitability and sustainability of financial institutions, and of the system as a whole, policies need to change, a European wide perspective has to prevail, and Banking Union needs to be completed urgently. Otherwise, vulnerabilities will persist, and fragmentation linger and become an entrenched feature of the European financial landscape. To the detriment of European citizens, unable to reap the full benefits of the euro.

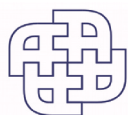
3. THE 10 EUROPEAN LESSONS OF THE EURO AT 20

This book is designed as a policy paper and conceived to illustrate and influence the European debate on the nature, shortfalls and implications of the European Monetary Union. On that basis, authors and topics are chosen to reflect different perspectives on the current relevant policy debates. We have never searched for unanimity, nor even basic agreement on anything but the need to complete the Euro project to make it stable and permanent. The issues are on the table, opinions and proposals are plenty. Discussion is already at the political and decision-making level; economists having already exhausted our arguments and capacity to persuade. That is the fundamental positive change from previous years.

However, the necessary political compromise, what we have called the “grand bargaining” on the completion of the Eurozone, seems yet too distant. Once again, the Euro at 20 looks like an infant in need of nurturing, slowly growing up to face reality. It is customary to finish the Yearbook with the Ten Lessons of the Year. This time we have opted for a longer horizon, for focusing on how should the Euro look like. Because having a clear destiny in sight, a sense of purpose and an agreed “steady state” of the Euro, makes finding the way easier and helps drawing the necessary road map. This is what we have attempted in this final section.

³⁷ Boer and Portilla underline that EBA estimates published August 2019 found that under conservative assumptions full implementation of Basel III would increase minimum capital requirements for European banks by 24.4% on average, an aggregate shortfall of about €135.1 bn. An impact significantly higher than in other jurisdictions.

³⁸ The EU is so far the only jurisdiction that has chosen a hard 90% for calibrating internal TLAC, and a 100% for banks within the EU. Hong Kong, UK and the US have proposed calibrating TLAC at the lower end of the agreed 75%-90% range



First, Completing the Euro needs decisiveness. Postponement is not an option anymore, neither political nor economic. Politically, procrastination has been abused and citizens are moving away from the European project, tempted by populism. They need direction and leadership. Will the new Commission deliver it? Economically, while the current slow-down appears only cyclical the external environment has become ever more demanding. Europe runs the risk of economic marginalization in an increasing bipolar world. Europe's soft power, a multilateral world of rules, cannot be displayed successfully without strong internal cohesion. Strengthening the role of Europe and the euro in the global economy will not happen without completing banking and fiscal union. The necessary changes have been sufficiently diagnosed. There will always be some disagreements on technical details and different national sensibilities on the relative merits of the various issues, but a large technical consensus exists on the architecture of a permanent and stable monetary union, even though there are different legitimate interpretations on how to get there. The road map is subject to negotiation; the end state cannot be.

Second, the European economy needs economic growth. Stagnation is a real threat. Low productivity growth, an aging population and a certain loss of technological leadership and ambition have conspired to reduce potential output. Industrial and competition policies need redefinition at the European level. Labor market liberalization is mandatory. Immigration policies are to be linked to the economy. The European Welfare State needs resetting. Malthusianism is reviving in the wake of a certain environmental hysteria. Climate change is a fact and demands smart policies that combine growth, job creation, fiscal stability and the right incentives, but most of all international coordination. Without growth, inclusion and redistribution policies are only confrontational, within countries and inside the Eurozone. Which would only weaken the Union.

Third, the scheduled strategic review of monetary policy is welcome. It has to be ambitious and go beyond minor changes on how and for how long to measure the inflation target. The ECB needs to rethink its reaction function and the relative weightings of inflation, unemployment and financial stability. It has to show humility and acknowledge that globalization, digitalization and an aging population are very powerful structural forces pushing for long but temporary disinflation. Forces to which monetary policy, no matter how unconventional, is a poor response. And it has to realize that a long period of negative interest rates damages not only the financial system, but also the real economy. It facilitates growing indebtedness, distorts risk assessments and creates central bank dependency on financial markets, a new form of moral hazard. Monetary policy is a poor substitute for structural policies.

Fourth, the European Union needs to reduce its dependency on the ECB as the only policy instrument, the only economic authority willing and able to operate at the European level. This activism threatens the independence of the Central Bank as it becomes a quasi-fiscal institution. The drive to use monetary policy for the decarbonization of the European economy is a perfect case in point. Fiscal and political decisions, no matter how relevant or urgent, are not the realm of monetary policy, and should never be. Disguising political decision as macro-critical is a road already travelled by many central



EXECUTIVE SUMMARY

banks, a road that led to its political use and abuse. The ECB needs to contain its outreach and worry about its efficiency. To do so, it demands a fiscal counterpart.

Fifth, the Eurozone needs to define and implement a fiscal stance. Developing a fiscal capacity and adequate fiscal institutions and governance for the Union cannot wait. Progress has been extraordinary slow in this area. Inaction has always been justified on the lack of sufficient progress in risk reduction. The recent approval of the Budgetary Instrument for Convergence and Competitiveness falls way short of the macro stabilization facility needed, and even then, essential operational details are still missing. Discussions on the simplification of fiscal rules in the Eurozone continue, while its implementation is increasingly discretionary. Furthermore, there has been no advance in building Euro Area Fiscal Institutions to grant legitimacy to the necessary process of transfer of sovereignty in fiscal policy. Nothing on setting up a Euro Treasury. No further progress on the European safe asset, an essential element of normalized monetary policy with obvious fiscal implications. The Eurozone appears to be waiting for the next crisis before seriously proceeding with Fiscal Union.

Sixth, the Union's crisis prevention and resolution mechanisms, despite its reform, remain insufficient. The European Stability Mechanism cannot be an external multinational process mirrored on the IMF. It cannot be subject to national political control and budgetary processes and ad hoc allocations. It requires an EU institution with unlimited capacity, direct access to euro credit and taxpayer's money, to be credible in times of stress or to deal with a large country. Its link to the bank resolution process is also controversial and can only be temporary. In every major jurisdiction, bank resolution authorities have direct access to funding, if need be. Particularly after the bail in of private financial institutions has been guaranteed through the establishment of the Resolution Mechanism and its regular funding secured through a levy on banks.

Seventh, progress in Banking Union is also lacking. The European Deposit Insurance System has been once again postponed sine die. A dangerous game that delays the creation of a level playing field for Euro Area banks, prolongs financial fragmentation and relies too much on the complacency of markets and the willingness of the ECB to keep acting as the price maker for securities. But redenomination risk will not disappear as long as EDIS is not even scheduled for implementation. Precisely because the inability to enact it, shows too clearly the lack of willingness and commitment of certain Member States to fully mutualize banking risk in the Eurozone. A necessary characteristic of any long-lasting monetary union.

Eight, cross-border consolidation of the European banking industry is a desirable consequence of monetary union. A logical response of financial institutions to its reduced profitability in a world of digital competitors, empowered customers and long lasting very low interest rates. Yet, it is not happening because of remaining legal and policy-induced obstacles and clear regulatory disincentives. The European Union has been unwilling and unable, from a supervisory and regulatory point of view, to treat intra-European cross-border transfers of capital and liquidity within banks' branches and subsidiaries as totally equivalent to intra domestic transfers in terms of risk provisions and capital charges. How can it expect other jurisdictions to do so? And how can anyone



expect banks to act as if they were, and merge or acquire cross-border? How long can the union survive without European-wide retail banks?

Ninth, fragmentation of the European financial system remains a reality. Despite recent reforms and improvements, home bias in savings and investment continues to be pervasive. Cross border movements of capital within the EMU have not reached the levels seen before the crisis. Part of this may reflect the growing renationalization of European politics and economics. In that sense, there is very little monetary authorities can do. But to a large extent, fragmentation is still a byproduct of the unwillingness to complete Banking Union, of insufficient application of the Single Rule Book, of the lack of progress in risk sharing, of a hesitant and unambitious implementation of existing policies in supervision and resolution. This adds to the vulnerabilities of the Eurozone, complicates its stability and deprives European citizens of the benefits of accessing a large single financial market; thus, rendering monetary union less accessible and popular.

And Tenth, digitalization of the financial system is a fact. It is already changing the way we think of money, monetary policy, and banking. And it will soon change the way we conduct the business of monetary policy and banking. European authorities are reacting to this new environment by stretching to strike an adequate balance between fostering innovation and ensuring stability and equal treatment. The benefits of financial innovation are clearly in the betterment of the payment system, particularly retail cross-border, and in helping financial inclusion and enlarging financial options, in savings and investments. However, the costs in terms of security, transparency and consumer and data protection are also obvious. Central Bank Digital Currencies are a promising field worth studying, but the risk to financial stability and to the crucial role of the commercial banking system in the holding of deposits and the provision of credit are too large to ignore; with the road to serfdom of the central bank all too present.

PART I
THE POLITICAL, ECONOMIC AND FINANCIAL ENVIRONMENT



1. THE NEW POLITICAL CYCLE IN BRUSSELS: WHAT TO EXPECT?

**JOSÉ IGNACIO TORREBLANCA & PAWEŁ ZERKA¹,
EUROPEAN COUNCIL OF FOREIGN RELATIONS**

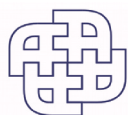
1.1. ABSTRACT

The new Commission has set an ambitious agenda for itself, both at home and abroad.

At home, it seeks to reconnect with its citizens and isolate or marginalize the populist forces that have so profoundly challenged the European integration project in the last decade. Also, the new Commission seeks to redress Europe's digital backwardness vis-à-vis the US and China, which is considered to be one of the major weaknesses threatening the European economy. It aims to ensure that basic progress is made in ensuring Europe's successful transition to a green economy. Regulation-wise, the Commission has doubled down on the commitment of Jean Claude Juncker's Commission to reduce red-tape, by setting an ambitious, though difficult to deliver, goal of removing two old regulations for each new one introduced.

Abroad, the Commission wants to take on the challenge posed by the rise of protectionism, unilateralism and nationalism by stepping up its foreign policy and security capabilities, as well as by taking a more strategic look at the geopolitical dimension of elements such as trade, the euro, investments and markets. Europe's growth and welfare has so far been based on the existence of an open and rules-based multilateral order. But this order is now increasingly put under strain by the return of great-power competition and the corrosive actions of the current leaders of the US, China and Russia. Most elements on which globalization is sustained (trade, investment, currency exchanges, technology, migration) are currently weaponized and turned into elements of geopolitical competition.

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The new Commission has a clear mandate: to win citizens back, to ensure a successful transition to a digital and green economy, and to redress Europe's diminishing weight and role in the world. Importantly, the external and the internal dimensions of this agenda should be treated as two sides of the same coin. But it remains to be seen whether Ursula von der Leyen and her team will be able to assert their leadership in the EU in the context of growing political fragmentation in the Council, in the European Parliament, and within Member States themselves.

Two events, in particular, will serve as a testing ground for its leadership, and for the relationship between the Commission, the Parliament, and the Council. As negotiations on the EU's multi-annual budget (MFF) enter a decisive stage and the UK leaves the block and starts a new round of negotiations with the EU, the EU's largest Member States are seeking to strengthen their position within the EU's internal power struggles. Still, for the time being, it looks like Brussels in general will be strengthened in this new political cycle of the EU – to the frustration of those Member States that are more used to the intergovernmental method.

Keywords: European Commission; Geopolitics; Public opinion; Multilateralism; New Green Deal; Digital Revolution; European Sovereignty.

1.2. INTRODUCTION

The new Commission has set an ambitious agenda for itself, both at home and abroad.

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Abroad, the Commission wants to take on the challenge posed by the rise of protectionism, unilateralism and nationalism by stepping up its foreign policy and security capabilities, but also by taking a more strategic look at the geopolitical dimension of elements such as trade, the euro, investments and markets. Europe's growth and welfare has so far been based on the existence of an open and rules-based multilateral order. But this order is now severely imperiled by the return of great-power competition and the corrosive and combined actions of the current leaders of the US, China and Russia. The majority of elements on which globalization is sustained (trade, investment, currency exchanges, technology, migration) are currently weaponized and turned into elements of geopolitical competition.

Therefore, the new Commission has a clear mandate: to win citizens back, to ensure a successful transition to a digital and green economy, and to redress Europe's diminishing



weight and role in the world. It is no doubt a huge challenge, but will it be achieved? Let us look at how the domestic and international challenges facing the new Commission could play out.

1.3. A GEOPOLITICAL COMMISSION

When assuming office back in 2014, President Juncker announced that his Commission would be a “political” one. By this, he meant that the Commission should stop being considered as just a technocratic body in charge of merely guarding the Treaties and finding technical or legislative solutions to answer the needs and calls of the Member States gathering at the Council, as the European Commission had mostly been acting after Delors left. And indeed, it was political, especially as Juncker’s energetic Vice-President – the Socialist Frans Timmermans – took up the fight on EU values with Poland and Hungary and unleashed the sanctions process envisaged under EU Treaty article 7. With this, the Commission not only brought the fight against populist and illiberal forces within the EU to the forefront of the Commission’s actions, but also made sure that the 2019 elections would take place under the more emotional theme of EU democratic values and the fight against nationalism and populism. Watching the poor results of the anti-EU forces and the increased mobilization of voters, which resulted in the EP elections’ turnout reversing its historic downward trend, one could say that politicization did the trick and, at least partly, managed to reconcile some citizens with the EU project and, most importantly, with its institutions.

The new Commission will no doubt take further steps down the road of politicization and politics. This will be particularly felt on the external relations front as the EU feels deeply challenged by current geopolitical developments.

For the majority of the EU’s history, the main challenges Europeans have dealt with have originated at home. Their prosperity has hinged more on their capacity to reconcile with each other, overcome the past, open their borders, bring down their barriers to the free movement of goods, capital, services and people and set up a common currency, than in their ability to relate with the rest of the world. In fact, in the past century, the European Community has often been accused of being a protectionist force undermining free trade regimes such as the GATT with its high tariffs and exports subsidies. Until very recently, the EU did not contribute a lot to sustaining the multilateral economic order that it benefitted so much from, as exemplified by the accusation of “Fortress Europe” which besieged it until the nineties, when a process of reform and opening up was launched under the Single European Act’s drive to complete the single market and make the four freedoms of movement (goods, capital, workers and services) a reality.

The situation is quite different now, when a great deal of the problems which the EU suffers have their origin in dynamics taking place beyond its borders and its control. Take climate change, which is one of the priorities the new EU Commission has set for itself. Even if the EU manages to successfully achieve its goals of decarbonization and the transition to a clean economy, that effort will be wasted in terms of combating global



warming if the US, China, India and other economies do not come onboard or do not fulfill their emissions reduction commitments. This means that (much as is happening in the digital realm, where the EU has effectively become, almost without noticing, a regulatory superpower able to set up global standards for privacy rules and very successfully export its competition rules to the large multinational firms dominating the digital market) the EU has to very carefully weigh up how best to use its internal market rules and regulation potential to design the incentives needed to bring other countries to the table, and also the penalties which it will be able to impose (carbon taxes, limits to trade or investment) for those not willing to play along and align the policies to achieve the goals of the Paris Declaration.

Both European security and Europe's prosperity are now under threat from unilateralism and protectionism. In as much as Trump's foreign policy is systematically undermining the transatlantic collective security defense system established by the NATO Treaty and its article 5 and introducing risk and tensions in issues of vital importance for Europe (e.g. the Iran nuclear deal and, the Israeli-Palestinian conflict), his policies are also undermining key multilateral economic institutions, most importantly, the WTO, but also a wide range of treaties ranging from arms control to climate change.

Every day protectionism rises and the rules-based multilateral order is further eroded, the EU discovers how its prosperity and welfare, mostly based in the efficient working of the single market, depend on both sustaining that order or, alternatively, when push comes to shove, in its capacity to preserve its interests from other great powers' attempts to impose unilateral policies on the EU or, even, to impose symmetric or deterring costs on those attempting to twist the EU's arm. No wonder then that the mandate given to the new High Representative for Foreign and Security Policy and Vice-President of the Commission for External Affairs (HRVP), Josep Borrell, by the President of the Commission, Ursula van den Leyden, includes a very clear line about salvaging multilateralism. The President stated in her mission letter to the HRVP that it is not only in our DNA, but is also the only way to make sure that globalization is ruled in a fair and inclusive way, both for the benefit of Europe and the rest of the world.

As unilateralism and trade wars, which Europeans have not sought or wanted, impose a negative cost on Europe's economic interests, Europeans have no other option than "to learn to speak the language of power", as Borrell bluntly put it in his confirmation speech before the European Parliament. In fact, it is quite revealing that Europeans have begun to openly talk about a concept which European integration was meant to overcome: sovereignty.

France's President, Emmanuel Macron, has been the one bringing the concept of sovereignty – most frequently used by anti-European forces and usually employed by pro-European forces in a dismissive way – back into circulation. But, as it is generally the case with radical populist forces, which do not hesitate to walk over to the enemy trenches and dispute their favorite concepts (whether democracy or laicity), Macron has sought to steal the concept of sovereignty from the populists, to bring it to European level for the pro-European forces and to make use of it. As he set it out in his September 26, 2017 speech at the Sorbonne, despite the claims of the nationalists, only Europe can



guarantee genuine sovereignty to help protect its citizens (“the route for ensuring our future is the route of rebuilding a sovereign united and democratic Europe”, he said).

Diving into the specifics, Macron identified six dimensions of sovereignty: first, security, which he said it would require, among other things, strengthening Europe’s defense industry; second, better border control and migration policies; third, a stronger and more united foreign policy; fourth, ensuring a successful ecological transition; fifth, achieving digital sovereignty by promoting Europe’s digital champions; and sixth and last, “industrial and monetary economic power”.² Long-term economic power making Europe able to compete with the US and China, Macron said at La Sorbonne, “can only be built around a single currency”, an idea he expanded on at the European Parliament in April 17, 2018, to include the defense of Europe’s strategic trade, investment and energy sectors.³

Macron’s proposals for “European sovereignty”, have created quite a substantial controversy. Some have disputed the need to use such a heavily loaded term and have taken refuge in the safer concept of “strategic autonomy”. In any case, the call for action and increased capacity to act has stuck in the European debate, and made its way into the priorities of the new European Commission.

This is clearly seen in Ursula von der Leyen’s opening statement at the European Parliament on July 16, 2019⁴ and in her mission letter to HRVP Josep Borrell establishing the Political Guidelines of the Commission, calling for Europe to be assertive in the world in defense of its value and interests (“we believe in multilateralism because it works. It makes us safer, more prosperous and better able to make the most of the major transitions of our times”). It was also evident when she spoke of “technological sovereignty”⁵, and more importantly, when she launched the concept of a “geopolitical Commission”⁶.

What does President Von der Leyen exactly mean when referring to a “geopolitical Commission”? First, becoming aware of the fact that “our internal and external work are two sides of the same coin”. Second, “strengthening the Union’s capacity to act autonomously and promote its values and interests around the world”. Third, ensuring that “our external financial instruments are used strategically, contribute to our wider political aims and enhance Europe’s leadership and influence in the world”.

² “Initiative for Europe”. Speech by M. Emmanuel Macron, President of the French Republic. Paris, September 26, 2017. Service de Presse de la Présidence de la République. https://www.diplomatie.gouv.fr/IMG/pdf/english_version_transcript_-_initiative_for_europe_-_speech_by_the_president_of_the_french_republic_cle8de628.pdf

³ Speech by Emmanuel Macron, President of the French Republic, at the European Parliament, April 17, 2018. <https://www.elysee.fr/emmanuel-macron/2018/04/17/speech-by-emmanuel-macron-president-of-the-republic-at-european-parliament.en>

⁴ https://ec.europa.eu/commission/presscorner/detail/en/speech_19_4230

⁵ https://ec.europa.eu/commission/presscorner/detail/en/IP_19_5542

⁶ https://ec.europa.eu/commission/sites/beta-political/files/mission-letter-josep-borrell-2019_en.pdf



As some observers have noted, the emphasis on economic instruments (though she also put on the table the so-called “European Defence Union”) means that she may be actually speaking more of a geoeconomic Commission rather than of a geopolitical one. As Jana Puglierin and Niklas Helwig have written: “instead of strengthening traditional foreign policy and EU diplomacy, the next Commission is setting out to reinforce Europe’s international footprint in those areas where the EU is strongest and has a real competitive edge [...] The EU cannot escape the trend of increased global competition; it needs to sharpen its economic sword”.⁷

In other words, the EU feels vulnerable abroad. It sees some of its most important values and interests jeopardized by the deteriorating rules-based international order and the rise of protectionism and great-power competition. And it feels the heat of other countries, especially the US, China and Russia, using their economies as tools of geopolitical competition. As trade, currencies, investment, sanctions, competition policy and digital issues are weaponized, the Commission feels that it is playing a great power game with one hand tied behind its back and that the time to fundamentally change this has come. How? By better tying together domestic economic policies with foreign and security policy (a phrase aptly summarized in Borrell’s assertion that “the European Union must learn to speak the language of power” and that “geopolitics begin at home”).

1.4. BRINGING CITIZENS BACK IN

Apart from the geopolitical rationality dominating the new EU Commission priorities, there is also an internal political rationale behind the re-arrangement of the EU’s priorities in the bloc’s new institutional cycle.

European voters have given a clear message to the new European leadership that they expect “change” and want the EU to “deliver” on their expectations. For the first time ever, the two political groups of the EU’s political mainstream – EPP and S&D – received less than half of the seats in the new European Parliament, in part because voters punished them for their wobbly positions on topics ranging from climate to migration to rule of law. In turn, two unequivocally pro-European groups – the Liberals and the Greens – grew in importance. But anti-European parties of varied pedigree also became stronger, obtaining almost a third of seats. All of that happened under an impressive turnout of 51% (an increase of ⁹ percentage points on 2014).

On the face of it, what voters have said at the ballot box could look contradictory. On the one hand, they are increasingly frustrated with politics in general, including with the EU. Across 14 countries included in ECFR’s pre-electoral poll⁸, 38% of respondents believed both the EU and their national political system to be ‘broken’, while only 25% considered

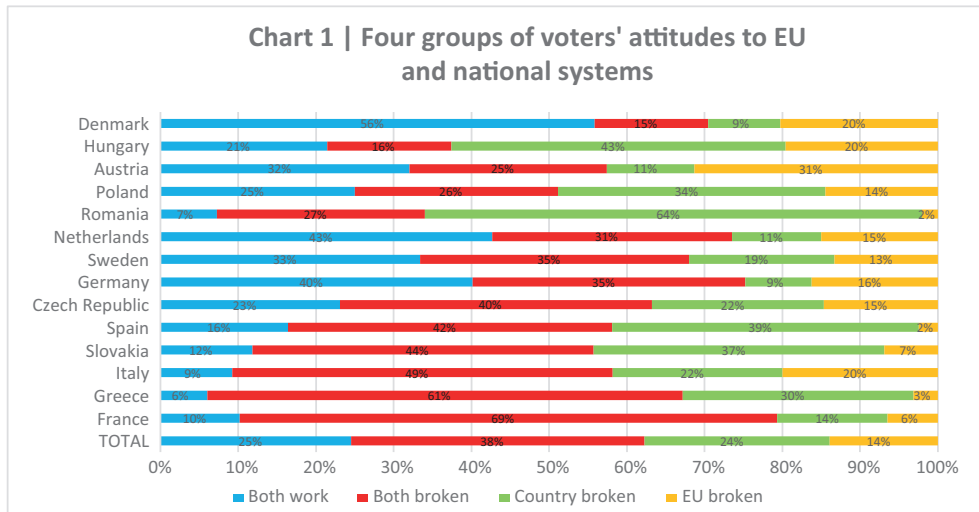
⁷ <https://dgap.org/en/think-tank/publications/further-publications/europes-geo-economic-commission>

⁸ I. Krastev, M. Leonard, S. Dennison, *What Europeans really want: five myths debunked*, ECFR Policy Brief, April 2019



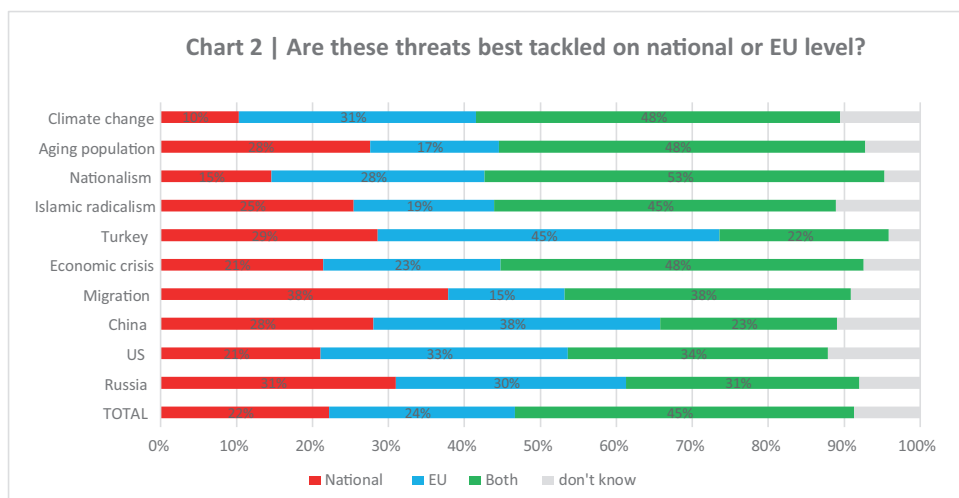
both to work well [Chart 1]. On the other hand, voters are also increasingly aware that delivering on the many expectations that they have vis-à-vis politics would require more than just national level initiatives. According to ECFR's post-election survey in six largest Member States⁹, 69% of voters think that tackling what they consider as Europe's greatest threats would need to be addressed at either just the EU level, or at both the national and the European levels [Chart 2]. This varies significantly by issue: for example, there is considerable resistance among Europeans to accept that migration should be tackled by anyone else apart from their national governments. But overall, for every issue, there is a majority recognizing the need to address key challenges, at least in part, at the European level.

Ursula von der Leyen may have realized that this paradoxical mix of high expectations and growing impatience of the European electorate constitutes both a challenge and an opportunity for her. In particular, it may give her more leeway to shape the EU's agenda, as long as she can claim to have regained popular support for the European project. While the appointment of a "Commissioner for the European way of life" to cope with several sensitive points on the agenda, such as migration, may look like a false start, it was telling to hear her explanation that she did so to reclaim the concept of the European way of life back from the populists¹⁰. At the same time, her mission letters to future Commissioners included several promises – such as seeking a greater transparency of trade policy, introducing a "one in, one out" principle for EU legislation, or re-opening the discussion about transnational lists for the European Parliament elections – which, if successful, could strengthen the EU's credibility in the eyes of European voters.



⁹ S. Dennison, P. Zerka, *The 2019 European election: How anti-Europeans plan to wreck Europe and what can be done to stop it*, ECFR Policy Paper, February 2019

¹⁰ Z. Sheftalovich, *Von der Leyen on 'European way of life': We can't let others 'take away our language'*, Politico, September 16, 2019



The fact that the new Commission has put the “New Green Deal” so high on the agenda can also be seen as a response to popular expectations, and not just to the pressures and urgencies of the ecological context. According to ECFR’s post-electoral analysis, 62% of new MEPs represent parties that, during the electoral campaign, promised more European cooperation on climate change; similarly, 56% represent those who advocated for progress in the EU to low-emission transition. No other issue – apart from the defense of democracy and the rule of law in the EU (65%) – has obtained as equally strong backing, judging by whom voters chose to support in May 2019¹¹.

Similarly, foreign policy has become an area where – contrary to widespread perception – the EU leadership should be able to count on the support of the European electorate. According to Susi Dennison’s analysis of ECFR’s survey data, ‘public opinion is no longer an impediment to the creation of a more coherent and effective European foreign policy (if it ever was)’¹². Voters may even be willing to accept a greater coordination between Member States on EU foreign policy, although they are yet to be convinced of the case for this.

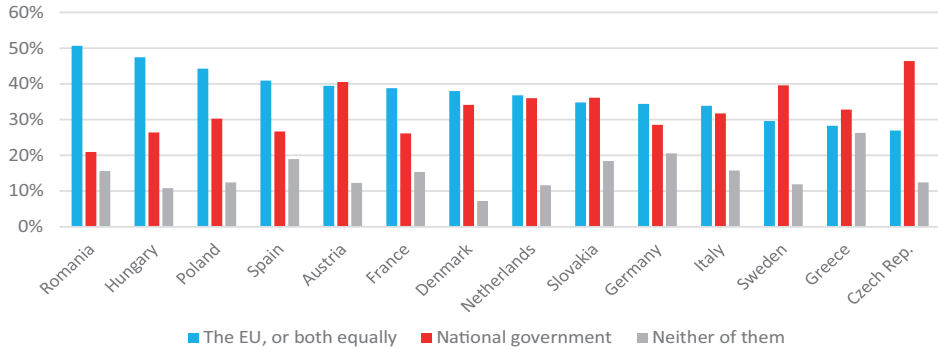
Again, the range of this support differs depending on the subject area. There is a widespread sensation that the EU should set its own course and become an independent actor with a non-confrontational strategy that would be able to avoid taking sides in conflicts involving other great powers, whether it is between the US and Russia or between the US and China. Support is also strong for the EU’s initiatives in those areas where it has already shown itself to be efficient, such as sanctions against Russia or the nuclear deal with Iran. However, trade and enlargement are two notable exceptions.

¹¹ Ibidem.

¹² S. Dennison, *Give the people what they want: Popular demand for a strong European foreign policy*, ECFR Policy Brief, September 2019

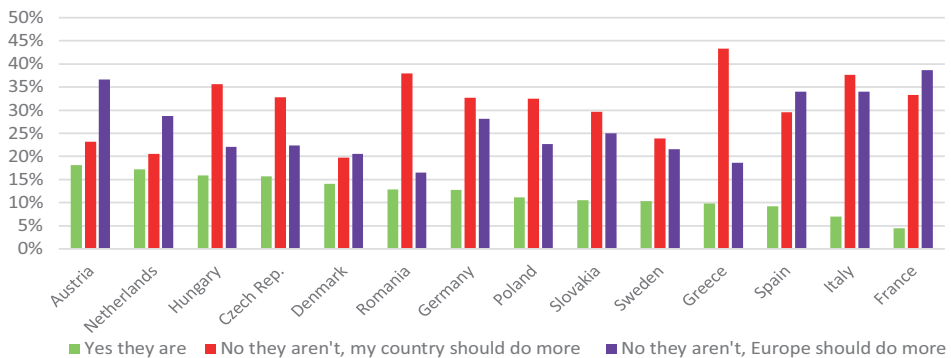


Chart 3 | Who would better represent your country's interests in international trade negotiations?



In the former case, many Europeans do not seem to have recognized or accepted the EU's exclusive authority over trade policy [Chart 3]¹³. In countries like Sweden, Austria, Slovakia or Czech Republic there is even a majority who believe that the national government alone would be best suited to represent their country's interests in international trade organizations. Similarly, while few Europeans believe that their country's economic interests vis-à-vis China are protected well, they do not necessarily expect the EU to help on this front [Chart 4].

Chart 4 | Do you think your country's economic interests vis-à-vis China are protected well?



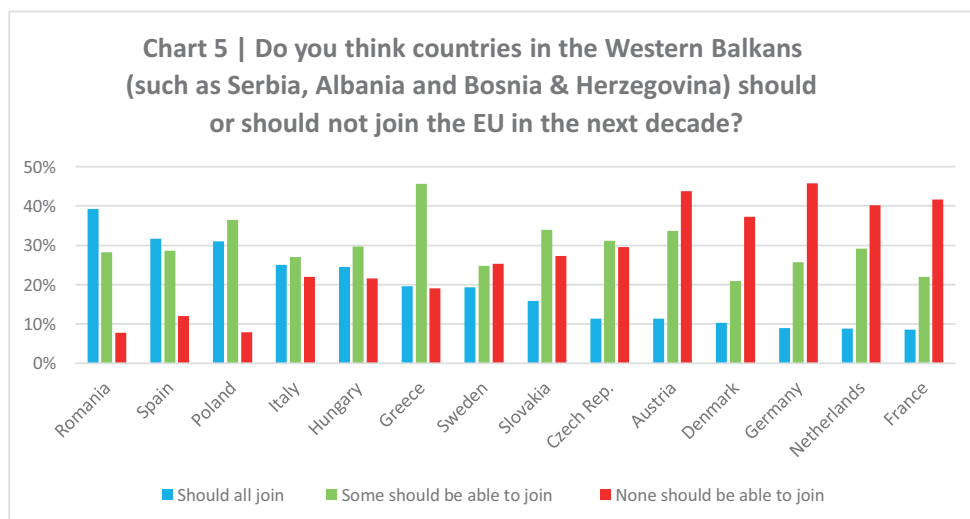
There are even greater divisions – and reservations – concerning the enlargement policy. While some countries (notably Romania, Poland, Spain and Greece) are strong support-

¹³ P. Zerka, *Tricks of the trade*, ECFR commentary, September 13, 2019



ers of allowing all or at least some Western Balkan countries to enter the EU, that may be too little to make this project happen anytime soon. As of late, most of the blame has been put on Emmanuel Macron who blocked the opening of accession talks with Albania and North Macedonia. But several other governments may simply be hiding comfortably behind the back of the French president. Even if such decisions were to be taken by qualified majority voting (a position defended by Commissioner Johannes Hahn¹⁴), it would still be difficult to gather the necessary majority. According to ECFR's analysis of 14 Member States, stopping any of the Western Balkan countries from entering the EU would be a preferred option among the electorate of the governing parties in Germany, France, Austria, Netherlands and Denmark. Together these countries jointly represent more than 35% of the EU population – which is equivalent to a blocking minority in the Council.

And here lies one of the biggest pitfalls for the EU in its new political cycle. If the European Commission, in addition to national governments, becomes too much obsessed with the need to satisfy voter expectations, they could become wobbly on issues like migration, trade or enlargement where the European public opinion remains divided or ambiguous. Ultimately, it risks disappointing the more general expectation that it can deliver on the “Europe that protects” project; a goal that may require difficult compromises on such complex matters. It will therefore largely be the task of the new Commission to chart a course between the EU's internal and external concerns, and to defend the interests of the EU as a whole against those of any particular individual Member State.



¹⁴ Statement by Commissioner Hahn on the move to qualified majority voting on enlargement matters, European Parliament, April 3, 2019



1.5. CASE STUDY: THE EU'S TRADE POLICY IN THE NEW POLITICAL CYCLE

Trade is a good illustration of the challenges that await the new Commission. For many decades, trade policy was separate from the political sphere and largely considered as a technical matter, aimed at providing market access to businesses and consumer protection. Recently, however, trade policy has become intertwined with many other policy areas – from foreign affairs, to security, to climate – which are, in turn, highly political. In particular, trade policy is undergoing a major transformation in three dimensions.

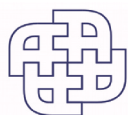
First, there is a growing link between the economic and the geopolitical sphere. This is a worldwide phenomenon, but it turns out to be particularly destabilizing for Europe. On the one hand, Europe's main ally – the US – openly leverages its economic centrality to enforce its own security preferences (as was, for example, visible with the American threat of using secondary sanctions against any business continuing to trade with Iran). On the other hand, Europe's main trade supplier – China – has departed from the doctrine that investment decisions should be exclusively guided by economic criteria. This, in turn, enables it buy discreet support of selected countries and sow discord inside the EU (as was, for example, clear in 2017 when Greece blocked the EU's statement at the UN criticizing China's human rights record). According to Philippe le Corre, "The greatest challenge is that Chinese investments in strategic sectors can generate economic dependence, especially among smaller countries and struggling economies, and this relationship can expand into the political realm"¹⁵.

As has already been mentioned the EU is suddenly realizing that it needs to regain economic sovereignty. Possible ways to do so include: developing economic retaliatory measures to respond to unilateral sanctions; state-aid control that would not be limited to EU companies; empowering the Council to block foreign investments which are deemed particularly dangerous; and developing a greater international role for the euro¹⁶. It is noteworthy that Ursula von der Leyen, in the mission letter to the EU's next Trade Commissioner, Phil Hogan, has openly admitted that "trade is more than simply the exchange of goods and services. It is also a strategic asset for Europe". Apparently, she has put trade policy at the center of her plans for the EU, not just because it can be used for several other purposes (including security), but also because this is an area where the EU enjoys exclusive competencies and therefore action and progress should, at least theoretically, be much easier to achieve than in several other spheres, such as defense integration.

Secondly, trade policy is increasingly perceived as one of the ways to pursue progressive agenda on environment, climate and labor rights. Again, this is not just a European phenomenon. In the US, Elisabeth Warren (who stands a chance of representing Democrats in the next year's presidential elections) promises that she would make trade policy

¹⁵ P. Le Corre, *On China's Expanding Influence in Europe and Eurasia*, Carnegie, May 9, 2019

¹⁶ J. Pisani-Ferry, M. Leonard, J. Shapiro, E. Ribakova, G. Wolff, *Redefining Europe's economic sovereignty*, ECFR Policy Brief, June 25, 2019



responsive to a “different set of interests”¹⁷, notably by focusing it much more on advancing environmental goals and protecting labor rights – at the expense of the traditional goal of expanding the American exporters’ access to foreign markets. Paradoxically, it is thanks to Donald Trump that other American politicians have rediscovered the potential of using trade policy for such goals, given the huge discretionary power that American presidents hold in this policy area.

A similar shift can be observed in the EU. Already, for some time now, the EU has been using its trade agreements to promote environmental and labor standards. But insufficient attention has been paid to the implementation and enforcement of these provisions. This is why preparations are underway to appoint a Chief Trade Enforcement Officer whose work would include monitoring the implementation of climate, environmental and labor protections enshrined in the EU’s trade agreements. At the same time, the high priority of climate issues on the EU’s agenda at the moment should motivate the new Commission to experiment with novel policy solutions: such as the Border Carbon Adjustment Tax, the introduction of which, is now being seriously debated in Brussels.

Thirdly – and very much because of the link between trade and the environment – a sort of “democratization of trade” is also taking place. In other words, trade is becoming increasingly subject to democratic legitimacy considerations. In Europe and the US, this is partly the consequence of recent controversies around the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP), which made many people realize that trade policy is deeply political. In Europe, more specifically, there is an understanding that popular trust in the EU needs to be regained. If the new Commission were able to demonstrate that trade policy can be an efficient tool for Europe to combat climate change and promote environmental and labor standards across the world, then that would help not only to challenge a widespread distrust vis-à-vis trade but also (more importantly) rebuild the EU’s tarnished image in the eyes of its citizens. As we demonstrated earlier, in most Member States a clear majority of voters say that their national governments would do a better job than the EU in representing their country’s interests in international trade negotiations.

It remains to be seen whether the EU’s trade policy under the leadership of the new Commissioner will be able to satisfy all the hopes that are currently associated with it. What we do know is that the changing understanding of the purpose of trade policy is likely to affect Brussels’ priorities for years to come. A new trade strategy should be published next year and it can be expected to focus on four challenges.

Number one is preserving a rule-based international trade system. The EU is due to present new ideas on WTO reform in 2020 and Ursula von der Leyen has clearly framed this issue as the most important task for her new Trade Commissioner.

Number two is conducting trade policy that continues to create business opportunities – but focuses much more on implementation and enforcement, rather than on trade talks.

¹⁷ M. Yglesias, *Elizabeth Warren’s vision for changing America’s trade policy, explained*, Vox, July 29, 2019



This stems from the sober assessment that there are few markets left where the EU can negotiate new agreements, which makes it even more important to ensure that those which already exist are achieving their potential.

Number three is ensuring fair and open trade, which is Brussels jargon for strengthening the EU's trade defense toolkit: not just in bilateral trade conflicts but also on third country markets or in the defense of the European Market against subsidized operations by other global players.

And finally, number four is pursuing climate and sustainability issues via trade.

There is surely some risk that excessive expectations around trade may lead to disappointments, criticism of window dressing, or even a new popular backlash. Details will matter a lot – on new state-aid control rules, Eurozone reform, or the carbon border tax – if the EU is to avoid capture by special interests or a lapse into protectionism. But there is also an opportunity for Brussels to make trade policy greener, fairer and more democratically accepted, while at the same time playing a responsible international role in seeking WTO reform. A fascinating moment for all trade aficionados.

1.6. MEMBER STATES' CONTRADANZA

In the meantime, two key internal events are likely to occupy the attention of European capitals. As the negotiations on the EU's multi-annual budget (MFF) enter a decisive stage, and the UK is set to eventually leave the bloc by the end of January 2020, the EU's largest Member States are seeking to strengthen their position within the EU's internal power struggles.

France's president, in particular, has intensified his involvement in EU institutional politics. This has already borne fruit in terms of the formation of a new liberal grouping in the European parliament and the appointment of a new EU leadership who (whatever one thinks about Ursula von der Leyen as head of the Commission, Charles Michel as President of the European Council, Josep Borrell as High Representative, or Christine Lagarde at the helm of the European Central Bank) are all seen as close allies of Macron. Frustrated with the little progress that the French-German tandem has achieved in delivering on the many ideas that he launched in his Sorbonne speech, Macron no longer shies away from confrontation with Berlin¹⁸. But he is also provoking the increasing resistance of other capitals that view Paris's rising assertiveness (as demonstrated by Macron's ideas on Russia, Brexit, enlargement, or NATO) as a distinct threat to European unity.

In the meantime, the Netherlands – heavily exposed to the economic and political consequences of Brexit – is exploring ways to extend its range of partners beyond the so-called "New Hanseatic League" (including Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden) which, so far, lacks sufficient leverage in the European Council. Poland's Law and Justice (PiS) government, having consolidated its

¹⁸ C. Demesmay, *Macron on the Move*, Berlin Policy Journal, October 31, 2019



power after the national parliamentary elections in October 2019, is now expected to display a more cooperative attitude towards Europe – and may actually be granted some degree of trust by other capitals that are aware they will need to live with PiS for another four years. Spain and Italy (under the new government) are in a good position to present themselves as representatives of the EU's South, although internal politics is, for the moment, preventing Madrid from engaging fully in EU affairs.

The MFF negotiations – where the three central problems that need to be solved concern the size of the budget, who should pay for it, and where the money should go – do not only constitute the stage for these intergovernmental power struggles. They will also set the stage for the EU's politics in the years to come. As some experts have already observed¹⁹, a new divide is emerging in the EU between, on the one hand, countries of the South and the East (such as Poland) that continue to nurture a vision of the EU as mostly an “economic convergence machine”; and the EU's Western Member States, on the other hand, that have largely departed from such thinking.

In turn, the West of the bloc is increasingly focused on strengthening the EU's position in the global political and economic order, which implies the implementation of a new economic model (based on low emissions and new technologies) and a strong focus on rule of law as a condition *sine qua non* for the bloc's internal cohesion. This may also include some further steps in the integration of the Eurozone, which would widen the distance between its members and non-members. As another expert observes, “the quest for more resilience vis-à-vis external threats begins at home”²⁰. For instance, if the EU is to be credible in its support for democracy and a rules-based order, it may also need to find more effective ways to sanction violations of the rule of law and democratic principles by Member States. Similarly, if Europe wants to become less dependent on the dollar, it may have to complete the Eurozone's institutional architecture.

Most importantly, the priorities of the new Europe are largely a reflection of this new way of thinking about the EU, and if the Commission chooses to play a less vocal role on the rule of law, as some people fear, then the new European Parliament will surely come to the rescue. All in all, it looks like Brussels in general will be strengthened in this new political cycle of the EU – to the frustration of those Member States that are more used to the intergovernmental method. The UK's departure will leave them more isolated than ever, which in turn may cause new tensions in the EU's internal affairs.

1.7. FRAGMENTATION AND LEADERSHIP

Overall, the central tension in the EU over the coming years will be between fragmentation and leadership.

As ECFR observed several months before the 2019 European Parliament elections,

¹⁹ S. Ananicz, *Unia sprzecznych modeli* ('The Union of contradictory models'), Batory Foundation, Warsaw, November 2019 (in Polish only)

²⁰ J. Puglierin, *A Question of Survival*, Berlin Policy Journal, October 31, 2019



while the political fragmentation in the EU was growing, this phenomenon did not necessarily have to be ominous. On the contrary, it could have a useful consequence of making the political debate across the Old Continent more pluralist as well as requiring a wider spectrum of pro-European parties “to become more open to compromise with one another” if they were to collectively defend the European project²¹. ECFR’s post-election analysis, based on a day-after opinion poll in six largest Member States, pointed out to a clear need for “regeneration” expressed by European voters who did not only reward the Liberals and the Greens (i.e. two pro-European groups outside the European Parliament’s traditional mainstream) but also brought to power many fresh, and young, faces²².

It was already obvious back then that the new European Commission would need to offer such a regeneration, and prioritize “delivery Europe” over “more Europe”, knowing that five years ahead European voters may no longer be as forgiving – and many could turn to anti-European parties should the EU fail to meet their expectations. A general recognition of this need to provide “change” in European politics was one of the key factors – next to Emmanuel Macron’s unrivalled engagement on the European front and the kingmaker’s role of the new liberal group that included *La République en Marche* MEPs – in enabling Ursula von der Leyen to be nominated by the Council as a candidate for the new head of the European Commission, even though she had not been the leading candidate of any of the political groups during the elections.

When she presented her Commission, in September 2019, it was clear that she understood the need to make the EU’s political fragmentation to work in her advantage. A strengthened position of the Liberals and the Greens vis-à-vis the traditional center-right (EPP) and center-left (S&D) has allowed her to put the issues of climate, competition and economy on top of the agenda. Frans Timmermans, Margrethe Vestager and Valdis Dombrovskis, who are responsible for these three portfolios, are to become Executive Vice-Presidents in the new Commission. At the same time, mission letters to Commissioners-designate displayed a preference for initiatives in the economic domain (where the EU does have strong competences) rather than, for example, in defense and security (where the EU cooperation is much harder).

While the jury is still out on whether the new Commission will indeed be able to deliver on the many expectations of the European electorate, it is evident that the early months of the EU’s new political cycle have been bumpy. Or, in the words of one of the EU’s brightest observers, “just when the European Union was supposed to forge ahead as a more united bloc, its three big institutions are weakened and at war with each other”²³. Not only did the new European Parliament reject three candidates to the new Commission, partly in revenge for the disregard of the *Spitzenkandidaten* process, but the three pro-European groups in the Parliament (or four, if one includes the Greens)

²¹ S. Dennison, P. Zerka, *The 2019 European election: How anti-Europeans plan to wreck Europe and what can be done to stop it*, ECFR Policy Paper, February 2019

²² S. Dennison, M. Leonard, P. Zerka, *How to govern a fragmented EU: What Europeans said at the ballot box*, ECFR Policy Paper, June 2019

²³ P. Taylor, *The EU transition that wasn’t*, Politico, November 4, 2019



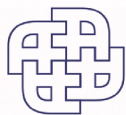
also failed to agree on a coalition agreement, without which implementation of the new ambitious agenda will be difficult. Without at least a rough accord, there is a risk that political groups will fight with one another, mindful to display their differences, rather than work pragmatically on converting promising ideas – such as the Border Carbon Adjustment Tax – into workable instruments. A Parliament in disarray, and clashing with the Commission, may only prove the EU’s critics right. The many divisions between Member States could make things even worse.

However, if Ursula von der Leyen manages to assert her leadership – as she is already trying to, through a firm engagement on climate, trade and competition policy – then one could also imagine some kind of political ceasefire in Brussels. Given the high expectations vis-à-vis the EU today, she has surely been allowed greater discretion in how she shapes the new Commission, as well as in the overall direction in which she wants to push the EU. One cannot accuse her of a lack of inventiveness either, as the presentation of her Commission has demonstrated many ways in which it would differ from the previous ones. To some extent, fragmentation in the Parliament and in the Council can work to von der Leyen’s advantage, if she succeeds in positioning herself as a sensible “leader from within”. However, on most occasions – whether it is trade policy, the new multiannual budget, or the rule of law – the EU will, of course, still need three to tango. That is the three largest political groups and the three main institutions²⁴.

1.8. CONCLUSION

The 2019-2024 European Commission has had a rocky start. The French president’s open challenge to the *Spitzenkandidaten* system led to his candidate for commissioner, Silvie Goulard, being rejected by the European Parliament. This shows that the power games between pro-Europe forces, countries and leaders can also be a danger to the efficient running of EU institutions, and that anti-EU populist forces are by no means the only serious threat. Seemingly, the Commission is “locked and loaded” to deliver on an ambitious policy agenda which enjoys a broad base of support among the main political groups. However, as we said earlier, the road to delivering it could still be a bumpy one.

²⁴ Ibidem.



2. THE ECONOMIC STATE OF THE UNION: HOW EXTENSIVE AND LASTING WILL THE SLOWDOWN BE?

OSCAR ARCE, ESTHER GORDO AND JAVIER J. PÉREZ, BANCO DE ESPAÑA¹

2.1. ABSTRACT:

The euro is celebrating its 20th anniversary in a challenging economic environment. Since the second half of 2018, the Economic and Monetary Union (EMU) has been heavily affected by global trade tensions and geopolitical uncertainties, best exemplified by the US-China trade dispute and the *Brexit* process, both of which reflect a certain exhaustion of the open, multilateral trade and economic order of recent decades. The confluence of the previous factors with some secular trends, related to demographic developments (ageing populations) and declining productivity, have fundamentally changed the global macroeconomic scenario. Even though these phenomena are common to the main advanced economies, they certainly appear more intense in the euro area. The deterioration of long-term growth expectations, the emergence of long-lasting disinflationary pressures and the persistence of very low interest rates pose significant challenges. Against this background, there is a need to reconsider the euro area's macroeconomic policy framework, in order to provide the most appropriate response. The incomplete architecture of Economic and Monetary Union and the pervasive difficulties in making progress on this front renders the challenge even more daunting.

Keywords: euro area, monetary policy, fiscal policy, EMU governance

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2.2. INTRODUCTION

The euro is celebrating its 20th anniversary in a challenging economic environment. Since the second half of 2018, the Economic and Monetary Union (EMU) has been heavily affected by rising global trade tensions and geopolitical uncertainties, best exemplified by the US-China trade dispute and the *Brexit* process. These events reflect to some extent a certain exhaustion of the open, multilateral trade and economic order of recent decades. The confluence of these elements with other, more persistent factors, including adverse demographic developments and a stagnant productivity path, have fundamentally changed the overall euro area macroeconomic scenario. Even though these phenomena are common to the main advanced economies, they are manifesting themselves with particular intensity in the euro area.

The deterioration of long-term growth expectations and the persistence of low inflation rates and, hence, of very low interest rates, pose significant challenges. There is thus a need to improve our understanding of this “new normal” scenario in order to reconsider the macroeconomic policy framework with a view to providing the most appropriate response. The incomplete architecture of Economic and Monetary Union alongside a number of political-economy barriers to higher levels of economic and financial integration in the euro area compound the aforementioned challenges.

In this chapter we develop the previous arguments, starting with an analysis of the current cyclical conditions of the euro area (Section 2). We then move in turn to the specific role of and challenges faced by the common monetary policy (Section 3), and the medium-term challenges that the euro area must address (Section 4).

2.3. THE ECONOMIC SLOWDOWN OF THE EURO AREA

2.3.1. THE DAMPENING ROLE OF EXTERNAL FACTORS

Global growth has undergone a sharp and geographically broad-based weakening since mid-2018. The most recent projections of the main international organisations suggest that world GDP will slow to around 3% by 2020, the weakest annual growth rate since the global financial crisis. This situation is largely due to the implementation of protectionist measures and to heightened uncertainty about how trade policies will develop in the future.² The decision by the US administration to distance itself from the multilateral trade system and start a bilateral “trade war” with China is having a significant bearing on the global economy, which goes far beyond the bilateral trade flows between both economies. Continued trade tensions have spread to the EU, Mexico, Canada and

² Some recent empirical evidence indicates that trade policy uncertainty contributes to explaining more than 70% of the substantial increase in global economic uncertainty observed since 2018 (see Ahir, Bloom and Furceri, 2019), with a considerable impact on economic agents’ investment and consumption decisions.

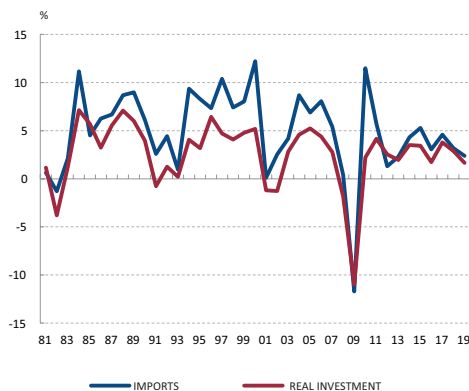


Japan, making for a fragile scenario clouded by risks of unprecedented magnitude, particularly for those countries with trade at the core of their economic model, as is the case in Europe. Global technology supply chains have been also threatened by the prospect of US-imposed restrictions on Chinese technological firms.

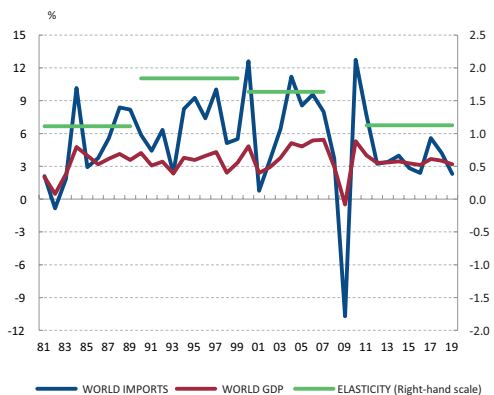
Without entering into the complex matter of judging the underlying reasons that have led to that situation, these tensions have unquestionably been one of the main drivers of the substantial worldwide slowdown of global investment, trade flows and industrial production, all of which are strongly interrelated (see Chart 1.1). Trade is receding more than the global economy, and in turn the interlinkages between global growth and trade have intensified the economic decline (see Chart 1.2).

CHART 1. WORLD INVESTMENT, TRADE, GDP AND THE MACROECONOMIC EFFECTS OF TARIFFS

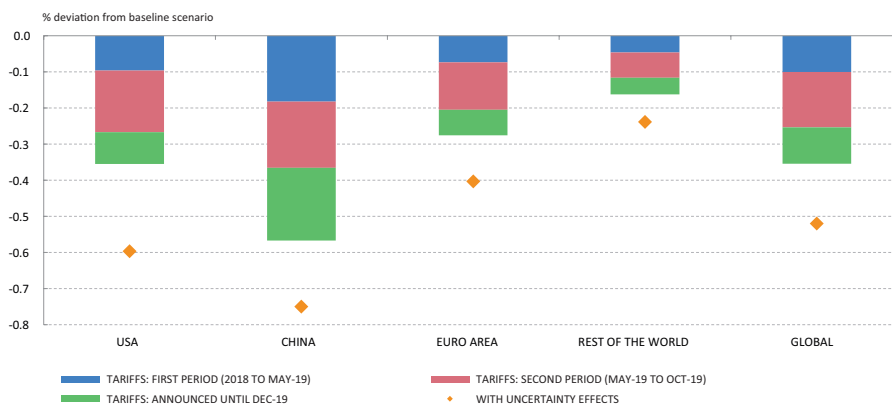
1 INVESTMENT AND TRADE IN ADVANCED ECONOMIES



2 WORLD TRADE AND GDP



3 TRADE TENSIONS: EFFECT ON GDP 2021 Q4



SOURCE : OECD and Banco de España.



Based on the available data it is difficult to accurately estimate the separate impact of tariff hikes on global economic activity. Estimated macroeconomic models help in providing an approximation to the order of magnitude of that impact. Specifically, Chart 1.3 shows the effect of the tariffs enacted or announced by the United States and China since mid-2018, using the NiGEM model.³ A first scenario depicts the real direct channels, i.e. those which run through changes in bilateral trade between the two countries and the global effects of the second round owing to the decline in global demand (distinguishing between the successive rounds of tariff increases). A second scenario, meantime, adds the hypothetical effects arising from an increase in uncertainty and the ensuing tightening of global financial conditions.⁴ According to the simulations, the macroeconomic impacts might be significant, taking global GDP 0.35% below the baseline scenario in cumulative terms in 2019-2021, in the first scenario. In the global economy, the most affected economies would be the US and China. In turn, the GDP of the euro area would contract by 0.26 % over the same period, reflecting its high degree of trade openness, which makes it more vulnerable to the fall in global activity. In addition, the second scenario shows how the confidence channel could produce additional adverse effects of a considerable magnitude.

Significantly, moreover, the repercussions of protectionism have the potential to be more lasting and go far beyond the current drag on demand and confidence, in particular given the potential for disrupting global supply chains, reducing the entry of new firms into the affected markets, and harming productivity and technological diffusion (see Handley and Limao, 2017). The slowdown of trade and industrial activity has spread rapidly through global supply chains to major advanced and emerging economies, although some sectoral-specific factors may also have contributed to the amplification of the slowdown. In particular, the broad-based downturn in the demand for vehicles might well have been influenced by a more cautious approach by consumers in a context of changing technology and new regulations related to pollution emission standards.

Protectionism has also contributed to exacerbating the slowdown in China, a major engine of global economic growth since the mid-2000s. Admittedly, the slowdown of China is being driven not only by trade tensions but also by the rebalancing of its economic model away from exports and manufacturing towards domestically oriented services sectors. But these developments are weighing on manufacturing activity all over the world, given China's prominence in the demand for manufactures, particularly for capital goods, and its deep engagement in global value chains (see, among others, Bing et al., 2019).

Other developments that have affected the euro area economy more idiosyncratically are those affecting the situation of some emerging economies, particularly Turkey (reflecting domestic vulnerabilities), and most notably the decision of the United King-

³ NiGEM has been developed by the British National Institute of Economic and Social Research. The documentation for the model is available at <https://nimodel.niesr.ac.uk/>. On a discussion about related simulations, see Banco de España (2019a).

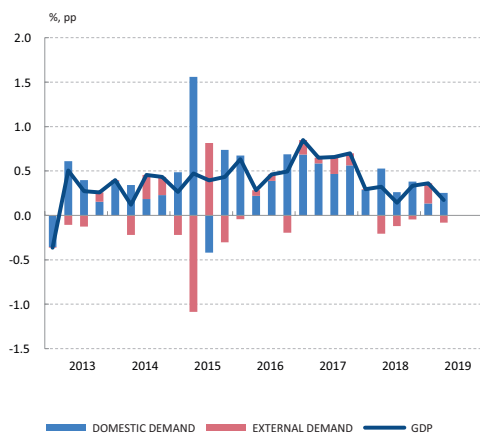
⁴ This channel is approximated through an ad hoc investment risk premium increase of 25 bp in the US and China combined with a 10 bp rise in the other economies - see Banco de España (2019a).

dom to leave the EU. True, substantial uncertainty prevails about the nature of the future relationship between the UK and the EU. But the economic costs of *Brexit* for the UK are becoming increasingly apparent⁵, and the impact on the euro area may prove significant, given the close ties between both areas through trade, migration flows and financial markets.

All in all, the euro area has been particularly exposed to all these shocks (see Chart 2). The member countries' high degree of trade openness, high participation in global value chains, and product (capital goods, automobiles) and geographical specialisation, have worsened the weakness of exports and industrial production.

CHART 2. EURO AREA. GDP AND EXPORTS

1 EURO AREA. GDP GROWTH AND CONTRIBUTIONS (a)



a. Excluding Ireland.

SOURCE : Eurostat and CPB

2 EURO AREA. EXPORTS AND FOREIGN DEMAND



As a consequence, the pace of growth of the euro area economy has gradually become very sluggish. Real GDP growth slowed from rates close to 0.8 % quarter-on-quarter in 2017, to 0.4 % in 2018, and 0.2 % in the second and third quarters of 2019 and 0.1% in the fourth quarter.

⁵ For example, Born et al (2019), employing synthetic control methods, find that the Brexit decision had caused an output loss of 2% for the UK at the end of the first quarter of 2019, which could increase to about 4% of GDP by end-2020. Investment has undergone the biggest decline (11%) with respect to a scenario of no-Brexit, with a significant decline in inward direct investment from EU firms. A disorderly Brexit would be particularly harmful for the UK but it would also negatively affect the EA. See, among others, Vega et al. (2019), and the references quoted therein.



2.3.2. DOMESTIC CONDITIONS HAVE HELD UP

Despite adverse external demand dynamics, EMU's domestic fundamentals remained more resilient over most of 2018 and 2019. In particular, employment growth resilience –albeit slowing in the most recent quarters – has so far supported household incomes. Since its trough at the beginning of 2013, euro area-wide employment has increased by more than 11 million people, while the unemployment rate steadily declined to 7.5%, approaching pre-crisis levels. The current expansion has been more employment-rich than previous ones (see e.g. Botelho and Dias da Silva, 2019). The reasons behind this behaviour are diverse. The recent literature gives credit to structural reforms aimed at increasing flexibility in labour markets, the surge in labour supply related to the higher participation of older workers and immigration.

However, despite the strong gains in total employment and falling unemployment, total hours worked have remained below their pre-crisis level, reflecting a continuous decline in average hours worked per person employed. While this trend started well before the crisis and is likely to reflect some structural factors (such as the increase in the labour supply of female workers who tend to work part-time), it could also stem from labour underutilisation given the sizeable amount of people in the euro area who work part-time, but would like to work more.

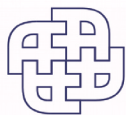
Job creation combined with improving household balance sheets and very accommodative financial conditions have continued to underpin private consumption. On the contrary, the contribution of fiscal policy has remained broadly neutral in 2019 for the euro area as a whole, after some years of public finances consolidation.

Nevertheless, not all the components of domestic demand have shown the same degree of resilience. Private investment has slowed significantly since early 2018, reflecting a gradual deterioration of the business climate as it has become clear that trade tensions were not a passing trend and uncertainty has become entrenched. The current decline in capacity utilisation in industrial sectors, the contraction of profit margins and the weakness in expected demand all make for a challenging scenario for investment.

Moreover, the forces that have sustained domestic demand in recent years might be losing momentum by the end of 2019. In particular, the services sector is increasingly affected by the protracted weakness in manufacturing, given the strong links between both sectors, and employment growth has declined.

2.4. MONETARY POLICY AS A KEY SUPPORT OF ECONOMIC GROWTH IN THE EURO AREA

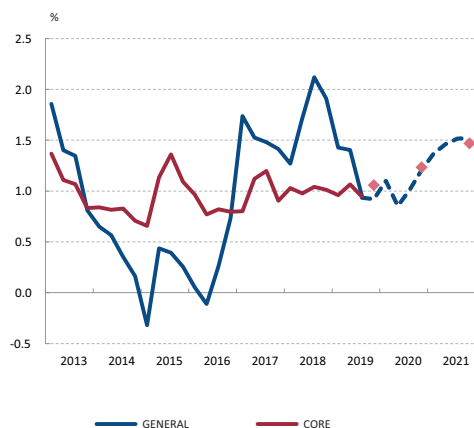
Apart from sluggish growth, the recent period has been characterised by a persistent situation of low inflation. Headline inflation has long stood below the European Central Bank (ECB) objective, with some fluctuations that have been mostly driven by temporary movements in energy prices (see Chart 3.1). Core inflation has remained stubbornly low, hovering around 1% during recent years and continuously undershooting the Eurosystem's forecasts and its inflation target (see Banco de España, 2019b). In this context, the



monetary policy of the ECB has provided substantial policy stimulus (see Charts 4.1 and 4.2), supporting euro area economic growth over recent years. It continues to do so, as we will discuss later.

