EXECUTIVE SUMMARY

1. INTRODUCTIÓN

When I was asked by the Fundación de Estudios Financieros [Financial Studies Foundation] two years ago to write a book about the crisis in Europe[1] we never though, especially me, that it would become a regular commission. We merely focused on identifying the nature of the problem and concluded that we were facing a crisis in the European Monetary Union which threatened to become endemic if the authorities continued to see it as just another currency crisis - a typical problem of excessive public and private debt in countries with lax economic discipline. We must not have been too far off track because the crisis rapidly spread and ended up spurring institutional reforms to ensure the voluntary and binding agreements in the Maastricht Treaty are met. The outcome was that the Foundation commissioned me to write a second book[2], this time on Europe's new institutional architecture, which at that time could not have been foreseen.

And thanks to the Fundación ICO [ICO Foundation], this one-off commission ended up leading to a third book - this Euro Yearbook, to which Professor Carlos Poza made a significant valuable contribution.

2013 was without doubt the year in which the Monetary Union changed the most since it was founded in 1999. A year in which the economic and political authorities in Europe clearly demonstrated that the Monetary Union is a political structure designed to last, and that they are therefore prepared to make any changes necessary. It was the year in which concepts such as banking union, fiscal union, economic union and even political union evolved from being secret codes used in academic meetings to become part of the official discourse and political agenda. This gave rise to spectacular results - always insufficient because there is much to be done, with the impatience shown toward the lack of progress made justified given the recession in Europe, but impressive nonetheless, if we look back to where we were just a year ago. The year saw the disappearance of the threat of a break-up of the euro (the so-called redenomination risk), a halting of the financial fragmentation in the eurozone, and a narrowing of bond spreads. Fiscal and bank debt mutualisation became a reality: embarrassingly and indirectly, albeit mutualised, through the launch of the European Stability Mechanism, while a single bank regulator and Single Resolution Mechanism were given the green light. The

[1] «The European crisis: sovereign debt crisis or euro crisis,» Fundación de Estudios Financieros, Madrid 2012.

[2] «The institutional architecture of the refounding of the euro», Fundación de Estudios Financieros, Madrid 2013.

year was characterised by a number of developments, all of which this Yearbook aims to systematically and critically analyse. As before, this executive summary is also therefore a deliberately-biased and provocative version of the opinions of the various contributors to this collective works.

This third report, or first Yearbook, is different to the previous editions in that it does not aim to identify a problem from which informed public opinion across Europe remained intentionally distanced. It is also not intended to point towards any possible solutions from the perspective of the economic situation in Spain; although an element of both objectives remains since the constituent process of refounding the euro has only just begun and, as proposed in this book, can only begin with a new European Monetary Union Treaty. Indeed, this Yearbook has a more immediate and specific aim, which is also fundamental: to inform Spanish readers of the huge developments in monetary, fiscal, economic and political union occurring during 2013. Meanwhile, the limitations and shortfalls of these changes shall be demonstrated with the dual aim of avoiding the foreseeable consequences and complacency that has caused so much damage in Europe and Spain. While it is true that spectacular progress has been made – today the eurozone is much closer to being a well-functioning monetary area, it is also the case that in the turmoil of ongoing reforms, the nature of the Union has moved towards a multinational model in which the Council has forced bilateral negotiations on the Community method on the Commission, and Europe has lost legitimacy and appeal. The task of reengaging European citizens, who have become disenfranchised due to so much unnecessarily technical or deliberately populist discourse, seems to be a priority. With this in mind, the best approach is to carefully and exhaustively recount the battery of changes that have taken place, analysing what they mean and how they will affect us.

The European Monetary Union is fruit of an unprecedented historical process through which a number of democratic nations, at the free will of their citizens, agreed to give up basic elements of their national sovereignty and transpose it into a new, evolving political space: a shift in sovereignty that presents a radically different Europe. The outcomes of this new, open yet irreversible design are only now just beginning to be understood. We need to be aware of and understand this process, as consumers, workers, investors, entrepreneurs or merely as citizens, to be able to give our opinion on and influence the process, and also prepare ourselves and respond to change since, one must remember, every crisis is an opportunity.

2. BASIC OUTLINE OF THE YEARBOOK: THE EURO HAS AVOIDED A DEATH FORETOLD

With this idea in mind, the Yearbook is split into nine chapters giving nine new perspectives on essential aspects of the building of Europe. The first three chapters are linked as they provide an in-depth look at the true state of the Monetary Union, beyond merely rhetoric. The latter six chapters analyse how the current situation can be overcome by building a new European Monetary Union. The analysis of the current situation begins with an overview of how the euro is used for the three traditional purposes of money: as a means of payment in international transactions, as a means of holding assets through the accumulation of international reserves, and as a financial asset subject to the forces of supply and demand, and speculation. This is followed by a description of how the euro is used in financial markets, systematically and exhaustively throwing light on the different international statistics thereon. We end this first part of the Yearbook by trying to answer a question that all of us have asked over recent years: did financial fragmentation in the euro area become less pronounced in 2013?

The second half of the Yearbook begins with an analysis of how the eurozone's monetary policy has evolved: an analysis which does not aim to provide an opinion on whether or not it is appropriate to the macroeconomics of the eurozone. Analysts, investors and politicians already do this whenever they have the opportunity and a Yearbook cannot contribute much to this debate, which is intrinsically tied to the present. Instead, it describes how the European Central Bank (ECB) has also steered towards increasingly unorthodox stances, thereby unearthing new problems that need to be contemplated and resolved. This leads on to delving further into the harmonisation of banking regulation and scrutinising legislative changes from the perspective of the rights of debtors, creditors, savers and shareholders of banks. A comprehensive chapter then follows covering banking union; the main development and most significant milestone during the year with the launch of a single regulator. Nevertheless, this chapter is somewhat unfinished (as is the banking union itself), since at the date of publication, many questions remained unanswered, above all regarding the systematic evaluation of European banks and the single resolution mechanism. We then move on to investigate the fiscal union – a complex and little known subject where the opaque European legislative process and, above all, the noise created by the bailouts of some countries have overshadowed reflections on the fundamental changes to budget controls in Europe and the transfer of sovereignty to European authorities – bringing to a close the fifth year since the euro crisis. Lastly, we turn to economic union, perhaps the most controversial part of the institutional design of the new European Union because doubts exist among academics about its advisability and policies concerning the opportunity it presents. Nonetheless, what is certain is that the crisis in Europe is also a crisis that concerns private capital flows and a lack of growth, and in this regard, the fundamentals and structural aspects have warranted further attention this year.

The Yearbook is rounded off with a double chapter on political union, in which two authors try to answer two different questions that are fundamentally the same. Firstly, is a new Treaty on Monetary Union needed? The complex legal interrelation between the European Union and the European Monetary Union shall be examined – a theme that will move more into the spotlight as the eurozone consolidates from a political and legislative perspective. Secondly, how can a new political union be built: an individual identity that helps the Union to regain its political legitimacy and public support? This is a difficult area where complying with agreed-upon rules is the norm, where sacrifices and adjustments must be in line with transfers, and where there is a dangerous rise of nationalism. Both authors conclude that a new European political will is needed, embodied by a new Treaty constituting the European Monetary Union.

3. USE OF THE EURO AND THE FINANCIAL FRAGMENTATION OF THE EUROZONE

The first chapter, An overview of the euro in the world, begins with a look at how the euro is used in global trade, since there is no doubt that one of the goals of the Monetary Union was precisely to replace the dollar as a means of payment in trading; thereby moving towards Europe's relative independence with respect to the exchange rate and the dollar. The main conclusion drawn is the surprisingly stable manner in which the euro has been used in international commerce; a stability that has withstood the crisis, although the euro has lost some ground to the dollar throughout. On average, eurozone countries have used the euro more or less to the same extent for primary goods and manufactured products (around 50% for imports and over 66% for exports). Nevertheless, the euro has been used considerably less in the case of oil, oil derivatives and related materials: 43% for exports and 12% for imports, reflecting the dollar's continuing dominant position in this and other crucial commodities markets.

Since it was introduced in 1999, the euro has gradually grown as a reserve currency, enabling it to become the second most used asset-holding currency in the world. In 1999, the volume of international reserves in euros equalled $247 billion, while in 2012 this figure amounted to $1.4 trillion, both at current exchange rates. In percentage terms, this meant that 17.9% of the world's reserves were in euros in 1999 and 24.3% in 2012. At a constant exchange rate, these percentages would be 22% in 1999 and 24.6% in 2012. However, this rising trend as a reserve currency has also come to an end since 2009 due to the effects of the European sovereign debt crisis on the euro's credibility.

At the same time as the rise in volume of reserves in euros around the globe, there has been a greater use of the euro as a nominal anchor of exchange rates in several countries. In 1999, 37 countries around the world either explicitly or implicitly linked their currency's value to the European currency, which rose to 46 in 2012. At present, there are: five «euro-linked» countries; two economies with convertibility towards the euro; 17 economies with a fixed exchange rate against the euro as an anchor currency; five countries setting their exchange rate within fluctuation ranges benchmarked to the euro; nine economies including the euro in the anchor currency basket; one country with a special euro-linked, exchange-rate pact with a restriction on appreciation; and seven countries with formally floating exchange rates that confirm they intervene depending on the euro exchange rate.

