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EXECUTIVE SUMMARY

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1. A DISAPPOINTING AND HAZARDOUS YEAR IN EUROPE

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

A year later, European excitement has vanished completely. Nobody knows why, but the European ideal is no longer attractive. Perhaps because Europe's achievements are taken for granted: they have become part of our daily lives, and have lost all value. Perhaps because Europe has already wasted too much time rethinking itself, and remains unable to achieve a united response to Rodrik's trilemma[2] by continuing to dither be-

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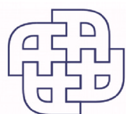
[1] Fernando Fernández Méndez de Andés is a professor at IE Business School and has been the editor of the Euro Yearbook from the outset.

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. COMPLETING MONETARY UNION FOR A DIFFERENT WORLD

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

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

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

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

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

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

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

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

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

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

3. EUROPE'S EXISTENTIAL DEBATE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

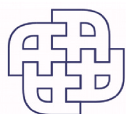
Papadia and Gonçalves devote much of their chapter to debunking the idea that the Italian budget generates growth. They begin by calling into question the calculation of the fiscal multiplier, which, we now know, reflects a non-linear relationship that depends on many factors. Applied to Italy, all these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

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

4. EUROPEAN MONETARY POLICY AND FINANCIAL SYSTEM

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

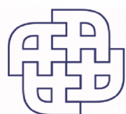
with Eurobonds will the problem disappear. Or, by granting an exorbitant privilege to the German saver and making the *bund* the secure and dominant asset in the portfolios of euro area banks. We must not confuse the symptom with the problem, as some deliberately and dishonestly did with the imbalances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

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

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

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

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



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

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

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

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

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

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

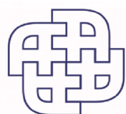
Lastly, the chapter provides an overview of the position of the European authorities with regard to DLTs. There are some basic questions that do not yet have binding legal answers: are they crypto coins, money, a token or a negotiable security?[20] What is their tax treatment? Are "smart contracts"[21]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

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

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

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

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



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

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

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

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

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

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

having been granted real access to this infrastructure[24] on British soil. But there is no "done deal", and, in the face of uncertainty, Euroclear has already decided to move its operations to Union territory.

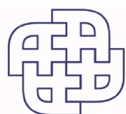
The first decision to be made by financial institutions in the UK must be either to retain their current domicile or move to Union territory. This requires authorisation at the venue of destination. Especially since the ECB has been strict about demanding a real move and not just a cosmetic one. There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

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

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

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

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



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

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

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

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

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

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

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

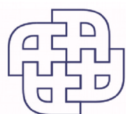
But the author adds that there are even more fundamental reasons: the excess of installed capacity; the presence of a large number of banks that are immune to competitive pressures;[26] and uncertainty about the effects of digital disruption on the profitability of the banking industry. A highly suggestive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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

6. THE TEN EUROPEAN LESSONS OF THE YEAR

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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