CHART 3. EURO AREA. INFLATION

1 INFLATION AND EUROSISTEM PROJECTIONS



2 CORE INFLATION AND OUTPUT GAP



SOURCES: Eurostat, European Commission and ECB

Low inflation has persisted in many advanced economies and in the euro area despite the significant reduction witnessed in unemployment levels and in negative output gaps (see Chart 3.2). This development has prompted an intense debate about the determinants of inflation, and specifically about the link between inflation and economic activity, i.e. the so-called Phillips curve relationship. The latter is grounded in various theoretical models, such as the hybrid New Keynesian framework, which describes inflation dynamics as a function of three main factors: firm's marginal costs (often proxied with a measure of economic slack); a measure of past inflation, seeking to acknowledge that some firms adjust prices gradually according to backward-looking rules of thumb or indexation; and forward-looking expectations of inflation. Although the results in the empirical literature are mixed, most of the evidence supports the existence of a systematic relationship between cyclical slack and inflation after the Great Recession, both for the euro area and the US, albeit of relatively small quantitative significance. A number of structural factors have been identified as partly rationalising the weak link between labour market tightness and inflation. These include most notably the economic dynamics and the structural change brought by population ageing, globalisation (with greater trade openness and exposure to international competition) and the impact of new technologies (digitalisation and new forms of trade).⁶

⁶ See Banco de España (2019b), Hooper et al (2019) and Moretti et al. (2019), and the references quoted therein. The empirical research suggests a number of factors that need to be taken into account when estimating Phillips curves, such as the uncertainties surrounding empirical estimates of

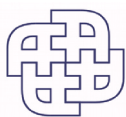
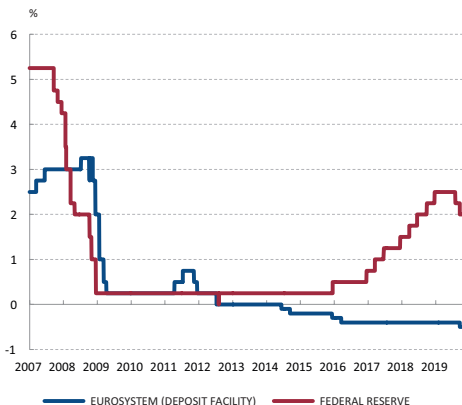
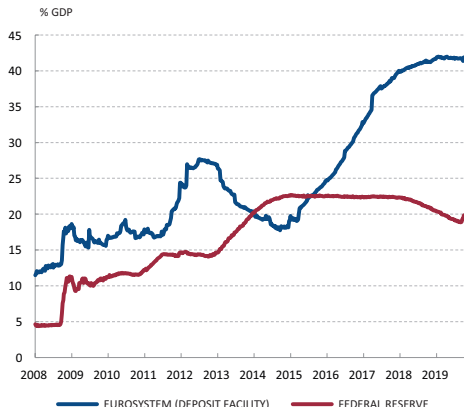


CHART 4. MONETARY POLICY

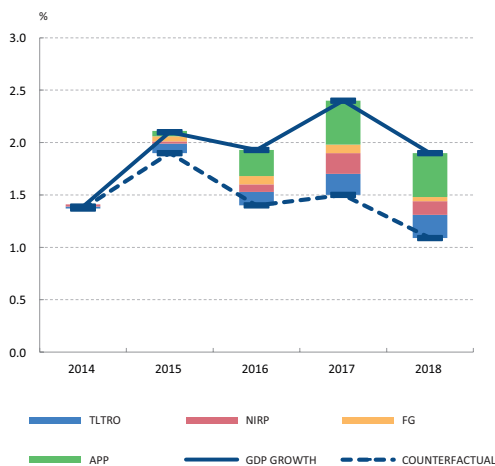
1 OFFICIAL INTEREST RATES



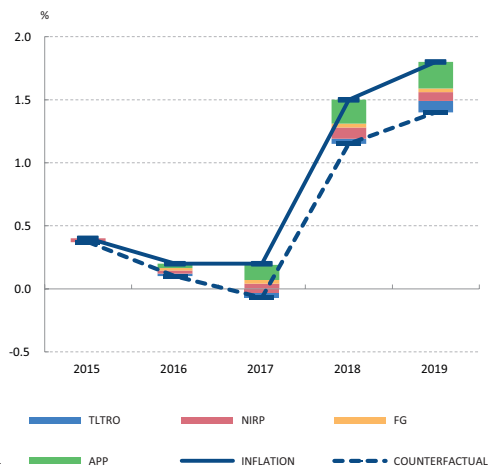
2 CENTRAL BANK BALANCE



3 CONTRIBUTION OF ECB NON-STANDARD MEASURES TO REAL GDP GROWTH



4 CONTRIBUTION OF ECB NON-STANDARD MEASURES TO HICP INFLATION



SOURCES: ECB, Federal Reserve, Eurostat and Rostagno et al. (2019)

The literature has also shown that inflation expectations are a key driver of actual inflation, in many advanced and emerging economies. The issue of whether inflation expectations are more linked to forward-looking elements (the ECB target) or past inflation over time remains a key issue in ascertaining current inflation developments, as

economic slack, the impact of changes in indirect taxes and administered prices, the impact of energy prices, and the relevance of international food commodity prices, among others. There is no conclusive evidence supporting the hypothesis of a flattening of the Phillips curve, although some papers suggest the presence of non-linearities related to the existence of downward rigidities in wages or prices.



it determines crucially the persistence of shocks to the inflation rate.⁷ In this regard it is particularly important that long-term expectations remain firmly anchored, as persistent deviations of inflation from the monetary policy reference or objective may ultimately affect long-term expectations.

Deteriorating macroeconomic conditions, mounting downside risks to the growth outlook, muted inflation and historically low inflation expectations led to a reassessment of ECB monetary policy in March 2019, and particularly during the summer of 2019. In March 2019, the Governing Council (GC) of the ECB decided to enhance its forward guidance by stating that interest rates would remain constant “at least through the end of 2019”. The GC also decided to launch a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), starting in September 2019 and ending in March 2021, each with a maturity of two years.

Later, in September 2019, the ECB GC implemented a comprehensive package of measures to support the convergence of inflation towards its objective. In particular, the GC decided to lower the interest rate of the deposit facility by 10 basis points, to -0.5%, in an attempt to induce a further decline in funding costs for business and households that would enhance their investment and consumption decisions.

Moreover, the GC package contributed to reducing uncertainty about future financial conditions by modifying forward guidance in a number of ways. Firstly, the GC strengthened the state-contingent forward guidance by announcing that they expect “to keep the key ECB interest rates at present or lower levels until they have seen the inflation outlook robustly converge to a level sufficiently close to, but below 2% percent within the projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics”. With this formulation, the ECB expressed their firm commitment to achieve an inflation rate consistent with the reference in a sustained way before starting to raise interest rates. The trajectory of underlying inflation should underpin this assessment. Secondly, they maintained an easing bias by stating that interest rates should remain at present or lower levels. Finally, the date-contingent leg of forward guidance was eliminated, since the current formulation provides sufficient guidance to the markets on the future path of monetary policy.

The GC also decided to resume net asset purchases at a monthly pace of 20 billion euros, as from the beginning of November. Purchases will be maintained for as long as necessary to reinforce the accommodative impact of interest rates, and to end shortly before the lift-off of key ECB interest rates. In addition, the GC reiterated their decision to continue reinvesting in full maturing principals for an extended period of time past the date of the lift-off. By affecting term premia, the APP complements the impact on long-term interest rates exerted by the modified forward guidance. And more importantly, the renewed APP provides a strong signal of the GC’s commitment to use all available instruments to achieve its aim, an element that could have a powerful effect on the formation of inflation expectations. At the same time, negative interest rates provide

⁷ See again Banco de España (2019b).



support to the portfolio rebalancing channel of the asset purchase programme (APP) by encouraging banks to lend to the real economy instead of holding liquidity.

To ensure a smooth transmission of monetary policy, the GC decided to adjust the parameters of the new series of targeted long-term refinancing operations announced in March (TLTRO III). The first series of TLTROs was announced in June 2014 and the second series in March 2016. They are targeted operations because the amount that banks can borrow, as well as the borrowing rate, are linked to their loans to non-financial corporations and households (excluding loans for house purchase). These operations have the specific aim of preserving favourable bank lending conditions and supporting the accommodative stance of monetary policy. As regards the third TLTROs, the GC decided in September to reduce the costs entailed in the initial pricing, eliminating the 10 basis points spread over the key policy rates, and extend their maturity from two to three years each. They started in September 2019 and are to end in March 2021. Importantly, to mitigate possible side effects of the ECB monetary policy on banks, they decided to introduce a two-tier system for reserve remuneration, which exempts part of credit institutions' excess liquidity holdings (i.e. reserve holdings in excess of minimum reserve requirements) from negative remuneration at the rate applicable on the deposit facility. This decision aims to support the bank-based transmission of monetary policy, while preserving the positive contribution of negative rates to the accommodative stance of monetary policy.

The evidence provided by Rostagno et al. (2019) and Banco de España (2016) shows that unconventional monetary policy measures have been effective in easing financial conditions with a notable contribution to growth and inflation paths (see Charts 4.3 and 4.4). According to Rostagno et al. (2019), the ten-year long-term interest rate would have been 1.4 pp higher in 2016, 2017 and 2018 in the absence of the ECB's non-standard measures. A significant part of this effect – close to 60% – can be attributed to the APP and the rest to the negative interest rates policy and to forward guidance. They also find that annual inflation would have been 0.4 pp lower on average in those three years, while GDP growth would have been around 0.8 pp lower each year since 2016.⁸

⁸ Other papers that study the transmission of unconventional monetary measures using micro-data for the banking sector confirm the efficacy of the ECB's unconventional measures. These include Andreeva and García Posada (2019), who assess the impact of the Eurosystem's TLTROs on the lending policies of euro area banks finding that refinancing programmes have contributed to improving funding conditions and to stimulating credit. In turn, Arce, Gimeno and Mayordomo (2018) show that the purchases of corporate debt under the APP had positive effects in the supply of bank credit to small and medium enterprises. The effects of negative interest rates are more difficult to assess, but the existing evidence tends to support their effectiveness: Altavilla, et al (2019) and Arce, García-Posada, Mayordomo and Ongena (2018), using data from the euro area banks, show that sound banks pass negative rates on to their corporate depositors, without experiencing a contraction in funding and that the tendency to charge negative rates becomes stronger as policy rates move deeper into negative territory; on the contrary, Heider, Saidi and Schepens (2019) suggest that negative interest rates might have adversely affected credit supply, entailing risks for financial stability.



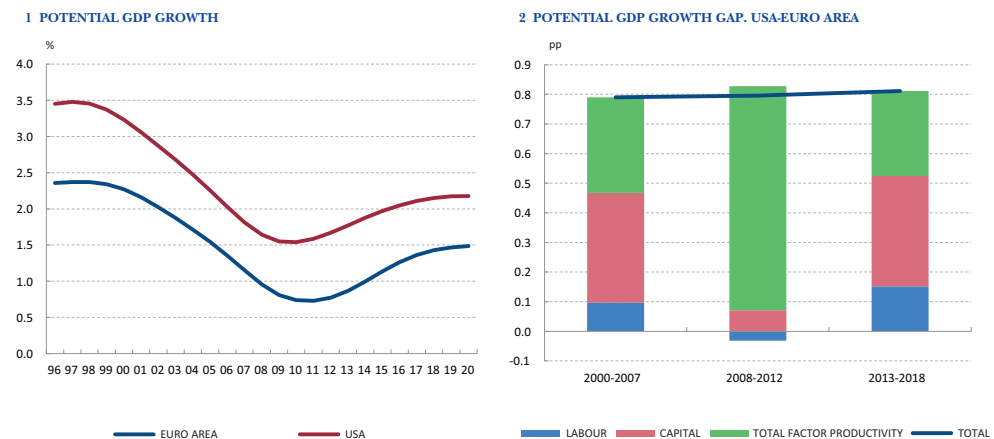
In sum, this package of monetary policy measures is expected to contribute to supporting the convergence of inflation towards levels consistent with the monetary policy reference in a sustained manner. Not surprisingly, there is a broad consensus that monetary policy has played an extraordinary role during the past decade. The ECB balance sheet represents around 40% of the euro area GDP and interest rates are at historically low levels, raising financial stability concerns.

2.5. LOWER FOR LONGER: A NEW NORMAL FOR THE EURO AREA?

2.5.1. ARE WE APPROACHING A NEW ECONOMIC “NORMAL”?

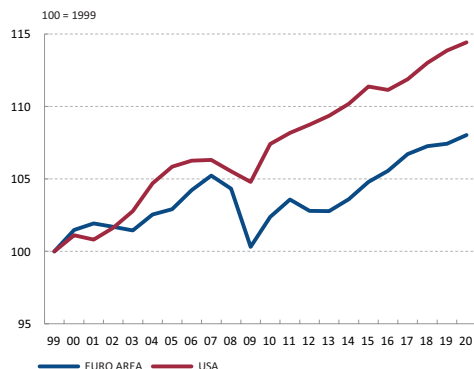
Trade and geopolitical uncertainty have come together with other fundamental sources of uncertainty related to the need to understand whether we are approaching a new “economic normal” (see Eggertson et al 2017). There is an increasing consensus suggesting that, behind moderate growth and low inflationary pressures, there may be some interrelated secular forces potentially shaping the future macroeconomic outlook in a permanent way. This is particularly the case in the euro area, in view of the persistently lower potential growth in comparison to the US, which is mainly due to lower productivity growth and weak investment (see Chart 5).

CHART 5. POTENTIAL GDP AND DEMOGRAPHIC TRENDS

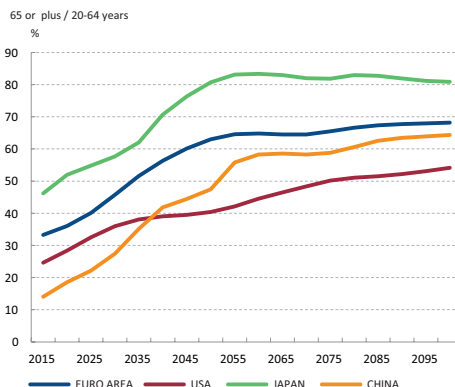




3 TOTAL FACTOR PRODUCTIVITY



4 OLD-AGE DEPENDENCY RATIO



SOURCES : European Commission, UN world population projections (2019) and Banco de España

Firstly, the demographic transition is having wide-ranging implications for the euro area and other advanced economies. Its effects on the labour force and the dependency rate imply not only increasing pension obligations and health care costs but also significant challenges in terms of productivity and growth.⁹ As seen in Chart 5.4, Europe faces much older populations than the US and China.

Another key element is the long-lasting decline in productivity growth and, in particular, in total factor productivity (TFP) in many advanced economies and in the euro area since the 1990s.¹⁰ The main factors behind this trend are related to a slowdown of technical progress and, in the case of the Eurozone, the low investment in intangible assets, digitalisation and other organisational changes complementary to these technologies¹¹, the misallocation of resources between firms (Bartlesman et al, 2018), regulatory barriers in the business environment, and the low skills of the work force in some countries (French National Productivity Board, 2019).

Finally, there is a broad literature documenting the weakness of investment in the euro area and other advanced economies since the financial crisis.¹² In the case of the euro area, the investment rate is still below 5% of net value added, while the average

⁹ See, among others, Aksoy et al. (2015) and Börsch-Schupan et al. (2019). The latter authors show that the ageing process could reduce euro area per-capita GDP (approximated by the aggregate of its three largest economies, France, Germany and Italy) by a cumulative amount of 8.7% between 2015 and 2030.

¹⁰ See e.g. Bergeaud et al. (2017) and Diaz del Hoyo et al. (2017).

¹¹ According to the European Investment Bank survey, in comparison to the US, there are more firms in the EU that do not innovate at all and there are fewer firms considered as leading innovators, investing in R&D and introducing new products. For related arguments, see also Elding and Morris (2018).

¹² See, among others, Dotting et al. (2017) and Banco de España (2018b), and the references quoted therein.



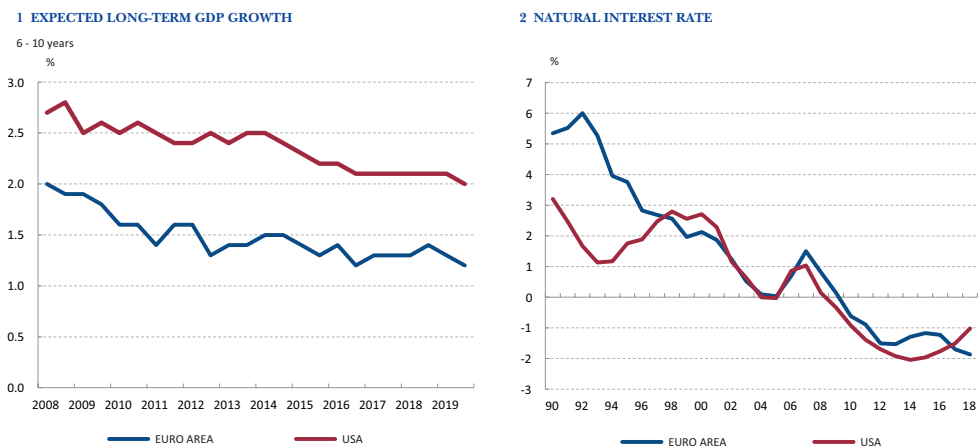
from 1999 to 2008 was above 7%. Some of the reasons may be related to cyclical weakness or to increasing uncertainty, but other authors stress the role of permanent changes in saving and investment propensities in industrial countries that make the economy prone to secular stagnation (see Lukasz and Summers, 2019).

2.5.2. HOW DO WE ADAPT THE POLICY FRAMEWORK TO THIS SITUATION?

As stated by Blanchard and Summers (2017 and 2019), all these factors call for a reappraisal of macroeconomic thinking and a reconsideration of the role that monetary and fiscal policies can play to stabilise the economy and to deliver the appropriate policy response. The architecture of EMU makes this challenge even greater.

Persistent low growth and inflation over a long period have resulted in a secular decline in the natural rate of interest in advanced economies and the euro area (see Chart 6).¹³ This has also been due, among other potential factors, to a lower trend growth rate of productivity, to demographic factors (Fiorentini et al. 2018) and to an increased preference for safe assets (Caballero et al., 2017).

CHART 6. LONG-TERM GDP GROWTH EXPECTATIONS AND THE NATURAL INTEREST RATE



SOURCES: Consensus and Banco de España Annual Report 2018 based on the mode of Fiorentini, Galesi and Pérez-Quirós (2018)

The consequences for the design of monetary policy of a permanent fall in the natural rate are significant (see e.g. Jorda and Taylor, 2019). Should this scenario persist, the leeway for a conventional policy response could be more limited than in the past as the

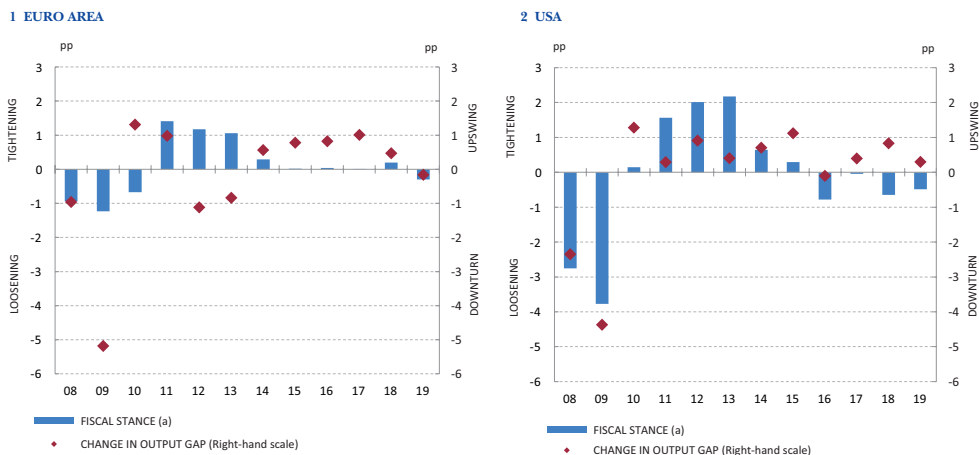
¹³ The natural rate is the rate that balances desired saving and investment in the economy. See Laubach and Williams (2016) and Del Negro et al. (2017).

effective lower bound on nominal interest rates becomes more frequent and the scope for reducing interest rates in response to future crises would be restricted. The first implication is that monetary policy will have to recur more frequently to non-conventional measures to achieve its goal. Yet in the current situation, marked by an already extremely expansionary monetary policy stance, the unused policy space might be more limited than in normal circumstances.

This has led some central banks, such as the Federal Reserve and the Central Bank of Canada, to discuss possible alternatives to the current monetary policy framework, encompassing strategy, tools and communication.¹⁴ The ECB has announced a review of the strategy that will be conducted under the tenure of the new President, although the precise scope and timeline of the review has not yet been fully fledged out. Against this backdrop, there is a growing literature exploring some alternative proposals [see Banco de España (2019c)].

In addition to the review of monetary policy frameworks, there have been increasing assertions that, for monetary policy to successfully achieve its inflation aim, a more active role of other policies, and in particular fiscal policy, is needed.¹⁵ This is particularly the case in the euro area. Chart 7.1 shows that after the procyclical tightening of the aggregate fiscal stance during the sovereign debt crisis (2011-2013), fiscal policy has been broadly neutral at the aggregate level, which contrasts with the more expansive tone in the US (see Chart 7.2).

CHART 7. FISCAL STANCE AND OUTPUT GAP

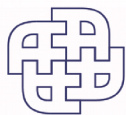


a. The fiscal stance is approximated by the change in the ratio of the cyclically adjusted government balance/GDP ratio

SOURCES : European Commission and IMF

¹⁴ Clarida (2019) mentions that the evidence of a lower natural rate in the US has been a key motivation for the Fed's current strategy review.

¹⁵ See, for example, Blanchard (2019), Sims (2016) and Leeper (2019a).



A variety of arguments have been put forward to support the claim for a more active role of fiscal policy in the current circumstances. First, fiscal policy becomes more powerful when monetary policy is close to the effective lower bound and it is fairly sure that interest rates will not increase (see e.g. Arce, Hurtado and Tomas, 2016). In the case of a monetary union, the fiscal multipliers (i.e. the positive impact on output of a given fiscal expansion) are higher not only for the country implementing the fiscal stimulus, but also for the rest of the members.

An important question is whether the two policy frameworks (fiscal and monetary) are mutually consistent to take into account the need for increasing coordination during long periods of very low inflation and interest rates.¹⁶ There is a growing literature calling for institutions and frameworks that are designed to take into account the interactions between monetary and fiscal policies.¹⁷ The challenge for the euro area is even greater given that monetary policy is designed at an aggregate level while fiscal policy is a national competence.

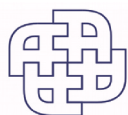
The incomplete governance of the euro area leads to a lack of mechanisms to guarantee a more suitable alignment of monetary and fiscal policy even in normal times (see e.g. Banco de España, 2017). The EU fiscal framework within the Stability and Growth Pact is equipped to prevent excessive deficits, but it has no instrument to incentivise a more active fiscal policy if needed. The debate on the fiscal stance at the euro area level and on the appropriate policy mix was absent from euro area policy design until the creation of the European Fiscal Board in 2014 with an advisory function. In particular, there is no tool in the framework to push those countries that have fiscal space, to use it or to implement fiscal policy at the euro area level.

In this sense, a central fiscal capacity at the euro area level could contribute not only to cushioning against country-specific shocks, but also to macroeconomic stabilisation if a common economic shock occurs and fiscal space is limited at the national level. The new Budgetary Instrument for Convergence and Competitiveness (Eurogroup, 2019) is a step in the right direction but a small one. In particular, its countercyclical stabilisation function will be rather limited.

Meanwhile, the most effective measure would probably be an investment-led stimulus at the euro area level. In this respect, there are strong reasons to develop a common European investment capacity. Indeed, public investment has higher multipliers and cross-border spillovers than other fiscal instruments (Alloza, et al, 2019). For instance, ECB model-based analysis finds that, in an economy like Germany, increasing investment by 1 % for 5 years could increase long term GDP by 2 %, with respect to the baseline, with a transitory impact of 0.6 % on the GDP growth rate of the rest of the EA countries (Jong

¹⁶ As stated by Sims (2016), during periods of rapid inflation growth as well as in long periods of very low inflation and interest rates, the coordination of fiscal and monetary policy is necessary. Central banks under these conditions need to explain the connections between monetary and fiscal policy and make clear the limits to their ability to control inflation without appropriate fiscal support.

¹⁷ Leeper (2019b) proposes a redesign of fiscal rules to take into account the interaction between monetary and fiscal policies.



et al, 2017). Both the Investment Plan for Europe (IPE)¹⁸ launched in 2015 (known as the Juncker Plan) and its successor the *InvestEU programme* have not been totally satisfactory in this regard as most of the projects involved do not fulfil the criteria of being truly additional. In the case of the IPE, according to the assessment of the European Court of Auditors, many of the projects would have been undertaken by the private sector regardless of the IPE's involvement.

A better designed public investment plan could contribute to reducing the investment gap in key areas – such as infrastructures, research and innovation, and the digital transformation – where the EU as a whole, lags behind other advanced economies. This would contribute to accelerating the transformation needed in some industrial sectors. Investment is typically one of the spending categories that most suffers in the event of a consolidation. Moreover, the participation of productive public investment (infrastructure, R&D and education) in total primary expenditure has fallen in the euro area economies. This is not only due to fiscal consolidation processes (see European Fiscal Board, 2019) but also to a secular decline resulting from demographic pressures on other types of expenditure (like pensions and health expenditure; see Banco de España, 2019d).

2.5.3. INCREASING THE RESILIENCE AND ENHANCING THE FUNCTIONING OF THE MONETARY UNION

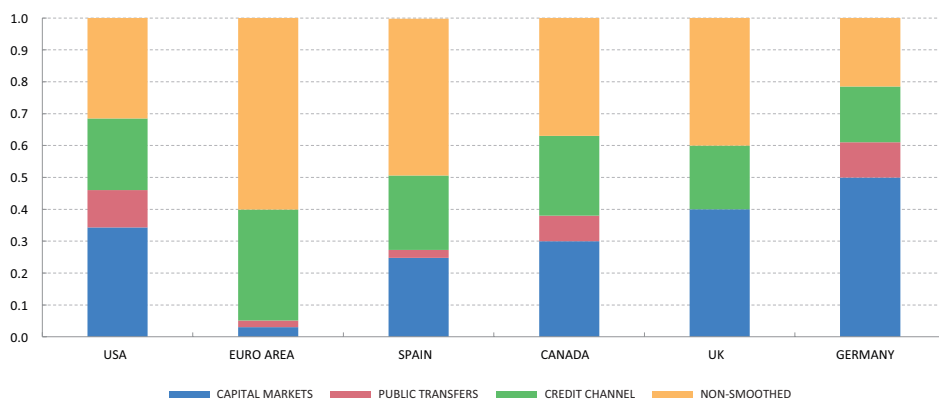
In any case, to achieve a significant improvement in the design of stabilisation policies during the cycle, other aspects of EMU architecture should be improved in order to increase resilience in the face of large asymmetric shocks. Significant steps have been taken since the crisis to enhance the overall capacity to handle crises and to make the euro area more robust. The European Stability Mechanism (ESM) was created to increase the euro-zone's capacity to deal with debt and liquidity problems and to withstand very serious asymmetrical shocks. To curtail the perverse dynamics of the feedback loop between banking and sovereign risks and the systemic consequences of institutions with strong cross-border links, significant headway has been made towards the creation of a Banking Union with the Single Supervisory Mechanism and the Single Resolution Mechanism. Finally, substantial progress has been made in reducing banking risks and non-performing loans.

¹⁸ The Investment Plan for Europe comprised three pillars: (i) first, the European Fund for Strategic Investments (EFSI), which provided an EU guarantee to mobilise private investment. The Commission works together with its strategic partner, the European Investment Bank (EIB) Group; (ii) second, the European Investment Advisory Hub and the European Investment Project Portal, which provided technical assistance and greater visibility of investment opportunities, thereby helping proposed investment projects become a reality. The Hub was a joint venture with the EIB Group; (iii) third, improving the business environment by removing regulatory barriers to investment both nationally and at EU level.



At the same time, however, there has been slow progress in some very relevant aspects of euro area governance reform. Among them, insufficient financial integration and the lack of supranational fiscal policy instruments leave the euro area vulnerable to economic shocks. Indeed, according to some recent estimates by Cimadomo et al. (2019) and Banco de España (2017), only around 40% of country-specific shocks are smoothed through credit and capital markets in the EA, while in the US around 60% of these shocks are smoothed through financial markets. Moreover, in the US 10-15% of a shock is smoothed through transfers from the federal budget, while in the EA this channel is totally inexistent. As a result, in the EA practically 60% of a country-specific shock is unsmoothed, while in the US this percentage is only just 30%.

CHART 8. STRENGTH OF RISK-SHARING CHANNELS



SOURCES: Cimadomo et al (2019).

As a consequence, one key challenge is how to integrate banking systems and capital markets to increase private risk-sharing in the euro area. Over recent years we have seen an increase in interbank lending across the euro area countries, but retail banking integration and cross-border consolidation has remained limited. While there are no formal barriers to the entry of foreign banks, there are still significant differences in banking regulation, including bankruptcy and liquidation laws, across countries. Despite the low profitability and excess capacity of the European banking sector, some of the existing savings banks or regional banks are protected by national regulations and do not have any incentive to merge or explore new opportunities in other countries (Restoy, 2018).

There is also a need to complete the Banking Union. A fully-fledged European deposit insurance scheme (EDIS) is the only way to equalise the level of depositor confidence across the single market, which would contribute to delinking the protection of depositors from their location by reducing the link between banks and sovereigns. Therefore, the EDIS will enhance financial stability across Europe, and reduce the incentive for bank runs and the severity of financial crises. The literature has suggested



alternative design features that could minimise cross-bank subsidies between countries in the event of a banking crisis (Carmasi et al., 2018).¹⁹

As regards capital markets, the use of equity financing by European firms is still exceptional and a significant national bias still prevails in the Eurozone relative to the United States (Gonçalves-Raposo and Lehmann, 2019). Progress in the Capital Markets Union (CMU) is key, but is so far proving too slow. A majority of firms and households remain largely dependent on the funding provided by their domestic banking systems. The lack of alternative sources of funding may be particularly hindering some types of investment, such as intangibles and other more innovative forms of investment, and hampering the creation of successful start-ups that typically rely on venture capital in their early stages of existence.

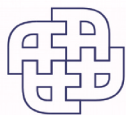
The EU directive to reform European insolvency systems is a significant step towards alleviating fragmentation. But some authors call for more ambitious measures, such as the establishment of a European system of courts specialising in bankruptcy, as exists in the US. A single or unified European supervision of capital markets, the revision of the debt financing bias existing in most taxation systems and regulatory harmonisation in areas such as insolvency legislation could contribute to this goal.

In any event, market-based risk-sharing mechanisms are not sufficient to cope with severe shocks. In this regard, Fahri and Werning (2012) show that even if capital markets were fully integrated, a system based solely on private mechanisms would not be optimal, since agents do not internalise the advantages of macroeconomic stability. Moreover, empirical evidence shows that private risk-sharing normally decreases in times of crisis (Banco de España, 2017; Gordo and Kataryniuk, 2019), thus private insurance needs to be complemented by public risk-sharing. Here, a supranational fiscal insurance mechanism would lead to a more resilient EMU.

Finally, completing the Single Market may also generate significant income gains for the EU. In't Veld (2019) estimates a macroeconomic impact close to 9 pp of GDP for the EU average stemming from the reduction in tariffs and non-tariff barriers achieved so far in goods and services. Nevertheless, non-tariff barriers, such as differences between regulatory regimes or product standards, still pose a major obstacle to trade.²⁰ Completing the Single Market, particularly in those areas such as the digital economy and financial services, could bring significant gains (Aussilloux et al., 2011 and 2017).

¹⁹ In the US, the FDIC allows banks in different States to insure each other against failure, backstopped by a credit line from the US Treasury.

²⁰ Aussilloux et al (2017) estimate that remaining non-tariff barriers, in particular in the services sector, reduce intra-EU trade to a level about four times smaller than the intensity of trade between US States, once the influence of language and other factors like distance and population are taken into account.



2.5.4. OTHER LONG-TERM-ORIENTED POLICIES

Regarding trade policy, the EU has demonstrated flexibility to adapt to new challenges both at the multilateral level (with the proposal to reform the WTO) and at the regional level (with the CETA, Japan and MERCOSUR trade agreements, among others). However, greater effort is needed in pursuing new trade and investment agreements with other major partners (China and India, for example) and to ensure a level playing field and increase transparency in trade negotiations.

As regards climate change, the EU countries are in the vanguard of climate mitigation policies compared with other advanced economies. However, more ambition is needed to meet the commitments entered into under the 2015 Paris Agreement to reduce greenhouse gas emissions by at least 40% from 1990 to 2030 and to limit the global temperature increase to well below 2° C above pre-industrial levels. Reforms in this area require strong coordination and analysis to compensate vulnerable groups for adjusting to higher energy prices and to mitigate the impact on energy-intensive firms competing in global markets.

Without seeking to be exhaustive, other policies meriting higher priority include: further EU-wide integration of R&D and innovation policies; promoting active labour market policies; tackling the high labour tax wedge existing in some countries; and reducing restrictive regulations in professional services, the retail trade and network industries.

2.6. SOME CONCLUDING REMARKS

The global financial crisis and the euro-specific sovereign-debt slowdown led to a significant leap forward in EMU completion. The lessons of the still recent double-dip crisis are too fresh, and its scars too deep, to forget that much remains to be done. And the current situation of synchronised, global deceleration is a call for action.

When thinking about the “Economic State of the Union”, European authorities should adopt a broad perspective, and implement policies conducive to curbing secular, dampening trends that risk engulfing the European economy in a low-growth, welfare-reducing, semi-stagnant trap, as discussed in this chapter. Thinking big requires not only completing and making effective the toolkit of EMU-wide short-run stabilisation policies, but mostly confronting the challenges posed by global technological, environmental and demographic developments.



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3. THE STATE OF THE EU BANKING INDUSTRY

JOSE MANUEL CAMPA¹

The EU banking industry has been in a process of transformation. A decade after the financial crisis, EU banks have been cleaning up their balance sheets, strengthening their capital levels, and enhancing their competitive positions. Banks have been required to deal with the fallout from the financial crisis, while at the same time redefining their business models in response to the enhanced regulatory framework and challenges confronting the industry, which have arisen as a result of the macroeconomic environment and technological transformation.

This improvement in the state of the banks has allowed them to reorganise their operating structures and continue to provide financing to the economy. Despite this progress a number of important challenges remain in the industry. Profitability remains low, cost-to-income ratios have increased slightly and credit quality - which has significantly improved over the last few years - may suffer as overall economic growth slows down.

The regulatory framework has generated additional demands on the behaviour of banks and continues to be updated. The implementation of the risk reduction package approved in the EU last summer, particularly in the areas of resolution planning and resolvability assessment, the implementation of the final agreements in capital standards regarding Basel III and the higher emphasis on adequate consumer protection will bring additional demands in the banking sector.

Additionally, the industry faces significant challenges arising from technological innovation, digital transformation and new competitors. Beyond this, new opportunities and risks are arising as the European economies as a whole confront the transformation arising from climate risk and sustainable growth objectives.

These challenges will remain in the near future and the industry needs to continue to enhance its competitiveness position and restructure so as to be able to provide adequate services to the economy.

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3.1. THE BANKING INDUSTRY: A CHALLENGE IN PROFITABILITY

3.1.1. BALANCE SHEET ENHANCEMENT: IMPROVEMENTS IN THE CAPITAL POSITION OF BANKS AND NPL REDUCTIONS

European banks have significantly increased their capital position over the last five years. As of June 2019, the average Common Equity Tier 1 (CET1) ratio stood at 14.6% (on a transitional basis), an increase of more than 2 percentage points relative to the average ratio in 2014. The same trend applies to the total capital ratio, which has increased by even more as banks have continued to build their liabilities eligible for the total capital requirement. The total capital ratio stood at 18.9%, as of June 2019. The Additional Tier 1 (AT1) component has increased to the level of 1.5%, while the T2 component stood at 2.7%².

In addition to this increase in total capital of recent years, banks have also increased their risk weighted assets by 3% in the last year.

Non-performing loans (NPLs) have been a major concern for supervisors, policy makers and market participants in the EU. The asset quality of EU banks has improved significantly in the past 4 years. As of June 2019, the weighted average NPL ratio stood at 3%, compared with 6% in June 2015. This is the lowest since EBA introduced a harmonised definition of NPLs across European countries in 2014. On average, the NPL ratio has improved by 75 bps each year over these last four years.

Reductions in NPL volumes, the numerator of the ratio, mostly drove the improvement. Total NPLs as of June 2019 stood at EUR 636 billion, down by almost 50% compared to June 2015. The decrease in NPLs is mostly attributed to NPL sales and securitisations. Although reductions were reported across all countries, and predominantly by those with higher starting ratios, NPLs remain unevenly distributed (from less than 1% in Sweden to 39% in Greece) and remain elevated for some countries. NPL ratios are higher for lending segments like SMEs, CREs and consumer credit.

The enhancement in the NPL ratio also comes with improvements in the coverage ratio and lower forbearance. The coverage ratio is highly dispersed across banks and countries. Banks with lower provisioning levels tend however to hold higher collateral values and vice versa. Forbearance ratios have been decreasing constantly since June 2015, to 1.9% down from 3.7% four years earlier.

Despite substantial improvements, legacy assets remain material and are concentrated in just a few countries. The main impediments to resolving NPLs identified by the banks, are differences in the ability to recover NPLs due to the legal framework and the lack of a market for them. These issues remain significant in a few countries, and in particular in those with higher NPL ratios. There are significant ongoing initiatives that

² According to the EBA Risk Assessment Report, 30% of the banks in the sample reported AT1 capital of at least 1.5% and 45% of the banks in the sample reported T2 capital of at least 2%.



aim to further boost the reduction of legacy assets in those countries, such as Greece and Cyprus which still have double-digit NPL ratios.

However, in light of weakening economic conditions, banks should closely monitor asset quality to identify any possible deterioration, especially in riskier segments, and continue to actively manage the NPLs from their balance sheets.

3.1.2. CHALLENGES TO PROFITABILITY

The profitability of EU banks remains below what would be considered an adequate level. EU banks' profitability has lagged behind that of US banks for years. Whereas the return on equity (ROE) stood at 6.5% for EU banks in 2018, it was 11.9% for their US peers³. This difference cannot be attributed to any single reason. Additionally, the share of participating banks in the EBA Risk Assessment Questionnaire (RAQ) expecting increasing profitability is low. Only about 25% of respondents expect an overall increase in bank's profitability in the next 6 - 12 months, compared to 29% expressing such expectation in December 2018.

Furthermore, EU banks have not been able to enhance their operating efficiency. EU banks cost-to-income ratio (CIR) has increased from an average value of 62.9% in 2014 to 66.3% in 2018. Comparing again, EU banks show lower efficiency than their US peers (62.8% CIR for US peers). These average ratios also underscore different underlying trends. US banks have decreased their CIR from 71.8% in 2014, whereas it has increased for EU banks.

The poor performance of the CIR is mostly explained by the difficulty of banks to adjust operating expenses in line with the evolution of their income in a challenging environment. Furthermore, many of the banks plan to simultaneously reduce overheads and staff costs while significantly increasing their investments in automation and digitalisation.

Differences in profitability and cost structures between EU and US banks are similarly reflected in investor perceptions of them. More than 80% of US banks were trading at a price-to-book multiple (PtB) above 1 in July 2019, compared to less than 30% of EU/EEA banks. At the beginning of 2008, the PtB was above 1 for around 90% of the banks in both jurisdictions.

It is striking that in the US the consolidation of the banking sector has moved much faster than in the EU. Also, the number of institutions that have survived has been lower in the US compared to the EU. Accordingly, when looking at banks that were the least profitable following the global financial crisis, in the US more than 50% exited the market or were acquired by a competitor, whereas for the EU/EEA this figure is below 40%.⁴ As a result, in the US the number of credit institutions has fallen by 30% since 2008, while the decrease in the EU was just 20%.⁵

³ EBA Risk Dashboard, US Fed.

⁴ Standard & Poor's Market Intelligence.

⁵ ECB, US Fed.



3.2. LOOKING FORWARD: CHALLENGES TO THE INDUSTRY

3.2.1. CHALLENGES TO CONSOLIDATION

Scope for consolidation in the EU banking sector has often been identified, as a potential answer to the profitability challenge. Economies of scale and of scope appear not fully utilised in the EU banking sector, and current business models often do not support long-term sustainable profitability. However, there has been very little merger and acquisition (M&A) activity in the years since the crisis, and in particular across borders. The number of M&A transactions has rather been in steady decline in the past years, and transaction values reached the lowest level in 1H 2017.

One should neither conclude that consolidation is a goal in itself nor that consolidation, as such, drives profitability up. However, through creative destruction, an active process by which more efficient institutions continue to gain market share, while weaker, less efficient institutions exit the market will be one contribution to improve profitability. At the same time, such consolidation could potentially benefit from operating synergies allowing the remaining firms to provide better services while enhancing their profitability.

Consolidation along national borders appears more appealing than cross-border consolidation within the EU. Overlaps in staff and branch networks of banks operating in different countries are more limited, and so would be the reduction of operating expenses from cross-border vs. domestic mergers.

Reluctance for cross border M&A may to some extent be a legacy from the financial crisis, where one response of EU banks was to reduce cross-border activity and focus on their core, mostly domestic, business, and national approaches often prevailed. Examples of not very successful M&A transaction in the EU banking sector in the past may also contribute to reluctance. When looking at existing reasons for the reluctance for cross-border consolidation, low margins, low profitability, cultural aspects and an identified lack of business cases for potential M&A are often suggested. Legal barriers in addition to regulatory restrictions to freely allocate capital and liquidity across borders are also mentioned.

Regulation should not pose additional undue obstacles, but should ensure that the basis for healthy competition exists. This should include adequate exits from weak banks with unsustainable business models, effective competition, and the ability for incumbents and newcomers to adopt new technologies that provide better services while ensuring financial stability.

The EU regulatory framework can help in this area by finalising the effective implementation of the resolution framework to ensure that orderly exits from banks occur. Effective supervision and harmonisation around the setting of capital buffers, like the systemic risk buffer and the buffer for other systemically important institutions, need to ensure that no unnecessary burdens exist. The setting up of a fully-fledged European Deposit Insurance Scheme in the Banking Union would also reduce the reluctance of regulators to exercise national waivers on liquidity and capital. Differences in tax and insolvency regimes also make cross-border transactions more complex. Finally, regulation



needs to be put in place to allow for the introduction of new technologies and new players in the industry, which foster competition while preserving financial stability.

3.2.2. MACROECONOMIC ENVIRONMENT

The prolonged low interest rate environment has been a key factor contributing to subdued profitability in the EU banking sector. In line with reinforced expectations of a continued scenario of low interest rates and flattening yield curves, the outlook for interest income and profitability remains subdued.

Net interest income (NII) is the most important source of bank income, but has decreased by 6.2% from March 2015 to March 2019 (EUR 347bn6) during the prolonged low interest rate environment, and in spite of growing lending volumes. Reduced net interest margins are the main driver of subdued NII, and point to challenges to increase interest income. Beyond NII, net fee and commission income, as the second most important contributor to EU banks' profitability, has decreased by 1.7 percentage points between Q1 2018 and Q1 2019.

Automation and digitalisation are key areas for EU banks to enhance their efficiency and reduce operating expenses. These efficiency gains should result in reduced overheads and staff costs, but require costly investments in IT and financial technology first. Banks need to find the way to preserve their business value while transforming their business models.

3.2.3. REGULATORY ENVIRONMENT

The financial industry has experienced a regulatory overhaul after the financial crisis. The bulk of these changes are already in place. Nevertheless, the changing economic environment, challenges from technology and higher expectations in the areas of conduct and fighting financial crime will shape the agenda going forward.

In addition to the global challenges facing the financial industry, the EU needs to ensure that it works internally to foster an effective single market for financial services. Progress in this area includes an effective finalisation and implementation of the Banking Union within the euro area countries, adequate progress in a deepening of capital markets within the EU, and collaboration in the areas of data, privacy, operational resilience and cyber risk that are arising as new technologies are deployed.

3.3. THE EBA AGENDA GOING FORWARD

The EBA is aware of these challenges and has set priorities in these areas. The finalisation and follow up mandates for the effective implementation of the risk reduction

⁶ Based on a stable sample of supervisory reporting banks, annualised.



package, approved last summer at EU level, is an important area of work for the coming months. Within this broad range of reforms, making the recovery and resolution of banks operational across the union is a priority.

In terms of prudential requirements, the implementation in the EU of the final Basel 3 agreement is the most salient pending part. The EBA believes that the proposed changes address many of the remaining weaknesses in the existing prudential framework and preserve adequate risk sensitivity and that the EU should target a faithful translation of global standards into EU regulations. Unwarranted deviations from the Basel rules could imply costs to the international credibility of the EU regulatory framework and the overall trust in EU banks. The EBA assessment shows that the impact on minimum capital requirements, in terms of capital, while material, is mostly driven by large and internationally active banks and can be largely absorbed during the long phase-in period. The impact in medium and small banks is much less significant.

Sustainable finance and the incorporation of environmental, social and governance (ESG) factors will be a core part of financial regulatory work going forward. The focus here would first be on the identification of key metrics that should form the basis of enhanced disclosure by banks. This taxonomy and better disclosure can facilitate banks' work on strategy, governance and risk management of their exposure along these criteria. A proper understanding, measurement and monitoring of the risks involved will be a precondition to assess the prudential treatment of these exposures.

Strengthening the European Union in the areas of customer protection, and anti-money laundering and counter-terrorist financing (AML/CFT) is a clear priority. The EBA has new mandates in this area that it will have to develop in relation to fostering cooperation among national authorities in the Union, and enhanced effective supervision through the performance of implementation reviews. Nevertheless, we need to reflect further on the merits of a more homogeneous regulation at EU level in this area and the merits of further integration.

Finally, the treatment of financial innovation will also shape the future of the regulatory framework. Financial products, services and business models, as well as the structure of the financial sector in general, are evolving fast. We need to ensure that the EU framework enables the adoption of new technologies that will bring potential for efficiency gains and new forms of competition, whilst at the same time effectively mitigating risks to consumers, to the integrity of the banking system and, ultimately, to financial stability.

PART II
ISSUES IN MONETARY POLICY



4. EUROPE'S POTENTIAL "JAPANIZATION"

JOSÉ RAMÓN DIEZ GUIJARRO¹

4.1. ABSTRACT

Structural stagnation and extremely low natural interest rates in some of the major developed economies have suggested a comparison to Japan's economic experience in recent decades. Indeed, the only example offered by recent economic history of this anaemic turn in the business cycle is the Japanese economy since the crisis of the early 1990s. This paper explores the causes and features of the economic phenomenon known as "Japanization", and the economic policy errors that have made these difficulties a chronic disorder. Finally, we assess the risk of "Japanization" in the euro area.

Keywords: monetary policy, negative interest rates, potential growth, Japanization

4.2. INTRODUCTION

The downward trend in potential growth rates, the fall in natural rates of interest, the difficulty for central banks to achieve stable inflation targets and the progressive aging of the population have shaped the behaviour of many developed countries since the last crisis. To a greater or lesser extent, this trend replicates the performance of the Japanese economy over the past three decades.

Slow and ill-conceived economic policy responses, delay in the shoring-up of financial institutions and swift demographic decline entrenched the problems, driving Japan into a spiral of falling inflation expectations, price declines, downward adjustments in consumption and the exhaustion of conventional monetary policy measures, from which the economy is barely beginning to emerge, almost three decades after the onset of the crisis. This anomalous economic behaviour, which resembles structural stagnation, has

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been dubbed “Japanization”, and is the only example in recent economic history from which lessons can be drawn to address problems such as those faced by some European countries today.

This paper presents an analysis of the characteristics, causes and consequences of the economic phenomenon known as “Japanization”. We also assess the risk of “Japanization” in the euro area, and consider lessons that can be drawn from the Japanese experience.

4.3. WHAT IS “JAPANIZATION”?

The significant reduction in potential growth, the fall in the natural rate of interest even to negative levels, the drop in prices and the exhaustion of the degrees of freedom of conventional monetary policy instruments (official zero rates) are some of the features that have shaped the performance of the Japanese economy over the last thirty years. This anomalous cyclical behaviour over almost the last three decades has been dubbed “Japanization”.

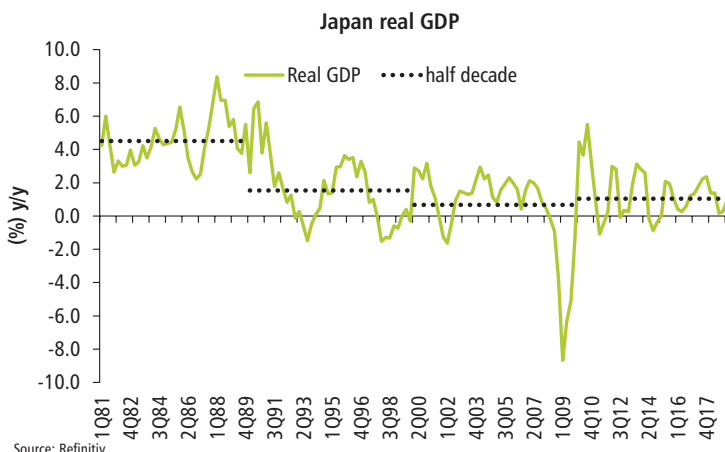
The state of “Japanization” followed a slowdown in the economy in the early 1990s, after a decade of average GDP growth of over 4% per year and strong revaluations on the stock exchange and the housing market. The credit boom and a lax monetary policy (the Bank of Japan reduced the reference rate by 675 bp throughout the 1980s) created bubbles in the price of financial and real assets.² After the financial shock caused by the tightening of monetary policy, the economy shrank, real and financial asset prices collapsed and a period of stagnation began that has lasted almost to the present day. This period was characterised by a “treble D”: deleveraging of the private sector, deflation and an exponential increase in government debt.

In addition to structural factors (aging population, fall in productivity), one of the main reasons behind the prolonged crisis was the slow reaction of economic authorities on three levels: poor and untimely fiscal response (not significant until 1992-93); banking crisis addressed late, and hesitantly (until 1997 the banks were not recapitalised); and merely tentative response in monetary policy, once conventional measures had been exhausted.

This process, with many of the features of secular stagnation, began when most OECD countries were still coping with the aftermath of the stagflation of the 1970s. Therefore, at the time, it was an economic rarity, becoming, along with the Great Depression, a lab experiment from which lessons could be drawn for the economic authorities of countries that, after the last great crisis, were at risk of entering a similar economic spiral. Japan’s real GDP grew from an average of 4.5% in the 1980s to 1.5% in the 1990s (figure 1), weakening further in the first decade of the twenty-first century (0.7%). In the current decade, it improved slightly, achieving average growth of 1.0%.

² Secured loans to property developers and households in the second half of the 1980s were made at 100% LTV of the security.

FIGURE 1: REAL GDP GROWTH



So, almost thirty years later, the economy is barely emerging from that dormant state which stakeholders have now come to expect. In fact, there is not even a consensus in the economic literature on what conditions might lead to a process of “Japanization”, although an economy is considered to be in that situation if it meets all of the following conditions:³

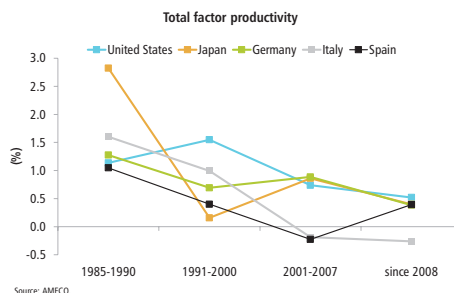
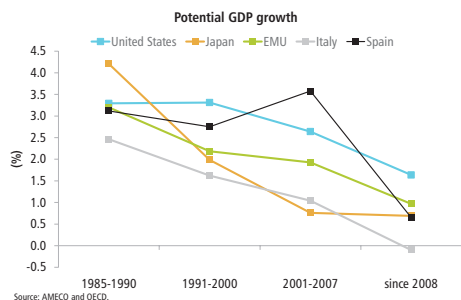
- Protracted and significant decline in potential growth.
- A negative natural rate of interest.
- Zero Interest Rate Policy (ZIRP).
- Widespread downward price trend.

The decline in potential growth in recent decades is not exclusive to Japan: it has gradually taken hold in the world’s major economies (Figure 2). In most cases, the decline started the early 1990s, while in Japan the downward adjustment is more marked than in the other countries, starting from levels above 4% in the 1980s and standing at less than 1% today.

³ Some of the most extensive papers seeking to define the term include Pesek (2014) and some chapters in Kawai and Morgan (2013), and Rhee and Posen (2013). More recently, Ito (2016) provided a very comprehensive summary of the conditions leading to a state of “Japanization”.



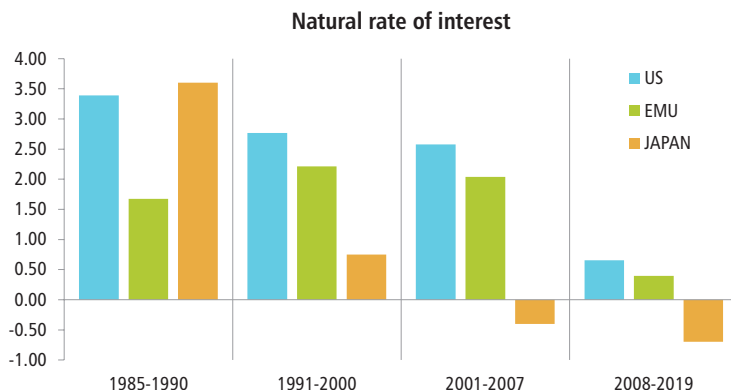
FIGURES 2 AND 3: POTENTIAL GDP GROWTH AND TOTAL FACTOR PRODUCTIVITY



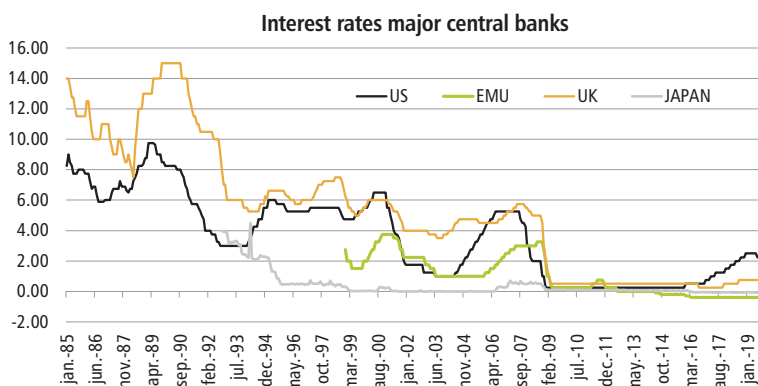
Moreover, the key feature of the downward adjustment of Japanese potential growth is negative momentum in total factor productivity (TFP) performance since 1990 (Figure 3). Not surprisingly, TFP accounted for almost 70% of potential growth before the crisis (2.8% average growth from 1985 to 1990) and came to a standstill in the 1990s. We tend to think of demographic factors, the decline in the working population, as the main source of the fall in potential growth in Japan, but it is productivity that explains most of the decline. The fall in productivity in Japan has been more intense than in the rest of the large OECD economies, with the exception of Italy.

The second defining feature of “Japanization” is a drop in the natural rate of interest to negative territory. A natural or equilibrium rate of interest is the real interest rate that equates savings to investment in a situation of full employment. In general, the latest estimates reflect levels at historic lows and, above all, a sharply downward trend since the 1980s. The factors driving this low level of natural rates are: high savings (driven by the aging of the population), scarce global investment in this recovery cycle, insufficient risk-free assets, increased inequality, deleveraging of private participants after a financial crisis (balance sheet recession), etc. In other words, this low natural rate of interest summarises a large part of the economic problems facing our societies. The question is whether we face a temporary phenomenon and, sooner or later, there will be an upward correction, or, rather, these low natural rates are here to stay (secular stagnation hypothesis).

**FIGURES 4 AND 5: NATURAL INTEREST RATE
AND NOMINAL INTEREST RATES**



Source: NY Federal Reserve, Bank of Japan and Bankia research unit.



Source: Bloomberg

From a monetary policy standpoint, central banks should theoretically set real interest rates below natural rates to try to boost economies in times of recession (expansionary monetary policy) and do the opposite when trying to cool the economy down (contractionary monetary policy). The problem is that deflation makes it impossible to bring real rates below natural rates when the latter are in negative territory, hindering and delaying emergence from the crisis. A Japanese-style situation is therefore caused by the combination of a negative natural rate of interest and the impossibility of real interest rates falling below it, when deflation is present.

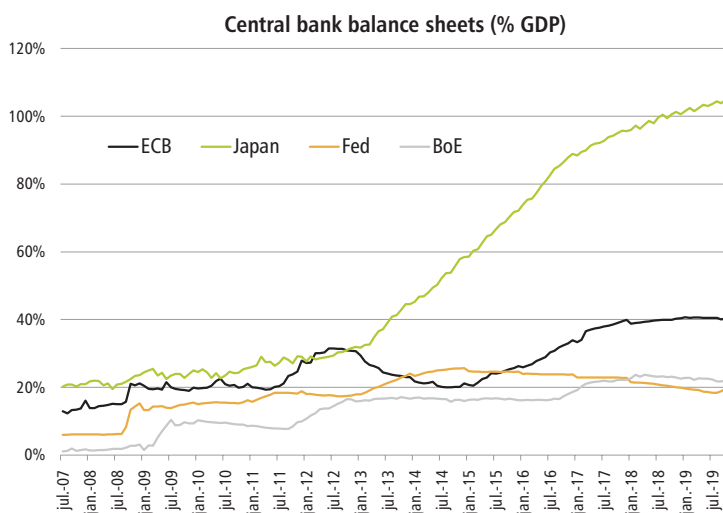
In Japan, the natural rate of interest reached 3.5% at the end of the 1980s and declined to below zero at the beginning of this century, where it remains today (Figure 4).



So, over the last decade and a half, monetary policy was constrained by the lethal combination of a negative natural rate of interest and a deflationary spiral.

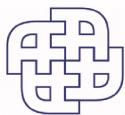
Thirdly, a Japanese-style situation leads to a fall in the nominal interest rate to zero and thus the exhaustion of conventional monetary policies (Figure 5). The zero interest rate policy (ZIRP) was initiated in Japan in 1999 (almost a decade after the onset of the crisis) and, ever since, with the exception of the period 2006-2008, the Bank of Japan (BoJ) has kept interest rates at the “zero lower bound”. In addition, the BoJ started a QE (quantitative easing) programme in 2001, which has driven up the size of the central bank’s balance sheet to 104% of GDP. The Japanese monetary authority was a pioneer in pushing the boundary for monetary policy. The other major central banks followed suit after the last crisis and, in many cases, were even more aggressive in deepening the negative interest rate policy (NIRP), alongside quantitative easing (QE) programmes (Figure 6).

FIGURE 6: BALANCE SHEET SIZE OF CENTRAL BANKS



Source: ECB, Bank of Spain, US Federal Reserve and Bank of England

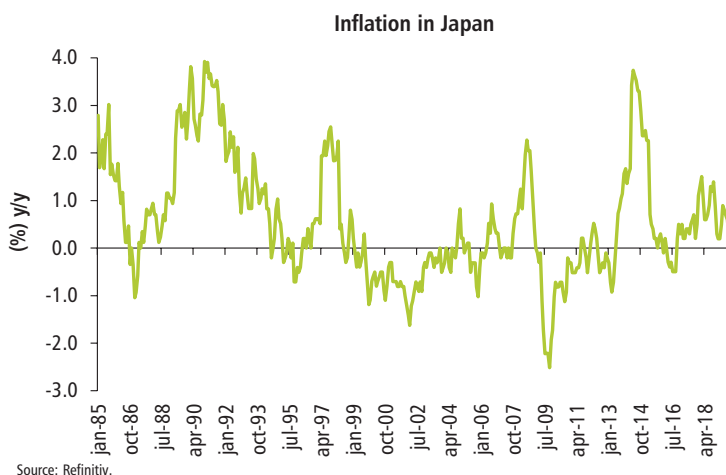
Finally, the Japanese economy underwent a downward trend in prices that lasted almost fifteen years (Figure 7). From 1992 to 1998, inflation declined, but remained positive most of the time. In that first stage, there was “disinflation”, but not deflation. But from the summer of 1998 prices started to fall and, with the exception of the period 2006-2008 and 2013 (when VAT increased), continued to fall almost until 2016. Therefore, over the past two decades the average annual change in the consumer price index was practically zero. This shows how hard it is for an economy to escape a deflationary spiral once participants’ expectations become accustomed to falling prices. In fact, after



price growth exceeded 1% for much of 2018, it recently fell back below 1%. At present, core inflation is stagnating at 0.5% and the BoJ is again warning of the risk of a further downward slide, especially as the recent VAT hike may lead to a drop in consumption and a contraction in GDP this quarter, which could wipe out the positive output gap that the country displayed until the summer.

The outcome is that, after two decades, the price level is only 1.2% above the level reached in 1998. During the same period, the consumer price index rose by an average of 60% in OECD countries.

FIGURE 7: INFLATION OVER TIME



In addition, "Japanization" coincided with accelerated population aging that further drove the momentum we have just discussed. The drop in the birth rate from 1.8 children per woman of childbearing age in 1985 to 1.4 today, and especially the increase in life expectancy at retirement age from 13 to 22 years, have made the Japanese the most aged population in the world. The onset of "Japanization" started when the working population peaked (1991). The difference is that, in the 1990s, the rest of the world was growing far more strongly, enabling Japanese investors to earn attractive returns by investing abroad.

So "Japanization" is an extreme state of the economy that satisfies all the above conditions. It can be defined as an economy with chronic low growth alongside a downward trend in prices. In this context, there is no conventional monetary policy capable of stimulating the economy, as the real rate of interest exceeds the natural rate of interest.



4.4. IS EMU AT RISK OF “JAPANIZATION”?

Although the Japanese economy is starting to emerge from hibernation by escaping deflation since 2016, the risk of “Japanization” has drawn the attention of many economists during this mature phase of the expansionary cycle, because some of the largest developed economies now satisfy many of the conditions discussed in the previous section. Some of these trends started even before the outbreak of the global financial crisis in 2008-09.

First, as mentioned in the previous section, the main developed economies, especially in Europe, have experienced a gradual but clear decline in their potential growth since the 1990s. Within EMU, besides Greece, with negative potential growth (-0.5%), the highlight is Italy, where potential growth declined from 2.5% per year in the early 1990s to only 0.5% today, according to European Commission estimates. This situation ties in with lower total factor productivity growth: in Italy, it has risen from rates of 1.5% to now fall to an average of -0.3%. In the case of EMU, potential growth gradually slid from 3.2% per year in the 1980s to 1.3% today.

Secondly, according to estimates by the New York Federal Reserve, natural rates of interest are currently below 1% in both the United States (0.6%) and EMU (0.2%), compared to levels between 2.8% and 2.2% in the 1990s (Figure 4).

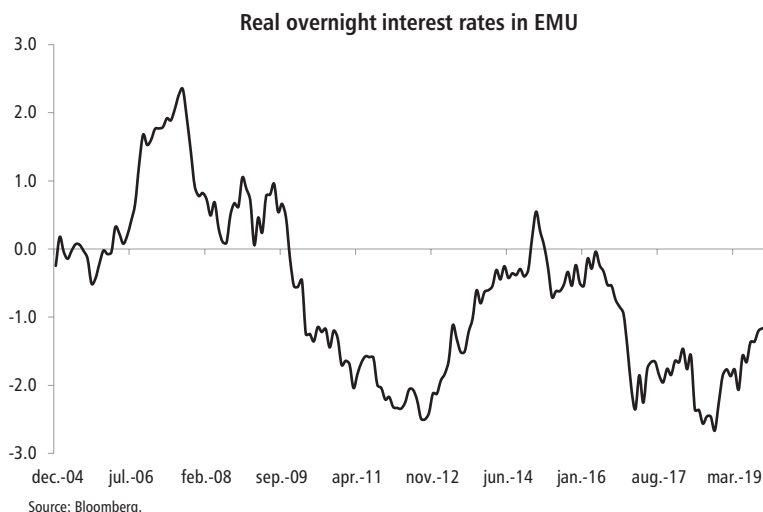
The case of EMU is particularly significant, given that each of the euro area countries has a different natural interest rate, but monetary policy is common, laid down by the ECB.