Euro-denominated deposits outside the euro area grew (at the current exchange rate) since the euro was introduced from $77 billion in 2000 to $379 billion in 2012. It is obvious that this trend has played a role in strengthening the euro, but it is not the only factor. The European sovereign debt crisis has neutralised part of the growth in international euro deposits experienced prior to 2007. Analogously, loans in euros rose with respect to total loans in all currencies to non-eurozone borrowers from 15.2% in 1999 to 16.2% in 2011, showing evident, strong growth in the pre-crisis period and a slight downturn during the crisis. The euro reached an all-time high of 30% of all foreign-currency loans in 2004. Nevertheless, the dollar has bounced back as the dominant vehicle currency for foreign-currency loans.

The data presented in this chapter, summarised above, leave a bittersweet taste because Europe's grand vision of its currency progressively replacing the dollar has not been achieved. That said, there is definitely a reason to be satisfied with regard to the exceptional institutional, social and economic events of recent years, which while not especially driving up use of the euro, have not effected its consolidation as an international currency in all its forms.

The euro's grand entrance onto the international stage occurred when it was put into circulation some 14 years ago. During the immediately following years, the main players in the trade of goods and currencies reconfigured their portfolios and strategies to take into account this new circumstance. Since then, the euro has become commonplace, regularly used, necessary, but also nothing outstanding. Its future as an alternative currency is secure, it does not depend on economic factors or the management of monetary or exchange-rate policy; however its success as a dominant currency is reliant not even on the transformation of the European banking sector but on geopolitical and geostrategic questions. And one cannot hope that the 21st century will exactly be Europe's.

It is widely accepted that the euro is a very important asset to Europe. An asset that cannot be lost without dramatic costs to all those concerned. This must also be underlined when certain sectors question the benefits of the euro. Its disappearance would give rise to the need to redenominate millions and millions of international transactions, asset and liability agreements, financial securities, and so forth – a nightmare scenario that nobody wants to consider and that appeared practically impossible at the end of 2013. That, however, was not the case at the start of that year.

In chapter 2, Pedro Antonio Merino and Mauricio A. Ortega Hinojosa examine the volumes of trading in euros in the different financial markets, concluding that many of the goals established when the single currency was launched have been reached. Without a doubt, the eurozone is now far more than the sum of its parts, and the benefits achieved in terms of availability of credit and the cost thereof support this view.

Turning to the various financial markets, it can be seen that inter-bank activity in the money markets, which had climbed from 12 trillion in 2000 to €9 trillion by 2008 – a pre-crisis record high, subsequently decreased by 13 trillion. Strictly speaking, however, one cannot talk of a credit crunch, a wholesale tightening of credit across the euro area, because the 11.7-trillion increase in the ECB's balance sheet and the growth in repos of 11.5 trillion offset the decline in inter-bank financing. With regard to commercial paper, the single currency brought with it a sharp rise in issues, with short-term corporate finance in euros already exceeding the sum of issues in US dollars; also reaching an all-time peak in 2008 equivalent to 1600 trillion. This outstanding balance of issues has since shrunk by 50%. Short-term public debt in the eurozone – which had historically shown modest growth – doubled from 1400 billion to 1800 billion between 2008 and 2011 because, in the darkest moments of the crisis, the different European governments either could not attract longer-term finance or were not prepared to pay the spreads demanded of them. The trend has been the same across all short-term markets: significant growth in the years prior to the crisis followed by a dramatic tightening of credit, which is only now beginning to normalise with the determined and belligerent stance of the ECB and the stabilisation programmes rolled out at a national level using European funding.

The public and private debt markets in the eurozone have $22 trillion of outstanding long-term debt, close in size to the US market of around $35 trillion. The financial crisis brought an end to a lengthy period of abundant liquidity. The appetite for international debt in euros, in the widest terms, fell 14% between 2009 and 2011. The particular feature of the eurozone debt market is the weight of bank issues, accounting for 90% of the total; corresponding to the importance of bank credit to the corporate sector, in contrast to the US where a third of issues involve non-financial entities that place their debt directly on the markets. This peculiarity heightens the degree to which the economic cycle and the bank credit cycle are interconnected in Europe, especially Spain. The aim of the monetary union project, which to a certain extent has been achieved, was to develop the incipient private debt market of non-financial corporations in Europe – a market that is presently growing at around 10% year on year. All governments say they are behind this market and that it will be highly critical to avoiding the required bank deleveraging from drastically affecting the private corporate sector and disproportionately hitting employment.

The most important exchange rate in the currency markets is the euro-dollar rate; the key price in the world economy. The dollar is the most heavily traded currency, accounting for 87% of all trades, while the euro is the second most traded currency, which has historically accounted for 38% of the market. In recent years, this share has fallen to 33% as a consequence of the euro crisis and the rise of the currencies of some emerging economies that have risen in stature as their growth persisted over time and they became more macroeconomically stable.

Interest-rate agreements traded on over-the-counter markets in euros have outstripped those in US dollars, explained by the growing importance of the European banking sector, which relies heavily on this type of instrument to mitigate market risk. The average volume of interest-rate agreements in euros entered into each day rose from $830 billion in 2010 to $1.15 trillion in 2013. In 2011, the first year of reference, the volume traded stood at only $0.2 trillion.

The market capitalisation of companies whose shares are listed in dollars amounts to over $20 trillion and is practically double the euro-market capitalisation. Nevertheless, in growth rate terms, shares in the European currency have risen by over 100%, while those in dollars have seen an upswing of only 40%. One must not, however, be under any illusions. This relative delay is not only down to the crisis, but also to the fundamental role of structural and technical factors such as economic dynamism, efficiency, innovation, segmentation and a dearth of liquidity.

In short and achieving one of the Monetary Union's fundamental objectives, the euro has gained a strong foothold in international financial markets. Nevertheless, the scale of financial-market contraction in the five years since the crisis of between 30% and 50%, depending on the market, has thrown into doubt this importance and slowed its consolidation. This is because the fragmentation of the eurozone has involved a contraction that has not been felt by any other monetary area, not even the US – epicentre of the banking problems. This contraction reflects the overriding need to finalise the institutional architecture of the euro. It is true that investors are no longer panicked; however their activity is dependent on the confidence and faith they have that the euro area will set in motion the structural changes needed to stabilise the euro and ensure its future.

José Ramón Díez focuses specifically on analysing the different indicators of financial-market fragmentation in chapter 3. This process has involved the renationalisation of deposits, which peaked between the middle of 2011 and the summer of 2012, when the markets discounted the high likelihood of a break-up of the euro. Since then, doubts about the Monetary Union's future have gradually disappeared, although savings remain static within the EMU specifically in the search for higher returns, with the consequent decrease in potential growth and damage to those countries that have traditionally been «importers» of external savings. This negative impact has only partially been offset by the ECB's decisive action as a redistributor of liquidity within the eurozone[3].

Sector risk or corporations' risk are the only risks in a monetary union worthy of the name, that should determine the financing terms of economic agents; not country risk. An integrated financial market is based on the assumption that:

(i) all players are on a level regulatory playing field; (ii) the one-price law applies, i.e. the interest rate for identical products (in terms of maturity, risk, etc.) is the same; (iii) there is a high incidence of cross-border trade; and (iv) no domestic bias is detected in investors' portfolios, above all among institutional investors, since retail investors face information barriers. These four economic laws are far from the reality in the euro area. Moreover, this first crisis for the EMU has raised to the ground a large part of the single financial market which was so painstakingly being built since the start of Maastricht Treaty negotiations. We Europeans have taken a long time to learn the right lessons, explaining why the crisis is being so unnecessarily long and painful. However, in 2013 we faced up to reality. This recognition and the first steps towards banking union have helped to partially halt fragmentation and reduce spreads and the leaning towards domestic investments.

Specifically, money markets have notably rebounded since July 2012, although their weakest point has been that the same levels of activity have not been reached as before the financial crisis and lending terms remain much shorter. A large part of the transactions currently performed in private markets are now being carried out by the ECB, resulting in a «centralisation» and «politicisation» of financial brokerage. It will only be possible to test whether the situation has returned to normal when the ECB starts to play a less significant role as a liquidity provider to financial institutions. 2013 saw the start of a reduction in the TARGET2 debit balances of countries under pressure in the EMU[4], which is a reflection of an improvement in their balance of payments imbalances and a gradual deleveraging of their financial systems. The main monetary policy challenge faced by the ECB in 2014 is to restore these balances and re-establish inter-bank market

[3] An essential and inevitable function of all central banks concerned about the stability of their area of monetary control, but which nevertheless, has drawn scathing criticism from some German economists who are more concerned about protecting German deposits than rescuing the euro. This matter is treated as if the two objectives were distinct, and as if Mario Draghi had played a dirty trick by stating the obvious that the Monetary Union's survival is as important as inflation in the eurozone.

[4] It is also important to highlight the less pronounced negotiated interest-rate spreads (measured by the standard deviation thereof), thanks to a decrease in the risk premiums demanded of counterparties from countries in the periphery of the EMU.

operations; a challenge that is further complicated by the lasting weakness of European economies and the fragility of their banks. This challenge does however make it more feasible for the ECB to assume the role of banking supervisor.

The return to financial integration in the EMU's sovereign bonds market is reflected by the shrinking of risk premiums between countries and of CDS premiums. This decrease has been very pronounced in Spain, with levels falling to around 200bp, which appears to be a new steady state, at least until the fiscal imbalances are substantially corrected and the fiscal discipline mechanisms approved by the European Union gain credibility, also as a result of the Union's institutional reform.

Retail lending markets have also seen moderate upturns in recent months, although Spanish companies (especially SMEs) are still paying spreads on their loans that are over the odds compared to core countries in Europe. The difficulty in this instance is defining which part of the spread is due to financial fragmentation (sovereign risk and financial sector solvency risk) and that should continue to be corrected through banking and fiscal union, and which part is due to where the country is in the economic cycle and the risk faced by companies themselves given their poorer sales and profit forecasts.

In short, there is a common theme running through these first three chapters, leading to a clear conclusion: market integration in the EMU is not functioning as is desirable in an ideal monetary area although, at least in recent months, there are signs that the schism arising from the policy errors made in response to the crisis is beginning to close. This uncertain and changing response spread concerns about the Monetary Union's viability and underlined the problems of asymmetric information in the eurozone. Since July 2012, the ECB has managed to calm financial instability across the region and gradually breathe life back into the wholesale financial markets, partially relieving some of the pinch points that were hindering the transposition of monetary policy in the eurozone. It is likely that the highest levels of financial fragmentation are now behind us, although there is still a long way to go before we can talk about a return to normal and a situation where economic agents in the eurozone are treated equally when accessing capital, irrespective of where they are located. This path depends heavily on the success of the Monetary Union's institutional reform, which is at the heart of this Yearbook and is covered in the whole of the second half of the publication.

4. INSTITUTIONAL REFORM IN THE EUROPEAN MONETARY UNION

The second part of this Yearbook kicks off with a chapter looking at the common monetary policy, which analyses the unorthodox approach taken by all central banks in developed countries to stop the recession from becoming the next great depression. One only has to look at the ECB's balance sheet and the volume and quality of its assets to see that this was also the path it definitively took, albeit it bound by its specific historical limitations and institutional characteristics. Its tradition has played a part because any European central bank will always take a more anti-inflationary stance than its American or Asian counterparts; more subject to rules and less interventionist. Meanwhile, its institutional features have influenced because the ECB continues to be called upon to prove its legitimacy which, along with its complex governance structure, affects its decisions and curbs its creativity and active stance.

The crisis challenged the traditional monetary policy model to the point where extremely strong head winds forced the main central banks to respond in a completely unconventional manner; first to reengage the financial and brokering markets, and secondly, by relaxing monetary policy to such an extent that interest rates fell to zero or even negative figures. The traditional rule book on monetary intervention had to be thrown out to avoid a great depression. All central banks therefore dramatically changed their roles as lender of last resort, charging penalty rates to banks encountering transitory difficulties, becoming the makers of those markets that had collapsed in the face of the sudden shortage of liquidity. The response to the risk of a collapse of the financial system was therefore to inject huge and very aggressive amounts of capital, expanding the number and characteristics of direct recipients of liquidity, the financial markets in which they intervened, lending terms, the quality of collateral required, etc.

Despite the widespread faith in its orthodox approach, the ECB also adopted aggressive, unconventional policies. Firstly, through the sterilised purchase of assets, either covered bonds in May 2009 and October 2011 or subsequently government bonds, corresponding to the public debt of countries in difficulty in 2010 with the start of the Securities Markets Programme (SMP) to bail out Greece. This was then replaced by Outright Monetary Transactions (OMT) in September 2012, involving a programme of financial assistance which, despite not being used, significantly improved stress indicators: the spread of ten-year government bonds and bank CDS, and corporate bond spreads. Secondly, the aggressive use of permanent facilities with monetary criteria: (i) reducing the credit spread to its lowest level from 1.5% to 0.75% in 2013; or (ii) cutting its deposit rate to 0%, and contemplating the possibility of applying negative rates to discourage/penalise the placement of surplus balances with the ECB. Thirdly, performing long-term refinancing operations (LTROs) through one-year Fixed Rate Full Allotment (FRFA), known in Spain as a «free bar», or unlimited fixed-rate refinancing operations over three years and foreign-exchange lending. Fourthly, pushing the interpretation of a decentralised policy to the limit and approving the national central banks' Emergency Liquidity Assistance (ELA) mechanism for solvent or nationally-systemic credit institutions without sufficient valid collateral. Lastly, by substantial relaxing its collateral policy; reducing the credit rating thresholds to beyond those required as a result of the rating agencies' downgrades and involving the ECB assuming a certain degree of credit risk.

The ECB also cut benchmark interest rates in November 2013 for no explicable reason, although this may have been down to the fact that there is not one but a multitude of concomitant factors: sufficiently low inflation forecasts in the eurozone that require stressed countries to implement an internal devaluation process as they move dangerously close to a deflationary scenario; an unequal, uncertain economic recovery concentrated in few countries which is not enough to stimulate job creation; a euro exchange rate that has risen sufficiently to complicate bringing down saving-investment imbalances; a certain willingness by the ECB to take a position ahead of the market curve and the new President to adopt a more «*American*» attitude; and finally, the ongoing concern about financial fragmentation which, whilst dampened down somewhat, remains at worrying levels.

Nevertheless, the ECB has been heavily criticised by some for abandoning the orthodox approach and threatening to move into the forbidden territory of funding governments. The hereto unheard-of situation where some of the most important decisions by the Governing Council have been taken despite a no-vote by the German governor must not be underestimated. Others, meanwhile, are critical because the ECB continues to remain obsessed with inflation, ignoring the fact that its 2% target condemns many countries to a deflationary spiral that hinders internal devaluation and the shoring up of budgets. As the new phase of banking union consolidation unfolds, the ECB will have to exercise prudence and use its imagination to ensure this fundamental objective is compatible with returning monetary policy and financial stability to normal. These are not easy times for central banks, and even less so for an institution such as the ECB, which always strives to be accepted politically and which guards its independence in a changing institutional environment.

In the following chapter, Pilar Lluesma Rodrigo and Ana García Rodríguez review banking regulation harmonisation from two standpoints – the European and the international, which are not always compatible although much effort has been made to tighten up coordination. The financial crisis has thrown up some major legal-economic challenges that the different states have had to face up to in recent years. Members of the G-20 discussed handling the banking crisis at an international level and issued a number of recommendations to the Basel Committee on Banking Supervision (BCBS) that resulted in the December 2010 proposal known as Basel III. It is well known that this regulatory standard recommends more stringent capital requirements and introduces a new international framework for liquidity that will be gradually rolled out until 1 January 2019. Markets are however pre-empting the requirements to apply this framework in full, especially with regard to banks from crisis-hit countries, while national regulators continue to determine the specific definitions of the general criteria and are striving to push back some especially controversial elements, in particular those relating to Liquidity Coverage and Net Stable Funding Ratios.

The main novelty regarding European banking regulation, i.e. approval of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD) and Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR), is a direct result of applying Basel III to European Union regulations. It is noteworthy that the basic concepts regarding the solvency of credit institutions and investment firms have been defined at a regulatory level rather than by way of the Directive, ensuring across-the-board application in Europe.

Both the Regulation and the Directive include almost completely literally the Basel III criteria, although the CRD introduces two new capital cushions for systemically-important firms and systemic risk, which must be set by Member States subsequent to notifying the Commission, the European Systemic Risk Board (ESRB) and the EBA. Member States cannot set higher buffers than those indicated, although there is a certain degree of flexibility to expand them in the event of systemic or macro-prudential risk and in the case of exposures secured by real-estate mortgages. The European Commission can also impose stricter prudential requirements. This discretionary margin for Member States and the Commission has been a highly-controversial matter due to the difficulty of bringing Member States' powers to avoid idiosyncratic crises into line with the need to avoid regulatory arbitration and guaranteeing a *level playing field without national protectionist policies. It is unclear if this has been achieved.*

One area in which EU regulation clarifies and develops the Basel recommendations concerns the remuneration policy of credit institutions. A central theme of the European regulation is the reasonable idea that remuneration must be commensurate to the level of risk and the long-term values and interests of the credit institution. The Directive also contains some significant developments: (i) a clear distinction between the criteria for setting fixed remuneration and variable remuneration. The first should primarily reflect relevant professional experience and organisational responsibility, while the second should reflect sustainable and risk-adjusted performance as well as performance in excess of that required to fulfil the employee's job description; (ii) the prohibition of guaranteed variable remuneration; (iii) a limit by which the variable component cannot exceed 100 % of the fixed component, or 200% if expressly approved by shareholders; and (iv) a condition that up to 100 % of the total variable remuneration shall be subject to *malus* or clawback arrangements. The CRR also regulates the information that credit institutions must publish regarding their remuneration policies and practices to improve transparency, and determines that Member States may require total remuneration of each member of the board or senior management to be disclosed.