From the birth of the euro to the onset of crisis in 2008, the real interest rate in EMU averaged 1.4%, i.e. below the average natural rate of interest for the region (2%), reflecting the need for lax monetary policy for the Northern European countries, especially Germany.^{4,5} Specifically, from January 2003 to the end of 2005 the negative gap between the natural and the real interest rate widened, with the average real interest rate standing at 0.2%, a full 1.5 percentage points below the natural rate of interest (Figure 8). So, at that time, monetary policy was extraordinarily expansionary, as real rates were below the lowest natural rate of interest in the region - which, at that time, was Germany's - to the detriment of the countries of southern Europe.

⁴ Twelve-month Euribor less inflation.

⁵ This was particularly detrimental to countries such as Spain, which from 2004 to 2008 had natural interest rates above 2% and a cyclical position that counselled restrictive monetary policy.

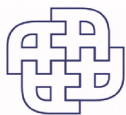
FIGURE 8: REAL INTEREST RATES



Everyone knows what happened next. From the end of 2005 until the summer of 2007, real interest rates began to rise, peaking in August 2007 (2.3%), precisely when the first warning bells went off in the international financial system. Since then, nominal interest rate cuts, especially since Mario Draghi became president of the ECB, brought real interest rates down to a low of -2.7% in October 2018 (-1.2% at present). However, the key point in Europe is that there are still widely different natural rates of interest within the region and, in fact, the gap has not narrowed over the past decade.⁶ At present, the ECB's expansionary monetary policy seems to be closer to the needs of Italy, where the natural rate is lower than in the rest of the major economies in the region (the natural rate of interest is estimated to have been negative since 2010). Something similar happened between 2003 and 2006, although on that occasion the favoured country was Germany.

By contrast, for the other EMU countries, and especially for the "core" economies (Austria, Belgium, Germany and the Netherlands), which have higher natural rates, current ECB policy is too expansionary, which would account for the dissent within the Governing Council. This highlights the difficulties involved in setting monetary policy for the entire euro area, as there are very marked structural divergences. The rule of thumb seems to be to set real rates below the lowest natural rate in the region when the intention is to implement an expansionary monetary policy. This has especially been so in recent years, when the ECB has had to assume the full weight of counter-cyclical economic policy in the face of a lack of cooperation in fiscal policy.

⁶ Brand, Bielecki and Penalver (2018).

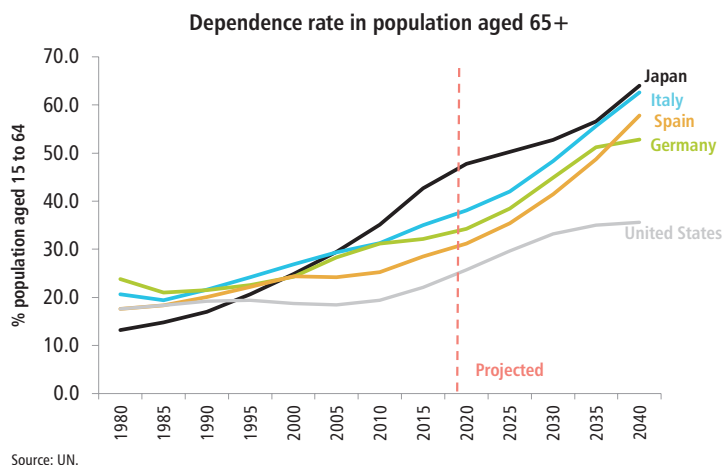


Third, the major developed central banks lowered nominal interest rates to around 0% to counteract the effects of the 2008-09 financial crisis and later lowered them even to negative levels in cases such as EMU, Denmark, Switzerland and Sweden. This is the clearest condition of “Japanization” that economies are currently replicating. While nominal rates around 0% or slightly lower are a recent phenomenon that stems from the global financial crisis, interest rates have been gradually falling throughout the developed world since the 1990s. In the case of EMU, after last September’s move, the deposit facility is at -0.5%.

Finally, although inflation remains low (at least below the target of the various central banks) in most developed economies, none has seen protracted deflation, as in the case of Japan. Some EMU economies even had months of negative inflation (notably Spain and Italy in 2014-16) and financial markets came close to price in that deflationary scenario for the euro area in 2014. However, in the end, this was a risk that did not quite materialise. In fact, in recent years, trend inflation in EMU was just over 1%, according to our estimates and those of the ECB itself - far from the 2% target, but also far from posing a real risk of deflation.

Other - structural - factors make the euro area similar to Japan, such as the aging of the population. The dependency rate of the population over 65 years of age is rising in Europe and, according to current UN projections, is set to skyrocket in the next few years, posing an additional challenge by putting pressure on the welfare states of European countries. By 2040, the over-65 age cohort will equal about 60% of the 14-to-64 age cohorts in countries such as Italy or Spain (compared to 30%-35% today, figure 9). By 2060, both life expectancy and the dependency ratio in countries like Spain, Italy and Germany will be very similar to that of Japan. This problem does not exist in other developed economies: in the United States, the dependency rate is expected to rise in the coming years (35% in 2040 compared to 22% today), but will not soar as in Europe.

FIGURE 9: DEPENDENCY RATE



Therefore, the situation in EMU clearly resembles “Japanization”, as the past decade has seen a fall in potential growth, a decrease in the natural rate of interest and intensive use of conventional monetary policy tools. The main difference is that only Japan has undergone a protracted period of deflation. The trend in inflation is also downward in all countries, but Japan remains an outlier.

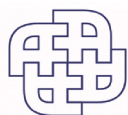
However, in the case of the EMU, with very wide structural differences between countries, not only should the risk of “Japanization” be assessed in the whole region, but also a further step should be taken and an assessment made of which countries are now most likely to suffer Japan’s fate.

Ito (2016) introduces the concept of a “Japanization” index that summarises the variables that define this state of affairs as a single indicator, constructed as the arithmetic sum of output gap, inflation and nominal interest rate.⁷

“Japanization” index (J) = differential of nominal v potential GDP ($g-g^*$) + inflation (p) + nominal interest rate (i)

The lower the index, the closer the economy is to a state of “Japanization”. If the index is negative, the economy has entered a state of “Japanization” (or at least the risk of it is extremely high). According to the author, an economy growing at its potential rate (output gap equals zero), with inflation around 2% per year and an interest rate at 4% would be in an ideal situation. Therefore, he considers an index value of 6 as consistent with an economy in a “sustainable state”. However, following the last turn of the ratchet by central banks in the use of unconventional measures, the structural change in interest rates over the last three years suggests that the long-term “equilibrium” interest rate

⁷ Takatoshi Ito (2016).



would be closer to 2% than 4%, which would imply achieving a “sustainable” economic state when the “Japanization” index remains above 4.

FIGURE 10: JAPANIZATION INDEX

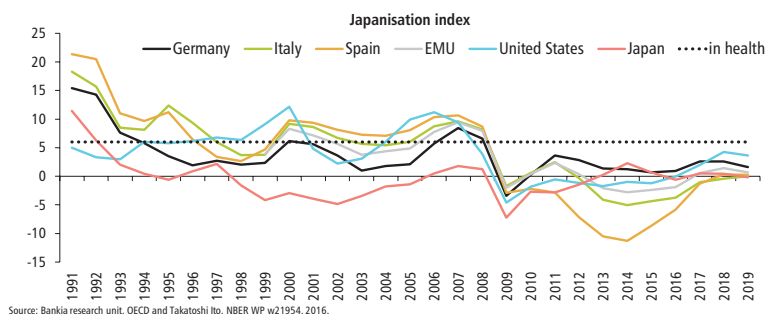


Figure 10 shows the estimated “Japanization” index for Germany, Italy, Spain, EMU, the United States and Japan. For its construction, the OECD’s output gap estimates were used, for inflation rates the databases of the statistical offices of each economy were used, and for nominal interest rates the data available from central banks were used.

First, of course, the standout trend is Japan’s, whose index fell below 6 at the beginning of the 1990s and entered negative territory in 1998. Although Japan improved sporadically in 2007-08 and 2014-15, in recent years its index remains close to zero. Secondly, the performance of the rest of the economies considered is striking: almost all of them started from a situation contrary to “Japanization” at the turn of the century (levels above 6) and began to worsen after the global financial crisis and, more clearly in the case of EMU, on the occasion of 2012-13 sovereign debt crisis. In fact, at present, the “Japanization” index is only slightly above zero in the case of Japan and Italy.

In the case of the United States, the average index between 1990 and 2007 remained in the sustainable state situation (around 6), but fell definitively below 6 from 2007 onwards. From 2009, it reached a situation close to “Japanization”, and then recovered after 2016. Now, with inflation at around 2% and a positive output gap, it seems that the risk of “Japanization” has passed.

This risk seems to be clearer among EMU economies, especially in the non-core or “peripheral” economies, which were harder hit by the debt crisis. In the case of Spain, the index hit bottom in 2014, reflecting an output gap that became sharply negative between 2014 and 2016. The situation in Italy was similar, although it did not experience as much of a negative output gap as Spain and hence the “Japanization” index did not reach such an extreme reading. However, the strong recovery of the Spanish economy closed the output gap and returned the index to positive territory in the past few years, while the scant growth of the Italian economy held the index down at close to zero. Germany, for its part, experienced “Japanization” for just a single year (the index was



negative only in 2009), but dipped below "sustainable" status (6) several times over the past few decades. This is explained by inflation below 2% for most of the years analysed and, in the period 1993-2005, by growth below potential.

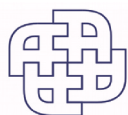
Hence the crisis placed all the major economies (perhaps with the exception of Germany) at risk of "Japanization". None of them, except for the United States, has returned to normal, while perhaps the most worrying case is Italy. The risk is asymmetrical in Europe, with some peripheral countries in the danger zone: this accounts for the tenor of monetary policy in Europe in recent years.

4.5. WHAT CAN BE DONE TO WARD OFF THE RISK OF "JAPANIZATION"?

The history of "Japanization" is one of a sharp economic and financial shock that combined with major structural changes in the economy (such as demography). Misdiagnosis by the economic authorities and an inadequate set of economic policies made the problem even worse. Almost three decades later, however, there is no consensus as to whether structural factors were more decisive in bringing about stagnation than a mistaken policy mix. The difference lies in the importance accorded to demographic change as the source of all ills, given its effects in the form of overcapacity and deflation. If population aging were really the key factor, then the two dozen countries in the world with demographic trends similar to Japan's would be facing a similar process of structural deterioration.

However, the majority opinion is that economic policy mistakes in the early 1990s entrenched the problems as a chronic malaise. Those mistakes can be summarised as: (i) a timid monetary policy response when the crisis started; (ii) an inadequate and untimely fiscal response, such as the VAT hike in 1997; and (iii) a banking crisis addressed only late and hesitantly.

The reality is that the Nikkei reached its highest point ever in December 1989 and a year later had lost almost 50% of its value. Even today, three decades on, it is still trading almost 40% below its highs. Real estate lost almost 90% of its value and today the price of residential land in the 6 major Japanese cities is well below the levels of 30 years ago. This gives an idea of the magnitude of the bubble that arose from 1975 to 1989. Therefore, although the debate focuses on the mistakes of economic authorities after the financial shock, it would perhaps be just as relevant to look at inadequate economic policies before the crisis. The BoJ lowered interest rates in the second half of the 1980s to curb the appreciation of the yen, which caused the economy to overheat; this was particularly intense from February 1987 to May 1989, when the BoJ kept interest rates at record lows, despite the exponential rise in land prices and the residential sector. When, in May 1989, the central bank began to tighten monetary policy (interest rates rose from 2.5% to 6% in just over a year), it was too late to redress the financial instability that had been created. Moreover, once the adjustment of stock exchange and real estate prices began, the restrictive approach was kept up to help correct previous excesses. So, first, action was taken too late to curb financial instability, and then the potential effects of the adjustment in real estate and share prices on banks' balance sheets, once the bubble had



burst, were not properly considered.⁸ This was perhaps because the initial adjustment of GDP and inflation was very mild, given that both activity and prices continued to grow at rates of over 2% until the summer of 1992.

Interest rates began to fall only when a further price correction in the housing market ended up abruptly slowing down GDP in 1992. But, by that stage, the impairment of assets on banks' balance sheets was already very severe. Property developer defaults affected financial sector delinquencies and hurt capital ratios very quickly. The solvency difficulties of the financial sector following the bursting of the bubbles were underestimated. It was from 1995 onwards that interest rate cuts accelerated (to 0.5%) and fiscal policy intensified its markedly expansionary stance, with tax cuts and increased public spending.⁹ In addition to the exponential increase in government debt, government spending programmes faced two challenges: low profitability, as infrastructure projects concentrated in rural areas due to political pressures, and adverse effects on private investment ("crowding out").

The economy recovered in 1996 (growth of over 2%), but in 1997 it was decided to raise indirect taxes on consumption (VAT) from 3% to 5%, in addition to increasing social security contributions. From then on, the toughest stage of the crisis began, as banks such as Hokkaido Bank, Yamaichi Securities and Sony Securities started to go bankrupt in the autumn of that year.¹⁰ At that time, a plan to restructure the financial system had to be improvised, which involved capital injections in 1998 and 1999 and a mechanism for bank resolution. Moreover, the central bank lowered official rates to zero (zero interest rate policy or ZIRP), although deflation kept real interest rates in positive territory at all times. Finally, in 2001, the Bank of Japan pioneered "quantitative easing" by buying short-term Treasury bonds.

So we had to wait almost twelve years from the onset of the crisis to see a full activation of economic policy tools, both conventional and unconventional. In fact, it was only in January 2013 that the inflation target was raised from 1% to 2%. The official interest rate is currently at -0.1%, 10-year debt is trading at -0.10% (2019 average, through November) and the BoJ has a debt purchase target of \$740 million per year. Furthermore, after the last Board meeting the "forward guidance" indicates that interest rates will remain at these levels "or lower" until inflation approaches 2%. The possibility is therefore opening up of deepening the negative interest rate zone, which had been ruled out until now - yet another example of how slow economic policymakers are to use all the degrees of freedom at their disposal. Finally, it is only in recent years that structural reforms were sped up, such as incentives to increase women's involvement in the labour market or changes in codes of good governance for businesses and the public sector.

⁸ In March 1990, measures were put in place to limit loans to property developers. This ended up worsening the price adjustment.

⁹ Between August 1992 and November 1999, nine government spending programmes and six tax reduction packages were announced.

¹⁰ Some Japanese economists consider this to have been the "Lehman moment" of Japan's crisis.



To analyse whether this risk of "Japanization", which is still present in part of the euro area, will become chronic, we must therefore review European economic policy response in recent years on the three fronts discussed above. As in the case of Japan, one could argue that the economic authorities did not react quickly enough. Especially since the countries most affected by the sovereign debt crisis were unable to implement as aggressive a fiscal policy as that of Japan to combat private sector deleveraging in a context of high fragmentation. But, since the summer of 2012, things started to change when the ECB put an end to speculation about a break-up of the euro area. Practically all degrees of monetary policy freedom have since been deployed, using both conventional and non-conventional instruments. At present, the deposit facility rate is at -0.5% in EMU, and the ECB's balance sheet size has almost quadrupled, topping 40% of the euro area's GDP. In fact, the real interest rate is below the lowest natural rate in the euro zone (Italy), as we mentioned in the previous section.

The key question is whether that margin for manoeuvre is exhausted or not. The limits of monetary policy, once the threshold of zero interest rates is crossed, have been the subject of academic debate in the past few years. The question is, are unconventional measures effective? The added difficulty here is that not even in Japan that not even in Japan (nor in the United States), where the natural rate of interest has been negative for almost two decades, has the central bank dared to venture deeper into negative interest rate territory. Data is therefore restricted to the ECB and the central banks of countries such as Switzerland, Denmark and Sweden.

All this means that it is very hard to test whether the transmission mechanisms of monetary policy still work once the zero lower bound is breached. Some studies stress that the transmission channel of unconventional measures through credit is broken by an interest rate, since from that point onwards additional rate cuts have practically no effect on the credit channel (neither on volume or on price).¹¹ Other analysts conclude that banks offset the fall in prices with higher volumes, lower wholesale financing costs and even efficiency improvements.¹² What does seem clear, however, is that unconventional monetary policy seems to be more effective in situations of financial stress than when deflationary pressures are entrenched and the economy is in the zero-rate zone for an extended period.¹³

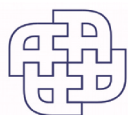
The ECB itself suggests that the monetary policy transmission mechanism continues to operate when central bank interest rates are below 0%, and banks pass negative rates on to corporate deposits.¹⁴ It is generally believed that deposit rates will not fall below zero, as customers would prefer to accumulate cash. This restriction may be more significant for households, who hold small deposits that can be easily withdrawn and held in cash. However, companies cannot readily carry out their business without deposits, and it is complicated and expensive to store large amounts of cash.

¹¹ Eggertsson & Summers (2019) place the threshold at -0.4%.

¹² Madaschi & Pablos (2017).

¹³ Dell'Ariccia, Rabanal and Sandri (2018).

¹⁴ Altavilla, Burion, Gianetti, Holton (2019).



Hence the ECB allows that there may be a limit to charging for household deposits, but, as has been the case in Germany, the Netherlands and Spain since the beginning of 2019, banks can always charge for corporate deposits. However, the potential 2019 transmission channel seems limited, given the share of corporate deposits in total deposits in countries such as Italy (16%), Germany (17%) or Spain (19%). In fact, the ECB acknowledges that, in the European aggregate, only 5% of deposits are in a negative zone (20% of total corporate deposits). This is insufficient to influence the cost of funding in most European countries.

Furthermore, the ECB relies on the idea that the effectiveness of monetary policy arises from the “corporate channel”, since companies, in response to negative deposit rates, would, in theory, rearrange their balance sheets, reducing the weight of current assets in favour of long-term investment, thus boosting the real economy. However, given the role of expectations in investment decisions and current levels of uncertainty, it is hard to see how the balance sheet rearrangement effect could be significant. Finally, the evidence is only valid for what the ECB considers to be sound banks: those with low NPL ratios (bad loans) and low risk premiums as measured by CDS (credit default swaps, a form of insurance against default). Healthy banks can apply negative rates without sustaining deposit outflows in a context of high demand for safe assets. However, when economic agents do not trust the banking system (weak banks), monetary policy is limited by the “zero lower bound”. The difficulty is that this is more likely to happen in countries less affected by a sovereign crisis. This can be a real problem, since the EMU banking system is still bedevilled by core/periphery fragmentation. This calls into question the whole spirit of ECB’s “one-size-fits-all” monetary policy for the whole region, as it could be that those countries least in need of an expansionary monetary policy would benefit more and, conversely, that weaker countries would even be harmed if interest rates were to be lowered further. If we factor in the side effects that, as the ECB itself acknowledges, the negative interest rate policy is causing, there are more doubts than certainties when it comes to further easing monetary policy.¹⁵ Especially if financial stability is genuinely important for central banks in the twenty-first century.

We are already moving along the razor’s edge of monetary policy effectiveness in EMU. The ECB can be blamed for mistakes at the onset of the crisis, but not for having procrastinated during Draghi’s tenure. Perhaps the discussion we need to engage in from now on is whether inflation targets designed for a very different world and economy from today’s can still make sense. The review of the strategy for monetary policy in Europe may be the first important contribution of the new President of the ECB.

Mario Draghi bade farewell to the ECB at the end of November with a plea for a more expansionary fiscal policy in the euro area. He advocated the creation of a common, suitably designed and sized fiscal instrument that does not bring about “moral hazard”. In this case, therefore, we are discussing not only whether the tone of fiscal policy has been appropriate, but issues of institutional design in the euro area. The reality is that

¹⁵ This would also explain the change in market expectations in recent months.



the average structural public deficit in the euro area between 2010 and 2014 was -2.4% of GDP. Stringent fiscal adjustment brought it down to -0.9% by 2015. Since then it has ranged from -0.8% (2018) and -1.0% (2016 and 2017), to end this year at -1% of GDP.¹⁶ So seems that sharply restrictive tenor of fiscal policy in the wake of the sovereign debt crisis has loosened in recent years. In fact, the problem is that, according to European Commission estimates, countries such as Italy (-2.4%), France (-2.6%) and Spain (-2.9%) have structural deficits that restrict the scope of fiscal policy. Hence all eyes are on countries that have structural surpluses such as Germany (1.1%) and the Netherlands (0.7%), precisely those most reluctant to use their fiscal room for manoeuvre, despite having public debt ratios below 60%.^{17, 18} These are also the countries most opposed to the creation of an anti-cyclical instrument in the euro area, which will start in 2021 with a modest contribution of 17 billion euros.

In the meantime, we are still waiting for the creation of a risk-free sovereign asset in the euro area that will avoid the current competitive disadvantage against other monetary areas. The existence of a Eurobond is the necessary condition to achieve a decisive step forward in the process of European integration and solve problems such as adverse spirals between banking and sovereign risk.¹⁹ Therefore, although in Europe the debate on the need for fiscal policy to regain more prominence remains open, the truth is that there are still obstructions to institutional design that should already have been removed in recent years. Probably the greatest obstacles to taking that final step remain the same: lack of a clear and simple framework of fiscal discipline, and a large volume of non-performing assets burdening the banking systems of European countries.

That would be the latest economic policy mistake in Japan, which was to face a banking crisis late and timidly. As we have said before, an adequate response only emerged in late 1997. In Europe, in the wake of the sovereign debt crisis, it was felt that capital levels should be raised, the supervisory framework strengthened and, eventually, the clean-up of unproductive assets in the financial sector accelerated; in short, the mistakes of Japan should be avoided. The total capital ratios of EU banks have increased significantly over the last ten years, marking an average of 18.89% in the second quarter of 2019, compared to just under 13% in 2009, according to data released by the European Banking Authority (EBA). This increase of nearly seven percentage points is partly a reflection of the efforts made by the sector to generate and attract more equity, mainly in the form of high quality capital, in addition to reducing risk exposures on the balance sheet by disposing of distressed assets, simplifying business lines and withdrawing from non-core activities in a context of global deleveraging. In terms of ordinary tier 1 capital or CET1, the average EU ratio stood at 14.64% in mid-2019, its highest level since 2014, the first year of

¹⁶ European Economic Forecast (2019), European Commission.

¹⁷ The German Constitution prohibits structural deficits of more than 0.35% of GDP except in times of crisis, which would mean a margin of no more than €10 billion per year.

¹⁸ In some cases, the public debt ratio is clearly lower, as in the Netherlands (49% of GDP).

¹⁹ Penalising domestic sovereign debt portfolios is certainly not the most advisable solution, especially in times of intense uncertainty and therefore fragmentation.



application of Basel III under the CRR/CRD IV Directive. The banks in the sample with CET1 levels above 14% account for 48% of total assets (19.7% in 2014), banks with CET1 levels between 11% and 14% account for 51.5% of total assets (39.3% in 2014), while the share of assets of institutions with CET1 levels below 11% is only 0.5% (41.1% in 2014), reflecting the significant change that has taken place.

TABLE: SOLVENCY AND NPLS IN EMU

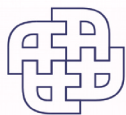
	Threshold	2014-12	2015-12	2016-12	2017-12	2018-12	2019-06
CET1 ratio	>14%	19.7%	22.4%	34.3%	52.7%	42.1%	47.9%
	[11%-14%]	39.3%	73.2%	61.2%	47.0%	57.2%	51.5%
	<11%	41.1%	4.4%	4.6%	0.3%	0.7%	0.5%
NPL ratio	<3%	34.4%	35.9%	39.5%	60.5%	67.3%	74.0%
	[3%-8%]	42.6%	50.2%	47.3%	28.5%	29.6%	23.1%
	>8%	23.0%	13.9%	13.2%	11.1%	3.2%	2.9%
Coverage ratio	>55%	9.3%	10.1%	16.9%	9.3%	15.1%	14.2%
	[40%-55%]	56.0%	50.0%	43.7%	51.6%	51.1%	53.2%
	<40%	37.7%	39.9%	39.4%	39.1%	33.7%	32.5%

Source: EBA

The only thing that can be blamed on the European authorities is a certain slowness in dealing with the problem of non-performing assets, which came to account for 6.7% of total EU credit in September 2014, when their volume reached €1.13 trillion. Since then, the stock of NPLs has almost halved (to €636 billion in June 2019), and represent 3.0% of the current loan portfolio. This proportion falls to less than 2% when coverage with specific provisions is considered, which is 46%. Institutions with NPLs above 8% account for 2.9% of total European assets (23% in 2014). Despite the progress made, the ratio is still high in historical terms, supporting the general view that, in terms of financial restructuring, EU banks must make an extra effort to cope with a change in the business cycle on a strong footing. For example, in other systems that also suffered from the crisis, such as the United States, non-performing loans are already at normalised values, below 1%.

To gain an overview of the financial restructuring process carried out in addition to NPL management, we should also consider the measures implemented to address other deficient portfolios such as refinancing and asset foreclosures, which in some countries took on enormous importance during the crisis. In the case of refinancing (NPL and performing), its weight in the credit portfolio of European banks, at a consolidated level, decreased from an average of 4% in December 2014 (nearly €700 billion) to the current 1.9% (some €400 billion in June 2019), which means portfolios carry more than €300 billion of refinanced loans.

Though timing could clearly have been better, it can nonetheless be said that the European economic authorities learned from the mistakes made in Japan. Above all, in monetary policy and strengthening the solvency and liquidity of the financial sector, steps were taken in the right direction, even with the doubts that remain about the



effectiveness of the transmission channels of monetary policy once interest rates are negative. The profile and contribution of the fiscal side to countercyclical policies is much more debatable, especially since the degrees of freedom are concentrated in countries that are highly critical of the current mechanism of fiscal discipline in the region. In addition, there are still shortcomings in the region's institutional design, such as the lack of a Eurobond or a fiscal aid mechanism large enough for countries undergoing difficulty in the event of a crisis.

The problem is that, as we said before, the risk of "Japanization" is not uniform across the region and, while monetary policy seems to be adapted to the needs of the country in the region that has the most problems (Italy), fiscal policy still has many weaknesses (institutional design, coordination, firepower, etc.) to address regional problems. That is the challenge for the next few years: to move forward with the single fiscal policy, to complete the banking union and to speed up the clearing of non-performing assets from banks' balance sheets.

4.6. CONCLUSIONS

"Japanization" is an extreme state of the economy characterised by chronic low growth alongside a general downward trend in prices. In this context, there is no conventional monetary policy capable of stimulating the economy, as the real rate of interest exceeds the natural rate of interest.

An economy is considered to be in a state of "Japanization" if each of the following conditions is satisfied: a protracted and significant reduction in growth potential, a negative natural rate of interest, a zero interest rate policy and a trend decline in the general price level.

The situation in EMU clearly resembles "Japanization", as the past decade has seen a fall in potential growth, a decrease in the natural rate of interest and intensive use of conventional monetary policy tools. The main difference is that only Japan has undergone a protracted period of deflation. The trend in inflation is also downward in all countries, but Japan remains an outlier.

Hence it can be argued that the crisis placed all the major economies (perhaps with the exception of Germany) at risk of "Japanization" at some time during the past decade. None of them, except for the United States, has returned to normal, while perhaps the most worrying case is Italy. The risk is asymmetrical in Europe, with some peripheral countries still in the danger zone, which accounts for the tenor of monetary policy in Europe in recent years: closer to the needs of Italy, where the natural interest rate is lower than that of the other main economies in the region.

In Japan, we had to wait almost twelve years from the onset of the crisis to see a full activation of economic policy tools, both conventional and unconventional. Part of the difficulty experienced by the country stemmed from the delay in and inadequacy of economic policy responses at three levels: (i) a timid monetary policy response when the



crisis started; (ii) an inadequate and untimely fiscal response, such as the VAT hike in 1997; and (iii) a banking crisis addressed only late and hesitantly.

From a European perspective, while monetary policy seems to be adapted to the needs of the country in the region that has the most problems (Italy), fiscal policy still has many weaknesses (institutional design, coordination, firepower, etc.) to address regional problems. That is the challenge for the next few years: to move forward with the single fiscal policy, to complete the banking union and to speed up the clearing of non-performing assets from banks' balance sheets. Measures in this direction, together with policies that address structural challenges (low productivity, aging population, etc.) are the best medicine for dealing with the risk of "Japanization".

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5. FACING THE LOWER BOUND: WHAT WILL THE ECB DO IN THE NEXT RECESSION?

ALIÉNOR CAMERON, GRÉGORY CLAEYS AND MARIA DEMERTZIS (BRUEGEL)¹

5.1. ABSTRACT

In responding to the global financial crisis and its aftermath, the ECB has pushed its monetary policy into uncharted territories over the past decade. Today, it appears increasingly constrained by persistently low interest rates and the uncertainty of the environment it operates in. This paper seeks to understand these new challenges and assess whether its current toolkit will allow the ECB to weather the next European recession. We make five key recommendations: first, the ECB must find a way to mitigate the potentially negative effects of its negative interest rate policy; second, it must rethink the issuer limit on its asset purchase program; third, a review of its monetary policy framework is in order; fourth, it must be fully prepared to use its outright monetary transactions (OMT) program; and finally, more innovative unconventional policies might be necessary.

Keywords: ECB; monetary policy; negative interest rates; zero lower bound; quantitative easing; recession; euro area

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5.2. INTRODUCTION

In responding to the global financial crisis and its aftermath, the European Central Bank (ECB) had to push its monetary policy into uncharted territories. In the last decade it has expanded its toolbox significantly with the introduction of negative rates, generous refinancing operations for banks, forward guidance, large-scale asset purchases, and tools to restore the transmission mechanism in all EMU countries.

As a result, the situation has improved in the euro area: deflation risks have abated, the economic recovery that started in mid-2013 has accelerated, investment has picked up, and unemployment has fallen considerably in the euro area as a whole.

However, since mid-2018, signs of deceleration have been piling up, as the euro area has been heavily affected by global trade tensions. Major euro-area countries, including Germany and Italy, might already be in a technical recession. After peaking at around 2% at the end of 2018, headline inflation has decelerated in recent months, market expectations have decreased to near their lowest historical levels, and core inflation is still stuck close to 1%. In addition to this cyclical challenge, it remains unclear what the ‘new normal’ of the post-crisis period really looks like, and how the ECB’s new and more traditional tools will fare in it.

Therefore, the most important question today is whether the ECB’s updated toolkit will be sufficiently robust and well-calibrated to fend off a new European recession.

One major issue is the impact that “low-for-long” (or even negative) interest rates will have on the economy. The ECB might not be able to indefinitely cut its policy rates without reaching a lower bound under which the transmission channel breaks down and its policy rates end up having an overall contractionary effect. Whether this threshold has already been reached is a point of contention, but it is clear that even if it has not, the ECB might be approaching it.

Its most traditional instrument being constrained, the ECB has, since 2007, increasingly had to rely on unconventional policies to stimulate economic growth and to bring inflation back towards 2%. Due to their relative novelty, the effects these instruments have on the economy are still uncertain and their calibration is more difficult, especially now that government yields are already very low. Moreover, after restarting its sovereign debt purchases in November 2019, the ECB will very soon face its self-imposed limit on this crucial unconventional tool.

This means that its two most important tools to face recessions and deflationary pressures – rate cuts and quantitative easing – could become insufficient in the next crisis.

Beyond these constraints weighing on its main instruments, other factors of uncertainty might also impact the transmission of the ECB’s monetary policy to the real economy. These include the possible weakening of the link between unemployment and inflation (i.e. the Phillips curve) as well as the remaining incompleteness of the EMU. Beyond that, the thread of reversing globalization and indeed the digital transformation further complicate our understanding of the “new normal” that policy makers will be asked to manage.



The ECB will thus have to put in place a systemic approach to manage this uncertainty, by designing monetary policies which are flexible enough to produce good outcomes given a variety of unpredictable circumstances. Communication will be crucial for the ECB to manage expectations and achieve its objectives.

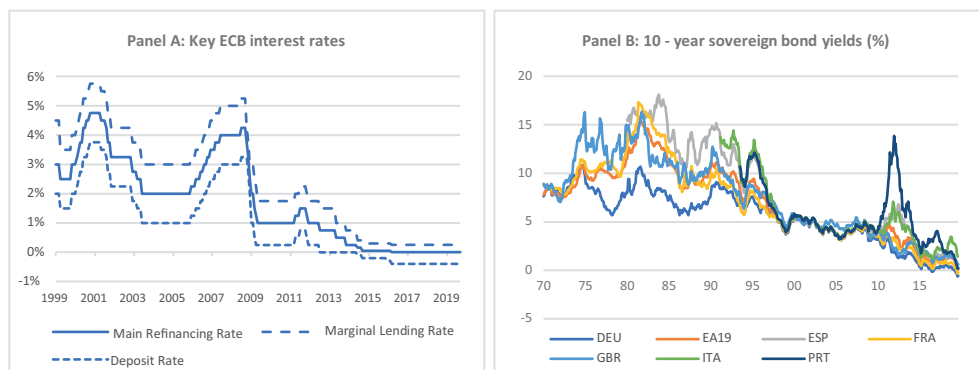
To this end, we make five key recommendations for the ECB to better prepare itself in the case of a new European recession: first, it must find a way to mitigate the potentially negative effects of its negative interest rate policy (NIRP); second, it must rethink the current issuer limit on its asset purchase program (APP); third, a review of its monetary policy framework is in order; fourth, it must be fully prepared to use outright monetary transactions (OMT); and finally, it should be ready to be innovative again if its current toolkit is insufficient.

5.3. UNDERSTANDING THE ZERO LOWER BOUND (ZLB) AND OTHER FACTORS IN THE BREAKDOWN OF CONVENTIONAL MONETARY POLICY TRANSMISSION

5.3.1. *PERSISTENTLY LOW RATES: WHY HAS THE ZLB BEEN REACHED?*

In a bid to provide more favorable financial conditions to support the recovery and bring inflation back towards 2%, the ECB has gradually lowered its short-term interest rates over the past decade, all the way down to the historically low levels observed today (Figure 1, panel A). This trend reached a tipping point in 2014, when the ECB pushed its deposit rate into negative territory. Since then, this rate has continued on its downward path, with the ECB's most recent policy change lowering it by another 10 basis points to its current level of -0.50% in September 2019. The central bank's two other key interest rates, the main refinancing rate and the marginal lending rate, followed this trend and are currently set at 0% and 0.25%, respectively. All three key rates have now been far below their long-term average for a significant period of time, with little perspective of being pushed back up in the near future. In parallel, a recent decline in long-term sovereign bond yields in the euro area has occurred (Figure 1, panel B) resulting in a flattened yield curve.

**CHART 1: ECB KEY INTEREST RATES
AND 10-YEAR SOVEREIGN BOND YIELDS**



Source: Bruegel based on OECD Statistics and Bloomberg

As the euro area's rate-setting authority, the ECB could easily be held fully responsible for the downward trend in long-term interest rates over the past two decades. However, the story is not quite so clear-cut. A growing literature points to other, more systemic factors which could be driving long term rates down. The main argument relies on the concept of the neutral interest rate², defined as the equilibrium rate compatible with full-employment and price stability. This rate points to a level of the real interest rate at which monetary policy neither stimulates nor restrains growth. This makes it an important guide for monetary policy. As such, central banks cannot be held solely responsible for the current level of long-term real interest rates.

The question then becomes twofold: what are the driving forces behind the neutral rate and what is its current value? Answering these questions is key in determining whether the current level of interest rates is justified by underlying dynamics outside of the ECB's control or if it is distorted by the Central Bank's policies. The latter situation could result in a distortion of the allocation of resources and produce harmful side-effects. However, the crux of the problem is that the neutral rate of interest cannot be directly observed. Historical averages of real rates do not help estimate its value either, as these could be influenced by distortionary monetary policy or other exogenous shocks. As such, estimating the neutral rate has become the focus of a significant strand of economic literature.

Theory states that the neutral rate is mostly determined by the saving behavior of households and the potential growth rate of an economy – which is itself largely determined by productivity and population growth trends. A range of models have emerged from the literature to explain how these long-run structural determinants affect the neutral rate³. Many empirical approaches have also been proposed, the most common of

² First introduced by Wicksell (1898), this concept has cropped back up in the economic literature a century later in New Keynesian models, led by Woodford's (1998) seminal work.

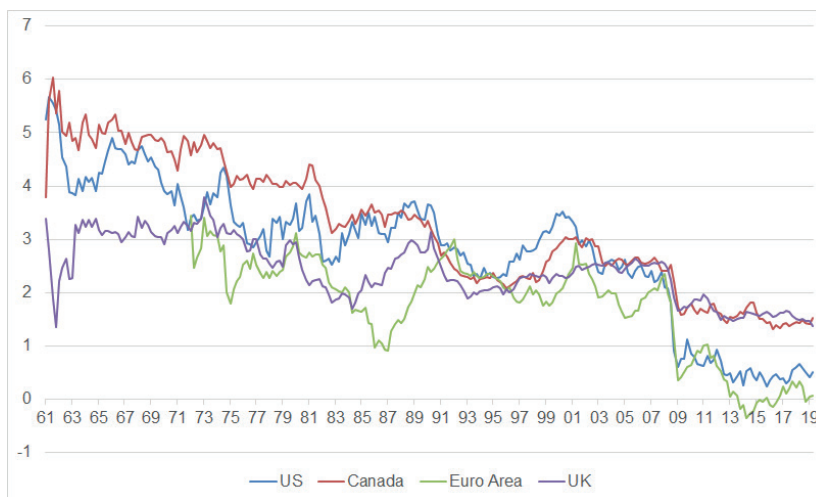
³ For instance, the simple Solow model (1956) considers the saving behavior of households to be fully

which are semi-structural models and full DSGE models. Brand, Bielecki and Penalver (2018) give a comprehensive review of the ways in which these have been used in the literature and point to the fact that most models, despite having different underlying assumptions and dynamics, find that the neutral rate of interest has been declining since the 1980s and that the euro area's neutral rate is likely below the 0% threshold today.

An example of such a study is that of Holston, Laubach and Williams (2016), whose main results are reported in Figure 2. Using a semi-structural model to filter data on output, inflation and short-term interest rates, the authors extract highly persistent components of the neutral rate of output, its trend growth rate and the neutral rate of interest in the US, Canada, the UK and the euro area. Based on this, they have two main findings. First, the neutral rate has a clear downward trend starting in the 1960s and picking up speed after 2008. Second, and perhaps even more significantly, there is a substantial co-movement across the four economies they study, suggesting that global factors may be of prime importance to explain these trends.

Though informative, these estimates are still subject to much uncertainty due to their high levels of volatility and significant confidence intervals. They should certainly not be used as real-time direct targets for monetary policy, but instead should be taken into account as an important indicator, among many others, for long-term structural and cyclical factors affecting the real rate of interest.

FIGURE 2: NEUTRAL INTEREST RATE ESTIMATES (IN %)



Source: Holston, Laubach & Williams (2017), updated in 2019.

exogenous, making technological change and population growth the only drivers of the equilibrium rate. On the other hand, micro-founded models like the Ramsey model or New Keynesian models take household preferences into account, along with population and productivity growth, to determine the long-run equilibrium rate. More sophisticated models like that of Eggertsson and Mehrotra (2015) even model changes in preference as households transition from borrowing to saving over their lifecycle, or as inequalities increase.



With this in mind, some argue that Hansen's (1939) secular stagnation hypothesis can largely explain this gradual decline in neutral rates. What he described as a "*sick recover[y] which [...] leave[s] a hard and seemingly immovable core of unemployment*", characterized by a combination of low capital formation and a high savings rate, was driven, in his view, by low population growth and the absence of new territories or techniques to invest in. Though he was ultimately proven wrong due to the increased government spending during the second world war, as well as the post-war recovery, the baby boom and a new wave of innovation, this hypothesis has been brought back to life following the Great Recession by Summers (2013) and Krugman (2011, 2013a, 2013b).

The secular stagnation hypothesis is appealing because it provides a good explanation for the slower recovery of post-crisis US, Japanese and European economies, compared to other post-war recoveries. Chronically-low interest rates, subpar growth and below-target inflation are not seen as characteristics of a cyclical economic downturn which will eventually and automatically be reversed, but rather as part of a "new normal" economic environment. These potentially permanent changes are driven by structural factors such as low aggregate demand and a chronic excess of savings over investments. Eggertsson *et al.* (2019) seek to quantify this phenomenon by building an overlapping generations model in which households change savings behavior throughout their life cycle. Their main finding is that reductions in fertility, mortality and the rate of productivity growth play the largest role in the secular decline of the real rate of interest while increased government spending can be the most important counterbalancing force to these factors.

While there is still some debate over the relevance of the neutral rate hypothesis and its estimation, one conclusion which can be drawn fairly unequivocally is that irrespective of their exact underlying reasons, the chronically low levels of the interest rate observed today is constraining conventional monetary policy. As a result, the ECB has to increasingly rely on unconventional monetary policy, for which calibration is much more difficult and whose effects are more uncertain.

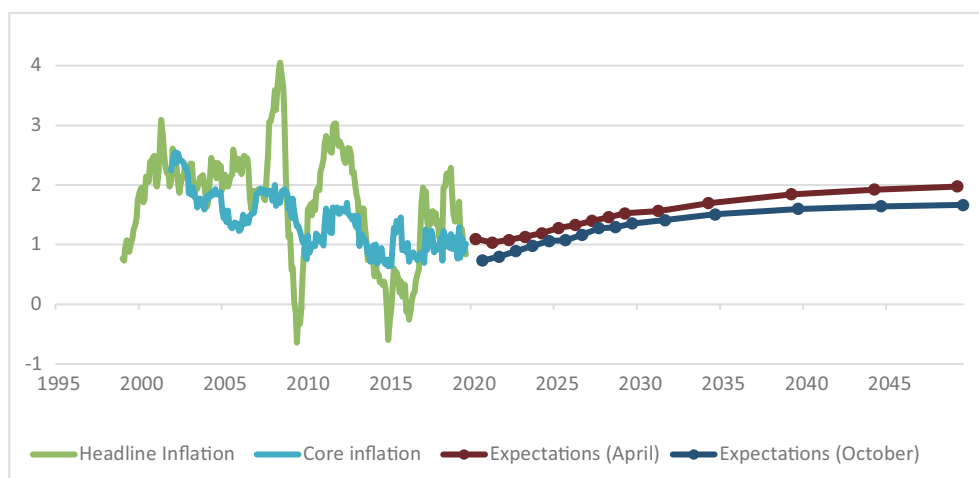
5.3.2. DETERIORATED ECONOMIC CONDITIONS IN AN UNCERTAIN ENVIRONMENT

The ECB has been confronted with a multitude of other challenges than having to conduct monetary policy in the context of persistently low rates. These have significantly and permanently altered the economic environment in which it has operated for the past decade. The global financial crisis, the Great Recession and the euro crisis have successively increased the risk of deflation – especially after the 18-month long double-dip recession – and made it all the more difficult for the ECB to fulfil its mandate of maintaining price stability. The banking crisis and the sovereign debt crisis have also weakened or even fully broken-down monetary policy transmission channels in some euro-area countries as redenomination risks emerged.

There has also been a much more recent deterioration of economic conditions since mid-2018, attributable to several factors. For one, the euro area has become far more

vulnerable to external shocks due to its heavily export-based economy. As the world's largest and most open trading bloc, it has been greatly affected by global trade tensions (González et Véron, 2019). Additionally, as of its latest update from early October 2019, the Eurozone's PMI index is at its lowest value since June 2013, estimated to be barely greater than 50⁴. This indicates a situation of quasi-stagnation, with countries like Germany and Italy potentially already in a recession. The manufacturing sector's weak performance can partly explain these conditions, especially in Germany, but there are other factors such as the low levels of aggregate demand and the uncertainty linked to Brexit which have also contributed to the slow-down of economic activity. These heightened uncertainties are reflected in the recent decline of market inflation expectations, as shown in Figure 3. There is little faith that the ECB will bring inflation back up to its 2% target in the next 10 or 20 years. Perhaps more worryingly, inflation expectations have even dropped further since last April.

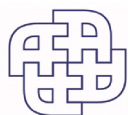
FIGURE 3: EURO-AREA INFLATION, CORE, HEADLINE AND MARKET EXPECTATIONS (YEAR-ON-YEAR %)



Source: Bruegel based on Eurostat and Bloomberg. Notes: Inflation expectations are derived from inflation zero-coupon swaps of different terms (1 year, 2 years, up to 10 years), which provide information on market expectations of average yearly inflation over the contract term. Expectations for 2020 inflation, for instance, are derived through expected inflation over the next year (2019), given by the 1-year swap, and expected inflation over the next two years (2019 and 2020), given by the 2-year swap. Expectations related to the Eurostat HICP excluding tobacco.

Another factor of uncertainty for monetary policy comes from the apparent weakening of the empirical relationship between unemployment and inflation captured by the Phillips curve. There have been discussions about the 'disappearance' or 'flattening'

⁴ 'IHS Markit Eurozone Composite PMI- Final Data'. IHS Markit, 3 October 2019. <https://www.markiteconomics.com/Public/Home/PressRelease/51de396b073d4d3889b1afe7b9a36872>.



of this curve for some years now, as the substantial variability in unemployment has not been mirrored in inflation, which has remained at relatively low levels. For instance, in France, contrary to what the Phillips curve predicts, lower levels of unemployment and higher wages have recently not translated into higher levels of inflation (Banque de France, 2019). The study attributes this to decreased company margins, a stronger euro, and the increase of the price of investment in construction, relative to that of consumption. In a similar study, the Bundesbank (2019) estimates that the elasticity of consumer prices to changes in wages is now close to one-third, meaning that a rise in the cost of labor is still somewhat being translated into higher inflation in Germany, though to a lesser extent than was previously the case. This phenomenon has two implications for monetary policy: first, the transmission mechanism of monetary policy to inflation seems weakened; second, to reach the same objective as before, monetary policy will have to be far more expansionary than it has been in the past.

Finally, the ECB is also in a particularly complex situation because it continues to operate in an incomplete monetary union. This implies a need for a higher level of adaptability than is the case for the Fed for instance, since a single monetary policy needs to be fit for 19 different economies. Given the multi-country nature of the monetary union and the fragmentation of governance, issues may also emerge regarding the coordination of fiscal and monetary policy or the timeliness of policy decisions.

All of these factors impact the way the ECB can conduct its monetary policy, and reinforce the constraint of the zero lower-bound on its policy rates. In the case of a new European recession, the ECB's instruments will need to overcome all of these challenges for it to effectively fulfil its mandate.

5.4. UPDATES TO THE ECB'S TOOLKIT TO FACE THESE NEW CONDITIONS AND CHALLENGES

5.4.1. *CHANGES TO THE OPERATIONAL FRAMEWORK AND NEW TOOLS SINCE 2007*

To answer the question of whether the ECB is prepared to face the next European recession, it is important to understand exactly what tools are currently at its disposal. Following the turmoil of the global financial crisis, the ECB expanded and diversified its toolkit to make up for the reduced space for its conventional policies and the deterioration of the economic conditions during and after the crisis. Over the course of the past 10 years, these changes – summarized in Table 1 – have been quite substantial.

One of the main ECB responses to the crisis has been to cut policy rates – as shown in Figure 1, panel A. This culminated with the introduction of a negative interest rate policy (NIRP) with the ECB dropping its deposit rate to negative values in 2014, when it was set at -0.10%. Since then, it has been cut a few more times below 0%, leaving little leeway for the ECB to further cut rates in the case of another recession. To highlight the gravity of this constraint, it is useful to remember that since the Second World War, the



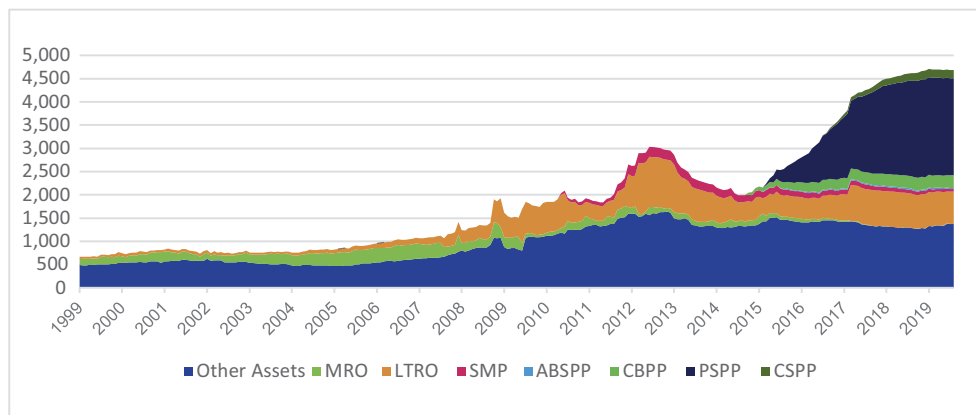
main central banks around the world (the Fed, the BoE, and the Bundesbank followed by the ECB) have cut their main policy rates by about 300 basis points on average when they faced economic downturns.

The NIRP was combined with the introduction of another unconventional policy: forward guidance, a formal commitment from the ECB to keep rates at constant or lower levels for an extended period of time. Since its first use in 2013, the ECB has fairly systematically employed forward guidance to give clear signals on the policy path decision-makers intend to follow in the medium term. Considering how constrained short-term policy rates currently are, forward guidance has become an alternative tool to influence long-term bond yields via future expected short-term rates, and reduce the volatility of market expectations for future policy rates. While the effects of these policies are subject to some discussion (see Haberis *et al.*, 2017 and Filardo and Hofmann, 2014 for relevant studies on the topic) there is a relative consensus over the fact that so long as the ECB maintains its credibility in the eyes of the market, its forward guidance will have an impact on market expectations.

In the realm of its open market operations, the ECB has made it easier for banks to access funding, turning its Main Refinancing Operations (MROs) into fixed-rate full-allotment tenders instead of variable-rate tenders in limited quantities as was previously the case. It also extended the maximum maturity of its Long-Term Refinancing Operations (LTROs), introduced Targeted LTRO programs in 2014, conditional on banks' net lending volume, and has extended the list of assets eligible as collateral several times since 2008. All of these measures have aimed to maintain favorable credit conditions and an accommodative monetary policy stance (in particular at the beginning of the crisis when there was the risk of a meltdown of the European banking sector).

The ECB introduced another major unconventional policy with its large-scale asset purchases. It successively implemented programs to buy euro-denominated covered bonds (CBPP since 2009), asset-backed securities (ABSPP since 2014), public debt securities (PSPP since 2015, also including supranational and locally-issued debt instruments) and corporate debt securities (CSPP since 2016).

As a result of these policies, its balance sheet went from being around 10% of euro area GDP in the early 2000s to over 40% in 2019. Figure 4 illustrates this significant increase in the size of the ECB's balance sheet since 2007, driven first by the increased role of (T)LTROS and in recent years by asset purchases. This has reopened a debate on the optimal size of a central bank's balance sheet, pitting arguments of potential risks of excess liquidity against the benefits of maintaining such a large balance sheet (see Claeys and Demertzis, 2017).

**FIGURE 4: ECB BALANCE SHEET, ASSETS (IN € BILLION)**

Source: Bruegel based on Bloomberg

Finally, the ECB also introduced tools to restore the transmission mechanisms of monetary policy. The first was the Securities Market Program (SMP), announced by the Governing Council in 2010, through which the ECB could directly intervene in the euro area's sovereign debt markets. In 2012, this was replaced by the announcement and specification of the Outright Monetary Transactions (OMT) program, which was never actually used but whose sole existence diffused the mounting tensions of a sovereign debt crisis by guaranteeing that the ECB would do “whatever it takes” to preserve the euro⁵.

All in all, the ECB's toolkit has proved to be quite flexible in the face of the worst crisis since the Great Depression, though sometimes adjusting at a slower pace than other central banks which do not operate in such a fragmented jurisdiction have done, such as the US Fed or the Bank of England.

⁵ European Central Bank. ‘Verbatim of the Remarks Made by Mario Draghi’. European Central Bank. Accessed 22 October 2019. <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>.



**TABLE 1. SUMMARY OF THE CHANGES
TO THE ECB'S TOOLBOX SINCE THE CRISIS**

	Instrument	Pre-crisis	Post-crisis	
Open Market Operations	Main refinancing operations	Variable-rate, limited quantity tenders, minimum bid rate set at 4.25% in 2007	2008	Fixed-rate, full-allotment tenders, interest rate set at 3.75%
			2016	Interest rate set at 0%
	Long-term refinancing operations	Maximum 3-month maturity	2008	Fixed-rate full-allotment tenders
				Increased length up to 3 years
			2014	Longer-term refinancing operations (LTROs) up to 4-year maturity
Standing Facilities				Introduction of targeted LTROs, conditional on net lending volumes
				Introduction of TLTRO I
			2016	Introduction of TLTRO II
			2019	TLTRO III: max. maturity of 3 years, with rate conditionally as low as the average interest rate on deposit facility during life of TLTRO III
	Collateral	-	2008	Extension of list of assets eligible as collateral
Reserve Requirements	Forward guidance	-	2014	Ex-ante announcement about rate level or use of unconventional policies:
	Deposit facility	Rate set at 3% in 2007	2008	Compressed then re-widened policy rate corridor
			2009	Increased role of deposit rate
			2014	Rate pushed down to negative values (-0.10%)
			2019	Interest rate set at -0.50%
Reserve Requirements	Marginal lending facility	Policy rate channel defined as Main refinancing operations (MRO) +/-1%	2016	Interest rate set at 0.25%
	Minimum reserves	-	2011	Reduced reserve ratio to 1% of deposits
			2019	Tiered reserves, amount of excess liquidity exempted from negative rates equal to 6 times required reserves



	Instrument	Pre-crisis	Post-crisis
Asset Purchase Programs	Securities Market Program (SMP)/Outright Monetary Transactions (OMT) program	-	2010 Introduction of SMP: conduct interventions in euro area public debt securities markets 2012 Terminate SMP and launch OMT: announced but never used
	Covered Bond Purchase Program (CBPP)	-	2009 Introduction of CBPP1: Purchase of euro-denominated covered bonds issued in euro area 2011 Introduction of CBPP2 2014 Introduction of CBPP3
	Asset-backed Securities Purchase Program (ABSPP)	-	2014 Introduction of ABSPP: Purchase a broad portfolio of simple and transparent asset-backed securities with underlying assets consisting of claims against the euro area non-financial private sector
	Public Sector Purchase Program (PSPP)	-	2015 Introduction of PSPP Increased issue share limit from 25% to 33%, subject to case-by-case verification Include debt instruments issued by local and regional governments
	Corporate Sector Purchase Program (CSPP)	-	2016 Introduction of CSPP: Investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area included in list of eligible assets for APP

Source: Bruegel based on ECB.

5.4.2. NEW PACKAGE PUT FORWARD IN SEPTEMBER 2019

On the 12th of September 2019, the ECB announced a new package of monetary policy measures in an effort to stimulate economic activity and boost inflation after another quarter of “*protracted weakness in euro area growth dynamics*”⁶. Five decisions were included in this package: the ECB would lower its deposit rate deeper into negative territory, restart its quantitative easing program, continue reinvesting the principal payments from maturing securities purchased under the APP, change the modalities of its third TLTRO program and introduce a two-tier system for reserve remuneration.

The first decision, to lower the deposit rate by an additional 10 basis points, took this rate from -0.40% to -0.50%. In combination with the decision to lower its deposit rate, the ECB also gave the following forward guidance: it expects to keep key rates at their current level or lower for as long as its inflation outlook does not reflect a convergence to its target of below, but close, to 2%, and until “*such convergence has been consistently reflected in underlying inflation dynamics*”⁸. This latter condition marks a turning point in the way

⁶ European Central Bank. ‘Account of the Monetary Policy Meeting’. European Central Bank. Accessed 22 October 2019. <https://www.ecb.europa.eu/press/accounts/2019/html/ecb.mg191010~d8086505d0.en.html>.



the ECB uses conditional forward guidance for its interest rates. It explicitly identifies underlying, or core, inflation as an indicator which will be used to assess when policy rates should be raised. Considering the lesser fluctuations that core inflation presents, as compared to headline inflation, this could help avoid rushed policy reversals and erroneous interest rate increases, like that of 2011 (see Claeys *et al.*, 2018).

The second decision in the September package, was to restart net purchases under the ECB's asset purchase program (APP), after these were stopped in December 2018. It was announced that the pace for these would be equal to €20 billion per month as from the 1st of November and that purchases would last for "*as long as necessary to reinforce the accommodative impact of [the ECB's] policy rates*". However, this open-ended and potentially long-term time limit might prove to be unrealistic. The reason for this is that the ECB has self-imposed rules to guide its asset purchases, particularly in the public sector. The Governing Council established a 25% issuer limit, subsequently upped to 33%, on Eurosystem holdings for its sovereign asset purchases. This was implemented to "*safeguard market functioning and price formation as well as to mitigate the risk of the ECB becoming a dominant creditor of euro area governments*"⁷ but now represents a tangible limit to the purchases which can be made under the ECB's newly re-launched APP. The holding of bonds of major countries was already close to the 33% limit by the end of 2018, due to the massive purchases which took place from March 2015 to the end of the APP in December 2018 (Claeys *et al.*, 2018). This means that asset purchases will have to be stopped relatively soon, when this threshold is reached, which clearly puts a constraint on the use of this instrument.

The third decision, which was unanimously accepted by the Governing Council and raised little controversy, was to confirm that the ECB will continue reinvesting, in full, principal payments from maturing securities purchased under the APP, at least until interest rates are raised again.

Fourth, the ECB changed the modalities for its third series of quarterly TLTROs, which were announced on the 7th of March 2019, launched in September 2019 and will end in March 2021. Originally, the maturity was set at two years and the pricing was set to be within a 10-basis point spread above the average interest rate of the MRO; for counterparties exceeding their lending benchmark, it was set above that of the deposit facility. In September, both of these elements were modified to make monetary policy more accommodative. First, the maturity for this series of TLTROs was increased to three years, with a repayment option after two years. Second, the 10-basis point spread was removed for both levels of interest rates, meaning that the rate for banks exceeding their net lending volume benchmark can now be as low as the deposit rate. However, while past auctions have collected bids amounting to €97 billion on average, with the last auction in 2017 reaching €233 billion, banks only bid €3.4 billion on the first wave on the new TLTROs on the 19th of September.

⁷ ECB Public sector purchase programme (PSPP) - Questions & Answers: <https://www.ecb.europa.eu/mopo/implement/omt/html/pspp-qa.en.html>



Finally, the ECB also introduced a two-tier system for reserve remunerations in its September package, through which the amount of a bank's reserves exempted from negative interest rates is equal to 6 times the amount of its required reserves. This was implemented in an effort to mitigate the potential side-effects of negative interest rates on banks' profitability and thus on their lending capacities. Preliminary studies suggest that this policy will alleviate the costs for banks associated with the NIRP in a meaningful way. This policy is estimated to cut the cost of negative rates to banks by approximately a third (Ducrozet and Gharbi, 2019). However, there is a trade-off between helping banks by reducing the negative impact of negative rates on their profits and the deposit rate having a strong transmission channel to the short-term market rate (EONIA, now €STR). Essentially, the larger the amount of exempted reserves, the less banks have an incentive to lend on the interbank market rather than just keep their excess liquidity and pay the deposit rate, which pushes the overnight rate up, away from the deposit rate. As a result, the transmission channel from the deposit rate to the market rate could be weakened to some extent.

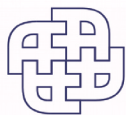
Considering all of these elements, the main question today is whether the current toolkit will be sufficient for the ECB to face a new recession. As discussed, the zero lower bound is a major constraint on policy rates, the newly-restarted APP is limited by the ECB's self-imposed issuer limit, while the take up in the first wave of TLTRO III has been rather disappointing. While the tiering system on reserve remuneration may positively impact bank profitability, it may also weaken the transmission channel of conventional monetary policy, so its overall impact is still unclear. Given these concerns, what can the ECB do to prepare itself for the next European recession?

5.5. WHAT CAN THE ECB DO IF THERE IS A NEW RECESSION IN THE EURO AREA?

5.5.2. CAN THE ECB PUSH INTEREST RATES FURTHER INTO NEGATIVE TERRITORY?

The main tool the ECB has had to face economic slowdowns and too low inflation since its creation has been to cut rates. The issue today is that its main policy rate is already in negative territory. The effects of negative rates are not yet fully understood, but they will no doubt impact the way the ECB can react to the next recession. A BIS survey (Potter and Smets, 2019) suggests that, overall, central banks which have implemented negative rates have been satisfied with the policy's capacity to reduce market interest rates. They consider that the passthrough to most economies has been almost complete, but also recognize that this may only be the case because rates have only been slightly in the negative range and for a relatively short period of time. If these rates are lowered more significantly or if they stay negative for much longer, their effects might be different.

Broadly speaking, there are two main effects of negative rates, with opposite consequences. The first effect is that a negative policy rate reduces market interest rates and



interest rates on loans made by banks. This increases credit demand and, ultimately, investment and consumption. The second effect is supposed to be contractionary because negative rates tend to decrease the profitability of banks, which as a result might reduce the supply for credit. This is because it is difficult for banks to pass negative rate onto their customers, as households could switch to cash instead of depositing their money in banks. As a result, the spread between their funding rate and their lending rate could be reduced and their profits cut. For instance, Rognlie (2016) models the trade-off between the adverse effects of negative rates and their expansionary benefits and finds that there is indeed a reversal rate at which negative rates become contractionary.

The most crucial question is therefore to know which one of these effects dominate and at which level this reversal rate is situated. However, given the relative novelty of the issue, unsurprisingly, the economic literature is still far from having reached a consensus.

After two years of negative rates in the euro area, Jobst and Huidan (2016) assessed whether the ECB's adoption of negative rates in 2014 had an overall expansionary or contractionary effect by using a DSGE model calibrated on euro area data. Their study shows that while there has been a significant and negative effect on bank profits, especially for those with stickier rates paid to their depositors, higher asset values and stronger aggregate demand have offset the negative effect, allowing for a modest expansion in credit, and overall, an easing of financial conditions.

A year later, Eggertsson, Juelsrud and Wold (2017) argued, on the contrary, that the negative effect of NIRP dominates. Using bank-level data from Sweden, Denmark, Switzerland, Japan, Germany and the euro area since 2008, they find that there is an empirical zero lower bound on rates paid by banks on deposits. Based on this finding, they build a DSGE model, with an embedded banking sector and find that because of NIRP and the strict lower-bound on deposit rates, the spread between banks' deposit rates and their borrowing rates has been diminished, mechanically leading to a drop in their profits. As a result, the authors argue that in their model, NIRP automatically has a contractionary effect on the economy.

However, a recent study by the OECD (Stráský and Hwang, 2019) which uses quarterly consolidated bank level data from approximately 50 banks supervised by the Single Supervisory Mechanism finds opposing evidence. They estimate that there is only weak empirical evidence that bank profitability has been significantly negatively impacted by NIRP, and that reduced bank profits in times of negative policy rates can actually largely be explained by overall weakened macroeconomic conditions. This implies that NIRP has an overall expansionary effect since bank profits are only weakly affected by it.

This is also what Altavilla *et al.* (2018) conclude based on a micro analysis they run on euro-area bank-level data. They find that policy easing, including NIRP, actually tends to have a positive effect on bank profits because it reduces loan loss provisioning by improving borrowers' capacity to repay their debt and increasing the quality of assets held in banks' portfolios. This offsets the loss in net interest income in their model, and confirms the expansionary effect of policy easing and NIRP.

In addition to this discussion on the opposite effects of NIRP, there is also the question of the power of the transmission channel. Eggertsson, Juelsrud and Wold (2017)



assume a breakdown of the interest rate transmission channel as soon as negative policy rates are introduced – since commercial deposit rates cannot follow policy rates and go below zero in their model. This is also what Eggertsson *et al.* (2018) argue. In their paper, they include a discussion on the dispersion effects of policy rates once they turn negative, driven by differences in banks' financing structure. According to their research, banks with a higher level of deposit financing are more affected by negative policy rates, causing them to have slower credit growth in a negative rate environment.