Bankers' remuneration has been the subject of academic debate and social outrage. In some instances, it appears that European politicians and legislators have been more sensitive to the latter. The academic debate has centred more around the requirement and challenges of finding an appropriate bonus structure that, without penalising the necessary taking of risks, does not promote excessively short-term strategies, as well as the ways in which conflicts of interests between owners and management or even between owners and other stakeholders can be regulated, particularly in the context of fiscal legislation that encourages indebtedness as a way of creating value for shareholder. The public backlash has been linked to bankers' outright total pay which has been deemed immoral. Academic research links financial stability (the public asset to be protected) and banking crises with the bonus structure, and not salaries received.

Lastly, this chapter covers the relationship between the EBA and the ECB. This relationship is an especially delicate and complex aspect of banking regulation in Europe, above all since the ECB assumed the role of banking supervisor. It is delicate because it constitutes an area of potential conflict between eurozone members and those outside, especially the United Kingdom given its sensitivity to the financial system. It is complex because it is a reflection of the legal and practical difficulties of building a banking union at the heart of a two-speed European Union but which does not renounce developing a single financial market in parallel. Specifically and in order to allow the ECB and EBA to work together, Regulation (EU) No. 1093/2010 establishing a European Banking Authority was enacted. The main novelty is that the ECB shall report to the EBA on banking regulation matters. Although everything has been put in place to avoid conflicts of interest and ensure each institution performs its duties and functions, only time will tell if this is successful.

The political world completely ignored economists when they began to talk about banking union in around 2009, seeing the debate as more a matter for academic thinkers and far from reality. However, as history shows, reality is obstinate and always rules the day. No monetary union has ever lasted without a lender of last resort for the entire union – an area where the same settlement, supervision and regulation procedures apply to all financial institutions. A common currency calls for not only a single monetary policy but also a shared banking and financial policy. This has been a central theme throughout 2013, and is covered in chapter 6 of the Yearbook.

By its very nature, and as laid down in the Maastricht Treaty, the common monetary policy recognises the mutualisation of losses that may be incurred by the central bank as a result of this single policy. However, this consideration is insufficient as the Treaty deliberately overlooks the fact that a common monetary policy has to be accompanied by a common banking policy for it to survive, whereby the mutualisation of bank debt is also necessary. However, if a government cannot print money, it will have to suspend payments and in doing so, or simply as a result of hysterical investors' fears that it may default,[5] exacerbate the government debt-bank debt spiral, forming a perfect storm like the one that swept through Europe.

An external crisis had to hit that triggered investors' aversion to risk and highlighted the unsustainable levels of debt of some euro area countries for Europe to finally confront the Monetary Union's constitutional problem. Thankfully, Europe responded and the advances made have been spectacular since mid-2012, and above all after the publication of the report by the quartet of European presidents[6]. Banking union is now an official doctrine of the European Union; a banking union that assumes three irreversible elements: a common supervisor for all European banks; a shared intervention and, where applicable, banking settlement mechanism; and a common deposit guarantee system for all eurozone banks. In 2013, Europe agreed in the overwhelming majority to establish a banking union within a fixed time frame. All that remains is to discuss how costs will be allocated during the transitional period, which is clearly not a minor matter but is also not a question that could threaten the project's survival.

The Single Supervisory Mechanism (SSM) is the first step towards banking union and transfers the responsibility of performing the supervisory functions traditionally fulfilled by the national supervisory authorities to the European authorities. In short, the ECB will be responsible for overseeing all eurozone banks and will apply the same rules to all of them. That said, small banks will continue to be directly supervised by the National Central Banks (NCBs), except if the ECB decides otherwise. Meanwhile, non-eurozone countries can also voluntary join the SSM.

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[5] See C. Reinhart and K. Rogoff, Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten, IMF Working Paper 13/266, International Monetary Fund, December 2013.

[6] *Van Rompuy, Herman (2012),* Towards a Genuine Economic and Monetary Union.

Concerns around creating an excessively-powerful monetary authority pervaded discussions about a single European supervisor, since they generated justified resistance to putting a disproportionate number of powers in the ECB's hands. In addition to this resistance, criticisms were made regarding a lack of democracy and accountability. Both issues are legitimate and are not resolved in academic literature[7], although it is clear that in the end, the European Union pragmatically adopted the only decision possible: to confer the task of supervision on the ECB. This is because a new Treaty would have had to be drawn up to establish a new European institution and because the ECB is the only institution presently in operation that is technically and professionally capable of assuming this role and bringing together the expertise needed to fulfil its duties with any success. Moreover, the conflict of interest between monetary policy and supervision was resolved by changing the ECB's internal structure and establishing a new Supervisory Board reporting to the Governing Council.

Thus, European regulations confer full powers on the ECB in relation to micro-prudential banking supervision. It will perform these functions directly and independently insofar as the individual supervisory powers of the national authorities are transferred in full to the ECB. There is no double supervision – two rule books for the different European banks depending on their size and their direct supervisor, merely a delegation of supervisory functions for banks that are not significant; a decentralisation of operations where the national authorities become *de facto* operational delegations of the ECB for supervisory purposes. This decentralisation is inevitable given the number of banks in Europe, their unequal distribution from country to country, and their geographical and linguistic spread. It is interesting to note that the transfer of state supervisory functions to the ECB also involves a significant transfer of economic and human resources. The impact on the NCBs will vary considerably due to the different banking structures in each of the Member States and the number of banks that will remain under national supervision. One only has to look at Spain, which will transfer the supervision of 16 of its 314 credit institutions, while Germany for example will only transfer the supervision of 24 of a total of 1,869 institutions.

Macro-prudential powers, however, will not be transferred, which could not be any other way given that macro-prudential supervision involves many more elements of economic policy. NCBs will continue to be responsible for calibrating capital conservation and discretionary counter-cyclical buffers as set forth in Basel III. NCBs will also take any steps they consider necessary to mitigate systemic or macro-prudential risks. That said, the ECB reserves the right to determine the requirements that are at a higher level than those enforced by the national authorities of the Member States, and the more stringent measures to be implemented to mitigate systemic or macro-prudential risks in an idiosyncratic manner in each Member State in coordination with its NCB.

The agreement to establish the SSM sets out that the ECB will conduct a full and systematic evaluation of banks' balance sheets prior to taking over the supervisory role. In

[7] See the excellent piece on how the central banks' doctrine and practice have changed as a result of the financial crisis in IMF (2010)a.

reality, this audit will involve three separate yet complementary processes: an Asset Quality Review (AQR), a Balance Sheet Assessment, and a stress test of the banks' balance sheets. In November, the ECB announced details of the methodology it will follow, although the specific technical parameters of this audit have not yet been made public at the date of this publication, which is causing unnecessary tension because it is clear that all kinds of pressure is being applied by the different governments and national banking authorities to improve the snapshot of their banks. It also appears that the ECB is once again courting the absurd idea of giving government debt holdings a haircut. Nevertheless, the rules of play cannot deviate much from international conventions and the recommendations of the Financial Stability Forum. We believe that the ECB audit will end up being the positive shock Europe needs to leave the banking crisis in its wake.

This will be especially true if the so-called fiscal backstop, designed to cover any possible capital requirements, is effective. This was one of the most talked about points in 2013 because it brought two solid but opposing lines of reasoning head to head: the logic that those nations with healthy banking systems or sufficient domestic savings to resolve any internal problems arising may refuse to assume the banking problems of other countries; and the view that countries suffering banking crises or with weak fiscal positions that are insufficient to clean up their banking systems may argue that their crises were the result not only of their own domestic errors but also of institutional faults in the original design of the Monetary Union.

In the true spirit of Europe, the solution to this fundamental dilemma does not satisfy anybody, is full of ambiguities and risks, allocates the costs of transition to all members, and offers a last-resort insurance in the event of a severe national crisis at a price that is, on the face of it, expensive but negotiable. It is far removed from a technically «clean» solution – a clear and definitive political agreement – but as always in the building of Europe, creates a procedure to respond to any possible problems that the prevailing absence of clarity could pose if the markets question Europe's commitment. In this summary and as can be read in detail in the corresponding chapter, once the audit of European banks is completed and their capital requirements determined by the ECB, this solution will entail governments having to cover any possible deficits with state and private funds and, if this is not achievable, Member States will agree to negotiate distributing the cost among all taxpayers in the euro area following the criteria for activating the European Stability Mechanism (ESM). For some, this agreement opens up the possibility of speculation and a further crisis, while for others it is an ignominious path towards the mutualisation of bank debt. For the majority of analysts, it is the only politically-viable solution that could work insofar as investors are not particularly prepared to directly sign up to mutualisation. For me, it is also a practical and working solution, albeit too slow and bureaucratic, that mitigates the risk of condemning ailing countries to a prolonged period of low growth, above all if they delay in adjusting their internal imbalances.

The ECB puts its credibility on the table in this process, while the euro area threatens the possibility of a sustained recovery of growth. It is precisely for this reason that the monetary authority should be prepared to supply as much liquidity as necessary to those banks that are deemed to be viable, and draw up very clear resolution rules for those that are not. European governments and the eurozone itself must be prepared, have sufficient fiscal capacity to deal with any potential recapitalisations, and accept any possible intra-European mergers that may be called for. Equally, the European Union must establish clear bail-in rules for the different public and private stakeholders. It is specifically for this reason that it was so urgent to reach an agreement on the bank resolution mechanism that was finally approved in the EU Summit.

The Single Resolution Mechanism (SRM) is the necessary second step towards so-called Banking Union. Finally approved in December 2013, it must ensure that if a bank included in the SSM encounters serious difficulties, its resolution (a term replacing the traditionally used «liquidation» in Spanish legislation) can be managed under the same conditions for all and in an efficient manner that incurs the minimum cost to taxpayers. Obviously, in addition to the institutional and organisational issues that are always a challenge in Europe, the key question is how to design a system that guarantees equal conditions irrespective of the sovereign credit rating of the country in which the bank is based. This question forces us to contemplate mutualisation of bank debt among taxpayers in the eurozone, agree on explicit allocation rules among the various countries, and establish an unlimited joint-and-several guarantee. In short, a single fiscal backstop is needed: a guarantor of last resort to cover the possible cost of bank liquidations, which must be a European authority with access to taxpayers in all the Member States, without exception or limitation. It is therefore not surprising that discussions about this issue lasted throughout most of 2013, resulting in a last-minute deal that still has loose ends and is far from being final.

The European Union had been working on a specific European regime that set forth clear and binding regulations for all Member States concerning the circumstances under which any state bail-outs of troubled banks may be performed, under what conditions and using what methods. The Commission put forward a proposal, which was accepted, that this regime comprise several components: a Single Bank Resolution Directive (SBRD), a review of the rules regulating state bail-outs in the event of a banking crisis, and an EU Regulation establishing a Single Bank Resolution Mechanism (BRM), a European Resolution Authority (ERA) and a Single Bank Resolution Fund (SBRF).

The SBRD was covered in detail in the previous study. It involved accepting the burden-sharing principle through which private creditors and eventually uninsured bank depositors would be called on to contribute to the cost of recapitalisation or eventual liquidation, as occurred in Spain with the Memorandum of Understanding (MoU). However, the Directive called for a network of national resolution authorities and funds: an approach under which a line had to be drawn, although valuable time was still lost. Finally, Europe understood that the SRM must be managed at the same level as the recently established supervisory function, not only because discrepancies could arise between the single supervisor and national authorities, but also because market expectations regarding the capacity of the different Member States to assume the liquidation of their banks would perpetuate the vicious cycle between bank and sovereign risk and fragmentation of the eurozone.

The timetable planned by the Commission has not been adhered to. Nonetheless, approval of an agreement of principles in a Council meeting on 19 December 2013 suggests that the Regulation could still come into force in 2015 along with the SBRD, followed a few months later by the SSM. Until then, bank liquidations will continue to be managed under prevailing national regimes which, nonetheless, are required to converge due to amendments to the rules on state bail-outs of failing financial institutions and the possibility of direct recapitalisation of banks through the ESM. This new scheme, in force since 1 August, requires a bank restructuring or resolution plan (as per the Spanish model) to be approved and losses assumed by shareholders and junior creditors before bail-outs can be received.

The proposed regulation resolution drawn up by the Commission was highly ambitious and focuses on centralising powers within the Commission rather than the Council, although it evidently lacked European ambition in other crucial areas. Firstly, it set forth a very strict cost allocation procedure that would probably be impossible to implement in a crisis. Next, the Commission was too slow in its attempt to assure some countries that bank debt mutualisation would always be an extraordinary measure. Accommodating these countries in this way (which nevertheless was useless as Germany rejected both the mutualisation and centralising decision-making powers in the Commission) meant that an opportunity was lost to gain legitimacy in those countries in crisis, credibility among investors, and political visibility. Lastly, this proposal did not provide an answer to Germany's main argument that there were no solid grounds for establishing an SRM, and that a new European Treaty would be required. This is an issue that will have to be dealt with sooner or later.

After intense negotiations and following the German elections that once again represented another slowdown in the decision-making process in Europe, the Council agreed in December to establish a Single Resolution Board (SRB) and Single Bank Resolution Fund (SBRF), and approved a draft of the SRM assuming the commitment to reach an inter-governmental agreement on how the Fund would work, and with the Parliament before 1 March 2014. The agreement also covers the basic design of the fiscal backstop of the SBRF. The SRM will come into force on 1 January 2015, In light of the Parliament's opposition and even the ECB's lukewarm reception according to its president, it is likely (and advisable) that the SRM regulation will be significantly amended before it is finally approved. Changes need to be made to streamline how it works; reduce the control major nations have reserved over its use; strengthen the Resolution Board's independence from the respective governments, the Council and the Commission; boost the size of the Fund; and improve its application alongside the ESM. Only once these issues have been resolved can the foundations for bringing the crisis in Europe to a close be laid, the vicious circle of the banking crisis hindering Europe's recovery broken, and an effective banking union created.

The European Deposit Insurance Fund (DIF) will form the third and final milestone on the road to Banking Union. Nevertheless, this is a necessary and unavoidable building block in the final design. The European project is currently moving at half steam from the national deposit insurance schemes to a Europe-wide system. To this end, it is necessary to unify the funding method and cover, as well as reach a consensus on the treatment of the different levels of capitalisation and solvency which the various national insurance schemes will use to finally coordinate and combine their activities. This issue still unsettles many European capitals and has been delayed until the single European resolution and supervision mechanisms are in place. It is perhaps inevitable that a tacit decision will be taken, although Europe needs to be more decisive because, irrespective of the rate at which change is made and the allocation of transition costs, the final design is not negotiable if we want to avoid its inexistence raising doubts about the entire edifice of the European Monetary Union.

Two contrasting positions on economic and monetary union prevail in discussions about the building of Europe[8]. On the one hand, proponents of a union with the wide-ranging mutualisation of the fiscal obligations of current Member States (Fiscal Union), and on the other, those who defend more or less explicitly an unwinding of the EMU towards a group of national states with minimum shared fiscal contingencies and a much more restrictive monetary union that at present. In other words, proposals range from a system of confederal or federal states to another based on national states with coordinated but individual fiscal and monetary policies[9].

The proposal put forward in this publication steers towards closer coordination and integration of common policies; bolstering fiscal mutualisation by Member States to ensure the Monetary Union is able to function. This position is in line with the two editions published previously. Although there could be many degrees of fiscal integration, it appears to be necessary that this integration be restricted to the eurozone and consistent with the Monetary Union construct.

Against a backdrop of never-ending macroeconomic discussions around rules and discretionality, fiscal rules become increasingly important to raising the credibility of fiscal policy outside the political sphere. Over time, these rules have become ever more complex and therefore, less predictable and more difficult to interpret. This is also true in the European Union. This move towards «structural» rules that are complex and can be interpreted differently only leads to a widening of the margin of political discretionality and an erosion of European authority because it sparks discriminatory tensions and accusations of unfair treatment.

The Stability and Growth Pact (SGP) was approved in 1997. Despite its apparent robustness, the European Union has lacked binding fiscal rules – effective budgetary restrictions. This can be demonstrated by the fact that at the end of 2013, only two countries had never been subject to EDPs: Estonia and Sweden, and no countries exceeding the deficit threshold have been penalised. The Commission itself has acknowledged that «the SGP was insufficiently observed by the Member States and lacked robust mechanisms to ensure sustainable public finances»[10].

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[8] See Pisani-Ferry, Vihriala and Wolff, 2013.

[9] An extreme example of this position that could be described as *«reformed»* is that of Professor Simm who does not tire of repeating that mutualisation of European debt will only be possible when there is a true European parliament, a common legal system and European armed forces. As this is evidently not feasible in the near term, he puts forward that the only solution for countries in southern Europe is for their debt to be given a haircut and for the euro to be temporarily withdrawn. What he does not specify is what he means by temporarily.

[10] European Commission, 2012: 4.

The latest figure for the public deficit in the eurozone (combined figure for 2012) was 3.7%, with public debt at 92.6% of GDP; both of which exceed the limit established in the SGP. The European Commission's latest estimates for 2013 show that progress made toward fiscal consolidation has driven down the deficit to 3.1%, although not enough to avoid public debt continuing to climb to 95.5%. These forecasts suggest that the debt will peak in 2014 (95.9%). The aggregated data, however, hide important differences between countries, which can be split into four major groups in 2013: (i) Member States that reduce their public deficits and fulfil fiscal rules: Austria and Belgium; (ii) Member States that despite cutting their deficits do not comply with fiscal rules: France, Ireland, Holland, Portugal, Slovakia and Spain (from 10.6% in 2012 to 6.8% in 2013, excluding bank recapitalisation costs); (iii) Member States that are in a position to increase their public deficit because they are in compliance with fiscal rules and can therefore implement expansionary policies: Estonia, Finland, Germany and Luxembourg; and (iv) Member States that increase their public deficit and also do not fulfil fiscal rules, raising concerns that the Commission will instigate an Excessive Deficit Procedure (EDP): Cyprus, Greece, Italy, Malta and Slovenia.

Only Germany would see a reduction in public debt as a percentage of GDP in 2013. It is not surprising that the countries experiencing funding difficulties in the last few years have debts that are well over the eurozone average (87%): Greece (176%), Italy (133%), Portugal (127%) and Ireland (124%). Spain's public debt moved from 86% in 2012 to 94.8% in 2013.