Other authors do not believe the effect of negative rates on the transmission channel is so clear cut. For instance, Brunnermeier and Koby (2018) defend the argument that as rates are lowered, their marginal effect on the real economy does decrease, but the reversal rate at which monetary policy is no longer transmitted is not obviously set at the zero-percent threshold. This reversal rate is actually dependent on several factors, including banks' fixed-income holdings, the strictness of capital constraints, the degree of pass-through to commercial deposit rates and the initial capitalization of banks. Altavilla *et al.* (2018) also consider that negative rates do not automatically break down the transmission channel and that this actually heavily depends on bank health. Sound banks, (characterized by lower CDS spreads and a lower level of non-performing loans) are more likely to set negative deposit rates than unsound banks. However, in periods of NIRP, there is also a higher demand for safe assets, which means these sound banks end up receiving more deposits than unsound banks, further reinforcing their capacity to follow policy rates into negative territory. As such, there is a higher likelihood of the breakdown of monetary policy transmission channels for unsound banks, but it is never a complete breakdown.

Another area of concern is the impact that negative rates may have on the risk-taking behavior of banks and ultimately on financial stability. Evidence from Heider *et al.* (2018) seems to point to the fact that once rates go negative, banks that mainly rely on deposit funding take on more risk and lend less than banks which rely on other sources of funding. As a result, NIRP could be less accommodative than initially thought and additionally increase financial instability if lending from high-deposit banks significantly increases.

Finally, from an empirical perspective, recent data released by the ECB (2018), shows that there are signs of cash hoarding by banks as a result of negative deposit rates – even if the sums at stake are still small compared to the overall amount of excess reserves.

Overall, the ECB could try to cut its deposit rate further to reduce short-term market rates. However, even if debates on the effects of negative rates are not yet fully settled, the literature discussed above suggests that the ECB might already be near its effective lower bound and that it might be difficult to go well below it in the future.

5.5.2. HOW TO LIMIT THE NEGATIVE SIDE EFFECTS OF NEGATIVE RATES?

Given all these issues and the uncertainty tied to the use of NIRP in the euro area, the ECB cannot wait for research to conclusively determine whether the reversal rate of interest has already been reached, and if not, at exactly what point in time this will be

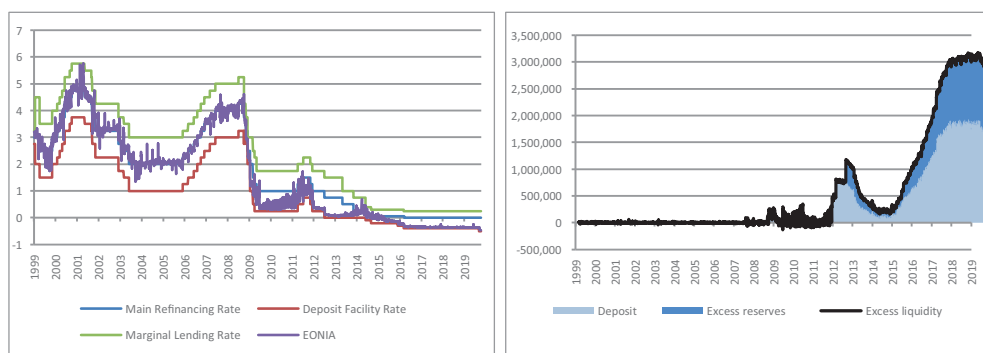


the case. Instead, it must adapt its policies so that they adequately respond to both possibilities. This means finding ways to mitigate the potentially negative effects of NIRP and maximizing its expansionary benefits.

A first step has already been taken in this direction with the new two-tier system the ECB announced in September, to be applied as of the 30th of October 2019. As discussed above, this will provide significant relief to banks as the amount of their reserves which is exempted from the cost of negative deposit rates is increased sixfold. While this will no doubt strengthen the expansionary effect of NIRP, it may also weaken the deposit rate's impact on the EONIA rate, as discussed previously. Indeed, the more reserves are exempted from negative interest rates, the less banks are incentivized to be active on the interbank market instead of simply depositing their excess liquidity at the ECB. This implies that the ECB faces a trade-off between reducing the side-effects of negative rates on banks and the economy and ensuring that the level of the deposit rate is reflected in short-term market rates (EONIA, now €STR).

This is particularly important given that the deposit rate has been the main determinant of the level of the EONIA in the past few years. Thanks to high levels of excess liquidity in the euro area since 2012 (Figure 5, RHS), the EONIA has remained stable and very close to the deposit facility rate (Figure 5, LHS), making it the ECB's most important policy rate in terms of monetary policy transmission. As such, the implications of a breakdown in this rate's transmission to overnight market rates would impact the way the ECB conducts monetary policy during the next recession in a significant way. That is why the ECB will have to monitor very closely how both bank profits and market rates are affected by the new tiering system.

**FIGURE 5: THE EONIA RATE (IN %) AND EXCESS LIQUIDITY
IN THE EURO AREA (IN € MILLION)**



Source: ECB via Bloomberg. Note: Excess liquidity is defined as deposits at the deposit facility net of the recourse to the marginal lending facility plus current account holdings in excess of those contributing to the minimum reserve requirements.

Another way the ECB could continue to cut its rates and have a more expansionary stance without lowering its deposit rate further (and thus avoid the negative impact on



banks and bank lending) would be to cut the TLTRO lending rate below the deposit facility rate, conditional on banks reaching a benchmark volume for loans. As of now, the TLTRO rate can only go as low as the deposit rate, but not below it. If this were the case however, it would allow banks to take out long-term loans from the ECB at a rate lower than what they would pay to deposit excess liquidity there. This would allow them to give out more loans, which in turn would mechanically increase their reserve requirements since these are calculated as a ratio of a bank's liabilities – mainly its customers' deposits. Considering the new tiering system on reserve remuneration, their exempted reserves would also be increased, even more than proportionally. This ultimately could create a virtuous cycle for bank profitability and incentivize banks to lend to the economy despite negative policy rates (or more precisely thanks to a negative TLTRO rate).

The main caveat would come from the fact that the ECB would actually be losing money on these operations. However, this should not be a major source of concern, given that, as discussed in Chiacchio, Claeys and Papadia (2018), while it is preferable for central banks to achieve profits rather than to record losses, they are not profit-maximizing institutions and their overriding mandate is price stability. As such, recording losses in the short-to-medium term when seeking to fulfil its macroeconomic function should not stop the ECB from using such a policy.

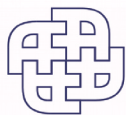
Finally, a more extreme solution to deal with the lower bound could include taxing paper currency (as suggested by Agarwal and Kimball, 2015; or Kimball, 2015) or abolishing it altogether (Rogoff, 2016). But this solution would be highly unpopular in some Member States, and, again, the potential side-effects on bank profitability and lending capacity could reduce such an instrument's effectiveness in stimulating growth and inflation in a bank-based financial system.

5.5.2. WILL THE ECB BE ABLE TO USE ITS ASSET PURCHASE PROGRAM IN THE NEXT RECESSION?

Considering the secular decline in the euro area's neutral rates, traditional monetary policy tools could be constrained by the zero lower bound for more frequent and longer-lasting periods of time. This makes its other policy instruments, namely asset purchases, all the more important in dealing with the next European recession.

This means that the ECB will have to be ready to use this tool more often and not to confine it to extreme situation. The peculiar institutional arrangement of the EMU and the reluctance of some countries to use such a policy have caused delays in the implementation of asset purchases in the last crisis, as the ECB program was launched 6 years after that of the Fed and the Bank of England.

It is true that the effects of this unconventional policy are not yet fully understood and that asset purchases are more difficult to calibrate than simple rate cuts. In particular it is difficult to know if their marginal effects remain significant when yields are already very low or even negative, as argued for instance by Coppola (2019). However, sovereign bond purchases are also a way to better coordinate with fiscal authorities. Indeed, even



if additional asset purchases have smaller marginal effects on the yield curve and financing conditions, they also allow fiscal policy to be more expansionary in bad times. Some might fear that this could reduce the independence of the ECB, enshrined in Article 130 of the Treaty on the Functioning of the European Union (TFEU). However, it could also be argued that the ECB cooperating more closely with fiscal authorities in the pursuit of a common goal does not have to lose its independence and could even lay the grounds for better coordination between fiscal and monetary policies, as long as the decision to launch QE is coming from the ECB.

From a more practical perspective, as already mentioned, the main problem for the ECB to use QE during the next recession is that its program is currently constrained by its (self-imposed) issuer limit. The ECB is already quite close to the limit in several countries, in particular in the Netherlands and Germany. In the current setup, this implies that purchases will have to be stopped in a few months. The most obvious answer to this would be to increase the issuer limit once again, even if the ECB does not seem inclined to do this for the moment. In a recent press conference, President Draghi stated that *“there was no appetite frankly to discuss the limits for one good reason, because we have relevant headroom to go on for quite a long time at this rhythm without the need to raise the discussion about limits”*⁸.

This reluctance to change the issuer limit can also be explained by the ECB's concern about monetary financing. If it owns a large enough share of some bond issues to have a blocking minority, the ECB would theoretically be in a position to block a vote on the restructuring of a euro area country's ECB-held debt. Not blocking this vote could be considered as monetary financing. However, one could question whether the current issuer limit strikes the right balance between running the risk *ex ante* of monetary financing and the ECB not meeting its primary objective of maintaining price stability. For instance, there would be very little risk of monetary financing in AAA-rated governments such as Germany or the Netherlands, given the near-zero probability of them needing to restructure their debt in the next few years. As such, the ECB should waive its issuer limit, at least for well-rated countries in order to allow for this policy to be used as much as necessary in the next European recession.

Considering the uneasiness some members of the ECB's Governing Council still have with the purchases of sovereign debt securities, another option for the ECB could be to buy other classes of assets, like bank loans or even equity.

5.5.3. REVIEWING THE ECB'S MONETARY POLICY FRAMEWORK WOULD ALSO HELP

Operating in a 'zero lower-bound world' means the ECB should also review its monetary policy framework, and especially its definition of price stability, to increase the flex-

⁸ European Central Bank. (2019, October 15). Introductory statement to the press conference (with Q&A). Retrieved October 15, 2019, from European Central Bank website: <https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is190912~658eb51d68.en.html>

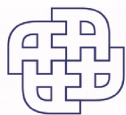


ibility it has when dealing with a new recession. The ECB's official mandate of maintaining price stability is not explicitly defined in the European Treaties: there is no numerical target, time horizon or particular variable which are mentioned. These elements were decided by the Governing Council in 1998 and then clarified in 2003. This means that they could be changed again. As explained in detail in Claeys *et al.* (2018), we think that the ECB's definition of inflation should be changed from "*below, but close, to 2 percent over the medium term*" to "*around 2 percent, on average, over the long run*". This would have many advantages.

First, the current definition of price stability implies that the ECB implicitly targets inflation that is smaller than 2 percent. It is unclear why the central bank keeps this room for interpretation around its inflation target, which we believe adds unnecessary noise to its operations and does not allow for a clear and well-defined target around which markets can realistically form expectations (Demertzis and Viegi, 2008). Changing the definition to make it two-sided, "around 2 percent", is a way of correcting this downward bias without having to go very far from what is currently communicated. Additionally, it would be important to set numerically defined tolerance bands around the 2 percent target within which inflation is considered to be acceptable. These would need to be carefully chosen so that the target still remains a good signal, and the definition of price stability is clarified (Demertzis and Viegi, 2010).

Second, the period over which price stability is measured could arguably be lengthened from its current 18 months to 3 years – the general definition of "medium term" – to a longer time frame, like the course of a business cycle⁹. If implemented successfully, not only could this help avoid too-rapid reversals in policy, it would also allow the ECB to let the economy overheat for some time after periods of undershooting its inflation target. If economic agents expect the ECB to act in this way, real rates would be further lowered during downturns and potential time inconsistencies in the ECB's forward guidance communication could be avoided. Indeed, in the current situation, the ECB could be seen as lacking credibility when it states it will keep rates low for a long period of time if market participants know that it may have to react quickly to maintain inflation below 2 percent. Having inflation defined *on average* would strengthen the role of inflation expectations as an automatic stabilizer to alleviate the problem caused by the zero lower bound (as formalized by Nessen and Vestin, 2002). In practice, this means that monetary policy, provided it is credible, will have long term expectations anchored at the inflation target, which then allows the medium-term expectations to deviate from this target by as much as needed to account for shocks. For example, in the case of a deflationary shock, medium-term expectations will increase above the target, and thus real rates will decrease which will help eliminate the effects of the shock. By contrast, in the current regime, credible monetary policy implies medium-term expectations are anchored at

⁹ While the typical length of a business cycle has been quite variable in the euro area since the 1970s, according to the CEPR business cycle dating committee, it has been around 9 to 10 years. See <https://cepr.org/content/euro-area-business-cycle-dating-committee>. The exact calibration of the time-horizon would have to be evaluated through experimentation on a number of models.



the target and therefore the change in the real rate will not help as much. We appreciate that lengthening the horizon can reduce the “controllability” of the instrument, in other words the ability of the monetary policy to control the way its instrument achieves the desired result. However, helped by clear communication which anchor expectations at the right level, this problem can be tamed.

Third, these changes should be accompanied with a move to systematically target core inflation, rather than headline inflation. The ECB’s recent decision to give more focus to core inflation by including it in its forward guidance is a first step in this direction and should be followed-up on. In addition, in the ‘average inflation targeting’ framework that we suggest, targeting headline inflation could have detrimental effects: temporary supply shocks to energy and food prices would automatically have to be compensated by lower inflation in the following periods.

Our proposed changes to the ECB’s definition of price stability are not as radical or complex as other proposals, such as an outright increase in the target or a move to nominal GDP targeting for instance. This means they do not risk damaging the central bank’s credibility or de-anchoring inflation expectations. On the contrary, they would reinforce the weight attached to its forward guidance on inflation as well as make it easier for economic agents to plan long-term investments and reduce risks linked to long-run contracts.

5.5.4. THE ECB SHOULD BE READY TO USE OMT IF NEEDED

Mario Draghi’s “*whatever it takes*” promise in 2012 proved to be instrumental in settling the euro area sovereign debt crisis. Faced with a rapid increase in interest rates and the risk of re-denomination related to a potential break-up of the EMU, the ECB stepped in and announced its Outright Monetary Transactions (OMT) program. This program was a potentially unlimited but conditional purchase program for euro-area government bonds, aimed at “*safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy*”. This broke the cycle of the self-fulfilling liquidity crisis which had taken hold of the euro area sovereign debt market, and the spreads between different countries fell once again, though they never returned to their pre-crisis levels, as market participants realized that there were still differences in credit risks within euro area countries.

What this case illustrates is that, in 2012, markets were fully convinced that the ECB had both the tools and the will to intervene to protect the integrity of the euro. This level of clarity and credibility needs to be maintained at all cost for the ECB to be able to face its next recession. As a key pillar in the euro area architecture, this means that the OMT needs to be strengthened and reaffirmed.

The first step to doing this is that the ECB should reconfirm that the central bank is fully ready to use its OMT program in order to avoid liquidity crises in the sovereign debt markets. It will need to remain very clear that the ECB is willing and capable of acting as a lender of last resort for sovereigns in case of self-fulfilling liquidity crises.



As a second measure, the OMT's architecture should also be re-evaluated to ensure its soundness. In its current setup, the precondition to accessing the ECB's OMT is a government's involvement in a European Stability Mechanism (ESM) program. This conditionality aims to avoid any moral hazard, as the involvement in an ESM program requires a neutral assessment by the European Commission of the sustainability of a government's fiscal position, as well as the political backing from the ESM board. However, in the original press release by the ECB which set out the framework for its OMT (ECB, 2012), there was some ambiguity regarding the exact pre-conditions under which a government could access the program. As explained in Claeys and Mathieu Collin (2018), the ECB explicitly mentions the ESM's precautionary programs – which include its Precautionary Conditioned Credit Line (PCCL) – and primary market purchases – which are possible under the PCCL – but it also singles out the (more difficult to obtain) Enhanced Conditions Credit Line, without making a mention of the PCCL. The ECB should clarify its stance on this subject by stating that the PCCL is considered a sufficient pre-condition to access an OMT program, in view of making its OMT more credible in the case of a new liquidity crisis.

5.5.5. BE READY TO INNOVATE (AGAIN) IF OTHER TOOLS ARE INSUFFICIENT

Finally, we recommend that the ECB be prepared to innovate in its use of unconventional monetary policy. Its current toolkit could indeed become insufficient in a new recession: 1) policy rates could reach the reversal point at which their overall effect becomes contractionary, leaving the ECB without its main monetary policy instrument; and 2) quantitative easing could also be a limited option, both because of the current issuer limit and because of potential diminishing returns. In that case, the ECB will have to be prepared to use different kinds of policy, with some idea of the way they work and the risks associated with them.

As such, while the ECB should first and foremost focus on adapting its existing tools to the economic situation and possible emerging risks and constraints (as discussed above), it should also at the very least begin evaluating potential alternative tools which may help it in dealing with the next recession. At this point, it is useful to remember that at the time of their implementation, asset purchases were considered an experimental policy, for which effects and risks were virtually unknown (see for example Giles, 2014 and Choyleva, 2014). This signals that the ECB is capable, and willing, to innovate when this is needed.

“Helicopter money”, as theorized by Milton Friedman (1969), could be such a policy innovation. The premise for it is that the ECB directly injects a volume of cash into the economy calibrated to bring inflation back towards its target by distributing it on an indiscriminate and equal basis to all households. It could serve as a solution to the drying up of credit during times of crisis, when conventional tools such as rate cuts and quantitative easing are no longer a sufficient boost to aggregate demand.



One condition for this policy to fulfil its objectives of price stability is that injections need to be credibly permanent, meaning that households must believe that once they receive this transfer, the central bank will not later implement contractionary policies to reduce the higher inflation it created. This is similar to what Krugman described as a central bank being “*credibly [...] irresponsible*” (2011) by committing to creating higher inflation. If the transfers are credibly permanent, households will be more inclined to spend the extra income rather than save it in wait of a future form of taxation.

Two main issues stand out when considering the implementation of helicopter money in the euro area, (as also discussed for instance by Pisani-Ferry, 2019). The first regards the legality of this policy – would the ECB be acting within its mandate? Some could consider this policy to be monetary financing, which is illegal under the TFEU’s Article 123(1). However, the case may not be quite so straightforward. First, article 123(1) does not ban operations such as helicopter money, as long as it would not be done through “*Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States*”. The ECB should thus find a way to circumvent fiscal authorities to interact directly with European citizens. Second, in order to fulfil the ECB’s primary mandate to maintain price stability, the Governing Council may define new instruments to achieve this mandate through a two-thirds majority vote – as enshrined in article 20 of the Protocol on the State of the European System of Central Banks and of the ECB. These two elements could give the ECB the sufficient freedom to implement some form of helicopter money which would not be considered monetary financing, such as direct transactions to all citizens of the euro area for instance¹⁰.

This brings us to the second issue, which is more operational – how can the ECB transfer a lump sum of money to every single person in the euro area, especially considering that some might not have bank accounts and that there are significant differences in income between euro-area countries? These issues of equity are of no small importance and would need to be addressed by the ECB when discussing this policy, even if helicopter money could actually be more equitable than QE, as the central bank would be directly supplying money to households instead of going through the channel of public and private sector security purchases which might affect different sections of the population differently.

More generally, while innovative solutions will be crucial to give the ECB more space to act, the merits of new tools need to be assessed against what constitutes a good macroeconomic policy mix. The benefits of ‘overextending’ monetary policy may be easy to match if fiscal policy were to contribute to managing the macroeconomic cycle.

¹⁰ In addition, if more clarity is needed on the exact actions prohibited from article 123, and thus on the legality of helicopter money, according to article 125(2) of the TFUE, the European Council may “*specify definitions for the application of the prohibitions referred to in Articles 123 and 124*”, on proposal from the Commission and after consulting the European Parliament.

5.6. CONCLUDING REMARKS

Though their effects are not yet fully understood, “low-for-long” interest rates are increasingly constraining the ECB’s monetary policy and may well present an unparalleled challenge when the next European recession hits. Given that interest rate cuts will probably be constrained by the lower bound, be it at the zero-percent threshold or lower, the ECB will have to find new ways to adjust its policy stance.

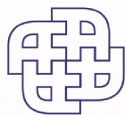
We have argued for several changes in its toolkit and its framework, which do not drastically depart from its current form but would give it more flexibility and leeway to approach future crises. First, the ECB should work on mitigating the potentially negative impacts of its NIRP, as these will be at the root of any contractionary effect this policy may have. Second, it should rethink its issuer limit on the APP, either by relaxing the issuer limit itself (at least for well-rated public debt securities) or by enlarging its list of eligible assets, to get more space to be able to continue its APP as much as possible. Third, it should change its framework to target inflation on average over a longer period of time and with a symmetric rather than a one-sided target of 2%. Fourth, to retain its credibility and ensure against a new liquidity crisis in the sovereign debt market, the ECB should also review the details of the OMT program so it is fully ready to be used if necessary. Finally, as was the case in the early 2010s, the ECB should look into new ways to conduct its monetary policy if its current toolkit is not sufficient to deal with the next recession.

The role of communication will continue to be pivotal in informing and guiding markets and broader audiences in forming their expectations. However, one important realization is that as the environment in which the ECB operates is highly uncertain, communication will become less about what will happen in the future and more about how to manage alternative outcomes in the future.

We believe that these changes will allow the ECB to manage some of the uncertainty it is facing and provide it with a credible strategy in the case of a new European recession.

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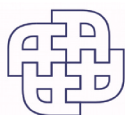
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PART III
ISSUES IN FISCAL POLICY



6. THE EU FISCAL RULES DURING THE JUNKER COMMISSION. IMPLEMENTATION, REFORM AND CHALLENGES AHEAD

CARLOS MARTÍNEZ MONGAY AND MIRZHA DE MANUEL ARAMENDÍA^{1,2}

6.1. ABSTRACT/EXECUTIVE SUMMARY

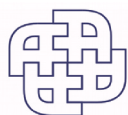
With the transition to the new Commission, it is a good occasion to take stock of the way the Juncker Commission implemented the fiscal policy framework, and assess its legacy to the new institutional cycle, including the fiscal challenges that the von der Leyen Commission is likely to confront in the next five years.

During the term of the Juncker Commission, the euro area went from a slow recovery into a stronger economic expansion. The Juncker Commission favoured the use of flexibility built into the existing rules, without changing the Pact. Fiscal policy played a slightly stabilising role in the euro area. However, the combination of nominal adjustment strategies under the corrective arm have weighted on the sustainability of public finances in high-debt countries, including France, Italy, Spain and Belgium. In the case of Italy, a combination of market pressure, peer pressure from other Member States and the application of the rules by the Commission managed to avert major risks.

While waiting for the output of the public debate launched by the Commission on the Six and Two Pack review, rather than present yet another reform proposal, this paper instead discusses the fiscal rules from the perspective of the economic challenges to

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² The authors gratefully acknowledge useful comments from L. Codogno, F. Fernández, M. Hallet, M. Larch, I. Maes, A. Margerit, J. Yaniz and C. Weise. Usual caveats apply, including that the views in the paper are only those of the authors and should not be attributed to the European Commission



which fiscal policies are likely to be confronted in the coming years. These challenges include demographic changes, migration, the costs of climate change, and the transformation of economic, social and political structures driven by technological developments.

A relevant question here is whether, in the current low interest rate environment, higher public investment should be financed primarily through public debt. A related question is whether some sort of “golden rule” should be adopted to exclude such investments from the SGP indicators. Our bottom line is that nothing ensures that interest rates will remain low in the future. In the end, high-debt countries vulnerabilities come not so much from the interest paid at any given moment, as from their short-term refinancing needs. Taxation policies should play a role as well.

Overall, given these challenges, the balance between the two main goals of fiscal policy – short-term stabilisation and long-term sustainability – might need to be reassessed and possibly broadened to encompass the quality of public finances, both in terms of revenues and expenditures. Too many objectives for a single instrument, which requires broadening the debate of the role and design of fiscal rules to bring other elements of the EMU architecture into the picture, including who should implement the fiscal rules and the possible introduction of a common fiscal capacity and a common euro-area safe asset.

Keywords: Fiscal policy. Stability and Growth Pact. Economic policy coordination. EMU deepening. Euro-area economy.

6.2. INTRODUCTION

This chapter presents an overview of the way the Juncker Commission interpreted and applied the EU fiscal rules and summarises the state of play of the reform of the Stability and Growth Pact (SGP). The chapter also aims at discussing the economic challenges for the five years ahead and the role fiscal policy might be expected to play.

When the Juncker Commission took office in November 2014, it found a euro-area economy in an incipient recovery within an environment of sluggish potential growth, a large negative output gap and very low inflation. Euro-area GDP was growing at a rate of 1.4%, potential growth was below 1% and the output gap recorded -2.6%. The investment ratio was 3 percentage points (pps.) of GDP lower in 2014 than in the pre-crisis period and the unemployment rate was 11.6%. Inflation, as measured by the harmonised index of consumer prices, was at 0.4%, well below the wage growth rate of 1.3%.

Where public finances are concerned, the euro-area aggregate posted a headline deficit of 2.5% and ten member countries were recording deficits of 3% or above. Interest expenditures attained 2.6% of GDP and the primary balance was practically at 0% of GDP. The structural balance was at -0.9% of GDP for the euro area as a whole. Public debt had reached 94% of GDP, which compared with the average of 68% between 1999 and 2008. Public investment had fallen to 2.7% of GDP from an annual average of 3.2% recorded between 1999 and 2008. Spain, Ireland and Portugal had successfully exited their respective financial programmes. The Greek and Cypriot programmes were still ongoing.



Private debt had decreased only marginally from its peak of over 162% of GDP in 2009. Corporate debt was at 101.5% of GDP and household debt represented 59.6% of GDP. The volume of non-performing loans (NPLs) in the euro area represented roughly 8% of total loans and advances. The intense repair and restructuring, that had affected hundreds of banks, was still ongoing, while bank profitability had become positive.³ By 2014 a series of partial but decisive steps had been taken in order to build the Banking Union. In particular, following the 2013 regulations to set up the Single Supervisory Mechanism (SSM), the ECB assumed this role in November 2014. On the resolution front, the Bank Recovery and Resolution Directive (BRRD) entered into force in 2014, and the Single Resolution Mechanism (SRM), including the Single Resolution Board (SRB) and Fund (SRF), were due to become operational in 2016.

As for economic governance, the post-crisis reforms of the SGP were fully in force. The “Six Pack” (2011) and “Two Pack” (2013) had strengthened the economic and fiscal surveillance toolkit. The macroeconomic imbalance procedure (MIP) had been introduced in order to prevent and correct economic imbalances, both external and internal. The fiscal rules included an expenditure rule, a debt reduction benchmark and a more gradual system of sanctions. In addition, the euro-area Member States had to consult the Commission before the parliamentary adoption of their draft budget plans (DBPs). These procedures were embedded in the “European Semester”, the central framework for European economic policy coordination and surveillance, which had been established in 2011. The Two-Pack also included crisis-resolution procedures and the European Stability Mechanism (ESM) was working at full speed. Finally, national “Independent Fiscal Institutions” had also been set up, which were expected to enhance the ownership of the fiscal rules at Member State level.

This is in a nutshell the economic, budgetary and institutional legacy that the Juncker Commission received when it took office in 2014. Five years after, it is a good occasion to take stock of the way the Juncker Commission reformed and implemented the fiscal policy framework, and assess its legacy to the next institutional cycle. It is also a propitious time to reflect on the fiscal challenges that the new Commission is likely to confront in the next five years. The paper is structured as follows: Section 2 summarises the euro area’s economic and fiscal performance between 2014 and 2019. Section 3 analyses how the fiscal rules have been interpreted and applied during the Juncker Commission. Section 4 summarises the state of play of the debate on the SGP reform. Section 5 presents the challenges ahead for the euro-area economy and discusses the role of fiscal policies. Section 6 concludes.

³ “The effects of temporary State aid rules adopted in the context of the financial and economic crisis” European Commission, Brussels, 5 October 2011, SEC(2011) 1126 final. https://ec.europa.eu/competition/publications/reports/working_paper_en.pdf



6.3. THE JUNKER COMMISSION IN RETROSPECT

6.3.1. FROM ECONOMIC RECOVERY TO EXPANSION, WITH RECORD EMPLOYMENT

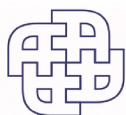
During the term of the Juncker Commission, the euro area transitioned from a slow recovery into a stronger economic expansion which lately appears to be slowing down again. Between 2014 and 2018, living standards, as measured by GDP per head, increased by about 12.4% up to €33,779, reflecting the effect of high growth (Figure 1) which also proved to be job-rich. From 2014 to 2018, GDP grew by 2.1% per year on average, compared to 0.7% in the previous four years. The growth in output was driven both by robust domestic demand and by dynamic exports, thanks to competitiveness gains and despite a largely uncertain international environment. Investment recovered markedly, increasing by more than 4% yearly on average over the period. As a result, the investment rate rose by 1.25 pps. of GDP, still 1.25 pps. below the 2000-2007 average.

The recovery in the labour market brought employment to a record high (Figure 2). The employment rate reached 72% in 2018, compared to 68.2% in 2014, bringing it closer to the Europe 2020 target of 75%. This means that more than 7 million new jobs were created in the euro area in four years. The unemployment rate declined by more than 3 pps. to 8.2% in 2018, close to pre-crisis levels. However, important challenges remain, including the growth in involuntary part-time work, the persistence of in-work poverty, and the still high levels of youth unemployment in some Member States. In spite of the strong job creation, the number of hours worked per employed person has not yet reverted the declining trend that started in 2009.

Labour market outcomes for the euro-area aggregate hide large differences across countries. For instance, the unemployment rate in Germany was as low as 3.5% in 2018, compared with 5% in 2014. A similar fall of about 1.5 pps. was recorded both in France and Italy, but their unemployment rates remained close or above 10%, respectively. In the case of Spain, the unemployment rate registered a record fall of almost 10 pps. to reach 15.3% in 2018, still the second highest in the euro area after Greece.

6.3.2. AN ASYMMETRIC CORRECTION OF MACROECONOMIC IMBALANCES

Within this context of positive growth momentum an asymmetric correction of macroeconomic imbalances took place. Debtor countries — those that recorded large current account deficits in the run-up of the 2008 crisis — managed to correct the large differences between savings and investments by rebalancing their economies, mostly through cutting investments. In contrast, creditor countries did not adjust their current account surpluses, and the gap between savings and investments kept increasing. As a result, the euro-area current account surplus peaked at 3.2% of GDP in 2016 and 2017,



the largest worldwide and above levels consistent with fundamentals.⁴ Since then, the overall euro-area surplus has declined only marginally. In parallel, debt stocks — either private or public, domestic or external — accumulated during the first decade of the century, decreased slowly (Figure 3). A number of Member States still have some way to go in addressing their large stocks of legacy debt and negative net international investment positions, which make them vulnerable to changes in investor sentiment in the event of economic shocks. In the successive rounds of euro-area recommendations in the European Semester⁵, the Commission has called Member States to coordinate the adjustment of their debt and current account imbalances better. In particular, higher domestic demand and investment in net-creditor countries would help the deleveraging process in net debtor countries and sustain growth in the euro area.⁶

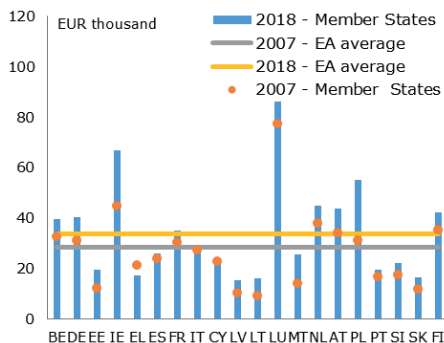
The recovery in the banking sector has also been prominent, strengthening its resilience to economic shocks and reducing the probability of spillovers into public finances seen during the financial crisis (Figure 4). Supported by the still ongoing overhaul of prudential regulation and supervision, banks achieved substantial improvements in the quantity and quality of their capital and reduced their leverage and reliance on short-term funding sources. However, profitability remains low and cross-border banking activity and mergers remain very limited. The weight of non-performing loans in bank balance sheets declined substantially, from around 7% in 2014 to somewhat more than 3% in 2018, close to pre-crisis levels, although in some Member States, such as Greece, Cyprus and Portugal, banks still experience excessively high levels of such assets.

⁴ “Analysis of the euro-area economy accompanying the Recommendation for a Council Recommendation on the economic policy of the euro area” European Commission, Brussels, 21 November 2018, SWD(2018) 467 https://ec.europa.eu/info/sites/info/files/2019-european-semester-recommendation-euro-area-staff-working-document_en.pdf

⁵ “Communication on 2019 European Semester: country-specific recommendations”, European Commission, Brussels, 5 June 2019, COM(2019) 500 final. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019DC0500&from=EN>

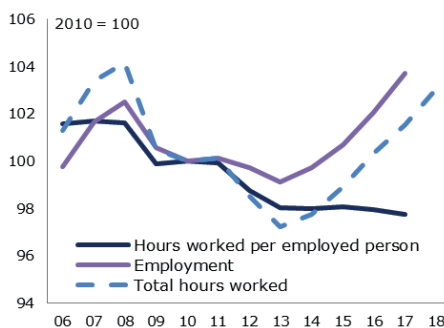
⁶ “Recommendation for a Council Recommendation on the economic policy of the euro area” European Commission, Brussels, 21 November 2018, COM(2018) 759 final. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0759&from=EN>

FIGURE 1: NOMINAL GDP PER CAPITA, EURO AREA



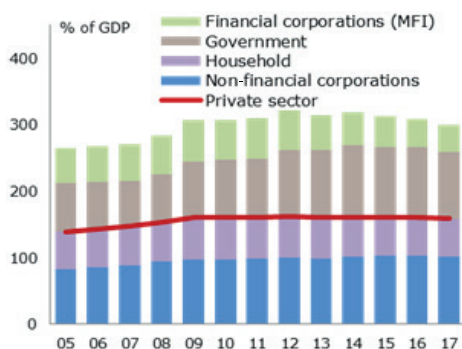
Source: European Commission, Spring forecast 2019.

FIGURE 2: EMPLOYMENT AND HOURS WORKED, EURO AREA



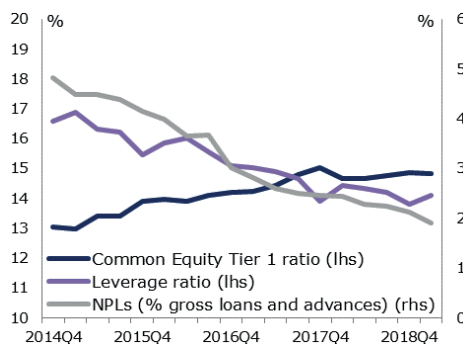
Source: European Commission, Eurostat.

FIGURE 3: INDEBTEDNESS BY SECTOR, EURO AREA



Non-consolidated debt. Source: European Commission.

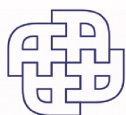
FIGURE 4: BANK STABILITY INDICATORS, EURO AREA



Source: European Central Bank.

6.3.3. GROWTH-DRIVEN CONSOLIDATION OF PUBLIC FINANCES

Where public finances are concerned, the euro area achieved significant improvements in its fiscal position during the Juncker Commission (Figure 5). Its aggregate headline deficit was 0.5% in 2018, down from 2.5% in 2014 at the beginning of the mandate, and the round of excessive deficit procedures that followed the financial crisis ended in 2018, when the procedure was abrogated for Spain. For the first time since the introduction of the euro, no euro-area Member State had a deficit above 3% of GDP.



At the same time, the adjustment in the headline deficit was driven primarily by the economic expansion rather than by the recommended fiscal adjustment paths. This applies in particular, but not only, to Member States that were in the corrective arm of the Pact at the beginning of the mandate. That was the case of France and Spain. In France, the nominal deficit went down from 3.9% of GDP in 2014 to 2.8% in 2017, on the basis of which the country exited the excessive deficit procedure (EDP), but the total fiscal effort over the period did not reach 0.3 pps.⁷ In the case of Spain, from 2014 until the correction of the EDP in 2018, the nominal deficit fell by 3.5% of GDP in spite of a negative fiscal effort. A similar conclusion would apply to some high-debt countries in the preventive arm of the Pact. For instance, in the case of Italy, the recorded fiscal effort between 2014 and 2018 was also negative.

The primary balance improved significantly over the period. This figure, which deducts interest payments from total expenditures, reached 1.3% of GDP in 2018, compared to 0.1% in 2014. In parallel, interest payments, fell by 0.8 pps. of GDP to reach 1.8% in 2018. This represents total savings of €152 billion over the period. Again, the situation in several countries diverged from these aggregate developments. In the case of France, the primary balance was in deficit over the whole period, although posting an improvement of 0.9 pps. of GDP since 2014, while interest payments declined by half a point. In the case of Spain, the improvement in the primary balance, including one-offs, was very large, going from a deficit of 2.5% of GDP in 2014 to a balanced position, two-fifths of which represents the fall in interest payments. Finally, in Italy, the primary balance was in surplus, remaining at around 1.5% of GDP over the period, while interest payments declined by almost 1% of GDP.

The structural balance, which corrects for the impact of the economic cycle, evolved less favourably (Figure 1). It remained constant for the euro area as a whole, hovering at around 1% of GDP deficit over the past years, and it is expected to increase in 2019 and 2020 according to Commission forecasts. While this indicator is subject to considerable uncertainty — as it relies on the estimation of the cyclical position of the economy —, its developments indicate that the worsening of the structural balance in some countries, such as Spain or Italy, was offset by the improvements recorded in some low-debt Member States, such as Germany, as well as in some high-debt countries, such as Belgium or Portugal.

The evolution of the aggregate public debt in the euro area recorded a substantial fall, from 92% of GDP in 2014 to 85% of GDP in 2018. Yet, this is still 20 pps. above the pre-crisis level of 2007 (Figure 6). As just seen, both the upswing in the economic cycle and the fall in interest rates contributed to the decline in the nominal deficit and thus in public debt in the euro area as a whole. However, the differences among countries remain wide. Public debt ratios are at or above 120% of GDP in three Member

⁷ Fiscal effort refers to a quantification of the fiscal impact of measures introduced, obtained by summing up the impact of the individual measures (bottom-up) or of the fiscal impact of government policy, obtained by looking at the overall change in the structural balance (top-down). Source: SGP Vademecum.



States (Greece, Italy and Portugal) and are close to 100% in four more, including Spain and France, while countries such as Germany or the Netherlands abide, or are close to abiding, by the Treaty reference value of 60% of GDP. Interestingly, the countries that entered the Juncker Commission with higher debt levels have recorded the less intense debt corrections. Debt levels have actually increased in France and to a lesser extent in Italy, while they declined by only 3 pps. of GDP in Spain (from 100% in 2014 to 97% in 2018), in spite of an accumulated nominal growth of about 20% since 2014.

The whole fiscal improvement in nominal terms came from expenditures, while revenues declined marginally (Figure 7). Government expenditure as a share of GDP came down by close to 2.3 pps., from 49.1% in 2014 to 46.8% in 2018. As for government revenues, they declined marginally from 46.2% of GDP in 2014 to 45.8% in 2018, in contrast to the increases recorded in 2011-2013. Approximately 20% of the adjustment in total expenditures was due to lower interest rates, thanks to the accommodative monetary policy pursued by the ECB.

In France and Spain, the profiles of the fiscal adjustment fit pretty well that of the euro area, almost exclusively coming from the expenditure side, although the differences in levels are striking. In France, expenditures fell by only 1 pp. of GDP to reach 56%, while revenues remained broadly unchanged at around 53.5% of GDP. In the case of Spain, expenditures recorded a fall of 3.5 pps. to 42% of GDP, while revenues remained broadly constant at 39% of GDP. In contrast, expenditures did not change in Germany at 44% of GDP but revenues increased by 1 pp. In Italy, revenues and expenditures fell by 1.5 and 2.5 pps., respectively.

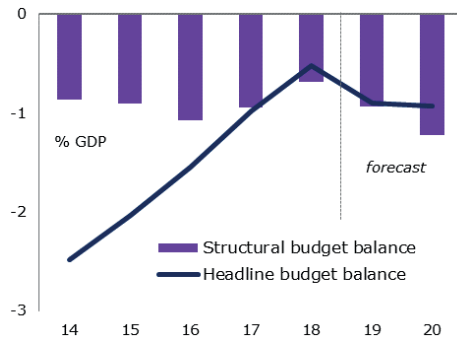
Public investment represented 2.7% of euro-area GDP in 2018. This is slightly lower ($\frac{1}{4}$ pps.) than the average of the period 2010-2014. Public investment declined in most of the main euro-area countries. In the Netherlands and France public investment remained above a 3% arbitrary benchmark, although on declining paths. In Italy, after a fall of half a percent of GDP, public investment records a meagre 2.1% of GDP, the same ratio as in Spain, although in this case the contraction represents 1% of GDP with respect to the 2010-2014 average.

Fiscal policy played a slightly stabilising role in the euro area during most of the Juncker Commission mandate, after recording a contractionary stance in the worst years of the crisis. The aggregate euro-area fiscal stance was expansionary in 2015 and 2016, helping to sustain the economic recovery, and broadly neutral in 2017 (Figure 8). In 2018, the fiscal stance was marginally restrictive, and, in 2019, it is expected to have become slightly expansionary.⁸

⁸ "Assessment of the prospective fiscal stance appropriate for the euro area", European Fiscal Board, Brussels, 25 June 2019.

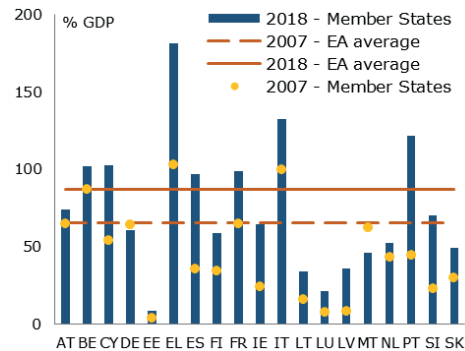
https://ec.europa.eu/info/sites/info/files/2019_06_25_june_report_final.pdf

FIGURE 5: GOVERNMENT DEFICIT, EURO AREA



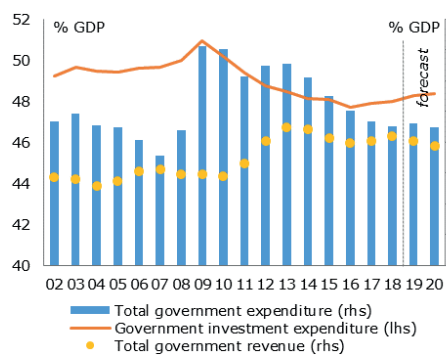
Source: European Commission, Spring Forecast 2019.

FIGURE 6: GOVERNMENT GROSS DEBT, EURO AREA



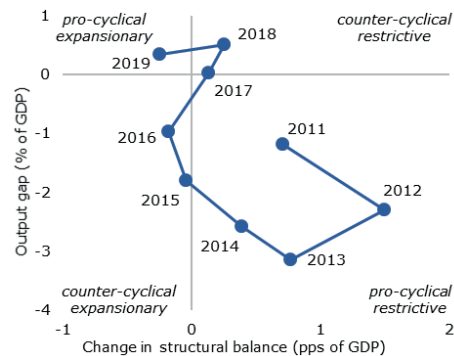
Source: European Commission, Spring Forecast 2019.

FIGURE 7: GOVERNMENT REVENUE, EXPENDITURE AND INVESTMENT, EURO AREA



Source: European Commission, Spring Forecast 2019.

FIGURE 8: AGGREGATE FISCAL STANCE, EURO AREA



Source: European Commission, Spring Forecast 2019

6.4. ECONOMIC AND FISCAL SURVEILLANCE DURING THE JUNCKER COMMISSION

6.4.1. AN IMPROVED FRAMEWORK

As spelled out in the introduction, when the Juncker Commission took office, the post-crisis reforms of the SGP were fully in force, with the adoption of the “Six Pack” (2011) and the “Two Pack” (2013). To promote structural reforms and investment, the



Juncker Commission introduced several practical changes to economic policy coordination and surveillance. The European Semester was strengthened. The dialogue with Member States and stakeholders was reinforced to increase the quality and ownership of the Commission's analysis and recommendations. The euro-area dimension and the cross-country spillovers also received more attention. The Commission monitored and advised on the adequacy of the euro-area fiscal stance and presented its policy recommendations for the euro area earlier in time to kick-start the Semester process in the autumn and inform national policies and fiscal plans. Moreover, the thematic focus of the country reports and the country-specific recommendations was strengthened in several areas, including employment and social policies, as well as investment needs and barriers.

The Commission also improved the way that it monitors the implementation of structural reforms by Member States, as recommended to each of them by the Council in the country-specific recommendations. Furthermore, the financing and technical support available to Member States to assist their implementation was enhanced. This included the creation of the Structural Reform Support Service (SRSS) to provide tailor-made technical assistance to Member States, at their request, in cooperation with other Commission departments, with a budget of €222.8 million over the period 2017-2020.⁹

Since the start of the European Semester in 2011, Member States achieved some progress in at least two thirds of their country-specific recommendations.¹⁰ Progress was faster in the aftermath of the crisis, particularly in the financial sector. However, in the last few years, as the economic situation improved, Member States have been less prone to pursue structural reforms and have even backtracked on some elements. Regarding public finances, countries made most progress on improving their governance and the least in broadening their tax base. The excessive tax burden on labour, the debt bias taxation, the fight against tax avoidance and evasion, and the improvement of tax administration remain important challenges. Furthermore, the reduction of current account surpluses has been marginal, in spite of reiterated recommendations addressed in particular to Germany and the Netherlands.

6.4.2. A MORE FLEXIBLE APPLICATION OF THE PACT

In fiscal surveillance, the Juncker Commission favoured a more flexible application of the SGP. As early in its mandate as January 2015, the Commission adopted a communication on "Making the best use of the flexibility within the existing rules of the SGP".¹¹

⁹ So far, the Service has engaged in almost 500 projects in 25 Member States.
https://ec.europa.eu/info/departments/structural-reform-support-service_en

¹⁰ "Communication on 2019 European Semester: country-specific recommendations", European Commission, Brussels, 5 June 2019, COM(2019) 500 final.

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019DC0500&from=EN>

¹¹ "Communication on making the best use of the flexibility within the existing rules of the Stability and Growth Pact" European Commission, Brussels, 13 January 2015, COM/2015/012 final.



One year later, in February 2016, the Council endorsed a commonly agreed position, providing guidance on the use of the flexibility built into the existing rules, without changing the Pact.¹² The Commission can modulate the required fiscal adjustment depending on the business cycle and public debt levels, within certain bounds, to reduce the pro-cyclicality in the application of the rules. The goal is that more (less) adjustment takes place in good (bad) times, while keeping longer-term fiscal sustainability in sight. In addition, Member States can ask for a temporary and limited relaxation of their fiscal adjustment path to carry out structural reforms or investment projects under some conditions — such as being in bad economic times in the case of investment projects.¹³

The implementation of the commonly agreed position on flexibility has been a subject of controversy, with some Member States blaming the Commission for a sometimes too lenient application of the fiscal rules, although all Commission recommendations were adopted by the Council without significant changes.

In the country specific recommendations of 2017, the Commission introduced the “margin of discretion” in assessing the degree of compliance with the preventive arm of the SGP. That meant in practice that the Commission would take into account both the cyclical position of the member economy and the sustainability of its debt. According to the recommendations, the 2018 budgets would “need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances”.¹⁴ At the time, the spring 2017 Commission forecasts projected euro-area growth at 1.8% for 2018, only slightly above the 1.7% projected for 2017. Interestingly, growth resulted much better than expected in both years.

There is not enough room in this paper to carry out an exhaustive review of the way the Juncker Commission implemented the fiscal rules but we can summarily discuss five prominent cases that serve to illustrate some of the challenges faced by a judgmental, non-mechanical implementation of the Pact: (i) the extension in 2015 of the 126(7) Council recommendation¹⁵ for France; (ii) the decisions adopted in 2016 concerning

<https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1479128901339&uri=CELEX:52015DC0012>

¹² “Commonly Agreed Position on Flexibility under the SGP” European Council, Brussels, 30 November 2015 (OR. in) 14345/15, ECOFIN 888 UEM 422.

<http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

¹³ “Vade Mecum on the Stability and Growth Pact” European Commission, Economic and Financial Affairs, Institutional Paper 101, Brussels, April 2019.

https://ec.europa.eu/info/publications/vade-mecum-stability-and-growth-pact-2019-edition_el

¹⁴ “2017 European Semester: Country-specific recommendations” European Commission, Brussels, 22 May 2017, COM(2017) 500 final.

<https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf>

¹⁵ If the Commission considers that an excessive deficit exists or may occur, the Commission issues an opinion to the Member State concerned under Article 126(5) TFEU; then, the Commission prepares a proposal for an Article 126(6) TFEU Council decision on the existence of an excessive deficit; and finally, the Commission prepares a so-called Article 126(7) TFEU recommen-



the fines associated to the stepping up of the excessive deficit procedure (EDP) for Spain and Portugal; (iii) the implementation of flexibility under the preventive arm for Italy; (iv) the rejection and subsequent negative opinion on the 2019 draft budgetary plan (DBP) of Italy in the autumn of 2018; and (v) the implementation of the debt rule in the case of Italy as well.¹⁶

6.4.3. THE EXTENSION OF THE EDP FOR FRANCE

When the Juncker Commission took office, France had been in the corrective arm of the Pact since 2009. On 27 April 2009, the Council had found that France's deficit was excessive and recommended the country to correct it by 2012 at the latest. Just a few months later, in December 2009, the Council extended the correction deadline by one year, to 2013, and when the time came, in 2013, a further extension was granted, this time up to 2015, when the deficit should attain 2.8% of GDP (down from 3.9% in 2013). In all these steps, the Council considered that France had taken effective action but that unexpected adverse economic events had prevented it from attaining the targets set in the corresponding recommendations.

The first Commission forecasts prepared by the Juncker Commission, those of winter 2015, indicated that the structural effort cumulated over 2013-2014 in France (1.9% of GDP) would fall short of the 2.1% recommended.¹⁷ Furthermore, according to those forecasts, the headline deficit was expected to reach 4.1% of GDP in 2015. Based on those observations, and taking into account the downward revision in inflation, the Council concluded that "the available evidence did not allow to conclude on no effective action", circumventing an explicit affirmation, following the text suggested by the Commission.¹⁸ This avoided the stepping up of the EDP for France and an extension of the 126(7) recommendation was granted.

In order to establish the deadline for the correction of the excessive deficit, the Com-

mission was recommended to be adopted by the Council, which sets a time limit to correct the Member State's public finance imbalances and to be compliant with both the deficit and the debt requirements. The recommendation contains annual deficit targets both in nominal and in structural terms, which are linked by an underlying macroeconomic scenario set on the basis of the Commission forecasts. Source: SGP Vademecum.

¹⁶ More information on the application of the fiscal rules can be found in the Commission's annual publication "Public Finances in EMU" and in the annual reports from the European Fiscal Board. https://ec.europa.eu/info/business-economy-euro/economy-finance-and-euro-publications_en https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/european-fiscal-board-efb_en

¹⁷ "European Economic Forecast - Winter 2015" European Commission, Brussels, 24 January 2015. https://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee1_en.pdf

¹⁸ "RECOMMENDATION with a view to bringing an end to the excessive government deficit in France" European Council Brussels, 5 March 2015 (OR. in) 6704/15, ECOFIN 177 UEM 81. <http://data.consilium.europa.eu/doc/document/ST-6704-2015-INIT/en/pdf>



mission took into account, within the framework of the “Flexibility Communication” just adopted, the French commitment to implement a series of structural reforms — even if France had made only limited progress in the correction of its excessive imbalances. In addition, the Commission considered that granting just one year would have been too demanding given the weak economic environment. Consequently, the Council recommended France to correct the excessive deficit by 2017, when the deficit should reach 2.8% of GDP. This consolidation path required improvements of the structural balance of 0.5%, 0.8% and 0.9% of GDP in 2015, 2016 and 2017 respectively.

Ultimately, though by implementing an almost exclusively nominal adjustment, France complied with the recommendation and corrected the excessive deficit by 2017. The 2018 spring forecast showed that the nominal deficit had attained 2.6% of GDP in 2017, down from 3.9% in 2014.¹⁹ However, the cumulated structural effort over 2015-2017 was just 0.9% of GDP (from – 3% in 2014 to – 2.1% of GDP in 2017), compared with the recommended 2.2%.

6.4.4. STEPPING UP THE EDP FOR SPAIN AND PORTUGAL

In contrast with the French case, in July 2016, the Council decided that Spain and Portugal, had not taken effective action in response to the corresponding 126(7) recommendations. Consequently, in August of the same year, pursuant Article 126(9) of the Treaty, the Council gave notice to both countries to take measures to correct their excessive deficits. Portugal was asked to correct the excessive deficit that same year, while Spain was granted two years until 2018. Although undoubtedly it would be worth analysing the content of both notices in depth, the reason why these cases are considered here is that such notices activated Article 6 of Regulation 1173/2011 to impose a fine for failure to take effective action. Since the Spanish and the Portuguese cases are similar, we chose the latter to refer to a small country.

As in the case of France, the Portuguese EDP had been opened in 2009 and the country had been granted two extensions. According to the last one, the deadline for the correction was 2015. However, in that year, the headline deficit attained 4.4% of GDP, and the structural balance had worsened by slightly more than half a point of GDP. Furthermore, according to the 2016 spring forecast, although the country’s headline deficit was expected to go down from 4.4% of GDP in 2015 to 2.7% in 2016, the structural balance was projected to worsen by ¼ pps. of GDP. The projections for 2017, pointed to a further reduction of the headline deficit to 2.3% of GDP with a further worsening of the structural balance by another ¼ pps. of GDP. Nominal growth was projected at a sustained rate of 3% per year.

¹⁹ “European Economic Forecast. Spring 2019” European Commission, Brussels, 07 May 2019. https://ec.europa.eu/info/sites/info/files/economy-finance/ip102_en.pdf



In the “126(9) notice”²⁰ of 8 August 2016, the Council extended the correction of the excessive deficit by just one year, as projected by Portugal itself, but requested additional structural measures amounting to $\frac{1}{4}$ pps. of GDP, so that the structural balance would remain constant.²¹ One day later, on 9 August 2016, the Council, following the corresponding Commission recommendation, decided to cancel the fine of 0.2% of GDP to be imposed to Portugal.²² The reasons put forward were based on the Commission’s assessment of the reasoned request submitted by Portugal to reduce the fine to zero. They, included in particular the sizeable fiscal adjustment and the comprehensive package of structural reforms undergone during the economic adjustment programme. In addition, the Council, always following the Commission, took into account the authorities’ commitment to correct any deviation in the execution of the 2016 budget, to implement a structural adjustment of at least 0.6% of GDP in 2017, and to implement a package of structural reforms in key areas, in particular in the banking sector.

Taking some perspective, and according to the 2017 spring forecasts, Portugal posted a deficit of 2.0% of GDP in 2016, helped by 0.2% of GDP one-off revenue from a tax amnesty launched at year-end, and the structural balance was estimated to improve by $\frac{1}{4}$ pps. of GDP, thus better than recommended in the notice of the Council and beyond the targets in the 2016 budget itself. In addition, although due to one-offs the headline deficit came close to the 3% threshold in 2017, the structural balance improved by 0.7% of GDP. In conclusion, the conditions that the Commission had established, to cancel the fine of 0.2% of GDP, were overachieved.

6.4.5. THE IMPLEMENTATION OF FLEXIBILITY FOR ITALY

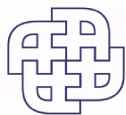
Italy is an interesting case for three reasons. First, it is the country that has benefited most from the flexibility and unusual event clauses. Second, it is the first country whose draft budget was formally rejected by the Commission and who received a subsequently

²⁰ For euro-area Member States whose EDP has been stepped up the Council issues a notice under Article 126(9) TFEU. The notice mirrors the Article 126(7) recommendation in that it includes a time limit for correcting the excessive deficit as well as annual nominal and structural balance targets, which are linked by an underlying macroeconomic scenario. In addition, the notice also contains a series of measures –and the corresponding timetable for their implementation– that are conducive to the achievement of the nominal and structural targets. Non-euro-area Member States are issued with revised Article 126(7) recommendations following an Article 126(8) decision that effective action has not been taken. Source: SGP Vademecum.

²¹ “Council Decision giving notice to Portugal to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit” European Council, Decision (EU) 2017/985 of 8 August 2016.

https://ec.europa.eu/info/sites/info/files/economy-finance/2016-08-08_council_notice_0.pdf

²² “Council Implementing Decision on imposing a fine on Portugal for failure to take effective action to address an excessive deficit” European Council, Decision (EU) 2017/2350 of 9 August 2016 https://ec.europa.eu/info/sites/info/files/economy-finance/2016-08-09_council_implementing_decision_0.pdf



negative opinion. Finally, although no EDP has ever been opened for any Member State on the basis of the debt criterion, Italy had to make commitments to avoid this possibility.

Starting with the implementation of flexibility under the preventive arm, between 2015 and 2018, Italy benefited from a cumulated allowance of 1.8% of GDP (€30 billion) and an additional 0.18% of GDP (€3 billion) was granted provisionally in 2019.²³ This includes allowances for a lower fiscal effort (0.25% of GDP) and refugee-related expenditure (0.03%) in 2015. In 2016, Italy was granted with 0.5% of GDP under the structural reform clause, 0.21% under the investment clause and 0.12% for refugee and security measures. The amount granted in 2017 reached 0.35% of GDP (exceptional investments and refugee-related expenditures) and, in 2018, the Commission used its margin of discretion to lower the fiscal effort from 0.6% to 0.3% of GDP.

An evaluation carried out by the Commission in 2018, at the request of the Council, found that the implementation of flexibility clauses did not reduce the standard pace of the necessary fiscal adjustment and therefore still supported the achievement of sound budgetary positions and debt reduction over the medium-term.²⁴ However, the actual fiscal adjustment by Member States tended to fall short of the required one and, in the few cases that flexibility had been applied, including Italy, Member States did not always deliver the structural reforms and investment projects in full as agreed in advance.

6.4.6. THE REJECTION OF THE 2019 ITALIAN DBP

The sequence of events that took place in 2018 showed both the strengths and limitations of the coordination and surveillance of draft budgetary plans (DBPs). On 16 October 2018, Italy submitted its DBP for 2019 implying a structural deterioration of 0.8% of GDP according to the government plans, compared with a fiscal effort recommended by the Council of 0.6%. A few days later, the Commission adopted an opinion requesting Italy to submit a revised DBP after identifying particularly serious non-compliance with the fiscal recommendation.²⁵ On 13 November, Italy submitted a slightly revised DBP that maintained the original headline target of 2.4% of GDP, which implied a structural deterioration of 1.2% of GDP, according to the Commission 2018 autumn forecast. Consequently, the Commission adopted an opinion confirming the existence of particularly serious non-compliance based on both the government plans and the autumn

²³ “Report from the Commission. Italy. Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union” Brussels, 5 June 2019, COM(2019) 532 final. https://ec.europa.eu/info/sites/info/files/economy-finance/com2019_532_it_en.pdf

²⁴ “Communication on the review of the flexibility under the Stability and Growth Pact” European Commission, Brussels, 23 May 2018, COM(2018) 335 final. https://ec.europa.eu/info/sites/info/files/economy-finance/com_2018_335_en.pdf

²⁵ “Commission opinion on the 2019 Draft Budgetary Plan of Italy” European Commission, Strasbourg 23 October 2018, C (2018) 7510 final. https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_opinion_it_en.pdf



forecasts.²⁶ The DBP procedure ended there, as the Commission could only request Italy to amend the DBP once.

6.4.7. THE IMPLEMENTATION OF THE DEBT RULE FOR ITALY

As just mentioned, Italy could have decided not to further modify the DBP and to adopt the corresponding budget for 2019. To observe the 2019 budget outcomes, the Commission would have had to wait until spring 2020, at which time it could consider opening a significant deviation procedure and/or a deficit or debt-based EDP, on the basis of 2019 notified data.²⁷ However, in order to keep the pressure on the Italian government to play by the rules, the Commission decided to initiate a debt-based EDP on the basis of 2017 data. Previously, in May 2018, the Commission had adopted a “126(3) report”²⁸ assessing compliance with the debt rule in 2017. In this report, the Commission had appreciated a series of relevant factors that would have justified not opening the EDP. However, in November, following the refusal of Italy to modify its DBP, the Commission adopted a new “126(3) report”, in which it considered that the risk of serious non-compliance in 2019 represented a material change in those factors. The report concluded that an EDP for non-compliance with the debt criterion in 2017 was warranted. Although agreeing with the Commission, in its opinion, the Economic and Financial Committee (EFC) noted that further elements could emerge from the dialogue between the Commission and the Italian authorities. This dialogue was also supported by the Eurogroup. As a result of the dialogue, Italy introduced a series of amendments in the 2019 draft budget. The Commission then concluded that the resulting budget did not represent a risk of serious non-compliance anymore and, therefore, an EDP was no longer warranted.

²⁶ “Report from the Commission. Italy. Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union” European Commission, Brussels, 21 November 2018, COM(2018) 809 final.

https://ec.europa.eu/info/sites/info/files/economy-finance/1263_commission_report_211118_-_italy_en_1.pdf

²⁷ If a Member State plans to break the SGP, the Commission can also activate procedures on the basis of projections.

²⁸ Following a breach of the deficit criterion (identified on the basis of outturns, plans or forecast data) or of the debt criterion (identified on the basis of outturn data), the Commission prepares a report pursuant to Article 126(3) TFEU. In that report, the Commission assesses the case for launching an EDP, based on a consideration of all factors pertinent to such a decision (Section 2.2). Article 126(4) TFEU requires that the EFC formulates an opinion on the Commission report. Following this, if the Commission considers that an excessive deficit exists or may occur, it issues an opinion to the Member State concerned under Article 126(5) TFEU. It then prepares a proposal for an Article 126(6) TFEU Council decision on the existence of an excessive deficit and, finally, a so-called Article 126(7) TFEU recommendation to be adopted by the Council, setting out adjustment requirements and a time limit to correct the Member State’s public finance imbalances. Source: SGP Vademecum.



In fact, the episode just described, was not the only time that Italy had to amend its 2019 budget to avoid a debt-based EDP. On the basis of notified 2018 data, on 5 June 2019, the Commission assessed *prima facie* non-compliance with the debt rule. As a share of GDP, the Italian debt had increased up to 132.2% in 2018 from 131.4% in 2017. In addition, the structural balance had deteriorated by 0.1% of GDP, whereas the recommended adjustment was 0.6% (0.3% considering the margin of discretion). In addition, the 2019 spring forecast projected a headline deficit above 3% of GDP in 2020. On these grounds, the Commission concluded that Italy did not satisfy the debt criterion in 2018. The EFC, agreed with the Commission but invited Italy to take the necessary measures to ensure compliance with the rules and concluded that possible further elements that Italy could put forward would be taken into account by the Commission and the EFC itself. On 1 July 2019, the Italian authorities adopted a mid-year budget representing a fiscal correction in structural terms of 0.45% of GDP, compared with the budget approved by the Parliament by the end of 2018. On 3 July, the Commission issued a communication to the Council, explaining why the package was material enough as not to propose the opening of an EDP.²⁹ According to the Commission 2019 autumn forecast, the 2019 headline deficit would be at 2.2% of GDP (0.2 pps. above the target) and the structural balance would improve by only 0.2% of GDP. Yet, this effort would be much larger than those projected for Spain (worsening of 0.2%) and France (unchanged structural balance).