In response to the SGP's lack of impact in this crisis, the European Commission proposed important reforms regarding fiscal discipline in Europe. These reforms have been tested and rolled out over recent months, and appear to lay down a battery of latest-generation fiscal rules and a new supervisory framework. Legislative measures have been approved to reinforce both the preventive and corrective arms of the Stability and Growth Pact. The first of these is the so-called Six Pack which took effect on 13 December 2011; the second is the Treaty on Stability, Coordination and Governance (TSCG), applicable as from 1 January 2013; and the third is the Two Pack, coming into force as recently as 30 May 2013. The Union cannot therefore be accused of resting on its laurels. Another matter is whether it has hit the mark in its diagnosis and solution.

The Six Pack is applicable to the 27 EU Member States without exception, establishing some specific rules for eurozone states, especially regarding financial sanctions. Two of the most outstanding of these are: (i) introduction of the debt criterion, so that an EDP may also be launched on the basis of a debt ratio above 60% of GDP which would not diminish towards the Treaty reference value at a satisfactory pace; and (ii) introduction of the reverse qualified majority voting (RQMV), which in practice confers decision-making powers on the Commission, except where a qualified majority of Member States in the Council submit a no-vote. In this sense, the Six Pack moves towards the federalisation of fiscal policy and hinders national government vetoes.

In March 2012, the Heads of State of all EU Member States, except the United Kingdom and the Czech Republic, signed the TSCG in the Monetary and Economic Union (known as the «Stability Treaty»), which included the Fiscal Compact that finally entered into force on 1 January 2013. This is an ambitious agreement on the foundations for economic-fiscal governance in the euro area, and enables the euro area, Euro summits and the Eurogroup formal legal, institutional standing in their own right. Previously, these entities had only met informally. Signatory Member States agreed to incorporate a budgetary rule into national law, which requires public administrations to reach a budget equilibrium or surplus; in practice, imposing a structural deficit limit of 0.5% of GDP. The specific national rules must also include an automatic corrective mechanism in case this limit is breached. Spain's parliament voted overwhelmingly to include the European stability rule into its Constitution in the summer of 2012, but also established an excessively long period over which to fulfil the requirement up to 2020. The Fiscal Compact also requires public debt issuance plans to be reported to the Commission and the Council before they are implemented, which should help coordinate the funding of the various countries' sovereign debt and fiscal and monetary policy in the eurozone.

On 20 February 2013, the European Council, the European Parliament and the European Commission reached a consensus on two EU Regulations (hence the popular term «Two Pack»), which came into force on 30 May 2013. The first sets forth a common budgetary timeline by which eurozone Member States must publish their draft budgets of 30 April. The European Commission will assess these budget plans and could issue an adverse opinion in the case of «severe non-compliance». Members States will not be required to issue new budget plans as a result of an adverse opinion, although it is expected that market discipline and the process of *Name and Shame will come into play*. The second Regulation sets out that the Commission can publicly decide to put a eurozone Member State under reinforced surveillance if this country is experiencing or threatened by serious financial difficulties that could have adverse effects on the other Member States. This imposition would be automatic should a Member State receive a bail-out.

In its April 2013 bulletin, the ECB indicated that the Two Pack could have been more exacting. Specifically, it stated that: «it would have been beneficial to strengthen some of the provisions, for example by giving the EU Council at least the possibility to make an explicit recommendation for a euro area Member State to seek financial assistance». The implications of such authorisation cannot be ignored: a Member State whose government resists requesting a bail-out but receives a public and formal recommendation from the Council to do so would be under the obligation to fulfil this requirement or risk an unprecedented debt crisis. This clause, which is desirable in the context of a surefooted move towards Fiscal Union, would have meant *de facto* that the Council would be responsible for deciding when a country should be party to a bail-out. This decision would involve giving up a considerable amount of sovereign power, and would only be justified if the country's public and private debt had previously been subject to a transparent process of mutualisation. This is because no powers can or must be transferred without being taken into due account. The Two Pack's success depends on how and to what extent the European Commission makes use of its new powers to recommend bail-outs and sanction Member States, and the support it may receive from the Council.

With respect to the sustainability of public debt, the Maastricht Treaty determines that all responsibility for economic stabilisation falls on the shoulders of those setting national budgets, under the requirements of the SGP. The central idea, which is now easy to criticise for being simplistic and mistaken, was basically not that far removed from American federalist standpoints which suggested very low levels of new debt for Member States. However, many countries did not respect the fiscal rules either literally or in spirit, and others saw this fiscal buffer as insufficient for automatic stabilisers to be effective and given the irresponsibility of some governments who increased their public spending in a disorderly and naïve manner. This scenario of high rates of public debt that grew alarmingly was not envisaged in the original design of the Maastricht Treaty and puts Member States in a far more vulnerable cyclical position, forcing them to consider how they can overcome the weaknesses endangering the stability of their domestic budgets. In no uncertain terms, this raises questions about the size of the European Monetary Union's budget and its stabilisation functions, as covered in chapter 7.

The euro crisis has highlighted basic deficiencies in the euro area's institutional design. In simple terms, it can be said that the Greek case is a symptom of weak fiscal rules in the Monetary Union, while Ireland's circumstances show that monetary union without banking union is inherently unstable. The Portuguese experience is a little more complicated since this country did not act especially irresponsibly with regard to its budget, and also did not experience an asset bubble that toppled a significant part of its banking system. Its problems basically centred around its completely insufficient growth rate since the euro came into circulation. The reasons for this relate to a competitiveness problem. In a fully-functioning monetary union in which resources can be freely moved around, these imbalances are redressed naturally, although at a high social cost, through mass emigration. However, this lack of structural labour mobility in the Monetary Union combined with an absence of capital transfers aggravated by financial fragmentation resulted in the perfect recipe for unequal, potentially-destabilising growth affecting the heart of the eurozone.

These conditions meant that convergence of the different countries' economic cycles was not assured, and instead required effective economic policy measures; particularly a policy of structural reforms in the euro area to drive up and maintain the economies' competitiveness. This was a well-known issue and was at the core of the Broad Economic Policy Guidelines (BEPG). What this crisis has shown, however, is that the Monetary Union cannot simply rely on generic best practice recommendations, but needs a more robust framework for defining and supervising competitiveness policies. The new Macroeconomic Imbalance Procedure (MIP) aims to respond to this necessity.

Taken as a whole, the eurozone's balance of payment figures appear to be reassuring, in sharp contrast to those of the US. This is especially true given that since 2009, the current account balance has been positive, rising consistently to 2.3% of GDP in 2013. Nevertheless, these global figures conceal very profound differences between countries. On the one hand, the peripheral economies have suffered high and persistent current account deficits, which rose the most during the period prior to the worsening of the crisis in 2008 and that would never have been possible without the nominal anchor of the euro. On the other hand, core Member States enjoyed healthy surpluses. This two-speed Europe makes managing the Monetary Union a major challenge because adjustments to their balances of trade must be achieved through domestic policies that restore competitiveness – measures that have become known as internal devaluation, i.e. reductions in production cost per unit through wage cuts and reductions in profits that boost the competitiveness of exports and raise the cost of imports, thereby improving the actual exchange rate. These are slow and painful measures that, in the context of very low inflation, almost intrinsically involve cutting nominal pay.

From a purely theoretical perspective, the current account deficits among Member States should be irrelevant in a true monetary union. However, eurozone Member States must be prepared to accept and even encourage significant transfers of manufacturing resources, labour and capital from one country to another to allow this circumstance to be economically and politically irrelevant. It is plain to see that this is not the case in the EMU. In these conditions, current account differences are not only significant but also economically and politically intolerable since they give rise to very high differences in unemployment rates – from 6% in Germany to 27% in Greece, and problems for treasuries, which continue to be national, to obtain finance. In other words, current account deficits are interpreted by the market as an indication of the solvency of the various treasuries and result in a sovereign debt crisis. Sovereign debt crises that represent crises of confidence about a Member State's continuation within the Union.

The problems of plugging trade deficits and restoring the balance of payments finally prompted eurozone countries to construct economic discipline mechanisms in the Treaty on Stability, Coordination and Governance (TSCG). For this reason, a MIP was drawn up which, like budget supervision, consists of a combination of preventive and corrective measures, as described in detail in chapter 8 of this Yearbook. The procedure is designed to prevent and correct macroeconomic risk scenarios, such as elevated current account deficits, unsustainable trade debt, excessive joblessness or real-estate or financial-asset bubbles. It supplements market discipline, but also involves a complex institutional process that is completely unheard of in consolidated federal states; meaning that the euro area must be recognised as a rara avis, a strange institutional invention that calls for new rules. It can and must be critical of itself, acknowledging that it aims to square the circle – balanced growth among Member States, as a desirable objective *per se* but also as a result of a reluctance to establish a true Transfer Union. An undeclared goal of the MIP is also to replace automatic transfers with ex-ante rules that avoid or minimise them.