The decisions not to open an EDP for Italy, either on the basis of 2017 or 2018 debt figures, were not without controversy for some Member States. Interestingly, none of them took the Commission to the Court of Justice. Perhaps the interpretation of the Commission was somewhat flexible compared with a strict reading of the rules but, looking at the debt-based EDP “saga” in a dispassionate manner, one can conclude that the Commission and the EFC took the right decisions to ensure a swift correction of the budgetary position of Italy. First, the Commission did not hesitate to reject the DBP of October and adopt a negative opinion on the November amended DBP. Second, once the DBP procedure was exhausted, the Commission did not hesitate either to initiate an EDP on the basis of the debt criterion, which forced Italy to significantly amend its DBP, to bring an end to the risks of particularly serious non-compliance. Third, the Commission initiated the debt-based EDP on the basis of 2018 data, which forced Italy to further amend its 2019 budget in the midst of its execution, further reducing the deviation from the recommended adjustment. No doubt, investors’ reactions and peer pressure also played a major role in convincing the Italian authorities to change their initial budgetary plans to preserve market access at reasonable costs. Therefore, one could say that a combination of market pressure, peer pressure from other Member States and the application of the fiscal rules by the Commission managed to avert significant risks and persuade the Italian authorities to follow a more cooperative attitude. In the end, sincere

²⁹ “Communication on the Spring 2019 round of fiscal surveillance for Italy” European Commission, Brussels, 3 July 2019 COM(2019) 351 final.
https://ec.europa.eu/info/sites/info/files/economy-finance/communication_to_the_council_aftercollege_-_final.pdf



cooperation is in fact one of the key pillars and goals of economic coordination in the EU, since the EU economy is “a matter of common concern” for the Member States.

6.5. THE REFORM OF FISCAL RULES

6.5.1. FROM “TOO SIMPLE” TO “TOO COMPLEX”?

The SGP is an essential element of the institutional architecture of the euro area. The EU fiscal rules are closely linked to the adoption of the euro with the ECB as the independent monetary authority. Among others, one necessary condition to underpin the independence of any central bank and consequently of monetary policy is to ensure that debt levels are sustainable. Unless fiscal dominance is avoided, the central bank might be obliged to accommodate monetary policy to finance the sovereign. Indeed, the fiscal rules enshrined in the Treaty of Maastricht and its protocol were mainly about debt sustainability. They ensured that, given the nominal growth conditions prevailing in the late eighties and early nineties, keeping the headline deficit below 3% of GDP would keep the debt level roughly stable at around 60% of GDP. These were simple rules, based on almost directly observable indicators.

The original SGP of 1998 affirmed that keeping a balanced budget over the cycle would not only avoid excessive deficits in normal economic cycles but would also ensure that debt remained at sustainable levels.³⁰ The balanced budget rule would allow automatic stabilisers to operate fully and symmetrically over the cycle. Implicitly, this required that any new permanent expenditure programme and/or tax cuts would be financed by higher taxes and/or lower expenditures, which, incidentally, is conceptually similar to an expenditure rule. On top of the regulations on clarifying and speeding up the EDP and the requirements to coordinate budgetary policies in the medium term, the 1998 version of the Pact also included a form of escape clause in case of extraordinary bad cyclical conditions.³¹ In addition, in the assessment of the *prima-facie* evidence on the existence of an excessive deficit, it was agreed that the composition of public finances, in particular public investment levels, would be taken into account.

This set of very simple and rather clear rules was later dubbed as “stupid”. The focus on headline targets in the correction of excessive deficits was criticised for ignoring that budgetary plans might not lead to the expected outcomes due to unanticipated changes

³⁰ “Resolution of the European Council on the Stability and Growth Pact”, Amsterdam, 17 June 1997. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM:l25021>
For the history of the SGP see: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/history-stability-and-growth-pact_en

³¹ See Article 2 in Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.
<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:31997R1467>



in cyclical conditions or unexpected events out of the control of the government. After the Council decision not to step up the EDPs for Germany and France, the 2005 reform of the fiscal rules tried to introduce some economic “intelligence” into the SGP. Basically, in the correction of the excessive deficit the focus moved from the fiscal outcomes to the so-called “fiscal effort”, mainly measured by the change in the structural balance, supposedly reflecting the discretionary measures taken by the government. In addition, the concept of the “balanced budget over the cycle” was also defined in terms of a structural balance target, calculated taking into account country-specific elements, such as potential growth, the future costs associated with ageing or the debt level.

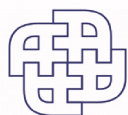
The run-up and the unfolding of the sovereign debt crisis showed that the fiscal rules, and the broader framework of economic policy coordination, were incomplete and had not delivered as intended. In the boom years, highly indebted countries had not seized the economic expansion to build sufficient fiscal buffers, and there were no tools to manage other types of imbalances that later translated into large increases in government debt.

Following the crisis, the “Six Pack” and “Two Pack” reforms shifted the focus of the fiscal rules to preventing excessive deficits and promoting more adjustment towards the country-specific Medium-Term Objectives (MTOs) in good times. In order to avoid relying on a single indicator (the “structural balance”), the “expenditure benchmark” was introduced to ensure that the part of the primary balance under the governments’ control would not increase annually beyond country-specific thresholds without being financed by new permanent tax revenues. The reforms also clarified the meaning of “debt reduction at a satisfactory pace”, operationalising the opening of a debt-based EDP. The goal was to ensure that high debt levels fell annually at a rate of $1/20^{\text{th}}$ of the difference between the actual debt level and the 60% threshold.

These and other innovations enhanced the economic meaning of the fiscal rules and attempted to reduce their pro-cyclicality, but at the expense of increasing their complexity. The flexibility introduced during the Juncker Commission also enhanced the economic meaning of the fiscal rules, by gauging the adjustment path towards the MTO as a function of the cyclical conditions, and trying to support the implementation of structural reforms to increase potential growth. It also put more emphasis on the need to preserve the quality of public finances, especially investment levels during the fiscal adjustment process in bad times. However, while giving even more economic meaning to the fiscal tools in the EU, flexibility also added to complexity, which at the end of the day translates into lower transparency and ownership.

6.5.2. HAS THE PACT DELIVERED ON ITS GOALS?

In terms of fiscal outcomes, international comparisons suggest that the fiscal rules have helped to contain debt levels. Aggregate public debt levels are much lower and have increased much less in the euro area (85% in 2018) than in Japan (235%), the US (138%), the UK (113%) or Canada (108%). However, the euro-area debt figure is far from being evenly distributed across Member States. Not surprisingly, aggregate deficit



figures also compare rather favourably with those of other jurisdictions, and the 3% reference value in the Treaty has been rather effective in containing larger slippages, though it has also acted as a target too often.³²

At the same time, the EU fiscal toolkit has achieved its goals only partially. True, the flexible application of the fiscal rules helped the euro-area economy recover from the recession. However, on the one hand, a number of high-debt Member States failed to build the necessary fiscal buffers to deal with the next downturn. The combination of nominal adjustment strategies under the corrective arm and the frequent spending of part of the windfall revenues and interest burden reductions have weighted on the sustainability of public finances in high-debt countries, including France, Italy, Spain and Belgium, which account for close to 50% of the euro-area economy in terms of GDP. On the other hand, the existing fiscal space in some other Member States has not been used to expand investment, and this in spite of a coherent combination of all the surveillance tools available to the Commission — including the euro-area recommendations, the country specific recommendations and the macroeconomic imbalances procedure —, requesting those countries to reduce their large current account surpluses. This is the case of countries such as Germany or the Netherlands.

6.5.3. TOO MANY PROCESSES AND INDICATORS?

The corrective arm of the Pact looks essentially at the headline balance, while the preventive arm looks at budgetary indicators adjusted for the position of the economy in the cycle. This can lead to inconsistencies in terms of the required adjustment.³³ Over the past few years, Member States in EDP were often recommended to implement structural adjustments above those required under the preventive arm and, in particular, by more than the 0.5% of GDP benchmark. However, the reality has been that what counts to abrogate the EDP is the headline balance, which has led some Member States to implement “nominal strategies” to correct their excessive deficits. This means that countries in EDP have relied primarily on the revenue windfalls from the stronger-than-expected recovery to meet the targets set by the Council, avoiding the consolidation that would have been required under the preventive arm.

As for the preventive arm itself, its reliance on multiple indicators — namely the structural balance and the expenditure benchmark — also adds to the complexity and can lead to divergent results. The Commission and Member States agreed in 2016 to give

³² “Fiscal outcomes in the EU in a rules-based framework – new evidence” Part IV Report on Public Finances in EMU 2018, European Commission, Brussels, 24 January 2019. https://ec.europa.eu/info/sites/info/files/economy-finance/ip095_part_iv.pdf

³³ In the corrective arm, the expenditure benchmark is derived from the budgetary targets established by the Council in its recommendation to the given Member State under the excessive deficit procedure, unlike in the preventive arm, where it is derived from the medium-term growth rate of potential output.



prevalence to the expenditure benchmark.³⁴ This is generally considered to be more predictable, easier to measure, less affected by factors that lie outside government control and better suited to act as an operational target for budget preparation. However, this non-binding agreement has seldom been applied as, with the economic recovery, the adjustment required under the expenditure benchmark was frequently larger than under the structural balance.

Another point of contention, perhaps more difficult to resolve, is the use and the variability of cyclically adjusted indicators under the preventive arm. Theoretically, at least, these represent an improvement compared to the use of headline figures under the corrective arm. However, this requires the estimation of an unobservable variable, i.e. the output gap. The methodology to estimate this variable is agreed by Member States and implemented by the Commission. It is nevertheless subject to estimation uncertainty and some countries contend that it does not capture the cyclical position of their economies well and leads to implausible results.³⁵ More broadly but importantly, output gap estimations are subject to a certain degree of volatility, which runs counter to the desired predictability of the budgetary goals over time.

To end with this partial enumeration of some of the shortcomings of the Pact, it has also been argued that the current set of rules are asymmetric and exclusively focus on the individual Member States, without appropriately considering the fiscal stance of the euro area.³⁶ An adjustment path towards the MTO at an annual pace of at least 0.5% of GDP, independently of the cyclical position of the country, will lead to pro-cyclical policies in bad times. However, the Pact does not impose countries having overachieved the MTO to implement expansionary fiscal policies in bad times. Consequently, as measured by the changes in the structural balance; fiscal policy in the euro area should be contractionary until all the members are at the MTO, in which case fiscal policy would become broadly neutral. Therefore, in the current circumstances, implementing an expansionary fiscal policy for the euro would require a fiscal policy coordination process outside the Pact framework.

³⁴ “Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm” Economic and Financial Committee, Brussels, 29 November 2016. <http://data.consilium.europa.eu/doc/document/ST-14814-2016-INIT/en/pdf>

³⁵ “France, Italy, Spain, Portugal urge EU to review its economic models” Reuters Business News, 4 May 2017.

<https://www.reuters.com/article/us-eurozone-economy-letter/france-italy-spain-portugal-urge-eu-to-review-its-economic-models-idUSKBN1801XQ>

³⁶ This aspect is also linked to the debate on a common fiscal capacity. See “Fiscal rules in the euro area and lessons from other monetary unions” Nadine Leiner-Killinger and Carolin Nerlich, ECB Economic Bulletin, Issue 3/2019, European Central Bank, Frankfurt am Main, 23 April 2019 https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201903_02~e835720b96.en.html#toc1



6.5.4. REFORMING THE FISCAL RULES

In this state of affairs, many institutions (national and international, public and private), academics and other experts have put forward their proposals to reform the fiscal rules. In some cases, these proposals consist of reasonably complete reform packages, but most of the time they consist of partial changes to the toolkit.³⁷

Most proposals advocate for reducing the number of indicators to one with a preference for the expenditure benchmark for the reasons considered above, and for using the same indicator in both the preventive and corrective arms. At the same time, Member States would need to comply with a debt-to-GDP medium-term objective, which is also a more intuitive measure than the structural balance used now. These changes might not only imply a simplification but also a relative tightening of the rules, compared to the current situation.

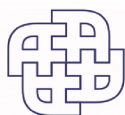
More specifically, for some commentators, a long-term debt-to-GDP target would be set for each Member State within a given horizon. This would translate into an adjustment path expressed as an expenditure benchmark over the medium term. During such a period, Member States could modulate their yearly adjustment. In this way, the only difference between the preventive and the corrective arms would be the intrusiveness of surveillance and the possibility of sanctions, rather than the type of indicators and the targets. As regards sanctions, some commentators suggest abandoning direct financial penalties and using economic conditionality, i.e. excluding countries in serious non-compliance from certain economic advantages linked to their EU or euro-area membership. For instance, reducing the co-financing rates linked to structural funds, their voting rights or their access to other instruments. Alternatively, or as a complement, a system of incentives could be considered, for instance on the basis of the future Budgetary Instrument for Convergence and Competitiveness.

The institutional architecture for the application of the Pact is also being discussed. The European Fiscal Board, for instance, has proposed to split the purely technical assessment of compliance from the more political one, either within the Commission or by entrusting the technical assessment to a party outside.³⁸ Other observers argue in favour of decentralising fiscal surveillance by strengthening the powers and resources of independent fiscal institutions that exist today at national level under the Treaty on Stability, Coordination and Governance.³⁹ One option would be to expand their mandates so they

³⁷ For a short review of the main institutions and authors active in this debate see Box 5.1 (“Other proposals to reform the EU fiscal framework”) in “2019 Annual Report” European Fiscal Board, Brussels, 29 October 2019. https://ec.europa.eu/info/publications/2019-annual-report-european-fiscal-board_en

³⁸ “Assessment of EU fiscal rules with a focus on the six and two-pack legislation” European Fiscal Board, Brussels, 11 September 2019. https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en

³⁹ “European fiscal rules require a major overhaul” Zsolt Darvas, Philippe Martin and Xavier Ragot, Bruegel Policy Contribution Issue n°18, October 2018. <https://bruegel.org/2018/10/european-fiscal-rules-require-a-major-overhaul/>



can make assessments of potential growth, inflation and the impact of tax changes on government revenues, and run long-term fiscal sustainability analysis. Others go as far as proposing a complete overhaul, by transferring fiscal surveillance to those national institutions and to set up a coordination procedure at EU level. The goal would be to devolve most of this competence to Member States and removing much of the onus (and the blame) away from “Brussels”. In any case, the Commission should remain responsible for the correction and prevention of “gross errors”, entrusted to it by the Treaty (Article 126), even if a larger part of the surveillance was carried out at national level.

These proposals are far from being the only ones, but a complete, coherent and detailed reform proposal remains to be sketched out. The Commission is expected to release its review of the Two and Six Packs by the end of 2019 at the earliest, when it may also give some initial indications regarding a possible broader review of the Pact. Yet, the reform of the Pact may not be as imminent as some may want. As it became clear in the informal Eurogroup and ECOFIN of September 2019, the appetite of the Member States to engage in a formal discussion on the reform of the rules appears to be quite limited, given both the technical and the political complexity of such a discussion, which could make an agreement unlikely over a reasonable time horizon.⁴⁰

As a matter of fact, the views are split among Member States concerning the way the rules have been applied, which are likely to lead to quite different reform approaches. Some criticise the Commission for being overly lenient and flexible, while others argue that the fiscal rules are still applied too strictly and continue to impose austerity. Some argue that the Commission should perform the role of a strictly technocratic body and constraint itself to a mechanical application of the Pact. Others consider that the Commission is also called to apply political judgement in the application of the Pact, as with any other Commission recommendation to the Council and Parliament. Finally, some also argue that the rules are applied differently depending on the (size of the) country at hand.⁴¹

There is broad agreement that a reform of the Pact along the lines discussed in this section, could have positive effects on budgetary surveillance overall, by making it more transparent and predictable, and therefore more accountable and effective over time. However, the consensus is less evident when allocating priority levels to the two traditional goals of fiscal policy, long-term sustainability and short-term stabilisation. The tensions between these two objectives will in all likelihood remain determinant for the future

⁴⁰ “Remarks by Vice-President Valdis Dombrovskis at the press conference following the second session of the informal ECOFIN in Helsinki” Helsinki, 14 September 2019. https://europa.eu/rapid/press-release_SPEECH-19-5575_en.htm

⁴¹ For an overview of this debate see “Why Do Large Countries Flout the Stability Pact? And What Can Be Done About It?” Marco Buti and Lucio R. Pench, 2004. *Journal of Common Market Studies*, vol. 42(5), pages 1025-1032. More recently, Luc Eyraud, Vitor Gaspar and Tigran Poghosyan (“Fiscal Policy in the Euro Area” IMF Working Paper no 17/18, International Monetary Fund, Washington DC, January 2017) found no conclusive evidence of bias in procedures in relation to country size.

<https://ideas.repec.org/a/bla/jcmkts/v42y2004i5p1025-1032.html>

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2938319



application and reform of the rules. The fact that for some the quality of public finances, especially investment levels, is also a matter of concern and should be embedded in the future fiscal rules will add to the complexity of the solution. Sooner or later, the discussion will have to become much broader. The multiple dilemma of “simple” versus “intelligent and economically meaningful” rules — encompassing the simultaneous goals of sustainability, stabilisation and growth-friendly composition of public finances — might only be solved after realising that the real choice is between rules and shared competences, and that one single policy tool cannot deliver on all the intended goals.

6.6. THE EU FISCAL RULES AND THE CHALLENGES AHEAD

6.6.1. A STRONGER FOOTING BUT CLOUDS ON THE HORIZON

The previous section discussed the reform of the fiscal rules by looking at their current architecture and some of the reform proposals put forward by different institutions and commentators. While waiting for the output of the public debate launched by the Commission on the Six and Two Pack review and any possible follow-up proposals, in this section⁴², we follow a different approach and discuss the fiscal rules from the perspective of the economic challenges to which fiscal policies are likely to be confronted in the coming years. Those are of a short, medium and long-term nature. The first one is associated to the sharp deceleration of the euro-area economy being observed since the second half of last year, which appears to be stabilising in 2020.

Although the European economy is today on a much a stronger footing than it was in 2014, a number of thunderclouds are mounting on the horizon. Since mid-2019, the forecasts of the Commission and other international organisations have confirmed that the global and euro-area economies are decelerating. In the euro area, GDP is projected to grow at 1.2% over 2019/2021, according to the Commission winter 2020 forecast.⁴³ These growth rates contrast with the 1.9% achieved in 2018 and the peak of 2.5% in 2017.

There are many factors behind the current slowdown, including supply shocks, such as trade tensions, the US-China conflict, Brexit or oil-market volatility. Commentators refer also to cyclical developments, especially in the US, and to more structural factors and shifts, such as those that might be taking place in the car industry. In addition, policy effects, such as the fading of the fiscal stimulus in the US or high global uncertainty are also mentioned. Finally, mounting uncertainty about the effects of the outbreak and spread of the 2019-nCoV coronavirus could worsen the global outlook.

⁴² Communication on economic governance review” European Commission, Brussels, 5 February 2020, COM(2020) 55 final.

⁴³ “European Economic Forecast. Winter 2020 (Interim)” European Commission, Brussels, 13 February 2020. https://ec.europa.eu/info/sites/info/files/economy-finance/ip121_en.pdf



Such shocks are affecting euro-area countries in different manners, according to their economic structure. For instance, countries with more reliance on external demand and industrial goods, compared to internal demand and services, will tend to be affected more directly by trade tensions. This seems to be the case of Germany, where the Commission projects growth at just 0.4% in 2019. The deceleration in Germany already started in 2018, with GDP growth at 1.5%, in sheer contrast with the 2.5% posted a year earlier. On the other hand, any ensuing contagion or asset repricing induced by the slowdown could have a larger effect on countries with high stocks of debt or negative international investment positions. For instance, the Italian economy, which already decelerated in 2018 to 0.8%, compared with 1.7% in 2017, is projected to practically stagnate in 2019. The Spanish economy appears in this context more resilient, with GDP expected to grow by 1.9% in 2019 and 1.5% in 2020 according to the Commission autumn forecast.

6.6.2. WHICH IMMEDIATE (IF ANY) POLICY RESPONSE?

Given the diverse nature of the shocks just mentioned and the different exposure of Member States to them, there are uncertainties regarding the policy response at the national and euro-area levels. The appropriate policy response — either monetary, fiscal, structural or more probably a combination of them—, should be different if the shocks take place on the demand side (cyclical factors, uncertainty) or on the supply side of the economy (permanent lowering of international trade, technological changes). The response should also consider whether the shocks are of a permanent (structural shift in the car sector) or of a transitory nature (lower car demand in the short term due to transitory regulatory uncertainty).

Our assessment is that we are confronted with a combination of demand and supply shocks, where the latter could consist of permanent reductions in trade levels and structural changes affecting some main manufacturing sectors. However, we also think that policy and economic uncertainties are also playing a prominent role in slowing down investment. This seems to be as well the position of the ECB. In September 2019, its Governing Council concluded that “fiscal policy should become the main instrument to raise demand” in the current context.⁴⁴ Additional monetary easing is expected to be less effective this time around, and can no longer be “the only game in town”, thus pointing to the need of a coordinated reaction of fiscal policies in the euro area. It has been argued that higher deficits in low-debt countries are needed to complement monetary policy, constrained by the zero lower bound. As reiterated in the previous sections, the fiscal space in the euro area is unevenly distributed across Member States. While some countries have quite substantial fiscal room for manoeuvre most high-debt euro-area members are in a much more vulnerable position. In an ideal world, high-debt countries

⁴⁴ “Introductory Statement by Mario Draghi on the outcome of the meeting of the Governing Council”, European Central Bank, Frankfurt am Main 12 September 2019.
<https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is190912~658eb51d68.en.html>



should build fiscal buffers at a prudent pace, while low-debt countries should support monetary policy, ensuring an expansionary fiscal stance for the euro as a whole.

In this context, the next question would be how to articulate a coordinated fiscal response. The fiscal rules are asymmetric and they do not refer to the euro area as such, as mentioned before. Therefore, a coordinated policy response will depend on the political capacity and will of euro-area countries to coordinate within the Eurogroup, possibly at short notice. The technical arguments to convince them should come from the Commission and the ECB, and both low and high-debt countries would need to agree on the response in order to ensure the appropriate fiscal stance for the euro area.

6.6.3. AVERTING THE RISKS OF A “1% ECONOMY”

Moving beyond the more immediate risks to employment and GDP growth, the euro area also faces important longer-term challenges that may require some form of fiscal policy response. Given the current trends in productivity growth, inflation and inequality, there is a risk that the euro area could become a “1% economy” over time. By a “1% economy” we refer to a situation where potential growth and inflation would hover around 1% and the share of income and wealth held by the richest 1% of the population would keep increasing.

Euro-area potential GDP growth, currently at around 1.5%, is expected to come under pressure over the medium term, mainly from demographic factors. AA projected slowdown in the working age population growth rate, coupled with mild productivity and investment developments, could bring potential GDP growth down to 1.1%, as of 2022, or lower if the downside risks linked to policy uncertainty materialise. Similarly, inflation rates, both realised and projected for the medium-term, have been persistently below the ECB mandate and deteriorated in 2019. Core inflation is hovering just above 1% without a clear trend.

When it comes to public finances, the consequences of a “1% economy” could be rapidly felt, particularly in a context where several euro-area governments have not sufficiently reduced their large stocks of debt. On the one hand, the combination of low GDP growth and low inflation would have a direct negative impact on debt sustainability, via a denominator effect. On the other hand, lower labour incomes could reduce private consumption and tax revenues, while wealth concentration could further erode tax bases. Faced with mounting sustainability risks and lower fiscal revenues, Member States would have little choice but to reduce investment expenditure, further curtailing future growth prospects.

While the scenario just described might be too bleak, it serves to illustrate some of the key policy challenges in the economic and fiscal arena for the new EU institutional cycle that is just starting. As put forward by President Ursula von der Leyen in her political guidelines, “A Europe that strives for more”, the EU needs to be ambitious about where



it wants to go and deliver on reforms.⁴⁵ A more positive economic scenario would indeed require ambitious policy action at national and European level to overcome existing barriers to productivity and potential growth, with an obvious role for fiscal policy, including composition issues.

At the same time, although the underlying trends of the “1% economy” are of a longer-term nature, the degree to which the euro area may slip into them is probably not disconnected from the policy response to the current slowdown, which might determine the central economic scenario in the medium term. Hysteresis effects could exacerbate the productivity slowdown, keep inflation subdued and worsen income distribution.

6.6.4. DEALING WITH BROADER MACRO-TRENDS

Broader macro-trends are also at play that could have profound repercussions for public finances. They include demographic changes, such as ageing in most developed economies and China, as well as migrations; the costs of climate change, plastic pollution, loss of biodiversity and other environmental degradation; and the transformation of economic, social and political structures driven by technological developments, notably in the areas of artificial intelligence or robotisation. Despite being longer-term phenomena, some of their effects are already taking place, perhaps earlier than anticipated.

Economies affected by ageing see their productive capacity fall and a diminishing labour force having to bear a heavy burden to support those in retirement. By 2070, the EU could go from having 3.3 working-age people for every person aged over 65 to only two working-age persons.⁴⁶ This can contribute to intergenerational inequality and place severe strain on pension systems, both funded and pay-as-you-go. Migration can help to rebalance the population pyramid and fill skill gaps in labour markets in receiving regions and countries, contributing positively to economic growth and public finances. However, in the short run, migration puts pressure on social, training and health systems. In addition, it can also reduce the economic potential of sender regions, contributing to spatial inequality, also within the EU and its member countries.

The costs of climate change adaptation and response to environmental disasters (growing in frequency and severity) frequently fall on the public sector as insurer of last resort and reduce irreplaceable productive resources from the economy. Europe has to close an investment gap of almost €180 billion per year to achieve EU climate and energy targets by 2030, according to Commission estimates.⁴⁷ The European Environment

⁴⁵ “A Union that strives for more: My agenda for Europe - Political guidelines for the next Commission (2019-2024)” Ursula von der Leyen, Brussels, 16 July 2019. https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf

⁴⁶ “The 2018 Ageing Report. Economic and Budgetary Projections for the EU Member States (2016-2070)” European Commission, Brussels, 25 May 2018. https://ec.europa.eu/info/sites/info/files/economy-finance/ip079_en.pdf

⁴⁷ “Action Plan: Financing Sustainable Growth” European Commission, Brussels,



Agency has calculated that the average annual economic losses associated to climate change were around €13.0 billion between 2010 and 2017, compared to €7.4 billion over the period 1980-1989 in the European Economic Area.⁴⁸

Finally, technological change, which should enhance productivity and wellbeing in the long run, can have disruptive impacts on competition, labour markets and income distribution in the short to medium terms. Such developments need to be watched carefully to avoid a winner-takes-all economy and further depletion of tax bases. Industrial and innovation policies in Europe are challenged both by the fragmentation of national interests and programmes and by the pressure coming from other jurisdictions, such as China.

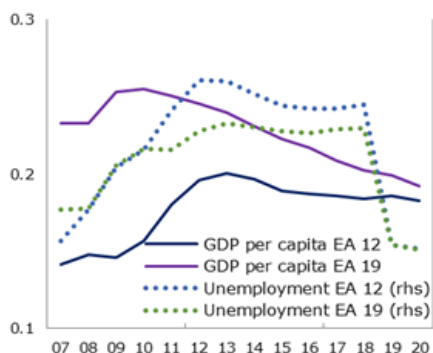
Moreover, the macro-trends just considered could also affect the process of economic convergence among Member States (Figures 9 and 10). Over the last institutional cycle, 2014-2019, economic growth restarted the convergence process that halted and partially reversed during the crisis. This renewed convergence is most likely taking place on a sounder footing than in the pre-crisis period, thanks to the important reforms undertaken to strengthen the financial sector and the architecture of the euro.⁴⁹ However, the euro area still lacks some of the features present in other currency areas. While capital mobility, price and wage flexibility and labour mobility have recovered from the crisis or progressed further, the euro area still lacks sufficient risk sharing mechanisms, both private and public. While the euro area has well developed banking markets, these are not sufficiently integrated, while capital markets are not only fragmented but also insufficiently developed compared to other economies. In addition, the euro area lacks a meaningful common budget, to complement private risk-sharing in times of crisis and redistribute resources to the regions or sectors worst impacted.

8 March 2018, COM(2018) 97 final. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097>

⁴⁸ “Economic losses from climate-related extremes in Europe” European Environment Agency, Copenhagen 24 January 2019. <https://www.eea.europa.eu/data-and-maps/indicators/direct-losses-from-weather-disasters-3/assessment-2>

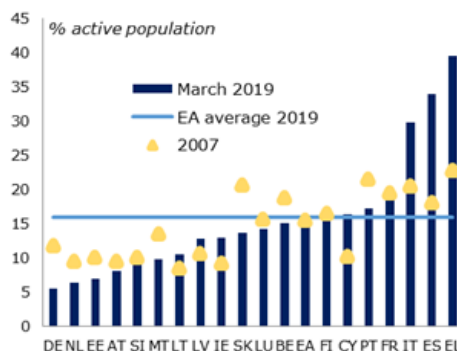
⁴⁹ “Reflection paper on the deepening of the economic and monetary union” European Commission, Brussels, 31 May 2017 https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_en

FIGURE 9: CONVERGENCE IN THE EURO AREA



Coefficients of variation, real GDP per capita. Changing composition excluding LU and IE. Source: European Commission Spring forecast 2019.

FIGURE 10: YOUTH UNEMPLOYMENT, MARCH 2019



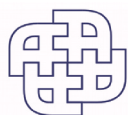
Source: European Commission, Eurostat.

6.6.5. FINDING A HOLISTIC POLICY RESPONSE...

To tackle these challenges, the EU should adopt a holistic approach in reforming the fiscal rules, which cannot be understood in isolation. The role that they are called to play, and their design, depends on the other elements of the EMU architecture.⁵⁰ As considered earlier, the fiscal rules attempt to fulfil two objectives, if not three, that can contradict each other. Further deepening of the euro area architecture could make the fiscal rules more effective by (i) increasing the opportunities for private-sector risk sharing, which would in turn increase the resilience of member economies to idiosyncratic shocks and hence reduce the need for fiscal stimulus for stabilisation; (ii) increasing public risk-sharing to fund growth-enhancing projects and cushion the impact of possible shocks; and (iii) advancing on common governance to complement risk-sharing by the public sector.

Completing the Banking Union and speeding up the development and integration of capital markets in Europe would be the two main tools to enable additional private-sector risk sharing in Europe. Pan-European banking services and banking entities, able to operate seamlessly and serve customers across jurisdictions, would break the bank-sovereign nexus and would be more resilient to local shocks. In turn, they would be able to keep the credit channel operating if the economy of one of their markets would suffer a shock, thanks to the geographical diversification of their business models.

⁵⁰ "Communication on deepening Europe's Economic and Monetary Union: Taking stock four years after the Five Presidents' Report" European Commission, Brussels, 12 June 2019, COM(2019) 279. https://ec.europa.eu/info/sites/info/files/economy-finance/emu_communication_en.pdf



To achieve this vision, Europe needs to remove the remaining obstacles to Banking Union. The High Level Working Group of Member States identified in June 2019 three areas for further progress: (i) a European Deposit Insurance Scheme that ensures an effective and uniform protection for covered depositors within the Union; (ii) further approximation of the crisis management framework, including bank insolvency law, and possible extension of the scope of the common supervisory framework; and (iii) addressing the sovereign-bank nexus and its financial stability implications at the EU/national level, through the possible review of the regulatory treatment of sovereign exposures and the introduction of a common safe asset.⁵¹

In turn, further progress in the Capital Markets Union would offer a broader choice of funding sources to companies and households at a lower cost, and facilitate access to cheaper and more efficient investment vehicles and the cross-border holding of equities and bonds. To make this a reality, it would be necessary to advance in controversial aspects such as common supervision and marketing rules, and in complex areas such as the harmonisation of national insolvency frameworks, and some aspect of tax and property laws. Moreover, the two legs of the Financial Union present many synergies, as capital markets will not develop without a common savings market and a benchmark yield curve, and well-functioning capital markets are called to play an important role in strengthening the resilience of banks and other corporates.

Of all the elements above the one with the closest links with fiscal policies is the common safe asset. There are increasing calls to develop a common safe asset for the euro area.⁵² Bank of Spain's governor Hernández de Cos recently summarised the main arguments: offering an alternative for banks to diversify their sovereign holdings, reducing the destabilising impact of flight to safety flows, providing a common yield curve to value other assets, facilitating the transmission of monetary policy, and buttressing the international role of the euro.⁵³ A common safe asset could be part of a common fiscal capacity or simply replace part of the existing stock of national bonds. To have sufficient size, it would have to be closer to the latter than to the former. There are several propos-

⁵¹ "Considerations on the further strengthening of the banking union, including a common deposit insurance system - Report of the HLWG Chair" Economic and Financial Committee, Brussels, June 2019. <https://www.consilium.europa.eu/media/39768/190606-hlwg-chair-report.pdf>

⁵² See for instance *Bruegel* ("Promoting sustainable and inclusive growth and convergence in the EU" by M. Demertzis, A. Sapir and G. Wolff, April 2019; and "Redefining Europe's economic sovereignty" by M. Leonard, Pisani-Ferry, J., Ribakova, E., Shapiro J. and G. Wolff, June 2019), *Centre for European Policy Studies - European Capital Markets Institute* ("Rebranding Capital Markets Union", task force report by K. Lannoo and A. Thomadakis, June 2019), *Peterson Institute for International Economics* ("Europe's Search for a Safe Asset" by J. Zettelmeyer and A. Leandro, October 2018), or *London School of Economics and Political Science* ("The rationale for a safe asset and fiscal capacity for the Eurozone" by L. Codogno and P. van den Noord, May 2019).

⁵³ "The EMU at 20: from divergence to resilience" Welcome address by Governor Pablo Hernández de Cos, Third Annual Research Conference of the Banco de España, Madrid, 16 September 2019. <https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/IntervencionesPublicas/Gobernador/Arc/Fic/hdc160919en.pdf>



als that could perhaps achieve that goal without mutualisation, including sovereign-bond backed securities, with possible enhancements such as capital or over-collateralisation, and E-bonds backed by senior loans from a common issuer to Member States.⁵⁴

A common fiscal capacity would complement the Financial Union. It could provide a stabilisation function for Member States in times of crisis, which would allow fiscal rules to refocus on ensuring the sustainability of national public finances. President von der Leyen announced in the political guidelines for her mandate that the Commission will propose a European Unemployment Benefit Reinsurance Scheme to “protect our citizens and reduce the pressure on public finances during external shocks”.⁵⁵ At the same time, a common fiscal capacity can take the form of a common budget for spending on projects of common interest, of which the Budgetary Instrument for Convergence and Competitiveness, agreed in principle by Member States, might be a very incipient core. To close the circle, it is worth noting that, although the fiscal capacity and a common safe asset are distinct, they might complement each other if the common budget were allowed to issue debt.

6.6.6. ... INCLUDING FISCAL POLICIES

Where fiscal policies and rules are concerned, the challenges brought by the long-run trends considered earlier, are likely to have important implications. In a nutshell, they are likely to require higher public spending and in particular higher public investment in order to decarbonise the economy, upgrade infrastructures to deal with climate change, or improve education to raise productivity and potential growth. In other words, spending more on public goods to avoid the risk of becoming a “1% economy”.

Several authors, including Olivier Blanchard and Ángel Ubide, have called recently for higher limits on debt and better coordination of fiscal policies in the euro area, both to meet cyclical stabilisation needs, as discussed earlier, and the structural demand for higher public investment in the economy.⁵⁶ Their call is also based on the observation

⁵⁴ “Creating a Euro-Area Safe Asset without Mutualizing Risk Much” Álvaro Leandro and Jeromin Zettelmeyer, Working Paper, Peterson Institute for International Economics, Washington DC, USA, August 2019. <https://www.piie.com/publications/working-papers/creating-euro-area-safe-asset-without-mutualizing-risk-much>

“A European safe asset to complement national government bonds” Gabriele Giudice, Mirzha de Manuel Aramendía, Zenon Kontolemis and Daniel P. Monteiro, University Library of Munich, Germany, August 2019. <https://ideas.repec.org/p/pramprapa/95748.html>

⁵⁵ “A Union that strives for more: My agenda for Europe - Political guidelines for the next Commission (2019-2024)” Ursula von der Leyen, Brussels, 16 July 2019. https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf

⁵⁶ “Why Critics of a More Relaxed Attitude on Public Debt Are Wrong” Olivier Blanchard (PIIE) and Ángel Ubide (Citadel), PIIE Real-time Economic Issues Watch, Washington DC, 15 July 2019. <https://www.piie.com/blogs/realtime-economic-issues-watch/why-critics-more-relaxed-attitude-public-debt-are-wrong>



that, faced with multiple sources of economic and policy uncertainty and inefficient taxation systems, corporations keep on hoarding cash worldwide.⁵⁷ In this context, ambitious reforms and investment programmes by the public sector would tend to crowd-in private investment rather than crowding it out.⁵⁸

The European Fiscal Board has recently proposed to introduce some version of a “golden rule” whereby eligible public investment programmes would be exempted from the application of the fiscal rules.⁵⁹ Eligible programmes could be identified and monitored both at EU level by the Commission and at national level by the independent fiscal institutions, to ensure that they are growth enhancing, implemented as described and “owned” at Member State level.

A golden rule would entail a significant change to fiscal policy coordination in the euro area, particularly if designed to cater for the structural investment needs mentioned in addition to short-term stabilisation. It would complement the surveillance of deficit and debt targets with a closer coordination of the quality of public finances by improving the planning, coordination and evaluation of the composition and efficiency of national expenditures. However, it should be kept in mind that, even if part of the debt is excluded from a fiscal rule, Member States would still need to finance it in the capital markets. High-debt countries would be the most concerned, as investors’ perceptions also depend on the total amount of their debt and refinancing needs. In addition, the proposal raises some important political and practical challenges, for instance to develop and implement planning and evaluation methodologies, and improve administrative capacity in many Member States, regional and local authorities. Currently, most of the coordination in this area takes place through soft tools as part of the European Semester.⁶⁰

Another relevant question here is whether higher public investment should be fi-

“Public Debt: Fiscal and Welfare Costs in a Time of Low Interest Rates” Olivier Blanchard, PIIE Policy Brief, Washington DC, 13 February 2019.

<https://www.piie.com/system/files/documents/pb19-2.pdf>

⁵⁷ “Uncertainty and the Economy” Kevin L Kliesen, The Regional Economist, Federal Reserve Bank of St. Louis, April 2013.

<https://ideas.repec.org/a/fip/fedlre/y2013iapr8.html>

⁵⁸ One example is the investment plan for Europe or “Juncker Plan”, which managed to mobilise €433 billion in total investment, out of €80 billion of public investment in the form of a first-loss tranche. https://ec.europa.eu/commission/priorities/jobs-growth-and-investment/investment-plan-europe-juncker-plan_en

⁵⁹ “Assessment of EU fiscal rules with a focus on the six and two-pack legislation” European Fiscal Board, Brussels, 11 September 2019. https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en

⁶⁰ Most notably, through the Annual Growth Survey, Member States’ Stability and Growth Programmes, the euro-area recommendations and the country specific recommendations. Projects co-financed by the EU budget are planned, monitored and evaluated according to specific rules and methods.



nanced primarily through higher public debt. Ángel Ubide deals with this issue in another chapter of the report. We do not have much to add except to recall that in the case of high-debt countries, even in the current low interest rate environment, the vulnerability comes not so much from the interest paid on issued debt at any given moment, but on the short-term refinancing needs.⁶¹

A significant part of this investment should be private⁶² and, at the same time, there seems to be room to increase public investment in Europe without having recourse to public deficits. The comparison of the annual investment gap in transport, energy and resource management to meet climate change and other targets (€180-270 billion, considered earlier) with the annual revenue gap from corporate and value-added taxes (€100-325 billion, see below) is telling.

Taxation systems in Europe present significant deficiencies that weigh on revenue. Corporate tax avoidance through profit shifting could amount to €50-70 billion per year in the EU, according to a study by the European Parliament.⁶³ If special tax arrangements, inefficiencies in tax collection and other practices are taken into account, this loss could reach €160-190 billion. This problem keeps increasing rather than abating in spite of international efforts, including the OECD's Base Erosion and Profit Shifting (BEPS) initiative, according to the IMF.⁶⁴ In addition, the yearly "VAT gap", meaning the difference between the expected VAT revenue and the amount actually collected, exceeds €135 billion due to fraud and tax evasion, corporate insolvency and bankruptcy, maladministration and tax optimisation. Of this, around €50 billion (or €100 per EU citizen each year) is estimated to be due to cross-border VAT fraud, that could easily be addressed through further reform of the VAT rules.⁶⁵

The Commission has proposed to move to qualified majority voting in four steps,

⁶¹ As it is well-known, a prudent debt management requires to keep a certain volume of short-term debt, which is rolled over the short terms, in general a few months. Financial crises always start by affecting the financing of short-term debt, thus creating a liquidity problem that sooner or later ends in a solvency problem for the sovereign.

⁶² "Action plan on financing sustainable growth" European Commission, Brussels, 8 March 2018, COM(2018) 97 final.

<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097>

⁶³ "Bringing transparency, coordination and convergence to corporate tax policies in the European Union" Dover, Ferrett, Gravino, Jones, and Merler, European Parliament Research Centre, Strasbourg September 2015.

[http://www.europarl.europa.eu/RegData/etudes/STUD/2015/558773/EPRS_STU\(2015\)558773_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2015/558773/EPRS_STU(2015)558773_EN.pdf)

⁶⁴ "The Rise of Phantom Investments" Finance & Development, IMF, Washington DC, September 2019. <https://www.imf.org/external/pubs/ft/fandd/2019/09/the-rise-of-phantom-FDI-in-tax-havens-damgaard.htm>

⁶⁵ Progress was achieved in this area recently. See "ECOFIN: Commission welcomes progress achieved on the road to a reformed EU VAT system" European Commission, Brussels, 2 October 2018, IP/18/5966.

https://europa.eu/rapid/press-release_IP-18-5966_en.htm



starting with decisions pertaining to cooperation and mutual assistance, climate change and environment protection and ending with decisions on major tax projects such as the Common Consolidated Corporate Tax Base.⁶⁶

6.7. CONCLUSIONS

When the Juncker Commission took office in November 2014, the euro-area economy was experiencing an incipient recovery. During the last five years, that incipient recovery became a sustained expansion accompanied by record employment levels. At the end of its mandate, the economic situation of the euro area seems uncertain. Most indicators seem to point at what might be a sharp deceleration that could turn into a recession. Within this context, this paper has analysed the way the Juncker Commission implemented the SGP and the challenges that the EU fiscal toolkit would be confronting in the next institutional cycle and beyond.

The way the Juncker Commission applied the EU fiscal rules has not been uncontroversial. For some, the approach was too lenient, while for others it was too strict. This paper, has provided some evidence that, over the past five years, fiscal policies were overall supportive of the economic recovery or, at least, they did not undermine it. By looking at some study cases, the paper suggests that the way the Commission implemented the fiscal rules has been reasonably strict and politically intelligent, even if availing from all possible flexibility in some cases. It might indeed be too early to establish a more unambiguous assessment. No doubt, we need some historical perspective.

The way the fiscal rules framework has been implemented has not been the only controversial issue, the appropriateness and performance of the EU fiscal rules as such are the main focus of an inconclusive debate. There seems to be a broad agreement that the current rules have become too complex and opaque and, to some extent, ineffective in achieving their goals. However, the consensus disappears regarding how and when the rules should be reformed. To say the least, there does not seem to be much appetite for an immediate reform. At the end of the day, the status quo seems to be the preferred option for both the “bad” and “good” performers under the current version of the Pact. For the former, the current rules sometimes allow them to hide their lack of fiscal discipline in legalistic compliance, while the latter fear that a reform of the Pact would become more symmetric or bring too much flexibility and leniency.

Given the challenges in the short term (a deceleration in GDP growth), medium term (the risks of the euro area becoming a “1% economy”) and the long term (from an ageing population, climate change, pollution and technological change), the balance between the two main goals (short-term stabilisation and long-term sustainability)

⁶⁶ “Towards a more efficient and democratic decision making in EU tax policy” European Commission, Strasbourg, 15 January 2019, COM(2019) 8 final.
https://ec.europa.eu/taxation_customs/sites/taxation/files/15_01_2019_communication_towards_a_more_efficient_democratic_decision_making_eu_tax_policy_en.pdf



might need to be reassessed and possibly broadened to encompass the quality of public finances both in terms of revenues and expenditures. The large number of objectives for a single instrument would suggest that finding the appropriate set of rules could be an impossible task. Perhaps, squaring this circle will require broadening the debate, as the role that the fiscal rules should play, and their design, depends on completing the other elements of the EMU architecture, including who should implement the rules and the possible introduction of a common fiscal capacity and a shared sovereign safe asset.



7. FISCAL POLICY WHEN INTEREST RATES ARE ZERO

ÁNGEL UBIDE, CITADEL LLC ^{1,2}

It is now widely recognized that even if a country has a perfectly benevolent central bank (one that attempts to maximize the social welfare function) it may suffer from an inflation rate which is systematically too high (Rogoff, 1985)

7.1. ABSTRACT

The fiscal policy frameworks in use today, including the Stability and Growth Pact, were created for a world that no longer exists: a world where interest rates were positive, the main risk was higher inflation, and fiscal policy had the luxury of being passive and able to ignore cyclical stabilization. That was the world of Rogoff (1985) “conservative central bankers”, where the focus was always to lower inflation: “Society can sometimes make itself better off by appointing a central banker who does not share the social objective function, but instead places “too large” a weight on inflation-rate stabilization relative to employment stabilization”.

The world has changed. With interest rates at zero in many countries and expected to remain so for a long time, and the main risk being too low inflation, the focus of economic policy has to change towards increasing both growth and inflation, and fiscal policy must be active and contribute to cyclical stabilization. Fiscal frameworks, and fiscal rules, must therefore change, especially in the euro area.

¹ Head of Economic Research, Global Fixed Income, Citadel LLC.

² This is an expanded and revised version of Ubide (2019). I would like to thank Olivier Blanchard, Tito Cordella, Daniel Gros, Christian Odendahl and participants at the October 16th, 2019 SUERF/ Societe Generale/ Columbia University/ EIB conference in NYC for comments. All errors are my own. This article reflects the analysis and views of Ángel Ubide. No recipient should interpret this article to represent the general views of Citadel or its personnel. Facts, analysis, and views presented in this presentation have not been reviewed by, and may not reflect information known to, other Citadel professionals. Assumptions, opinions, views, and estimates constitute Mr. Ubide’s judgment as of the date given and are subject to change without notice and without any duty to update. Citadel is not responsible for any errors or omissions contained in this presentation and accepts no liability whatsoever for any direct or consequential loss arising from your use of this article or its contents.



This paper discusses how inertia and behavioral biases are the main impediment against a more active fiscal policy. It analyzes the desired relationship between monetary and fiscal policy in different configurations of interest rates and inflation. It concludes that, when interest rates are zero and inflation is well below target, fiscal policy must be the leading instrument to boost growth and inflation, while monetary policy must support fiscal policy with forward guidance and asset purchases. It also discusses the concept of fiscal space at the zero lower bound, and in environments of high risk aversion and low inflation, arguing that fiscal space is a flow, not a stock concept, and that therefore debt and deficit ratios are not good indicators of fiscal space at the zero lower bound. In a world characterized by a persistent increase in the demand for bonds, the implication is that there is more fiscal space than it is commonly assumed. Finally, it proposes a series of principles to guide fiscal policy when interest rates are zero. The application of these principles to the euro area suggest that fiscal policy in the euro area is too tight, and that a large, multi-year public investment program financed by debt would be appropriate to support growth and help increase inflation to the target.

Keywords: Fiscal policy; monetary policy; inflation; euro area; debt sustainability

7.2. INTRODUCTION

The fiscal policy frameworks in use today, including the Stability and Growth Pact (SGP), were created for a world that no longer exists: a world where interest rates were positive, the main risk was higher inflation, and fiscal policy had the luxury of being passive and able to ignore cyclical stabilization. That was the world of Rogoff (1985) “conservative central bankers”, where the focus was always to lower inflation: “Society can sometimes make itself better off by appointing a central banker who does not share the social objective function, but instead places “too large” a weight on inflation-rate stabilization relative to employment stabilization”.

The world has changed. With interest rates at zero and expected to remain so for a long time, and the main risk being too low inflation, the focus of economic policy has to change towards supporting growth and inflation, and fiscal policy must be active and contribute to cyclical stabilization. Fiscal rules must therefore change, especially in the euro area. This paper argues that inertia and behavioral biases are the main impediment against a more active fiscal policy. It analyzes the desired relationship between monetary and fiscal policy in different configurations of interest rates and inflation, discusses the concept of fiscal space at the zero lower bound, and proposes a series of principles to guide fiscal policy when interest rates are zero.

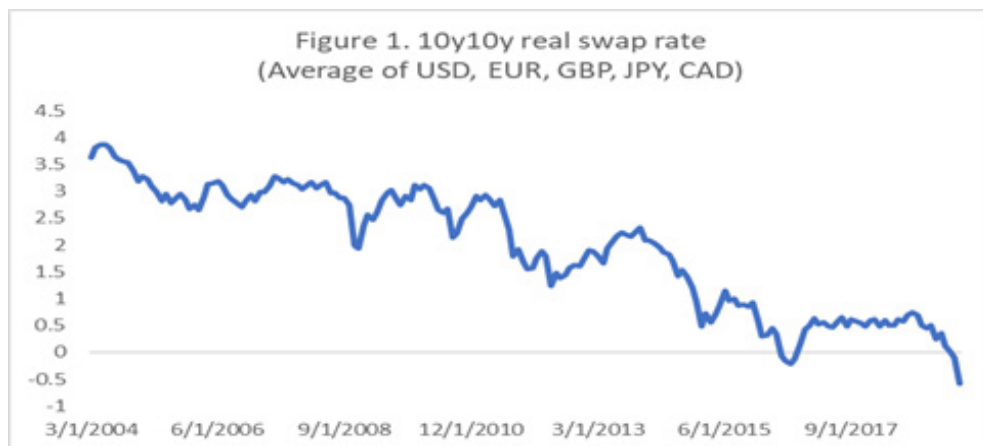
7.2.1. THE SECULAR DECLINE IN LONG TERM NOMINAL INTEREST RATES

Since Ken Rogoff published his seminal paper on the need for conservative central bankers in 1985, interest rates have been on a secular downward trend, and they have recently reached all-time lows. In August 2019, German 10-year rates reached a record

low of -0.71% and Germany issued, for the first time, a 30-year bond at 0% interest rates. The record low interest rates were not limited to AAA bonds. Portuguese 10-year rates reached 0.07% and Spanish 10-year rates 0.03%. Markets also expect interest rate to remain very low for a very long time. For example, markets expect German 10-year rates to still be negative in 5 years. Of course, markets can be wrong. But they can also be right. Over the last decade, market expectations of low or lower interest rates have proved to be more accurate than economists' and policy makers' warnings that higher interest rates were around the corner.

Very low interest rates could look extraordinary, and perhaps an aberration of markets. However, an examination of the two components of long-term nominal rates, real interest rates and inflation expectations, suggest that nominal long-term interest rates structurally lower and unlikely to increase in the foreseeable future.

1. Real interest rates in developed countries have declined over the last two decades, as shown in Figure 1, which displays the 10-year interest rate, 10 years forward, extracted from interest rate swaps for a basket of major currencies. This decline has been driven by an array of structural factors, including demographics; the change in the nature of investment and the decline in the price of capital goods; the dearth of public investment; a steady decline in the supply of safe assets; and an increase in risk aversion (see, among others, Gagnon, Johansen and Lopez Salido (2016) or del Negro et al (2017)). This has led to a decline in the neutral real interest rate, which is now estimated to be close to zero in most developed countries (see Holston, Laubach and Williams (2017)) or even negative (see Kiley (2019)).



2. Attitudes towards inflation have also changed. Before 2007, all the focus was on upside inflation risks. Wage growth was robust, commodity prices were on a secular upward trend, realized inflation had averaged 2% in most developed countries, and inflation expectations were well anchored at targets (outside Japan). The fact that interest rates were positive – and thus provided plenty of room to



ease policy – likely helped anchor inflation expectations. Today the situation is very different. Wage growth is weak, commodity prices are stable, realized inflation has been below 2% for a decade, and inflation expectations are below target. As a result, the focus is on downside inflation risks, and inflation risk premia have become negative. For example, markets expect euro area inflation to be below 1.5% for the next decade.

Very low real interest rates and inflation may look like a great outcome, but they are not. There can be too much of a good thing. Excessively low nominal interest rates reduce welfare, as they limit the monetary policy space to cushion recessions and manage the business cycle. In other words, when interest rates and inflation are too low, the expected future output gap increases.

7.2.2. THE “PARADOX OF RISK” IN FISCAL POLICY

The “paradox of risk” describes situations where policy makers, in their quest to be conservative and prudent, mistakenly are not aggressive enough and make the outlook riskier (see Ubide (2017)). This concept described well the debates among central bankers during the Great Financial Crisis (GFC), when worries about “keeping the powder dry”, disciplining governments, or minimizing the potential losses in central bank balance sheets precluded more timely and aggressive policy easing. In the end, by delaying their actions and acting without conviction, central bankers ended up having to do more of what they didn’t want to do initially – keeping interest rates lower for longer, buying more bonds - and made the recovery weaker and inflation lower.

The paradox of risk happens because of the inertia inherent to policy frameworks and the behavioral biases that afflict policy makers, which prevent agile and nimble policymaking³. Inertia was the result of applying otherwise sound economic policy concepts to the wrong economic situation: for example, it led to central bankers taking too long to realize that the main risk was not that inflation may spiral up, as had been the case for two decades, but that it may never increase enough. Loss aversion (excessive aversion to realizing a loss that leads to suboptimal decisions) led to an excessive focus on the possible downside of policy actions, such as the fiscal “cost” of QE. The endowment effect (excessively valuing things that we already own) blinded policy makers into keeping for too long policy frameworks that were failing, such as the asymmetry of inflation targets.

The paradox of risk has affected fiscal policy as well. Excessive fear of debt and deficits during the crisis led to contractionary fiscal policies that depressed growth and inflation at the wrong time, creating a very powerful headwind for monetary policy and, in turn, worsening rather than improving the fiscal outlook. Policy inertia and behavioral biases were in play again. The inertia of decades of considering monetary policy as the only instrument for cyclical stabilization created the false belief that fiscal austerity is the

³ For an in depth discussion of behavioral biases such as loss aversion, the endowment effect, or anchoring, see Kahneman (2011)



right policy at all times, and delayed excessively the necessary easing of fiscal policy. The anchoring effect (giving excessive importance to an initial observation) of the Greek crisis created a powerful incentive for governments to blindly tighten policy first and ask questions later. The endowment effect has led European governments to keep the main principles of the SGP Pact unchanged, even if today's world is diametrically opposite to the world when the SGP was created.

a. Fiscal policy is the leading economic policy at the zero lower bound (ZLB).

A critical mental bias that continues to hamper economic policy is the concept of “unconventional” policies. In monetary policy, “unconventional” applied initially to the use of forward guidance – because central bankers use to operate under the principle of never pre-committing to a policy – and of asset purchases – because central bankers worried about the moral hazard consequences of buying government bonds. The term “unconventional” carries stigma, denotes a temporary nature, and highlights a desire to exit as soon as feasible, leading to policies that are too tight. As I recommended in Ubide (2017), the concept of “unconventional” should be abandoned, as all monetary policy tools within the legal framework of a central bank are legitimate, and central bankers should just talk about policy easing or tightening. Fed Chair Powell apparently agrees: “Perhaps it is time to retire the term “unconventional” when referring to tools that were used in the crisis”⁴. As a result, central banks are embracing this reality and have embarked in a review of their monetary policy frameworks.

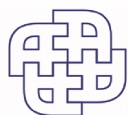
The world has changed, and fiscal frameworks must be reviewed as well. Despite very low interest rates and large bond purchases, inflation is too low, not too high, and fiscal policy has been too tight. Contrary to expectations, despite higher debts and deficits, interest rates have fallen. The review of fiscal frameworks must start by embracing the “unconventional” idea that, at times, monetary and fiscal policy must be explicitly coordinated. In fact, the relationship between monetary and fiscal policy depends on the level of inflation (π) with respect to the inflation target (π^*) and on the level of interest rates (r), in a strictly symmetric fashion. Table 1 shows a stylized framework to understand this relationship.

**TABLE 1. THE OPTIMAL RELATIONSHIP
BETWEEN MONETARY AND FISCAL POLICY.**

	Monetary	Fiscal	Example
$\pi > \pi^*$	Tight, leads	Tight	1970-80s
$\pi = \pi^*$ and $r > 0$	Manage cycle	Focus on sustainability	Great Moderation
$\pi = \pi^*$ and $r = 0$	Manage cycle	Neutral	
$\pi < \pi^*$ and $r \leq 0$	Easy	Easy, leads	Japan, eurozone today

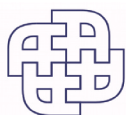
There are four different cases:

⁴ See Federal Reserve Board (2019)



1. Case 1: When inflation is clearly above target, monetary policy leads and fiscal policy explicitly cooperates. This is the legacy of the experience of the 1970s, which ushered the literature on time inconsistency (Kydland and Prescott (1977)) and the need for independent and conservative central bankers (Rogoff (1985)). Monetary policy has to be tight to reduce inflation and inflation expectations, and fiscal policy must cooperate with fiscal adjustments to facilitate this process. In fact, the historical episodes when inflation has been tough to contain have been episodes when fiscal policy has been unduly expansionary and has not cooperated with monetary policy (for example, in the early years of Volcker's tenure at the Fed).
2. Case 2: When inflation is anchored at target and interest rates are positive, as in the Great Moderation, monetary and fiscal policy can decouple. Monetary policy has enough room to ease policy to manage economic fluctuations, and fiscal policy can focus on long-term sustainability while allowing automatic stabilizers to operate. The definition of long-term sustainability may vary across societies, as preferences needn't be homogeneous regarding the size of the government and the levels of debts and deficits. This is the environment of the benchmark New Keynesian model with inflation targeting, where the only distortion affecting the economy is nominal rigidities and monetary policy, taking fiscal policy as given, can fully offset the distortion and achieve its inflation target. Importantly, this assumes that inflation expectations are well anchored at the target. This is the economic background where expansionary fiscal contractions could be effective.
3. Case 3: When inflation is anchored at target but interest rates are very low, this framework starts to fail. In those cases, fiscal policy should be in "first do no harm" mode, with an easy or at most cyclically neutral stance, to avoid becoming a disinflationary force that, with very low interest rates, becomes difficult for monetary policy to manage. This is the case of, for example Australia today (see the discussion in Lowe (2019)).
4. Case 4: When inflation and inflation expectations are below target and interest rates are already zero or negative, fiscal policy must lead with an expansionary stance and monetary policy must explicitly cooperate by guaranteeing low interest rates for as long as needed. This is the mirror image of the 1970s (Case 1): unless both monetary and fiscal policy cooperate in an active manner, the economy will fail to restore price stability and sustainable growth. This is the case of Japan over the last few years, where the government has adopted an expansionary fiscal stance and the Bank of Japan is cooperating with its Yield Curve Control framework. This also describes very well the current situation in the euro area. An expansionary fiscal policy when interest rates are very low is costless and has large multiplier effects (see Blanchard (2019) and Cohen-Setton, et al. (2019)).

Case 4 is the relevant case to the current economic situation. In addition to boosting growth and inflation, an active and well-designed expansionary fiscal policy at the ZLB has several advantages (see Ubide (2016)):



Increase neutral interest rates by reducing public savings, increasing the effectiveness of monetary policy and limiting the constraining effect of the ZLB.

Increase potential growth, in two main ways: by sustaining demand, reducing slack and avoiding hysteresis effects, thus facilitating the return to the labor market of the long-term unemployed⁵; and by increasing public investment.

Help reduce inequality and other side effects of monetary policy by reducing the need for, and the extent of, very low interest rates. To be clear: the main source of inequality is unemployment, and therefore an easy monetary policy that reduces the unemployment rate reduces inequality. But, *ceteris paribus*, a combination of easy monetary policy and tight fiscal policy that leads to very low interest rates for a long time favors higher income asset holders and harms lower income pensioners.

Help reduce financial stability risks derived from a prolonged period of very low interest rates. This risk is more evident for insurers and pension funds that provide products with guaranteed returns (see, i.e. Berdin and Grundl (2015)).

The key question for policy makers when the economy is in Case 4 is this: would they prefer an economy with a bit higher growth and inflation, a bit higher interest rates, and a bit higher deficits? The answer should be an unambiguous yes.

b. The concept of fiscal space at the zero lower bound

A standard criticism of the idea of a more active use of fiscal policy to support demand at the ZLB is that there is no fiscal space, because debts and deficits are already “too” high. Here, too, inertia and behavioral biases are playing a role.

The anchoring effect is behind the arbitrary 3% deficit limit and 60% debt/GDP target of the Maastricht Treaty: they were chosen simply because 60% was the average debt level at the time - and a 3% deficit, assuming 5% nominal GDP growth, would stabilize debt around those levels. The 90% threshold popularized during the GFC has been shown to have no empirical basis, but created a powerful loss aversion bias among policy makers after the crisis – finance ministers prioritized adopting policies to reduce debt at all cost, at the expense of growth. Japan is a prime example of the irrelevance of these limits.

Fiscal space is a function of the willingness of governments to adjust during bad times. Faced with a problematic fiscal outlook, the decision between reducing deficits or default is a political choice about the allocation of the cost of adjustment between taxpayers and creditors. Typically, governments decide to reduce deficits: Ostry et al (2010) show that as debt levels increase, governments are more prone to have higher primary surpluses to stabilize their debt ratios. Using the past behavior of governments, they calculate the debt ratio “limit”, defined as the debt/GDP ratio above which debt grows without bound, given a country’s historical primary balance behavior. Their estimates of the debt limit range are between 150% and 200% of GDP, with a median of 180%. Of course, the authors recommend that countries stay well below the debt limit, as unexpected shocks

⁵ The US experience is very positive in this regard, see Krueger (2018).



could push the country above that boundary, or governments could radically change their preferences with respect to willingness to adjust, and make the debt unsustainable. But from 180% to 60% there is a long distance.

Fiscal space, like debt sustainability, is at its core a flow concept, not a stock concept. Economic theory has treated defaults as the result of liquidity and rollover crises, and these crises are, mostly, a factor of the credibility and design of economic policies⁶. Recognizing this flow concept, the IMF has expanded its definition of debt sustainability “with high probability” by combining a level assessment – debt/GDP ratio - with a flow assessment - the gross financing needs as a share of GDP (see IMF 2013). From a flow standpoint, the IMF reckons that the debt is sustainable if gross financing needs as a share of GDP are below 15% for developed countries and below 10% for emerging markets. This flow criterion becomes more relevant in an environment of very low interest rates. For example, it underpinned the assessment of Greece’s debt outlook as sustainable with high probability despite a debt/GDP of 180%.

The debt dynamics equation illustrates the flow concept of fiscal space. Equation 1 below shows that the debt/GDP ratio (d/y) is a function of the past debt ratio, the primary balance (pb), and the relationship between the rate of growth of GDP (g) and the interest rate cost of the debt (r):

$$\frac{d}{y}(t) = \left(\frac{1+r}{1+g} \right) * \frac{d}{y}(t-1) - pb(t)$$

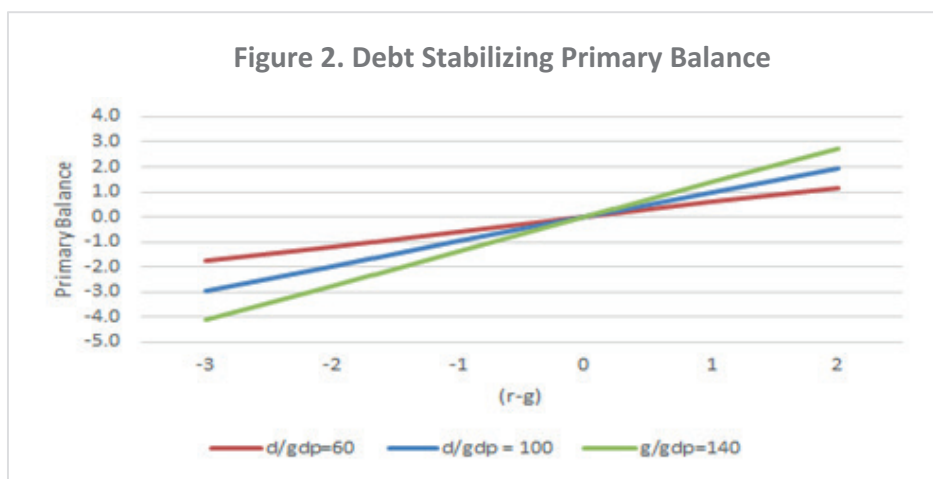
Operating, the change in the debt is a function of the level of debt, the primary balance and $(r-g)$, the difference between GDP growth and the interest rate.

$$\Delta \frac{d}{y} = \left(\frac{r-g}{1+g} \right) * \frac{d}{y}(t-1) - pb(t)$$

The debt path can improve if the primary balance improves, if GDP growth improves, or if the interest cost of the debt declines. Therefore, policies that increase potential growth, such as public investment, improve the debt path; policies that reduce interest rates and commit to keeping them low for a long time, such as central banks’ forward guidance, improve the debt path. Both increase fiscal space. At the ZLB, where interest rates are very low and where $(r-g)$ is negative, public investment financed with debt improves the debt path.

⁶ See, e.g. Giavazzi and Pagano (1989) or Cole and Kehoe (1996)

An interesting property of this equation is that, when the debt/GDP ratio is elevated, the evolution of the debt/GDP ratio is more dependent on $(r-g)$ than on the primary balance. Figure 2 shows the relationship between changes in $(r-g)$ and changes in the primary balance that keep the debt/GDP constant, for different initial levels of debt/GDP. At 60% debt/GDP, the main driver is the primary balance: the line is flatter, which means that $(r-g)$ has to decline by 2pp to achieve the same effect as a 1pp improvement in the primary balance. At 140%, however, the main driver is $(r-g)$: the line is steeper, which means that an improvement in $(r-g)$ of less than 1pp is equivalent to a 1pp improvement in the primary balance. At high levels of debt, the quality of policies, which drives the interest rate and the GDP growth rate, become more important than the size of the primary balance in determining the evolution of d/y and thus the available fiscal space.



Of course, this dynamic applies symmetrically: bad policies can quickly erode fiscal space if it leads to markets demanding a higher risk premium on the debt. The recent experience in Italy during 2018-19 provides a real-life experiment. The arrival of the Lega-M5S government led to a sharp increase in Italian bond yields, mostly due to the so-called redenomination risk: the fear, based on the statements by Lega officials, that the Italian government could decide to leave the euro, thus increasing the probability of a default on its debt. When the parliamentary majority shifted and the Lega went to the opposition, bond yields declined sharply, as the redenomination risk all but disappeared. The change in government policies created fiscal space, facilitating a more expansionary fiscal policy. At the ZLB, it is the quality, more than the quantity of debt and deficits, the main determinant of fiscal space.

c. Fiscal space under high risk aversion and low inflation

The traditional discussion of fiscal space has always had, as background, inflationary risks and misbehaving governments, and therefore has always focused on exploring the



odds of higher inflation and/or default. But the situation today is different, inflation is too low and, if anything, governments are being too austere. And that requires a further reconsideration of the concept of fiscal space.

Fiscal space, at its core, describes the probability that a government will be able to roll over its debt. It therefore depends on the interplay between the supply of and demand for government bonds. However, the discussion of fiscal space always relies on models of debt sustainability that focus only on the supply of bonds: models analyze the evolution and relationships between debt and deficits – the expected supply of bonds – and look for conditions that may lead to an explosive debt path. In other words, these models assume a fixed, time invariant demand for bonds. In these models, the interest rate on the debt is just a positive function of the supply of bonds, a function that could become, at some point, non-linear (see, for example, IMF (2011) or D’Erasmus, Mendoza and Zhang (2016)).

However, the assumption of stability of the demand for bonds is not necessarily true in reality, and it has not been true in particular in recent years. The demand for bonds is not fixed. Bonds are purchased in order to earn a return as part of a portfolio. As such, their demand depends on their expected return, and on their relative value and risk characteristics vs. other assets. And these considerations may change over time.

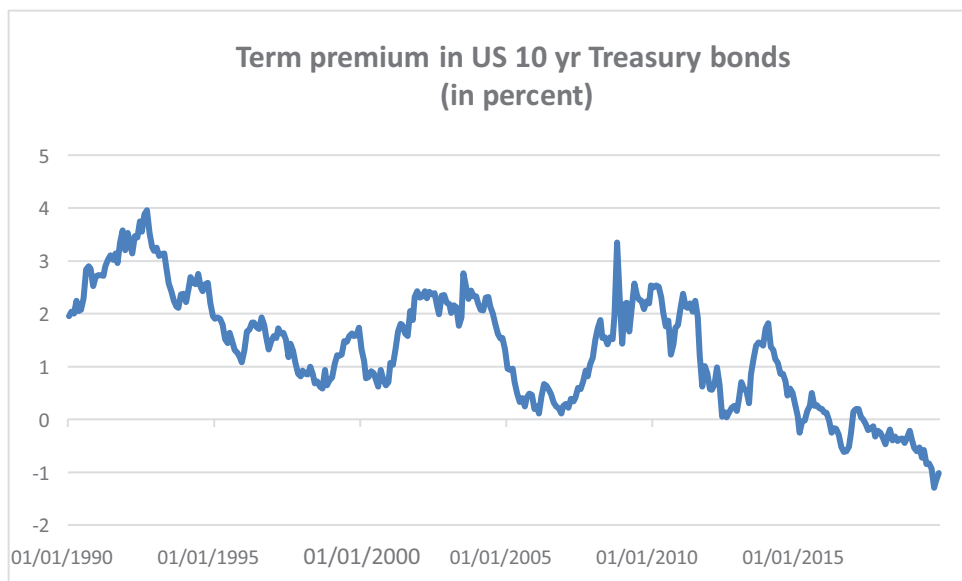
Analytically, the yield on government bonds depends on two factors: the future expected path of short-term interest rates, and a risk premium that investors demand for holding long-term securities. This risk premium is time varying, and can be affected by three main factors: (1) inflation, which erodes the real value of the principal, which is fixed in nominal terms; (2) default risk, which would reduce the nominal value of the principal at expiry; and (3) shifts in the relative demand for bonds vs. other assets, which would affect the price of bonds over time.

When the risk premium is low and stable, the main determinant of bonds price is the future expected short-term rates. In those cases, the yields on long-term bonds are positively correlated with economic activity: lower growth would lead to lower interest rates. What this means is that, assuming automatic stabilizers work and therefore deficits increase during recessions, higher deficits would be accompanied by lower, not higher, long-term interest rates. Since bond prices increase when interest rates decline, this makes government bonds a good hedging instrument in a portfolio.

When the risk premium is elevated, volatile, or displays a secular trend, it may become more relevant than the expected path of short-term rates for the pricing of bonds. The time varying nature of the risk premium is a good proxy for the time varying element of the demand for bonds (see the discussion in Cohen, Hordahl and Xia (2018)). The higher the demand for bonds, the lower the term premium, and vice versa. Depending on the direction and volatility of the term premium, the correlation between bond yields and economic activity may change.

Traditionally, the time varying nature of the term premium has been seen as a potential source of upside risk to government bond yields: inflationary risk, and fiscal risks, would put upward pressure on the term premium. The concept of expansionary fiscal contractions was based on this assumption: a well-designed fiscal consolidation would reduce the

term premium, reduce long term interest rates, and boost growth. This was possible because the term premium has typically been positive. However, the term premium has declined steadily in recent years and has become persistently negative (see Figure 3, which shows the term premium estimated in 10-year US treasury yields, using the methodology of Adrian, Crump and Moench (2013)). This steady decline in the term premium suggests that the demand for bonds has increased steadily over the last several years – and, as a result, the fiscal space has increased.



Why has the term premium declined? As discussed above, the term premium can be explained as a combination of inflation risk premium (higher if the inflation risk is elevated), default risk premium (higher if the fiscal risk is elevated), and equity risk premium (higher if the relative demand of equities vs bond is elevated).

The inflation risk premium has declined as realized inflation has been persistently below target and the pass through from wage growth into inflation has been muted, which has been reflected in the decline in inflation breakevens. With inflation muted, there is little need to hedge against higher inflation and bonds become even more attractive as an instrument to hedge against growth weakness, especially in an environment where central banks are expected to use asset purchases as a policy instrument – and thus where the demand for bonds is almost guaranteed to increase in a downturn. This attractiveness of bonds as a hedging mechanism is amplified by the central banks' strategy of communicating in advance their reaction function at the zero lower bound, which will likely include asset purchases and keeping rates at zero for a long time, as a way to enhance the effectiveness of their policies.

The default risk premium has also declined, despite the surge in debts and deficits after the crisis that increased the financing needs and thus the supply of bonds.



The statement that higher deficits lead to higher interest rates remains valid. For example, Rachel and Summers (2019) and Tedeschi (2019) both show that higher public debt has led, *ceteris paribus*, to higher interest rates. However, the *ceteris paribus* clause is critical, as there have been several compensating factors that, on net, have reduced default risk and increased the attractiveness of government bonds. For example, central banks' asset purchases have increased the demand for bonds and exerted downside pressure on interest rates. In addition, policies targeted at reducing the uncertainty about the future path of interest rates, such as forward guidance, have also contributed to dampen the response of interest rates to higher bond supply, creating additional fiscal space. Furthermore, the relentless focus of governments to reduce debts and deficits in an environment of subdued growth and low inflation has further reduced the sensitivity of interest rates to the levels of debt and deficits and shifted the focus to the quality of fiscal policy, as the events in Italy showed.

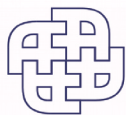
The equity risk premium has remained elevated, supporting the demand for bonds (for a discussion of potential underlying drivers of the persistently high equity risk premium, see Caballero, Farhi and Gourinchas (2017) and references therein). The relative demand for bonds as an investment asset is a critical and often overlooked element in the discussion of fiscal space. An environment of high risk aversion increases the demand for bonds – what has been characterized as a shortage of safe assets – and with it the fiscal space for a given level of debts and deficits.

Of course, these trends in the demand for bonds can change and the term premium may increase again. But the reasons that could lead to such an increase, such as higher inflation or a decline in the equity risk premium, would be fiscally benign. Only in the case that a country decided to worsen the quality of its fiscal policy, or hinted at strategic default, such as Italy in 2018-19, the increase in the term premium would be problematic, and deservedly so.

d. This is not Modern Monetary Theory

A standard criticism of this supportive view for a more active use of fiscal policy is that this is an argument in support of the Modern Monetary Theory (MMT). The answer is no. And it is worth explaining in some detail why.

To start, MMT is a combination of ideas with no clear framework. At its core, it argues that countries that issue debt in their own currencies can never “run out of money” the way households or businesses can because, according to MMT, governments create money whenever they spend. In this narrative, taxation plays two roles: it gives citizens in the country a reason to use the government-issued currency; and taxes are a tool governments can use to control inflation. Finally, a jobs guarantee – a government job at the minimum wage – would ensure that the economy always runs at full employment. Therefore, MMT posits that governments can use their budgetary policies to both promote their policy objectives and to manage the business cycle – and thus inflation – via changes in taxes. Interest rates are not a relevant variable to manage the economy, and most MMT advocate zero interest rates.



There are many caveats to this story. For example, it assumes perfect intertemporal credibility of government policies, no strategic behaviors, and no crises. The employment guarantee as an instrument to manage demand has a wide range of distributional and efficiency issues. In fact, what MMT describes is a very special case of the standard macro model when interest rates are zero, inflation is low, and inflation expectations are fully credible. And here lies the critical difference: the quest for a more active fiscal policy at the zero lower bound is precisely a strategy to be able to abandon the zero lower bound and return the economy to Cases 2 and 3, where monetary policy can manage the business cycle and fiscal policy can focus on redistribution and long term sustainability. The call for a more active role for fiscal policy at the zero lower bound is precisely a strategy to avoid an economic situation like the one MMT advocates.

7.2.3. EURO AREA FISCAL POLICY AT THE ZERO LOWER BOUND

The application of the previous discussion to the euro area suggest that the euro-area fiscal framework does not work at the zero lower bound, because the SGP was created for a world that no longer exists. It was a world where the main risk was excessive inflation and the deficit bias in economic policies. It was a world with still untested inflation targets and with doubts over the credibility of the not yet born European Central Bank. In the framework of Table 1, the SPG was created with Cases 1 and 2 in mind. But the euro area is now in Case 4, and likely to be in Case 4 for the foreseeable future.

The SGP served the euro area reasonably well until 2007, when the economy was in Case 2 and fiscal policy could focus on debt sustainability. Despite its shortcomings and rigidities, the numerical targets were a credible anchor for fiscal policy. The political stigma – and the associated focus on markets and rating agencies - of entering a conflict with the European Commission, limited, de facto, the room for large policy mistakes.

However, the same reasons that made the SGP a useful instrument until 2007 have made it a problem since 2007. The anchoring effect of the SGP targets has introduced a pernicious and very damaging asymmetry in euro area fiscal policy. The SGP works well in Cases 1 and 2, when fiscal policy needs to be passive and with a tighter bias. It does not work well in Case 4, when fiscal policy needs to be active and with an easier bias. Despite successive reforms to enhance its flexibility, the SGP retains an asymmetric tightening bias and there is no mechanism to “force” a member state to ease fiscal policy against its will and achieve the optimal fiscal policy stance at the euro area level. The German debt brake and the German government’s “black zero” strategy have compounded this tightening bias.

In addition to being asymmetric, the SGP framework is unreliable because its recommendations depend critically on an unobservable variable, the output gap, which tends to make fiscal policy procyclical after a large shock, as there is a tendency in Europe – different from the US - to interpret large shocks as permanent shocks to potential output. Lane (2019) shows the stark difference between the IMF and European Commission measures of the euro-area output gap, which suggest a closed output gap in 2019, and



those of a model based on the behavior of inflation in the euro area, which suggest an output gap of about -3.5% of GDP in 2019 (see also Brooks (2019)). This mismeasurement of the output gap has made euro-area fiscal policy unduly restrictive and created a significant headwind for growth and inflation.

a. What if the output gap is a misleading concept? The plucking theory of the business cycle

In addition to being mis-measured, there is an additional shortcoming in using the output gap as an anchor for the stance of fiscal policy: the concept may not be well defined. The output gap derives from a view of economic fluctuations that assumes output as a combination of a steady growing trend and a cycle around it. In this view, output would spend a similar amount of time above and below trend, so that, on average, output gaps would be zero over time.

However, the reality seems to contradict this view. It seems that, based on the available techniques for the estimation of the trend-cycle decomposition of activity, economies have been spending more time below trend than above it. In other words, average output gaps have been negative (for example, the IMF estimates of the output gap since 1990, for both the US and the euro area, has averaged about -0.5%). There are two ways to rationalize this empirical result:

1. Economic policy has had a persistent tightening bias, as it was aiming over the last few decades to reduce trend inflation, in an “opportunistic disinflation” approach. This may have been the right approach after the 1970s inflation, but it would require a symmetrical approach now that inflation and inflation expectations are below target – namely, economic policy should be aiming at creating a positive output gap on average over the next few business cycles.
2. The “plucking theory” of the business cycle, whereby economies never generate positive output gaps, they just return back to potential output after negative shocks. This theory was developed by Friedman (1964) and posits that negative shocks lead to higher unemployment while positive shocks lead to higher wage growth. The result arises from asymmetric nominal rigidities, as nominal wages are rigid to the downside but flexible to the upside. This theory has the empirical implication, which is largely confirmed by the data (see IMF 2019, box 1.4), that increases in unemployment during a contraction forecast the amplitude of the subsequent decline in unemployment during the expansion, but the decline in unemployment during an expansion has no forecasting power for the subsequent increase at the next recession. Under this theory, especially when the economy is in Case 4, policy makers should avoid preemptive tightening and always test the limits of growth, to ensure that the output gap closes.

Regardless of which of the two is the right explanation, the conclusion is that relying on estimates of the output gap as a driver of fiscal policy in the current environment could lead to excessively tight economic policies. That is a low cost mistake when the economy is in Cases 2 or 3 (interest rates are positive and inflation is at target), but it is a high cost mistake when the economy is in Case 4.

Thus, fiscal policy should be redesigned to eliminate its dependence on output gaps.

b. Principles for fiscal policy in the euro area at the ZLB

The euro area fiscal policy framework must change to eliminate its asymmetry, complexity and procyclicality, be effective at the ZLB, and help monetary policy restore growth and inflation. In order to avoid the inertia and behavioral biases that make the policy frameworks inefficient, we follow best practices in behavioral science. This implies pretending the current euro area fiscal policy framework does not exist and pose the following question: if euro-area fiscal policy were to be designed from scratch for the current environment of Case 4, what should it look like⁷? We arrive at four principles:

1. Bygones are bygones with respect to debt/GDP. Large increases in debt/GDP typically happen after a large crisis. The policy mix after the crisis must focus on the need to restore demand growth and inflation, and close the output gap as fast as possible, not on returning the debt/GDP ratio to some arbitrary level (conditional, of course, on a non-explosive debt outlook post-recession). Of course, while doing so countries can always adopt policies that improve the long-term sustainability of their public finances and do not focus on the current debt/GDP ratio, especially pension reforms.
2. A Golden Rule: net public investment should be financed with debt. A Golden Rule helps increase potential growth and prevents the very damaging cuts to public investment that governments implement during recessions – something that it is not solved with a nominal spending rule. Public investment should be carefully defined and include programs that increase potential growth – which could include infrastructure, investment in pre-school education, or whatever each country may need to address its growth bottlenecks. At the ZLB, a multi-year, well designed, public investment program pays for itself via higher future growth. Given the ample scope for misuse of the Golden Rule, independent fiscal councils should determine what is included in the investment budget. An obvious area where the Golden Rule can be applied immediately is public investment to fight climate change – a “Green Golden Rule”.
3. A PAYGO rule for the current (non-investment) budget: increases in current spending or tax cuts should be “paid-for” (offset with lower spending or higher taxes) on a 5-year forward basis (or longer, depending on the size of the recession). Independent fiscal councils must score new fiscal proposals before adoption. A PAYGO rule introduces discipline to allow the Golden Rule to operate while maintaining markets confidence, and the 5-year forward period allows for gradualism in the adjustment to accommodate cyclical fluctuations. In addition, the process of finding offsetting measures typically leads to improvements in efficiency.
4. A mandatory annual spending review, performed by independent national fiscal councils, to ensure the quality of the public finances and reduce waste. If fiscal

⁷ Blanchard, Leandro and Zettelmeyer (2020) adopt a similar approach, suggesting replacing the fiscal rules with qualitative fiscal standards.

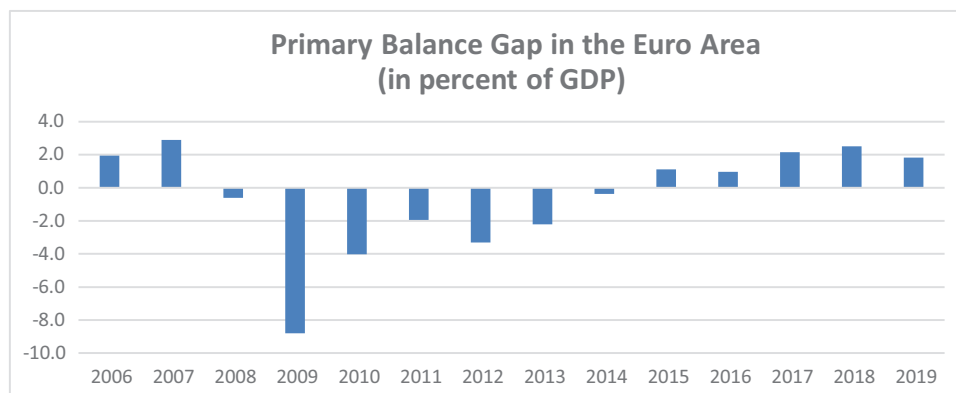


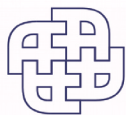
policy is to be used more actively, it must be scrutinized more closely. Spending better to be able to spend more should be at the core of any fiscal framework. Therefore, the creation of independent fiscal councils should be a precondition for the application of these principles.

These principles could be complemented with a simple fiscal rule: for as long as the economy is in Case 4 - interest rates are at the ZLB and inflation is below target - countries must design their budget each year so that, considering the expected level of GDP growth and interest rates, the primary balance does not lead, *ex-ante*, to a decline in the debt ratio. In other words, for as long as interest rates are at the ZLB and the country's inflation is below target, the primary balance gap (the difference between the planned primary balance and the debt-stabilizing primary balance) must be at most zero.

This simple rule has four desirable characteristics: it keeps fiscal policy expansionary while inflation is below target, helping monetary policy; allows countries to reduce their debt when actual (r-g) turns out to be better than expected; provides incentives to improve the efficiency of fiscal policy and adopt a policy mix that keeps interest rates low; and it doesn't rely on any unobservable variable like the output gap. Of course, this rule applies to periods of positive growth. If the economy falls into recession while in Case 4, fiscal policy must be expansionary and countercyclical.

Under this rule, there is a large amount of fiscal space currently in the euro area. Figure 4 shows the evolution of the primary balance gap. It shows that, *ex post*, fiscal policy has actively contributed to reducing the debt/GDP ratio in the last few years. Based on the rule described above, this debt reduction strategy must end, providing the euro area with at least 2 percentage points of GDP of fiscal space. Note that these calculations are conservative, as the primary balance gap is calculated using the current cost of debt which, in this environment of very low interest rates, is likely to continue to decline over coming years.





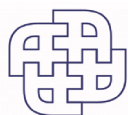
7.4. CONCLUSION

When interest rates are zero, and inflation is too low, fiscal policy must support the efforts of monetary policy to increase inflation towards the target. This note has proposed four principles to guide fiscal policy at the ZLB that could serve as building blocks for a reform the Stability and Growth Pact. These four principles are: bygones are bygones as far as debt/GDP; a Golden Rule for the investment budget; a PAYGO rule for the non-investment budget; and mandatory annual spending reviews performed by independent fiscal councils. These four principles would be complemented by a primary balance rule: for as long as interest rates are zero and inflation is below target, budgets should be designed such that the primary balance gap is at most zero, so that debt ratios would not be projected, *ex-ante*, to decline.

Of course, interest rates may suddenly increase. But, as discussed in Blanchard and Ubide (2019), the plausible scenarios that could lead to an increase in interest rates in coming years – a decline of the equity risk premium, an increase in productivity growth, or an increase in inflation – are all fiscally benign. And, if this were to shift the economy from Case 4 to Cases 2 or 3, then the policy mix should shift again, and fiscal policy could focus again on reducing deficits and debt. This is not a call for fiscal irresponsibility. It is a call for fiscal policy to take the lead when needed and help deliver an optimal policy mix.

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PART IV
ISSUES IN BANKING



8. THE FUTURE OF MONEY

MANUEL CONTHE, ARBITER AND EDITORIAL BOARD OF EXPANSION¹

8.1. ABSTRACT

Governments in industrial countries will fight tooth and nail to preserve their traditional sovereign prerogatives in the monetary domain and prevent the emergence of any private outside or fiat money - like Libra - not redeemable into a single traditional sovereign currency (like the US dollar or the euro): even if initially pegged to an underlying basket of currencies, as soon as Libra's brand name and practical convenience become familiar to users across the world, global demand will increase and gradually stabilize even if the private currency is unmoored from its initial anchor.

Cryptocurrencies, like Bitcoin and others, will remain essentially speculative assets for a limited segment of investors. They will lack the broad users' base required to create the network externalities necessary to displace well entrenched sovereign standards of value; and by being volatile with respect to the established standards of value they will lack stable demand as a means of payments.

At the same time, some countries may do away with cash and create a general Central Bank Digital Currency (CBDC). But retail CBDC tokens, held directly by the general public, will substitute for cash and are unlikely to reduce the role of bank deposits and private e-money, as this might wreak havoc in existing bank-based financial and credit systems. Besides, central banks will prefer to preserve their "wholesale" nature and will shy away from anti-money laundering (AML)/know your customer (KYC) responsibilities.

Financial inclusion for the poor and cheaper cross-border payments are good arguments in support of domestic e-money - like Kenya's M-Pesa - or new low-cost systems for cross-border transfers, but not for the creation of a new global digital private currency

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with billions of potential users across the world, with the Hayekian ambition to become a “parallel currency” even in leading industrial countries and a significant potential to destabilize existing financial and monetary systems.

Keywords: Stablecoins, Cryptocurrencies, Central bank money, Denationalization of money, Network externalities, Central Bank Digital Currencies (CBDC)

8.2. INTRODUCTION

Any discussion on the future of money - including whether new technology-based digital currencies, private or public, may substitute for traditional bank deposits or cash - must start from a key insight: “money” is a concept which conflates two separate attributes, the standard of value and the means of payment functions.² The two attributes frequently combine in some objects - very much like wings and feathers in most birds - and, hence, make it practical to describe such objects as “money”. “Money” is thus one of those categories which, as linguists explain, “tend to become defined in terms of prototypes or prototypical instances that contain the attributes most representative of items inside and least representative of items outside the category”.³

However, to discuss the future of “money” we need to unbundle its two attributes -i.e. standard of value and general means of payment-, since they are different, respond to different needs and may dissociate, even if they exert on each other a “gravitational pull” which explains why they appear so frequently combined.

Besides being attracted to each other, standards of value and means of payment share a common feature: they are subject to “network externalities”, i.e. the more people use them, the more useful they become.

Finally, any reflection on the future of money will inevitably have to address the role and comparative advantages of governments and private firms in performing money’s two separate functions.

In this paper, then, I will start with a preliminary discussions of those four issues -i.e. the distinction between the standard of value and the means of payments; the spontaneous attraction between these two functions; the network externalities they enjoy; and the role of governments and private companies in creating objects which perform these functions. I will then analyze the structure of modern monetary systems and some recent changes and innovations - like the diminishing role or even disappearance of cash, the emergence of private digital currencies, including Facebook’s Libra - and the issuance of central bank digital currencies (CBDC). And I will conclude with some educated guesses on how monetary systems could evolve in the near future.

² I leave out the third traditional function attributed to money, “store of value”, as it is not specific of money, but shared by many other financial or even real assets (e.g. securities, gold, real estate, etc.).

³ Eleanor Rosch, “Principles of Categorization”, Chapter 8 of “Concepts. Core Readings”, edited by Eric Margolis and Stephen Laurence, MIT Press, 1999, p.191.



8.3. STANDARD OF VALUE VS MEANS OF PAYMENT

Saint Patrick, the patron saint of Ireland, describes in his *Confession* some payments -probably bribes- he had to make for his safe conduct when, still as a Christian missionary in the late 5th century, he visited Western Ireland:⁴

“You know by experience how much I have paid out to those who were judges in all the regions which I have often visited; for I think that I have given away to them not less than the price of fifteen humans” (i.e. kumal or slave girls).

Paul Einzig hastens to explain away the Saint’s surprising reference to slave girls:

“This may mean that he actually surrendered fifteen slaves or slave girls, or merely that he made payment of some form to an amount equal to their price. As he was strongly opposed to slavery, the latter explanation, according to which he used slaves merely as standard of value and not as a means of payment, seems much more likely to be right (...) The Hibernian Synod, which sat under him in the 5th century, decreed that he who sheds the blood of a bishop or a high prince or a scribe ‘shall be crucified or pay seven ancillee’. The text adds that if paid in specie, one-third of the fine must be paid in silver. This clearly indicates that the unit of slave girl merely served, on that occasion at any rate, as a standard of value. (...) It is believed that the kumal became an abstract unit of account by the 2nd century A.D. (...) Seven kumals appear to be the popular unit, and there are also references to payments of half of seven kumals, which conclusively proves that kumal was during that period a standard of value, not a medium of exchange”.

I bring up this historical episode not to highlight the barbaric customs of ancient Ireland, but to illustrate the difference between two monetary institutions or functions which facilitate transactions:

1. The expression of the prices of all goods, services, financial assets and debts in a common “unit of account” or “standard of value”.⁵
2. The acceptance by creditors of a commonly-accepted means to settle payments.

⁴ The quote is taken from Paul Einzig, “Primitive Money”, Second Edition, Pergamon Press, 1966, p.239.

⁵ Throughout this article I will use these two terms as equivalent, even if many authors make a distinction between the unit of account and the standard of value (or standard of “deferred payments”).



8.4. THE STABILITY OF THE STANDARD OF VALUE

The use of a common unit of account or standard of value makes price comparisons easier, with the standard of value playing the same role as other measurement units or standards (e.g. metric length units or weight measures).

Expressing the prices of N goods in the same unit allows the reduction of $N(N-1)/2$ bilateral price relations into $N-1$ prices (assuming one of them serves as the standard), as eloquently described by American economist Charles Kindleberger when explaining the traditional role of gold in the international monetary system:⁶

“Assume ten commodities: wheat, tin, cloth...shoes. Without money, the price of any commodity can be quoted in terms of the nine others. To have a system of prices, however, it is convenient and economical to pick one as numéraire and to quote the price of each of the other in it. Since it is convenient and economical, it is done. The numéraire is not exactly chosen, or rather it is chosen by an evolutionary process rather than by a deliberate decision. If wheat were chosen as numéraire, a pound of tin might be worth three-quarters a bushel of wheat, a yard of cotton, one-eighth a bushel, a so on. For ten commodities there are nine prices. If N is 10, $N-1$ is 9, and the n th commodity becomes numéraire”.

At a single moment in time, this useful role could be played by any unit, even an abstract one, to the extent that all prices were expressed in such unit. But what if the particular standard of value used was unstable and volatile, so that prices of individual commodities or services could not be forecasted in advance, even in the short term, with any modicum of certainty?

The answer to this question makes it obvious that although any unit of account can help simplify the expression of relative prices, only a standard with a sufficient degree of stability vis-à-vis most commodities will be useful as a standard for deferred payments.

This simple conclusion explains why currencies suffering high inflation are frequently displaced by foreign stable currencies - as is the case in “dollarized” economies and illustrates the phenomenon of “parallel currencies” - or why a number of new digital private “currencies”, while originally labelled “cryptocurrencies”, now aim at becoming “stablecoins” and having a relatively stable value vis-à-vis existing currencies: otherwise they will not stand a chance of becoming an appealing store of value and means of payment.

⁶ Charles P. Kindleberger, “The Price of Gold and the $N-1$ Problem”, in “International Money. A Collection of Essays”, George Allen & Unwin, 1981, p.76.



8.5.THE CONVENIENCE OF THE MEANS OF PAYMENT

While stability is the key attribute of an attractive standard of value, convenience (i.e. user-friendliness and low transaction costs) plays the fundamental role in the selection of a means of payment.

For this reason, once an object - say gold, or a US dollar banknote - has become a generally accepted means of payment, competitive pressures and the ingenuity of private entrepreneurs will unleash a process in search of substitutes which, while claiming to bear a fixed 1 to 1 relation to the underlying means of payment, will be designed to be more useful or attractive.

Many years ago, the great American economist and Nobel Prize Milton Friedman described this process with respect to monetary commodities (like gold):⁷

“Private promises to pay the monetary commodity are as good as the monetary commodity itself -so long as they command confidence that they will be fulfilled- and far cheaper to produce, since the issuers can meet possible demands for redemption by keeping on hand an amount of the monetary commodity equal to only a fraction of their outstanding promises. A pure commodity standard therefore tends to break down”.

But this substitution process - which we could call “monetary piggybacking” and Hayek described, in more derogatory terms, as “parasitic” - may apply not only to monetary commodities, but also to fiduciary means of payment. Monetary history, from the distant past until today, is full of examples of the emergence of new financial claims which, while convertible or redeemable into the established means of payment, offered more convenient features. A similar process is discernible in the transfer of monetary value between distant places.

Thus, for instance:

- Letters of credit, promissory notes and bills of exchange, drawn in hard currencies, were popular means of payment among merchants, travelers or governments sending armies marching into distant territories, and were extensively used in Medieval fairs. When endorsable, they circulated among merchants as actual means of payment.⁸
- “Hawala” and similar informal fund transfer systems - like China’s “fei-ch’ien” (“flying money”) - emerged years ago in several countries and regions around the world (India, Pakistan, the Philippines, the Middle East, etc.) as a way to transfer

⁷ Milton Friedman, “A Program for Monetary Stability”, Fordham University Press, New York, 1960, p.6.

⁸ For a detailed study, see Benjamin Geva, “The Payment Order of Antiquity and the Middle Ages. A Legal History”, Hart Monographs in Transnational and International Law, Volume 6, Hart Publishing, 2011



money to distant places, with payments being made by a network of *hawaladars* operating in local currency. In the wake of the 9/11 terrorist attacks this primitive but efficient cross-border transfer system elicited the interest of agencies fighting terrorism, as it was used to finance illegal and terrorist activities.⁹

- Private banks issued convertible private banknotes - until legislation, like the 1844 Bank Charter Act in England, restricted this privilege to one single, government-supported bank, the “central bank”-; and, subsequently, they accepted deposits. Both notes and deposits were most of the time convertible or redeemable into gold bullion or notes, which led to occasional bank runs and financial crises when holders feared that such convertibility would not be honored. But the key insight was that, even if convertible, they had become effective means of payments or “money”, as the English Banking School rightly claimed during its famous controversy with the Bullion School.

While the process of “monetary piggybacking” or creation of “inside money”¹⁰ provided more convenient means of payments, it was not without drawbacks, as American economist James Tobin put it:¹¹

“It is important to provide economic agents a convenient substitute for currency, usable in payments and riskless as a store of value in the unit of account. It is important to protect the society’s payments system from interruptions and breakdowns due to bank failures. The problem is that this provision and this protection cannot be accomplished by unregulated competition for checkable demand deposits and loans. (...) The accident of history that made the principal medium of exchange (i.e. bank deposits) inside money also made it vulnerable to events that impair the value and liquidity of the assets backing the money. Striking a balance between competitive efficiency and the protection of depositors seems to be increasingly difficult and costly”.

The recent emergence of technology-based new digital currencies and payments applications operated through smartphones, to be mentioned later on, can be seen as part of this long-standing process of monetary innovation aimed at providing users with more convenient means of payment.

⁹ Mohammed El Qorchi, Samuel Munzele Maimbo, and John F. Wilson, “Informal Funds Transfer Systems. An Analysis of the Informal Hawala System”, IMF-World Bank, 2003, available at https://www.elibrary.imf.org/doc/IMF084/03590-9781589062269/03590-9781589062269/Other_formats/Source_PDF/03590-9781452791388.pdf

¹⁰ The distinction between “inside” (or redeemable) money and “outside” (or fiduciary) money was first made by in 1960 by John G. Gurley and Edward S. Shaw in their “Money in a Theory of Finance”. For a recent explanation, see Ricardo Lagos, “Inside and Outside Money”, Federal Reserve Bank of Minneapolis, Research Department Staff Report 374, May 2006, available at <https://www.minneapolisfed.org/research/sr/sr374.pdf>

¹¹ James Tobin, op.cit., p.25.



Note, however, that the mere creation of a user-friendly digital payment system, while reducing transaction costs, will not help users escape the problem of hyperinflation or the depreciation of the standard of value in which the digital balances are denominated.

This was borne out recently in Zimbabwe, a country currently suffering a new bout of hyperinflation, but this time in an “almost digitalized monetary economy” due to the proliferation of mobile payments in the country. As described recently by the Financial Times’ journalist Izabella Kaminska:¹²

EcoCash, Zimbabwe’s equivalent of Kenya’s better-known M-Pesa system, counts as much as 90 per cent of the adult population as customers. (...) As it was growing in popularity and serving the unbanked, EcoCash’s nationwide network of agents sucked dollars out of the hands of the population, turning them into digital balances. This amounted to the transfer of foreign cash stock from citizens to the banking system, with the money ending up in the control of the central bank”. The Government subsequently introduced a new local currency, the RTGS dollar, declared it legal tender and redenominated in the new currency all Government contracts. While the original exchange rate was set at 8-to-1 to the US dollar, the free-market rate has since reached 21-to-1, which led many people to offer EcoCash agents premiums and additional commissions in exchange for hard cash (in US dollars). Outages and glitches became more common and in September 2019 the Government took action to prevent “illegal activities abusing the cash-in, cash-out and cash-back facilities” and the “buying and selling of cash through mobile agents at high rates above approved charges, and suspended all of EcoCash’s cash-in and cash-out activities. But the move was highly unpopular, leading the government to reinstate in October 2019 a limited cash-out option with a \$100 per transaction cap”.

8.6. MONETARY GRAVITATION LAWS

If the standard of value and the means of payment functions are so conceptually different, then why is their degree of correlation such that the prototypical exemplar of “money” or “currency” - e.g. a euro banknote - combines both?

In my view, there are two reciprocal “gravitational forces” which pull together the two functions:

¹² Izabella Kaminska, “Mobile money is not helping Zimbabwe’s hyperinflation”, Financial Times, October 31, 2019.



- The practical advantages when the value of the means of payment is expressed in units of the standard of value (e.g. when we settle a €10 debt - the euro being the standard of value - by offering a €10 banknote as the means of payment). This tendency for means of payment to be denominated in the standard of value could be described as the “monetization of the standard of value”; and, reciprocally
- The natural tendency for the units of the established means of payment, when stable, to become the unit in which prices and debts are set, i.e. to become the “standard of value” (e.g. if oil deliveries are customarily invoiced and paid by bank transfers in US dollars, over time oil prices will naturally be expressed in that currency). While this process could be considered an illustration of the “money illusion”, for the reasons to be explained below I will describe it as the “*Cheshirization*” of convertible means of payment.

8.6.1. THE MONETIZATION OF THE STANDARD OF VALUE

We have already seen the practical advantages, in terms of lower transaction costs, of using as a means of payment an object whose value bears a fixed relation with the units of the debt to be settled. In the case of precious metals, this is the reason for the emergence of a reliable coinage system which guaranteed the exact metallic content of a piece and allowed cumbersome payments by weighing to be replaced by payments made “by tale”.

The inconvenience of such reliable, user-friendly means of payment can be inferred from French historian Pierre Vilar’s description of how in 1529, King Francis I of France and the Spanish Emperor, Charles V, carried out the agreement for the Emperor to free the French King’s sons -who he had kept in Spain as hostages to guarantee Francis’ compliance with the Madrid Treaty- in exchange for the payment of a cash ransom in gold. The exchange finally took place on the waters of the Bidasoa (the river serving as border between the two countries) but only after the emperor’s agents checked, one by one, over a 4-month period, the gold content of the 1.2 million ecus delivered by king Francis!¹³

Thus, there are significant practical advantages in the standard of value becoming “monetized” through the emergence of means of payments with a value expressed in standard units. This was, according to mainstream economists, the main historical reason for the involvement of governments in monetary affairs:¹⁴

“From time immemorial, government has played a role in the monetary system. One element of that role has been to seek to monopolize the coining of money. The objective was partly to standardize the money. The sovereign’s seal on a coined piece of metal was intended to certify its weight and fineness and thus enable such coins

¹³ Pierre Vilar, “Or et monnaie dans l’histoire”, Flammarion, Paris, 1974, p.213.

¹⁴ Milton Friedman, “Money Mischief. Episodes in Monetary History”, Harcourt Brace Jovanovich Publishers, 1992, p. 42.



to be used in transactions by tale, or number, rather than by weight, thereby reducing the costs of transactions”.

This law of the “monetization of the standard of value”, meant to reduce transaction costs by doing away with the need to apply a fluctuating price or exchange rate between the value of the object being used as the means of payment and the value to be settled, probably explains why precious metals were so frequently coined. This led to a very long period in financial history of “specie” or full-bodied coins becoming the prototype of “money”, both representing the standard of value - i.e. the precious metal - and serving also as means of payment.

This may have contributed to entrenching the misguided view of “money” as a unitary concept performing two functions, as opposed to the existence of two separate monetary functions -the standard of value and the means of payment- occasionally combining in a single object.

8.6.2. THE CHESHIRIZATION OF THE MEANS OF PAYMENT

But experience shows that the gravitational force between the standard of value and the means of payment (*rectius*, the unit in which the value of the means of payment is expressed) also runs in the opposite direction: when a means of payment is widely used, its units often become at some point the *de facto* standard of value, provided it has a stable value that the public can trust.

Probably the modern US dollar is one of the best illustrations of this process.

US dollar banknotes and bank balances in the Federal Reserve remained convertible or redeemable into gold until well into the XX century, at a fixed price, with the ultimate standard of value being gold, with US dollar notes and US dollar-denominated bank deposits being just a means of payment expressed in units bearing a fixed relation to gold. More specifically, the Gold Standard Act of 1900 fixed the value of the dollar as 1.5046 grams of pure gold.

The dollar’s emancipation from gold took place in two major stages:

- First, when on April 5, 1933, president Roosevelt required all US citizens to deliver all gold coin, gold bullion and gold certificates owned by them to the Federal Reserve by May 1 and, shortly thereafter a Joint Resolution of Congress abrogated the gold clauses in contracts requiring debtors to repay creditors in gold dollars of the same weight and fineness as those borrowed; and
- Second, when on August 15, 1971 president Nixon suspended the convertibility into gold of foreign official holdings of US dollars.

Nixon’s decision severed the remaining link between foreign official dollar balances and the old international standard of value, gold. This had consequences for the international monetary system and for the fixed exchange rate system administered by the International Monetary Fund under the Bretton Woods agreement. It also paved the



way for a bout of inflation in the United States, as president Nixon put pressure on the president of the Federal Reserve, Arthur Burns, to lead an expansionary monetary policy which would help him win his second term.¹⁵

But the key aspect to underline here is that the unmooring of the US dollar from its gold “anchor”, i.e. its transformation into a pure fiduciary currency, had very little effect on its domestic and international use: the prevalence of the dollar as the international means of payment had already entrenched it as the *de facto* standard of value, such that the *de facto* fiduciary “dollar standard” smoothly replaced the “gold exchange standard” officially enshrined in the Bretton Woods agreement.

Milton Friedman described this move from a commodity standard, based indirectly on gold, to a purely fiduciary or fiat money with this pithy Carollian metaphor:

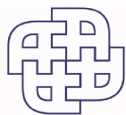
“The commodity Cheshire cat has completely disappeared, and only the fiat grin remains”.

I find Friedman’s metaphor so bright that in its honor I would label “*Cheshirization*” the process by which the units of a convertible or redeemable means of payment - e.g. any claim, like a bank deposit or money balance, which is legally or contractually convertible at a fixed exchange rate into a different standard of value - becomes the new fiduciary standard of value after severing its convertibility link with the original one.

This process of *Cheshirization* has been at work constantly throughout financial history, not only in cases of transformation of a formerly convertible currency into a fiduciary one, but also in the smooth emergence of two separate currencies out of a previous, common one. This can be illustrated with the case of Australia, which under the Australian Coinage Act of 1909 issued Australian coins on the basis of the same standard of weight and fineness laid down in the British Coinage Act of 1870 and declared them to be legal tender throughout the Commonwealth, on a par with British coins. In 1910 a new law created the “Australian pound”, but it remained on a 1-to-1 relation with the British pound, until 1929, when Australia left the gold standard two years before the United Kingdom (it would only be in the 1960s that the Australian pound would adopt a decimal division system and, subsequently, be replaced by the current “Australian dollar”).

In conclusion, once a means of payment has become entrenched, its unit of account will remain the standard of value (i.e. the unit in which prices and debts are expressed) even if it breaks its former link or peg with the commodity or asset which made it originally acceptable.

¹⁵ See Burton A. Abrams, “How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes”, *Journal of Economic Perspectives*, Volume 20, Number 4, Fall 2006, available at <https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.20.4.177>



8.7. NETWORK EXTERNALITIES

Charles Kindleberger, one of the most insightful writers on international finance and monetary affairs, once drew an apt comparison between the dollar and the English language and explained that the international dominance of both was based on a similar principle: world efficiency is achieved when all countries learn the same second language (namely, English) as *lingua franca* and when all foreign transactions are carried on “in the vehicle currency of a common second language, the dollar (...) It is not nationalism which spreads the use of the dollar and the use of English; it is the ordinary search of the world for short cuts in getting things done”.¹⁶

In another famous article on standards as public goods, Kindleberger explained that both the unit of account and the medium of exchange are among those standards that serve as public goods and, by being extensively used, help reduce transaction costs. Public goods have “economies of scale”, so that “the more producers use a given standard, the more each gains from use by others through gains in comparability and interchangeability”.¹⁷

Another great economist, James Tobin, shared Kindleberger’s view:¹⁸

“The use of a common monetary unit of account and the adoption of generally acceptable media of exchange in this numeraire carry important positive externalities. Free market competition by itself cannot achieve and protect these social benefits (...) A payment system, like any other communications network, derives efficiency from universality, standardization, and predictability. It is not efficient to have competing currencies with varying rates of exchange between them”.

In modern parlance, we would describe Kindleberger’s “economies of scale” more precisely as “network externalities”, which are defined as the increasing utility that any user derives from a product as the global number of users increases. This concept applies indeed to public standards, as those mentioned by Kindleberger (e.g. official time, weight measures, etc.), but also to private goods and services which connect a network of interdependent users, like telephones, credit card or computers. The term “network externalities” is more specific than “economies of scale”, since the latter seems to point to the scale of production -the greater the production, the lower the average cost-, while the former refers to the benefits from a bigger consumers’ or users’ network.

¹⁶ Charles Kindleberger, “The Politics of International Money and World Language”, chapter 2 of “International Money. A Collection of Essays”, George Allen & Unwin, 1981, p.32.

¹⁷ Charles Kindleberger, “Standards as Public, Collective and Private Goods”, *Kyklos*, Volume 36, 1983, Fasc. 3, p.377.

¹⁸ James Tobin, “Financial Innovation and Deregulation in Perspective”, Keynote Paper Presented at The Second International Conference of the Institute for Monetary and Economic Studies, Bank of Japan, Tokyo, May 29-31, 1985, available at <http://www.imes.boj.or.jp/english/publication/mes/1985/me3-2-3.pdf>, p. 20 and 22.



Network externalities apply both to the standard of value (the wider the use of a standard, the more convenient it becomes to set prices or define debts) and to the means of payment (the wider the number of people who accept a specific means of payment, the more convenient it will become).

The existence of such monetary network externalities entails several practical consequences:

- Until they reach a minimum or critical level of users, standards of value and means of payment will be of little practical use; but
- Once they become established, their use will enjoy significant inertia and they will be difficult to replace, particularly if there are switching costs, if only because enough users will need to make a simultaneous move to the new standard or means of payment if they are to become useful.

As discussed below, Facebook might be among the few private entities which could reap, for the benefit of Libra, the huge network externalities stemming from its enormous customer base. This is why governments' previous benign neglect of Bitcoin and other digital currencies has given way to their outright hostility to Facebook's project.

8.8. THE ROLE OF GOVERNMENTS

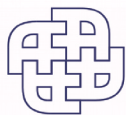
While there has been little disagreement among economists and scholars on the spontaneous emergence of a monetary "standard of value" as a way of expressing prices and debts in a common unit, there is a wide discrepancy between two schools of thought - the "Metallist theory" and the "credit theory" - on how a generally accepted means of payments historically emerged.

8.8.1. THE METALLIST-COMMODITY THEORY

The "Metallist theory" is the standard textbook explanation and goes back to Aristotle and Adam Smith. As described recently by Robert Skidelsky:¹⁹

"Before money -it is claimed-, there was barter -direct exchange of goods for goods. But barter requires a 'double-coincidence' of wants. Both partners need to want what the other has, at the same time. So, money was invented to enable one of the parties to pay the other in something which the other could use to buy something else. Adam Smith conjectured that the 'something' which became the 'medium of exchange' must have been 'some commodity... [which] few people would be likely to refuse in exchange for the

¹⁹ Robert Skidelsky, "Money and Government. A Challenge to Mainstream Economics", Penguin Books, 2018, p. 23-24.



produce of their industry'. Though cattle, salt, shells and the like were used, metals, and especially the precious metals gold and silver, came to be preferred, for their divisibility, but even more for their durability and scarcity. It was these qualities which fitted them to be the measure of perishable things.

At first 'rude bars' of iron, copper, gold and silver sufficed, because of their great relative stability of value. To avoid having to weigh a lump of metal for each transaction, it became customary to affix a public stamp upon certain quantities of metals, certifying their weight and quality. 'Hence the origin of coined money, and of those public offices called mints'".

The Metallist theory is essentially the same as the "commodity theory" advocated in the XIX century by Stanley Jevons, and by Carl Menger and his followers of the Austrian School, who saw in the "marketability" of a good - initially probably cattle, subsequently precious metals - the main reason why it spontaneously evolved into the generally accepted means of exchange.

It is not by chance that Stanley Jevons, who had spent five years as assayer in the Sydney Mint, begins his book on "Money and the Mechanism of Exchange" (1875), with a celebrated story about the drawbacks of barter. He refers to the French opera singer Mademoiselle Zélie, who gave a concert in the Society Islands during a world tour and received as her fee one-third of the proceeds. "Her share consisted of three pigs, twenty-three turkeys, forty-four chickens, five thousand coconuts and considerable quantities of bananas, lemons and oranges. Unfortunately, the opera singer could consume only a small part of this total and found it necessary before she left to feed the pigs and poultry with the fruit".²⁰

Under this Metallist view, money emerged as a market-driven, spontaneous institution to avoid the practical inconvenience of barter, without any essential role being played by governments or public authorities. In Menger's words:²¹

"Since there is no better way in which men can become enlightened about their economic interests than by observation of the economic success of those who employ the correct means of achieving their ends, it is evident that nothing favored the rise of money so much as the long-practiced, and economically profitable, acceptable of eminently saleable commodities in exchange for all others by the most discerning and most capable economizing individuals. In this way, custom and practice contributed in no small degree to converting the commodities that were most saleable at a given time into com-

²⁰ Glyn Davies, "A History of Money. From Ancient Times to the Present Day", University of Wales Press, 1994, p.13.

²¹ Carl Menger, "Principles of Economics", translated by James Dingwall and Bert F. Hoselitz, introduction by F.A. Hayek, New York University Press, 1976, p. 261.



modities that came to be accepted, not merely by many, but by all economizing individuals in exchange for their own commodities”.

From this view that money was born as a market-driven creature without any essential role for governments, it is only a small step to argue, as Friedrich Hayek subsequently did, that the public monopoly on money should be challenged and the issuance of money be “privatized”:

“When the genuineness of metallic money could be ascertained only by a difficult process of assaying, for which the ordinary person had neither the skill nor the equipment, a strong case could be made for guaranteeing the fineness of the coins by the stamp of some generally recognized authority which, outside the great commercial centers, could only be the government. But today these initial advantages, which might have served as an excuse for governments to appropriate the exclusive right of issuing metallic money, certainly do not outweigh the disadvantages of this system”. “Since the function of government in issuing money is no longer one of merely certifying the weight and fineness of a certain piece of metal, but involves a deliberate determination of the quantity of money to be issued, governments have become wholly inadequate for the task and, it can be said without qualifications, have incessantly and everywhere abused their trust to defraud the people”.²²

As will be explained later, Facebook’s announcement in June 2019 of its intention to launch an international new digital means of payment – Libra - with its standard of value bearing no fixed relation to any established national currency, can be regarded as a modern illustration of Hayek’s approach.

8.8.2. THE DEBT-CREDIT THEORY

But the mainstream theory about the historical origin of money has been challenged by a number of anthropologists and economists who argue that no real primitive barter economy ever existed, with debts and credits playing from time immemorial an essential role as means of payment.

Among the first questioning the “myth of barter” was British diplomat Alfred Mitchell-Innes, who wrote that in the Newfoundland fisheries where Adam Smith had claimed that dried cod served as money, fishers and traders sold each other regularly dried fish and fishing supplies all priced in pounds, shillings and pence, with reciprocal payments being settled through credit in the traders’ books and “balances due by the traders [being] paid for by drafts on England or France”.²³

²² *Id.*, p.26.

²³ A Mitchell Innes, “What is money”, *Banking Law Journal*, May 1913, p.378.



More recently, British economist Felix Martin has used the famous example of the “stone money” (or *fei*) in the Pacific island of Yap, in the Caroline Islands, to illustrate the role of credit. The island’s peculiar monetary system was described by the young American adventurer William Henry Furness II, after a two-month visit to the island in 1903.²⁴ It consisted of *fei*—“large, solid thick stone wheels ranging in diameter from a foot to twelve feet, having in the center a hole varying in size with the diameter of the stone, wherein a pole may be inserted sufficiently large and strong to bear the weight and facilitate transportation”. But the key thing was that *fei* did not move: physical transportation of *fei* from one house to another was in fact rare. Numerous transactions took place—but the debts incurred were typically just offset against each other, with any outstanding balance carried forward in expectation of some future exchange. Even when open balances were felt to require settlement, it was not usual for *fei* to be physically exchanged. “After concluding a bargain which involves the price of a *fei* too large to be conveniently moved, its new owner is quite content to accept the bare acknowledgement of ownership and without so much as a mark to indicate the exchange, the coin remains undisturbed on the former owner’s premises”.

And here comes Martin’s key conclusion:²⁵

“Yap’s money was not the *fei*, but the underlying system of credit accounts and clearing of which they helped to keep track. The *fei* were just tokens by which these accounts were kept. As in Newfoundland, the inhabitants of Yap would accumulate credits and debts in the course of their trading in fish, coconut, pigs and sea cucumber. These would be offset against one another to settle payments (...). Money is the system of credit accounts and their clearing that currency represents”.

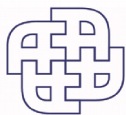
In a similar vein, a modern anthropologist, David Graeber, argues that Mesopotamian cuneiform documents attest that credit was already widely used *circa* 3500 BC, so that credit systems preceded the invention of coinage by a thousand years:²⁶

“Temple bureaucrats used the system to calculate debts (rents, fees, loans, etc.) in silver. Silver was, effectively, money. And it did indeed circulate in the form of unworked chunks, ‘rude bars’ as Smith had put it. In this he was right. But it was almost the only part of his account that was right. For one thing, silver did not circulate very much. Most of it just sat around in Temple and Palace treasuries, some of which remained, carefully guarded, in the same place for literally thousand years. It would have been easy enough to standardize the ingots, stamp them, create some authoritative system

²⁴ William Henry Furness, “The Island of Stone Money, Uap of the Carolines”, J.B. Lippincott Company, 1910, available at <https://archive.org/details/islandofstonemon009573mbp>

²⁵ Felix Martin, “Money. The Unauthorized Biography”, Alfred A. Know, 2013.

²⁶ David Graeber, “Debt. The First 5,000 Years”, Melville House, 2014, p.39.



to guarantee their purity. The technology existed. Yet no one saw any particular need to do so. One reason was that while debts were calculated in silver, they did not have to be ‘paid’ in silver -in fact, they could be paid in more or less anything one had around. Peasants who owed money to the Temple or Palace, or to some Temple or Palace official, seem to have settled their debts mostly in barley, which is why fixing the ratio of silver to barley was so important. But it was perfectly acceptable to show up with goats, or furniture, or lapis lazuli. Temples and Palaces were huge industrial operations -they could find a use for almost anything”.

He adds a comment very relevant for our discussion on the future of money:²⁷

“We did not begin with barter, discover money, and then eventually develop credit systems. It happened precisely the other way around. What we now call ‘virtual money’ came first. Coins came much later, and their use spread only unevenly, never completely replacing credit systems”.

These authors explain that, besides bilateral or centralized credit arrangements, the circulation of debt instruments payable by reputable debtors in good credit standing was for centuries a popular means of settlement among merchants.

In spite of this recognized role for issuers of private debt instruments, I do not think it a stretch to argue that the debt theory of money is closely aligned with a school of thought, “Chartalism”, which runs counter to the Metallist view and considers money a “creature of the State”. This is so because governments have always played a key role:

- In the definition of the standard of value to be used as the unit of account for prices and debts;
- The enforcement of creditors’ legal rights resulting from private money debts, expressed in units of the standard of value;
- The issuance of circulating instruments expressed in units of the standard of value.

The most famous exponent of the Chartalist theory was the German historian G.F. Knapp, author of the “State Theory of Money”, originally published in German in 1905²⁸. He claimed that only chattels issued by the legal authority of the State could acquire the character of ‘money’, and that the value attributed thereto is fixed by law, rather than by reference to the value of the materials employed in the process of production.

Knapp’s views, while leading to withering criticism by Ludwig von Mises in “The Theory of Money and Credit”, were endorsed by many legal scholars, including the German-born British jurist Frederick Alexander Mann in “The Legal Aspects of Money”

²⁷ *Id.*, p.40.

²⁸ Georg Friedrich Knapp, “Staatliche Theorie des Geldes”, Dunder& Humblot, Leipzig, 1905, available at <https://archive.org/details/staatlichetheor00knappgoog/page/n8>



(1938). For F.A. Mann, Knapp's State Theory of Money is supported by the universal acceptance of the principle of nominalism (i.e. the doctrine that money debts can be discharged by paying the nominal number of monetary units in which they were expressed, irrespective of changes in their purchasing power). Mann stated:²⁹

"The State theory of money is the necessary consequence of the sovereign power or the monopoly over currency which states have assumed over a long period and which is almost invariably established by modern constitutional law".

This view about monetary powers being an essential part of political sovereignty is currently shared by all legal experts, as illustrated by the initial rotund statement by Spanish scholar Rosa María Lastra in her manual on international monetary law:³⁰

"The power to issue currency is a sovereign power, one of the attributes of sovereignty as classically defined".

While the legal discussion on the two competing approaches to money seems settled in favor of Knapp, the divergent economic approaches on the origin of money survived and led in more recent times to new debates on the possibility of "denationalizing money" and creating "private currencies".

8.8.3. THE DENATIONALIZATION OF MONEY

In 1976 Austrian economist Friedrich Hayek challenged the "universally but tacitly accepted creed that a country must be supplied by its government with its own distinctive and exclusive currency" and advocated the "denationalization of money".³¹

"For more than 2,000 years the government prerogative or exclusive right of supplying money amounted in practice merely to the monopoly of minting coins of gold, silver or copper. It was during this period that this prerogative came to be accepted without question as an essential attribute of sovereignty-clothed with all the mystery which the sacred powers of the prince used to inspire.

The task the government was understood to assume was of course initially not so much to make money as to certify the weight and fineness of the materials that universally served as money, which af-

²⁹ As quoted by Charles Proctor in "Mann on the Legal Aspects of Money", 7th edition, Oxford, 2012, p. 16.

³⁰ Rosa María Lastra, "International Financial and Monetary Law", Oxford University Press, 2015, p.3.

³¹ F.A. Hayek, "Denationalization of Money. The Argument Refined", Hobart Special Paper 70, The Institute of Economic Affairs, available at <https://nakamotoinstitute.org/static/docs/denationalisation.pdf>



ter the earliest times were only the three metals, gold, silver, and copper. It was supposed to be a task rather like that of establishing and certifying uniform weights and measures. There is no reason to doubt that private enterprise would, if permitted, have been capable of providing as good and at least as trustworthy coins. Yet so long as the technical task of providing uniform and recognizable coins still presented major difficulties, it was at least a useful task which government performed. Unfortunately, governments soon discovered that it was not only useful but could also be made very profitable, at least so long as people had no alternative but to use the money they provided. The seigniorage, the fee charged to cover the cost of minting, proved a very attractive source of revenue, and was soon increased far beyond the cost of manufacturing the coin. And from retaining an excessive part of the metal brought to the government mint to be struck into new coins, it was only a step to the practice, increasingly common during the Middle Ages, of recalling the circulating coins in order to recoin the various denominations with a lower gold or silver content. But since the function of government in issuing money is no longer one of merely certifying the weight and fineness of a certain piece of metal, but involves a deliberate determination of the quantity of money to be issued, governments have become wholly inadequate for the task and, it can be said without qualifications, have incessantly and everywhere abused their trust to defraud the people”.

Hayek described how he would organize the issuance of a new private currency -which he called “ducat”-:

“I would announce the issue of non-interest-bearing certificates or notes, and the readiness to open current cheque accounts, in terms of a unit with a distinct registered trade name such as ‘ducat’. The only legal obligation I would assume would be to redeem these notes and deposits on demand with, at the option of the holder, either 5 Swiss francs or 5 D-marks or 2 dollars per ducat. This redemption value would however be intended only as a floor below which the value of the unit could not fall because I would announce at the same time my intention to regulate the quantity of the ducats so as to keep their (precisely defined) purchasing power as nearly as possible constant. I would also explain to the public that I was fully aware I could hope to keep these ducats in circulation only if I fulfilled the expectation that their real value would be kept approximately constant. And I would announce that I proposed from time to time to state the precise commodity equivalent in terms of which I intended to keep the value of the ducat constant, but that I reserved the right, after announcement, to alter the composition of



the commodity standard as experience and the revealed preferences of the public suggested”.

Hayek considered the possibility of several private currencies, each with its own brand name, competing with each other. This competition would force issuing institutions to keep the value of their currencies constant (in terms of a stated collection of commodities), so as to preserve their attractiveness for savers, without the need for any obligation to redeem the currency in those commodities or in gold.

He expressed some concern about the likely emergence of what he described as “parasitic currencies”, i.e., the creation by banks and financial intermediaries of deposits and other financial instruments denominated in the currency of the original issuer (say, in “ducats”, to use his own example), to the extent that this could expand the supply of the new currency. His solution to the problem was the following:

“What the original issuer of such a currency could do and would have to do is not to repeat the mistakes governments have made, as a result of which control of these secondary or parasitic issues has slipped from their hands. It must make clear that it would not be prepared to bail out secondary issuers by supplying the ‘cash’ (i.e. the original notes) they will need to redeem their obligations”.

Writing in the mid-70s, at a time of a very weak dollar and rising inflation, Hayek saw the attraction of a new private currency in the stability of its purchasing power (in terms of a representative and adjustable basket of commodities) and the protection it would provide against inflation, not so much in its convenience as a means of payments, like the most recent batch of digital currencies.

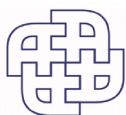
8.8.4. THE MIRAGE OF PRIVATE MONEY

But other economist, like James Tobin, took issue with Hayek’s view and claimed an essential role for governments in the definition of money, especially in a *fiat* world in which any gold or commodity standard has been abandoned. He considered pure “private money” (i.e. outside money, not convertible into a different standard of value) a mirage: ³²

“Currency is the physical embodiment of the monetary unit of account defined by the sovereign. Currency is the sure and perfectly liquid store of value in units of account. It is legal tender, for the payment of taxes and for the discharge of private obligations enforceable in courts of law for payments in units of account. Consequently, it is generally acceptable in payments.

I find it difficult to imagine a system in which there is no governmentally issued store of value in the unit of account. Some discus-

³² James Tobin, op.cit., p. 21-22.



sions of ‘private money’ in the literature seem to suggest that the government can define the ‘dollar’ as the unit of account without printing and issuing any dollars. Private agents could issue promises to pay dollars, and these would circulate. But what are they promising to pay? Of course, if the governments sanctified the issues of a particular bank or private firm or individual by agreeing to accept them in payment of taxes and by granting them legal tender status, those issues would be currency. The sovereign would be delegating its fiat to the favored private institution. History suggests that such an institution would eventually be nationalized and made politically responsible, like the Bank of England. The idea of a disembodied fiat unit of account, with embodiments of it freely and competitively supplied by private agents, seems to me to be a fairy tale. Private monetary issue makes more sense for commodity money. The government can define a dollar in terms of gold or silver, or plywood or wheat, or some combination of goods. The commodity itself can circulate, especially if coinage by the State or by any other credible government or agency puts it in a form of readily ascertainable weight and quality. Experience suggests that societies will also find it convenient to handle transactions with promises to pay the numeraire commodity. Whose promises? Just those of competing private agents? Of unregulated private agents? Once again, the government cannot escape the question of what IOUs it will accept from citizens in payment of taxes and other obligations, or avoid deciding whose IOUs will be regarded as discharging private debts. Neither can a government take a laissez-faire attitude toward the ability of private issuers of such IOUs to redeem their promises, especially if the government gives them the cachets of acceptability and legal tender (...) I conclude that there must be store-of-value embodiments of a monetary unit of account, and that basically these will be and should be designated and supplied by the central government”.

As explained below, the traditional rivalry between those libertarian and free-marketeters distrusting the role of governments in monetary affairs and those seeing money creation and regulation as an essential public or sovereign prerogative have emerged anew as a result of the emergence of private digital currencies.