Since its launch in 2011, the experience of using the MIP has been intense and controversial, serving to raise awareness of the unsupportable internal imbalances in the euro area. In November 2013, the Commission published the 2014 Alert Mechanism Report underlining that EU economies are making headway in redressing their internal and external imbalances. It also considers it necessary to highlight excessively high rates of growth of internal credit, persistent surpluses and deficits, loss of competitiveness, and the accumulation of public and private debt. It also underlines that considerable progress is being made as a result of some structural reforms and market pressure.

This same report sees Spain continuing to experience an excessive macroeconomic imbalance, particularly due to the high levels of public and private debt, which could raise doubts about financial stability. The Commission indicates in its assessment that the national authorities must continue to intervene despite the swathing cuts, which have avoided the need to trigger the corrective arm of the MIP, because of the challenges linked to rising sovereign debt and exorbitant levels of unemployment. The Commission is concerned by what it perceives to be reform fatigue and the insufficient imposition of fiscal discipline on the public administrations.

One of the most striking features of the 2014 Alert Mechanism Report is, however, that the European Commission has included Germany among those nations with an imbalance. In particular, it believes that Germany's surplus is excessive and accuses it of altering the situation of the other eurozone countries. It recommends that this country encourage a rise in private spending and, in general, «strengthen domestic sources of potential growth»[11]. Although the Commission agrees with the International Monetary Fund and academic opinion on the whole, it is still at the very least surprising that a country is questioned for enjoying too much success. Can anyone imagine the Federal Reserve or the US Secretary of the Treasury accusing California of being too competitive and calling on it to curb its exports, consume more and raise the minimum wage? I am not convinced that the best way of creating an effective monetary union is by making it less internationally competitive to avoid the appearance of internal imbalances. I argue that the cost of having «more Europe» cannot be that Europe takes an increasingly minor role on the international stage. This is because the eurozone problem is not due to the relative competitiveness of Germany, Italy, France or Spain, but is a consequence of it becoming less competitive with emerging economies.

In the area of structural reforms, the Member States of the eurozone signed up under the TSCG to jointly coordinate any economic reforms proposed for implementation at a national level, in order to establish best practice criteria and act in a way that maximises the cyclical impact thereof across the region. By taking a highly important decision on the need for closer economic coordination at the heart of the Monetary Union, the Council recognised that responsibility for the overarching economic policy strategy of the euro area lies with the Eurogroup. These supervisory, budgetary and control powers mean that the Eurogroup is a central instrument of the euro area's economic policy. It is therefore unsurprising that it is seen by the public as the seed of economic governance of the euro; a type of governing committee of a future Eurozone Ministry of Economy and Finance.

I have tried to make it clear from the start that the European Monetary Union is, and has always been, a political project. It must also be obvious that the European crisis is a political crisis in the sense that it can only be overcome by resolving the problems of and completing the original design of the euro area's institutional design. Up to this point, we have discussed economic, fiscal, banking and monetary union, but now we must turn our attention to political union. Two external experts have therefore been drafted in to provide their own complementary views on the legal and political implications of economic integration in the eurozone – implications for the future of the Monetary Union and the European Union.

In her study, Marie-José Garot looks at the legal and institutional implications of banking union and analyses how the European Union has redressed this «existential» cri-

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[11] European Commission, 2013a: 14.

sis affecting the euro, taking into account the legal and political limitations that have obviously shaped the answers given. She turns first to the solutions found to stabilise the euro area and then those concerning economic governance. She subsequently examines the new distribution of power and roles in the EU institutions, finally moving on to discuss the extent to which these solutions have been able to affect what is called the «Community method». The reader's sensation is a mix of wonder at the imagination and creativity shown by European politicians in dealing with the unexpected circumstances, and astonishment at the inflexibility shown at an institutional level and the burden of national interests and inertia.

Professor Garot very thoroughly reviews the EU's legal foundations, the questions raised by its citizens, and the doctrine of the European courts, which enabled the European Union to react to the economic challenges thrown up by the euro crisis. These legal foundations also changed as all facets of the crisis began to be understood and it was no longer considered to be an exceptional situation in a few countries but an institutional problem of the Monetary Union. This conceptual shift had important legal implications as temporary and extraordinary procedures such as the European Financial Stability Facility were no longer valid, and it was necessary to back up the new arrangements through new laws, hence the reform of the Treaty on the Functioning of the European Union (TFEU) through the inclusion of a third section of Article 136 and the Treaty on Stability, Coordination and Governance (TSCG), giving the European Stability Mechanism legal character. The reasons explaining the adoption of the TECG are both political and legal, and in this instance, more political than legal since it does not add anything substantial to the Six Pack and Two Pack. Politics were the primary driving force behind the Treaty because it allowed Chancellor Merkel to sell in Germany «certain things that she knows need to be done but that she is not able to sell to her own political public opinion otherwise»[12], and because the United Kingdom made it impossible to amend the Treaty on European Union. However, to a certain extent: «the Union shows signs of weakness when it has to rely on the constitutions of Member States to impose its rules»[13].

On assessing the various instruments introduced to deal with the euro crisis and shore up the Economic and Monetary Union, it seems to be evident that the answers have had to be found outside the boundaries of the European Union itself and beyond EU law. This is an understandable posture given the reasons presented in the study, although it also poses risks that could affect the very future of the European integration project. Although these instruments have different legal bases, both under and not under the Treaty on European Union, they share a common trait: the European Council's pre-eminence – an intergovernmental institution par excellence.

This raised profile comes at a detriment to the European Commission – a supranational institution of the highest order, and the European Parliament. While it is true that

[12] See Anna Hyvärinen, p 8 in Anna Kocharov, «Another Legal Monster? An EUI debate on the Fiscal Compact Treaty», EUI Working Papers, Law 2012/09.

[13] Víctor Ferreres Comella, «The euro crisis and the golden rule: constitutional problems», Actualidad Jurídica Uría y Menéndez, extraordinary issue, 2012, p 100.

these new instruments have given the European Commission the task of controlling national budgets and steering national policies, even of proposing sanctions for excessive deficits, it has lost some of its power to drive forward the European project. In conclusion, the euro crisis has resulted in a redefinition of the responsibilities and powers of the various European institutions, bringing into question the evolution of the aforementioned Community method.

The Community method appears to become lost not only due to the use of the European institutions but also because of the choice of instruments deployed. Two of these are international pacts in the strictest sense, to which the *Euro Plus Pact* can also be added. In other words, the EMU has gained a foothold outside the EU, choosing to move in the opposite direction to some policies such as foreign policy and migration, which have become the sole responsibility of the Member States as they are shared across the European Union. This strategy is risky because first, an instrument signed by only some Member States cannot rely on the precedence principle and the direct effect of European Union law; and second, since the outcome is to split EU Member States into three groups: those that are in, those that want to be in, and those that do not want to be in the eurozone; with the subsequent risk of a break-up of the Union. I am unsure how this risk can be avoided given the fact that the crisis has caused a fundamental fracture in the Union because the euro requires a new level of political and economic integration. However, for Professor Garot, a less risky option would have been to continue the European integration process through binding cooperation agreements such as those defined in the EU Treaties.

This section concludes with an affirmation that there are several political-legal formulae for establishing a true fiscal union and thus a political union, depending on the level of economic federalism that is pursued. In any event, «it seems obvious that an amendment to the Treaty is needed given the current state of the Economic and Monetary Union, to integrate the provisions adopted over the last two years. Otherwise, we will be discussing the break-up of Europe rather than its integration».

Torreblanca and Piquer adopt a very different approach: a political approach that they do not hide from the off. According to them, the euro has managed to survive collapse, and a road map has been designed that will pave the way for full monetary union through the economic, fiscal and financial components needed to save the euro and the European project. The problem in their opinion is that this rescue effort has left in its wake a considerably delicate situation. From an institutional angle, we have seen a necessary realignment of powers regarding the European Council and the Eurogroup, but we have also witnessed the ECB's entrance onto the stage, playing a key part in the process to the detriment of the European Commission and Parliament. This merely exacerbates the lack of democracy in the EMU. From a political standpoint, the traditional balances have given way to a Germany-centric EU, with this country playing the role of a diffident hegemony, and a periphery that is politically and economically prostrate. And on top of that, there has been a new and powerful wave of euro-scepticism among citizens and profound differences in opinion and perception among the citizens of one country and another.

They do have a case on the one hand, but I believe they have also overlooked the fact that the lamented European Constitution has not been the victim of national egoisms unearthed by the euro crisis, but of Europe's inability to maintain its technological leadership and human capital, the lack of growing competitiveness, and the end of the European-Western exceptionalism that has led to globalisation and the democratisation of economic growth around the world.

Our commentators seem to agree that the trail of rules, institutions and mechanisms left behind by the euro crisis has had a very notable effect on the formal and material nature of the EU, especially of the eurozone. All EU institutions have felt this change. The European Commission has substantially increased its powers to supervise and sanction Member States, although this increase has not, however, bolstered its executive function compared to that of the Council. The European Council, and the Eurogroup in particular, have been strengthened by the crisis, becoming the true centres of power and decision-making in the euro area. This is precisely because of the Council's political legitimacy due to the seats held by democratically-elected governments on the Council. The Commission has thus seen its powers as a delegate increase, but not as a principal agent. And as a delegate its task in conjunction with the European Parliament has been to launch and enact in law the initiatives approved by the European Council.