8.9. A TAXONOMY OF MODERN MEANS OF PAYMENT

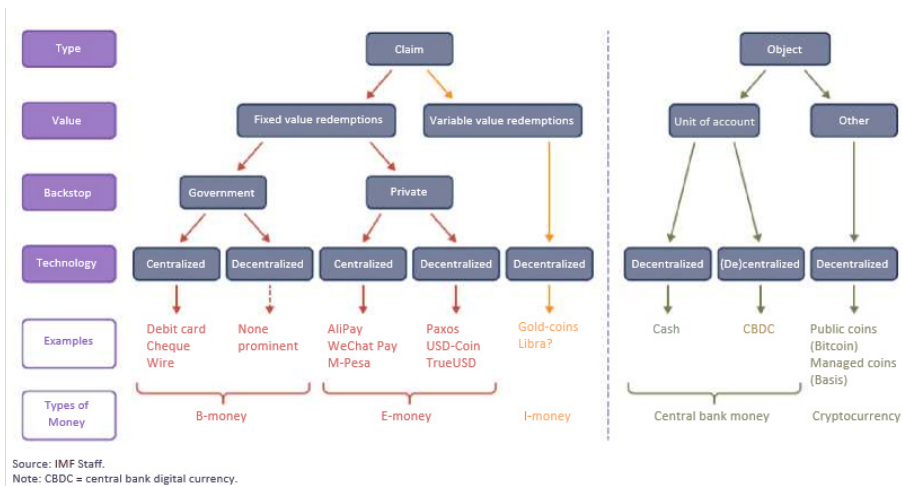
As a result of the historic trends and innovations described above, monetary systems include a variety of means of payments.

From a legal standpoint, a Spanish former legal counsel of the European Central Bank, Antonio Sáinz de Vicuña, coined the term “institutional theory of money” to de-

scribe the fact that currently money consists primarily of a claim against the issuing central bank (i.e. cash), but also the credit balance of sight deposits held by the public in commercial banks.³³

Going forward, however, we should take a broader perspective and classify existing and potentially new means of payment according to several features, thereby arranging them in a “money flower”, as originally done by Morten Bech and Rodney Garrat³⁴, or a “money tree”, as presented by Tobias Adrian and Tommaso Mancini-Griffoli.³⁵

In Adrian and Mancini-Griffoli’s “money tree”, four separate attributes of means of payments are considered (see graph).



The first one is whether they are “claims” on something (e.g. bank deposits, redeemable in cash) or just “objects” (like modern banknotes or reserve deposits in the central bank).

They argue that claim-based payments simplify transactions, but require a complex infrastructure. “With the advent of claim-based systems in the Renaissance, merchants could conveniently travel with letters of credit from their banks and exchange them for goods abroad instead of carrying heavy and risky gold coins in their purse. Today, most payments are claim-based. These require that payers be recognized as the rightful owners of the claim they offer, that sufficient funds be identified to back the claim, and that the transfer be registered by all the relevant parties”.³⁶

³³ Antonio Sáinz de Vicuña, “An Institutional Theory of Money”, in Mario Giovanoli et al. (eds.), “International Monetary and Financial Law: The Global Crisis, Oxford 2010, para. 25.18. Quoted as well in Charles Proctor, op.cit., para.1.34.

³⁴ Morten Bech and Rodney Garrat, “Central Bank cryptocurrencies”, BIS Quarterly Review, September 2017.

³⁵ Tobias Adrian and Tommaso Mancini-Griffoli, “The Rise of Digital Money”, International Monetary Fund, July 2019.

³⁶ *Id.*, p.2.



The second attribute is their “value”. In the case of claims, the relevant question is whether the redemption of the claim into the asset which backs its value is at a fixed or variable rate. “For instance, a claim on a bank in the form of deposits for, say, €10 can be exchanged for €10 worth of bills and notes. These claims resemble debt instruments (which may or may not pay interest) that can be redeemed upon demand at face value”. In the case of objects (e.g. banknotes or gold ingots), the relevant question is the unit of account or standard of value in which they are denominated.³

The third attributes applies only to fixed-value claims and is whether the redemption guarantee is “backstopped” by the government, or just relies on the private trustworthiness of the issuer.

The fourth and final attribute is the “technology” - centralized or decentralized - underpinning transfers of the means of payment. It happens to be centralized in the case of bank deposits, credit cards, or certain non-bank digital assets - like M-Pesa in Kenya or WeChat Pay in China - and fully decentralized in the case of cash or blockchain-based cryptocurrencies - like Bitcoin.

Let us now consider some specific combinations of these attributes.

8.9.1. CENTRAL BANK MONEY

In all countries, there are two object-type means of payments produced by the local central bank: central bank notes and central bank balances (i.e. reserves) held by banks and other authorized account-holders (e.g. domestic Treasury, foreign central banks....). These balances are currently excluded from monetary aggregates since they are not held by the public at large, but have a “wholesale” nature. Both assets are not “claims”, but “objects”, since at present they are “fiduciary” and cannot be exchanged into anything else.³⁷

8.9.2. BANK DEPOSITS (“B-MONEY”)

In most countries, the other predominant means of payments are deposits in commercial banks – “b-money” in Adrian and Mancini-Grifolli’s terminology -, which are claims convertible into official banknotes. They can be transferred and used for payments through a number of centralized technologies, like traditional bank transfer orders or credit and debit cards. The emergence of digital transfer systems carried out through smartphones and specific applications does not detract from the essential fact that the asset being transferred remains a bank deposit.

³⁷ Obviously, central bank reserves can be converted into notes. But this is not an essential feature and does not transform those balances into “claims”, as they would no longer be convertible into anything if the central bank were to stop issuing physical banknotes, as currently discussed as part of the discussions on “Central Bank Digital Currencies” (CBDC).



For Adrian and Mancini-Griffolli, “the key distinguishing feature of b-money is that its redemption guarantee is backstopped by the government. Of course, a prudent business model helps meet potential redemption requests. But public policy also plays a role. Banks are regulated and closely supervised. Where regulation is effective, banks cannot take excessive risks and must keep ample liquidity. In addition, if banks run out of liquid assets to honor requests for withdrawals, central banks may provide liquidity via overnight loans or emergency facilities in times of systemic stress. Finally, deposits are insured in many countries up to a certain limit.”³⁸

8.9.3. “E-MONEY”

But in a number of countries with a low density of traditional bank branches -like Africa or Asia-, balances stored not in traditional bank accounts but in digital accounts or “wallets” held in mobile cell-phones operated by telecom companies have become a very popular means of payment.

A good representative illustration is Kenya’s M-Pesa (“pesa” being Swahili for “money”), a mobile phone-based money transfer system launched by Vodafone in 2008 and operated by Safaricom, Kenya’s largest mobile network operator. It allows users to transfer money and pay for goods and services with just a mobile device. M-Pesa is not an “object”, but a “claim”, as it is, in Vodafone’s words³⁹, “a digital representation of cash which Vodafone stores safely in a ring-fenced bank account (a “trust” account). The mobile money account of each customer is linked to their mobile phone account. The central platform securely keeps tracks of the value in case a phone or SIM card is lost. M-Pesa is specifically designed to benefit customers who have no access to banks - either because they do not have a bank account or because they live too far away from a bank branch. Each transaction is made with a mobile handset, enabling our customers to send money from any location”. “M-Pesa agents pre-buy mobile money so that they can sell it to customers in exchange for cash (so the customer can ‘cash-in’); they also do the reverse, selling cash in exchange for mobile money (so the customer can ‘cash out’). The cash and M-Pesa balances that agents manage and store are always their own”.

M-Pesa is, thus, an easily transferable “claim” on a bank deposit, not an “object”.

Within the European Union, e-money was regulated in the “Electronic Money Directive” (2008/110/EC), which was aimed at facilitating the emergence of new, innovative and secure e-money services. It required e-money institutions to get a license and meet minimum requirements of own funds.

Under article 7 (“Safeguarding requirements”), electronic money institutions should safeguard received funds in “low-risk assets” (i.e. mostly public debt instruments, but also “units in an undertaking for collective investment in transferable securities (UCITS), which invests solely in low-risk assets).

³⁸ Id., p.4.

³⁹ Available at <https://www.vodafone.com/what-we-do/services/m-pesa>



Article 11 requires that “electronic money issuers issue electronic money at par value on the receipt of funds” and that “upon request by the electronic money holder, electronic money issuers redeem, at any moment and at par value, the monetary value of the electronic money held”.

Interestingly, article 12 prohibits “the granting of interest or any other benefit related to the length of time during which an electronic money holder holds the electronic money”.

8.9.4. “I-MONEY”?

Adrian and Mancini-Griffoli also consider a potential new means of payment: claims on a portfolio of investment assets, such as gold or financial assets (e.g. shares). This “i-money” (short for “investment fund money”) would be similar to e-money, except that it would not have a variable redemption rate in terms of currency, but a variable one, depending on the market price of the underlying assets. In their view, “shares in private investment funds could become i-money. They can be tokenized, meaning they can be represented by a coin of any amount on a digital ledger. The coin can then be traded directly, at low cost, and constitutes a payment denominated in the underlying portfolio’s going worth in any currency. For instance, if B owes A €10, B could transfer €10 worth of a money market fund to A. To the extent that the fund is liquid, its market price should be known at any point in time. And to the extent the fund comprises very safe assets, A may agree to hold these with the expectation of using these to pay for future goods and services at approximately the same exchange rate with local currency. In other words, i-money could be sufficiently stable to serve as a widespread means of payment”.⁴⁰

8.10. RECENT INNOVATIONS

Recent international discussions on domestic monetary systems have been prompted by some new interrelated changes:

- The emergence of new digital private “currencies” (like Bitcoin, Ether and many others).
- The spontaneous decline of the use of cash in some advanced economies -like Sweden- and the deliberate attempt by the authorities in some other countries -like India- to phase out large denomination banknotes, to fight tax evasion and the underground economy.
- The discussion by central banks and monetary experts of the issuance by central banks of their own “central bank digital currencies” (CBDC), to compensate for the decline in the use of cash and to keep a significant role in the provision of means of payment.

⁴⁰ Id. p.5.



- The launch in June 2019 by one of the leading Big Techs, Facebook, its “Libra Project”.

I will discuss briefly these changes before presenting in the final section my own guesses or hunches on the future of money.

8.10.1. PRIVATE DIGITAL CURRENCIES

“Virtual currencies” have been defined as “digital representations of value, issued by private developers and denominated in their own unit of account, that can be obtained, stored, accessed, and transacted electronically, and can be used for a variety of purposes, as long as the transacting parties agree to use them”⁴¹. “The concept of virtual currencies covers a wide array of ‘currencies’, ranging from simple IOUs of issuers (such as Internet or mobile coupons and airline miles), virtual currencies backed by assets such as gold, and “cryptocurrencies” such as Bitcoin. However, they differ from other digital currencies, such as e-money, which is a digital payment mechanism for (and denominated in) fiat currency. Virtual currencies are not denominated in fiat currency and have their own unit of account”.⁴²

Since the launch of Bitcoin in 2009, new virtual currencies utilizing a “distributed ledger technology” (DLT), particularly ‘blockchain’ data structures, mushroomed, especially after Bitcoin’s price briefly rose to nearly US \$20,000 per bitcoin. This growth has been propelled by an unprecedented amount of early venture capital raised in “initial coin offerings (ICOs) outside the regulated financial services industry. As argued by Rosa María Lastra and Jason Grant Allen, “the development of the virtual currency market to date has largely been a matter of private initiative, often motivated by a techno-libertarian ideological outlook that stresses the private creation of money and adopts a skeptical position towards state interference in economic arrangements generally, which translates into a skeptical position towards central banks in particular”.⁴³

Irrespective of their success as speculative financial assets, none of them seem to have gotten even close to becoming a general means of payment, probably as a result of two factors:

- The lack of a sufficient broad base of users which could generate the necessary network externalities for a new currency to compete with established ones.
- The volatility of the value of these cryptocurrencies in terms of the established official currencies, which has limited their attraction as a new standard of value.

⁴¹ Dong He et alia, “Virtual Currencies and Beyond; Initial Considerations”, IMF Staff Discussion Notes 16/3, 2016, p.7.

⁴² Id.

⁴³ Rosa María Lastra and Jason Grant Allan, “Virtual Currencies in the Eurosystem: Challenges Ahead”, European Parliament, Monetary Dialogue, July 2018, available at http://www.europarl.europa.eu/cmsdata/150541/DIW_FINAL%20publication.pdf



The analysis of these cryptocurrencies would not thus belong in an article on the future of “money”, but the situation changed dramatically with Facebook’s announcement in June 2019 that it intended to launch its own digital stablecoin, “Libra”, an initiative which is discussed below.

8.10.2. THE CURSE OF CASH

In 2016, Kenneth Rogoff, a former chief economist of the International Monetary Fund (IMF), called again for advanced-economy governments to phase out paper currency over a 10- to 15-year period, except perhaps for small denominations notes and coins.⁴⁴ He gave two main reasons:

- To prevent high-value anonymous payments and thereby discourage tax evasion and crime –like the drug trade, human trafficking and exploitation of migrants-. He had already invoked this argument back in 1998, when he criticized the expected issuance by the newly created European Central Bank (ECB) of a €500 note. In Rogoff’s view, the potential gains from reducing tax evasion would offset, at least partially, the forgone benefits from seigniorage. Furthermore, central banks would get more than enough revenues from electronic money to cover their operating costs in most scenarios.
- To allow central banks, when required to stimulate demand and avoid the “liquidity trap”, to overcome the “zero lower bound” for interest rates and apply unfettered negative interest rates, without people being able to take refuge in big denomination bank notes, which can be seen as an anonymous bearer zero-interest-rate bond.

Rogoff’s idea was severely criticized, most famously by former ECB board member and chief economist Otmar Issing, who described paper currency as “coined liberty”⁴⁵. Other German economists came out also in support of cash, claiming that its abolition would have major drawbacks and entail undesirable consequences.⁴⁶ Furthermore, they argued that if doing away with cash were to make it impossible to convert deposits at commercial bank into central bank money, there would be mounting pressure to consider one of the following alternatives:

- Bank deposits wholly covered by central bank money (“narrow banking”);
- Deposits in central bank accounts available to everyone, or

⁴⁴ Kenneth S. Rogoff, “The Curse of Cash”, Princeton University Press, 2016.

⁴⁵ The expression is from Fyodor Dostoyevsky’s “The House of the Dead”: “Money is coined liberty, and so it is ten times dearer to the man who is deprived of freedom. If money is jingling in his pocket, he is half consoled, even though he cannot spend it. But money can always and everywhere be spent, and, moreover, forbidden fruit is sweetest of all”.

⁴⁶ Franz Seitz and Malte Krueger, “The Blessing of Cash”, International Cash Conference 2017 – War on Cash: Is there a Future for Cash? 25 - 27 April 2017, Mainau Island, Germany, Deutsche Bundesbank.



- Digital central bank money (e-euro).

In the case of a narrow banking solution, certain bank deposits would have to be wholly covered by central bank money, with the banking system divided into “deposit-taking or payment transaction banks” and “investment or commercial banks”.

As a matter of fact, Nordic countries, like Norway, Sweden and Denmark, have taken the lead in the promotion of a cash-less society and in phasing out the largest notes in circulation, like Sweden did in 2013 with the 1,000-krona note. Not surprisingly, they have also been at the forefront in the discussions about the creation of central bank digital currency (CBDC).

8.10.3. CENTRAL BANK DIGITAL CURRENCIES

As early as 1985, James Tobin argued that “one way to provide [means of payment like currency, but without its disadvantages] would be to allow individuals to hold deposit accounts in the central bank, or in branches of it established for the purpose and perhaps located in post offices”.⁴⁷ But he himself considered this alternative unlikely, given the then current sentiment in favor of privatization.

Recently, however, the idea of providing greater access to digital forms of central bank liabilities has resurfaced, as a result, according to banking experts from the Committee on Payments and Markets Infrastructures and Markets Committee of the Basel Committee of Bank Supervisors, of several factors:⁴⁸

- Interest in technological innovations for the financial sector;
- The emergence of new entrants into payment services and intermediation;
- Declining use of cash in a few countries; and
- Increasing attention to so-called private digital tokens.

This has led to the concept of “central bank digital currency” (CBDC), originally defined as “a digital form of central bank money that is different from balances in traditional reserve or settlement accounts”. Within this broad concept, at least three different types of CBDC can be considered, depending on who has access (i.e. general purposes vs. restricted or wholesale) and what technology is used (i.e. tokens vs. accounts):⁴⁹

- Digital tokens that can only be used by financial institutions, for “wholesale transactions” (e.g. for interbank and securities settlement);
- Accounts at the central bank for the general public; and
- Digital “cash” tokens that could be used by the general public for retail payments.

⁴⁷ James Tobin, op.cit., p.25.

⁴⁸ Committee on Payments and Market Infrastructures and Markets Committee, “Central Bank Digital Currencies”, Bank for International Settlements, March 2018, p.3.

⁴⁹ G-7 Working Group on Stablecoins, “Investigating the impact of global stablecoins”, Annex C on Central bank digital currencies (CBDC), October 2019.



Their main differences in terms of availability, anonymity (vis-à-vis the central bank), and possibility of peer-to-peer transfer are summarized in the following table:⁵⁰

	Existing central bank money-		Central bank digital currencies		
	Cash	Reserves and settlement balances	General purpose		Wholesale only token
			token	accounts	
24/7 availability	✓	×	✓	(✓)	(✓)
Anonymity vis-à-vis central bank	✓	×	(✓)	×	(✓)
Peer-to-peer transfer	✓	×	(✓)	×	(✓)
Interest bearing	×	(✓)	(✓)	(✓)	(✓)
Limits or caps	×	×	(✓)	(✓)	(✓)
✓ = existing or likely feature, (✓) = possible feature, × = not typical or possible feature.					

The distinction between token- and account-based money bears on the form of verification needed when it is exchanged: while token-based money relies on the ability of the payee to verify the validity of the payment object -with the main concern being “electronic counterfeiting”-, account-based money depends on the ability to verify the identity of the account holder -the main concern being identity theft-.

In their 2018 report, BIS experts concluded that:

- Traditionally, central banks have tended to limit access to account-based forms of central bank money mostly to banks, while making banknotes widely accessible. “This approach has, in general, served the public and the financial system well, setting a high bar for changing the current monetary and financial structure”.
- The benefits of a widely accessible CBDC may be limited if fast (even instant) and efficient private retail payment products are already in place or in development. A central bank introducing such a CBDC would have to ensure the fulfilment of anti-money laundering and counter terrorism financing (AML/CFT) requirements, as well as satisfy the public policy requirements of other supervisory and tax regimes. An anonymous general purpose CBDC would raise further concerns and challenges. On the contrary, a non-anonymous CBDC could allow for digital records and traces, which could improve the application of rules aimed at AML/CFT.
- If flows into CBDC were to become large and not associated with offsetting declines in physical banknotes, as could be the case in times of financial stress, challenges could arise (such as a need to broaden the assets that the central bank can hold or take on as collateral).

⁵⁰ “Central bank digital currencies”, op.cit., Table 1, p. 6.



- On the positive side, a general purpose CBDC could enrich the options offered by the central bank's monetary policy toolkit, by allowing for a strengthening of pass-through of policy rate changes to other interest rates or addressing the zero lower bound on interest rates (provided high denomination banknotes were retired)
- As a liquid and creditworthy asset, a wholesale variant available to institutional investors that would be akin to interest-bearing central bank reserves or reverse repo facilities, yet widely tradeable, could function as a safe asset comparable in nature to short maturity government bills.
- A general purpose CBDC could compete with guaranteed bank deposits, with implications for the pricing and composition of banks' funding. It could give rise to higher instability of commercial bank deposit funding and facilitate, at times of stress, a fast and large flight towards central bank money, challenging commercial banks and the central bank to manage such situations.
- For international currencies, the above considerations would apply with added force, especially during market waves of flight to safety. Hence, the introduction of a CBDC in one jurisdiction could adversely affect others and, consequently, central banks seeking to introduce a CBDC should consider cross-border issues.
- In conclusion, any steps towards the possible launch of a CBDC should be subject to careful and thorough consideration.

Uruguay's Central Bank ran a pilot test from November 2017 to April 2018, in cooperation with a telecoms company, of a digital version of the Uruguayan peso, called "e-peso". It issued the equivalent of some €0.5 million, for digital wallets of some 10,000 mobile phone users, chosen on a first-come-first-served basis, who could use them for payment transactions in registered stores and businesses as well as for peer-to-peer transfers among registered users. The pilot system provided for instantaneous settlement, relied merely on a working mobile phone line, not requiring an internet connection, and the users' wallets and the encrypted e-note manager were designed to render transactions anonymous yet traceable. According to Uruguay's central bank, "the overall experience with the pilot was positive". The Central Bank highlighted the many advantages of CBDC, including lower costs, financial inclusion, prevention of crime and tax evasion, and customer protection, and has called for central banks to embrace new technologies and promote further financial innovation in cooperation with the private sector and start-ups.⁵¹

In Sweden, the Riksbank has proposed to Parliament that a technical committee perform a review of the concept of "legal tender" and study the legal amendments necessary to facilitate the issuance of e-krona and the phasing out of cash. The second report on the e-krona included this statement:⁵²

⁵¹ "Do We Need Central Bank Digital Currency? Economics, Technology and Institutions", edited by Ernest Gnan and Donato Masciandaro, SUERF Conference Proceedings 2018/2, p.18 and 82-90.

⁵² The Riksbank's e-krona project, Report 2, October 2018, available at <https://www.riksbank.se/en-gb/payments-cash/e-krona/>



“Cash use continues to decline in Sweden. In future, cash may be so marginalized that it becomes difficult to use as a means of payment. For 350 years, the Riksbank has provided the general public with money but going forwards, the technical development and digitalization of payments will bring the issue of the State’s role to a head. If the marginalization of cash continues a digital krona, an e-krona, could ensure that the general public still has access to a State-guaranteed means of payment. Alternatively, not to act in the face of current developments and completely leave the payment market to private agents, will ultimately leave the general public entirely dependent on private payment solutions, which may make it more difficult for the Riksbank to promote a safe and efficient payment system”.

While the general discussion among BIS experts on the availability of a CBDC has centered on whether it is to be limited to financial institutions or be extended to the public at large, a separate question is whether, while access remains restricted, it should be opened to telecom and fintech companies offering e-money wallets.

In this spirit, Adrian and Mancini-Griffoli under the heading “What if E-money Providers Could Hold Central Bank Reserves?” argued that “the ability to hold central bank reserves would fill the sails of e-money providers by allowing them to overcome market and liquidity risk, and would transform these into narrow banks. Fractional banks would feel greater pressure. For one, they would no longer benefit from wholesale funding from e-money providers. [Furthermore] while banks should be able to hold their ground in normal times, a question mark arises in crisis times. Would there be massive runs from bank deposits into e-money in times of crises? If client funds backing e-money were held as wholesale funding for banks, the run could be in reverse, from e-money to b-money as clients seek the protection of banks’ deposit insurance. But if client funds were held as reserves at the central bank, then run risks cannot be discounted. Certainly, uninsured deposits might migrate from banks to e-money providers”.⁵³

By way of conclusion, Adrian and Mancini-Griffoli suggest that central banks, rather than creating CBDC tokens available for the general public, limit themselves to allowing e-money providers to hold traditional central bank reserves, in bankruptcy-remote trusts which issue e-money 1-to-1 for reserves. They describe such e-money as “Synthetic Central Bank Digital Currency” (or sCBDC, for short), which they characterize as a public-private partnership in which e-money providers would be responsible for performing customer due diligence, offering or vetting wallets, developing or selecting the underlying technology, managing customer data, and interacting with customers’ requests, complaints and questions. “Each of these raises risks of glitches and cyberattacks, entails significant costs, and puts the central banks’ reputation at risk”.⁵⁴

⁵³ Adrian and Mancini-Griffoli, op.cit., p. 12.

⁵⁴ Id. p.14.



8.10.4. THE LIBRA PROJECT

On June 18, 2019, Facebook publicly announced its intention to launch in the first half of 2020 a new global digital currency, “Libra”.⁵⁵

According to the project’s White Paper, Libra would have the following features:

- The unit of account or standard of value of the users’ balances would be a new unit, “Libra”, meant to become a “new global currency”.
- Libra would be “fully backed by a reserve of real assets. A basket of bank deposits and short-term government securities will be held in the Libra Reserve for every Libra that is created, building trust in its intrinsic value. The Libra reserve will be administered with the objective of preserving the value of Libra over time”. “The assets in the Libra Reserve will be held by a geographically distributed network of custodians with investment grade credit rating to provide both security and decentralization of the assets”.
- Libra users would not “receive a return from the reserve”, i.e. Libra balances would earn no interest. Financial returns from the Libra Reserve would be used “to cover the costs of the system, ensure low transaction fees, pay dividends to investors who provided capital to jumpstart the ecosystem, and support further growth and adoption”.
- Libra would be established as a “permissioned blockchain”, so that only certain number of “validators nodes” would be authorized. It would use the Move programming language, specifically “designed to prevent assets from being cloned”. This would lend Libra digital assets “the same properties as physical assets: a resource has a single owner, it can only be spent once, and the creation of new resources is restricted”. “The Libra Blockchain is pseudonymous and allows users to hold one or more addresses that are not linked to their real-world identity”.
- Libra would be backed by a “competitive network of exchanges buying and selling Libra. That means anyone with Libra has a high degree of assurance they can convert digital currency into local fiat currency based on an exchange rate, just like exchanging one currency for another when travelling”.
- A “Libra Association”, an independent, not-for-profit organization headquartered in Geneva (Switzerland), would be the governing entity of Libra. Specifically, it would be “the only party able to create (mint) and destroy (burn) Libra. “Coins are only minted when authorized resellers have purchased those coins from the association with fiat assets to fully back the new coins. Coins are only burned when the authorized resellers sell Libra coin to the association in exchange for the underlying assets. Since authorized resellers will always be able to sell Libra coins to the reserve at a price equal to the value of the basket, the Libra Reserve acts as a ‘buyer of last resort”.

⁵⁵ Information retrieved from https://libra.org/en-US/wp-content/uploads/sites/23/2019/06/LibraWhitePaper_en_US.pdf



Its governing body would be its Council, comprised of one representative per validator node, with major decisions requiring a two-thirds majority.

As a consequence, Libra would be a “global, digitally native currency that brings together the attributes of the world’s best currencies: stability, low inflation, wide global acceptance and fungibility”. Libra is a cryptocurrency and “by virtue of that, it inherits several attractive properties of these new digital currencies: the ability to send money quickly, the security of cryptography, and the freedom to easily transmit funds across borders. Just as people can use their phones to message friends anywhere in the world today, with Libra, the same can be done with money -instantly, securely, and at a low cost.”

The White Paper makes a reference to the process which I described above as “monetary piggy backing” when it states that its approach “is similar to how other currencies were introduced in the past: to help instill trust in a new currency and gain widespread adoption during its infancy, it was guaranteed that a country’s notes could be traded in for real assets, such as gold. Instead of backing Libra with gold, it will be backed by a collection of low-volatility assets, such as bank deposits and short-term government securities in currencies from stable and reputable central banks. It is important to highlight that this means that one Libra will not always be able to convert into the same amount of a given local currency (i.e. Libra is not a ‘peg’ to a single currency). Rather, as the value of the underlying assets moves, the value of one Libra in any local currency may fluctuate”.

8.10.5. G-7 REACTION

Shortly after Facebook’s announcement, the G-7 countries set up a working group to report on the initiative and, more broadly, on “stablecoins”, i.e. private digital currencies that, unlike Bitcoin, seek to stabilize the price of the “coin” by linking its value to that of a pool of assets. The working group, chaired by Benoît Cœuré -in his capacity as chairman of the BIS Committee on Payments and Market Infrastructure (CPMI)-, released publicly its report in October 2019.⁵⁶

The report starts by recognizing that cross-border payments remain slow, expensive and opaque, especially for retail payments such as remittances. Moreover, there are 1.7 billion people globally who are unbanked or underserved with respect to financial services. Given the innovative potential of the underlying technology, crypto-assets were originally envisioned to address some of these challenges. However, to date, they have suffered from a number of limitations, not least severe price volatility. Thus, crypto-assets have served as a highly speculative asset class for certain investors and those engaged in illicit activities, rather than as a means to make payments. Stablecoins have many of the features of crypto-assets but seek to stabilize the price of the “coin” by linking its value to that of a pool of assets. Therefore, stablecoins might be more capable of serving as a

⁵⁶ G-7 Working Group on Stablecoins, “Investigating the impact of stablecoins”, October 2019, available at <https://www.bis.org/cpmi/publ/d187.pdf>



means of payment and store of value, and they could potentially contribute to the development of global payment arrangements that are faster, cheaper and more inclusive than present arrangements”.

However, stablecoins, “regardless of size, pose legal, regulatory and oversight challenges and risks related to legal certainty; sound governance, including the investment rules of the stability mechanism; money laundering, terrorist financing and other forms of illicit finance; safety, efficiency and integrity of payment systems; cyber security and operational resilience; market integrity; data privacy, protection and portability; consumer/investor protection; [and] tax compliance”.

Moreover, stablecoins that reach global scale (“global stablecoins” or GSCs) “could have significant adverse effects, both domestically and internationally, on the transmission of monetary policy, as well as financial stability, in addition to cross-jurisdictional efforts to combat money laundering and terrorist financing. They could also have implications for the international monetary system more generally, including currency substitution, and could therefore pose challenges to monetary sovereignty. GSCs also raise concerns around fair competition and antitrust policy, including in relation to payments data”.

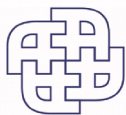
The report concluded that “no global stablecoin project should begin operation until the legal, regulatory and oversight challenges and risks outlined above are adequately addressed, through appropriate designs and by adhering to regulation that is clear and proportionate to the risks”. At the same time, it welcomed the Financial Stability Board’s plan to submit in April and July of 2020 a consultative report to the G-20 Finance Ministers and central bank Governors”.

Finally, as part of the public authorities’ efforts to promote faster, more reliable and less costly payment systems for both domestic and cross-border purposes, the G-7 report recommends that “central banks, individually and collectively, assess the relevance of issuing central bank digital currencies (CBDCs) in view of the costs and benefits in their respective jurisdictions”.

The reaction of ministers to the Libra initiative was probably even more hostile than their experts’, due probably to sovereignty concerns.

This became particularly clear during the July 2019 ministerial G-7 summit in Chantilly (France), where its rotating chairman, French finance minister Bruno Le Maire, considered that, given that Facebook has hundreds of millions of customers around the world, Libra could jeopardize the monetary sovereignty of nations and have a destabilizing effect on the global financial system. “We cannot accept private companies issuing their own currencies without democratic control,” he declared. On October 17, 2019, he penned an article in the Financial Times with the eloquent title “Facebook’s Libra is a threat to national sovereignty”, where he argued that “the project would mean a private company controlling a common good and taking over tasks normally discharged by States. This is unacceptable for both economic and political reasons”.⁵⁷

⁵⁷ Bruno Le Maire, “Facebook’s Libra is a threat to national sovereignty”, Financial Times, October 17, 2019.



Such political hostility of the G-7 finance ministers has been mirrored in similar attitudes of the US Government and US Congress and in the European Union's Ecofin Council. More specifically, European ministers have reserved the right to "impede" the emergence of global stablecoins, like Libra, which may jeopardize governments' sovereignty on monetary issues.

8.10.6. LIBRA RESPONSE

On October 17, 2019, in its response to concerns expressed in the G-7 Report ("Investigating the Impact of Global Stablecoins"), the Libra Association argued that:⁵⁸

- It will set appropriate standards for its members to maintain anti-money laundering (AML)/know your customer (KYC) standards, cooperate with law enforcement investigations and be able to analyze prior transactions on the Libra Blockchain and share indications of potentially suspicious activity with law enforcement.
- Individuals and entities who hold Libra coin will be responsible for filing their taxes in accordance with local laws. Wallets and financial services built on the Libra Blockchain will be expected to provide consumers with tools to help manage their tax filings.
- While Libra coins will not give people the legal right to buy and sell coins from or to the Libra Association, authorized resellers will have such a contractual right.
- The Libra payment system and Libra coin are not designed to replace the U.S. dollar or any other currency, but to extend the functionality of those currencies by enabling cheap and fast payments. Libra will not diminish the sovereignty of governments to conduct monetary policy. Libra is not intended to change the role and influence of central bankers in the global financial system.
- Wallets and other financial services operating on the Libra Network (including exchanges and other on and off ramps) will have to comply with regulations, such as local capital controls, which can be tailored to prevent large scale flights from local currency to Libra coins in emerging markets.
- Every Libra coin will be fully backed by fiat held in bank deposits and cash equivalents in the form of very short-term government securities. This mitigates the risk of a "run on the bank" because Libra coins are fully backed one-to-one by cash and other liquid assets rather than by a fractional reserve the way bank deposits are.
- The Libra Association will also establish robust cybersecurity requirements for node operators and implement protocols designed to function correctly even if some validator nodes are compromised to ensure the resilience of the payment network.

⁵⁸ "Libra Association Response to the G-7 Report", available at <https://libra.org/wp-content/uploads/2019/10/Libra-Association-Response-to-G7-The-Regulatory-Regime-for-Stablecoins.pdf?sf221718478=1>



- The Libra Association is committed to protecting users' data privacy and will ensure the application of data protection laws. The Libra Association members, acting as node validators, will not be able to access, use, or share personal data regarding end-users of the Libra Blockchain. Companies that interact directly with customers like wallet services and exchanges will be expected to comply with data protection laws, including data portability.

Furthermore, in his testimony in Congress Facebook's president, Mr. Zuckerberg has argued that "blocking Libra will be a boon to China tech".

8.10.7. THE FUTURE OF MONEY: SOME GUESSES

The time has come to bring all the threads together and make some educated guesses on the future of "money" (or, more accurately, standards of value and means of payments).

These are my guesses:

1. Any discussion about the future of "money" makes it imperative to distinguish or unbundle two separate monetary functions - standard of value and means of payments - which, while occasionally combined in a single object (e.g. full-bodied gold coins or modern banknotes), follow different dynamics.
2. The mainstream Metallist view about the origin of money obscures the fact that debts, clearing arrangements and book-entry systems played a significant role in many monetary and payment systems from time immemorial, with modern digital currencies being less innovative than frequently thought.
3. As a matter of fact, irrespective of the potential merits of any new Hayekian private currency, governments in industrial countries will fight tooth and nail to preserve their traditional sovereign prerogatives in the monetary domain, which are legally recognized in almost all countries' constitutions, laws and statutes. Monetary standards of value (i.e. "currencies") will thus remain sovereign ones, based on national laws (like the dollar, the yen, the pound and most other currencies) or international Treaties (like the euro), with limited circulation of "parallel currencies", except in border areas, international places or dollarized economies, where the inability of the local sovereign to provide a stable currency makes rational for people to trust only a foreign one.
4. Consequently, G-7 governments will prevent the emergence of any private outside or *fiat* money-like Libra- not redeemable into a single traditional sovereign currency (like the US dollar or the euro), even if designed as an SDR-like or currency board-type stablecoin (i.e. backed by a basket of stable international currencies).

It has been argued that the way to allay fears about Libra would be "to require Libra to operate as a currency board, issuing one Libra against one unit of a pre-defined basket of currencies. This way, Libra might add a useful tool to secure,



accelerate and make cheaper the exchange of goods and services around the world, without creating any liquidity or solvency risks and without chipping at the seigniorage collected by central banks. (...) If all concerns about money laundering, tax evasion and terrorism financing are addressed in an effective way, and if Libra is allowed to proceed under the rules of a strict currency board, then its usefulness to world trade would be enhanced by having it backed by a basket of currencies with weights representing the weights of the respective currencies in international trade”.⁵⁹

I do not think this will convince G-7 governments and allay their fears about stablecoins, and especially global stablecoins (GSCs), because of the risk of *Cheshirization*: even if initially pegged, however tightly, to an underlying basket of currencies, as soon as Libra's or any other private currency's brand name and practical convenience become familiar to users across the world, global demand will increase and gradually stabilize even if the private currency is unmoored from its initial anchor. As explained above, this was the case with the US dollar in July 1971, when President Nixon severed its link with gold and made it a full fiduciary, *fiat* currency: over the years, the “gold-exchange standard” had gradually become a *de facto* dollar standard and, except for the demise of the Bretton Woods system and the dollar's subsequent runaway inflation, the dollar remained the main international currency despite only its fiduciary grin remaining. As Rogoff has argued, “being able to control the unit of account is an extremely important safety valve [allowing governments to draw on large pools of liquidity in the event of a war, pandemic, or other crisis that creates unexpected short-term funding needs]. It is especially useful if a country's debt is denominated in its own currency, giving the government the option of partial default through inflation. On top of dealing with outright catastrophes, a country that does not control its own currency is unable to use modern monetary stabilization policy. Multiple units of account may coexist, and one can find many small economies where both the local currency and the dollar (or euro) are widely accepted. But, in general, the unit of account is a natural monopoly, which a well-run government with strong legal and fiscal institutions is uniquely well poised to control”.⁶⁰

In other words, G-7 governments will make sure, with the support of international institutions, that no private standards of monetary value emerge and Hayek's wish for a “denationalized money” remains a dream or a “fairy tale”, to use Tobin's expression.

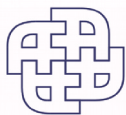
5. Cryptocurrencies, like Bitcoin and others, will remain essentially speculative assets for a limited segment of investors. Even if left unbothered by governments, they will lack the broad users' base required to create the network externalities necessary to displace well entrenched sovereign standards of value; and by being

⁵⁹ Rakia Moalla-Fetini, Financial Times, October 29, 2019.

⁶⁰ Rogoff, op.cit. p. 209-210.



- volatile with respect to the established standards of value (e.g. US dollar, euro...), they will lack stable demand as a means of payment, even if potentially attractive as financial speculative assets.
6. Even if governments remain more tolerant with non-Libra private virtual currencies, they will fight to prevent any new digital or technology-based means of payment allowing users to bypass anti-money laundering (AML)/know your customer (KYC) regulations and escape the purview of regulatory authorities.
 7. For all the hype about technology and new digital currencies, most governments will not allow the introduction of free capital movements by stealth either. Hence, authorities will strive for e-money providers to be subject to similar exchange control regulations as traditional bank deposits, as illustrated by the case of Zimbabwe's Eco Cash discussed above. Back in the summer of 1997, when members of the IMF were on the brink of amending the Articles of Agreement to embrace the freedom of capital movements as a general obligation over time, the East Asia crisis made them recoil, as they suddenly realized that cheap cross-border currency flows may occasionally be more of a curse than a blessing. A Tobin tax has regularly been discussed as a way to "throw sand in the wheels" of financial transactions and to prevent excessive short-term financial flows. This suggests that low transaction costs for new digital means of payments should not always be seen as an overriding priority.
 8. Many jurisdictions - led by Sweden, Uruguay, China, India and others - are likely to do away with cash (except, maybe, for the smallest denominations) and create a general token CBDC for retail payments. But this is unlikely to be the case in the US and the eurozone, given the psychological attachment to cash in some leading countries (including Germany) and the seigniorage accruing to central banks issuing internationally-used banknotes (like US dollar and euro banknotes).
 9. It is an open question whether retail CBDC tokens, held directly by the general public, could become in the future a significant chunk of monetary aggregates and reduce the role of intermediated means of payments (i.e. traditional bank deposits and private e-money). Central banks will tread carefully here, since, as indicated by BIS experts, a significant and fast substitution of CBDC balances for traditional retail bank deposits might wreak havoc in existing bank-based financial and credit systems. There is a good chance that central banks might in the end opt for the "synthetic CBDC" approach (i.e. private e-money with 100% central bank money backing) suggested by Adrian and Mancini-Griffoli and stay away from retail clients, as this would allow traditional commercial banks to adapt and compete in this field and would also preserve the "wholesale" nature of central banks, with AML/KYC daily chores remaining the responsibility of private financial intermediaries.
 10. The case for Libra, as made in its White Paper, is not consistent: financial inclusion for the poor is a good argument in support of domestic e-money - like M-Pe-



sa or any other low cost system for retail cross-border remittances -, but not for the creation of a global digital currency with billions of potential users across the world, including affluent countries, and with the Hayekian ambition to become a “parallel currency” even in leading industrial countries.⁶¹ Most industrial countries will never accept the concept of a parallel currency (*Parallelwährung*, for Germans!) circulating, even in digital form, within their borders. Like Hayek’s “ducat”, Libra will remain in all likelihood a pipedream, unless its ambitions are fundamentally scaled down.

11. As of today, while standard of values are all public ones, money supply (i.e. the overall amount of liquid balances held by the public) is a combination of a small amount of public means of exchange (cash) and a huge number of private ones (bank deposits). Some have called for the issuance of CBDC open to the public with a view to “renationalizing” the money supply and, probably as a result of Libra’s threat, even the most reticent central banks, like the European Central Bank or the Federal Reserve, have been dragged into exploring the potential merits of CBDC. Disruptive changes are unlikely in the immediate future, but if in the end CBDC makes the overall money supply more “nationalized” and less private, I wonder whether Hayek might turn in his grave?

⁶¹ Facebook’s case for Libra is a good example of what I have described elsewhere as the “synecdoche trick”, i.e. using a narrow, unrepresentative case which commands public support to advocate a policy whose practical effects will be much broader. See Manuel Conthe, “El truco de la sinécdoque”, available at <https://www.expansion.com/blogs/conthe/2018/09/25/el-truco-de-la-sinecdoque.html>



9. THE JUNE BANKING PACKAGE

**SOFÍA RODRÍGUEZ RICO, ENRIQUE CORCÓSTEGUI AND
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9.1. ABSTRACT

The financial crisis triggered a profound overhaul of banking prudential regulation. The EU is entering the final phase of transposition of most aspects of these global banking regulatory accords into EU Law.

On November 23rd 2016, the European Commission launched a proposal to amend the Capital Requirement Directive (CRD IV), Capital Requirement Regulation (CRR), Banking Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR). This set of rules is commonly known as the Risk Reduction Package (RPP). On 7 June 2019, after months of intense discussions, the final texts were published in the Official Journal of the European Union.

The RRP includes elements agreed at the international level by the global financial standard-setting bodies along with a number of targeted measures to cater for EU specificities. By strengthening capital, leverage and liquidity requirements - as well as improving bank resolvability - the agreed rules seek to reduce risks in the financial sector by further reinforcing banks' ability to withstand shocks. On aggregate, the implementation of the RRP represents a further step towards a more robust EU regulatory regime. The regulatory agenda is, however, not finished and the so-called "Basel IV" is already on the table.

While the EU has made good progress in strengthening the regulatory and supervisory framework and enhancing the institutional setup, the RRP should not interfere with the process of removing barriers to further integration and development of the European market. The EU financial architecture is still not sufficiently conducive to cross-bor-

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der integration and incentives for ring-fencing and home bias remain. There are also some new challenges ahead that regulation will have to face such as financial stability risks posed by climate change and cybersecurity.

In the following pages we: (i) summarize the new regulations and EU financial architecture, (ii) provide a general assessment of the current situation, (iii) explain the main elements of the forthcoming Basel IV regulation and (iv) give our views on what we consider the main challenges ahead in the context of the significant transformations that the banking system is facing”

Keywords: Prudential Regulation, Basel III, Banking Union, Single Rulebook, Risk Reduction Package MREL

Disclaimer: The views expressed in this article are solely those of the authors and do not necessarily represent the views of their current or previous employers

9.2. INTRODUCTION: EU’S INSTITUTIONAL ARCHITECTURE AND REGULATORY RESPONSE TO THE CRISIS

9.2.1. BANKING UNION AND SINGLE RULEBOOK

The global financial crisis has been one of the most disruptive events in decades. Tensions coming from a relatively small part of the financial system evolved into a severe global crisis causing massive economic and social costs. Given its severity, persistence and complexity, it is difficult to identify a single cause of the crisis. However, it seems clear that the accumulation of financial imbalances was at the heart of the problem.

In the European Union (EU), the immediate response from the public sector to the crisis was less decisive than the actions taken by the authorities in the United States. This was largely due to a lack of coordination in what was an incomplete political and financial architecture. To remedy some of these structural issues, European authorities concluded that the proper functioning of the Economic and Monetary Union required a euro area “Banking Union” (BU). The BU would restore, preserve and reinforce financial integration by reducing the dependence of banks on sovereigns and minimising the risks to taxpayers from financial disturbances and contagion. BU would also allow banks to expand their investor and funding base to help isolate their balance sheets from domestic sovereign stress. Such a framework was recognition that - within a single currency union - the financial sector creates far-reaching externalities and taxpayer risk across borders that should be overseen at a euro area level. Furthermore, banks’ influence over national authorities should be curtailed.

This called for an integrated banking supervision and resolution regime and a common insurance scheme for deposits in the euro area, which constitute the three pillars of the BU. The two first pillars are already in place: the Single Supervisory Mechanism (SSM) –in operation since 2014 - and the Single Resolution Mechanism (SRM) – established in 2016 - comprising the Single Resolution Board (SRB) and the Single Resolution



Fund (SRF). The European Deposit Insurance Scheme (EDIS) is the missing pillar in the three-tiered BU.

The cornerstone from which the three pillars are built is the so-called Single Rulebook for financial regulation. Logic suggests that a single market requires common rules for the supervision and regulation of credit institutions. The Single Rulebook promotes the efficient functioning of the single market and facilitates greater financial integration in Europe. This mitigates regulatory arbitrage opportunities and lowers competitive distortions. Transparency is improved and regulatory and compliance costs are, on paper, reduced.

Hence, harmonisation and strengthening of the regulatory capital framework through the Single Rulebook has always been critical for the success of the BU.

9.2.2. BASEL III: CAPITAL, LIQUIDITY AND ENDING “TOO-BIG TO FAIL”

Despite the fact that the pre-crisis picture was of relatively well capitalised banks, during the crisis, markets lost confidence in regulatory capital ratios and started focusing on alternative, stricter, measures (e.g. tangible common equity). This was partly driven by the fact that most of the banks that ended up receiving government support had capital ratios above the minimum required. The global regulatory community drew some conclusions from this experience: (i) banks held too little capital relative to certain risks; (ii) banks held capital of low quality; (iii) regulatory capital was not harmonised enough and disclosures on capital were limited.

In the aftermath of the financial crisis, the Basel Committee on Banking Supervision (BCBS), spurred by the G20/Financial Stability Board (FSB), drove a profound reform of the international banking regulatory framework. In 2010, the BCBS made proposals to fix these deficiencies and increase banking sector resilience in three key areas: (i) capital; (ii) liquidity and (iii) Global Systemically Important Banks (G-SIBs). For capital, the proposals had four building blocks. The first two blocks referred to the minimum capital ratio, namely the definition of capital (numerator) and risk coverage (denominator). The third building block aimed at capital retention and addressed procyclicality with the build-up of capital buffers. Finally, the fourth building block was the leverage ratio, acting as a backstop to excessive credit growth.

All these proposals crystallized in what is known as the Basel III framework, which introduced significant changes to the preceding framework (Basel II). As a result, it laid the foundations for a more resilient banking system, designed to deter the build-up of systemic vulnerabilities.

The initial phase of the Basel III reform focused on strengthening certain aspects of the regulatory framework:

- Improving quality of bank regulatory capital by prioritising going-concern, loss-absorbing capital in the form of Common Equity Tier 1 (CET1) capital.
- Increasing the level of minimum capital requirements to ensure that banks are sufficiently resilient to withstand losses in times of stress.
- Enhancing risk capture by revising the risk-weighted capital framework that

- proved to be acutely miscalibrated, including global standards for market risk, counterparty credit risk and securitisation.
- Adding macroprudential elements to the regulatory framework, by:
 - (i) Introducing capital buffers that are built up during the good times and can be drawn down in times of stress, so as to limit pro-cyclicality issues.
 - (ii) Establishing a large exposures regime to mitigate systemic risks arising from interlinkages across financial institutions and concentrated exposures.
 - (iii) Putting in place a capital buffer to address the externalities created by systemically important banks.
 - Specifying a minimum leverage ratio requirement to constrain excess leverage in the banking system and to complement the risk-weighted capital requirements.
 - Introducing an international framework to mitigate excessive liquidity risk and maturity transformation. The Basel III liquidity rules aim to ensure that banks rely on their own capacity to build liquidity buffers and raise stable funding, thus reducing reliance on central banks as liquidity providers – in particular during times of crisis.

The EU adopted two key legislative packages mainly based on the above-mentioned standards.

The first initiative is known as the 2013 “CRD IV” package, comprising a directive (CRD IV) and a regulation (CRR). It strengthened prudential requirements for banks to ensure their ability to absorb losses caused by potential shocks in the economy. Namely, it raised the quantity and quality of capital requirements, improved the coverage of risks, limited the growth of leverage and enhanced governance and transparency requirements.

The second initiative is known as the 2014 Bank Recovery and Resolution Directive (BRRD). It provides authorities with procedures to manage failing banks. Since its implementation, banks must prepare recovery and resolution plans to ensure their resolvability without having recourse to public funds. As the failure of banking institutions cannot always be avoided and can be a natural stage in the lifecycle of an institution, the new general rule is that failing banks should be “bailed-in”, instead of being “bailed-out”. Therefore, banks’ shareholders and creditors have to assume the costs arisen from the failure of an institution and from the resolution process and, should it be necessary, additional resources would be provided by national resolution funds.

9.2.3. OTHER ELEMENTS OF THE POST-CRISIS REFORMS

There have been numerous regulatory initiatives beyond the capital and resolution framework. The CRD IV already includes prudential considerations related to risk management, governance and remuneration. Among those outside the CRD IV remit, it is worth highlighting:



- Consumer protection has become a central part of legislation, with regulations, like the Markets in Financial Instruments Directive (MiFID) II, that impose much greater transparency, quality and simplicity of the information that financial firms provide to their customers and much more regulated advice customised to each client's knowledge.
- The regulatory response also tackled problems outside the banking sector, with measures to make the wholesale funding markets and the financial markets infrastructures more transparent and secure. In the EU, these reforms are contained in the European Market Infrastructure Regulation (EMIR) which compels market infrastructures to meet certain liquidity and functioning criteria, whilst also increasing the power of supervisors. In addition, the standard requires agents to report all their operations and incentivises the use of centralised clearing of over-the-counter (OTC) operations.

Additionally, in terms of strengthening the institutional and regulatory framework, as Basel II already recognised, it is worth highlighting another lesson from the crisis: the financial soundness of individual institutions does not prevent the accumulation of systemic risks. This change of paradigm favoured the inclusion of the macroprudential perspective of the financial system and the creation of a European System of Financial Supervisors, which includes three sectoral supervision authorities (the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA)), and the European Systemic Risk Board. The macroprudential policy framework is, for now, mainly focused on the banking system and includes capital and liquidity-based measures that are included in the EU legislative acts. Other tools, such as borrower-based instruments (e.g. Loan-To-Income, Debt Service-To-Income) remain national.

9.3. FOSTERING RISK REDUCTION

Right after the implementation of these reforms, the Five Presidents' Report –published on 22 June 2015– identified completing the BU as one of the top priorities of its global project for establishing a strong Economic and Monetary Union. As a precondition for this step, the report suggested that additional measures should be taken to reduce risks at the EU level so that progress could then be made regarding risk-sharing mechanisms. The order of these concepts is important: first, European banks had to further reduce risks and second, the remaining risks could then be mutualised. A few months later, the European Commission (EC) published a document on 24 November 2015 entitled “Towards the completion of the Banking Union” which addressed the need for further risk reduction as a fundamental and necessary step to complete the BU, particularly, its third pillar (EDIS).

To this end, the EC committed itself to implement a “Risk Reduction Package” reflecting the policies agreed upon at BCBS level.

This new framework aims to reduce risks in the banking sectors of Member States and set the stage for risk-sharing across the EU. On 23 November 2016, the EC presented a review of the banking regulatory framework, which had been negotiated during a period of almost three years with the European Parliament and Council of the EU. Finally, on 14 May 2019, the risk reduction package was adopted entailing a number of new challenges for European institutions over the coming years and, on 7 June 2019, the documents were published on the Official Journal of the EU.

9.3.1 RISK REDUCTION PACKAGE (RRP)

The new provisions in the RRP can be segregated into three main categories. The first category consists of those provisions that are a direct reflection of the international standards set by the Basel Committee, the second comprises the provisions that address European-specific issues, and the third and final category establishes the resolution framework. The final legal acts that incorporate all these are CRR 2; CRDV and BRRD II.

9.3.1.1 Basel Committee international standards

- **Leverage ratio**

Prior to the financial crisis, institutions' assets had been growing significantly whilst their capital levels did not follow the same trend. Moreover, the intense use of risk-sensitive internal models by banks underestimated the risks that were being underwritten. To address this issue, the BCBS introduced the leverage ratio: a new capital ratio which is non-risk sensitive and represents a backstop to other risk-sensitive capital ratios. It is set at 3% of Tier 1 capital (meaning that the total assets of a bank cannot exceed a level equivalent to around 33 times its Tier 1 capital).

Additionally, in order to take into account systemic risks, the BCBS set up a leverage ratio surcharge for G-SIBs equal to 50% of their G-SIB buffer.

- **Net Stable Funding Ratio (NSFR)**

One of the key functions of a bank is the maturity transformation that occurs when short-term funding is used to finance long-term projects. The financial crisis demonstrated the risks and incentives of increasing this maturity mismatch. Indeed, if the maturity transformation is not properly managed, even solvent banks can face serious liquidity issues that can even lead to the failure of the institution.

In order to address this problem, a new structural liquidity ratio, the NSFR, was designed with the aim of promoting resilience over a longer time horizon by creating incentives for banks to fund their activities with more stable sources of funding.

This ratio, linking the bank's available stable funding to its required stable funding, is set at 100%. In simple terms, it means that long-term assets must be financed by long-term liabilities.



- **Large exposure**

The risk of large losses associated with the failure of a single counterparty or a group of connected counterparties was introduced by the BCBS in April 2014 with the aim of ensuring that internationally active banks' exposures to specific counterparties are appropriately monitored and limited. The CRR originally introduced this standard in Europe in 2013, but - as it was not totally finalised by the BCBS at that time - the RRP revisited this standard.

The large exposures framework sets prudent limits to large exposures, whereby a large exposure is defined as the sum of all exposures of a bank to a single counterparty and connected clients that are equal to or above 10% of its Tier 1 capital. The limit is set at 25% of Tier 1 capital (not Total Capital as previously). Furthermore, a lower limit of 15% for G-SIBs exposures to other G-SIBs is introduced and it has imposed the use of the Standardised Approach for Counterparty Credit Risk for determining exposures to OTC derivative transactions (even for banks using internal models).

- **Fundamental Review of the Trading Book**

Losses suffered by banks in the financial crisis revealed that the design of the framework was not sufficiently robust to ensure that banks could withstand episodes of significant market distress. Therefore, the Basel Committee introduced a set of revisions to the market risk framework in July 2009. While these reforms addressed the most pressing deficiencies of the framework, the Committee acknowledged that a number of structural shortcomings that came to light during the crisis remained unaddressed. Consequently, it conducted a "fundamental review of the trading book" (FRTB). The objective of the project was to develop a new, more robust framework to establish minimum capital requirements for market risk, drawing from the experience of "what went wrong" in the build-up to the crisis. In 2016 the Basel Committee revisited FRTB and finally agreed upon a new version in January 2019.

Mainly, this revision specified two issues that have been addressed in the RRP:

- o **A stricter criterion for the assignment of instruments to the trading book.**

The definition of the regulatory boundary between the banking book (exposures subject to credit risk capital requirements) and the trading book (exposures generally subject to market risk capital requirements) relied solely on the bank's intent to trade an instrument, and left open the possibility for a bank to move instruments between its trading book and its banking book in pursuit of lower capital requirements.

- o **Overhaul of the internal models approach to better address risks that were observed during the crisis and introduce a more risk-sensitive standardised approach.**

The internal model approach was not sufficiently comprehensive to incorporate all relevant risk drivers that could lead to material losses. At the same time, the standardised approach lacked risk-sensitivity and therefore was not a credible alternative to the internal model approach.

As the implementation of the capital requirements has been controversial, it has initially been introduced in the RRP as a reporting framework for banks that will feed into the final calibration proposal that is expected by June 2020.

- **Counterparty Credit Risk (CCR)**

Weaknesses in derivatives risk management practices led the BCBS to include a strengthening of its framework for CCR for securities financing transactions for both OTC and centrally-cleared derivatives.

CCR is a complex risk to assess. It is a hybrid between credit and market risk and depends on both changes in the creditworthiness of the counterparty and movements in underlying market risk factors.

The Basel Committee developed in 2014 the Standardised Approach for Counterparty Credit Risk (SA-CCR) with the objective of being able to: apply the framework to a wide variety of derivatives transactions (margined and unmargined, as well as bilateral and centrally-cleared); be implemented simply and easily; and address known deficiencies of the methods used currently (the Current Exposure Method and the Standardised Method).

The SA-CCR addresses some of the drawbacks of the previous methodology, providing a more risk-sensitive measure of counterparty exposure (reflecting netting, hedging and collateral benefits) and improving the calibration of observed volatilities.

In line with the BCBS standards, the RRP transposes the SA-CCR to EU law and among others, replaces the Current Exposure Method and the existing Standardised Method.

Moreover, a simplified standardised approach is included for those institutions with a small derivatives business (under €150 million and less than 10% of the institution's total assets).

9.3.1.2 European specific issues

- **Pillar 2**

Pillar 2 capital requirements are bank-specific requirements set by the supervisors in order to cover risks that are not included in the Pillar 1 capital requirements.

The RRP has split this requirement into two components that the SSM was already addressing, a capital requirement (P2R) and capital guidance (P2G).

P2R covers risks underestimated or not covered by Pillar 1 and is a binding requirement. Its breach can imply legal consequences for the institution. Whereas the P2G is a recommendation by the supervisor of the level of capital to be maintained and the calculation is based mainly on the adverse scenario of the stress test. Even though it is not binding, full compliance is expected by the supervisors.

The RRP clarifies that both P2R and P2G have a purely microprudential perspective, so as to avoid overlaps with the existing macro-prudential tools.

It is to be noted that the RRP provides additional flexibility for the entities to partially cover the P2R with capital instruments other than the CET1.



- **SME supporting factors**

Small and medium-sized enterprises (SMEs) are one of the pillars of the European Union's economy based on the fundamental role they play in creating economic growth and providing employment. The 2013 capital regulation already contained a supporting factor for SMEs, which consisted in lowering the capital requirements by 23.81% for credit risk exposures to SMEs of up to €1.5 million.

The new banking package extended the reduction in capital requirement to include up to €2.5 million of an SME's exposure. Furthermore, the exposure amount exceeding this threshold will be subject to a 15% reduction in capital requirements.

Nevertheless, the final Basel III framework proposes a more risk-sensitive framework for the standardised approach and the resulting lower risk-weighting of SMEs' exposures is making authorities to reconsider the SME supporting factor in Europe.

- **IFRS9**

The transition from IAS39 to IFRS9 accounting regime in 2018 generated an increase in accounting provisions which consequently impacted the capital resources of financial entities. This impact occurred without there being neither a change in the risk profile, nor a change in the total losses (expected + unexpected) of the entities.

As such, it was necessary to review the prudential framework in order to make it compatible with the expected-loss accounting regime. The RRP permits entities to apply for a transitional period of up to 5 years in which the negative effect of these provisions on the banks' capital is temporarily mitigated.

- **Software**

The EU classification of software as an "intangible asset" under IAS38 implies a competitive disadvantage for European Banks as it forces them to deduct investments in software from CET1.

This practice does not favour the build-up of technological or human capital in Europe and may reduce the incentive for banks to invest in technology which is necessary to execute the sectors' digital transformation. The RRP includes a mandate for the EBA to assess technical standards regarding software's value in resolution or liquidation that could justify a more favourable accounting treatment and perhaps change the current classification of such investments as intangible assets.

- **Anti-Money Laundering (AML)**

Some European banks have recently been involved in money-laundering scandals highlighting that weak AML procedures and infrastructures may compromise the viability of a bank and have severe consequences for financial stability.

The new provisions in the banking package aim at reinforcing the cooperation and exchange of information between prudential and AML authorities. Moreover, AML risks are already taken into account in several prudential aspects such as authorisations, fit and proper tests and it will be considered in the SSM supervisory review and evaluation process (SREP).

- **Intermediate Parent Undertaking (IPU)/ Intermediate Holding Companies (IHC)**

The banking package requires third-country groups operating in the EU to set up an IPU in the EU in order to allow a more holistic supervision of banking activities in the region.

Similar to the United States (US) requirements for large foreign banks to set up local IHCs in the US, the intermediate EU parent undertaking follows the same idea.

The EU IPU requirement applies to G-SIBs headquartered outside the EU with a subsidiary in the EU and to any other third-country group that owns two or more institutions (credit institutions or investment firms) established in the EU with total assets of at least €40 billion vs the US threshold of USD 50 billion (the aggregate assets of both subsidiaries and branches of those third-country groups will be taken into account in the calculation).

Where qualifying third-country banking groups have established subsidiaries within the EU, these will need to be consolidated under an existing institution or new IPU.

Like the US IHC, the EU IPU will have to meet local requirements, including (without limitation) enhanced EU prudential standards, regulatory reporting and accounting standards, and governance.

Within the Eurozone, an IPU will be considered significant and directly supervised by the SSM. This IPU consideration will also have an impact on resolution planning, in that banking groups should take the introduction of an EU IPU requirement as a signal that authorities are moving toward a multiple point of entry resolution strategy, with the assumption of limited cooperation among authorities across jurisdictions.

- **Environmental, social and governance (ESG)**

ESG risks have been taken into consideration in the RRP. Specifically, the banking package incorporates a mandate for the EBA, albeit at a later stage, to incorporate ESG risks into the SREP. In addition, large institutions will be required to publicly disclose information on exposures to ESG-related risks starting on June 2022.

- **Disclosure and reporting**

The banking package establishes a disclosure and reporting regime that will improve transparency and increase the exchange of information with regulators and supervisors.

For smaller and less complex banks, simplified and proportionate requirements in terms of substance and frequency are introduced.

9.3.1.3 Resolution Framework

The Resolution Framework seeks not only to avoid banking failures, but also to minimise their impact when they happen. Since the 2008 crisis, banks are more aware that failures are possible and that taxpayer funds will no longer be allowed as part of the solution.

To this end, in November 2015 the FSB published an international standard for Total Loss-Absorbing Capacity (TLAC) to be applied to G-SIBs. The TLAC standard is designed to ensure that a G-SIB, in case of failure, has sufficient loss-absorbing and recapitalisation



capacity to implement an orderly resolution that minimises the impact on financial stability, ensures the continuity of critical functions, and avoids exposing public funds to losses.

In Europe, the RRP has incorporated the TLAC standard for G-SIBs in the CRR 2 and a European-specific resolution framework has been developed through the revision of the BRRD and the Single Resolution Mechanism Regulation (SRMR). The latter initiatives establish a Minimum Requirement for Own Funds and Eligible Liabilities (MREL) that will be set by resolution authorities on a bank-by-bank basis.

In Europe all banks will have to meet an intermediate target level of MREL in 2022 and a binding, full requirement by 2024.

The RRP also creates a new category of banks called “top tier banks” that applies to resolution entities or groups with total assets of over €100 billion.

The BRRD II requires that “top tier banks” meet part of their MREL requirement with subordinated liabilities. This subordination requirement has to be fulfilled by 2022. The subordinated own funds and eligible liabilities must be equal to at least 8% of a bank’s total liabilities and own funds (TLOF). However, under certain conditions, the resolution authority may allow part of eligible liabilities not to be subordinated.

In order to minimise the costs of compliance with the subordination requirement, the Directive 2017/2399² created a new subordinated TLAC/MREL-eligible debt called Senior Non-Preferred that ranks in insolvency above own funds instruments, but below other senior liabilities.

Additionally, with the aim of improving the resolvability of banking groups, resolution authorities should be able to upstream the losses of a subsidiary to the resolution entity or group (the entity to which resolution tools are applied) without placing the subsidiary itself into resolution. To this end, resolution authorities may impose MREL requirements as an “internal MREL” requirement on subsidiaries. Liabilities eligible for internal MREL must be issued to and bought by the resolution entity.

If a bank breaches its MREL/TLAC requirements, it may be subject to restrictions on the distributions related to dividends and Additional Tier 1 instruments and variable remuneration (M-MDA³). For the first nine months following a breach, restrictions might be applied only if certain conditions are met. After nine months, restrictions must be applied, but can be waived if strict conditions related to market conditions or financial stability are met.

Banks must ensure that the resolution tools can be effectively exercised. If a liability is governed by the law of a third country, banks must include a clause stating that counterparties recognise that their claims may be written down or converted to equity.

The BRRD 2 also includes a number of conduct requirements that should prevent mis-selling of MREL instruments to retail investors. First of all, the seller of MREL liabilities must perform a suitability test in accordance with the currently applicable rules under

² Transposed in Spanish law by Royal Decree Law 11/2017, of 23 June, on urgent financial measures.

³ M-MDA: MREL Maximum Distributable Amount

the MiFID II. Secondly, where the retail client's portfolio does not exceed €500,000, the seller must ensure that the retail client does not invest an aggregate amount of more than 10% of the portfolio, and that the required initial investment amount is at least €10,000. As an alternative to these requirements, Member States may instead set a minimum denomination amount of at least €50,000.

9.3.1.4. Assessment

The RRP represents an important milestone in lowering the risk of bank failures and avoiding tax payer bailouts. However, there are some issues that have been tackled within the package for which the approach might not be the ideal one. To mention a few of the key issues, we would highlight the following:

- **Software.**

Prudential rules prescribe that the use of banking software is penalised instead of incentivised. Unlike in the US, European banks are forced to cover expenditure on software solutions with the same amount of capital. The legislators understood this was unfair penalisation, but proposed a halfway solution when mandating the EBA to link the capital relief related to software investments to its value in resolution/liquidation scenarios.

As it stands, this solution limits the scope of capital relief that the EBA can legislate.

- **MREL.**

Unlike the US, where TLAC requirements only apply to US G-SIBs, the EU's bail-in tool can be applied to any credit institution where resolution is deemed feasible and credible. This is because the BRRD requires banks to comply with MREL requirements that are determined by resolution authorities on a bank-by-bank basis and that may include a subordination requirement, for those banks that are expected to be resolved rather than liquidated under normal insolvency procedures.

The European resolution framework separates entities into different tiers, comprised broadly of:

- o **G-SIBs with active participation in capital markets** that are subject to the resolution procedures and have the scale to cope with the recurrent regulatory costs.
- o **Mid-sized institutions**, for which resolution could be considered in the public interest, have access to the capital markets, but whose business models could be affected by stringent MREL and operational requirements.
- o **Non-systemic institutions** that are subject to national insolvency procedures, have limited access to the capital markets and are struggling to cope with the regulatory costs.

This framework clearly penalises the European banks and generates a competitive disadvantage with regards to other jurisdictions.

Regulation seems to have gone too far when establishing a minimum subordinated MREL requirement, which is set in general at of 8% TLOF for banks with more than



€100 billion in assets (to be accomplished from 1 January 2022).

If we compare this requirement with the cost of bail-out for all the failed banks in Spain, Greece, Cyprus and Ireland in what has been the deepest financial crisis since the great depression, this amounted to around 10% of TLOF. This measure goes beyond simply imposing prudential discipline, and needless to say impacts the recurrent profitability of banks, particularly medium-sized banks.

- **SME supporting factor.**

As mentioned before, the scope of application of the existing supporting factor for exposures to SMEs has been expanded, but represents a historical deviation from the Basel standard.

A month after entering in force, the EBA recommended this incentive be deleted as it is not aligned with Basel standards. This is not in line with the European reality where growth and jobs are heavily linked to the SME sector while real progress regarding the Capital Market Union remains under political discussion.

Lastly, it is important to recall that other major jurisdictions have transposed Basel without exacerbating existing structural economic vulnerabilities.

9.3.2. “BASEL IV”

The entry into force of the RRP represents by no means the end of the process of revising European banking regulation. In December 2017, the BCBS published its final documents on the reform of Basel III also known as “Basel IV”. These last elements still need to be transposed into European legislation. The EC has already launched work on CRR III and CRD VI.

These reforms should be implemented by 2022 (some of them with a transitional phase) and impact the standardised approach for credit risk, the Internal Ratings-Based (IRB) approach, the final calibration and design of the output floor, operational risk approaches and the quantification of Credit Valuation Adjustment risk. The approved RRP already includes some of these aspects.

Upon reaching an agreement with the BCBS, the EC issued a call for advice to the EBA in order to receive an impact assessment and policy recommendations on the transposition of Basel IV to EU Law.

The EBA delivered a detailed report of its advice on the “Basel IV” package to the EC in August 2019. There are two pending standards related to the CVA and FRTB that are expected by the end of 2019. Thus, on the basis of this analysis, European institutions will start to work on the revision of the RRP. The key topics that are expected to be addressed are:

- ***Standardised approach***

The Committee’s revisions to the standardised approach for credit risk enhance the regulatory framework by improving its granularity and risk-sensitivity.

Banks will have to conduct their own due diligence and develop non-ratings-based approaches for those jurisdictions that cannot or do not want to use external credit ratings.

These measures reduce the reliance on external credit ratings and ensure that banks have a better understanding of the risk profile of their counterparties.

The risk weights of the main exposure categories have been recalibrated with a more granular and risk-sensitive approach. It is remarkable that the treatment of SME exposures has been improved and consequently the BCBS encourages removing the SME supporting factor recently increased in Europe with the banking package.

- ***IRB approach for credit risk***

The financial crisis highlighted the excessive complexity of the IRB approach that caused a lack of comparability across banks' capital requirements and to the questionable robustness in modelling certain asset classes.

To address these shortcomings, the BCBS has removed the option to use the advanced IRB approach for certain asset classes, adopted input floors (minimum values for bank-estimated parameters used as inputs to the calculation of Risk-Weighted Assets -RWA) and provided greater specification of parameter estimation practices to reduce RWA variability.

- ***Operational risk***

Currently, banks can calculate their operational risk using different approaches. However, capital requirements calculated with these approaches have proved to be insufficient to effectively cover operational losses, the nature of which, also demonstrated the limits of internal models in estimating these risks.

Hence, the advanced measurement approaches (based on internal models) for calculating operational risk capital requirements and the existing three standardised approaches have been replaced with a single risk-sensitive standardised approach to be used by all banks. It determines a bank's operational risk capital requirements based on a bank's income and its historical losses, assuming that operational risk increases with the bank's income and its experienced operational risk losses. This simplifies the calculation of capital requirements and enhances the comparability across banks.

- ***Output floor***

With the objective of reducing the unwarranted variability of RWAs, the Basel II framework introduced an output floor. However, its implementation has been inconsistent across countries.

Hence, the Basel III reforms replace the existing floor with a floor based on the revised Basel III standardised approach. It provides a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approach, thereby guaranteeing a level playing field between banks using internal models and those using the standardised approach.

Under the revised output floor, the total RWAs calculated using internal models cannot be lower than 72.5% of the total RWAs calculated using the standardised approach. In other words, this means that internal models cannot reduce RWAs by more than 27.5% in relation to the standard approach.

The output floor will be implemented gradually between 2022 and 2027.



- **Credit Valuation Adjustment (CVA)**

The Basel III reforms introduced a capital charge for potential mark-to-market losses of derivative instruments as a result of the deterioration in the creditworthiness of counterparties (CVA risk).

The Committee has agreed to revise the CVA framework to enhance its risk sensitivity (taking into account the exposure component of CVA risk along with its associated hedges), strengthen its robustness (removing the use of internally-modelled approaches) and improve its consistency (the framework is now consistent with the approaches used in the revised market-risk approach based on fair value).

With the transposition of “Basel IV” into EU law, the post-crisis financial regulatory framework will be mainly completed. However, the authorities should continue: (i) addressing the barriers that currently prevent a smooth functioning of the different pillars of the BU and (ii) providing the system with an appropriate prudential framework that considers the risks and uncertainties posed by new economic realities.

9.4. MAIN CHALLENGES AHEAD

9.4.1. FRAGMENTATION

Several structural weaknesses persist in the EU. Most of them can be boiled down to lack of financial integration or, in other words, the fragmentation of the financial system. The banking sector remains fragmented along national lines. Banks are not in a position to consider the euro area as their *domestic market*. There is a clear need to take actions that may help to improve scale across the EU, such as consolidation or cross-border development, which are difficult to achieve with persistent regulatory and supervisory fragmentation.

There are many reasons for this, but four of them stand out.

First, notwithstanding major progress in creating a Single Rulebook, there is still ample room for national discretions. There is a need for standardisation of rules in the EU (this could also apply to other areas such as AML, taxes on financial instruments). The amount of Optional and National Discretions remains high and Member States still have the last word regarding some issues such as the treatment of sovereign exposures, large exposures, liquidity regimes and waivers of prudential requirements. The SSM is supposed to operate on a single set of rules.

The CRD IV and CRR were originally conceived with specific areas for national flexibility. However, the final text ended up reflecting even greater national flexibility. The exercise of this greater discretion without coordination damages the single market.

Second, in the absence of common crisis management tools, countries resorted to ring-fencing measures during the crisis. The obstacles they put up still hinder the free flow of capital and liquidity within cross-border banking groups. This is particularly relevant for groups which are affected by solo and consolidated supervision.

While a banking group located in the BU is supervised by the SSM and no longer by home and host supervisors, subsidiaries are subject to individual requirements with remaining national powers over legal entities of a group. The subsidiaries of multinational parent banks are often of systemic importance in small countries and thus the stability of the bank a high priority, while the host country operation of the bank is not material for the parent bank and thus of lower priority for the home country supervisor. This issue was not totally tackled in the RRP.

Third, a fully-fledged EDIS is essential for the completion of the BU. A shared deposit insurance scheme contributes to the smooth transmission of monetary policy, and avoids the flow of deposits to safe havens that disrupts bank funding and credit supply to the economy. EDIS is necessary to isolate deposits from the domestic sovereign. Only in this way will depositors be persuaded that their money is safe in any euro bank, independently of its country of operation or of legal residence.

EDIS has always been recognised as a fundamental part since the inception of the BU. The existing political deadlock should urgently be overcome. The current economic conditions are favourable and the brunt of the risk reduction across the banking sector has already occurred. To name just a few clear examples: significant improvements in banks' capital positions, higher provisioning, reduction of non-performing loans, substantial progress in the build-up of the SRF and the political agreement for its backstop. Consequently, the current window of opportunity can and should be used.

Fourth, enhancement is needed in the crisis management toolbox for the BU. Significant progress has been made to clarify how to proceed with troubled financial institutions, but there are still loopholes that have to be addressed. The key hurdle is that the EU lacks a common bank insolvency regime and that the institutions that lead insolvency and resolution processes are different.

The decision to put a bank in resolution depends on the SRB Public Interest Assessment (PIA), which determines if the preservation of the bank's critical functions is required to maintain financial stability. If the PIA's outcome is negative, a failing bank will be sent into national insolvency and then the decision rests on different Member States with different insolvency proceedings. Clearly a common set of insolvency rules are needed.

9.4.2. NEW ECONOMIC REALITIES

- **Bigtech, Fintech, Digital Transformation and Level Playing Field**

Technological developments and new regulations are favouring the entry of new competitors: Fintechs and Bigtechs. The latter have unique characteristics that resemble those of natural monopolies and are subject to less stringent requirements, which place them in a very favourable competitive situation.

These regulatory asymmetries require the action of legislators to level the level playing field among all market participants and prevent that the users of the services of these companies have a lower level of protection than the customers of credit institutions.



Regulation should concentrate on the “what” not on the “who”. Key among other issues is appropriate use of customers’ personal data.

- **Cybersecurity**

Cyber risks not only jeopardise the operational continuity of the banking business, but can also have implications for the rest of the agents and hamper financial stability.

In general, banks alone cannot meet this new challenge and the involvement of national and international authorities in this area is necessary, coordinating strategies and facilitating the prosecution of these criminal acts throughout different jurisdictions.

- **Climate change risks**

Climate change has economic and financial implications, both directly and indirectly. Using FSB terminology, there is an increased risk of more frequent and severe natural disasters labelled as “physical risks”. There are also “transition risks” stemming from shocks that occur due to policy changes, adjustments in the behaviour of economic agents and/or technological changes during the transition to a low-carbon economy.

Mobilising large amounts of private sector finance to pay for decarbonisation poses a financing challenge. Hence the banking system, bond markets and institutional investment might need to adapt (or be adapted) to overcome possible market failures and facilitate the availability of finance at an acceptable cost.

Moreover, the transition to a low-carbon economy also carries financial stability challenges. For instance, the often cited ‘stranded asset’ theory assumes that about a third of the world’s proven oil reserves are not economically viable. This in turn would mean that there could be a sudden re-pricing of carbon-intensive assets, which are financed in large part by debt.

Europe, driven by the EC’s Sustainable Finance Action Plan, is playing a leading role in adapting to this new reality. The EC aims to: (i) reorient capital flows; (ii) manage financial risks; and (iii) promote transparency and the long-term vision of economic and financial activity. The financial sector is a key player in financing sustainability projects, but it needs to have a clear prudential framework.

9.5. CONCLUDING REMARKS

In the prevention, management and resolution of financial crises it is important to have a set of institutions (central banks, regulators, supervisors, macroprudential authorities, resolution authorities, agencies, etc.) with well-defined mandates and with a sophisticated toolkit.

All the institutional and regulatory developments of the last years are proof of how inadequate the previous architecture was. Significant and relatively timely progress has been made in strengthening the framework in which banks operate. Having come this far, it would be worth optimising what has been done and improve the consistency of some of the measures. For example, by solving duplications and unwanted impacts created by an excessive regulatory burden and at times conflicting goals.



One could also argue that, although well-intentioned, some of the regulation focuses on addressing the causes of previous crises instead of truly ensuring a robust financial system. In this respect, a more integrated and holistic approach would have been preferred.

Going forward, there are no doubts that Basel III strengthens the resilience of the banking sector and that the implementation of the RRP will further accelerate the already acute reduction of risks in the EU banking sector. Hence, it is high time the EU starts advancing with further risk mutualisation mechanisms to be better prepared for the next crisis. Taking a pragmatic and holistic approach to complete the BU with a fully-fledged EDIS seems a sensible way forward that should foster cross-border integration in the sector and further reduce risks to financial stability.

Additionally, while the post-crisis regulatory framework makes the banking sector more resilient, regulation has not been as demanding for other sectors. In particular, the absence of a regulatory “level playing field”, for BigTechs, Fintechs and shadow banking activities, could have implications for financial stability. In addition, the macroprudential framework for non-banks is not as developed and lacks the appropriate tools to deal with systemic risks stemming from these entities.

In this sense, it is crucial that there is a well-designed, effective regulation capable of adapting quickly to new environments, with an eye on the globality of processes and the interrelationships between economic agents, risks and the different regulatory standards.

Similarly, it is important that regulators, when deploying regulations, take into account not only the impact on processes and costs of the new rules, but also the effects generated by the regulatory uncertainty on the system. Indeed, the transposition of Basel III into EU law has been characterised by an extended period of calendar uncertainty and lack of concretion about technical details (levels, calibration, perimeter). This has created uncertainty for the strategic management of banks and has increased the cost of regulatory compliance, which is very significant nowadays. Uncertainty, in turn, reduces the attractiveness of banks to investors, hinders the ability to attract capital to the sector and its ability to finance the region’s economic development. Banks must be profitable to generate and attract capital. This ensures the sustainability and solvency of the sector which is required for it to finance families, companies and public administrations and to ensure that the financial stability of the EU is not compromised.

Finally, the operating environment is changing very quickly, especially when it comes to new technologies and climate change. Institutional design and regulation should be done with an eye on these new challenges. The focus must therefore shift rapidly, leaving the financial crisis behind, and looking ahead in order to design a robust framework for the new environment. At the end of the day, authorities and the private sector need to be able to correctly identify the economic transformations confronting us and make sure that the appropriate toolkits and risk frameworks are available to cope with these new disruptive transversal risk vectors. Fighting these risks should not be left to the banking sector alone, as authorities would be unduly overloading a private agent with an objective that is public and broader in its essence.



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10. CONSOLIDATION OF THE EUROPEAN BANKING INDUSTRY: OBSTACLES AND POLICIES

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10.1. ABSTRACT

Consolidation of the European banking industry can lead to stronger and more resilient banks, and can also boost profitability due to greater economies of scale. However, while the business case for consolidation is clear, there are a number of significant obstacles preventing mergers and acquisitions. The obstacles arise from various economic, political, regulatory and cultural factors, or are related to the business environment in which European banks currently operate. Global and regional geopolitical uncertainty and rapid and profound changes in the global banking industry's outlook due to innovation and technological change add to these challenges. This chapter reviews the current European banking landscape, considers the various obstacles to consolidation and discusses policy recommendations aimed at strengthening the European banking system to achieve a healthier, more stable and more profitable future.

Keywords: Bank consolidation; EU Banking Union; EDIS; Banking regulation; Cross-border banking.

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10.2. INTRODUCTION

Today's global banking industry is radically different than it was before the global financial crisis. Globally, banks have fundamentally transformed their balance sheets, increasing both the quantity and quality of their capital, their funding strategies and overall liquidity. European banks, in line with the global trend, have substantially strengthened their capital positions and liquidity. However, a number of factors have negatively impacted their profitability, with many banks currently unable to meet their cost of capital. Traditional corporate finance concepts indicate that mergers and acquisitions (M&A) can create greater economies of scale, leading to higher profitability. A consolidated banking system would become healthier, more stable and more profitable. A healthier financial system would also have a positive impact on the broader European economy, which would help spur investment, employment, trade and economic growth. That, in turn, helps create a positive loop where the banking sector would benefit from the strength of the broader economy, as it did over the past decades before the financial crisis.

If such a premise is true, a necessary question is to identify why greater consolidation is not taking place and what policymakers and authorities can do to stimulate greater consolidation? These are all important questions that we will explore in this chapter.

10.3. IS EUROPE OVERBANKED?

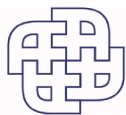
Danièle Nouy, the former Chair of the Supervisory Board of the European Central Bank (ECB) delivered a spirited speech in Madrid in 2017 entitled, "Too much of a good thing? The need for consolidation in the European banking sector."² Ms. Nouy argued that banking in itself is a good thing, but when the banking sector grows too large, an economy can become overbanked and this can seriously harm both the health of the banks themselves, and by extension, that of the wider economy.

Overbanking may occur if there are too many banks that for various reasons do not exit the market. This can lead to high competition between the banks and subsequently to low profits, poor or no dividends and a reduced capacity of these institutions to build up capital buffers. Furthermore, banks would be inclined to take on higher risks to increase their profits, which could cause instability. The banking sector could be too large not only in comparison to other sectors, which may lead to inhibited growth, but also in comparison to other sources of funding, such as capital markets, which might cause bank-based economies to be more strongly hit by a crisis. Moreover, the banking sector could be too large with regards to its assets, which may be a sign that the economy is over-indebted. Therefore, an economy could be overbanked in many, interconnected, ways.³

More recently, Andrea Enria, the new Chair of the ECB Supervisory Board, said

² Danièle Nouy 2017. "Too much of a good thing? The need for consolidation in the European banking sector." September 27, 2017

³ Danièle Nouy 2017.



that removing excess capacity in the system continues to be a structural challenge for the European banking sector: “Consolidation would be beneficial for the sector, but there seem to be a number of impediments blocking progress.”⁴ Over the last decade, European Union (EU) officials have tried to prioritize consolidation of the European banking industry, especially once the financial crisis had exposed weaknesses across the financial sector, that were further exacerbated by the links between the banking and the sovereign sectors.

As the financial crisis spread across the euro area it was clear that a deeper integration of member states’ banking sectors was needed and had not been achieved through earlier attempts at approximating bank regulations across EU jurisdictions, especially as the financial systems across these countries were deemed to be strongly interdependent. The European Banking Union was created in 2014 to stimulate this integration through the establishment of a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), in addition to a Single Rulebook.

While these institutions have already achieved a great deal in terms of making supervision more consistent and providing a common resolution framework, Banking Union remains unfinished and European banks - especially retail banks - still mostly operate on a national basis. A fully integrated single market for financial services remains a long way off.

10.4. BANKING IN EUROPE TODAY

The euro area banking market has by and large remained fragmented since the beginnings of the financial crisis. Evidence of this, firstly, is that intra euro-area cross border claims, and the market share of foreign branches and subsidiaries have declined since 2008; and, secondly, that in 2017 domestic institutions made up 86% of loans to euro-area non-financial institutions, a number which has not changed over the last few years. In addition, in 2016, foreign-owned banks’ share of the domestic banking system was only 17%.⁵

It is difficult to determine what the optimal size of a financial system should be. There are strong benefits to consolidation but too few banks could also lead to lack of competition which may harm consumers, lead to less innovation and weigh on economic growth.

In 2018, there were 6,088 credit institutions in the 28 member countries of the European Union, down 2.6% from the previous year, and a reduction of 2,437 (29%) since 2009, meaning that about one in four has disappeared since the financial crisis.⁶

⁴ Andrea Enria 2019. “The banking union – a personal view on its past, present and future.” October 30, 2019.

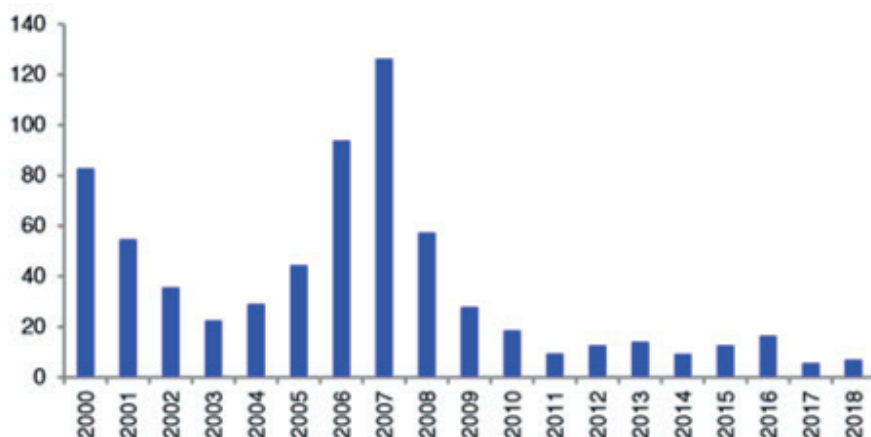
⁵ Philipp Hildebrand 2018. “What next for banking union?” June 8, 2018.

⁶ European Banking Federation 2019. “Banking in Europe: EBF Facts & Figures 2019”



This decline is comparable to the United States, where there were 4,715 commercial banks in 2018, down 31% from 6,829 in 2009.⁷

FIGURE 1: EUROPEAN BANK M&A HAS DWINDLED BY VALUE (\$BLN)



Sources: Deutsche Bank, Dealogic

But it is also the case that the consolidation that has occurred in Europe over the past few years has mainly occurred domestically, within the borders of Member States. Figure 1 shows that total European bank M&A has dwindled to less than \$10 billion in 2018, from around \$130 billion in 2007. The number of cross-border mergers and acquisitions has also fallen over the recent years with only 28 deals in 2017, compared with 65 in 2010.⁸ Bank mergers, especially cross-border, seem to have slowed down since the financial crisis, not only in value, but also in the number of transactions.⁹

Another way to determine the relative size of the European banking sector is the ratio of bank assets to GDP, which stands at 86% in the EU, ranging from Denmark (179%), Portugal (135%) and the Netherlands (127%) at the higher end, down to Romania (40%) and Cyprus (18%) at the lower end. In comparison, total assets of the U.S. banking sector accounts for only 63% of GDP.¹⁰ There are well-known reasons for this, including distinct banking system structures, mortgage markets and the respective developments of capital markets, but the difference remains stark.¹¹

⁷ FDIC Statistics at a Glance 2019. "Historical Trends, as of June 30, 2019."

⁸ ZEB 2018. "European Banking study" November 2018.

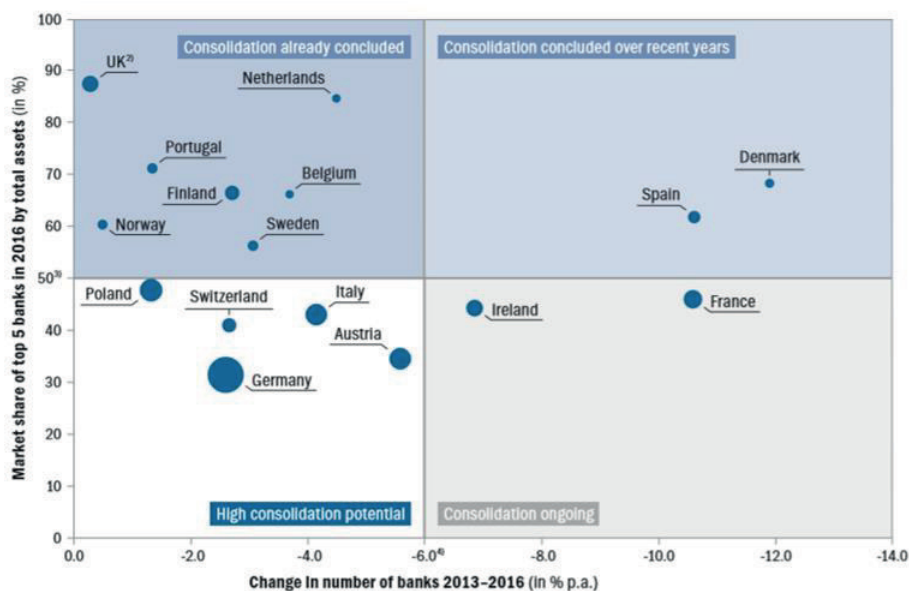
⁹ Deutsche Bank 2019. "How to fix European banking...and why it matters." March 13, 2019.

¹⁰ Global Economy.Com 2019. "Bank assets to GDP in the European union and United States" with 2016 data being the most recent.

¹¹ Danièle Nouy 2017.

Furthermore, the five largest banks in the U.S. share 50% of bank assets, whereby the five largest EU banks share less than one-quarter of the assets of all banks in the bloc. Therefore, the U.S. banking sector is more than twice as concentrated as the European market. The U.S. banking sector represents a single market, while Europe is fragmented into national markets. In the absence of full Banking Union, the eurozone remains split into 19 separate markets, each with its own divergent regulatory and supervisory requirements. Since the European banking system is significantly more fragmented than those in other developed markets, banks' competitive positions suffer, and returns are structurally lower.¹²

FIGURE 2: CONSOLIDATION PHASES IN EUROPE



Sources: ECB, EBF, ZEB

There are clear differences between European states with regard to the overall European consolidation trend. Some large markets, including Germany, Austria and Switzerland, have high consolidation potential because of their heterogeneous and dispersed banking sectors (e.g., savings banks, cooperatives and private banks), and segmentation is in some cases enshrined in the country's banking laws to safeguard some public or societal goals.

¹² Deutsche Bank 2019.



Figure 2 shows the likelihood of further consolidation, based on the market share of the top five banks and the change in the overall number of banks. In this way, Austria, Germany, Italy, Poland and Switzerland are identified as the countries with the highest consolidation potential. By contrast, other regional markets like the Benelux and Scandinavia, for instance, that have already undergone this process, are rather unlikely to consolidate much further.¹³

In countries like France, Germany, Italy, the Netherlands and Spain the share of assets of foreign euro area branches and subsidiaries also remains extremely low, whereas the share is only substantial in a few smaller Member States, such as Slovakia and Luxembourg.¹⁴

Cross-border retail banking in general is low across the euro area. For instance, only 1% of European households and 9% of non-financial corporations took out cross-border loans and almost no private household and only 8% of corporations made cross-border deposits. While the creation of the Single Market was intended to lead to consolidation, and thereby improve banking returns, only in Belgium, Denmark and the Netherlands have the banking sectors undergone significant consolidation.¹⁵

10.5. BENEFITS OF CONSOLIDATION

Consolidation can occur either when a bank exits a market or when it merges with another bank. With a few exceptions, neither are currently occurring in Europe. Nouy emphasizes that bank mergers could help reduce excess capacity and make banks more efficient. Alongside domestic mergers, cross-border mergers would, not only help the banking sector shrink, but also deepen integration, which would subsequently support the goal of a truly European banking sector. By this means, savers would have more investment options, more sources of funding would be available to companies, risk-sharing would be improved, and the economy would become more stable and efficient. Banks would be in the position to diversify their portfolios better and could gain economies of scale, which would make them more efficient and more profitable.¹⁶

A more developed and integrated pan-European banking market would lower banks' vulnerability to asymmetric shocks. Cross-border banks would be able to offset losses in one state with income from other states and would subsequently, unlike local banks, not have to cut lending activities during times of recession.¹⁷

¹³ ZEB (2018). "European Banking study". Page 16. Although several (small) deals could be observed, ZEB would not expect any major changes with regard to the top 50 banks in Europe and emphasized that there would be still a long way to go on the political front until the European situation could be compared to other large banking markets like in the U.S. or China, where banks would succeed in large harmonized domestic markets.

¹⁴ Hildebrand 2018.

¹⁵ Deutsche Bank 2019.

¹⁶ Danièle Nouy 2017.

¹⁷ Hildebrand 2018.



There is also ample evidence that integrated financial markets, supported by international banks, help decouple consumption and income in any single country.¹⁸ If labor income falls during a recession but the private sector holds a diversified financial portfolio, people can smooth their consumption with the financial returns they receive on assets in better performing regions.

There is evidence that economic shocks have been better absorbed in the U.S. than within the euro area, partly due to U.S. interstate banking. See especially Mario Draghi, former President of the European Central Bank, who notes the development of U.S. interstate banking (aka U.S. banking union) in the 1990s and the link to a reduction in regional downturns.¹⁹ Buti et al. (2016)²⁰ compared the degree of cross-border private risk sharing within the EU to that between U.S. states.

In the U.S., finance absorbs around 70% of local economic shocks (with capital markets absorbing around 45% and credit markets 25% after interstate banking/U.S. banking union). By contrast, in the euro area – where the establishment of the European Banking Union is so far incomplete – the total figure for risk absorption is just 25%, leading to more severe local economic cycles.

A consolidated European banking market could also create new opportunities and new business models for banks due to scale effects. Without having a sustainable business model in their home market, banks would be compelled to pursue much riskier businesses.²¹ In order to ensure a more stable euro area banking sector it is necessary to allow and promote cross-border banking consolidation, and thus make banks more diversified and more profitable.²²

Integrated financial markets, as noted by Augustin Carstens, the General Manager of the Bank of International Settlements, among others, also bring a number of social benefits. “They help enlarge the opportunity sets of lenders and borrowers, increasing competition in the provision of financial services and offering possibilities to diversify idiosyncratic risks away from the national economies, thereby contributing to financial stability.”²³

This last point is especially important in a currency union like the euro area, which requires effective risk-sharing mechanisms to offset economic developments, and resources and financial stability concerns in each particular member country.

Another benefit of M&A is that it can prevent costly bank failures or bail-ins by allowing stronger banks to acquire failing banks. This can take place within a country or across countries – allowing for cross-border consolidation increases the set of options and may

¹⁸ IIF 2019. “The value of cross-border banking and the cost of fragmentation.” November 2019.

¹⁹ Mario Draghi 2018. “Risk-reducing and risk-sharing in our Monetary Union.” May 11, 2018.

²⁰ Buti, Leandro and Nikolov 2016. “Smoothing economic shocks in the eurozone: The untapped potential of the financial union.” August 25, 2016.

²¹ Hildebrand 2018.

²² Hildebrand 2018.

²³ Augustin Carstens. “The quest for financial integration in Europe and globally.” September 2019.



result in more efficient outcomes.²⁴ Cross-border M&A can be particularly advantageous if the local banking system has been hit by a widespread shock or is highly concentrated.²⁵

There are also benefits specific to cross-border banking in particular. For example, a 2016 Federal Reserve Bank of San Francisco research paper found that when banks in two countries become more closely connected through the syndicated loan market, trade between those countries tends to increase in the following year by a statistically and economically significant amount.²⁶ Research by the Bank of England also shows that foreign banks tend to facilitate trade more than domestic banks.²⁷ Claessens finds that a larger presence of foreign banks and a larger footprint (more branches) results in greater access to external financing, including for small and medium-sized enterprises (SMEs).²⁸

At present, there are multiple examples of the valuable role foreign banks play in advanced economies. In the U.S., Foreign Banking Organizations (FBOs), especially European and Japanese banks, are key participants in U.S. primary and secondary capital markets, across multiple asset classes and activities.²⁹ FBOs also assist the smooth operation of U.S. monetary policy and government debt distribution, as they comprise more than half of the primary broker-dealers of the Federal Reserve Bank of New York.³⁰ Similarly, in the EU, U.S. investment banks and increasingly Japanese banks have a presence, making them critical to the good functioning of EU capital markets for corporates and sovereigns.³¹

10.7. RAPID TRANSFORMATION

While the benefits of consolidation are evident, European banks are being challenged in a number of critical areas that require substantial management time and attention on internal developments and processes. European banks - as everywhere else - are currently undergoing a rapid transformation, trying to quickly transition to more digital strategies, business models and operations channels. Boards are also focused on the risks

²⁴ For example, see ECB 2017 (May) and Enria 2019, “Is less more? Profitability and consolidation in the European banking sector” presentation at the at the CIRS Annual International Conference, Lisbon (July 4).

²⁵ IIF 2019. “The value of cross-border banking and the cost of fragmentation.” November 2019.

²⁶ Caballero, Candelaria and Hale 2016. “Bank Linkages and International Trade.” February 2016.

²⁷ Claessens, Hassib and Van Horen 2017. “The role of foreign banks in trade.” April 10, 2017.

²⁸ Claessens 2017. “Global Banking: Recent Developments and Insights from Research.” September 2017.

²⁹ SIFMA 2019. “SIFMA Insights: The Importance of FBOs to U.S. Capital Market” April 2019.

³⁰ U.S. Department of the Treasury 2017. “A Financial System That Creates Economic Opportunities: Banks and Credit Unions” (June 2019). Page 5. Refers to data from Federal Reserve Bank of New York, Primary Dealers, available at: <https://www.newyorkfed.org/markets/primarydealers>.

³¹ Comparing the European market shares of the top five U.S. and European investment banks in 2017, PWC found that the U.S. banks had 71% of the market capitalization and 74% of the deal volume in primary markets. See PWC 2018, Presentation at the European Banking Summit 2018 (September 27, 2018).



and opportunities of a digital world and industrializing the use of machine learning and artificial intelligence across their businesses and bank operations.³²

After having spent the past decade implementing the post-crisis reforms, that resulted in more and higher quality capital buffers, deeper pools of liquidity and credible resolution strategies aimed at separating banks from the taxpayers, banks are now investing in and innovating their approaches to new, or newly emphasized, non-financial risks, including cyber risk, operational resilience, conduct, compliance and fraud, and financial crime and money-laundering.

Not only is the world of banking changing quickly but there are considerable questions about Europe's political and economic position in the world, given geopolitical challenges, the rise of populism, prolonged economic weakness and the reality of the UK, the largest financial sector and capital market in the EU, leaving the Union.

Consolidation, especially meaningful cross-border tie-ups, require risk-taking and betting on the future. But all these uncertainties – uncertainty about the future, about the shape of Europe, about leaps in technology and innovation and what that all means for the state of banking going forward – contribute to a climate that is more risk adverse and careful about undertaking complex, expensive and risky deals.

There are also a number of serious obstacles that hinder the consolidation of the EU banking sector, including issues of an economic, political, regulatory or cultural nature or factors associated with the business landscape within which European banks are operating.

10.8. ECONOMIC CONDITIONS

The economic environment in Europe has been challenging for banks as timid economic growth has been coupled with low, and now negative, interest rates. The outlook continues to be challenging, and the latest International Monetary Fund (IMF) projections foresee growth across the EU declining from 2.3% in 2018 to 1.4% in 2019 with risks to the downside given weakness in trade and manufacturing and uncertainty around a no-deal Brexit.³³

The European Central Bank (ECB) has also been actively cutting interest rates in an effort to support the region's flagging economy. In September, the Central Bank cut its interest rate for deposits by 10 basis points to minus 0.5% and pledged to keep them at that level, or lower, until the outlook for inflation improves. Negative rates have cut borrowing costs for homebuyers and businesses but have not yet resulted in a turnaround in investment, consumer spending or growth.

For banks in Europe the impact has been especially damaging, as low interest rates and flattening yield curves make it exceedingly difficult to offer traditional commercial banking services such as lending and opening new accounts. Several large European

³² See 10th Annual IIF/EY Global Risk Management Survey, November 2019.

³³ IMF 2019. "Regional Economic Outlook: Europe." November 2019.



banks have warned that the record-low interest rates are weighing on their profitability, as they have been forced to lower their borrowing charges and in some cases pay to store money at central banks, without a similar reduction in the rates they pay to savers.³⁴ On the positive side, recent measures adopted by the ECB, have been implemented with the goal of amortizing in some way the impact of “low for long” on the European banking sector. Overall uncertainty is also impacting households, who are often saving more rather than spending, which further depresses economic growth.

The economic environment also impacts mergers as banks are less likely to take risks during periods of economic weakness and uncertainty. Consolidation is cyclical, as mergers imply risks and M&A activity is much more likely to flourish during periods of strong economic confidence and performance, when there is also a higher probability of generating positive returns.³⁵ Persistent low levels of profitability also depress the appetite for cross-border expansion, and any consolidation is more likely to occur within-border consolidations seeking economies of scale.³⁶

10.9. POLITICAL FACTORS

Across Europe there is a diverse range of banking systems, each one with different characteristics. Some individual features of such diverse systems also raise barriers to consolidation. There are different policy and legal treatments for privately-owned banks and state-owned ones (e.g., cooperative, public sector, savings and nationalized banks). Public and private banking sectors also have different return on equity targets, which can put further downward pressure on overall profitability.

Another variable is the legal status, specific governance and ownership structure which many banks have that make it difficult to acquire public and cooperative banks. In some cases, preference shares have also been issued for the public sector and thereby create further barriers.

Similarly, the issue of holdings of domestic sovereign debt, explained in part by structural factors including the scarcity and asymmetric provision of safe assets, remains as a specific challenge in the euro area that adds uncertainty as to how governments would welcome further merger or acquisition activities.

Perhaps the biggest political hurdle has been the lack of agreement around European Banking Union. This project was launched in 2012 to integrate the European banking market and thereby break the link between domestic economic developments and financial stability in each member jurisdiction.

The first pillar, the Single Supervisory Mechanism (SSM), aims to ensure the soundness of the banking system, increase financial integration and ensure consistent supervision throughout the euro area. In its first few years, the SSM has already made big strides

³⁴ FT 2019. “UniCredit leads trio of European lenders alarmed by low rates.” August 2019.

³⁵ ECB 2018. “Financial integration in Europe.” May 2018.

³⁶ Carstens 2018.



in streamlining the Single Rulebook, unifying the supervisory practices and increasing comparability and transparency across the sector. The second pillar, the Single Resolution Mechanism (SRM), created a common resolution authority that is responsible for common rules and managing the European Single Resolution Fund (SRF).

While the first two pillars are in place and operational, the remaining pillar – the European Deposit Insurance Scheme (EDIS) – is still missing despite intense and political negotiations. By truly completing the Banking Union, and introducing a common deposit insurance scheme, host jurisdictions within the euro area might feel less inclined to make use of prudential safeguards of their own.

By completing the Banking Union, as Mario Draghi recently noted, there would be less need for public risk sharing in the future, because there will be instruments in place to stabilize crises more quickly and for private sector risk sharing to develop more sustainably: “Without public insurance, in a crisis, markets typically panic and begin fire sales, which propagate risk. Appropriate backstops, on the other hand, help stabilize market expectations and reduce risks.”³⁷

In late 2019, as a new five year EU political cycle commenced, there was fresh commitment from Commission President Ursula von der Leyen to complete the Banking Union.³⁸ She said this would include a common backstop to the Single Resolution Fund, a last-resort insurance measure in the event of a bank resolution. She also pledged to create a European Deposit Insurance Scheme and put forward measures for a robust bank resolution and insolvency framework. These have all been politically difficult issues, but her personal commitment, along with significant support from key Member States, might be enough to break the political deadlock, helped further by the accelerating risk reduction measures that bring non-performing exposures down to comparable levels across all Banking Union Member States. This in due course will phase out problematic legacy losses and facilitate the move to the inevitable necessity for risk sharing in a true Banking Union.

Significantly, Olaf Scholz, the Finance Minister of Germany, a country that has been among the most resistant, recently pledged to re-launch the debate to create a full Banking Union and drop its opposition to the deposit insurance scheme. “The need to deepen and complete European banking union is undeniable. After years of discussion the deadlock has to end,” he penned in early November 2019.³⁹

His support in particular for EDIS could prove substantial, given the well-known objections that Germany and a few other euro area countries have raised against the idea that insurance schemes, funded by their taxpayers, could be used to support banks in other countries.

³⁷ Mario Draghi 2019. “Stabilisation Policies in a Monetary Union.” October 1, 2019.

³⁸ Ursula von der Leyen 2019. “A Union that Strives for More: My Agenda for Europe.” October 2019.

³⁹ Olaf Scholz 2019. “Germany will consider EU-wide bank deposit reinsurance.” November 6, 2019.



Scholz also asked for a number of caveats, some of which will be more difficult to accept for certain Member States. He called for a common insolvency and resolution process for all banks, especially for smaller banks that today continue to fall under different national insolvency laws, with the market distorting nationalization option intact. Scholz also reiterated the need to further mitigate risks by continuing to reduce non-performing loans and tackling risks associated with sovereign debt.

Critically, his proposal includes a requirement not to treat sovereign bonds as a risk-free investment and for capital charges to be introduced to reflect credit and concentration risks associated with sovereign exposures. The ambition would be to help banks all over Europe diversify their portfolios of sovereign bonds. Finally, he pledged that Germany together with France will work to create common tax laws, including a common corporate tax base and a minimum effective tax to help prevent arbitrage and distort tax arrangements.

While the changes in Germany's views on European financial and fiscal policy are significant and inject a welcome breath of fresh air to this ongoing debate, the proposals are likely to be challenged by other Member States.⁴⁰

10.10. REGULATORY HURDLES

While there are common regulatory frameworks created by the European Commission that apply across the EU, there are substantial national divergences that fragment the market. In some cases, Member States apply strict measures to branches and subsidiaries, rather than at the group level of the bank as a whole. This is the case for capital and liquidity requirements of euro area entities of the same banking group. There are also national discretions and exemptions around capital requirements, deductions and large exposure limits that are not extended at group level to banks operating cross-border in the euro area. It would help to ensure that domestic and cross-border banking groups are treated in a consistent way. A useful step could be to lower capital requirements of European subsidiaries, on the condition of safeguarding their financial position through credible cross-border guarantees.⁴¹ The European Commission's proposal to grant capital waivers within banking groups on an EU cross-border basis, for example, would address these only being given locally.

Luis de Guindos, Vice President of the European Central Bank, has also argued that financial integration may be hampered by regulatory obstacles that hinder the free flow of capital and the liquidity of banking groups.⁴²

⁴⁰ FT 2019. "Europe should be wary of Olaf Scholz's proposals." November 10, 2019

⁴¹ Competition Policy International 2019. "EU: ECB policymaker calls bank consolidation "desirable." June 5, 2019.

⁴² Luis de Guindos 2018. "Euro area banking sector – current challenges." November 15, 2018.



In the area of capital, he argued that, unfortunately, in the EU Capital Requirements Regulation, Member States have not agreed to introduce cross-border capital waivers within the European Union. “This is a missed opportunity, as such waivers would be consistent with the establishment of the Single Supervisory Mechanism and the Banking Union.” He argues that the potential financial stability concerns raised by their proposed introduction could have been addressed by making the waivers subject to additional prudential safeguards and transition arrangements that would accommodate the planned future development of the Banking Union.

A second point Mr. de Guindos highlighted is the free flow of liquidity. In theory, the existing legal framework already allows for cross-border liquidity waivers within the EU. “Unfortunately, the remaining national options and discretions in the EU regulatory framework hamper the practical application of such waivers.” As an example, it is noted that the national large exposure limits on intragroup exposures that are currently in place in several European countries prevent banks from transferring liquidity flexibly within the group. De Guindos concludes that the EU needs further harmonization to address such practical obstacles, also given that the regulation already contains appropriate prudential safeguards for applying liquidity waivers.

Finally, de Guindos has also concluded that Banking Union should also be approached in the context of a single jurisdiction. In coherence with the current common supervision and resolution mechanisms, it is argued that the international regulatory framework should treat the Banking Union as a single geographical area, for example, when it comes to calculating capital surcharges of Global Systemically Important Banks.

Furthermore, uncertainty prevails with regards to when and how regulation will be implemented. While Europe is committed to implementing the global standards that have been agreed at the Basel Committee and Financial Stability Board levels, there are sometimes delays and discrepancies, which create uncertainty for European banks and also create a generally more uneven playing field globally between jurisdictions.

The Fundamental Review of the Trading Book (FRTB) is a good case in point with potential divergences regarding adoption and timing of planned implementation. With regard to FRTB, Europe has near final rules pending further legislative proposals due in 2020, and proposed rules in the U.S. are expected in 2019. Differences in implementation timeframes would result in a number of significant trading banks operating under different rules and capital requirements, resulting in financial market fragmentation during this time, with some banks incentivized to increase exposures to risks for which they have relatively lighter requirements.

Another critical area is the implementation of the final Basel III package, a comprehensive set of reform measures developed to strengthen the regulation, supervision and risk management of the banking sector. The package was agreed internationally to be implemented on January 1, 2022 and includes transitional arrangements and phase-in up to 2027, to give banks sufficient time to prepare for what are quite significant changes around credit risk, market risk, operational risk and the creation of an output floor.

The European Banking Authority (EBA) in August 2019 published a quantitative analysis of the impact that the full implementation of Basel III will have on European



banks. The EBA found that the impact on a group of 189 banks, under conservative assumptions, would increase the minimum capital requirement (MRC) by 24.4% on average. Furthermore, this increase in capital requirements would imply an aggregate shortfall in total capital of about EUR 135.1 billion (EUR 91.1 billion in terms of common equity tier 1, CET1).⁴³ A similar assessment by the IIF among its own member banks found that on a regional basis, the impact is significantly higher in Europe than in other parts of the world.

Given the significant potential impact of Basel III on European banks, elements of uncertainty about the future financial condition of some European banks will exist until more is known about the exact details and timing of Basel III implementation across Europe.

Another important area of consequence is recovery and resolution. New tools like Total Loss-Absorbing Capacity (TLAC) are intended to ensure that Global Systemically Important Banks (G-SIBs) have enough equity and bail-in debt to pass losses to investors and minimize the risk of a government bailout.

As each relevant home and host jurisdiction translates the provisions of the TLAC Term Sheet into local regulation, it is worth noting how the calibration of internal TLAC can contribute to fragmentation. While some jurisdictions like the UK and Hong Kong have generally proposed calibrating internal TLAC at the low end of the range (75%), others have issued rules that go to the high end of the range (i.e., 90%, or even 100% within the EU).

This calibration can have significant consequences. If jurisdictions default to the most stringent calibration, this lowers the flexibility of the parent to allocate resources – increasing misallocation risk and therefore the risk of bank failure. Excessive pre-positioning requirements also mean that financial institutions lose the ability to let capital flow freely to its most productive use.⁴⁴

A related problem is the use of ring-fencing measures that home and host jurisdictions apply to protect and control their domestic markets. Mario Draghi has stressed that ring-fencing has impaired monetary transmission across the EU and reduced the ability of EU banks to cushion economic shocks, especially when the financial crisis hit the euro area. “Financial markets then began to fragment along national lines and cross-border funding dried up, exacerbated by defensive risk management by banks and ring-fencing of liquidity by supervisors in the core countries.”⁴⁵

This resulted in a malfunctioning of the monetary policy transmission mechanism, pressure on the currency union, distortions in competition in the single market, lack of liquidity, capital depletion from domestic losses and a renewed credit crunch.

⁴³ EBA 2019. “EBA advises the European Commission on the implementation of the final Basel III framework.” August 5, 2019.

⁴⁴ Randal K. Quarles 2019. “Government of Union: Achieving Certainty in Cross-Border Finance.” September 26, 2019. Remarks at FSB Workshop on Pre-Positioning, Ring-Fencing, and Market Fragmentation.

⁴⁵ Mario Draghi 2018.



When Member States try to protect and control their domestic markets this forces significant and increased fragmentation within financial groups. There is optimism, however, that if EDIS can be agreed upon and if common European insolvency laws are introduced, that host jurisdictions might have the additional comfort needed not to introduce ring-fencing measures for foreign banks going forward.

Another issue, which weighs on consolidation is the difference in tax regimes and legal systems between Member States. This is also true for banking regulation, in spite of the Single Rulebook. These discrepancies may also be a reason, why cross-border mergers are less appealing to banks, because they hinder them in harvesting the full benefits.⁴⁶ Legal, judicial and tax systems still remain in the hands of Member States, and thereby fragment approaches and regulations and make it more difficult for banks to merge and to offer cross-border products and services. There are substantial differences in banking regulation and supervision, as well as disparate approaches to insolvency laws, consumer protection, company law, private law, employment protection and labor laws.

Lastly, as part of the political compromise of eurozone Member States to accept centralized supervision and resolution powers at the European level macroprudential powers were given to national competent authorities in exchange, which have been used to varying degrees, most often for real estate exposures. This fragmented supervisory enforcement is not always conducive to cross border consolidation and reintroduces authority at national levels that can differ from others.

10.11. CULTURAL DIFFERENCES

There are also different cultural factors across European countries that deter consolidation, especially when it comes to cross-border mergers and banking. Many consumers say they are reluctant to change banks because of long-standing (family) tradition, or to bank with third-country European banks, often for cultural and linguistic issues. Any bank that wants to enter a new market in Europe, through organic growth or acquisition, has to factor in very different cultural approaches to banking, as well as different local unions, labor laws and business practices. Different approaches and uncertainty make it difficult to calculate and materialize sale and synergy effects.

A related problem, is that some customers are reluctant to trust banks from elsewhere in the Union as they would a domestic bank. This is certainly not the case in every part of Europe, like the Benelux and Scandinavia, for example, where retail banking has consolidated across borders. But in other countries there is concern that if something goes wrong that the bank might not be supported by the authorities the way a domestic bank would. Agreement around a common European Deposit Insurance Scheme (EDIS) would help in addressing these concerns.

Mortgage markets in Europe are still very locally determined and regulated (includ-

⁴⁶ Danièle Nouy 2017.



ing for example in the areas of forbearance, protection, LTI versus traditional LTI) which results in tailoring to local custom remaining a strong requirement. This also makes achieving economies of scale by standardizing mortgage/loan products across markets more difficult. Less mature markets in the euro area, but also in the EU, have legacy issues (e.g., mortgages in foreign currencies, large numbers of non-performing loans) that could weigh on consolidation opportunities.

10.12. BUSINESS LANDSCAPE

The business landscape adds uncertainty as banks are still recovering from the financial crisis and there are substantial legacy vulnerabilities remaining in the system, including the high stock of non-performing loans (NPLs) and large exposures to highly indebted sovereigns. The business environment also challenges the economic value of mergers, given questions around the quality of assets of potential partners and their ability to generate growth.

Not only are NPLs still an issue in some parts of the euro area, but also banks' ability to generate profits depends on their capability to adapt their business models.⁴⁷ Reducing the size of NPLs has been a key priority since the financial crisis for regulators and policy makers. Europe's stock of bad loans now is at its lowest since the financial crisis. According to the EBA, total NPLs decreased from over EUR 1.15 trillion in June 2015 (6% as a percentage of total loans) to EUR 636 billion as of June 2019. The NPL ratio declined to 3%, the lowest ratio since the EBA introduced a harmonized definition of NPLs across European countries.⁴⁸

But despite the considerable progress, the rate of improvement has slowed in recent quarters, and some countries in the bloc still have double-digit NPLs ratios. The EBA said it also has concerns about the large number of loans which are more than a year past due, which are considerably devalued and pose a risk to banks that have an increased share of these assets on their balance sheets.

Banks have also reported uncertainty about the quality of credit portfolios, high levels of legacy assets, different types of banking products and different IT systems as barriers to making acquisitions. Cultural and linguistic issues again play a role for cross-border mergers.

Besides that, various structural issues exist. It is unclear, what impact digitalization will have on the optimal structure and size of a bank and whether it would, against the backdrop of their decreasing usefulness, still be rewarding to acquire branch networks for example.

The fact that consolidation often leads to rationalizing workforces also creates reputational risks. Many banks are already decreasing their staff levels, in part because of

⁴⁷ Danièle Nouy 2017.

⁴⁸ EBA 2019. "EBA shows that efforts to improve EU banks' asset quality have proven successful but pockets of risks remain." November 8, 2019.



digitalization, and negotiating smaller staff sizes with labor unions, workers councils and within the confines of domestic labor laws. Undertaking a substantial (cross-border) merger can introduce substantially more redundancies and additional costs and risks to the acquiring bank.

All these uncertainties have caused banks to concentrate on internal projects like adapting their business models, reducing their costs, addressing their legacy assets and making best use of digitalization, while at the same time being bound by stricter regulations.⁴⁹

10.13. THE WAY AHEAD

So, where does this leave consolidation in the European banking industry? And, what can policymakers and authorities do to help stimulate consolidation? These are important questions and the right answers will ultimately support a healthy and more profitable European banking sector.

10.13.1. CONTINUE PRIORITIZING THE IMPORTANCE OF THE EUROPEAN BANKING INDUSTRY WITHIN EU POLICYMAKING

While a number of business and economic factors are currently preventing further consolidation, there is undoubtedly a clear role for policy makers to facilitate it. At its most basic level, a clear and visible commitment to undertake policy decisions that remove barriers to consolidation should be part of the agenda for the new European authorities. A healthy and more profitable banking sector is essential for the continuing economic growth of the region and as such, reflecting consolidation as part of the policy goals will help drive attention by key decision-making authorities in the region.

Similarly, the fresh commitment by Commission President Ursula von der Leyen to complete the EBU has instilled new energy into the project, and aligns European policy with, as discussed, a fundamental element of the policy agenda needed to promote greater integration and consolidation of the European banking sector. German Finance Minister Scholtz's recent proposals could be seen as further cementing this policy shift.

10.13.2. POSITION THE EUROPEAN BANKING INDUSTRY TO COMPETE IN A GLOBAL CONTEXT

Banks all around the world are undergoing radical transformation, driven by fundamental changes in technology and innovation. The European banking sector is not insulated from these trends. To become a healthy and more profitable sector in the long

⁴⁹ Danièle Nouy 2017.



term requires banks to quickly transition to more digital strategies, business models and operations channels. Boards are rightfully focused on the risks and opportunities of a digital world and ensuring that machine learning and artificial intelligence are effectively deployed across their businesses and bank operations. The European authorities and policy-makers should see European banks in this context and help them in transforming the sector towards a new reality, that can compete effectively with leading banks in other jurisdictions.

Given the global nature of financial services, and the interconnections between financial firms and economies all around the world, it is important that policies and regulations are coordinated globally as much as possible. Europe plays an important role in developing the standards at the Financial Stability Board, the Basel Committee on Banking Supervision and other important authorities, and it is important that as much as possible these standards are implemented faithfully and consistently in Europe, as across all jurisdictions.

10.13.3. COMPLETE THE EUROPEAN BANKING UNION AND THE EUROPEAN DEPOSIT INSURANCE SCHEME”

The European Banking Union is an ambitious project. By integrating the European banking market, the link between domestic economic developments and financial stability in each member jurisdiction would be eliminated. The first pillar, the Single Supervisory Mechanism (SSM), has already made big strides in streamlining supervisory practices and increasing comparability and transparency across the sector. The second pillar, the Single Resolution Mechanism (SRM), created a common resolution authority that is responsible for common rules and managing the European Single Resolution Fund (SRF). It is important that the SRF be properly capitalized so it can provide sufficient liquidity when necessary.

While the first two pillars are in place and largely operational, it is really the remaining pillar – the European Deposit Insurance Scheme (EDIS) – that needs to be completed, despite intense political negotiations. By truly completing the Banking Union, and introducing a common insurance scheme, host jurisdictions within the euro area might feel less inclined to make use of prudential safeguards in their own jurisdictions. The completion of EDIS and proper capitalization of the SRF are central to the recovery of the European financial sector, and by extension the further consolidation of the banking sector. It is particularly encouraging that both the new President of the European Commission and the German Finance Minister have relaunched the debate to create a full Banking Union, including a common European Deposit Insurance Scheme.



10.13.4. PROMOTING COMMON SUPERVISION AND ADDRESSING NATIONAL DIVERGENCES ACROSS THE EU

While there is now a Single Rulebook that unifies common supervisory practices there are still substantial divergences around regulation, tax regimes and legal systems. All these discrepancies contribute to why mergers are less appealing to banks, especially cross-border deals that involve different cultures and banking systems across Member States. It would be especially helpful to consider a common insolvency and resolution process for all banks, especially for smaller banks that today continue to fall under different national insolvency laws. By consolidating the single market and by promoting a common European banking sector, financial firms, as well as those in other sectors, will be able to harvest the full benefits of operating in the world's largest common market. The European Monetary Union also needs a common shock absorption capacity, to help stabilize the economic cycles across the bloc. This could perhaps be conceived through a European safe asset.

10.13.5. CONTINUE ADDRESSING NPLS ACROSS THE SYSTEM

European authorities and banks have both been actively focused on reducing the stock of non-performing loans (NPLs) and they are now at the lowest level since the financial crisis, which is a very positive development. That said, European authorities have noted that reductions have been slowing down and that there is a particular concern about Member States with double-digit NPL ratios and loans that are already a year past due. NPLs can impact the ability of those banks to generate profits and they thereby continue to weigh on the recovery of the financial sector. It is important that the authorities and banks work together to keep reducing the stock of bad loans to ensure a healthy and more profitable banking sector.

10.13.6. MANAGE RESOLUTION APPROACHES AND ENCOURAGE COOPERATION

Finally, resolution approaches are an important consideration. Resolution should be approached from a common position within the EU to help reduce market fragmentation in the areas of capital, TLAC and liquidity. When individual Member States pre-position capital between them it further limits the ability of firms and home regulators to respond with group-wide resources during times of stress.

The EU is so far the only jurisdiction that has chosen a hard 90% for calibrating internal TLAC, and 100% for banks from within the EU. This not only creates fragmentation within the EU but also makes it harder for banks in the EU to compete with other jurisdictions - including Hong Kong, Japan, the UK, and possibly the U.S. - that have proposed calibrating TLAC at the lower end of the 75%-90% range. This calibration can have significant consequences.



As explained in this chapter, if jurisdictions default to the most stringent calibration, this lowers the flexibility of the parent to allocate resources – increasing misallocation risk and therefore the risk of bank failure. Excessive pre-positioning requirements also mean that financial institutions lose the ability to let capital flow freely to its most productive use.

Perhaps by completing EDIS, sufficiently capitalizing the Single Resolution Fund and harmonizing insolvency laws, home and host supervisors would gain sufficient comfort to reconsider the hard 90% approach to internal TLAC. This would also help motivate additional consolidation as banks could operate across borders in a more centralized and consistent approach.

This set of policy proposals represents a challenging task for authorities in Europe. However, the need for consolidation is increasingly urgent, which will only intensify further as new non-banking actors enter the market, primarily through new technologies. The agenda of the new EU Presidency and the clear drive to complete the European Banking Union gives hope and optimism that such challenges can be addressed.



GLOSSARY

AT1	Additional Tier 1
AML	Anti-Money Laundering
APP	Asset Purchase Programme
ABSPP	Asset-Backed Securities Purchase Program
BIS	Bank for International Settlements
BOJ	Bank of Japan
BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
BEPS	Base Erosion and Profit Shifting
BCBS	Basel Committee on Banking Supervision
BICC	Budgetary Instrument for Convergence and Competitiveness
CMU	Capital Markets Union
CDR	Capital Requirement Directive
CRR	Capital Requirement Regulation
CB	Central Bank
CBDC	Central Bank Digital Currency
CEPR	Centre for Economic Policy Research
CAC	Collective Action Clauses
CREs	Commercial Real Estate
CPMI	Committee on Payments and Market Infrastructure
CET1	Common Equity Tier 1
CETA	Comprehensive Economic and Trade Agreement
CSPP	Corporate Sector Purchase Program
CIR	Cost to Income Ratio
CCR	Counterparty Credit Risk
CBPP	Covered Bond Purchase Programme
CDS	Credit Default Swap



CVA	Credit Valuation Adjustment
DLT	Distributed Ledger Technology
DBPs	Draft Budget Plan
DSGE	Dymanic Stochastic General Equilibrium
EFC	Economic and Financial Committee
EMU	Economic and Monetary Union
ESG	Environmental, Social and Governance
EA	Euro Area
EONIA	Euro Overnight Index Average
EZ	Euro Zone
EBA	European Banking Authority
ECB	European Central Bank
EC	European Commission
ECFR	European Council of Foreing Relations
EDIS	European Deposit Insurance Scheme
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
EMU	European Monetary Union
EP	European Parlament
EPP	European People`s Party
ESMA	European Securities and Markets Authority
ESM	European Stability Mechanism
EU	European Union
EDP	Excessive Deficit Procedure
FSB	Financial Stability Board
FBOs	Foreing Bankng Organizations
FG	Forward Guidance
FRTB	Fundamental Review of the Trading Book
GATT	General Agreement on Tariffs and Trade
GSCs	Global Stablecoins
G-SIB	Global Systemically Important Bank



GLOSSARY

GC	Governing Council of the ECB
GFC	Great Financial Crisis
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
HM	Helicopter Money
HRVP	High Representative (Vicepresident) of the Union for Foreign Affairs and Security Policy
IOU	Informal Document Acknowledging Debt, (I Owe You)
ICOs	Initial Coin Offerings
IIF	Institute of International Finance
IHC	Intermediate Holding Company
IPU	Intermediate Parent Undertaking
IRB	Internal Ratings-Based
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPE	Investment Plan For Europe
KYC	Know your Customer
LTRO	Longer Term Refinancing Operations
MIP	Macroeconomic Imbalance Procedure
MROs	Main Refinancing Operations
MiFID	Markets in Financial Instruments Directive
MTDs	Medium-Term Objectives
MERCOSUR	Mercado Común de América del Sur
M&A	Merger and Acquisition
MRC	Minimum Capital Requirement
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
MMT	Modern Monetary Theory
MFF	Multiannual Financial Framework
NIGEM	National Institute Global Econometric Model
NIRP	Negative Interest Rate Policy
NII	Net Interest Income
NSFR	Net Stable Funding Ratio



NPLs	Non Performing Loans
NPA	Non-Performing Asset
NATO	North Atlantic Treaty Organisation
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
OTC	Over-The-Counter
SPD	Partido Socialdemocrata Alemán
P2G	Pillar 2 Capital Guidance
P2R	Pillar 2 Capital Requirement
ZIRP	Zero Interest rate Policy
PCCL	Precautionary Conditioned Credit Line
PtB	Price to Book
PIA	Public Interest Assessment
PSPP	Public Sector Purchase Program
PMI	Purchasing Manager`s Index
QE	Quantitative Easing
ROE	Return on Equity
RAQ	Risk Assessment Questionnaire
RRP	Risk Reduction Package
RWA	Risk-Weighted Assets
SMP	Securities Market Program
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation
SSM	Single Supervisory Mechanism
SME	Small and Medium-sized Enterprise
S&D	Socialist & Democrats
SGP	Stability and Growth Pact
SA-CCR	Standard Approach for Counterparty Credit Risk
SRSS	Structural Reform Support Service
SREP	Supervisory Review and Evaluation Process



GLOSSARY

SCBDC	Synthetic Central Bank Digital Currency
TLTRO	Targeted Longer-Term Refinancing Operations
TFP	Total Factor Productivity
TLOF	Total Liabilities and Own Funds
TLAC	Total Loss-Absorbing Capacity
TTIP	Transatlantic Trade and Investment Partnership
TPP	Trans-Pacific Partnership
TFEU	Treaty on the Functioning of the European Union
UCITS	Undertaking for Collective Investment in Transferable Securities
US	United States
VAT	Value Added Tax
WTO	World Trade Organisation
ZLB	Zero Lower Bound



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