The European Parliament meanwhile – a new player that does not always receive sufficient recognition – has started to exert its powers to make joint decisions through a prodigious amount of legislative activity, although it has not played a star role either in managing the crisis or in terms of calling the other European institutions to account. It has also not become a tool for bringing democratic legitimacy to the exceptional measures rolled out by Member States. Since a large part of the crisis has been managed through inter-governmental channels, not under the Treaties, this task of demanding accountability has, where applicable, remained in the hands of the national parliaments. The European Parliament has therefore lingered in some form of no man's land: striving to strengthen its position relative to the Commission. It has not clearly understood that the Member States (and to a large extent their citizens) have not wanted to grant it the role of the protector of EU democracy. It therefore operates under the contradiction that it could enjoy its heightened powers at the same time as becoming increasingly marginalised when bringing legitimacy to the exceptional measures adopted by European institutions.

What may be more questionable is the commentators' assessment of the ECB, which they argue has become one of the centres of power and focus during the crisis because it is a technocratic institution that is designed to be anonymous. The ECB has been a decisive tool in avoiding the eurozone's collapse, and has emerged as a true federal institution of the EU thanks to its ability to make decisions despite the divisions between Member States. It is the place where the EU's overarching interests have taken priority over national interests.

New players with veto powers, such as the constitutional courts or the national parliaments, should also be mentioned alongside these realignments. The active role of these new players has altered, and I would even venture to say slowed, the normal decision-making process in the EU. The clearest, but by no means only, example of this is the case of the Federal Constitutional Court of Germany.

Torreblanca and Piquer believe that it would be necessary to close four fissures in Europe in order to win public support: (i) the divide between the elite and citizens; (ii) the split between North and South, or the core and periphery; (iii) the gap between eurozone Member States and those that are outside or do not wish to be a part of it; and (iv) the confrontation between democracy and efficiency.

They conclude, in a political interpretation that economists do not always fully appreciate, that: «the greatest challenge today does not lie in finding appropriate technical solutions, but in gaining the public support needed to implement these reforms». On this basis, the Monetary Union has two possible choices. On the one hand, it could opt to bolster the current model of a «union of rules», or it could become a «union of politics», i.e. introduce a political system that as well as having oversight rules and mechanisms also has economic policy rules at its disposal, as Member States presently have. It goes without saying which is its preference. I do, however, consider that this is a slightly more complex issue. What I hope this book makes very clear is that a union of rules in a strict sense is not sustainable. The key question is to define and agree on what exactly these policies that need to be implemented at a federal level in Europe are[14]. This is the real debate, and one that will occupy Europe's minds in years to come. We hope that by illustrating this debate, this Yearbook will help to improve one's understanding of the various standpoints and their consequences, and put forward solid and economically-coherent arguments for the necessary redefinition of the European Monetary Union.

5. BY WAY OF CONCLUSION: TEN LESSONS FOR REDEFINING THE EUROPEAN MONETARY UNION

The two previous publications ended with ten learning points from the crisis, which appears to be a good approach to adopt here too, although given the nature of this Yearbook, an effort has been made to ensure the reader does not focus too much on these. Again, I would like to reiterate that this is because the aim here is not only to put forward solutions to the problems but also explain the impacts of the solutions that are being weighed up in the European debate. We shall at least try:

One, the euro is a commonly used currency in international trade, and the second most important currency used to accumulate international reserves. It has become an inevitable anchor currency, and has continued to be used to the same extent despite the crisis in Europe. This suggests that confidence in the euro has not been hit, except at specific moments, but rather that a crisis of confidence has affected some assets denominated in euros. Nonetheless, the euro has not dethroned the dollar and will not do so in the near term, because this will depend on factors that are more geostrategic than economic, while there is fundamental political uncertainty about the future of the euro area

[14] The authors identify the need to have a European Central Bank «with political objectives», something that the vast majority of economists cannot stomach but also that will never occur if the Union continues to revolve around Germany.

as a «state» with its own policies, including a defence and security policy. It is therefore prudent to be realistic about the euro's possibilities as an international currency.

Two, financial fragmentation in the eurozone has diminished but not disappeared. In particular, the interbank market is still malfunctioning and is excessively reliant on the ECB guarantee and its role in distributing liquidity within the euro area. Savings continue to remain static in the EMU, and are driven purely by the search for greater returns. Reinstating cross-border interbank lending is an immediate and urgent concern. The audit of the balance sheets of Europe's bank prior to the ECB assuming the role of supervisor should be a determining factor in this regard.

Three, eurozone investors' portfolios continue to have an excessive domestic component to be able to talk with any authority about an integrated financial market. This bias is a result of both the information received by investors and regulation, and above all the perception that very different fiscal backstops are in place in the various Member States, which means that the location of assets is important. Europe's banking map also needs to be reconfigured. Governments and National Central Banks must be prepared to accept, and the ECB willing to demand and encourage, transnational mergers of financial institutions.

Four, fundamental weaknesses in the functioning of the transmission mechanisms of monetary policy in Europe remain, which will continue to complicate the ECB's task; all the more so when it has to start withdrawing liquidity and reversing the extraordinary measures. We continue to lack a European tool that can be used to standardise monetary policy in Europe – an issue that has been put on hold but will have to be picked up again with some haste. This will involve reconsidering the question about a European Treasury.

Five, the ECB is putting its credibility at stake and that of the entire Monetary Union due to its three-pronged strategy of reviewing bank assets, evaluating their balance sheets and performing stress tests. The specific methodologies and criteria involved in this process must be announced as soon as possible, and it will be necessary to avoid protecting the «national champions» and taking a masochistic approach that stigmatises the fortunes of sovereign debt. If Europeans formally accept a haircut, the possibilities of one being applied rise exponentially along with the cost to taxpayers.

Six, the Single Resolution Mechanism must be approved once the audit has been conducted and the potential recapitalisation requirements of European banks identified. Any other alternative opens the door to a heightening of financial tensions in the euro area and a new vicious circle between a banking crisis and sovereign debt. Moreover, the Resolution Mechanism approved at the European Council summit in December is insufficient. It must be significantly modified to simplify and streamline how it works, reduce the control major nations have reserved over its use, strengthen the Resolution Board's independence, boost the size of the Fund, and improve its application alongside the single fiscal backstop, the ESM.

Seven, the European Monetary Union's fiscal discipline framework has been significantly shored up in recent years in a move towards federalisation. The Commission has been granted powers to supervise and sanction, and the Eurogroup has become the authentic governor of fiscal affairs associated with the euro. The jury is still out on how it will employ these powers and what impact its capacity to impose recommendations will have in practice, even though these continue to be non-binding. The reverse qualified majority vote mechanism is a potentially very powerful tool. Nonetheless, the governments of Member States continue to resist handing over their fiscal sovereignty to a supranational body, and public debt mutualisation remains taboo, even though it has been adopted *de facto* with the launch of the ESM. However, it is still seen as an extraordinary procedure, with a limited budget, to be applied as a last resort, and only after national governments have explored all avenues to introduce policies to cut their budgets and indebtedness. The idea of a derogation regime that penalises infractor Member States has gained support, although it is difficult to imagine how it could be sustained in a monetary union without a guarantor of last resort. It will be necessary to call for a Transfer Union for some years to come, while it should be mentioned that a fiscal union requires three elements: straight-forward rules that are applied automatically, the ability to ensure such automatic adjustments are made, and a federal stabilisation budget that reduces the social cost of these adjustments.

Eight, in a fully-functioning monetary union with free movement of labour and capital, internal balance-of-payment differences should be irrelevant. However, they are not immaterial in the euro area, which is a voluntary union of long-established sovereign states, and will not be for some time to come. These imbalances in savings and investment therefore need to be carefully looked at since they could result in growth and employment differences that are socially unsustainable. A European competitiveness policy, structural reforms and greater supervision are needed, perhaps even intervention, in these areas. Nevertheless, I am not convinced that the best way of dealing with the eurozone's competitiveness is to penalise the most competitive countries. This is because the euro area, Europe as a whole, competes, and not necessarily from a favourable position, in an increasingly globalised economy. A much more sensible and promising approach would be to use structural reform and cohesion policies in a more efficient and discriminatory manner – an astute combination of carrot and stick, even if this raises the question of whether the Union lacks democratic legitimacy.

Nine, the changes that need to be made to the Monetary Union's institutional design inevitably point towards a new Treaty that is practically constitutional in nature. This is because it may be necessary from a legal perspective to allow economic, financial and fiscal transfers, but above all because the eurozone needs a new level of validity that brings it closer to its citizens. Arguments about the extent and form of political union are inevitable, and the sooner constructive discussions take place the better. The best way of avoiding a rise in populism is not to bow down to it but to respond with a European political project that respects individual national traits at the same time as guaranteeing economic efficiency. The key to economic recovery is to be able to have this debate while moving towards economic, fiscal and banking union.

Ten, the consolidation of the eurozone as a political union creates an unavoidable problem in the European Union. Managing to maintain a common market, not just a free-trade area, at the same time as the eurozone becomes a politically-integrated space poses a real challenge It is however necessary that we try because the cost of saving the euro cannot be the break-up of the European Union.

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